National Australia Bank

Quarterly SME Survey December quarter 2013

SME business confidence up for a fourth quarter – consistent with increases seen by larger firms. Confidence is finally gaining traction to support business activity, with conditions rising to their highest since mid-2011 – but remain soft. SME's continue to outperform larger firms in number of industries, particularly in the services sectors, but smaller retailers are suffering relatively more. Forward indicators better, but still very subdued, implying soft near-term sales.

- SME business confidence saw its fourth consecutive rise in the December quarter, reaching its highest level since 2010. The increase was consistent with what we have seen from larger firms in the quarter, suggesting that lower interest rates and (to a lesser extent) AUD are having the desired impact on the economy (NAB Quarterly Business Survey). Consistent with this, property/construction and finance/business firms are the most confident, reflecting a pick up in leading indicators of construction activity. Confidence rose the most, and is now highest, in Western Australia despite anticipated headwinds from mining investment. Confidence improved across all tiers of SMEs, but mid-tier SME's are the most confident by a significant margin.
- SME business conditions rose strongly in the December quarter, but the index is still pointing to relatively soft business activity. Conditions at high-tier firms were unchanged, while low and mid-tier firms recorded a significant improvement and are now outperforming their larger counterparts. Cash flows results at very small and mid-tier SMEs recovered from alarmingly low levels in Q3.
- SME conditions still vary widely between industries, with property and financial services, heath, business services and accommodation, cafes & restaurants all holding up relatively well – and out performing their larger counterparts. Transport, retail and (surprisingly) construction were the weakest industries for the quarter – retail was the only industry to significantly under perform against larger firms. Business conditions improved across all states, but remain very weak in SA and Qld and strongest in WA.
- Forward orders improved, but remain subdued, while employment conditions continue to be weak. This suggests little likelihood of any near-term strengthening in sales.
- Responses to a special question suggest that in the past twelve months, more than half of SMEs developed or improved their websites to improve competitiveness, while a similar proportion looked to develop new products. Price discounting also remains a popular strategy, possibly helping to limiting down stream price pressures.

Key quarterly business statistics**

	2012q4	2013q3	**2013q4**		2012q4	2013q3	**2013q4**
		Net balance				*Net balance*	
SME business confidence	-8	**6**	**9**	SME trading conditions	-4	**-4**	**5**
Low	-7	**4**	**5**	Low	-10	**-15**	**7**
Mid	-8	**8**	**16**	Mid	-8	**-8**	**9**
High	-9	**4**	**6**	High	2	**5**	**3**
SME business conditions	-7	**-7**	**-1**	SME profitability	-12	**-12**	**-4**
Low	-10	**-14**	**1**	Low	-14	**-20**	**1**
Mid	-10	**-10**	**3**	Mid	-13	**-16**	**-2**
High	-3	**-2**	**-2**	High	-10	**-6**	**-6**
SME cash flows (n.s.a.)	-2	**-8**	**3**	SME employment	-6	**-6**	**-3**
Low	-4	**-20**	**4**	Low	-6	**-8**	**-4**
Mid	-10	**-12**	**4**	Mid	-11	**-6**	**0**
High	5	**1**	**3**	High	-2	**-4**	**-5**

Low: $2-3m p.a. Mid: $3-5m p.a. High: $5-10m p.a.

** Data are seasonally adjusted by NAB, except SME cash flow (insufficient time series available). All data are net balance indices. Fieldwork for this Survey conducted from 25 Nov to 13 Dec 2013 covering almost 700 SME firms across the non-farm business sector.

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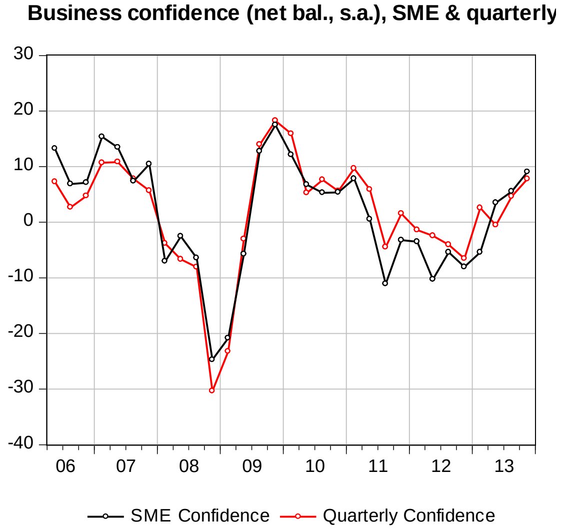
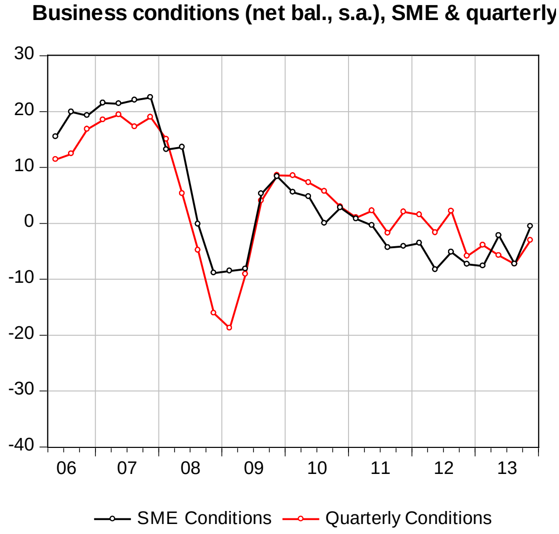
Next release:
11 March 2014 (February Monthly)

