

COMMERCIAL BANKING



Bank of Scotland Research Report 2016 — Food and Drink



BANK OF
SCOTLAND

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Foreword



By sharing our research and insight with the wider industry, we aim to give food and drink firms a stronger sense of the opportunities and challenges they face.



**Jane
Clark-Hutchison**

**Regional Director,
Mid Markets,
Central Scotland**

The food and drink industry is a source of great pride for Scotland, and is key to the ongoing success of the Scottish economy.

From traditional producers following centuries of practice, to innovative manufacturers at the leading edge of technology, Scotland has it all. Our food and drink puts us on the global map. That's why Scotland has earned its reputation as the Land of Food and Drink.

It's an ambitious industry too, with a stated target of building a sector with a turnover of £16.5 billion by 2017.

Looking at the data contained in this report, that seems entirely achievable. At Bank of Scotland, we look to support the sector in whatever we can, which is why we have been producing this report for five years now. By sharing our research and insight with the wider industry, we aim to give food and drink firms a stronger sense of the opportunities and challenges they face.

With the vote to leave the European Union, the United Kingdom entered a new phase in 2016, and the business climate has been dominated by uncertainty. So it's incredibly heartening that, just weeks after the EU Referendum result, our survey shows that bullish food and drink firms expect to grow, invest, recruit and innovate.

They believe in the provenance of their produce and the skills of their staff, and they are confident enough to invest in taking their goods to new markets across the globe. They are working together to achieve their ambitions and forming partnerships to share their expertise and minimise risk. But they do need support, and be that in financing new product development or sourcing intelligence on new markets, Bank of Scotland is there for them.

I hope that, like me, you find this report informative, encouraging and inspiring.

Executive summary

In a year of uncertainties, Scotland's food and drink sector is in a buoyant mood. It is set to increase employment, investment, exports and research and development spending in the next five years.

The fifth Bank of Scotland survey of the food and drink sector was conducted in the wake of the EU Referendum vote to leave the European Union. It has found that, despite uncertainties over the level of sterling and future trading relations with the EU, there is an uplift in business confidence and growth expectations compared with 12 months ago.

Forecasting growth

Across the sector, firms expect to increase their turnover by an average of 24 per cent over the next five years, an increase of five per cent compared to this time last year. Among large firms this figure rises to 36 per cent compared to 25 per cent previously.

Half of all firms said the result of the EU Referendum had caused them to raise their business growth estimates by a small or large amount, compared to only one in four (25 per cent) who said it had led them to reduce their estimates. And among large firms, almost two thirds (62 per cent) have adjusted their business growth estimates upwards.

On investment intentions, job creation, and research and development, the survey responses indicated companies plan to increase their forecasts. Firms say they plan to invest an average of 56 per cent of their current annual turnover over the next five years - notably higher than the responses to the previous year's survey, where this figure stood at 40 per cent. Firms with a turnover in excess of £750m said they plan to invest as much as 68 per cent of their current annual turnover over the next five years.

Exporting

Particularly heartening is that the industry is continuing to focus on exports. More than two thirds (69 per cent) of all respondents say that they are investing or planning to engage new international customers over the next five years.

The survey also found a sharp increase in the number of small and medium sized enterprises (SMEs - those with a turnover of £1-25 million) who say they are seeking new international partners. The response here has risen to 72 per cent of SMEs, well up on the 44 per cent in the previous year's survey.

The survey strongly suggests that the sector will be able to build on the momentum of recent years. Scottish food exports have surpassed the £1.1 billion mark for the first time, with total food and drink exports valued at £5.1 billion in 2014.¹

However, many firms continue to be concerned over price volatility, while coping with the complex logistics of exporting remains a concern for many SMEs.

Overall, however, the survey points to a positive response to the post EU Referendum uncertainties ahead. With this, the sector should continue to provide uplift in an otherwise difficult year for Scotland's economy.

The Fraser of Allander Institute has lowered its 2016 forecast of growth across the Scottish economy from 2.2 per cent to 1.9 per cent in 2017.² However, the £14 billion a year turnover food and drink sector is of increasing importance. It is the largest manufacturing sector in Scotland, and employs 34,000 people accounting for 19 per cent of Scottish manufacturing jobs.³ And it shows every sign of resilience.

- 1 HMRC export statistics for 2014, updated July 2016
- 2 Fraser of Allander Quarterly Bulletin Vol 40 No1, June 2016
- 3 Scottish Food and Drink Federation

▶ **With £14 billion year turnover, food and drink is the largest manufacturing sector in Scotland.**

Key findings

Growth

24%

growth in turnover is forecast over the next five years

56%

average investment of current annual turnover over the next 5 years

49%

of food and drink firms aim to generate growth by entering new markets in the UK

The EU Referendum

40%

said leaving the EU was the biggest challenge facing the sector

52%

of firms said the EU Referendum result had led to an increase in investment plans

40%

said the build up to the EU Referendum had a negative impact on their business

Challenges and opportunities

44%

said that complexity of logistics is stopping them from planning to engage new international customers

53%

see the increased focus on provenance as an opportunity for the sector

45%

say growing awareness around public health is an opportunity for producers

Industry growth and employment

Despite current uncertainties, Scotland's food and drink sector is remarkably more confident compared with 12 months ago. The latest Bank of Scotland annual report on the sector finds a significant improvement in business growth expectations, new business investment, export ambitions and job creation plans.

