

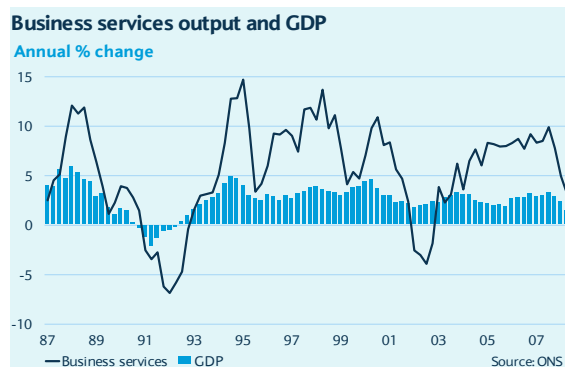
Business Services & Logistics Review

October 2008

Summary

- Following several years of rapid growth, the business services industry essentially stagnated in the first half of 2008. As a result, the annual rate of growth in this industry has fallen to its lowest level (3.1% in the second quarter) since 2003.
- However, despite slowing considerably, annual growth in business services activity continues to outpace that of the wider economy. Having experienced robust growth during 2007, the UK (along with the other major global economies) has been impacted by the turmoil in global credit and financial markets over the past year.
- As a result, the UK economy stagnated in the second quarter of 2008, bringing to an end over 15 years of unbroken growth. On an annual comparison, GDP growth slowed to 1.5%, the weakest rate of growth since the end of 1992.
- Moreover, although prospects are highly uncertain, it seems inevitable that next year will be a period of stagnation, or even outright contraction, in the UK economy.
- The credit crunch has also had a significant impact on industries such as financial services, which have helped drive business services growth in recent years.
- The resultant tightening of corporate budgets, rise in unemployment and slowdown in demand for commercial property space has been felt across a wide range of business services activities, with sectors such as facilities management support services, recruitment, management consultancy and marketing and advertising all affected.
- In contrast, growth in the transport and logistics industry remains robust as a pickup in international goods trade appears to have helped offset (to a degree) the slowdown in key demand sectors, such as retail and construction.
- Continued growth in passenger transport also continues to underpin growth. However, performance varies between sectors, with strong growth in rail transport contrasting with signs of slowing demand in the aviation sector.
- In terms of profitability, strong growth in demand in the transport industry has been offset by the sharp rise in fuel costs during the past year. This has had a particularly significant impact on the air transport industry as a result of the greater sensitivity of aviation fuel costs to changes in oil prices.
- Together with slowing demand, this has already resulted in several airline failures. A number of airlines are also planning to cut capacity in response to higher costs and slowing demand.
- With the UK economy expected to continue to slow during 2009, corporate spending and investment plans will clearly be impacted. Allied to slower growth in planned public sector spending, this is likely to see business services growth continue to decelerate.
- This may result in some consolidation in sectors such as recruitment, which have seen capacity build amid strong growth in recent years.
- The transport industry is also likely to face more challenging conditions, particularly the aviation and haulage sectors.

Overview



The latest quarterly data reveal that the business services industry essentially stagnated during the first half of 2008, following several years of rapid growth. As a result, the annual rate of growth slowed to just 3.1% during the second quarter of 2008. Although this was still more than twice the rate of growth recorded by the economy as a whole, it was the weakest annual growth rate recorded for the industry since 2003 and was considerably slower than the 8.6% growth rate achieved during the same period last year.

Growth in business services activity has tended to outpace that of the wider economy since the early 1990s, amid widespread outsourcing of various support services by firms seeking to focus resources on core activities, as well as public sector institutions. At the same time, the rapid pace of technological development (particularly in terms of communications and information technology) has increased productivity and lowered costs for business service providers in a number of key sub-sectors, providing a further boost to wider industry growth. More recently, robust growth in industries such as financial services, a key source of demand for business services, has also supported growth.

However, the credit crunch, which began more than 12 months ago, has begun to feed through to the real economy. On a quarterly basis, GDP growth stalled in the second quarter of 2008, bringing to an end a prolonged period of consistent growth stretching back over 15 years and slowing the annual rate of growth to just 1.5% - the weakest since the end of 1992 and less

than half the 3.0% growth rate recorded in 2007. Most key indicators and survey evidence suggest weakness in the economy during the third quarter.

The slowdown has been led primarily by a fall in investment and weakening consumer spending. While the available data suggest that this has been driven largely by a slowdown in property investment, slower growth in business investment suggests that corporates have become more cautious as the outlook for the economy has deteriorated, with tighter credit conditions also having a dampening effect. This has clearly had an impact on demand for business services.

Having previously been constrained by high rates of inflation, the Bank of England has responded by lowering base rates by 50 basis points (to 4.5%) earlier this month. The cut was part of a wider global monetary policy response to the recent intensification of the credit crunch. Although inflation reached 5.2% in September (more than double the Bank's 2% target rate), it is widely thought to be at, or close to, its peak. The Bank believes that, although both upside and downside risks to inflation persist, the slowing economy (and rising spare capacity), and the recent fall in oil and commodity prices, will see inflation decelerate relatively quickly during 2009-10. This may allow for monetary policy to be loosened aggressively in the months ahead.

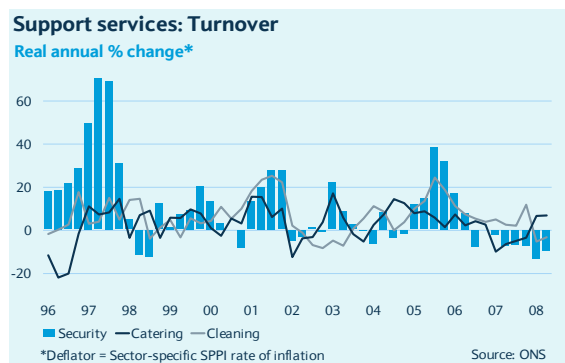
However, the turmoil in wholesale financial markets over the past year has limited the ability of financial institutions to pass previous interest rate cuts on in full. Indeed credit conditions for households and corporates have generally tended to tighten. With tight credit conditions expected to persist (at least in the short term) and economic growth expected to remain subdued, corporate spending and investment is likely to remain weak.

Facilities Support Services

According to Department of Business, Enterprise & Regulatory Reform (DBERR) data, there were 11,915 industrial cleaning firms, 6,330 security firms, and 5,730 contract catering firms operating

in the UK at the beginning of 2007. Although the number of firms in each sector continues to grow, the rate of net new firm formation slowed somewhat during 2004-07 (particularly in the security services sector) compared with the growth rates seen during the previous decade.

Adjusted for Services Producer Price Index (SPPI) inflation within the respective sectors, real turnover data suggest that growth in activity in the support services industry has slowed during 2007-08. This is likely to at least partially reflect weaker growth in demand in the commercial property sector during this period, following a period of robust growth.



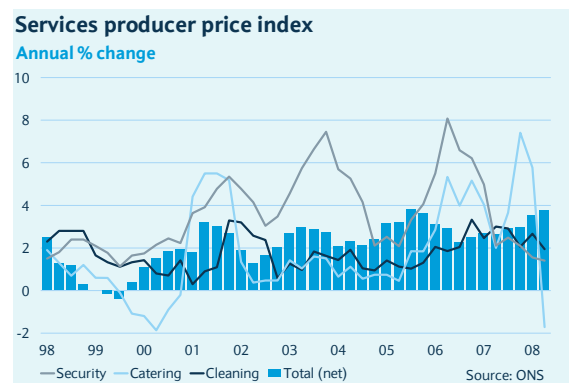
The security sector has seen real turnover growth contract following a sharp rise in 2005 in the aftermath of the London bombings. The latest data show that turnover continued to contract at a rate of around 10% in real terms in the second quarter of 2008, despite a significant slowdown in sector price inflation. A similar (though less severe) slowdown has also been evident in the contract cleaning sector, which has also experienced lower SPPI inflation as pricing power has diminished.

