BTG Global Advisory

UK INSIGHT

Manufacturing Issue 4: October 2015

Stormy weather

In the fourth of a series of updates for BTG Global Advisory, we analyse manufacturing and its role in rebalancing the UK economy in uncertain times.

Just when things seemed to be looking up and even the eurozone was showing signs of recovery, the Chinese economic balloon deflated and the FTSE fell 5% in a day. Is this another setback in the UK's quest to rebalance the economy with greater recognition for the manufacturing sector?

The UK's summer was particularly unsettled, reflecting an outlook for the economy in general and manufacturing in particular that is less certain than for a few years. Some of the uncertainty is historical and can be ascribed to the period leading up to the General Election. The Conservative victory has enabled the Government to develop a less diluted policy and economic strategy for the next few years, but the UK does not exist in a vacuum. The outlook for eurozone countries will remain poor for as long as the situation in Greece, especially, remains unresolved. The high profile of the Greek problems may have obscured ongoing troubles in other countries, including Portugal and Spain, although there are signs of a limited and sluggish recovery in the latter. While there have been suggestions that interest rates are likely to increase in the next few months, 0% inflation (CPI, 17 September) makes any such move unlikely – in the UK, at least, circumstances are different across the Atlantic. Demand from emerging economies continues to grow, mostly among the smaller countries, and the slowdown in the Chinese economy is causing a few grey hairs among those who looked to it as a source of continuing demand for the foreseeable future.

Home Truths

The UK economy expanded by 0.7% in April-June inclusive, but manufacturing declined by 0.3%. The broad heading 'manufacturing' covers a swathe of activities, from meat processing to aircraft and spacecraft production. The sectors that have performed particularly poorly include iron, steel and other metal production; weapons and ammunition; machinery and equipment (other than specifically described); and furniture. Those that have done better include air and spacecraft and related machinery, ship and boatbuilding, and motor vehicles.

The Markit/CIPS manufacturing purchasing managers' index (PMI) for July 2015 stood at 51.9, higher than June's 51.4 but below the average of 54.3 for the "current sequence of growth", which began in April 2013. So the PMI remains in positive territory, but only just; it is reckoned to be dependent on strong performance in the consumer goods sector, which Markit says offsets "lacklustre growth" for intermediate goods producers and contraction in the investment goods sector. This picture extends into the export market: July saw the fourth successive month of decline in new orders, ascribed primarily to the strength of sterling against the euro. Levels of new work from overseas were reported to be lower in the intermediate and investment goods sectors, but rose solidly for consumer goods producers.

The decline in raw material costs may have been the strongest story of the year, were it not for the situation in China, and remains a significant factor. A surge in North Sea oil and gas production lifted overall industrial output by 1% and the mining and quarrying component of the industrial output figures, which includes oil and gas extraction, rose by 7.8% in the quarter – the biggest increase since 1989 – but it is a double-edged sword. The collapse in oil prices is good news for energy-dependent manufacturing and, overall, for the chemical industry, but definitely not good news in the longer term for the North Sea and for manufacturers and suppliers who are dependent on healthy activity in oil and gas exploration and exploitation. It is uneconomic to develop the more remote and smaller resources in the Continental Shelf when oil is below $50/barrel.

On a more positive note, the CBI said in August that UK manufacturers generally are seeing an improvement in orders and even in exports. The balance of those reporting increased orders (21%) against those saying the opposite (22%) gave a balance of -1%, a significant improvement over July's figure of -10%. The export balance was reported at -8%, compared with -17% in July. Output overall stands at +14%, 33% of firms reported increased output in the three months to August and 20% said it decreased.

Investment and Concerns

Jaguar Land Rover (JLR), BAE Systems, and other companies in engineering, defence, aerospace and machinery, have announced increases in sales, output and production. Reports on the UK's overall economic performance going back several years have indicated a paradox: poor productivity and growing manufacturing output appear to be incompatible, but we have a complicated economic structure. Factors influencing these anomalies include the role of the financial sector, behaviour of supply, behaviour of companies, flexibility of the labour market, and measurement errors in GDP estimates.

Since the emergence and widespread adoption of Lean principles, the UK's manufacturing sector has improved its inbuilt flexibility and productivity; the numbers in the wider economy are heavily influenced by the financial sector, which is still suffering the after-effects of the credit squeeze and banking collapse of 2008, although it performed strongly in Q2. Productivity in the finance sector is a challenge: there are limits to the additional productivity that can be extracted from accountancy and financial services, and the world is more cautious since 2008 about financial instruments that claim to create value from nothing.

The UK has particular strengths in aerospace and in automotive, where markets extend across the world, beyond the eurozone. While these markets will be affected by the strength of sterling, JLR has opened assembly plants in China and in Brazil, which will help to mitigate the effects of currency fluctuations while maintaining some level of demand for UK-sourced components, as well as design assets.

