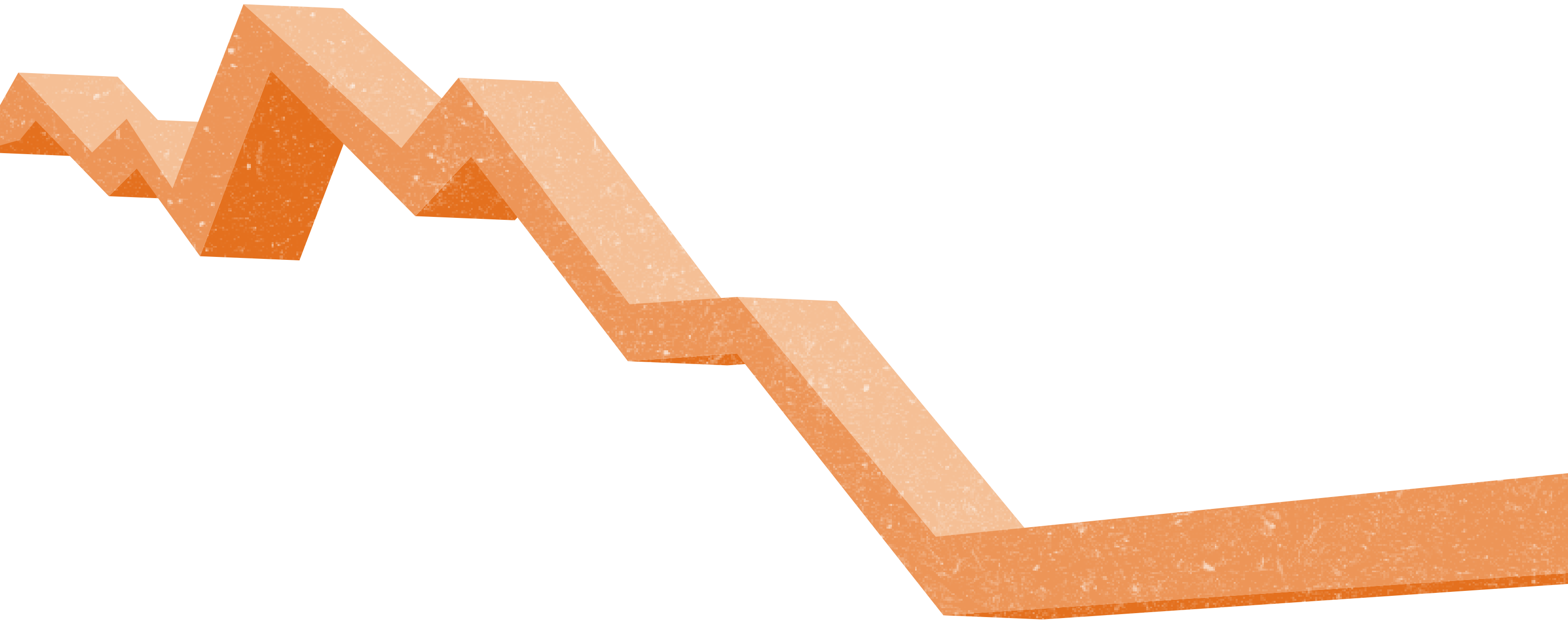
THE UK LOGISTICS CONFIDENCE INDEX H1 2013

Moving in the right direction



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Introduction

Grant Thornton UK LLP and Barclays, in conjunction with specialist sector research agency Analytiqa, have undertaken their latest bi-annual survey to assess confidence and expectations in the UK logistics sector.

Over 100 senior decision-makers, including CEOs, managing directors and finance directors provided their views and insights into the recent performance of the sector, as well as their expectations for the sector in the near term. Their responses have been compiled to create our latest UK Logistics Confidence Index.

Our index calculations take into account the proportion of respondents quoting improvement, no change or deterioration in the sector. These are then presented as an index figure of 0-100, where any number over 50 signifies expectation of future growth.

