

House of Lords Select Committee on SME Exports

Exporting from the UK – an SME dominated sector perspective

Engineering and Machinery Alliance Submission

Summary

- EAMA is an alliance of 12 independent trade associations representing 1,700 firms mostly mechanical engineering SMEs with sales of £8.5 billion, predominantly from exports. (1-3)
- UK mechanical engineering is very export oriented (70% of sales). It's a powerful net contributor (£3-5bn annually) to the balance of payments, but has a low profile because its products are machinery or components that are used by other industries to make planes, cars etc, so that it is prone to slip under government's radar when it comes to export strategy. (4-7)
- SMEs increasing their machinery exports will not only increase product sales but will also extend their service packages to meet the requirements of mechanical engineering markets, where currently the UK appears to be competitive. (8-12)
- Our five top export markets are USA, Germany, France, Singapore and China. Selling capital equipment into a new export market generally takes two to six years. (13-17)
- Access to finance, skills and even accounting standards can be barriers for SMEs that can be resolved if they are made into a priority. But as the experience with UK Export Finance (UKEF) shows it's not sufficient to have good products on offer. If take up is low, as is the case with the vastly improved range that UKEF manages, it's a case of focusing on the other elements, marketing, distribution, sales support and customer after care. (18-39)
- When allowance is made for the budget pressure UKTI has been under, it's achieved some good results. But the pressure on UKTI may well have gone too far. It has certainly skewed judgment so that the peculiarities of some of the charges raise hackles, for example charging exporters for introductions to contacts they may have provided in the first place. (40-43)
- Trade shows and missions are vital to SME exporters. But there's only £8 million to support trade shows out of a UKTI activity programme of £100 million and an overall budget of £350 million. An international comparison shows UK needs to be more flexible to be more effective. (44-48)
- A crucial first step would be handing the responsibility to an organisation solely focused on exporting. Absent such a move, there's a danger budgetary pressures could force BIS and UKTI to become too introspective, when they should be engaging with partners. Some trade associations could help in this if given the chance, but it would require a more open sharing of information round export activity and a much more flexible approach. (49-50)
- The UK's operating environment as a whole affects companies' ability to export from here. It's not clear that simple fact is readily appreciated across all relevant departments. But it's equally true that SME exporters in a sector like mechanical engineering can suffer the double whammy of being 'taken for granted' because they are SMEs and because the sector itself has no single profile because it supplies into other industries. Despite that it has its own characteristics in the way business is done round the world. If the UK is to make the most of this in the future then it needs much better recognition at export policy level. (51-57)

Introduction

The Engineering and Machinery Alliance

1. Formed in November 2001, the Engineering and Machinery Alliance comprises 12 independent trade associations representing 1,700 firms, overwhelmingly mechanical engineering SMEs with 60,000 employees and combined sales of some £8.5 billion.
2. Typically, these 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.
3. The overall sector challenge is to grow mechanical's positive balance each year instead of letting it continue to hover in the £3-5 billion range. For that the sector requires skilled people and a flexible approach to support from all stakeholders (e.g. HMG, the banks, insurers) to be able to better the overseas competition who are plying the same foreign markets, introducing new technologies (e.g. mechatronics).

How these views were assembled

This submission draws on:

- A. The manufacturers segment of a recent Institute for Export survey that EAMA members contributed to (2012)
- B. European Mechanical Engineering Competitiveness Study commissioned by EU Enterprise and Industry Directorate (2012)
- C. Exporting members' views expressed over the last 30 months.
- D. A Study produced by ICC comparing UK and five other countries support for exporters commissioned by the Manufacturing Technologies Association an EAMA member (2007)

The Current Export Market

Export survey (source A) found manufacturers:

- Dependence on exports: important, very important, extremely important (63%)
- Dependence on exports to: increase (58%), stay the same (39%)
- Export growth driven by: product demand (53%), strategy (41%), growth potential (29%), reduce home market (22%)
- Top ten markets: Europe (69%), India (31%), China (29%), USA (26%), S. America (22%), Asia (18%) Russia (12%), Middle East (10%), Africa (7%), Australia (5%)

