fdf | FOOD & DRINK POWERS OUR NATION

State of Industry Report

Q4 2023

Executive summary

- The Q4 FDF net confidence score fell to 0%, the first decline in five quarters. The outlook confidence score for Q1 2024 is 31%. Businesses are more optimistic as they expect stability or improved market conditions.
- Labour vacancy rates fell to 5.2% in Q4 from 6.5% in Q3, but remained significantly above rates in manufacturing (2.7%) and the UK (3.0%). SMEs were impacted the most by labour shortages, with vacancies running at 6.0%, higher than those of large businesses (5.5%) or mid-size businesses (4.3%).
- We estimate that persistent labour shortages have cost the industry about £1bn in lost output in 2023.
- With the new Border Target Operating Model in effect from 31 January 2024, manufacturers are most concerned by new inspection fees (36%) and the readiness of EU suppliers (23%).
- The industry is firmly focused on growth in the new year, with 73% of manufacturers aiming to grow sales in the UK market and 66% to develop new products.
- 43% of respondents aim to increase their investment in skills in 2024 and 41% in plant and machinery. 65% of manufacturers intend to make use of full expensing capital allowance now that it is permanent.

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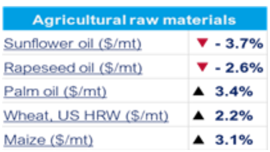
Prices dashboard

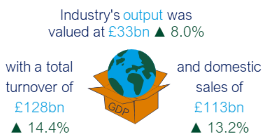


Agricultural raw materials	
Sunflower oil ($/mt)	▼ - 3.7%
Rapeseed oil ($/mt)	▼ - 2.6%
Palm oil ($/mt)	▲ 3.4%
Wheat, US HRW ($/mt)	▲ 2.2%
Maize ($/mt)	▲ 3.1%

Inflation commentary

Trade snapshots

Industry facts and stats



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2023 was a difficult year

Food and non-alcoholic drink annual inflation slowed for the tenth consecutive month in January to 7.0%, down from 8.0% in December, the lowest rate since April 2022. On a monthly basis, prices fell by 0.4%.

Of the main 49 product categories reported by the ONS, five were in deflationary territory, with prices of whole milk and butter dropping at the fastest annual pace (Chart 1). Inflation slowed for 30 of the remaining categories. Olive oil and 'cocoa and powdered chocolate' saw the highest price rises, linked to poor harvests.

On the cost side, producers saw overall costs fall on the year by 0.9%, with prices of UK-sourced ingredients dropping 2.1%, while prices of imported ingredients rose by 4.5%. On the month, overall costs fell by 0.5%.

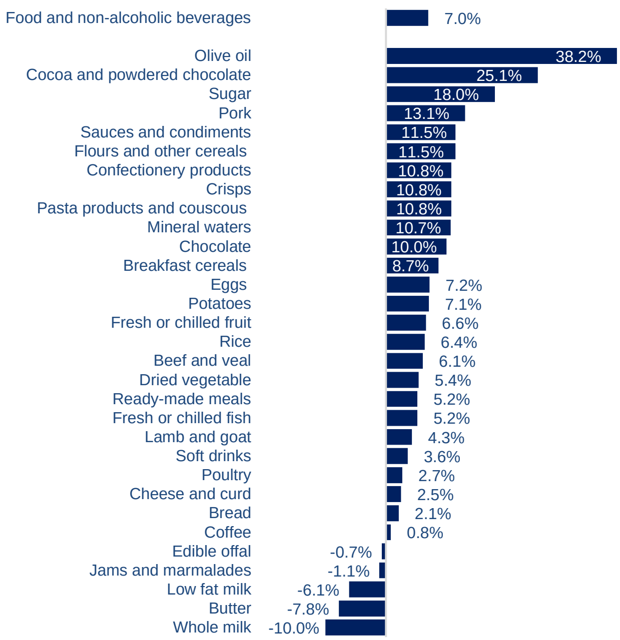
There's hope that 2024 will see the industry grow, following a very challenging period. The sharp rise in all costs over the last few years coupled with the cost-of-living crisis for households, meant that many food and drink manufacturing sub-sectors have shrunk. With the exception of bakery sector and 'Other food products' sectors, which includes condiments and spices or ready meals, all sub-sectors of the industry were smaller at the end of 2023 than they were a year ago (Chart 2). Moreover, insolvencies in the industry reached 288, up from 244 in 2022 or 122 in 2019. Compared to 2019, the number of insolvencies in the industry rose by 136%. That compares to a rise of 35% in Great Britain and 45% in the whole manufacturing sector.

