



THE INSTITUTE
OF CHARTERED
ACCOUNTANTS
IN ENGLAND AND WALES

Q4 2007

UK BUSINESS CONFIDENCE MONITOR

South East Summary Report



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The **ICAEW UK Business Confidence Monitor** (BCM) provides a snapshot of the state of the economy from senior finance professionals working at the heart of business, across all commercial sectors, sizes of businesses and UK regions.

We share the BCM findings with a range of policy makers at a national and regional level. It is utilised by the business community, academics and researchers, and provides a robust tool from which government and regional authorities can base decisions for developing both business and economic policy.

Please visit www.icaew.com/bcm for full national and regional reports.

A handwritten signature in black ink that reads "Michael Izza". The signature is written in a cursive, flowing style.

Michael Izza
Chief Executive
The Institute of Chartered Accountants in England and Wales

Q4 2007 KEY POINTS

- Business confidence declines for second consecutive quarter to a two-year low
- Turmoil in financial markets, higher interest rates and a slowing housing market result in pessimism about business prospects
- Current divergence between ICAEW Business Confidence Index and economic growth likely to reflect a turning point. This is particularly important with the Bank of England focusing on business confidence and the housing market to monitor the UK economy
- Property and finance sectors plummeted to their lowest levels since the survey began, a key point considering the UK is more dependent on the housing market and finance sector than most other large economies
- Decline in confidence broad based across all sectors with the exception of business services and IT, both of which remain optimistic. However, confidence in these sectors may take a hit in 2008 as repercussions of current concerns in the finance sector impact.

FOREWORD

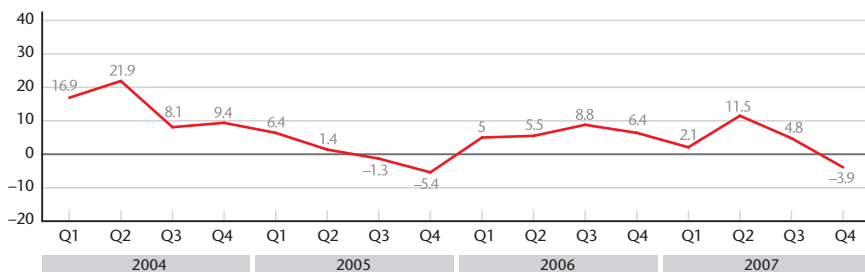
BY ICAEW CHIEF ECONOMIST, MAUREEN RAYMOND



Business confidence shaken as financial uncertainty continues

Turmoil in financial markets, substantially higher interest rates since August 2006 and a slowing housing market have created a perfect storm causing finance professionals to become pessimistic about business prospects. Only in one previous period did the ICAEW Business Confidence Index register a lower score than this quarter's – in the aftermath of 7/7 terrorist attacks. In Q4 2007 the index declined for a second consecutive quarter to a two year low (see Fig. 1).

Fig. 1 BCM Confidence Index trend



Source: ICAEW UK Business Confidence Monitor

Business confidence index worsens

In our report of Q3 2007, written at the end of July, we highlighted the risk that financial contagion via the US sub-prime mortgage market would transmit through global financial markets and could exacerbate the chance of a slowdown in the UK. We also warned that it could spread into leveraged buy out and M&A activity leaving London as a financial centre vulnerable. Unfortunately these words of caution have materialised. Financial contagion has spread from the US to Europe and elsewhere causing financial shock to global credit markets. M&A and private equity deals are also off sharply.

The most important contributor to negative confidence this quarter has been financial disturbance and the credit crunch. Since August, the asset-backed securities market seized. Moreover, inter-bank rates have decoupled from official central base rates, increasing the cost of capital for the banks and other financial intermediaries. These costs will continue to be passed on to businesses. This was reiterated in the Bank of England's (BoE) first Credit Conditions Survey released in September.

