KPMG

KPMG UK Tech Monitor

Tech sector held back by slowing UK economy in Q2

PMI® By IHS Markit

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kpmg.com/uk

KPMG UK Tech Monitor

Key findings

Tech sector growth slows in Q2

New business softens as firms feel a chill from weaker UK economy

Staff hiring plans at tech companies are now the lowest for two years

"Another increase in new business ensured a resilient overall performance for the UK tech sector despite the challenging global economic landscape.

"However, the latest Tech Monitor Index highlights that there are limits to which the sector can decouple from the rest of the UK economy.

"Domestic political uncertainty and spill overs from US-China trade frictions were the main headwinds in the second quarter."

Bernard Brown, Vice Chair, KPMG in the UK

KPMG

Welcome to the KPMG UK Tech Monitor Index

We have compiled the quarterly UK Tech Monitor Index by taking a representative sample of tech companies from IHS Markit's widely-watched Purchasing Managers' Index® (PMI®) surveys. The tech sector is defined in this report as technology software, technology services and manufacturing of technology equipment. Historical data is available since Q1 2003 and full details are in the methodology section.

Our panel of tech sector executives are asked about actual changes in business activity, new work, backlogs, employment, costs and charges. The headline UK Tech Monitor Index measures changes in business activity on average over the most recent quarter. Results are seasonally adjusted. Index numbers vary between 0 and 100, with readings above 50 indicating an overall increase and below 50 a decrease.

Stagnant UK economy holds back tech sector growth

The UK tech sector marked seven years of continuous business activity expansion in Q2 2019, but there are now signs that subdued domestic economic conditions have started to hold back growth. In fact, just as this milestone was reached by tech companies, equivalent survey data pointed to the worst overall performance for the UK economy since the end of 2012.

At 53.0 in Q2, the headline KPMG UK Tech Monitor Index dropped from 54.4 in Q1, to signal a softer rate of business activity growth than at the start of this year. The index has remained above the 50.0 'no change' value since the third quarter of 2012. However, the latest reading indicated the second-weakest rate of UK tech sector growth for three-and-a-half years.

Political uncertainty ushers in greater corporate risk aversion

Tech companies often reported that more subdued domestic economic conditions had curtailed business activity growth in Q2. A number of survey respondents also noted that Brexit uncertainty had led to greater risk aversion, cuts to corporate spending and a corresponding slowdown in new business growth.

Weaker expansion of new work

Sales volumes increased moderately at tech companies during Q2, which contrasted with the declines reported by other areas of the UK economy. Where an improvement in new work was reported, tech firms often cited entry into overseas markets and a strong pipeline of new product innovation.

That said, the latest rise in total new orders received by tech firms was among the weakest recorded since 2015. Survey respondents commented on sluggish demand from domestic customers as political uncertainty encouraged some clients to postpone new projects.

Tech sector hiring stepped back

Latest data revealed a clear slowdown in the pace of UK tech sector employment growth compared to the same time in 2018. The rate of job creation still exceeded the UK economy as a whole. Some tech firms simply put slower hiring down to difficulties finding suitably skilled candidates.

Business optimism stays close to the 10-year low seen in Q1

The slowdown in tech sector growth during the second quarter of 2019 is perhaps unsurprising given the slide in business optimism reported at the start of this year.

Tech firms indicated that confidence has since picked up only fractionally from the 10-year low seen in Q1.

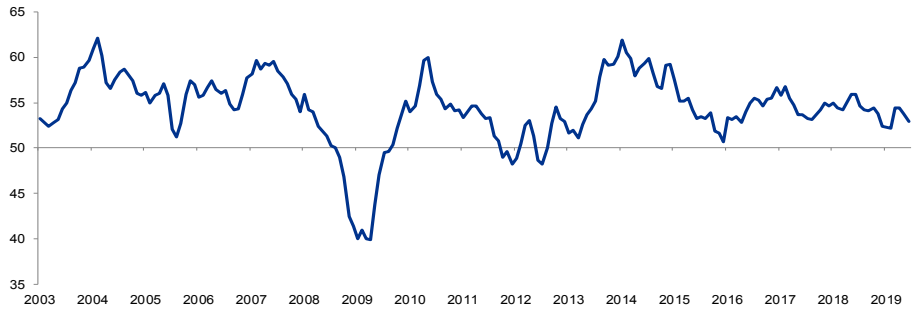
Worries about global economic prospects, US-China trade tensions, and the unclear path to Brexit were the most commonly reported threats to the business outlook.