All of this means that the recovery of the industry hinges on its ability to invest. Businesses postponed or cancelled investment projects and diverted those funds into day-to-day operations. As a result, business investment has seen a sustained decline over the last few years (Chart 3). Over the year to Q3 2023, investment was 33.2% lower, in real terms, than over the same period in 2019, contrasting with the UK as a whole where investment rose by 5.4%.

Weak food demand renders that recovery difficult. In volume terms, December retail food sales were 4.9% lower than in December 2019. But January brought a strong rebound, with sales rising by 3.4% on the month.

In summary, the economic landscape is still a difficult one for food and drink manufacturers, but lower cost pressures and improving household finances offer hope of a recovery.

Chart 1: Inflation by category, January 2024



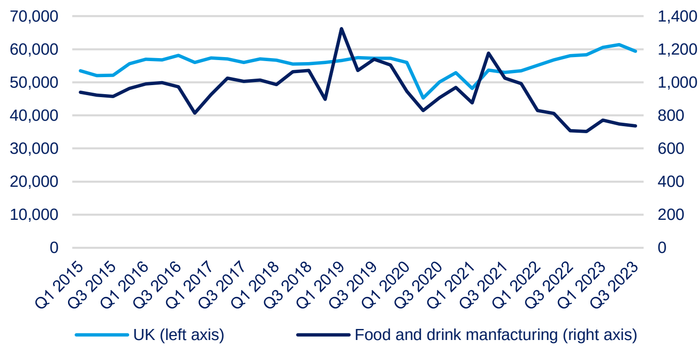
Source: ONS

Chart 2: Growth by sector, Q4 2023

	2023 on 2022	Q4 2023 on Q4 2022
Food manufacturing	**0.3%**	**4.1%**
Meat	-0.6%	-1.2%
Fish, fruit and vegetables	-2.5%	3.9%
Oils and fats	-2.2%	4.5%
Dairy	-3.8%	-0.8%
Grain mill and starches	-3.6%	-6.8%
Bakery	7.1%	11.5%
Other food products	1.1%	8.7%
Non-alcoholic drink manufacturing	**-1.6%**	**-0.8%**

Source: ONS, GVA, chained volume measures.

Chart 3: Business investment



Source: ONS, Business investment, £ mil, chain volume measures, reference year = 2019.

Manufacturers see more positive outlook

The Q4 FDF net confidence score fell to 0%, the first decline in five quarters (Chart 4), as more businesses perceived no change in the business climate. This score is calculated as the difference between the share of respondents perceiving improved business conditions in Q4 from Q3 and the share of respondents believing conditions had deteriorated. Businesses that saw conditions unchanged are therefore excluded from this calculation. 47% believed conditions remained the same, with 27% of businesses seeing improved conditions on the quarter, down from 31% in Q3.

Perceptions of market conditions varied by business sizes, with a pronounced difference between large companies and SMEs (Chart 5). 44% of large businesses saw better conditions in Q4 and 11% saw worse conditions. In sharp contrast, only 6% of SMEs fared better, while 50% felt their circumstances had deteriorated. One third (35%) of mid-size companies saw an improvement, whereas 15% of them had experienced a deterioration.

However, the outlook confidence score for Q1 2024 is 31%. Businesses are more optimistic as they expect stability or improved market conditions. Half of respondents (51%) believe conditions will not change. Large companies are more positive, with over half (56%) of large businesses expecting improved business conditions, compared to only 38% of mid-sized companies and 38% of SMEs (Chart 6).

