In partnership with:

BDO IDEAS | PEOPLE | TRUST

MAKE uk
The Manufacturers' Organisation

MANUFACTURING OUTLOOK

2021 QUARTER 4

With support from:

Scottish Engineering and Manufacturing NI

FOREWORD

Seamus Nevin
Chief Economist
Make UK

Richard Austin
Head of Manufacturing
BDO LLP

In the opening scene of Charles Dickens' *A Christmas Carol* readers are introduced to Ebenezer Scrooge when two men arrive at his office to ask for charity. True to character, Scrooge, offers no money.

The famous protagonist is described as "a tight-fisted hand... a squeezing, wrenching, grasping, scraping, clutching, covetous, old sinner".

His name has become synonymous with penny-pinching, knowing the price of everything and the value of nothing. Yet, arguably Ebenezer Scrooge is misunderstood. As Dickens made clear, he may seem heartless, but old Ebenezer was a product of his time.

For, in December 1843, the year the book was written, Britain was suffering severe deflation. The price of goods had been falling continuously for the previous four years, increasing the real value of debt, and inducing recession.

Like for other businessmen of his day, Scrooge's fear of "the Spirit of Christmas Yet to Come", was a parable for widespread anxiety about the future of the British economy. Scrooge was "tight-fisted" not simply out of miserliness, but as a precaution in case his business took a turn for the worse.

Move forward roughly 180 years and many business leaders are feeling similarly apprehensive about the future of the British economy after Christmas, albeit for precisely the opposite reason. This time the worry is inflation, not deflation.

The latest Office for National Statistics figures revealed that the cost of living rose by 4.2% year-on-year last month, the highest rate in a decade and more than twice the Bank of England's 2% target.

Half of that jump came from Ofgem's October increase to the energy price cap (something to look forward to again in April) in response to Britain suffering a shortage of fuel at petrol stations. The global price of oil and coal has more than doubled this year and British manufacturers are especially vulnerable to the rising price of gas. About a dozen energy retailers in this country have already gone bust.

The cost of freight shipping too has increased, almost tenfold since last summer. Major trade ports are suffering serious congestion.

The labour market has tightened since the end of the Coronavirus Job Retention Scheme, after which the number of people in work actually rose, but the worldwide shortage of truck drivers is more acute in the UK because a combination of Brexit and COVID-19 saw thousands of EU citizens leave the country since January 31st 2020.

The pressures caused by energy price rises, labour shortages, and supply chain disruptions will take months to ease.

So shoppers face the biggest price increases in over 30 years this Christmas with widespread shortages of raw materials and computer chips continuing to cause bottlenecks throughout the supply chain. Retail sales rose for the first time in 6 months during October as consumers started to buy their Christmas presents early before pressure intensifies on household budgets.

The Bank of England has consequently indicated that the conditions now exist for it to increase interest rates, later this year or early next.

So, mirroring Dickens' allegory, the performance of the manufacturing sector has been forewarned of a portentous economic future. The news of the Omicron coronavirus variant (B.1.1.529) is a reminder that just as for Scrooge's firm, future plans can have unexpected changes. Manufacturers will hope that as with Scrooge, this Christmas marks the start of a happier future.

HEADLINES

Make UK’s Q4 2021 *Manufacturing Outlook* report, in partnership with BDO, provides an update on the activities of UK manufacturers and the sector’s progress as it bounces back from the pandemic.

In the last two quarters manufacturers reported output levels expanding at record rates as firms saw a significant rise in demand for goods. The domestic market has continued to expand since Q4 2020 and showed little indication of slowing down, until our latest findings. Export orders are now struggling to keep pace following a significant change in the UK-EU trading environment.

The fourth quarter’s research shows manufacturers continue to perform well as all key metrics remain in positive territory. However, for the first time this year we have found most balances to have fallen relative to the previous quarter, an indication that a growing share of manufacturers are more commonly reporting declines in output, orders, employment, and investment intentions. Almost certainly this reflects between manufactures who desire to hire and the supply of labour and skills. On the investment intentions front, we find the risk-taking appetite from manufacturers have tempered slightly but remains positive on balance.

This quarter’s headline challenge is the impact of rising inflation and increasing supply-chain difficulties that is evidently beginning to stunt the growth of UK manufacturing. Domestic prices have now expanded in our survey for the last six quarters in a row, with the last two being record breaking highs, with the latest balance at 52%. A similar story has followed for export prices too, at 51%. Manufacturers have highlighted the risks imposed on the wider economy as the impact of rising input prices, energy costs, wages and logistics cumulatively place industry in a vulnerable position. Consumer prices are yet to expose the true level of inflation that is taking place upstream, and industry will be weary of how and if the Government or the central bank chooses to react in a timely manner.

INDICATOR	BALANCE	CHANGE	
Confidence	7.3	↓	Business confidence dips slightly
Output	35%	↓	Output balance growth slows
UK orders	35%	↓	Domestic market orders slow
Export orders	27%	↓	Export orders slow in line with output
Employment	22%	↓	Job's growth remains positive but falls marginally
Investment	21%	↓	Investment intentions still strong but scales back slightly

Source: Make UK Manufacturing Outlook Survey

recent supply-chain related challenges which are beginning to outweigh the benefits of robust demand. The main impact of this, as we will see in this report, are prices being the only metric to still grow at record pace.

An output balance of 35% this quarter indicates that a large share of manufacturers are reporting higher output volumes, but that share has decreased relative to the last quarter. The relative slowdown in the pace of growth is also reflected by a slowdown in order books, with total orders falling from 49% to 43%.

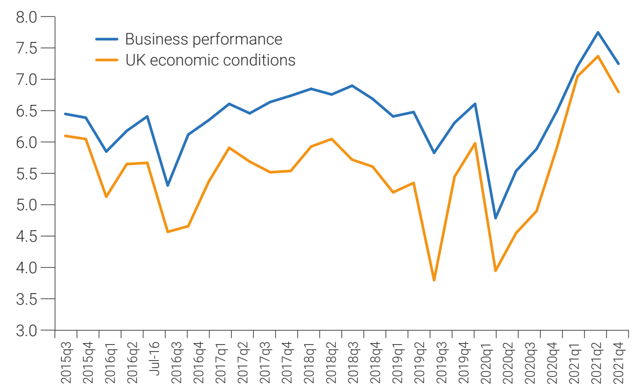
UK and export order balances have reported positive numbers this quarter, at 35% and 27% respectively. This means the UK order a balance will finish the year having achieved positive balances of growth in every quarter in 2021. If not for the shift in the UK-EU trading environment, the same may have been true for export orders too. However, official data have been reporting UK exports to be improving so it is possible we will see improved growth in the international markets in 2022.

Employment growth has remained stable at 22%, down slightly since Q3, but failed to grow at the rate manufacturers had predicted for Q4. The difficulties in employment have only been exacerbated by the continued challenge that firms are facing as they scale production back up following the end of recent lockdowns. As a result, there is a large gap in the industry

Both business and economic confidence have fallen slightly relative to their levels in Q3 2021. However, confidence remains historically high as manufacturers remain optimistic about the future as the wider economy returns to normal.

