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# THE SHAPE OF BRITISH INDUSTRY

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GROWING FROM STRONG FOUNDATIONS



## Introduction

After a deep recession in which the economy shrunk by 6%, a manufacturing-led recovery has helped drive a year of good economic news. Exports to developing economies are booming and the private sector is slowly creating jobs again. But with public sector cuts looming and a currency war threatening to derail the global economy, we cannot take this growth for granted.

Generating long-term, sustainable growth will require the private sector and government to work together to build on the strengths of sectors – such as manufacturing – that are essential to tackling our future challenges, such as global security, demographic change and climate change.

Government, therefore, has a big part to play in providing the right framework that will support and catalyse private sector investment and business growth. As the Prime Minister stated in his speech on growth, this will mean more than government getting out of the way. Instead it will need to be clear about what its role is in generating and supporting growth.

The previous government's preferred approach was overly focused on industrial champions. The current government's attention to start-ups and young businesses is helpful, but is in danger of swinging too far in the opposite direction.

Yet growth is not a big or small issue. It is about providing sufficient demand to sustain a dynamic and diverse supply network. It is about big businesses with the capacity to drive innovation and productivity down supply chains. And it is about growing bigger businesses with the scale and muscle to invest in tackling our long-term economic challenges.

How well prepared are UK manufacturers for the next challenge of turning their investments in productivity and competitiveness over the past decade into transformational growth in the next?

To answer this question and to understand the current state of British industry, this report draws on a survey of 300 manufacturers as well as in-depth discussions with dozens of businesses. What comes out is a picture of an industry starting from strength, but cautious about growth. Having weathered the recession, UK manufacturing emerges as an innovative, diverse and globally engaged sector. Firms have continued to boost productivity and competitiveness, even if they have struggled to deliver profits or meet their ambitions.

There is, however, one striking feature: the UK, has relatively fewer large manufacturers – those employing more than 250 people – than our closest competitors. The twin dynamics that could drive growth in manufacturing are large companies creating markets for a dynamic, diverse supply chain and innovative, agile suppliers attracting large, mobile multinationals to the UK. The danger for manufacturing and the economy is that the lack of larger companies could slow this dynamic, leading to a hollowing out of supply chains and placing a cap on future growth.

Prior to the recession, manufacturers' investments in innovation, their collaboration and their agility were paying dividends. But knocked off their plans for growth during the recession, many companies are now justifiably cautious about investing in growth until they gain greater certainty over the economic and business environment.

Growing more, larger manufacturers is, in part, about continuing to attract new ones to the UK. But it is also about ensuring small and medium-sized manufacturers overcome barriers that constrain them. The limited availability of affordable finance traps some young and small companies in a Catch-22: unable to get the necessary finance, their ability to plan for growth is constrained, yet unable to demonstrate clear ambitions for growth, some firms find it difficult to get the appropriate finance. And even if they did manage to grow, these firms would be caught in the thicket of tax and red tape that helps make mid-sized cautious about planning to become truly global in scale.

The Prime Minister has challenged industry to commit “to create and innovate; to invest and grow; to develop and break boundaries”.<sup>1</sup> This report shows that manufacturers are already rising to the challenge, but it also sets out where both manufacturers as well as government must make better progress if we are to grow a generation of bigger manufacturers.

Maintaining momentum behind the recovery is crucial. But not all economic growth is equal: imbalanced and unsustainable growth can leave a terrible legacy, as the recent financial crisis and recession have shown. To ensure our economy can pay its own way in the future, the UK does not need a handful of bigger manufacturers, we need hundreds of them.

<sup>1</sup> Prime Minister, Creating a New Economic Dynamism, speech delivered on Monday, 25 October, 2010

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## 1. The current and future state of British industry

UK manufacturing has not only survived, but thrived through a decade of seismic economic and political change. This resilience points to a sector with the potential to be a major driver of economic growth going forward.

Manufacturers rose to the challenge of low-cost economies. They adapted to challenging new environmental regulations triggered by mounting concern over climate change. Major improvements in productivity and competitiveness left the sector better placed to cope with the fallout of the banking crisis than in previous downturns.

Tough lessons learnt from earlier recessions saw companies work incredibly hard to keep skilled workers so that they could compete for new business when the economy recovered. The net result was that the sector bounced back quicker than after previous downturns, enjoying its fastest growth since 1994 in the twelve months following the end of the recession in September 2009.

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*Manufacturing has bounced back quicker than after previous downturns, enjoying its best 12 months of growth since 1994.*

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This success has been achieved by companies competing on their strengths and taking a more strategic view of their supply chains. Manufacturers stopped competing on price and turned to innovation to drive their businesses forward by building an edge in product quality and customer service. They also became more discerning about how and where they sourced their products. By the end of the decade, one in seven manufacturers was bringing production back to the UK as the potential trade-offs of outsourcing to low-cost economies became clear<sup>2</sup>.

However manufacturing output still is down 10% on its 2008 peak and a new set of challenges, such as deep cuts in public spending, are already looming. Building on competitiveness and productivity to generate strong, sustainable growth is, therefore, the challenge facing manufacturers over the next decade.

According to our survey, manufacturers' strategies are centred on new product development and export growth. Yet with many other competitor countries also seeking to export their way to growth, manufacturers' success will be determined by their ability to turn their investments in innovation, their collaboration and the diversity of the sector into long-term growth.

<sup>2</sup> EEF/BDO LLP (Nov2009) Manufacturing Advantage – How manufacturers are focusing strategically in an uncertain world

## Manufacturing is innovative and capital intensive

Over the past decade, manufacturers stopped competing on price with low cost economies. They opted instead to invest in innovation to differentiate themselves on the basis of quality and customised products and process.

Translating innovation into commercial success is about more than R&D. Process, product and service innovation are inextricably interlinked and reinforce each other. As well as developing new products, successful manufacturers invest in cutting-edge design to improve the customer experience, re-engineer their processes to drive efficiencies and open up new revenue streams by offering an increasingly sophisticated range of after sales services.

The rapid obsolescence of modern industrial machinery means manufacturers need to re-invest in plant and machinery continuously. Capital investment is not just about replacement. In high labour cost economies like the UK, the productivity gains generated by state-of-the-art machinery are essential to staying competitive.

Consequently, manufacturers see innovation and capital investment as the main drivers of their growth plans. More than three-quarters of companies plan to increase innovation and more than two-thirds to raise capital investment in order to meet their strategic objectives.

### *Capital investment and innovation drive growth in manufacturing*

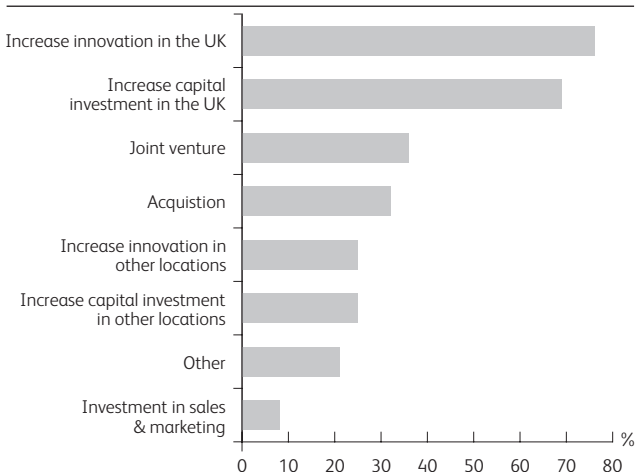
Numatic International, famous for the Henry vacuum cleaner, provides a good example of the twin-track approach to growth typical in manufacturing. The company's longstanding strategy has placed a major emphasis on increasing the productivity of its operations as well as on continuous innovation to meet evolving customer needs.

