



UK BUSINESS CONFIDENCE MONITOR

Q3 2010



WELCOME



This quarter's *ICAEW / Grant Thornton UK Business Confidence Monitor* (BCM) suggests that while the economic recovery continues to take hold, there is still a degree of uncertainty among business leaders on what the future holds. Interviewing spanned the general election. Since then, there has been much focus on the coalition government's strategy to tackle the fiscal deficit and the emergency budget.

What the economic impact of the cuts in public spending will be is still unclear. Government needs to ensure that the action it takes doesn't undermine the recovery. More importantly, it needs to deliver on its commitment to ensure that the UK is truly open for business and investment. It must do all it can to promote economic growth as a means of delivering long-term economic stability.

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

Michael D M Izza
Chief Executive
ICAEW



This quarter's findings provide some encouragement to the business community. BCM offers a regular insight into the state of the economy and the mindset of business leaders running all types of businesses across the UK. Clearly the economic environment remains tough, but the signs are that companies feel ready to start taking decisions affecting their longer term futures.

With conditions apparently easing, I am optimistic that the recovery is starting to take hold and that, with key indicators moving into positive territory, the underlying financial health of UK business is on an upward trend. Everyone would like to see this process accelerate and there remain areas of concern, not least over the impact of public spending cuts on the private sector.

Yet with spare capacity in the economy starting to be absorbed and the private sector looking to increase the workforce, together with investment in R&D and capital expenditure, the outlook for business continues to improve in line with economic conditions.

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 fell back in the third quarter of 2010. The data imply that the UK recovery continued, but growth is likely to cool in the second half of the year.

The ONS preliminary estimate of quarterly economic growth in Q2 2010 was 1.1%, considerably higher than had been expected. The acceleration is explained partly by the effects of restocking as well as a – potentially anomalous – boost in construction activity, and a number of factors point to a moderate recovery rather than a sharp bounce back to trend growth.

KEY ISSUES EMERGING THIS QUARTER

- Business confidence has weakened significantly as businesses acknowledge the path to recovery contains further challenges, with a fast return to strong growth by no means guaranteed.
- Turnover and profit growth have returned to positive territory for the first time since the start of 2009; however, expectations for growth over the next year softened from last quarter.
- Exports continue to expand, with solid growth forecast to continue as weak sterling helps the UK economy to rebalance. Weak sterling is also supporting confidence among UK manufacturers.
- Only modest price rises are planned by firms. Combined with spare capacity this suggests inflation will cool off.
- Access to capital continues to ease for all, though is still more of a challenge to private companies than listed companies.

Currently the UK economy is running at more than 4% below pre-recession levels. The public sector cuts outlined by the new Government and consequent reduction in public sector demand will have a significant downward effect on growth, constraining take up of spare capacity as the private sector recovers.

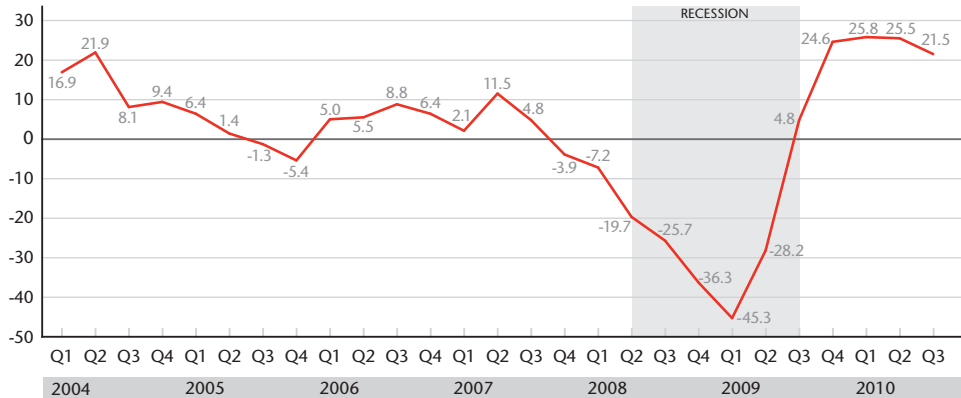
Combined with clear signs in BCM that inflation will fall back from the persistently high levels experienced during the first half of 2010, this makes a strong case for keeping the Bank of England base rate at its historic low of 0.5%. Bank of England Governor Mervyn King has pointed out that there are still significant headwinds for the UK and global economy. As such, monetary policy will have to remain looser for longer.



