SCOTTISH BUSINESS MONITOR

Q2 2023

ADDLESHAW GODDARD

MORE IMAGINATION MORE IMPACT

INTRODUCTION

THIS REPORT SUMMARISES THE KEY RESULTS FROM OUR LATEST FRASER OF ALLANDER INSTITUTE (FAI) SCOTTISH BUSINESS MONITOR, PUBLISHED IN PARTNERSHIP WITH ADDLESHAW GODDARD.

The survey sampled 400 firms in July and August from across the Scottish economy, examining business sentiment in Q2 2023 and the outlook for the year ahead.

Over Quarter 2, businesses typically experienced a contraction in business sales, turnover, investment, and export activity, with just employment increasing on Quarter 1.

Business sentiment fell this quarter suggesting relative optimism drove Quarter 1's figures. Additionally, the share of firms expecting weak/very weak growth in the Scottish economy has increased from 62% to 71% this quarter.

Despite falling, business sentiment remains positive however, expected export activity and business investment fell further into the negative this quarter.

2 in 5 firms surveyed reported cancelling or delaying investments - primarily physical assets - over the past year. The most common reasons for these cancellations and delays have been economic uncertainty, affordability, and the cost of borrowing. Half of the firms that have cancelled/delayed investments are either unsure when they plan on making these investments, or they are planning them for 2025 onwards.

OUR LATEST RESULTS ALSO SHOW THAT:

- 2 in 3 firms that have experienced increasing costs over the past year have absorbed them to avoid passing them on to their consumers. The construction, wholesale and retail, and manufacturing sectors have absorbed the greatest proportion of rising costs. Half of surveyed businesses are either unable to absorb costs for any longer or are unsure how much longer they can absorb costs, while over a third expect to only be able to absorb costs for another year.
- Supply chain issues and inflationary pressures, particularly energy costs, continue to ease however, firms continue to find it difficult to fill vacancies, with a lack of skills and applications persistently driving labour supply challenges. Overall, with the exception of wages, Scottish firms expect cost pressures to lessen in the second half of 2023.
- Despite price pressures easing, inflation remains stubbornly high therefore, we asked firms for their thoughts on the Bank of England's policy decisions. Just over a fifth of firms surveyed think the Bank of England should continue to raise rates this year to bring down inflation while 18% were unsure and almost half were against further rate rises.[1]

[1] This survey closed before the Bank of England raised the base rate of interest by 0.25-percentage points to 5.25% on the 3rd August.

