KPMG

KPMG UK Tech Monitor

Tech sector recovery slows as firms face record increase in costs

PMI® By IHS Markit

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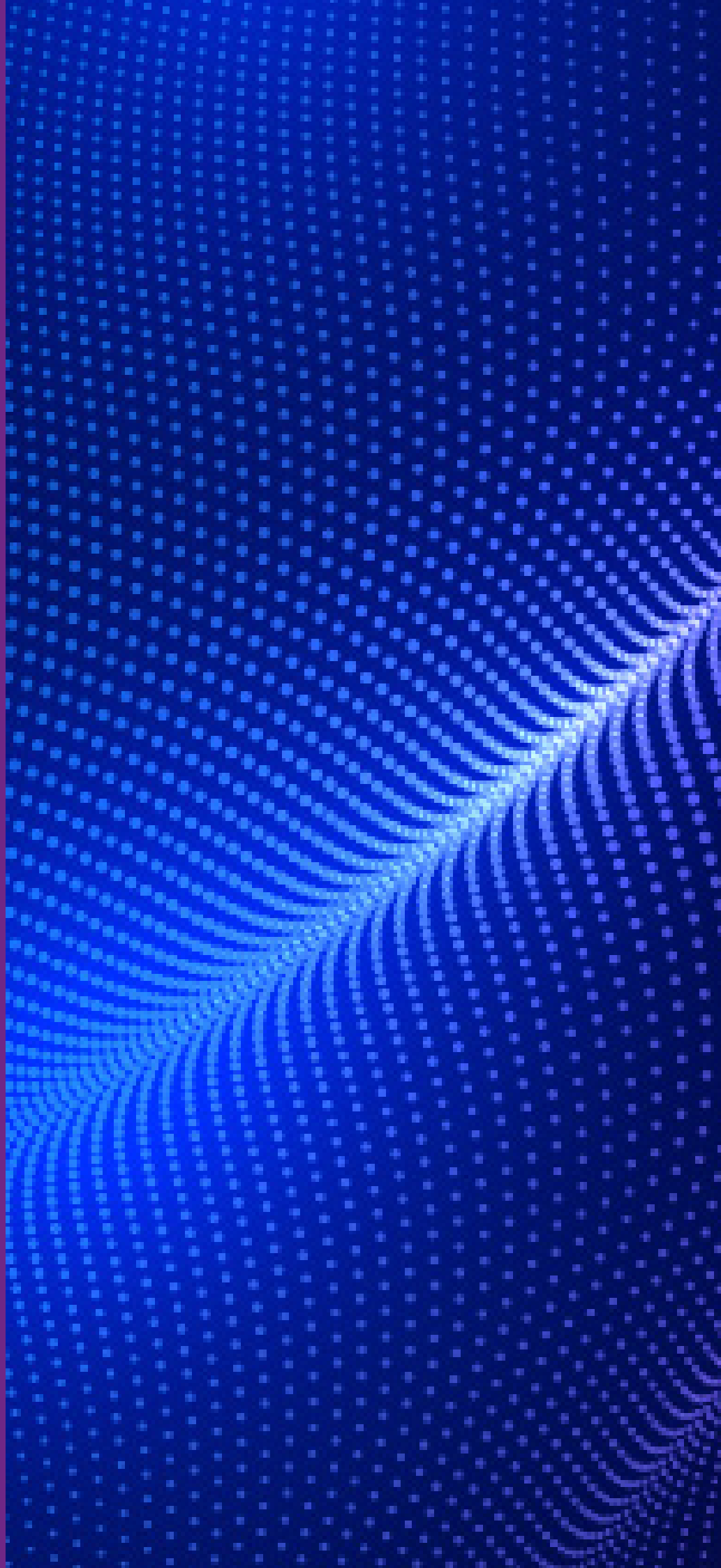


Foreword

Having experienced months of buoyant growth the UK tech sector has signalled a slow-down in growth momentum as significant cost increases bite. However, the sector is upbeat about longer term prospects.

Improved client confidence, stronger economic conditions and stock building by customers have all helped to boost intakes of new work, and as a result tech companies have added to their payrolls again during Q3, with the rate of job creation only fractionally slower than the record pace seen in Q2. Confidence in business activity for the year-ahead remained positive with a level of optimism among the highest seen since early-2007.

However, as activity slows, the tech sector is facing the fastest increase in costs for two decades. Higher wages, component shortages and increased shipping and logistic costs have resulted in supply chains coming under severe pressure. Not only are tech firms finding it challenging to find skilled candidates to fill vacancies, but they also cited severe shortages of critical raw materials as the global economy recovers.