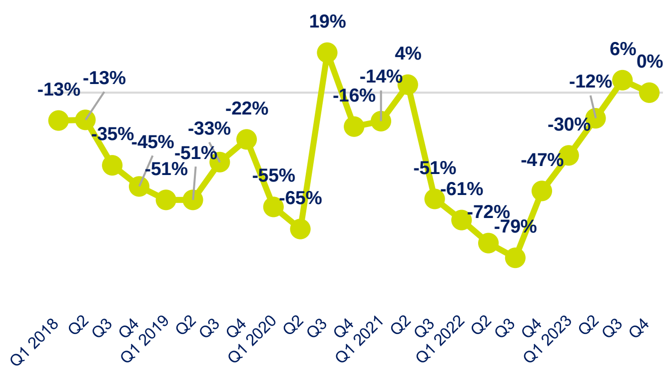
These positive expectations are driven, in part, by the outlook of inflation and of the wider economy.

Inflation is expected to continue to slow over the coming months, with a range of factors at play. Some inflationary pressures will persist, such as wage growth. A record increase of 9.8% in the National Living Wage in April 2024 will impact business costs for manufacturers, but also supermarkets, where a large share of the retail labour force is on minimum wage rates.

At the same time, the steady falls in global agricultural commodities and energy prices are dampening inflationary pressures.

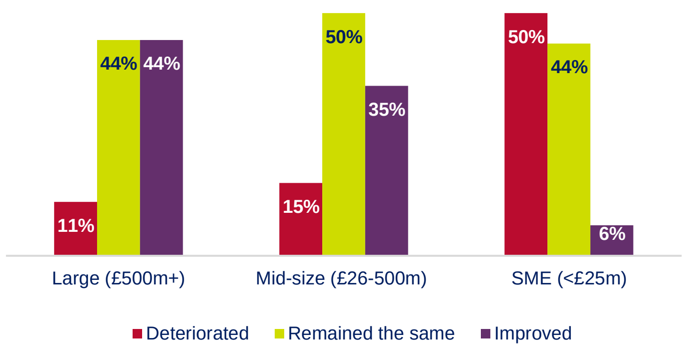
While geopolitics, unusual weather and upcoming domestic regulations introduce further uncertainty for the future path of UK food inflation. The longer the Middle East conflict continues, the higher the potential to negatively impact the cost of oil and energy, which then will influence food prices. Forthcoming domestic regulation, for example 'Not for EU' labelling regulation, will impose sizeable costs and further deter investment.

Chart 4: FDF net confidence score



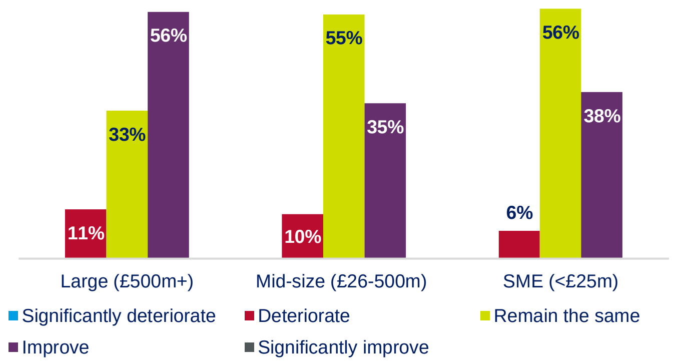
Source: FDF State of Industry Survey

Chart 5: Business conditions in Q4 2023 compared to Q3 2023 by business size



Source: FDF State of Industry Survey
Note: nobody chose 'significantly deteriorated' or 'significantly improved', although those choices were offered.

Chart 6: Expectations about business conditions in Q1 2024 relative to Q4 2023 by business size



Source: FDF State of Industry Survey

Labour shortages hurt small businesses the most

There were fewer labour shortages in the industry in Q4, with the vacancy rates falling to 5.2% from 6.5% in Q3 (Chart 7). Labour shortages remain higher than those in wider manufacturing and the UK, of 2.7% and 3.0% respectively.

Two-thirds of manufacturers (67%) reported vacancies of 0 to 5%. By size, 75% of mid-size businesses had vacancies in the 0-5% range, and half (50%) of large businesses reported vacancy rates between 6-10% (Chart 8). Some small businesses were greatly impacted, with 13% of them reporting a vacancy rate between 11-15%.

