



UK BUSINESS CONFIDENCE MONITOR

Q1 2012



WELCOME



The first quarter of the 2012 *ICAEW/Grant Thornton Business Confidence Monitor* (BCM) indicates that this will be another year of uncertainty for businesses. While there has been no significant deterioration in business performance, BCM does reveal some threats to economic growth this year. Scaled-down investment plans, low increase in headcount and static exports are all disappointing in the context of what needs to happen for GDP to rise.

Of course, there are exceptions and some companies are doing very well – but tough times remain ahead for many. Consumer demand will continue to fall as people face little or no salary increases and public sector job losses have a bigger impact on employment figures. The private sector pick-up which the government is relying on is looking increasingly like wishful thinking. With no clear way out from the economic mire, the forthcoming Budget will need to give confidence to business and a sense of optimism about the future.

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

Michael D M Izza
Chief Executive
ICAEW



The key performance indicators in the BCM remain weak, and the concern for business is that domestic and international demand will remain low as we see unemployment continue to rise in 2012 and wages remain static. Exports remain an important factor for growth but, with the eurozone still in crisis, it is no surprise that businesses are shielding themselves from the potential risks of growing their overseas markets.

However, these figures are perhaps not as bad as many anticipated and, individually, many of the companies surveyed are anticipating growth, albeit on a very restricted level.

This mirrors the position in particular of many of the medium-sized businesses we serve; they are more confident that they will be able to ride out this storm than they are in the economy as a whole, and are playing it safe until a degree of stability and certainty returns to their domestic and global markets and they opt for a more expansive path.

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 remains firmly in negative territory at the start of 2012 but has shown little movement from the previous quarter. The Confidence Index stands at -9.3 in Q1 2012, similar to the -9.7 result in Q4 2011.

The Confidence Index is a leading indicator for growth; it correctly predicted the end of the recession in 2009, provided early warning signs in 2007-08 and pointed towards economic contraction in Q4 2011. This quarter's Confidence Index suggests the UK economy could already be in the middle of recession, defined as two consecutive quarters of declining gross domestic product (GDP).

KEY ISSUES EMERGING THIS QUARTER

- Turnover and profit growth expectations remain well below levels seen before the financial crisis.
- With consumer and public sector spending constrained, business investment is particularly important for economic growth at this time; however, firms are reining in plans for capital investment.
- BCM indicates we could expect to see businesses destocking during 2012, representing a further threat to growth.
- Employment growth expectations remain weak, and it is uncertain whether the private sector will be able to make up for job losses in the public sector. Headcount growth expectations are higher among SMEs than among large firms.

The short-term economic outlook for the UK remains weak. Consumers in 2012 are unlikely to see their living standards improve significantly, as rising unemployment and weak earnings growth impact on household spending power, despite the expected fillip from lower inflation. In addition, business investment is unlikely to be buoyant while confidence in economic prospects remains fragile. Government spending cuts will weigh down on the economy, while the eurozone sovereign debt crisis is likely to dampen exports demand.

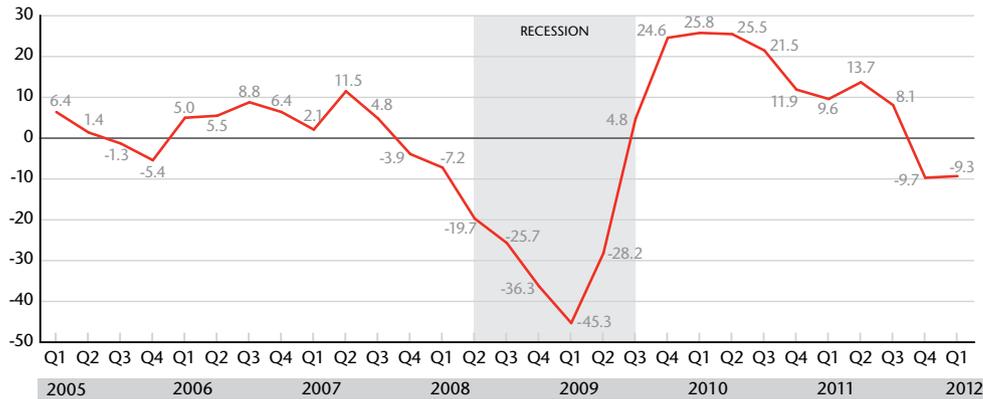
Bank of England Governor Sir Mervyn King recently described the path to recovery as 'arduous, long and uneven'. Indeed, it is difficult to see where significant, consistent growth will come from in the near term. Further quantitative easing is expected later this year to boost the floundering economy and the Bank of England is also almost certainly going to keep interest rates on hold throughout 2012 and beyond.



