16 November 2012

Agricultural Engineers Association
British Automation and Robot Association
British Paper Machinery Suppliers Association
British Plastics Federation
British Turned Part Manufacturers Association
Confederation of British Metalforming
Gauge and Toolmakers Association
Manufacturing Technologies Association
Polymer Machinery Manufacturers and Distributers Association
Printing Industry Confederation
Processing and Packaging Machinery Association
UK Industrial Vision Association

The Rt Hon George Osborne Esq MP
Chancellor of the Exchequer
HM Treasury
1 Horseguards Road
London SW1A 2HQ

Dear Chancellor,

Autumn Statement -- Engineering and Machinery Alliance Submission

We welcome the government's continued commitment to sound public finances and the imaginative ways the government has found to support priorities in terms of growth and exporting. More of the same is needed on both counts.

1 Summary

Our recommendations on investment, skills, exporting, government's interface and finance include:

- A temporary (two year) 110% first year capital allowance for expenditure in excess of the £25,000 Annual Investment Allowance
- Allowing firms to recruit leading 'knowledge/expertise' to work in the UK (e.g. cryogenics engineers from Russia)
- Extending the NIC holiday to SMEs for one additional worker for two years
- A more flexible export promotion regime that dovetails better with the different market requirements (e.g. consumer, capital goods, infrastructure) in different countries
- Combining the push to limit the EU budget with a specific focus on operations/bodies that generate the most red tape so that the limitations release extra economic activity
- Encouraging banks to give UK Export Finance's new product offerings a much higher profile.

2 Background

The Engineering and Machinery Alliance (EAMA) represents circa 1,700 firms from 12 different trade associations (please see the masthead) mostly SMEs in the mechanical engineering sector with sales of some £8.5 billion.

They account for a quarter of the UK's mechanical engineering output, and according to HM Customs' data, sector exports account for about 70% of sector sales.

Typically, our companies supply 'enabling technologies' to other sectors (e.g. automotive, aerospace, medical, power, printing and food industries) in the form of machinery or packages combining services and products. Some of our members make machines that make machines.

Mechanical engineering an SME dominated sector with strong export performance

The mechanical engineering sector is low profile because it supplies into other industries. OEMs in other sectors rely on mechanical engineering to help make products such as cars and planes. And because there are also plenty of other companies in other countries that do too, UK-based mechanical engineering firms run a surplus for the balance of payments year after year of between three and five billion pounds Sterling according to ONS's Monthly Review of External Trade (Table 1). The only other UK manufacturing sector to achieve the same sort of record is the chemicals industry.

Table 1 UK mechanical engineering exports and net balance of trade (£ billion)

Year	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Exports	22.7	24.2	23.8	25.8	28.22	28.9	32.3	29.3	32.9	38.6
Balance	3.8	5.3	4.1	3.9	5.6	3.2	3.4	4.9	4.1	5.7

Source: Monthly Review of External Trade May 2012

The sector's five top markets in 2011 were: USA (£4.6 billion), Germany (£3 billion), France (£1.5 billion), Singapore (£1.2 billion), China (£1 .0 billion).

One of the main characteristics that set mechanical engineering apart from the other main exporters is the average size of the companies involved.

Table 2 Average size of companies in different UK manufacturing sectors

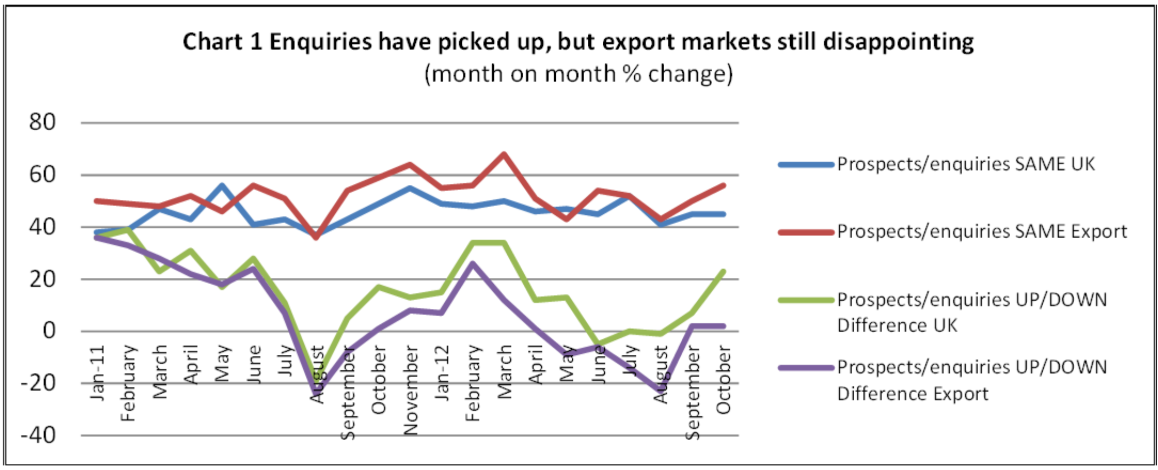
Sector (2010)	Mechanical engineering	Chemicals	Pharmaceuticals	Motor vehicles	Air and space craft
Average firm sales £m	3.8	13.9	38.9	54.0	43.3