Douglas McWilliams
Chief Executive, cebr
ICAEW Economic Partner

BUSINESS CONFIDENCE IN Q3 2010

FIG. 1 TREND OF UK BUSINESS CONFIDENCE

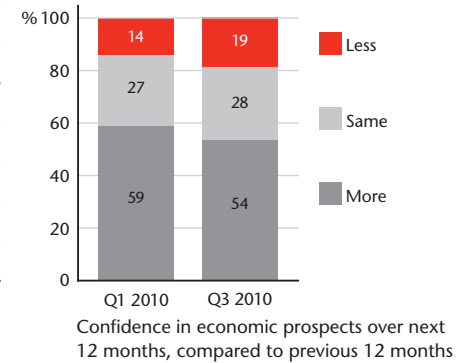


The latest ICAEW / Grant Thornton UK Business Confidence Monitor (BCM) shows a decline in business confidence in Q3 2010. The Confidence Index has declined significantly for the first time since Q1 2009 but remains much higher than pre-recession norms. The decline in business confidence this quarter is consistent with a range of other data that have pointed to a slowdown in the pace of recovery in the second half of 2010.

BUSINESS CONFIDENCE TREND TURNS THIS QUARTER

The latest findings from BCM show that the Q3 2010 Confidence Index has fallen to 21.5, four points below last quarter. Over half of businesses (54%) are more confident about economic prospects facing their organisation over the next 12 months compared to the last 12 months. This is five percentage points down on the first quarter of this year. Further, 19% of businesses are now less confident about the coming 12 months – up from 14% in Q1 2010. The Confidence Index remains considerably higher than during the recession when it reached a record

FIG. 2 CONFIDENCE INDEX – DETAILED RESPONSES



low of -45.3. It is also still elevated compared to typical pre-recession levels. This year's record highs in the Confidence Index have partly been due to businesses comparing against the lows of the recent recession. The current point of comparison – Q3 2009 – is the period just before positive GDP growth returned to the UK economy. Even so, the fall in the Confidence Index indicates an acknowledgement among the business community that the path to recovery contains further challenges, and a fast return to strong growth is by no means guaranteed.

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



The latest BCM Confidence Index points to continued growth in Q3 2010, although at a slower rate than in Q2 2010. Preliminary estimates from the Office for National Statistics (ONS) showed the economy growing at 1.1% quarter on quarter in Q2 2010. This was significantly higher than had been predicted by independent forecasters, and was largely driven by an apparently anomalous bounce-back in construction activity, combined with further evidence of the effects of restocking boosting production.

CONFIDENCE INDEX POINTS TO SLOWER GROWTH IN Q3

The ONS published its first estimate of GDP for Q2 2010 in July, showing quarter-on-quarter economic growth of 1.1%. Output rose in Services (0.9%), Government and Other Services (0.9%), Construction (6.6%) and Manufacturing (1.6%).

