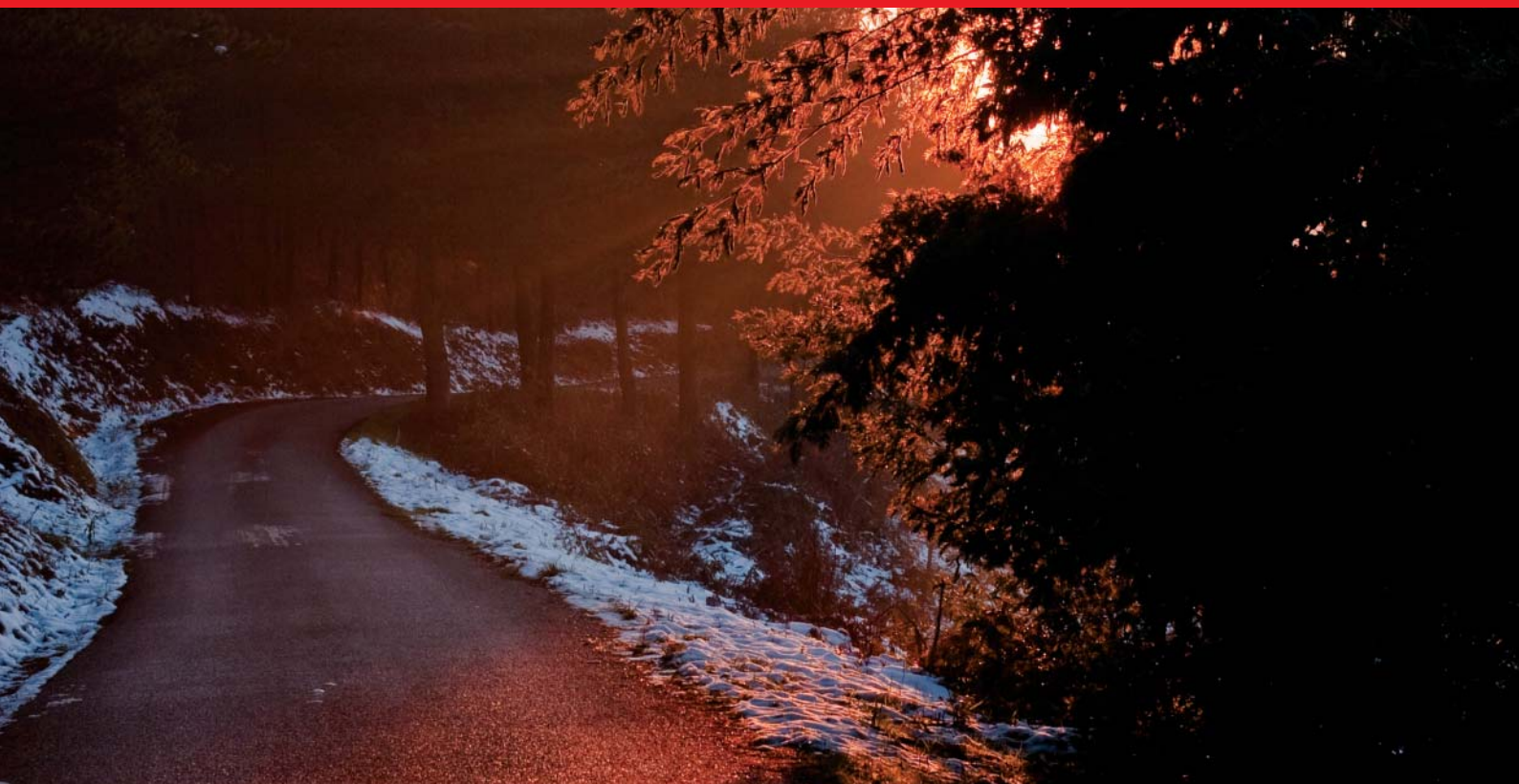




# UK BUSINESS CONFIDENCE MONITOR

## Q1 2011



# WELCOME



This quarter's *ICAEW/Grant Thornton UK Business Confidence Monitor* (BCM) suggests that there are some grounds for optimism in 2011, despite last quarter's surprising decline in GDP. As our report indicates, there is no doubt that businesses now have the foundations in place to grow, something which could not be said a year ago. However, the path to recovery will continue to be slow and bumpy for at least the next 12 months.

As its strategy to reduce the fiscal deficit is implemented, the coalition government needs to be doing all it can to support private sector growth. Next month's budget will be critical in demonstrating that the government is making clear, tangible progress in reducing the regulatory burden, simplifying the tax system and making it easier for companies to borrow, invest and hire. Together, this will demonstrate that the UK is truly open for business.

A handwritten signature in black ink that reads "Michael Izza".

Michael D M Izza  
Chief Executive  
ICAEW



BCM continues to be a good indicator of the mindset of business leaders throughout the UK. This quarter shows that, despite a weakening in confidence, UK plc is well placed to take advantage of any opportunities that arise.