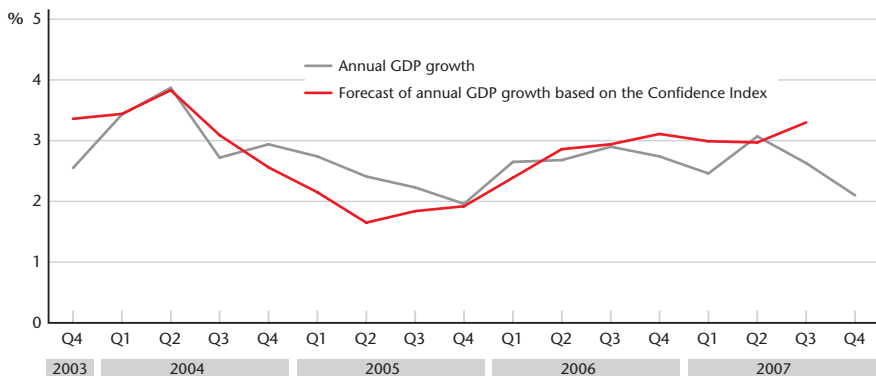
The current divergence between the ICAEW Business Confidence Index and economic growth is likely reflecting a turning point for the economy (see Fig. 2). Although it is too early to judge the full impact of financial turbulence and tighter credit conditions on the real economy, negative business confidence in most sectors and broadly across regions indicates a slowdown in the UK is on the horizon.

Business confidence drops anticipating an economic slowdown

It is our members' financial proficiency that makes the ICAEW Business Confidence Index a leading economic indicator with a proven track record of closely predicting GDP growth. This is particularly important because the BoE is focusing on business confidence and the housing

market to monitor the UK economy, according to Kate Barker, Monetary Policy Committee (MPC) Member who spoke recently at an ICAEW event.

Fig. 2 Forecast of annual GDP growth based on ICAEW Confidence Index



Source: National Statistics First Release – Gross Domestic Product (GDP) – and cibr regression calculations

City and property market lead decline

With confidence declining in the majority of sectors, finance professionals are clearly factoring in the combination of financial uncertainty, tighter credit conditions and the scale of potential fall out. Property and finance sectors, accounting jointly for about 20% of economic output, plummeted to their lowest levels since the survey began, a key point to note given the UK is more dependent on the housing market and the finance sector than most other large economies.

Higher interest rates have caused confidence within the property sector to drop from -10 in Q3 to -26 in Q4. A weakening housing market will feed through to consumer spending via the wealth effect. Property accounts for 43% of UK households' total net wealth compared to 28% a decade ago.

In addition, as banks lose billions of pounds City bonuses will be lower next year causing further downward pressure on property especially in the buy-to-let market. Confidence in the finance sector collapsed to -13.9 in the Q4 from +13.7 in the Q2 of this year.

The decline in confidence was broad based across sectors with only IT and business services remaining optimistic. In the business services sector optimism increased as firms continue to benefit from exporting services such as legal and accountancy. In addition, business services companies depend on the finance sector at the latter stage of transaction processes, suggesting confidence in the sector will take a hit in 2008.

The credit crunch has caused finance professionals to reduce capital investment growth further next year. Firms also expect to see a slowdown in turnover and profits growth in 2008. However, the decline could prove to be deeper than expected as oil prices hit a record \$97 per barrel eroding profits further, and the negative fallout from tight credit continues to impact economic activity.

So, while the Confidence Index suggests an economic slowdown, the BoE relied on the latest official data and kept interest rates high. Despite inflation retreating below the 2.0% target for the moment, record high oil prices will put upward pressure on inflation. The BoE may have lost its golden opportunity to make a pre-emptive cut to prevent a sharper economic slowdown. A recession in the US and slowdown in the Eurozone will only exacerbate this.