Two concerns persist. The UK has, historically, failed to invest in automation to the same extent as its competitors – a fact that is borne out by the presence of robots in manufacturing. It was estimated by World Robotics that there were approximately 190,000 robots in operation in Germany in 2013, compared with just 16,000 in the UK. 'Robot density' in the UK generally stood at 27 per 10,000 employees, compared with 147 in Germany. The automotive industry leads the field by a street, with 677/10,000 employees in the UK – but that is still only just over half of Germany's 1,133/10,000 in the auto sector.

While the lower level of investment is a concern, it should be borne in mind that productivity in the UK's auto sector is rather good – at the OEM (original equipment manufacturer) level, at least. The Nissan plant in Sunderland remains the most productive plant in Europe. In September, the company announced that it will invest £100m into the Sunderland plant, in order to facilitate production of the next-generation Juke model; this was in addition to the £37m investment announced in June, which will be used to create an eighth press line. GM Europe continues to build Astras at its Ellesmere Port facility because of its highly competitive record of productivity and flexibility. Tier One suppliers such as GKN, Unipart, Johnson Controls and others, have levels of automation and productivity that are at least as high as their OEM customers; whatever problems and issues there are exist further up the supply chain.

Annual Investment Allowance Encouraging Automation?

The UK government is doing something to try to stimulate more investment. The Chancellor's announcement in the Summer Budget that the Annual Investment Allowance (AIA) will continue at its current level of £500,000 until the end of 2015 is welcome. January 1 2016 will see it fall back to £200,000, which remains a usefully high figure for most SMEs.

There are indications that this encouragement is having an effect. In 2013 the UK's level of orders for industrial robots was at its second-highest ever, after 2012. According to the industrial IT company, Delmia, 'UK Mittelstand' – essentially, companies with turnovers of £100-£400m/year – have been making substantial investments in robotic lines, for activities such as cleaning and fettling. The company has also seen the UK's network of 'high-value catapult' technology centres helping mid-sized organisations, and believes that these and other initiatives will also help smaller organisations to work with high-value manufacturers, to access specialist knowledge and to improve assessments of the likely value and ROI of investments under consideration. It is also the case that hardware costs are not as challenging as they once were – robot and automation applications can be found for as little £8,000. Rather, it is software that can be the major financial hurdle for SMEs. While OEMs will often buy Delmia, Catia, SolidWorks and similar application 'seats' for use by companies in the supply chain, Dassault Systèmes is looking at means to enable OEMs to use the Cloud to share information in a secure environment, which will help to bring costs down. There is evidence that manufacturers have been and continue to invest in automation projects, some of which are quite large. A survey by *The Manufacturer* found that automation projects of £100,000 and over are currently a regular part of annual expenditure.

The latest indications are that this trend is continuing and banks in the UK are seeking to assure their customers that they are very interested in supporting these investments. Hire purchase and leasing specialists are reporting increased activity; the August report from the Finance & Leasing Association (FLA) showed 20% growth in asset finance new business for deals of up to £20m in June 2015, compared with the same month in 2014, with total new business in this market reached £27.1bn in the 12 months to June. This is a new record level: the pre-crisis peak was £26.7bn. Within that overall figure, IT equipment finance grew by 32% in June 2015 over the same month in 2014; plant and machinery finance grew by 11% over the same period, to £544m in June 2015, with the 12-month total to the end of June amounting to £5,722m – a rise of 16%.

The Land of the Living – and the 'Living Dead'

Positive developments in UK manufacturing include the opening of Jaguar Land Rover's new Ingenium engine plant in Wolverhampton. BAE Systems is pursuing a new deal with Middle Eastern countries for its Typhoon fighter.

The confidence extends into the SME segment and across different markets. Gardner Denver's Redditch plant, which recently celebrated its 40th year of manufacturing compressors and vacuum pumps, is expanding its output. It has launched a new high-pressure reciprocating compressor, designated WH35, which has an output of 2120 cu m per hour at 40barg and is aimed at mid-range PET blow-moulders and bottlers. Over 80% of production is destined for export, mainly to Turkey, Asia and the Middle East. It has seen improvements in productivity as a result of initiatives including Lean manufacturing. It is also investing in its workforce by the introduction of an apprenticeship scheme – a trend that the Chancellor's announcement of an Apprenticeship Levy may encourage in other companies.

The second concern in the context of the manufacturing base is 'zombie companies' – those being kept going by their banks, but which are really 'walking dead'; their creditors are simply waiting for a general upturn in the economy that will enable them to go in, close the business and sell the assets for prices that will get closer to covering debts.