There is no doubt that it is still a tough environment, with household finances being squeezed and the VAT increase impacting on sales. There are signs, however, of improvement among the key financial indicators. Turnover and gross profits are both on an upward trend. Exports continue to be important to the UK economy, and businesses should look to take advantage of the relatively low value of sterling. With domestic demand in the UK expected to be weaker than in previous years, this is one area where companies can expand with products and services more price-competitive in the global market.

A handwritten signature in black ink that reads "Scott Barnes".

Scott Barnes  
Chief Executive Officer  
Grant Thornton

# ECONOMIST'S VIEW



The latest *ICAEW/Grant Thornton UK Business Confidence Monitor* (BCM) shows that business confidence has continued on a downward trend this quarter, after a sharp drop in Q4 2010.

The preliminary estimate of quarterly economic growth in Q4 2010 showed an unexpected contraction of 0.5%. Even once the effects of December's adverse weather are taken into account, the economy still showed signs of stagnation – prompting renewed concerns about the prospect of a double-dip recession. However, our data imply that official figures will show Q1 2011 quarterly economic growth in positive territory.

## KEY ISSUES EMERGING THIS QUARTER

- The downward trend in the Confidence Index which began in Q2 2010 has slowed this quarter. This mainly reflects the gradual return to normality as the economy moves further away from the financial crisis.
- Annual input price growth has continued to rise, placing pressure on business profit margins. This likely reflects soaring commodity prices, with the price of Brent crude oil recently passing the \$100 per barrel mark. However, selling price inflation remains modest.
- Confidence has fallen sharply among Construction firms. Concerns over dwindling public sector contracts are likely to be driving this.

The current economic environment – weak growth figures combined with consistently above-target consumer price inflation – is proving a headache for economic policy makers and driving vigorous debate on interest rates.

We continue to believe rates should remain on hold this year. January's VAT rises and short-term volatility in world commodity markets are the primary drivers of inflation at present, not an overheating domestic economy. The loss of momentum in the UK economy towards the end of 2010 should keep rate risers at bay – at least until April, when the preliminary estimate of Q1 2011 growth will indicate whether or not the country is veering dangerously close to another recession.

Our view is that quarterly growth in Q1 2011 will be weak but positive. Sectors derailed by the snow could see robust growth with completion of a backlog of unfinished projects. A cautious interpretation of Q1's growth figures will be essential, however: this snow 'bounce-back' could mislead that the recovery is back on track while in fact there is still a great deal of underlying weakness.



Douglas McWilliams  
Chief Executive, cebr  
ICAEW Economic Partner

# BUSINESS CONFIDENCE IN Q1 2011

FIG. 1 TREND OF UK BUSINESS CONFIDENCE

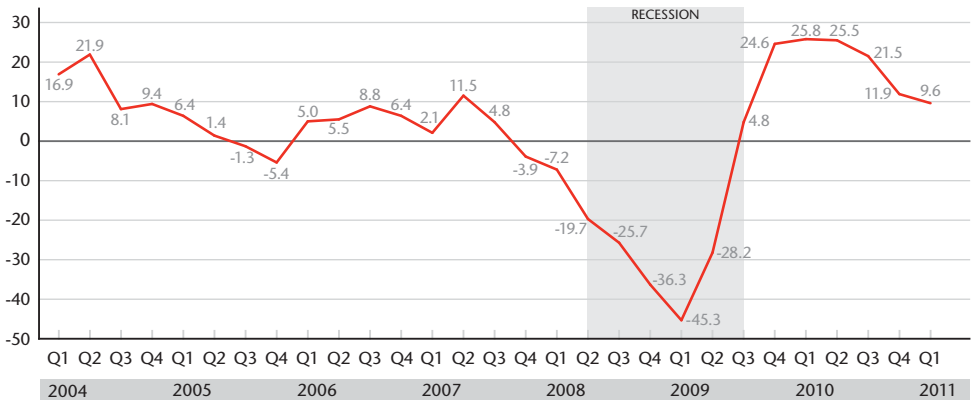
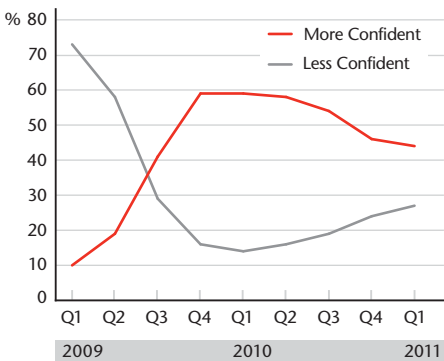


FIG. 2 CONFIDENCE INDEX – DETAILED RESPONSES



The latest ICAEW/Grant Thornton UK Business Confidence Monitor (BCM) shows a continuing downward trend in business confidence in Q1 2011. The Confidence Index has declined for the fourth consecutive quarter, weakening from 11.9 in Q4 2010 to 9.6 in Q1 2011, although the pace of decline slowed noticeably this quarter. The Index is gradually returning to levels typically seen before the financial crisis.