Key highlights

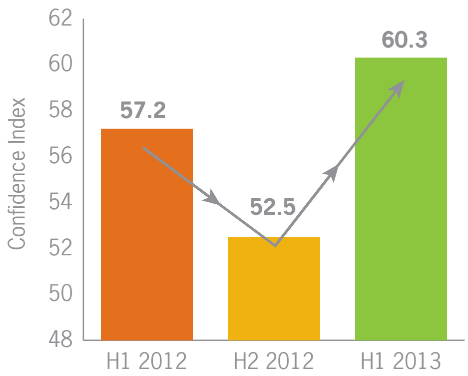
- Our confidence index has rebounded since the last survey, with an overall reading of 60.3, up 7.8 points on H2 2012. This is the highest index rating since our first survey in H1 2012. The majority of logistics operators appear cautiously optimistic that turnover and profitability will increase over the coming year, with fewer expecting business conditions to deteriorate any further. This slightly more positive outlook has increased the prospect of operators investing in capital expenditure and headcount in the near future.

- Ongoing challenges for the sector include continued pressure on margins and an emphasis on cost control. Margin pressure is easing slightly but continues to be the biggest concern for operators in the face of intense competition within the sector. Legislation and bureaucracy are additional concerns, along with fuel duties – particularly given the imminent introduction of Euro 6.

- Winning new contracts remains the key driver to achieving growth plans, with over a quarter of respondents highlighting value-added services – not just price competitiveness – as crucial to contract wins. Providing new services, breaking into new sectors and collaboration are also identified as key growth opportunities.

- Overall attitudes to acquisitions and disposals remain neutral. Most operators say they are unlikely to make an acquisition over the next six months, preferring instead to focus on investing in organic growth, while a significant 94% have no plans to make a disposal.

Figure 1
Confidence Index



Foreword

There appear to be some slightly more promising signs of renewed confidence among logistics operators in our latest survey, despite ongoing concerns about the strength of the UK economy and the difficulties in the Eurozone.

A range of indicators suggests that the macroeconomic environment is starting to improve and this is supported by our survey results. Operators will now need to make the most of this growing confidence by identifying the key drivers for sustained recovery and profitability.

Philip Bird
Director, Corporate Finance,
Grant Thornton UK LLP

Rob Riddleston
Head of Transport and
Logistics, Barclays

Our confidence index has been set at 60.3, compared to 52.5 in H2 2012. This is in line with recent economic data indicating signs of renewed growth in the UK economy. After almost three years of flat growth, the UK quarterly growth rate has rallied, more than doubling from 0.3% in Q1 2013 to 0.7% in Q2 2013[1]. Similarly, the Confederation of British Industry (CBI) has recently upped its forecast for annual economic growth from 1% to 1.2%.

Cautious optimism

It appears that the logistics sector shares the other forecasts' optimism, with slightly more companies expecting the economic environment to improve over the next six months. This more promising outlook is demonstrated through a range of indicators in our survey including turnover and profitability, headcount and capital expenditure prospects; however, operators remain cautious. While confidence has improved, not surprisingly, given the direct impact on the sector of changes in GDP, there is still a long way to go.

Signs of investment for growth

Growth through investment rather than by acquisition appears to be the order of the day, with nearly two-thirds of our survey participants planning to make significant capital expenditure. Ongoing investment in fleets and other capital expenditure is, of course, critical to driving efficiency and competitiveness for logistics businesses. Many operators have been forced to improve cashflow management as a result of the recession and it would appear that some are now more confident about investing their own cash reserves or raising external funding to grow their businesses as we enter a new fledgling growth stage of the economic cycle.

Managing growth

The general economy is the key driver behind a return to growth in the logistics sector but there are a number of other factors, such as increased outsourcing, which may help to boost business. A fifth of new business won in the last six months came from customers expanding their contracts with existing service providers. However, with nearly half of new customers switching from other providers over the same period, it appears that the sector is no less competitive and cut-throat than evidenced in our previous surveys. Price competitiveness is clearly still a key factor in winning contracts, but we may be beginning to see a decline in its dominance. There are signs that customers are increasingly focused on added value and service quality, particularly for more complex, specialised work.