Douglas McWilliams
Chief Executive, Cebr
ICAEW Economic Partner

BUSINESS CONFIDENCE IN Q1 2012

FIG. 1 TREND OF UK BUSINESS CONFIDENCE

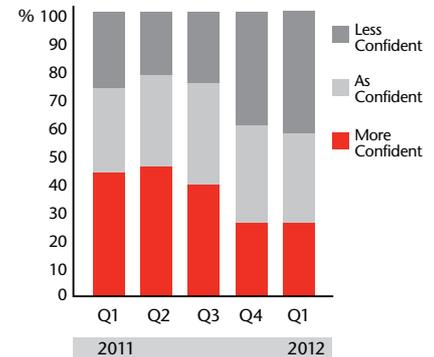


The latest ICAEW/Grant Thornton UK Business Confidence Monitor (BCM) shows business confidence remains firmly in negative territory this quarter, though it has not deteriorated further following the record drop in Q4 2011. The Confidence Index stands at -9.3 in Q1 2012, broadly unchanged from -9.7 in Q4 2011.

CONFIDENCE INDEX UNCHANGED AND STILL FIRMLY NEGATIVE

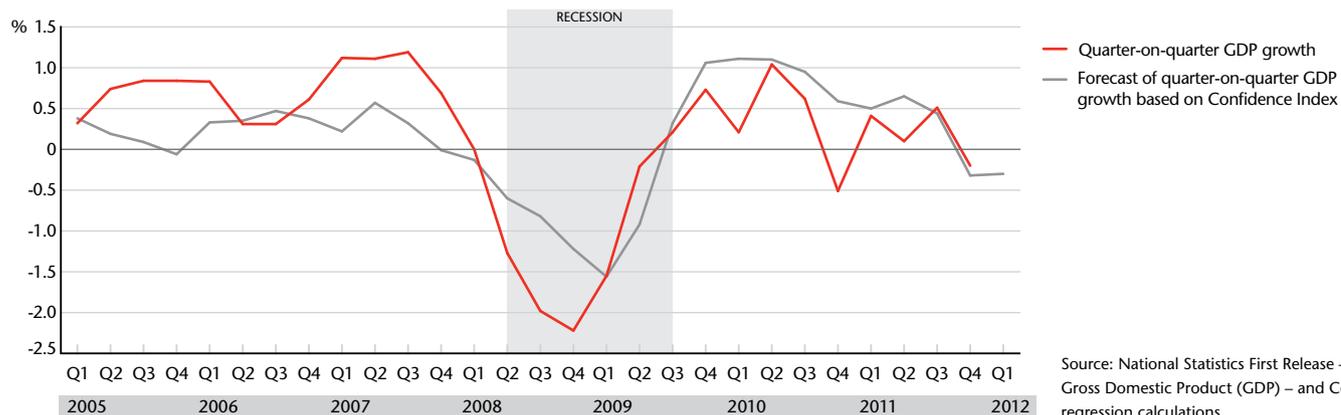
The latest findings from BCM show little change in the Confidence Index, which has steadied at -9.3 in Q1 2012 from -9.7 in Q4 2011. While this suggests that the economic outlook has not deteriorated further since the end of last year, the Index is 18.9 points lower than in Q1 2011, indicative of how global economic weakness has impacted business sentiment over the past year.

