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State of Industry Report

Q3 2023

Executive summary

- The Q3 FDF net confidence score reached 6% in Q3, the first positive value since Q2 2021, a sign that market conditions have stabilised.
- Labour vacancies rose in Q3 to 6.5% up from 4.8% in Q2, due to increased production ahead of Christmas resulting in more job openings that were difficult to fill. Vacancies persists across all skills levels.
- 41% of businesses plan to increase their capital investment, while 18% expect a decrease over the coming year. This is against a significant fall in industry investment of 36% in H1 2023 compared to H1 2019.
- Innovation is key to maintaining competitiveness, hence a top priority for 81% of manufacturers. Grocery volumes are in decline and consumer behaviours are changing, with 73% of businesses noticing a notable shift towards cheaper products.
- Poorly designed regulation hinders growth. 68% of manufacturers are concerned about forthcoming packaging regulations and 65% worry about upcoming carbon footprinting/ net zero regulations.
- Manufacturers faced higher costs of 14.2% over the last year, while selling prices rose by 10.0% and pay by 5.2%. Costs are expected to rise by 3.9% over the next year, and prices by 2.7% and pay by 4.9%, on average.

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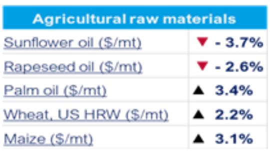
Prices dashboard

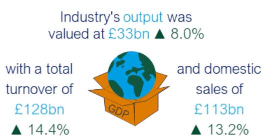


Agricultural raw materials	
Sunflower oil ($/mt)	▼ - 3.7%
Rapeseed oil ($/mt)	▼ - 2.6%
Palm oil ($/mt)	▲ 3.4%
Wheat, US HRW ($/mt)	▲ 2.2%
Maize ($/mt)	▲ 3.1%

Inflation commentary

Trade snapshots

Industry facts and stats



Investment has taken a hit

Food and non-alcoholic drink annual inflation eased for the seventh consecutive month in October to 10.1%, down from 12.2% in September. On the month, prices rose by 0.1%, compared to a monthly decline of 0.1% in September, a sign that it will take a while for prices to embark on a downward trajectory.

Annual inflation has been slowing for 36 categories out of the 49 main categories reported by the ONS, with butter and milk firmly in deflationary territory (Chart 1). In sharp contrast, olive oil and sugar continued to see eye-watering price rises of 49.6% and 50.2%, respectively.

Some producer costs are falling. UK-sourced ingredients were 1.9% cheaper compared to a year ago, but 0.7% more expensive on the month, the first monthly rise since May. Imported ingredients were 9.0% more expensive on the year and 0.6% on the month.

But the battle with inflation is not yet over. Persistent labour shortages continue to put pressure on manufacturers' labour cost bill. The weakening of the sterling for six months to November pushed up the cost of imports as most agricultural commodities are traded in US dollars. Adverse weather patterns and low fertiliser use over the last year has reduced yields and quality. All of this means we are likely to see ongoing inflationary pressures.

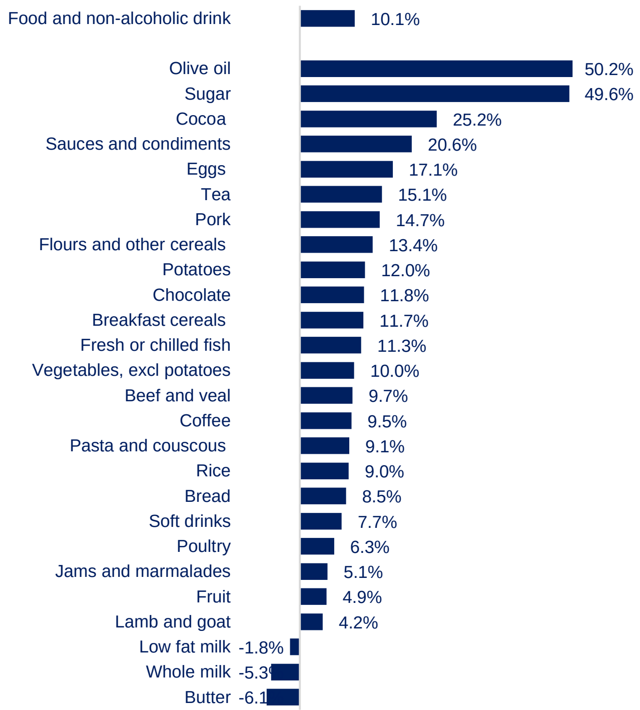
Almost three years of intense cost pressures left the industry in a difficult place. A new OC&C study shows that operating margins across the top 150 manufacturers fell from 6.2% to just 3.9% in 2022, an all-time low in the near 40 years since records started.

