EMBARGOED UNTIL: 11.30AM THURSDAY 16 FEB 2017

NAB QUARTERLY SME SURVEY

DECEMBER QTR 2016

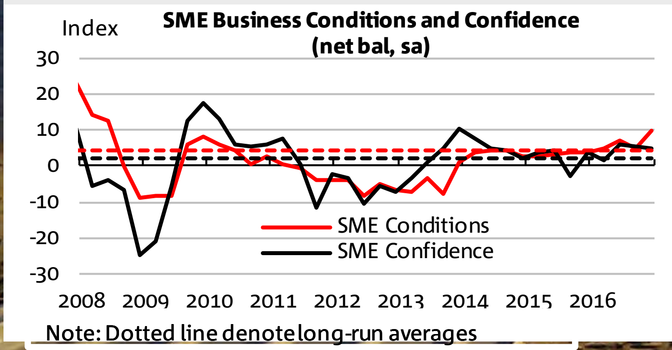
National Australia Bank

Key points:

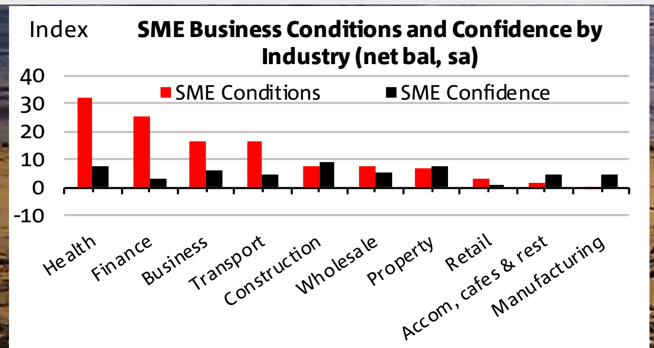
- The Q4 results from the NAB SME Survey show a sharp rebound in business conditions while confidence eased marginally. Business conditions for SMEs jumped by 5 points to +10 index points, to be at the highest level since the pre-GFC period. Despite a slight fall, business confidence, at +5, remains well above its long-run average of +2. As a sign of the broadening non-mining recovery, low-tier firms have mostly caught up with mid and high-tier firms to enjoy comparably strong conditions. All three components that make up business conditions – trading, employment and profitability conditions – recorded strong improvements in the quarter. Trading and profitability conditions have returned to levels last seen in 2008 and 2009 respectively, while employment conditions are the strongest since 2010. Firms of all size categories also reported mostly positive results for the components of business conditions in the quarter.
- By industry, all sectors except for manufacturing reported positive business conditions in the quarter, while it is worth noting that all industries have reported neutral to positive confidence levels. The dominance of health, finance and business services SMEs which started in mid-2016 continued into Q4. Transport SMEs improved by the most in the quarter, potentially reflecting a pick- up in commodity exports. At the same time, the relative weakness in retail SMEs (despite an improvement in the quarter) remains a concern given the importance of household spending to the economic outlook. Similarly, business conditions in hospitality-related sectors (such as “accomodation, cafes and restaurants”) and manufacturing have softened noticeably from their recent peaks in early late 2015 and early 2016 respectively to be the weakest in Q4, potentially indicating the washing out of the positive impetus from earlier AUD depreciation.
- All states reported stronger business conditions in the quarter, apart from Victoria where conditions were unchanged (at a relatively strong +11). NSW’s conditions surged further into the lead against other states, with its overall index at a robust +16 index points. Meanwhile, SME business conditions in WA improved by the most (up 8 points to -7 index points), but still lagged other states and was the only state with a negative reading. Victoria and NSW also dominated in the realm of business confidence (at +8 and +7 respectively) while WA is the most pessimistic (at -3).
- Leading indicators are generally resilient, with capacity utilisation remaining unchanged at the strongest level since 2011, although capex fell further in the quarter but was still above the long-run average. Overall, SME input and final price indicators remain subdued and are consistent with relatively contained price pressures.

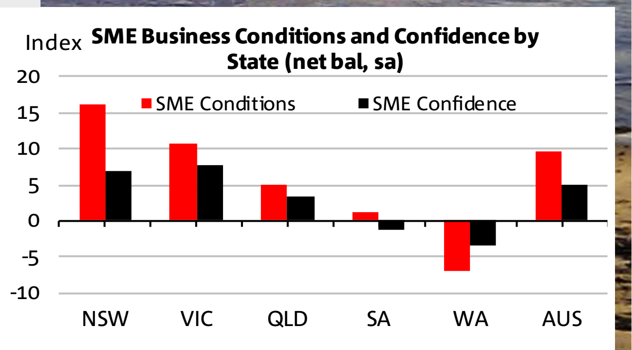
	2015	2016	2016
	Q4	Q3	Q4
Business Conditions	3	5	10
Low-tier firms	-7	3	8
Mid-tier irms	1	6	9
High-tier firms	8	6	10
Business Confidence	3	6	5
Low-tier firms	1	2	2
Mid-tier irms	7	7	2
High-tier firms	1	7	9
Trading Conditions	10	12	17
Low-tier firms	-3	5	17
Mid-tier irms	11	10	13
High-tier firms	14	18	17
Profitability	1	4	8
Low-tier firms	-11	6	8
Mid-tier irms	-1	4	8
High-tier firms	8	4	9
Employment	-3	-1	4
Low-tier firms	-6	-4	0
Mid-tier irms	-5	5	7
High-tier firms	0	-5	3

Note*: Low-tier : turnover $2-3m p.a. Mid-tier: turnover $3-5m p.a. High-tier: turnover $5-10m p.a.



Note: Dotted line denote long-run averages





** Data are seasonally adjusted by NAB, except SME cashflow (insufficient time series available). All data are net balance indices. Fieldwork for this Survey conducted from 21 Nov to 9 Dec 2016 covering around 684 SME (non-farm) firms.

