WESTPAC BUSINESS SNAPSHOT

From one challenge to the next, businesses remain resilient

31 October 2023

Tenacious businesses move into the next stage of the cycle

WELCOME TO THE QUARTERLY BUSINESS SNAPSHOT.

Small and medium-sized enterprises (SMEs) have operated in a difficult environment over the past few years. Cost pressures have been the most significant challenge. We have recently seen these pressures ease, but a fresh challenge is emerging as growth in SME topline revenue is now starting to slow. These are two of the key trends highlighted in our latest quarterly business snapshot.

This report draws on our internal business banking data to detail how evolving economic conditions are influencing business cash flows. We run the microscope over millions of daily transactions to gain a real-time understanding of the conditions facing businesses. By examining the inflows and outflows of our business customers, we can pinpoint clearly what is influencing trading conditions. And, by better grasping the nature of cost pressures, we can further gauge the evolution of the SME sector's bottom line.

Right now, some households are doing it tough. Elevated inflation and higher interest rates are weighing on disposable income, which is driving a slowdown in consumer spending, especially on non-essential items. However, record growth in the population is working in the other direction, adding to the goods and services demanded from businesses.

In aggregate, SMEs have generally been unable to fully pass on higher costs to final consumers. However, recent trends show that businesses in the transport & storage and the construction industry have been better able to pass on higher costs.

While the experience across industries has been broadly similar, there's a stark difference when it comes to size, which can matter in terms of pricing power. SMEs with annual turnover under $3 million are likely to be feeling the squeeze.

In the first edition of this report (July 2023) we explained how SMEs had accumulated sizeable financial buffers during the pandemic. Our latest snapshot reveals some of the pressing reasons they may now be leaning on these buffers. We know how important SMEs are to the Australian economy. They represent 99.8% of all Australian businesses. That's why it's vital that these businesses have a good understanding of how economic conditions are affecting the sector.

Turnover insights: Is the spending pulse shifting?

TURNOVER LOWER THAN A YEAR AGO

Business turnover declined over the September quarter in annual terms, according to our internal banking data. It's the first time in the post-pandemic period we have recorded an annual decline.

After holding up in July, turnover dropped for SMEs throughout the remainder of the September quarter – and that's despite the quarter featuring a boost from one-off events, such as the Women's World Cup, and higher nominal wages resulting from the 2023-24 Fair Work Commission's minimum and award wage decision. In fact, we saw a sharp pullback in accommodation, retail, and transport & storage turnover over the month of September.

Businesses have responded to more difficult conditions by finding new ways to move stock and boost sales. This has included discounting, packaging up or bundling goods and services, and offering better deals – and it's a trend that looks set to continue. More businesses deploying innovative marketing and sales methods to offer value to cash-strapped consumers will likely bring stronger competitive pressures into the market.

Our analysis suggests turnover remains relatively more resilient in industries that provide essential services for the rapidly growing population. These include education, construction, personal services, and health. On the other hand, the wholesale, property services, accommodation & food services, and retail industries have experienced a significant slowdown in turnover over the past year.

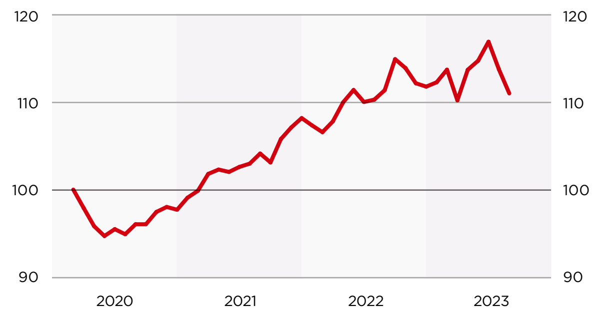
12 MONTH CHANGE IN INCOME:

-7.3% Wholesale Trade

-6.8% Communication Services

8.5% Education

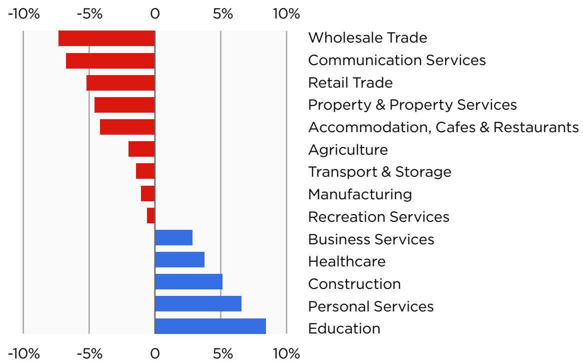
Chart 1: Business income



Index: March quarter 2020 = 100 **Source:** Westpac Group

Chart 2: Business income

Change over year to the September quarter 2023, by industry



Source: Westpac Group

KEY INSIGHT: BUSINESSES ARE RESPONDING TO THE MODERATION IN DEMAND

The slowdown in turnover over the September quarter provided further evidence that the weakness from households that are feeling the strain is spreading to businesses. This is likely to continue and broaden as monetary policy impacts further through the economy and households continue to draw down on their savings.

Consumers have become more frugal. But that doesn't mean there isn't still demand to be found. Businesses will need to think outside the box to boost turnover. Those that provide value for money and essential services for the growing population are likely to outperform.

Expense insights: Cost pressures appear to be decreasing

HIGHER COSTS HAVE MADE FOR A CHALLENGING PERIOD

Businesses have endured one of the toughest cost environments in living memory.

The price of inputs, such as machines, electronics, fuel, power, and other goods traded globally has increased significantly. Add to that domestic wage pressures from a generationally tight labour market.

Cost pressures have been hard to escape and are universal across industries. However, we have now turned the corner with the cost base for businesses first moderating and now easing over the course of 2023. As global supply chains continue to improve, we expect further relief in the months ahead.

Most industries experienced a decline in cost pressures over the September quarter, except for education and property services. This is significant.

Large increases in the minimum and award wage took effect from 1 July 2023.

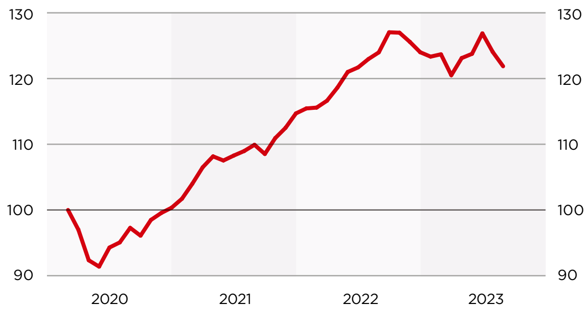
This led to an initial spike in expenses, which dissipated during the quarter, suggesting that the wage rise created a one-off increase in the level of cost pressures (more below on this).

> Cost pressures have been hard to escape and are universal across industries. However, we have now turned the corner.

Over the past 12 months, only four of 14 industries have experienced an increase in expenses, among them personal services and education.

These are the same industries enjoying the strongest growth in turnover. This suggests that they are purchasing more inputs to help meet solid demand.

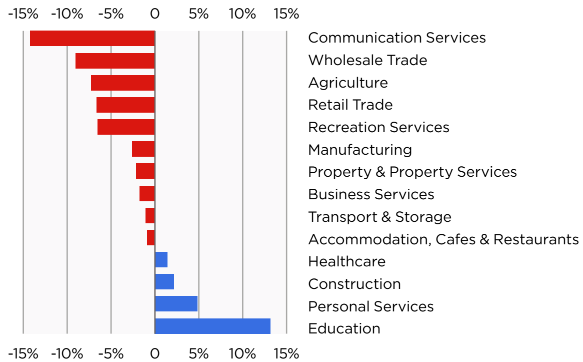
Chart 3: Business expenses



Index: March 2022 = 100 **Source:** Westpac Group

Chart 4: Business expenses

Change over year to the September quarter 2023, by industry



Source: Westpac Group

KEY INSIGHT: FINDING COST EFFICIENCIES IS THE NAME OF THE GAME

Businesses have been hit with one shock after another. The conflict in the Middle East could present another fresh headwind for energy costs, and domestic cost pressures are becoming more important. There's a need for businesses to continue to be agile and make cost efficiencies going forward.