Heightened economic and political uncertainty has led many UK firms to cut back on their capital spending and employment plans, according to the latest survey data. Capex intentions across the UK economy are now the lowest since Q4 2011.

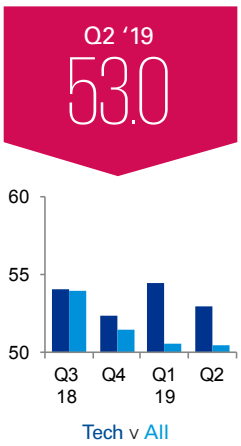
Tech firms are much more upbeat than those in other areas of the economy, but the latest data point to the weakest staff hiring plans in the sector for two years.

KPMG UK Tech Monitor Index

Above 50 = business activity growth, seasonally adjusted



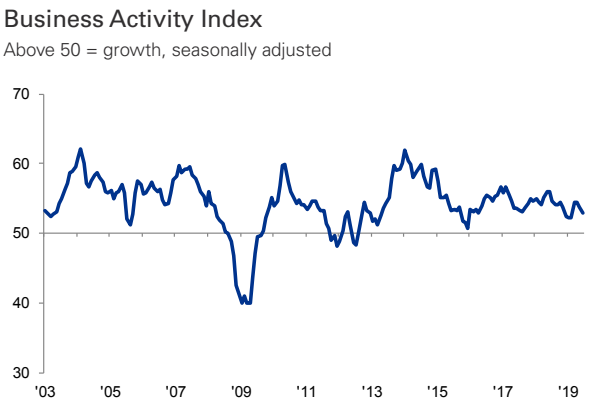
Tech Sector Output: Business Activity Index



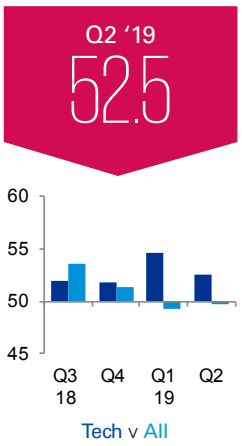
Tech sector growth softens amid stagnate UK economy

The seasonally adjusted Business Activity Index signalled a further rise in tech sector output, though the index slipped from 54.4 in Q1 to 53.0 in Q2. Softer growth momentum was often linked by surveyed firms to subdued market confidence due to lingering Brexit-related uncertainty and a weaker upturn in new business.

Companies that registered increased activity attributed this to relatively robust overall demand and higher new order intakes from overseas markets.



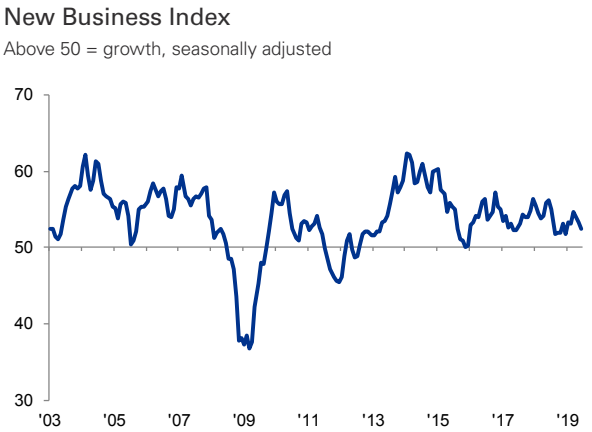
Tech Sector Sales: New Business Index



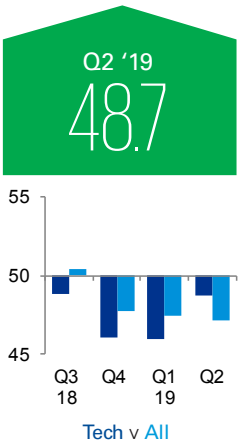
Sales growth contrasts with UK-wide trend

At 52.5, the New Business Index fell from 54.7 in Q1 to signal a softer increase in new orders received by UK tech firms in Q2. Although only modest, the upturn contrasted with the wider UK trend, which highlighted a slight drop in new work.

