UK Quarterly Industry Report

QUARTER 4 2016

February 2017

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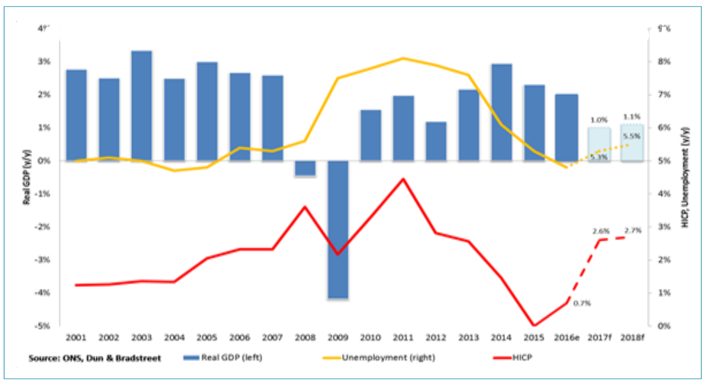
1.0 UK ECONOMIC OUTLOOK

Despite the elevated levels of uncertainty caused by the June 2016 Brexit vote, the British economy finished the year reasonably strongly. In the manufacturing sector, the December Purchasing Managers' Index (PMI, compiled by Markit) rose to its highest level in 30 months, at 56.1 points, far above the neutral 50-point line that divides expansion in sectoral activity from contraction. The picture was equally bright in the service sector, with the PMI rising to 56.2 as new order inflows expanded rapidly.

Nonetheless, the outlook is becoming gloomier as the weak pound (which has fallen considerably against the dollar, the euro and other major currencies since the referendum) is pushing up inflation. The input price inflation sub-index in the service sector PMI reached a 68-month high in December, while consumer price inflation came in at 1.1% in November - the highest value in more than two years. We predict that living standards will be hit in 2017, with inflation reaching 2.6% for the year as a whole (and therefore likely to outpace wage growth). In terms of real GDP expansion, Dun & Bradstreet forecasts the economy to grow by just 1.0% in 2017 (and 1.1% in 2018), only half the rate we estimated for 2016. Import demand in particular will suffer, with the weakness of the pound likely to last until a Brexit settlement with the EU is in place.

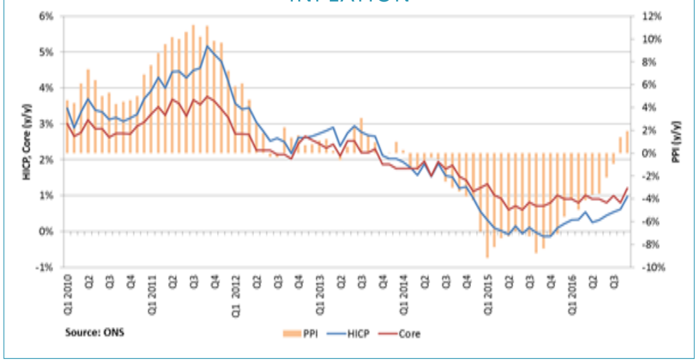


The British government remains committed to invoking Article 50 (the legal basis for Brexit) in Q1 2017, but it remains to be seen how its strategy for the upcoming talks will play out. Comments made by Prime Minister Theresa May in recent months hint that the government is likely to prioritise ending the freedom of movement for EU citizens post-Brexit, which would mean the UK losing access to the EU's common market in the medium term (the EU has frequently pointed out that freedom of movement is a prerequisite for market access). Our baseline scenario still foresees Brexit being completed within the 24-month timeframe laid out in Article 50; however, as two years will not be sufficient time to negotiate post-Brexit EU-UK relations, we predict that an interim arrangement will come into force in Q1 2019, and that this will maintain freedom of movement in exchange for market access, thus giving the British economy time to prepare for 'hard' Brexit.

By the mid-2020s, this interim arrangement will be replaced by a final agreement between London and Brussels: it seems likely that, under this deal, only certain sectors (such as manufacturing and potentially financial services) will be able to do cross-border business relatively easily, with others facing tariffs and other obstacles.

