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MARKET INSIGHT: UK Manufacturing

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Xenia’s Market Insight reports are designed to work alongside a credit insurance programme. The purpose of this report is to provide you with objective and practical information that will help to advance your understanding of the issues and how they might impact your business.

We welcome your thoughts and questions on the issues covered. Please email us on info@xeniabroking.com should you require any further advice or have questions about this report.

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Introduction

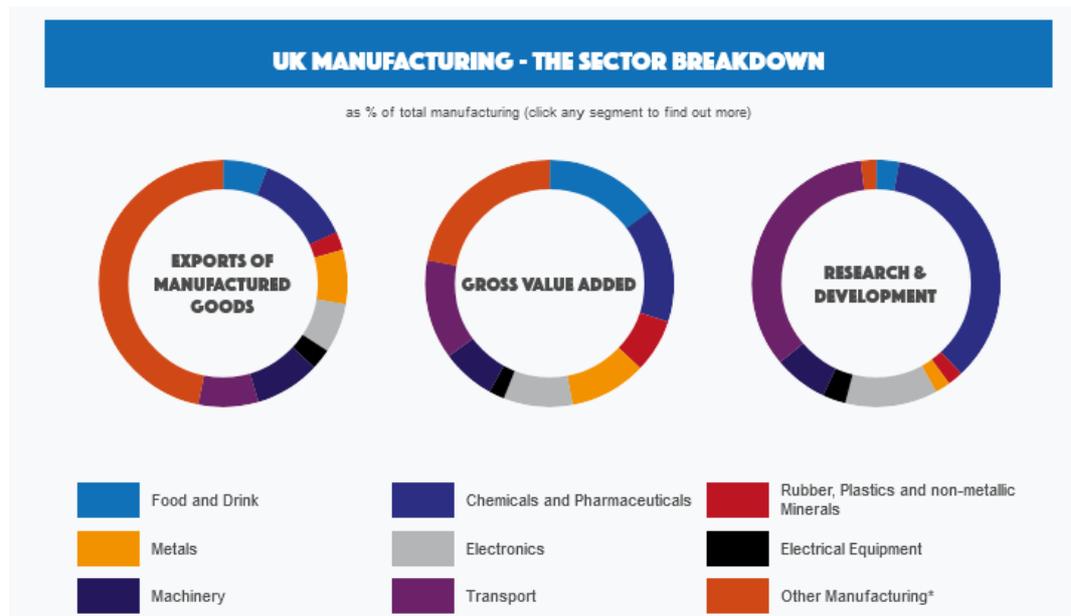
The past 30 years have been characterised by a surge in international trade as globalisation has become more and more dominant. In many advanced economies this intensification has been associated with increased imports from low wage economies. Two key developments are the ascendancy of China as an important player in global markets and the inclusion of some Eastern European economies to the European Union. Both changes were associated with a shift in trade regimes and led to a sharp rise in import competition, particularly in the UK manufacturing sector. These changes are likely to have accelerated the decline of UK manufacturing.

The UK has always been a strong, innovative, and spirited manufacturing nation and in recent years the sector has been approaching a significant confluence on the back of technological acceleration and economic hardship. The future of the UK manufacturing industry will certainly be driven by design capability and innovation, coupled with a strong understanding of digital technology and the escalating threat of cyber security. But as our economy is going through a transition following a period of heightened uncertainty, the changes and adjustments in this sector will require significant investment together with a consummate focus on fostering the right skills for the industry to thrive for the next generation. Businesses are not only committed to the long-term investments required, but this has become a necessity in the wake of Brexit and the Covid 19.

In 2023 and for the ninth consecutive month, production volumes have contracted due to a decline in new order intakes caused by weak demand both at home and overseas. The downturn in manufacturing production certainly deepened during the latter part of 2023. The ensuing trading conditions for many manufacturers have become even more difficult as they face such headwinds from destocking, market uncertainty, acute volatility and the cost-of-living crisis on consumer demand.

Key observations

Despite the extremely challenging economic environment, some industry observations and measures are moving in an encouraging direction as the UK aims to rebuild and enhance the offering from the notorious manufacturing industry, especially since our exit from the Single Market. The other side of the coin suggests that the UK economy is set to remain stagnant at best in the coming months as higher borrowing costs take a bigger toll on consumer spending and business confidence.