Analysis

Confidence ticked up in line with larger firms



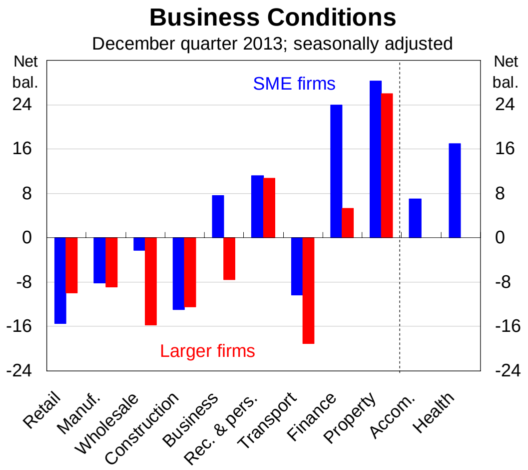
Conditions lift, but remain at subdued levels



SME business confidence rose for the fourth consecutive quarter in the December quarter, up 3 points to +9 index points, building on the post-election exuberance. At +9 points, the confidence index has reached its highest level since early 2010 and is well above the series average of +1 point since mid-2006. Property, construction and business/financial services firms remained the most optimistic, reflecting the good performance of property markets in 2013 – supported by the lower interest rate environment. Political factors also appear to be becoming much less of a concern for SMEs. Confidence of larger firms kept pace with SMEs, but the latter remain marginally more confident – possibly reflecting greater sensitivity to the AUD and interest rates (larger firms may be more likely to hedge their exposures). Mid-tier firms appear to have been the most confident in the quarter, although both high and low-tier firms recorded modest improvements in confidence.

SME business conditions ticked up, but continue to trail confidence by a significant margin and point to persistently subdued business activity. Conditions were up 6 points to -1 points, which is the highest level since mid-2011, but still 5 points below the series average of +4 points (since mid-2006). Conditions improved or were unchanged for most industries in the quarter, but transport and (surprisingly) construction were the only exceptions. Similar to trends in confidence, conditions facing property/financial services are the most positive, but the limited pass-through of building/finance approvals to actual construction activity has kept construction conditions soft. However, conditions are currently the weakest in retail, despite signs of a more positive holiday trading period compared to recent years. Business conditions of SMEs rose by more than their larger counterparts and are now higher, although both remain subdued.

SME service firms out performing their larger counter parts

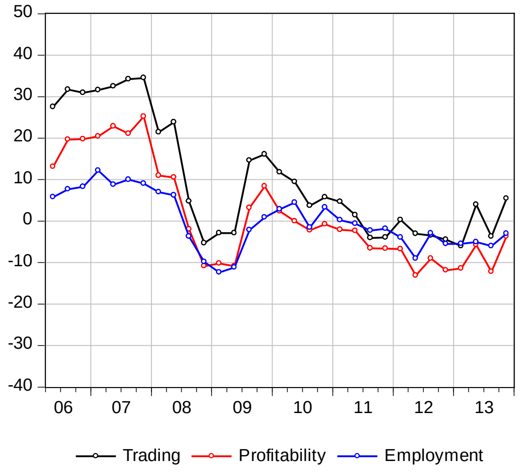


A comparison of industry conditions for SMEs and larger sized firms (taken from NAB's Quarterly Business Survey) suggests that there has been a growing divide between large and small firms in a handful of industries, although smaller firms appear to be reporting better conditions overall. The largest disparities are occurring in business/finance services and transport and wholesale, where smaller firms are performing much better. The only industry where larger firms are reporting better conditions than their smaller counterparts is in retail – one of the worst performers overall.

Analysis (cont.)

Profits, trading conditions and employment all rose

SME business conditions components (net bal., s.a.)



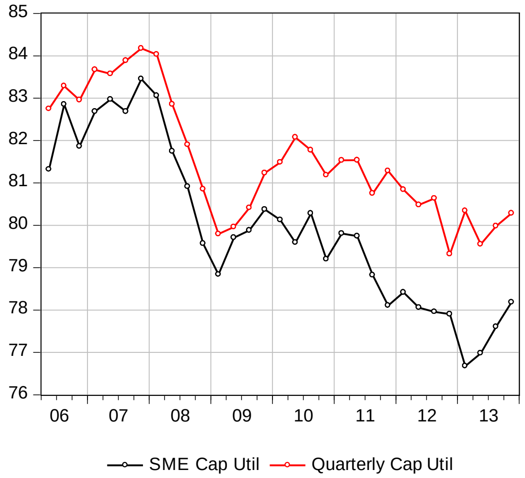
Cash flows better, but still soft

SME business conditions & cash flow (net bal.)

The marginal improvement in business conditions reflected strong rises in trading conditions and profitability, while employment conditions showed a slightly more modest increase. Additionally, SME cash flows (not seasonally adjusted) improved in the December quarter, more than unwinding a notable deterioration in the previous quarter.