Confidence falls slightly but manufacturers remain optimistic

Confidence in the next 12 months 1 = substantially worse, 10 = substantially better



Source: Make UK Manufacturing Outlook Survey

OUTPUT

As is the case for the majority of the metrics within this fourth quarter edition of *Manufacturing Outlook*, the balance figure for output hasn't quite reached the heights that the industry expected it to reach when manufacturers laid out their intentions last quarter. Not only were those previous balance figures incredibly high – the highest in our survey's 30-year history – but the second and third quarters of this year saw a succession of record-breaking figures posted for output. The manufacturing industry had expected Q4 to be the third consecutive record-breaking quarter for output but those expectations have not been fulfilled.

However, the balance figure that has come to pass, 35%, is not low by any means. Furthermore, if we were to cast a blind eye to the turbulence the industry has endured throughout the pandemic, a balance figure of this magnitude would be near record-breaking in its own right. For comparison, that's only 7 balance points down on the previous quarter's record-breaking results.

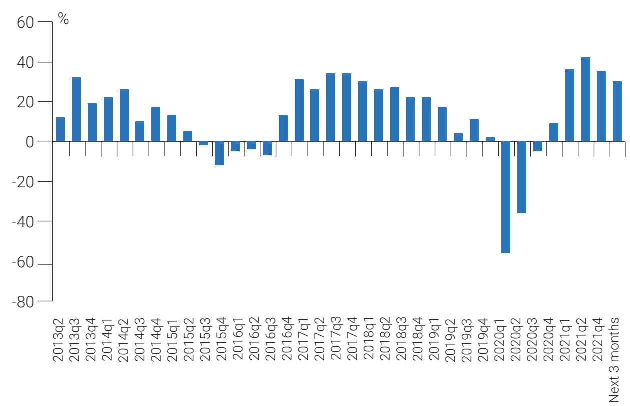
When we look at output performance for the quarter by size of firm we see a trend emerge where larger companies have outperformed smaller ones. In the £25m+ category, output balance is reported at 49%, which is approximately twice as high as the balance figure reported in the smallest category, £0-9m, which was 24%. We reported on this phenomenon in the previous quarter as well, noting that it was likely arising from larger companies typically being able to scale production back up to capacity more quickly during the 'recovery' phase. This usually occurs because larger companies either have greater liquid capital reserves at their disposal, or have richer lines of credit, giving them greater purchasing power when it comes to building up input stocks. Nevertheless, expectations are for this gap to dissipate somewhat next quarter, with manufacturers across the size spectrum reporting that this gap in output performance between larger and smaller firms will shrink in the coming three months.

PAST THREE MONTHS	↓	35%	NEXT THREE MONTHS	↓	30%

Expectations for the first quarter of 2022 have also slowed, albeit only a little. A positive balance of 30% is expected for the coming quarter, although this is now a far cry from the lofty expectations there were for this quarter. This lowering of expectations is coming at a time when the industry is settling in for an extended period of input and cost pressures that will likely hamper firms' ability to deliver their output at full capacity.

Output growth slows as manufacturers struggle to meet demand

% balance of change in output



Source: Make UK Manufacturing Outlook Survey

Output summary

% balance of change

SECTOR	PAST 3 MONTHS	NEXT 3 MONTHS
Basic Metals	11%	67%
Metal Products	36%	12%
Mechanical	36%	37%
Electronics	29%	-14%
Electrical	-14%	21%
Rubber & Plastics	20%	40%
TURNOVER		
£0-9m	24%	27%
£10-24m	34%	44%
£25m and over	49%	26%

Source: Make UK Manufacturing Outlook Survey

ORDERS

The total orders balance in this *Manufacturing Outlook* survey has remained historically high in Make UK's records. However, a balance of 43% is slightly below its Q3 2021 score of 49% indicating that the pace of growth, which has been record breaking for the previous two quarters, may be beginning to slow.

The growth in orders is a strong sign that demand has continued to bounce back in the sector allowing manufacturing to make great strides towards closing the output gap left by the COVID-19 pandemic. Nevertheless, the gradually widening gap between the growth in orders and the growth in the output balance suggests demand continues to outstrip supply adding significant pressure on the sector to increase its capacity. The manufacturing industry is now dealing with a worrying rising inflation, particularly on inputs.

Last quarter Make UK predicted that over time the recent high scores in our performance metrics for the sector would slow down eventually. However, this has surprisingly come earlier than expected as businesses initially predicted Q4 orders to expand even faster. If any positive news can be drawn from this, it is that capacity pressures within the sector may now be easing.

For the start of 2022 manufacturers expect the balance of growth in total orders to slow down even further, from 43% to a balance of 33% for Q1 next year. However, as manufacturers had overestimated their expected performance this quarter, it is best to take these forecasts with a grain of salt. Given the stormy environment manufacturers are operating in, resulting in highly uncertain economic conditions for businesses it has become increasingly challenging to forecast future performance.

UK ORDERS

Last quarter's UK orders reported a record-breaking balance high of 48%. Following the end of the transition period, growth in the domestic market has been outperforming export orders consistently since Q1 2021. Despite both UK and export order metrics indicating a slow-down in growth, domestic orders appear to be maintaining their lead over export growth.

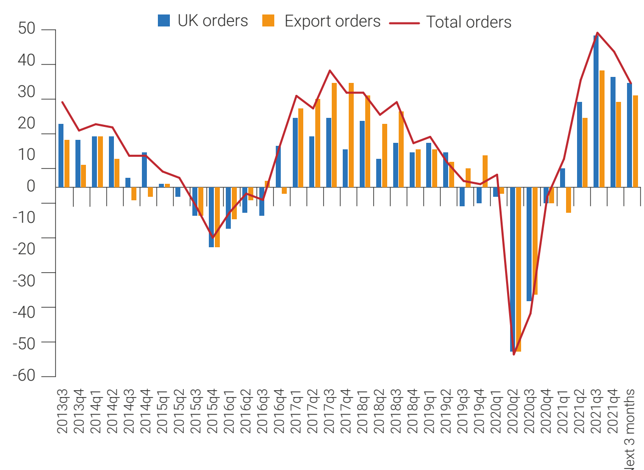
This UK orders balance has fallen from 48% to 35% in Q4 2021. As an isolated figure, a balance of 35% is still very high by historical standards and indicates the domestic market is still performing well. It is possible the changes in the trading environment have led to an increase in opportunities for domestic producers who have seen customers switching away from the EU market to UK sources. However, whether this indicates an increase in investment in reshoring or onshoring activities remains to be seen.

Our Q3 balances for intermediate subsectors show positive balances across the board for new UK orders. The latest figures for the fourth quarter have maintained overall positive performances, albeit all subsectors have indicated some level of slow-down. One subsector,

UK ORDERS	PAST THREE MONTHS	↓	35%	NEXT THREE MONTHS	↓	33%
EXPORT ORDERS	PAST THREE MONTHS	↓	27%	NEXT THREE MONTHS	↑	29%
TOTAL ORDERS	PAST THREE MONTHS	↓	43%	NEXT THREE MONTHS	↓	33%

Order balances remain strong, but indicates the beginning of a slow-down

% balance of change in orders



Source: Make UK Manufacturing Outlook Survey

Electrical Equipment, reported a -23% balance indicating a contraction in the domestic market. This was the only subsector to indicate so.

Subsectors with notably strong performances include Metal Products, Rubber & Plastics, and Mechanical Equipment, all of which produce inputs for manufacturers across the industry.

UK manufacturers expect the domestic market to produce a mixed performance, varying by subsector, at the start of next year. Whilst subsectors such as Electrical Equipment and Mechanical Equipment are expected to improve, Electronics on the other hand is expected to contract early next year.