Mechanical engineering an SME dominated sector with strong export performance

4. The mechanical engineering sector must qualify as one of the sectors best able to compete internationally. It may be low profile because it supplies into other industries. It doesn't have the immediate 'appeal' of the automotive or aerospace sectors, but OEMs in those sectors rely on mechanical engineering to make their cars and planes. And because there are also plenty of other industries in other countries that do too, UK-based mechanical engineering companies 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. The only other UK manufacturing sector to achieve the same sort of record is the chemicals industry.

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

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

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

6. The lack of public profile is a disadvantage when it comes to government recognition and its export strategy.
7. Nonetheless, the sector is characterised by a large number of niche SMEs and a few large specialist companies. Success for many of these firms is predicated on their ability to develop machines or components that deliver performance to a customer specification that may be unique.

Likely future sector trends

8. 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.
9. 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 UK exporting success.
10. But there are other important sector considerations too:
 - a) Selling (large scale) capital plant depends on the company's ability to establish its reputation for quality, delivery and commitment to the market in question.

- b) Trade Shows are therefore absolutely central to exporting in our sector, a factor amplified by globalisation which is tending to promote global 'super-shows'.
- 11. Our impression is that UK SMEs are integrated into international supply chains both directly and indirectly through their customers -- witness the impact of the German and French car scrappage schemes on UK suppliers; witness the significant export market for car components from the UK.
- 12. A BIS report (*Industrial Strategy: UK Sector Analysis*) published this month shows UK labour productivity slightly ahead of Germany's in this sector based on 2007 data.

Internationalisation of SMEs

- 13. 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).

Tackling a new market

- 14. All markets are different.
 - a) Developing a new business to business market successfully may take many visits over several years. If it's not tightly managed it will be costly to the company. Advice and support that reduce the risks involved are therefore helpful in these opening stages which have to be financed before there is any return.
 - b) On their first visit to a new market, the company will look at all the relevant parameters, the competition, the size of the market and some potential customers and probably agents (particularly if the firm is new to exporting). A later visit will lead to the firm appointing an agent and then agreeing sales and marketing activity. It's then a question of showing prospects that they can trust your products to work perfectly in their operating environments. That's likely to take time and more than 'three' visits. All or some of these steps will be repeated in neighbouring markets. In large national markets (e.g. China, USA, Russia), 'neighbouring markets' may be other regions in the same country, rather than other independent states.

Some characteristics of success

- 15. Successful exporting is not a straightforward extension of home sales. 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.
- 16. This means that the margin on export business will almost always be lower, but there are two very significant, boosting benefits:
 - a) First, more stable order income from sales in several different markets: this helps iron out the volatile highs and lows that inevitably apply if a company sells into a single (home) market.
 - b) Second, increased volume through the factory: this allows the manufacturer to spread the overheads across higher output and therefore reduces manufacturing costs per item.
- 17. Successful exporters therefore have a plan about how to broach the market, the time and resources that will be needed. Financial partnership is vital. Preparation before entering negotiations with a local prospect will help ensure the exporter has no surprises and is able to offer competitive financing arrangements for the purchase of machinery or package.

Barriers and market failures

Export survey of members (source A) found:

- Barriers: Red tape 25%, Finance 22%, No relationship 17%, Languages 17%, Taxation 13%, Lack of knowledge 13%, Experience 12%.
 - Train in international trade 18%
 - Major issues facing business: Finance (24%), Lack of skilled people (23%), Lack of demand (8%) current economic climate, red tape, competition, lack of government support (all 6%)
- 18. 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.