Real turnover growth in the contract catering sector has picked up in recent quarters (with growth of over 7% recorded in both the first and second quarters of 2008). However, this in part reflects the favourable base effects of the decline in turnover during the first half of 2007 and, more recently, a fall in SPPI inflation in this sector.

Cost pressures have been increasing for many firms across the business services industry as a result of both the direct and indirect impact of

rising fuel and utility costs in recent years. Wage increases have also added to cost pressures in recent years as facilities service companies, which tend to employ largely unskilled staff on low wages, have been impacted by above-inflation increases in the minimum wage. A reported shortage of skilled staff in some sectors (notably catering) has exacerbated the situation, although the influx of low-wage migrant workers to the UK, following the eastward expansion of the European Union (EU) in 2004, has offset this to a degree.

While a softening labour market and lower minimum wage increase for 2007-08 should help to contain wage pressures, the recently announced rise in energy prices means that other cost pressures are likely to persist, at least in the short term.



In terms of profitability, any easing in cost pressures will also be offset by declining pricing power, with SPPI inflation in all three sectors below that of the services sector as a whole, and of inflation in the wider economy. Barriers to entry are generally low across the facilities support sector, particularly in activities such as non-specialist cleaning, and the corporate market is mature. This limits operators' pricing power in the longer term.

Also, while large and specialist operators have benefited from securing public sector contracts in recent years, public sector clients (like their private sector counterparts) are likely to become increasingly cost conscious as departmental budgets tighten.

Management Consultancy

Although a few large firms offering a diverse range of services account for the lion's share of fee income, the majority of firms in the management consultancy sector are small and tend to be highly specialised.

The latest Management Consultancies Association (MCA) data reveal that the UK consulting sector as a whole generated revenue of £8.5 billion in 2007. This represented a nominal increase of 10%. However, while still relatively robust, this was below the 16% growth rate achieved in 2006, with respondents to the MCA survey reporting greater caution among clients amid rising concerns over the economic outlook. Performance also varied significantly within the sector. Among MCA member firms, which account for an estimated 70% of total fee income, the ten largest firms saw income increase by 14%, while smaller firms achieved income growth of just 4%.

Growth was driven primarily by the IT consultancy segment, which accounts for the largest share of fee income. Programme/project management (the second largest segment) also enjoyed good growth. Demand for environmental consultancy services has also risen, with fee income almost doubling last year (albeit from a low base). However, fees from operational and business processing work contracted last year following several years of growth.

Although still strong, at around 20%, fee income from financial services firms slowed last year, reflecting the impact of the credit crunch on the financial services industry, with income growth from banks in particular slowing. However, this also reflects the fact that the boost to consultants' fee income from the implementation of Basel II regulations, and Sarbanes-Oxley legislation in the US, has largely run its course.

Slower growth in financial management consultancy was offset by strong growth in demand from the technology and telecoms sector. In contrast to previous years, fee income from the public sector slowed last year, with

central government spending on consultancy stagnant and local government spending declining by 26%. This followed a report by the National Audit Office (and subsequent Public Accounts Committee hearings), which raised some concerns over public spending on consultancy services.

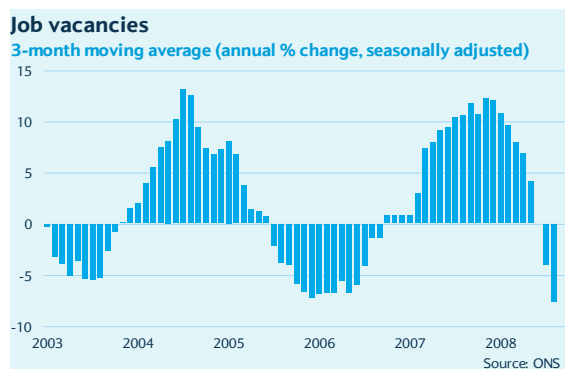
Improved demand will have enabled firms to continue to increase fee rates over the past couple of years. However, recruitment in the sector has also risen rapidly, with the number of consultants employed by MCA firms increasing by a further 9% last year. Competition for suitably qualified staff has meant that many firms have struggled to fill vacancies in recent years. This will have resulted in upward pressure on remuneration costs. Combined with slowing revenue growth, rising employment in the sector resulted in growth of just 2% in average revenue per consultant last year, the MCA estimates. As a result, profit margins in the sector are tightening.

Recruitment

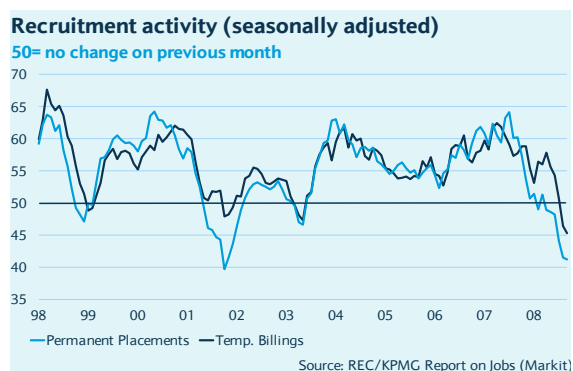
There were 18,985 VAT-registered recruitment firms in the UK at the beginning of 2007, according to DBERR data. The number of recruitment firms has more than doubled over the past decade. However, the pace of growth of net new firm formation in the sector, which was running at double-digit rates in each of the five years to 2001, has steadily slowed. Although robust relative to many other sectors, the 5.5% increase in the business stock in this sector during 2006-07 was the slowest rate since 1995.

The sector has benefited in recent years from relatively robust economic growth and the resultant strength of the UK labour market. At 29.4 million, the number of people in employment in the UK remains close to record levels. The labour force has been bolstered in recent years by higher participation rates among older workers (partly as a result of concern over pensions provision) and a continuing inflow of mainly low-wage, migrant workers, primarily from the Eastern European countries that joined the EU in 2004.

However, slower economic growth and the steady deterioration in the economic outlook have seen employment slow and unemployment increase in recent quarters. The latest data show that 1.79 million people were unemployed in the UK in the three months to August 2008. This was the highest unemployment total since 1999. At 5.7%, the rate of unemployment is also at its highest level since 2000. The rate at which unemployment is increasing has also accelerated markedly in recent months, reflecting recent faster growth in the number of redundancies.



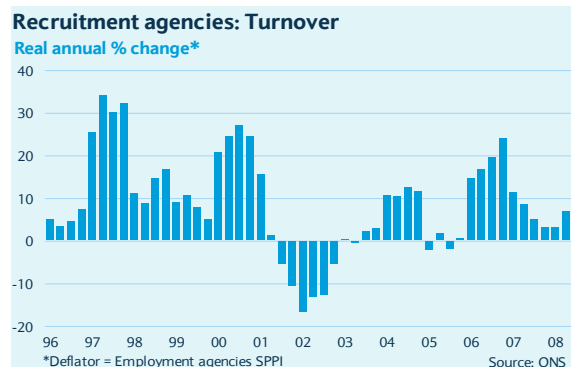
At the same time, the number of job vacancies (the key determinant of demand for the recruitment sector) has also begun to decline, with employment and vacancy rates now slowing markedly in a number of sectors that had previously recorded strong growth, such as business and financial services, construction and distribution.