EXPORT ORDERS

Export orders reported a balance of 27%, 10% lower than what was reported last quarter.

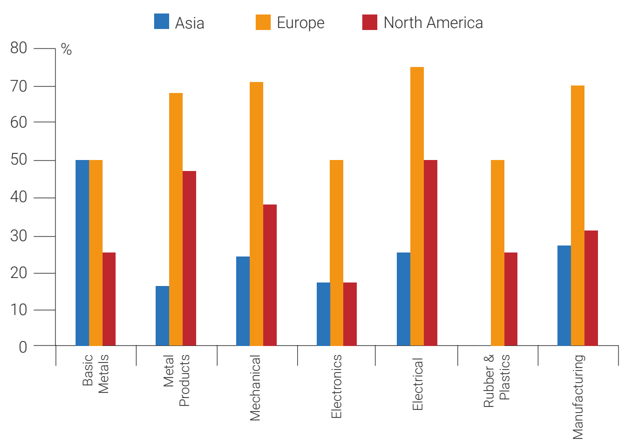
Despite the evident slowing of export orders, new business from international customers continues to improve. It has been almost twelve months since the new UK-EU trading arrangements began to be phased in and many manufacturers have dealt with those changes by slowly adapting to the new procedures and requirements for exporting, most notably filling in copious and complex customs forms. Further new challenges await manufacturers when import controls are rolled out more heavily next year, increasing the difficulties for UK importers who buy from EU manufacturers. This will unfortunately negatively impact UK-EU supplier/customer transactions in the short term likely resulting in a reduction in trade.

However, unlike many other metrics this quarter, manufacturers are optimistic that export orders growth will accelerate slightly from the start of next year. This could be an indication that while the booming domestic market may have peaked, exports will continue to recover next year as manufacturers seek out opportunities outside of the EU.

Manufacturers continue to report positive, and improving, demand conditions in the EU, with an average of 70% of the sector reporting positively. This is followed by North America as usual, and the return of Asia as was expected following last quarter's introduction of the Middle East in third place.

Demand conditions improve for most intermediate subsectors

% of companies reporting positive demand conditions by market



Source: Make UK Manufacturing Outlook Survey

Orders summary

% balance of change

	UK ORDERS		EXPORT ORDERS		TOTAL ORDERS	
SECTOR	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS
Basic Metals	13%	11%	0%	0%	22%	33%
Metal Products	55%	36%	14%	10%	55%	36%
Mechanical	32%	35%	31%	34%	40%	32%
Electronics	0%	-8%	18%	18%	7%	0%
Electrical	-23%	38%	0%	15%	7%	43%
Rubber & Plastics	40%	20%	20%	0%	40%	20%
TURNOVER						
£0-9m	26%	26%	19%	16%	32%	29%
£10-24m	45%	40%	33%	33%	44%	44%
£25m and over	37%	33%	41%	39%	45%	36%

Source: Make UK Manufacturing Outlook Survey

EMPLOYMENT & INVESTMENT

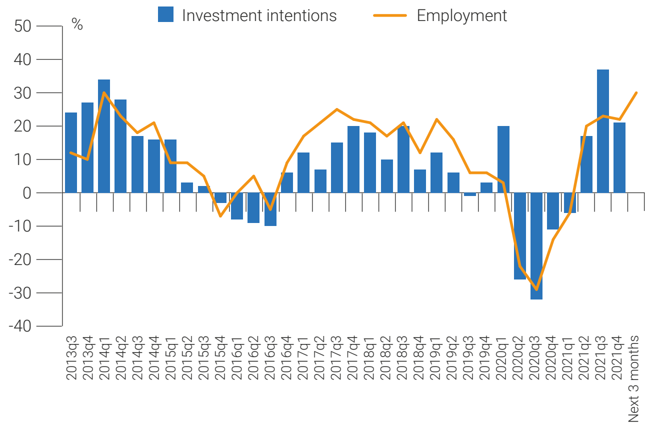
There has been an ever so slight dip in the balance figure for employment compared to last quarter, by only one percentage point, leaving this quarter's balance figure for employment at a positivity level of 22%. Investment intentions have not fared as well, and although remaining significantly positive, the balance figure has dropped by 16 percentage points. Despite this drop in positive growth compared to last quarter, the investment figure for this quarter is still reassuringly positive overall, at 21%.

Even considering the mild drop in positivity for our employment metric, and a more significant drop in investment positivity, this quarter now marks the third consecutive *Manufacturing Outlook* report where both our employment and investment metrics have shown positive balance figures. They had previously been negative since the second quarter of 2020. The single quarter super-positive blip we saw last quarter in investment has transpired to be just that, a blip. There's no doubt that this surge in investment was fuelled by soaring confidence in the industry during the earlier stages of the 'recovery' period, where the brakes had not yet been fully applied by threats of input cost inflation and labour shortages now being felt more thoroughly throughout industry in this fourth quarter.

highest level for proportional vacancies in the manufacturing sector since records began. The humorous saying "Can't get the staff!" has returned to its verbatim meaning for the sector.

Employment maintains steady growth whilst investment plans scale back slightly

% balance of change



Source: Make UK Manufacturing Outlook survey

EMPLOYMENT	PAST THREE MONTHS	↓	22%	NEXT THREE MONTHS	↑	30%
INVESTMENT	NEXT TWELVE MONTHS	↓	21%			

One thing to note, however, is that despite the Chancellor's announcement of the extension to the higher capital investment allowance limits which was made in the period between our third and fourth quarter research, this hasn't borne fruit, at least as of yet, in the manufacturing industry's investment intentions.

The difficult employment challenges facing the industry have only been exacerbated by the continued challenge that firms are facing in acquiring staff as they scale production back up following the end of recent lockdowns and the easing of recent trade disruptions. This quarter's employment balance figure of 22% is not far off the highest figure we have recorded in the past decade of *Manufacturing Outlook* research. That record came in the third quarter of 2017 when the figure was 25%.

More pressing, however, is that despite a significantly positive balance figure for employment this quarter, demand for labour within the industry is falling far short of being fulfilled. What we've seen now for two consecutive quarters is incredibly high employment intentions, but an inability to realise those intentions as the labour market proves unable to provide industry with the skilled staff UK manufacturing firms need. Indeed, the latest ONS data for vacancies by industry shows a sizeable chunk of unfulfilled demand, with approximately 3 vacancies for every 100 roles in industry. In normal times this figure rarely peaks above 1.8, yet it currently stands at the

Employment and Investment summary

% balance of change

	EMPLOYMENT		INVESTMENT
SECTOR	**PAST THREE MONTHS**	**NEXT THREE MONTHS**	**NEXT TWELVE MONTHS**
Basic Metals	33%	44%	-33%
Metal Products	33%	21%	13%
Mechanical	12%	36%	17%
Electronics	21%	29%	31%
Electrical	-7%	7%	21%
Rubber & Plastics	20%	20%	20%
TURNOVER			
£0-9m	10%	29%	15%
£10-24m	32%	19%	22%
£25m and over	36%	38%	42%