There has been very little activity under this heading so far, which is not the normal experience of an economy coming out of recession; the number of insolvencies usually shows a significant uptick as things are getting better, as the banks seek to clear their books. There are arguments that a 'zombie clear-out' is a good thing, as it will open up the market for more vigorous, more soundly financed and stronger companies to expand.

First, however, you have to find your zombies. No business owner is likely to put his or her hand up, admit they are a secret zombie and volunteer to be culled, so they have to be named, shamed and decapitated by third parties. So far, they do not appear to have been identified in any large numbers. Why this is currently the case is not entirely clear, but a few reasons suggest themselves. First, after their experiences in the immediate aftermath of 2008, those businesses that have been able to find alternatives to bank financing have and continue to do so – even if it means digging into their own resources, remortgaging or downsizing the house, or calling on crowdfunding, family, friends and others. They may be lurching along – or they may be businesses that genuinely are doing quite well but would, in the past, have found themselves closed down because of what they would see as short-sightedness by their lenders. Indeed, there may not be the number of zombies normally expected; the businesses may have made themselves leaner, adapted to customer demands or actively gone out to seek new markets – or a combination of these strategies.

An increase in interest rates should enable identification of the zombies quickly as they will be most exposed to any rise, but until we see the dead, soulless emptiness in their eyes, the zombies will not provide their hunters with a field day.

Chinese Whispers

The PRC (mainland China) was the source of a series of unwelcome events during the summer. The Chinese government devalued the yuan twice and then its listed stock market companies started shedding share value. This is important to British companies because our relationship with the country has changed. In the 1990s and into the first decade of this century, China was seen as a source of cheap labour and, consequently, low-cost finished and part-finished goods. Now it is rather more important as a market – particularly for luxury and premium goods, from Burberry to JLR cars. In the latter case it has become so important that JLR has built an assembly plant at Changsu, near Shanghai, in a 50:50 joint venture with Chery, the Chinese automaker. The plant, which started production in October 2014, is expected to produce 130,000 vehicles a year, beginning with a version of the Range Rover Evoque that has been tailored to the local market. Almost one-quarter of JLR's total 2014 sales – more than 100,000 of 425,000 cars – were in China and the company expected a 20% increase in 2015.

Not all of the Chinese demand is currently being satisfied by local production; on a sombre note, approximately 5,800 British-built vehicles recently shipped to China were stored at various locations in Tianjin, the site of an explosion that killed 114 people and left hundreds more injured or unaccounted for.

What the longer-term impact will be of the upheavals in the Chinese economy remains to be seen. The Chinese stock market is dominated by individuals and small investors, rather than the institutional pattern that typifies the West. If individuals suffer heavy losses they will feel less inclined to make big-ticket purchases; if the reluctance is large enough then the retail side of the economy will slow down and will impact on British companies exporting there. It is far too early to say what the effect will be in the longer term, although Rain Newton-Smith, CBI Director of Economics, observed: "With only 4% per cent of the UK's exports going to China, the country's slowdown is not a direct cause of concern for our manufacturers but it will make life harder for our firms in exposed sectors like metals and commodities."

The role of China as a supplier has come under review in recent years. Pete Waterman may be better known as a record producer and the power behind the sound of Kylie Minogue, Steps, and Rick Astley (among others), and for his involvement in the *Pop Idol* talent show, but in business and manufacturing circles his reputation is based on his involvement with Britain's railways. He is Deputy Chair of the Cheshire & Warrington Local Enterprise Partnership (LEP), founded the Railway Exchange Training Academy and previously owned a company that provided maintenance services to train operating companies, which he sold to Arriva. His experience of supply from China is not entirely positive.

"I went to look at wheelsets [for rolling stock] and everything was great, but that's not the case now," he says. "They have fallen back very fast. The first set was great, the second was OK but not so good, the third was awful." He also maintains that the lag on the UK's competitiveness – labour costs – is not as much of a disadvantage in current circumstances.

"When it comes to China, the cheapness we think of is essentially a myth, these days," he maintains. "While you will find people working very cheaply in some industries, in toy manufacturing, say, that is not the case in engineering. We in the UK cannot manufacture cheaply in bulk, but skilled labour is a different matter. When I visit schools I tell the kids that if they become engineers they can go anywhere in the world, because the world wants skills." As does the UK, especially; manufacturers continue to report difficulties in filling skilled vacancies in engineering.

Straws in the Wind

Other important international developments that are likely to affect demand for UK products include the ongoing situation in Ukraine and continued sanctions against Russia; and the foundation of the New Development Bank (NDB) by the BRICS countries. The latter is likely to prove to have the greater impact, both within emerging economies and, consequently, across the rest of the world. The UK has got on board, despite opposition from some quarters, but the ultimate outcome will have to wait on the resolution of the latest China crisis.

Ref: BTG 1539_4/01.16