These trends have quickly filtered through to the recruitment sector. Seasonally-adjusted data from the REC/KPMG *Report on Jobs* survey produced by Markit reveal that permanent placements

declined for a sixth consecutive month in September, with the monthly headline index reading of 41.2 the lowest since October 2001. Temporary placements, which had held up rather better as firms adopted a more cautious attitude to recruitment, also declined for a second consecutive month. The survey reveals that overall demand for staff contracted at the fastest rate in its 11-year history, with only the healthcare sector recording an increase in vacancies. In marked contrast to 2007, candidate availability is now increasing at a rapid rate, with further moderation in pay demands also evident.

The slowdown in activity is also evident in the official data. According to the ONS, turnover growth adjusted for SPPI inflation within the sector has slowed markedly from the double-digit rates recorded during 2006-07, which were the highest since the dotcom boom at the beginning of the decade. While data for the second quarter of 2008 show some improvement, this is due, in part, to the impact of the sector's lower pricing power.



With growth continuing to slow and further job cuts expected, there appears little likelihood of an improvement in the near term. Indeed, the slowdown is likely to be exacerbated by the implementation of measures aimed at ensuring that the UK's 1.3 million agency workers receive the same pay and conditions as permanent staff after being employed for 12 weeks.

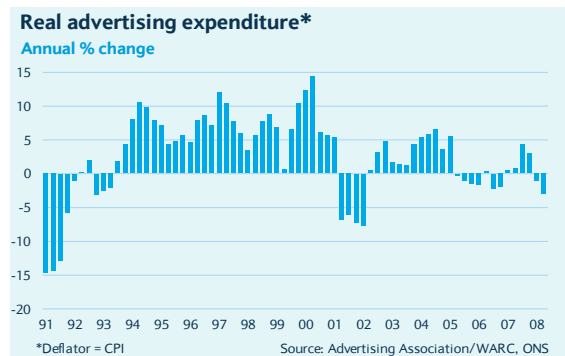
Furthermore, although technological change has helped to reduce costs for agencies since the early-mid 1990s, it has also reduced entry barriers to the industry and, more recently, has enabled

many UK firms (and, increasingly, public sector organisations) to recruit directly through their own in-house websites and/or HR functions. This strategy is likely to become more widespread when candidates are in greater supply and/or when economic conditions deteriorate and cost considerations come to the fore.

While larger, international firms should be afforded a degree of protection, given the diversity of the markets in which they operate, taken together, recent trends could result in a period of consolidation among firms with a national and/or specialist industry focus.

Advertising & Marketing

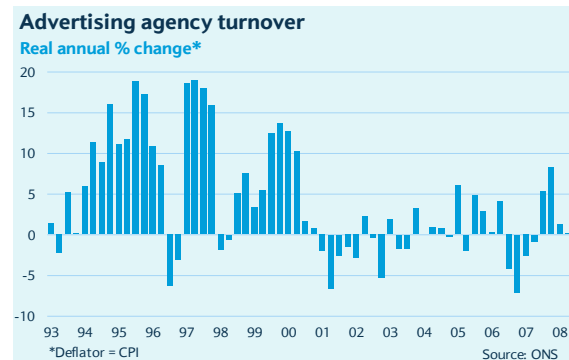
Having decreased by between 1% and 2% each year during 2001-05, the number of VAT-registered advertising firms operating in the UK has since begun to increase, according to DBERR data. Indeed, the 5% increase recorded during 2006-07 (the latest period for which data are available) was one of the largest on record. The total number of firms in the sector stood at 12,795 at the beginning of 2007, eclipsing the previous industry peak of 12,490 recorded in 2001.



Advertising is a highly cyclical industry, with long-term trends in advertising expenditure closely correlated to GDP and consumer spending growth. However, advertising expenditure responded belatedly to the recovery in GDP and consumers' expenditure growth during 2006-07 (which followed a brief slowdown in 2005), with real growth only really returning in the second half of 2007.

According to the latest WARC/Advertising Association Quarterly Survey of Advertising Expenditure, the upturn has proven to be relatively modest and short-lived, with real advertising expenditure declining once more in tandem with the slowing economy, signs of weakness in the consumer sector and a deteriorating financial and economic outlook. Indeed the 3.1% decline recorded in the second quarter was the largest since the first quarter of 2002. The timing of the slowdown gives further cause for concern, as it coincided with a number of major events, such as the European football championship, Olympic Games and the US presidential election race, which do not take place on an annual basis and which would normally see advertising expenditure increase.

These trends are evident in official data which show that, after a brief, sharp rise in the latter part of 2007, advertising industry turnover stagnated in real terms (on an annual comparison) in the second quarter of 2008.



The latest Institute of Practitioners in Advertising (IPA) Bellwether Report suggests that the slowdown is set to continue, as the corporate sector seeks to minimise the impact of rising costs and weakening demand on profit margins by trimming budgets. The report, based on survey evidence from the third quarter of 2008, reveals that advertising budgets have been revised down for a fourth consecutive quarter, with the latest cuts the largest in the survey's nine-year history. The slowdown has been wide-ranging, with the exception of internet advertising, which has been by far the fastest growing advertising medium in recent years. However, even this category saw budget expenditure for the year stagnate. Internet

search advertising was the only category in which expenditure increased, although the IPA notes that the rise was only marginal.

In addition to cyclical trends, structural changes resulting from technological developments have begun to pose an increasing challenge to the industry. Multichannel television has resulted in significant audience fragmentation, which has limited the reach of traditional television advertisements. Although more commercial channels provide more platforms for advertising and have succeeded in attracting firms previously priced out of traditional television advertising, this has failed to offset the impact of a decline in advertising rates on aggregate industry turnover. At the same time, developments such as video-on-demand, which allow viewers to skip advertisements, have further eroded the impact of television advertising.

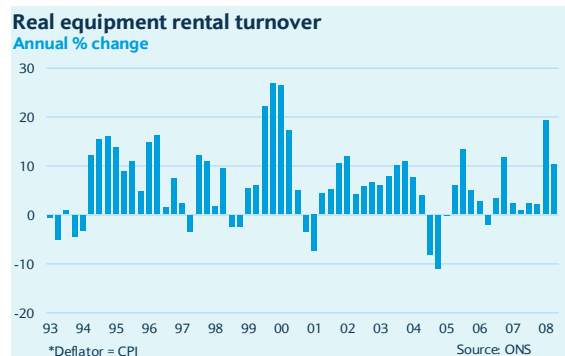
The situation has been exacerbated by the rapid proliferation of high-speed broadband internet connections, which has seen younger consumers in particular (a key target market for advertisers) devote an increasing amount of their leisure time to internet-based activities at the expense of traditional media. According to the WARC/Advertising Association data, internet advertising expenditure accounted for 20.1% of total UK advertising expenditure in the second quarter of 2008. This compares to less than 1% at the beginning of the decade. As a result, internet advertising seems poised to overtake television advertising, which accounted for 23.8% of advertising expenditure in the second quarter of 2008 (down from 26.7% at the beginning of 2000). It may also overtake newspaper advertising, which, at 26.4% of total expenditure, still accounts for the largest share of UK advertising, (although this is some way below the 36.8% share recorded for newspaper advertising at the beginning of the decade).

While these developments clearly offer potential opportunities, as well as challenges, the advertising industry appears to be struggling to develop strategies that will help it to realise (and, perhaps more importantly, to monetise fully) the potential gains of new media advertising.

Vehicle & Equipment Hire

Despite continued consolidation, and the emergence of a small group of dominant firms, the **plant and machinery** rental sector remains fragmented, and prone to periods of excess capacity. Some larger firms have responded to the relatively high degree of cyclicity within the sector by extending their international reach, while at the same time, expanding into new markets (such as oil, steel and specialist manufacturing). This has allowed them to benefit from both geographical and industrial diversification. However, the small firms which form the majority of the sector lack the scale and scope to adopt such strategies and remain highly dependent on local market conditions.