Source: Derived from Annual Business Survey 17 November 2011

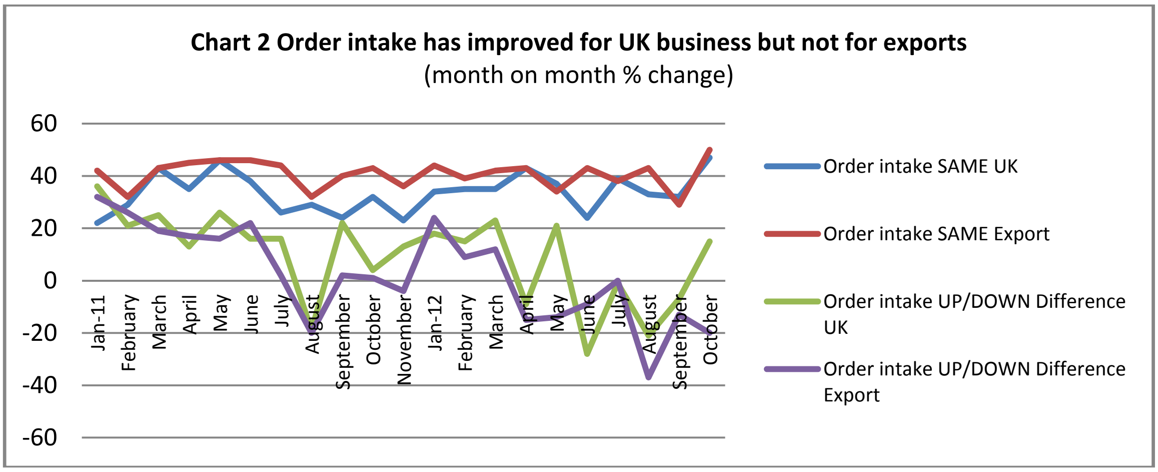
3 Business environment

EAMA Business Monitor

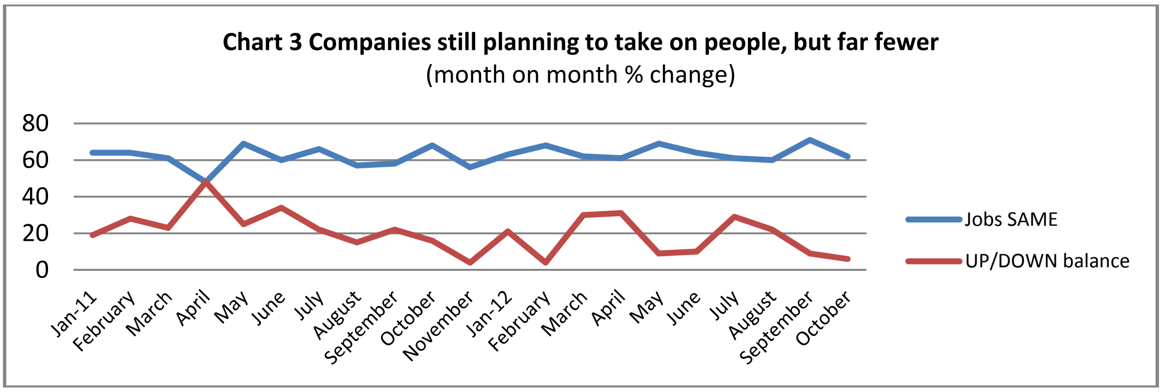
After nearly half a year of erratic results some improvements were noted in September for UK and overseas enquiry levels. The preliminary October reports showed similar improvements in these leading indicators.