Sales growth was often linked to new client wins, most notably in the US and across Europe. However, a number of panellists indicated that political and economy uncertainty had led some clients to cut back on spending.



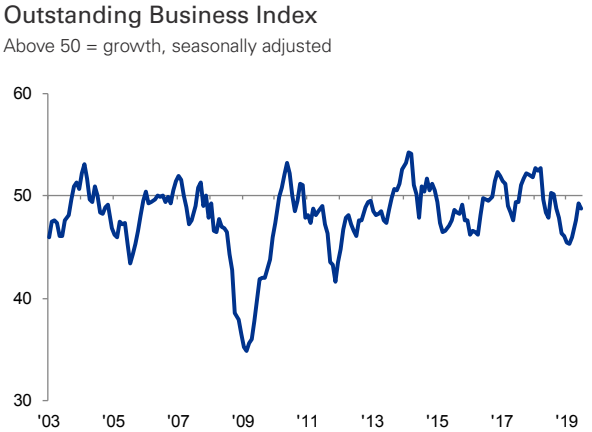
Tech Sector Capacity: Outstanding Business Index



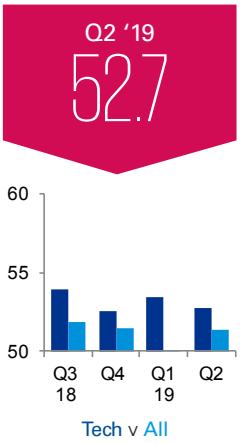
Pressure on business capacity moderates in Q2

After dropping at the fastest rate in over seven years in the opening quarter of 2019, backlogs of work fell only modestly in Q2. The respective index climbed from 46.0 to 48.7 in the second quarter, to mark the weakest reduction in outstanding business since Q3 2018.

According to firms, slower new order growth and targeted efforts to boost productivity underpinned the latest drop in unfinished workloads.



Tech Sector Jobs: Employment Index



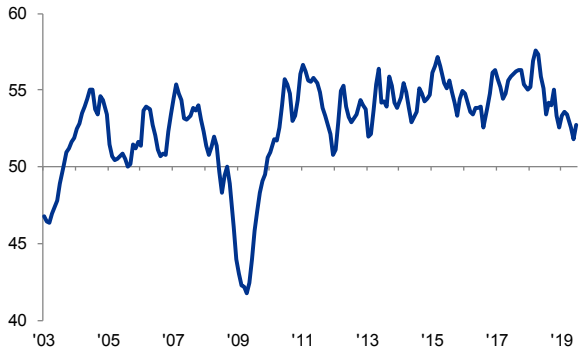
Job creation remains lacklustre

Employment growth across the tech sector remained relatively subdued in the second quarter. At 52.7, the Employment Index edged down from 53.4 in Q1 to signal a modest expansion of payrolls that was among the weakest since 2013. Nonetheless, the rate of job creation outpaced that seen at the national level.

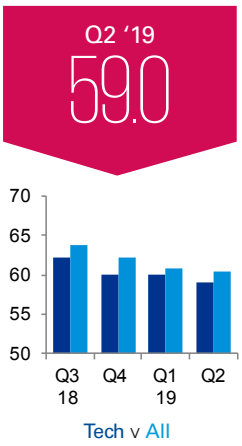
Surveyed firms linked the softer rise in staff numbers to decisions not to replace leavers due to increased economic uncertainty, while others indicated that persistent skill shortages made it challenging to find new hires.

Employment Index

Above 50 = growth, seasonally adjusted



Tech Sector Costs: Input Prices Index



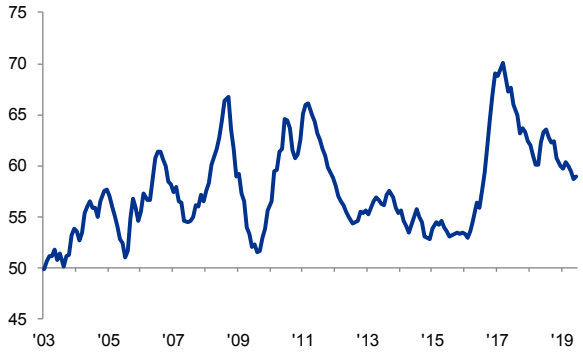
Input costs rise at slowest pace for three years

Although business expenses faced by tech sector firms continued to rise sharply in the second quarter, the rate of inflation remained much weaker than the peaks in Q1 2017. The seasonally adjusted Input Prices Index fell from 60.0 to 59.0 in Q2, to signal the slowest increase in costs for three years.

