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EXECUTIVE SURVEY 2016

Manufacturers' expectations on the economy, opportunities and risks in the year ahead

eef The manufacturers' organisation

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Contents

Introduction

In the fifth year of our survey, an annual look at manufacturing executives' views on the year ahead, we see a muted outlook for 2016 with business confidence subdued under the lingering cloud of risks across the global economy.

Manufacturers expect more of the same in 2016 as they have seen in 2015 – potential challenges are apparent, weaknesses in the global economy are not expected to dissipate and little change is expected in conditions in both the UK economy and industry.

Whilst some of this will result in tough decisions for some manufacturers, companies once again are proactive about creating opportunities for growth.

2015 in review

The 2015 survey showed that growth was anticipated by manufacturers across the UK economy and in manufacturing, albeit the pace companies were planning for was more modest, and concerns about the global economic outlook had grown compared with a strong 2014.

Whilst manufacturers continued to see the UK is a competitive location, risks were still looming on the horizon, and companies were putting in place strategies in response to a patchwork of opportunities, risks and uncertainties.

Companies viewed the balance between risks and opportunities to be a fine one, but they showed some confidence they could achieve sales growth in the year ahead.

But it is fair to say that as a new year starts, 2015 did not end where manufacturers expected it to be 12 months previously. The balancing act fell down on the side of risks and these hit harder than expected. Consequently, we expect manufacturing output to show a marginal contraction of 0.1% in 2015.

The year ahead – what to expect

The strongest theme that emerges from this year's survey is that risks have become more prominent for manufacturers. More than two-fifths of companies believe there are more risks than opportunities for their business in the next 12 months. Whilst opportunities abound, potential challenges, and uncertainty about whether these will materialise, are leading to a more muted picture.

First off in this report, we tackle the key risks that manufacturers are concerned about in the year ahead. Featuring high up on this list in 2016 are significant movements in exchange rates, economic volatility in a major market, and uncertainty around the UK's place in the EU. The global weakness that manufacturers experienced in 2015 is expected to persist in 2016.

Nonetheless, our report shows that despite these expectations of weaker global economic growth, manufacturers still expect to be able to grow their export sales in 2016, albeit modestly.

Looking more generally at firm-level performance, this report examines how the subdued outlook has led to something of a reduction in expectations for growth in 2016. Fewer manufacturers now expect the domestic market to support sales growth and outlook for workforce expansion has moderated significantly. Against that backdrop, and whilst still seen as an attractive location to do business, companies say that the UK is not looking quite as good a place to manufacture as it was last year.

Amidst these concerns, this report shows that manufacturers are taking a broad range of actions to create their own opportunities for growth.

Manufacturers' top priorities for the year ahead are to increase their investment in technology and innovation and to sell into new export markets. Once again, working with customers and suppliers to ensure supply chain flexibility features high. But not all activities in the year ahead will be focused on finding growth opportunities, with some difficult decisions on the table; a proportion of firms will be reducing costs and improving organisational efficiency.

As another risk-filled year starts for the UK manufacturing sector, companies are preparing themselves with a broad-based effort to capture opportunities and mitigate exposure to these risks.

Risks in the year ahead

- Two-fifths of manufacturers see more risks than opportunities in the year ahead
- Global economic volatility continues to eat into manufacturers' confidence
- Upward pressure on business costs is expected from a broad range of sources
- Cash flow and payment terms slowly becoming more of a risk across the sector

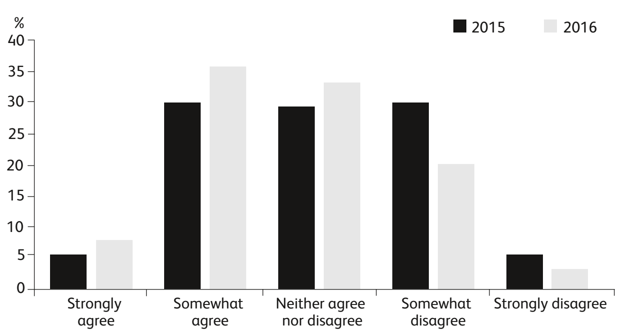
The strong theme that comes from this year's survey is that risks have become more prominent in manufacturers' outlook for 2016 and therefore, we look at these results to begin with. At the start of 2015, manufacturers saw a fine balance between risks and opportunities. But, against a backdrop of continued problems in Europe, the slowdown in emerging markets as well as continued weakness in the oil and gas sectors, the outcome fell down firmly on the side of risks. Manufacturing felt the hit and manufacturers' confidence in their growth prospects dipped as the year went on; with our Manufacturing Outlook confidence indicator falling every quarter through 2015.

This faltering confidence is expected to continue into this year. Whilst just under a quarter of respondents believe there are more opportunities than risks in 2016, more than two-fifths believe the opposite (chart 1). This is the case across manufacturing sectors and larger companies are more likely to expect more risks than opportunities.

Chart 1

Risks still looming large in 2016

% of companies agreeing with the statement: 'There are more risks than opportunities for my company in 2016'



Source: EEF Executive Survey 2015 and 2016

Exchange rate movements continue to be source of risk

So where do companies see risks to growth? Significant movements in exchange rates continue to be a source of risk for 45% of companies, rising slightly from the 38% seeing it as a risk in 2015. A greater proportion of small companies see this as a risk compared to large firms and for a fifth of companies, this will be the biggest potential risk to growth in 2016. Not only can exchange rate movements impact on sales margins, they also can take their toll on export sales volumes and import costs as well as the issue of managing exchange rate volatility.

Companies concerns are to be expected after large movements in the exchange rate in the past year, seeing the sterling/euro exchange rate oscillating between a low of 1.27 to 1.44 in mid-2015. Continued exchange rate volatility looks highly likely as central bank policies around the world are set to diverge. Notably, the expectation of rates lift off from the US contrasted with continued monetary stimulus in the eurozone.

59% The proportion of companies saying that if the sterling/euro exchange rate rose to 1.50 it would have a negative impact on their business

Further strengthening of sterling against the euro is thought likely to present a large risk by manufacturers. Indeed, if the sterling/euro exchange rate were to rise to 1.50, three-fifths of manufacturers in our survey say it would have a negative impact on their business, and for nearly three-tenths a strong negative impact.

Major market volatility

Concerns about world trade growth and the strength of demand from both developed and emerging markets have become more prominent in the headlines over the course of 2015. The risk of economic volatility in companies' major markets continues to be a risk for 39% of firms going into this year. And for 23% of firms, it would pose the most significant risk.

