MAKE uk
The Manufacturers' Organisation

EXECUTIVE SURVEY

MANUFACTURERS' EXPECTATIONS FOR THE YEAR AHEAD

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Assembly of the underbody of a Jaguar Land Rover (Sport)
Process underbody 24, taken by Jakub Wasik at Jaguar Land Rover in Solihull, winner of the Amateur category of the EEF Photography Competition 2017.

MANUFACTURERS' PREDICTIONS FOR 2018

This is the seventh edition of our annual Executive Survey, manufacturers' look at the growth opportunities and challenges that lie ahead, and our first in partnership with AIG. Every year we take a look at companies' expectations for growth – in their business, across the UK economy and globally – and their headline predictions are outlined below.

In addition, our survey provides an early warning of some of the issues that could knock these predictions – which are largely positive for 2018 – off track. Some standout developments for 2018 include the inevitable cornucopia of challenges that could come with the ramping up of Brexit negotiations.

But outside of domestic politics, as manufacturers have been investigating what the fourth industrial revolution means for their business, their heightened awareness of the risk of cyber-attacks is clearly in evidence this year.

We've seen the agility and responsiveness of UK manufacturers in the face of a host of economic developments in our surveys over the past seven years and again we see companies putting in place defensive and offensive business strategies to make the best of whatever is in store in 2018.

1. After beating expectations in 2017, manufacturers are planning for improved trading conditions in their industry in the year ahead.

2. A stronger global outlook will help; a balance of companies predict an acceleration in the world economy.

3. Exports will fare well with 47% and 51% of companies expecting higher orders from EU and non-EU customers respectively.

4. Companies manufacturing investment goods will see a strong year supported by growth in export markets this year.

5. The UK will not be as buoyant, with another year of subdued activity in prospect according to a majority of manufacturers.

6. Manufacturers will try to increase jobs in response to capacity constraints, but the decisions of EU nationals will also dictate how much recruitment will be needed in 2018.

7. Manufacturing investment levels will be little changed in 2018, but appetite to increase capital expenditure will lag our competitors.

8. Some emphasis on process innovation and automation will pay off as two-thirds of manufacturers expect to improve productivity this year.

9. Managing costs will be one of the main challenges for UK industry this year – a consequence of sterling volatility and rising commodity prices.

10. A balance of 48% of manufacturers predict the UK will be a good location for their manufacturing activities this year.

MANUFACTURERS' 2018 GROWTH EXPECTATIONS

- A pick-up in global activity looks set to support a year of improvement in industry fortunes
- In contrast to the buoyant assessment of prospects for the rest of the world, manufacturers are less confident about the fortunes of the domestic economy
- The global outlook is having a bearing on how companies view their own business prospects with firms planning for improvements across all indicators

Manufacturers have again shared their expectations for growth in the year ahead. Looking to 2018 there has been a clear shift in companies' assessment of prospects for their business and the wider economic outlook compared with 12 months ago. The rebound in global demand that was benefitting manufacturers through 2017 is predicted to continue this year, but industry executives share the view of economic forecasters that the UK will face ongoing challenges through 2018.

2017 – more up than down for UK manufacturing

Last year's Executive Survey was characterised by expectations of a subdued global outlook and weakening growth in the UK economy translating into only a modest balance of manufacturers (10%) planning for industry growth in 2017.

In fact, manufacturers underestimated the strength of the world economy last year. The rebound in European markets, the resilience of the US economy and acceleration in growth in large emerging markets provided a boon for exporters and their supply chains. In EEF's last Manufacturing Outlook report of 2017, we reported that 81% of manufacturers had seen improved demand conditions in at least one major overseas market in the final quarter of the year.

Official statistics put manufacturing on track for an expansion of over 2% in 2017 – the fastest pace of increase since 2014. And exports also look to be on track for double-digit growth.

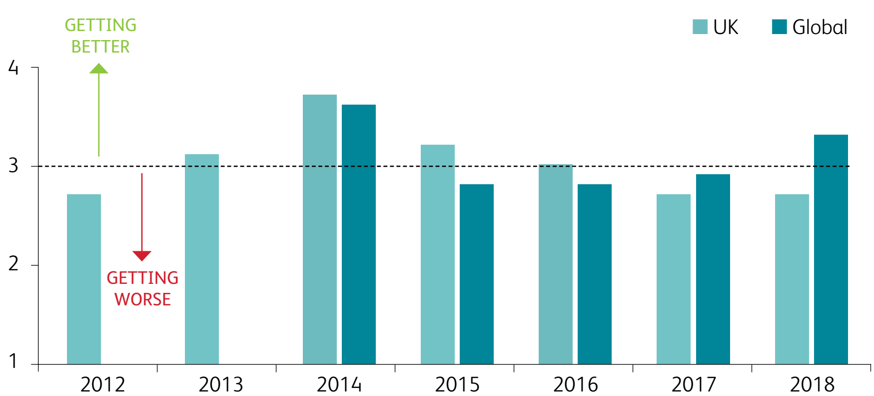
Global growth on the rise

The pick-up in global activity, which was very much evident in official data and survey indicators hovering at multi-year highs at the end of last year, is predicted to sustain a further year of improvement in industry fortunes.

Our 2018 survey shows a balance of companies expecting improvements in global economic conditions, with responses scoring the highest level since 2014 (see chart 1). A positive outlook for the world economy is also shared by manufacturers of all sizes. These expectations track the views of international forecasters, including the IMF, which is now pencilling in a stronger global growth rate of 3.7% in 2018.

Chart 1: Global growth expectations recover strongly in 2018

Growth expectations for the next 12 months, 5 = significant improvement, 1 = significant deterioration



Source: EEF Executive Survey

UK still in the slow lane

In contrast to the upbeat assessment of global prospects, UK manufacturers are less confident about the fortunes of the UK economy. For the second year running, more manufacturers expect a deterioration in the domestic economic situation than expect an improvement (chart 1). They are not alone, developments since the EU referendum have led to lower levels of confidence amongst households and businesses, together with more subdued growth in consumer spending – a dominant driver of growth (see UK forecasts boxout below for more detail).