Source: UK Trade Info (2022), ONS (2021), Oxford Economics (2023)

Economic

- Whilst inflation is now reducing from recent heights and tracking towards the 2% target, manufacturing producer price inflation fell by 2.6% in the year to October 2023 with producer output prices falling 0.6% in the year to October, down from a revised increase of 0.2% in the year to September.
- The Annual inflation rate of the input Producer Price Index (PPI) was negative for the 5th consecutive month.
- Inflation rate of the output PPI was negative for only the third time in the last four in contrast.
- Index levels for both input and output prices have remained high since mid-2022.
- The largest downward contributions to the annual input inflation rate in October 2023 came from inputs of metals and inputs of chemicals.

Business conditions

- Core CPI continues making it difficult for manufacturers and suppliers to pass on price increases to customers, meaning that their margins remain under pressure.
- The main concerns reported by businesses for December 2023 according to the ONS outlook survey were falling demand of goods and services (19%), up from 16% for November 2023, energy prices (10%), down from 12% and inflation of goods and services (8%), down from 10% for November.
- More than one in five (21%) trading businesses reported their performance had decreased in October compared to the same month in 2022. However, when broken down, manufacturing reported a 14.7% increase in performance.
- What is undeniable is that businesses will need to evaluate their supply chains, adjust their business models accordingly and consider introducing technology where applicable, a strategy that's been encouraged and recommended for some time.

Financing conditions

- Financial obligations within the sector remain at typical and expected levels. Borrowing costs are up and capacity is restricted.
- Banking support and liquidity credit flows is tightening and thus hampering working capital needs.
- This sector is dependent and relies on this support for capital expenditure and heavy investment therefore hopefully we can see less contraction.
- Firms are constantly exposed to price and currency volatility too therefore critical to monitor appropriate FX movements.
- The base rate was maintained at 5.25% in December 2023 and thus borrowing costs at their highest level since 2008.

Export endeavours

- The UK has moved up a level and is now ranked 8th largest manufacturing country in the world with a total of £34 billion being invested into the economy yearly.
- In other categories, UK is the 14th largest for export of goods (10th in 2022), 8th for import (5th in 2022) and maintained 2nd in the service trade, which probably encapsulates how the UK is now perceived as a service focussed nation.
- In 2022, UK's exports of goods and services totalled £834 billion, and imports totalled £902 billion.
- The overall trade deficit was £68 billion in 2022 with the EU accounting for 41% of UK exports of goods and services and 47% of imports in 2022.
- There were 2.6 million jobs provided in UK manufacturing in the year with 9% higher wages than whole economy. The sector also attracted 16% of total UK business investment.
- Previously, more than half of the UK's exports headed to EU nations, but this has now fallen under the 50% mark. However, the EEA remains the UK's most important export market, but many are now considering new markets following the European Union exit.
- For some businesses the EU exit represents a positive opportunity to import raw materials from non-EU markets at a lower cost and remove EU import restrictions and tariffs, but we are not seeing benefits from this in its entirety yet. For other businesses, the EU exit means a change to the status quo, which brings with it volatility and uncertainty. Europe and the USA remain key export markets with a shifting focus towards Asia and the Middle East.
- The trade deficit with all countries decreased to £4.5 billion in Quarter 3 of 2023 (July to Sept) compared with a £9.9 billion deficit in Q2. Exports decreased by 0.6% in cash terms over this period while imports decreased by 3%.

Credit risk dynamics

- There has been a deteriorating trend in non-payments this year according to data sourced from Allianz, Atradius and Coface.
- There is anticipation of further insolvencies as we progress to the end of the year.
- Recent Q3 insolvency data conveyed a trajectory corroborating such theories.
- According to leading economists, captains of industry and credit insurance data analysis, the situation is expected to worsen in 2024 before recovery.
- Invoice payments take between 45 and 60 days on average according to research by Atradius.

Manufacturing PMI Appraisal

At end of 2023 the UK continued its downturn trajectory following a slight recovery in November with the seasonally adjusted S&P CIPS UK Manufacturing PMI (Purchasing Managers' Index) reported at 46.2 in December, after rising to a seven month high of 47.2 in November. Not only did new orders, employment, and output decline, but stocks of purchases declined with an improvement in suppliers' delivery times, which is a sign of weak demand.