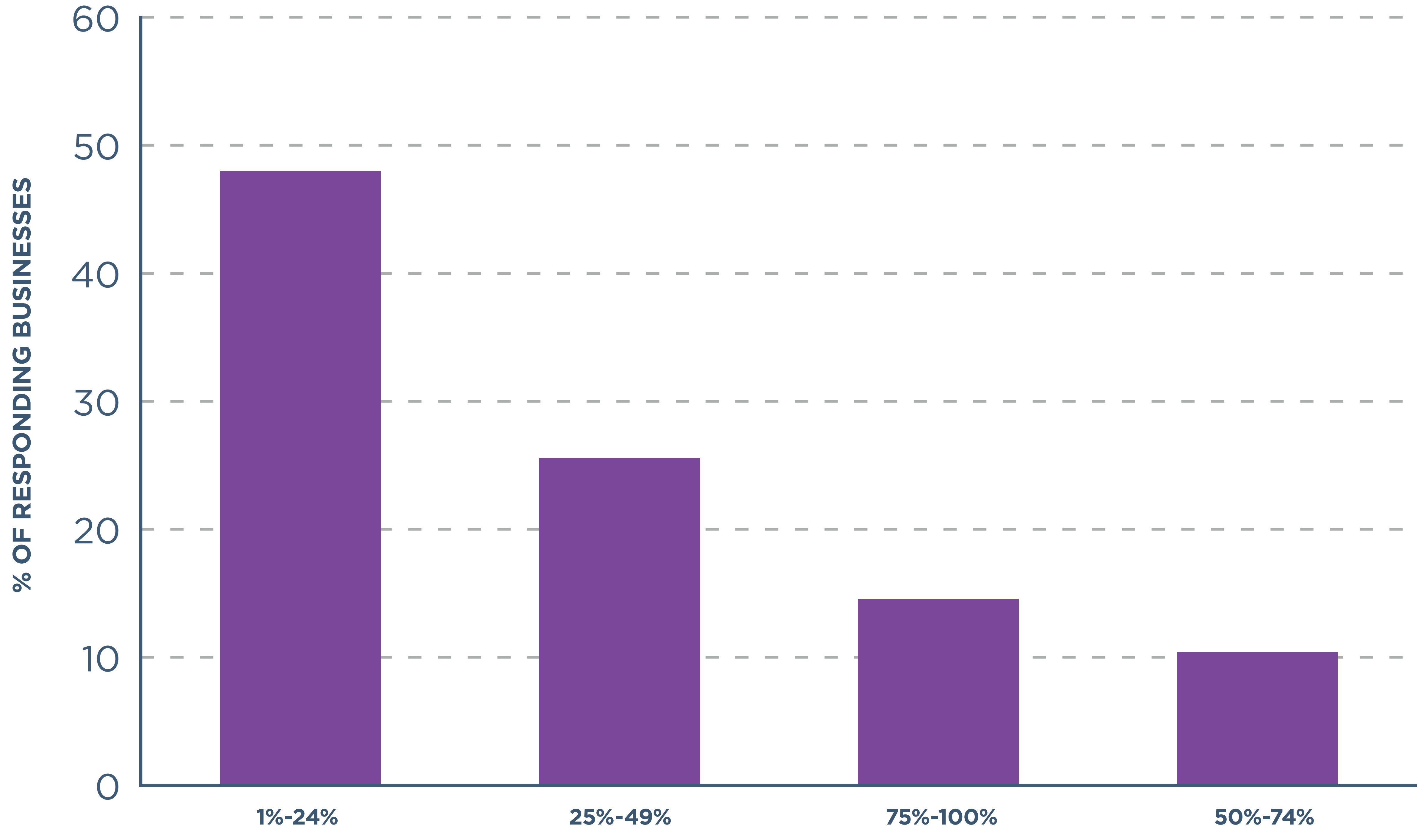
KEY RESULTS

BUSINESS COSTS

- This quarter we continued to ask businesses across Scotland how their costs have changed over the past year.
- **83%** of firms in Scotland have seen their costs increase, with **71%** experiencing increased costs of up to **50%**.
- This was higher in certain sectors: **87%** of construction firms, **78%** of manufacturing firms, and **76%** of wholesale and retail firms reported business costs rising by up to **50%**.
- **67%** of Scottish firms facing increased costs have absorbed these costs to avoid passing them on to their consumers. **74%** of these firms absorbed up to **50%** of their increased costs.
- The construction, wholesale and retail and manufacturing sectors have absorbed the greatest proportion of rising costs, with **71%** of construction firms, **67%** of wholesale and retail, and **66%** of manufacturing firms absorbing costs.
- However, many firms have reported that absorbing costs is unsustainable: **35%** of firms cannot absorb costs anymore, **36%** of firms expect to only be able to absorb costs for the next year, and **14%** of firms are unsure how much longer they can absorb costs for.

Chart 1:

Roughly, what percent of increased costs incurred over the past 12 months has your business absorbed?



*2% of businesses responded N/A; therefore, percentages will not sum to 100%

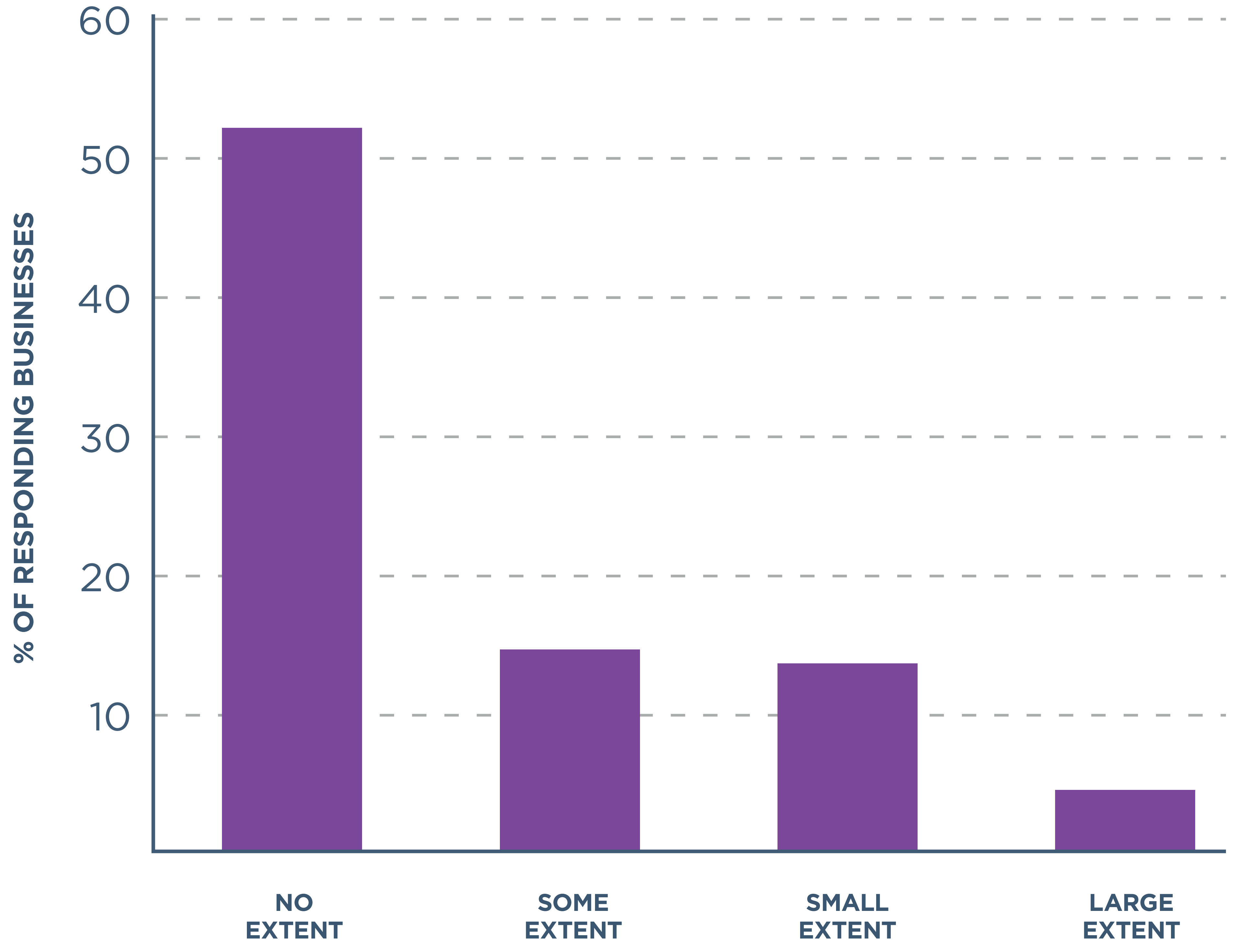
KEY RESULTS

ENERGY COSTS

- We continued to ask firms about energy costs and how this is expected to impact their operations.
- **33%** of firms surveyed expect to reduce their operations this year due to higher energy prices, continuing the downward trend seen over the last two quarters.
- However, energy cost pressures are still being felt more strongly in certain sectors, as **43%** of firms in the wholesale and retail sector and **39%** of manufacturing firms expect to reduce their operations this year due to higher energy prices.

Chart 2:

To what extent do you expect to reduce operations this year due to increases in energy (electricity, gas, or fuel) prices?