FIG. 2 UK CONFIDENCE INDEX – DETAILED RESPONSES



This quarter, over two fifths (42%) of businesses are less confident in their economic prospects for the coming year, compared with the last 12 months. This is the highest share since Q2 2009, when the UK was in the middle of recession. Just over a quarter (26%) of businesses are more confident about economic prospects, unchanged from last quarter and remaining at the lowest point since Q2 2009.

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



Source: National Statistics First Release – Gross Domestic Product (GDP) – and Cebr regression calculations

Latest official data confirm that the UK economy shrank in the final quarter of 2011, reigniting fears that the UK is experiencing a double-dip recession. Preliminary estimates from the Office for National Statistics (ONS) show the economy contracted at a quarter-on-quarter rate of 0.2% in Q4 2011, in line with the forecast in last quarter’s BCM. For 2011 as a whole the economy grew at a sluggish rate of just 0.9% – well below average growth of 3.1% seen over the years 2000–2007.

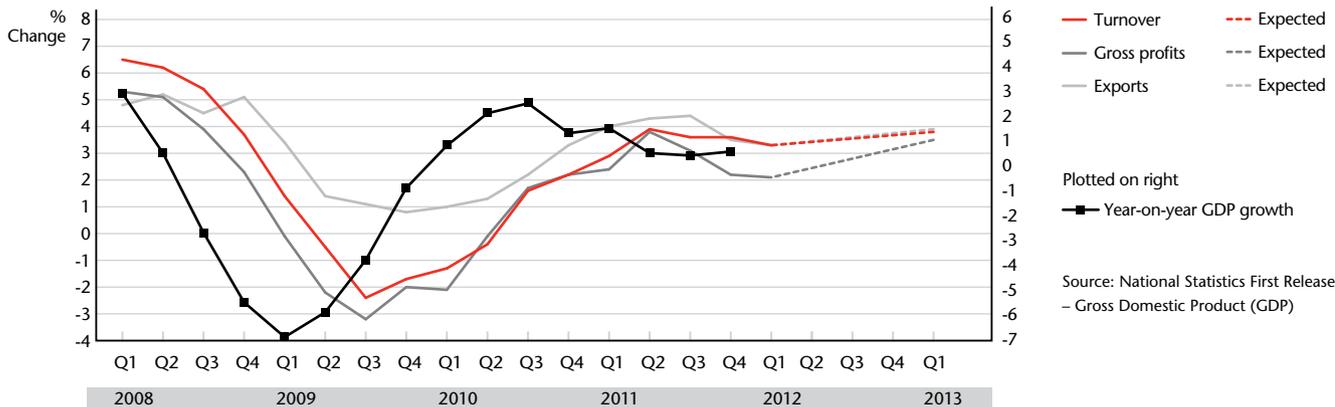
BCM POINTS TO ANOTHER QUARTER OF NEGATIVE GROWTH

The UK economy contracted at a quarter-on-quarter rate of 0.2% in Q4 2011, down from positive growth of 0.6% in Q3 2011. Decline and stagnation in output was broad-based, with most sectors affected by the slowdown seen in the final quarter of the year. Output in the production industries fell at a quarter-on-quarter rate of 1.2%. Output in the construction sector decreased by 0.5%, while in the services sector output was unchanged compared with Q3 2011.

The Q1 2012 BCM Confidence Index points to a second consecutive quarter of contraction in GDP of 0.2%, indicating that the UK is experiencing a double-dip recession. However, it does not point to worsening economic contraction at the start of 2012 compared to the end of last year, suggesting that if we are in a double-dip recession, it is likely to be relatively mild.