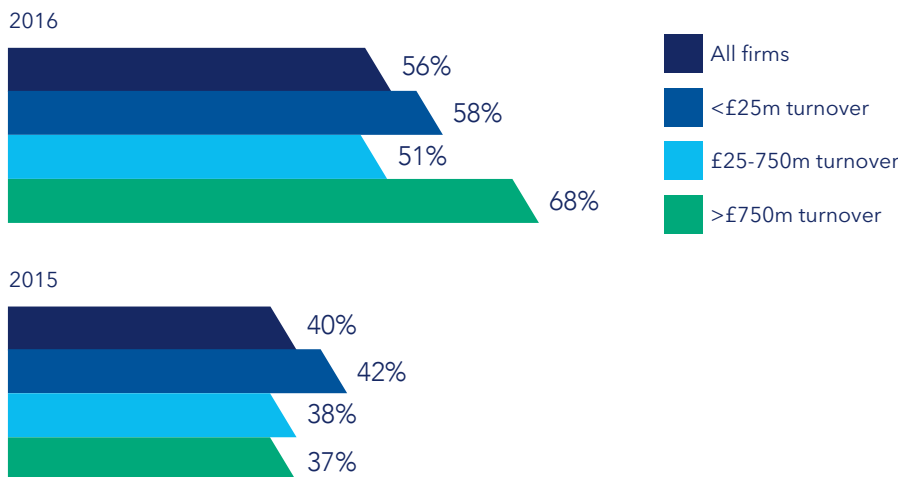
Arguably the most positive news is about investment intentions. Food and drink companies say they plan to invest an average of 56 per cent of their turnover over the next five years, significantly higher than the 40 per cent figure in the previous year's survey. Among larger firms the average investment estimate has risen sharply to 68 per cent over the next five years compared with 37 per cent in 2015.

▶ **52%**
of firms said the EU Referendum result had led to an increase in investment plans

▶ **31%**
of firms said the EU Referendum would lead to a fall in investment

▶ **24%**
of turnover is average expected growth for the next five years

As a percentage of business turnover how much are you planning to invest?





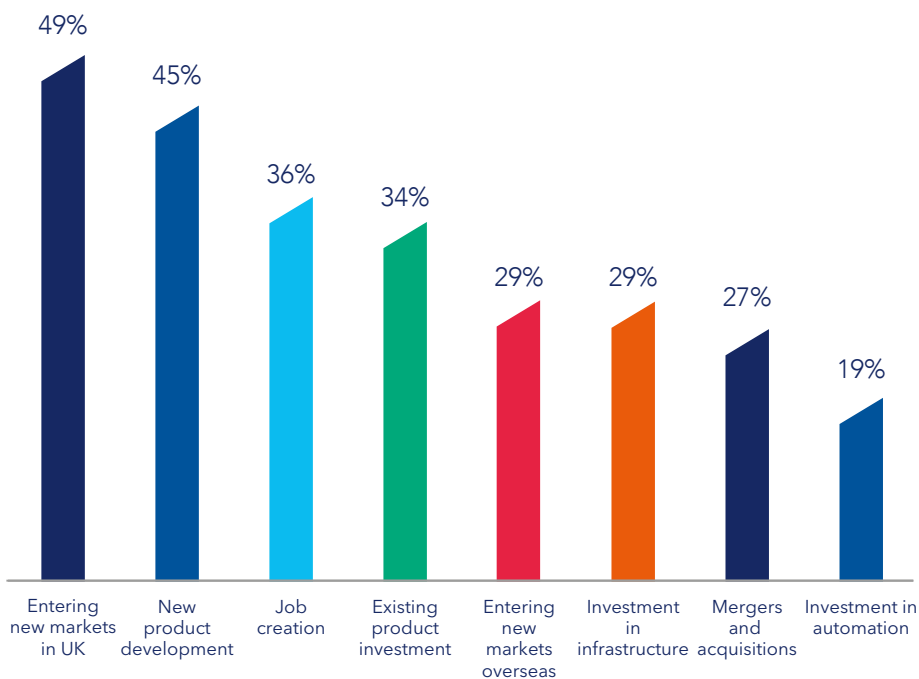
Among larger firms the average investment estimate has risen sharply to 68 per cent of current annual turnover over the next five years compared with 37 per cent in 2015.

Although the survey was conducted in the weeks immediately after the EU Referendum decision, it finds some interesting initial responses to the decision. A total of 52 per cent of firms said the EU Referendum result had led to an increase in investment plans.

Across survey respondents as a whole, 31 per cent said the vote would lead to a fall in investment. Just six per cent of mid-sized businesses (turnover between £25 million and £750 million) said they were feeling more confident about investment, but 44 per cent of the large company segment said confidence within the industry has increased.