Linked to this is the possibility of uncertainty about the UK's place in the EU. With a referendum occurring possibly in the next 12 months but definitely within the next 24 months, 39% of firms cite uncertainty around this as a risk; a sentiment felt across all sizes of company and all sectors.

73% The proportion of companies saying stronger than expected growth in the eurozone would have a positive impact

There are both upside and downside risks across markets for 2016. Whilst recent relaxation of trade sanctions in Iran should have a positive impact for nearly a third of firms in our survey, other scenarios may hit manufacturers. A sharper than expected slowdown in China would have a negative impact on 60% of firms in the survey, whilst stronger than expected growth in the eurozone would provide help – with nearly three-quarters of companies reporting it would have a positive impact. Later in the report we discuss the global outlook that manufacturers see in the next 12 months as well as forecasts for global growth.

60% The proportion of firms saying a sharper than expected slowdown in China would have a negative impact on their business

Upward pressure on business costs

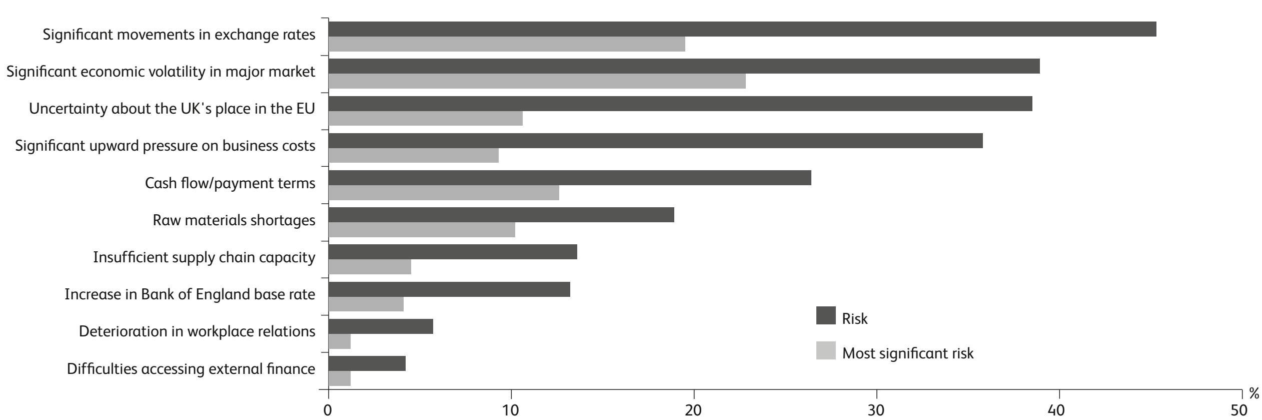
The squeeze on margins for manufacturers can come from all areas of business costs and 36% of respondents see upward pressure on business costs as a possible risk to growth in 2016. Digging into this area, upward pressure is expected to come from a broad range of sources.

Pay pressure is expected to remain; whilst inflation has been flat over the past year, pay settlements have been running at around 2% and the new National Living Wage (NLW) will start in April 2016. EEF research has shown that the majority of manufacturers will see little impact from the move to implement a new NLW with many already paying above the level currently proposed by the government. However, many are concerned about the potential for upward wage pressure as more highly paid workers seek to maintain pay differentials, as well as future wage rate uncertainty from an unknown trajectory of the new NLW post 2016. Holiday pay calculations having to include compulsory overtime will also be having an effect. Whilst upward pressure on pay is a worry across all sizes of firms, for mid-sized companies it tops the list.

Chart 2

Risks not abating

% of companies citing risks to business plan in 2016



Source: EEF Executive Survey 2016

Pension costs are also a potential source of upward pressure, especially for small companies where it is the top business cost risk, ahead of pay and regulatory compliance. The introduction of auto-enrolment has increased the take-up amongst employees of workplace pensions, feeding through into increased employer contributions. The costs of supporting Defined Benefit schemes, of which around a quarter of EEF members still have in some form, continue to rise and increase the demands upon businesses. Even for those businesses who have closed their final salary schemes, the impact of supporting accrued rights will continue to be felt for some time.

Many manufacturers have strongly supported workplace pensions over a long period. Typically, the employer contribution far exceeds the minimum required for auto-enrolment (3%). These higher employer contributions leave manufacturers particularly exposed to any changes in tax relief, particularly if they were required to pay the employer national insurance contribution, which the government has consulted upon. The possibility of the loss of this relief is likely to have a negative effect upon businesses.

Compliance with regulation is also expected to provide upward pressure on business costs, especially for companies in the rubber and chemicals sectors. Energy costs continue to be a worry for manufacturers as well as other input costs; these have been considerable risks in previous years although the pressure of input costs has dropped considerably since highs seen in the 2013 survey, alongside the falls seen in commodity prices such as metals and oil.

Cash flow risk becoming more prevalent

External finance poses a risk to business growth for only a small proportion of firms – 4% – however cash flow problems and changing payment terms (normally extensions) are regarded as more of a risk. Over a quarter of firms mention it as a risk and 13% see it as their top risk to growth, up five percentage points from last year's survey. This is cited as more of an issue by small and medium sized companies. We have slowly seen this becoming somewhat more prevalent across the sector over several surveys. The issue could feed through to business performance by putting pressure on working capital and limiting funds for investment, for example.

The myriad of possible risks for 2016 means an uncertain outlook for manufacturers. Whilst opportunities are present, as we will discuss later, potential challenges and uncertainty on whether risks will materialise is leading to a more subdued picture for the next 12 months.

Manufacturers' view of the global outlook

- Manufacturers expect weaknesses in the global economy to persist
- Despite pessimism about global economy, manufacturers still expect to grow exports
- Transport manufacturers most upbeat about export prospects
- Europe and North America thought most likely to provide growth opportunities

As we have seen in the last section, major market volatility is seen as a risk to business growth for a considerable proportion of firms in the year ahead. This is a concern for the sector as manufacturing is export-intensive, accounting for 44% of the UK's total exports. While this enables companies to take advantage of opportunities in growing markets, it also means they are highly exposed to changing global economic conditions. The last year proved a challenging one for exporters, as world trade growth fell to its lowest level since 2009. Between 2014 q3 and 2015 q3 total UK goods exports fell by 3%.