The sector's fragmented structure means that changing trends in the construction industry, the key source of demand for the sector, tend to be accentuated and recent performance suggests that cyclicity remains high.



Despite the recent slowdown in the construction industry, growth in equipment rental turnover has picked up strongly in recent quarters. This may reflect a shift in the pattern of construction activity towards non-residential activities (such as large infrastructure projects), which tend to require more intensive use of heavy equipment. However, those firms highly dependent on the housebuilding sector are likely to have experienced a sharp fall in demand.

The slowdown in corporate spending and recruitment is likely to have impacted on the **computer and office** equipment leasing sector. However, budget tightening may have resulted in

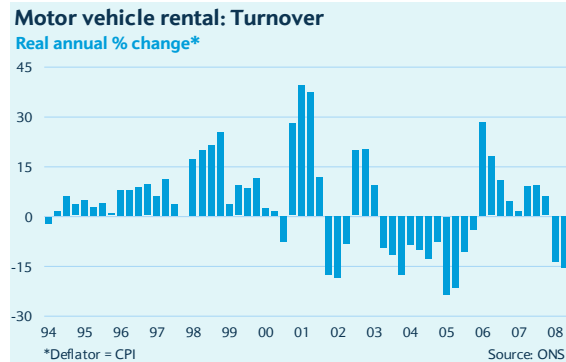
some firms switching from purchasing equipment to leasing, which may have helped to partially offset this.

Competition means that margins in the sector remain tight, while the longer-term decline in the price of computer and other office hardware and the rapid pace of improvement in both its specification and performance represent mixed blessings for firms in the sector. On the one hand, leasing companies benefit from lower costs and an increased volume of equipment renewal (as clients seek to keep pace with technological improvements). On the other hand, falling prices erode the incentive to lease rather than buy, as well as limiting the pricing power of leasing companies. At the same time, shorter equipment life cycles require more regular investment and equipment turnover.

The *auto* rental sector has become much more complex, not only as a result of technological and regulatory change, but also as a result of having to offer clients ever greater choice and flexibility (particularly in the leasing sector). These changes naturally favour the scale economies and expertise of the larger, established operators and pose significant barriers to many potential new entrants.

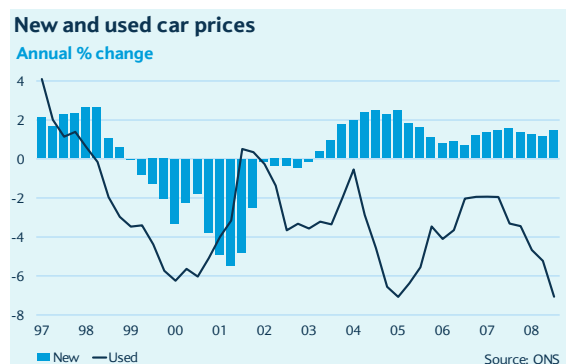
There were 2,800 VAT-registered vehicle rental companies at the beginning of 2007, according to DBERR data. Having grown strongly in the late 1990s, net new firm formation in the sector slowed markedly in the first half of the current decade. However, the 4.3% growth rate recorded for 2006-07 was the fastest since 2000.

The sector experienced a prolonged period of declining revenues (in both real and nominal terms) during 2003-05. This came to an end in 2006-07, with strong real turnover growth recorded during the first half of the year (although it should be noted that favourable base effects provide a partial explanation). However, growth has slowed once more in recent quarters, with turnover falling by an inflation-adjusted 15.9% in the second quarter of 2008.



The short-term car rental sector is dependent, to a large extent, upon demand from overseas visitors. Despite a relatively brief downturn following the 2005 London bombings, overseas visitor numbers experienced strong growth during 2004-07. However, they have slowed over the past year, driven by decline and stagnation in the key North American market and Western European markets. Visitors from these regions typically spend more and are more likely to be undertaking leisure or business travel (and therefore to hire a car) than those from other regions. The past year has also seen a marked increase in fuel costs, which is also likely to have either deterred visitors from renting cars, or seen them choose more cost-efficient models.

The slowdown follows a 14.8% increase in the fleet of short-term rental vehicles. According to the British Vehicle Leasing and Rental Association (BVLRA), this was led by a 25.2% increase in cars, which offset a continued (and, at 16.2%, a deepening) decline in light commercial vehicles.



It also coincides with a further decline in residual values, and rising financing costs, which continue to erode profitability. Official data show that new

car prices continue to rise, albeit at modest pace. However, used car prices continue to fall, with the rate of deflation accelerating once more to 7.1% in the third quarter of 2008.

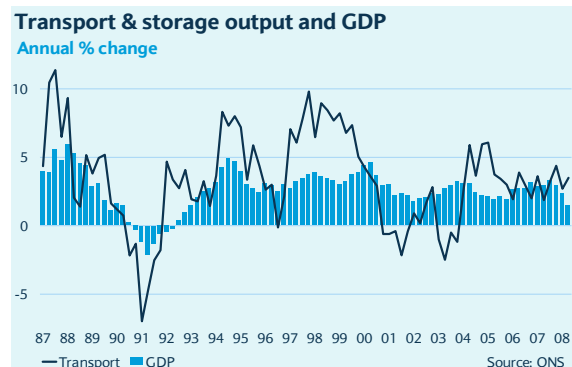
Structural changes also continue to impact upon the sector. Wider internet usage has increased competitive pressures, which in turn has led to downward pressure on prices and margins. It also means that vehicles tend to be booked much closer to the time of rental, making forward planning more difficult.

Tax and regulatory pressures (at both the UK and EU level) are also driving change - particularly emissions and environmental policies which, together with rising fuel costs and the development of low-emission, hybrid cars, are driving a switch to smaller, lighter, more fuel-efficient cars. This will also impact on the leasing market with the current leasing disallowance on cars (worth over £12,000) set to be replaced by a 15% flat charge on all cars with emissions in excess of 160g/km in April 2009.

Vehicle leasing and fleet management companies have benefited over the longer term from the outsourcing of company car schemes by the major corporates. This saw the fleet of long-term rental vehicles, including both LCVs and HGVs, almost treble between 1995 and 2005. However, while the size of the fleet remains close to its 2005 peak, it has levelled off in the last couple of years. The size of the fleet management sector has contracted in recent years.

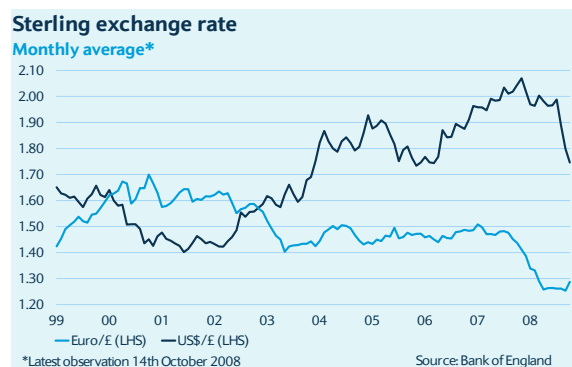
As the corporate rental sector has matured, vehicle leasing companies have turned increasingly to the personal contract hire (PCH) sector. BVRLA data, which now includes employee car ownership (ECO) schemes, show that the PCH fleet increased by 60% in 2007. However, with higher fuel prices undermining the tax-free mileage rates that underpin ECO schemes, many participating firms are now reported to be reverting to company car schemes.

Transport & Logistics Overview



Despite the slowdown in the wider economy, the transport and storage industry continues to achieve good growth. Indeed, the latest quarterly data reveal that, having achieved growth in line with that of the wider economy during 2006-07, the industry recorded annual growth of 3.5% in the second quarter, compared with GDP growth of 1.5%.