Prospects for research and development (R&D) spending have also become more positive. The survey reveals that across all firms, R&D investment is expected to total 39 per cent of current turnover over the next five years, well up on the 27 per cent figure in last year's survey. Among large firms, the comparable figure is up from 23 per cent to 44 per cent.

How do you plan to achieve that business growth in the next five years?

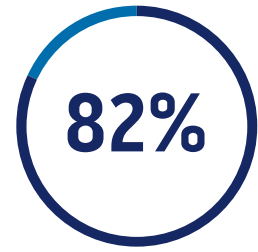


Planning for growth

When asked how firms planned to achieve business growth over the next five years, the most cited response was entering new markets in the UK (49 per cent of companies surveyed). The next most popular route is new product development (45 per cent), followed by job creation (36 per cent) and investment in existing product (34 per cent).

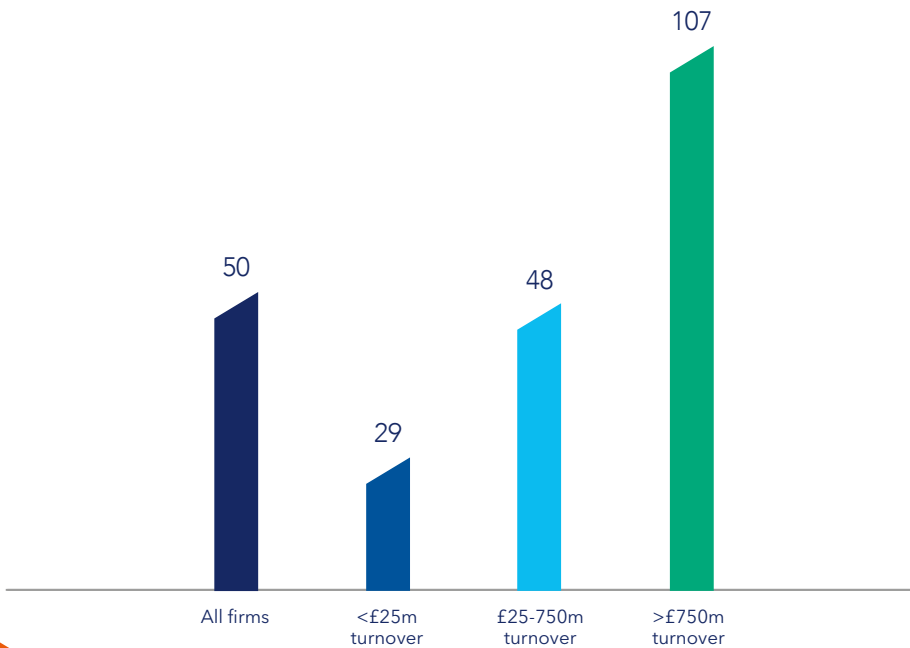
As for finance, resort to cash reserves is the most mentioned response, (38 per cent) followed by joint venture (30 per cent) and cash flow finance (29 per cent). The number of firms planning to enter joint ventures has jumped up since this time last year from 20 per cent to 30 per cent, suggesting businesses are seeking lower-risk growth options.

A stand-out finding is a big jump in preference for asset finance among large firms - this was called out by half of all large firms (50 per cent) compared with 23 per cent a year ago. Across the survey overall, just 21 per cent cited debt as a means of funding business growth, against almost a third previously.



predict increase or no change in jobs forecast following the EU Referendum

How many net new jobs do you plan to create in the next five years?



▶ 49%

of companies plan to enter new markets in the UK

The job forecast

The sector's prospects for job creation look set to increase. Overall, firms expect to create an average of 50 net new jobs over the next five years, against an average of 47 cited in the previous year's survey. Large firms expect to create an average of 107 jobs over the next five years.

Scotland's food and drink industry currently employs around 34,000 people⁴, accounting for 19 per cent of all Scottish manufacturing jobs⁵ and the industry looks set to create more than 14,000 net new roles over the next five years.

The decision to leave the EU has affected job creation plans in the industry. 66 per cent of firms said that it had affected their plans for recruitment, and 42 per cent of

firms said that the EU Referendum had increased their job creation plans by either a large or small amount, suggesting recruitment plans that may have been put on hold prior to the EU Referendum are now coming back online as firms look to grow over the next five years.

The survey results are particularly heartening given the forecasts for Scotland's economy. The Fraser of Allander Institute has revised down its output forecast for 2016 from 1.9 per cent to 1.4 per cent and predicts only modest recovery to growth of 1.9 per cent in 2017 - but with plans for investment, growth and new jobs, we may see the food and drink sector buck this trend.

⁴ Scottish Food and Drink Federation, Statistics at a glance

⁵ BDO International Food & Drink report 2015

► **The industry looks set to create more than 14,000 net new roles over the next five years.**



International expansion and export

The food and drink sector has made huge progress in international expansion. Building on existing export markets and finding new opportunities will be critical in the coming years.

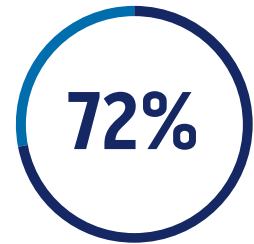
Between 2004 and 2014 food exports from Scotland increased by more than 50 per cent. Food exports have now passed the £1.1 billion mark for the first time, with total food and drink exports hitting £5.1 billion in 2014⁶. The latest survey of the sector gives grounds for optimism that good progress can be maintained in the period ahead.