Access to finance

19. UK SME manufacturers won't outperform the competition in export markets if their financing packages are uncompetitive. The priority needs are:
 - a) Better access to finance for investment and growth as well as exports so that they can improve productive capacity and increase their market presence.
 - b) Customer deposits paid to confirm their order should be treated as a source of working capital for the manufacturer/supplier not the bank (see para 25).
20. Better financing terms will reduce export risk and help firms grow through export sales ultimately providing additional corporate and personal tax-take both directly from the companies involved and from their suppliers and their employees.
21. Confidence is currently fragile, changing almost every month according to our monthly Business Monitor. Our members' trust in banks is low.
22. 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.)
23. We don't see 'Funding for Lending' tackling this 'risk premium' as long as the banks are the sole distribution channel.
24. 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.
25. In mechanical engineering it is standard practice for a customer to pay a 20-30% deposit to confirm their order. In return for the deposit, the customer expects to receive a guarantee, normally from a bank, that they will either receive the machine they have ordered or their money back. Too often the whole of this deposit is taken by the bank as security against the export order, rather than releasing it to the company for them to use as working capital.
26. We welcome the advances that UK Export Finance has made in its product offering (some of which is designed to fix the deposit question), but these real improvements aren't being taken up/promoted adequately by the banks to make a real difference to UK SME export performance.

The importance of skills

27. Skills development is one of the two most important issues for companies in the sector. 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.
28. In our sector, the prevailing view is that educational standards have slipped in the last 20 years and that the school leavers the companies see tend to lack the commitment and work ethic found in immigrants from eastern Europe.
29. Even on the assumption that recent measures being applied rectify the problem, it's still going to take a long time.
30. Meanwhile, our internationally competitive high-tech companies need top class engineers in their chosen disciplines as well as a raft of supportive technicians.
31. 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.
32. It's therefore 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.

Accounting standards

33. The current system discourages SME companies from setting up operations to handle client after-sales care in export markets (see para 8). This is an increasingly important and competitive area for firms tendering for longer term contracts.
34. Government can resolve this.
35. 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.

36. 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.
37. Larger companies have to pay the tax due in quarterly instalments.
38. 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.
39. 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.

Government actions

Support services for exporters

40. 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).
41. 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.
42. Their governments are investing heavily in support trade shows and missions. Their ambassadors attend the shows and extol the strengths of their countries' manufacturing capabilities. In short they sell themselves very well.
43. 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), some initiatives border on the surreal.

Here are a couple of examples.

- a. "This week I came across an extraordinary paradox from UKTI the organisation that is there to assist small UK companies to do business overseas. I was invited on a trade mission to the US to meet some senior officials in NASA. To my amazement when I enquired the details I found we are to be charged for the introductions being provided. I quote 'The British consulate offices in Washington and Los Angeles will charge a fee for making the connections within NASA and the prime contractors, taking care of logistics and for aspects of mission organisation that will be passed onto mission delegates. We have agreed with the consulate offices on a per company charge of £480 + VAT for the mission.'

"I would end by making the point that these guys are the very same ones who regularly contact me asking for names and introductions to various contacts that I have around the world. Can you imagine them ever paying me/ us for such information?"

- b. "For me this comes on top of recently having to pay the Consulate in Taiwan £500 to validate an electronic signature on a UK Export Licence – because the new electronic signature had not been agreed with the countries to which it applied. Our customer, the Taiwanese Government, wouldn't believe the signature."

Trade shows

44. Trade shows are vitally important to companies selling capital goods overseas. 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.
45. BIS needs to do more to ensure that UK trade show participation doesn't compare unfavourably with our major competitors. That doesn't necessarily mean having contingents of a similar size. But we do need to show that the UK has the depth of supply chain and manufacturing to match others. Key sector events are one route to achieving this and may be under threat of further budgetary cuts.
46. A study (2007) by the International Consultancy Group for the Manufacturing Technologies Association (an EAMA member) comparing the UK's support for exporters at international exhibitions with French, German, Italian, Spanish, Turkish and Chinese practice found that:
 - c) UK's competitors offer more funding and attend the same number or more exhibitions.