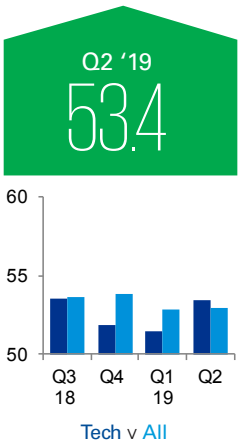
Higher prices for electronic components, unfavourable exchange rate movements and greater staffing costs were all reported by tech sector firms.

Input Prices Index

Above 50 = growth, seasonally adjusted



Tech Sector Margins: Prices Charged Index



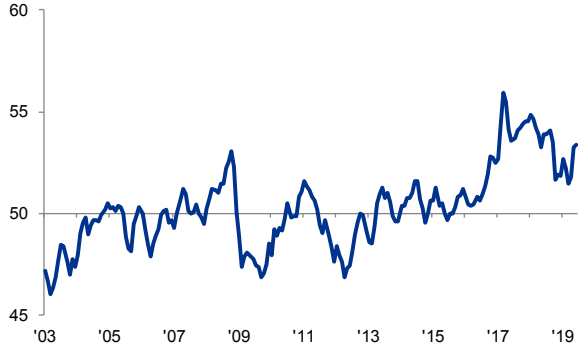
Fastest increase in selling prices since Q3 2018

A sustained rise in input costs led tech companies to raise their output charges again in Q2 2019. The seasonally adjusted Prices Charged Index picked up from 51.5 in Q1 to 53.4, to signal a solid rise in selling prices.

The stronger rate of inflation was despite a softer trend in sales, as firms highlighted the need to cover rising expenses, particularly higher staff salaries.

Prices Charged Index

Above 50 = growth, seasonally adjusted



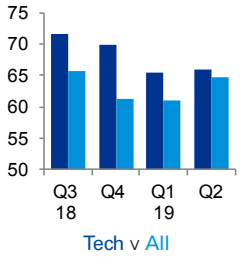
Tech sector outlook

Business confidence stuck near 10-year low

Latest data revealed that business confidence across the UK tech sector regarding the year ahead remained muted in Q2 2019. This was shown by the Business Activity Expectations Index rising only slightly from a ten-year low of 65.6 in Q1 to 66.0. The latest figure was only slightly above that recorded for the UK as a whole.

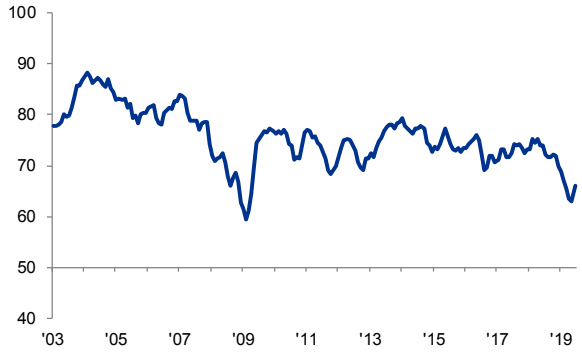
Panellists indicated that political and Brexit-related uncertainty had weighed on confidence in the second quarter, combined with worries of a wider global economic slowdown. These factors are expected to limit opportunities for growth and dampen both corporate and consumer spending.

Companies that were optimistic regarding future activity linked this to new product innovations (particularly around software), company restructuring efforts, expansion into new overseas markets and new marketing strategies. A number of firms also anticipate demand conditions to recover if the current Brexit impasse is resolved.



Business Activity Expectations Index

Above 50 = growth in the next 12 months



UK tech sector outlook survey Q2 2019

In this section we ask UK tech firms about their plans for employment, capital spending, profits and pricing over the next 12 months. The latest survey was compiled in Q2 2019, using a panel of respondents to IHS Markit's tri-annual Global Business Outlook Survey. All figures are presented as percentage net balances.