Many of the weaknesses in the global economy are set to persist in the year ahead, and this is reflected in manufacturers' expectations for 2016. On balance, manufacturers' outlook for global economic conditions in 2016 points to more of the same.

40% The proportion of firms expecting a deterioration in global economic conditions in 2016

That said, the proportion of companies expecting things to stay the same was large, at 37%, this was the most commonly cited expectation.

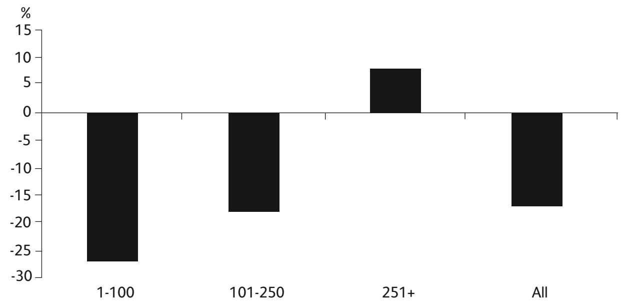
Negativity about the global economy is fairly broad based with balances of companies in all sectors – with the exception of rubber and chemicals manufacturers – saying they expect conditions to worsen in the year ahead. However, most negative are machinery and electrical equipment manufacturers where 48% and 44% of companies expect the global situation to look worse in 2016 respectively.

After a somewhat beleaguered year for investment goods manufacturers, the depressed outlook reflects the fact that the key factors that limited demand for investment goods in 2015 – a low oil price and softening demand from China – show no sign of dissipating.

Chart 3

Large manufacturers are more optimistic about the global economy

Changes in global economic conditions planned for in 2016, % balance by number of employees



Source: EEF Executive Survey 2016

As well as variation by manufacturing sector, there is also some difference in outlook depending on the size of the company. In contrast with last year's survey, where companies of all size bands reported negativity, this year large companies are relatively upbeat about global economic conditions, with a balance of 8% saying they expect the global economy to improve in 2016. However, small companies are markedly more negative, with a balance of 27% of companies with fewer than 100 employees expecting global conditions to deteriorate in the year ahead.

Despite challenging global economic conditions, manufacturers expect to grow exports

Although manufacturers have expectations for global economic conditions to remain subdued, they still think they can grow their exports – albeit moderately – in 2016. Over four in ten manufacturers expect an improvement in export sales in the year ahead compared with just over two in ten who expect a decline. Despite smaller manufacturers' negativity about global economic conditions, companies of all size bands report positive expectations for export growth and no sector reported a declining balance of orders.

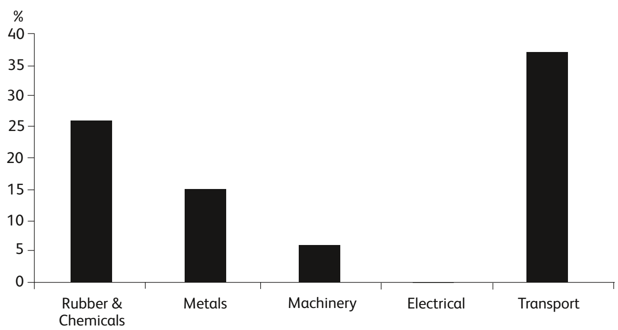
43% The proportion of firms expecting an improvement in export sales in the year ahead

By some margin, the most positive with regards to export expectations are transport manufacturers, with 57% of companies saying they expect their exports to grow in 2016. Notably, as well, 17% of transport companies expect their overseas order growth to be significant. Our Manufacturing Outlook survey[1] shows that motor vehicle manufacturers reported a pick-up in demand from Europe at the back end of 2015, where improvements in consumer demand will be supporting their optimism.

Chart 4

On balance, no sector expects exports to fall

Expected change in export sales in 2016 relative to the previous 12 months, % balance



Source: EEF Executive Survey 2016

Mixed picture on markets

It is no surprise that for the most part manufacturers' expectations for export growth are moderate, as the most frequent response to the question "in which countries is your company expecting sales growth in 2016?" was "none". This chimed with the results from our Manufacturing Outlook[2] surveys which have shown a steady increase in the proportion of companies reporting no notable pick-up in demand from any market. Electrical and machinery manufacturers were particularly likely to say there were no markets where they expected demand to improve.

However, this is not to say there are no opportunities for manufacturers out there. Nearly one third of manufacturers said that they expected improvements in sales to European markets in 2016, with Germany and France presenting the most opportunities.

Next on the list for export markets that promised growth was North America, with 18% of companies citing it as a source of expected sales growth in the year ahead, this is predominately led by the US and these positive expectations were fairly broad based across sectors.

Looking to China, there is a very mixed picture with regards to demand. While 5% of companies expect sales to fall in China in 2016 another 4% of companies said they expected sales to increase in the year ahead. Indeed, despite the slowing in China headline numbers, some manufacturers tell us that they have not experienced the same weakness on the ground.

But as well as more established markets, what also stands out is the breadth of markets that manufacturers are exploring for growth opportunities. Between them, respondents to the survey raised 60 different markets where they expected growth in 2016. Outside of Europe, the US and China, stand-out markets included the Middle East, Australia, India, Malaysia and Turkey.

Whilst firms expect weakness in the global economy to continue and have doubt about global economic prospects over the year to come, manufacturers remain reasonably upbeat about their opportunities to grow exports. We continue to discuss companies' firm-level expectations and priorities to achieve growth in subsequent chapters.

[1] https://www.eef.org.uk/resources-and-knowledge/research-and-intelligence/industry-reports/manufacturing-outlook
[2] Ibid

International forecasts

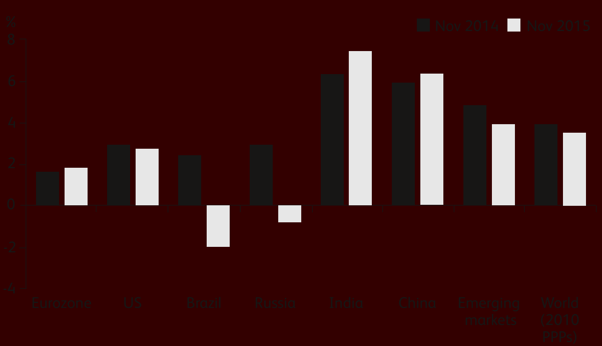
This time last year our forecasts pointed to a fairly weak global picture, particularly focused on the eurozone. Indeed, the downside risk scenario presented in Executive Survey 2015 anticipated the risk of a slowdown in global trade. The reality was weaker still, and global growth has surprised on the downside, particularly following on from a marked slowdown in China and the result of renewed crisis in the eurozone.