## CONFIDENCE INDEX RETURNS TO PRE FINANCIAL CRISIS LEVELS

The latest findings from BCM show the Q1 2011 Confidence Index has fallen to 9.6, marginally (2.3 points) down on last quarter. The overall proportions of businesses less confident and more confident about the coming 12 months remained fairly consistent between Q4 2010 and Q1 2011, although the longer-term trend demonstrates how dramatically the outlook for business has changed over the last two years.

The Confidence Index fell significantly during the economic downturn, and then rose sharply in Q3 2009, signalling the end of the recession.

Between Q4 2009 and Q3 2010 the Confidence Index reached historic highs, but it has subsequently fallen back, showing signs of levelling off this quarter. This return to pre financial crisis levels is to be expected as the UK economy moves further away from the economic downturn and business prospects return to some degree of normality.

PACE OF DECLINE IN CONFIDENCE SLOWS • SOME DEGREE OF NORMALITY RETURNS TO BUSINESS PROSPECTS

**FIG. 3 FORECAST OF QUARTERLY GDP GROWTH BASED ON ICAEW CONFIDENCE INDEX**



A surprise fall in GDP at the end of 2010 has led to renewed fears of a double-dip recession. Preliminary estimates from the Office for National Statistics (ONS) showed the economy contracting by 0.5% quarter on quarter in Q4 2010, which took almost everyone by surprise. Even excluding the effects of the snow, the ONS estimates that economic growth was flat in the final quarter.

### CONFIDENCE INDEX SUGGESTS RETURN TO GROWTH IN Q1 2011

The ONS published its first estimate of Gross Domestic Product (GDP) for Q4 2010 in January, showing a quarter-on-quarter contraction of 0.5%. This was much worse than analysts had expected. The snow at the end of the year clearly had a negative impact on output. However, the ONS estimates growth was flat even if these weather effects are excluded, suggesting the recovery lost all momentum at the end of the year.

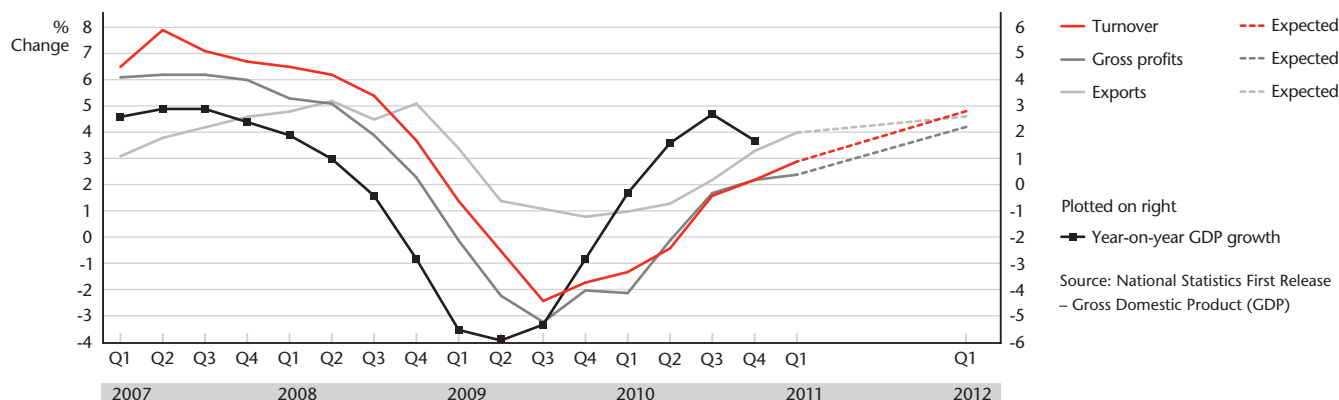
The Confidence Index points to positive quarterly growth in Q1 2011, rather than there being a return to

recession (defined as two consecutive quarters of negative quarterly growth). The poor performance of the economy at the end of last year may actually produce a stronger growth picture in Q1. Sectors most affected by the adverse weather in 2010, such as Construction, could show significant expansion as projects delayed by the snow resume. However, there are clearly downside risks too, with VAT at 20% and pressures on real income as the cost of living rises in a climate of pay constraint.

Q4 GDP CONTRACTION A SURPRISE • EVEN WITHOUT EFFECT OF DECEMBER SNOW, ECONOMIC GROWTH FLAT

# BUSINESS FINANCIAL PERFORMANCE

FIG. 4 AVERAGE % CHANGE OVER 12 MONTHS TO...



