



UK BUSINESS CONFIDENCE MONITOR

Q4 2011



WELCOME



This quarter's ICAEW/Grant Thornton Business Confidence Monitor (BCM) reflects just how rocky things could become. In the first nine months of the year, businesses have played their part in supporting economic growth. Many of those I meet as I travel around the country are proud of how their businesses have held up against a backdrop of the sluggish economic recovery.

Despite this, what is clear is that the outlook for businesses is becoming increasingly uncertain. They are becoming increasingly worried about the risk of a double dip recession. This is making them more cautious in their planning and they are holding back on decisions on hiring and investing. While the situation is worrying, despair is not the answer. Instead we need to look at how to reverse this fall in confidence. In particular, government must now show that it understands the need to rapidly change the mood music that the business community clearly feels.

A handwritten signature in black ink that reads "Michael Izza". The signature is fluid and cursive, with the first name "Michael" and the last name "Izza" clearly distinguishable.

Michael D M Izza
Chief Executive
ICAEW



BCM highlights the extent of negative sentiment in the UK economy with underlying business performance indicators showing confidence dropping across our regions and sectors. The slump in consumer demand and the on-going crisis in the eurozone will take a toll and the central question is around the resilience of domestic and international markets.

Yet it gives me some reassurance that among our clients, many dynamic, private and smaller-listed companies continue to do well and outperform the market. No-one is pretending that there aren't very real problems in the global economy and therefore businesses need to look closely at their own individual circumstances and assess the threats but also make the most of the opportunities that are open to them while keeping a close eye on cost and efficiency. 2012 is set to be another challenging year but it is business that will drive recovery and create employment, and we will be doing everything we can to support its future growth.

A handwritten signature in black ink that reads "Scott Barnes". The signature is written in a cursive style with a long, horizontal flourish at the end.

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 suffered its largest quarterly decline since the survey began in 2004. The Confidence Index is at its lowest level since the depths of recession in 2009.


BCM is a good indicator for overall growth in the economy; it correctly predicted the end of the recession in 2009, provided early warning signs in 2007–8 and pointed to modest positive growth in Q3 2011. This quarter's sharp drop in confidence among businesses implies that the economy is likely to contract by 0.2% in the final quarter of 2011. As such, growth for 2011 would come in at 0.9%, against the 1.7% Office for Budget Responsibility (OBR) projection in March.

KEY ISSUES EMERGING THIS QUARTER

- Turnover and profit growth expectations have now declined for two successive quarters; providing firm evidence on top of the Confidence Index that overall growth is slowing.
- Both reported and expected export growth have fallen back in Q4 2011, suggesting the UK's export-led recovery is being hit by turbulence in key export markets.
- Firms are increasingly cautious about capital expenditure in the ever more uncertain economic environment.
- Businesses expect both input and selling price growth to ease, supporting the Bank of England's view that inflation will fall back in 2012.

Recently the world economic backdrop has deteriorated significantly. The eurozone crisis rumbles on without a clear solution, growth indicators have worsened, major concerns of another liquidity and capital crisis continue to build, and market sentiment has nosedived through the quarter. It is clear that global growth has slowed in the second half of 2011, and growth in 2012 as a whole is likely to be lower than 2011. However the picture will vary considerably across the globe, with some glimmers of hope from better recent performance in the US and growth in emerging markets still relatively strong.

On the upside, slowing global growth should ease commodity prices, which will help businesses and hard-hit consumers alike. However, in the UK sluggish economic growth is likely to deteriorate into contraction, so further asset purchases from the Bank of England could well be possible on top of the £75bn announced in October.