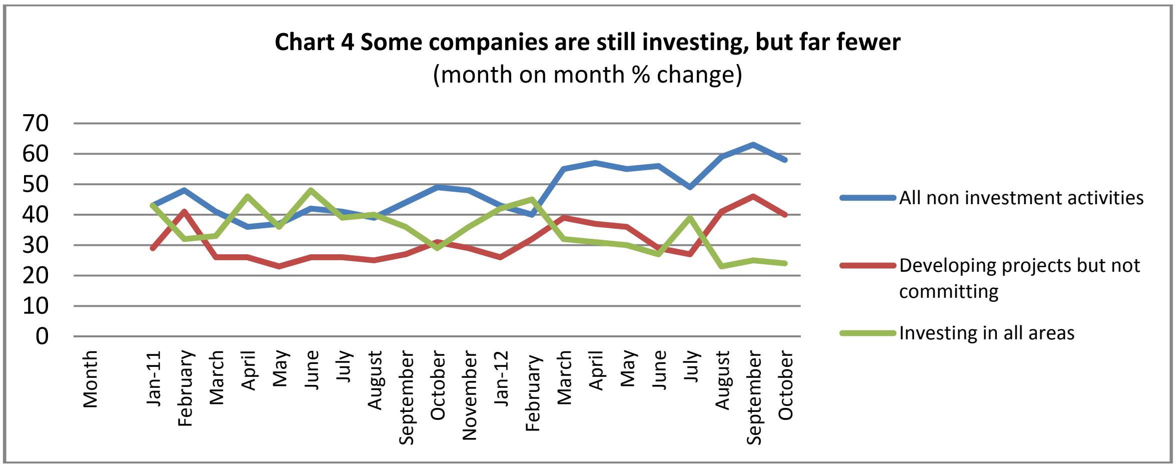
An improvement in UK orders is also foreshadowed, but export orders still look to be a problem area. The balances in September's three-month running averages underscored the problem, leaving a lot of potential to be made up in the remainder of the year.



Companies remain positive about their employment plans, but with some narrowing in the September returns reconfirmed in October.



Investment activity continues to flatline. The major decline captured by the Monitor coincided with the cut in the Annual Investment Allowance to £25,000 this year. Now it looks as though October will be the third month in a row when two-fifths of companies or more report they are developing but not committing to new projects. It's the first time we've seen that for three consecutive months. Meanwhile there's little or no change in overall access to finance. Albeit business confidence does seem to be coming back.



Our members say that finding new customers is their number one priority, closely followed by skills. The bottlenecks on financing and investment now are due to companies relying on their own funds, rather than putting themselves in the hands of the bank where the credit risk assessments penalise SMEs, exporters, new exporters and far-flung markets.

And this 'financing scene' is unfortunately about to become less competitive, as ING Lease with about £1 billion written predominantly with SMEs withdraws from the UK, because the parent bank in The Netherlands needs to increase its capital, not because the operation performed badly or the market's uneconomic. We have received assurances competitors will fill the space. Our fears are that a slick operation focused on the SME end of the business is exiting the UK and there was little or no interest amongst the bigger banks to take over their portfolio. At the time of writing we believe ING have not sold the Lease book while they did the consumer finance business for £10 billion to Barclays.

4 So how's the UK performing compared to others?

The EU Industrial Performance Scorecard (memo 12/760) summarises the UK's comparative performance as: excellent business environment , strengthened by the quality of its public administration; access to finance is a major challenge; labour productivity is lower than in its major competitors, caused by the country's underlying weaknesses in investment and skills.

Exporting
Over the last five years, UK's share of extra-EU exports has remained static, while its proportion of intra-EU business has fallen by a quarter (24%). Germany and The Netherlands have managed to increase their shares of intra and extra EU trade while French and Italian companies' experience has been mixed (Table 3). The €/£ exchange rate strengthened from 68p in 2006 to the mid 80sp in 2011.