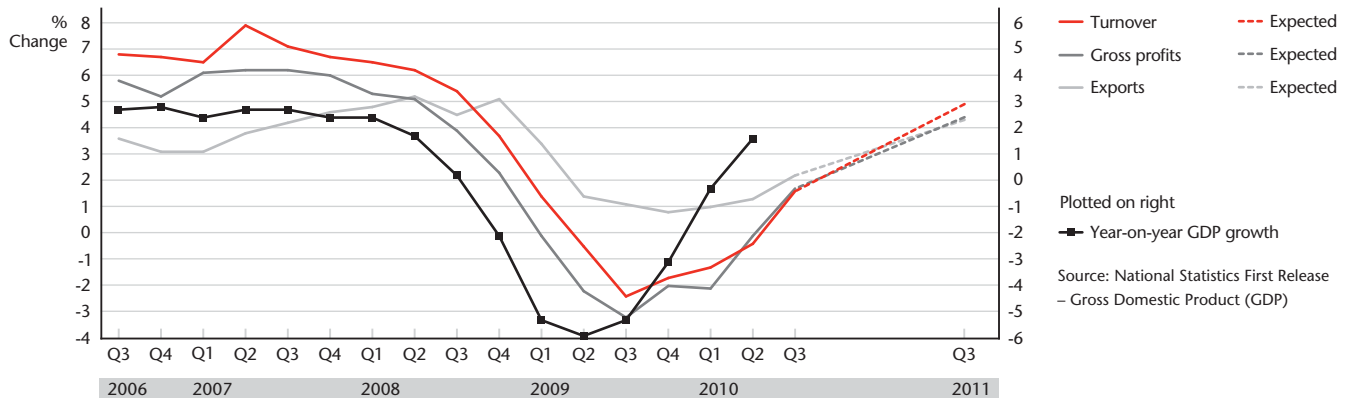
The Confidence Index suggests that quarter-on-quarter growth will slow in Q3. This is highly plausible, given government contribution to growth is set to decline sharply, and sectors with strong reliance on public spending – including construction – will face downward pressure on growth as public sector demand contracts.

Moreover, the evidence in BCM is consistent with other survey data suggesting the pace of recovery is likely to cool in the second half of 2010.

The labour market continues to show signs of improvement, with the proportion of the working-age population claiming Jobseeker's Allowance falling to 3.8% in June 2010 from 4.2% in March. Over the next few years, however, public sector redundancies are likely to add to unemployment levels, so private sector job creation will have to be strong if further rises in unemployment are to be avoided.

BUSINESS FINANCIAL PERFORMANCE

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



For the first time since Q1 2009, firms are reporting an increase in turnover compared to a year ago. The latest BCM financial performance indicators show that businesses' financial results have improved significantly. Businesses also report year-on-year growth in gross profits for the first time since Q4 2008, while export growth has strengthened further this quarter, with expectations for solid growth in the year ahead.

SIGNIFICANT IMPROVEMENT IN FINANCIAL PERFORMANCE

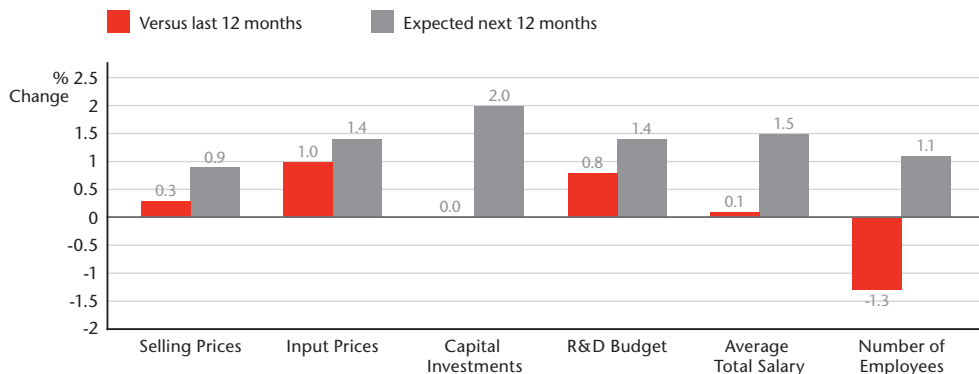
BCM findings in Q3 2010 suggest a significantly improved financial situation for businesses. Both turnover and gross profits are reported to have grown at the strongest pace since Q4 2008. Turnover has increased by an average of 1.6% on the previous year, while gross profits have risen by 1.7%. The yearly growth rate in exports has risen to 2.2% in Q3 2010, from 1.3% in Q2 2010.