Internal Investment

More than two thirds (69 per cent) of all respondents say that they are investing or planning to engage new international customers over the next five years, seven percentage points ahead of the 2015 figure.

The survey found a sharp increase in the number of SMEs seeking new international partners. This will be widely welcomed, given the drive in Scotland in recent years to encourage SMEs to build a presence in export markets.

The survey shows that 72 per cent of SMEs in the sector plan to engage new international customers, up from 44 per cent in the previous year's survey. And the fall in sterling in the wake of the EU Referendum vote may help make Scottish food and drink exports more competitive.

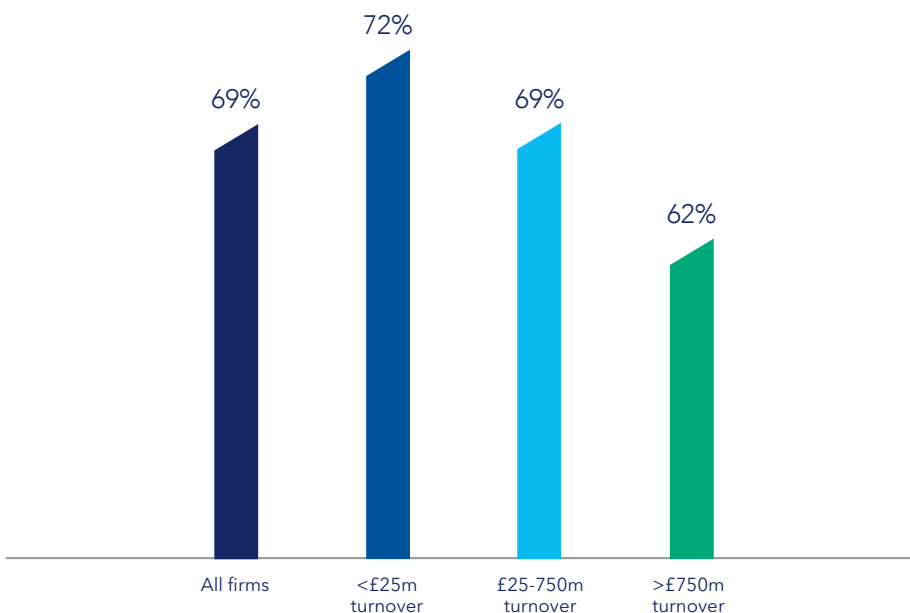


of SMEs in the sector plan to engage new international customers



of all respondents say that they are investing or planning to engage new international customers over the next five years

Firms that are investing in or planning ahead to engage new international customers in the next five years.





Between 2004 and 2014 food exports from Scotland increased by more than 50 per cent.⁶

Going global

Notwithstanding the vote outcome, Western Europe remains the most favored region for international investment, followed by the Middle East and North America.

However, among large firms, the Middle East and Asia/Far East are cited as the most favoured areas for export investment, both named by 80 per cent of large companies, with turnovers topping £750 million followed by Central/South America (70 per cent), North America (60 per cent) and Eastern Europe (60 per cent).

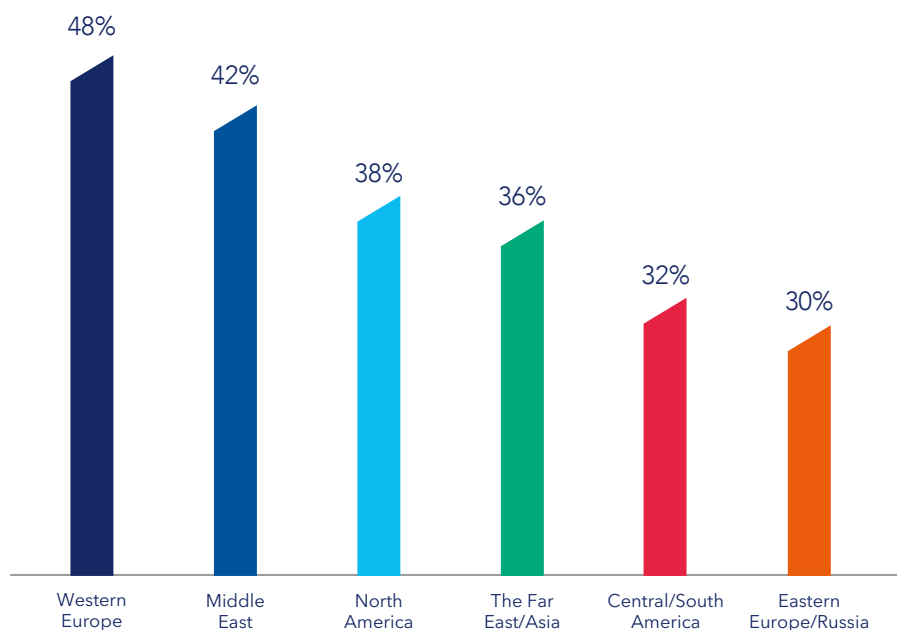
The challenge of exporting

Complexity of logistics is cited as the biggest factor inhibiting firms from seeking out new international customers. This is pointed to by half of all SMEs and by 57 per cent of mid-sized businesses, and shows little improvement on the 2015 results suggesting that understanding how to export continues to be a challenge for food and drink firms.