Equally, the cost of living crisis left many households in a dire financial situation, causing a persistent decline in grocery sales volumes and a notable shift to own-label products. To rebuild margins and grow, manufacturers need to either be able to raise prices or increase sales, neither likely in today's environment.

Industry's investment has been on a steep downward trajectory since Q3 2021 (Chart 2). During the first half of 2023, compared to the first half of 2019, food and drink manufacturing investment was 36% lower and 17% lower compared to the first half of 2016. This is in sharp contrast with a rise in UK investment by 7% or 6%, respectively. Investment is the engine of future growth and a drop in investment will negatively impact the industry's growth and productivity as well as its global competitiveness.

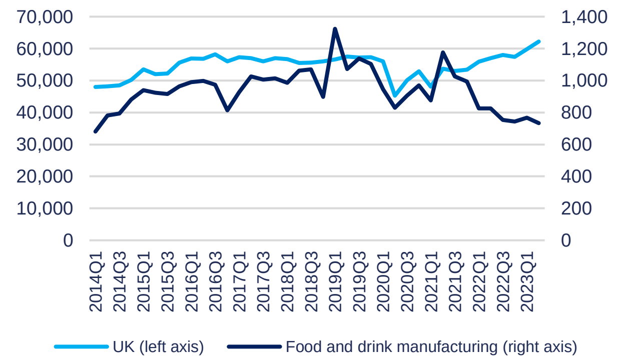
Production in some subsectors is contracting. In Q3, the meat, dairy, grain mill and non-alcoholic drink sectors were smaller both compared to Q3 2022 and to Q2 2023 (Chart 3).

Chart 1: Inflation by category, October 2023



Source: ONS

Chart 2: Business investment



Source: ONS, Business investment, £ mil, chain volume measures, NSA.

Chart 3: Growth by sector, Q3 2023

	Q3 2023 on Q3 2022	Q3 2023 on Q2 2023
Food manufacturing	**1.2%**	**1.3%**
Meat	-0.4%	-0.1%
Fish, fruit and vegetables	-4.3%	0.7%
Oils and fats	0.0%	4.5%
Dairy	-4.5%	-0.1%
Grain mill and starches	-1.1%	-0.9%
Bakery	4.0%	2.0%
Other food products	5.3%	2.8%
Non-alcoholic drink manufacturing	**-4.1%**	**-5.8%**

Source: ONS, GVA, chained volume measures.

Business conditions are stabilising

The FDF net confidence score for Q3 entered positive territory for the first time since Q2 2021, reaching 6% (Chart 4). Net confidence is the difference between businesses who perceived business conditions had improved in Q3 from Q2, and those believing conditions had deteriorated. Businesses that saw conditions remained the same are therefore excluded from this calculation. 44% believed conditions remained unchanged. 31% of businesses said conditions had improved, up from 26% in Q2.

Perceptions of market conditions varied by business sizes. 40% of large business sizes felt that conditions improved compared to Q2, while SMEs fared worse, with 34% feeling that their circumstances deteriorated (Chart 5). Two-thirds (33%) of mid-size companies saw an improvement, while a quarter (25%) of them experienced a deterioration.