Douglas McWilliams
Chief Executive, cebr
ICAEW Economic Partner

BUSINESS CONFIDENCE IN Q4 2011

FIG. 1 TREND OF UK BUSINESS CONFIDENCE



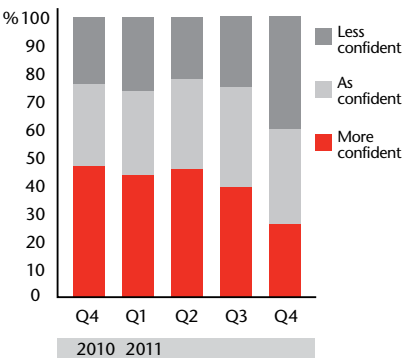
The latest ICAEW/Grant Thornton UK Business Confidence Monitor (BCM) shows business confidence has declined by the largest amount in one quarter since BCM began in 2004. The Confidence Index stands at -9.7 in Q4 2011, down from 8.1 in Q3 and the lowest level since Q2 2009 when the UK was still in recession. Most striking is the fact that the quarterly decline is greater than any seen in the lead up to and during the recession itself in 2008–9.

CONFIDENCE INDEX IN SHARPEST EVER QUARTERLY DROP

The latest findings from BCM show the Confidence Index has fallen steeply to stand at -9.7 in Q4 2011, down by 17.8 points from the previous quarter and 21.6 points from a year earlier. Business confidence has now declined for two successive quarters. Worryingly, the quarterly decline is the largest since BCM began in 2004. The previous largest quarterly drop was 12.5 points in Q2 2008 – the first quarter in which the UK economy contracted in the 2008–9 recession.

While there has been a trend decline in the Confidence Index following the

FIG. 2 UK CONFIDENCE INDEX - DETAILED RESPONSES

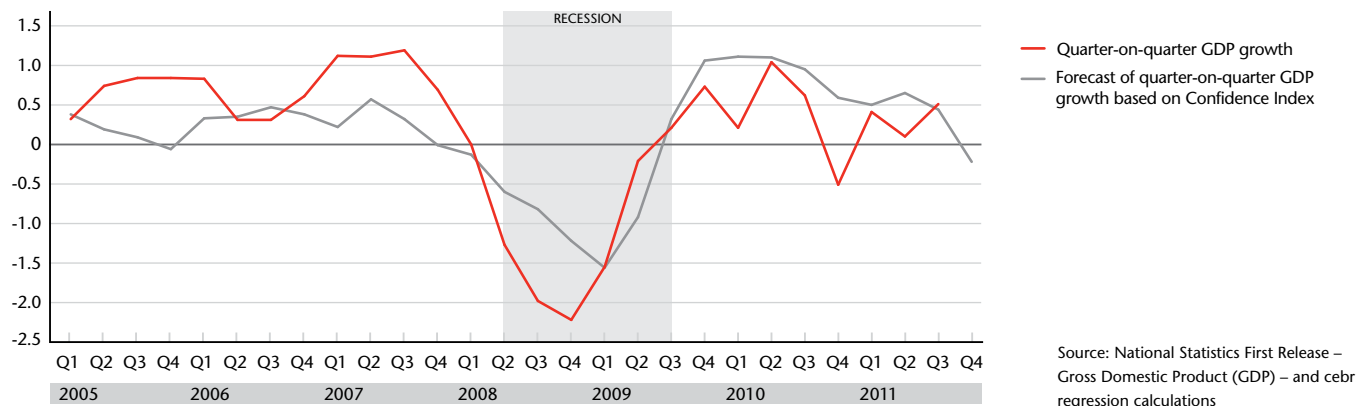


post-recession bounce-back, the large quarterly decline implies business sentiment has worsened markedly in recent months. The decline in confidence followed the steepest quarterly fall in the FTSE 100 in nine years, as concerns over the eurozone debt crisis mounted.

The overall share of businesses more confident about the coming 12 months has dropped by 13 percentage points to just over one in four businesses (26%) while the share less confident surged to two in five, up some 15 percentage points from the previous quarter.

BUSINESS SENTIMENT HAS WORSENERD MARKEDLY • BCM'S LARGEST EVER QUARTERLY FALL IN CONFIDENCE

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



The UK economy grew slightly faster than expected in Q3 2011, albeit still below long-run trends and following very weak growth in Q2.