Data for the second quarter of 2019 shows that tech firms remain more upbeat than the average UK company with regards to hiring, profits and capital expenditure plans over the next year.

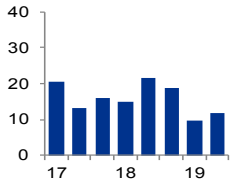
In terms of employment, approximately 41% of tech firms plan to expand their staff numbers over the next 12 months, compared to around 10% that anticipate a decline. This led to a net balance of +30.5% of businesses expecting higher workforce numbers in Q2, down from +31.1% in Q1, and the lowest figure since mid-2017. Nonetheless, the net balance remains comfortably above that seen for the UK as a whole, which remains at a five-year low.

According to anecdotal evidence, lingering uncertainty regarding the domestic and political landscape, alongside signs of softening client demand led firms to maintain a relatively cautious approach to staff hiring.

At the same time, confidence towards the 12-month outlook for profits at UK tech firms improved during the second quarter. More than half (53%) anticipate greater profits over the next year, compared to 21% that expect a reduction. The resulting net balance of +32.8% is up

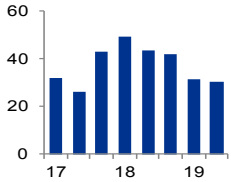
Capex plans

Net balance expecting growth



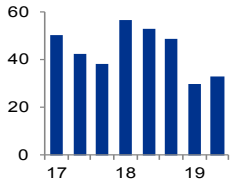
Staff hiring plans

Net balance expecting growth



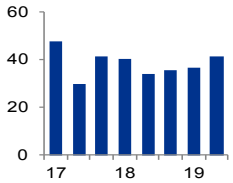
Profit expectations

Net balance expecting growth



Output charges expectations

Net balance expecting growth



from +30.0% in Q1, but still the second-lowest figure since mid-2012.

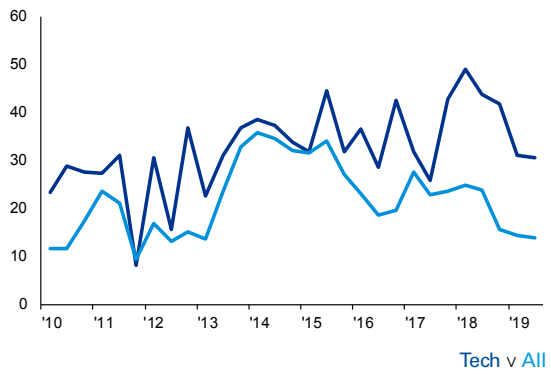
Tech firms often linked subdued profit forecasts to tough competition, greater operating expenses and adverse exchange rate movements.

The slight improvement in optimism regarding future profits coincides with forecasts of rising output charges. Notably, the net balance of tech companies planning to hike their selling prices over the next year rose from +36.5% in Q1 to +41.4% in Q2, which is the highest figure since early-2017.

In line with forecasts for charges and profitability, capital expenditure plans at tech companies improved slightly in the second quarter of 2019. At +11.7%, the net balance for capex is up from +9.8% in Q1, but remains among the lowest seen over the past six years.

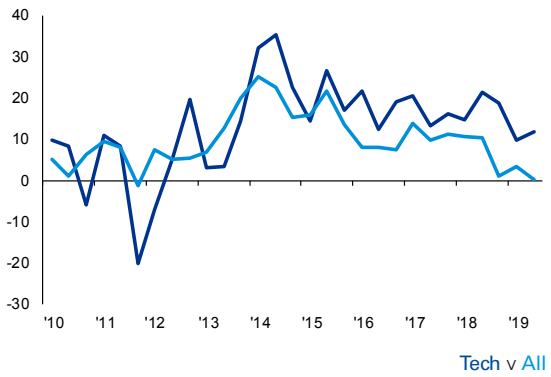
Employment Outlook

Net balance expecting growth, next 12 months



Capital Expenditure Outlook

Net balance expecting growth, next 12 months



UK sector rankings

Business confidence recovered slightly at services companies during the second quarter of 2019, as fears over an imminent no-deal Brexit receded. At 64.7, the index measuring optimism rose from a decade low of 61.1 in Q1, but still suggests that confidence remains somewhat fragile.