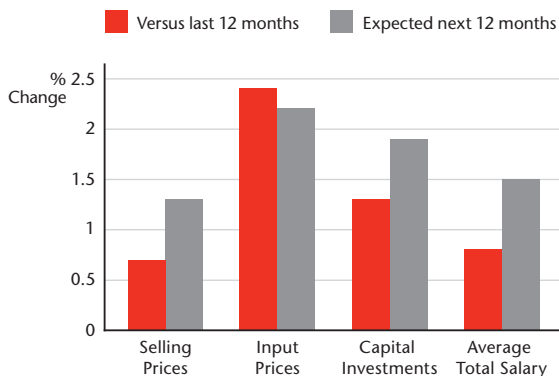
**Business financial performance continues to improve in Q1 2011.** The latest BCM financial performance indicators show continuing improvement in businesses' financial results. Annual growth rates for turnover, profits and exports performance all strengthened in Q1 2011 compared to the previous quarter, and stand at their highest rates since the end of 2008.

## EXPORT GROWTH CONTINUES TO STRENGTHEN

Q1 2011 marks the third consecutive quarter with annual export growth outstripping growth in all other key performance indicators tracked by BCM. This will bolster hopes of an export-led recovery emerging over this year. In Q1 2011, businesses report exports have grown by 4.0% over the last year. This is the highest annual growth rate since the last quarter of 2008. Moreover, exports are expected to continue to grow, by 4.6% over the next 12 months – up from 4.3% in the previous quarter and the highest expected export growth rate since Q1 2008.

The strong outlook for exports reflects the tailwind from which the economy is benefiting as a result of the ongoing relatively low value of sterling. This is making UK products and services more price-competitive in global markets. Exports will be particularly important in 2011, given that domestic demand is likely to be very weak as government demand is withdrawn and households continue to face squeezed real incomes amid high inflation and weak earnings growth.

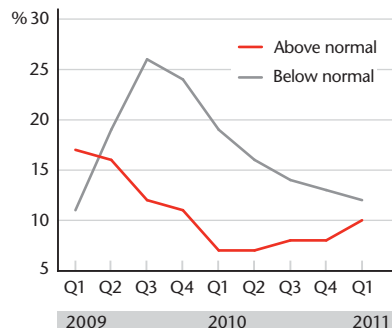
**FIG. 5 Q1 2011 – AVERAGE % CHANGE IN...**



Stock levels are returning to normality, driven by the inventory cycle. The proportion of businesses in the Manufacturing, Construction and Transport sectors reporting stock levels below normal has fallen steadily over the last year, from nearly one in five (19%) in Q1 2010 to just over one in ten (12%) in Q1 2011. Businesses have rebuilt stocks which they ran down during the economic downturn. This will have given a short-term boost to economic growth which may now be at an end.

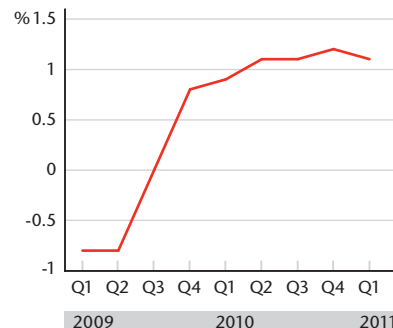
**FIG. 6 STOCK LEVELS – RAW MATERIALS AND COMPONENTS**

Manufacturing, Construction and Transport sectors



**FIG. 7 EXPECTED % GROWTH IN HEAD COUNT**

Next 12 months



## SOARING INPUT PRICES CONTINUE TO PLACE PRESSURE ON FIRMS

In Q1 2011 firms report an average annual increase in input prices of 2.4%, the highest since Q1 2009 and up from the 1.6% increase reported in Q4 2010. The rising price of inputs will place a squeeze on margins, and firms are likely to be facing difficult decisions about whether or not to pass on these cost rises to customers.

The upward movement in input price inflation mirrors movements in international commodity markets. The price of oil has been creeping upward, and Brent crude broke the \$100 per barrel mark recently. Price pressures also remain in

so-called 'soft' commodity markets, with futures prices of wheat and cotton remaining elevated after poor harvests in 2010.

