Scottish Pacific SME Growth Index

September 2017

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Executive Summary

Australia's small to medium business owners have had their say about what's impacting their productivity and growth, and what they'd change if they were Prime Minister for a day, in our latest *Scottish Pacific SME Growth Index*.

Our Index polled more than 1200 small to medium business owners and senior managers of businesses with annual revenues of A$1-20 million, and these SME leaders had very clear ideas about the first problem they'd fix if they were Prime Minister for a day.

With the Federal Government's Red Tape Committee due to table a report to Parliament in December 2017, our results give a clear indication of actions SMEs would like to see. Despite the Government's efforts to streamline BAS, this is the most common problem SMEs would focus their "day as PM" efforts on, indicating that more needs to be done to alleviate the time burden of this reporting obligation. SMEs indicated they would also take action to change the Fair Work Act, reduce company tax and remove payroll tax.

This round's insights into productivity constraints for SMEs are timely, given the upcoming release of findings from the Productivity Commission's year-long Productivity Review. Our data provides a valuable "voice of the customer" perspective on this important and difficult challenge facing the economy. The SME sector employs more than two-thirds of Australia's workforce, and the Federal Government has rightly pinpointed this sector as powering Australia's next 25 years of growth – for this to happen, the pain points SMEs have identified around staff issues, red tape and the reporting burden that comes with employing staff must be addressed.

Despite a political environment where initiatives have been taken to support the sector (from investigating SME access to bank funding, to looking at barriers to productivity and reducing red tape), there are signs in our latest Index that many SME owners are parking growth and expansion and taking a "wait and see" stance. The percentage of SMEs predicting no revenue growth has increased this round to 28.1%, up from 24.2% when we first reported in 2014. Twice as many SMEs predict revenues to improve in the next six months (48%) compared to those expecting revenue to decline (23.4%). However, it is worth noting that on average the declining SMEs are predicting a bigger revenue drop (-6.1%) than the average revenue growth forecast by growth SMEs (4.1%).

We'd also flag that there needs to be a watching brief on the impact of rising housing prices on the SME market. Already, one in ten SMEs indicate housing prices are creating a reduced demand for their products and services and 7% are holding back on new capital expenditure due to house prices making business investments riskier.

Finally, with an almost 10% jump in the number of growth SMEs citing cash flow as a key barrier to business growth (up to 60.9% from 55.9% in our Index for the first half of 2017), and with the continuing trend of SMEs moving towards non-bank lending, the time is right for those SME lenders able to step up and solve the cashflow problems of growth businesses.

Peter Langham
CEO
Scottish Pacific

Key Index Insights

PM for a day – cut red tape

In Round 7 of the SME Growth Index, when asked "If you were Prime Minister for a day, what law or red tape would you change/introduce that would have a major positive impact on your business performance", SMEs' priorities were evenly distributed among three major focus areas.

The need to streamline Business Activity Statement (BAS) reporting is most pressing, as this was identified as a major drag on business performance by 24.3 percent of the SME segment. BAS reporting is a significant administrative burden that consumes a great deal of small business owners' time.

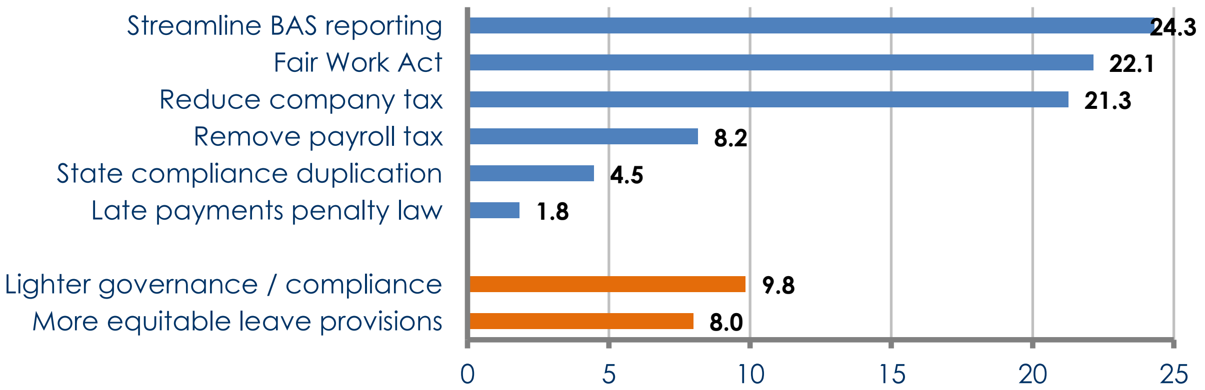
The ATO has already moved to address SME concerns around the BAS burden, with the introduction of 'Simpler BAS' for enterprises with a GST turnover of less than A$10 million (now only needing to report G1 total sales, 1A GST on sales and 1B GST on purchases and linking closely with online accounting software). However, from the latest SME Growth Index findings where one in four SMEs listed it as the top action they would take as Prime Minister to improve their business situation, it appears the small to medium business sector would like to see even further BAS simplification.

The Fair Work Act (22.1 percent) and company taxes (21.3 percent) are also highly emotive issues for SMEs. More work needs to be done to align the Fair Work Act with small businesses' needs, while a lower company tax rate would also be warmly welcomed.

Negotiating to remove state government payroll tax (8.2 percent) and respective state-based compliance duplication (4.5 percent) are other immediate actions that would be taken if SMEs were running the country. A high number of SMEs provided unprompted feedback, suggesting the introduction of lighter governance and compliance requirements (9.8 percent) and changing leave provisions and regulation to be more equitable (8.0 percent).

If you were PM for a day, what law or red tape would you change/introduce that would have a major positive impact on your business performance?

Red Tape / Law Change for Most Positive Impact on Business Performance
% of Total SMEs (N: 1251)



PM for a day – cut red tape (continued)

When investigating what SMEs would prioritise if they were PM for a Day, the Index went further and analysed responses based on the size of the SMEs.

Of SMEs with a $10m plus turnover, one in five (21.1 percent) nominated streamlined Business Activity Statement reporting as the priority change they would introduce. This finding confirms that even at the larger end of the small business sector, there is material concern towards cutting red tape, specifically when it comes to BAS.