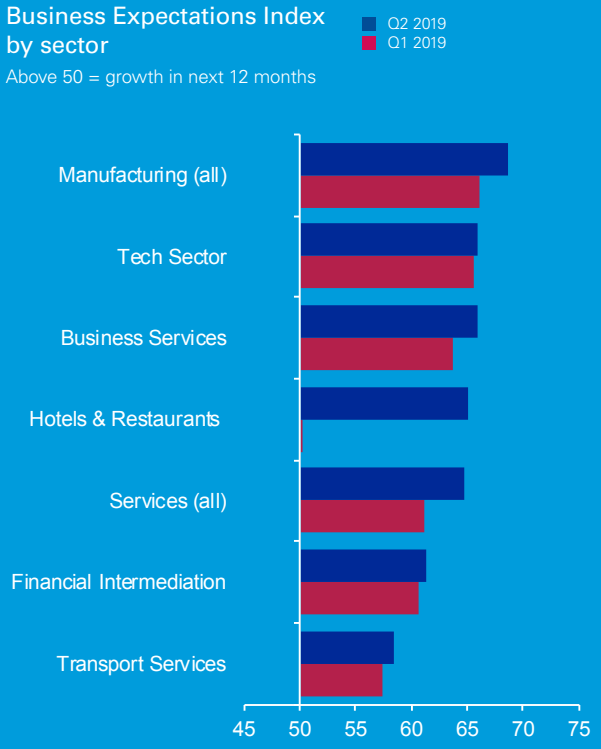
Tech companies remained more confident than all areas of the UK service sector. The most marked improvement in optimism was however seen in Hotels & Restaurants, which saw a solid turnaround in expectations after appearing at the bottom of the forecast table in the previous quarter.

Data covering other sectors of the economy indicated a broad-based rise in expectations since the opening quarter of the year, though on all fronts confidence remained relatively subdued compared to recent years.

Political uncertainty continued to weigh on growth expectations for all types of businesses, while signs of weaker global economic conditions and international trade conflicts were also said to have dampened prospects.

Business Expectations Index by sector

Above 50 = growth in next 12 months



Cyber security: special feature

"Companies continue to struggle to deal with the diverse nature of attacks on their systems and data. In many instances companies have little or unproven incident response capabilities in place.

Investigations are often hampered by poor logging and monitoring capabilities especially in the SME space. Detection across businesses remains a key vulnerability as the average detection time is between 200-300 days.

Larger companies have often untested crisis management procedures and undocumented escalation protocols and poor third-party support contracts.

The threat landscape continues to see a growth of commoditised attacks using business email compromise and ransomware. However, there is a growing number of advanced and targeted network intrusion attacks."

Oisin Fouere, KPMG

Oisín currently leads KPMG's Cyber Response services providing holistic and turn-key crisis, incident and forensic response advisory services to a range of global clients including a number of international insurance providers.

Three-quarters of UK firms identify cyber security as a high priority for their organisation

There is clear evidence that UK businesses are becoming more aware of cyber risks and have stepped up engagement and prioritisation in response. Around three-quarters of UK businesses (78%) report that cyber security is a high priority for their organisation's senior management, up from 74% in 2018, according to the latest Cyber Security Breaches Survey compiled by the Department for Digital, Culture, Media & Sport (DCMS).

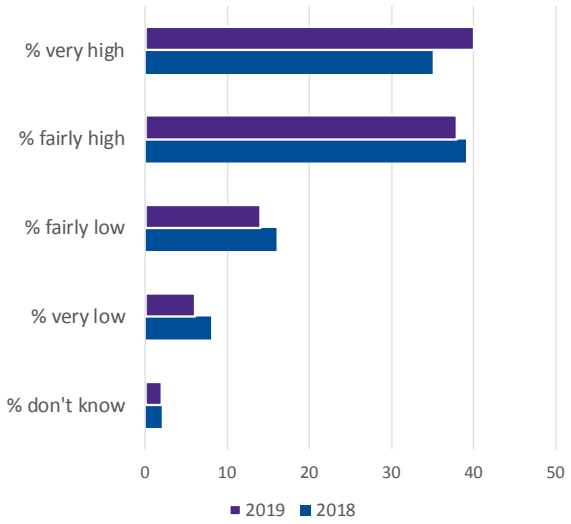
The introduction of the General Data Protection Regulation (GDPR) in May 2018 appears to have contributed to the recent increase in prioritisation of cyber security, by ushering in formalised policies around personal data and more frequent reporting to senior management.