Recent growth in the transport industry reflects the impact of stronger international goods trade volumes on freight transport since the turn of the year, following a period of contraction last year. This likely reflects the marked depreciation of sterling against the euro that occurred at around the same time (the eurozone is the UK's main trading partner).

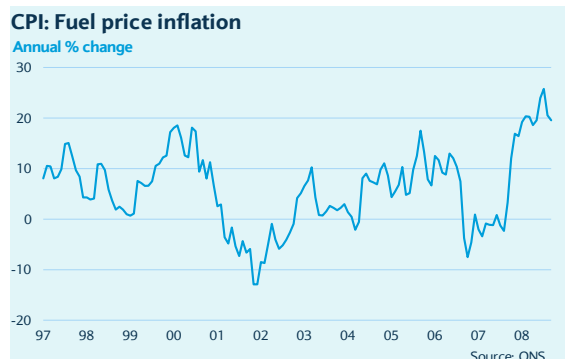


Growth in international passenger transport also continues to drive demand. At the same time, sub-sectors such as rail have also benefited from continued growth in domestic passenger transport (see below). Resumed growth in agriculture and continued (albeit slower) growth

in retail, wholesale and the wider distribution sector have helped to sustain demand in the freight sector, although this has been offset by a decline in mining and quarrying and a slowdown in the manufacturing and construction industries.

However, in terms of profitability, continued growth in demand has been offset by the negative impact of the rapid rise in oil prices on transport firms' margins. International benchmark prices moved to a record \$147 per barrel in July 2008. This was almost double the oil price recorded a year earlier. Although oil prices have since declined markedly, they remain volatile amid tight supply, periodic geo-political episodes in key oil states and shifting investor sentiment (particularly with regard to the US dollar).

The sharp rise in oil prices has fed through to fuel prices, prompting the Chancellor to delay a planned increase in fuel duty, which had been included in the 2008 Budget. Although the pace of annual fuel price inflation slowed to 19.6% in September from a peak of 25.8% in July (based on the consumer price index), it remains elevated.



Until recently, sterling's appreciation against the dollar provided a degree of protection from the rise in dollar-denominated oil prices. However, the recent weakness of the pound means that the positive impact of the fall in oil prices since July will have been offset when the dollar price is translated into sterling.

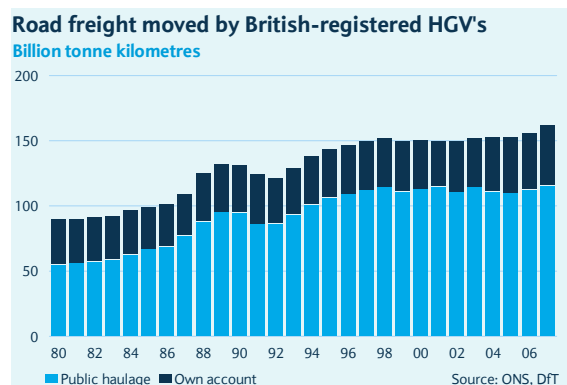
Road Haulage

There were around 100,000 goods vehicle operators and 446,000 goods vehicles over 3.5 tonnes in the UK in 2006-07, according to the

Department for Transport (DfT). The sector is highly fragmented, with a large proportion (around 45%) of single vehicle operators. The number of operators with large fleets is small. Only 275 haulage firms (just 0.3% of the total) have fleets of more than 100 vehicles, although these firms collectively operate around 14% of the UK's road haulage vehicles.

The number of UK haulage firms has steadily fallen over the last decade (there were around 115,000 in 1996-97), but the latest data suggest that the fall began to level off in 2006-07. However, the 41,000 new vehicles over 3.5 tonnes registered last year was the lowest number since 1997 and marked a 16% fall compared to 2006.

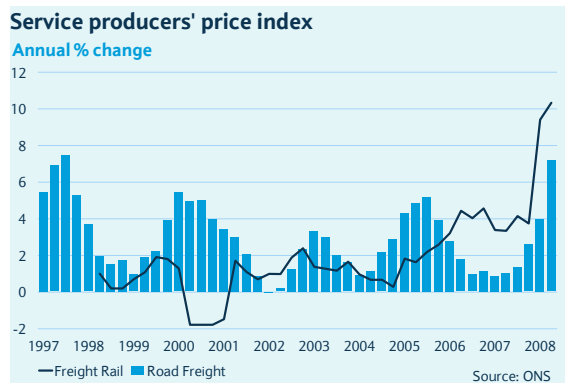
Having experienced several years of stagnation and decline during the early years of the current decade, the volume of freight transported by UK haulage firms began to increase in 2003, with the pace of growth increasing in recent years. The latest DfT data reveal that freight moved by British-registered heavy goods vehicles within Great Britain increased by 4% last year to 161 billion tonne kilometres. This was the fastest rate of growth since 1995. Goods lifted increased by 3% to 1.9 billion tonnes and vehicle kilometres by 1% to 22.4 billion vehicle kilometres.



Both public haulage firms, which transport the lion's share of UK freight (around 70% measured in tonnes per kilometre), and own account hauliers have experienced growth in activity. However, while both segments have experienced patchy and rather volatile growth during the current decade, own-account haulage has generally experienced the faster growth in recent

years. As a result, this segment has begun to regain its share of overall activity from a low of 23% in 2001 to 28% in 2007, when own account haulage activity increased by 5.3%, compared to a 3.1% increase in public haulage.

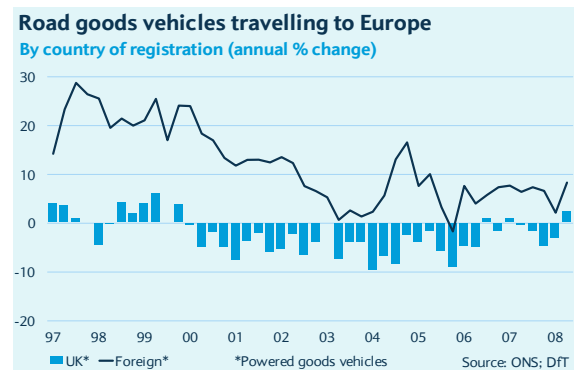
Reflecting the overall improvement in demand, there are also signs that haulage firms are now better placed to pass on some, though by no means all, of the recent sharp rise in fuel costs. Road freight charges increased by an average 7.2% in the year to the second quarter. Hauliers' pricing power has been further assisted by an even greater acceleration in rail freight charges, which has seen rail freight activity slow (see below).



Despite some signs of improvement in the industry as a whole, hauliers continue to struggle in the face of competition from European hauliers (although the recent sterling depreciation will have helped ease competitive pressures to a degree). Even during periods of relatively strong growth in trade with mainland Europe during the past decade, UK hauliers have struggled to take advantage because sterling's strength and cost differentials have reduced their international competitiveness. A significant increase in road haulage capacity in Eastern European countries, 10 of which have joined the EU since 2004, has added to longer-term competitive pressures.

The number of vehicles travelling to mainland Europe from the UK last year increased by 5%. However, revised DfT data show that the number of UK-registered vehicles heading for Europe continued to decline last year (by 1.5%), while the number of vehicles registered abroad continued

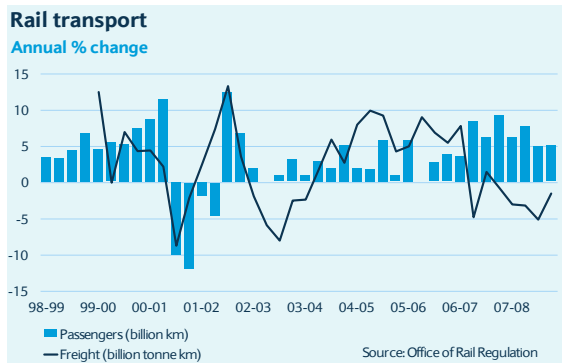
to increase (by 7%). As a result, the proportion of UK-registered vehicles taking goods to Europe declined once more to 19% from 20% in 2006 and almost 50% a decade earlier. Although the latest quarterly data show that the number of UK-registered vehicles travelling to Europe increased by 2.3% (the fastest rate of growth since 1999), this compares with an 8.3% increase in overseas-registered vehicles.