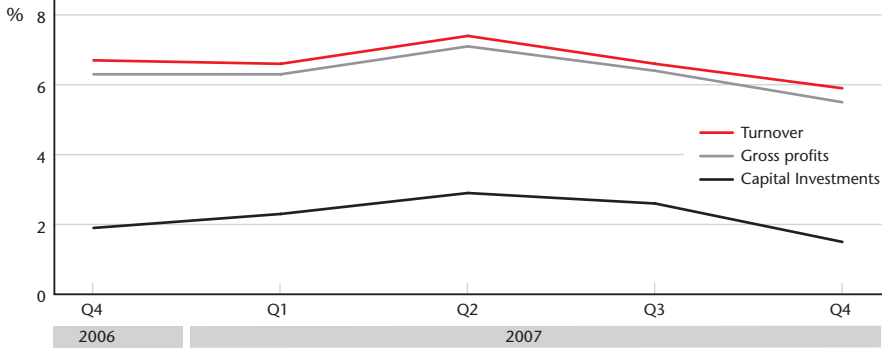
Maureen Raymond, Chief Economist, ICAEW

MAIN FINDINGS

BUSINESS FINANCIAL PERFORMANCE

Capital spending budget growth is likely to slow significantly in the next 12 months, after expanding 3.1% over the last 12 months. This is due largely to finance professionals becoming less optimistic in their expectations for turnover growth, expecting this to rise by 5.9% in the next 12 months, down from 6.7% in the preceding 12 months. Profit growth is also predicted to slow, with 5.5% growth predicted in the next 12 months down from 6.0% in the last year.

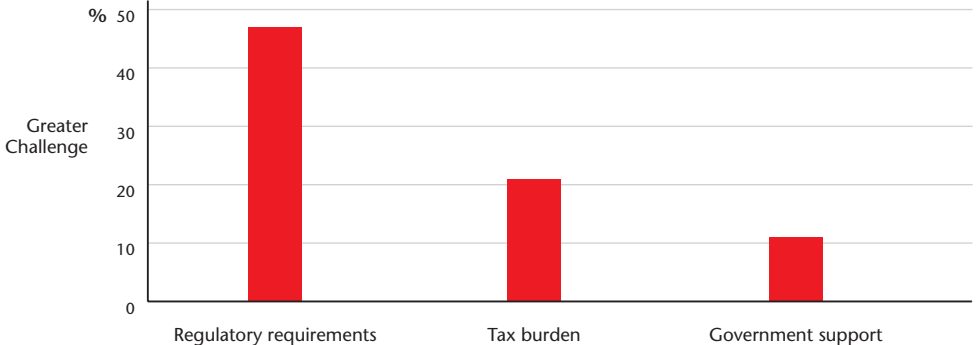
Fig. 3 Business financial performance in the coming 12 months



Factors affecting business performance

Almost half (47%) of finance professionals claim that regulatory requirements have become a greater challenge for their business over the last 12 months. Government support for business and the tax burden are also posing a greater challenge when compared with a year ago for some businesses, though for a smaller proportion than is the case for regulation.

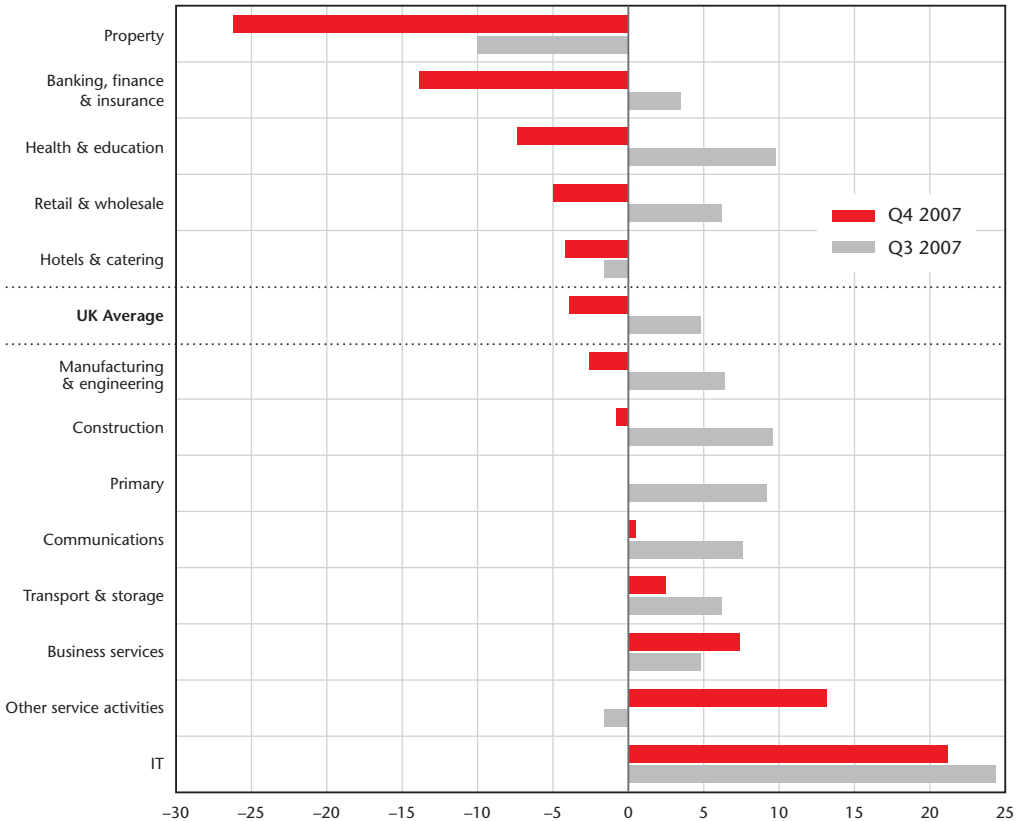
Fig. 4 Factors becoming a greater challenge to business performance over the past 12 months