Table 3 Share of EU exports 2006-2011
(Intra and Extra EU trade)

Country	Intra-EU Trade		Extra EU Trade	
	2006	2011	2006	2011
UK	11.3	8.6	11.5	11.5
France	12.3	12.7	11.7	10.7
Germany	19.0	21.0	27.6	27.7
Italy	8.4	7.8	11.1	10.6
Netherlands	6.8	7.3	6.6	6.9

Source: Eurostat tet00039

Table 4 Difficulties accessing finance
(0 = worst possible; 1 = best possible)

Country	2009	% EU average	2011	% EU average
EU average	0.53	-	0.55	-
UK	0.61	+15	0.45	-18
France	0.76	+43	0.48	-13
Germany	0.83	+57	0.79	+44
Italy	0.66	+25	0.53	-4
Netherlands	0.36	-32	0.47	-15

Source: The EU Industrial Performance Scorecard

Access to finance
According to the same *Scorecard*, in 2011, access to finance was more problematic in the UK than in France, Germany, Italy and the Netherlands (Table 4).

Comparing two similar sources for EU and UK data shows fewer SMEs are applying for bank loans in 2012 (new or renewal) in the UK than in France, Germany and Italy and despite that UK refusal rates are higher.

Table 5 Quarterly bank loan performance for SMEs applying for loans (new or renewals) excluding overdrafts and credit lines in 2012

Country	Firms applying %	Got all they asked for %	Rejected declined %
France (1)	31	75	15
Germany (1)	19	81	4
Italy (1)	30	48	20
Netherlands (1)	14	21	31
UK (2)	9 (Q1+Q2)	53 (Q2)	34 (Q2)

Sources:
1) Survey on the access to finance for SMEs in the Euro Area April-September 2012 (November 2012)
2) SME finance monitor Q1 and Q2 (September 2012)

Stimulating R&D
EAMA very much welcomes the way government is tackling UK R&D and innovation. It's sorely needed. Another EU comparison (*Innovation performance 190 regions compared 2011*) shows how timely government's intervention is:

- Innovation 'leadership' countries are: Denmark, Finland, Germany, Sweden and Switzerland, which outperforms all EU member states in 'innovation leadership')
- UK is in a second 'follower' group with Austria, Belgium, France, Ireland, Netherlands and Slovenia
- The UK only had two 'leadership' regions out of 12 across the country (compared with Germany 12/16, Sweden 5/8, France 2/9, Netherlands 4/12)
- East of England and South East are 'leadership' regions, Northern Ireland is in a third 'moderate' category and the nine other regions are all classified as 'followers'.

Investment
While some of the money being generated by companies operating in the UK is being used to pay down debt, companies are investing the majority of it overseas, £253 billion in net foreign direct investment and purchases of foreign equity according to a recent (October) analysis by Citigroup.

5 Conclusions

- Investment performance is weak amongst SMEs. And large companies also seem to be holding off
- EU markets don't look promising
- Ideally we need a framework that makes it less risky for SMEs to invest, find new customers and enter new markets

- That will make it easier to plan and will reinforce business confidence producing a more positive environment.

6 Investment

1. The priority is to stimulate investment. Boardroom discussions round UK investment are bounded by the uncertainties of the current economic situation. Finance directors have a strong bias against action here at this time, unless there's an offsetting counterweight.
2. Government should therefore frame policy to make it much more difficult to put off investment in the near term, i.e. so that to delay means the company will end up 'leaving money on the table'.
3. As you will recall EAMA favours a much more substantial Annual Investment Allowance (£100,000 and building) to create a positive, sustained manufacturing environment. However, the current scheme ceiling of just £25,000 does very little indeed to encourage companies to invest in capital plant where the costs may run into many hundreds of thousands of pounds. It's simply not an attractive incentive on its own.
4. So any major, temporary measure introduced say for two years, will have a commensurately greater impact if it's clearly temporary and something 'my competitors will take advantage of'.

Recommendation

5. **Examine a two-year scheme offering 110% first year capital allowances above the £25,000 AIA**. It's our understanding that 100% capital allowances are used in the United States as a timely economic stimulus lever to good effect.