Utilised capacity increases but remains at very low level

Capacity utilisation (per cent, s.a.), SME & quarterly



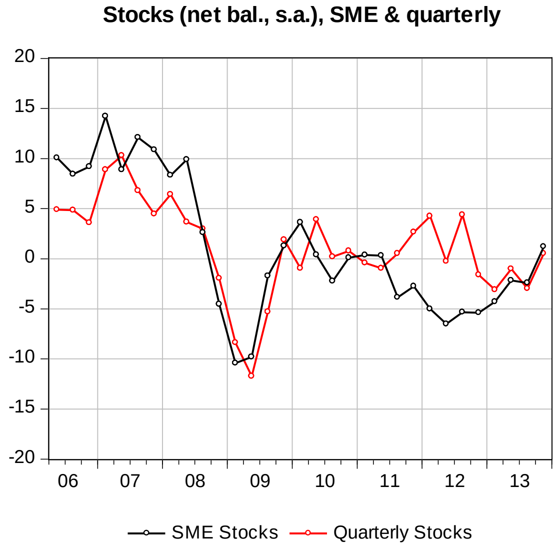
Orders stop contracting, but suggest little to no growth

Forward orders (net bal., s.a.), SME & quarterly

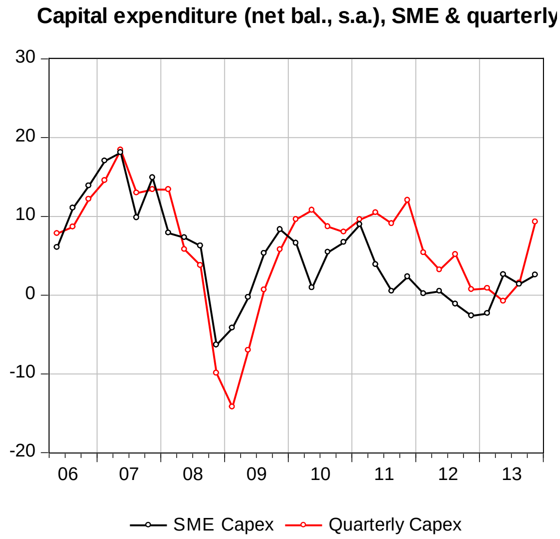
Capacity utilisation rose to 78.2% in the December quarter, up from 77.6%. Despite the rise, utilisation is still well below the series average of 80.0% since mid-2006, and significantly below the level of utilised capacity of larger firms (80.3%). In the quarter, solid increases in capacity utilisation of low-tier (up 2.7 ppts to 79.1%) and mid-tier firms (up 1.7 ppts to 78.3%) were partly offset by a decline in utilised capacity of high-tier firms (down 0.8 ppts to 77.9%). Across industries, capacity utilisation was very high in health services (86.3%), as well as business services (85.1%) and financial services (83.4%), while it was very low in manufacturing (74.1%) and accommodation, cafes & restaurants (74.5%). Forward orders of SMEs improved in the quarter, rising 8 points to 0 points, suggesting little-to-no growth in output over the coming quarter. The improvement in the orders index was largely concentrated in retail and property, although at -3 index points for retail orders, this still suggests a contraction in sales for the industry. Orders are by far the strongest for property (+25). Orders are still very weak for transport and manufacturing, despite a modest improvement in the latter in the month.

Analysis (cont.)

De-stocking may have ended?

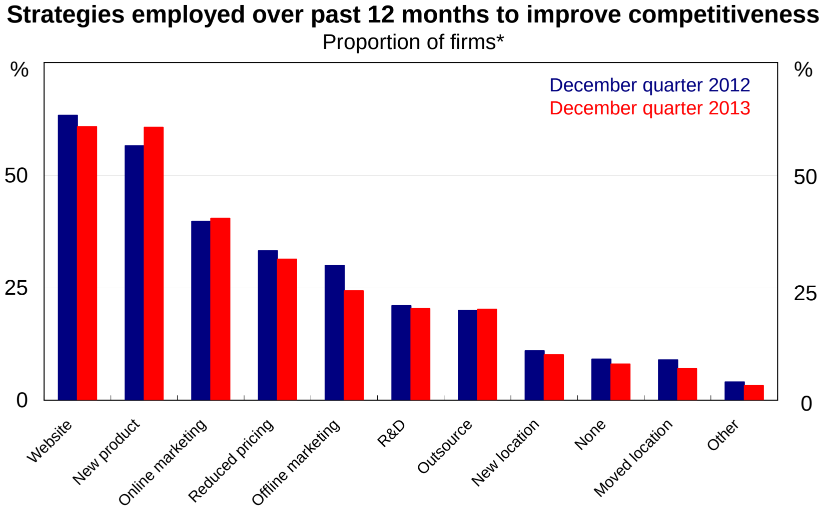


Investment activity lagging behind larger firms



The SME stocks index was up 3 points to 1 index point in the December quarter, similar to the change in stocks of larger firms over the same period. The positive reading for SME stocks – the first since mid-2011 – implies a moderate build in inventories in the quarter, which could signal that a broad spectrum of firms are becoming more confident in the demand outlook. The stocks index is now close to a four year high. Capital expenditure ticked up in the December quarter (excludes mining), largely unwinding the pullback in the September quarter, lifting the index close to the two year high recorded in the June quarter. However, investment spending of smaller firms is being outstripped by larger firms, which showed surprising strength in Q4.