Expectations for the future are also optimistic. Businesses expect an average 4.9% expansion in turnover and 4.4% in gross profits over the

coming 12 months. While this positive picture is welcomed, it is important to bear in mind that there has been an inherent optimism bias in business expectations recorded in BCM throughout the recent recession. Expected growth in profits and turnover were well above actual outcomes through 2008 and 2009, as business plans were derailed by the fall-out of the global financial crisis and consequent recession. The current unprecedented public sector spending cuts have the potential to do the same.

TURNOVER AND PROFITS GROWTH POSITIVE YEAR TO DATE • SOLID EXPANSION FORECAST FOR YEAR AHEAD

FIG. 5 Q3 2010 – AVERAGE % CHANGE IN...



Businesses feel confident to plan for investment in capital equipment and R&D. Capital investment was flat over the year to Q3 2010 while R&D spending is reported to have grown only marginally. Budgets for capital investment and R&D are expected to grow over the year ahead, with growth in capital investment stronger than at any time since Q1 2008. Firms also report the shallowest year-on-year decline in headcount since Q1 2009, though they expect limited growth over the coming year.

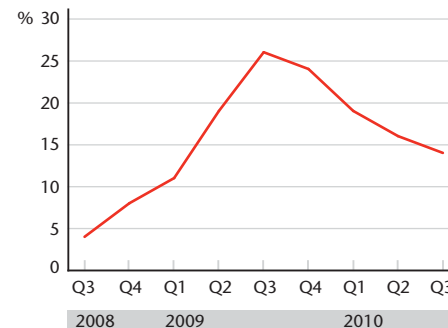
INFLATIONARY PRESSURES LIMITED

Businesses expect to increase selling prices by 0.9% on average over the next year, with input prices expected to rise by 1.4%. While in positive territory, these rates of expansion are still below pre-recession norms. This suggests that inflationary pressures in the economy will remain muted over the next year after the recent period of above-target inflation. Modest expectations for salary growth also suggest low inflationary pressures.

Annual consumer price inflation has fallen from a peak of 3.7% in April to

FIG. 6 STOCK LEVELS – RAW MATERIALS AND COMPONENTS

BELOW NORMAL, Manufacturing, Construction, and Transport sectors



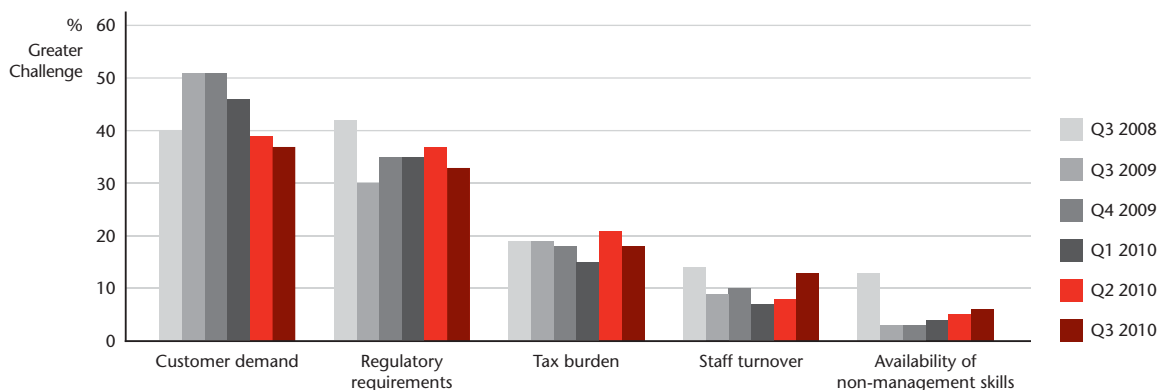
3.2% in June. This is still well above the Bank of England 2.0% target, although this is largely due to increases in indirect taxes, commodity prices and the relatively weak value of sterling. Excluding indirect taxes, annual consumer price inflation was only 1.6% in June.