UK FORECASTS

This time last year, manufacturers' confidence about the UK economy faltered as forecasters predicted Brexit would hit economic growth. Reflecting markets' immediate reaction to the outcome of the EU referendum, sterling depreciated sharply, and this was expected to push inflation up in 2017. As consumers started to feel the squeeze on real incomes, they would drastically reduce spending. The slowdown in UK demand, coupled with uncertainty around the outcome of the EU negotiations, would urge companies to cut back investment plans. Only net trade was expected to provide some relief, as a better global outlook and the weak pound were projected to spur export growth.

Some of these predictions did come true, and the UK was no longer the fastest growing G7 economy in 2017. Inflation crept up to 3% towards the end of 2017, and as wage growth remained subdued, households faced a prolonged period of falling real incomes. As a result, consumer spending – once the largest contributor to GDP growth – expanded at its slowest pace since the recovery from the 2008 financial crash was on track.

Although the UK economy was not firing on all cylinders, GDP growth did not come to a halt, and some bright spots are worth noting. First, global growth has beaten expectations over the past year, and as sterling remained weak, UK exporters made the most of the synchronised recovery in world markets. Second, the UK labour market showed remarkable resilience, with the unemployment rate slipping to a 42-year low of 4.3% by the end of 2017. This has partly offset the slump in households' confidence from falling real incomes, compensating some of the negative impact on consumer spending.

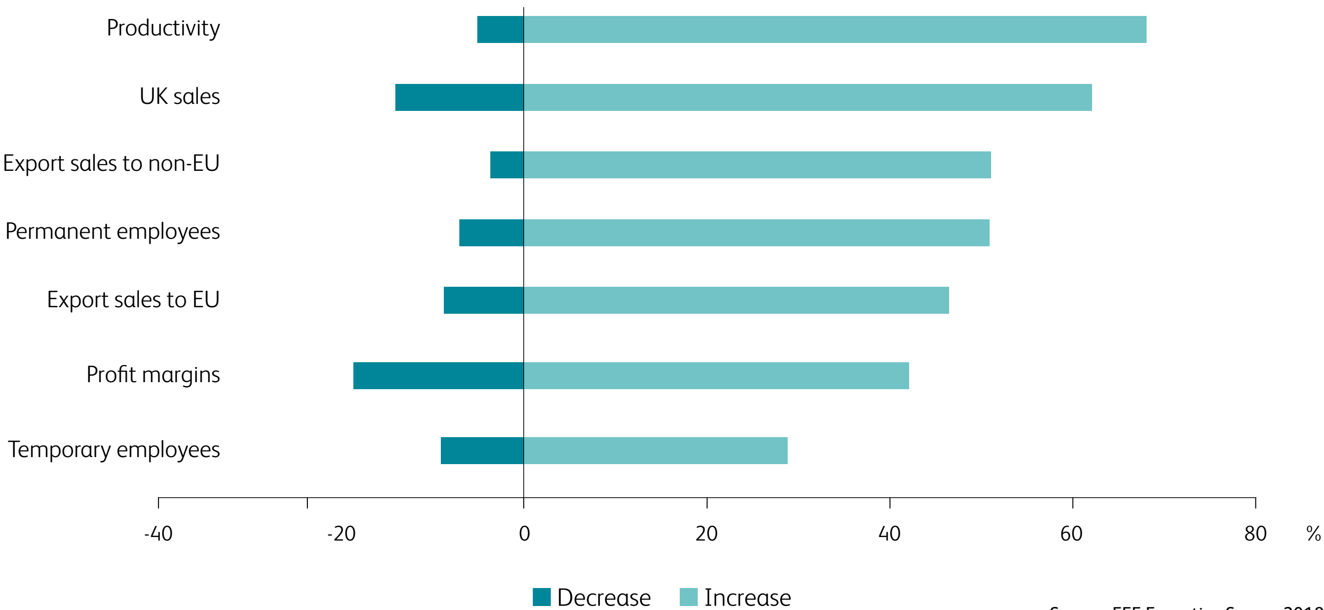
These trends resulted in business investment holding up over the past 12 months as companies faced drastically higher orders than levels they might have expected a year ago. Yet business investment expanded below the level required by busy order books and signs of emerging capacity constraints intensified over the past year, suggesting companies were still proceeding with caution.

Looking at the year ahead, manufacturers' confidence about the UK economic outlook slips again in 2018, reflecting expectations of a further slowdown in GDP growth. Although inflation is expected to slide back from its high levels over the next 12 months, as the effects of the sterling depreciation and the upsurge in energy and commodity prices start to fade, the sluggish performance in wage growth is likely to persist, and the squeeze on households' incomes will continue to weigh on consumer spending over the next 12 months.

By contrast, the solid performance of the global economy is set to continue in the year ahead, sustaining the momentum in export growth. This won't be enough to propel capital spending however, and with Brexit uncertainty still looming large, investment growth will likely remain subdued in the year ahead.

Chart 2: Productivity, sales and employment are expected to all be on the up in 2018

% of companies planning for change in indicators in 2018



Source: EEF Executive Survey 2018

Firm level indicators all in the black

Overall, the more positive developments in the rest of the world are having a greater bearing on how companies view prospects in their own businesses. Chart 2 illustrates the optimistic outlook industry executives have for their own businesses in the year ahead.

A balance of companies is planning for improvement across all our indicators (chart 2) for the first time in three years and in every case responses are more positive than a year ago.

Topping the rankings again this year is productivity gains in the next 12 months. Just over two-thirds of companies surveyed expect to make efficiency improvements to their UK operations this year, up from 56% last year. That manufacturers deliver on these expectations is becoming ever more critical as aggregate productivity across the economy (as measured by growth in output per hour in official statistics) has been static for the best part of a decade. Continuing stagnation will bear down on the UK's long term economic performance.

While manufacturing accounts for around a tenth of UK output, it has traditionally punched above its weight when it comes to contributions to overall productivity. The third section of this report looks in more detail at some of the actions and strategies that firms are planning to help drive productivity gains.