A majority of firms increasing their online presence and developing new products to boost their competitiveness in the market

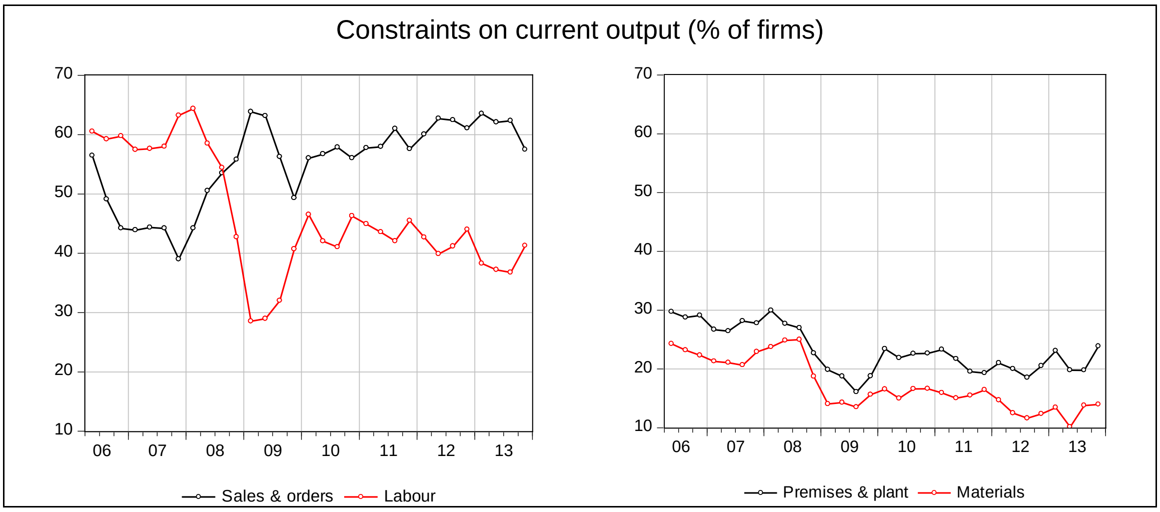


* Multiple responses allowed; will not sum to 100%
Source: NAB Quarterly SME Survey

In the December quarter SME Survey, we again asked firms whether they had employed any new strategies over the past 12 months in an attempt to improve competitiveness in the market. The outcomes suggest a degree of consistency in how firms are reacting to competitive pressures, although new product development became noticeably more common, while less are focussing on 'offline' marketing. The heavy focus on creating an online presence (over 50%) is consistent with firms having less of a focus on the (somewhat more disruptive) strategies of moving (or establishing new) locations.

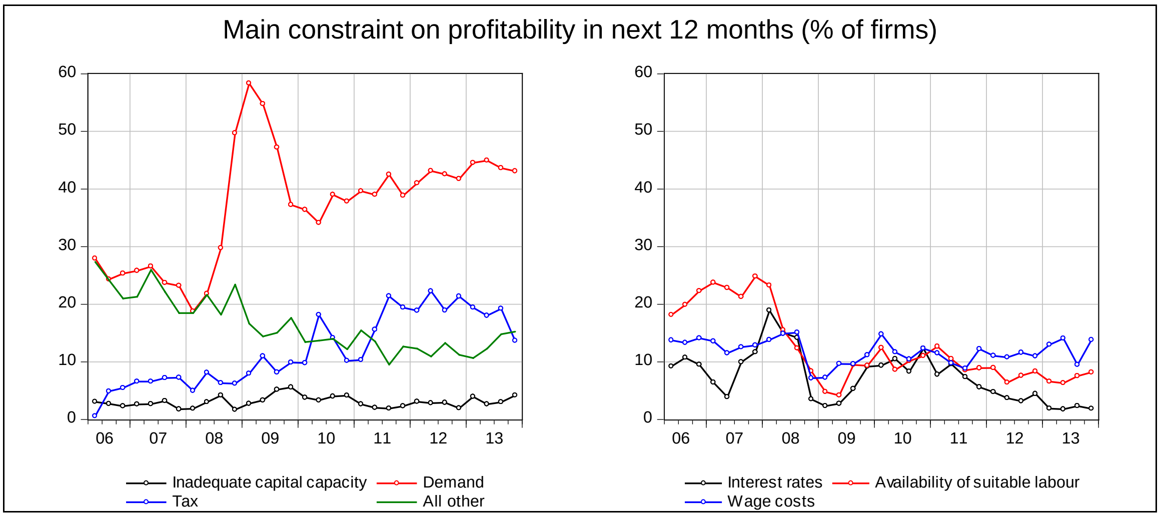
Analysis (cont.)

Demand is the biggest constraint on output, labour availability still good



Despite a reported rise in trading conditions for the quarter, demand (sales and orders) continue to be the major factor constraining SME output. However, the proportion of firms reporting demand as a constraint dipped to its smallest share in three years (57.5%) – consistent with that reported by larger firms. The availability of labour has also been a concern for SMEs, but the proportion reporting it as a constraint remains at low levels relative to the pre-GFC period – consistent with the soft labour market and weak wages growth. Labour availability appears to be more of an issue for SMEs than for their larger counterparts. The labour market deteriorated further in late 2013 and we expect that headwinds from the elevated AUD and impending decline in (labour intensive) mining investment will keep conditions difficult for a while yet. Labour availability appears fairly good for all firm sizes compared to pre-GFC levels. The importance of premises & plant and material both edged up, but remain low overall.