This meant that 2015 saw the slowest rate of world trade growth since 2009. Key factors contributing to the slowdown included deceleration in China and another difficult year for the eurozone. And in the run up to the first interest rate move from the Federal Reserve, there was also growing caution about the health of other emerging markets.

Chart 5

Expectations for world economic growth revised down over the course of the year, but not all markets are equal

Forecasts for growth, annual % change, 2016



Source: Oxford Economics

While some improvement in the world economy is expected in 2016, many of the same risks are still alive.

Starting with the potential upsides; signs of improvement in Europe are emerging, causing a modest upgrade to forecasts over the course of 2015. We now expect growth of 1.8% in the year ahead.

Although the US has been buffeted by global headwinds, which has caused forecasts to come down a touch since the start of the year, the domestic economy has been steadfastly improving. Strong consumer spending, supported by a solid labour market should provide a particular boost in 2016, although some of the support from low inflation will start to be eroded by base effects this year. The improvements in the US mean that an interest rate hike has now happened and global financial conditions have already started to tighten. A key issue for 2016 is how global growth will hold up as US rates start to rise.

Emerging markets are particularly at risk from rates lift off in the US. This puts those countries with large debt burdens – or heavy dependence on external funding – particularly at risk of capital outflows. In particular the outlook for Russia and Brazil has continued to worsen throughout 2015 and these economies both look likely to contract in 2016. Capital outflows are not the only concern however, as both economies are also vulnerable to sustained weakness in commodity prices.

Recent signs of weakness in imports and slow growth in industrial output point to another year of slower growth and continued deceleration in China is set to have a softening impact on overall global growth rates in 2016.

Forecasts for emerging markets in total have been steadily revised down over the course of 2015, and we now expect overall growth of 3.9% in 2016. So, as the outlook for emerging markets and advanced economies diverges, we take a closer look at what could happen if things moved even further apart than we currently expect.

Risk forecasts

A faster than expected slowdown in China would hit motor vehicles and investment goods manufacturers hardest

As our survey results show, one of the key risks that could affect manufacturers in the year ahead is a greater than expected slowdown in China. Our baseline forecasts show China growing by 6.3% in 2016, down from 6.9% in 2015. But what would happen if China slowed further, with growth slowing to 4% as the difficult rebalancing process sees consumer spending fail to plug the gap left by weaker investment and exports?

This slowdown would reduce UK manufacturing output growth in 2016 from 0.8% in our central forecast, to 0.65%. However, not all sectors would be affected equally. Transport sectors, particularly motor vehicle manufacturers, have a high exposure to China and would therefore see direct exports drop more markedly. Under this scenario motor vehicles would see the biggest downward impact on their growth.

Similarly, as China seeks to refocus its economy, demand for investment goods is likely to be particularly vulnerable, and our scenario shows that a drop in demand from China would exacerbate challenges for mechanical and electrical equipment sectors.

Not all sectors are as badly hit however. Despite a high proportion of textiles exports going to China, the sector exports only a small proportion of total output meaning it is relatively unscathed. Chinese consumption has also been robust in 2015 which should prove to be a positive for textiles demand. Overall we expect limited impact on the textiles sector.

The impact of improvements in demand in the eurozone would be broad, though consumer-facing sectors stand to benefit the most

Not all risks are to the downside, an improvement in the eurozone would be likely to have a positive impact. If exports to Europe grew at pre-recession rates in 2016 this would boost manufacturing growth from 0.8% to 1.2% in 2016, with continued positive impact in 2017 taking manufacturing growth up to 1.8% rather than our baseline of 1.5%.

For all manufacturing sectors, the eurozone is a key export market, but some have greater exposure to Europe than others, and would be likely to see a larger benefit. For the rubber and plastics sector, 56% of all exports head to the eurozone, higher than for any other sector, with Germany and France the top two markets. The sector therefore stands to benefit to a greater extent from a turnaround in Europe.

This is also an upside risk for the food and drink manufacturers, 55% of whose exports are destined for the eurozone. After a challenging 2015 on export markets for the sector, an improvement in European demand would offer a positive boost.

Similarly, the automotive industry has already started to benefit from new strength in the eurozone, something that is evident in our survey results, with 84% of transport manufacturers saying a stronger than expected recovery in the eurozone would have a positive impact on growth. This could offset the impact of continued weakness in China. Despite the breadth of export markets for motor vehicle manufacturers, an improvement in eurozone consumption has the potential to offer a large positive impact for motor vehicles growth.

Table 1

Sectoral impact varies with market exposure

Impact on growth, annual % change, 2016

	Baseline forecast	Impact of weaker China	Impact of stronger eurozone
Basic metals	-12.6%	Small negative	Limited
Textiles	-2.3%	Limited	Small positive
Mechanical equipment	-2.0%	Large negative	Small positive
Electrical equipment	-0.3%	Small negative	Small positive
Food & drink	1.1%	Limited	Large positive
Rubber & plastics	2.6%	Limited	Large positive
Motor vehicles	2.7%	Large negative	Large positive
Other transport	5.1%	Large negative	Limited

Source: Oxford Economics and EEF

Manufacturers' business expectations

- 2015 outturn will, in aggregate, be weaker than manufacturers had expected
- The reality of global challenges prompts a downward adjustment to forecasts for the year ahead
- The sector composition of growth in manufacturing in 2016 expected to look similar to 2015
- But, while still attractive, the UK is not looking quite as good a place to manufacture as last year

As we have seen, risks are prominent in this year's survey and companies have some doubts about the pace of growth in the global economy in 2016. In this section we discuss how this pessimistic outlook is affecting manufacturers' views of their own firm-level performance this year.

Coming off the highs of 2014, manufacturers entered last year with a bit more nervousness. The supply chain effects of the oil price slump and the lingering concerns about the future of the eurozone weighed on confidence. This was evident in the lower expectations about industry conditions overall and relatively fewer companies forecasting growth in sales, profits and employment. Table 3 gives a brief summary of 2015's expectations against what conditions have materialised over the past year.