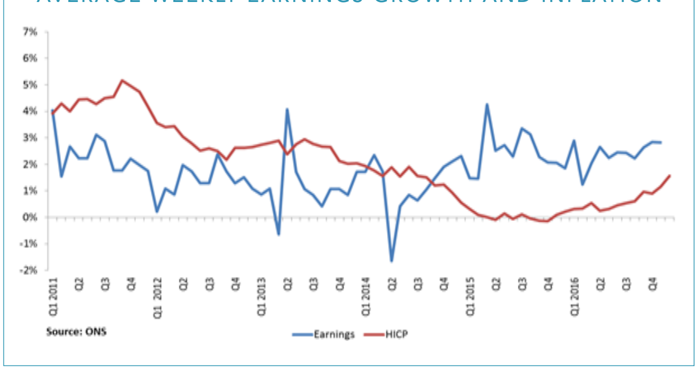
However, implementation risks remain high, and the timing of future events is uncertain. We recommend monitoring developments in London and the EU closely and frequently, as political events (such as parliamentary elections in France and Germany in 2017) will inevitably have a significant impact.

INFLATION



In the background to this, the UK fell by one position in the World Bank's recent *Doing Business 2017* report, slipping from 6th to 7th, thereby still outperforming most of its peers. Overall, seven out of ten sub-indices deteriorated and two stagnated. The only sub-ranking where the UK saw an improvement was 'paying tax'; the country rose from an already high 11th spot to 10th. Compared with the OECD average, it takes fewer payments (8.0 versus 10.9) and less time (110.0 hours versus 163.4 hours) to settle tax bills, with the total tax rate (as a percentage of profits) in the UK also comparing very favourably against the OECD average (30.9% versus 40.9%).

AVERAGE WEEKLY EARNINGS GROWTH AND INFLATION



UK CFOs PESSIMISTIC ABOUT BREXIT: DUN & BRADSTREET SURVEY

As 2016 comes to an end, the immediate fallout from the Brexit referendum has not had as big an impact on the UK as some had initially feared. In fact, the UK is widely expected to finish 2016 as the fastest-growing G7 economy. However, Dun & Bradstreet expects Brexit's impact on the UK economy to be much stronger in the future. This sentiment is backed by a Brexit survey we commissioned in November 2016.

The survey, based on the responses of 200 CFOs/financial directors in medium or large UK-based companies, indicates that corporations in the UK will reduce future investment, as they consider Brexit to be financially damaging for their companies' growth models. The effects will be especially felt after the government invokes Article 50 in March 2017.

Worryingly, 64% of survey respondents either strongly agreed or agreed with the statement that Brexit has negatively impacted business growth potential. Furthermore, 58% support the view that Brexit will eventually have financially damaging repercussions. As a consequence, a majority of survey respondents (albeit a small one, 49% versus 42%, with the rest being undecided) say that their company is likely to scale back on investment activities in the UK post-Brexit.

The biggest worry for companies concerns data availability from European partners and customers once Brexit is completed (41%). Another concern is lower growth opportunities because of a loss of single-market access (27%), followed by concerns about rising compliance-related costs (16%).

The main culprit for the slowdown will be a drop in investment, but consumer spending will also take a hit. This is because of rising inflation rates that will outstrip nominal wage growth, thereby reducing living standards and also undermining consumer confidence in the UK.

November 2016 figures from the Office for National Statistics show that consumer prices increased by 1.2%, still below the Bank of England's (BoE) 2% target but at a two-year high. Looking ahead, the weak pound, despite having regained some ground, will keep import prices high, and inflation should start to overshoot the BoE target from mid-2017 on.

Positively for domestic real GDP growth, the weak pound will help British exporters and thus counterbalance some of the negative Brexit impact, at least for as long as access to the EU's common market continues (until Q1 2019, at least). However, exporters to the UK, especially those located in the US, will face lower British import demand on the back of the pound's weaker purchasing power on global markets.