Not only has Numatic continued to reinvest in its manufacturing facilities since moving to a single integrated site in 1992, but it has also made significant investments over the past seven years in 'rapid prototyping' equipment to anticipate better and respond more quickly to the needs of its customers. These advanced new facilities help to maintain the company's competitive edge in a fast-moving industry by shortening the lead time for developing new products and lessening the need for bespoke and expensive machine tools.

### Chart 1

#### *Manufacturers see innovation and capital investment as keys to fulfilling their strategic objectives*

*% of companies citing how strategic priorities will be achieved*



Source: EEF/GfK NOP Shape of British Industry survey, 2010

## Manufacturing is interconnected

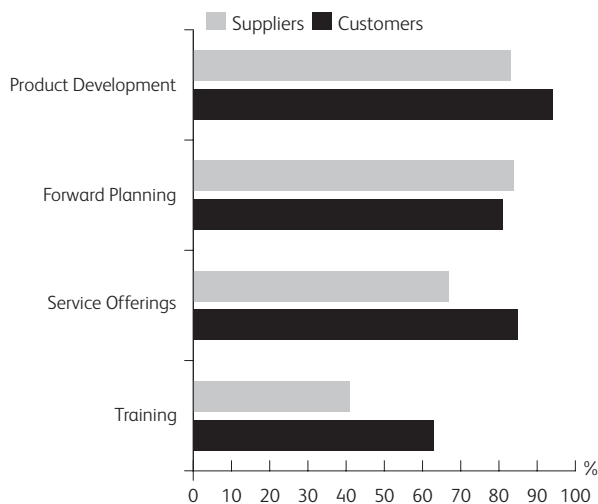
The focus on innovation highlighted in the previous section, helps foster openness and collaboration, with a majority of companies able to collaborate up and down supply chains on a range of business critical activities like planning and commercial offerings.

More than two-thirds of manufacturers, for example, collaborate with their suppliers and customers on forward planning, product development and service offerings. In some of these areas the level of collaboration is considerably higher. For example, 83% of manufacturers collaborate with their suppliers on product development and 94% with their customers. Whilst collaboration on training is less common, it is still significant – two in five companies work with their suppliers on training and more than three in five with their customers.

### Chart 2

#### *Manufacturing is a highly interconnected and collaborative activity*

% of companies collaborating with suppliers and customers



Source: EEF/GfK NOP Shape of British Industry survey, 2010

However, industry and government need to be aware of the risks posed by an erosion of industrial supply chains. Manufacturing is a highly interconnected activity, whose success is often forged on close and local working relationships. The loss of key suppliers or customers could have far-reaching consequences for production in this country. Not only will it force companies to source more products from overseas or even reconsider where they locate production, it will make the UK less attractive to the foreign investment which has been a major driver of growth in the sector.

Our survey confirms that concerns over the depth and breadth of the UK manufacturing base are widespread. Whilst nearly three-quarters of manufacturers were pleased or satisfied with the quality of UK suppliers, a quarter of companies expressed serious concerns about the quantity of UK suppliers.

The experiences of the nuclear and rail industries demonstrate the long-term consequences of hollowing out. The risk of supply chain erosion was also highlighted by concerns raised by BAE Systems during the recent Strategic Defence and Security Review. The company warned that cancellation of one of the planned aircraft carriers would precipitate the loss of 5,000 jobs in its business and many more in the hundreds of companies in its supply chain that would effectively end UK capability in the manufacture of complex warships.

#### *The 'Hollowing Out' of supply chains*

Whilst JCB, a family-owned business, has grown into a multinational with production across the globe, it also retains a strong attachment to manufacturing in the UK. But patriotic sentiment will not be allowed to trump sound business decisions and it will prove challenging to attempt to reverse the consequences of the erosion of critical supply chains for key components like castings and hydraulics. The gravity of the situation is exemplified by the fact that the British content of JCB's backhoe loader, one of the company's leading products, dropped from 96% in 1979 to 36% in 2009 because it can no longer source a growing range of components in this country.

## Manufacturing is outward looking and internationally engaged

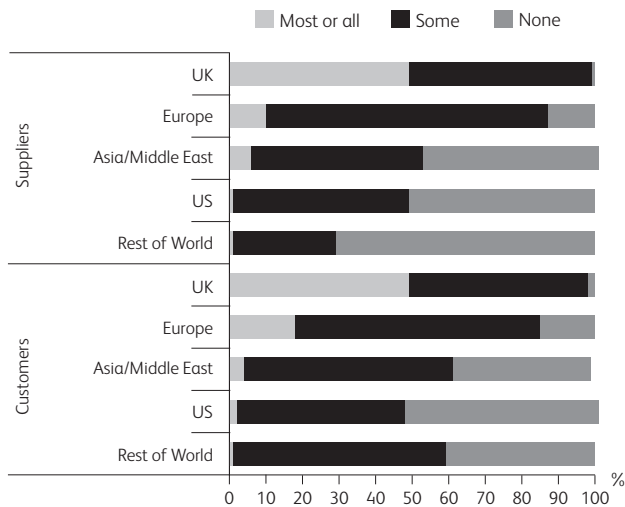
UK manufacturing is also closely interconnected with the global economy. Exports account for more than half of turnover in nearly 40% of companies and nearly a third have production facilities outside the UK.

The international web of activity is strikingly illustrated by the diverse locations of companies' customers and suppliers. Over four-fifths of companies have suppliers and customers in Europe. But the sector's strong links to international markets go further afield. For example, more than half of companies either source components or sell their products, or both, in Asia and the Middle East. The USA is another important location for UK manufacturing – over 40% of companies are either suppliers to or source products from the world's largest economy. With developing economies accounting for about half of global GDP, UK manufacturers are well placed to capitalise on increasing demand for their products from emerging markets.

### Chart 3

#### UK manufacturers source and sell across the globe

% of companies with suppliers and customers in world regions



Source: EEF/GfK NOP Shape of British Industry survey, 2010

The shift in global markets is reflected in the growth strategies of UK manufacturers. The most obvious is an increasing focus on exports, but a quarter of companies are also looking to increase capital investment overseas. As many as a third of large companies are looking to make investments in plant and machinery both in the UK and abroad which will allow them to ramp up overseas production.

We return to companies' growth strategies later in the report.

### Emerging markets go green

David Brown, the industrial gear specialist is reorganising its business into a 'network organisation' to take advantage of growth in emerging markets and green technologies. The company has formed a number of joint ventures with developing world partners to avoid import duties and reassure its target market by positioning itself as a 'local' business. At the same time, it is investing in growing its UK business by leveraging its core expertise in emerging industries like offshore wind and re-emerging industries like nuclear power.

## One sector, many business models

UK manufacturers have demonstrated the strategic and operational flexibility to adapt to both a rapidly changing world and their individual circumstances. Part of the inherent strength of UK manufacturing is its agility. It spans a wide range of industries, receives investment from around the world and comprises companies of all shapes and sizes. The sector is therefore well-positioned to take advantage of growth in a wide range of markets but not over-reliant on any particular one. It benefits from ideas and best practice from around the globe and boasts the advantages of small nimble companies as well as those of large well-resourced ones.

Companies have adopted a variety of different business models to grow their businesses. They successfully operate across the entire spectrum of industrial activity from R&D, through design and production, to the provision of after sale services. Some undertake most or all activities themselves, whilst others concentrate on areas of expertise.