While many of manufacturers' predictions were on point last year, others were somewhat off track. For example, over half of companies exporting to Asia were expecting to see growth from those markets support their business, but the slowdown in China had a direct hit on exports from some UK sectors. In addition, some of the sub-sectors – notably metals – that had been planning for rising output and orders in 2015 saw the reverse.

Looking ahead to the rest of this year there is a familiar degree of caution in our survey responses. Given the balance of challenges and opportunities identified for 2016, this is not surprising. Just under a third of our respondents expect to see conditions in their industry improve over the next 12 months, this is down slightly from the optimistic 37% at the start of last year. However, a growing proportion of manufacturers are planning for a turn for the worse – 29% versus 17% a year ago.

Sector variances persist

The sectoral spread of these views is little changed from a year ago, as chart 6 demonstrates. The most upbeat parts of industry remain the rubber and chemicals and transport sectors, and for good reason. Official statistics and EEF's Manufacturing Outlook survey painted a positive picture for these industries over the past year.

Table 2

Expectations for 2015 and outturn

Expectations	Outturn
Three quarters of manufacturers expected UK growth to be the same or better in 2015 than in 2014	The UK economy has continued to grow through 2015, but expansion will be slightly down on 2014 at 2.4%
Mechanical and electrical equipment were the most pessimistic sectors at the start of the year	The oil and gas induced weakness persisted and both of these sectors will have seen a decline in output last year
Employment growth across manufacturing was expected to continue	Manufacturing jobs were up in the first half of 2015, but official statistics show growth heading into reverse in H2
A drop in UK and export sales was planned for following a bumper 2014	Our Manufacturing Outlook[3] indicators showed not only a weakening in UK and export orders, but an outright decline in the last two quarters of 2015
The eurozone was forecast to be a particular weak point	Another eurozone crisis was avoided, but growth was subdued hitting exports across all manufacturing sectors, except rubber and plastics

Source: EEF Executive Survey 2015

[3] https://www.eef.org.uk/resources-and-knowledge/research-and-intelligence/industry-reports/manufacturing-outlook

Automotive and aerospace have maintained a momentum of their own as past investments in technology and new products continues to pay off. Similarly the diversified rubber and chemicals sector incorporates a large degree of activity from construction-related products through to pharmaceuticals. Lower input costs, innovation and some resilient market segments have supported output growth. These underlying trends will carry through this year and lead to further expansion of these sectors, according to both company expectations as well as our own forecasts.

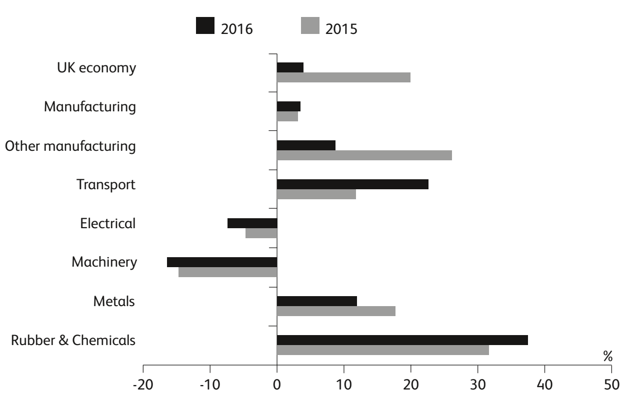
In contrast the gloom that descended on the mechanical and electrical equipment sectors at the start of 2015 has yet to lift. A balance of 16% and 7% of companies respectively believe there will be another year of deterioration in industry conditions. With few signs of relief coming for the oil and gas sector and the concerns about the global economy, these export intensive sectors look set to struggle in 2016, even as manufacturers seek to pivot into new supply chains.

Middle of the pack is the metals sector – this includes the embattled steel industry and the more diversified metal products sector. The former will mostly likely continue to be a drag on manufacturing output this year as there is little alleviation from industry overcapacity, exchange rate volatility and domestic cost issues. In contrast, end markets for the metal products sector will also certainly lead to a divergence in performance with construction and automotive demand supporting the sector.

Chart 6

Sector variation to persist in 2016

Changes expected in business conditions, % balance of change



Source: EEF Executive Survey 2015 and 2016

Subdued confidence reflected in lower expectations about business growth

With more subdued confidence overall across manufacturing, this is inevitably reflected in lower expectations about growth in some key business indicators. Chart 7 shows that the balance of companies planning for growth across the sales and employment variables has fallen again for 2016, and to the lowest level since our survey started in 2012.

As we have already discussed, whilst companies are looking at moderate export sales growth in the year ahead, the high degree of uncertainty about the outlook for the global economy has led to a fall in this indicator from previous years (chart 7).

The drop in forecast sales in the domestic market for 2016 is somewhat more widespread across manufacturing. UK demand, a previous bright spot for manufacturing, started to wane last year, and while there are still predictions for modest growth in the next 12 months, this is a far cry from the levels of optimism about the home market seen a couple of years ago. UK household spending should continue to be fairly robust this year, but the strength of the revival in construction will be a more important growth determinant for the manufacturing supply chain.

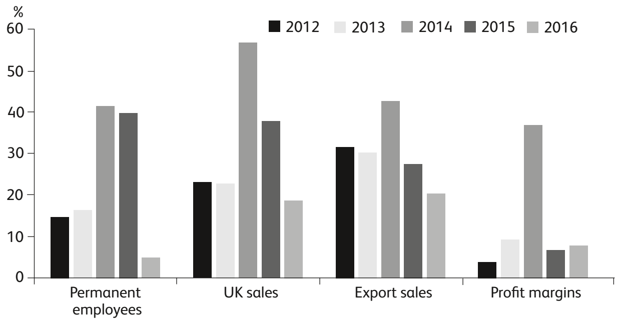
43% The proportion of firms expecting an improvement in UK sales in the year ahead

Looking at how this will all feed through to manufacturers' workforce plans, we see that after two years of very positive recruitment plans – which have also been seen in the official manufacturing employment data – the outlook has moderated significantly. The transport sectors continue to lead the pack on employment intentions, which tallies with expansion announcements from a number of the major OEMs.

Chart 7

All business indicators fall from their 2014 peak

% balance of change expected in 2016



Source: EEF Executive Surveys

The mood has turned on the UK as a place to manufacture

Manufacturers are essentially looking at a fairly middling performance this year, with a balance of risks skewed to the downside and the on-going challenges of improving productivity and profitability, managing supply chains and dealing with some building cost pressures. Against that backdrop it is imperative that the UK is regarded as a good place for manufacturing activities.