Source: Make UK Manufacturing Outlook Survey

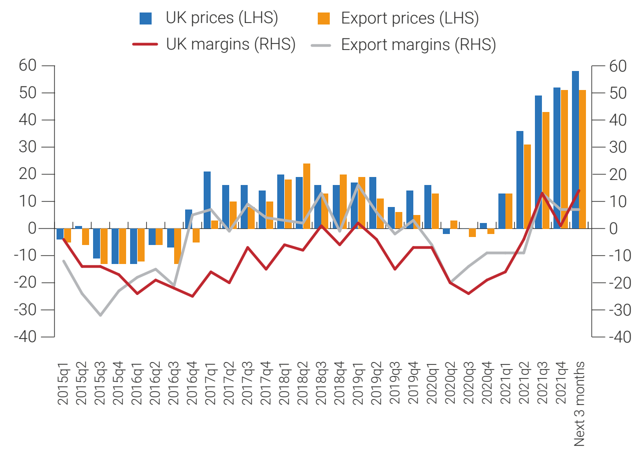
PRICES & MARGINS

Rising inflation is currently one of UK manufacturer's biggest concerns as cost increases emanate from various sources with little room for businesses to keep up with the speed at which prices are changing. The Bank of England (BoE) earlier this year opted to shy away from increasing interest rates in an attempt to convince market forces that this inflationary situation was temporary and a result of the very low levels of inflation experienced in 2020. Although consumer prices have not been growing at concerning rates, upstream inflation for inputs are currently up 13% according to latest figures and is expected to worsen.

Make UK's Q4 *Manufacturing Outlook* reports that prices for UK and export goods have increased consistently for four quarters in a row now. The latest results show a balance of 52% of manufacturers reporting higher prices for UK goods, whilst a balance of 51% said the same for foreign goods. This is the narrowest price gap since the start of this year when both metrics reported at 13%. It reinforces the idea that inflation is currently a worldwide challenge but regardless of this the latest score is another record-breaking balance for our quarterly survey.

Price growth shows little sign of slowing down as manufacturers expect further inflation in 2022

% balance of change



Source: Make UK Manufacturing Outlook Survey

UK PRICES	PAST THREE MONTHS	↑	52%	NEXT THREE MONTHS	↑	58%
EXPORT PRICES	PAST THREE MONTHS	↑	51%	NEXT THREE MONTHS	↔	51%
UK MARGINS	PAST THREE MONTHS	↓	1%	NEXT THREE MONTHS	↑	14%
EXPORT MARGINS	PAST THREE MONTHS	↓	7%	NEXT THREE MONTHS	↔	7%

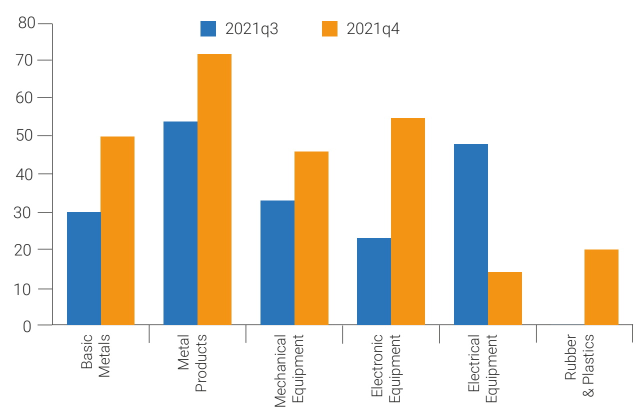
Margins turned positive last quarter for both UK and export goods, reporting at 13% each. This was an indication of price increases being passed on at a higher rate down supply-chains which led to an improvement in margins for a greater share of manufacturers. However, an early frost may have killed off that budding sign of optimism. The latest results, which reported UK margins at 1% and export margins at 7%, indicate that margin growth has already slowed, possibly indicating cost pressures are accelerating faster than the rate of pass through in the form of higher prices.

Just like last quarter, in this edition's survey all key intermediate subsectors indicated widespread increases in average prices for export goods. The only subsector which reported a slowdown in the growth of prices is Electrical equipment, which saw the balance for export prices fall from 48% to 14%.

Manufacturers expect UK prices and margins to grow faster in Q1 2021, whilst export prices and margins is expected to be flat.

Export prices of materials rising for most manufacturers

% balance of change in export prices in the past three months

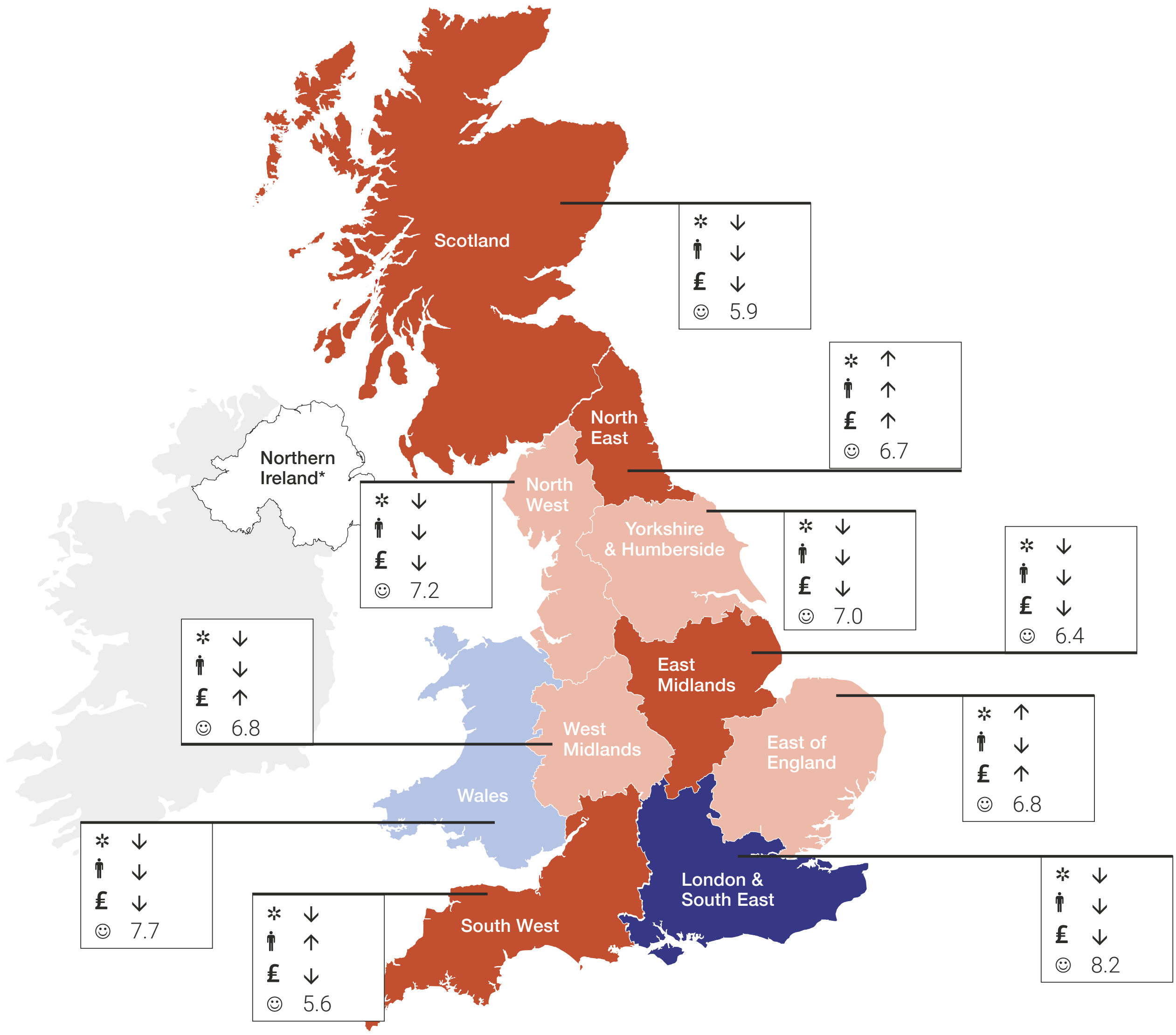


Source: Make UK Manufacturing Outlook Survey

NATIONAL & REGIONAL

This quarter's *Manufacturing Outlook* report finds that firms' confidence in business conditions and the UK economic environment remains very optimistic. However, this is the first quarter since the start of the pandemic in Q2 2020 where confidence has also dipped slightly. Despite this it remains positive (above the "5" inflexion point), suggesting that despite all the challenges facing the industry, manufacturers remain optimistic about the future.