Despite popular myths based on relentlessly increasing competition from low cost economies, all elements of industrial activity can be competitively undertaken in the UK. Most manufacturers in the UK compete primarily on quality rather than cost. As a result, many view production and a near-shore-supply base as key sources of competitive advantage which allows them to retain control over product quality and offer a more responsive and integrated customer service.

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*Despite popular myths based on relentlessly increasing competition from low cost economies, all elements of industrial activity can be competitively undertaken in the UK.*

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More fundamentally, for many companies production is integral to their ability to innovate. For example, insights from the production process can enable the development of better engineered products and adopting leaner production processes can enhance speed of service. So unsurprisingly, more than half of manufacturers believe that design and development activities are best located in the same country as production<sup>3</sup>.

### *One sector, many business models...*

In-depth company interviews carried out for this report revealed a wide range of successful business models involving UK-based production. Examples from across the spectrum include:

- **Contract manufacturing:** Sheffield-based MTL Group is one of the fastest growing ‘contract manufacturers’ in the metals sector. The company produces high-precision metal components to the design and specification of customers in a range of industries including defence, off-shore renewable energy construction, and rail. Competitiveness is built on close relationships with customers, state-of-the-art machinery and rapid turnaround of orders. The presence of local OEMs, such as BAE Land Systems and Caterpillar, is essential to a business model based on a deep understanding of customer needs and exploiting outsourcing opportunities.
- **Design, integrate and service:** Wallsend-based SMD is a subsea engineering firm specialising in the design and manufacture of remotely operated vehicles. The company has full capability from concept and design to assembly and support. However all standard components are outsourced to trusted local partners. Competitiveness is built on close relationships with customers and suppliers, a market-leading product range and a focus on high-value added engineering activities which allows capital investment to be kept to a minimum.
- **Own and produce:** Worthing-based Seward manufactures the market-leading ‘Stomacher’ range of sample preparation machines used for microbiological analysis in food testing. Leveraging the value of this successful brand is at the heart of the strategy of this high-margin business. As a result, all its machines are manufactured in-house to control quality and a significant investment is made in maintaining intellectual property rights (IPR). Conversely R&D, which is viewed as expensive and risky, is outsourced to a trusted local partner in the knowledge that the IPR for its products are well-protected.

<sup>3</sup> EEF/IFM High Value Manufacturing Survey (2009)

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Indeed, many companies with experience of outsourcing production overseas see competitive advantages to manufacturing in the UK. In a survey carried out for EEF in 2009<sup>4</sup>, 14% of manufacturers reported having moved production back to the UK from abroad in the previous two years. The main reasons were higher than expected costs, poor product quality and problems getting products to market quickly enough.

*The grass isn't always greener...*

Replacement catalytic converter manufacturer BM Catalysts encountered unexpected problems when it outsourced production overseas. Success in this market depends on product quality and speed of service – replacement catalytic converters need to be able to integrate seamlessly into a wide range of vehicle models, meet stringent environmental standards and get end-users back on the road quickly. After serious logistical issues with suppliers in India and China, and a desire to further improve quality, the company is bringing the production of key components in-house.

<sup>4</sup> EEF/BDO LLP Nov 2009) Manufacturing Advantage – How manufacturers are focusing strategically in an uncertain world

## 2. The growth challenge for UK manufacturing

The twin dynamics that could drive growth in UK manufacturing are large companies creating markets for a dynamic, diverse supply chain and innovative, agile suppliers attracting large, mobile multinationals to the UK. If it persists, the relative dearth of large manufacturers could, over time, erode the supplier base, thus making it more difficult to attract and retain mobile manufacturers and FDI into the sector.

Growing bigger manufacturers, therefore, is the key challenge facing the sector over the next decade.

UK manufacturing boasts a range of features that leaves it well placed to prosper in the future. Manufacturers' investments in innovation, their collaboration and their agility are paying dividends. However, our research suggests that having few large manufacturers is a weakness that could potentially affect the long-term prospects for growth.

On a number of measures the UK has relatively few large manufacturers compared to key competitors. For example, Germany has more than twice as many manufacturers with 250 or more employees as the UK. The proportion of large manufacturers is also significantly lower in the UK than in Germany – 1.2% compared to 2.1%. The disparity with the USA is even greater – firms employing 500 or more people account for 0.6% of manufacturing firms in the UK compared with 2.9% in the US.

UK manufacturing has proved resilient during difficult times, overcoming stiff challenges by boosting productivity to stay competitive. But can manufacturers build on this success and grow their businesses to next level? Will recent start-ups consolidate their businesses and turn a sustained profit? Will companies with successful domestic businesses take the leap into export markets? Will mid-sized firms achieve the truly transformational growth that turns them into major manufacturers?

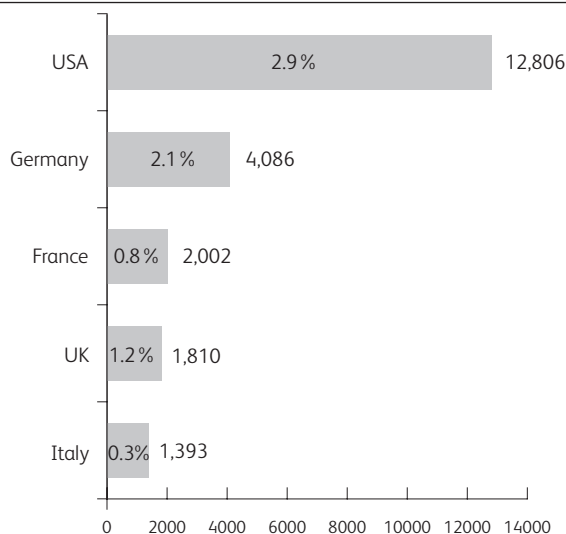
Past performance suggests this is a challenge which has yet to be fully met. Whilst the overwhelming majority of manufacturers have raised their productivity in the past three years, the record on increasing profits and implementing growth strategies is less compelling. A significant number of companies, especially amongst small and medium-sized firms, have been unable to translate productivity gains into profits or growth.

The rest of this report sets out to understand the full value of large manufacturers to the UK economy and the barriers small and medium sized manufacturers face in growing their business.

**Chart 4**

### *UK has fewer large manufacturers than competitors*

Number and % of manufacturing companies employing 250+ employees\*

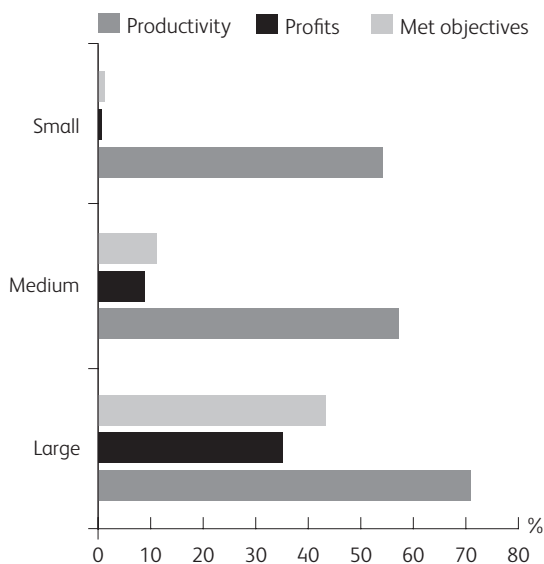


Source: OECD, 2006 (\* USA figures are for manufacturing companies with 500+ employees)

**Chart 5**

### *More manufacturers need to translate productivity into growth*

% balance that have raised productivity, increased profits and met strategic objectives in past three years



Source: EEF/GfK NOP Shape of British Industry survey, 2010

### 3. Why the UK needs more large manufacturers

Although large companies make up a small proportion of businesses in the sector, their limited numbers belie their importance. Bigger manufacturers drive collaboration in the sector, make investments that benefit entire industries and have the scale to invest in key areas of emerging opportunity. Put simply they will play a pivotal role in sustaining supply chains and catalysing further investment in the sector.