Unfortunately on this broad metric the mood has also turned in 2016. After a run of several years when more and more companies were expressing positive views about the UK business environment, nearly a fifth of companies no longer share this view.

Large manufacturers are far and away the most positive about the UK as the place for their manufacturing activities. And we can point to a number of potential reasons why this is likely to be the case – a competitive corporation tax rate, an improving innovation landscape, which they are more likely to have experienced.

72% The proportion of large companies saying the UK will be a competitive location for their manufacturing activities in 2016

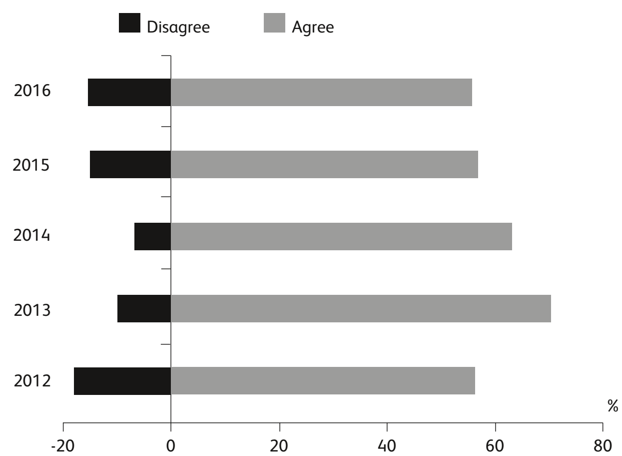
On the other hand sectors that see a less supportive demand environment in the UK and those that have been at the sharp end of higher energy costs and rising pay bills have reassessed their view of the UK as a place to do business in 2016.

That said, the sector as a whole has been relatively positive about the outcome of the recent government Spending Review (which was announced after this survey closed). If the government maintains its commitments to innovators and exports and ups its focus on the competitiveness of the UK cost base with actions on business rates and the frictionless implementation of the apprenticeship level, this drop in confidence about the UK business environment could prove a temporary one.

Chart 8

Gloss comes off UK as a manufacturing location

% agreeing that the UK is a good place for manufacturing



Source: EEF Executive Surveys

We have seen how the outlook on risks to business growth, global conditions as well as muted confidence across manufacturing has led to lower expectations from firms about growth prospects in some key business areas. But once again, as we discuss in the next section, we see companies prioritising action aiming to achieve business growth in the year ahead.

UK economy forecasts

Despite weakness in the global economy, the UK economy has performed relatively strongly in 2015. Although global headwinds took their toll on net trade, the consumer continued to consume and investment was recovering, will this continue in 2016?

Our central scenario shows whole economy business investment growing by 4.4% in 2016. However, in recent years, investment has often underperformed compared with forecasts as a series of economic challenges have undermined business confidence. Indeed, 2016 presents a number of downside risks for investment in manufacturing including the weakening demand situation in emerging markets, continued postponement of investment in North Sea oil and gas, and the dampening impact of companies' pension deficits. If these risks were repeated throughout the whole economy and investment expenditure stalled in H1 2016 this would take business investment growth down to 2.6% in 2016.

This would knock 0.2 percentage points off GDP growth in 2016, and its impacts would persist into 2017 as well. Manufacturing would take a bigger hit – as demand for investment goods is an important contributor to growth – with manufacturing output growth dropping from 0.8% in our baseline forecast to 0.5% in this downside scenario.

However, there are some upside risks to investment too. Manufacturers will always invest to improve productivity, but there may be additional impetus behind this in 2016. As real wage costs are starting to rise, some companies may begin to invest more to automate and improve productivity; our survey evidence shows that increasing productivity would be manufacturers' top response to the new National Living Wage.

In addition, rising real wages will also contribute to rising consumption, which can boost economic growth and business confidence. All factors that can support investment spend. Finally, there are also longstanding factors such as strengthening profitability and improvements in external finance that could come to play, pushing annual business investment growth across the whole economy up to 5.8%. This would have a positive impact on both whole economy output growth and manufacturing output growth.

Table 3

Impact of scenarios

Impact on growth (annual % change, 2016)

	GDP		Manufacturing output	
	2016	2017	2016	2017
Downside	1.9	2.4	0.5	1.4
Central	2.1	2.5	0.8	1.5
Upside	2.2	2.6	0.9	1.6

Source: Oxford Economics and EEF

Manufacturers' priorities in the year ahead

- Manufacturers are proactive about creating opportunities for growth
- Growing exports a key priority, but also a key challenge
- Working with customers and suppliers remains important for visibility
- There will be some tough decisions for manufacturers on the table

Manufacturers have been dealing with challenging economic conditions for several years now, and as this report has shown, manufacturers do not see this challenging environment dissipating this year. In order to grow, companies have had to be proactive about creating opportunities for growth and this is certainly something that will come to the fore in 2016 albeit coupled with some more tough decisions for some firms.

In this year's survey, no one action stands head and shoulders out from the rest as the 'silver bullet' to address the risks that companies expect to face in 2016. Instead, companies are prioritising a range of actions, some of which will go hand-in-hand with each other, aimed at ensuring their business prospects are better than the economic prospects.

Top priorities closely linked

Manufacturers' top priorities for the year ahead are to increase their investment in technology and innovation and to sell into new export markets. The two are also closely linked, as our Innovation Monitor survey[4] earlier this year showed, over half of manufacturers said that their reason for innovating was to increase sales into new export markets.

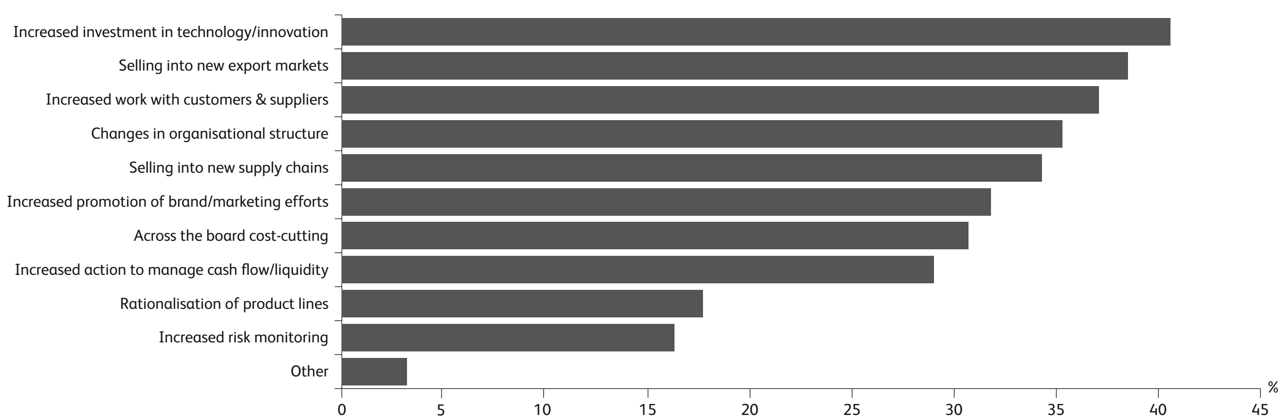
41% The proportion of firms citing increased investment in technology/innovation as a priority in the year ahead

