COMMERCIAL BANKING

Automotive Research Report 2017

For your next step

LLOYDS BANK

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WHAT'S IN THIS REPORT

FOREWORD

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This is Lloyds Bank's third annual survey of the UK automotive manufacturing sector, part of a series of reports that look to examine the main opportunities and issues affecting Britain's key industries.

2016 was a tumultuous year, with huge political upheaval across the globe bringing potential economic uncertainties.

The UK's decision to leave the EU created the biggest potential uncertainty for the UK's automotive industry last year.

Not only are many of the car makers operating in the UK internationally owned – from Bentley to BMW – but the EU is the biggest overseas market for British-made cars, accounting for 94.7 per cent of all commercial vehicle exports in 2016[1].

But the industry has been extremely proactive in seeking assurances from the government about the shape of the post-EU referendum trading environment and ministers appear keen to sit down with industry bodies and manufacturers to listen to their concerns and opinions.

The Chancellor, Phillip Hammond, reinforced the government's support for the future of the industry in his Autumn Statement when he announced £390million to help British businesses develop future transport technology[2].

That included a £100million investment in testing infrastructure for driverless cars and £80million to install more charging points for electric vehicles.

The automotive sector is hugely important to the UK economy. It is the UK's largest manufacturing export sector[3] and its supply chain is spread nationally, with a presence in every UK region[4].

Our automotive sector is also one of the most efficient in the world, bucking the national trend with the most productive workforce in Europe[5].

The industry's focus on lean manufacturing and automation is one that could pay dividends for other manufacturing sectors too, as tackling Britain's productivity gap is currently a top priority for government.

The UK automotive industry is a shining example of a British success story and we hope you find this research both useful and informative.

1 European exports fuel commercial vehicle production in 2016, SMMT, January 2017
2 Autumn Statement, November 2016
3 Ministers discuss Brexit with the automotive industry, December 2016
4 Automotive Council UK 2010
5 Automotive sector responds to Autumn Statement, Motor Trade News, November 2016

See David Atkinson give his insight into the future of the UK automotive industry.

Watch the video now at http://resources.lloydsbank.com/insight/automotive-report/

EXECUTIVE SUMMARY

The UK automotive industry is going from strength to strength, despite the potential issues and uncertainties presented by the global economy.

In 2016, the sector enjoyed a record year, building more than 1.7 million cars, around 1.3 million of which were exported[6].

It directly employed 169,000 people in manufacturing, and is one of the most productive sectors in the UK[7].

But our car makers (which are now almost exclusively foreign-owned) and their supply chains are reliant on the EU for more than half of British car sales, and growing, so the automotive industry had more reason than most to watch the outcome of the EU referendum closely.

Before the referendum, more than three quarters of members of the Society of Motor Manufacturers and Traders (SMMT) – which represents the UK motor industry – said remaining in Europe was best for their business[8].

And with the first half of 2016 having been characterised by the overriding uncertainty that affected the economy in the run up to the referendum, it's encouraging to see that the industry ended the year with positive production figures, the result of years of continued investment.

Our research found that the sector is cautiously optimistic, but we expect firms to have an eye on the longterm, where continued uncertainty could have an impact on investment and growth.

That was reflected in investment and recruitment plans, with average investment plans over the next two years holding firm at 19 per cent of turnover and job creation aims remaining stable at around 85,000 new jobs over the next two years.

However, much rests on the nature of the UK's future trading relationships and some firms are continuing to put plans on hold as they await further details of Britain's exit from the EU.

Having said that, firms are moving to create new growth opportunities, looking at increasing their investment in research and design (R&D), with a particular focus on electric cars and driverless vehicle technology. The automotive industry is currently experiencing one of the biggest periods of transition since the invention of the internal combustion engine, with technology firms like Google, Apple and Uber all looking to disrupt the market.

It's clear that the cars on our roads in a decade's time will be significantly different from those that we are driving today.

British manufacturers are displaying the kind of insight and innovation that will secure their place at the heart of the new global automotive industry.

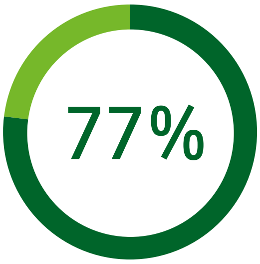
6 December and Full Year 2016 Overview, SMMT
7 UK car production hits 12-year first-quarter high, the Guardian, April 2016
8 Remaining in Europe is best for our businesses, SMMT, March 2016

> Firms are moving to create new growth opportunities, looking at increasing their investment in research and design, with a particular focus on low carbon and driverless vehicle technology.