BUSINESS FINANCIAL PERFORMANCE

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



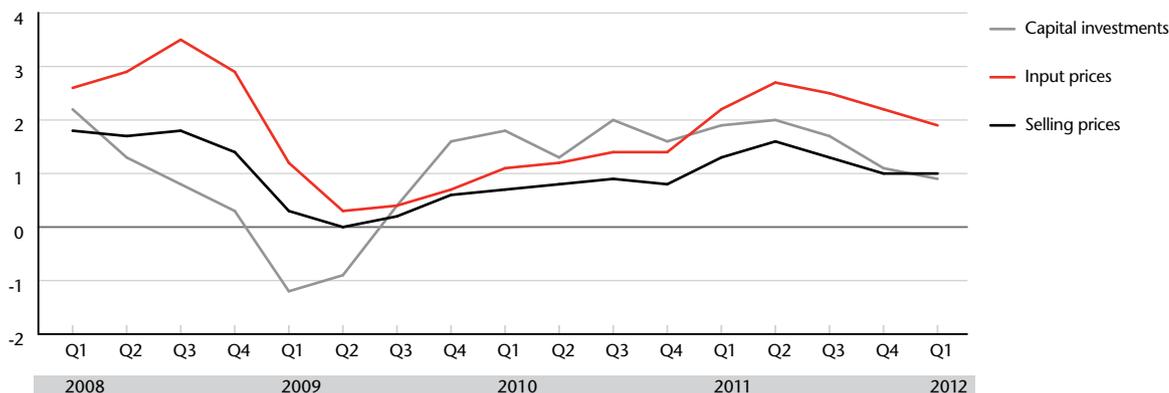
Key indicators show business performance broadly unchanged in Q1 2012, in line with the stable Confidence Index seen this quarter. Gross profits have grown by 2.1% in the 12 months to Q1 2012, while reported annual turnover growth stands at 3.3% this quarter. Expectations for growth over the next 12 months are also broadly unchanged from last quarter.

EXPECTED EXPORT GROWTH HOLDS UP DESPITE EUROZONE CRISIS

Although exporters have seen growth in exports slow over the last year, their expectations for the coming 12 months are for a consistent level of expansion, with businesses expecting exports to grow by 3.9%, unchanged from the level of growth expected in Q4 2011. Overall, this suggests that exporters may still be hopeful that the ongoing eurozone sovereign debt crisis will not significantly impair demand for UK exports over the next year, so exports could still be a driver of economic growth in 2012.

Notably, expected export growth has returned to levels comparable with the pre-recession average. This is in sharp contrast to expected turnover growth (3.8%) and expected gross profits growth (3.5%), which are both significantly below pre-recession levels, suggesting that the majority of businesses do not expect a return to pre-recession growth levels any time soon.

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



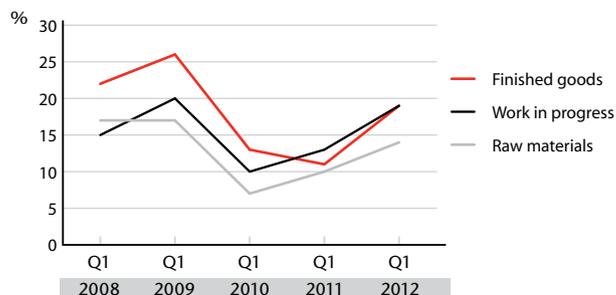
This quarter, businesses expect capital investment to grow by just 0.9% over the next 12 months, down from a recent peak of 2.0% in Q2 2011. Capital investment growth expectations have now fallen for three consecutive quarters, suggesting that businesses are becoming increasingly reluctant to invest in the future, probably related to cautiousness over the economic outlook.

INFLATION LIKELY TO FALL

Businesses expect input prices to grow by 1.9% over the next 12 months; this is down from a recent peak of 2.7% in Q2 2011. Similarly, businesses expect selling prices to grow by 1.0% over the next 12 months, down from 1.6% in Q2 2011. Overall this supports the view that consumer price inflation is likely to fall back over the coming

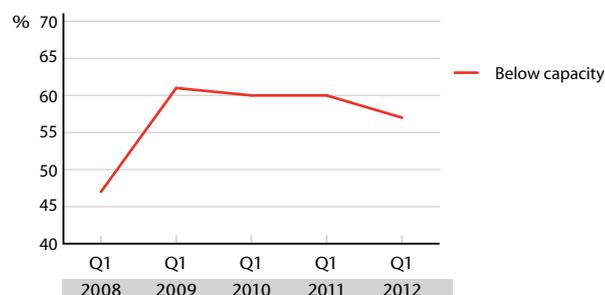
year, as demand in the economy remains weak and cost pressures on firms show signs of easing. The effects of last year's VAT rise will also drop out of the annual rate of consumer price growth this year, which will also bear down on the annual rate of selling price inflation.