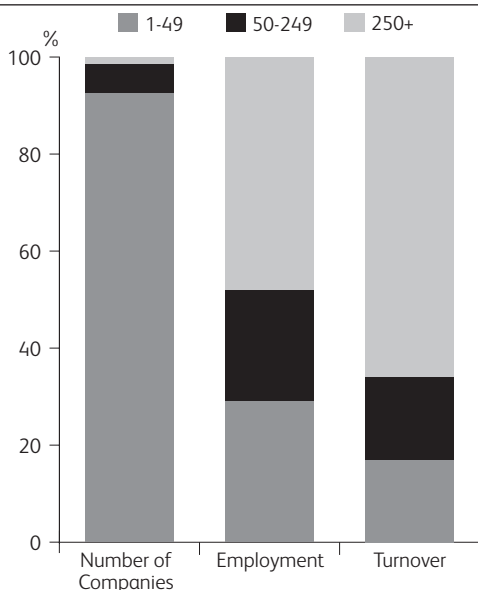
A partnership between government and industry will be the key to maximising growth in the sector. Big companies help drive growth in manufacturing and have the capacity to make large-scale investments in areas like skills and industrial infrastructure.

Looking at the contribution that different sized companies make to employment and turnover underlines the direct value of large manufacturers to the economy. Manufacturing companies employing 50 people or more account for more than 70% of employment and more than 80% of turnover in the sector. The largest manufacturers account for half of employment and two-thirds of turnover despite representing just over 1% of companies in the sector.

**Chart 6**

*Large companies make a major contribution to the sector*

*% of companies by number of employees and their share of sector employment and turnover*



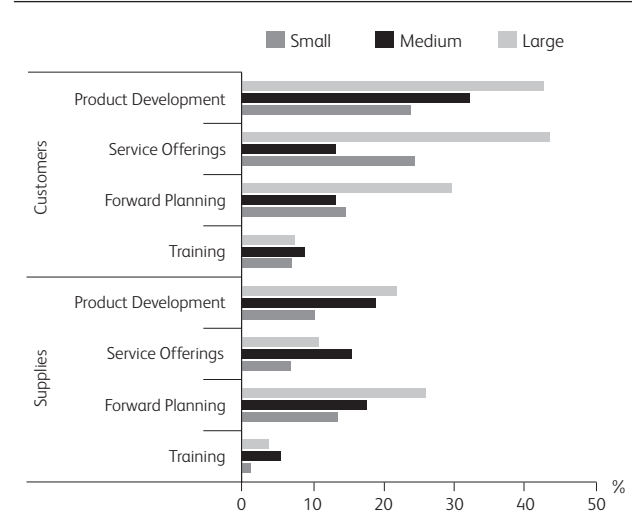
Source: BIS Enterprise Directorate, 2008

Looking beyond these headline statistics provides further insights into the importance of large manufacturers. Big companies are at the heart of the collaboration that makes the sector tick – they anchor supply chains and drive cooperation within them. Not only are large companies more likely to work with their customers and suppliers, but they also tend to engage more deeply with them.

**Chart 7**

*Large manufacturers drive collaboration in supply chains*

*% of companies collaborating fully with suppliers and customers*



Source: EEF/GfK NOP Shape of British Industry survey, 2010

Large manufacturers are twice as likely as small companies to collaborate fully on product development and forward planning with their customers and suppliers. In today's fast-changing industrial environment characterised by increasingly sophisticated logistics, processes and products, the role that large manufacturers play in driving supply chain cooperation is crucial to the success and competitiveness of the sector as a whole.

The collaboration driven by large manufacturers has a multiplier effect – it creates benefits which ripple down the supply chain to smaller companies. For example, fabrications specialist Francis Brown has reaped wide benefits from working on product development with subsea engineering firm SMD. As a result of the collaboration, the company has developed specialist welding skills and fabrication processes for high-integrity steel which have enabled

it to win business it otherwise would not have been able to get. For instance, it recently signed a deal to supply components for oil and gas well sealing systems to oilfield services firm Expro Group.

There is a wealth of evidence demonstrating that the collaborative nature of large manufacturers plays an important role in developing skills and facilitating innovation. For example, they have the capacity to invest in workforce skills which benefit entire industries as well as their own businesses. Similarly, large companies play an important part in developing and strengthening innovation networks which link the private sector with universities and colleges.

*Large companies have the capacity to help address industry-wide skills shortages*

A number of visionary and progressive manufacturing companies are developing large-scale training programmes and new training infrastructure to address skills shortages or emerging needs in their sectors. Prominent examples include the following:

- **Siemens** is addressing the skills shortages that have been forecast in the UK wind industry through a dedicated training facility that opened in 2009. The training centre for wind turbine servicing will not only help meet the company's high demand for specialist skills – projected to include 100 new technicians a year until 2015 – but will also help build expertise in the wider industry by training customer employees.
- **Toyota** is complementing large-scale investment in hybrid car production in Derbyshire with the creation of a dedicated qualification in collaboration with Burton College. The Diploma in 'Hybrid Vehicle Introduction and Environmental Improvements' is the first of its kind in Europe and is recognised at NVQ Level 2. The qualification operates alongside three other complementary Level 2 NVQs – Business Improvement Techniques, Performing Manufacturing Operations and Information Technology Qualification.

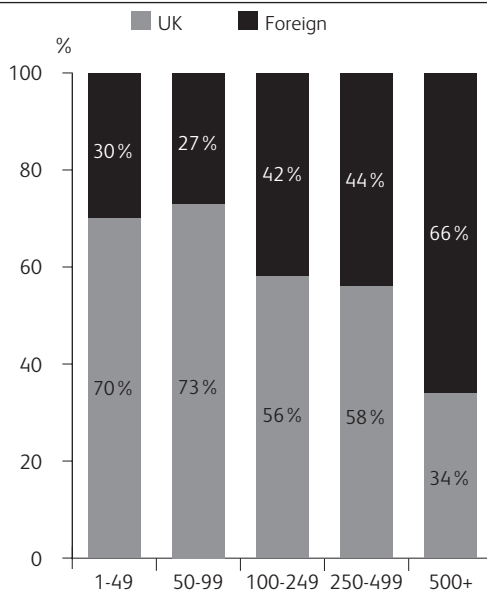
## Ownership in focus

Put simply, there are relatively few large UK-owned manufacturers. The proportion of UK-owned companies falls from more than two-thirds amongst companies employing less than 50 people to a third amongst those employing more than 500 people.