Production volumes have also contracted for the ninth consecutive month, which in contrast is the longest sequence of decline since 2008-09, as weak demand at home and overseas has led to the decline in new order intakes. Companies are categorically finding trading conditions difficult as they face headwinds from clients destocking, market uncertainty and the waves of impact of the cost-of-living crisis on consumer demand.

Even though November seen some respite, the Outlook has remained tilted, inventories and overall business optimism dipped to a 10-month low, and manufacturers' increased belt-tightening drove cuts to employment, purchasing and stock levels. December seen a continued occurrence of job losses for what is the 13th consecutive month. Although the rate of contraction eased slightly, it remained sharper than the average for the current sequence of decline. Signs of spare capacity at manufacturers contributed to the latest round of job cuts and to a further reduction in backlogs of work.

However, as input costs and output charges decreased, pricing pressures saw a decline. Furthermore, purchase prices dropped for the sixth sequential month thus reflecting lower costs across the board on fuels, steel, packaging, paper, pulp, components, and transportation. Dynamic market influences, especially low demand played an added role in reducing costs. Although, macro signs are starting to improve, this latest contraction is undoubtedly going to impact any optimism gained and any confidence will be a simple case of desire.

UK Manufacturing PMI

sa, >50 = improvement since previous month



Source: S&P Global PMI.
Data were collected 6-19 December 2023.



Insolvency analysis

A recent annual manufacturing survey undertaken by Make UK conveyed a strong message that financial risk dominates over opportunity for manufacturers given the sustained uncertain economic environment. This coupled with 41% of manufacturers planning to expand their exports abroad to non-EU countries means risks associated with trade become more acute. The survey also underlined that a high percentage of businesses expressed either a concern with regards to the risk of late payments or extended payment terms and increased frequency of bad debt as a risk.

Q3 UK insolvency data for 2023, accentuates the testing conditions in the market. Although, company insolvencies decreased slightly during Q3 vs the previous quarter, data confirmed there was a staggering total of 6,208 company insolvencies in the quarter. This comprises of

- 4,965 Creditors' Voluntary Liquidations (CVLs),
- 735 Compulsory Liquidations,
- 466 Administrations and
- 41 Company Voluntary Arrangements (CVAs).

The number reported for the third quarter was 2% lower than the previous quarter, but 10% higher than the corresponding period in 2022. The number of CVLs remained very close to the highest level on record (Q2 2022), since start of the record keeping back in 1960. Of the 6,208, manufacturing reported 1,473 up to Q3 2023 vs 1,687 for 2022 and this is almost certainly going to be leapfrogged by the end of the year. Manufacturing related insolvencies amounted to 8% of all insolvencies in the 12-month period ending Q3 2023 recorded at 1,911 cases captured. Insolvencies of UK Food & Drink manufacturers surged 108% in the year ended June 2023, according to new research from supply chain management consultancy Inverto. It's been cited the rapid rise in costs has been a key driver with 287 businesses entering insolvency as a result up from 138 in 2022. The significant inflation of supply costs was of course driven by the war in Ukraine notably impacting the supply of cereals and grains as well as products needing substantial fuel outlay to source.

According to an annual survey from Close Brothers finance, the top five concerns for Manufacturing businesses, currently, are energy costs, inflation, interest rates, materials supply, and cash flow. 63% of firms are concerned about rising company insolvencies in their supply chain thus leading to the following measures being exercised to ensure they remain solvent: Cost cutting, improving efficiency, seeking new funding, considering refinancing of assets, and adopting credit insurance.

Any business knows that in order to mitigate risk due to insolvency, suppliers and customers need active monitoring to ensure consistency and quality. It is not about pointing the finger or waiting for failure, but building strong business relationships that can withstand financial distress. Therefore, strengthening the credit management function must be a priority to enrich a business's ability to withstand any possible challenges and events that could give rise or impact their own business. By strengthening credit-management and reinforcing it with credit insurance, manufacturers can better protect their revenues, unlock trade finance opportunities, and navigate new markets.