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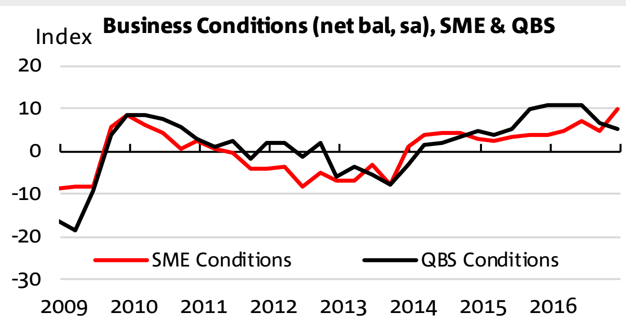
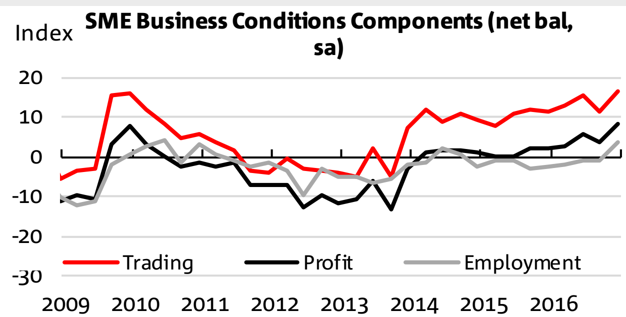
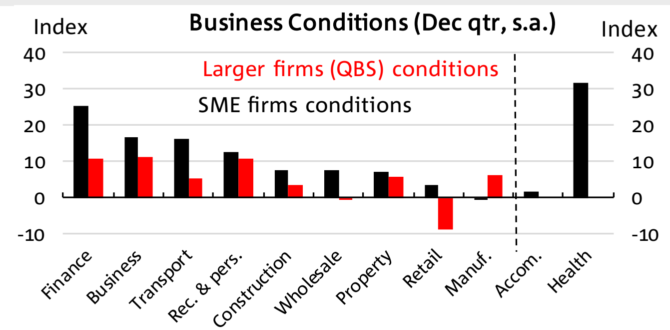
INDUSTRY BUSINESS CONDITIONS & CONFIDENCE

SME business conditions improved on the back of broadening economic recovery

- Business conditions for SMEs jumped in Q4 to more than reverse the fall in Q3 and remain comfortably above the long-run average of +4. As a sign of the broadening non-mining recovery, low-tier firms have mostly caught up with mid and high-tier firms to enjoy comparably strong conditions. For the first time since late 2014, SME conditions have surpassed those of general businesses indicated by the NAB Quarterly Business Survey (QBS), with the former appearing to gain traction and the latter losing steam, although a very strong NAB Monthly Business Survey for January points to a possible rebound in QBS results in Q1 2017. Meanwhile, SME business confidence eased in the quarter to +5 (from +6 in Q3), but remains above the long-term average of +2.
- All three components that make up business conditions – trading conditions, employment and profitability – recorded strong improvements in the quarter. Trading conditions (up 5 to +17) and profitability (up 4 to +8) have returned to levels last seen in 2008, while employment conditions (up 5 to +4) are the strongest since 2010. Encouragingly, it appears that a sustained period of relatively strong trading and profitability conditions have finally flowed into stronger labour demand, with the SME employment index now exceeding that of the QBS.
- In Q4, business conditions improved in every state except for Victoria (where conditions were unchanged at +11). Up 2 points to +16, NSW's lead ahead of all other states widened in the quarter, with the second strongest state, Victoria, being 5 points behind but still strong. SME business conditions in WA improved by the most (up 8 points to -7 index points), but still lagged other states and was the only state with a negative reading, while Qld (up 5 to +5) and SA (up 3 to +1) continue to occupy the middle rung. NSW (at +7) and Victoria (at +8) also reported the strongest confidence in the quarter, while SA (at-1)and WA (-3) were the most pessimistic. There is very little evidence to-date that stronger commodity prices and exports in the quarter have bolstered the confidence of SA and WA, perhaps reflecting the small extent to which SMEs in Australia engage in commodity exporting.
- Most industry sectors also reported better conditions in the quarter, with all but manufacturing (at -1) reporting positive business conditions. The dominance by health (at +32), finance (at +25)and business services (at +17) which has started since mid-2016 continued into Q4, while transport (up 24 to +16) improved by the most, potentially reflecting a pick-up in commodity exports in the quarter. Meanwhile the relatively steady conditions reading for the wholesale sector (down 2 to +7) indicates that upstream factors are benign, while subdued conditions in retail (at +3) and accompanying weak final price growth are symptomatic of less favourable downstream factors. On the other hand, business confidence results by industry are more consistently positive. Apart from retail at the neutral mark, all other industries recorded positive confidence. Possibly reflecting some renewed traction in housing activity, confidence of property SMEs rose by the most (up 17 to +8), only trailing construction (at +9) as the second most confident industry. Manufacturing confidence fell by the most (down 5 points) in the quarter, but remains positive at +5. The relative weakness in retail conditions and confidence is still of concern given the importance of household consumption to the economic outlook.
- Interestingly, SMEs outperformed larger businesses as indicated by the QBS in all industries except for manufacturing in the quarter, which is consistent with the superior reading of SME business conditions relative to QBS.
- Analysis by firm size shows that the conditions of low-tier firms have improved significantly in the quarter, to rise by 5 points to +8 index points, which is only marginally below that of mid-tier (at +9) and high-tier firms (at +10). However they still reported a relatively subdued confidence reading at +2, which is the same level as mid-tier firms but way below high-tier firms at +9.