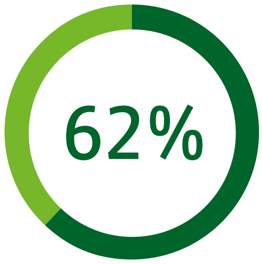
KEY FINDINGS

CHALLENGES AND OPPORTUNITIES

say increased costs due to weak sterling is a challenge



are investing in or planning to engage new international customers in the next two years



think the 2015 emissions issue negatively impacted consumer confidence in the industry

PRODUCTIVITY, PAY AND GROWTH

19%

of current business turnover is the average planned investment over the next two years

50%

say automation is the biggest investment priority for their business

15%

average forecasted growth in turnover over the next two years

INNOVATION

57%

have started work to develop driverless vehicle technology

64%

plan to develop low carbon or electric vehicle technology

24%

of turnover is the average planned investment in R&D

THE EU REFERENDUM

> By the time this research was conducted, the dust around the leave vote had settled to some extent, and the UK economy proved more robust than many had expected.

In the build up to the referendum, the automotive sector was strong in its view that a vote to leave the EU would not be in the industry's best interests.

That's understandable, given that our respondents said that an average of 31 per cent of their business was dependent on foreign owned automotive manufacturers, up from 26 per cent in 2015.

But by the time this research was conducted, the dust around the leave vote had settled to some extent, and the UK economy proved more robust than many had expected.

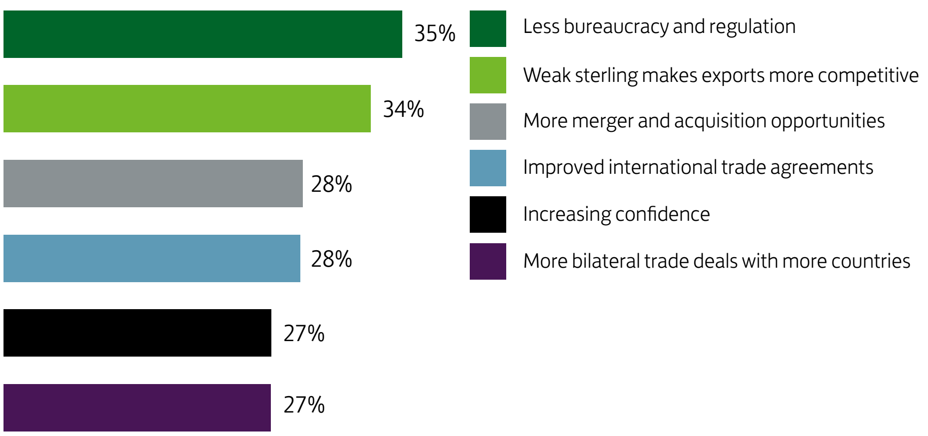
And businesses do see opportunities from Britain's exit, chiefly through less bureaucracy and regulation (35 per cent), more competitive exports from the ongoing weakness of sterling (34 per cent), more opportunities for mergers and acquisitions (28 per cent), and improved international trade agreements (28 per cent).

Given that the negotiations over Britain's exit from the EU may not make any significant headway until later in 2017, and with two years set to lapse before the UK ceases to be part of the EU, it seems that firms are using this time to take action to future-proof their business.

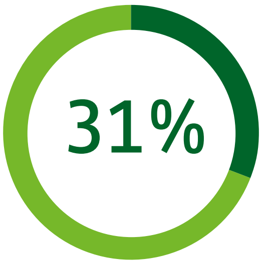
But that doesn't mean that their concerns have evaporated. The exit from the EU was considered to be the biggest threat to supply security over the next two years, flagged by 30 per cent, while 29 per cent said leaving the EU was one of the biggest challenges facing the industry over the next two years.

The most commonly raised challenge being faced as a direct result of leaving the EU was the increased cost of goods, caused by the devaluation of sterling, which was of concern to 26 per cent of firms.

What are the biggest opportunities that you see for the industry following the decision to leave the EU?



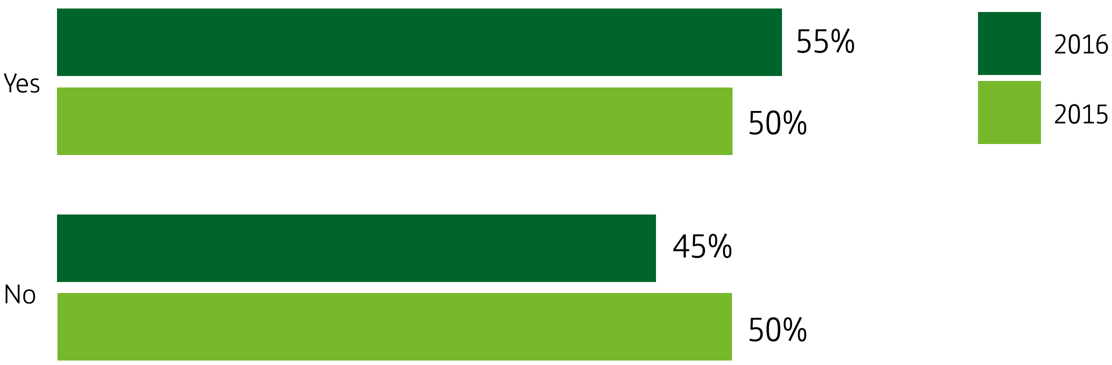
Despite challenges, the UK remains an attractive place to do business according to Lawrence Davies MBE, chief executive of the Automotive Investment Organisation, part of the Department for International Trade (formerly UKTI). He said, "The sector is still highly attractive in terms of costs, ease of doing business and providing access to world class R&D."