Lack of demand expected to constrain profitability the most; taxation & government policy less important

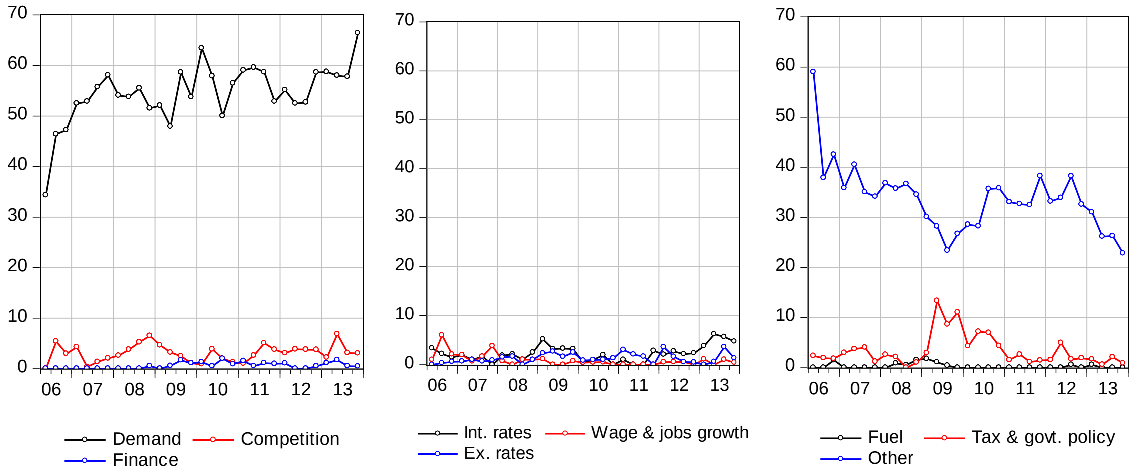


In the December quarter, a lack of demand remained the number one factor expected to constrain profitability over the next 12 months. This showed little change from the previous quarter, despite the apparent improvement in trading conditions and orders in the December quarter. This suggests that firms still have some reservations about the demand outlook, which might be expected to continue weighing on hiring and investment intentions – although our survey (surprisingly) suggests that this has not been the case, with both employment and capex expectations over the next 12 months picking up. The proportion of firms concerned about the impact of changes to tax policy is elevated, but dipped in the quarter, consistent with proposed changes to the carbon and mining taxes. More firms were worried about wage costs in the quarter, which is an unexpected finding considering the weakness of the labour market, which we are expecting to persist.

Analysis (cont.)

Demand was the primary driver behind the improvement in trading performance – exchange rate and interest rates apparently very little help

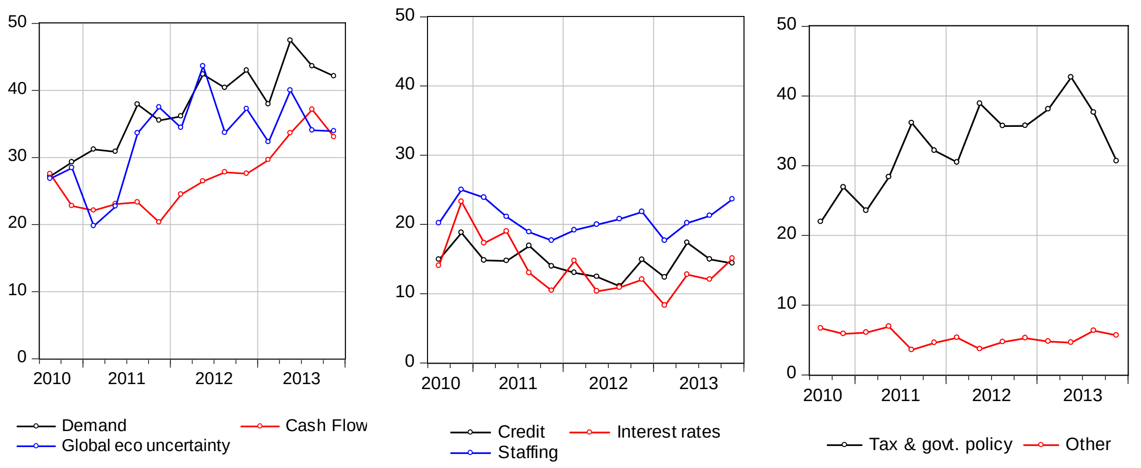
Main reason for improvement in trading performance (net balance)



Trading performance jumped in the December quarter, with SMEs reporting that stronger demand was the sole reason behind the improvement. “Other” reasons as a contributing factor to improved trading remained reasonably significant – largely reflecting seasonal and company specific factors – but have been steadily declining for a number of quarters. Access to finance, fuel costs, wage & jobs growth and tax & government policy appear to have provided very little support to trading performance in the quarter.