The proportion of firms with below-normal stock levels continues to fall this quarter, down to 14% from 26% a year earlier. Restocking as part of the inventory cycle is thus continuing to contribute to economic growth in Q3 2010.

CAUTIOUS INCREASES IN INVESTMENT PLANNED • INFLATION HAS FALLEN BACK • RESTOCKING CONTINUES

FACTORS AFFECTING BUSINESS FINANCIAL PERFORMANCE

FIG. 7 IMPACT ON ORGANISATION'S PERFORMANCE – CHANGE VERSUS 12 MONTHS AGO (UK AVERAGE)



Market conditions appear to be continuing to improve: the encouraging trend for share of businesses reporting customer demand as a greater challenge to performance than 12 months ago has continued this quarter.

However, as the market picks up, the issue of staff retention may come to the fore for some firms. This quarter a trend is beginning to emerge for increasing proportions of businesses to report staff turnover as a greater challenge, albeit from very low levels.

STAFF TURNOVER BECOMES A GREATER CHALLENGE

The proportion of firms reporting staff turnover as a greater challenge than 12 months ago is up this quarter, most likely reflecting a mild recovery in the labour market. The number of vacancies rose from 475,000 in Q1 2010 to 486,000 in Q2 2010. With more vacancies available, employees have more options and firms find it harder to retain talent.

However, the proportion reporting availability of non-management skills as a greater challenge than 12 months ago remains low, and well below typical pre-recession levels of one in five firms reporting this trend.

With unemployment at 7.8% over the three months to May there is still a large pool of unemployed skilled labour from which businesses can hire.

The proportion of businesses reporting regulatory requirements or the tax burden as increased challenges to performance has remained stable since last quarter, and is in fact little changed since a year ago. With an expectation that the new coalition government will be more pro-business and anti-bureaucracy, it will be interesting to track whether these factors become less of a challenge to business performance as the parliamentary term progresses.

FIG. 8 ACCESS TO CAPITAL – CHANGE VERSUS 12 MONTHS AGO



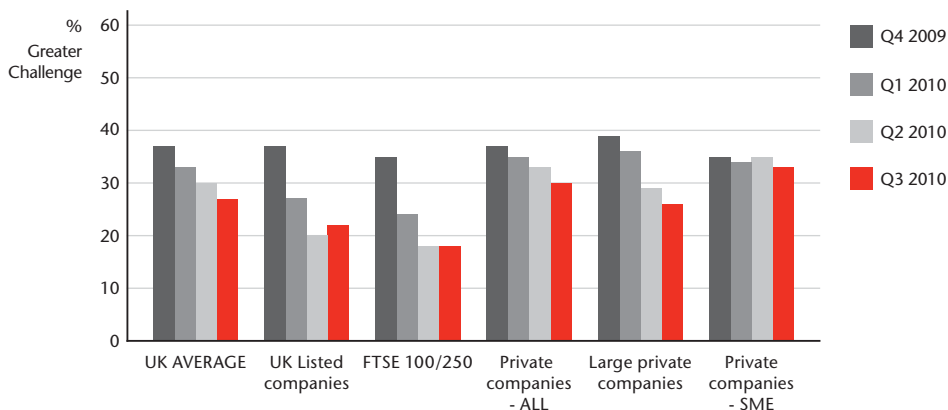
ACCESS TO CAPITAL CONTINUES TO BE EASIER FOR LISTED FIRMS

Overall the proportion of businesses reporting access to capital as a greater challenge to performance than 12 months ago now stands at pre-recession levels, though there are differences between listed and private firms. This divergence may reflect differences in the most common means of financing.

Listed companies tend to issue equity and bonds while private companies – especially small and medium-sized private companies – are more reliant on bank loans which remain constrained. However, other work by ICAEW indicates that there is a limited demand for new debt as firms work to manage their costs. Instead they are meeting their financial needs by other means.