Though both business confidence and UK economy confidence have fallen they remain the second highest since data collection for the metrics began in 2014.



KEY:

↑/↓ INCREASE/DECREASE ON PREVIOUS QUARTER
✲ OUTPUT
EMPLOYMENT
£ INVESTMENT
☺ BUSINESS CONFIDENCE
* INSUFFICIENT NI DATA FOR CALCULATION IN THIS INSTANCE

The map is coloured according to the business confidence levels difference from average UK business confidence

HIGH CONFIDENCE

LOW CONFIDENCE

Source: Make UK Manufacturing Outlook Survey

However, as always, confidence is a volatile metric and does not necessarily correlate with future performance. This is particularly the case in the current context where manufacturers are still dealing with significant trading and commercial instability. The industry was blind-sided by the energy crisis this year and it now appears that a possible return to COVID-19 restrictions may be on the cards if infection rates continue to rise, especially of the new Omicron variant. For the time being, high demand for manufactured goods is the main driver keeping optimism levels up.

In line with the national average, all regions and devolved nations, except for Wales, reported a fall in business confidence compared to Q3 2021. However, all regions and nations remain within positive territory[1]. The most confident region remains the South East & London, reporting a business confidence level of 8.2, though this is slightly down from its 8.5 last quarter.

Headline business confidence reported at 7.3, the second highest average reported in the survey. The decline on the previous quarter may be an indication of manufacturers tempering their expectations for the future as growing challenges around supply-chains, energy, and input prices create anxieties about what further challenges the sector may face in the next 12 months.

Manufacturers in the South West reported the largest contraction in confidence since Q3, falling by 1.0 points to 5.6, well below the UK average of 7.3. It is the region with the lowest business confidence, remaining just about marginally positive. In contrast, only one area reported an improvement in confidence and that is Wales, jumping to 7.7 for this quarter. However, it should be noted that the sample size for Wales is small relative to other regions/nations and should be treated with caution. Other regions with notable decreases in confidence include the North West (which declined by -1.0), the East Midlands (-0.9) and Yorkshire & the Humber (-0.5). Each of these regions had very high confidence last quarter which made it more likely that they would trend downwards this time around.

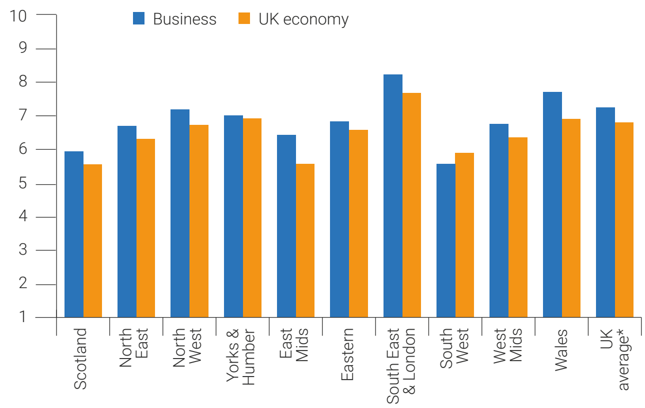
To state the obvious, many manufacturers continue to experience unprecedented pressures on many fronts – from post-Brexit trade arrangements, to skills and labour shortages, to COVID-19 – that all require rapid responses. As a result, it stands to reason that confidence would fall and this explains why business investment intentions have also taken a small hit this quarter.

UK ECONOMY CONFIDENCE

Manufacturer's views of the overall UK economic condition came in at 6.8, a historically high level for economic optimism. However, the gap between the gap between confidence in business performance and confidence in the wider UK economy has once again widened to 0.45, compared to last quarter where the gap was at 0.38. This may be an indication of optimism trends returning to normal. Conventionally it is common for businesses to place greater confidence in their own firm than they do in the wider economy.

Business confidence fell slightly for most UK regions and nations

Confidence in the next 12 months 1 = substantially worse, 10 = substantially better



* Average =/= component parts due to instances of undeclared regionality

Source: Make UK Manufacturing Outlook Survey.

1 This includes Scotland which follows a different survey elicitation method, which means Scottish confidence values should be compared with previous Scottish confidence values only.

Regional summary

% balance of change

	OUTPUT		TOTAL ORDERS		EMPLOYMENT	
REGION	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS	PAST 3 MONTHS	NEXT 3 MONTHS
Scotland	28	23	36	26	17	34
North East	62	23	54	23	31	23
North West	23	14	50	32	9	5
Yorks & Humber	15	62	38	62	23	38
East Mids	14	29	7	36	29	14
Eastern	25	67	75	50	0	33
South East & London	52	39	39	48	33	35
South West	11	56	11	0	22	22
West Mids	18	6	35	24	35	35
Wales	50	40	40	50	30	30
Northern Ireland*	–	–	–	–	–	–

* Insufficient NI data for calculation in this instance

Source: Make UK Manufacturing Outlook Survey

ECONOMIC ENVIRONMENT

As we approach the end of another eventful year manufacturers may look back and consider whether the experience of 2021 was even more tumultuous and turbulent than the year before it. COVID-19 is an ongoing global challenge but the UK has not been spared its own additional challenges – some even being self-inflicted – from the "pingdemic" episode to shortages in poultry and other food stuffs because of increased trading difficulties and supply-chain delays at our ports.

Despite all this, however, Make UK data indicates UK manufacturing output has consistently grown quarter on quarter since the start of the year. The results in this *Manufacturing Outlook* edition suggest a strong Q4 to top it off, though there are signs of slowdown as challenges around supply-chains and inflation increase the cost of doing business.

The latest national statistics on gross domestic product (GDP) suggest that the UK is still recouping its lost output from 2020. GDP grew by only 0.6% in September, which remains 0.6% below its level in February 2020. The rebound has been faster than many predicted but it may never be known what the UK's output could have been if there was no pandemic to begin with.