Manufacturers have also used innovation to deal with some of the challenges that they have faced over the course of this year already. For example, companies affected by weakness in the oil and gas supply chain increased their investment in new product development to help them move into new supply chains where there were more growth opportunities. Indeed, selling into new supply chains also makes manufacturers' top five priorities for the year ahead.

Chart 9

Manufacturers proactive about finding growth opportunities

% of manufacturers citing actions as a priority in 2016



Source: EEF Executive Survey 2016

[4] https://www.eef.org.uk/resources-and-knowledge/research-and-intelligence/industry-reports/innovation-monitor-2015-16

Increasing exports to new markets also helps support growth by expanding sales opportunities, and providing exposure to faster growing sectors elsewhere in the world. Companies in all sectors are prioritising selling into new markets, but for companies in the electrical sector – where current expectations for exports are flat – this pips investment in technology and innovation to the post as the top priority for manufacturers in the sector.

Also linked to manufacturers' exporting efforts are branding and marketing activities, which help raise awareness of products and capabilities in both existing and new markets. Four in ten manufacturers who will prioritise selling into new markets in 2016 said they would also focus on branding and marketing, compared with three in ten companies who do not plan to focus on new markets.

Growing exports will be a challenge

Despite companies' proactive focus on growing exports, they do not expect the outcomes to be easily achieved. When we asked manufacturers which outcomes they thought would be most challenging, selling into new export markets topped the list by some margin, with 58% of companies looking to do this saying that they thought it would be the biggest challenge they faced.

Exporting is always a challenge, with differences in business practices, trade barriers and a lack of knowledge of opportunities among the many barriers that manufacturers face. However, recent weakness in global demand will have exacerbated difficulties and is likely to continue to do so in 2016.

Working with customers and suppliers

Working with customers and suppliers always features high on manufacturers' lists of priorities and 2016 will be no exception; 37% of manufacturers say that this will be a priority in the year ahead.

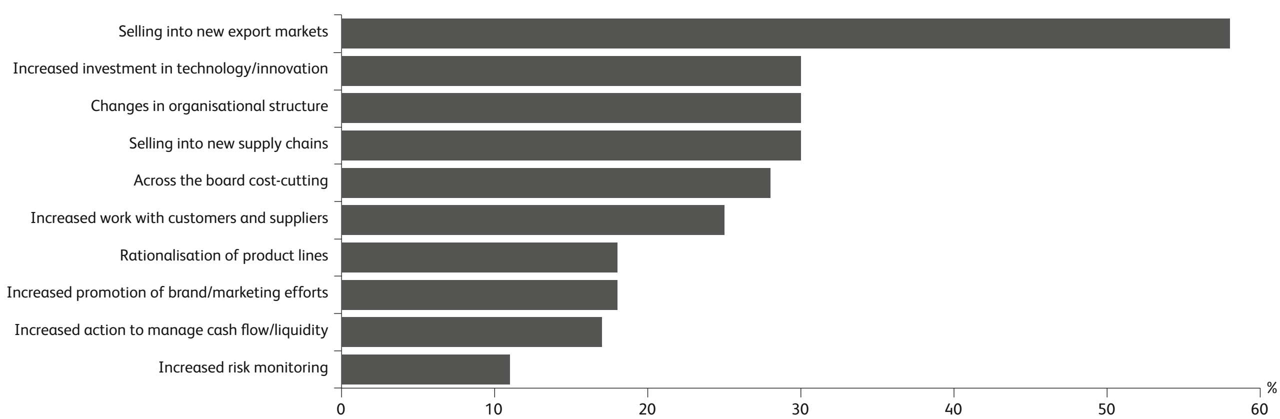
For manufacturers in the mechanical equipment sector – which was badly hit by the weakness in demand for investment from oil and gas – increased work with customers and suppliers is a particular priority, to help increase visibility about both demand and supply. Indeed, manufacturers in oil and gas supply chains tell us that they are now adapting to a 'new normal' of lower demand in the sector.

Although for the most part, manufacturers think this is something they can achieve, a quarter of companies looking to increase work with customers and suppliers said that they thought it would be the biggest challenge they faced.

Chart 10

Growing exports likely to be the biggest challenge

% of companies who said action would be a priority citing it as their biggest challenge to implement in 2016



Source: EEF Executive Survey 2016

Difficult decisions on the table

Not all of manufacturers' activities in the year ahead will be focused on finding growth opportunities, some will be on reducing costs and improving organisational efficiency. Organisational restructuring is a priority for 35% of manufacturers in the year ahead, and 31% are planning across the board cost-cutting.

Metals manufacturers – who have been amongst the worst-affected by the challenging conditions of 2015 – are most likely to be considering changing their organisational structure in the year ahead. In fact, this is their joint-top priority in the year ahead.

As this report has shown, some manufacturers expect pay to put significant upward pressure on their costs in the year ahead, driven in many cases by the introduction of the new National Living Wage (NLW). Although manufacturers' top response to the introduction of the NLW will be to drive through productivity improvements, for some manufacturers, the onset of the NLW will be a driver of workforce restructuring. Indeed, our survey evidence shows that nearly a fifth (19%) of companies said that this would be a response to the NLW.

Despite this prevalence of organisational restructuring, manufacturers do not expect it to have a negative impact on workplace relations, with only 5% of companies anticipating that this would be a risk in 2016.

Increased risk monitoring

Despite the increased concerns about risks building in 2016, increased monitoring of risks features bottom of the list of manufacturers' priorities in the year ahead. However, with 16% of companies saying this will be a priority, this is little-changed from when we asked a similar question at the start of 2014. Then, 14% of companies said they would spend more time monitoring risks in response to economic uncertainty in key markets. Manufacturers continue to choose proactive action to minimise the impact of a range of risks, rather than try to forecast what the risks might be.