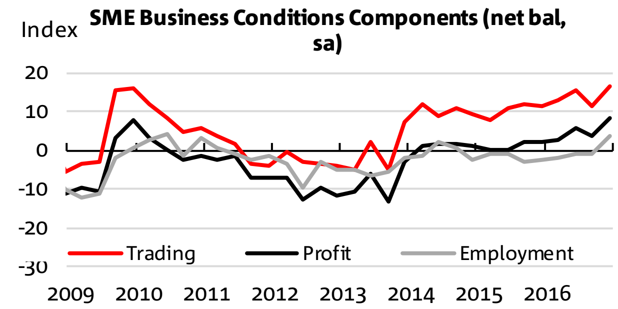


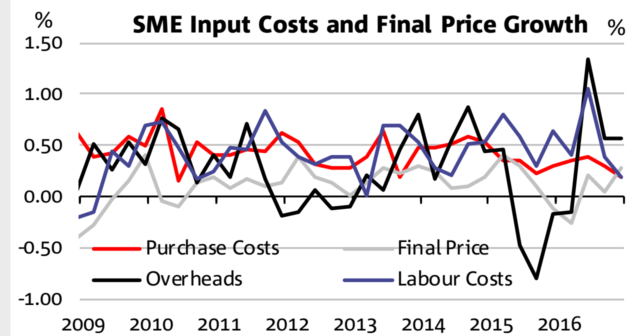


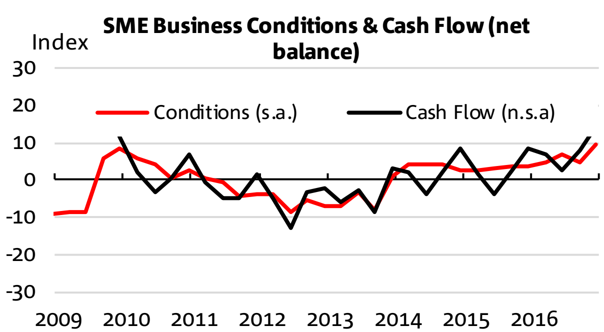
FORWARD INDICATORS

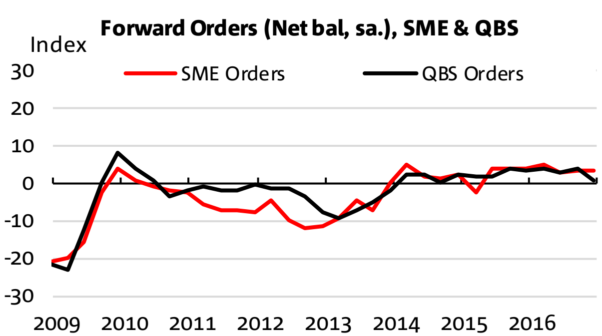
Forward and financial indicators point to expansionary business activity

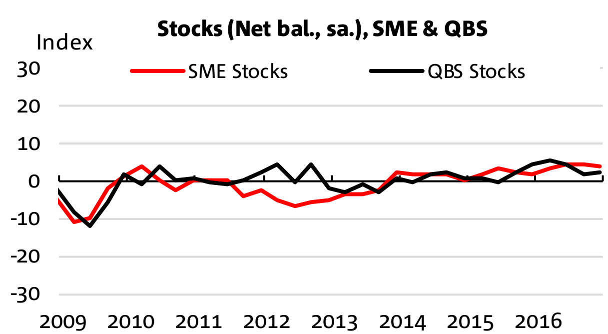
- SME forward orders were unchanged at +4 index points in Q4, which is notably above the long-term average of -1 index points and now exceeds the result for general businesses as reported in the QBS. A sustained period of positive forward orders readings has been consistent with a positive trend in business conditions and recovery in SME activity.
- By industry, retail again recorded the weakest orders (at -5), which suggests little prospects of a pick-up in the activity of the sector in the near term. Not far ahead of retail in forward orders was the property sector at -1, possibly indicative of lower transaction volumes for property sales despite continuously rising prices. Meanwhile finance (down 6 to +12) continued to record the strongest forward orders despite a fall in the quarter, while the orders for manufacturing rebounded to +11 (from -1) to be the second strongest.
- Consistent with a steady forward orders index, the SME stock index was unchanged +4 index points, to be above the long-term average of +2 index points and that of larger businesses indicated by the QBS (at +3). The stock index for wholesale (+10) was the highest in the quarter, followed by retail (down 3 points to +7). The relative higher stock level for the retail sector is more likely due to a lack of demand rather than the opposite, which could weigh on the wholesale sector if it persists. In fact, business conditions of the wholesale sector have eased further this quarter, and look likely to deteriorate further on the back of a weak retail sector. Meanwhile, stocks for business services (down by 11 points to +2) fell by the most in the quarter, but remained in positive territory. The accommodation (at -5) and transport(at -4) sectors had the lowest stock levels in the quarter.
- In Q4, financial services again recorded the strongest cash flow result (non-seasonally adjusted) amongst all industries, to reach the highest level on record at +52. This is consistent with the sector having the strongest profitability result in the quarter as well. Also performing well in terms of cash flow were business services (at +32) and health services (at +30), while manufacturing (at -5) and retail (at +1) are the weakest, although it was the first positive reading for retail since the series started in 2006.
- Overall, SME price indicators continue to point to relatively contained price pressures. Labour costs growth has moderated substantially from recent highs, while growth in other input costs (purchase costs and overheads) continue to be muted. Meanwhile, strong downstream competition has kept a lid on final price growth, which is consistent with a subdued inflation outlook.