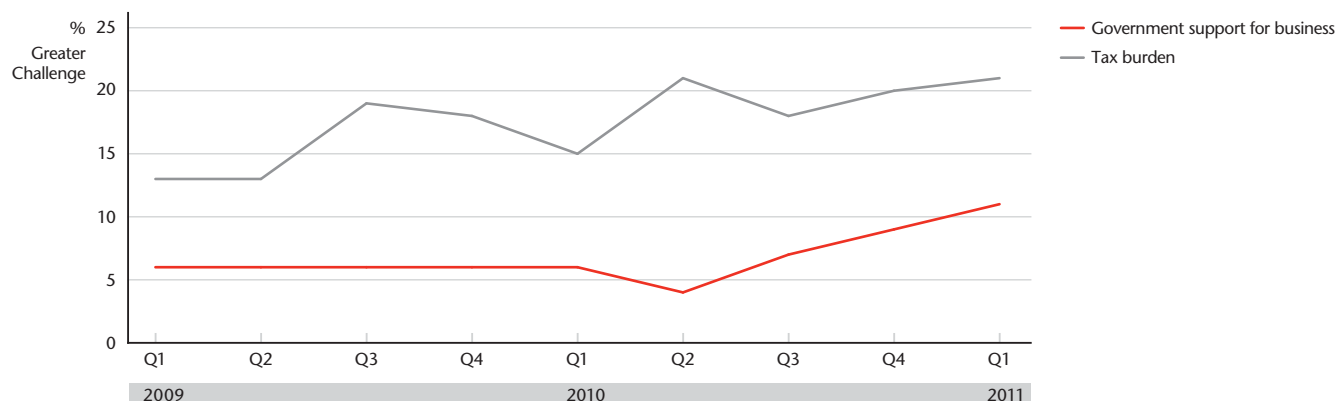
Business average expected employment growth for the coming year is unchanged this quarter, at 1.1%. This would imply at least 100,000 new private sector jobs created in 2011, although it remains to be seen whether or not these will be full-time permanent jobs rather than part time or temporary.

INPUT PRICE GROWTH HIGHEST SINCE Q1 2009 • AT LEAST 100,000 NEW PRIVATE SECTOR JOBS IN 2011



# FACTORS AFFECTING BUSINESS FINANCIAL PERFORMANCE

**FIG. 8** IMPACT ON ORGANISATION'S PERFORMANCE – CHANGE VERSUS 12 MONTHS AGO (UK AVERAGE)



BCM suggests more needs to be done to support private enterprise. The proportion of businesses reporting the tax burden as a greater challenge to performance than 12 months ago is up compared to last year, and concerns about government support for business have also increased.

## POLICY MAKERS MUST SUPPORT PRIVATE SECTOR GROWTH

This quarter 21% of businesses report the tax burden as a greater challenge to performance than 12 months ago, up from 15% at the start of 2010. Only 2% report it to be less of a challenge. In addition, 11% of firms now report government support for business as a greater challenge than 12 months ago – up from 6% last year.

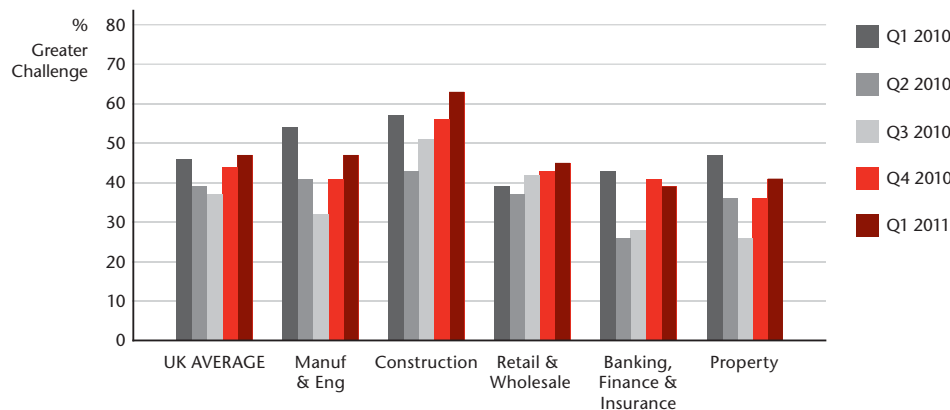
The government has already made some headway in moving towards a tax regime which is conducive to private enterprise. The announcement in the June 2010 Budget that the rate of corporation tax will fall from 28% to 24% – the lowest corporation tax

rate in the G7 group of nations – over the next four years will be seen as a welcome move in the right direction. However, firms are still looking to the government for further progress towards an environment which is conducive to private sector expansion, especially as the onus will be on the private sector to provide jobs and income for the UK economy over the coming years.

MORE FIRMS REPORT TAX BURDEN A GREATER CHALLENGE • REDUCED CORPORATION TAX WILL BE WELCOME



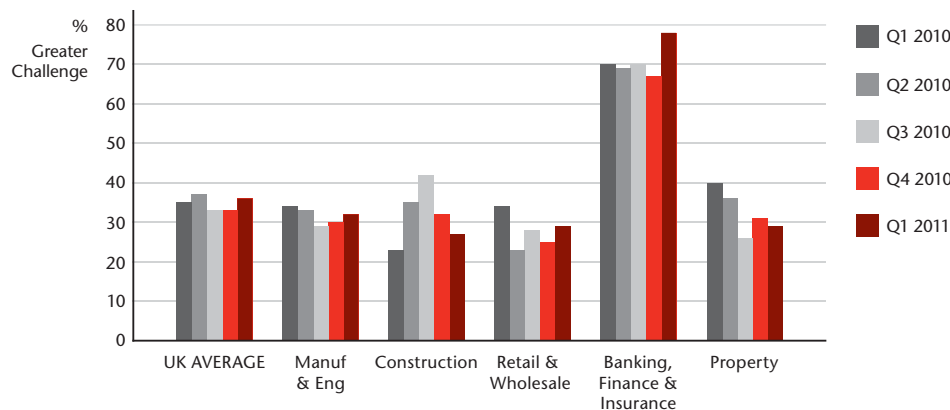
**FIG. 9 CUSTOMER DEMAND – CHANGE VERSUS 12 MONTHS AGO**