*15% of businesses responded N/A; therefore, percentages will not sum to 100%

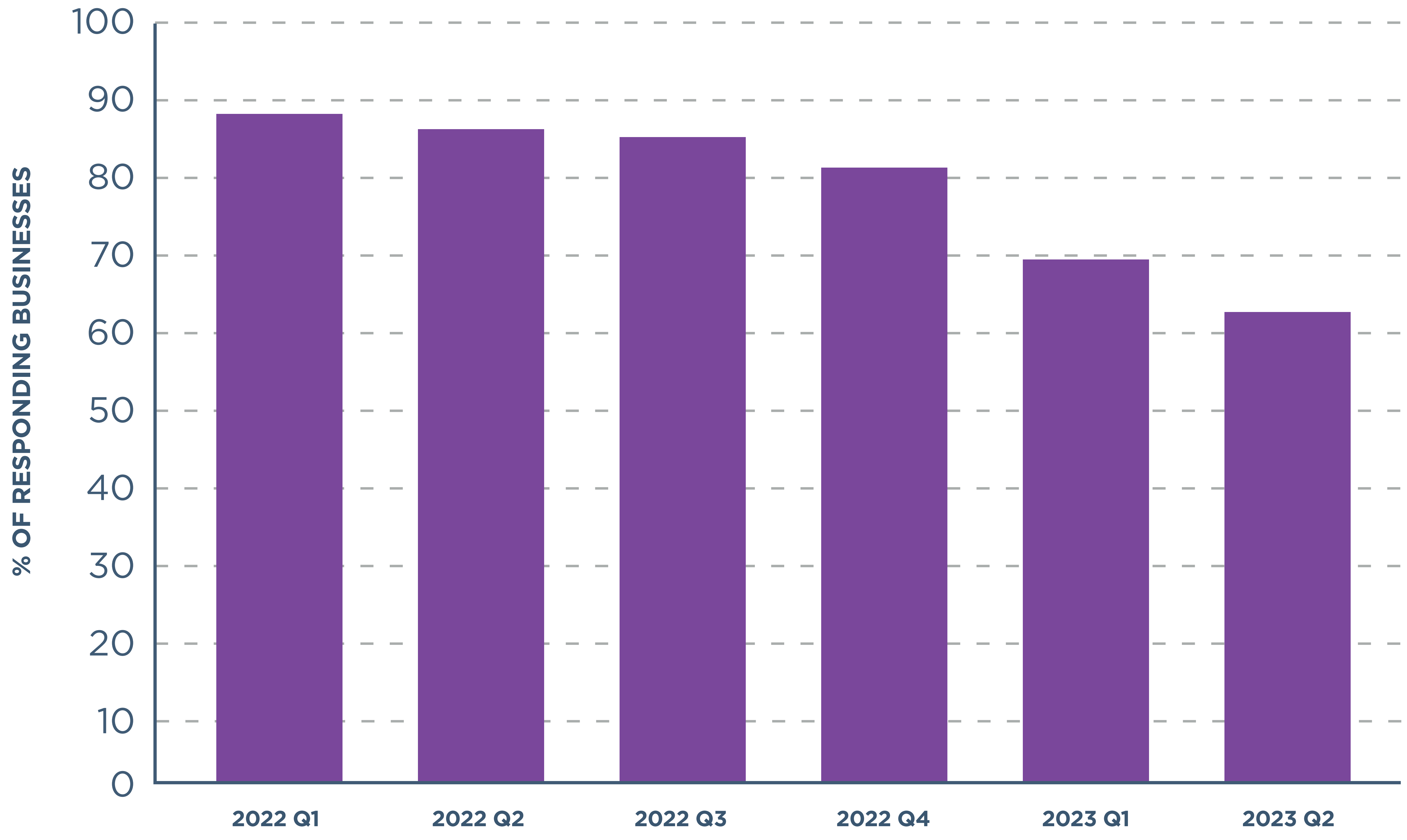
KEY RESULTS

INFLATIONARY PRESSURES

- Inflationary pressures show continued signs of easing.
- **62%** of firms surveyed said that they expect to increase their prices by more than, or a lot more than normal, over the next 12 months. This is down from **69%** in 2023 Q1 and has been falling gradually from **88%** in 2022 Q1.
- Inflationary pressures have also been felt differently across sectors, as **70%** of businesses in the professional services and wholesale and retail sectors, **63%** of construction firms and **59%** of manufacturing firms expect to increase their prices by more than, or a lot more than normal, over the next 12 months.

Chart 3:

Over the next 12 months, how do you expect the prices of your goods and services to change compared to normal? 2022 Q1 – 2023 Q2