Chart 8

### *Large UK-owned manufacturers are the rarest breed*

Ownership by company size



Source: EEF/GfK NOP Shape of British Industry survey, 2010

Whilst foreign ownership and investment bring many benefits to UK manufacturing, they also bring risks and challenges. In two-thirds of foreign-owned manufacturers, decisions on the location of production and investment are made by the parent company.<sup>5</sup> So for many foreign-owned UK manufacturers, major investment decisions impacting their businesses and the supply chains in which they are embedded are made overseas. For example, a quarter of these manufacturers say that innovation occurs outside the UK due to the location of a head office or parent company.<sup>6</sup>

If investment decisions crucial to the future of many of the country's biggest manufacturing operations are made overseas, the UK must be viewed as a highly competitive and attractive industrial location. In particular, it requires an effective partnership between government and industry in which manufacturers develop the right strategies for growth and the government provides the framework that provides them with the confidence and ability to implement these strategies in the UK.

An appropriate balance needs to be struck between minimising barriers to the investment which is the lifeblood of the sector and ensuring that M&A activity works in best long-term interests of the UK economy. Similarly, the UK must continue to attract FDI, for example into off-shore wind. The challenge is encouraging FDI and takeovers in the long-term interest of the UK, while also growing more UK-owned large manufacturers. In the next section, we look at what shapes ambition and some of the main obstacles facing companies looking to expand their businesses.

<sup>5</sup> EEF/IFM High Value Manufacturing Survey, 2009

<sup>6</sup> EEF/GfK NOP Global Value Chains survey, 2009

## 4. Going for growth

Growing bigger manufacturers requires small and medium sized firms to turn their investments in productivity into growth strategies for the future. For companies to take this next step, we need a business environment that allows firms of all sizes to pursue their ambitions and grow.

Unlocking the growth potential of SMEs is vital. Removing obstacles to their expansion will raise their aspirations and pave the way for the next generation of large home grown companies. The benefits will be felt across the sector. The emergence of a new breed of large manufacturers in this country will generate business opportunities for supply chains, strengthen the manufacturing base and make the UK more attractive to overseas investors.

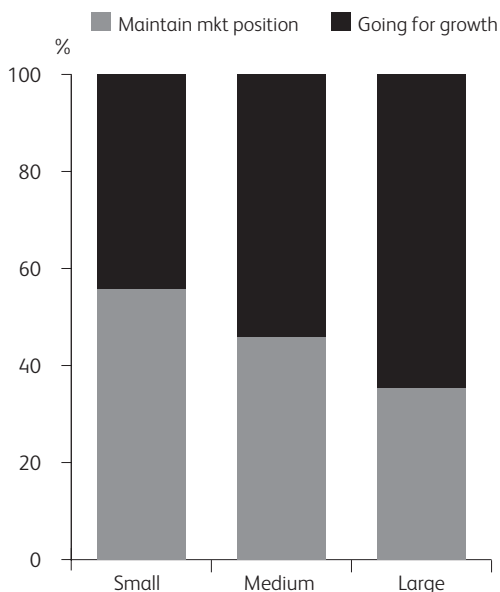
### *Ambition shapes strategy...*

The past performance and future ambition of SMEs points to challenges that need to be overcome. Not only have fewer smaller companies translated productivity gains into growth, as seen in Chart 5, they are less likely to be focusing on growing their business, as shown in Chart 9.

**Chart 9**

### *Larger firms more likely to be going for growth*

% of companies going for growth or maintaining market position at the current time by company size



Source: EEF/GfK NOP Shape of British Industry survey, 2010

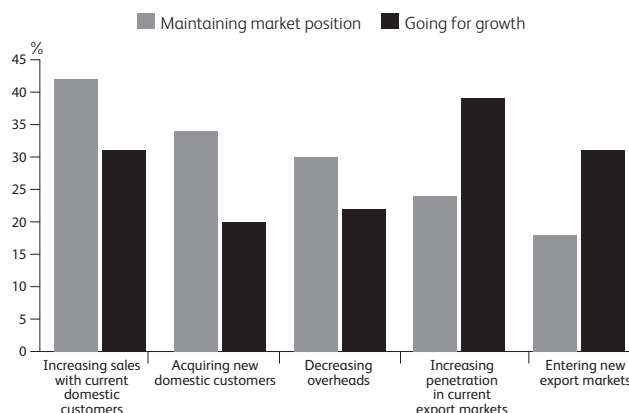
Cautious attitudes to growth may reflect a manufacturer's experience of the recession and its impact on their business. Companies may lack the profitability and resources to invest in growth. Caution is also a justifiable reaction to the severity of the recession and uncertainty about the strength of the recovery. Our survey shows the recession halted over three-quarters of firms' growth plans, causing them to rethink their growth strategy.

More ambitious companies, who place the strategic emphasis on growth, are focusing on export markets. A recent UKTI survey showed that 38% of companies achieved a level of growth through exporting that would not have been possible otherwise<sup>7</sup>. Manufacturers that remain more concerned with maintaining their market position than growth are pursuing more risk-averse strategies that focus on cutting costs and exploiting domestic rather than export markets. For these firms, it will likely take time to rebuild the cashflow and confidence necessary to develop a new strategy based on growth. Manufacturers' caution, consequently, could limit future growth and competitiveness of those firms, as well as the sector more broadly.

**Chart 10**

### *Ambitious manufacturers focus on export markets*

% of companies prioritising different business strategies by current growth outlook



Source: EEF/GfK NOP Shape of British Industry survey, 2010

<sup>7</sup> UK Trade and Investment, From Surviving to Thriving: Doing Business Overseas, October 2010

### ...but barriers shape their ambitions

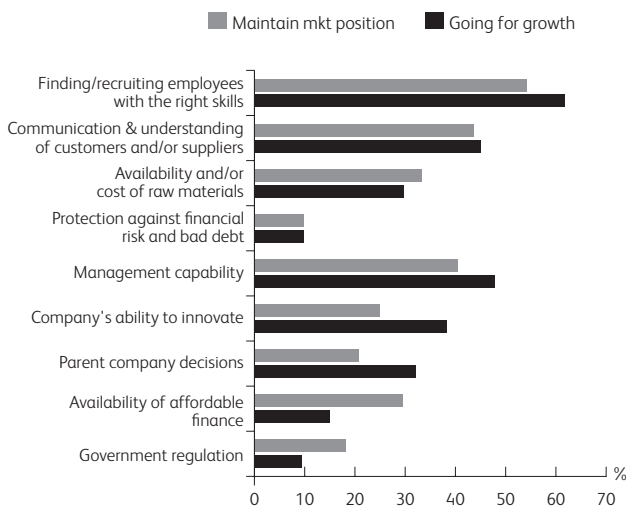
Most firms in our survey faced a core set of challenges, including ongoing skills problems, communicating with customers and suppliers, sourcing affordable raw materials and mitigating risks. However, as Chart 11 shows, firms opting for growth and those preferring to maintain their market position face different challenges.

For those maintaining their position, they are more likely to be concerned with external challenges, including the availability of affordable finance and government regulation. The challenges facing growth-oriented companies are internal, including their ability to innovate and management capability. We need to remove the external barriers faced by companies currently opting to maintain market position, so that they can begin to tackle the challenges of pursuing growth.