Our first report explained how businesses had been improving their liquidity positions using a range of strategies, including paying down debt where possible, increasing liquid assets, maintaining credit lines, and investing in productive capacity. This focus has put businesses in good stead to tackle the uncertain economic environment.

Expense insights: Domestic drivers of costs are becoming more important

HOME-GROWN COST PRESSURES

Domestic sources of cost pressures are becoming increasingly significant, whereas the price of inputs traded globally, such as machines, equipment and other intermediate goods, were previously a larger concern.

We have seen the wages bill jump by almost 35% relative to pre-pandemic levels. However, the data shows some early signs that wage pressures are moderating.

The cost of labour continues to increase, overheads such as energy costs and rents are higher, and the cost of servicing debt has risen. All businesses need labour to operate, though some industries use more labour than others. Labour costs have increased recently due to the tight labour market and the 2023-34 Fair Work Commission decision, which kicked in on 1 July 2023.

In addition, businesses have bolstered their headcount to help keep up with strong demand, adding to labour costs.

As a result, we have seen the SME wages bill jump by almost 35% relative to pre-pandemic levels (March quarter 2020). However, the data shows some early signs that wages pressures are moderating. This is despite employment continuing to grow at a solid pace over the September quarter. By industry, the wage bill has increased the most in education, agriculture and construction over the past year.

UPS AND DOWNS:

UP

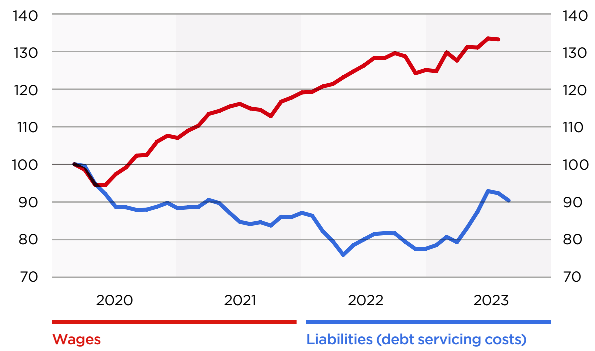
Cost of labour

Tax payable

DOWN

Aggregate debt servicing levels

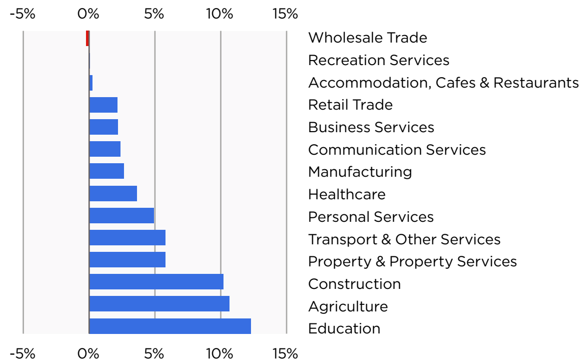
Chart 5: Business wages vs debt servicing costs



Index: March quarter 2020 = 100 **Source:** Westpac Group
*Wages data only available until August 2023

Chart 6: Business wages

Change over year to the September quarter 2023, by industry



Source: Westpac Group

DEBT SERVICING LEVELS STAY LOW

The cost of servicing debt declined during the pandemic as the RBA reduced the cash rate to 0.10%. Businesses took the opportunity to save and strengthen their balance sheets by paying down debt.

The RBA has hiked rates by 4 percentage points in 18 months. Business cash flows are therefore coming under pressure and the total cost of servicing debt has increased. But due to the large amount of debt previously repaid, total debt servicing costs remain below their pre-pandemic levels in aggregate.

Costs are just as important as demand

PROFITABILITY IS UNDER PRESSURE

Cost pressures have been the most significant challenge facing SMEs, impacting profitability.

Many businesses have been unable to pass on higher costs to end-consumers in full, as growth in costs is outstripping their growth in turnover.

Business conditions, as measured by the income to expense ratio, have improved over 2023 as cost pressures started easing – and this demonstrates how important it is to get inflationary pressures under control.