As for capability, more than half (57 per cent) of all respondents say they have the capacity to increase production or expand operations quickly. Among large companies this proportion rises to more than eight in ten firms (81 per cent), well up on 59 per cent recorded last year.

⁶ HMRC export statistics for 2014, updated July 2016

In which markets are you considering investing in or planning ahead to engage new international customers? (All firms)



Capitalising on provenance

Innovation, transformation and re-invention drives businesses forward. Nowhere is this truer than in Scotland's food and drink sector.

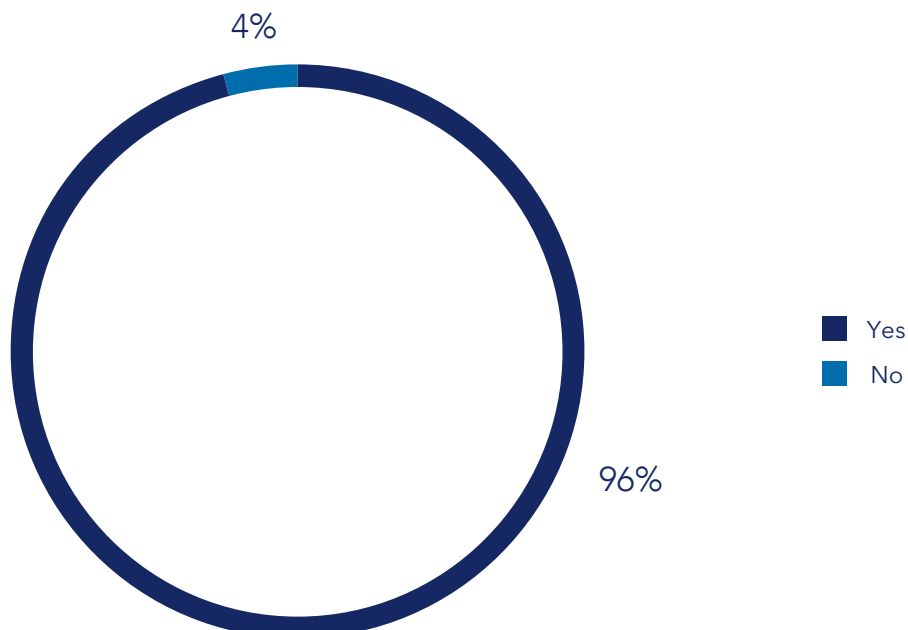
Taking advantage of the good reputation of Scottish produce in international markets scores particularly highly in the latest survey. Some 87 per cent of all respondents say they are already capitalising on the reputation of Scottish produce, up from 71 per cent previously. SME sized businesses scored particularly high here, with more than nine in ten (91 per cent) making use of the good standing of Scottish produce.

Just over half (51 per cent) of all firms surveyed say they plan to use clearer labelling and packaging, with no less than 86 per cent of large companies saying they are increasing spend on retail marketing campaigns to capitalise on provenance. Reflecting the growing consumer interest in locally-sourced products, organic foods and awareness of ingredients, increased spend on origin/traceability marketing also figures highly here, with 71 per cent of large firms saying they intend to pursue this.



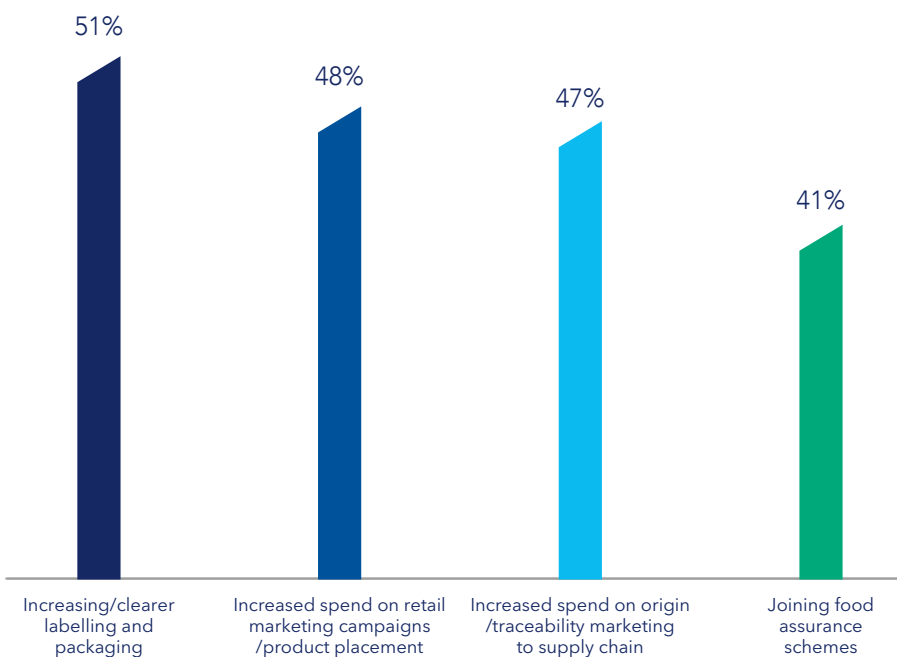
of small and medium sized businesses are making use of the good standing of Scottish produce

Do you think that Scottish produce currently has a good reputation in international markets?