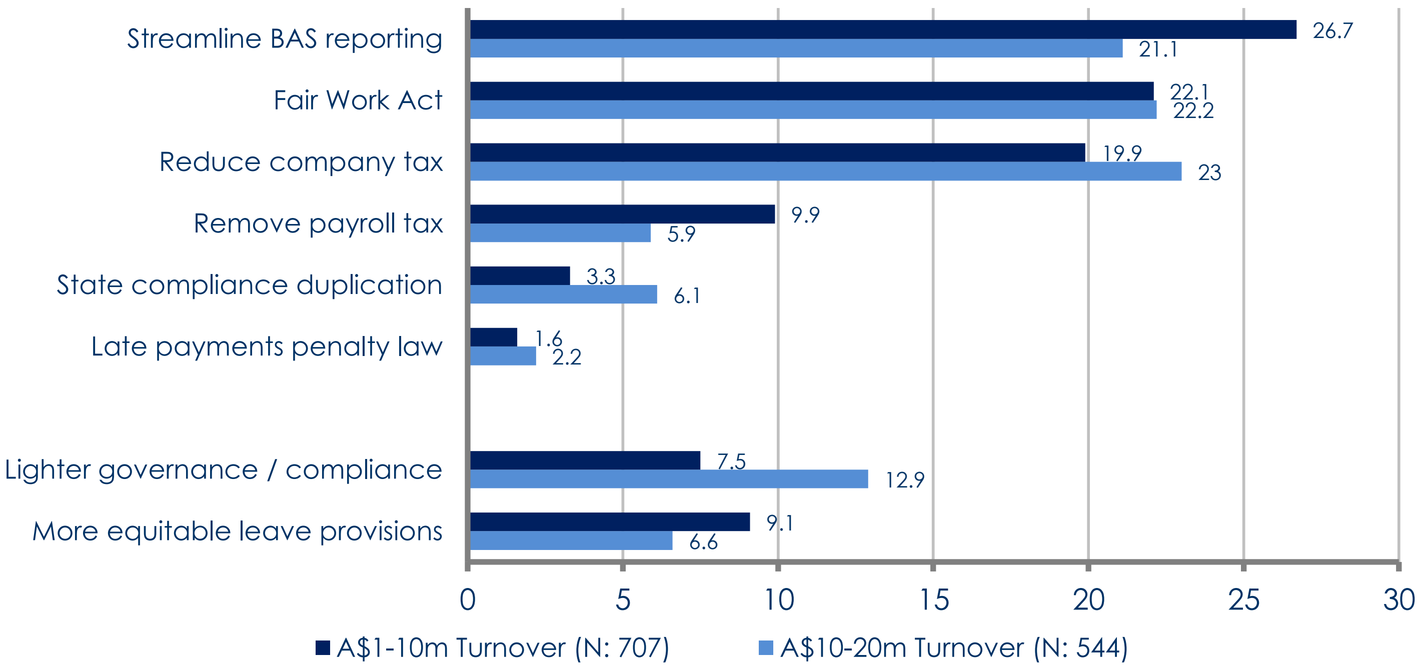
More than one in four (26.7 percent) of SMEs with a $1m-$10m turnover named streamlining BAS as their top priority if they were PM for a Day. This prompts the question of whether there is a lack of awareness around the ATO's newly introduced reporting changes for SMEs in this bracket – or whether small business is seeking the government to go even further in cutting BAS red tape.

The $10m plus turnover SME segment were more likely to nominate reduced company tax as their priority (23 percent, against 19.9 percent of sub-$10m SMEs), and had more of an issue with state compliance duplication (6.1 percent, in comparison with 3.3 percent of $1m-$10m businesses). Regardless of SME size, a very similar number of just over 22 percent of the SME segment nominated changing the Fair Work Act as their priority.

Compliance and governance were greater issues for larger SMEs, with 12.9 percent of the $10m plus segment naming this as their priority, as opposed to 7.5 percent of the $1m-$10m segment.

The priority of removing payroll tax (9.9 percent) and creating more equitable leave provisions (9.1 percent) resonated more with the smaller SMEs than the $10m plus sector.

PM For a Day – Reanalysis by Segment
% of SMEs – Total Market (N: 1251)



Productivity puzzle

This round's insights into the most pressing productivity constraints for SMEs is timely, given the impending release of the Productivity Commission's Productivity Review findings (following an intensive year-long inquiry into Australia's productivity performance, the review will provide recommendations on reform priorities to the Australian Government). The data from this round of the Index provides a valuable "voice of the customer" perspective on what is a critically important and difficult challenge facing the whole economy, as businesses adapt to rapid technological change and seek to keep pace with innovation.

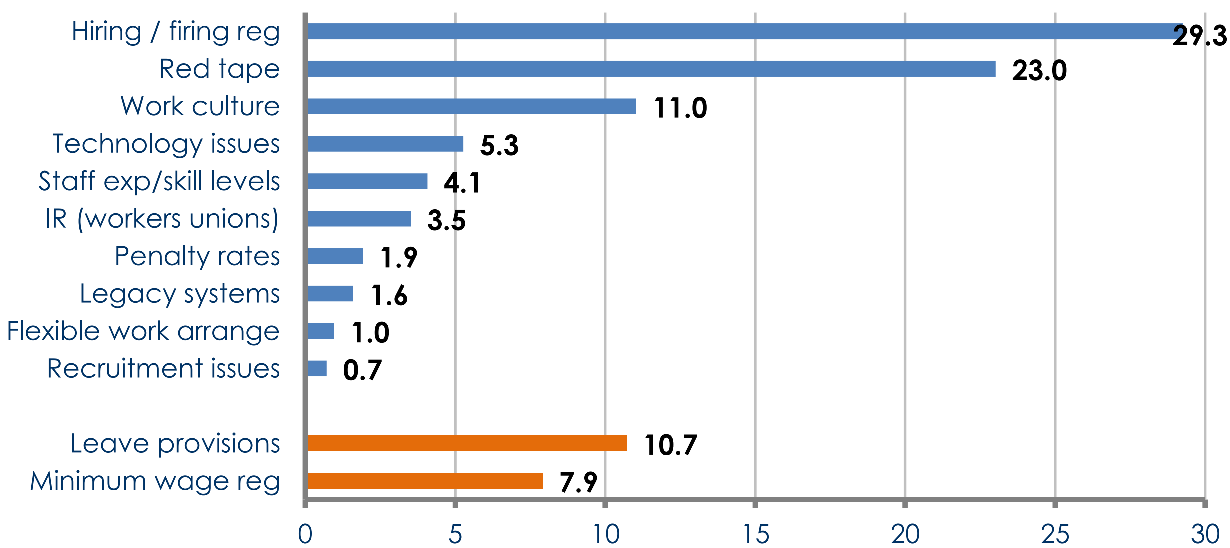
'Productivity' by definition concentrates on the need to 'work smarter' instead of 'work harder', reflecting SMEs' relative capability to transform inputs into outputs more efficiently by applying new ideas, technologies, and business strategies.

Regulations around hiring and firing are cited by SME Growth Index respondents as the biggest constraint on productivity for business – this constraint was nominated by 29.3 percent of SMEs. Clearly a disconnect between managers and regulatory authorities exists if bringing on new employees or replacing staff is limiting productivity improvements so severely. Almost one in four SMEs (23.0 percent) declare that red tape is their biggest productivity constraint.

One in ten SMEs (11 percent) find that work culture limits productivity, suggesting engrained processes or a reluctance for change are key challenges. Technology issues (5.3 percent), staff skill levels (4.1 percent) and industrial relations/workers unions (3.5 percent) also register prominently as major constraints on small business productivity.

A high number of SMEs went as far as to independently nominate leave provisions (maternity/paternity/annual leave) and minimum wage regulation as productivity constraints, registered by 10.7 percent and 7.9 percent of businesses respectively.

Main Productivity Constraint on Business
% of Total SMEs



Rising house prices impact on SME business operations

Booming residential house prices are not at the forefront of small business management concerns, falling behind other pressing issues, such as improving cash flow, compliance and regulatory requirements, high or complicated taxes and human resources management.