Policy support, in the form of financial assistance during the pandemic, and record low interest rates have allowed SMEs to build buffers, pay down debt and reduce capital servicing expenses.

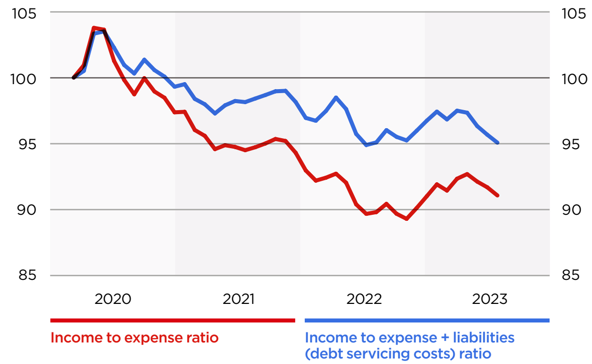
Now that the RBA has pushed interest rates up, SMEs are seeing the cost of servicing debt increase – but the stronger financial position, highlighted in our first report in July, is helping the sector deal with higher rates.

SMEs have been unable to pass on higher costs to end-consumers in full, as growth in costs is outstripping their growth in turnover.

Other domestic cost pressures such as labour costs are also becoming more important.

At the same time, turnover fell in the September quarter compared with a year ago, after an early show of resilience turned out to be a temporary bounce.

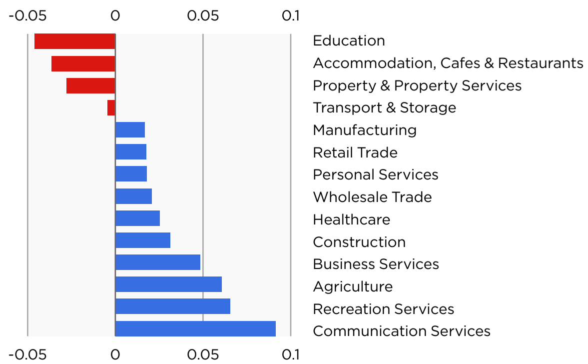
Chart 7: Business income to expense ratio



Index: March quarter 2020 = 100 **Source:** Westpac Group

Chart 8: Business income to expense

Change over year to the September quarter 2023, by industry



Source: Westpac Group

THE EXPERIENCE IS BROADLY CONSISTENT ACROSS MOST INDUSTRIES

Business conditions generally deteriorated with surging cost pressures in 2022, but an improvement followed in 2023 as cost pressures started to ease.

The income to expense ratio has not yet recovered to pre-pandemic levels across any industry. However, the deficit is only small in construction, transport & storage, wholesale trade, manufacturing, and education.

The relative strength for construction represents a recovery from the recent disruptions in the sector. This could be because the industry is one of the most sensitive to improvements in supply-chain disruptions and stands to benefit significantly from easing cost pressures.

At the other end of the spectrum, the income to expense ratio is well below pre-pandemic levels for businesses in cultural & recreational services, retail, and accommodation & food services.

Small business insights: Buffers to boost business tenacity

SIZE DOES MATTER WHEN IT COMES TO PRICING POWER

While the divergence in cost pressures and turnover between industries is rather small, there is significant variability when it comes to business size. Conditions have weakened materially for small businesses with annual turnover of less than $3 million a year.

For these businesses, the income to expense ratio is almost 14% below where it was before the pandemic. This compares to just under 7% for businesses with annual turnover above $3 million. Interestingly, most of this divergence has occurred since mid 2022.

The difference in outcomes between these two groups can be explained by larger businesses enjoying much more of the increase in demand for goods and services over recent years compared to smaller businesses. Consequently, larger businesses can more easily pass on cost increases without sacrificing demand.