TRENDS BY INDUSTRY

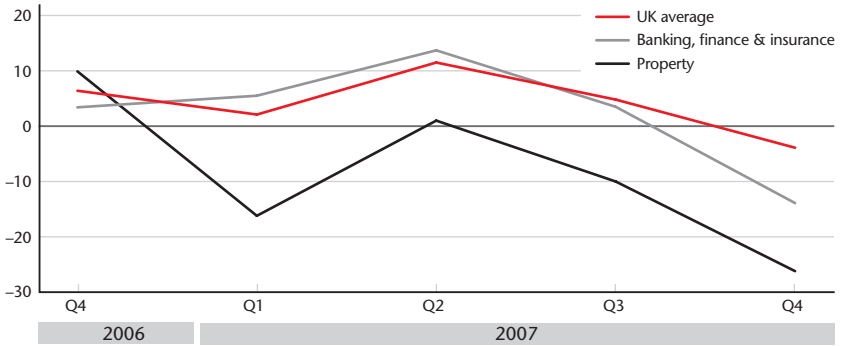
The banking, finance & insurance and property sectors have led the general decline in confidence this quarter. The former reflects the ongoing turmoil in the financial markets, where banks remain uneasy about providing credit and have strong concerns regarding their degree of exposure to the deepening US housing slump. Confidence in the banking, finance & insurance sector fell to its lowest recorded level since the survey began registering -13.9 this quarter from +3.5 in the last and +13.7 in Q2 this year.

Fig. 5 BCM Confidence Index trend



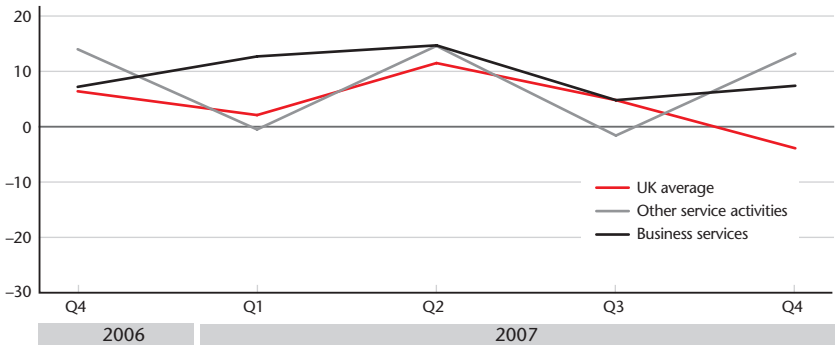
Similarly, the current decline in housing activity has driven confidence in the property sector to -26.2 the lowest level on record. This decline is supported by recent BoE data showing the number of new mortgage approvals dropped to the lowest level in two years in September. In addition to this, confidence in the retail & wholesale sector, that which best represents the consumer, declined by 11.2 points this quarter to -5.0.