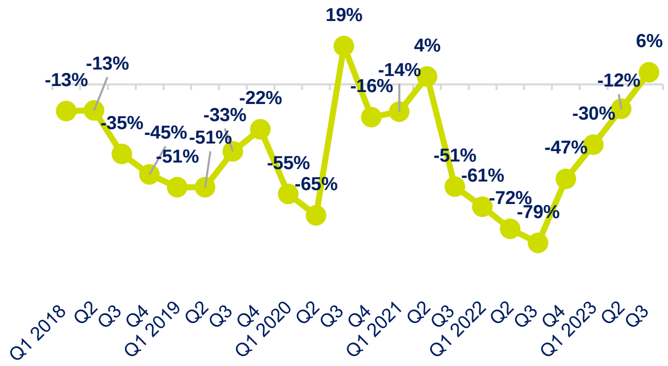
Looking ahead to Q4, the outlook confidence score for Q4 is 16%, highlighting that businesses are more optimistic and are largely expecting stability, with over half (53%) of respondents believing that conditions will remain the same. Outlook perceptions broken down by business size show all large businesses expect similar conditions in Q4, half (50%) of mid-size companies anticipate an improvement, while 27% of SMEs expect a deterioration (Chart 6).

Conditions are stabilising because market volatility has dissipated compared to last year, and not because costs have come down across the board. However, many prices remain significantly higher than pre-pandemic, with global food prices 21% higher and energy more than double.

The question now is how fast inflation will continue to fall. The Bank of England predicts that food inflation will average 9% over the remaining 3 months of the year and around 5% for the first three months of 2024. And while that is likely to happen, the difficulty will be in bringing down the inflation rate below 5%.

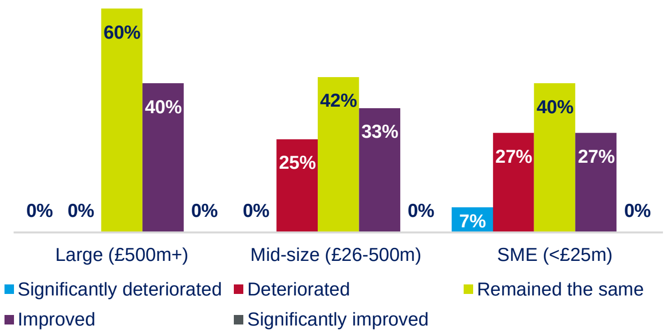
Since August, the Bank of England has kept the base rate at 5.25%. Although no more rises are expected for the near future, the transmission mechanism by which higher borrowing costs put downward pressure on prices will take time for the full impact to be felt in the economy. The increases in interest rates over the last 18 months have made borrowing more expensive, posing a headache for SMEs especially, that typically operate on smaller margins and are more cash constrained.

Chart 4: FDF net confidence score



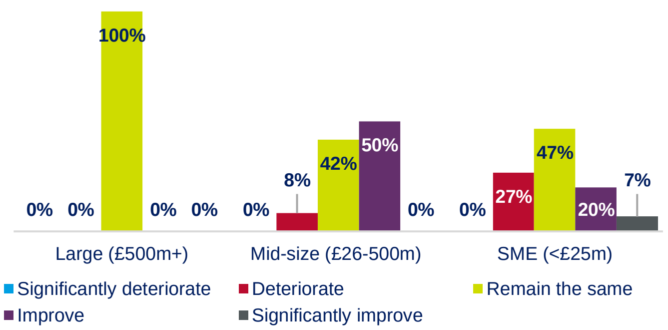
Source: FDF State of Industry Survey

Chart 5: Business conditions in Q3 2023 compared to Q2 2023 by business size



Source: FDF State of Industry Survey

Chart 6: Expectations about business conditions in Q4 2023 relative to Q3 2023 by business size



Source: FDF State of Industry Survey

Labour shortages rise in the run-up to festivities

Industry's vacancy rate (the number of vacancies per 100 employees) rose in Q3 to 6.5% from 4.8% in Q2 (Chart 7). This is the first increase in the vacancy rate since Q3 2022. Labour shortages remain higher than those in wider manufacturing and the UK, of 2.9% and 3.1% respectively.

In the lead up to Christmas, it appears that there is a seasonal impact in Q3, with more job openings being created in the build up to the festive season. Labour shortages continue to hold back growth, with a lack of available staff and skills having repercussions on rebuilding margins and investment.

Nearly two-thirds of manufacturers (65%) reported vacancies of 0 to 5%. By size, 80% of small businesses had vacancies in the 0-5% range, and half (50%) of large businesses reported vacancy rates between 6-10%. Some mid-size businesses were severely impacted, with 17% of them reporting a vacancy rate between 16-20%.