FIG. 6 PROPORTION OF FIRMS WITH STOCK CURRENTLY ABOVE NORMAL LEVELS



Stock levels of finished goods and work in progress are increasing. The share of businesses reporting these at above normal levels has increased significantly, compared to a year ago. In Q1 2012, almost one in five (19%) businesses report their stock levels of finished goods and work in progress above normal.

FIG. 7 PROPORTION OF FIRMS CURRENTLY RUNNING BELOW CAPACITY



DESTOCKING COULD LIE AHEAD

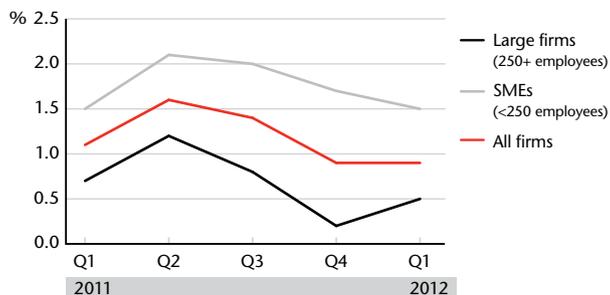
The rise in the stock level of finished goods is particularly important, as it suggests there could be insufficient demand to shift the current level of produced goods, implying that destocking could be around the corner.

Such a mismatch between the supply and demand for goods occurred through 2008 as the financial crisis led to reduced levels of demand. The consequence was particularly profound as firms running down their stock levels led to lower demand through the supply chain, and had further knock-on effects on the

economy. So, as more businesses now report stock levels standing above normal, there is a risk that through 2012 firms will cut back demand through the supply chain as they run down existing inventory. While there is no sign in BCM of this yet, this needs to be closely watched in the coming quarters.

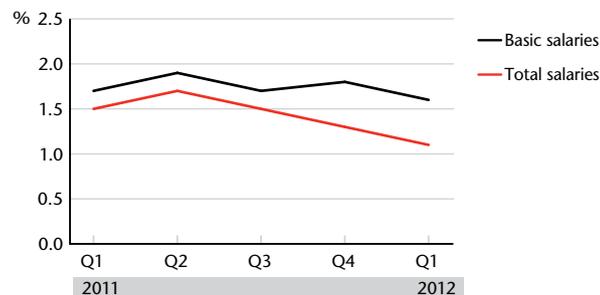
At the same time, most businesses still report operating below capacity this quarter. The proportion of firms operating below capacity rose sharply as the UK economy entered recession in 2008, and has yet to return to levels seen before that.

FIG. 8 AVERAGE EXPECTED % CHANGE IN EMPLOYEE NUMBERS ... NEXT 12 MONTHS



SMEs remain most optimistic in expectations of employee headcount growth. This quarter, SMEs (firms with fewer than 250 employees) expect to increase headcount by 1.5% over the next 12 months, compared with 0.5% growth expected by large firms (firms with at least 250 employees).