SMEs increasingly constrained by staffing. Cash flows eased back, but remain high, as did government policy/taxes

Most significant constraining factors for SMEs (per cent, multiple response)

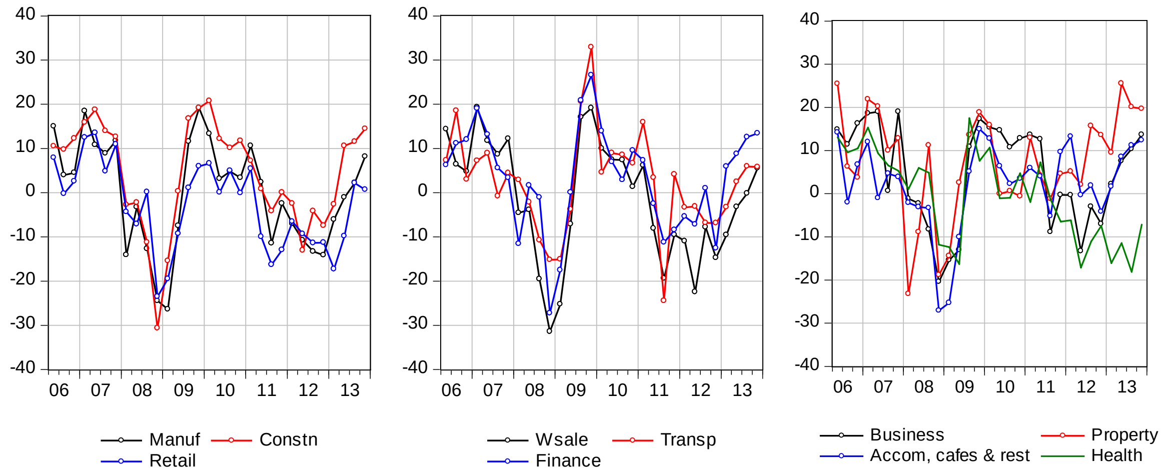


The ability of SMEs to make longer term decisions became increasingly constrained by staffing problems, although demand, cash flows, global economic uncertainty and government tax/policy all remain more significant – although each of these generally become less significant in the quarter. It is possible that the change in government is still helping alleviated SME concerns about tax & government policies, while improved trading conditions are helping the demand outlook. Firms were a little more constrained by interest rates (and less constrained by credit), but its significance has been limited by lower interest rates and better performing financial markets through 2013.

Industry analysis

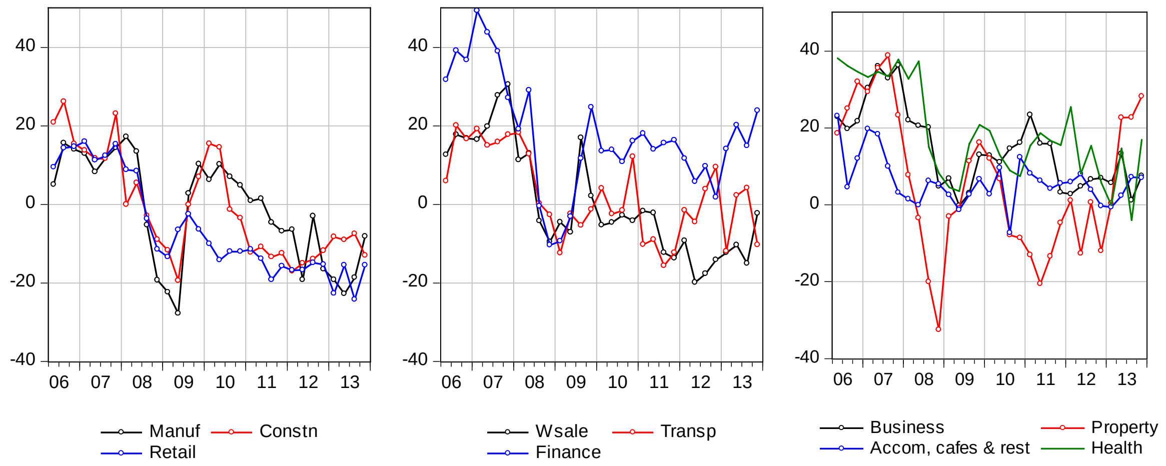
Property & professional services most optimistic; health services very pessimistic

Business confidence (net balance, s.a.)



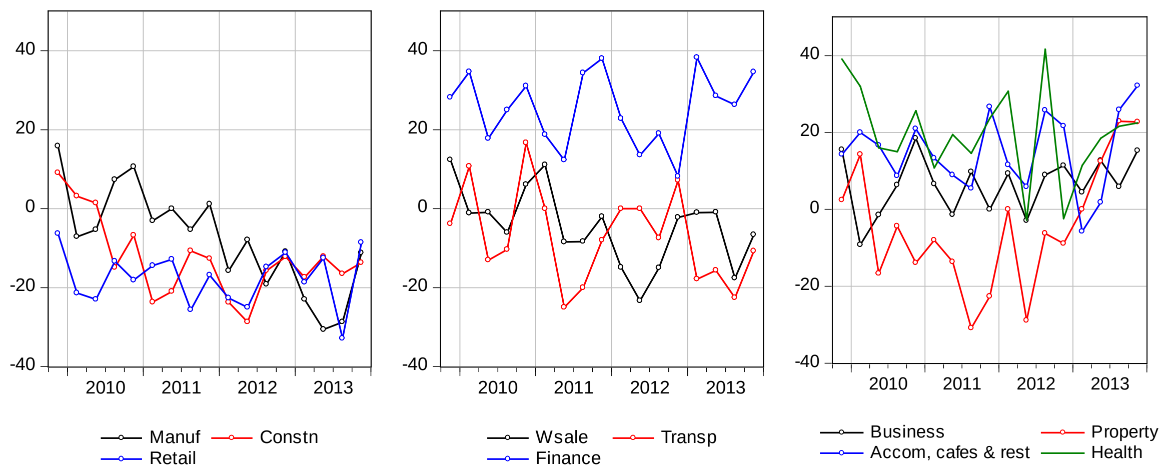
Weaker conditions for construction and trans, offset by rises elsewhere

Business conditions (net balance, s.a.)