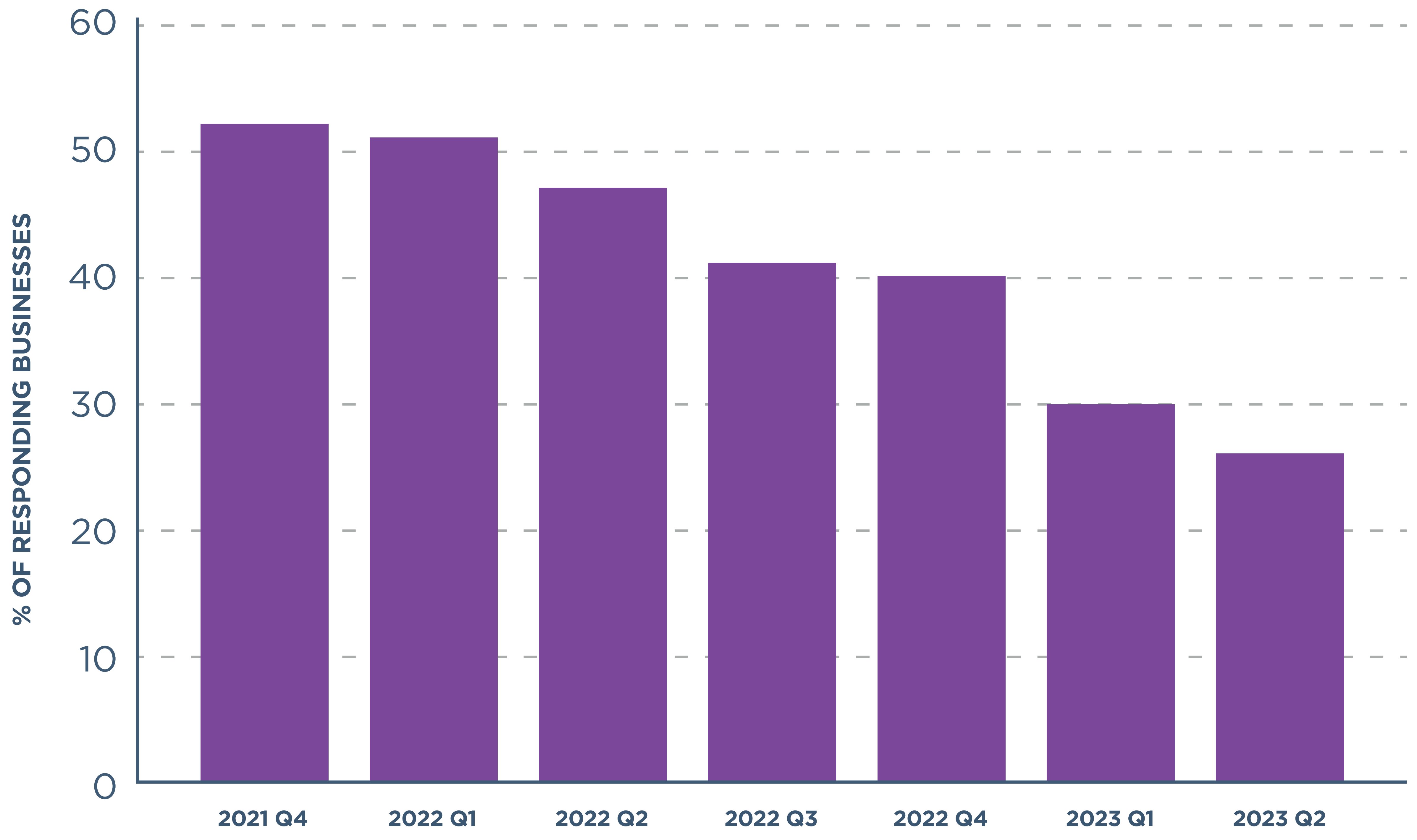


KEY RESULTS

SUPPLY CHAIN ISSUES

- We continued to ask businesses about their experience sourcing goods and services.
- Supply chain issues appear to be continuing to ease for businesses in Scotland. **26%** of firms report finding it difficult or very difficult to source goods and services, down from **30%** in Q1.
- This is a continued downward trend since 2021 Q4, where **52%** of firms reported difficulty.
- A lack of UK supply continued to be the most common factor affecting firms' ability to source goods and services, with **78%** of firms reporting this, up slightly from last quarter.
- The price of goods and services is the second most common issue, with **66%** of firms reporting that price was a factor in sourcing goods and services, compared to **64%** last quarter.
- However, freight costs and availability and delays, lack of international supply, and administrative burden in trading with the EU have all eased since last quarter.

Chart 4:
How easy or difficult are you finding it to source available goods and services your business purchases? (Business responding 'difficult or very difficult between 2021 Q4 – 2023 Q2)