## DWINDLING PUBLIC SECTOR CONTRACTS STOKE FEAR IN CONSTRUCTION SECTOR

The proportion of UK businesses reporting customer demand to be a greater challenge than a year ago continues to rise, reflecting ongoing concerns that pressures on consumer spending are likely to curtail demand. This trend is particularly marked in the Construction sector. Further, over half of Construction sector businesses (55%) report competition in the market place to be a greater challenge than 12 months ago; this is understandable given the diminishing pool of public sector contracts available due to fiscal consolidation.

**FIG. 10 REGULATORY REQUIREMENTS – CHANGE VERSUS 12 MONTHS AGO**

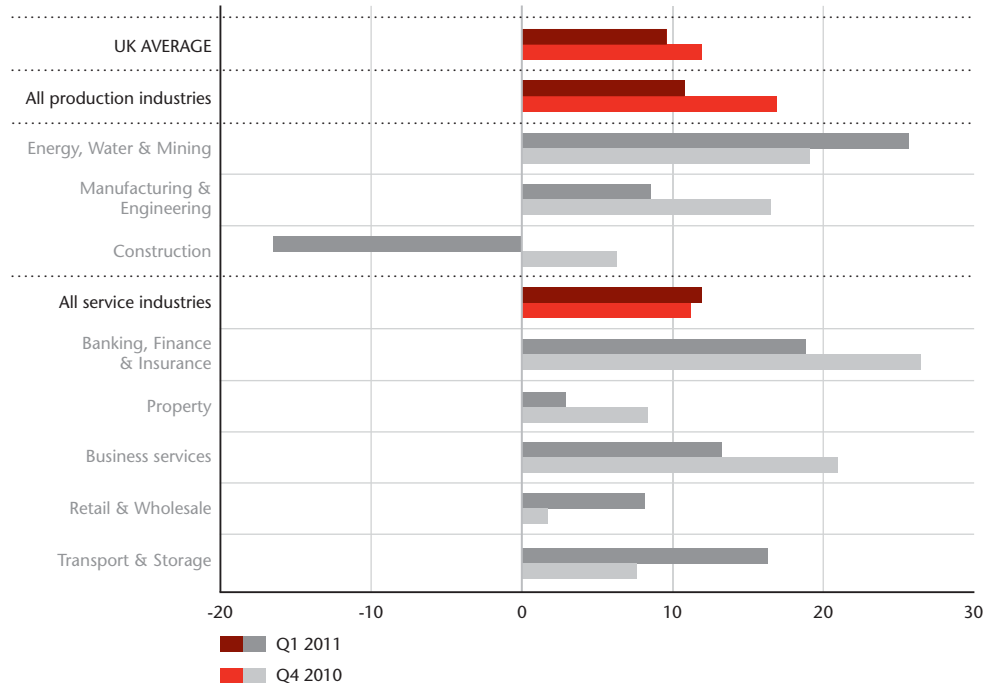


This quarter, businesses in Banking, Finance & Insurance are particularly likely to report regulatory requirements as a greater challenge than a year ago. The financial services sector remains important to the UK economy, contributing about 8% to total GDP. Concerns in the sector over increasingly stringent regulatory requirements represent a risk to the economy, as they could trigger banks to move their headquarters to more favourable regimes. Ongoing calls for government intervention on bank bonuses and lending to businesses are also likely to be fuelling bankers' concerns.

# TRENDS IN BUSINESS CONFIDENCE

## INDUSTRY

FIG. 11 TREND OF BUSINESS CONFIDENCE BY INDUSTRY



Confidence continues to vary somewhat across sectors, although last quarter's marginal divergence between production and service industries has not developed into a more definite trend. While the Confidence Index has moved marginally up in some sectors and marginally down in others, the only really notable movement this quarter is in Construction, where confidence has returned to negative territory.

### CONFIDENCE VARIABLE WITHIN SERVICE SECTOR

Across the service sector as a whole confidence is largely unchanged this quarter, following a sharp nine point decline at the end of last year. This indicates some degree of stabilisation in the sector as economic conditions gradually recover. There are, however, variations in confidence within the service sector. Among the Banking, Finance & Insurance, Property and Business Services sectors confidence will be significantly down next quarter if this quarter's directional shifts develop into a real trend, while in Retail & Wholesale and Transport & Storage – sectors which were relatively weak last quarter – a more positive trend may be emerging.