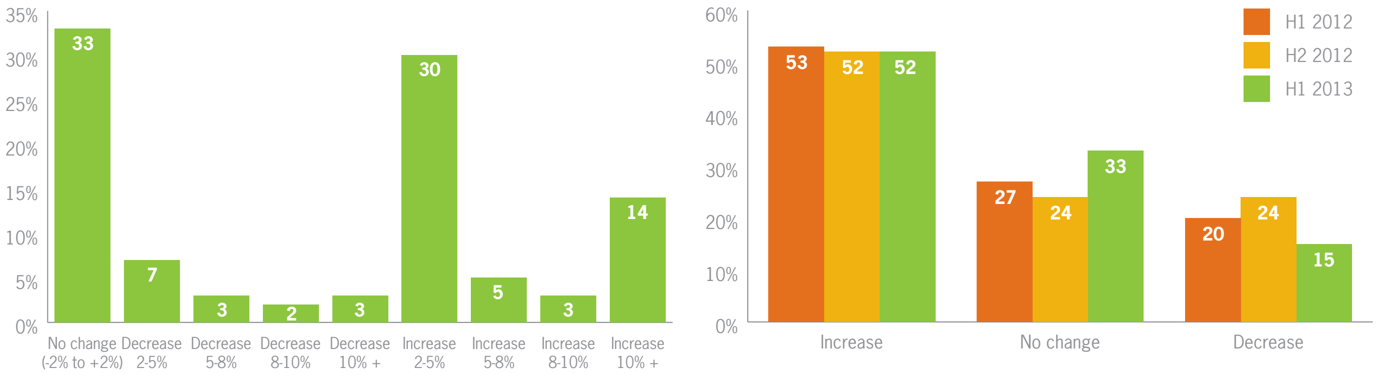
Ongoing challenges

Margin pressure remains a major challenge for logistics operators. Customers expect more for their money and, according to our survey, still appear very willing to change service providers in order to achieve this. Procurement and formal tendering has increased in importance, particularly for larger-scale work, with customers placing greater emphasis on value-added services rather than relying solely on existing personal relationships.

Not surprisingly, legislation and red tape continue to be further areas of concern for our respondents. Coping with government regulations can be frustrating at the best of times, but particularly when operators are feeling financially squeezed from all sides. In fact, our survey respondents cite less government regulation, increased government spending and lower taxes as critical to the UK economy and to further boosting confidence within the logistics industry. Additionally, some operators stress the importance of a more level playing field with Europe and better tax breaks for UK service providers as important to the sector's recovery.

Figure 2

Do you expect an increase or decrease in profit over the next 12 months?



[1] Source: Office for National Statistics

Renewed confidence

Business conditions are no more favourable than they were in the second half of 2012, according to our survey, but respondents appear less pessimistic. Only a third say the current outlook has deteriorated, compared to 41% in H2 2012, while 42% say it has stayed the same, up 10%.

The outlook for the sector is forecast to improve over the next six months. Over a third of respondents expect more favourable conditions and just 17% see conditions worsening, compared to a significant 41% in our previous survey. This reflects wider sentiment that the UK economy seems to be slowly gathering pace. For example, the Q3 2013 ICAEW/ Grant Thornton UK Business Confidence Monitor (BCM) suggests that confidence among UK businesses is at its highest since Q2 2010.

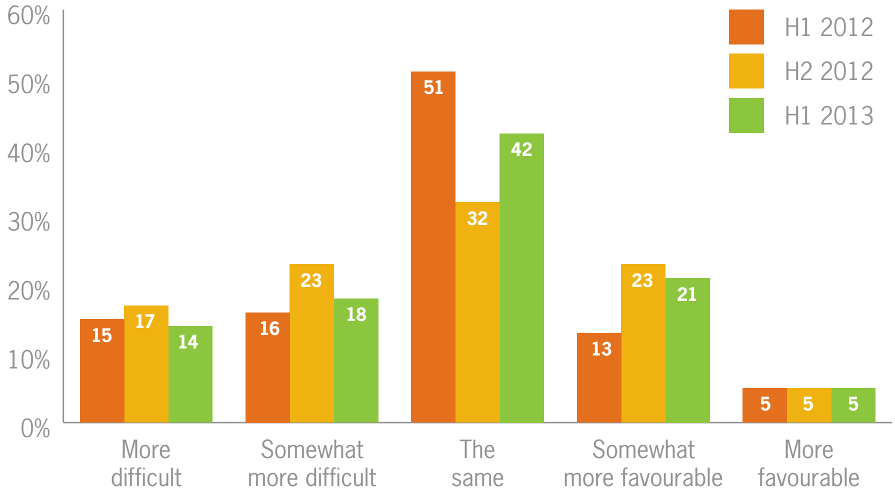
According to Barclays, recent activity data from the retail, manufacturing and services sectors reinforces the view that a recovery is underway. Improved clarity over UK interest rates will also help to underpin improvements in consumer demand and business investment, along with the International Monetary Fund's revised 2013 UK GDP growth forecast from 0.6% to 0.9%.