Unfilled vacancies continue to affect a wide range of roles and skills, including:

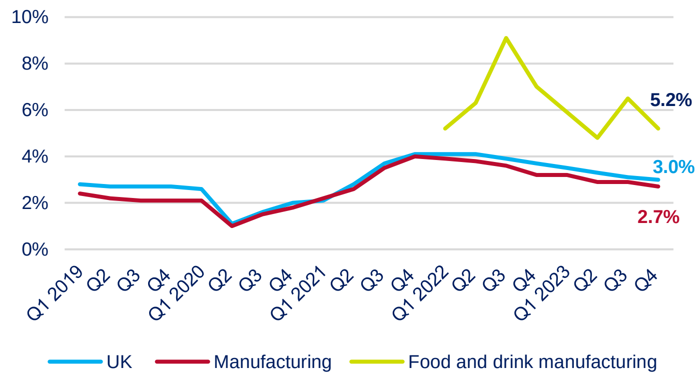
- **High-skilled workers:** project engineers, cyber security, accounting, finance, and engineering.
- **Technical specialists:** robot operatives, food safety specialist, electrical maintenance technicians.
- **Production operatives:** packers and food handlers, warehouse and factory operatives, forklift truck drivers.

SMEs reported a vacancy rate of 6.0% on average, higher than that of large businesses (5.5%) or mid-size businesses (4.3%). Labour shortages are impacting smaller businesses more, given the competitive nature of the UK labour market. With fewer resources and less control over their pricing policies, SMEs are likely to find it more difficult to compete for talent with larger manufacturers.

Labour shortages continue to hold back the growth potential of food and drink manufacturing. We estimate that persistent labour shortages have cost the industry about £1bn in lost output during 2023.

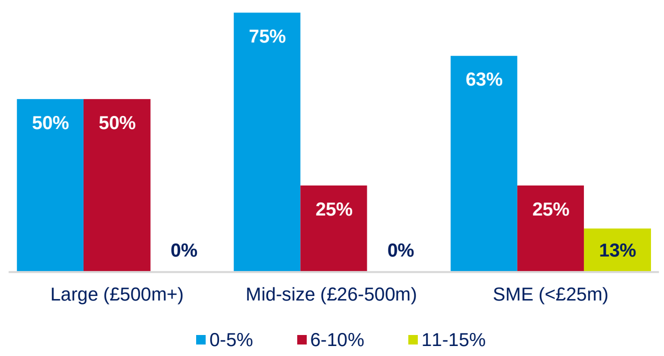
Labour shortages are also reflected in the capacity utilisation rate. Generally, an operation rate of about 80 to 85% of full capacity is considered optimal. In 2023, the industry's average rate of operation was 71.3% (Chart 9). By size, the utilisation rate stood at 73.4% for large businesses, 78.1% for mid-size businesses and at 63.0% for SMEs. The lower utilisation rate in SMEs is consistent with their reported experience of higher labour shortages.

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



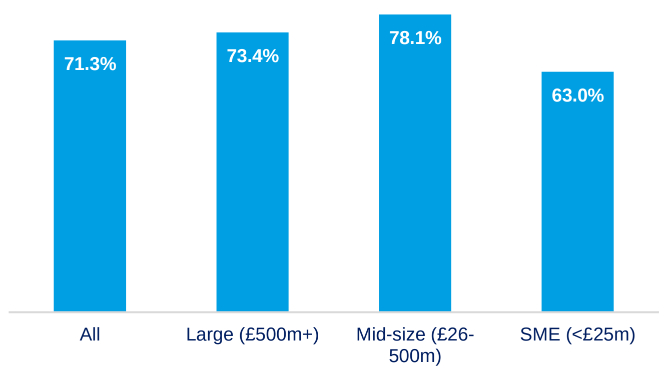
Source: FDF State of Industry Survey and ONS

Chart 8: Vacancies by business size



Source: FDF State of Industry Survey

Chart 9: Average rate of operation as a percentage of full capacity over 2023



Source: FDF State of Industry Survey

Cost pressures are abating

On average, total production costs increased by 12.8%, while selling prices rose by 8.6% in 2023. However, at the individual business level, experiences were mixed. 45% of respondents listed cost rises of over 10%, 48% of up to 10%, while 3% reported their costs had actually declined (Chart 10). A quarter of respondents (25%) stated their prices rose by over 10%, with 5% of respondents seeing lower selling prices and 13% unchanged prices from the previous year.