Following close behind positive productivity expectations for the year ahead is sales growth – at home and from overseas customers. Despite concerns about a slowing UK economy, manufacturers appear confident that demand from UK customers will nevertheless hold up. This apparent contradiction can be explained by the sector composition of responses. The most upbeat about UK demand are manufacturers in the intermediate goods segment; two-thirds expect UK sales growth this year, of which a quarter are planning for significant growth. This sector includes industries such as chemicals and metal products, which are diversified and the foundations of many supply chains producing goods destined for home and export markets.

Consumer goods manufacturers are also more positive than might be expected about the UK sales outlook. This could be based on expectations that the squeeze on household incomes from rising inflation could subside as this year progresses. But it could also be a consequence of some import substitution, with UK manufacturers looking more price competitive compared with imports due to the persistent weakness of sterling.

The rest of the world is investing

Capital goods manufacturers (mechanical equipment and electronics sectors) are somewhat less positive about UK sales, but the rapid growth in business investment in other parts of the world is expected to more than make up for any domestic weakness this year.

Our survey is showing overall positive readings for sales growth to EU and non-EU markets in the next 12 months – expectations buoyed by strong demand and the competitive pound.

But the stand-out sectors are likely to be capital equipment producers. Over three-fifths of companies in this sector are predicting export growth to EU and non-EU markets this year, compared with just under half of our total sample.

Forecasters' expectations for business investment growth in the rest of the world would support capital goods manufacturers' growth plans for this year. The OECD, for example, is looking for 4-5% growth in business investment in the US, Germany and South Korea, which will help drive sales for UK exporters.

Employment on the rise

Rising sales and overall expectations of industry growth this year will lead to rising demand for skills. Our survey indicates that the balance of this employment is likely to be permanent rather than temporary. Over half of manufacturers surveyed are planning for workforce expansion this year with just 7% expecting to reduce numbers employed, this compares with 36% and 20% respectively last year. The ease with which companies will be able to achieve this is more uncertain given the current prevalence of hard-to-fill vacancies and the potential loss of key migrant workers.

Overall, there are a lot of things that could go right this year and a balance of 22% of companies expect their industry trading conditions to be better this year than last – up from the 10% recorded in 2017. Inevitably, there are risks that all will not be plain sailing, the next section looks at where some of the main business risks could lie in 2018.

RISKS IN THE YEAR AHEAD

- Half of companies see more risks than opportunities in the year ahead, while a quarter think the opposite
- Risks bubble up at the firm level as well as assessments of risks in the international economy
- Brexit continues to apply pressure to anticipated risks with significant upward pressure on input costs topping the list

Despite the expected positive outlook for economic conditions in 2018, companies in the survey are still very much alive to the risks that could knock growth off course. Following the past two years where a positive balance of companies have said that they 'see more risks than opportunities in the year ahead', the view for 2018 is no different, with the proportion agreeing with the statement increasing, whilst the share disagreeing has stayed constant (chart 3).

Risks approaching on numerous fronts

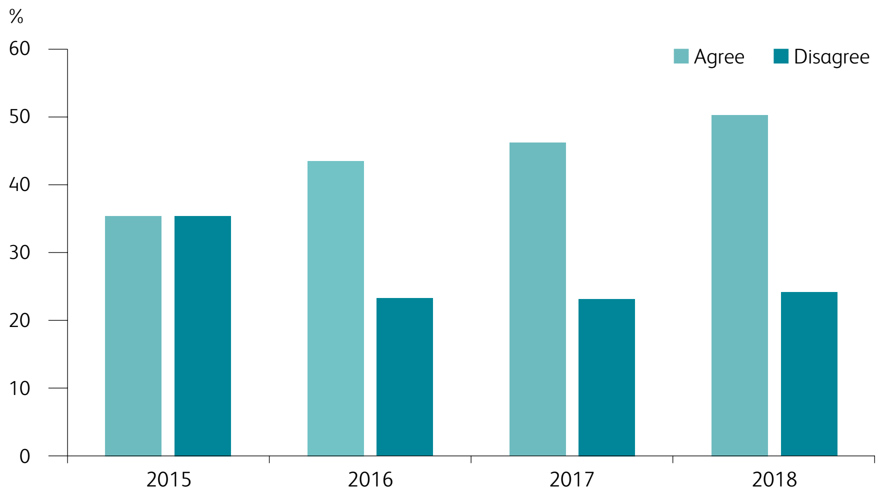
So why are more companies expecting more risks than opportunities in the next 12 months, in the face of the strong outturn of 2017 and reasonably positive views for growth in 2018? Whilst it is easy to look to Brexit for the reasons why, and indeed it is one area which is very much exacerbating risks, it is not the only reason for manufacturers to enter this year with a degree of caution.

Robust upturn means capacity concerns

With companies reporting improving orders and output levels in our Manufacturing Outlook surveys throughout last year, and with strong indicators that this picture will continue in the next 12 months, there is a growing pressure on capacity in the sector. The demand upturn was stronger than firms were expecting in 2017 and investment intentions have lagged somewhat. Add to this the on-going challenge of recruiting skills into the sector and the result is an emerging concern that companies across supply chains could struggle to accommodate further growth in sales.

Chart 3: More companies observing a risky outlook

% of companies agreeing with statement 'There are more risks than opportunities for my company in year ahead'



Source: EEF Executive Survey

Half of companies cite insufficient capacity within their business to meet demand as a risk for 2018, and this is a threat felt similarly across all sizes of company. And for these businesses it will be one of the major risks if it materialises during the year – the extent to which companies will allow this to affect their business and the strategies to combat this risk is discussed in the next section.

Balancing the technology risk and reward

Throughout 2017, the fourth industrial revolution and the ability of technology to transform the manufacturing sector through smarter and connected production, supply chains and products, was a much discussed topic and will continue to be during this year. But risks inevitably run alongside the opportunities and rewards.

Over six in ten businesses in the survey said that disruptions due to a cyber-attack was on their risk radar for the year ahead. As technology and data start to play increasingly critical roles in industry, companies will inevitably find themselves more vulnerable to cyber breaches. But whilst a considerable proportion of firms cite this as a risk for 2018, very few cite it as the most significant risk they will face.