Preliminary estimates from the Office for National Statistics (ONS) show the economy grew by 0.5% quarter on quarter in Q3 2011, following 0.1% growth in Q2. As an illustration of the sluggish pace of growth over the last year, the economy grew by just 0.5% between Q3 2010 and Q3 2011.

BCM SUGGESTS STRONG CHANCE OF NEGATIVE GROWTH IN Q4

Economic growth was stronger in Q3 2011 than in Q2, at 0.5% quarter on quarter. While an improvement from the marginal growth in Q2, this is still below the long-run trend for the UK economy. BCM was pointing to growth of around 0.4% in Q3, so the outturn was broadly in line with expectations. Looking ahead, this quarter's sharp drop-off in the Confidence Index points to negative growth in the UK economy in Q4 2011.

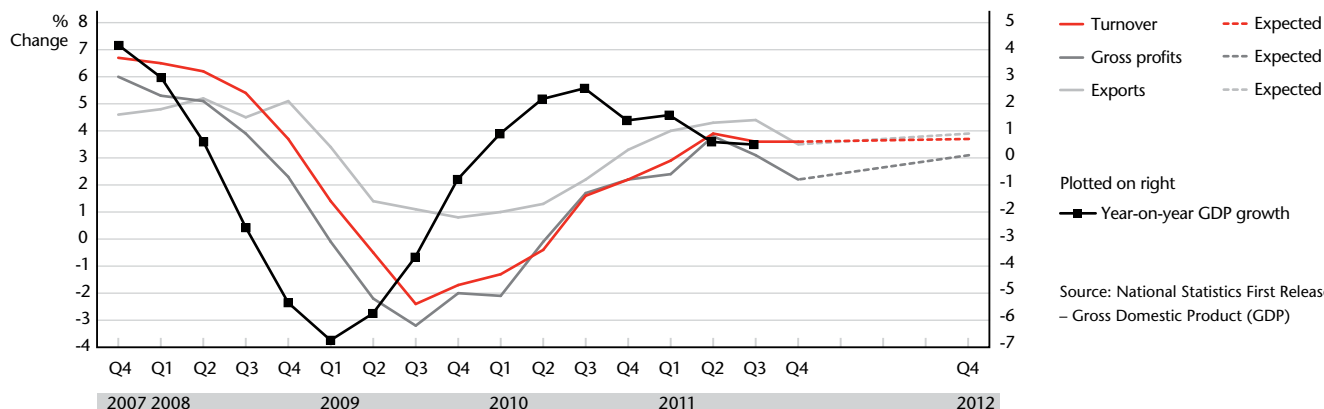
The Q4 2011 Index points to a 0.2% contraction in GDP; the last time the

Confidence Index was in negative territory the economy contracted by 0.2% quarter on quarter. Indeed, whenever the Confidence Index has been as low as, or lower than the Q4 2011 level the economy has contracted. Further, the record quarter-on-quarter decline in the Confidence Index suggests a significant deterioration in the economic outlook. If the UK economy performs in Q4 as predicted by BCM, it will have grown by just 0.9% in 2011 compared with the OBR's March projection of 1.7% growth.

ECONOMIC GROWTH STILL BELOW LONG-RUN TREND • BCM SUGGESTS JUST 0.9% GROWTH ACROSS 2011

BUSINESS FINANCIAL PERFORMANCE

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



Key indicators point to a deterioration in business performance in Q4 2011, making it the second successive quarter that performance has weakened.