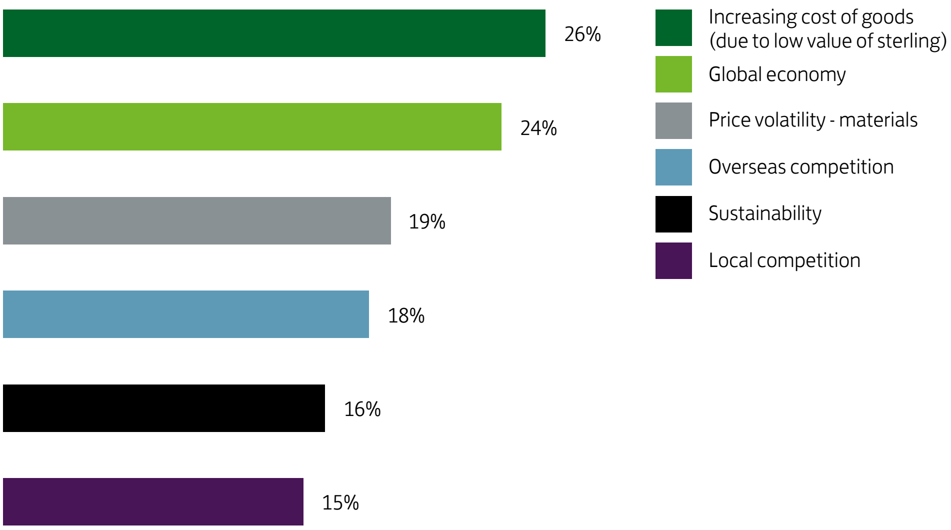
of respondents' business is dependent on foreign-owned manufacturers

> With two years set to lapse before the UK ceases to be part of the EU, it seems that firms are using this time to take action to future-proof their business.

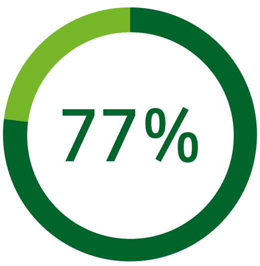
Have you already brought any of your manufacturing process back to the UK?



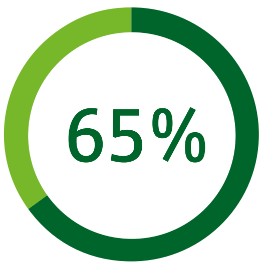
Challenges faced as result of leaving EU



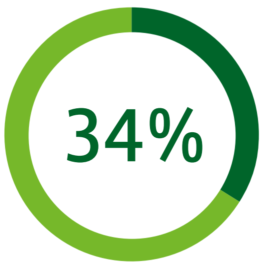
> The most commonly raised challenge being faced as a direct result of leaving the EU was seen as the increased cost of goods, caused by the devaluation of sterling, which was of concern to 26 per cent of firms.



plan to engage new international customers in the next two years



of planned investment is estimated to be in the UK



of planned investment is estimated to be in the EU

GROWTH & INVESTMENT

2016 was the UK automotive industry's most productive period this century.

More than 1.7 million cars rolled off UK production lines in 2016, an 8.5 per cent uplift on 2015 and the highest output since 1999[9].

But with around eight out of every ten cars manufactured in the UK now exported, bound for one of 160 markets worldwide, and more than half of all UK car exports going to the EU, plenty rests on the future overseas trading relationships that Britain develops.

However, planned investments into the industry mean 2017 should continue on track, providing there are no political or economic shocks affecting demand or supply.

Firms told us their growth forecasts for the next two years remain at 15 per cent of current turnover, on an anticipated investment of 19 per cent of turnover over the next two years, which is unchanged on last year.

This level confidence looks well-placed given the industry's track record in bidding for new business. We asked firms what percentage of all tender opportunities received do they respond to, and the average was 44 per cent – although perhaps a substantial figure it does pose the question as to what prevents the supply chain tendering for an element of the other 56 per cent - is this a lost opportunity?

Of those, firms told us that they won a healthy 40 per cent of tender opportunities they went for.

When it comes to achieving growth, the focus this year remains on new product development (39 per cent), which is likely to be driven by firms seeking to capitalise on the shift towards low emission, electric and driverless cars.

Plans to invest in infrastructure (22 per cent) and to pursue mergers and acquisitions (20 per cent) fell back significantly on last year, from 43 per cent and 35 per cent, respectively. Firms are also prioritising existing product development (36 per cent) and entering new markets (31 per cent), likely in a move to seek out alternatives to EU markets.