► Taking advantage of the good reputation of Scottish produce in international markets scores heavily in the latest survey.

What are you doing to capitalise on the UK provenance of your product or produce?



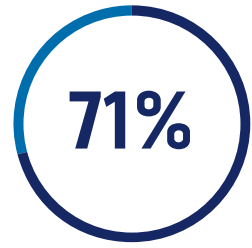
► **53%**
view the increased focus on provenance as an opportunity for the UK food and drink industry

► **51%**
of firms are increasing clearer labelling and packaging to capitalise on provenance

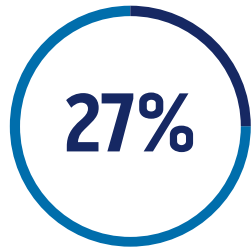
► **87%**
of all respondents say they are already capitalising on the reputation of Scottish produce

Alongside provenance, a stand-out result of the survey is the response to the growing awareness around public health. Overall, 45 per cent of all firms say this presents an opportunity for the food industry, compared with 23 per cent who view it as a negative.

A positive balance of respondents view the introduction of a sugar levy as an opportunity (39 per cent) rather than a threat (27 per cent). Half of all large companies viewed the levy as an opportunity, suggesting the new policy will not be as challenging for the industry as perhaps first anticipated.



of large firms intend to increase spend on origin/traceability marketing



say the sugar levy is one of the biggest challenges for the food and drink industry in the next five years

▶ **45%**

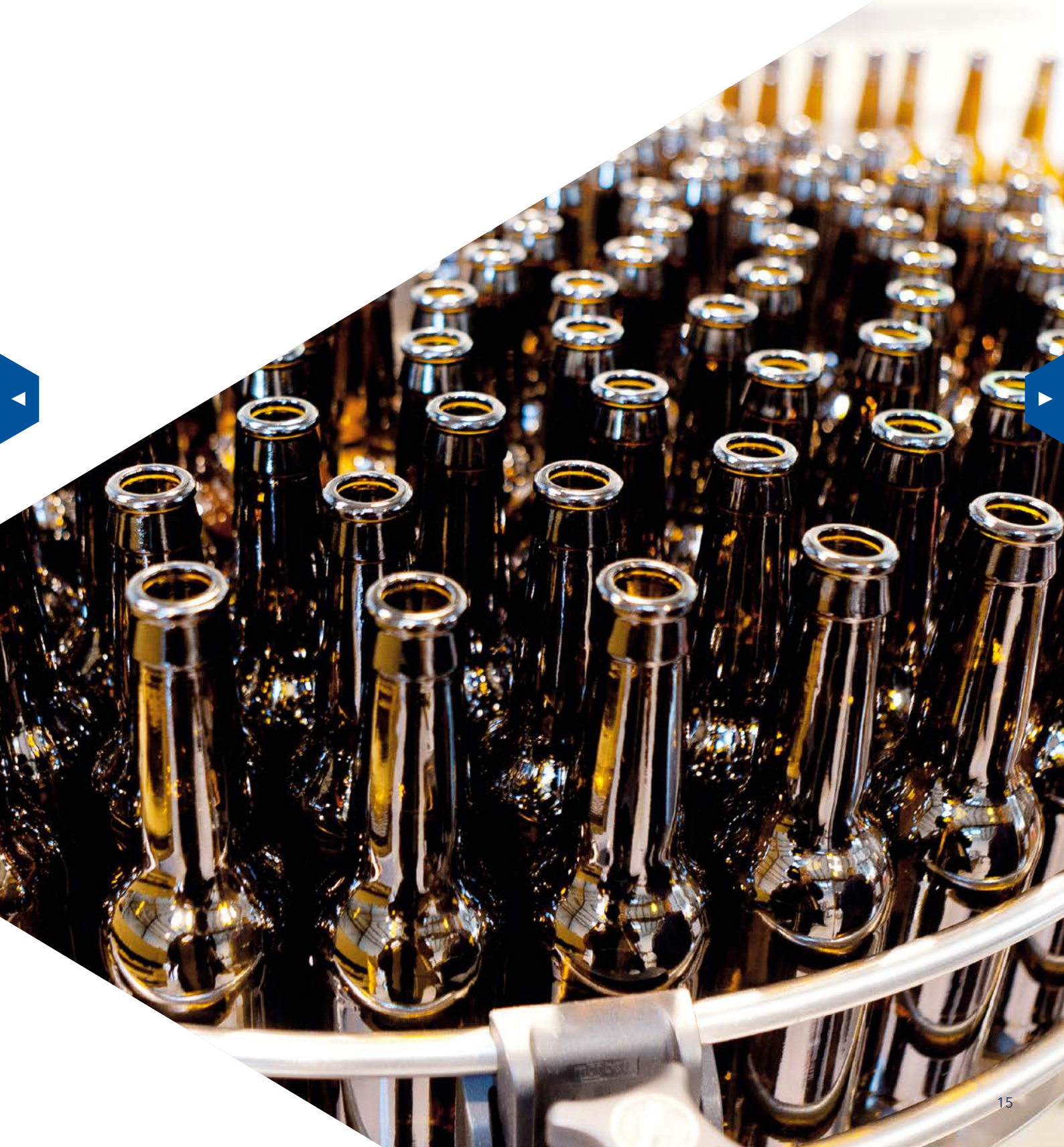
of all firms see the growing awareness around public health as an opportunity

▶ **23%**

of all firms see the growing awareness around public health as a threat.