**Chart 11**

### External challenges confront companies seeking to maintain market position

% of companies citing barriers to growth by current growth outlook



Source: EEF/GfK NOP Shape of British Industry survey, 2010

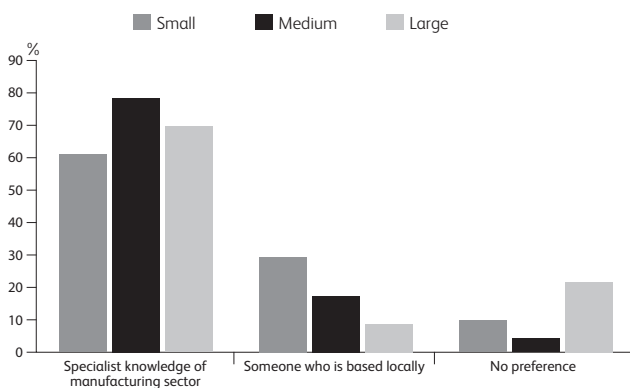
### Finance a potential challenge

Although credit conditions worsened through the financial crisis and in to the recession, EEF's Credit Conditions Survey suggests that conditions, for example for working capital, have stabilised over the past 12 months. However, for companies planning transformational growth, our survey suggests that problems accessing finance is one reason why some firms – especially small and young firms – may be more cautious about their growth plans.

More than a quarter of small companies see the availability of affordable finance as one of their top three challenges, compared with only 15% of large companies. Young companies also see it as a major concern, with approximately half of companies under ten years old citing it as a top three challenge compared with just a fifth of companies over 10 years old.

For younger companies, the start-up capital required to build a factory and buy machinery, equipment and tools or to bring in talented staff is significant. But lacking sufficient trading history to access unsecured lending, they must seek other forms of finance. For example younger firms are more than twice as likely to use asset finance, 61% compared with 30% on average.

The structural shift in lending conditions that has occurred following the financial crisis is inevitable. Yet for some SMEs the pendulum has now swung too far in the other direction, making credit more expensive and less available. In addition, companies believe there is a lack of transparency around banks' lending policies, the use of personal guarantees and other ancillary costs. The financial crisis also appears to have exacerbated the shift of emphasis from cash flow to security in lending decisions, which may have been building, prior to the crisis.

**Chart 12***Manufacturing knowledge preferred by majority of firms seeking advice**% of companies expressing preference of banking advice by company size*

Source: EEF/GfK NOP Shape of British Industry survey, 2010

*Young companies face funding challenges requiring multiple sources of finance*

The funding challenges faced by young companies are illustrated by recent start-up Just Love Food. The South Wales manufacturer of nut-safe cakes had to convince and secure a range of different sources of finance before launching the business.

Founder Michael Woods funded product development (e.g. sourcing nut-free suppliers and developing a cake recipe/design) and setting up his business (e.g. identifying a manufacturing site and developing a brand) through a combination of personal resources and a grant from the Welsh Assembly.

The additional finance required to launch the business and begin trading was secured from a combination of different types of conditional external finance. A bank was willing to provide a loan sufficient to meet part of the company's financial needs, on the condition that it could only be drawn down once a written commitment from at least one retailer had been secured.

The remainder was sourced from Finance Wales, an equity finance company specialising in high-growth potential SMEs. The latter was convinced to invest after rigorous testing of a detailed 3-year strategy which clearly identified several stages of growth and included a detailed plan to scale-up the business to meet expected demand.

In April 2010, Just Love Food began trading after securing an exclusive 12-week trial of products with one of the nation's leading supermarkets.

Underlying these issues also appears to be limited practical knowledge about manufacturing and a lack of competition in the financial sector. In addition, chart 12 demonstrates that for all sizes of firms, manufacturing knowledge is preferred by a strong majority of firms seeking advice, while local knowledge or proximity are more important for smaller and younger firms. This lack of expertise in manufacturing or local knowledge likely reads across into other potential sources of finance too, such as equity investors.

These manifest themselves in investment or lending decisions where risks and returns may not be adequately appraised. For example, previous experience from manufacturers indicates that riskier investments they have made in the past have been supported by new or foreign banks or investors trying to gain a foothold in the UK market.

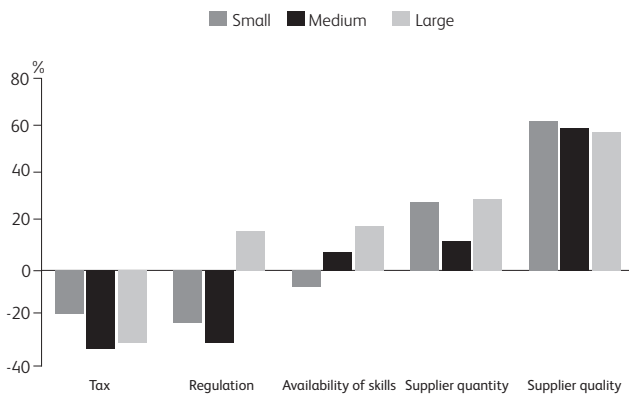
*Mid-sized companies get caught in thicket of tax and red tape*

Given their scale and experience, today's mid-sized firms are potentially the best positioned to make the transition to tomorrow's large companies. Yet there are distinct obstacles in the business environment holding them back, including the tax and regulatory environment.

Chart 13

### *Tax and regulation are major concerns for mid-size firms*

% balance of companies citing UK strengths by company size



Source: EEF/GfK NOP Shape of British Industry survey, 2010

Tax was the only area that had a negative balance across all sizes of companies, mid-sized and large firms rating it more negatively than small ones. Overall, two-fifths of companies rated the UK tax system as quite or very bad with just 18% rating it as good.

There have been some helpful changes to the tax regime in recent years, including a new approach to working with large businesses, lower tax rates and improved consultation with business. However, the survey shows that most firms still have a negative view of the UK's tax environment, with many benefits of recent changes not yet visible.

For smaller firms, recent changes to the tax system have raised the cost of investing in the latest technologies, eroding their competitiveness. Mid-sized companies meanwhile are most critical. They face the same burdens and challenges as smaller manufacturers, but given their size also have to navigate the same tax-related complexities and uncertainties larger companies face in financing overseas operations. In addition, frequent changes to the legislation have saddled them with rising administrative and compliance costs as well as an adversarial relationship with HMRC.

Less mobile SMEs have little choice but to bear this burden in the UK, but larger, more mobile

manufacturers are beginning to be pushed abroad. Consequently, the UK must remain internationally competitive for tax purposes to ensure that businesses have the funds to invest in growth, to encourage our larger manufacturers to remain headquartered here and to attract inward investment.

*The UK must remain internationally competitive for tax purposes to ensure that businesses have the funds to invest in growth, to encourage our larger manufacturers to remain headquartered here and to attract inward investment.*

Regulation is also a major concern for manufacturers. They rate it as the second worst aspect of the UK business environment. Complying with regulation can be time consuming and costly. In our survey, more than half of respondents cited regulation as an obstacle to their growth plans.

Mid-sized companies are especially concerned about regulation. Nearly three-fifths identified it as a barrier to growth and a significant majority rated the UK business environment as poor in this area. These companies typically face the same level of burden as the largest companies, but have fewer administrative resources with which to comply.

For example, Swantex, a medium-sized manufacturer of paper tableware, has found that as the company has grown so have the administrative burdens imposed by government regulation – for example the frequency of reporting requirements and pre-payment of corporation tax.

For most manufacturers, the experience of the past decade has been an increase in the burden imposed by regulation. So the strong emphasis placed by the coalition government on reducing the burden on business is very encouraging for manufacturers. However the impact of eye-catching policy initiatives, like the 'one-in, one-out' system for new regulation, will depend on how they are implemented.

The focus must be on stability and reducing the flow of new regulation. Businesses build systems and develop processes to comply with regulation. Removing an individual regulation may have little or no impact on the overall burden because there are costs involved in changing as well as introducing business processes or operating procedures. A poorly implemented ‘one-in, one-out’ system could actually increase the burden if it results in twice the amount of change without significantly reducing compliance costs.