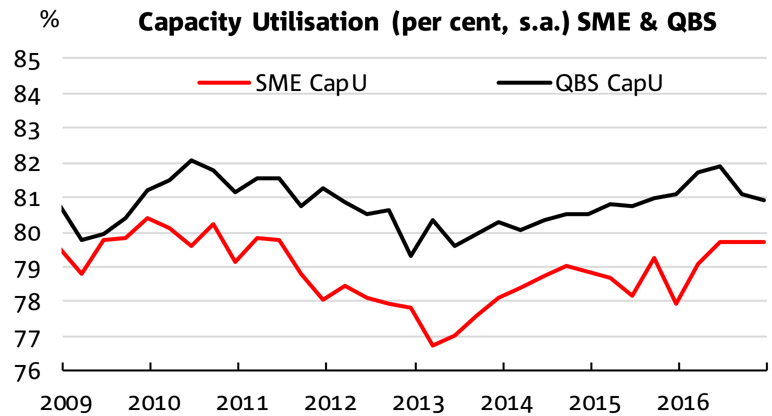


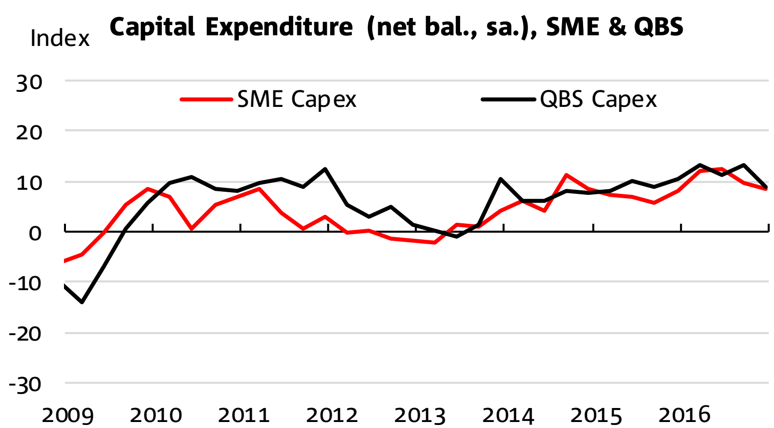




CAPACITY UTILISATION AND CAPITAL EXPENDITURE

SME capacity utilisation robust but capex lost some momentum

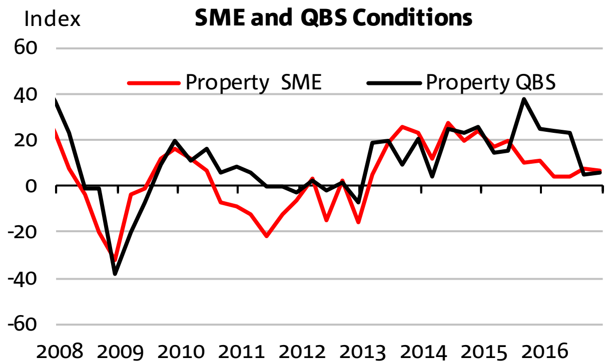


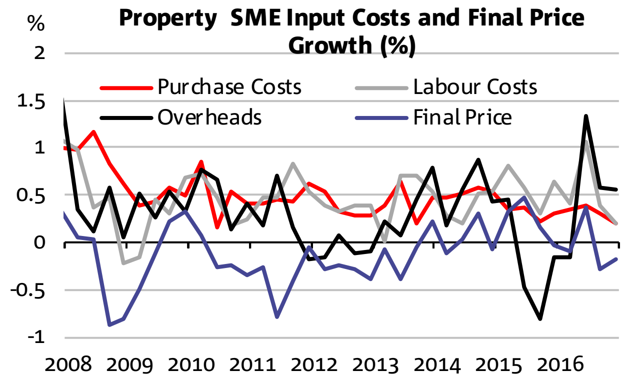


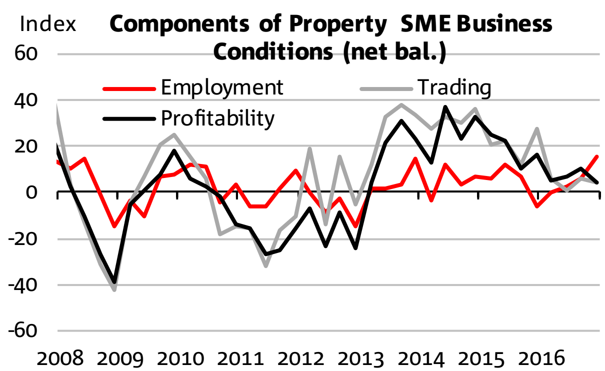
- SME capacity utilisation was steady at a relatively robust level of 79.7% in the quarter, but still below that of general businesses indicated by the QBS, although the gap between the two has narrowed noticeably recently. Most industries reported higher capacity utilisation rates in the quarter, with personal services (up 1.7ppts to 82.5%), finance (up 1.3ppts to 83.5%) and health (up 1.2ppts to 87.3%) gaining by the most, while business services (down 1.2ppts to 81.4%) and transport (down 0.8ppts to 77.6%) recorded the steepest falls. At 82.5%, property services SMEs now operate at a capacity utilisation level furthest above their long-run average, while transportation SMEs (at 77.6%) have deviated below their long-run average by the most. Health continues to report the highest capacity utilisation across industries, followed by finance and property services. Meanwhile, manufacturing and accommodation once again reported the weakest capacity utilisation rates at 75.1% and 76.1% respectively.
- Analysis by firm size suggests that the capacity utilisation rates of the high-tier (up 1.2ppts to 80.6%), mid-tier (up 0.1ppt to 80.5%) and low-tier firms (down 0.7ppt to 77.7%) have generally followed an upward trend since late 2015, although the trajectory for low-tier SMEs has been more volatile and continues to track below their larger counterparts.
- Despite an improvement in trading conditions in the quarter, capital expenditure (capex) by SMEs has lost a bit more momentum in the quarter and dipped to +8, but still remained above the long-term average of +6 and broadly similar with the capex reading for larger businesses as indicated by the QBS. However, longer-term capex intentions are notably more positive, with the 12-month capex expectations (at +16) slightly above the level seen in the same quarter last year (at +15).
- That said, all industries continued to report positive capex in the quarter, which suggests that they are still in an expansionary mode in terms of activity. At +18 index points, transport had the highest capex reading out of all industries, followed closely by health at +17. Meanwhile, manufacturing reported the weakest capex reading of +2.

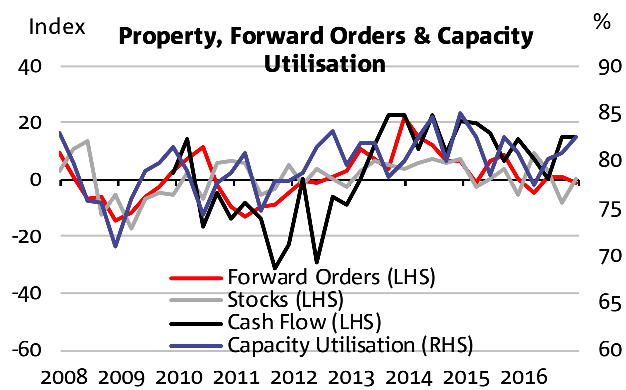
IN FOCUS: PROPERTY

Property SMEs' business conditions easing, reflecting fewer housing transactions









- Broadly in line with the developments in the housing cycle, SMEs in the property services sector have started to emerge from a soft patch in early 2013, consistently recording positive readings since then. However, their business conditions appear to have peaked sooner than those experienced by larger businesses in the property sector as indicated by the QBS, possibly reflecting the relative strength in the apartment sector which are typically serviced by larger businesses.

- However, it is apparent that business conditions of property firms included in the SME Survey and QBS have softened in 2016, despite reports of strong rises in house prices in Sydney and Melbourne markets through most of the year. This corresponds to the evidence which suggests that the volume of housing transactions has dwindled over the year, which has flow-on impact on the trading and profitability conditions for those firms.

- The moderation in property SMEs' business conditions over the past two years was largely driven by the trading and profitability conditions, while employment conditions have been relatively softer before the sharp pick-up in Q4.

- Overall, property SMEs generally have been able to keep their input costs growth reasonably contained (see top RHS chart), despite a momentary spike in their overheads. Despite strong increases in house prices, the final price growth of property services SMEs has been subdued, which indicates stiff competition among firms and a soft rental market overall.