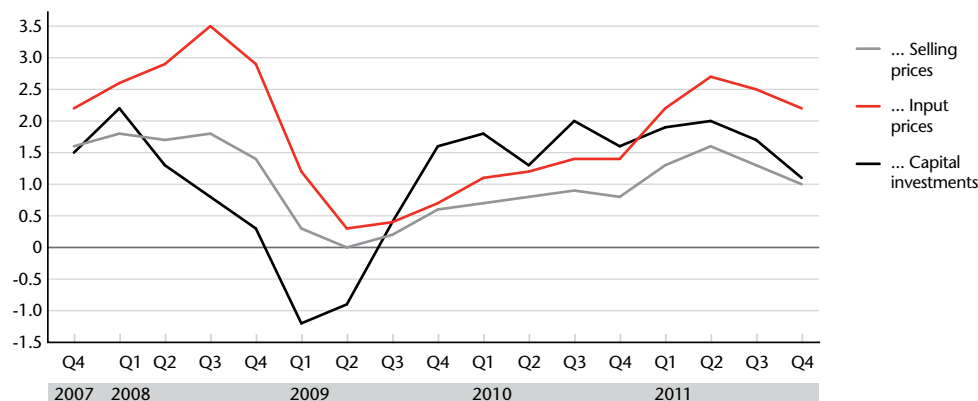
Gross profits grew by 2.2% in the 12 months to Q4 2011, the weakest performance since Q4 2010, while reported turnover growth stood still at 3.6%. Further, expectations for growth over the next 12 months have declined noticeably and moved closer to reported growth, suggesting a weakening outlook.

EXPORT GROWTH SLOWS AS KEY INDICATORS DROP BACK

The main indicators of business performance point to a tough trading environment in Q4 2011. Reported profit growth weakened more this quarter than at any point since Q3 2009, when the economy had only just emerged from recession. Expectations for growth over the next 12 months have also fallen back significantly. Importantly, the gap between profit growth expected over the next 12 months and that reported over the previous 12 months is smaller than it has been since Q1 2009.

Against a backdrop of declining real incomes for consumers, and government spending cuts beginning in earnest this financial year, the role of export growth is increasingly salient to the rebalancing of the UK economy. It is therefore of concern that although firms remain hopeful that growth in exports will be maintained over the coming 12 months at levels close to those typical before the recession, reported export growth has weakened considerably this quarter, falling from 4.4% to 3.5%.

FIG. 5 AVERAGE EXPECTED % CHANGE IN ... Next 12 months



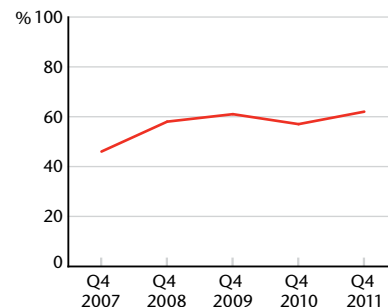
The latest BCM data show a sharp drop in businesses' expected capital investment growth. Businesses expect capital investment growth at 1.1% over the next 12 months, down from 1.7% in Q3 2011 and the lowest expected growth since Q3 2009. This is the sharpest drop in capital investment growth expectations between quarters since Q1 2009, as firms become increasingly cautious about capital expenditure amid an increasingly uncertain economic environment.

SPARE CAPACITY HIGH; INFLATION EXPECTED TO EASE

While reported capital investment growth has picked up to the highest level since Q3 2008, the expectation that it will ease to its lowest level since 2009 is more relevant. Business investment had been expected to play a key role in driving growth as heavily indebted consumers and the government retrench.

Amid the weaker growth environment, the share of businesses running below capacity remains high at more than three in five firms (62%). A similar level of firms were operating below capacity when the economy was contracting in 2009, providing further evidence that the

FIG. 6 PROPORTION OF FIRMS RUNNING BELOW CAPACITY

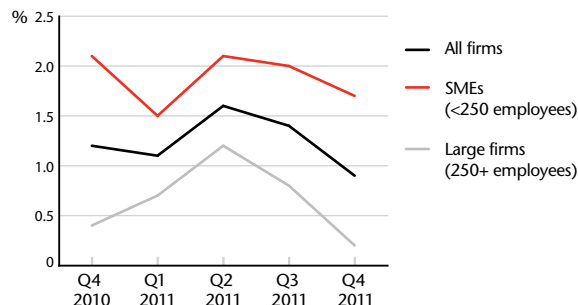


UK economy has failed to grow sufficiently to absorb spare capacity created by the recession.