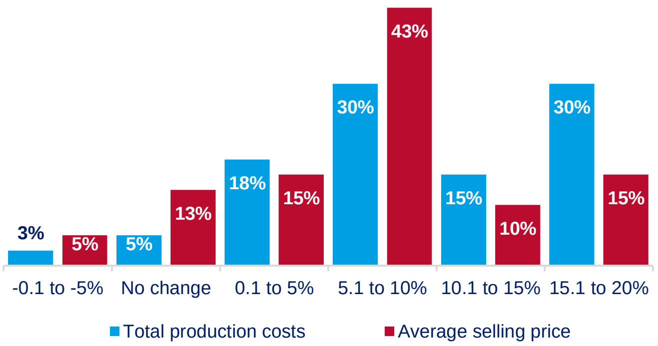
By business size, a quarter (25%) of small business saw their average selling price unchanged, highlighting that smaller producers have little bargaining power with retailers, as own-label products do not benefit from brand loyalty and many face intense competition.

For 2024, it's expected that production costs will rise by 4.1% and prices by 2.3%. 18% of manufacturers expect total production costs to stay the same, with a higher proportion (29%) also expecting no change in average prices.

The Border Target Operating Model (BTOM) came into effect on 31 January 2024. Manufacturers are most concerned by new inspection fees (36%), the readiness of EU suppliers (23%) and the UK port infrastructure (15%) (Chart 11). From the end of January, the BTOM will add to cost pressures. It is critical that the government works closely with industry to implement or improve regulations that do not work for businesses and add unnecessary cost, and therefore ultimately for UK consumers.

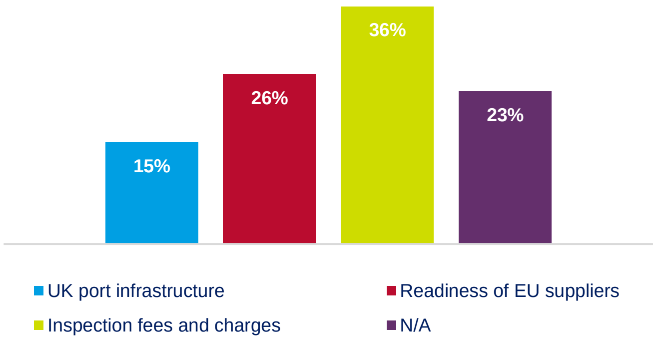
In line with movements in wholesale energy markets, energy costs to producers have declined. In Q4, energy amounted to 6.2% of operating costs, down from 8.1% in Q3 2022. By size, energy accounted for 5-9% of their operating costs for two-thirds (67%) of large businesses and between 10 and 19% for a quarter (25%) of small companies (Chart 12). Energy accounts for the highest percentage of operating costs for smaller companies, at 8.1% of operating cost, compared to 7.9% and 5.6% for mid-size and large businesses, respectively. Global shipping disruption in the Red Sea had increased freight costs, and could have implications on the cost of oil and energy.

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



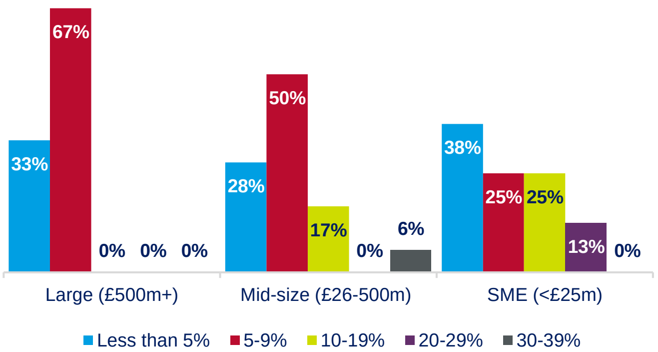
Source: FDF State of Industry Survey

Chart 11: Concerns about the Border Target Operating Model



Source: FDF State of Industry Survey

Chart 12: Energy as a percentage of operating cost base by business size, Q4 2023



Source: FDF State of Industry Survey

The industry is focused on growth

Manufacturers are aiming to increase their sales, with 73% of manufacturers prioritising growth in the UK market (Chart 13). 86% of SMEs aspire to grow their UK sales.