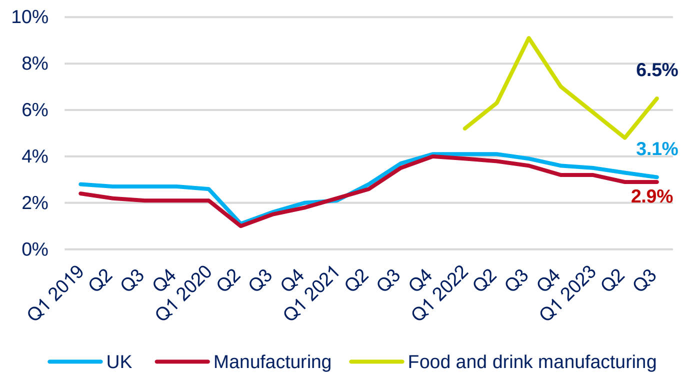
Unfilled vacancies continue to affect a wide range of roles and skills, including: **high-skilled workers** (project engineers, scientists, finance, software engineers), **technical specialists** (PLC control, field sales support, process experts), and **production operatives** (machine operatives, cleaning, warehouse, and factory operatives).

Faced with persistent labour shortages and rising costs, the industry saw average pay rise by 5.2% over the year to September 2023. Over a third (37%) offered pay rises ranging from 4.1 to 6%, while 37% offered pay rises over 6% (Chart 8). Over the coming year, industry expects average pay to increase by 4.9%.

Starting April 2024, minimum wages will rise by 9.8%, following a rise of 9.7% in April 2023. While this will be a great help for employees on minimum rates, this will negatively impact wage differentials, as few businesses will be able to increase all wages by 9.8%. In today's tight labour market, that will mean food manufacturers, SMEs in particular, will find it even harder to attract higher skilled workers.

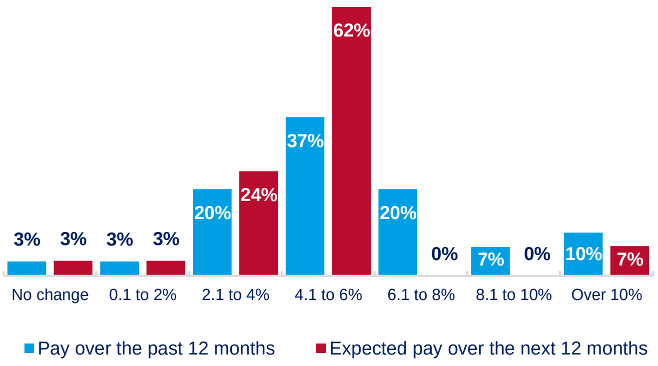
To deal with wage inflationary pressures, over three quarters of manufacturers (76%) have paid larger wage increases compared to the previous year, with 31% also offering bonuses (Chart 9). 28% of manufacturers offered more generous non-monetary compensation in the form of recognition, meals or extra holidays and 14% agreed to multiple pay rises over the last year to September. Some businesses have also launched financial wellbeing platforms to provide extra support to their employees.

Chart 7: Vacancy rate in UK, manufacturing and food and drink manufacturing *(vacancies per 100 employees)*



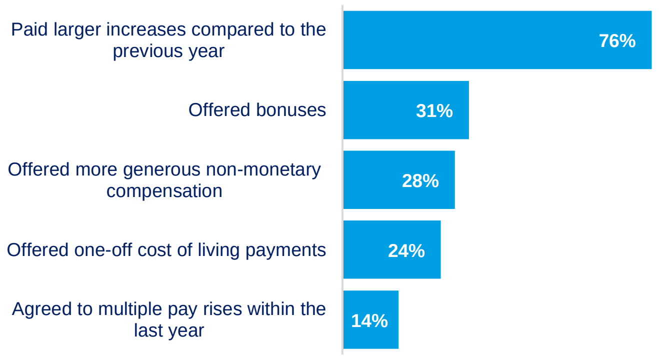
Source: FDF State of Industry Survey and ONS

Chart 8: % of manufacturers that offered pay increases and expectations of pay rises over the next year



Source: FDF State of Industry Survey

Chart 9: Dealing with wage inflationary pressures



Source: FDF State of Industry Survey

Some cost pressures are subsiding

On average, total production costs increased by 14.2%, while selling prices rose by 10% over the year to September 2023. Nearly half (49%) of respondents listed cost rises of over 10%, down from two-thirds (67%) of respondents who experienced this in Q2. The most common price rise (for 31% of companies) was between 0.1 to 5% (Chart 10).