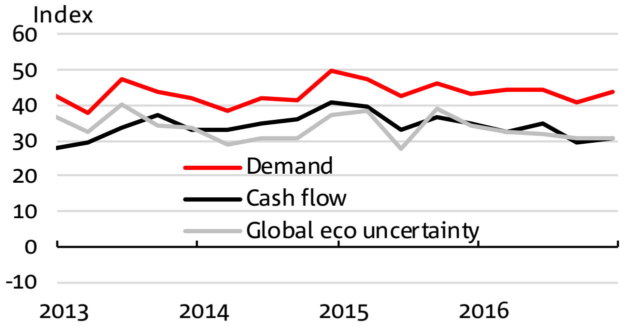
- While having moderated from their recent peaks, the cash flow and capacity utilisation indexes of property SMEs continue to track at solid levels, although weakening forward orders and stock indexes – corresponding to tightening supply in the housing market – point an easing pace of near-term activity.

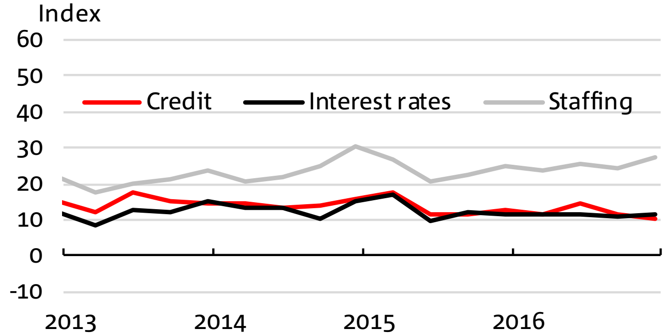
SIGNIFICANT CONSTRAINTS AND COMPETITIVE STRATEGIES

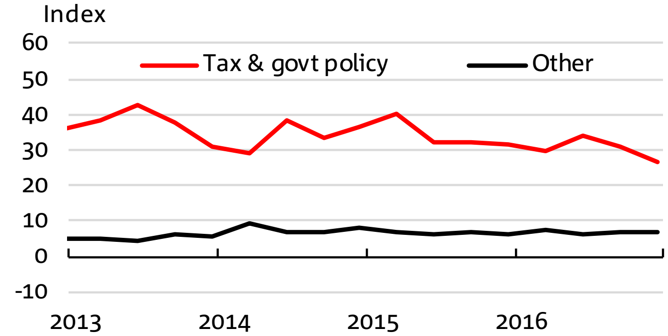
SMEs reported easing constraints from demand and cash flow conditions

- Looking through the quarterly volatility, there has been an amelioration in a number of constraining factors affecting SMEs' long-term decisions since late 2015, including demand, cash flow, global economic uncertainty and tax & government policy. Meanwhile, staffing as a constraining factor has been on a rising trajectory since late 2015, indicating that the pool of suitable workers available to SMEs is looking increasingly tight, which may force wages growth to tick higher in the medium term.
- In Q4, movements in the significant constraining factors affecting SMEs' long-term decisions were mixed. The severity of (the lack of) customer demand, staffing and cash flow has increased, while the restrictions posed by tax & government policy and credit eased. SMEs continue to face a benign borrowing environment from low interest rates and relative ease of obtaining credit, which suggests that they face few funding restrictions in their long-term business investment decisions.

MOST SIGNIFICANT CONSTRAINING FACTORS FOR SMES (PER CENT, MULTIPLE RESPONSES)

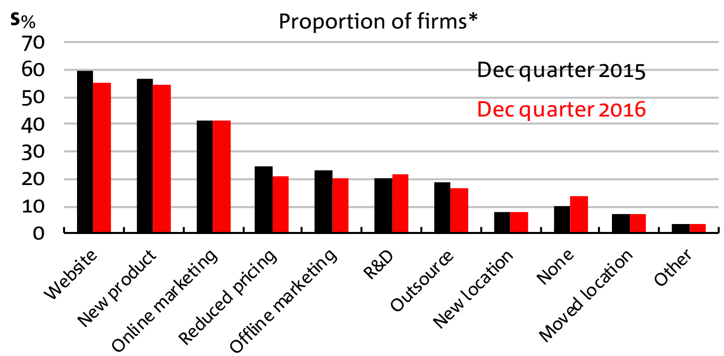






- In the December quarter, we again asked firms whether they had employed any new strategies over the past 12 months to improve their competitiveness in the market.
- Compared with the results in the same quarter in 2015, there had been clear falls in the proportion of firms that embarked on a number of less resource-intensive strategies, including website, price discounting, introducing a new product and offline marketing. Meanwhile there is a slight uptick in the deployment of R&D by SMEs to improve their competitiveness, which could be relatively more resource-intensive. This possibly reflects the improved financial positions of SMEs in general from a sustained period of improving trading and profitability conditions.

STRATEGIES EMPLOYED OVER PAST 12 MONTHS TO IMPROVE COMPETITIVENESS



* Multiple responses allowed; will not sum to 100%
Source: NAB Quarterly SME Survey

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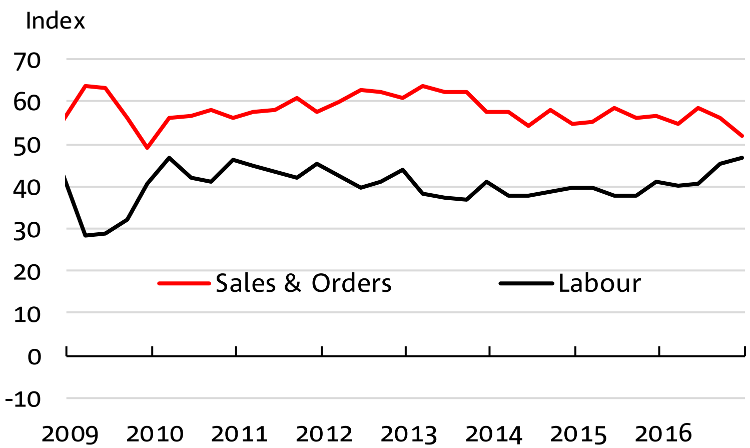
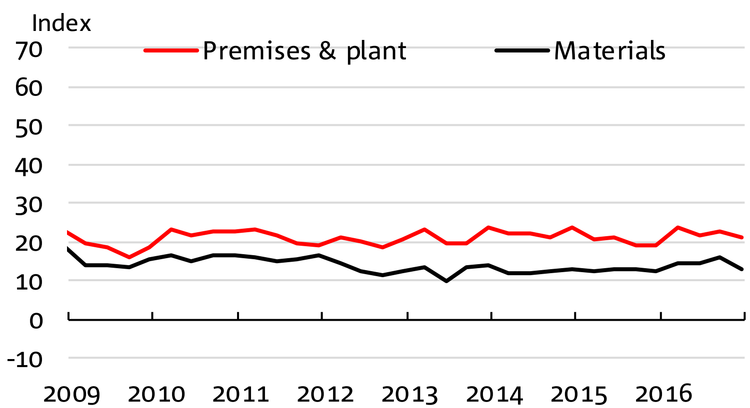
CHARTS