Although the UK is one of the worst performers in Dun & Bradstreet's country risk ratings this year, having fallen by three quartiles in two downgrades since June 2016, the country is still ranked in the 'low risk' category, on par with France, Japan, Singapore, and South Korea.

2.0 GLOBAL ECONOMIC OUTLOOK: CENTRAL BANK POLICIES CONTINUE TO DIVERGE

The policies of the main 'G3' central banks continue to diverge. In December, the ECB extended its quantitative easing programme from March to at least end-2017, although it reduced its asset purchase programme from EUR80bn to EUR60bn monthly. Similarly, the Bank of Japan continued with its easing policies, by announcing it would ramp up purchases of bonds maturing in over ten years' time. In contrast, the US Federal Reserve took another step towards tightening policy, with only its second interest rate increase of the 2000s. The move had been extensively signalled and priced in by most markets.

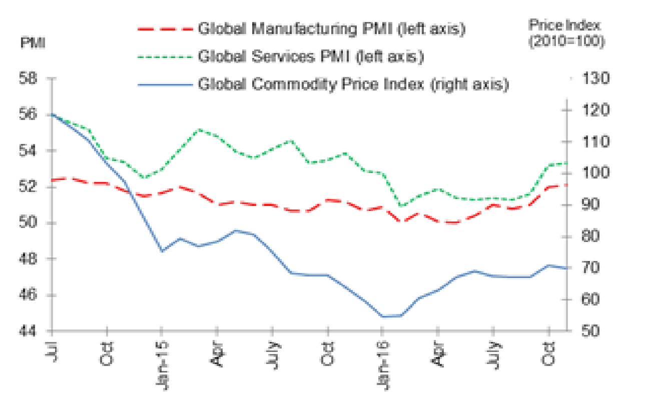
However, the markets appeared to have been taken by surprise when the Fed indicated that it would adopt a more aggressive policy towards tightening with three more rises projected in 2017. The differing policies reflect the divergent paths of economic growth across the globe, with the US economy moving towards full employment and target inflation, while inflation in the Eurozone and Japan remains muted. The state rescue and potential nationalisation of Italy's oldest bank in the last weeks of 2016, after a USD1bn anchor investment from Qatar failed to materialise, shows that Italy's financial system was still vulnerable: indeed, Italy's bank stocks lost half their market value in 2016.

KEY RISK: EMERGING MARKETS FACE LONG HAUL OF HIGHER INTEREST RATES

The median Fed policy rate forecast of 2.125% by 2018, up from 1.875% in September, will contribute to debt-servicing stresses and capital flight from emerging markets. This is because the US 'risk-free' benchmark rate is central to global financial markets via its ability to lure footloose capital and momentum trades in the US currency. The upward trend for interest rates will be exacerbated by non-US central bank sales of US Treasuries from official FX reserves. As they attempt to 'lean against the wind' by selling FX from official reserves to prevent overcorrections in their national currencies, the effect will be to raise US government bond yields. The ten-year yield was already at 2.6% in December.

For Japanese policymakers, this will be a welcome boon. In December, Bank of Japan governor Haruhiko Kuroda said it would maintain its 0% target for Japanese government bond yields, which, given the differential from equivalent US yields, will help depress the yen further and boost large exporter earnings. But for Nigeria and Egypt, which have already seen their currencies fall 40% and 50% year-on-year in US dollar terms, this is hardly welcome news. Meanwhile, fund managers will be monitoring the current account deficits of Turkey, South Africa and Brazil carefully. Commodity prices may strengthen and assist emerging market exporters, but much of the price defence is from supply cuts.