By business size, smaller companies are still absorbing a larger share of the rising costs, with 27% of small business seeing their average selling price stay the same. Smaller producers have little bargaining power with retailers, as own-label products do not benefit from brand loyalty and many face intense competition.

On average, it's expected that production costs will rise by 3.9% and prices by 2.7% over the coming year. 20% of manufacturers expect total production costs to decrease, with a similar proportion (19%) also expecting decreases in average prices.

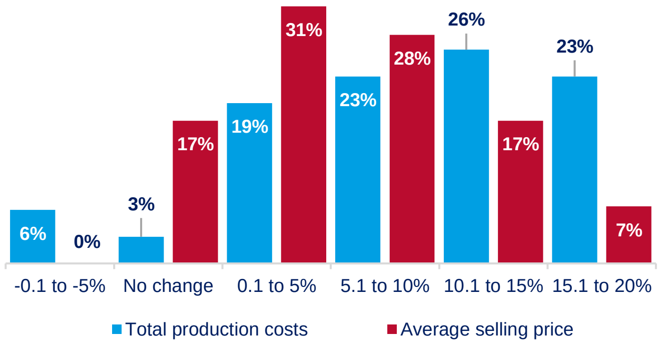
Forthcoming regulation is a concern for many manufacturers. Over two-thirds of businesses are worried about upcoming packaging regulations (68%) and carbon footprinting/ net zero (65%) (Chart 11). 39% are apprehensive about HFSS (high in fat, salt or sugar) regulations and the Windsor Framework, while border changes and new trade deals also pose a headache. It is critical that government works with industry to design appropriate and efficient regulation to improve the business environment and to avoid driving up unnecessary costs.

Amongst these, the 'not for EU' labelling is particularly concerning, as it has the potential to be extremely costly, with manufacturers having to duplicate production processes and hire extra warehousing space, without providing any benefit.

On average, in Q3 2023, energy amounted to 8.1% of costs, up from 6.9% in Q3 2022, but below 8.4% seen in Q2 2023. By size, energy accounts for less than 5% of their operating costs for half of large businesses (50%) and between 10 and 19% for 50% of mid-size companies (Chart 12).

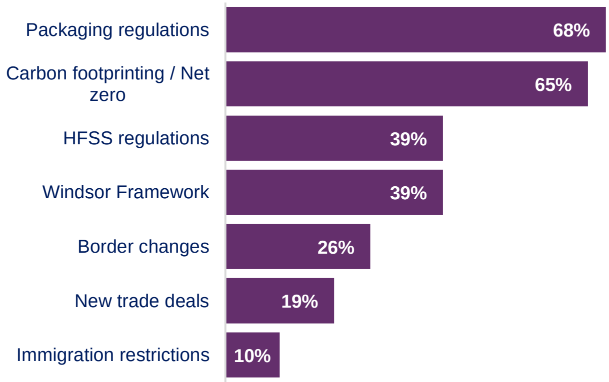
Risks of rising costs in the near future come from the mixed impact of weather and lower fertiliser use, high energy costs, geopolitical factors, such as Ukraine finding it more difficult to ship grains out or the escalation of the Middle Eastern conflict, or forthcoming regulations.