However, the SME segment has clearly been impacted, given one in ten businesses (11.1 percent) foresee a reduced demand for products and services due to residential house prices. This is concerning if reduced customer demand, as a direct result of house prices, acts as a drag on revenue for 11.1 percent of the SME sector.

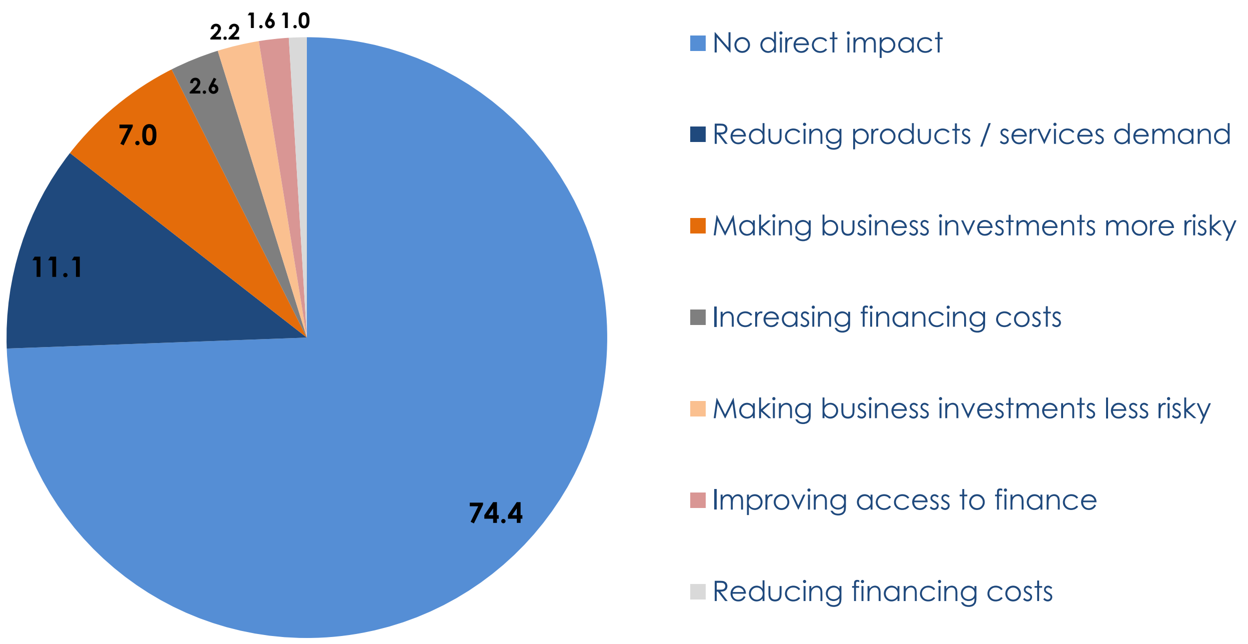
Other negative impacts resulting from current Australian house prices were that 7.0 percent of SMEs are holding back on new capital expenditure due to house prices making business investments riskier, and 2.6 percent have seen an impact with increased financing costs.

In terms of positive impact, 2.2 percent of SMEs say house prices are making business investments less risky and 1.6 percent have noted improved access to finance.

So while 74.4 percent of SMEs believe current house prices are having no direct impact on their business, the remaining quarter (25.6 percent) believe house prices are having a defined impact on their growth prospects.

Exceptionally high house price growth amid the low interest rate environment has been a feature of the Sydney and Melbourne real estate markets over the last ten years as new house and apartment stock struggles to keep pace with demand. According to Domain, the median Sydney house price is A$1.17 million followed closely by Melbourne on A$865,712.

House Price Impact on Business
% of Total SMEs



SME revenue forecasts stabilise - investment uncertainty prevails

Australian SMEs forecast revenues to improve by only 0.8 percent on average for the next six months to February 2018. The result falls in line with last year's muted growth projection, but marks a slight decline from the one percent rise predicted by small business owners earlier for the first half of 2017. This figure is much less buoyant than the average 5 percent revenue growth SMEs were predicting in Round One of the SME Growth Index in the second half of 2014.

Conducted twice a year and running continuously since 2014, the SME Growth Index research is based on direct interviews with 1,251 small business owners, CFOs, and corporate treasurers. A representative sample of businesses dispersed nationally by state and sector are split across metropolitan centres (70.7 percent) and regional areas (29.3 percent).

The Index provides coverage of SMEs forecast revenue changes, current business phase, product and service development, geographic expansion intentions, merger and acquisition (M&A) activity, investment funding plans, business growth drivers and growth barriers.

The rising level of indifference expressed by SMEs towards their revenue prospects continues, a key trend identified in recent rounds of SME Growth Index reporting which has only strengthened this round.

28.1 percent of small businesses predict revenues to remain unchanged in H2 2017, in comparison with 24.2 percent in Round One of the Index in 2014.

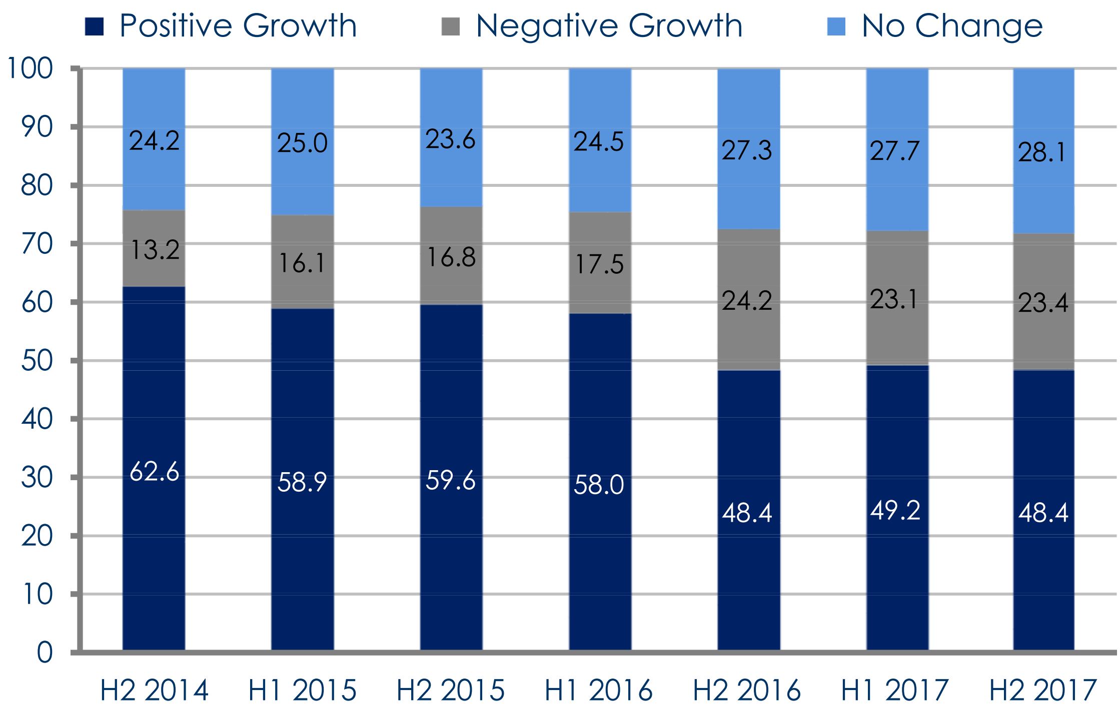
48.4 percent of growth SMEs predict revenues to improve in the next six months, compared to only 23.4 percent of negative growth SMEs predicting an improvement in revenue. Although this figure should convert into stronger business sentiment and confidence, underlying weakness is exposed by SMEs' revenue change forecasts.