Businesses expect lower price growth over the next year despite the current high level of annual inflation (at 5.2% on the consumer price index in September). Firms expect selling prices to rise by 1.0% over the coming 12 months. This is the second successive quarter of weakening price growth expectations. However, firms do expect input price inflation to continue to fall back; expected growth in input prices has also declined for the second quarter in succession.

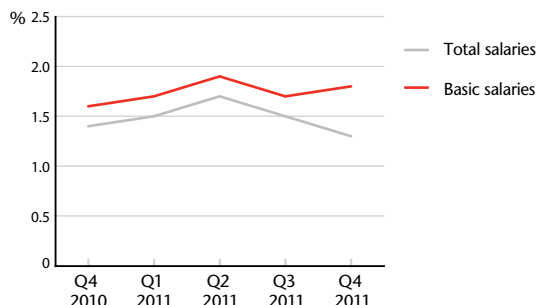
FIRMS ARE INCREASINGLY CAUTIOUS ABOUT CAPITAL EXPENDITURE • PRICE GROWTH EXPECTED TO MODERATE

**FIG. 7 AVERAGE EXPECTED % CHANGE
IN EMPLOYEE NUMBERS** Last 12 months



This quarter firms report the strongest growth in employment since Q3 2008. However, expectations for growth in headcount over the coming 12 months have weakened sharply. Over the last 12 months, employee numbers grew on average by 1.1%, an improvement on the 0.4% decline reported a year earlier. However, with business confidence declining, firms expect employment to grow by 0.9% over the next 12 months, compared to a forecast 1.4% increase for the 12 months from Q3 2011.

**FIG. 8 AVERAGE EXPECTED % CHANGE
IN SALARIES** Last 12 months



LABOUR MARKET LIKELY TO WEAKEN

Firms are more cautious about increasing headcount than they were last quarter. This quarter's expected rise in employment is the lowest since Q1 2010. However, the story varies notably across different sizes of firms.

Large firms (with at least 250 employees) expect employee numbers to rise by just 0.2% over the next 12 months, down from 0.8% expected growth in Q3 2011. In contrast, SMEs – which account for roughly 60% of private sector employment in the UK economy – expect to expand their headcount by 1.7%. This suggests

SMEs will account for more new jobs in the private sector than larger firms over the next 12 months.

The weakening trend in expected private sector employment growth, alongside the public sector cutting jobs – public sector employment declined by 111,000 in Q2 2011 – implies unemployment is likely to rise further. This is contributing to limiting labour cost inflation, as total salary growth is expected to be 1.3% over the next year, compared with 1.4% a year earlier and still well down from typical pre-recession levels.

FACTORS AFFECTING BUSINESS FINANCIAL PERFORMANCE

FIG. 9 CUSTOMER DEMAND – CHANGE VERSUS 12 MONTHS AGO



This quarter over two fifths (43%) of businesses report customer demand to be a greater challenge to their financial performance than a year ago. There is little variation on this between the three broad sector groupings. The share of Construction sector firms reporting customer demand to be a greater challenge is lower than the recent trend.

CUSTOMER DEMAND REMAINS A KEY CHALLENGE

Businesses have been consistently concerned at the level of customer demand during and since the recession, and this remains one of the predominant concerns in Q4 2011. Compared with the previous quarter, the overall share of businesses reporting customer demand to be a greater challenge to performance is flat at 43%, both overall and for Production and Service Industries.

Notably, the share of businesses reporting customer demand to be a greater challenge to performance tends to be negatively correlated with economic growth. Hence, the

fact that the share of businesses reporting customer demand to be a greater challenge remains similar to the previous quarter provides further evidence of a weak growth environment.