Another top priority for the industry is the continual development of new products, as innovation is key to maintaining competitiveness.

29% of businesses are focused on adapting their supply chains (down from 41% in Q2) and 22% are prioritising restructuring their operations (down from 41% in Q2). The intense cost pressures of the last few years have pushed businesses to switch suppliers and to reorganise their activity, with most companies now switching their focus back onto growth.

SMEs are the least likely to invest in automation to address labour shortages, with 7% of their respondents, compared to 33% and 39% of large and mid-size companies, respectively. Support for SMEs to de-risking these investments is critical to encourage technology adoption.

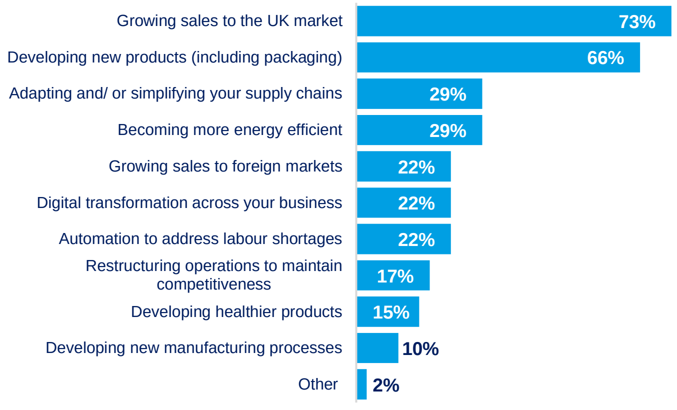
Around half of respondents are planning to keep their investment expenditure on plant and machinery, skills and training, and buildings unchanged (Chart 14). As investment in the industry has been falling for four years, this is not necessarily good news. Nevertheless, 43% of respondents aim to increase their investment in skills and 41% to increase their plant and machinery expenditure.

Now that the full expensing capital allowance has been made permanent, almost two-thirds (65%) of manufacturers intend to make full use of it. This will help businesses with their cashflow, i.e. the ability to claim the tax relief in the first year of their expenditure, and encourage investment in vital plants and machinery.

55% of businesses increased their output in 2023, while 32% produced a lower output (Chart 15). 65% of manufacturers are optimistic and believe they'll grow their business this year, while only 11% think that they will see a reduction.

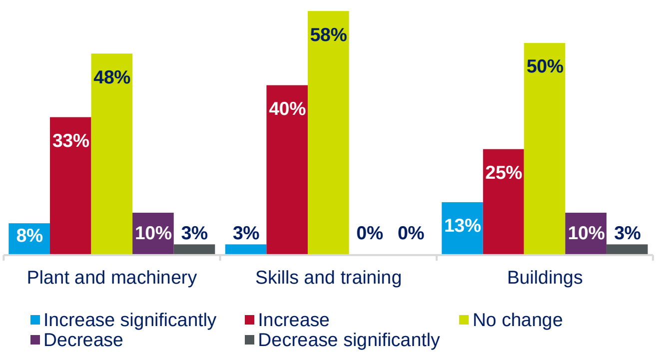
Our previous Q3 survey highlighted that uncertainty about demand, changes in projected net return, and uncertainty about regulation could likely deter investment. Ongoing labour shortages are adding to these barriers, but manufacturers are showing the intention to grow their business in 2024 after a difficult period. Government must continue to prioritise policies that support investment, while also reconsidering planned regulation that may negatively impact business growth plans.