It is worth noting that the average negative change forecast (-6.1 percent) exceeds the average positive revenue change forecast (4.1 percent) by a significant margin. This result is in stark contrast to Round One of the Index when the positive change average that was forecast (8.6 percent) was more than double the negative change average (-3.9 percent).

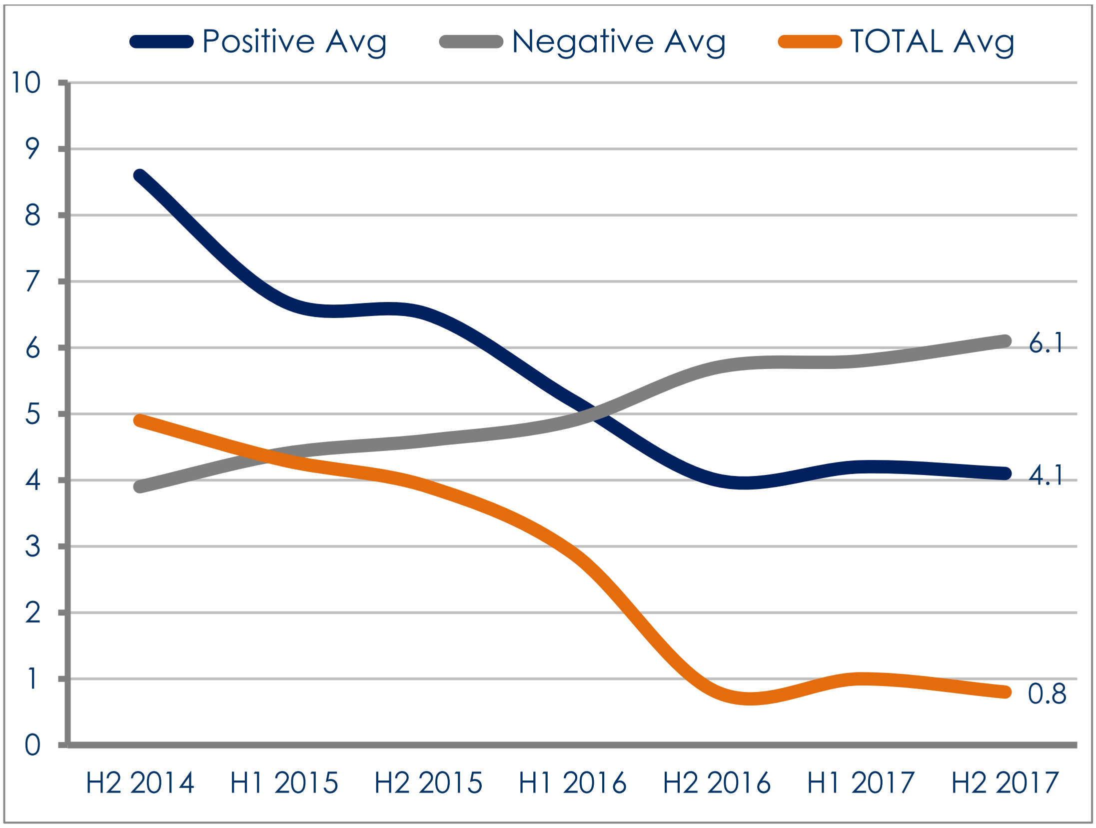
Of greater concern is the broadening range of negative revenue change forecasts, blowing out from -2.5 to -7.7 percent (a spread of 5.5 percent) in Round One of the Index to -4.4 to -12.9 percent this round (a much broader spread of 8.5 percent).

This indicates that among businesses expecting revenues to decline over the next six months, many firms are flagging serious financial difficulty.

Forecast Changes in Enterprise Revenue – Historical Trend
% of SMEs – Total Market (N:1251)



Forecast Changes in Enterprise Revenue
Average % Growth Change Forecast (N:1251)



Business phase analysis – how many new start-ups are 'starting up'?

Within the business cycle, companies graduate from start-up phase through to a period of rapid growth (expansion), level out in a defined 'stable' phase (peak/prosperity), experience consolidation (recession) and then undergo contraction as margins tighten, barriers to entry fall and competition intensifies (trough).

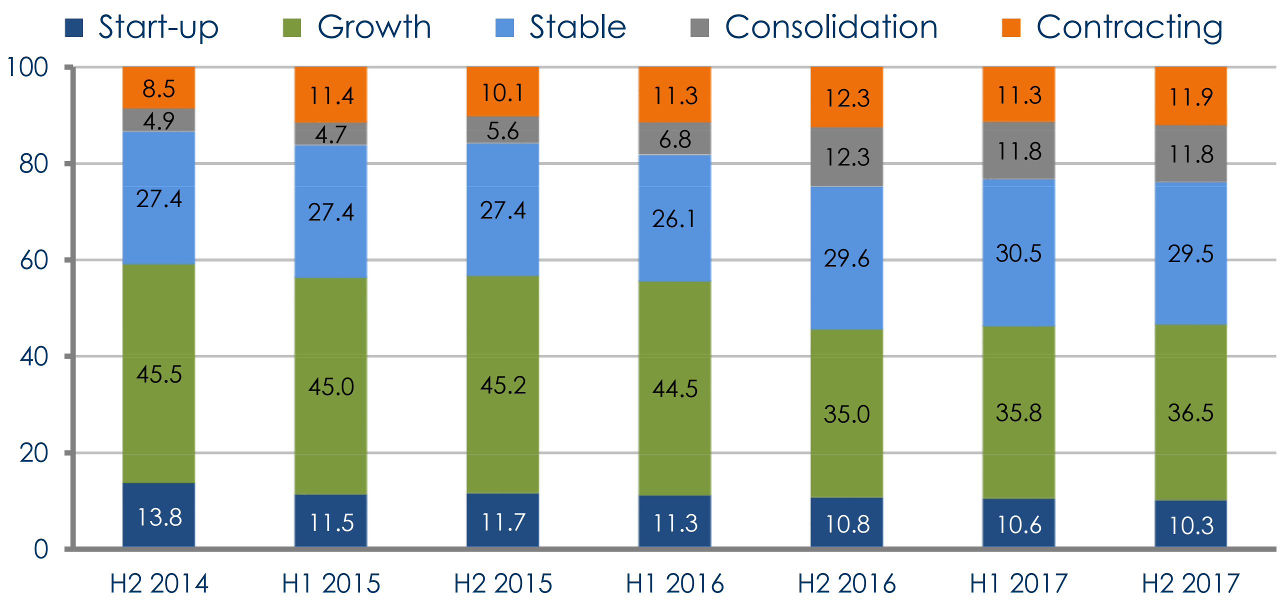
The composition of the SME segment by business phase provides a fascinating insight into the mindset of key decision makers at a small business level, especially by highlighting prevailing views towards underlying economic activity, financial stability, and customer demand.