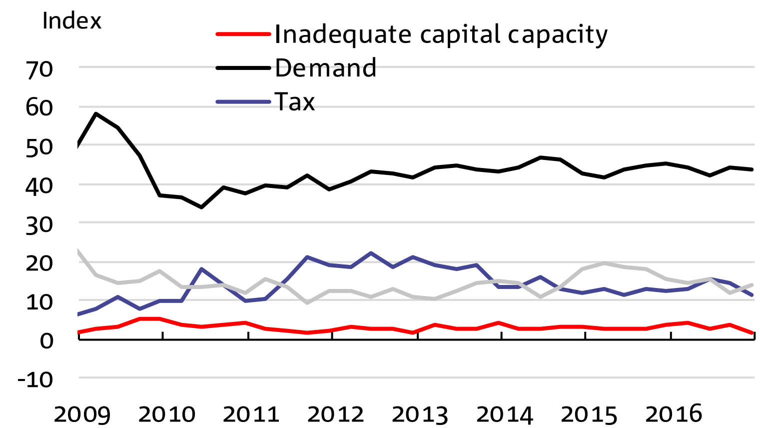
Constraints facing SMEs' output and profitability

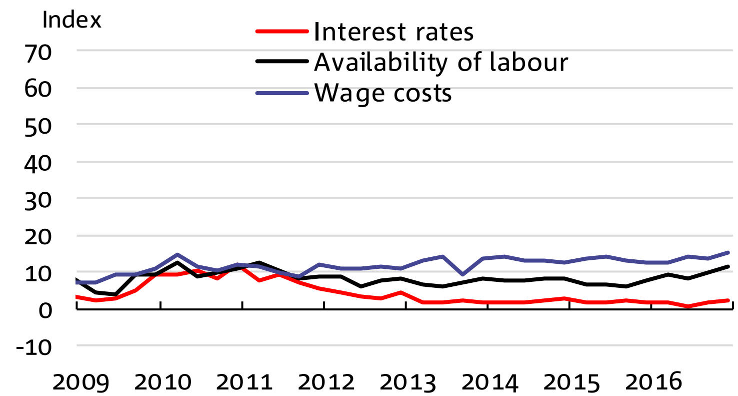
CONSTRAINTS ON OUTPUT





CONSTRAINTS ON PROFITABILITY

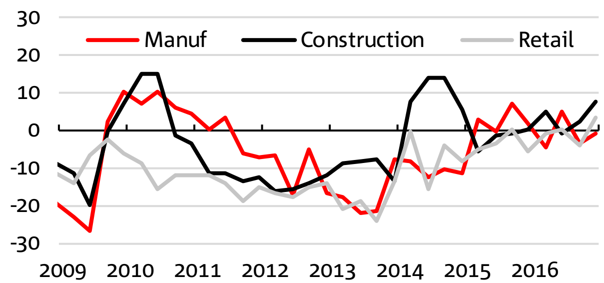


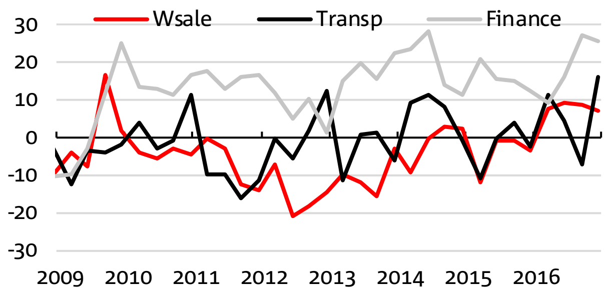


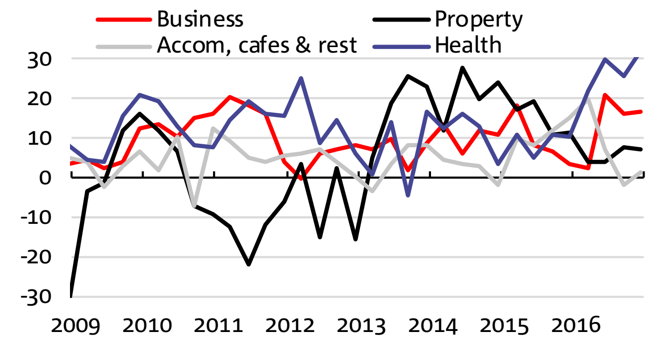
CHARTS

Business conditions and confidence by industry

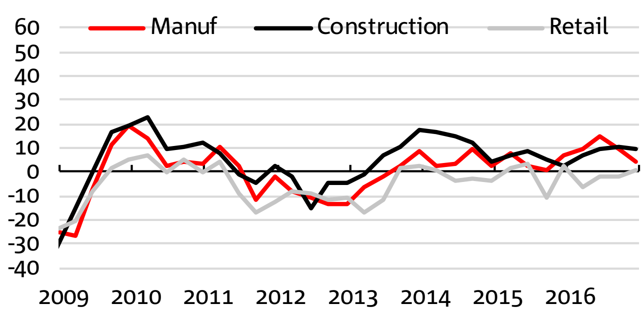
BUSINESS CONDITIONS BY INDUSTRY (NET BALANCE)