It is unclear why confidence in the Manufacturing & Engineering sector has continued to weaken, given that recent GDP statistics continue to point towards robust growth in Manufacturing. While the overall economy is estimated to have contracted at a quarterly rate of 0.5% in Q4 2010, the Manufacturing sector expanded by 1.4%. Growing concerns about reductions in public sector business may be a factor here.

**FIG. 12 TREND OF BUSINESS CONFIDENCE BY INDUSTRY**



**For most sectors, confidence is notably down on a year ago.**

The Confidence Index for Construction has fallen by 40 points since Q1 2010, and by 16 points among Production Industries overall and 14 points among Service Industries. The predominant driver of this pattern is that 2009 was, economically speaking, much worse than 2010. Consequently, businesses in 2011 are now comparing future business prospects against a more favourable base year.

## CONSTRUCTION SECTOR CONFIDENCE COLLAPSES

Confidence in the Construction sector has fallen sharply this quarter, from 6.3 in Q4 2010 to -16.5 in Q1 2011.

The bad weather at the end of 2010 is likely to have temporarily weakened business sentiment in the sector, although ongoing concerns about the implications of fiscal consolidation on revenue streams dependent on public sector investment are almost certainly the greatest driver of this extremely negative outlook for the sector.

Confidence remains high among Energy, Water & Mining businesses this quarter. This probably reflects

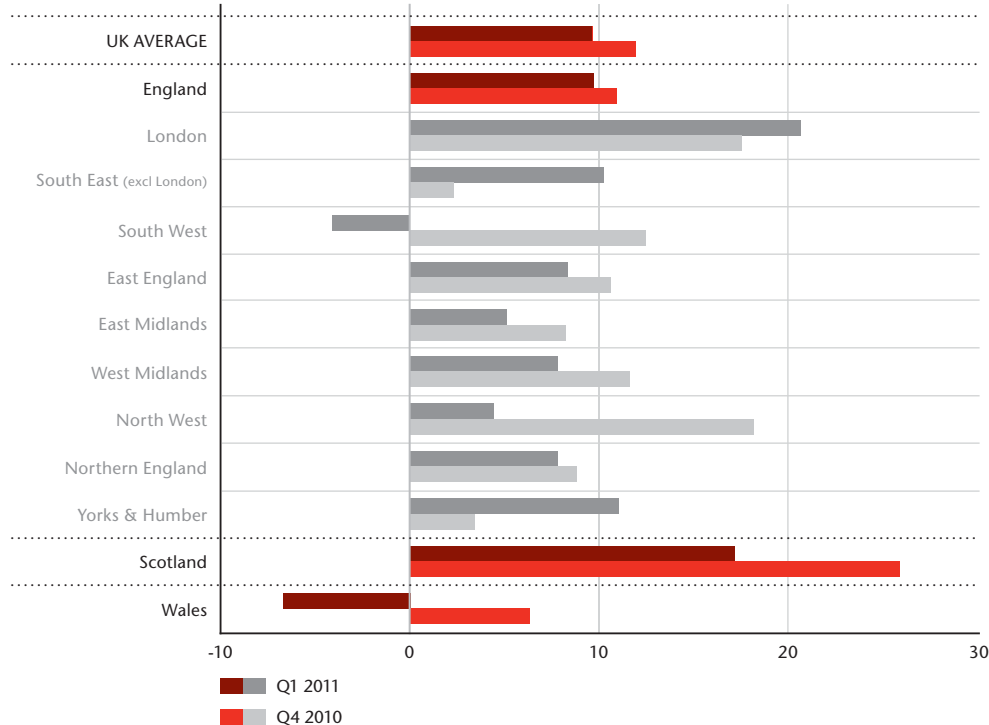
continued robust export growth in the UK economy, the continued weak value of sterling and the upward trend in the price of hard and soft commodities leading to increased profit margins for many firms in this sector – particularly those in the mining industry.

CONFIDENCE AMONG CONSTRUCTION FIRMS NOW NEGATIVE • ENERGY, WATER & MINING SECTOR POSITIVE

# TRENDS IN BUSINESS CONFIDENCE

## REGION

FIG. 13 TREND OF BUSINESS CONFIDENCE BY REGION



Trends in the BCM Confidence Index show some regional variation, although the longer-term trend is common across the country, with confidence significantly weaker than last year in most regions. There are negative movements in confidence this quarter for three regions: the South West, the North West and Wales, while the outlook of firms in London and Scotland is relatively strong, as was the case at the end of 2010.