Market wide, SMEs predominantly perceive themselves to be in a growth phase (36.5 percent) or stable phase (29.5 percent). The remainder of the segment is split evenly across consolidation (11.8 percent), outright contraction (11.9 percent) and start-up phases (10.3 percent).

Despite a concerted effort by government and industry bodies to support innovation, only one in five positive revenue growth SMEs are in a start-up phase (21.3 percent), consistent through all seven rounds of the Index. As indicated in other Index results, taxes, credit conditions and the availability of credit are cited as the three main barriers to growth, clearly impacting Australian start-ups who require improved underlying market demand, less red tape, and tailored funding solutions.

Until these issues are addressed, many brilliant ideas and new business opportunities will not be nurtured through to the highly challenging start-up phase – the economy remains unattractive for bright new sparks to take hold.

Perception of Own Business Phase
% of Total SMEs



M&A activity gathers pace

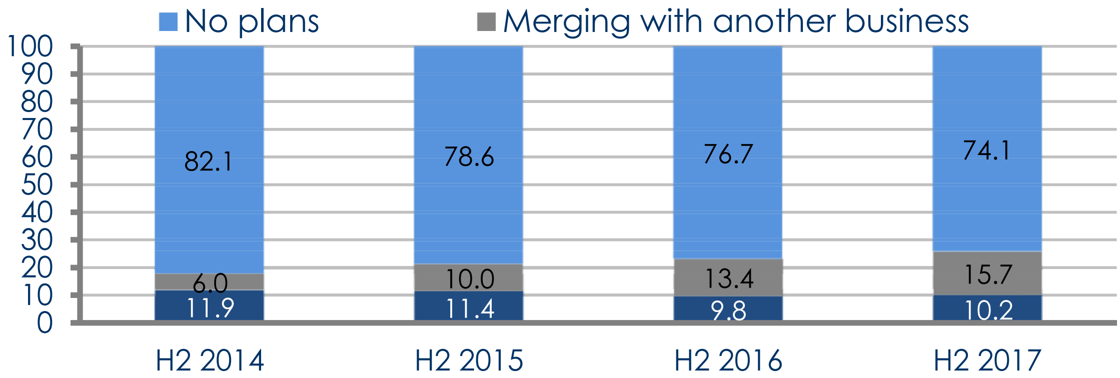
In the last three years the SME segment has become considerably more receptive to merger and acquisition proposals, evidenced by the proportion of SMEs with no M&A plans falling from 82.1 percent to 74.1 percent since 2014. One in four SMEs are open to new M&A activity, exhibiting a preference towards merging with another business over acquiring another business (15.7 percent and 10.2 percent respectively).

17.4 percent of SMEs who are in a declining or negative growth phase are willing to consider merging with another business to improve flagging fortunes. Unsurprisingly, only SMEs with a positive revenue growth profile are positioned appropriately to absorb new business units either outright or as a joint venture through acquisition.

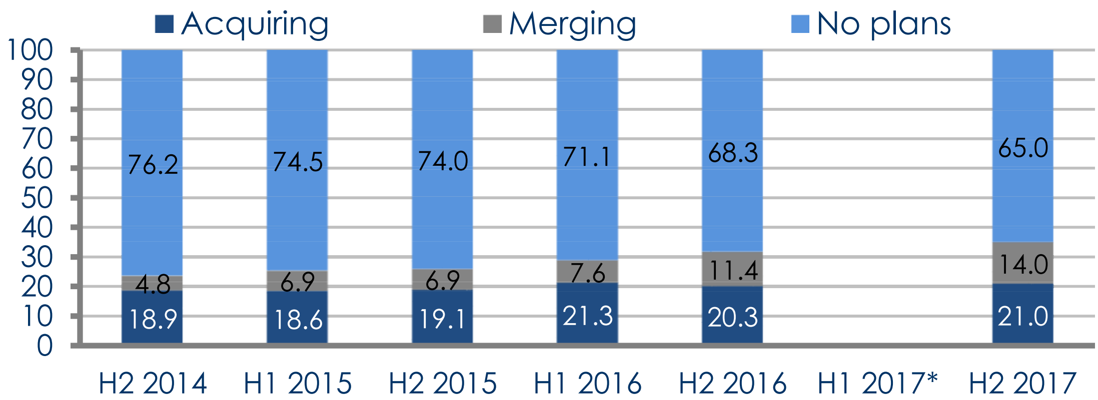
The number of SMEs (across the whole market, growth and non-growth) expressing an intention to merge with another group has more than doubled from only 6.0 percent in 2014 to 15.7 percent in this most recent round of the Index. Similarly, the number of growth SMEs indicating an intention to merge has risen in the past three years from 4.8 percent to 14 percent. The number of growth SMEs planning acquisitions has risen in the same timeframe from 18.9 percent to 21 percent.

Business Acquisition / Merge Intentions

% of Total SMEs – Total Market (N:1251)



Growth SMEs (N:606)



*Question not included in H1 2017 Round Six research sweep

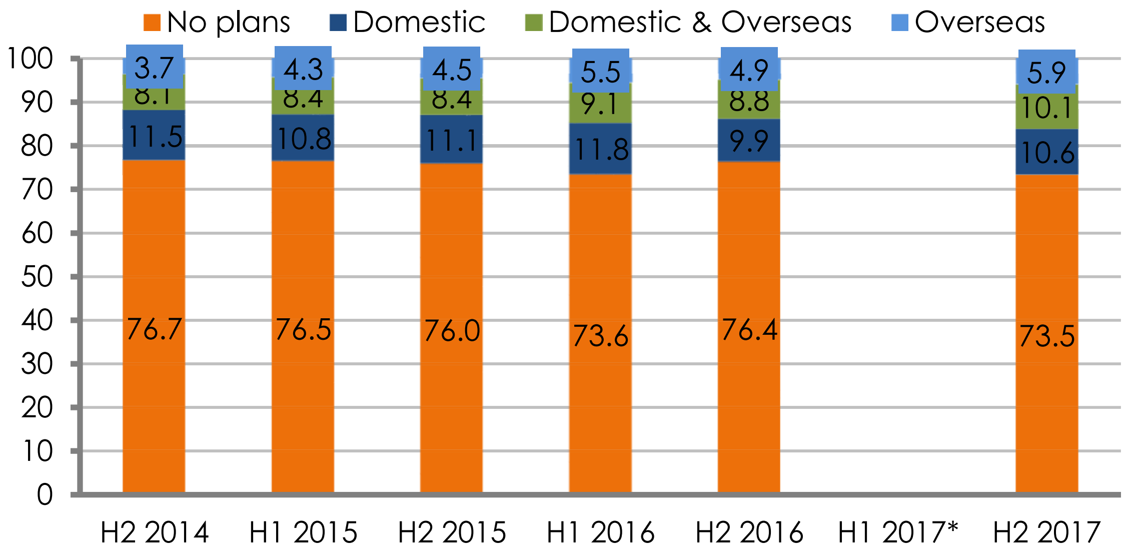
SME expansion plans materialising at home and abroad

Small businesses, regardless of state location or industry sector, are increasingly seeking to tap into lucrative new international markets and offshore growth opportunities to diversify their customer base. Export participation is a key focus for the SME segment, as online sales and digital payments continue to bring global markets closer to Australian suppliers.