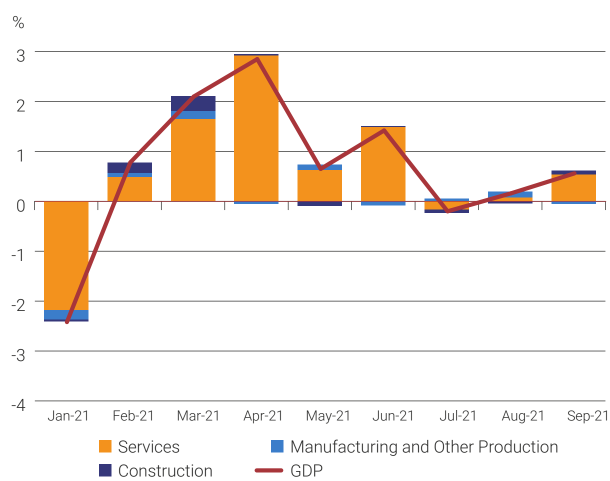
However, as is becoming a common feature this year, most of this growth was driven by the services sector and less so from production-based industries. According to the ONS's Index of Production (IoP) data, whilst GDP has expanded, manufacturing output has fallen by 0.1%. Most of this decline was driven by subsectors such as transport equipment, which fell by 5.1% as manufacturers struggled under increasing energy bills and shortages of materials. Pharmaceuticals led the growth pack, rising by 3.8% due to demand for booster vaccinations. This was followed by metals production at 2.4% growth. It is clear the rate of recovery within the manufacturing industry varies widely depending on subsector.

The biggest problem facing manufacturers in the immediate future will be ongoing cost and price inflation. Higher prices are filtering up the supply-chain as manufacturers pass on increased costs for inputs, energy, wages, logistics and other overheads to their customers. The latest figures for Producer Price Inflation (PPI) currently show input prices are up 13%, driven by sharp increases in the price of oil, metals, non-metallic minerals, and chemical products. Make UK members have recently pointed to the rise in input prices being their biggest challenge next year. Many manufacturers fear costs spiralling out of control. The challenge is so great that firms are beginning to postpone investment plans in favour of dealing with more pressing short-term challenges.

Pressure is mounting on the Bank of England (BoE) to act sooner rather than later. Huw Pill, the Bank's newly installed chief economist, has said that the "ground has now been prepared for policy action" — the clearest hint yet that borrowing costs will rise soon.

On the trade front, manufacturing has faced a very difficult year in many respects. New processes were adopted for trading with the European Union (EU), following the introduction of the post-Brexit Trade Cooperation Agreement (TCA). For many manufactures, this change produced quite a few bumps on the road as businesses learned to complete copious and complicated customs and rules of origin certificates

Contributions to monthly GDP, percentage points, January to September 2021



Source: ONS

for the first time. Make UK research found that these challenges diminished over time as manufacturers developed expertise in exporting through trial and error. The next phase of this challenge is how the introduction of further import controls due in next year will impact EU manufacturers and their willingness to trade with the UK, because extra controls will increase friction for foreign based manufacturers selling to the UK.

Last but certainly not least of the immediate challenges facing UK manufacturers comes in the form of labour shortages and access to skills. The impact was vividly brought home to consumers when the worldwide shortage of truck drivers hit the UK hard earlier this year due to a combination of Brexit and COVID-19 that saw thousands of EU citizens leave the country since January 31st 2020 and resulted in major delays across industry. Vacancies appear to be at an all-time high, and at least 90,000 jobs are currently unfilled within the sector. Despite the end of the Job Retention Scheme (JRS), which still had just under 120,000 manufacturing workers on furlough by the 30th of September, it seems the labour shortages have persisted, and the problem is primarily a shortage of available skills.

UK Economic Forecasts

% change except where stated

	2020	2021	2022
TRADING ENVIRONMENT			
Exchange rate (€/£)	1.13	1.16	1.18
Exchange rate ($/£)	1.28	1.38	1.38
Exports	-13.2	-1.9	10.7
Imports	-17.8	2.1	10.9
Current account (% GDP)	-3.4	-2.7	-3.3
OUTPUT			
Manufacturing	-9.9	6.9	3.3
GDP	-9.9	7.2	5.7
COSTS AND PRICES			
Average earnings	1.6	5.4	3.2
Oil price (Brent Oil $/bl)	41.8	72.0	66.9
EMPLOYMENT			
Manufacturing (000s)	2,618	2,539	2,562
Rest of economy (000s)	35,029	34,828	35,583
Unemployment rate (%)	4.5	4.7	4.5

Source: Oxford Economics and Make UK

International Economic Forecasts

% change

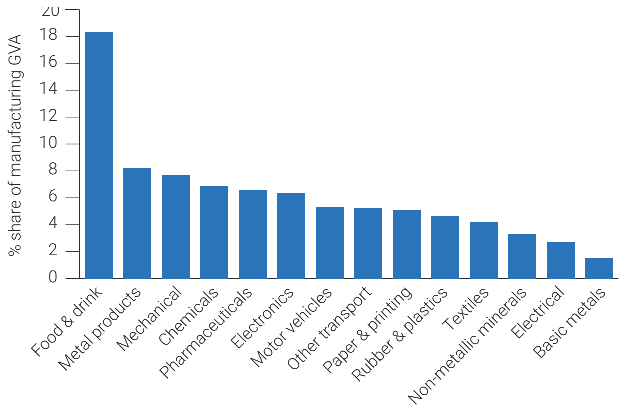
	GDP			INFLATION		
	2020	2021	2022	2020	2021	2022
US	-3.5	5.5	4.5	1.3	4.5	3.7
Eurozone	-6.8	5.1	4.2	0.3	2.4	2.0
France	-8.3	6.8	3.8	0.5	1.7	1.9
Germany	-5.3	2.7	4.3	0.5	3.0	2.0
Japan	-5.0	2.3	2.9	0.0	-0.1	0.5
China	2.3	8.0	5.4	2.5	1.1	2.9
India	-7.1	7.9	7.8	6.6	5.2	5.1
World (2015 PPPs)	-3.6	5.8	4.7	2.8	4.2	3.9

Source: Oxford Economics

SECTOR FORECASTS

Q4 2021 Manufacturing Sector composition by GVA (% share)

Subsector share of Manufacturing Gross Value Added



Source: Oxford Economics

FOOD & DRINK

The **Food & Drink** subsector's total share of manufacturing gross value added (GVA) has continued to expand for the second consecutive quarter, rising to 18.3%. This is the highest proportion of value the subsector has accounted for within the manufacturing industry this year, across four quarters. Now nearing the end of the year, the total growth in output for the subsector for 2021 has been upgraded a little compared to the previous quarter, with a final fourth quarter forecast of total output growth within the industry at 3.9%. This still falls significantly short of recouping the losses incurred within the subsector in 2020 and is beneath the average manufacturing industry output growth forecast of 6.9%. Nevertheless, sustained and steady output recovery will be preferable for the subsector compared to the volatility that is being seen in other subsectors, most notably the Automotive and Aerospace subsectors. The employment forecast for the Food & Drink industry bucks the negative manufacturing average, with a total growth of employment by 1.9% expected within the subsector for 2021.

ELECTRONICS

The **Electronics** subsector continues to see its output forecast for 2021 downgraded as a result of the enduring challenges in the semiconductor supply chain. These challenges have been present for the sector for at least the past two quarters, with now little sign of them easing up in the coming year. As a result, the newly revised forecast for output growth for the subsector stands at 2.4%, which leaves the Electronics subsector with one of the smaller growths in output for 2021 out of all manufacturing subsectors. Total employment levels within the Electronics subsector are also bleak for 2021 with a total decline of -7.6% of workers in the industry, a much steeper decline in employment levels than the whole industry manufacturing average for the year, which stands at -2.4%.