Profitability and capital expenditure

Despite continuing concerns over margin pressure, customer demand and market volatility, just over 70% of respondents expect their turnover to increase in the next year and around half of respondents are forecasting an increase in profits. Only 15% foresee a decrease in profitability, compared to 24% for the second half of 2012. In keeping with this more positive outlook, nearly two-thirds are planning to make significant capital expenditure, which suggests that companies are now starting to invest for growth.

Figure 3

How do you view current business conditions vs the last six months?



> **Our survey suggests that smaller companies may be leading the beginnings of a recovery.**

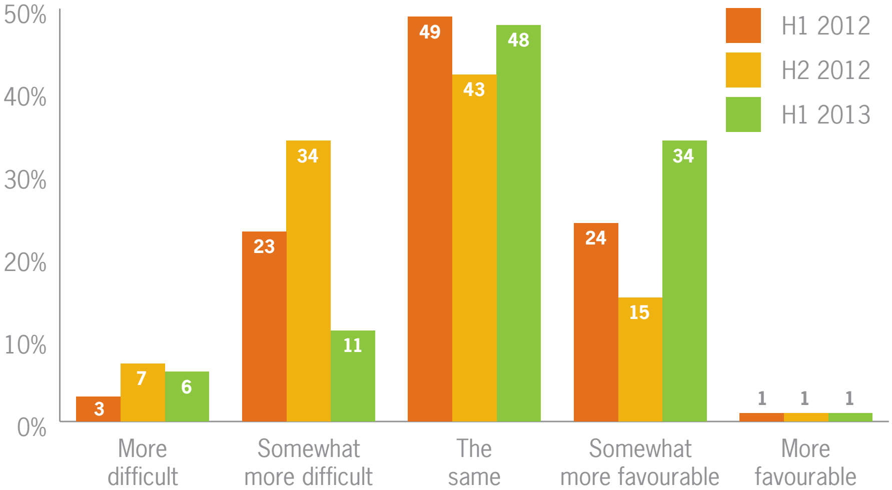
Size factors

Our survey suggests that smaller companies may be leading the beginnings of a recovery. Nearly three-quarters of the smaller operators in our survey are forecasting an increase in turnover over the next year, up from 58% in the previous period. Of the larger operators, 60% are expecting an increase in turnover, down from 70% in the second half of 2012. The percentage of smaller operators anticipating a drop in profits has decreased more than that for larger operators, compared to H2 2012.

Very broadly, smaller operators appear to be more optimistic about business conditions over the next six months, with 37% forecasting a more favourable outlook compared to 28% of larger operators.

Figure 4

How do you foresee business conditions to be over the next six months?

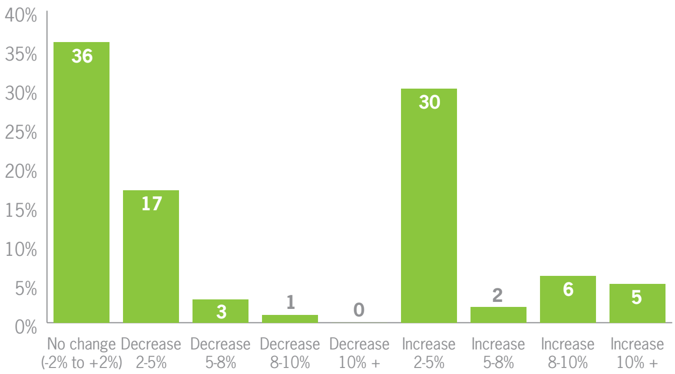


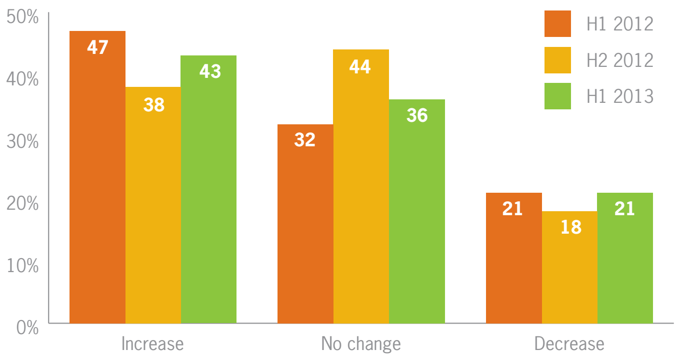
Headcount

The more optimistic outlook is also evidenced by employment prospects. Around 43% of service providers plan to increase headcount, up 5% on the last six months. Meanwhile, a fifth of operators are still looking to reduce staff numbers, up 3% on the previous period. It will be interesting to see whether we are beginning to see an upturn in employment prospects in the results of our next survey.