Cash flows improved largely across the board following reports of very poor cash flow in some industries last quarter

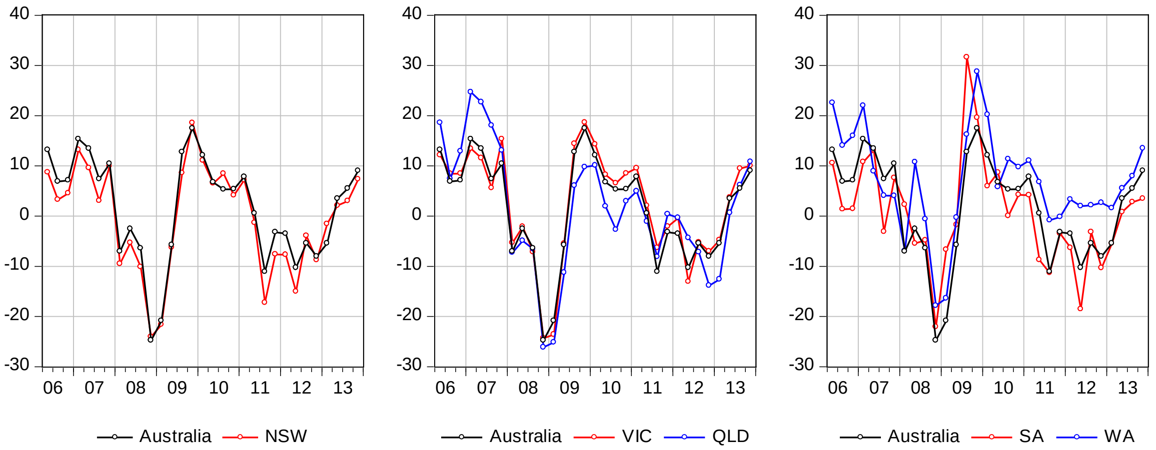
Cash flow (net balance, n.s.a.)



State analysis

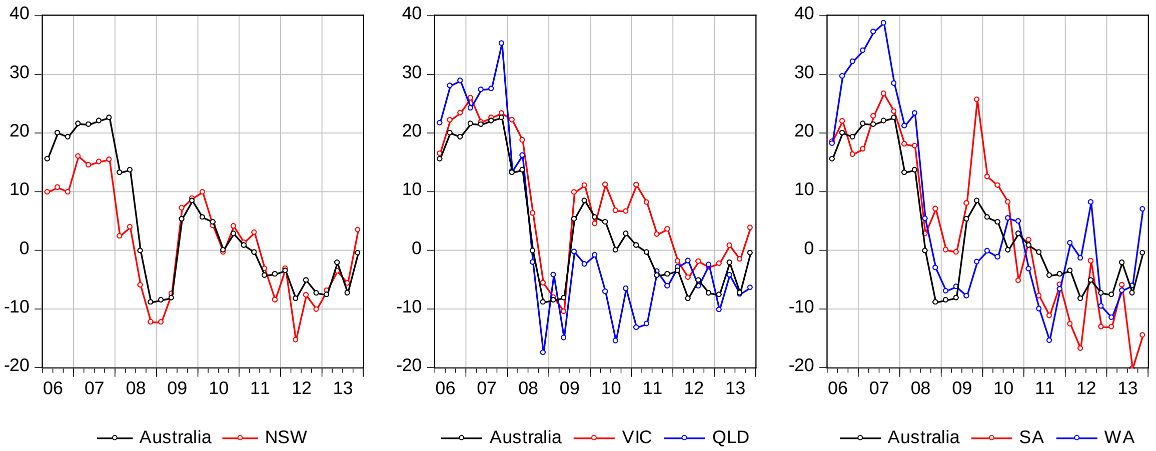
Business confidence up across all states; level of confidence trailing for South Australia

Business confidence (net balance, s.a.)



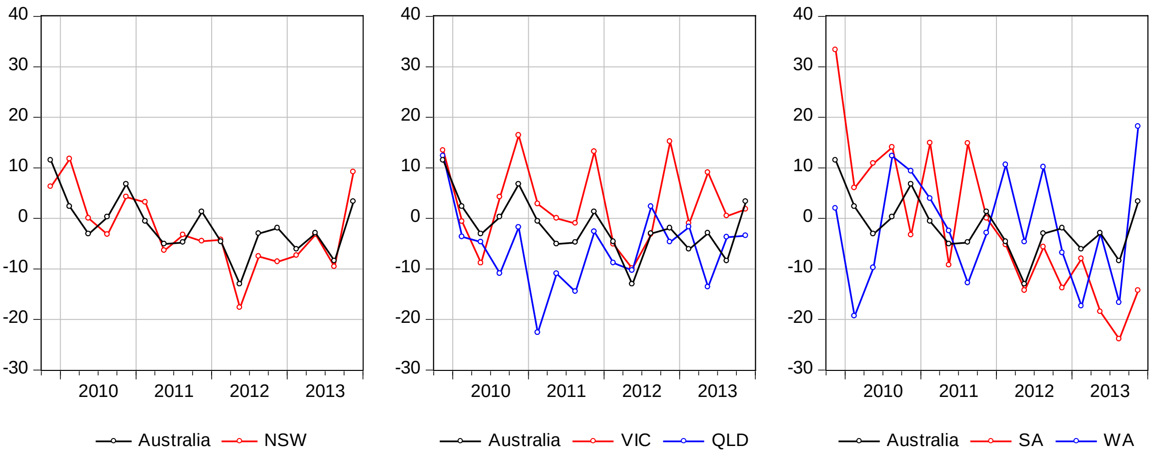
Conditions rise across all states; still very weak in WA and Qld