Chart 10: Changes in total production costs and average selling price over the year to September 2023



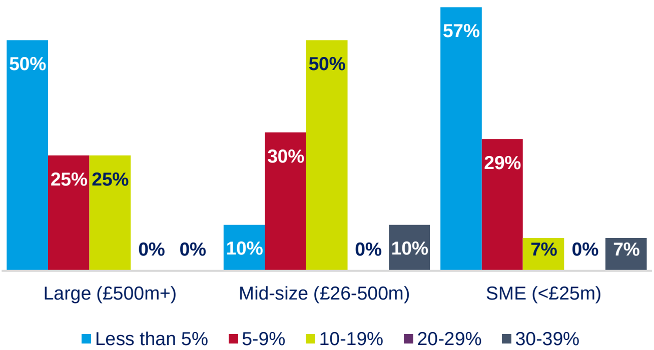
Source: FDF State of Industry Survey

Chart 11: Concerns about forthcoming regulation



Source: FDF State of Industry Survey

Chart 12: Energy as a percentage of operating cost base by business size



Source: FDF State of Industry Survey

Intense focus on innovation

Manufacturers prioritise innovation more than ever, with 81% of them, up from 54% in Q2, focusing on new product development (Chart 13). Over the last couple of years, manufacturers have seen a deep erosion of their profit margins and a change in consumer behaviour towards buying fewer and cheaper goods. In this context, developing new products helps maintain competitive advantage. All large businesses and most (91%) mid-size companies stated they are developing new products.

42% of businesses aim to restructure operations and 39% seek to adapt and/or simplify their supply chains to support their growth. A third (33%) of mid-size businesses prioritise automation, and a third (33%) of SMEs and mid-size businesses focus on energy efficiency.

In support of prioritising innovation, 41% of businesses plan to increase their capital investment expenditure in the next 12 months and only 18% expect to incur lower capital expenditure (Chart 14). Some manufacturers have plans of acquiring new equipment or of refurbishing their facilities, while others stated they have no profits to reinvest or that they had to reduce their investment in order to manage cashflow.

The announcement in the Autumn Statement that 100% of the first year capital allowance (Full Expensing) will be made permanent was welcomed news for the industry, as it provides certainty for businesses who want to invest in vital plants and machinery and helps with their cashflow.

The likeliest factors that could deter investment over the next 12 months were: changes in projected net returns (58% of respondents), uncertainty about demand (50%) and uncertainty about regulation (31%).

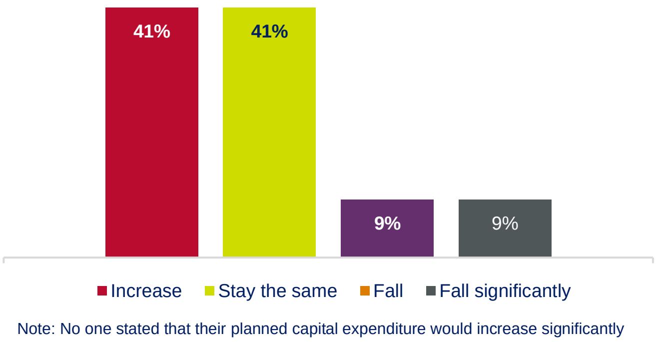
Just less than a third (31%) of businesses report that their output has decreased over the year to September 2023, while 34% have increased production (Chart 15). 58% of manufacturers are optimistic and believe they'll grow their business over the next year. Only 10% think that they will see a reduction.

Over the past year, manufacturers have dealt with cost pressures in a variety of ways. Our past surveys found that 73% of manufacturers have changed their procurement strategies and/or switched suppliers, 60% has paused or cancelled investment and 31% have reduced product lines. In addition, they have absorbed cost rises, and cut their marketing or training budgets. The focus on new product development will help businesses to remain competitive while increasing choice and quality for consumers.

Chart 13: Top three growth priorities

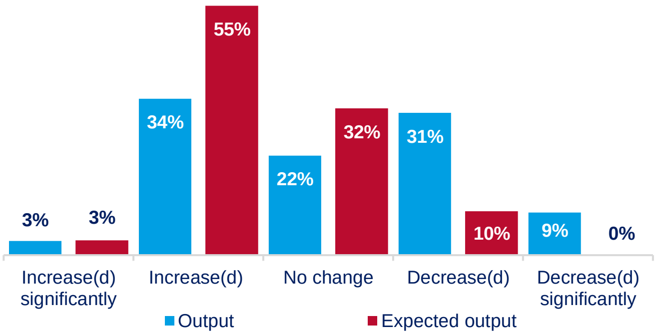
Source: FDF State of Industry Survey

Chart 14: Expectations of planned capital investment expenditure over the next 12 months



Source: FDF State of Industry Survey

Chart 15: Output changes in the year to September 2023 and expected output changes over the next 12 months



Source: FDF State of Industry Survey

Who responded?