Late payment, while less of an issue for business generally, remains a considerably more stubborn problem for smaller than larger companies. Combined with a desire to meet finance requirements without resorting to further external debt financing, cash flow remains a key issue for SMEs.

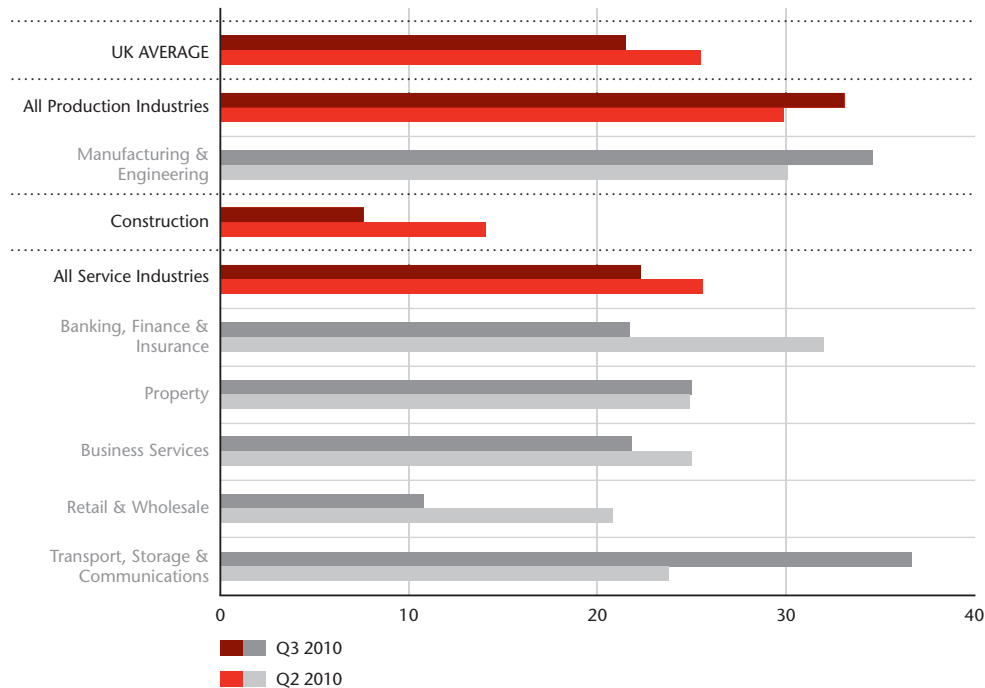
FIG. 9 LATE PAYMENTS FROM CUSTOMERS – CHANGE VERSUS 12 MONTHS AGO



CONCERN ABOUT FUNDING AT PRE-RECESSION LEVELS OVERALL • IMPROVEMENT GREATER FOR LISTED FIRMS

TRENDS IN BUSINESS CONFIDENCE INDUSTRY

FIG. 10 TREND OF BUSINESS CONFIDENCE BY INDUSTRY



While confidence has generally weakened among service sectors this quarter, it remains robust among manufacturers. The Confidence Index has fallen particularly sharply in the Banking, Finance & Insurance and Retail & Wholesale sectors as the ONS reported service sector output rose by only 0.9% in Q2, with growth set to slow in the second half of 2010. Confidence has risen most strongly among businesses in the Transport, Storage & Communications sector which tend to be selling their services to other businesses rather than to the consumer.

BCM REVEALS DISPARITIES ACROSS THE ECONOMY

This quarter's BCM shows a growing disparity in business confidence between different sectors of the economy. The Confidence Index in most sectors fell between Q2 and Q3 2010, although the Manufacturing & Engineering and Transport, Storage & Communications sectors are exceptions to this.

Confidence among firms in Manufacturing & Engineering – which account for about 13% of the UK economy – has strengthened this quarter, reflecting positive estimates by the ONS of 1.6% quarter-on-quarter growth in Q2 2010 for the sector.