While GDPR compliance is just one element of cyber security, there are signs that its introduction has built up awareness and sharpened up business procedures. The latest DCMS survey data reveals that just under two-thirds (62%) of large businesses and almost half of medium-sized business (51%) have made changes to their cyber security policies since GDPR.

The transition to cloud technologies has transferred

Perceived importance of cyber security[1]

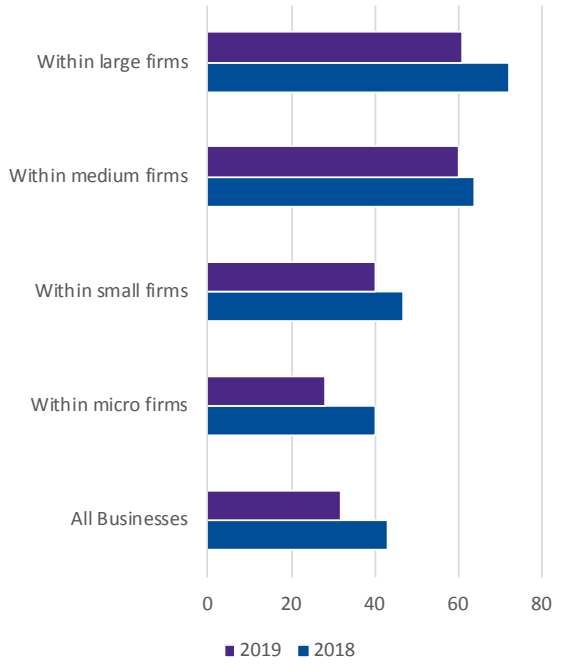
Q. How high or low a priority is cyber security to your organisation's directors, trustees or senior management?



Source: Department for Digital, Culture, Media & Sport (DCMS)

Prevalence of cyber attacks at UK companies[1]

Percentage of survey respondents experiencing a cyber security breach or attack in the last 12 months



Source: Department for Digital, Culture, Media & Sport (DCMS)

business investment on cyber security from individual companies to the large providers of cloud services, which means that the directly reported spend on cyber security may not reflect the full investment. Companies that have transitioned to cloud services will be purchasing cyber security as part of their monthly fees or subscriptions. This has resulted in a shift in investment in cyber security from individual companies to the large cloud providers such as Amazon, Google and Microsoft.

How prevalent are breaches or attacks?

According to the DCMS survey, the frequency of cyber incidences has stepped up for those experiencing a breach or attack, with the median number of incidents rising to six in the past year (up from 4 in 2017). The proportion of UK businesses identifying breaches or attacks has fallen from 43% to 32% in the past year, with this decline broad-based across all company sizes.

However, there is evidence that cyber breaches are becoming more sophisticated and harder to spot. Given that those who have spotted breaches are reporting more of them, it's possible attacks have occurred at companies reporting no breaches but these fell below their detection capabilities or were handled by their cloud technology provider.

UK financial services sector trends

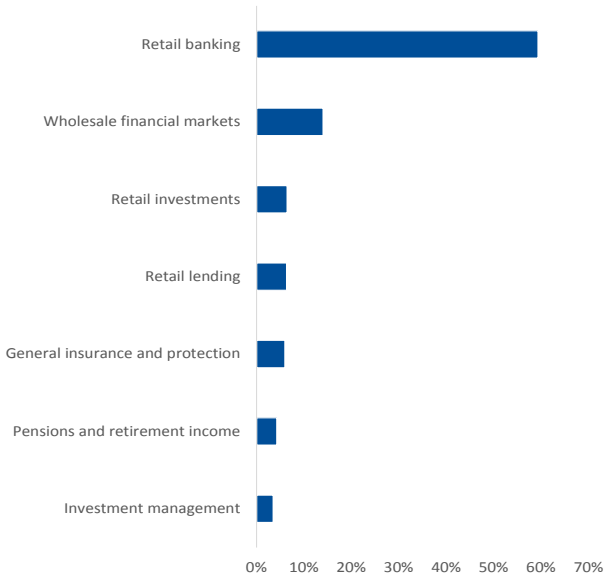
Financial Services is the largest sector by business investment spending on cyber security. The sector faces a challenging environment for cyber security; data provided by the Financial Conduct Authority reveals that 819 cyber incidents were reported to them in 2018 (more than nine per week). This is up from 69 in 2017, although the numbers are not directly comparable because of new reporting and notification requirements under the second Payment Services Directive (PSD2), which took effect in January 2018.