In addition to higher fuel costs, and competitive pressures, UK hauliers have been impacted by a shortage of skilled labour in recent years. As well as drivers, reports suggest that many operators are struggling to recruit qualified support staff. The situation has been exacerbated by limits on drivers' working hours contained in the EU Working Time Directive and Road Transport Directive, which came into force in March 2005. Some operators have responded by hiring staff from Eastern Europe, but with UK unemployment now rising, these pressures may now be easing.

Public Transport

The number of *rail* passenger journeys undertaken in the UK increased by 7.1% to 1.2 billion in 2007-08, according to the Office of Rail Regulation (ORR). This was above the 6.3% growth rate recorded during the previous year. At 8.3%, growth in London and the south east was almost double the aggregate rate (4.3%) recorded for other regions. Measured per kilometre, passenger journeys increased at a slightly slower rate of 6% over the same period (to 49 billion kilometres). While still robust, this was slower than the 7% growth achieved during the previous year.



Total passenger revenue increased by 10.8% to £5.6 billion in 2007-08, although this was also below the growth rate recorded during 2006-07 (11.6%). London and the south east experienced the fastest growth in passenger revenue (11.5%). However, long-distance and regional operators also recorded robust growth of 10.6% and 9.3% respectively.

While increasing passenger numbers have boosted revenues, further above-inflation ticket price rises have also been a significant factor. Between January 2007 and January 2008, average rail fares increased by 6.9%, compared with 5.5% the previous year. This was driven by an increase of 8.2% in long-distance fares. By comparison, fares in London and the south east increased by 5.9%, while regional operators increased prices by 5.5%.

Growth in passenger traffic was again driven by commuters, rather than long-distance travellers. The fact that London and the south east account for around two-thirds of all passenger journeys, and that growth has been driven primarily by season ticket holders since 2002-03, tends to support this view. Congestion charging and higher fuel costs have resulted in an increase in public transport usage in the capital. Regional operators have also benefited from increasing road congestion and rising petrol costs, as well as upgrades to rail network infrastructure.

While passenger demand continues to rise, freight traffic declined by 3.2% to 21.2 billion net tonne kilometres during 2007-08. This was the first full-year fall since 2002-03 and was primarily driven by a 5.4% decline (to 102.4 million tonnes) in

freight lifted. This followed a 2.8% increase the previous year, although quarterly data reveal that this was largely concentrated at the beginning of 2006-07, with activity weakening in the latter part of the year.

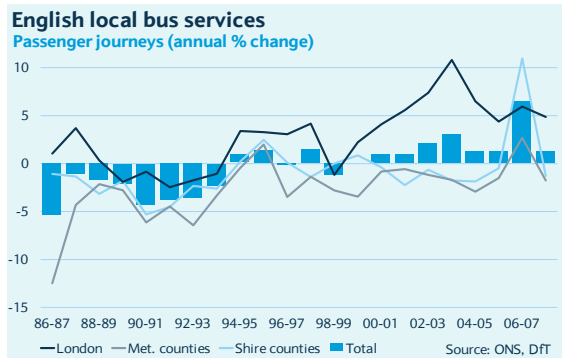
Rail operators had previously benefited from strong growth in the volume of rail freight, reflecting continued performance improvements across the rail network, the impact of increasing road congestion and, until 2006, relatively faster growth in road haulage costs (see above). However, the recent slowdown has coincided with a sharp rise in rail freight costs, both absolutely and relative to road haulage charges (although haulage firms are also increasing prices rapidly).

In addition to passenger and freight revenues, rail operators also continue to benefit from significant subsidies. However, the government plans to increase significantly the proportion of passenger funding for the rail industry. Passengers accounted for around 50% of funding for the rail industry in 2007, but the government hopes to increase this to 75% by 2014. As a result, from 2009, the annual subsidy for the railways will fall from £4.5 billion to £3 billion. Further rapid growth in passenger numbers is expected to provide around half of the additional funding, with the remainder expected to come from fare increases.

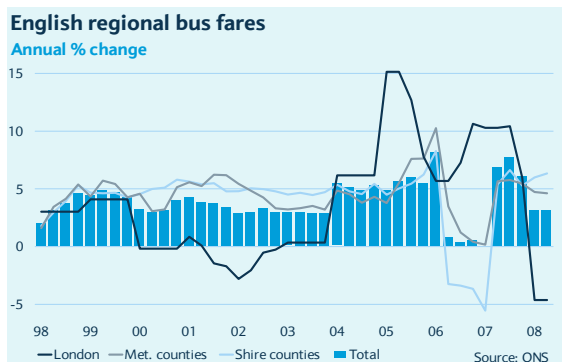
The government plans to invest in improving capacity to ensure that continued demand growth can be met. It plans to deliver 1,300 extra carriages annually to 2014, and has approved a number of infrastructure improvement projects. A £16 billion funding package has also been agreed for the construction of Crossrail, which will link east and west London and which is scheduled to be operational by 2017.

The *bus and coach* sector has experienced a steady (if largely unspectacular) improvement in demand since the beginning of the decade, following a long period of decline and stagnation during the 1980s and 1990s. Apart from 2006-07, when a sharp fall in fares in the shire counties and a marked slowdown in fare inflation in Metropolitan areas helped to boost local demand,

the improvement has largely been concentrated in London, where road congestion and congestion charging, as well as policies to promote bus use (including caps on fare increases earlier in the first half of the current decade) have increased patronage.



However, while demand continues to increase in London, growth in passenger journeys in the capital has slowed from a peak of 10.8% in 2003-04 to around 5% in recent years. Allied to a renewed decline in demand in other regions (reflecting higher fares), this has seen growth in bus use across England slow from 6.5% in 2006-07 to 1.3% in 2007-08.



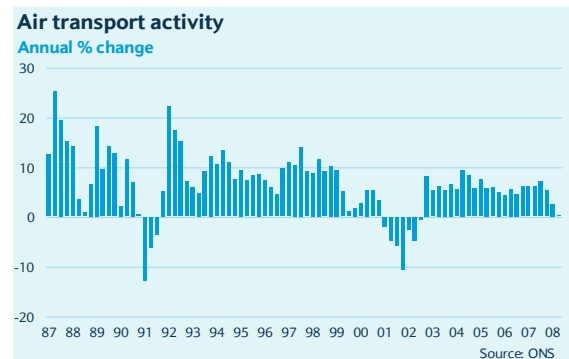
With the notable exception of 2006-07, bus fares across England have risen at above-inflation rates for much of the current decade. Having previously been held in check by price caps, the increase has been driven primarily by rising fares in London, although the latest quarterly data show a fall in fares in the capital during the first half of 2008, compared to the same period last year.

Given the largely captive market for regional bus services, above-inflation fare increases have

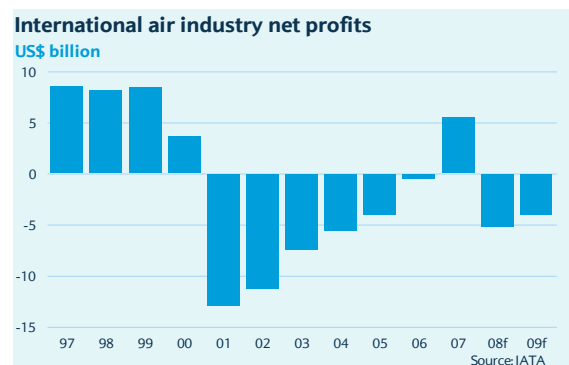
helped to offset (at least partly) the impact on regional bus operators' margins of rising fuel, as well as labour costs (although reported driver shortages have been partially offset by overseas recruitment, notably from Eastern Europe).