BASIC METALS AND METAL PRODUCTS

The **Basic Metals** subsector has received a much welcome improvement in its 2021 output forecast following a troubled 2020. That's now changed, with 1.8% total growth expected in 2021. While this is still far behind the manufacturing industry average growth of 6.9%, this upgrade in the forecast in the final quarter of the year indicates the improvement of conditions in the Basic Metals subsector between the third quarter and the end of the year. Total employment levels within the subsector are expected to fall by -1.1%, although this is approximately half as severe of a fall as is expected across the wider manufacturing industry.

Having declined in output by a similar amount to that of the Basic Metals subsector in 2020, by -9.5%, the **Fabricated Metals** sector is set to have seen total growth in output for this year by 6.5%. This is a slight downward revision on the forecast for the subsector posted last quarter, arising from continued supply chain challenges. This output forecast is roughly in line with the manufacturing average, which is to be expected as the performance of the subsector is tightly linked to wider manufacturing activity in the UK, as its products are often a key intermediate input in production. Total employment within the subsector is expected to decline by -3.8% in 2021.

MECHANICAL EQUIPMENT

The **Mechanical Equipment** subsector was one of only three subsectors that saw a decline in output in 2020 in excess of -20% yet it is now set to post the most significant recovery in output out of all manufacturing subsectors in 2021. At 18.8% total output growth expected for the year this leaves the subsector's growth not far shy of the three times the overall industry average growth for the year. This figure has been marginally revised downward compared to last quarter. Contributing to the subsector's high growth this year has been the improvement in investment seen within the manufacturing sector over the past few quarters. The Mechanical Equipment subsector is often a recipient of this investment expenditure by other firms in the industry and along with the current pro-investment policies that are in place, it has seen these positive drivers keep its output growth forecast at the highest in the industry. However, as is a trend across most of the industry, total employment levels are forecast to have declined by -4.6% this year.

TEXTILES

The **Textiles** subsector is one of the few industries that has seen its output forecast for 2021 revised upward compared to last quarter, albeit only by half a percent. Its forecast for total output growth in 2021 stands at 17.3%, the second largest forecasted output growth for 2021 across the entire manufacturing industry, coming second to that of Mechanical Equipment. Sustained demand in the retail sector over the past few quarters is what has seen the subsector's growth forecast remain in double digits for most of the year, albeit having suffered a double-digit decline in output in 2020 the subsector is still recovering lost value. Despite having the second largest output growth expectation, the subsector has the worst employment forecast, with -11.0% less employment within the subsector expected this year compared to 2020. The UK textiles industry previously had many EU workers within it so this greater than average decline in employment will be associated with the enduring challenges firms are facing with hiring workers from the EU.

PAPER & PRINTING

The **Paper & Printing** subsector has enjoyed a significant upward revision in its output growth forecast for 2021, in light of strong and growing demand for its products as the year wraps up. Heightened levels of domestic and global demand for its products has seen production spin up and in many cases firms are finding their order books swelling in excess of capacity. The total output growth forecast for the subsector in 2021 stands at 9.3%, which is approximately four percentage points higher than its forecast last quarter. Nonetheless, having lost -11.5% in output in 2020, the subsector is making up for the value lost in the previous year. The Paper & Printing subsector has one of the more moderate declines in employment for the year, with a fall of -1.1% expected, approximately half as severe as the overall manufacturing average.

ELECTRICAL EQUIPMENT

The **Electrical Equipment** subsector's forecast has been revised down by approximately three percentage points this quarter but remains in notably positive territory at 9.3% growth for 2021. While the subsector is certainly exposed to some of the significant challenges being faced by the Electronics subsector, most notably concerning semiconductors, products produced by the Electrical Equipment industry are of a far greater 'infrastructural' nature and so, while they'll certainly interface with more semiconductor-dependant products, supply chains aren't quite as limited as those more explicitly dependent on semiconductor supply. Total employment in the subsector is expected to shrink by -6.1% this year.

NON-METALLIC MINERALS

Having seen positive revisions to its output forecast for two consecutive quarters, the **Non-metallic Minerals** subsector has received a modest downward revision to its output forecast for 2021, by three percentage points. The forecast now stands at 14.2% growth for the year, which remains just over double that of the manufacturing industry's average. Sustained construction activity following the easing of pandemic-related restrictions has bolstered demand for the sector, which often supplies products into the construction industry. Employment in this subsector is expected to decline roughly in line with the manufacturing average, at -2.0% for 2021.

PHARMACEUTICALS

This is the first quarter since the inception of the pandemic that the **Pharmaceuticals** subsector has received a negative output forecast for the year. However, it is only marginally negative at -0.4%. The subsector is only one of two industries that experienced positive output growth in 2020 (along with the Chemicals subsector), so despite the now negative forecast for output in 2021, overall, the industry has grown compared to pre-pandemic times – a rare accolade. Naturally, this growth over the past two years has been stimulated by the subsector's provision of COVID-19 related interventions. Nonetheless, total employment is expected to decline this year, by -3.4%, although it must be noted that due to large employment growth in 2020, total employment levels within the subsector are still higher now than they were before the pandemic.

CHEMICALS

The **Chemicals** subsector's story is similar to that of the pharmaceutical sector over the past two years, but with a lesser magnitude. The output growth forecast for the subsector for 2021 stands at 3.7%, which while being beneath the manufacturing average, never saw a decline in output in 2020, rather it saw growth. Therefore, despite a lower than average growth expectation for this year, the subsector is still outgrowing the wider industry over the past two years. Employment growth is also expected to occur, by 2.8%.

RUBBER & PLASTICS

Plastics remain in high demand in the sector as firms scale production back up at pace. As a key component to many manufacturing processes, demand is likely to continue to be high in the coming quarters as well, with it continuing to lead supply.

As the majority of UK rubber manufacturing is tied to the production of vehicle tyres, the faltering performance of the automotive subsector will be acting as a drag on its output growth this year. However, tyres are still in demand from the retail and commercial sector as domestic road travel continues to return following the easement of restrictions. Together, the **Rubber & Plastics** subsector is one of the few industries to be forecast double-digit growth in output in 2021, at 11.9%. Employment in the subsector, however, is set to shrink just over twice that of the average at -5.9%.

MOTOR VEHICLES (AUTOMOTIVE)

The **Motor Vehicles** subsector continues, in this last quarter of the year, to see its output forecast revised heavily downwards. Having stood at 23.6% back in the second quarter of the year, the subsector's forecast has been consecutively revised downward due to significant challenges within the industry, now leaving it with an output growth forecast of only 4.1%. Having endured the most significant output loss across all of the manufacturing industry in 2020, at -25.6%, this only meagre recovery in 2021 shows that the subsector is a fair way off before gaining back the value lost last year.

The fall in employment is also significant, with a decline of -7.9% expected.

OTHER TRANSPORT

While this subsector's forecast had been revised upward (albeit still negative) last quarter, the rising challenges across all of manufacturing in the last quarter have seen the **Other Transport** subsector's forecast revised downward again, by approximately one and a half percentage points, leaving the final forecast of the year for the subsector at a decline in output of -8.5%. The subsector is comprised of the core industries Defence, Aerospace and Shipping. It's these industries, particularly in the case of aerospace, that have continued to suffer as a result of reduced levels of international travel in the wake of the pandemic. Employment in the sector is also expected to continue to decline, at the second greatest rate after Textiles, at -9.4%.