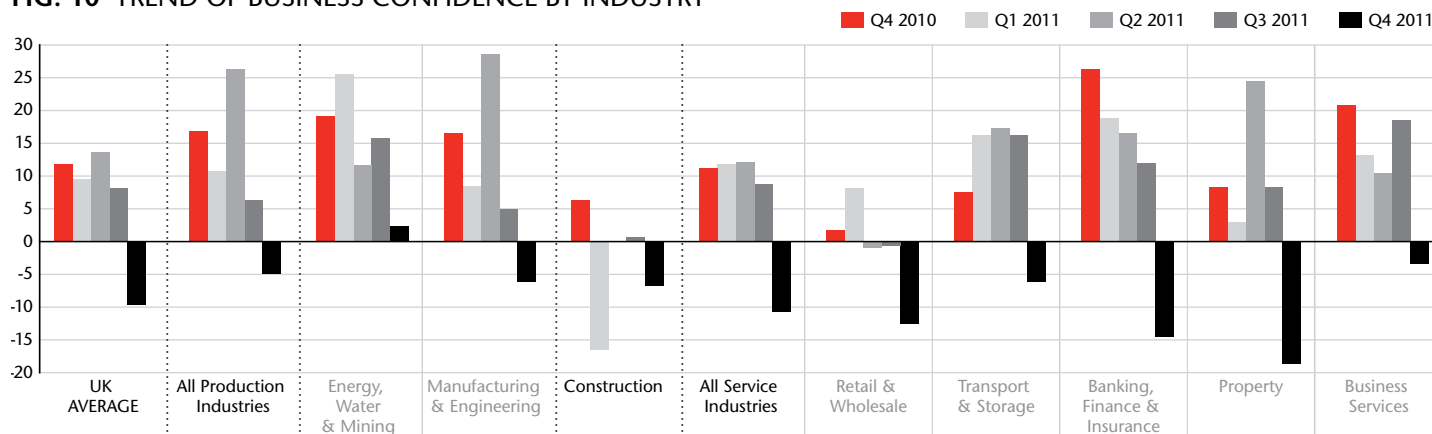
There has been a marked decline in Construction sector businesses reporting customer demand to be a greater challenge to performance. However, given the continued low levels of house building, lower public sector spending and businesses' lower expected investment growth, it remains to be seen whether the outlook for the sector is genuinely improving.

CUSTOMER DEMAND STILL MAJOR CONCERN • FURTHER EVIDENCE OF WEAK GROWTH ENVIRONMENT

TRENDS IN BUSINESS CONFIDENCE

INDUSTRY

FIG. 10 TREND OF BUSINESS CONFIDENCE BY INDUSTRY



There has been a broad-based decline in business confidence across all sectors of the economy, with the steepest falls in the Banking, Finance & Insurance and Property sectors. The Confidence Index now stands in negative territory in every sector except Energy, Water & Mining, which continues to benefit from high commodity prices. Not since the start of the recession in Q2 2008 has the Confidence Index declined over the quarter across every sector.

FINANCIAL SERVICES SUFFERS STEEP DROP IN CONFIDENCE

The Banking, Finance & Insurance sector suffered the seventh quarterly decline in the last eight quarters in its Confidence Index, making the sector the second least confident. Following the steepest drop in equity markets in nine years through Q3 2011, an array of announcements of poor results in the sector, the Independent Commission on Banking's recommendations on increased capital requirements and the ongoing sovereign debt crisis in the eurozone, the Banking, Finance & Insurance sector has suffered the steepest quarterly decline in its

Confidence Index on record. The 26.6 point fall surpasses the 17.4 point decline in Q4 2007 in the early stages of the financial crisis.

Confidence has fallen just as sharply in the Property sector, with a 27 point drop in the Confidence Index through the quarter to -18.7. Property is now the least confident sector of all.

Sentiment in the Retail & Wholesale sector remains weak, with the Confidence Index at -12.5 as consumers face declines in real income – a result of the annual rate of inflation running at more than double earnings growth.

CONFIDENCE NEGATIVE IN EVERY SECTOR BUT ONE • FINANCIAL SERVICES CONFIDENCE SEES RECORD FALL

FIG. 11 TREND OF BUSINESS CONFIDENCE BY INDUSTRY



Confidence has fallen sharply across the Service Industries in Q4 2011. Previously in 2011, Service sector firms had been relatively resilient overall, recording a positive Confidence Index for nine quarters in succession. This quarter's decline in confidence in the Service Industries is the largest on record: the 19.6 point decline surpasses the 13.3 point decline in Q2 2008 when the UK had just gone into recession.