Air Transport

The UK air transport industry has benefited from relatively strong growth in the international economy, a continued rise in both inward and outward traveller numbers and (in particular) the continued expansion of the budget airline segment in recent years. Growth in air freight activity has provided a further boost.



However, activity has slowed in recent quarters and essentially stagnated on an annual basis during the second quarter of 2008. This compares with growth of 6.3% during 2007 as a whole.

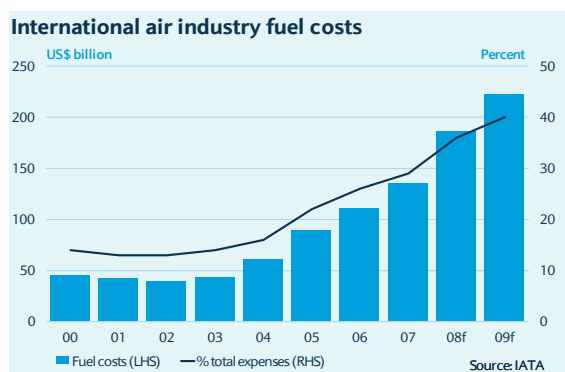


After six years of consecutive (although diminishing) net losses, the international airline industry recorded a net profit of US\$5.6 billion last year, according to the International Air Transport Association (IATA). Last year's turnaround largely reflects the improved performance of the US

airline industry, which recorded a US\$2.8 billion net profit in 2007. Continued losses in the US have tended to offset improved profits in Europe and Asia in recent years.

In the UK, a combination of cost saving initiatives earlier in the decade and improved passenger numbers has ensured that the UK flag carrier, British Airways (BA), and the key UK-based budget airlines (Ryanair and easyJet) have maintained relatively healthy profits in recent years.

However, both the UK and international air industries have come under pressure from high oil prices, environmental protection measures and slowing demand (both passenger and freight) in the key US and European markets, which has already resulted in a number of airline failures. While high oil prices have affected the entire transport industry, air transport is particularly vulnerable. Aviation fuel is not subject to fuel duties, which means that oil represents a larger share of its overall cost, making the air transport industry particularly sensitive to oil price rises (and volatility). Also, because of higher fuel costs, fuel now accounts for around one-third of the airline industry's total costs, compared to less than 15% in 2003.



Although hedging arrangements have provided a cushion for the major carriers, they have only partially offset the sharp rise in oil prices in recent years and have become more expensive to renew as a result of higher oil prices and their relative volatility. At the same time, while major operators have been able to raise fuel surcharges on long-haul flights in recent years in a bid to pass on

rising fuel costs, fierce competition in the European short haul market has meant that operators have tended to limit increases in fuel (or other) surcharges and have therefore had to absorb a more significant share of the rise in fuel costs.

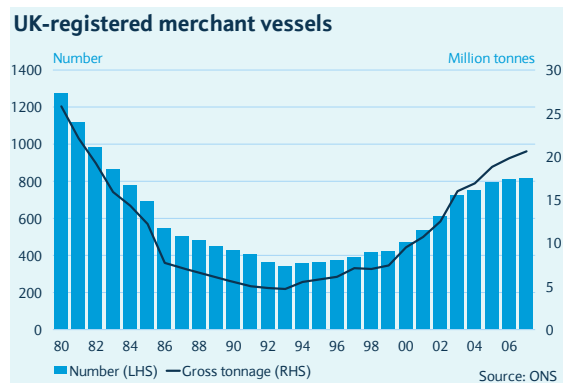
A number of leading airlines have announced plans to implement capacity cuts in response to the high cost of fuel and lower demand. However, with oil prices having now fallen to around half of their July peak, airlines may begin to experience some respite from rising costs.

In the longer term, the new 'open skies' agreement between the US and Europe, which came into force on 30 March, and which allows any European or American airline to fly from any European airport to any US airport, is likely to see competitive pressures increase. However, in the current climate, this is unlikely to result in the type of rapid growth (particularly in the budget segment) that followed de-regulation of the European market.

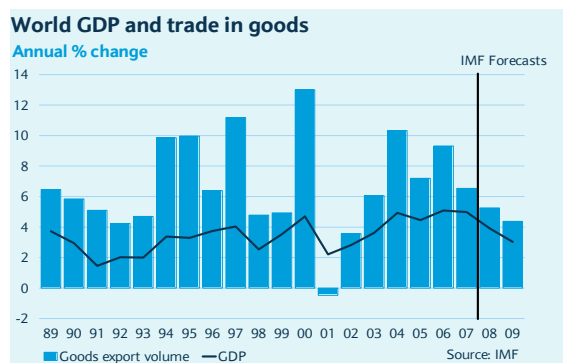
Airlines operating from the UK are expected to benefit from efforts to increase competition between UK airports. As part of its continuing investigation into competition between UK airports, the Competition Commission has said that BAA may have to sell three of the seven UK airports under its control (Heathrow, Gatwick, Stansted and Southampton in England, and Edinburgh, Glasgow and Aberdeen in Scotland), including two of its three London airports, because of market dominance concerns. The Civil Aviation Authority, the industry regulator, has supported the Commission's proposals and BAA has already announced its intention to sell Gatwick.

The government's recent decision to allow a further 23,000 flights a year (carrying an extra 10 million passengers) from Stansted airport should also provide the sector with a boost in the longer term.

Shipping



The introduction in 2000 of a new tax regime, under which firms with ships registered in the UK pay a set tax based on their vessels' tonnage (rather than on profits), brought about a reversal of the long-term decline in the UK shipping industry at the beginning of the current decade. This has resulted in a significant increase in the British-registered merchant fleet, in terms of both gross tonnage and the number of vessels.



The resurgence in UK shipping has coincided with a prolonged period of robust growth in global trade and GDP, which has driven a boom in demand for oil and bulk commodities, as well as finished goods. This has helped fuel rapid growth across the key shipping segments, with benchmark freight rates reaching record levels. This, in turn, has resulted in UK shipping industry turnover increasing from £4.7 billion in 2002 to £11.6 billion in 2005, according to the Chamber of Shipping.

However, the increase in the UK shipping fleet has begun to level off in the past couple of years,

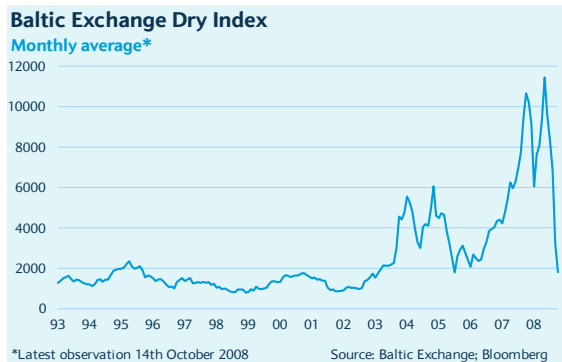
while UK shipping turnover slowed to around £9.8 billion in 2006 (the latest period for which data are available). The prolonged global shipping boom has resulted in more intense competition from other leading global shipping centres such, as Dubai and Singapore, which have sought to match (or even better) the incentives offered by the UK tax regime in recent years.

At the same time, recent changes are reported to have eroded the UK's competitive edge with regard to shipping. Taxation rules on leasing contained in the 2006 Finance Act are reported to have had a negative impact on the industry and the Chamber of Shipping has warned that subsequent uncertainties over the taxation status of non-domiciles and tonnage tax have resulted in the migration of some UK shipping business.