Figure 5

Will you be increasing or decreasing headcount over the next six months (excluding seasonality impacts), and if so, by how much?





Investing for growth

There are signs that finance directors may be beginning to loosen the reins on capital expenditure, with nearly two-thirds of survey respondents saying that they expect to make significant capital expenditure over the next six months. As indicated in our last survey, larger operators appear to be investing their way through the recession, which is putting pressure on competitors to do the same. Investment in fleets, warehousing and IT may also be driven by a desire to capitalise on opportunities in the stronger Asian and emerging economies, again driven predominantly by larger logistics companies.

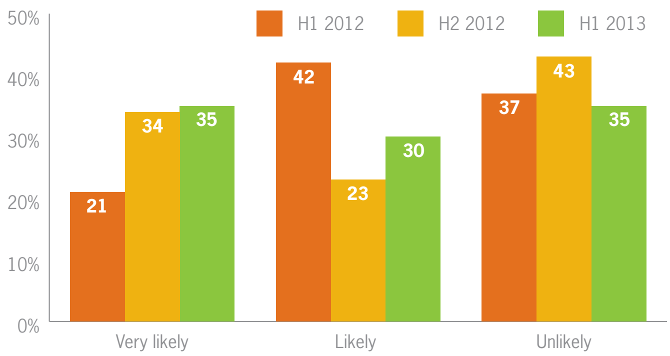
Mergers and acquisitions

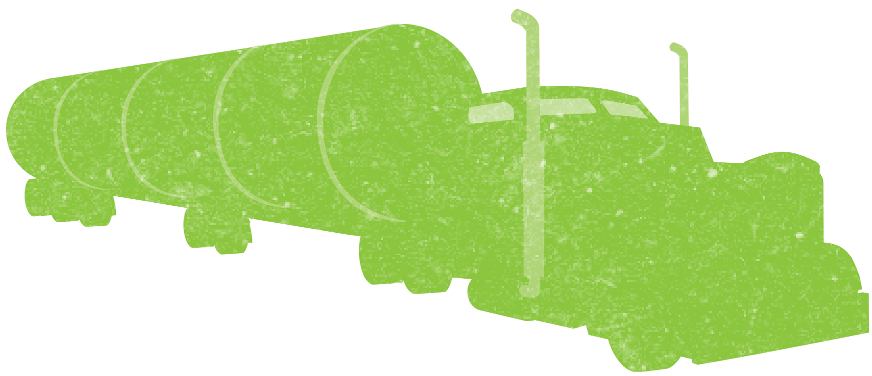
By contrast to the outlook for capital expenditure, the overall attitude to acquisitions remains neutral, with three-quarters of respondents unlikely to make an acquisition in the near term. The majority of operators still remain risk averse when it comes to considering a significant transaction, preferring instead to focus on organic growth. This is in line with the data on global M&A transactions in the logistics sector, which has fallen by 25% from 886 transactions in the second half of 2012 to 667 in the first half of 2013[2].

A significant 94% of operators state that they are unlikely to make disposals over the next six months, even higher than in H2 2012. Having been forced to scrutinise their costs over the last three or four years, the vast majority have already undertaken any significant disposals or drastic cost-cutting measures available to them. Despite this, mergers and acquisitions are likely to recover in the medium term, driven by the need for economies of scale, global reach and the requirement for logistics companies to broaden their service offering.

Figure 6

How likely is it that your company will make significant capital expenditure over the next six months?





[2] Source: Thomson Reuters

Managing growth

Winning new contracts continues to be the main focus for logistics operators looking to achieve their growth plans. Just over half of new business appears to be from customers switching from other service providers. While volumes appear to be increasing slightly, operators are clearly still having to work hard to compete for market share. Maintaining the existing customer base, along with cost control, are other factors cited as key to growth by survey respondents.

> “Breaking into new sectors, introducing new services or collaborating with other service providers to win new customers are the key areas of opportunity in the logistics industry today, according to our survey respondents.”