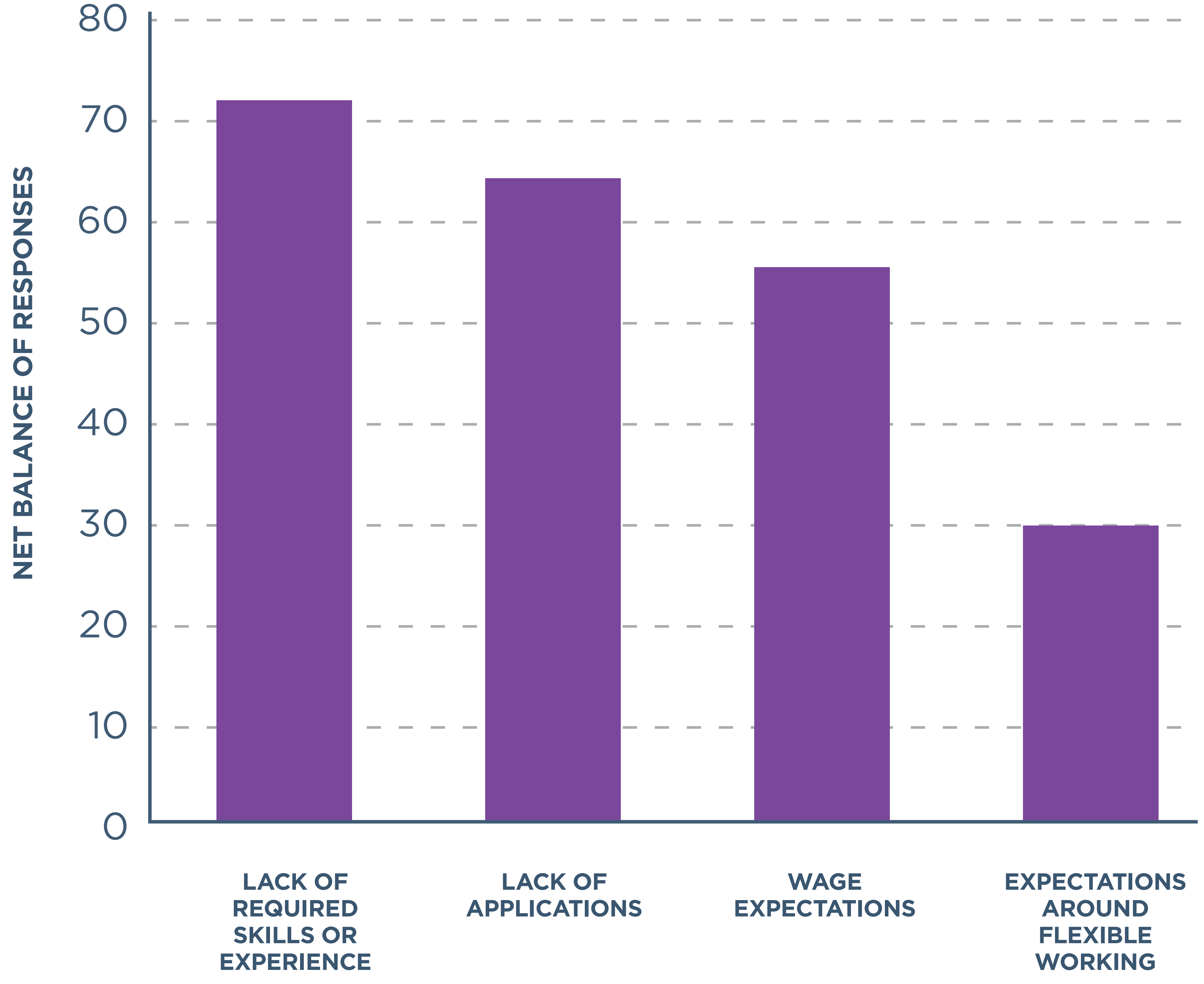


KEY RESULTS

VACANCIES

- **49%** of businesses have current vacancies, down marginally from **50%** in 2023 Q1.
- **84%** of these firms report they have found it difficult or very difficult to fill these vacancies, which is slightly higher from last quarter.
- **72%** of these firms say this is due to a lack of required skills or experience (down from **76%** in Q1), **64%** report a lack of applications (up from **62%**), and **55%** cite wage expectations (down from **58%**).
- **25%** of businesses report difficulties in retaining current staff, which is **3 percentage points** higher than last quarter.
- Only **13%** of firms found that it was easier than normal to retain workers in the current climate, falling from **25%** in 2023 Q1.

Chart 5:
What factors have made filling vacancies difficult?

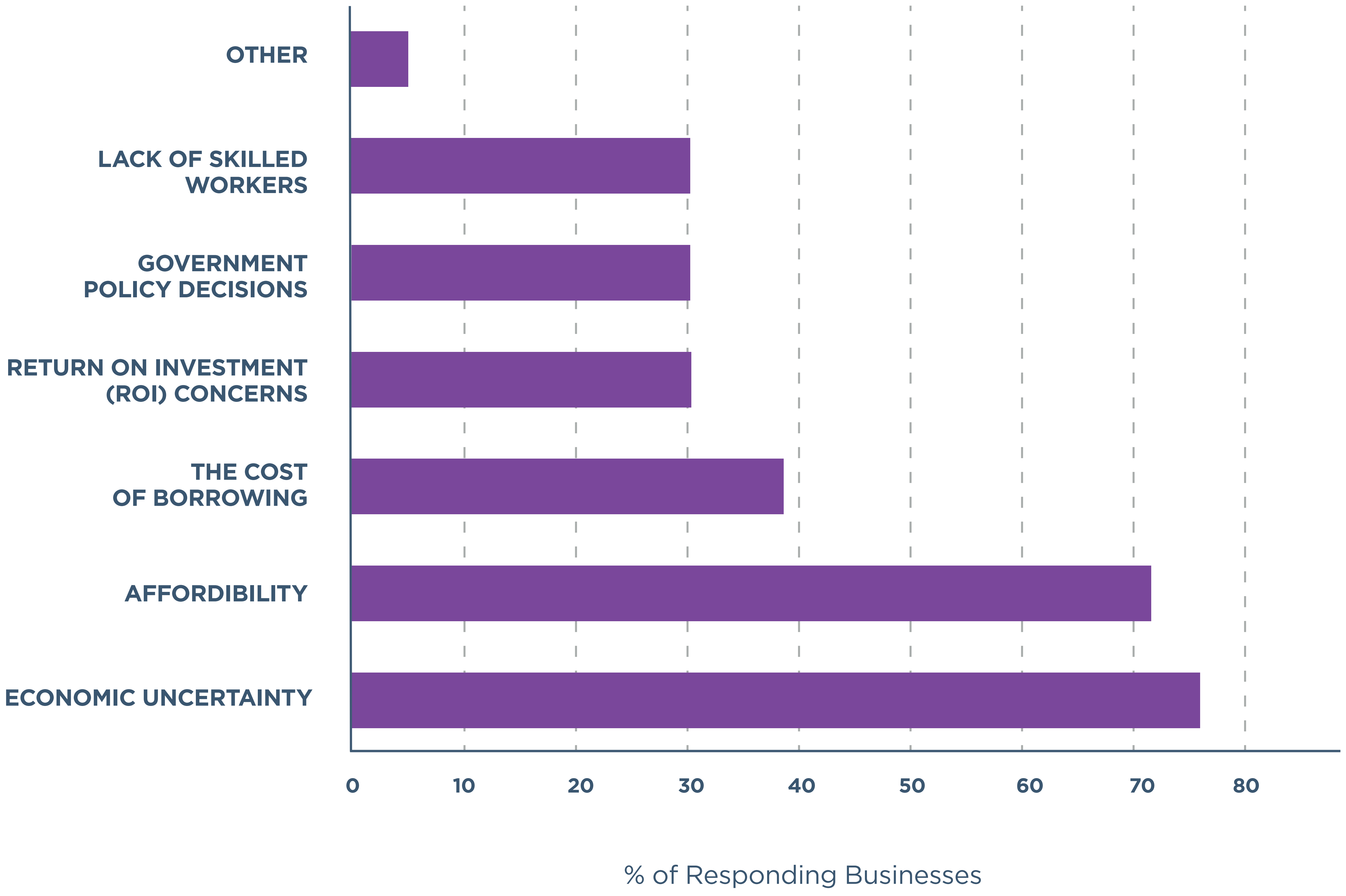


KEY RESULTS

BUSINESS INVESTMENT

- This quarter we also asked Scottish firms about their planned business investment.
- **40%** of firms report having cancelled or delayed planned investments in the past 12 months.
- The majority of this delayed or cancelled investment has been in physical assets (**73%**) but has also included investment in the workforce (**36%**) and environmental initiatives (**26%**).
- The most common reasons for cancellation or delay of investment have been economic uncertainty (**75%**), affordability (**71%**), and the cost of borrowing (**38%**).
- Of those businesses delaying investment, **13%** of firms anticipate initiating investment in 2023, **37%** in 2024, **27%** in 2025 or beyond, and **22%** are unsure.