- d) The competition is very strong and more adept at involving all 'stakeholders'. It is also growing fast in places like Turkey and China.
 - e) Other countries don't restrict support to categories such as 'new to export', or SMEs. Unlike the UK, they use their support to have a broad swath of industry represented.
 - f) France and Germany in particular have a range of schemes that support companies under a variety of different scenarios, for example encouraging prospecting in markets over time or supply chain co-operation at exhibitions.
47. Our member associations are Accredited Trade Organisations (ATOs) to the Trade Access Programme (TAP). Some have offices in China and Russia. In their view what's appropriate when supporting major defence, infrastructure and natural resource deals doesn't necessarily apply when it comes to selling operating equipment into overseas businesses.
48. 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.
49. 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:
- a) Encourage different sectors (e.g. consumer, investment and industrial goods producers) to tackle what they see as their most prospective markets.
 - b) Task the export agency with delivering a high profile British branded presence at prestigious trade shows around the world.
 - c) 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).
 - d) Manage a range of alternative services to create a wider and more confident exporting presence at exhibitions, trade shows and missions.
 - e) Cut out prescription (e.g. three visits might arguably be OK for a medium priced consumer goods exporter in a European market, but it certainly won't do for specialist machinery manufacturers establishing their credentials in a market like the USA or China).
 - f) Ensure that the agency works with trade associations that are able to demonstrate existing export promotion expertise or a willingness to develop it.
50. Absent such a move we would like to see clear and consistent guidelines about charging and the levels applicable. The guideline ought to be to ensure the best quality result, not to raise revenue. In addition:
- a) There are areas where UKTI could work much more closely with trade associations. For example, some trade associations have their own overseas trade offices to support their members (e.g. in Russia, China, Brazil and the USA). Here is an opportunity to optimise sector initiatives by encouraging wider geographical coverage promoting technical specialities through these offices.
 - b) There is still a lot of confusion about the way UKTI is funded and on what basis its funds are allocated to trade promotion and other activities.
 - c) For example in Resource Accounts 2009-10, the total UKTI budget is put at £350 million, £81 million of which is staff costs (UKTI, BIS, FCO). £100 million is spent on UKTI programmes (including revenue of £6 million from sales of OMIS¹ charges to users). £8 million is spent on supporting trade shows. The remaining 50% goes on BIS and FCO administration. These costs are then placed against some impressive outputs/outcomes to provide some management measurement.
 - d) Trade associations and other organisations involved in promoting export and developing links with UKTI would find other information more useful, e.g. breakdown of companies by size and sector, activity type and service rating. After all as partners working with UKTI, their members are the exporters.

Cross departmental responsibilities

- 51. All 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.
- 52. 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

¹ OMIS = Overseas Market Information Service under which firms pay for services supplied.

comprehensive and don't produce conflicting outcomes and pressures other than at the policy margin.

53. For example, most potential investors coming to the UK will only consider a sales office if they are looking at the UK exclusively as a market. It's only if they want to export competitively from the UK into Europe or elsewhere that they'll consider something more substantial. So actually, the main trade and inward investment considerations for mechanical engineering firms relate to exporting from the UK, the investment environment and the policy pressures and regulations on operations based here.
54. Many departments of state therefore have an impact on policies that affect UK-based manufacturers' ability to export and the country's attractiveness in inward investor's eyes.

Sounding out policy alternatives within industry -- top down vs. bottom up

55. As previously mentioned (para 4) companies in this sector supply other industries so their products don't have the general recognition or immediate visual impact of cars or planes. But OEMs including those producing cars and planes depend on them.
56. Many primes, like some of the supermarkets in retail, have sought cost out at the expense of supply chain margin with a corrosive impact on their supply chains' investment performance and innovation.
57. 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. But government also needs to 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 within the supply chains -- they are exporters and also release and invest in technological innovation on their own account. And after all government recognises that much of the economy's innovation so vital to our export potential lies within these SMEs.