Sector growth rates and forecasts

% change

	OUTPUT			EMPLOYMENT		
	2020	2021	2022	2020	2021	2022
Basic metals	-9.5	1.8	3.1	-4.9	-1.1	-3.9
Metal products	-9.5	6.5	0.8	-13.8	-3.8	2.4
Mechanical	-20.1	18.8	10.4	-5.1	-4.6	5.0
Electronics	-7.3	2.4	3.0	2.7	-7.6	-1.8
Electrical	-11.8	9.3	2.0	-11.2	-6.1	7.8
Motor vehicles	-25.6	4.1	10.2	-10.8	-7.9	3.8
Other transport	-22.2	-8.5	5.1	-2.8	-9.4	0.8
Food & drink	-5.7	3.9	3.2	-1.0	1.9	-1.1
Chemicals	2.7	3.7	-0.1	0.1	2.8	-2.9
Pharmaceuticals	13.6	-0.4	0.8	14.0	-3.4	-4.5
Rubber and plastics	-8.2	11.9	1.2	6.7	-5.9	4.4
Non-metallic minerals	-10.4	14.2	1.6	2.5	-2.0	2.5
Paper and printing	-11.5	9.3	3.1	-10.6	-1.1	3.2
Textiles	-14.6	17.3	-0.2	9.1	-11.0	-3.5
Manufacturing	-9.9	6.9	3.3	-2.8	-2.4	0.8

Source: Oxford Economics

Source: Oxford Economics

BDO VIEWPOINT

FROM BREXIT TO COVID-19 AND BEYOND – KEY CONSIDERATIONS FOR MANUFACTURERS EXPANDING INTERNATIONALLY

Following the record-breaking lows seen in 2020, manufacturers are finishing 2021 in a much stronger position. However, growth is being stalled as manufacturers face significant challenges with rising costs, labour shortages and supply chain disruptions.

A HARSH ENVIRONMENT

Against the background of Brexit and the economic impact of COVID-19, the corporate tax environment for manufacturers in the short-term remains a tough one, with the forthcoming increase in tax rate (from 19% to 25%), withdrawal of super-deduction and reduction in Annual Investment Allowance all planned for Spring 2023.

However, it is promising to see many manufacturers on the road to recovery and looking to expand. This, coupled with the need in some cases to develop a European presence, has led to a trend towards the incorporation of European subsidiaries. Ireland and the Netherlands are proving popular locations for UK groups.

INTERNATIONAL EXPANSION – KEY TAX ISSUES TO BE AWARE OF

European (or broader international) expansion means manufacturers need to consider tax matters that may not feature in their existing tax environment.

This could include the requirement to deduct withholding taxes on the repatriation of funds (e.g. dividends, interest) to the UK in a post-Brexit environment, and to comply with the associated administrative obligations that brings.

Another commonly encountered issue is the risk of the newly incorporated subsidiary becoming UK tax resident if all its strategic and operating decisions are made in the UK, with limited board presence locally and board meetings held in the UK. Dual residency can be a complex issue to resolve, often requiring mutual agreement of two tax authorities.

Other matters to consider include:

- Having local substance and/or presence on the ground can sometimes be a requirement, in particular to achieve a lower corporate tax rate in some territories (e.g., Ireland)
- Being aware of permanent establishment risk where the decision has been taken not to incorporate overseas but you have employees undertaking sales activity on the ground, or have recently leased premises
- Application of OECD transfer pricing principles (and retention of compliant documentation) to minimise risk of challenge (some territories e.g. Belgium, have relatively onerous requirements involving annual submissions for groups of a certain size)
- The potential impact of the EU Mandatory Disclosure (DAC 6) rules if you are expanding into Europe and are undertaking cross-border transactions with the newly incorporated entity
- Local plans for new green taxes (similar to Plastic Packaging Tax in the UK) in the territory of expansion.

A GREENER FUTURE?

On the subject of environmental taxes, there is no doubt that we will see an increasing trend towards green taxes in the coming years.

EC statistics* show that environmental tax revenue-to-GDP ratios in 2019 ranged from 1.4 % (Ireland) to 3.9 % (Greece). Taxes on energy accounted for more than 50% of the environmental tax revenue, and transport taxes were the second-largest component for all EU Member States but Estonia and Lithuania. Pollution and resource taxes accounted for only a very small portion and perhaps this is an area where will we see future change.

There is much to consider on the corporation tax front for those manufacturers looking to expand into Europe and perhaps further afield. Advance planning and careful consideration of local rules and cross-border interactions will be key to success.

Claire Hudson
Director | Business Tax
+44 (0)785 404 6613
claire.hudson@bdo.co.uk

* https://www.ec.europa.eu/eurostat/statistics-explained/index.php?title=Environmental_tax_statistics

Make UK works for the success of more than 2.7 million men and women employed in UK manufacturing. Representing member companies – from small businesses to multinationals – across every industrial sector, we are the most influential voice of manufacturing, enabling our members to connect, share and create opportunities together.

We stimulate success for manufacturing and technology related businesses, enabling them to meet their objectives and goals. We empower individuals and inspire the next generation.

We create the most supportive environment for UK manufacturing growth and success and we represent the issues that are most important to our members, working hard to ensure UK manufacturing remains in the government and media spotlight.

Our extensive knowledge of manufacturing means that we're able to influence policy-making at local, national and international levels. We push for the policy changes that our members want to see. We are the voice of manufacturing.

MakeUK.org

To find out more about this report, contact:

Fhaheen Khan
Senior Economist
fkhan@Makeuk.org

James Brougham
Senior Economist
jbrougham@Makeuk.org

Seamus Nevin
Chief Economist
snevin@Makeuk.org

Make UK Information Line
0808 168 5874
research@Makeuk.org

The data used in this survey have been provided by UK manufacturers including members of Scottish Engineering, Manufacturing NI, and Make UK. Contributing to our surveys helps to accurately reflect trends and behaviours that shape the UK manufacturing sector. If you would like to participate in future surveys, please contact our Information and Research team research@Makeuk.org

Accountancy and business advisory firm BDO LLP is the UK member firm of BDO International, which has more than 1,600 offices in 167 countries. We operate from 18 offices across the UK, employing 5,650 people offering tax, audit and assurance, and a range of advisory services.

Manufacturing is a priority sector for BDO and this focus enables us to tailor the wide range of services we offer and apply our skills and knowledge to help clients achieve their objectives.

We provide real solutions to industry issues, utilising our capabilities in everything from sector-specific tax, audit and business advice to patent box, research and development claims and acquisition opportunities to help our clients grow in the UK and overseas.

We have an excellent understanding of the issues affecting UK manufacturers as an industry sector, but we also focus on specific sub-sectors to improve our knowledge and our service to clients. These include: aerospace, automotive, building products, chemicals and pharmaceuticals, electrical, food and drink, industrials, technology and test and measurement.

Manufacturing remains one of the key industries of the UK economy. We are delighted to be able to play an active role in supporting the businesses that operate in this vibrant, changing and challenging sector.

For further information about our business and services, please visit our website: **www.bdo.co.uk**

To talk about any issues your manufacturing business may be facing please contact:

Richard Austin
Head of Manufacturing, BDO LLP
07808 24613
richard.austin@bdo.co.uk

Baljit Bhamra
Marketing and Business Development Manager, BDO LLP
0121 352 6296
baljit.bhamra@bdo.co.uk

The Manufacturers' Organisation

makeuk.org

Ref: 21.12.POL.JB.FK.NB