Among Construction sector firms, however, confidence weakened considerably. This comes after the ONS reported Construction output up 6.6% quarter on quarter in Q2 2010 following a 1.6% rise to Q1 2010. The boost to output probably reflects previous orders coming online, while the forward-looking confidence indicator suggests firms see more challenges ahead. Impending public sector spending cuts will be of concern, since the public sector has been an important source of demand for construction projects in recent years.

FIG. 11 TREND OF BUSINESS CONFIDENCE BY INDUSTRY



The Banking, Finance & Insurance Confidence Index peaked in Q4 2009 and has declined in each subsequent quarter. Confidence among Retail & Wholesale and Construction sector firms has also declined consistently since the start of the year. In contrast, confidence in the Manufacturing & Engineering sector has risen in every quarter since Q1 2009 as a significantly weaker sterling has helped the competitiveness of firms.

FINANCE SECTOR CONFIDENCE WEAKENS AGAIN

The Confidence Index for the Banking, Finance & Insurance sector has fallen from a 37.6 peak in Q4 2009 to 21.7 this quarter. This is the third consecutive quarter where confidence has weakened in the sector, as concerns over sovereign debt issues in the eurozone rumble on, and ongoing questions remain over regulatory developments such as the implementation of Basel III.

The continued decline in confidence in the Banking, Finance & Insurance sector may also reflect expectations of a toughening of the regulatory

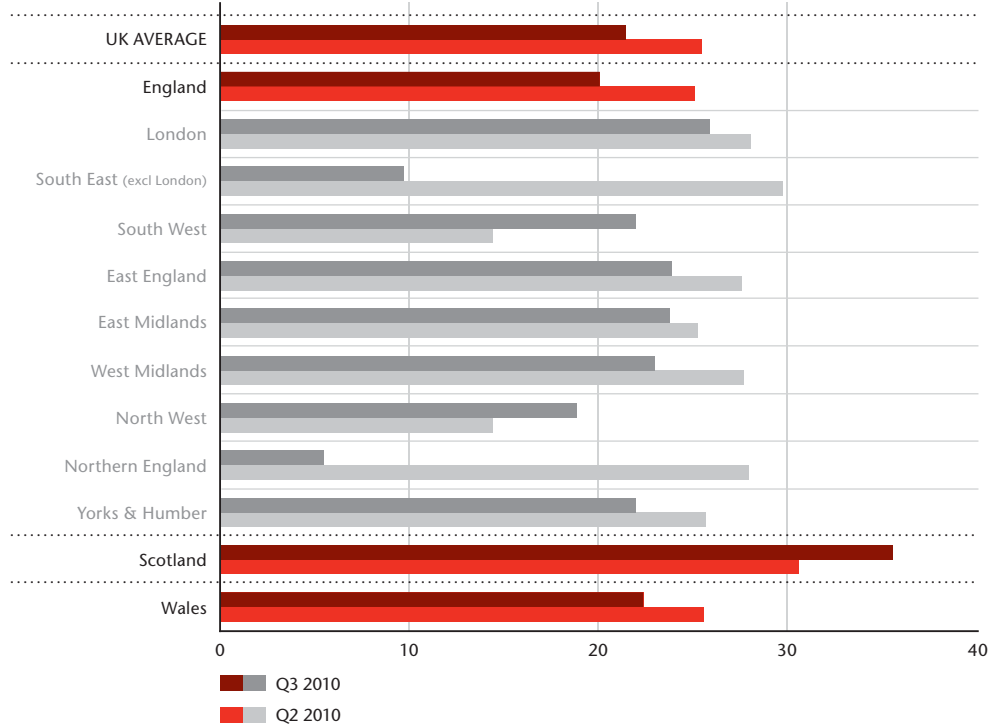
regime over the coming 12 months. The bank levy announced in the June Emergency Budget is expected to extract more than £8bn from the Banking sector over the next four years, while the Bank of England is to be given new financial regulatory powers.