9 17 year high for British car manufacturing, SMMT, January 2017

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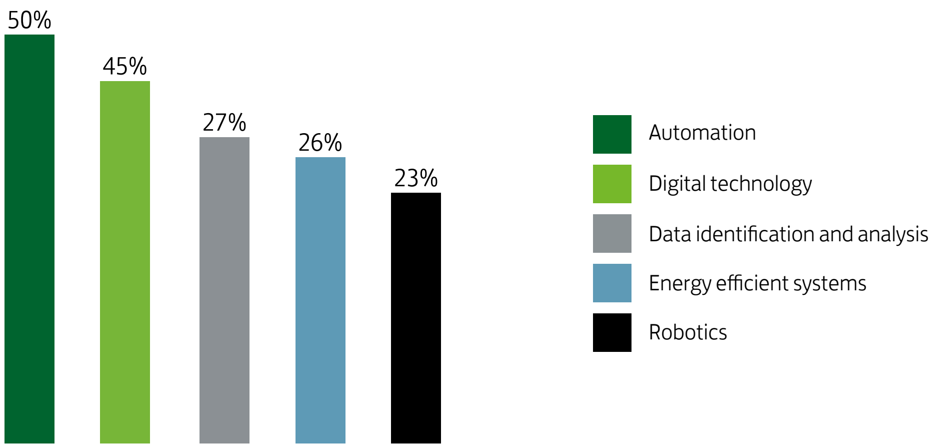
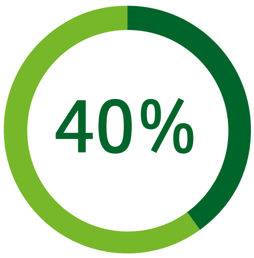
What are the biggest investment priorities for your business?





percentage of tender opportunities entered are won

When asked how they planned to fund growth plans, a large majority (65 per cent) identified cash reserves, followed by cash flow finance (46 per cent), asset finance (43 per cent) and equity (40 per cent), all of which have grown in popularity year-on-year. One striking result was the dramatic fall from favour of using debt to fund growth. This formed part of 25 per cent of firms' growth plans last year, but has since fallen to 14 per cent, perhaps because of the possibility of interest rate rises on the horizon.

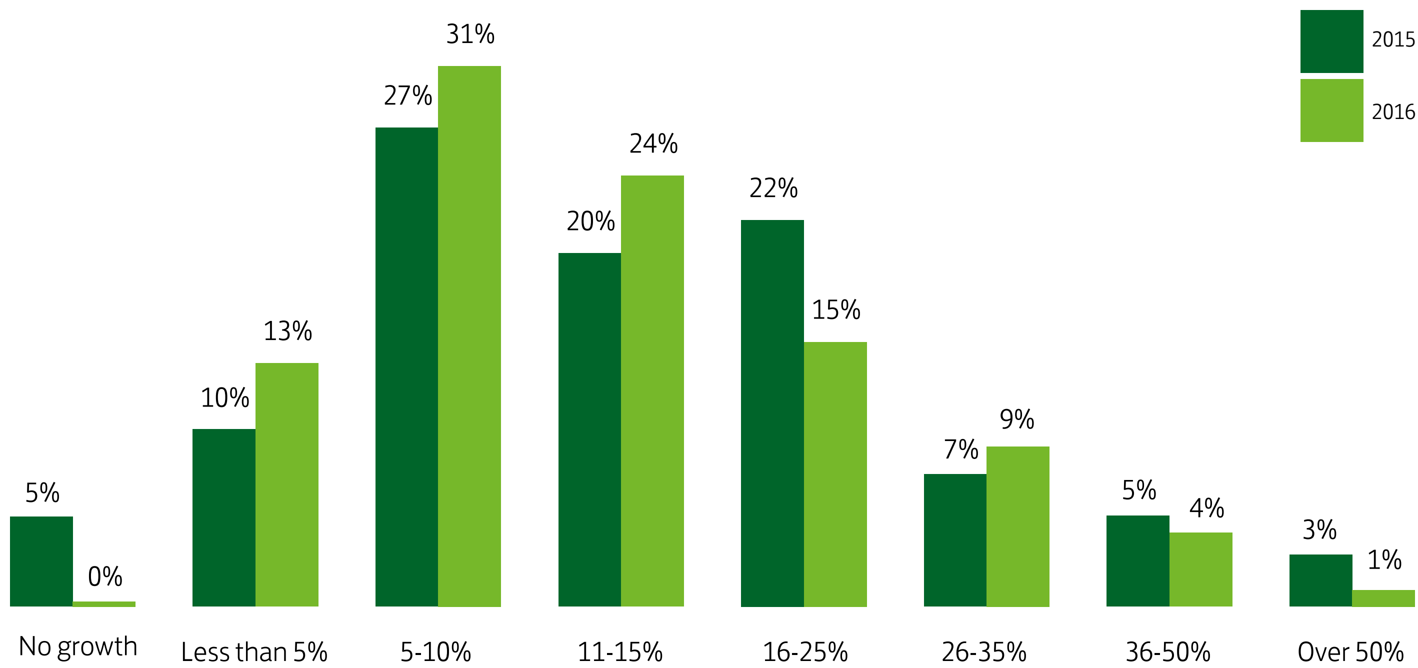
But it seems that firms are convinced of the value of investing to boost their productivity further, with automation, digital technology, data, energy efficiency and robotics the top five investment priorities.