KEY GLOBAL GROWTH INDICATORS

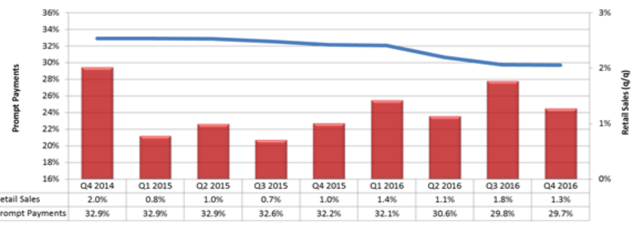


REAL GDP GROWTH (%)

	2016e	2017f	2018f
World	**2.2**	**2.7**	**3.0**
Advanced economies	1.6	1.8	2.1
US	1.6	2.2	2.3
Euroland	1.6	1.6	1.9
Japan	1.0	1.0	1.5
UK	2.0	1.0	1.1
Emerging economies	3.3	4.2	4.5
Brazil	-3.5	0.9	1.5
Russia	-0.6	1.3	1.4
India	7.0	7.5	8.0
China	6.5	6.1	5.8

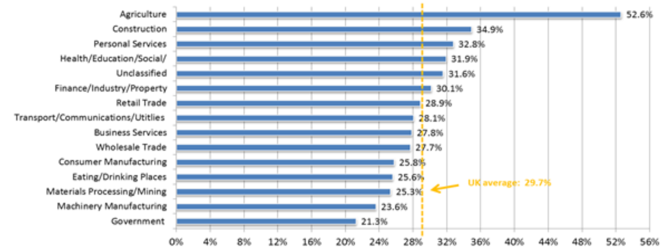
3.0 PAYMENT SNAPSHOT

PROMPT PAYMENTS TRENDLINE – Q4 2014 TO Q4 2016



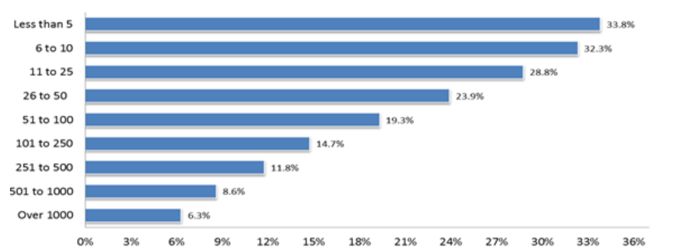
Source: Dun & Bradstreet; ONS

PROMPT PAYMENT BY INDUSTRY, Q4 2016



The chart above depicts how promptly all UK businesses have been paying their bills over the past nine quarters (blue line). Despite stronger-than-expected real GDP growth in Q3, and a weaker pound, Dun & Bradstreet's Q4 data reveals that the proportion of prompt payments decreased slightly over the quarter, to reach 29.7% (from 29.8% in Q3). Such a deterioration could be partly explained by the uncertainty triggered by Brexit, which might have affected UK businesses' capacity (and/or willingness) to pay promptly, as well as by lower retail sales volumes (red bars). Looking ahead, we expect a further deterioration in prompt payments due to rising headwinds triggered by the Brexit vote.

PROMPT PAYMENT BY EMPLOYEE SIZE FOR Q4 2016



Source: Dun & Bradstreet

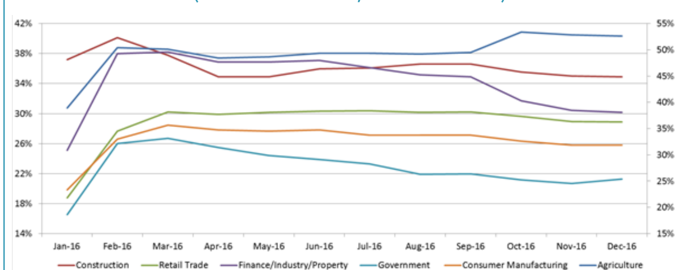
As the data in the chart above reflect, larger businesses continue to squeeze their suppliers by paying in a much slower manner than their smaller counterparts. The differential in payment habits between those companies employing 1,000 workers or more and those employing fewer than five is significant: 6.3% (it was 6.8% in Q3) as opposed to some 33.8% (from 35.5% in Q2).