Chart 6:
What factors have contributed to the cancellations or delays in your investment plans?



CURRENT AND EXPECTED SCOTTISH BUSINESS ACTIVITY

CURRENT BUSINESS ACTIVITY

- The net balance of firms reporting an increase in volume of business activity has fallen to **3%**, which is a drop from **9.1%** in 2023 Q1, but still higher than **-2.2%** in 2022 Q4.
- The level of employment in business is now positive at **2.2%**, following negative values in the previous two quarters.
- However, turnover has fallen this quarter, and new capital investment and export activity have fallen further into the red, following relative improvements last quarter.

Table 1:
Net balance (%) of firms experiencing an increase in activities over the past three months, Q1 2021 – Q2 2023

	2021				2022				2023	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
VOLUME OF BUSINESS ACTIVITY (I.E., SALES)	-7.1	30	26	27.1	30.1	15.3	4	-2.2	9.1	3.0
VOLUME OF NEW BUSINESS ACTIVITY	-1.9	20.8	21.9	10.4	24.9	8.8	0	-4.9	5.7	0.0
VALUE OF BUSINESS ACTIVITY (I.E., TURNOVER)	-8.8	23.7	18.7	12.8	32.3	15	6.4	-0.7	8.1	3.7
LEVEL OF EMPLOYMENT IN YOUR BUSINESS	-13	6.4	5.7	10.8	15.5	10.2	8.5	-5.4	-0.5	2.2
LEVEL OF NEW CAPITAL INVESTMENT	-9.9	4.2	3	7.6	6.3	1.2	-5.9	-14.7	-4.4	-12.1
EXPORT ACTIVITY	-21.6	-19.5	-18.1	-11.8	-8	-9	-9.2	-11.5	-8.4	-11.4

*Net balance of firms is defined as the share of firms reporting higher minus the share of firms reporting lower

CURRENT AND EXPECTED SCOTTISH BUSINESS ACTIVITY

CURRENT BUSINESS ACTIVITY – SECTORAL ANALYSIS

- Sectors reported mixed changes in net balance for the volume of business compared to the first quarter of the year.
- Manufacturing, construction, and transport and storage all reported improvements in their net balance. However, all other sectors reported a contraction in business volume.
- Construction, retail and wholesale, and admin and support services all remain negative for this indicator.

Table 2:

Net balance (%) of firms experiencing an increase in their volume of business over the past three months by sector, Q1 2021 – Q2 2023

	2021				2022				2023	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
MANUFACTURING	5	45	36	-6	22	2	24	-21	2	15
ACCOMMODATION & FOOD SERVICES	-77	46	31	0	14	17	17	-11	33	0
CONSTRUCTION	14	55	40	5	29	26	16	-25	-7	-3
TRANSPORT & STORAGE	-36	32	15	9	41	21	9	25	0	15
INFORMATION & COMMS	3	44	29	7	27	14	7	7	29	19
RETAIL & WHOLESALE	-11	18	17	4	30	17	-1	-4	18	-4
PROFESSIONAL, SCIENTIFIC, AND TECHNICAL	15	24	32	14	31	14	-5	9	17	6
ADMIN & SUPPORT SERVICES	-13	26	7	0	31	3	-14	-6	22	-9

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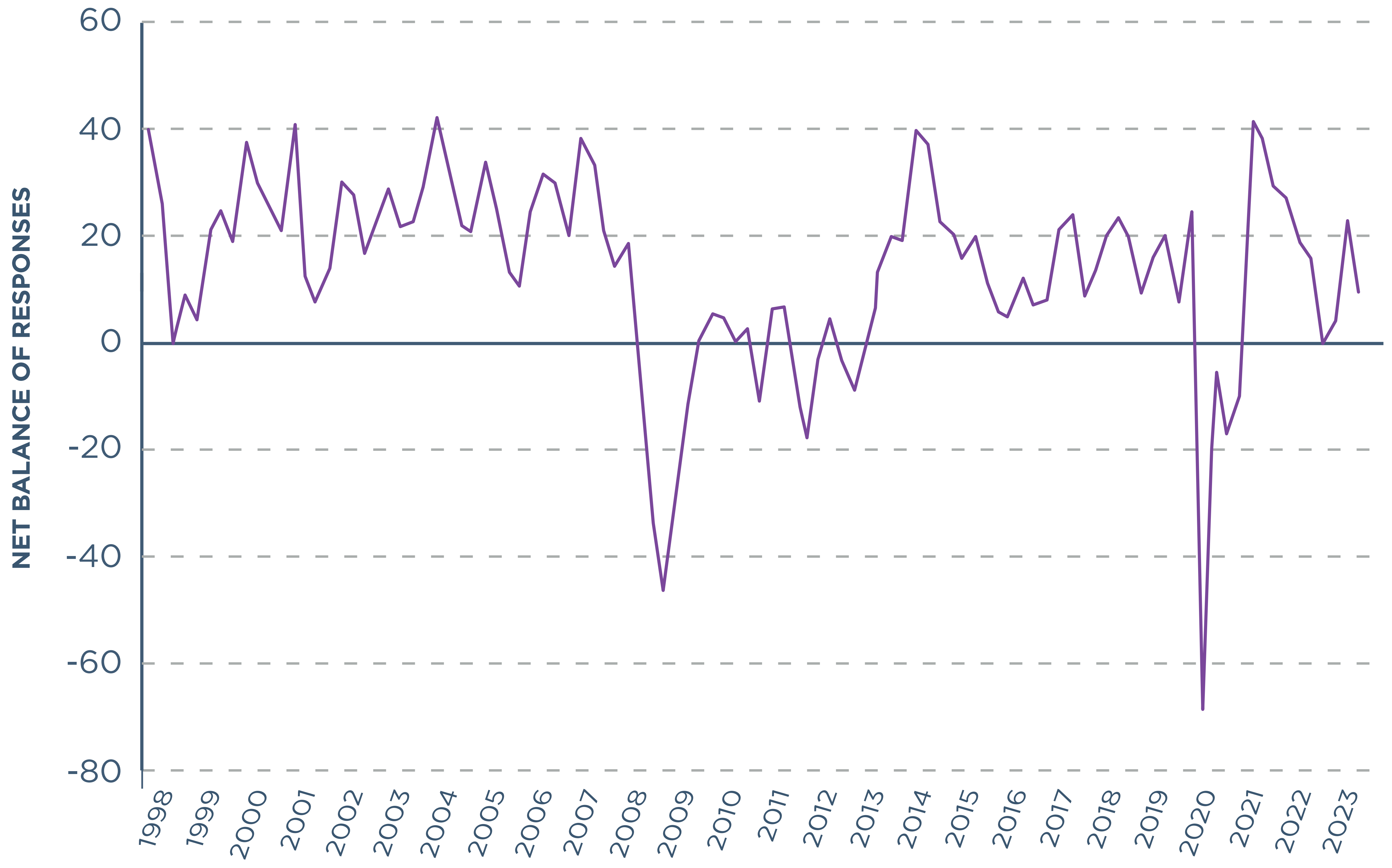
CURRENT AND EXPECTED SCOTTISH BUSINESS ACTIVITY