Almost two thirds (65 per cent) of investment will take place in the UK, with 34 per cent still headed for the EU and just one per cent destined for elsewhere.

65%

plan to use cash reserves to fund growth over the next two years

As a percentage of current business turnover, what is your expected growth forecast for the next two years?



EMPLOYMENT

64%

plan to bring some of their manufacturing back to the UK within the next two years

The British automotive sector employs some 169,000 people directly in manufacturing, including some of the world's most-skilled engineers, with more than 30 manufacturers building more than 70 different models.

They are supported by more than 2,000 component providers, employing more than 814,000 people across the wider industry[10].

A key focus for the industry has been to secure a pipeline of skilled engineers by providing apprenticeships and training, which is a strategy that Lloyds Bank is supporting as part of its Helping Britain Prosper plan.

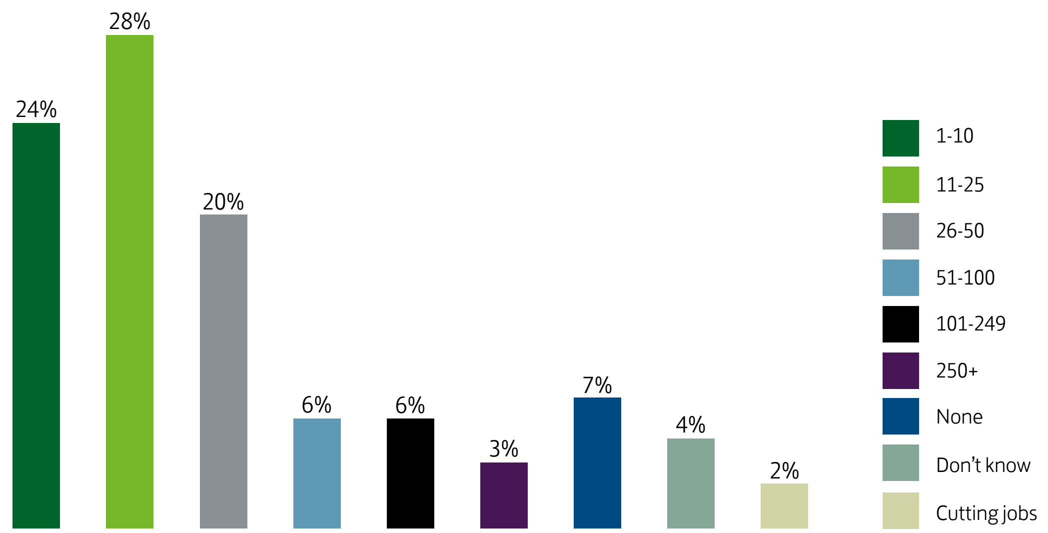
Lloyds Banking Group has committed to supporting the Advanced Manufacturing Training Centre in Coventry, investing £1 million a year to develop more than 1,000 manufacturing apprentices, graduates, and engineers by 2020.

2015 was a big year for automotive investment, with announcements from Jaguar Land Rover, The London Taxi Company and Nissan creating more than 2,500 new jobs. In 2016, Nissan announced plans to develop its Sunderland factory into one of the biggest car plants in the world, safeguarding more than 7,000 jobs, while Jaguar Land Rover has said it could create 10,000 jobs building electric cars in the Midlands[11].

10 UK Automotive, SMMT, 2016

11 Jaguar Land Rover aims to create 10,000 UK jobs in electric car push, Financial Times, November 2016

How many jobs do you plan to create in the next two years?



We have already seen how manufacturers are making moves to invest in automation to maintain their high levels of productivity, but that does not appear to have had a huge impact on job creation as yet.

Automotive firms told us their job creation plans had fallen back only marginally, from an average of 33 to 31 jobs per business over the next two years.

If their job creation plans come to pass, the sector's job forecast growth is stable, with 84,909 jobs set to be created across the automotive supply chain by 2019 – very similar to the 84,975 in 2015. However, much depends on securing the conditions which maintain UK automotive competitiveness, to safeguard jobs in the future.

Another factor supporting homegrown job creation is the ongoing reshoring of manufacturing to the UK, which has accelerated since last year, possibly due to firms bringing operations back from Europe.

Last year 58 per cent of firms said they planned to bring some manufacturing back to the UK within two years, which has grown to 64 per cent in 2016.

In the same period, the proportion of manufacturing operations that firms planned to reshore also grew from 26 per cent to 31 per cent. Anecdotally, employers aren't onshoring purely to secure supply or quality, with many demonstrating a desire to support the economy in the UK and their local area too.