Fig. 6 BCM Confidence Index trend



In sharp contrast to the sectors already mentioned, and indeed the rest of the economy, confidence has actually risen in the business services and other services sectors this quarter. This possibly reflects exports of services such as law, accountancy, and those by the creative industries, which continue to benefit from rapid growth in both established and emerging markets.

Fig. 7 BCM Confidence Index trend



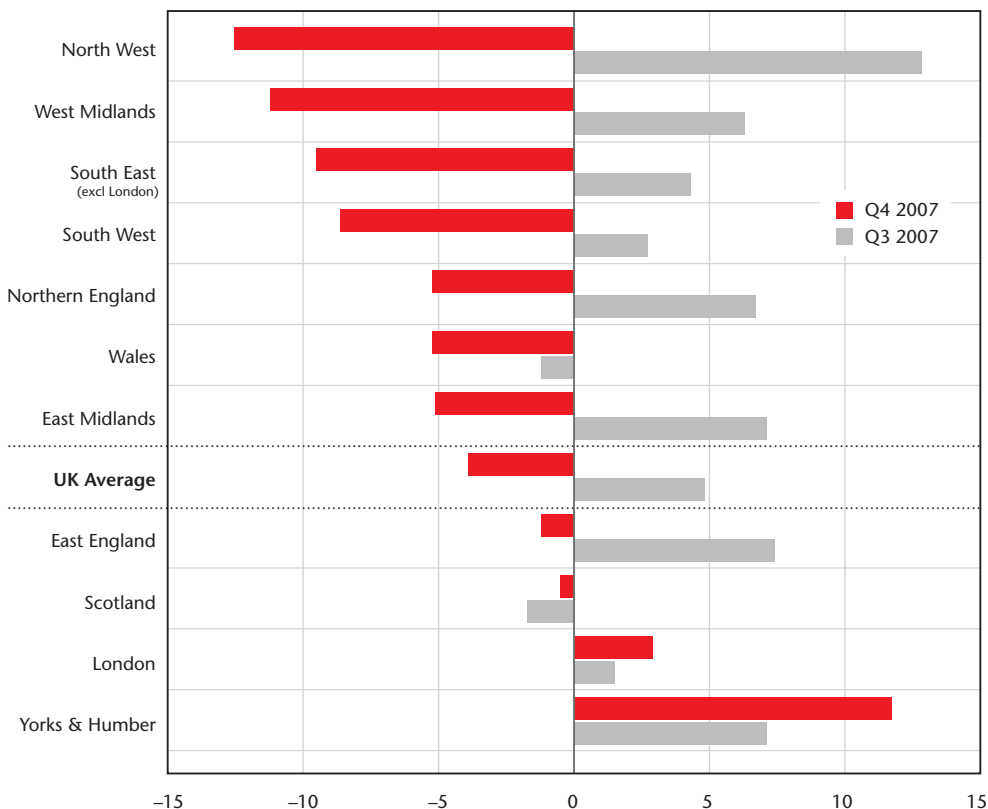
TRENDS ACROSS UK REGIONS

Firms in most regions of the UK are pessimistic about their outlook through 2008. Only Yorkshire & Humber and London record positive confidence, with the Confidence Index score rising from +7.1 to +11.7 in the former and from +1.5 to +2.9 in the latter in this last quarter.

It is most likely that the Confidence Index score recorded by finance professionals in Yorkshire & Humber is largely sustained by transport activity with the region being home to the UK's largest port.

Confidence in the IT and business services sectors, which play an important role in the economy of the capital are buoying confidence in London.

Fig. 8 BCM Confidence Index trend



Finance professionals in the North West and the West Midlands are more concerned about the outlook for their business than their colleagues in any other region, registering scores of -12.5 and -11.2 respectively in the fourth quarter of this year.