- ▶ A positive balance of respondents view the introduction of a sugar levy as an opportunity rather than a threat.



Challenges and opportunities

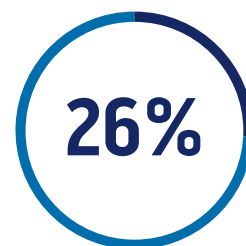
This year has brought formidable challenges for Scotland's food and drink sector, not least the reductions in growth forecasts, both for the global economy and here at home.

The stand-out issue is the UK-wide referendum vote to leave the EU. This has brought immediate uncertainties for Scotland's food and drink exporters to the EU and for raw material and input costs with the fall in sterling.

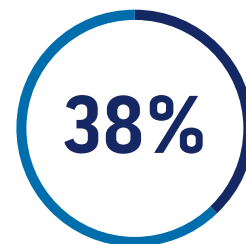
The survey revealed a wide range of responses to the EU Referendum result. Overall, 31 per cent of all firms said there would be a decrease in investment, and just over a quarter (26 per cent) that industry confidence had decreased.

Anecdotally, firms said they'd put expansion and growth plans on hold due to the result and recruitment had been paused as a result of the uncertainty in the lead up to the EU Referendum.

But the response among large companies was more confident. Replies here were evenly split between those predicting a fall in investment and those forecasting an increase. A total of 38 per cent said they would be looking to the EU for more opportunity along with one in four (23 per cent) mid-sized firms.

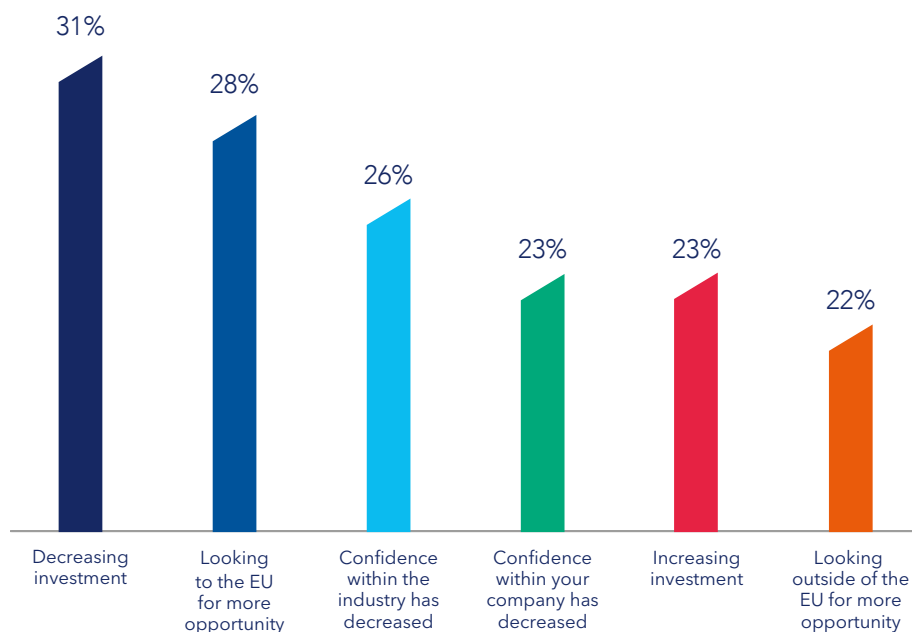


said that industry confidence had decreased



of large firms said they would be looking to the EU for more opportunity

How has the EU Referendum result to leave the EU affected your business in the short term?





According to the Scottish Food & Drink Federation, the sector will need 19,000 new recruits by 2024.

Asked whether confidence within the industry had increased, post EU Referendum, 44 per cent of large firm respondents agreed, while just 11 per cent of small firms said it had.