Industry 4.0

The term Industry 4.0 denotes the combination of major innovations and advancements in digital technology, consistently in progression and on the verge of transforming the manufacturing space. These technologies/concepts include artificial intelligence, cloud computing, the Internet of Things, data capture and analytics, digital fabrication (including 3D printing), plus blockchain technology. Moreover, the embedding of these and more will create a shift in the interoperable global value chain, shared by many companies from many countries.

When you look closely at the rapid pace of digitisation in industry today, the name doesn't seem hyperbolic at all. It is a signal of sweeping change that is rapidly transforming many companies but may catch others by surprise. IR4 supports the very fundamentals of good, strong, and sustainable business models, typically efficiency and effectiveness. Manufacturers are already seeing the cost savings that automation and digitalisation can bring through lean processing, virtual production lines and 3D printing, but this is only the start.

There is little doubt that the Fourth industrial revolution is quickly becoming realised, creating significant opportunities for UK manufacturers. By investing in exciting new technologies and keeping ahead of global competition, the future for the industry could be very bright. The challenge, however, is to be properly prepared for, and protected against, the inevitable risks which come with it. The goal for the insurance industry, therefore, is to be nimble enough to adapt to rapid change and to help businesses build strategies which predict the risks that lay ahead as early as possible. Working together, 4IR has the potential to positively change the face of British manufacturing. It's a long-term project with big time goals and if every manufacturer embraces this new paradigm, they will surely get their brick-by-brick step by step.

Credit insurance market sentiment

Credit Insurers remain committed to supporting this important and advantageous sector, a fundamental part of the UK supply chain. UK insurers will continue to underwrite cover where possible but in view of the current environment and sentiment, will remain strategic and prudent in their underwriting line and risk strategy.

The speed at which a good performing business can deteriorate and topple often requires extra scrutiny, forensic assessment and evaluation of its top line, profit margins, debt position, working capital management, risk control measures employed and its strategic roadmap. All of these are key areas that underwriters will pay close attention to along with the following critical guidelines:

- **Information is key** - Credit Risk departments remain in regular dialogue with a variety of businesses across the manufacturing space with a mission to furnish updated management accounts to fully understand both the trading performance in the current environment and the funding facilities that are being made available to support working capital needs of the business.
- **Refinancing** - When meeting with the key buyers in the sector, risk analysts and underwriters will seek to understand how they are mitigating inflation and the impact of increasing interest rates alongside how they are driving efficiencies and the level of CAPEX. Intensive or not.
- **Case by case** - Each business is reviewed on its own financial and fundamental merits for the purpose of its underwriting judgement.

There is certainly an air of caution radiating across the credit market, however, support continues where possible to ensure strong risk management is in place whilst facilitating trade and growth.

Key risks & endorsed actions

The UK Manufacturing industry is not only a critical part of the global economy, but continues to evolve and transform as it moves in alignment with the exponential technology curve. It covers a wide variety of businesses, including food and drink, construction, textiles, electronics and more. However, like all other sectors, they face their own challenges and key risks in this sector include:

Economic Uncertainty: Economic slowdowns and downtrends caused by a number of factors including a volatile unstable currency, global political tensions, changing macro-optics such as interest rates and inflation. As a result, businesses are experiencing reduced order books and thus profits, leading to closures, downsizing, or other financial difficulties.

Investment in new tech: It is imperative that manufacturers continue to invest in new technology in order to remain both competitive and relative. The gradual move and necessity towards lean manufacturing is a far more efficient way of working but often requires intensified and large investment into new plant, machinery, technology, and equipment. Very CAPEX intensive.

Increased competition: The industry, by and large, is highly competitive, particularly those from emerging markets where there is drive, focus, funding and government backing to support businesses vying for market share and commercial loyalty. In this environment, businesses must differentiate themselves and find ways to maintain profitability, which can be challenging.

Regulatory pressures: Governments around the world often impose strict regulations and standards on manufacturing to ensure health and safety standards are adhered to. This comes with added costs and investment requirement amongst other inclusions. Compliance with these regulations can often be costly and time-consuming, which may place a strain on businesses, especially smaller establishments with limited resources. In some instances, smaller businesses have simply shut rather than invest in ways to stay up to regulatory standards.

Supply chain instability: Delays, interruptions and bottlenecks can lead to significant financial woes and challenges as the industry naturally relies on complex global supply chains for raw materials, components, ingredients and finished products. Any disruptions to these supply chains and the movement of goods or components can lead to shortages, price increases, and production delays. Such disruptions can be challenging to manage and may result in lost sales and damaged reputations and failing to meet contractual obligations.