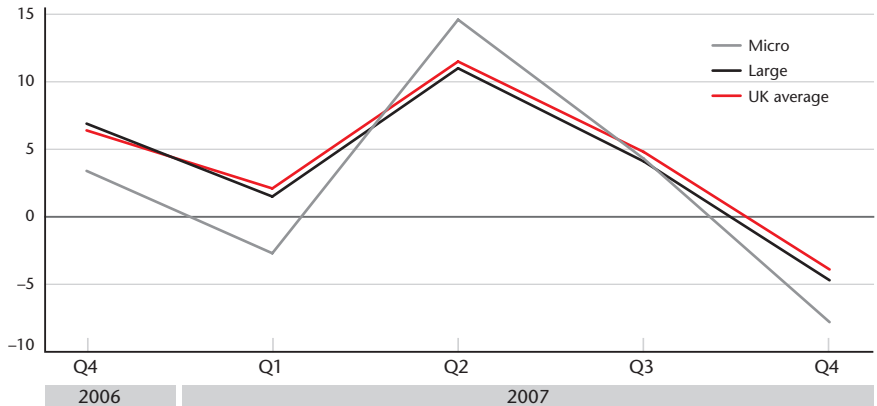
This may be rooted in concerns regarding the housing market and finance sector being exacerbated by a decline in confidence in the manufacturing & engineering sector in these regions.

TRENDS BY SIZE OF BUSINESS

The Confidence Index score for micro-sized firms (those with up to 9 employees) showed the largest decline this quarter. At -7.8, the score for micro firms is now at the lowest level since this survey began.

Large firms (those with more than 250 employees) have also experienced a drop in confidence to -4.7, the lowest level for this business size since Q4 2005.

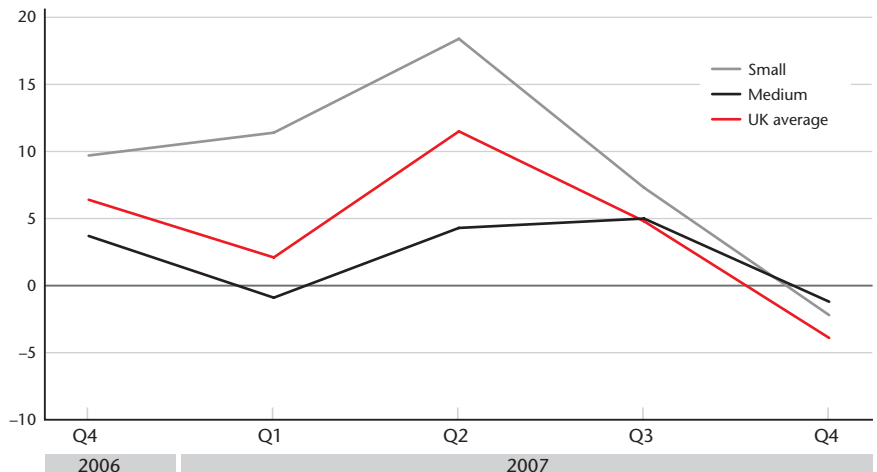
Fig.10 BCM Confidence Index trend



Confidence is also negative for the other business size categories. Small and medium-sized firms have also registered declines in confidence, dropping to -1.2 and -2.2 respectively this quarter from +5.0 and +7.3.

The decline in confidence across all business sizes reflects the worsening outlook for the UK economy as a whole, as well as the global economy.