FIG. 9 AVERAGE EXPECTED % CHANGE IN SALARIES ... NEXT 12 MONTHS



LABOUR MARKET REMAINS FRAGILE

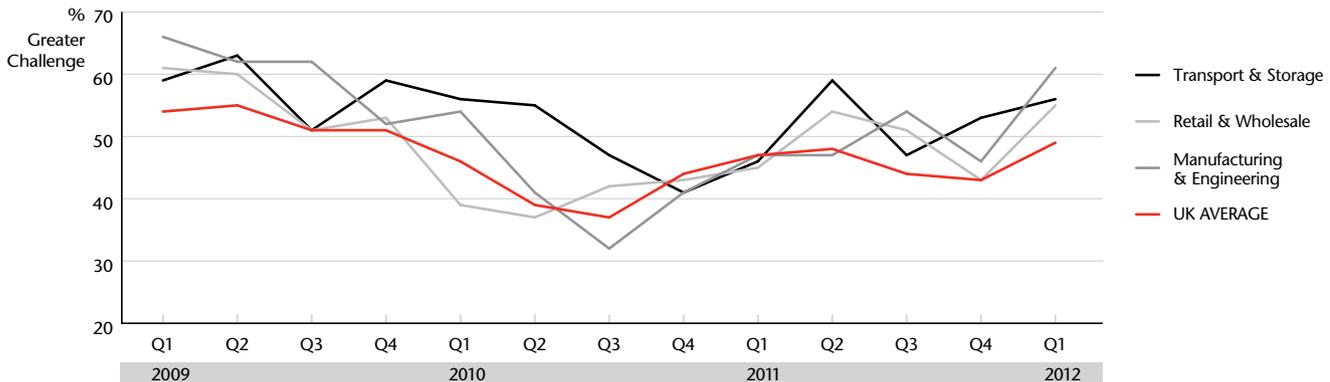
BCM Q1 2012 indicates continuing fragility in the labour market. Businesses remain cautious in their hiring intentions, expecting to increase headcount by just 0.9% over the next 12 months. It is unclear whether private sector job creation will be sufficient to offset the job cuts in the public sector which the Office for Budget Responsibility (OBR) expects to total 110,000 in the 2012/13 fiscal year.

In addition to restrained headcount growth, businesses are planning only modest increases in salaries over the next 12 months. Basic salaries are

expected to increase by 1.6%, with total salaries expected to increase by an average of 1.1%. Expected total salary growth stands at its lowest level since Q3 2009, suggesting that the poor economic outlook is likely to curtail bonus payments over the coming year. With the OBR expecting consumer price inflation (CPI) to average 2.7% this year, salary growth looks set to continue trailing behind the rising cost of living over the coming year – implying further deterioration in living standards for many UK households.

FACTORS AFFECTING BUSINESS PERFORMANCE

FIG. 10 CUSTOMER DEMAND – CHANGE VERSUS 12 MONTHS AGO



This quarter around three-fifths (61%) of businesses in the Manufacturing & Engineering sector report customer demand to be a greater challenge than 12 months ago. The share of Manufacturing & Engineering firms reporting customer demand to be a greater challenge has shown an upward trend since a low of 32% in Q3 2010.

CUSTOMER DEMAND CHALLENGING IN KEY SECTORS

The proportion of businesses reporting customer demand to be a greater challenge than 12 months ago has risen across most sectors. Over the last year, there has been a notable rise in the share of businesses in the Transport & Storage sector reporting customer demand to be a greater challenge to business performance. The sector is something of a bellwether for the economy as a whole, as its performance is closely tied to the overall level of economic activity in the UK. In addition, the proportion of manufacturers reporting customer demand as a greater challenge than 12 months ago also stands at its highest since Q3 2009.

The share of businesses in Retail & Wholesale reporting customer demand to be a greater challenge also remains high at 55%, as consumers face weak earnings growth and rising unemployment, despite falling inflation.

BCM suggests that the weak demand for goods and services will bear down on growth in the short term, with most sectors of the economy affected. Pressure on household budgets will impact domestic demand, and the economic slowdown in the eurozone poses a risk to demand for exports.

CUSTOMER DEMAND AN INCREASING CHALLENGE • WEAK DEMAND LIKELY TO LIMIT GROWTH IN SHORT TERM

TRENDS IN BUSINESS CONFIDENCE INDUSTRY

FIG. 11 TREND OF BUSINESS CONFIDENCE BY INDUSTRY



Confidence remains weak across most sectors of the economy, although the situation generally has not deteriorated further. Firms in the Energy, Water & Mining and IT & Communications sectors record positive Confidence Index scores.

The Retail & Wholesale sector has recorded a negative Confidence Index for four successive quarters, with confidence remaining below the UK average. Firms in the Property sector are the least confident for the second consecutive quarter.