Inflation to knock on pay?

Increased pay pressure continues to be on the risk list for manufacturers. In last year's survey, 47 % raised it as a risk and this has increased in this year's survey to 54 %, with large companies slightly more likely to cite this. The surge in inflation, the rise in the National Living Wage, together with the improvement in firms' profitability and the buoyant demand outlook are all pointing towards a stronger momentum in pay growth across manufacturing and firms are preparing themselves for possible pay pressure to be building in the year ahead. The risks from a tighter labour market – a consequence of the potential loss of EU workers (covered later in this section) is likely adding to concerns this year.

However, we shall have to watch closely to see if pay pressure appears from all parts of the workforce and if this pressure translates into pay increases. Despite similar expectations last year and similar forces at play, official statistics showed negative growth in real earnings in 2017 with the wage squeeze even more pronounced in manufacturing.

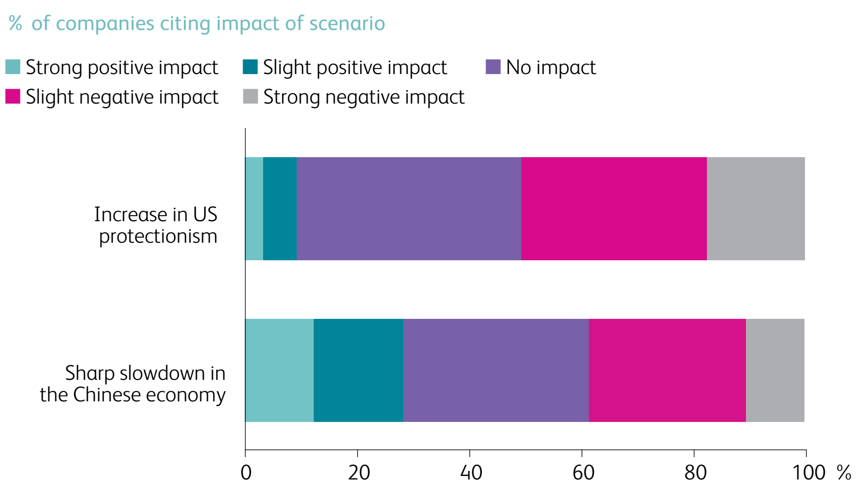
What risks to the global growth outlook?

The cyclical pickup in global activity is welcome after a decade of subdued performance and the solid performance of the world economy looks set to continue this year. However, concerns over the medium term outlook are still on the radar. Weak productivity continues to weigh on the potential growth of the world economy, while increased protectionism could severely undermine the future path of production and trade of highly integrated supply chains.

As discussed in our *Global Trade* report[1], trade liberalisation stalled in the aftermath of the financial crisis followed by a surge in protectionist measures as governments attempted to protect local businesses from the consequences of the economic downturn. The report found that the rise in protectionist policies was most notable for survey respondents selling into the US.

With President Trump renegotiating NAFTA and showing increasing disdain for multilateral organisations, such as the World Trade Organisation, there is justifiable concern about the prospect of increased protectionist measures in the US – whilst 10 % say this would positively impact their business, half say it would be harmful. UK trade in manufactured goods to the US accounted for 16.9 % of exports and 9.4 % of imports in 2016[2] – and an overall trade surplus of £8.7bn – and in our survey, more capital goods manufacturers are worried about the impact of this compared with consumer and intermediate goods manufacturers.

Chart 4: Impact from possible changes in global market conditions



Source: EEF Executive Survey 2018

[1]EEF, Global Trade – Run aground or structurally sound? July 2017
[2]UKtradeinfo (SITC 5, 6, 7, 8)

RISKS IN THE POLICY ENVIRONMENT

In addition to all the risks that policy makers will be navigating as they negotiate the UK's exit from the European Union, there are other policy decisions which matter to manufacturers.

With the government's final draft of its industrial strategy now published, manufacturers are now keen to see departments getting into implementation mode. An ambitious strategy that sees government tackle issues in the business environment that are holding back productivity is ever more critical as the UK leaves the EU. Our survey shows that government's failure to launch on this important policy would be seen as having a negative impact on nearly three-fifths of businesses surveyed.

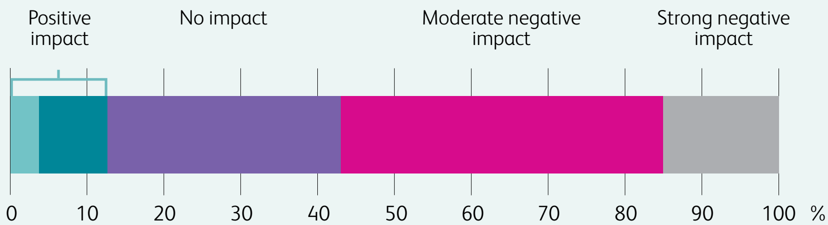
See www.eef.org.uk/industrialstrategy for all the details on the government's white paper

We could also see further policy change from the Bank of England. Last year the Bank raised interest rates for the first time in a decade. It also indicated that more were likely to follow, but there would be baby steps to policy normalisation. Manufacturers saw only a negligible impact from last year's quarter point rise, but they aren't entirely relaxed about the prospect of further rate increases – as shown in chart 6. A third of companies cited no risks to their business from any change in Bank rate.

We know that Bank rate can fall as well as rise, but there are more concerns about the latter, particularly what it might mean for domestic demand and borrowing costs – not just a small company concern. We would not expect these concerns to materialise to any great extent from further modest tightening that may happen this year. Nevertheless, these potential risks should form part of the Committee's judgement on future policy changes.