More than half of these incidents were reported in the retail banking sector (59%), with wholesale financial markets the next largest contributor (14%). The most common root cause of cyber incidents is third-party failure (21%). Of the sub-set classified as 'cyber attacks', the most frequent root cause was Phishing/Credential compromise (52%), followed by Ransomware (20%).

What are the costs of a cyber incident?

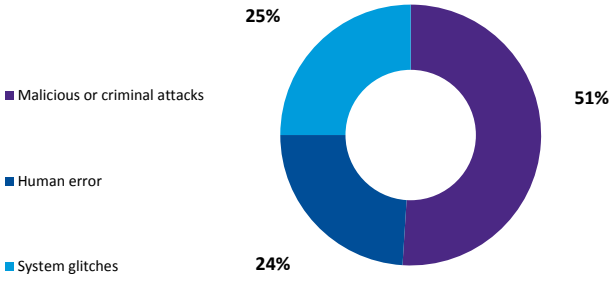
Benchmark research on the cost of a cyber breach is conducted each year by the Ponemon Institute. The latest report puts the average cost of a data breach resulting from a cyber attack at $4.45million (£3.8million). In terms of root cause of data breaches worldwide, more than half are malicious or criminal attacks (51%), with 24% due to human error and 25% involving system glitches.

Proportion of cyber incidents reported to the Financial Conduct Authority in 2018, by impacted sector [2]



Source: Financial Conduct Authority

Root cause of a cyber security breach or attack[3]



Source: IBM Security/Ponemon Institute

Data sources

1. Department for Digital, Culture, Media and Sport data sourced from the Cyber Security Breaches Survey 2019.
2. FCA data sourced from Freedom of Information disclosures.
3. Ponemon Instutute data sourced from Cost of a Data Breach Study 2019, conducted for IBM Security.

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About KPMG

KPMG LLP, a UK limited liability partnership, operates from 22 offices across the UK with approximately 16,300 partners and staff. The UK firm recorded a revenue of £2.338 billion in the year ended 30 September 2018. KPMG is a global network of professional services firms providing Audit, Tax and Advisory services. We operate in 153 countries and territories and have 207,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

About IHS Markit

IHS Markit (NYSE: INFO) is a world leader in critical information, analytics and solutions for the major industries and markets that drive economies worldwide. The company delivers next-generation information, analytics and solutions to customers in business, finance and government, improving their operational efficiency and providing deep insights that lead to well-informed, confident decisions. IHS Markit has more than 50,000 business and government customers, including 80 percent of the Fortune Global 500 and the world's leading financial institutions.

UK Tech Sector Purchasing Managers' Index® (PMI®) survey data

UK Tech Monitor Index data is derived from a representative sub-category of approximately 150 tech companies within IHS Markit's regular PMI® surveys of UK manufacturers and service providers. Tech is defined in this report as technology software, technology services and manufacturing of technology equipment. All figures are seasonally adjusted and smoothed using a three-month moving average, to better highlight underlying trends in the data.

UK Tech Sector Business Outlook data

Business activity expectations data are drawn from the monthly PMI® surveys question on companies' expectations for their activity/output over the next 12 months. Prior to July 2012, only service sector companies were asked this question. Employment, capex, profits and input cost expectations data are based on responses from UK services and manufacturing firms participating in IHS Markit's tri-annual Global Business Outlook survey, which is based on the same panel of companies as the PMI® surveys.

Technology Sector industry groups:

Software publishing (SIC 582), Computer programming, consultancy and related activities (SIC 620), Data processing, hosting and related activities; web portals (SIC 631), manufacture of computer, electronic and optical products (SIC 26), manufacture of electrical equipment (SIC 27).

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