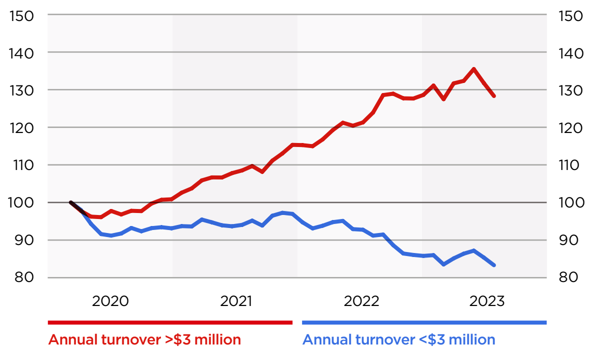
Income for businesses with turnover over $3 million per year is around 30% above its pre-pandemic level (peaking at 35% in July). Costs for these businesses have increased by an even larger amount, currently up around 37% after peaking just shy of 45% above pre-pandemic levels.

In comparison, businesses with turnover of less than $3 million are yet to see their incomes recover to pre-pandemic levels. Aggregate income is currently running around 17% lower. Their expenses have not increased dramatically as weaker demand has not warranted more spending on supplies. Expenses, however, have recovered to pre-pandemic levels and inflation is eroding their bottom lines, even though they are likely purchasing less.

The story changes somewhat, though, when debt servicing repayments are included. Businesses have paid down their debt and, despite interest rate hikes, they are using less resources than before the pandemic to service debt. This is particularly true for businesses with turnover below $3 million, where debt-servicing outlays are down by 20%.

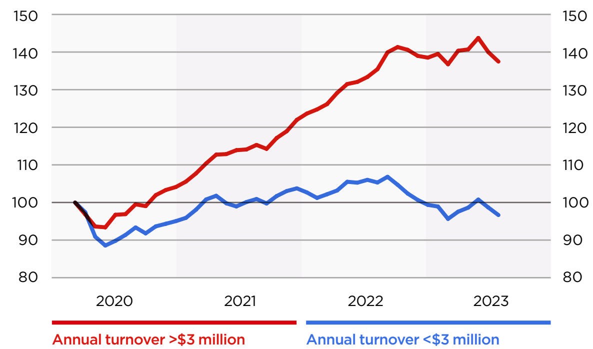
In stark contrast, debt-servicing costs are back around pre-pandemic levels for businesses with annual turnover above $3 million.

Chart 9: Business income by size



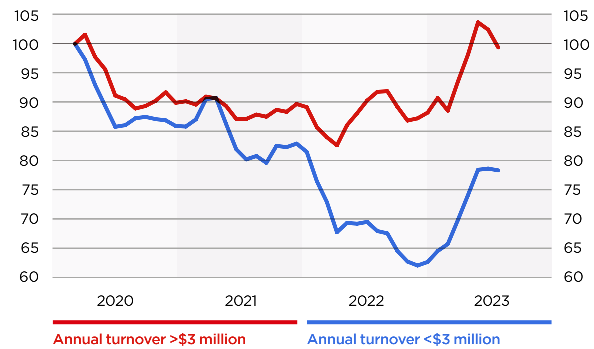
Index: March quarter 2020 = 100 **Source:** Westpac Group

Chart 10: Business expenses by size



Index: March quarter 2020 = 100 **Source:** Westpac Group

Chart 11: Business debt servicing costs by size



Index: March quarter 2020 = 100 **Source:** Westpac Group

Businesses ready for the next challenge

EASING COST PRESSURES ARE OFFERING MUCH NEEDED RELIEF, BUT SLOWING DEMAND PRESENTS A NEW CHALLENGE.

Households are tightening their belts in response to higher inflation and interest rates, and this is beginning to show up in business cash flows. However, the pull-back in demand remains limited due to the offsetting forces coming from surging migration.

More importantly, easing cost pressures are providing much needed relief for businesses, and – for the time being – countering the sliding demand from households. This is welcome news and it's contributing to business resilience.

Solid conditions have meant that in aggregate, businesses have not yet had to rely on the impressive balance sheets they built up during the pandemic. But this experience is not unanimous.

Some small businesses are under stress as their income flows have slowed materially. For these businesses, the size of their financial buffers will be crucial for weathering the challenges.

Additionally, the slowdown in demand has only just begun and still has some way to run. Monetary policy acts with a considerable lag and the outlook for growth remains weak.