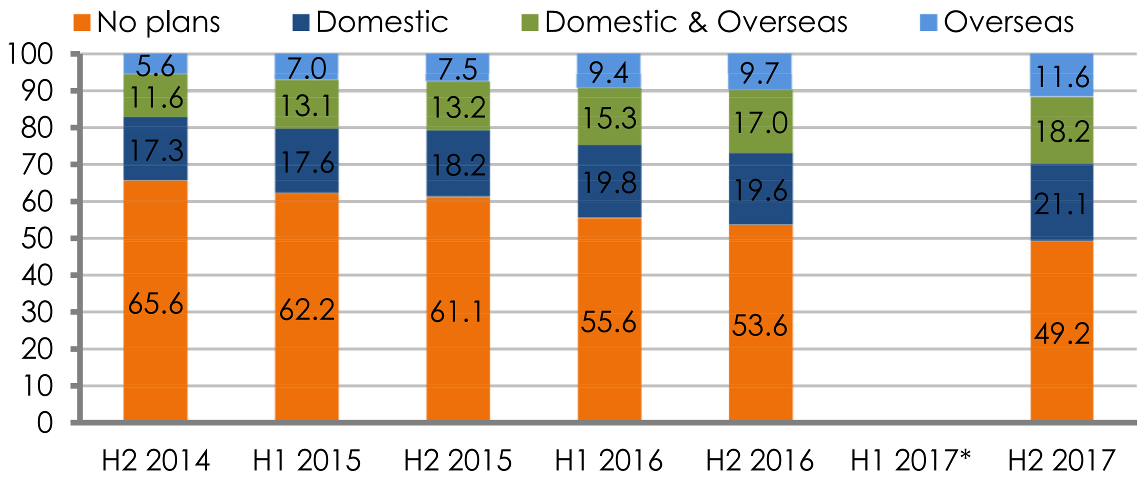
This is clearly having an impact on the future strategic planning needs for the segment. More than half of positive revenue growth SMEs (50.8 percent) have plans to expand interstate or overseas. Among growth SMEs, one in five (21.1 percent) are expanding their supply chain and sales channels domestically and one in ten are expanding into overseas locations, representing a twofold increase since Round One of the Index, from 5.6 percent to 11.6 percent. Just under one in five growth SMEs (18.2 percent) hold both domestic and international geographic expansion intentions.

Geographical Expansion Intentions

% of SMEs – Total Market (N:1251)



Growth SMEs (N: 606)



*Question not included in H1 2017 Round Six research sweep

Are you planning to introduce new products/services in next six months?

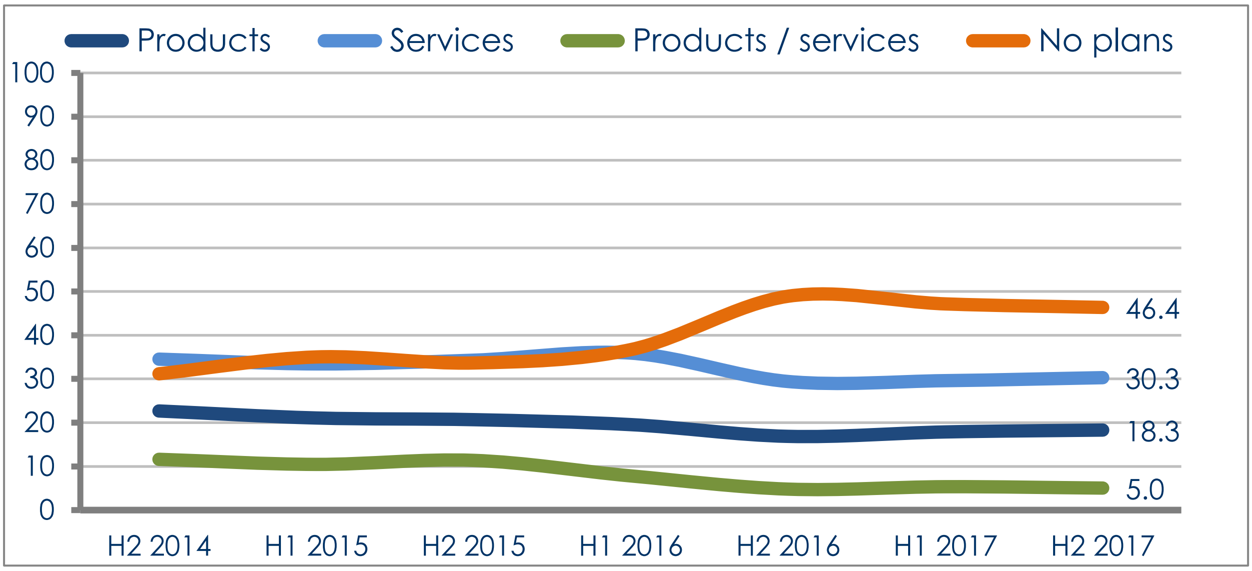
Business investment intentions seem to be on the wane - 46.4 percent of SMEs express no plans to release new products or services, rising sharply from 31.2 percent in 2014.

5 percent of SMEs plan to release new products and services, with 30.3 percent planning to launch new services and 18.3 percent unveiling new products.

Amongst only growth SMEs, 56.4 percent are planning to release new services, 36.6 percent new products and only 5.1 percent new products and services.

For SMEs with declining growth or no change in growth, 88.2 percent of them have no plans for either new products or new services.

New Product / Service Plans in Next Six Months – H2 2017
% of SMEs – Total Market (N:1251)