All of this shows that manufacturers are making a broad-based effort to boost their growth opportunities and mitigate exposure to risk, in what is expected to be a challenging year with a myriad of risks and a pessimistic global outlook. Manufacturers are taking action to place their businesses in good stead to withstand whatever the year may bring.

Aldermore viewpoint

The outlook for manufacturers is much the same as it was a year ago, with expectations of a slowing global economy and at best minimal growth in the UK. This comes off the back of a year in which manufacturing output is expected to have contracted marginally, so this lack of confidence should be viewed in the context of a difficult twelve months for UK manufacturing.

Going into 2016, performance expectations are lower than a year ago. Many manufacturers expect to suffer a fall in both productivity and UK sales, although expectations around export sales remain broadly in line with a year ago. This muted outlook is no doubt a symptom of the many macroeconomic factors that manufacturers expect to weigh on them, with more than two fifths of companies anticipating more risks than opportunities for their business over the next year.

The good news is that manufacturers are alert to these risks. Unfavourable movements in exchange rates are identified as the most pressing risk which is hardly surprising given the impact that exchange rate volatility can have on manufacturers' margins and sales volumes. This can be particularly acute for firms that import their raw materials or make a large proportion of sales in export markets.

Uncertainty about the UK's place in the EU is another prominent risk. With an EU referendum on the horizon, possibly at some point later this year, this comes as no surprise and chimes with what we are hearing from SMEs. Britain's exit from the EU, or Brexit, has to be treated as a very real possibility and given that the repercussions of such a move can only be guessed at, it is to be expected that manufacturers are concerned about how they would be impacted.

It is also interesting to see that this year more manufacturers have cited cash flow and payment terms as the biggest risk they face. We regularly witness how cash flow can be particularly problematic for smaller, innovative manufacturers due to the ongoing investment in staff and equipment needed to maintain their pace of growth. Fortunately there are measures that businesses can take to protect themselves and last year's government action to remove bans on assignment contracts which are sometimes put in place by large corporations to prevent smaller businesses from securing finance against their invoices can only be positive.

We are pleased to see that difficulties accessing external finance remains at the bottom of the list of anticipated risks faced by manufacturers. It was a similar story in 2015 and shows that for those manufacturers in a position to invest, they can generally secure the external finance that will enable them to do so.

In light of these risks, one of the most notable, and potentially worrying, findings relates to the perceived competitiveness of the UK as a location for manufacturing. This year's survey shows a sharp drop in the proportion of manufacturers that view the UK as a competitive place to operate. Part of this perception could be down to labour costs with wage inflation being pushed up by a tightening labour market and government policies such as the National Living Wage. Anticipation of a rise in interest rates is also surely playing into this perception.

Despite the industry's more muted expectations going into 2016, it is not all bad news. Business insolvencies remain steady and close to pre-crisis levels. We are seeing that the manufacturers we work with are putting in place strategies to manage the risks and uncertainties they face. Demand for finance from manufacturing businesses, and particularly SMEs operating in the sector, continues to be strong.

Looking at manufacturers' priorities for the year ahead paints a rosier picture and it is pleasing to see that positive priorities top the list. Increased investment in innovation and technology has come out as the top priority in 2016, closely followed by selling into new export markets. The digitisation of manufacturing processes continues at pace so it is reassuring to see that firms are embracing this. Likewise, with many manufacturers anticipating a fall in UK sales, it makes sense that they are looking to foreign markets to generate the growth that they may struggle to find at home.

Aldermore understands that the success of SMEs is vital for the UK's ongoing economic recovery and that many manufacturers play a particularly important role as our leading exporters. We are committed to supporting our clients in the manufacturing industry and beyond to manage the challenges they face, take advantage of opportunities that arise and ultimately to help them fulfil their business ambitions.

Carl D'Ammassa is Group Managing Director – Business Finance at Aldermore (www.aldermore.co.uk)

About EEF

EEF is dedicated to the future of manufacturing. Everything we do is designed to help manufacturing businesses evolve, innovate and compete in a fast-changing world. With our unique combination of business services, government representation and industry intelligence, no other organisation is better placed to provide the skills, knowledge and networks they need to thrive.

We work with the UK's manufacturers from the largest to the smallest, to help them work better, compete harder and innovate faster. Because we understand manufacturers so well, policy makers trust our advice and welcome our involvement in their deliberations. We work with them to create policies that are in the best interests of manufacturing, that encourage a high growth industry and boost its ability to make a positive contribution to the UK's real economy.

Our policy work delivers real business value for our members, giving us a unique insight into the way changing legislation will affect their business. This insight, complemented by intelligence gathered through our ongoing member research and networking programmes, informs our broad portfolio of services; services that unlock business potential by creating highly productive workplaces in which innovation, creativity and competitiveness can thrive.

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The data used in this survey has been provided by EEF members. Contributing to our surveys helps us to accurately reflect the trends and behaviours that shape the UK manufacturing sector.

If you would like to participate in future surveys, please contact Amanda Norris in our Information and Research team research@eef.org.uk

About Aldermore

For more information about Aldermore and how they can support you and your business visit: www.aldermore.co.uk

Aldermore is an SME-focused bank which operates with modern, scalable and legacy-free infrastructure.

It offers straightforward financial products and solutions to meet the needs of underserved Small and Medium-sized Enterprises (SMEs) across their business and personal lives, as well as homeowners and savers.

Aldermore focuses on specialist lending across four areas: Asset Finance, Invoice Finance, SME Commercial Mortgages and Residential Mortgages. Its lending is predominantly supported by the deposits it receives from Britain's savers.

By offering a genuine alternative to the incumbent banks, Aldermore provides much needed diversification in the British banking landscape.

Aldermore has no branch network but serves its customers and intermediary partners online, by phone and face to face through its network of regional offices located around the UK.

Aldermore places its customers at the heart of everything it does. Its brand pillars – exceptional service, total transparency and community – are the direct result of feedback from customers, differentiating Aldermore from its competition and helping it deliver banking as it should be.

Aldermore Bank PLC is an operating entity of Aldermore Group PLC. In March 2015, Aldermore Group PLC's shares (ALD.L) listed on the Main Market of the London Stock Exchange.

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