### CONFIDENCE REMAINS STRONG IN LONDON AND SCOTLAND

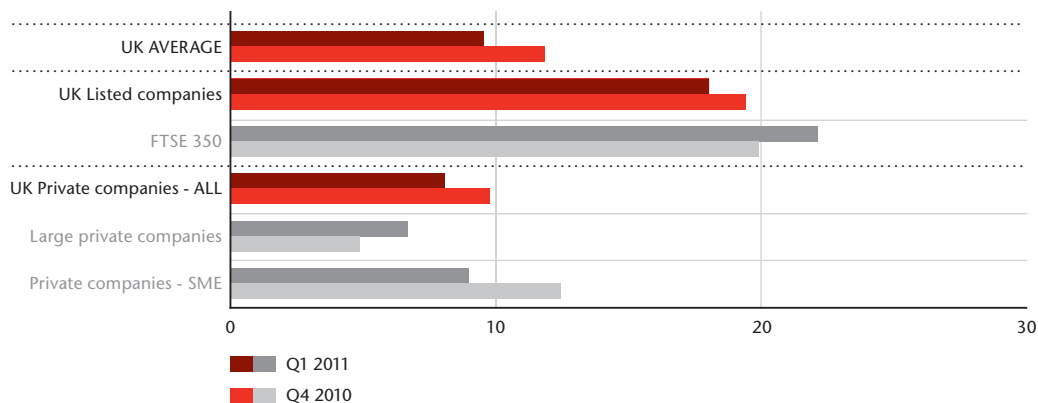
The Banking, Finance & Insurance sector is particularly important to London's economy, and positive sentiment in this sector is contributing to the generally buoyant outlook. London is also less dependent on the public sector, with public sector spending constituting only around 35% of GDP compared to nearly half (48%) for the UK as a whole. Moreover, London service sector firms tend to be more globalised in outlook than is typical across the whole economy, so may be less concerned about weak domestic demand expected over the coming years.

Financial services are also an important part of the Scottish economy, particularly in Edinburgh. However, here exposure to the public sector is also relatively high. Confidence remained relatively robust in Scotland throughout 2010 as the national government worked hard to guard against the worst effects of UK-wide fiscal belt tightening. However, compared to the middle of last year confidence is now significantly weaker as the potential impact of the cuts comes into sharper relief.

# TRENDS IN BUSINESS CONFIDENCE

## TYPE

FIG. 14 TREND OF BUSINESS CONFIDENCE BY COMPANY TYPE



As with last quarter, listed companies record higher confidence than private companies. While the Confidence Index is 18.1 for listed companies in Q1 2011, it is only 8.1 for private firms.

### CONFIDENCE REMAINS WEAKER FOR PRIVATE COMPANIES

This quarter, confidence among private companies remains below that of listed companies. Listed companies are more likely than private firms to be internationalised. Operating internationally, their fortunes are less closely tied to UK economic trends, so they will be less exposed to the impact of the weakening UK domestic demand which is expected over the years ahead.

The less positive outlook among private firms may also relate to their greater reliance on bank finance than is the case for listed firms.

According to the Bank of England's January *Trends in Lending* report, access to bank finance remains historically tight, with credit conditions tighter for small businesses than for large corporates. However, other research by ICAEW has established that SME 'demand for debt finance remains muted and is not expected to rise dramatically in the short to medium term while businesses continue to tread water'.

LISTED FIRMS' CONFIDENCE STILL ABOVE AVERAGE • CREDIT TIGHT BUT SME DEMAND FOR FINANCE MUTED

# ABOUT BCM

BCM is one of the largest and most comprehensive quarterly reviews of UK business confidence and provides a regular snapshot of the economy, informed by senior business professionals running all types of businesses across the UK. It is shared with a range of national and regional policy-makers, the business community, academics and researchers. It is a credible predictor of GDP and economic change and supports policy decision-making.

The report is based on 1000 telephone interviews conducted 25 October 2010 – 26 January 2011, with ICAEW members working in industry and commerce. These probed opinions on past performance and future prospects for members’ businesses, as well as investigating perceived changes in impact of factors such as availability of skills, government regulation and the tax regime. Data are weighted to represents the UK economy by value.

## BUSINESS CONFIDENCE INDEX METHODOLOGY

The Business Confidence Index is calculated from the responses to the following:

**‘Overall, how would you describe your confidence in the economic prospects facing your business over the next 12 months, compared to the previous 12 months?’**

A score was applied to each response as shown to the right, and an average score calculated.

Using this method, a Confidence Index of +100 would indicate that all survey respondents were much more confident about future prospects, while -100 would indicate that all survey respondents were much less confident about future prospects. Further technical details on the design of the survey are available upon request.

Variable	Score
Much more confident	+100
Slightly more confident	+50
As confident	0
Slightly less confident	-50
Much less confident	-100

# ACKNOWLEDGMENTS

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### Kudos Research

Interviewing and data analysis was undertaken by Kudos Research.

Kudos Research specialises in premium quality, custom-tailored UK and international data collection, as well as data analysis and research advisory services. Kudos Research interviews customers, stakeholders, business leaders and opinion formers across the globe, online and by telephone, as well as recruiting them for focus groups and depth interviews.

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