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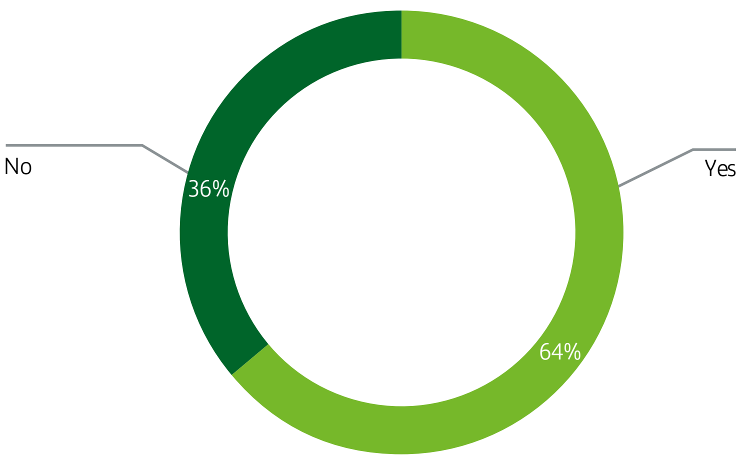
Does your business plan to bring any percentage of its manufacturing back to the UK within the next two years?



INTERNATIONAL

The US is a natural fit for many firms, given the lack of a language barrier and the entrenched relationships that already exist with UK suppliers.

The British automotive sector is a global institution.

But decades of consolidation in the sector mean that most British car makers – even quintessentially English brands like Rolls Royce, Aston Martin and Land Rover – are largely overseas-owned and their biggest markets are all abroad.

More recently years of investment have helped to build an industry that is globally competitive, achieving long-term growth after being damaged by poor productivity and overseas competition in the latter part of the 20th century.

Of course, in 2016, the economy was impacted by some significant events, from the EU referendum to the Chinese slowdown and the election of Donald Trump, which will have caused many firms to reflect on the nature of their existing and future overseas operations.

But the UK sector clearly still has a strong appetite for engaging new international customers, with 77 per cent reporting they were investing or planning to do just that in the next two years, up slightly from 74 per cent last year.

The number of firms planning to engage new customers in Western Europe rose slightly to 65 per cent, from 61 per cent last year.

The number of firms targeting North America grew more strongly, from 46 per cent to 53 per cent. This could be because firms are seeking alternatives to existing European customers in order to hedge against any potential disruption to trade as the UK moves to leave the EU.

The US is a natural fit for many firms, given the lack of a language barrier and the entrenched relationships that already exist with UK suppliers – in 2016 the USA was the biggest single market for UK-built cars after the EU, accounting for 14.5 per cent of total sector exports[12].

We've also seen that investment in infrastructure and mergers and acquisitions was a strong focus for the industry in 2015. This appears to have paid dividends as 75 per cent of firms said they had the capacity to increase production if the opportunity arose to expand into a new market.

Only five per cent said this would require additional investment, down from 14 per cent last year.

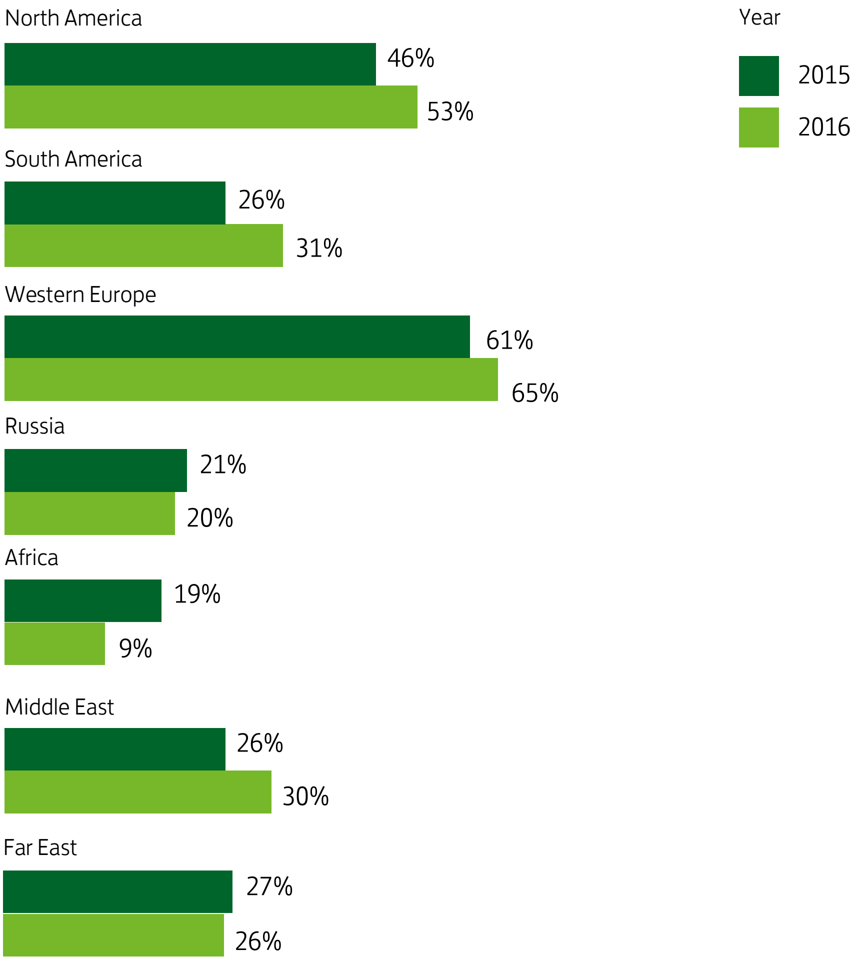
Of the few customers not planning to engage new customers overseas, the main barrier was the same as last year – a lack of knowledge of international markets (60 per cent) – followed by a focus on the domestic market (47 per cent) and the weakening of the pound (40 per cent) which has impacted the cost of overseas investment.