EXPECTED BUSINESS ACTIVITY

- The expected volume of business over the next six months has fallen this quarter, suggesting relative optimism driving the better-than-expected results in Q1.
- Positive net balances have continued this quarter for expectations of new business activity, turnover and employment in the coming six months.
- However, negative net balances have also continued and worsened for expected capital investment (**-13 percentage points** from **-1%** in Q1) and export activity (**-7 percentage points** from **-3%** in Q1).

Chart 7:

Net balance (%) of firms expecting an increase in their volume of business over the next six months, Q1 1998 – Q2 2023



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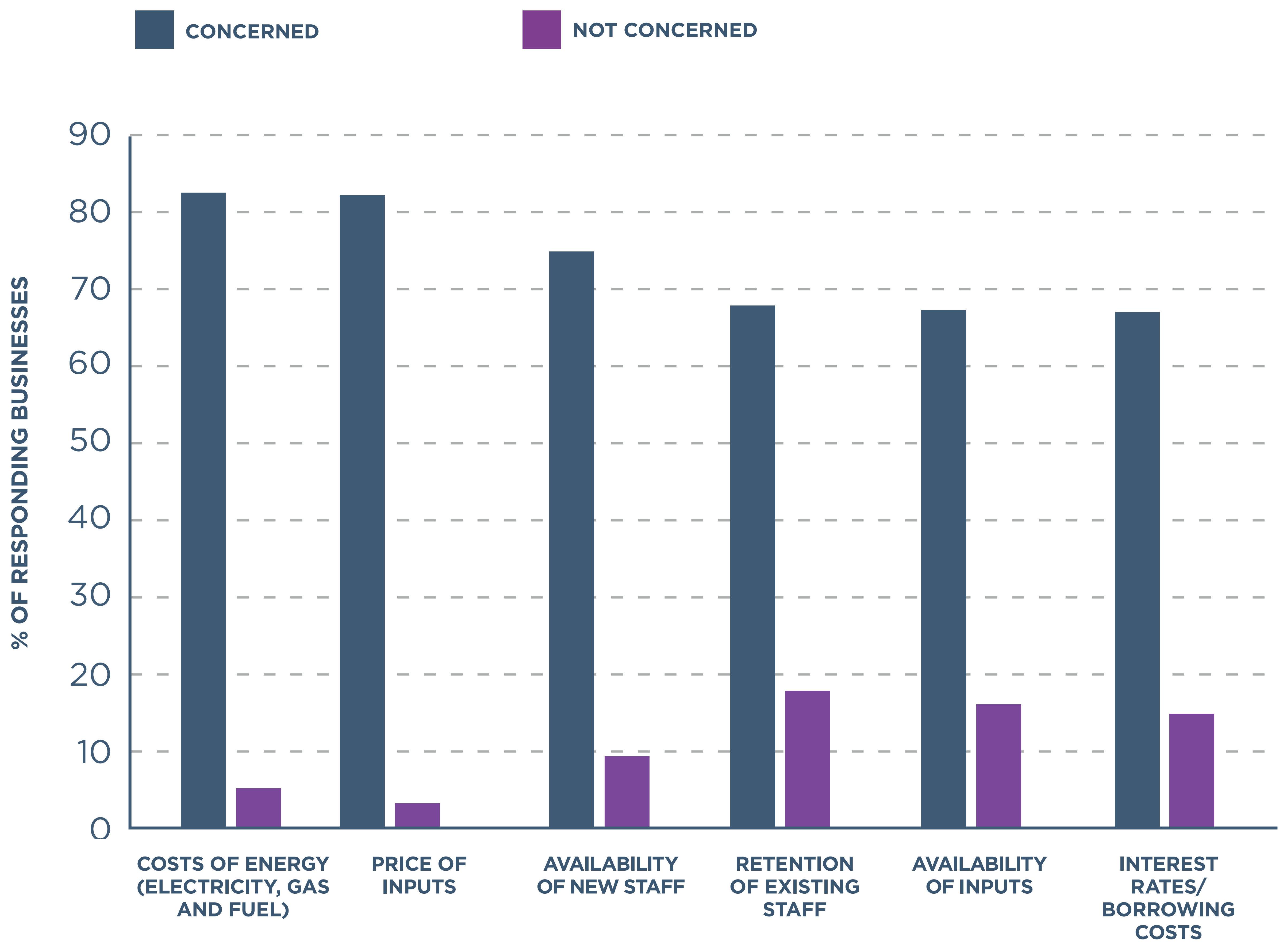
BUSINESS CONCERNS

- We asked Scottish firms what they expect to be important to their business over the coming quarter.
- Most businesses expect economic/ business uncertainty (**83%**), staff availability (**77%**), and political uncertainty (**69%**) to be important or very important over the next three months.
- As reported last quarter, the cost of energy (**82%**) and price of inputs (**82%**) are the biggest cost concerns for businesses. While concerns over fuel bills have fallen slightly since Q1, concerns over input prices have increased from **78%**.
- Firms reporting concerns about interest rates and borrowing costs have increased **3 percentage points** from last quarter (**67%**).