Having rallied well from the middle of last year, confidence among both Retail & Wholesale and Construction sector firms now stands well below that of most other sectors. Together these sectors account for about 18% of the UK's economic output.

TRENDS IN BUSINESS CONFIDENCE

REGION

FIG. 12 TREND OF BUSINESS CONFIDENCE BY REGION



Confidence has remained relatively stable in most regions since last quarter. The downward movement in the national Confidence Index is driven by significant downward trends in confidence among firms in the South East and in Northern England.

CONFIDENCE WEAKENS IN SOUTH EAST AND NORTH

The South East and Northern England report sharp reductions in confidence this quarter.

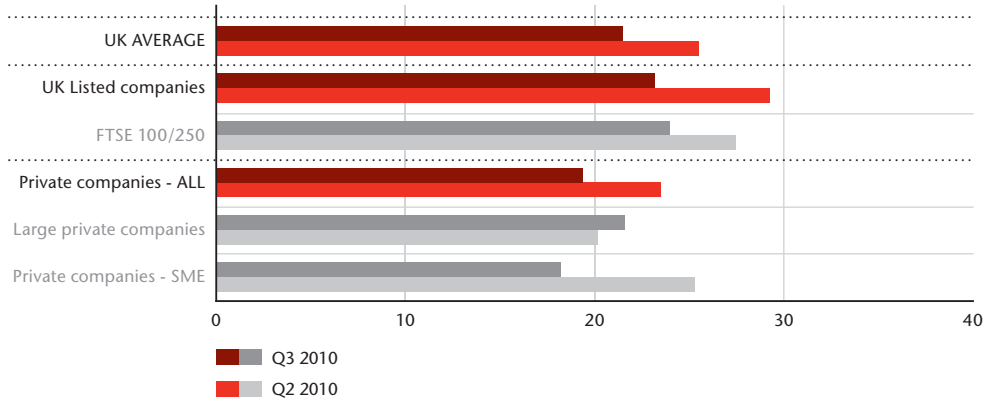
Service sectors account for around 75% of the South East regional economy, and growth in service sector output has been – and is expected to remain – sluggish. Further, while the share of public sector employment in the region is the second lowest in the UK (around 17% against 21% as a whole), the local economy does include companies that rely heavily on public sector contracts.

In addition, anecdotal evidence suggests that businesses in the South East are concerned the region is being specifically targeted for withdrawal of much government support for business.

In Northern England local development agency support is also under threat, while heavy job losses are expected in public and private sectors. Public sector spending has been estimated by cebr to account for about 64% of GDP in the region. The cuts in public spending announced in the June Emergency Budget are likely to be of particular concern to businesses in the region.

TRENDS IN BUSINESS CONFIDENCE TYPE

FIG. 13 TREND OF BUSINESS CONFIDENCE BY COMPANY TYPE



Confidence has declined markedly this quarter among small and medium sized private companies. Among top FTSE listed companies and large private firms it has remained relatively stable.

SMALL AND MEDIUM FIRMS LESS CONFIDENT THAN LAST QUARTER

While the difference between most and least confident by company type is not wide, this quarter confidence has fallen significantly among small and medium sized private firms.

Among listed companies the longer term trend for the Confidence Index is stable. Confidence among large private firms is also unchanged this quarter.

SME FIRMS SIGNIFICANTLY LESS POSITIVE • LARGER FIRMS' OUTLOOK BROADLY IN LINE WITH LAST QUARTER

ABOUT BCM

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

The report is based on 1000 telephone interviews conducted 29 April 2010–22 July 2010, with ICAEW members working in industry and commerce. These probed opinions on past performance and future prospects for members' businesses, as well as investigating perceived changes in impact of factors such as availability of skills, government regulation and the tax regime. Data are weighted to 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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Interviewing and data analysis was undertaken by Kudos Research.

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