7 Skills

Meeting the sector's skills needs

1. Skills development is the second most important issue for most companies in the sector (after finding new customers).
2. The industry has a problematic skills profile because of the decline in the numbers of new entrants over the last three decades. Government seems to be well seized of this and its significance.
3. The prevailing industry view is that educational standards have slipped in the last 20 years and the school leavers the companies see tend to lack the commitment and work ethic found in immigrants from Eastern Europe.
4. Even on the assumption that the recent measures being applied rectify the problem, it's still going to take a long time.
5. Meanwhile, our internationally competitive high-tech companies need top class engineers in their chosen disciplines as well as a raft of supportive technicians.
6. For example, Germany and Japan lead the world in control systems. Unsurprisingly, those countries also produce the best control engineers. Stopping UK companies recruiting there means that UK companies aren't going to be cutting edge leaders in their chosen field. Hobbling them in this way therefore makes them less competitive and reduces their export potential. The top cryogenics companies worldwide recruit from Russia etc.

Recommendation

7. It's vital that business is able to recruit from the best worldwide to raise standards in business and ultimately to help raise UK standards in further education and research establishments.
8. Foreigners studying for second degrees here should be encouraged rather than constrained from working here as a rapid way to fill the gaps the UK education system has thrown up in STEM subjects at advanced levels.

Skills displacement

9. As you know, there are only a limited number of places on UK university engineering courses. A large proportion of graduates from these courses are directly recruited by non-manufacturers (e.g. management consultancies) offering much bigger initial salaries than a typical manufacturer can afford. This displacement undermines UK manufacturers' competitiveness, depriving them of the country's home grown talent.

Recommendation

10. Government to examine pros/cons of introducing a temporary (say five year) counter employment bias into the 'milk round' by forgiving graduates their university loans if they take up employment for a minimum of three years in manufacturing or a closely allied sector (e.g. consulting engineering). Graduates going elsewhere for higher pay will be able to afford the repayments.

Hanging on to the investment in the skills base

11. Despite all the economic uncertainty, the UK is trying to rebuild its skills base. We believe that now is also the time to look in more detail at how the UK can perform better at retaining the skills in the sector in addition to the Talent Retention Solution.
12. As you know, German unemployment increased by just over 200,000 in the most recent recession (compared to the UK's approx 1 million since spring 2008). And as German firms have come out of recession their industry has been able to re-skill immediately thanks to their short time working arrangements. For UK companies that had to let people go in 2008/09 the road back will take much longer and will be more expensive, involving training and/or re-skilling.

Recommendation

13. Government to set the parameters for a potential UK solution, perhaps adapting the framework of the German insurance based scheme and by involving experts from the UK insurance industry, major manufacturers and some supply chain SMEs for a practical solution. (Note: A well designed practical scheme could also have an important impact on young people's career decisions if it helps create a more stable employment environment.) Manufacturers are natural partners for such a scheme given their businesses' asset intensity.

Employment

14. In the current environment there are two broad employment issues: getting unemployed people back into work and with 'rebalancing' helping people to move from one firm or sector to another. In both cases the candidates concerned will in all likelihood need some training, additional skills development and/or orientation (e.g. on health and safety). In addition, flexible attitudes need to be encouraged amongst both work candidates and employers if some rebalancing from one sector to another is to be achieved.
15. Government supported apprenticeship schemes understandably focus particularly on the younger workers and school leavers (up to age 24), but we understand there are plans to reduce support for those aged 24+, which is the age group that is going to make up a large proportion of those having to change jobs.

Recommendations:

16. Expand the NIC holiday for start-ups to all SMEs for one additional (long term unemployed or under 24 year-old) worker for two years. The SMEs can then combine this with the support for training to give new employees the wherewithal to make a new career in a new sector.
17. Ensure that Government support for those in 24+ age range encourages SMEs to take them on as trainees for a qualifying period just as much as for young people under 24.

8 Exporting

Likely future sector trends

1. To expand into foreign markets, SMEs will not only have to consider their manufacturing capabilities but also their capacity to develop service packages to maintain machines working in factories around the world.
2. As on-demand manufacturing grows to meet bespoke requirements and UK firms increase their added-value content mechanical engineering firms will play an even bigger role in supporting the UK balance of payments

Some characteristics of success

3. In capital goods, the three basics that differentiate the economics of exporting from home sales are:
   a. The cost of sales in export markets is usually much higher than in the home market (e.g. cost of delivery, translation and maybe some local adaptation)
   b. The sales price is often reduced by the local competition in the export market.
   c. Exchange rates.

Access to finance, decent trade cover and encouragement to invest for the long term are vital for exporters, so are trade shows and missions to help SMEs expand their capacity to grow.