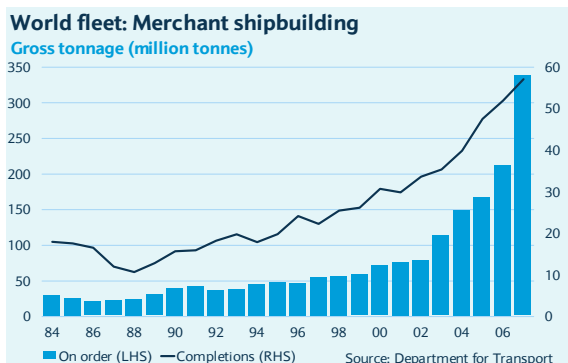
The global industry's strong performance in recent years has also been dampened to a degree by higher (and increasingly volatile) bunker fuel prices, as well as additional security costs and logistical bottlenecks. Delays caused by port congestion have resulted in lengthier transit times (and associated costs) for many companies. At the same time, global trade imbalances have created logistical problems, including both capacity and container imbalances on key routes. These problems have been exacerbated, in many cases, by inadequate hinterland transport infrastructure serving routes to and from major ports, which has led to increasing demand for limited warehouse capacity and/or vessels remaining tied up at ports for longer periods. With capacity, freight volumes and the size of new ships likely to increase, these bottlenecks are likely to persist. This will place additional pressure on already congested ports and hinterland transport infrastructure.

Infrastructure-related bottlenecks have been evident in the major UK ports in the past couple of years. While a number of investment projects should help to alleviate capacity constraints, there is still concern that the UK could lose deep-water traffic, with goods trans-shipped to the UK from other European ports instead. This is compounded by the fact that many of the new, high-capacity ships are only able to access a

limited number of ports. It also remains to be seen whether planned investment in new port capacity will be matched by investment in the UK's heavily-congested hinterland transport infrastructure.



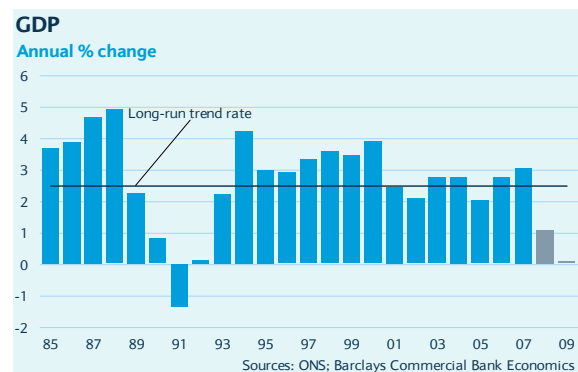
Reports suggest that the industry has been significantly impacted by the credit crunch in recent months as trade finance costs have risen and access to credit tightened. Although ship owners with long-term contracts are reported to have been largely unaffected, this has resulted in a marked decline in activity in the short-term spot market. This, in turn, has seen a marked decline in previously buoyant benchmark indices. The Baltic Dry Index, which measures shipping costs for commodities, decline by almost 85% from its peak just five months ago, although tanker rates appear to be holding up, partly as a result of a relative shortage of vessels.



Looking ahead, the expected slowdown in global economic growth is likely to slow global trade growth. In line with the industry's typical boom-bust pattern, this will occur at a time when capacity is set to increase significantly. The marked rise in orders for vessels has resulted in a corresponding rise in new-build costs, while

second-hand values have also continued to rise across the major segments. However, with funding yet to be agreed on an estimated US\$550 billion worth of ships on order, and a possible acceleration in the scrapping of older vessels, the ultimate expansion of new capacity may prove less than the pipeline figures suggest. While this may mean that some operators lose deposits on new ships, or incur higher ship-breaking costs, this may mitigate some of the impact of new capacity entering the market.

Outlook



The latest consensus forecasts suggest that UK economic growth will slow to just 1.1% during 2008 as a whole, with growth of just 0.1% expected in 2009. However, the outlook is currently highly uncertain and risks are widely considered to be on the downside.

Consumers are expected to rein in their spending amid continued pressures on disposable income, tighter credit conditions, high debt levels and the slowdown in the housing market.

The weak economic outlook is likely to continue to impact on corporate spending and investment, particularly in key sectors such as financial services, which remains under significant pressure as a result of the continuing credit and financial market dislocation.

At the same time, increasing pressure on government finances means that growth in demand from the public sector, an increasingly important source of demand for many business services firms in recent years, is also set to slow.

According to the 2007 Comprehensive Spending Review, real annual growth in total government spending will almost halve to 2.1% during the fiscal period 2008-11. It remains to be seen whether recent government measures to support the financial sector will result in a further tightening of public spending.

As a result, growth of the business services industry is likely to continue to slow. With both corporate and public sector organisations likely to use their bargaining power to ensure value for money, margins on service contracts are also expected to tighten. This may result in consolidation in sectors such as recruitment, which have seen capacity build following several years of rapid growth.

The slowdown in the economy is likely to see unemployment continue to rise. Combined with planned increases in the minimum wage that are more closely correlated with wage inflation in the wider economy, and lower public sector wage growth, this should help to contain wage pressures, especially for those providing lower-value-added services. However, rising unemployment and declining job vacancies will clearly impact on the recruitment sector, while any cuts in staffing levels will tend to affect business services activity more generally.

The expected increase in spare capacity in the economy and the recent decline in oil prices have raised expectations that the recent sharp rise in consumer price inflation is now close to its peak, with inflation expected to fall relatively quickly during 2009. This will give the Bank of England more scope to cut interest rates. Indeed, following the recently announced, internationally co-ordinated cut in base rates, it seems likely that monetary policy will be loosened aggressively over the coming months, although the extent to which financial institutions can pass this on to households and corporates will also depend on an easing in the pressure on wholesale – interbank – funding rates.

Although oil prices have declined significantly from their July peak, they remain both high (from a longer term perspective) and volatile heading

into winter in the northern hemisphere. As a result, cost pressures on transport firms are likely to persist. Airlines in particular remain vulnerable to any renewed oil price increases, given the sensitivity of aviation fuel costs to oil prices, the rising share of fuel in the sector's cost base and slowing demand.

Smaller haulage firms are also likely to remain under pressure, in contrast to larger firms, which are able to exploit economies of scale by adopting 'hub and spoke' models, which allow for more local deliveries from a network of regional distribution centres. These can be carried out at lower cost using smaller vehicles and less-qualified drivers.

However, larger firms are likely to be affected by the relatively weak outlook for the wider global economy, and, in particular (from a UK perspective), the eurozone. This is likely to dampen growth in global trade volumes, which will clearly impact on the international freight transport sector.

Prepared by Dr Brian Clark, Senior Economist, Portfolio Management, Barclays Bank PLC.

All data and factual information referred to in this report were correct as of 14th October 2008
Source of ONS data: National Statistics website:
www.statistics.gov.uk
Crown copyright material is reproduced with the permission of the Controller of HMSO.

The article is proprietary to Barclays Bank PLC, who have all rights of copyright in it, and may therefore only be reproduced, in whole or in part, provided you acknowledge Barclays Bank PLC as the author and copyright owner of the article. Every attempt has been made to try to ensure that the information contained in the article is accurate at the time of publication. However, Barclays Bank PLC and its employees give no warranties or undertakings of any kind, whether express or implied, regarding the accuracy or completeness of the information and take no responsibility for any errors and omissions, and accept no liability for any loss, however arising, that may result from the use of, or any decisions made based on, this information.

Barclays Bank PLC. Authorised and regulated by the Financial Services Authority.

Registered in England. Registered No: 1026167. Registered Office: 1 Churchill Place, London E14 5HP.