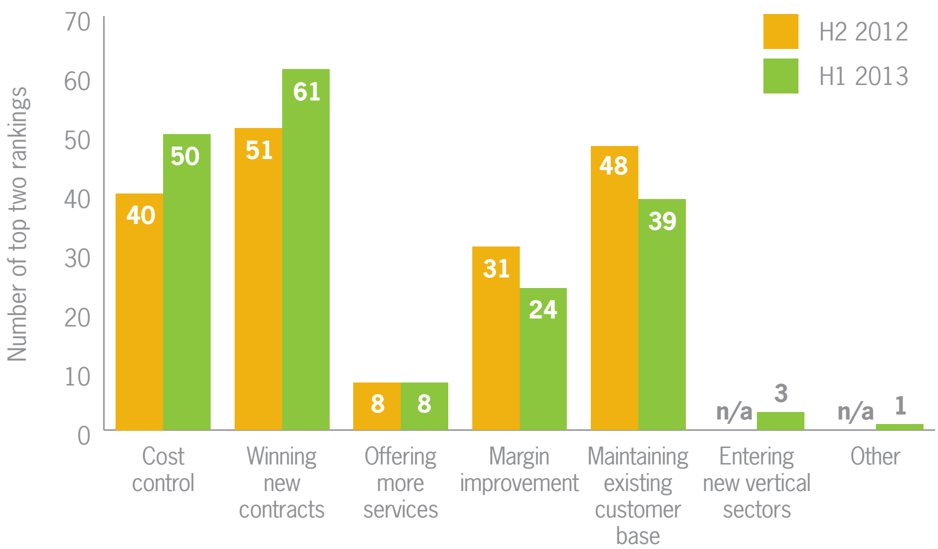
New opportunities

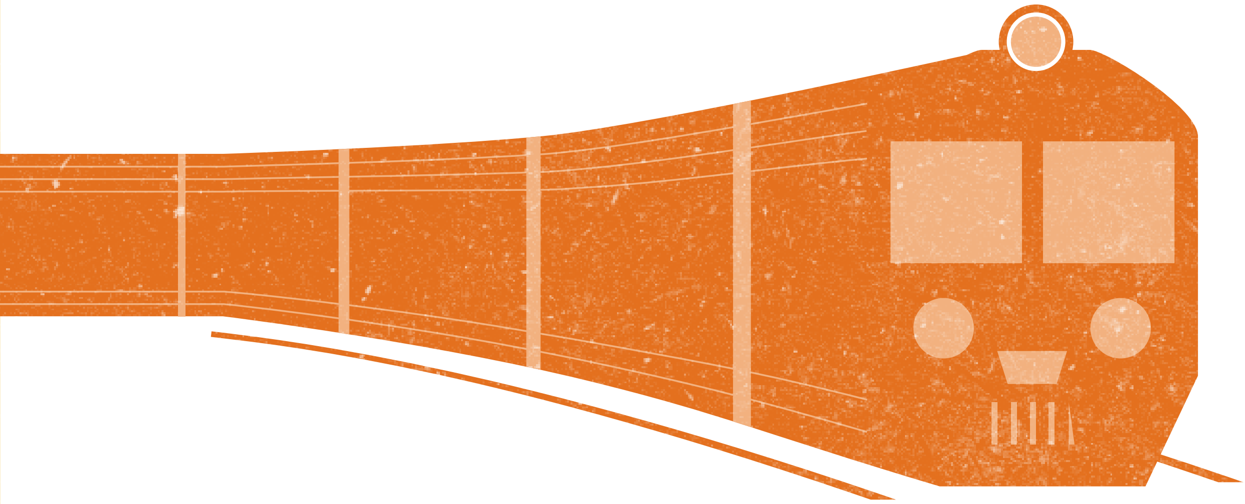
Breaking into new sectors, introducing new services or collaborating with other service providers to win new customers are the key areas of opportunity in the logistics industry today, according to our survey respondents. A common feature is capitalising on new opportunities within existing or closely related niche sectors, for example, supplying forecourt shops as well as delivering fuel to petrol stations.

Another potential growth opportunity is through the UK government, as the Ministry of Defence prepares to outsource its procurement and supply chain management activities to logistics operators over the next 18-24 months. E-commerce and fulfillment also continues to present opportunities for providers looking to serve the online requirements of retailers and consumers. Online sales activity is still increasing year by year, although making sustainable profits remains a challenge for the logistics industry.

Figure 7

What is the main focus for your company over the next six months in order to achieve your growth plans?





> The fragmented and diverse nature of the logistics industry means that there is still considerable scope for greater collaboration between logistics companies and their clients. Working in partnership to offer complementary services makes good business sense for companies trying to maximise the value of the supply chain, a prime example being Morrison's recent £200 million deal with online grocer Ocado to outsource its home delivery business for the first time.