Chart 5: Stakes high for industrial strategy delivery

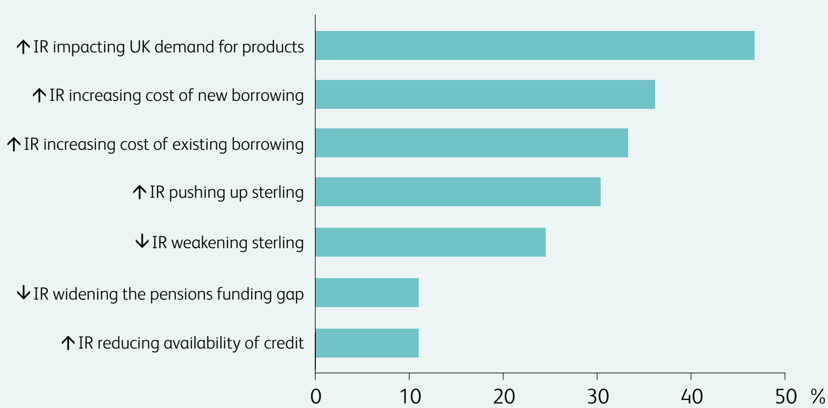
% of companies citing impact of government not delivering its industrial strategy



Source: EEF Executive Survey 2018

Chart 6: Monetary policy risks in both directions

% of companies identifying risk from change in interest rates (excluding those citing no risks)



Source: EEF Executive Survey 2018

Possible concerns for Chinese growth

China should see its economy expand by 6.8% in 2017, representing the first acceleration in annual growth since the turn of the decade. Whilst this may help to disperse some fears of a slowdown there remain concerns around the nature of this growth and in particular, how it is associated with rapid private credit expansion. A sharp slowdown in the Chinese economy would affect survey respondents negatively on balance, although not to the same degree as US protectionism (chart 4), perhaps reflecting the relatively lower levels of penetration into the Chinese market by UK exporters compared with the US.

The all-important Brexit factor

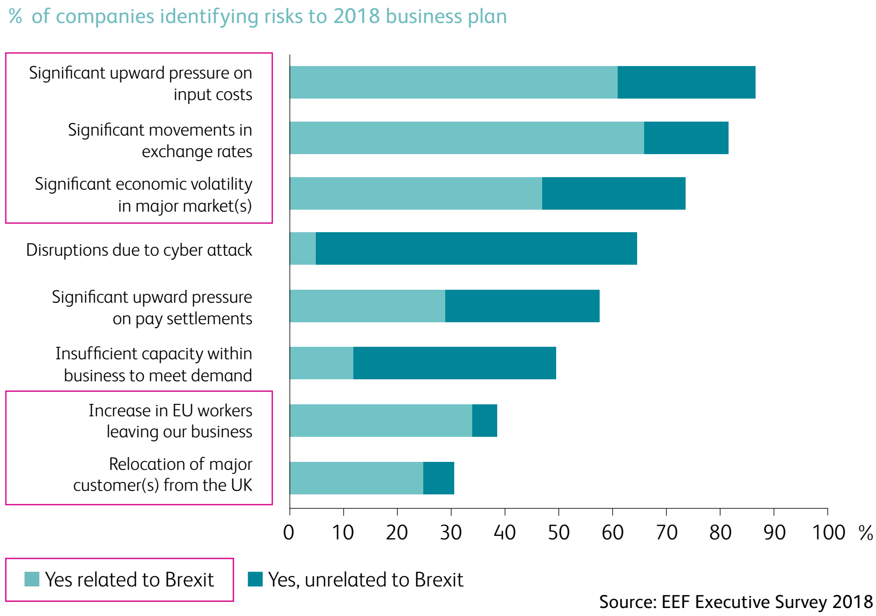
Much like the results seen in the 2017 survey, the UK's decision to leave the EU continues to exacerbate risks to manufacturers' growth prospects and most of these top the list for this year (chart 7). Despite the ongoing negotiations, businesses are no clearer about what life might be like after March 2019 than they were at this time last year.

Input prices

Concern about rising input costs has moved up to top spot in the list of business risks for 2018, with a slight increase in the proportion of companies expressing concern that this could trip up their growth plans.

While a majority of companies that have expressed worries about rising costs relate this to Brexit, this share has dropped back from a year ago. In 2017 a substantial driver of increased input costs was exchange rate related following the large depreciation of sterling in mid-2016. We've seen further downward (and some upward) pressure on sterling from political developments, primarily in the UK, which have rippled through to further increases in imported input costs.

Chart 7: Many risks in the year ahead exacerbated by Brexit



Source: EEF Executive Survey 2018

In addition, global developments are also pushing up commodity prices. At the end of 2017 the price of Brent Crude was holding at over $60 per barrel and steel prices hit their highest level since the financial crisis. Official factory-gate price data and our Manufacturing Outlook survey have indicated that there has been some pass through of past rises, but some companies – particularly small ones in our survey – and sectors may face challenges in pushing through future rounds of price increases, which would inflict more damage on profit margins.

A global sector

There is a positive outlook for the global economy in this year's survey, and whilst manufacturers will certainly work hard and take advantage of growth opportunities wherever they are in the world, they also are alive to the risks that may appear on the horizon to affect their prospects.

Seven in ten firms report that they have recognised that there may be significant economic volatility in a major market that could risk business plans in 2018, and for nearly a fifth of companies this is the most significant risk. With many respondents attributing this to Brexit – it is clear that even with global growth being on the rise, the uncertainty around what could happen in the next 12 months is enough for firms to have it on their radar.

Alongside this, four-fifths of companies in the survey identify significant movements in sterling as a risk to their business plan, just behind the proportion seeing risks around input costs, and tempering slightly from the 86% of firms citing it as a risk in 2017 – when it topped the list of risks and was at an all-time high in the survey's history.

Eighty percent of manufacturers citing this risk link it to Brexit, reflecting not just the memory of the immediate plunge in sterling value but also the increased volatility in the wake of the EU referendum. Overall, for a fifth of firms this is considered the most significant risk facing them. Volatile exchange rates add complexity and management time into managing pricing strategies in export markets, as well as dealing with the impact of changing imported materials and goods prices.

Further weakening of sterling against the euro is thought likely to present a risk by manufacturers – if the sterling/euro exchange rate were to hit parity, 55% of manufacturers in our survey say it would have a negative impact on their business.