Fig.11 BCM Confidence Index trend



SOUTH EAST FINDINGS

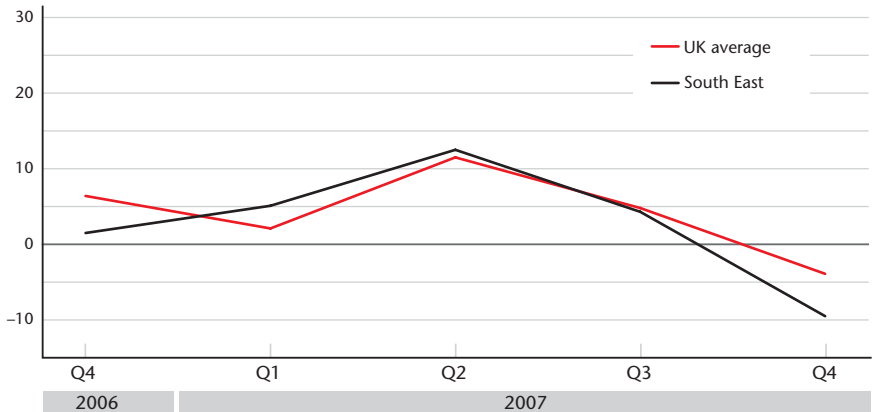


SOUTH EAST RECORDS LOWEST CONFIDENCE SINCE THIS SURVEY BEGAN

One hundred and forty responses were received from finance and accountancy professionals in the South East, who record a **score of -9.5** in the Q4 2007 ICAEW – UK Business Confidence Monitor. Confidence has fallen sharply this quarter, by 13.8 points, to hit the lowest point on record for the region.

Finance professionals in the South East are among the most concerned about the housing slowdown and the economic effect of the credit crunch. In addition, the region is one of the most exposed to the economic slowdown in the US. This is largely due to the proliferation of multi-national firms located in areas such as the Thames Valley, Portsmouth and Milton Keynes. Finally, the negative outlook for the retail & wholesale sector has also contributed to the fall in confidence this quarter, hitting retail centres such as Reading and Bluewater.

Fig. 12 Trend of Business Confidence in the South East



FINANCE PROFESSIONALS CAUTIOUS ABOUT FINANCIAL OUTLOOK...

In line with negative confidence, finance professionals in the South East predict a slowdown in the growth of turnover and profits over the next 12 months, relative to the growth experienced in the past 12 months. These two variables are both seen underperforming nationwide growth, by 0.7 percentage points and 0.3 percentage points respectively.

...ON WEAKER DOMESTIC AND FOREIGN SALES GROWTH

Firms in the region foresee both international and domestic demand growth slowing down through 2008. Sales within the UK are foreseen rising 5.2%, down from 5.8% growth in the past 12 months. International sales are expected to rise 2.8%, down from 3.4%.

However, firms in the South East plan to raise their sales prices by more than they did in the past year, suggesting the potential for inflationary problems. Despite continuing to expect a decline in input price inflation, even though oil prices are not far from \$100 a barrel, firms expect to raise selling prices by 1.6% compared to the 1.4% rise reported for the past 12 months. However, a larger price rise may prove difficult to pass through in a climate of softening demand growth.

INVESTMENT AND JOBS GROWTH AT RISK NEXT YEAR

According to finance professionals in the region, firms in the South East are planning to slow investment growth in the next 12 months relative to the previous 12 months. This is a likely result of the increased difficulties in accessing credit, manifested for example in a doubling of the number of private equity deals being withdrawn in the past three months. Business investment will only increase by 1.4% next year, down from 2.1% in this past year.

In addition, firms in the region plan to cut jobs growth to just 1.3% next year after an expansion of 1.9% reported for the past year. This contrasts with 2.0% growth foreseen across the country as a whole. Salary growth is also expected to be curbed to 2.8% next year. However, South East finance professionals do expect to slightly increase the rate of growth of staff development budgets, albeit from relatively low levels of growth seen in the past 12 months.

OF ALL UK REGIONS, TAX BURDEN IS THE GREATEST CHALLENGE IN THE SOUTH EAST

The South East claims that the tax burden has become more of a challenge to deal with relative to all other regions and countries of the UK. Nearly one in three (28%) in the region claim that their tax payments have become more of a challenge, compared with one in five of their colleagues nationally.

TECHNICAL INFORMATION

This research was conducted by the Institute of Chartered Accountants in England & Wales (ICAEW) with assistance from centre for economic and business research (cebr).

During the period August 20 to October 26, 1003 ICAEW members working in industry in the UK were interviewed by telephone. Questions covered past performance and future prospects for their businesses and perceived changes in impact of factors such as availability of skills, Government regulation and the tax regime.

Data has been weighted to ensure the profile of the survey sample accurately represents the UK Economy for company size (no. of employees), regional location and industry sector.

Further technical details and the full question set available upon request.

DETAILED RESULTS AND FURTHER INFORMATION

For more detailed national results and analyses, including full regional reports and summaries and further information on the UK BCM, please visit:

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