Indeed, late payments remain a major problem for UK-based small and medium-sized enterprises (SMEs). While legislation is in place to assist small businesses with their struggle against late payments, most businesses, especially SMEs, elect to take no action for fear of alienating their larger customers.

Indeed, according to the Association of Chartered Certified Accountants (ACCA), firms with fewer than 50 employees are typically twice as likely as larger businesses to experience late payment issues. Besides giving rise to tighter financial conditions and higher administrative, transaction and financial costs (external financing may be necessary to manage cash flows), late payments can cause insolvency and ultimately lead to bankruptcy.

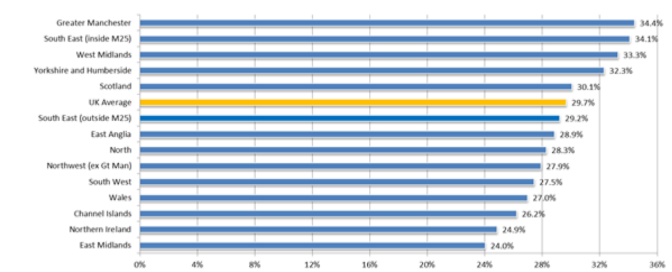
Dun & Bradstreet data show an overall deterioration in payment habits by industry on a quarter on quarter (q/q) basis in Q4 2016. The data, broken down by industrial sector, reveal that between Q3 and Q4 2016 the largest deterioration in payment habits was recorded in the 'Eating and Drinking places' sector, followed by the 'Health/ Education/Social' and 'Finance/Industry/Property' sectors, and then by 'Business Services' and 'Personal Services'. 'Agriculture' was the only sector recording an improvement in prompt payments (up by 3.1% q/q).

PROMPT PAYMENT EVOLUTION IN CRITICAL SECTORS (AGRICULTURE, RIGHT AXIS)



Source: Dun & Bradstreet

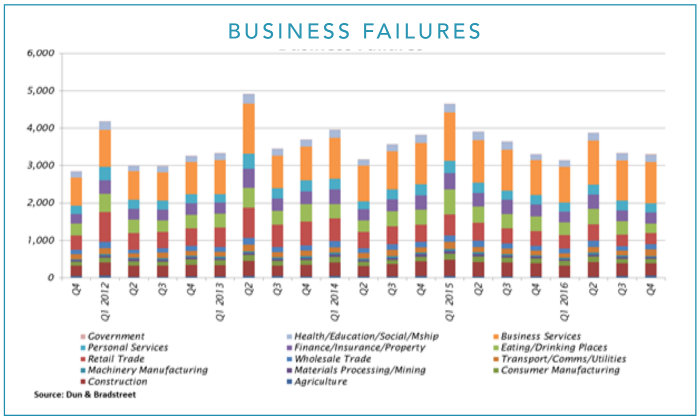
PROMPT PAYMENT BY REGION, Q4 2016



Source: Dun & Bradstreet

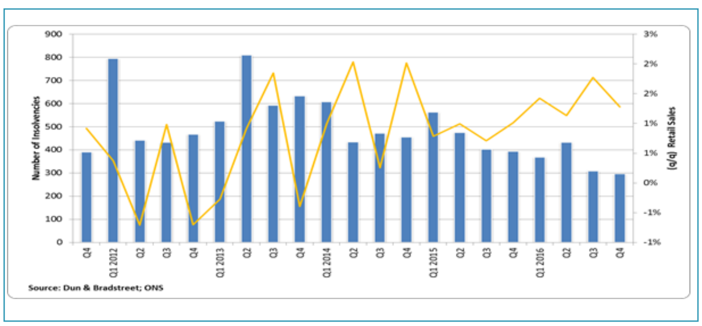
Dun & Bradstreet's Q4 data reveal a slight deterioration in overall payment performance in almost all regions. In particular, the West Midlands' average prompt payments (as a percentage of total payments) edged down to 33.3%, from 33.6% in Q3 (although it remains one of the best performers). The East Midlands area continues to lag behind all the other regions (only 24% of payments were made promptly, compared to a UK average of 29.7%), while the South East (Inside M25) and the Great Manchester areas exhibit the best payment performance times for the second consecutive quarter.