### *Poor regulation can be a major drag on UK manufacturers*

Poorly conceived or implemented regulations can undermine the business plans of companies of all sizes. Examples raised during company interviews carried out for this report include:

- **Disproportionate unilateral regulation creates competition issues:** poorly conceived European climate regulations can put the Continent’s manufacturers at a competitive disadvantage for little or no environmental benefit. For example, tightening diesel engine emissions standards are increasing the cost and undermining the business case for producing construction vehicles in Europe. According to leading UK manufacturer JCB, they could actually increase rather than decrease emissions. The standards for ‘non-road’ vehicles are based on the per vehicle limit approach used for cars. However a larger and higher emitting construction vehicle can often do the same work as several smaller ones in a shorter time and for less total emissions.
- **Poor transposition of EU legislation into UK law creates uncertainty:** the UK has been a laggard in adopting EU standards on catalytic converters. The UK finally implemented the standards towards the end of a long compliance window at short notice and with very limited consultation. The net result was not only a prolonged period of uncertainty for the industry but many companies, such as Mansfield-based BM Catalyst, having to write-off significant volumes of valuable but non-compliant stock with no compensation.

## Management is a key to success

Some of the most important factors that determine whether manufacturers’ growth plans succeed or fail are within their control. For example, in our survey companies rated management capability as one of the most important factors for meeting their strategic priorities.

Management is an increasingly important differentiator. From running supply chains strung across the globe and building strong relationships with lenders to combining process and product innovations to deliver successful commercial offerings; effective leadership is essential.

Good management matches long-term vision and the capability to deliver it. By identifying and investing in future sources of growth, companies can build a platform for transformational growth and long-term success.

### *Strong management is vital to creating and delivering ambitious strategies*

Subsea engineering firm SMD has developed into a rapidly growing and market-leading manufacturer of subsea robots. This has been achieved through astute management that has consistently targeted long-term growth and investment in the capabilities to deliver it.

The 2003 acquisition of Hydrovision, a manufacturer of remotely operated vehicles (ROVs), laid the foundations for growth. It allowed SMD to diversify away from the declining subsea optical cable market and into the rapidly growing market for ROVs spurred by the boom in deepwater oil and gas production.

Following a 2008 change in ownership, a new management team is building on the success of its predecessors. The company is entering a number of new markets and building the capacity to service them. SMD has moved into the offshore renewables and subsea mining markets and is targeting further expansion in areas like nuclear decommissioning and port security. To meet the anticipated growth in orders, SMD has strengthened its capabilities with the 2010 acquisition of Hallin Robotics.

## 5. Recommendations

British industry is strong. Over the past decade UK manufacturers have invested heavily in boosting productivity and improving competitiveness. Yet if manufacturers are to help the UK pay its way in the world, their next challenge is to grow their businesses.

The issue is not about big versus small or home-grown versus foreign owned. The UK needs manufacturers of all shapes and sizes to be able to pursue and realise their ambitions. This will deepen supply chains, help grow more of the large companies we currently lack and make the UK a more attractive location for overseas investors.

Manufacturers hold many of the keys to success in their own hands, chief amongst them good management and communication with existing or would be employees, suppliers, customers and investors. Such qualities are increasingly important in a complex, multifaceted and globalised industry.

Government, however, must also work with the grain of industry, to lever the strengths within manufacturing – its innovation, diversity and international reach – to enable growth. For example, a policy approach based on promoting a single aspect of industrial activity like R&D or only certain types of sectors, like so-called “high-tech” industries, is unlikely to maximise growth. Such an approach would waste scarce resources and risks failing to maximise economic growth.

The government’s Growth Strategy and Manufacturing Framework shouldn’t be the last words on growth. Rebalancing the economy through growth in manufacturing requires long-term investment. In some cases, such as finance, tax and regulation, government has much greater responsibility for ensuring that its approach helps rather than hinders economic growth. In other areas this involves working in partnership with business on issues such as local economic growth, skills and procurement.

### *The challenge for manufacturers*

The image of UK manufacturing is slowly improving. However, because of the nature of British industry, manufacturers will need to work hard to promote themselves, their supply chains and the sector at every opportunity.

The interconnected nature of manufacturing means that its strength ultimately stems from a critical mass of expertise and capabilities embodied in complex supply chains rather than any individual company, no matter how large or successful. But at the same time, UK manufacturing’s diversity, lack of large companies and focus on niche areas means that its profile does not match its contribution to our economy.

UK manufacturing must raise the visibility of its capabilities and successes. Unfavourable myths based on historical bias can be challenged and dispelled. British manufacturing makes a pivotal contribution to many of the world’s leading products. From the engines of choice for the next generation of airliners to key electronics within the iPod, UK manufacturers are at the heart of the 21st Century economy and its greatest success stories.

- *EEF will front an industry-led charge to drive a campaign designed to bolster the image of manufacturing in the run up to the 2012 Olympics, showcasing the breadth and depth of capabilities and opportunities.*

### *The challenge for government*

#### *Create a competitive and stable business environment*

Growth requires a competitive and stable business environment. A stable business environment is crucial to growth. Even the best laid plans of many businesses, especially SMEs and young businesses, were derailed by the turbulent economic and business environment over the past three years. Against the backdrop of a deep recession and uncertain recovery, ad hoc changes (for example, the Carbon Reduction Commitment) have fostered uncertainty, while others – such as the reduction in investment allowances – have hurt growing, capital intensive businesses the hardest by compounding problems around finance.

Manufacturing is more capital-intensive and has a longer investment horizon than most other parts of the economy. A government’s reputation and track-record for setting out clear ground rules and sticking to them will be a key factor in encouraging investment in growth and increasing foreign investment in the UK.

*1 Cut through the thicket of tax and red-tape and provide long-term clarity over reforms.*

The government has taken welcome steps to improve the quality of tax policy and simplify the tax system. However, this progress is outweighed by waning competitiveness and increasing uncertainty about the taxation of foreign profits, innovation and investment. And government's narrow focus on corporate tax reforms does not match businesses' broader concerns. Smaller, less mobile companies have little choice but to bear this burden in the UK, but larger, more mobile manufacturers are considering moving abroad.

- *For the UK to develop an internationally competitive tax regime, the government needs to provide clarity about which corporate, environmental and personal tax reforms it will seek over the next five years.*

The government's 'one in, one out' policy is a good start at reducing the regulatory burden on business. However, identifying the cost of regulation is an art rather than a science, as businesses are impacted by the cumulative effect of layers of regulation that build up over time.

- *The government should use seven-yearly sun-setting reviews to consult with business on the impact of the regulatory domain as a whole, and all of the burdens it contains.*

*2 A simpler, demand-driven system of skills provision is a necessary condition for growth.*

While companies and government have invested significant sums of money in skills and training in recent years, the outcomes from the training system are still not fully satisfying the demand from manufacturers. The challenges and problems in developing skills and building a strong pipeline of young people from the education system with good quality STEM skills are largely well understood. The issues are primarily with a complex and fragmented skills infrastructure that can actually stand in the way of companies accessing appropriate, good quality training provision, when they need it. A simpler, demand-driven system of provision, with well-informed employers and individuals is a way of addressing this.

*3 Any long-term changes to the takeover regime should focus on the best interests of the UK economy.*

As our survey shows, company ownership is important for UK competitiveness, in large part because the location of company headquarters affects decision making. But the government should avoid protectionist measures that might prevent much needed investment from flowing into the UK. Any changes to the UK's takeover rules must, therefore, strike an appropriate balance between minimising barriers to the investment which is the lifeblood of the sector and ensuring that M&A activity works in the best long-term interests of the UK economy – and the underpinning rationale for reform.