Labour & skills shortages: Traditionally manufacturing was always a labour-intensive sector until the immersion of technology and advancements to speed up processes and volumes arrived. However, the sector still requires a large workforce to operate effectively and is now facing its greatest skill shortage in nearly three decades. A survey from the BCC (British Chambers of Commerce) made the discovery that 4 out of every 5 manufacturers reporting troubles and struggles finding skilled staff especially the younger generations. Businesses in this area often face labour shortages due to factors such as low wages, high turnover rates, and seasonal fluctuations but a lack of skilled workers can lead to operational difficulties, decreased productivity, and increased labour costs.

So, in view of the above and with financial distress a pertinent theme and insolvency on the rise, understanding the warning signs is now an essential step to protect your business and avoid liquidation.

Some endorsed actions are:

- Ensure you continue to tighten credit control procedures and pay close attention on sudden changes in payment patterns.
- React swiftly to any late payment as it's generally the most accurate predictor of an imminent business failure or a business in trouble.
- Therefore, don't always be tempted to extend agreed terms in the case above.
- Become more familiar and aware of your suppliers and their operating base perhaps how they are performing financially and against the competition.
- Remember, complacency can be a killer, only the paranoid survives.
- This ever-changing economic uncertainty can suddenly lead to problems in the supply chain so plan accordingly.
- Look to enhance and grow levels of business with new customers steadily and prudently.
- Try to be agile and flexible. These are unprecedented times, and many businesses are feeling the pinch but there will be a bounce and it's important to retain the flexibility to benefit from growth when it comes.

Financial strategies for mitigation:

- Exercise a greater focus on controlling costs and optimising opportunities.
- Enhance the credit management function and system.
- Implementation of a Credit Insurance provision to not only protect against insolvency/bad debt but support growth ambitions.
- Review financial arrangements/facilities with financiers.
- Introduce or re-examine the hedging strategy.



Xenia analyst assertion

The UK is currently the 8th largest manufacturing nation in the world accounting for around 10% of the country’s GDP. In recent years, many manufacturing companies have started to embrace new technology and ‘lean’ processes to deliver cost savings, reduce waste and improve efficiencies, thus helping to increase overall productivity. However, despite many success stories, and post period of upmost uncertainty and challenge there are a significant number of manufacturers that are still struggling with financial problems and their overall health. UK’s manufacturers are almost certainly preparing for difficulty, on reflection of recent PMI datasets, amid a very sharp slowdown in activity and potential recession. The findings in the Make UK Manufacturing Outlook survey portrayed a contrasting picture with the drive and recovery of the first half of the year, now in reverse, with recruitment plans on hold and firm orders slowing at home and abroad. Owing to this revelation, Make UK has cut its forecast for growth for the remainder of 2023 with output set to continue its fall this year, with the forecast for 2024 within the margins of no growth at all.

But the overall picture isn’t that bleak and there is a strong emerging sectoral divergence with the aerospace, food and drink, and chemicals sectors continuing to perform very strongly relative to other sectors in manufacturing. Aerospace in particular has benefitted from a large number of orders for new aircraft over the last year, as well as a strong rebound in long haul international travel. Furthermore, in response to this downturn there is a calling for the treasury to target measures on skills, digitalisation and productivity and energy efficiency at the upcoming Autumn Statement. By and large, many manufacturing companies are indeed suffering for several reasons, many of which are beyond their full control, including late payments, minimum wage changes and the emergence of new markets to name but a few and with all the challenges that remain prevalent companies will need to become more agile, embrace change, introduce, or intensify the use of technology and be open minded to innovation in order to survive.

It is clear that in the short term, where possible, suppliers should be considering strategic decisions to minimise their risk, through credit insurance as well as curbing any over-reliance on single customers. This year has seen a very sharp rise in companies in financial distress and reduced profitability, reflected in the surge seen in companies in administration and insolvencies during the first half of 2023. Although, inflation and costs are now starting to abate, businesses also need to be preparing for potential future risks. This often requires a leaner way of thinking including a revision of strategies and ways of working with their suppliers to ensure they can enhance and solidify their future resilience to further potential supply shocks.



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