4.0 BUSINESS FAILURES



The number of corporate insolvencies remained stable in Q4, according to Dun & Bradstreet data: 3,307 companies went bankrupt in the three month to December, compared to 3,337 the previous quarter, possibly tracking the resilience of the economy, which is likely to have expanded more than previously anticipated in the second half of the year. Between Q3 and Q4 2016, corporate insolvencies were down in almost all the sectors of the economy, with decreases of 36.2% q/q in ‘Machinery Manufacturing’ and 28.6% q/q in ‘Eating/Drinking Places’. ‘Government’, ‘Agriculture’ and ‘Transport/Utilities’ were among the sectors recording the highest increase in the amount of bankruptcies, up by 60% q/q, 30% q/q, and 48% q/q, respectively:

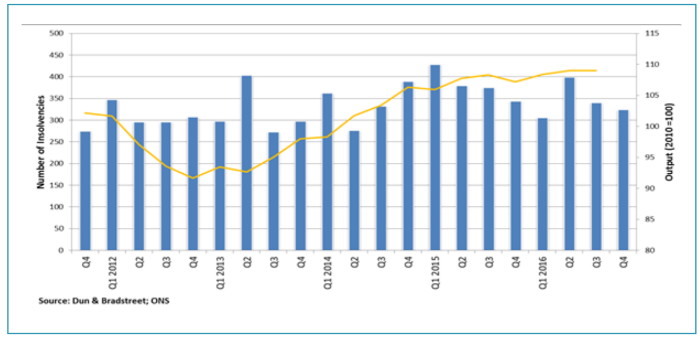
BUSINESS FAILURES: RETAIL TRADE



The number of insolvencies in the retail sector (which accounts for almost 6% of the UK economy) marginally decreased in Q4, tallying with the latest positive (albeit weaker) retail sales data. Figures from the ONS show that the seasonally-adjusted retail sales volume rose by 1.3% q/q in Q4; a little slower than Q3’s 1.8% growth pace. As we expect a slight increase in the unemployment rate on account of slower GDP growth, so we expect retail sales growth to decelerate in the quarters ahead. Lower sales growth could lead to a small rise in the number of bankruptcies in the coming quarters.

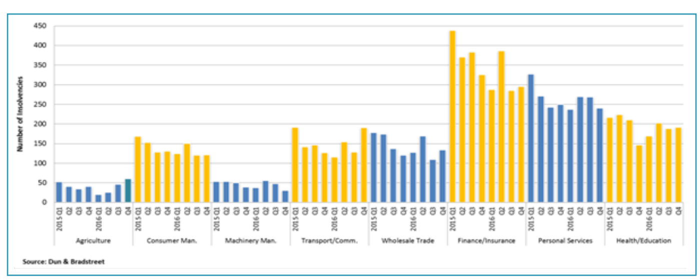
Against this backdrop, the uncertainty surrounding the retail sales outlook remains high, with risks tilted to the downside. On the upside, real wage growth and the still-low unemployment rate will continue to provide a boost to domestic sales volumes. On the downside, a slowdown in overall economic growth and Brexit could weigh on consumer spending.

BUSINESS FAILURES: CONSTRUCTION



After falling in Q3, the number of construction companies going bankrupt dropped further in Q4: 324 companies went bankrupt in the three months to December, compared with 340 in Q3. The construction industry plays an important role in the UK economy. The entire sector contributes £90bn in gross value added to the UK economy and supports 2.9m jobs. Improved momentum in this sector is likely to bolster real GDP growth in the quarters ahead. The latest seasonally adjusted Markit/CIPS UK Construction Purchasing Managers’ Index (PMI) tallies with the implied strengthening of momentum in the sector. The PMI posted a reading of 54.2 in December, up from 52.8 in November and well above the 50-point expansion threshold. Markit’s report reveals that UK construction companies signalled a positive end to the year, led by the fastest rise in new order volumes since January 2016. Stronger demand patterns resulted in sustained job creation and a broadly based upturn in business activity during December. New business volumes expanded at the strongest rate for 11 months in December, which marked a sustained recovery from the soft patch seen in mid-2016, according to Markit.