Government actions

Support services for exporters looking for new customers

4. Budgetary pressure on UKTI has reduced its capabilities to support export activity, just as global competition is increasing and the UK is more dependent on trade than ever before (55% of UK GDP depends on trade according to the World Trade Organisation).
5. There's plenty of good work going on at UKTI and elsewhere to help exporters, but unfortunately companies often say that the paring back makes the UK presence look smaller, less professional and therefore less competitive when compared to the likes of Germany, France and Italy.
6. Their governments are investing heavily to support trade shows and missions. HM Treasury pressure is forcing posts to dream up ways of charging exporters for their services. While there may be some merit in this (e.g. when it tests the seriousness of the information or market enquiry), others have no merit.

Recommendations

7. HM Treasury to review the impact of the cost savings alongside the challenge to double SME UK exports and compare this performance with competitor country support for their exporters (e.g. USA and Germany).
8. Consider setting a three-year rolling cycle of activity focused specifically on raising exports in markets agreed with business so that export partners can plan activities in line with local capital equipment procurement practice, rather than according to HMG's budgeting cycle.

Trade shows

9. Trade shows are vitally important to companies selling capital goods overseas (currently UKTI spends some £7 million on trade show support out of a budget of some £350 million). Prospects need to have seen the goods and get to know and trust the company behind the product before they will spend £300,000 or more on a new piece of machinery for their plant.
10. Prestige events with the great and the good promoting UK capability are important, but when an exporter is looking to develop and sustain a relationship of trust with the production director or factory manager, that exporter needs a different type of support to foster that relationship.
11. The crucial step to facilitating this type of diversity is to set up an export agency exclusively focused on exporting with a policy framework that's flexible enough to: encourage different sectors (e.g. consumer, investment and industrial goods producers) to tackle what they see as their most prospective markets, provide sensible exhibition and seminar support, advice and guidance (i.e. no open cheque book), so that firms taking advantage of government support are vetted to ensure that they are able to make the most of the opportunities (e.g. at a trade show).

Recommendations

12. The UK needs a national agency that champions UK exports and exporters.
13. To match the best in the world this agency should be totally separate from inward investment activities and staff so that it can champion services such as finance packages for overseas customers purchasing UK goods.
14. The regime should be far simpler, run with a national focus, and sectoral expertise.
15. Companies should be supported when they show commitment and proper preparation, not on the basis of their exporting 'virginity'.

Accounting standards

16. The current system discourages SME companies from setting up operations to handle client after-sales care in export markets. This is an increasingly important and competitive area for firms tendering for longer term contracts.

Government can resolve this

17. Companies are responsible for assessing their own liability for corporation tax and for ensuring that all the money that is due is paid on time. Most companies have to pay CT within 9 months of the end of their accounting period.
18. This rule applies to SMEs with profits up to £1.5 million. The £1.5 million threshold is reduced for every active company under common control within a group. For an SME active say in five overseas markets, the figure of £1.5 million reduces to £250,000.
19. Larger companies have to pay the tax due in quarterly instalments.
20. This is very onerous on cash flow in the transitional year, as the company has to pay its CT liability under the '9 month' rule and a quarter of its estimated liability for the following year in the first 6 months on the new accounting year.
21. All this means that the simplest way to minimise your CT bill is to limit the number of subsidiary or associate companies, which hampers a UK SME trying to grow its international capability in areas

such as servicing machinery, which is an increasingly important and competitive part of the higher value added export sale.

9 Interface with government

Cross departmental responsibilities

1. All government departments that have an impact on business should understand how they fit in to the whole picture and what the overarching priorities for the country are.

Recommendation

2. A strategy for rebalancing the economy, of producing jobs and growth through industrial investment (in part) should be shared by all those departments so that government's plans are comprehensive and don't produce conflicting outcomes and pressures other than at the policy margin.

Sounding out policy alternatives within industry -- bottom up as well as top down

3. Clearly government needs input from OEMs when developing policy. They are usually much bigger companies than their suppliers and drive requirements through their supply chains.
4. However, as previously mentioned, supply chain companies in seeking to serve their customers competitively are also often the innovators in the supply chain.

Recommendation

5. Government should be more accurate in reflecting industry flows by sounding out views within the supply chain so that schemes such as the Advanced Manufacturing Supply Chain Initiative or Funding for Lending reflect both the top down drive from large OEMs/banks and the bottom up push from small and medium sized firms as innovators within the supply chains.

