

ITEM Club Forecast

Chief Financial Officer Programme



Economic outlook for business: briefing paper for CFOs

The Ernst & Young sponsored ITEM Club¹ (ITEM Club) published its latest quarterly forecast for the UK Economic Prospects on 21 April 2008. Produced as part of Ernst & Young's CFO programme, this paper is an extract of the key factors relevant to the CFO agenda and comments on implications and potential actions.

The full forecast can be found at www.ey.com/uk/itemclub.

Overview

The ITEM Club forecast of 21 April 2008 highlights the following:

- ▶ The UK economy is rebalancing from consumer consumption (reliant on international funding) towards export and investment; the liquidity crisis is providing an overarching context of uncertainty.
- ▶ GDP growth for 2008 and 2009 is forecast at 1.8% and 1.5% respectively, down from 3.0% in 2007, rising to 2.7% by 2010.
- ▶ Growth in domestic demand is forecast to reduce from 3.7% in 2007 to 1.1% in 2008, rising to 2.6% by 2010.
- ▶ Fixed investment growth is forecast to reduce from 6.2% in 2007 to 0.4% in 2008, rising to 3.5% in 2010.
- ▶ Exports, which fell by 5.3% in 2007, are forecast to grow by 3.2% in 2008 and 5.4% in 2009.
- ▶ Manufacturing output is forecast to grow by 1.5% in 2008 and 2.5% in 2009; this will be the first time it has risen faster than GDP growth since 1994.
- ▶ Inflation (CPI) is forecast at 2.7% in 2008, falling to 2.2% in 2009.
- ▶ Interest rates (3-month) are forecast at 5.5% by the end of 2008, falling to 4.4% in 2009.
- ▶ The Sterling exchange rate (as measured against a basket of currencies) is forecast to fall to 95.6 in 2008 (from 107.2 in 2007) and 92.4 in 2010 (ITEM predicts that a further fall of 10% would not have a material effect on the 21 April forecast).

Taken together we see the environment as extremely uncertain for the remainder of 2008 at least. Many of the indicators in the forecast are in fact positive which point to significant business opportunities; however the credit crunch, coupled with consumer retrenchment make it extremely difficult to assess the timing of the likely turning point.

Given this uncertainty we see the main challenge for the CFO in this period is to satisfy themselves and then reassure the board that the current business plan is realistic and achievable.

Key questions to answer in providing this reassurance are:

- ▶ Are you confident that the trajectory in your business plans is accurate?
- ▶ Are you tracking the key lead indicators to predict how the 'turn' will impact your businesses?
- ▶ Have you stress-tested your planning assumptions for the likely future exchange rate scenarios?
- ▶ Is your funding secure; do you know that you are compliant with all terms and conditions; has the treasury policy been reviewed in light of the current environment?
- ▶ How is the commodity inflation impacting you and your supply chain?
- ▶ Have you rigorously re-assessed your risk assessment in this uncertain climate?

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1. Ernst & Young is the sole sponsor of the ITEM Club, which is the only independent economic forecasting group to use the HM Treasury model of the UK economy. Its forecasts are independent of any political, economic or business bias.



Further implications for the CFO

When responding to these big picture questions, drawing on our experience, there are many detailed questions and considerations we believe the CFO should be looking at today:

Growth

- ▶ Ensure that the right lead indicators are being used by individual business units to support order intake and revenue forecasts; assessing the impact of change in key growth markets such as China and India will be important.
- ▶ The board is likely to be sceptical of investment plans; anticipate questions and assemble detailed evidence to support proposals and assumptions
- ▶ The consumer downturn is unlikely to have worked its way through your business model yet; where do you assess it to be; how much further has it to go?
- ▶ Despite the uncertainty are you looking for the right opportunity? How will you respond if you have to move quickly?
- ▶ Think carefully about your financial communication; the mood is bearish; how will you evidence good news so that it gets recognised in value terms?

Cost

- ▶ Have you re-evaluated your supply chain and the risks it carries; are your suppliers able to absorb commodity price increases and your commercial arrangements with them; can suppliers access adequate volumes for you?
- ▶ Is the climate having an impact on staff morale; do they have personal concerns that will impact productivity?
- ▶ Do your business units fully understand the impact of input inflation; are your hedging policies and strategies in step with your current buying environment?

Financing

- ▶ Has your treasury team satisfied you that they are on top of your funding arrangements; down to compliance with all the detailed terms and conditions?
- ▶ Do you have to re-assess your debt profile? Should you/can you de-risk by refinancing now at a higher cost? How real are alternatives?
- ▶ New sources of financing are opening up (e.g. sovereign wealth funds); do you know how to access them and whether they are relevant for you? What are the pricing models?
- ▶ If you do have growth plans, have you locked in the necessary funding? Have the banks the ability to withdraw and if so what are the consequences?

Final thoughts

These are exceptional times. Now is the time to think about the worst case scenario ahead of time and have a plan ready to deal with it! The ITEM Club forecast shows a 'net, net' positive picture, but the context is one of considerable uncertainty. The questions we have noted above draw on the collective experience of what we are seeing in the market today. The leading CFOs will be those who are able to sort through their priorities to stay on top of their forecasts and provide the confidence to support growth opportunities. 2008 will be a year to remember!

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