Business conditions (net balance, s.a.)



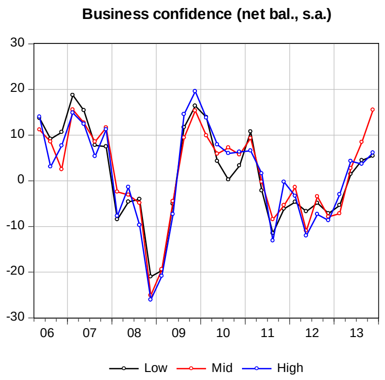
Cash flows are strongest in Western Australia and weakest in South Australia

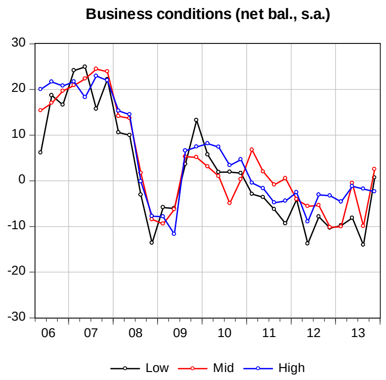
Cash flow (net balance, n.s.a.)



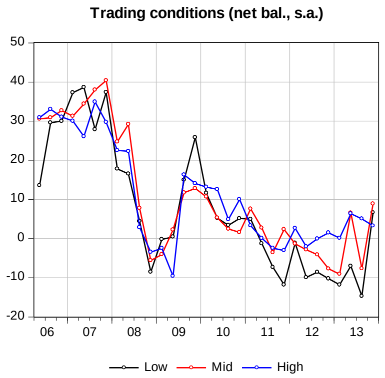
Firm size analysis

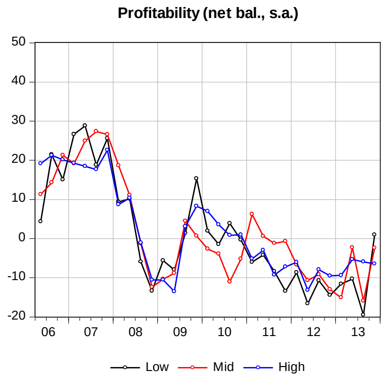
SMEs more confident but conditions still difficult



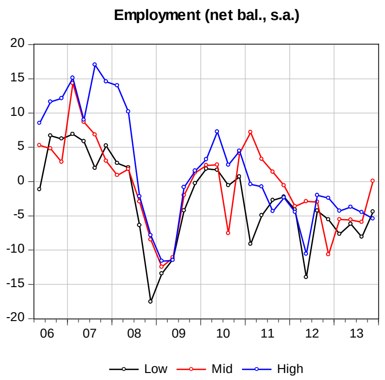


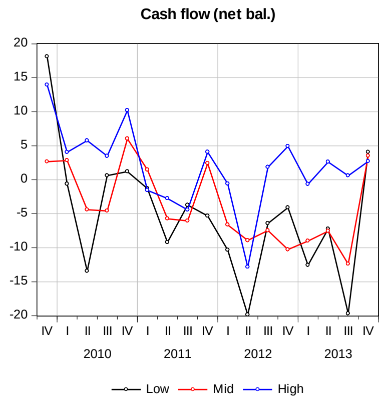
SME conditions consistent across firm size; still soft



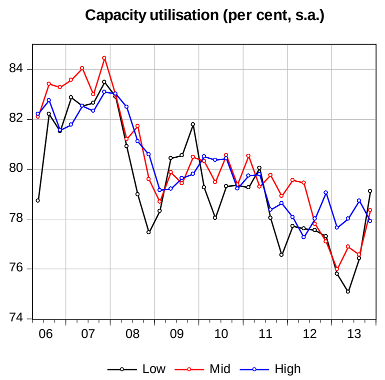


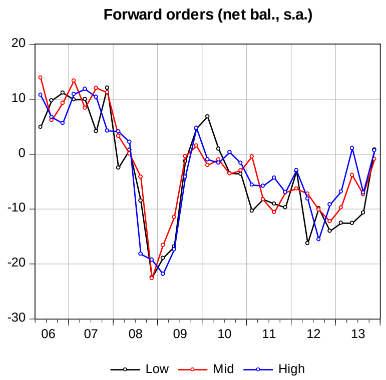
Cash flows recover from sharp deterioration in September quarter





Capacity utilisation rises for mid-tier and low-tier firms; forward orders better, but still soft





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