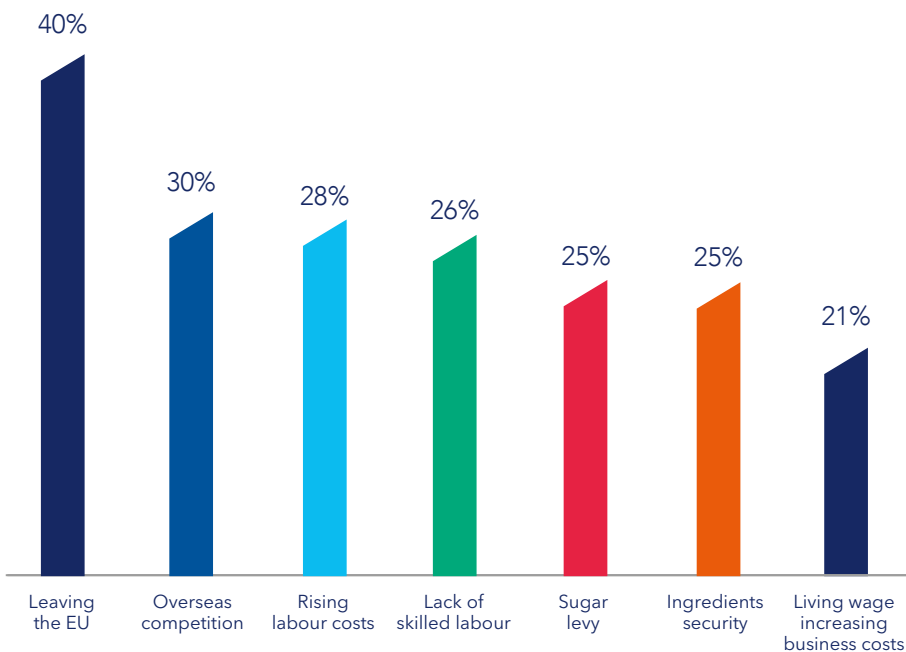
A similar proportion of small firms said their investment plans in the short term had increased (17 per cent) by a large amount, compared with 50 per cent of large firm respondents. This is perhaps a result of plans put on hold due to the EU Referendum.

Volatility of raw material and ingredient prices was cited as a concern by more than a quarter (28 per cent) of companies, with a third of SMEs (33 per cent) concerned about it. Volatility of energy prices was also a worry for 41 per cent of large firms.

While firms have plans to increase job creation, rising labour costs remain a challenge for the industry, with 28 per cent of all firms saying it was a barrier and 26 per cent of companies saying a lack of skilled labour was also an issue. According to the Scottish Food & Drink Federation, the sector will need 19,000⁷ new recruits by 2024 to meet the skills needs of the industry.

⁷ Scottish Food and Drink Federation

What do you feel are the biggest challenges for the food and drink industry in the next five years?



Ambition and innovation



James Withers
Chief Executive
Scotland Food
& Drink

Once again, this report has given us an important measure of the industry's sentiment. The findings here reiterate that our growing food and drink industry is marked by both ambition and innovation. Both those attributes have underpinned the unprecedented growth we have seen since 2007.

Much is made of the current uncertainty in our operating environment, most notably all the questions that emerge from the EU Referendum result. Yet, so many factors in the day-to-day lives of food and drink firms are uncertain; from exchange rates to weather events, as well as political upheaval. So uncertainty can be managed and growth can be driven.

For a sector that burst back into growth during a global financial crisis, there is no reason to presume that current uncertainty should dampen our momentum. That said, the road ahead for the trading relationship with the EU, the future of the European workforce and the next generation of agricultural support are just some of the key considerations that will be focusing our minds in the weeks and months ahead.

A combination of global trends and a massive amount of development work within Scotland itself all point to an exciting future for Scottish food and drink producers. Many other sectors would eye enviously a forecast growth rate of 24 per cent over the next five years. However, the clear focus on research and development, internationalisation and capitalising on Scotland's growing brand all suggest to me that this level of growth may well be conservative.

At the start of 2017, Scotland Food & Drink will launch a new industry strategy, setting out a roadmap to 2030. The first ever industry-wide strategy, supported by government and its agencies in Scotland, began in 2007 and is now reaching the end of its 10-year lifespan. We will begin a new growth cycle in good health. One look at our membership and you will see a huge diversity of businesses producing world-class products.

The opportunity is to continue to build our customer base. Our home market is fiercely competitive but still ripe for further development. And that strong domestic market is the platform for us to go global, building markets in North America, the Middle East, Far East and, still, the EU.

Food and drink has been a bright spot in Scotland's economic story for nearly 10 years now. This report is further evidence that we have all the ingredients for that to continue.

- ▶ **A combination of global trends and a massive amount of development work within Scotland itself all point to an exciting future for Scottish food and drink producers.**

The support you need

For more information, get in touch with us



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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 Scotland's leading and up-and-coming food and drink producers, and can tailor a range of solutions for your business.

References

- Food and Drink Federation, Statistics at a glance, January 2016
- HMRC export statistics for 2014, updated July 2016
- Fraser of Allander Quarterly Bulletin Vol 40 No1, June 2016
- Scottish Food and Drink Federation
- BDO International Food & Drink report, 2015
- BDO International Food & Drink report, 2016

Methodology

Field research for this report was undertaken in July 2016 by Coleman Parkes Research.

To gather representative data from this diverse industry, a broad cross-section of 100 food and drink manufacturers in Scotland were interviewed from companies ranging in size from less than £25m, £25-£750m and more than £750m annual turnover.

Business owners, managers, senior managers, directors and department heads took part in the survey.

Our survey questions focused on growth and export plans, job creation, capacity and investment, international markets and challenges.

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Helping businesses to grow



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