Brexit and the attractiveness of the UK

Lower down the list, but still a significant risk for just less than 10% of respondents, are risks related to Brexit and the attractiveness of the UK as a place to both work and do business. Nearly four in ten manufacturers in the survey cite an increase in EU workers leaving their business as a risk in 2018 – and something which may impact on the employment growth expected by manufacturers this year.

EEF research[3] has shown that three-quarters of manufacturers currently have at least one EU national working in their business – and the bigger the company the more likely they are to employ an EU national. This trend plays out in this year's survey, with large companies more likely to cite EU workers leaving as a risk. Given that EU workers fill plant and machine operative roles, skilled trades and technical and professional roles such as engineers – where there are already skill shortages – any further loss of skills will place pressure on the sector.

The attractiveness of the UK as a place to conduct business in light of Brexit is also on the minds of firms in the survey. A third of firms are concerned about relocation of major customers away from the UK, the same proportion as last year's survey. Whilst there have not been any major announcements from firms choosing to close their UK operations during 2017, as the Brexit deadline approaches and more details of the post-Brexit landscape become clear, firms see that the possibility of customers leaving may come to fruition in 2018.

In the next section, we discuss the strategies and tactics that manufacturers are planning to ensure the risks they have identified do not cause their expected growth to veer off track.

say that the sterling/Euro exchange rate hitting parity would have a negative impact

[3]EEF, Making migration work for manufacturers: Accessing skills in a post-Brexit world – June 2017

NEW STRATEGIES TO MANAGE GROWTH AND MITIGATE RISKS

- With a busy but risky year ahead, firms have new strategies in train to help ensure success
- Topping the list are actions that manufacturers will be taking in order to meet increased demand and deliver expected productivity aims
- While there is a dominance of 'business as usual' strategies there are also a host of planned actions closely related to potential risks on the horizon

With manufacturers planning for a busy year, but one that could be punctuated with a host of risks, a number of new strategies are also in train this year. Meeting increased customer demands, delivering on productivity objectives and building business resilience against Brexit and non-Brexit related challenges are placing new demands on companies. The range of strategies we explored this year are illustrated in chart 8.

Business improvements top list of priorities

Starting with the actions that manufacturers will be taking in order to meet increased demand, top of the list and cited by 86% of companies in our sample is increased efforts on process innovation and efficiency improvements. We know that this is becoming an ever more important strategy across the sector[4] as industry looks to adopt new fourth industrial revolution (4IR) technologies into their operations and in support of the introduction of new products and services.

Given that the benefits from these activities include better customer relationships, greater flexibility and improvements to the bottom line, it's not surprising that manufacturers are seeing process innovation as an ever more important component of their business strategy. However, if this is to drive meaningful improvements in productivity across the sector, these innovations will need to be associated with new technology adoption as well as lean techniques and new management practices.

As part of the on-going growth drive some two-thirds of manufacturers will also be looking to do more to market themselves overseas this year. This is a positive signal that the ambition amongst UK exporters is to capture market share in the expanding global economy. While looking outwards is frequently cited as a priority in our annual Executive Surveys, our report this year also shows that some companies are pursuing this strategy in response to identified risks in 2018, such as volatility in a major market or a resurgence in protectionist actions in the rest of the world.

Similarly, further expansion into overseas markets and the potential for economic volatility is prompting increased action to ensure companies are protected against bad debts. While we see more emphasis on this from 40% of the companies surveyed, a sizable majority of SMEs plan no action on this, which could lead some businesses exposed to additional risks this year.

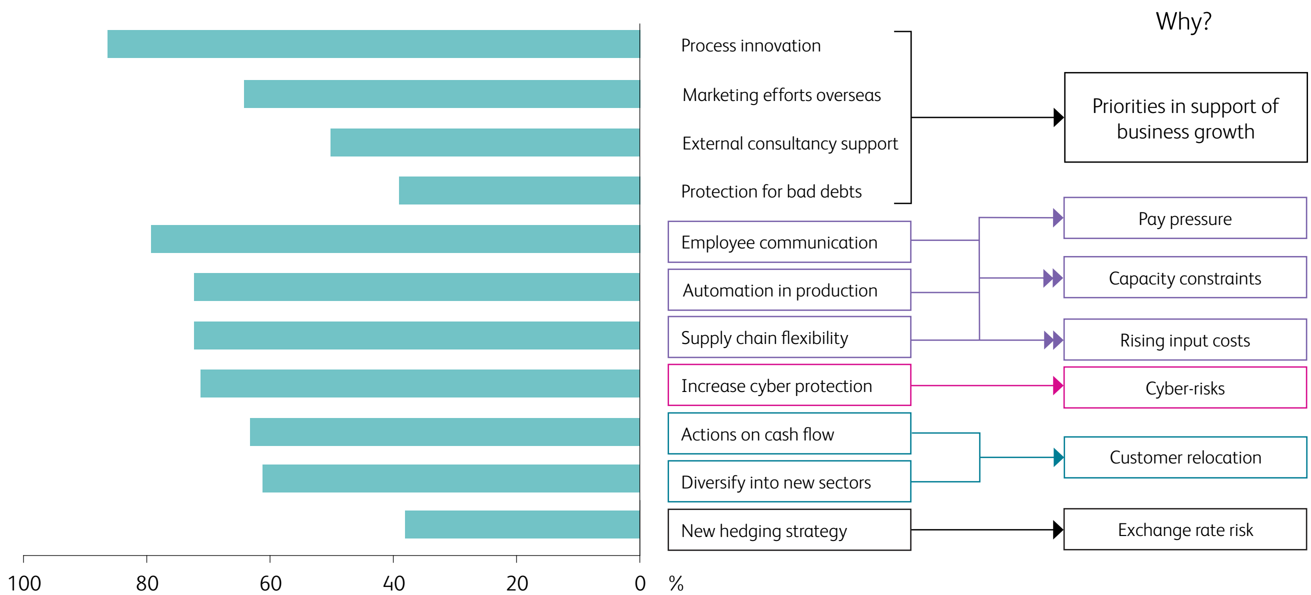
More manufacturers – of all sizes – are, however, set to take action to better manage cashflow in the coming year. For some this action is directly related to risks, for example from the potential relocation of a major customer. But we also see that better economic conditions and a build-up of inventories in response to rising costs is putting pressure on companies to increase their working capital. This could unravel if economic conditions take a turn for the worse.