Chart 13: Top three growth priorities



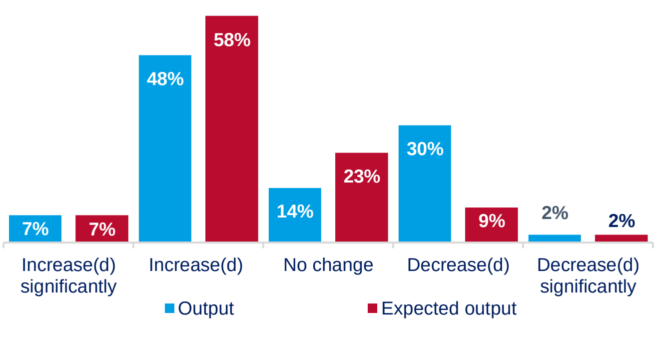
Source: FDF State of Industry Survey

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 December 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.

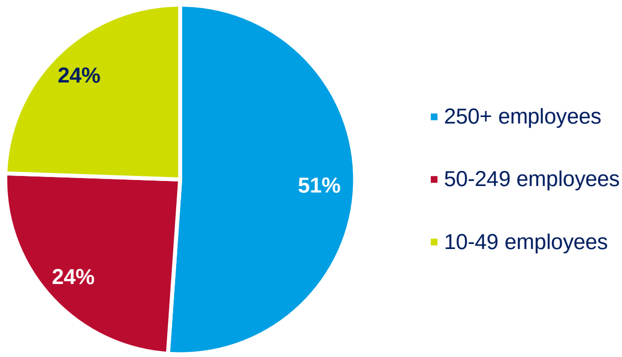
51% of the businesses surveyed are large employers with more than 250 employees, while 24% are small businesses with 10 to 49 employees (Chart 16).

By turnover, 13% are small businesses with a turnover of £5m or less, while 13% are businesses with a turnover in excess of £1bn (Chart 17).

Businesses also represent a wide variety of sectors (Chart 18). A third (33%) operate in the bakery goods sector. The second best-represented sector is ingredients, with 24%.

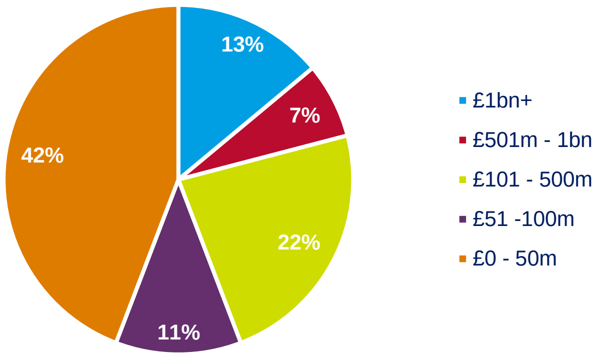
76% of manufacturers operate in England, while 33% have production facilities located in Scotland and 20% in Wales.

Chart 16: Respondents by employment size



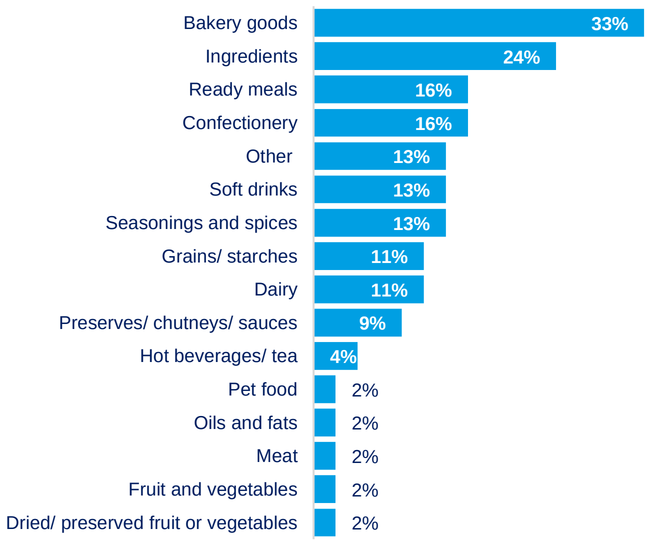
Source: FDF State of Industry Survey

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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