Adding value

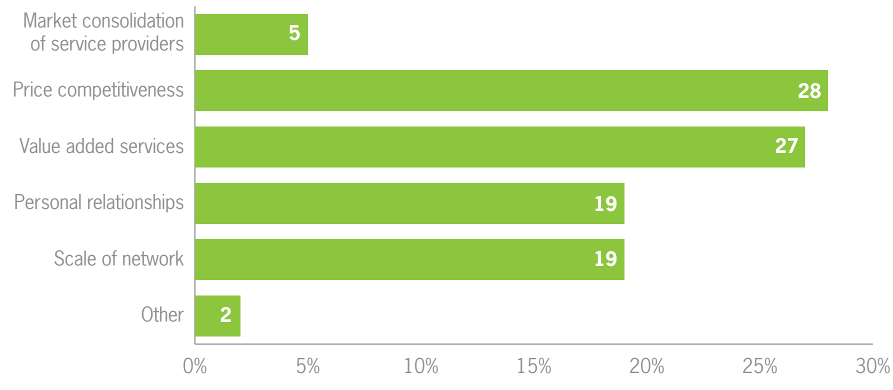
With only 28% of respondents referring to price competitiveness as a key driver behind winning work, customers are clearly not making purchasing decisions solely on the basis of price. Value-added services (27%), personal relationships (19%) and scale of network (19%) are cited as other key factors behind contract wins.

Examples of value-added services include a repair and maintenance capability for any products that are moved, stored or delivered, or a rework and returns logistics capability. These additional services often carry a higher margin than transport and warehousing.

Operators clearly recognise the importance of offering more value to their customers, but delivering this without incurring significant additional costs remains a challenge. Getting the service offering in line with the customer's requirements, identifying ways to exceed those requirements and negotiating favourable contract terms are crucial if operators are to achieve better margins.

Figure 8

In the last six months, what are the key drivers behind your contract wins?



Ongoing challenges

Maintaining existing business in the face of stiff price competition is proving a significant challenge for some operators. The tendency for some, particularly smaller, operators to chase turnover at the expense of profitability and take on work at unrealistic and unsustainable prices to ease short-term cashflow difficulties is putting others under pressure to match costs, say some of our respondents.

Margin pressure

Margin pressure, customer demand, fuel costs and market volatility are the greatest causes for concern over the next six months for operators, according to our survey. Pressure on margins remains by far the biggest issue for operators, as margins continue to be squeezed across the supply chain; however, it has slightly decreased in importance compared to H2 2012 and by 6% on the previous year.

While there is still concern over fuel costs, particularly with the introduction of Euro 6, these have marginally diminished by 4%. The recent fall in fuel costs may explain why this is apparently less of a concern for some operators, although it may simply be that other issues are currently taking priority. Interestingly, uncertainty over the Eurozone has also decreased, perhaps because it has featured less in the news recently. However, unease over market volatility has risen by 4%.

Legislation and 'red tape'

Logistics providers point to less government regulation (21%) and increased government spending (20%) as fundamental to boosting the UK economy, as well as confidence within the logistics industry itself. Some suggest that stringent legislation and bureaucracy are in danger of choking the UK's growth prospects.

> Higher capital costs are a major concern for operators, however, with speculation that the new engines could cost around £6,000-£8,000 per unit. Manufacturers have yet to start supplying these, so it remains unclear what the actual return on investment will be in terms of fuel economy gains.

Impact of Euro 6

The onset of the European Commission's 'Euro 6' regulations on diesel engine emissions is expected to bring about higher maintenance costs (29%) and higher fuel use (26%), according to survey respondents. Interestingly, 20% suggest that it will have no impact on them at all. It could be that at this stage, some service providers are still uncertain as to how the regulation will impact on them. Alternatively, they may feel that they can pass on any additional costs to retailers or absorb them within their own operating costs over time.

Pull of Europe

Europe is still viewed as an important market for operators and concerns over the Eurozone appear to have diminished somewhat. Many stress the substantial export opportunities for the UK logistics industry offered by Europe and argue for more government support and an overhaul of the tax system to promote exports to the region. There is concern however that, as is often the case in logistics, any cost savings generated by more favourable tax treatment may be squeezed by retailers.

Figure 9

What impact do you believe that Euro 6 will have on the sector?