As Lloyds Bank's latest Working Capital Index noted, *"businesses that are actively growing tend to focus more*

[4] EEF (2017) Process innovation: Bringing manufacturers to the frontier

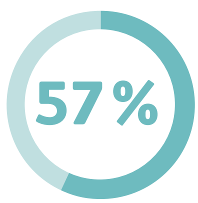
Chart 8: Strategies for business growth and risk mitigation

% of companies taking action in area in year ahead and associated reasons why



Source: EEF Executive Survey 2018

on revenue and margins than working capital and balance sheet efficiency. However, many firms are likely to be left exposed if economic conditions deteriorate which would require them to free up cash quickly." And aware of the potential pitfalls and experiencing challenges such as extended payment terms, more companies see mitigation strategies as important this year.



agree that supply chain resilience has become more of a business issue since Brexit

Capacity challenges and supply chain risks

While there is a dominance of 'business as usual' strategies to manage shifts in trading conditions, there are also a host of planned actions that are more closely related to potential risks on the horizon in 2018.

Manufacturers have relayed their concerns about challenges emanating from capacity constraints, emerging weakness in supply chains related to Brexit and rising input costs. In response 72% of companies are looking at increasing the level of automation in their production processes and the same proportion will be collaborating more closely with their supply chain to improve flexibility and responsiveness.

Previous EEF[5] research has shown that there remains plenty of scope to introduce more automation into manufacturing processes, but that progress to date has yielded benefits from improved productivity and flexibility to freeing up employees to undertake higher value-added functions within the business. If manufacturers are able to overcome some of the challenges of financing and employee capability to introduce more automation then this should lead to additional manufacturing capacity and higher levels of efficiency.

However, our survey also highlights the need to maintain good levels of employee communication and engagement. This will be necessary in response to changes in shift patterns to accommodate increased production activity, but also as part of the drive towards greater automation.

[5] EEF, Investment Monitor 2017/18

WHO'S IN FOR A BIG PAY RISE THIS YEAR?

Manufacturers are also ramping up their employee engagement in response to potential upward pressure on pay settlements in the year ahead. Earnings growth has been muted across the economy in recent years, but with inflation hitting 3 % at the turn of the year, individuals will be hoping for a corresponding uplift in pay to restore real income growth.

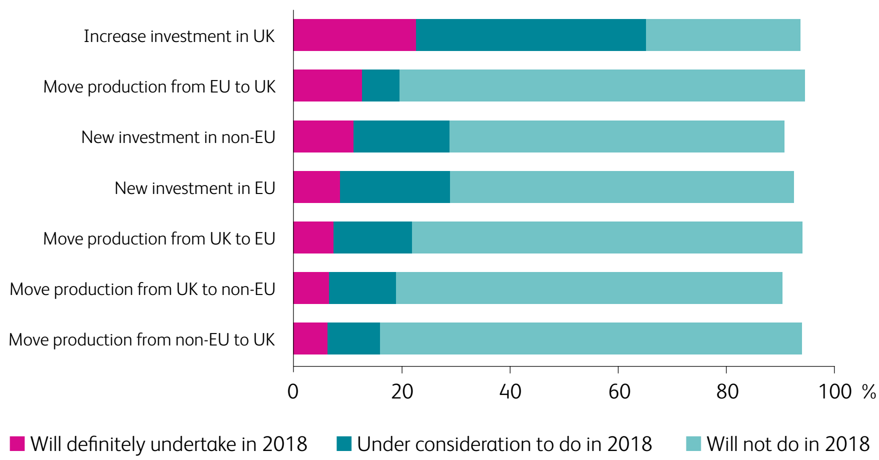
Manufacturers could again be treading a fine line in pay negotiations, balancing the need to reward and retain employees, but with an eye on affordability given potential economic risks. We're seeing more companies supplement annual pay increases with bonus and incentive payments in response.

We'll be keeping a close eye on wage settlements and pay strategies over the course of this year and manufacturers can find out more at www.eef.org.uk/benchmarking

It has to be regarded as positive that companies are looking at a range of options to ensure they are not capacity constrained this year. With Brexit-related risks dominating the outlook this year (and potentially beyond) there was a possibility that companies may have held back from adding to their production capability in the UK. Our research suggests that companies are focusing on current opportunities rather than future 'what ifs' with a balance of 49 % of companies disagreeing that they will restrict new order intake rather than invest to increase capacity in 2018.

Chart 9: Reshoring production as likely as moving it out of the UK

% of companies planning investment in response to Brexit and exchange rate risks



Source: EEF Executive Survey 2018

How are Brexit negotiations influencing investment decisions?

There are clearly competing influences at play when it comes to decisions on UK investment this year. EEF's *Investment Monitor 2017/18* showed that companies were divided on the impact of the Brexit negotiations on their capital expenditure plans. Half were holding back or doing only what was necessary to meet customer demand while the other half of manufacturers we spoke to were undeterred by negotiations around the UK's future relationship with the rest of the EU or were investing in response to new opportunities.

We're nearly six months on from our Investment Monitor survey, and there is arguably little more clarity on the final Brexit outcome. But 2018 will be a decisive year in this process if the UK is to exit in March 2019. We therefore wanted to explore whether investment plans were further advanced in light of the negotiations as well as associated risks, such as exchange rate volatility.

The first key finding from our survey is the preparatory work being undertaken by manufacturers for a 'no deal' outcome. Of the companies that were prepared to give a view, around a third were making contingency plans for such as outcome. There was a greater propensity to undertake these actions by larger companies in our sample.

Anecdotal feedback suggests these plans range from workforce planning to considering supply chain restructuring. Our quantitative evidence, however, does not suggest that a large swathe of manufacturing will be relocating operations to another jurisdiction in the coming 12 months (see chart 9).