STEEP FALL IN CONFIDENCE ACROSS SERVICE SECTOR

The steep decline in confidence among the Service Industries sees the Service Industries' Confidence Index dip to -10.8. This brings confidence marginally below the Construction sector (-6.8) and Production Industries (-4.9).

This is particularly significant since the Service sector was the main reason the economy recorded surprisingly strong growth at 0.5% quarter on quarter in Q3 2011, with a 0.7% quarterly expansion across the sector as a whole. A weak performance from the Service sector in Q4 would make it exceptionally hard for the economy as a whole to grow.

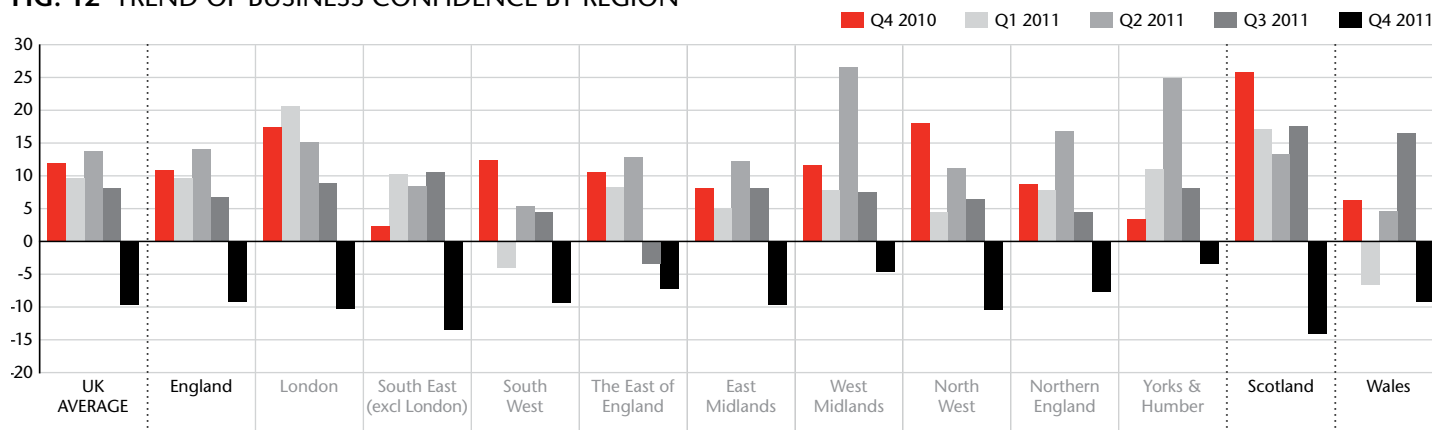
Notably, the Construction sector has experienced low confidence for much of the recent past, and Q4 2011 is the first time this year that confidence in the Construction sector has not been below the UK average. In Q4 2011 the Production Industries' Confidence Index has fallen into negative territory for the first time since Q3 2009, following an 11.3 point decline in confidence from Q3 2011; however, their Confidence Index had declined more steeply in the previous quarter. Within the Production Industries, the Manufacturing & Engineering sector Confidence Index stands at -6.1, the lowest score since Q2 2009.

PRODUCTION INDUSTRIES CONFIDENCE LOWEST SINCE RECESSION • MANUFACTURING SECTOR NOW NEGATIVE

TRENDS IN BUSINESS CONFIDENCE

REGION

FIG. 12 TREND OF BUSINESS CONFIDENCE BY REGION



Confidence has declined in every region and is now in negative territory throughout the UK. This is the first time since Q2 2009 – the final quarter of the recession – that the Confidence Index in every region has been in negative territory. Over the course of 2011 there have been particularly steep declines in confidence in Scotland and London, both regions where the financial services sector is significant for the regional economy.