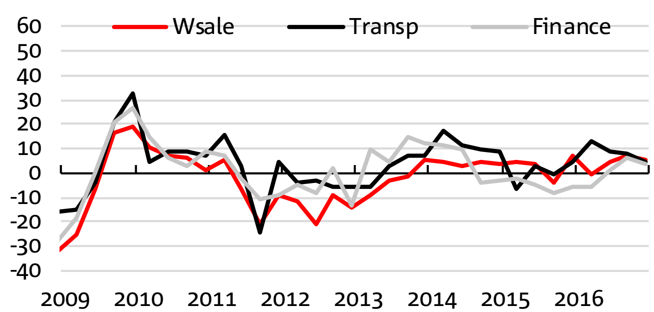


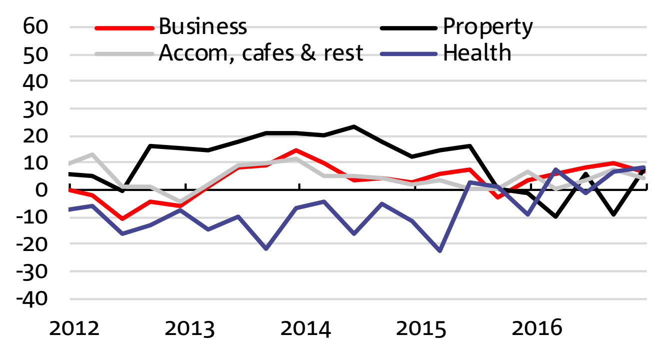




BUSINESS CONFIDENCE BY INDUSTRY (NET BALANCE)



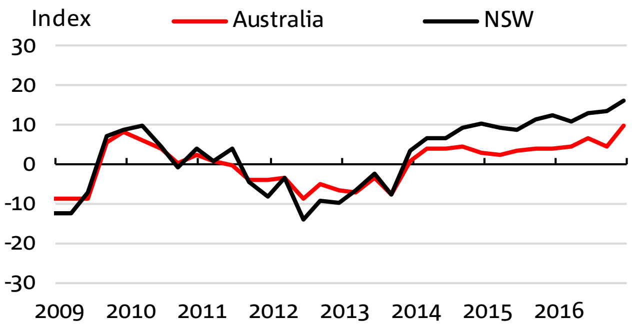


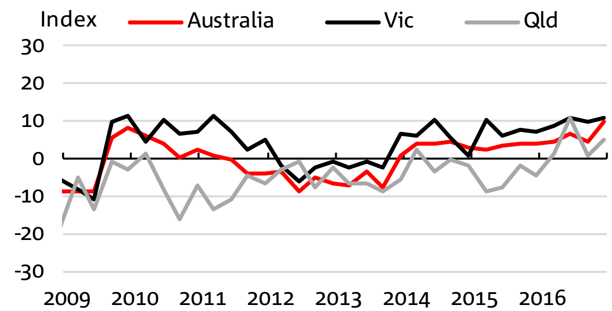


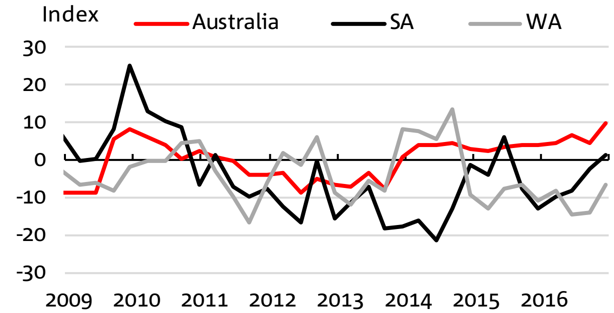
CHARTS

Business conditions and confidence by state

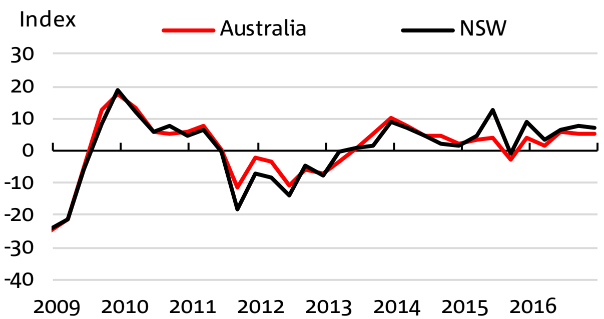
BUSINESS CONDITIONS BY STATE (NET BALANCE)

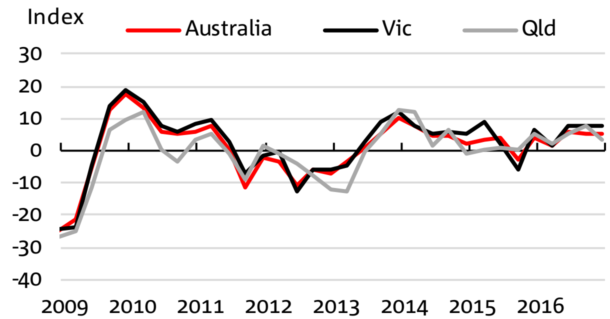


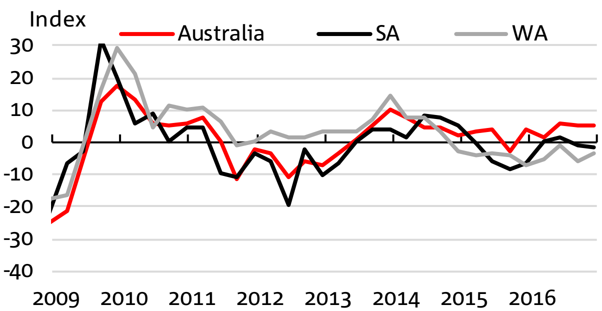




BUSINESS CONFIDENCE BY STATE (NET BALANCE)