Chart 8:

Compared to normal, how concerned is your business about the following factors?

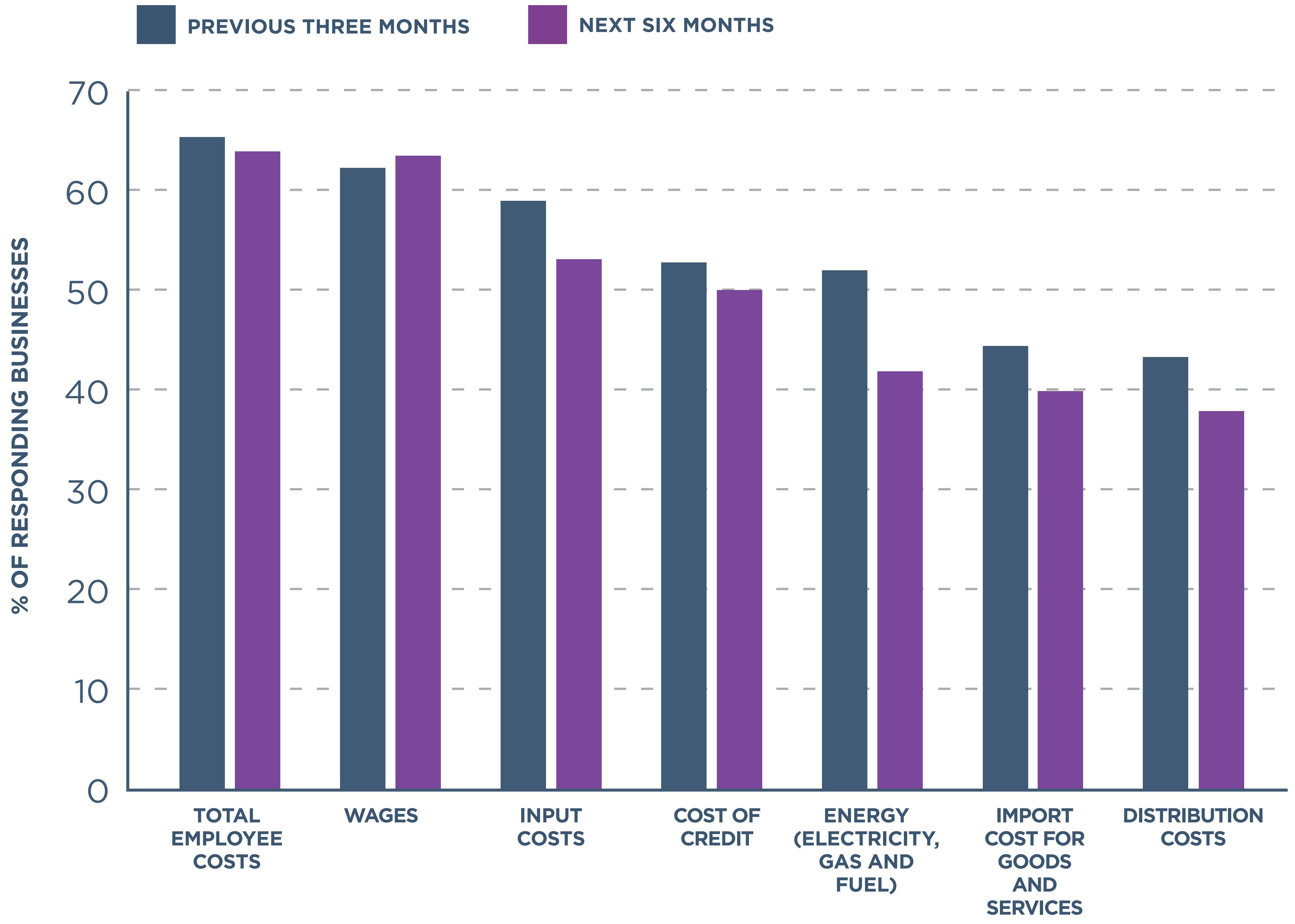


THE OUTLOOK FOR THE NEXT YEAR

- We also asked businesses what the main cost drivers have been over the past quarter and what effect they might have over the next 6 months.
- Energy costs continued to fall this quarter as a key cost driver for businesses. **52%** of firms reported energy bills as their key cost driver over the past 3 months (down from **65%** last quarter). **42%** of firms expect energy costs to continue to be a key cost pressure in the coming six months (down from **54%** last quarter).
- Since 2023, Q1 total employee costs and wages have remained the most common cost pressure for businesses both in the previous 3 months and in the coming 6 months.
- Overall, with the exception of wages, Scottish firms expect cost pressures to lessen in the second half of 2023.
- Despite cost pressures easing, inflation remains stubbornly high therefore, we asked firms for their thoughts on the Bank of England's monetary policy decisions.
- Just **over a fifth** of firms surveyed think the Bank of England should continue to raise rates this year to bring down inflation while **18%** were unsure and **almost half** were against further rate rises .
- Looking forward, businesses continue to be pessimistic about the outlook for the economy, with **71%** expecting that growth in the Scottish economy over the next 12 months will be weak or very weak. This pessimism has grown since Q1, when **62%** of firms reported weak or very weak growth expectations.

Chart 9:

Thinking about the key cost drivers for businesses, what is your business' assessment of the following cost pressures over the past 3 months and the next 6 months?



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