IT AND ENERGY ARE RELATIVE BRIGHT SPOTS

While confidence across most sectors remains in negative territory, there is a mixed picture, with the IT & Communications and Energy, Water & Mining sectors consistently recording positive Confidence Index scores over the last four quarters and, indeed, since Q3 2009. Yet, like all other sectors, confidence remains much lower than levels recorded a year earlier.

In the Production Industries, confidence remains broadly flat compared to last quarter. In a sector in which exports are particularly important, the likely recession in the eurozone presents a challenging economic environment. Output fell

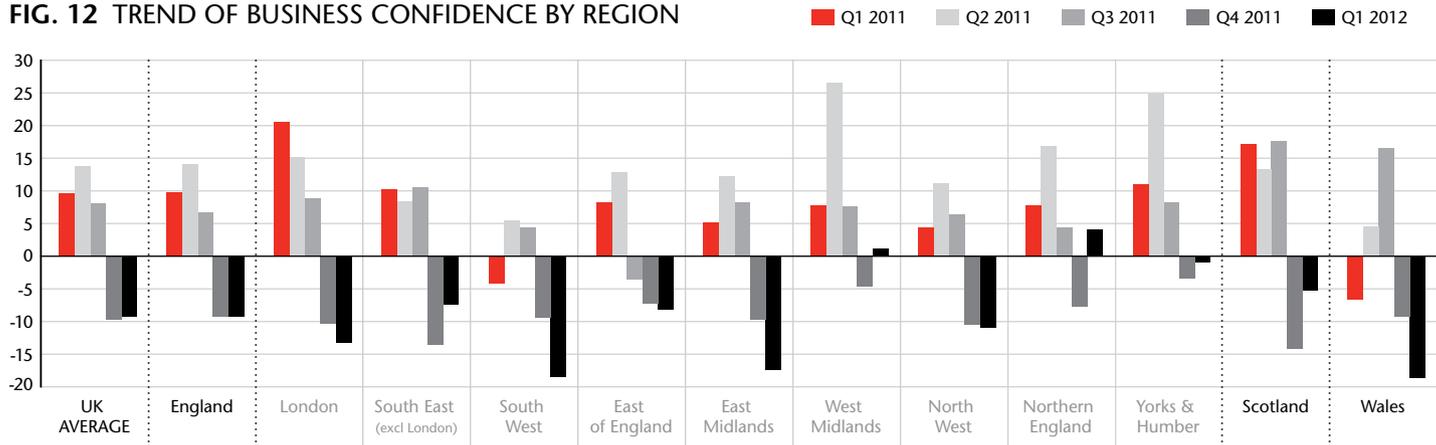
by 1.2% in the final quarter of 2011 and could indicate further weak performance in Q1 2012, despite Energy, Water & Mining remaining relatively buoyant.

Confidence in the Property sector has reached its lowest level since Q1 2009. The volume of housing transactions remains at a very low level, with HMRC data showing transactions fell by 1.3% in 2011. The Retail & Wholesale sector remains beset by a challenging economic environment, as consumers face an ongoing real income squeeze and unemployment began to rise again through the second half of 2011.

CONFIDENCE NEGATIVE IN ALL BUT TWO SECTORS • IT AND ENERGY MORE POSITIVE THAN OTHER INDUSTRIES

TRENDS IN BUSINESS CONFIDENCE REGION

FIG. 12 TREND OF BUSINESS CONFIDENCE BY REGION



Across the UK, confidence remains in negative territory in all but two regions. Businesses in London, the UK's largest economy, remain pessimistic following a sharp decline in confidence last quarter, while the South West and Wales saw their Confidence Index drop below the -18 mark, their lowest since Q2 2009.

CONFIDENCE REMAINS LOW ACROSS THE REGIONS

Over the last year there has been a declining trend in the Confidence Index for all regions, and this quarter it remains negative in all regions except Northern England and the West Midlands. The sharpest year-on-year decline has been in London, where the Confidence Index is 33.8 points down. The capital has been particularly hit by turmoil in the financial sector as the eurozone debt crisis continued.