There was strong representation from the industry, with companies from all turnover bands, all employment sizes and from a wide range of industry sub-sectors.

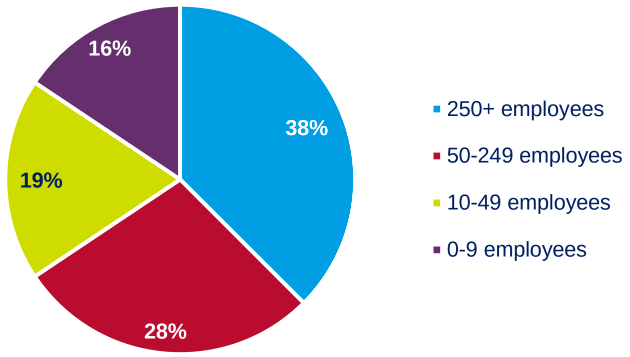
38% of the businesses surveyed are large employers with more than 250 employees, while 16% are micro-businesses with fewer than 10 employees (Chart 16).

By turnover, over a quarter (28%) are small businesses with a turnover of £5m or less, while 9% are businesses with a turnover in excess of £1bn (Chart 17).

Businesses also represent a wide variety of sectors (Chart 18). A half (50%) operate in the bakery goods sector. The second best-represented sectors are soft drinks and ingredients, with 25% each.

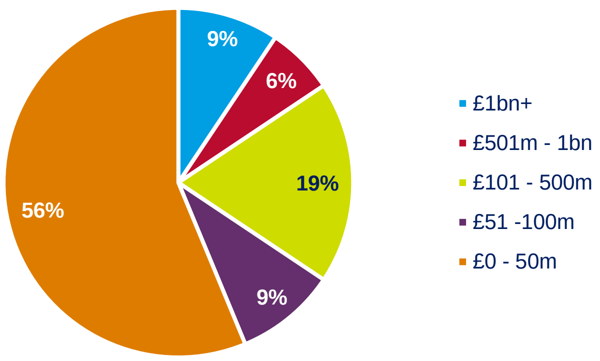
69% of manufacturers operate in England, while 19% manufacture in Scotland and 16% have production facilities located in Wales.

Chart 16: Respondents by employment size



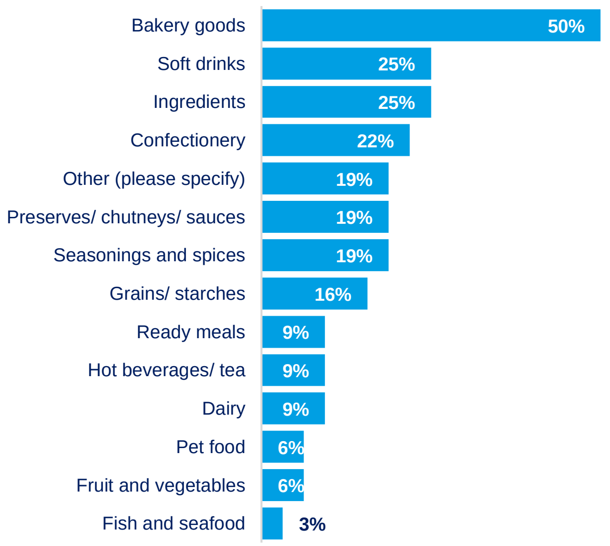
Source: FDF State of Industry Survey

Chart 17: Respondents by turnover



Source: FDF State of Industry Survey

Chart 18: Respondents by sub-sector



Source: FDF State of Industry Survey

About the FDF

The FDF is a powerful voice for the UK's vibrant, resilient and diverse food and drink manufacturing industry. For over 100 years, we have successfully contributed to policy making and legislative development, championing our members' views – large and small – on the critical issues of the day.

We bring together business, government and stakeholders to ensure our manufacturers have the right conditions to grow, invest and employ, while continuing to produce high quality, nutritious and affordable food and drink. With more than 1,000 members – from the most recognisable global brands to the most innovative start-ups – we represent the largest manufacturing sector in the country.

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