Regulation

6. It is readily accepted that UK manufacturers operate in a globalised market. But regulators must be more alive to the fact that they do too. The norms they set affect the UK's position in that globalised market. If the UK is to enjoy the benefits of manufacturing goods, the parameters for operating here must not be economically out of kilter with the requirements set offshore, otherwise companies will continue to migrate.
7. Today maybe 60-80% of the regulations affecting business come through the EU, although of course they may start out as proposals sponsored by a Member State.

Recommendations

8. In seeking to cut the EU budget, focus the cuts on the Directorates General (departments) and other bodies that generate the most red tape, so that the cuts produce more economic activity.
9. Other actions to reduce wasteful regulation:
    a. To ensure fair competition in a global market it is important the UK maintains the ability to verify that goods entering the UK conform to the standards nominally specified.
    b. For preference imported manufactures will be produced in factories meeting similar social and environmental standards as those required of UK companies.

12 SME financing

1. Although Government wishes to maintain the freedom to impose tougher conditions on the banks than those set out in the Capital Requirements Directive (and we have seen how the UK's tougher access to finance environment is playing out competitively) you may, should you so wish, have some room to help ease Basel III requirements on the banks, through action by the FSA or HM Treasury in the following areas:
    a. *SMEs in large company supply chains:* Most large OEMs depend on SMEs in their supply chains. If the OEMs highlighted these suppliers to their banks, the banks would be able to grade them as a lower risk, warranting easier terms and therefore reducing the level of interest that the banks would need to charge.
    b. *Premature default:* Strict adherence to the Capital Requirements Directive triggers default "90 days past due". It can do so for relatively paltry sums. It would be more sensible to place more importance on the sums involved and their significance to the company owed the money.
    c. *SME loans:* Banks would be able to lower their rates if the risks associated with default could be reduced, e.g. through some insurance scheme as per UK Export Finance.

Access to finance

2. UK SME manufacturers won't outperform the competition in export markets if their financing packages are uncompetitive. Confidence is currently fragile and SMEs' trust in banks is low.
3. Increasing sales at this time means growing sales in export markets, an apparently 'riskier' path that immediately 'causes' banks to increase their charges and collateral requirements, when new markets or customers are involved (particularly for SMEs.)
4. We don't see 'Funding for Lending' tackling this 'risk premium' as long as the banks are the sole distribution channel.

Recommendation

5. Confidence will improve both for the banks and for the businesses if a proportion (say 30%) of the (financial) risk could be shared by another trusted party (e.g. a UK Enterprise Bank). Finding new customers is the number one priority for our firms. That's why we welcome Business Secretary Cable's announcement of an enterprise bank to encourage investment.
6. We welcome the advances that UK Export Finance has made in its product offering, but these real improvements need to be better promoted within and by the banks to make a real difference to UK SME export performance.

Reluctantly, we are coming to the view that UK manufacturing SMEs are unlikely to benefit from the sort of supportive banking relationship that similar size firms enjoy in Germany and France or the USA. Action on the above will help ensure a more competitive financial partnership for many manufacturers but ultimately as long as the risk analysis forces banks to treat SMEs as substantially riskier prospects the problems will remain.

Conclusion

Together with BIS you have introduced an important and potentially very significant shift in policy that certainly could help UK manufacturers advance on the road to being the best they possibly can be.

As an alliance of trade associations rooted in the sector our prime aim is to help firms on that journey to which end we are trying to take forward certain initiatives jointly with the banks through the BBA as well as working with the so-called challenger banks such as Aldermore.

But we believe despite the positive changes we have seen that there's still one vital element missing – a powerful mechanism that rewards investors in plant so that they can immediately start to make money and create wealth for the UK at large by making things here. We therefore urge you to consider the benefits that will flow from a 110% first year capital allowance scheme for a two-year period to kick-start investment on a competitive scale.

With best wishes

Yours sincerely

(signed electronically 16 November 2012)

Martin Walder
Chairman

cc Michael Fallon MP – Minister of State, BIS
Lord Green – Minister of State, BIS
Matthew Ahmed, Dashiel Caldwell, Claire Wren, HMT
Brian Greenwood, Ivan Youd – BIS
Janet Tingle, UKTI
Member associations