The outlook in Scotland has also deteriorated notably over the last year. Scottish firms were more optimistic

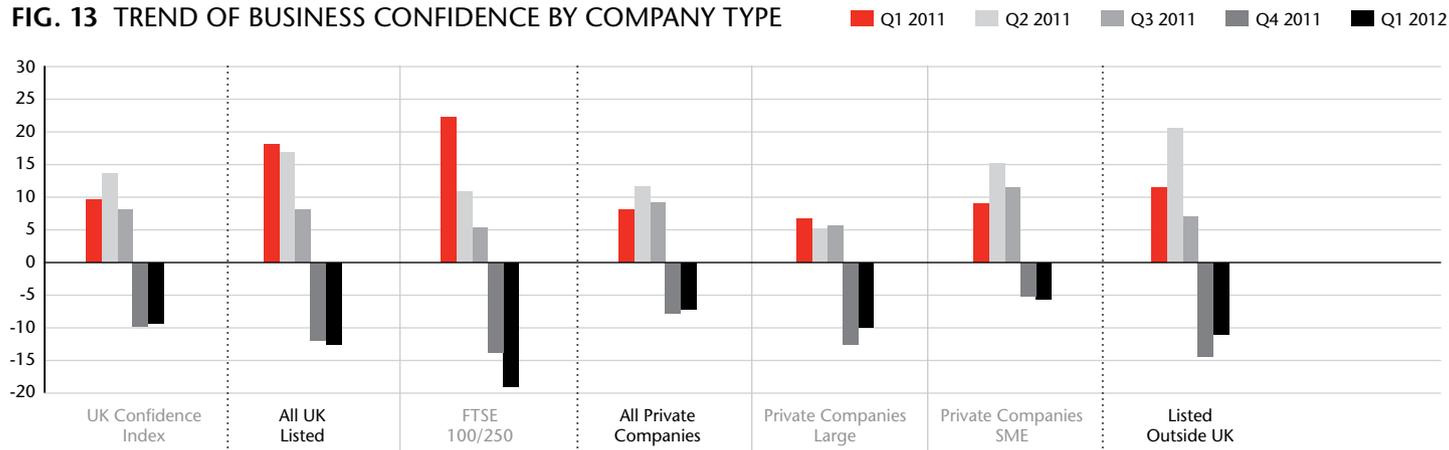
than the UK generally throughout the recession and recovery, but their Confidence Index remains in negative territory in Q1 2012. This coincides with a significant worsening in the Scottish labour market through the second half of 2011, with unemployment reaching 8.7% over the three months to November, up from a low of 7.7% earlier in the year.

The Confidence Index in Wales fell to -18.6 in Q1 2012, the lowest across the UK. Wales is expected to be hard hit by public sector cuts.

CONFIDENCE NEGATIVE IN ALL BUT ONE REGION • PARTICULARLY STEEP DECLINES IN WALES AND SOUTH WEST

TRENDS IN BUSINESS CONFIDENCE TYPE

FIG. 13 TREND OF BUSINESS CONFIDENCE BY COMPANY TYPE



FTSE 350 companies' confidence continues to weaken whereas among private companies confidence remains stable. Confidence remains negative for all types and sizes of company.

LISTED COMPANIES REMAIN IN THE DOLDRUMS

Confidence among listed companies remains very low in Q1 2012, with FTSE 350 firms suffering another decline in their Confidence Index following a steep drop in Q4 2011. Confidence remains low among firms listed both in the UK and abroad – these firms are likely to be closely tied to global economic trends,

suggesting that the eurozone crisis and global economic slowdown is taking its toll.

Private companies saw their Confidence Index remain in negative territory although there was no real deterioration in confidence in Q1 2012 from the previous quarter.

UK LISTED COMPANIES' CONFIDENCE WEAKENS FURTHER • SMES STILL 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 1,002 telephone interviews conducted 1 November 2011 – 26 January 2012, 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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