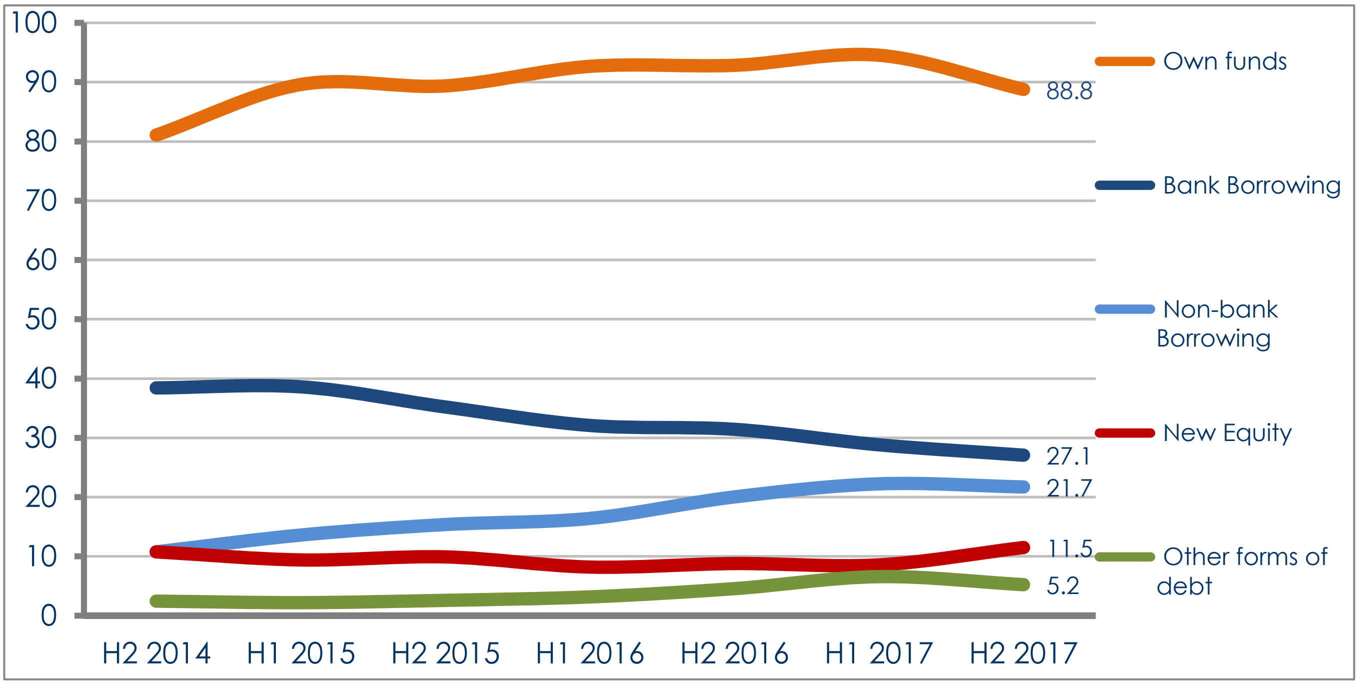
How are you planning to fund business growth in the next six months?

The trend of SMEs moving away from using their main relationship bank to fund growth continues: 27.1 percent of SMEs indicated they would borrow from their main relationship bank, down from 38.4 percent three years ago in the first round of the SME Growth Index.

Non-bank funding is the first option for 21.7 percent of SMEs, up from 10.8 percent in 2014.

88.8 percent of the SME segment plan to use their own capital to fund new investment, 11.5 percent will draw on new equity while the remaining 5.2 percent will use other forms of debt.

Funding Plans for Business Investment
% of SMEs – Total Market (N: 783)



Note: Sums to over 100 percent – multiple responding allowed

What do you see as the key barriers to business growth?

High taxes are cited as the main drag on growth, nominated by 75.1 percent of SMEs. Credit conditions (68.7 percent) and availability of credit (64.0 percent) are also major impediments, as are red tape (44.0 percent), cash flow (39.2 percent) and government policies (34.5 percent).

Barriers to Business Growth – Growth SMEs

% of Total

Growth SMEs	1H 2017 (N: 617)	H2 2017 (N: 606)	Change (%)
Availability of credit	58.3	60.4	3.6
Cash flow / its security	55.9	60.9	8.9
Conditions of credit	65.5	69.6	6.3
Cost of credit	5.0	4.8	(4.0)
Government policies / business unfriendly	34.2	38.0	11.1
High / multiple taxes	68.4	73.6	7.6
Margin compression	13.0	11.1	(14.6)
No real private / friendly equity funding available	18.8	21.0	11.7
Offshore competition	7.1	6.4	(9.9)
Quality of available talent / human resources	10.7	12.2	14.0
Red tape / regulatory change / imposts	61.4	65.0	5.9
Other	1.1	0.8	(27.3)
None	8.9	2.0	(77.5)

Barriers to Business Growth – Declining / No Change SMEs

% of Total

Declining / No Change SMEs	H1 2017 (N: 636)	H2 2017 (N: 645)	Change (%)
Availability of credit	63.2	67.4	6.6
Cash flow / its security	19.7	18.9	(4.1)
Conditions of credit	64.6	67.9	5.1
Cost of credit	3.9	3.4	(12.8)
Government policies / business unfriendly	30.5	31.3	2.6
High / multiple taxes	72.6	76.4	5.2
Margin compression	19.5	21.4	9.7
No real private / friendly equity funding available	28.3	24.7	(12.7)
Offshore competition	15.1	15.8	4.6
Quality of available talent / human resources	1.4	1.4	0.0
Red tape / regulatory change / imposts	23.3	24.2	3.9
Other	1.1	0.9	(18.2)
None	1.7	1.6	(5.9)