BROAD-BASED DECLINE IN CONFIDENCE ACROSS THE REGIONS

This quarter confidence has declined across all regions. This has not been seen since the recession in 2008–9. The steepest decline was in Scotland, breaking a trend in which confidence has generally been higher than the rest of the UK.

The largest two regional economies in England – London and the South East – have both seen sharp declines in confidence. For the capital this continues a trend that started in Q3 2010, with confidence declining

in six of the last seven quarters. The London economy is likely to be hard hit by turbulence in financial markets and weak confidence in the financial sector. This is also likely to be playing a role in Scotland, since there is a significant financial services presence there too.

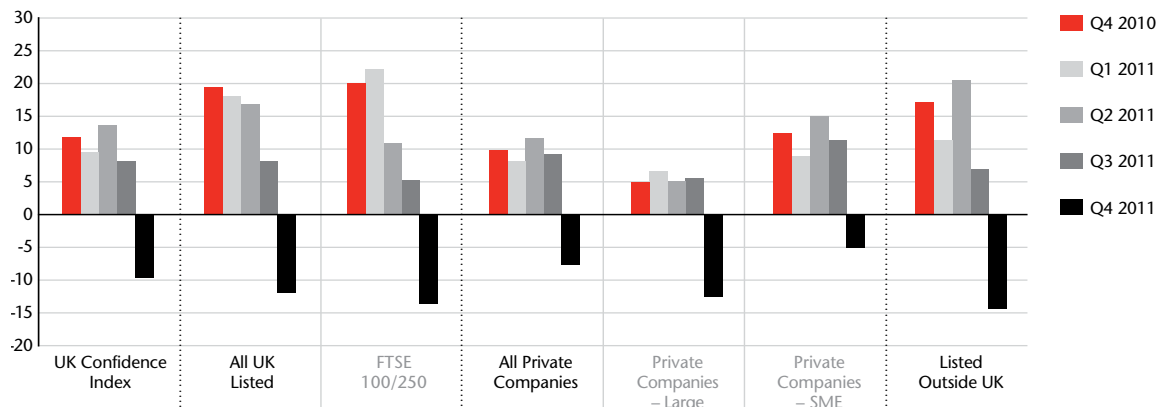
The North West and East Midlands have both suffered declines in their Confidence Index of more than 15 points, no doubt reflecting their focus on manufacturing.

CONFIDENCE INDEX NEGATIVE IN EVERY REGION • PARTICULARLY STEEP DECLINES IN SCOTLAND AND LONDON

TRENDS IN BUSINESS CONFIDENCE

TYPE

FIG. 13 TREND OF BUSINESS CONFIDENCE BY COMPANY TYPE



Confidence has weakened significantly for all types of business. Listed companies have seen a second consecutive steep decline in confidence. The Confidence Index for UK listed firms has dropped to -12.0, while confidence among those listed outside the UK has declined as severely, reaching -14.4. Both large and SME private companies have also seen a steep drop in confidence.

LISTED COMPANIES SUFFER STEEP DROP IN CONFIDENCE

Listed companies have seen a steep drop in confidence over the last two quarters. Confidence among FTSE 350 listed firms has declined by 33.7 points from Q4 2010 to Q4 2011. This compares with a decline of 17.5 points among private companies over the same period. Hence, listed companies are now generally less confident than private companies.

Within private companies, confidence has declined by a similar amount for both SMEs and larger firms since last quarter, so their position relative to each other remains unchanged, with SMEs marginally more positive.

CONFIDENCE NEGATIVE FOR ALL COMPANY TYPES • SMES MARGINALLY MORE POSITIVE THAN LARGER FIRMS

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 1,001 telephone interviews conducted 3 August – 27 October 2011, with ICAEW members working in industry and commerce. These probed opinions on past performance and future prospects for members’ businesses, and investigated perceived changes in impact of factors such as availability of skills, government regulation and the tax regime. Data are weighted to represent 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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