The array of challenges facing businesses is evolving. But SMEs are tough and that resilience continues to shine through.

On the bright side, as inflation moderates further businesses will likely see further cost relief, while household spending power will improve. This will help support businesses over the year ahead.

The array of challenges facing businesses is evolving. But SMEs are tough and that resilience continues to shine through. There remains a rocky path ahead, but in aggregate, the SME sector is more ready than ever to take the challenge on.

Appendix 1: Major indicators by industry, % change

	Expenses			Income			Liabilities			Wages		
	YTD	2022	2021	YTD	2022	2021	YTD	2022	2021	YTD	2022	2021
Accommodation, Cafes & Restaurants	8.9	23.9	18.7	4.4	18.2	14.6	6.5	-3.4	1.6	4.0	15.7	20.2
Agriculture	-0.7	10.5	11.8	0.4	3.2	7.4	3.3	4.3	4.7	7.0	3.7	10.0
Business Services	2.1	11.3	16.5	4.7	5.8	9.0	10.0	-3.0	-7.3	4.4	11.8	15.1
Communication Services	0.4	3.0	12.4	-0.1	1.0	3.9	-3.7	-25.0	-5.9	7.3	10.8	-0.5
Recreation Services	-6.9	16.4	22.9	1.6	-0.5	7.7	-8.0	-3.7	2.0	2.5	17.0	17.6
Education	13.2	11.8	5.4	10.3	8.6	-0.1	1.4	1.5	-11.1	11.1	9.2	23.0
Healthcare	5.2	10.3	13.3	7.3	4.7	4.5	18.1	-12.8	-11.4	5.7	9.0	19.7
Manufacturing	1.3	9.6	8.0	1.8	6.4	3.6	4.4	-2.3	-12.5	3.7	6.8	11.9
Personal Services	5.9	14.4	8.7	5.3	8.1	2.5	8.1	-6.6	-21.4	4.0	10.7	19.0
Retail Trade	-1.5	12.5	8.2	-1.6	8.3	0.8	12.0	-13.4	-12.7	4.2	8.8	8.6
Transport & Storage	5.7	27.6	5.8	6.9	21.6	5.0	2.8	1.3	3.5	6.0	4.7	10.1
Wholesale Trade	-5.7	7.1	6.9	-4.5	4.9	1.5	-0.8	-8.1	-2.3	2.4	5.8	7.3
Construction	-0.4	15.8	11.8	2.8	12.4	7.4	32.5	-14.2	-2.3	12.3	5.4	7.2
Property & Property Services	-4.7	9.9	22.1	-3.9	7.2	12.6	8.8	16.7	-17.3	10.6	4.1	13.3
Total	**1.8**	**12.6**	**10.8**	**2.0**	**7.7**	**5.3**	**6.3**	**-6.8**	**-6.8**	**5.0**	**9.6**	**13.2**

Annual % change over the respective calendar year for 2021 and 2022. YTD reflects % change over the year to date.

About the report

The quarterly Business Snapshot report uses aggregated and de-identified data from our business customers. This data provides a real-time read on aggregate business conditions and the economic trends impacting the SME sector, providing our clients with insights to help them grow and prosper.

Turnover is derived by summing inflows paid to the accounts of the Group's business customers. Inflows related to transfers within business groups or capital transactions are excluded. Expense data is derived by summing outflows from the accounts of our business customers. Outflows related to transfers within business groups, capital transactions and outflows direct to any lending facility are excluded from the analysis. Liability (debt servicing cost) data is derived by summing the outflows from the accounts of our business customers for servicing any financing facilities or loans. It captures both interest and principal payments as applicable. Sample is adjusted where possible for changes in customer numbers. Therefore, the reported aggregates reflect the experience of the typical or average SME in Australia, as opposed to changes in customer numbers.

Individual series are seasonally adjusted. All data is presented using rolling three month moving averages to smooth volatility related to the flows of income, expenses, and liabilities. Given the limited length of the time series available and volatile economic landscape over the past few years, seasonal factors are subject to change – however, different robustness methods are used to help ensure that any changes going forward are small.

We're here to help.

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