12 17 year high for British car manufacturing, SMMT, January 2017

77%

are investing or planning to engage new international customers in the next two years

In which markets are you considering investing or planning ahead to engage new international customers?



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CHALLENGES & OPPORTUNITIES: FROM EMISSION TO ELECTRIC CARS

57%

are developing driverless vehicle technology

62%

of firms thought the 2015 emissions issue had a negative impact on consumer confidence in the industry

The automotive industry is experiencing a period of intense technological innovation that will help shape the sector for many years to come.

The drive to create cleaner, lighter, more efficient vehicles is behind much of the new product development we are seeing, though driverless cars are also a key focus for investment.

Much of this innovation is to help cut vehicle emissions as consumer demand for cleaner cars grows. Electric cars are becoming ever more practical options for drivers, as vehicle manufacturers have invested billions developing new plug-in cars and vans with an ever-greater range.

Lauren Pamma, Head of Consultancy at Lex Autolease, which has more than 10,000 alternative fuel vehicles on its fleet, comments:

"Uptake of plug-in electric vehicles across the UK market has shot up over the last couple of years. In late 2014 Lex Autolease had just over 1,600 plug-in vehicles. This number has increased to almost 6,000, with more than 5,600 being plug-in hybrids that run on both electricity and petrol or diesel.

"This increase has been fuelled on one side by tax incentives and grants, and on the other by the increased driving range in pure electric mode and greater availability of more models from manufacturers."

Mercedes has said that it is likely to be 2025 before electric motors are the same price as traditional engines, though cheaper running costs will mean that the tipping point for consumers considering an electric car will come sooner[13].

There seems little doubt that electric cars will become increasingly important in the future, and the rewards for those who secure a slice of that market will be huge, hence the enormous amounts being invested by the industry and new players looking to disrupt the market.

And the UK seems determined to stay at the forefront. Almost half (46 per cent) of firms told us they were investing in R&D to address the current opportunities around innovation. While 38 per cent were collaborating with other firms, 34 per cent were hiring new staff, presumably to upskill their workforce, and 28 per cent were looking to acquire other businesses to maximise innovation opportunities.

And firms told us they increased planned R&D investment from 17 per cent of turnover in 2015 survey, to 24 per cent in 2016, although in future this may change as the implications of Britain's exit from the EU become clearer. They also reinforced plans to upskill their staff or change their processes or business model to develop low carbon or electric vehicle technology, which is being pursued by 64 per cent of firms, up from 52 per cent last year.

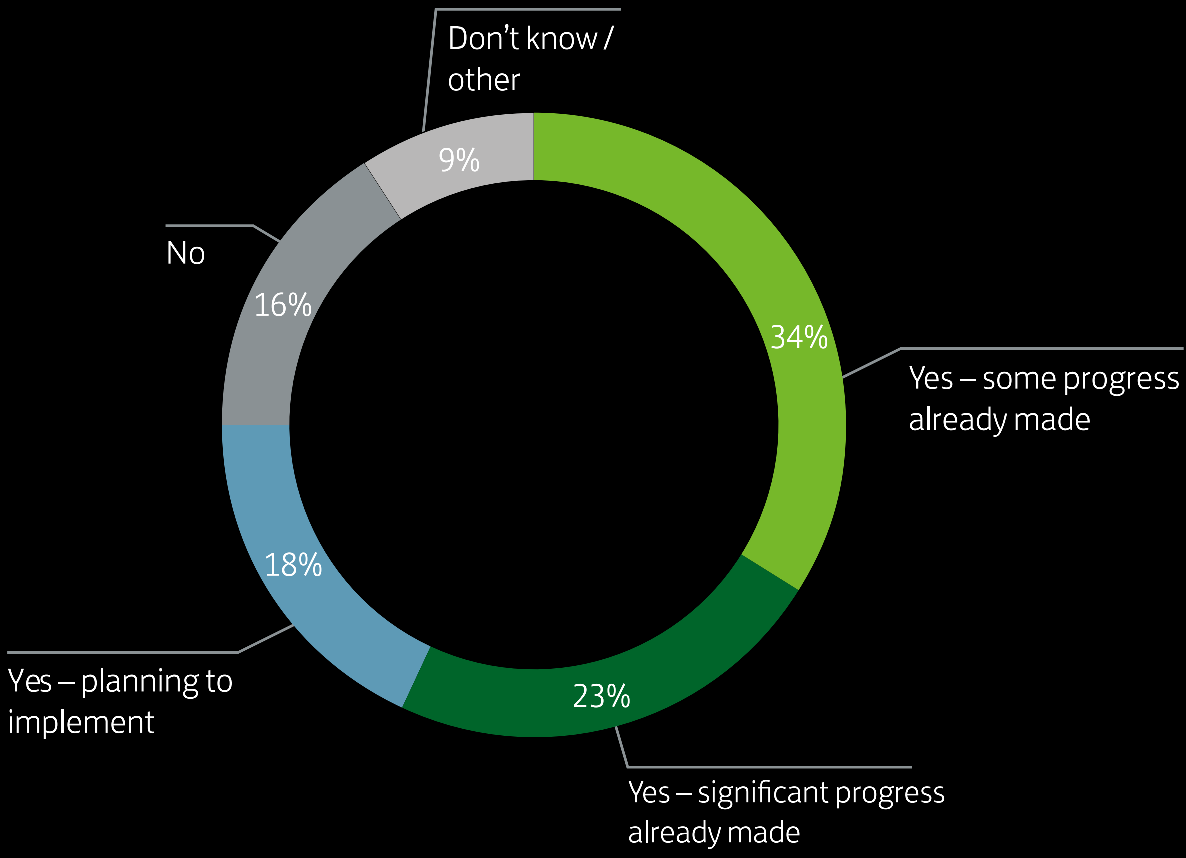
They are chasing the opportunity with more urgency than last year: 27 per cent are already active in that area, 40 per cent plan to start in the next year and a further 27 per cent plan to start within two years. Driverless technology, despite the field being occupied by disruptive new players to the market like Google, Uber, Apple and BlackBerry, is also on manufacturing firms' agendas.