Barriers to Business Growth – Whole SME Market

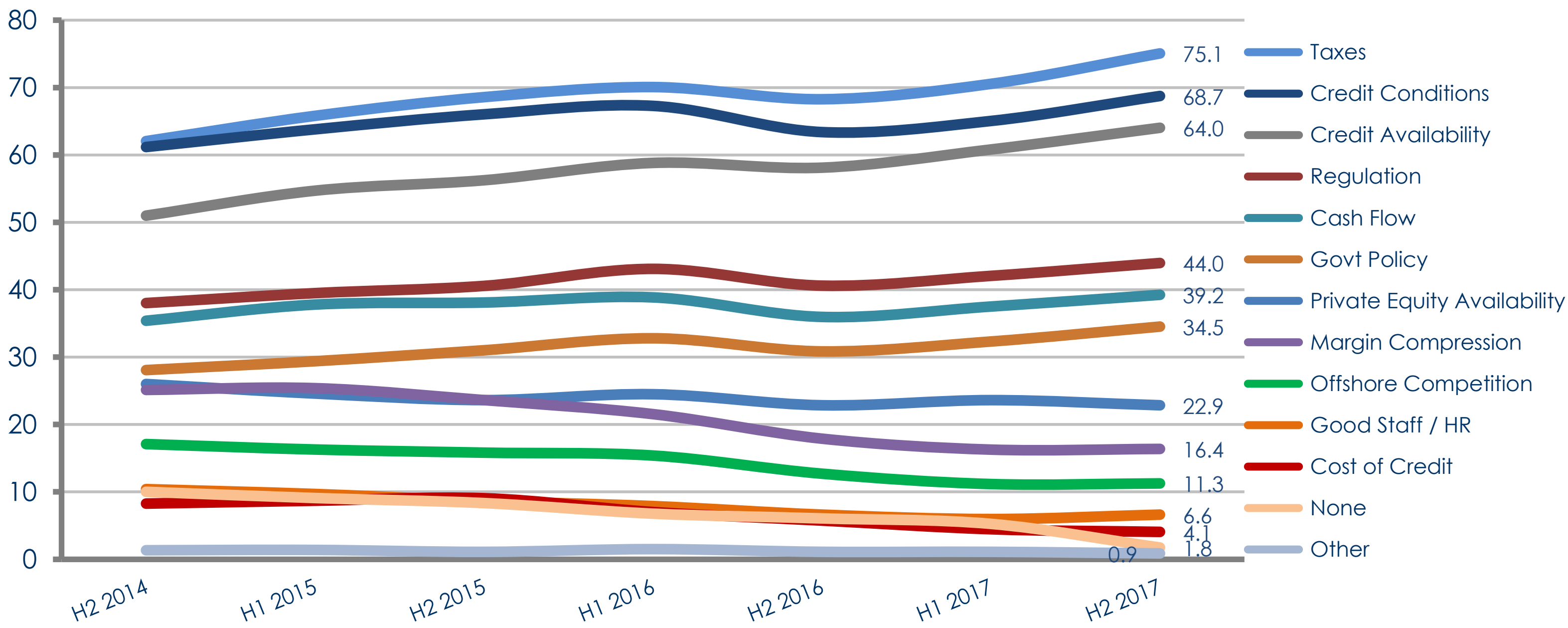
% of Total

Growth SMEs	H1 2017 (N: 1253)	H2 2017 (N: 1251)	Change (%)
Availability of credit	60.8	64.0	5.3
Cash flow / its security	37.5	39.2	4.5
Conditions of credit	65.0	68.7	5.7
Cost of credit	4.5	4.1	(8.9)
Government policies / business unfriendly	32.3	34.5	6.8
High / multiple taxes	70.6	75.1	6.4
Margin compression	16.3	16.4	0.6
No real private / friendly equity funding available	23.6	22.9	(3.0)
Offshore competition	11.2	11.3	0.9
Quality of available talent / human resources	6.0	6.6	10.0
Red tape / regulatory change / imposts	42.1	44.0	4.5
Other	1.1	0.9	(18.2)
None	5.3	1.8	(66.0)

Note: sums to over 100 percent due to multiple responding allowed

Barriers to Business Growth – Trending

% of SMEs – Total Market (N:1251)



What are the key drivers behind your business growth?

For those SMEs predicting their revenue would grow, they predominantly view core customers as the major driver of business growth (44.9 percent).

Other key drivers were great staff (36.3 percent), following their nose (35.8 percent), good luck (33.3 percent) and innovation (24.9 percent).

Drivers of Business Growth
% of Growth SMEs

	H1 2017 (N: 617)	H2 2017 (N: 606)	Change (%)
Anchor / core customers	41.0	44.9	9.5
Availability of equity / positive backers	12.5	11.7	(6.4)
Continual change / innovation	23.2	24.9	7.3
Effective mentors / advisors	4.5	5.4	20.0
Good industry networks	21.2	20.8	(1.9)
Great people/staff/strong team	37.8	36.3	(4.0)
Little / no direct competition	5.8	5.3	(8.6)
Luck / good fortune / good timing	30.8	33.3	8.1
No legacies / history	10.5	8.9	(15.2)
Smart management	9.4	8.1	(13.8)
Smart marketing	18.0	16.2	(10.0)
Successfully integrating technology with the business	12.8	13.7	7.0
Tightly defined markets / segments	12.0	13.2	10.0
Don't know / just followed our nose	37.0	35.8	(3.2)
Other	0.6	0.7	16.7

Note: sums to over 100 percent due to multiple responding allowed
Note: the question was confined to SMEs self-reporting as growth businesses

Methodology

East & Partners interviewed 1,251 SME businesses with annual revenues of A$1-20 million over a four week period leading up to August 2017. 82 percent of respondents were SME business owners, CEOs or CFOs.

All interviews were conducted over the telephone or face-to-face by an accredited East interviewer, speaking with the company CEO, CFO or treasurer as represented in Table B below.

The sample was framed in accordance with ANZSIC codes to provide a natural sample of the Australian enterprise population, with state and sector demographics outlined in Tables A and C.

Geographical Distribution

% of Total

	H1 2017 (N: 1253)	H2 2017 (N: 1251)
NSW & ACT	39.6	39.4
VIC & TAS	22.8	22.9
QLD	17.8	17.8
WA	13.2	13.4
Other	6.5	6.4
TOTAL	100.0	100.0
Regional Australia	—	29.3
Metro Australia	—	70.7
TOTAL	—	100.0

Interviewee Distribution

% of Total

	H1 2017 (N: 1253)	H2 2017 (N: 1251)
Business Owner / CEO	59.3	58.9
CFO	22.7	22.9
Finance Director	8.7	8.9
Treasurer	2.7	2.8
Other	6.6	6.5
TOTAL	100.0	100.0

Sample Industry Sector Distribution

% of Total

	H1 2017 (N: 1253)	H2 2017 (N: 1251)
Agriculture, Forestry, Fishing	5.8	6.0
Mining & Resources	7.7	7.6
Manufacturing	18.1	18.0
Electricity, Gas & Water	0.9	0.8
Construction	9.3	9.4
Wholesale	9.2	9.4
Retail	12.5	12.4
Accommodation, Cafes & Restaurants	2.5	2.3
Transport & Storage	7.3	7.4
Media & Telco	1.2	1.2
Finance & Insurance (non-banks)	4.1	3.8
Property & Business Services	12.5	12.5
Personal & Other Services	9.0	9.1
TOTAL	100.0	100.0

East & Partners is a leading specialist business banking market research and analysis firm. The firm's core expertise is in the provision of analysis and advisory services tailored for the commercial, business and institutional banking markets across Asia Pacific, Australasia, Europe and North America.

The delivery of accurate quantitative analysis on businesses exploding demand for sophisticated transaction, FX, debt, treasury, investment and advisory banking services and products has been uniquely addressed by East's "bottom up" research methodologies since 1987, based on many thousands of customer interviews with CEOs, CFOs, treasurers and business owners.

East's multi-client demand side research and consulting work has enabled the firm to partner virtually every major domestic and international bank present in the geographies the firm operates in.

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About Scottish Pacific

Established in 1988, Scottish Pacific Business Finance (ASX: SCO) is Australia and New Zealand's largest specialist provider of working capital solutions with a comprehensive range of debtor finance, trade finance and specialised finance solutions for the SME business sector. Scottish Pacific handles more than $14 billion of invoices each year, providing funding lines exceeding $1 billion, and has full operations centres in Sydney, Melbourne, Perth, Brisbane, Adelaide, Auckland, London and China.

Scottish Pacific was awarded Australia's best Cash Flow lender for three years running (2014, 2015 and 2016) as voted by brokers in The Adviser's annual Non-Bank Lending Awards.

Clients are predominantly Small and Medium Sized Enterprises (SMEs) requiring personalised facilities that best suit their individual needs, and who often find it difficult to obtain appropriate funding from their main banking providers.

As a specialist provider of working capital, Scottish Pacific is well placed to understand the needs and the sentiment of SME businesses, and the Scottish Pacific SME Growth Index is a response to the firm's unique position in the market, and its status as a market leader.

The purpose of the Index is three-fold:

- To drive development of the financial solutions available to SMEs throughout Australia and New Zealand, by providing Scottish Pacific with market intelligence to deepen our understanding of SMEs' needs.

- To provide Scottish Pacific with the data to help us act as advocates for SMEs, and as thought leaders within the business finance community.

- To share our insights with the broad SME community - the lifeblood of business in Australia - and with fellow business finance professionals.

The next SME Growth Index will be released in March 2018.

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