BUSINESS FAILURES: OTHER SECTORS



The chart above shows the number of business failures in several critical sectors. Insolvencies rose by some 22% q/q in ‘Wholesale Trade’ and by 30.4% q/q in ‘Agriculture’. Bankruptcies dropped in the ‘Machinery Manufacturing’ sector by 36.1% q/q.

5.0 RISK OF FAILURE AND PAYMENT DELINQUENCY – INDUSTRY SECTOR COMPARISON

		RISK OF FAILURE	
		RISK (Rating 1,2,3) Minimal to above average risk	**HIGH RISK** (Rating 4)
RISK OF VERY SLOW PAYMENT	**HIGH RISK** (Delinquency Score <=11)	**CASH VULTURES** UK AVERAGE – 23% RETAIL – 10% CONSTRUCTION – 13% Offer discount for prompt payment Charge interest on late payments Reset payment terms accordingly Improve relationship with client to induce prompt payment	**TROUBLE – LET YOUR COMPETITORS HAVE THEM** UK AVERAGE –3% RETAIL – 3% CONSTRUCTION – 3% Increase prices to cover risk Reduce exposure - stop orders until paid Take guarantees Monitor vigorously Avoid new clients with this profile Up-front payment
	RISK Minimal to above average risk (Delinquency Score >=10)	**IDEAL CUSTOMERS – CULTIVATE** UK AVERAGE – 73% RETAIL – 86% CONSTRUCTION – 82% Push for more sales Strengthen relationship with client	**MONITOR CLOSELY** UK AVERAGE – 1% RETAIL – 1% CONSTRUCTION – 1% Reduce exposure – minimise outstanding orders Monitor vigorously Take guarantees

Dun & Bradstreet's statistical analysis reveals that some 3% of UK businesses are deemed to be at high risk of failure and are highly likely to pay in a severely delinquent manner, while 73% offer a low risk of failure and of slow payment. Sales emphasis towards these latter businesses will enhance opportunities and enable suppliers to reduce risks of non-payment. Additionally, some 23% of UK businesses fall within the lower risk categories and are thereby less likely to fail; however, the payment habits they exhibit are somewhat slow, and while suppliers can be fairly secure in the knowledge that the business will not fail, payment may be somewhat protracted.

DUN & BRADSTREET'S OVERALL RECOMMENDATIONS

- Note that the UK's risk outlook is still 'deteriorating', hinting that further downgrades on top of the two made since the referendum are possible.
- Count on the economy growing by only 1.0% in 2017, down from our pre-referendum forecast of 2.0%.
- Expect the government to invoke Article 50 of the Treaty of the EU (the legal base for EU exit) in early 2017, setting the EU exit date for early 2019.
- In general, firms should adopt a wait-and-see approach, as it will take many more quarters until the full impact of the Brexit vote is fully felt.
- Expect the UK to lose full access to the EU's common market, although certain sectors should be able to trade more easily than others.
- Monitor the government's plans for increased infrastructure spending (such as a new runway for Heathrow airport).
- Keep a close eye on firms that are sourcing from abroad to sell to the domestic market, as the weak pound is undermining their profitability.
- Watch developments in the banking sector closely; support from the central bank will have a stabilising impact, but further turmoil cannot be ruled out.
- Assume that payments performance in the UK will remain average by European standards in 2017-18.

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ABOUT COUNTRY INSIGHT

Dun and Bradstreet also have a team of economists dedicated to analysing the risks and opportunities of doing business across the world, monitoring 132 countries on a daily basis. For further details please contact Country Risk Services on 01628 492595 or email CountryRisk@dnb.com.