While 57 per cent said they had already made moves to develop driverless vehicle technology, a further 18 per cent hold plans to do so. Such investment, alongside the impact of the referendum on sterling exchange rates, are likely to have influenced respondents' views on the price of cars going forward.

While a fifth (20 per cent) predicted they would increase significantly in the next two years, 39 per cent forecast a marginal increase and 29 per cent anticipated they would stay the same. Just 12 per cent foresaw a marginal decrease in car prices with no respondents thinking they would decrease significantly.

13 Investors get ready for the coming electric car revolution, The Wall Street Journal, December 2016

ARE YOU PLANNING TO CHANGE YOUR PROCESSES TO DELIVER DRIVERLESS VEHICLE TECHNOLOGY?



FORWARD THINKING

Mike Hawes
Chief Executive, the Society of Motor Manufacturers and Traders (SMMT)

Despite uncertainty and political upheaval, 2016 was a strong year for UK automotive.

A record 2.7 million new cars were registered by British buyers, while car production achieved a 17-year high of 1.7 million and global exports reached record levels.

An impressive performance, but we must be clear that it is one built on significant earlier investment. Businesses will inevitably pause investment decisions when conditions are unclear, and we're already seeing evidence of this, with fewer major commitments made in 2016 than in recent years.

This report's finding that companies are exploring opportunities to future-proof their businesses in the hiatus before we leave the EU is, therefore, encouraging.

Our members have been clear. We must secure the right deal with Europe if we are to safeguard future investment. So SMMT will continue to advocate the need for tariff- and non-tariff barrier-free access that keeps vehicles, components and people moving freely across borders – thereby helping keep us globally competitive. If the UK gets it wrong, the impact will be felt, not just in manufacturing, but the market as a whole.

There are, however, good reasons to be positive: The UK is home to world-class manufacturing facilities, one of Europe's most highly skilled, flexible and productive workforces, and an ever-growing ecosystem of suppliers and services.

We are now the second biggest producer of premium vehicles in Europe, behind Germany, and the third largest car producer.

We must build on these strengths with initiatives such as The Advanced Manufacturing Supply Chain programme, which has already delivered £75 million worth of investment, playing an important part in cementing the supply chain in the UK. Funding will be crucial to growth which is why we welcome the work Lloyds Bank is doing. Government collaboration is also critical and we're encouraged by its commitment to supply chain growth as part of its proposed industrial strategy for the UK.

As this report demonstrates, UK Automotive is forward looking and committed to continuous development, with manufacturers already investing in digital technology that will take production into the next decade and beyond.

With our engineering excellence, rich heritage in innovation, and a commitment from government to support research, development and testing of next generation ultra low emission and connected and autonomous vehicles, Britain remains a fantastic place to design, produce and sell automotive products with global appeal.

HELPING BUSINESS TO GROW

Our financial teams have the experience and know-how to help make your growth, investment and export plans a reality. We're proud to work closely with some of the leading automotive businesses in England and Wales, and could provide a range of solutions for your business.

For more information, get in touch with us.

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METHODOLOGY AND REFERENCES

Methodology

Field research for this report was undertaken in November and December 2016 by Coleman Parkes Research. To gather representative data from this diverse industry, a broad cross-section of 100 automotive manufacturers in England and Wales was interviewed from companies ranging in size, from less than £25m, £25m to £750m, and more than £750m annual turnover. Product type was limited to automotive producers and manufacturers. Business owners, managers, senior managers, directors and department heads took part in the survey, with a higher proportion of respondents from small and medium enterprises and mid-market firms. Our survey questions focused on growth and export plans, job creation, investment, international markets, electric vehicle manufacturing and challenges and opportunities.

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< PREVIOUS PAGE