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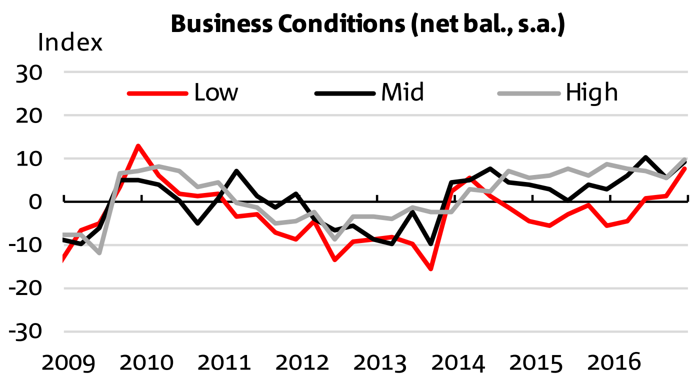
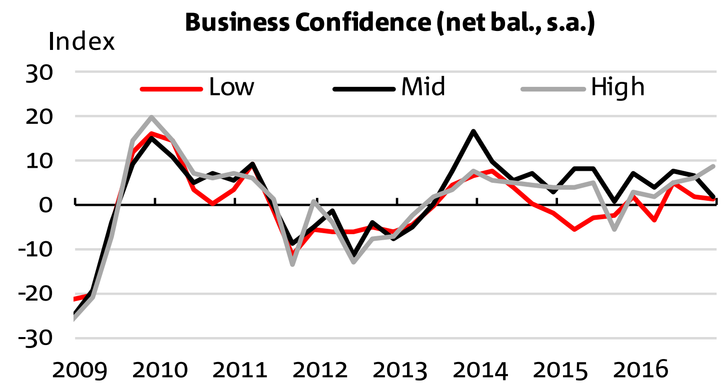
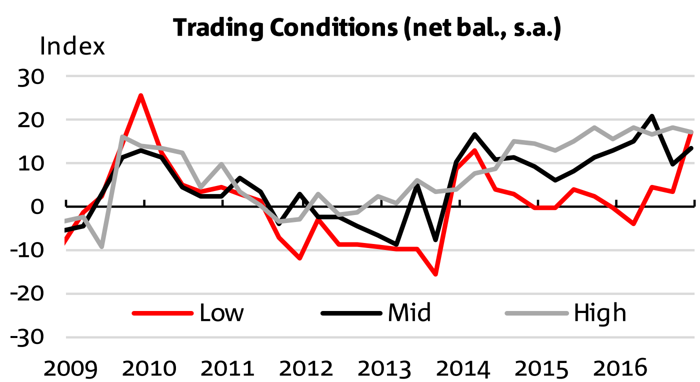
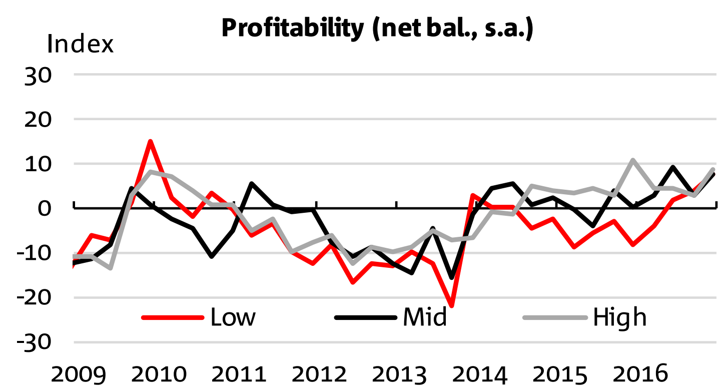
CHARTS

Details by firm size



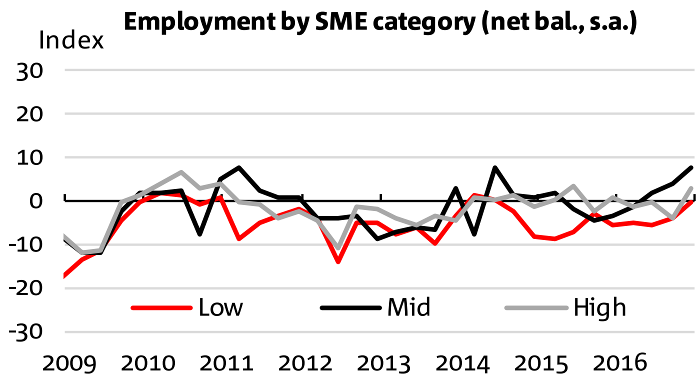


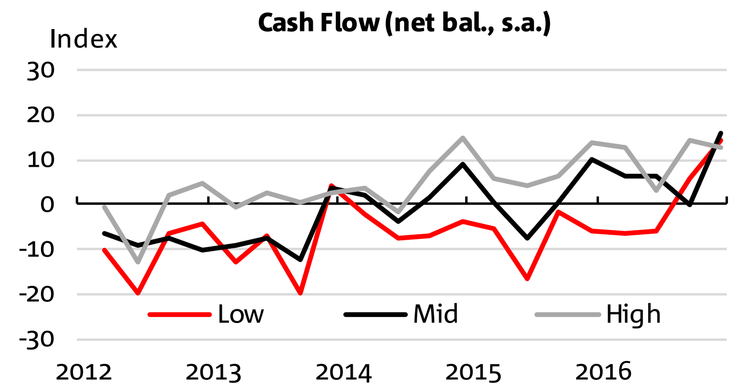


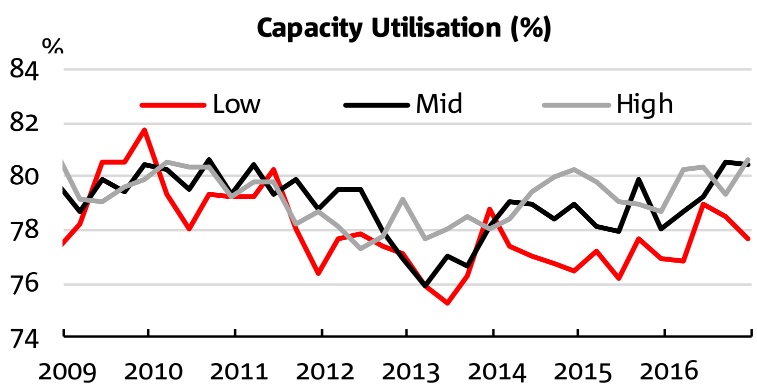


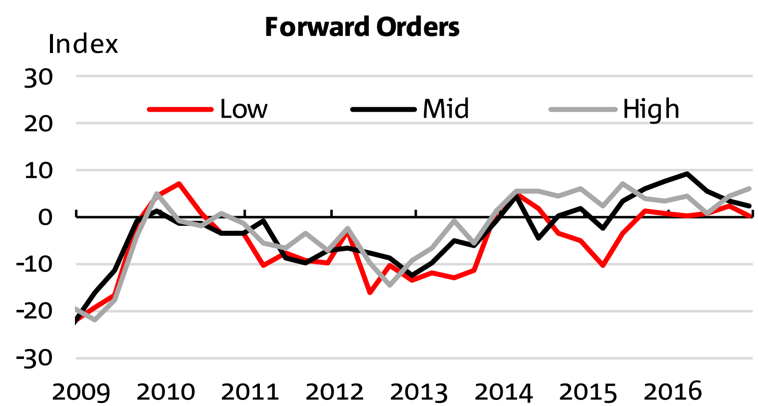
CHARTS

Details by firm size (con't)









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