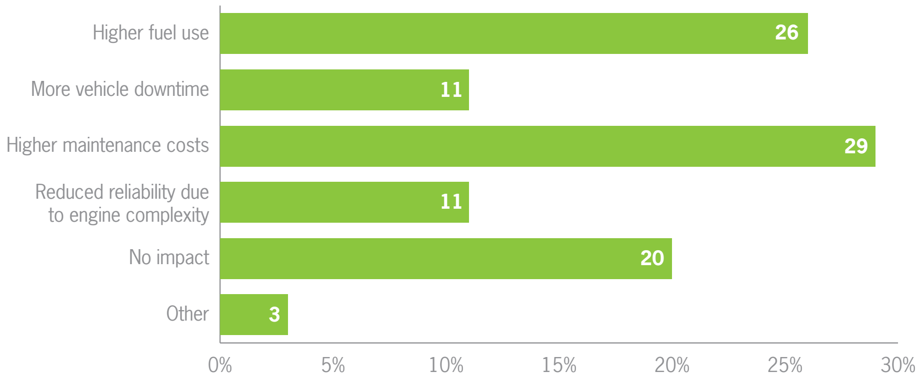
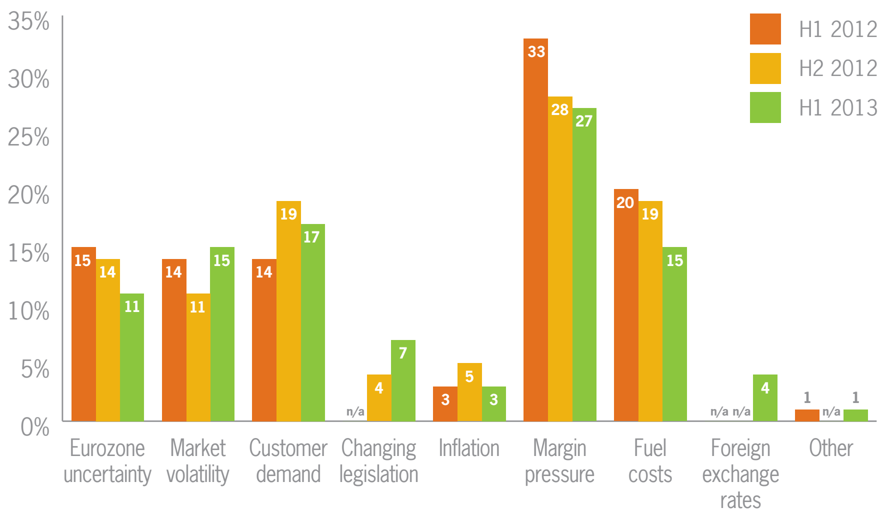


Figure 10

Which areas are of greatest concern to your business over the next six months?



Industry insight

Martin Palmer, Business Development Director at Norbert Dentressangle Logistics UK Ltd, reflects on our survey results.

Has the UK economy finally turned a corner? After several years of sluggish growth, we are starting to see signs of an economic recovery which, combined with increased spending, has the potential to drive growth and volumes in the logistics sector. For now, however, market conditions remain challenging and operators are continuing to identify ways in which to optimise their resources and minimise costs on behalf of their customers.

Opportunity knocks

Over the past few years, customers have been forced to review and adapt their business practices in order to weather the economic uncertainties. While the resulting cutbacks have been bad news for some operators, this has also offered potential growth opportunities for those service providers with the flexibility to respond to customer needs.

In the FMCG sector, for example, an increasing number of businesses have turned to sales promotions in order to boost revenues. By their very nature, sales promotions mean fluctuating volumes, which not all operators are geared up to handle. Larger operators are often better suited to this type of business as they have greater resources to cope with these fluctuating demands. Regardless of size, those operators with experience in managing fluctuating volumes may have an ongoing competitive advantage, as most retail outlets are likely to continue offering promotions long after the economic recovery.

Another potential growth area for operators is managing costly transit media, such as pallets and trays, to ensure they are handled carefully and returned to the supplier. In addition, online retailing continues to offer a range of opportunities. For example, the reprocessing and recycling of customer returns, including clothing and electronic goods, to determine which items can be sold on again, may be a value-added service that some operators can offer beyond the standard delivery of goods.

Challenges remain

On the downside, issues including unhelpful legislation, such as increasing road tax and the removal of rate relief, high fuel duties, restrictions on vehicles and the lack of prime warehouse space in the UK, are ongoing areas of concern for the logistics sector.

> **Any help that can be given by government will be helpful to capitalise on the changing economic situation as we return to growth.**
>
> **Martin Palmer**
> Business Development Director
> Norbert Dentressangle Logistics UK Ltd

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