In terms of moving production, our survey suggests that it is as likely for companies to be reshoring production as moving it out of the UK, to either a site in the EU or a non-EU market. There are, however, slightly more companies looking at putting new investment into operations outside the UK – 8 % and 10 % will definitely put new investment in the EU and non-EU markets this year, with another fifth looking at it as an option in 2018.

Taken together with some Brexit caution on the one hand and rising demand on the other, our view – in the short term at least – is that we will see neither growth in business investment at the same rate as our competitors, nor significant outflows this year. We also recognise that the final terms of the Brexit deal could change this view – and quickly – in either direction.

Tackling risks head on

As we've already highlighted the challenge of another year of sterling volatility is significant – in terms of the number of manufacturers affected and the scale of the risk. While it seems that few are looking at restructuring operations in response, nor are a large proportion revisiting their hedging strategies in the year ahead. Unsurprisingly, of those that say they will be looking again at their foreign exchange management this year, most are large companies, likely with the experience and internal capability to take such actions.

Chart 10: In spite of risks, the UK remains a good place for manufacturers

Source: EEF Executive Survey 2018

In contrast, and encouragingly, many more manufacturers will be prioritising action to protect against identified cyber risks. With manufacturers increasing focus on 4IR investments, so comes the growing awareness of the greater business risks that come with more connected equipment and supply chains. Additionally high profile breaches in the past year will inevitably have prompted more action by companies – large and small. And not just to protect profits, but also to mitigate against reputational risks. This may be steps in training employees and requiring appropriate security controls, to making sure that there is a cyber-breach incident response plan and ensuring there is suitable monitoring and analysis that highlights unusual activity that could indicate an attack.

Still plenty of reasons to manufacture in the UK

There has been no shortage of risks and challenges facing UK manufacturers in the past decade. Companies have told us that uncertainty is the new normal[6] and in the past three years have consistently identified more risks that opportunities for their business in the year ahead. In spite of this and perhaps because of the strategies manufacturers develop and implement in response, the UK remains a good place for manufacturers in 2018.

[6]EEF, Executive Survey 2014

AIG VIEWPOINT

Waking up to cyber risk

This year's EEF annual survey highlights the importance of two key issues to businesses: minimising risks around their supply chains (exacerbated by Brexit and recent natural disasters), and addressing emerging cyber exposures. We focus on the latter in this piece, noting that even cyber and supply chain risks are connected.

Awareness of cyber risk has grown substantially. So what are the threats and how should manufacturers be looking to respond?

At a time when Brexit is dominating concerns about the future, cyber risk stands out as a largely unrelated threat that is rapidly rising up the risk agenda. In the past, manufacturers could have been forgiven for thinking they were relatively sheltered from the cyber risk, but the summer of 2017 has turned this thinking on its head.

The WannaCry ransomware attack crippled organisations from a wide range of industry sectors around the world, spreading indiscriminately and causing lengthy and costly business interruption. The attack was followed by a fresh strain of the Petya ransomware, which further exploited the same Microsoft Windows vulnerability. Some systems were down for several weeks, costing billions of dollars in lost revenue. While the worm was not specifically designed to target operations technology networks, WannaCry impacted several large manufacturers.

Concern over cyber risk is also likely to be driven by growing compliance responsibilities. The European General Data Protection Regulations (GDPR) are

HOW TO ACHIEVE CYBER RESILIENCE IN 7 STEPS

STEP 1 — SYSTEM HYGIENE
Establish a proactive and systematic process for managing standard systems hygiene.

STEP 2 — DEVELOP A PLAN
Create a cross-functional team of senior management to plan for cyber security events and consider hypothetical attacks.

STEP 3 — MAP OUT RISK PROFILE
Study cyber patterns and attack modes to develop a tailored approach to protecting company assets.

STEP 4 — ASSESS & MEASURE
Focus on rough figures, not precise estimates and avoid analysis paralysis.

STEP 5 — MITIGATE RISK
Invest in risk mitigation measures to protect company assets at greatest risk.

STEP 6 — CYBER INSURANCE
Obtain cyber insurance to provide contingent capital and specialized assistance in the event of an attack.

STEP 7 — GET STARTED
A rough plan is okay – becoming resilient to cyber risk starts with a single step.

coming into force in May this year with strict rules regarding collection, use and storage of sensitive data. Companies that experience a breach will be required to notify stakeholders and there will be steep fines and penalties for firms that have inadequate controls and protections in place.

Losing the 'air gap' defence

At a time when manufacturing and engineering companies are looking to further automate production and have greater supply chain flexibility, it is also clear that a connected world is also a more vulnerable one. The 'air gapping' defence of industrial control systems no longer exists in a world of connected devices, where something as benign as a smart thermostat can be exploited as a way in by hackers.

It is clear that cyber risk can impact manufacturing and engineering organisations in numerous ways, including the disruption to production resulting from ransomware and denial of service attacks, as well as the costs and reputational fallout associated with data breach attacks. Physical damage resulting from a cyber incident is also possible, although not all insurance policies provide affirmative cover. It is important for organisations to consider how different cyber scenarios could play out, with help and guidance from insurance brokers. Mapping these exposures against their suite of insurance policies will show how they should respond and whether there are any exclusions or gaps that can be identified and dealt with.

In addition to risk transfer, brokers and cyber insurers offer pre-loss services, working with insureds to ensure they maintain standard systems hygiene in order to avoid being the low-hanging fruit. With the knowledge that it is now impossible to prevent every attack, even with the best security and systems in place, companies should also practise their breach response, so they can take swift action when their systems are compromised.

For more information please contact your insurance broker or read our cyber insights at: http://www.aig.com/knowledge-and-insights

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Head of Industrials Segment
AIG UK

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Our Manufacturing Industry Group pulls together the strengths and capabilities of AIG together to focus intensely on the current and future needs of the Manufacturing sector. We have a strategic partnership with EEF, the leading Trade Industry Body for the sector to ensure we are at the forefront of the market in providing tailored and distinctive risk and insurance value propositions for a fast moving and developing sector. With the onset of 4IR (Fourth Industrial Revolution) and the evolution of risk within Manufacturing, our Cyber Health Check is an example of our innovative solutions to help our clients understand cyber exposures.

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