*4 Improving access to finance.*

We do not see a simple solution to increasing the flow of finance to businesses seeking to expand and grow. Successive governments have tried to solve the problem with an array of government-backed solutions many promising up to £1 billion in finance. While government funding is crucial, its impact has been limited. For growing companies, the problem is also structural.

Building on the BBA Taskforce's recommendations to improve credit conditions, government should focus on the following reforms to improve access to finance.

- *Prioritise transparency on lending principles and ancillary costs for SMEs.*
- *Foster greater non-price competition among lenders and improve the provision of alternatives to equity finance and bank lending.*
- *Restructure government-backed schemes to provide a single source of funding capable of investing through successive rounds of business growth.*

*Target and coordinate support to catalyse growth*

The interconnected nature of manufacturing is a catalyst for growth that smart policy can exploit. Strategic investments by government in areas such as innovation and infrastructure can reap returns far beyond the initial outlay by strengthening, stimulating and cascading benefits through supply chains.

5 *LEPS should be able to use Tax Increment Finance (TIF) to compete for business investment.*

EEF has been critical of the process for establishing LEPs, particularly the lack of business engagement. We are still concerned that they lack sufficient critical mass. With central government resources stretched and RDAs winding down, there is a governance and finance gap at the sub-national level. For example, RDA grants have allowed manufacturers to raise capacity by re-engineering existing sites and financing new production facilities. As the government's decentralisation agenda takes shape, it is vital that LEPs have sufficient resources to continue this important role. While the Regional Growth Fund provides one potential source of financing for LEPs and Business Rates Supplement should be used to make local infrastructure improvements, LEPs should explore how Tax Increment Finance (TIF) could potentially be used to attract and grow businesses in their area.

6 *Targeted support is needed to build on industrial strengths.*

Business support must be well-coordinated and carefully targeted to make best use of scarce public resources. Support should be focused on sectors with significant growth potential and in which the UK has a competitive advantage such as low-carbon technologies. The impact of strategic investments can be enhanced further if they are coordinated to provide benefits to several industries at the same time.

The recent investment in port infrastructure to attract investment in turbine manufacturing is a good example. It also reinforces the major public investment in the demonstration of carbon, capture and storage (CCS) technology. The emerging CCS industry is likely to be focused on the east coast to access storage sites in the North Sea and will also benefit from enhanced port facilities in the region. Other examples of targeting industrial capability include new nuclear, electric cars and high-speed rail.

7 *Improve the skills, experience and incentives of public procurers and scrap the 25% SME target.*

Government needs to become a more strategic, better customer by engaging earlier with industry to convey its needs. This will require significant culture change to upgrade the skills, expertise and experience of public procurers if the public

sector is to focus on long-term value for the economy rather than short-term cost savings. Moreover, a wealth of evidence suggests that the government's target for 25% of contracts to go to SMEs is likely to be bureaucratically burdensome, while providing little, if any benefit to SMEs. Rather, EEF believe that SMEs – and the economy as a whole – would benefit from improving the experience and incentives of public procurers.

8 *Business support and management quality.*

Government faces tensions between providing support for a strong private sector growth and having limited resources to deliver that support to all companies that need it. Funding for business support will, therefore, need to be better targeted, but should not simply be viewed as a product to help companies get started but also for those wanting to grow.

The array of ambitions and opportunities which are available to manufacturers requires a range of support products from accessing new export markets and guidance on finance options to help with process improvements and finding the right partners for innovation.

Rather than a maze of support solutions that can differ from region to region, more effective targeting of resources can be achieved by offering companies access to a hub of complete solutions.

For example, the experience of government funded interventions such as the Manufacturing Advisory Service, Designing Demand and the Proof of Concept scheme in Scotland (which mentored companies with new ideas on how to make a business case to potential investors) is that the most effective way to raise the quality of management is engaging with them on this issue in the context of the practical barriers that they face to realising their ambitions. An important role therefore for the proposed Growth Hubs is to help firms with high growth potential to access management training, and coaching and mentoring as part of a package which addresses the range of issues facing their business.

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## NatWest Viewpoint

NatWest PLC is delighted to be supporting *The Shape of British Industry* report and the valuable contribution it makes to the debate on the future direction of the UK's manufacturing sector.

Manufacturing continues to make a significant contribution to the UK economy and this is echoed by the findings of this report. At the time of writing, certain economic indicators support our view that the sector is likely to post respectable growth rates in the fourth quarter of 2010 which, if achieved, would be very welcome news. Compared with a number of other sectors, manufacturing is more geographically diverse, both nationally and internationally, which will help stimulate new opportunities. With the right support, companies will be able to take advantage of these opportunities for growth and, looking ahead, we remain optimistic about the performance of the sector.

The outlook for manufacturing will, of course, continue to be influenced by a range of issues but on the positive side, the report suggests that strategic

collaboration with key stakeholders has a favourable impact on a company's performance. This report, supported by the findings from additional research recently commissioned by NatWest, highlights the significant level of collaboration that already exists in the manufacturing sector between suppliers and customers. And in our experience, the benefits extend to finance too. A close working relationship with our customers allows us to gain a thorough understanding of a company's finance needs. Our dedicated relationship teams have specialist knowledge of the manufacturing sector and we can help businesses address the kind of issues covered in this report.

*The Shape of British Industry* report touches on a number of issues affecting the manufacturing sector. There is, of course, no shortage of challenges such as innovation and capital investment. But, by the same token, there are a number of positive indicators too, and by working with customers in the manufacturing sector, we are witnessing growth as businesses look to build their domestic and export markets.

Peter Russell  
Head of Manufacturing  
Corporate Banking London

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## About us

EEF is dedicated to the future of manufacturing. Everything we do is designed to help manufacturing businesses evolve, innovate and compete in a fast-changing world. With our unique combination of business services, government representation and industry intelligence, no other organisation is better placed to provide the skills, knowledge and networks they need to thrive.

Around a quarter of the UK's manufacturing businesses are our members and many more use our services to help them work better, compete harder and innovate faster. Because we understand manufacturers so well, policy makers trust our advice and welcome our involvement in their deliberations. We work with them

to create policies that are in the best interests of manufacturing, that encourage a high growth industry and boost its ability to make a positive contribution to the UK's real economy.

Our policy work delivers real business value for our members, giving us a unique insight into the way changing legislation will affect their business. This insight, complemented by intelligence gathered through our ongoing member research and networking programmes, informs our broad portfolio of services; services that unlock business potential by creating highly productive workplaces in which innovation, creativity and competitiveness can thrive.

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## About NatWest PLC

### About NatWest PLC

At NatWest, we are committed to supporting your business through our extensive range of banking, finance and risk management products and services. We can provide you with a tailored solution to suit your specific business needs, however simple or complex they are, both in the UK and when you're trading internationally.

Our range of financial solutions are designed to help you to free up working capital through asset and invoice finance, exploiting opportunities to expand by trading internationally and mitigating interest rate and foreign exchange risk via the financial markets.

Your dedicated relationship director will maintain a thorough understanding of your organisation and always strive to provide you with the support you need to achieve your strategic goals. Our relationship directors also coordinate the skills and expertise of product specialists across the RBS Group to help your organisation succeed.

For more information or to explore how we may be able to support your organisation, please contact your relationship director or email [manufacturing@natwest.co.uk](mailto:manufacturing@natwest.co.uk).