Looser pandemic restrictions, greater corporate budgets for technology investment, new export opportunities and stronger global economic conditions were all expected to support growth in 2022, but rising costs remain dark clouds on the horizon. Staff availability and supply chain issues will not be resolved quickly, which presents a near-term risk of rising inflation and slower growth in the UK tech sector.

Bina Mehta, Chair,
KPMG in the UK

KPMG's Outlook

People

Demand in the experienced hire population, bringing with them the right technical skills in situ, is causing a steep rise in wages and resultant increases in costs. It may be time for the industry to take a closer and more serious look at investing in upskilling programmes – bringing in new entrants to the tech talent pool as well as reskilling those already there in new technologies. The return on investment of upskilling, if executed well, is compelling and will grow over the coming months.

Mel Newton
Partner, KPMG LLP (UK)
Insurance & Workforce Transformation

Supply Chains

Recent disruptions and geopolitical trade tensions have seen supply chain risk rise up the agenda. To address the war for talent — as both people and operational capacity become an issue — organisations will need to amend their supply chain operating models so that they can take advantage of digital operations and agile logistics networks. From a shortage of raw materials, transport disruption, availability of labour, or the challenge of the profitable last mile, it's sure supply chains will stay on the board agenda for the next 12-18 months.

Iain Prince
Associate Partner, KPMG LLP (UK)
Operational Transformation & Supply Chain

Pricing

In 2021, prices charged by most telecom operators increased by 3-5% as companies continued to restore profitability. At an overall level the differences between list and promoted prices have also started to narrow and consumers could enjoy discounts if they bought bundled deals in combination with broadband services. We expect this upward price trend to continue in the short term.

Shashank Dewan
Director, KPMG LLP (UK)
Pricing Strategy

M&A and Value Creation

While the Covid-driven growth boost in Tech is slowing, M&A valuations remain at an all-time high.

Tech executives and their Boards will need to increase focus on post-deal value creation initiatives to deliver the expected financial returns.

Alfonso Marone
Partner, KPMG LLP (UK)
TMT Deal Advisory Strategy & Value Creation Lead

Key findings

- Business activity growth slows as post-lockdown boom fades
- Job creation at tech firms remains rapid
- Input prices increase at record pace amid higher staff costs and supply shortages

"Like many areas of the economy, our latest Tech Monitor has signalled a slow-down in growth momentum during the third quarter across the tech sector.

"The slowdown coincided with the fastest increase in costs faced by tech companies for two decades.

"Despite rising cost pressures, which could be with us for a while, it's very encouraging to see that tech firms are upbeat about their prospects for 2022. Optimism held close to a 14-and-a-half-year high as companies anticipate activity to rise as clients recover from the pandemic and corporate spending continues to increase. Survey respondents also commented on planned expansion into new export markets, alongside strong growth in areas such as cyber security and cloud-based services."

Bina Mehta, Chair,
KPMG in the UK

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.

Tech sector output increases at softer pace, while cost pressures intensify

UK tech companies signalled a further increase in output during Q3 2021, as most pandemic-related restrictions ended and economic activity continued to recover, according to the latest KPMG UK Tech Monitor Index survey. Though solid, the rate of expansion was not as sharp as that seen during Q2, as the initial bounceback in activity petered out.

Sales growth also softened since the previous quarter. However, robust confidence towards the business outlook led firms to expand their staff numbers at a substantial pace that was little-changed from the record high seen in Q2. Rising labour costs and global shortages of components contributed to an unprecedented increase in input prices.

Business activity growth cools in Q3

At 55.0 in Q3, the headline Business Activity Index fell from a recent high of 59.9 in Q2, but remained comfortably above the neutral 50.0 level that separates growth from contraction. Furthermore, it was the second-highest reading since Q2 2018 and consistent with a solid rise in activity.

Survey respondents indicated that the removal of most COVID-19 restrictions and firmer demand conditions had boosted activity over the third quarter.

A slower, but still sharp, rise in business activity was also seen across the rest of the UK economy. For the second quarter in a row, the overall rate of growth was slightly quicker than that seen in the tech sector, as the rollback of restrictions drove strong growth in areas such as hospitality, leisure and transport.

Further sharp rise in new orders

New business received by tech companies rose for the second consecutive quarter. In line with the trend for business activity, growth slowed compared to Q2, but remained sharp overall and was among the strongest seen over the past four years.

Improved client confidence, stronger economic conditions and stock building by customers all helped to boost intakes of new work, according to tech firms.

Tech employment growth holds close to all-time high

Rising volumes of new work and efforts to expand capacity led tech companies to add to their payrolls again during Q3. The rate of job creation was only fractionally slower than the record pace seen in Q2 and remained steeper than that seen across the UK as a whole.

Although staff numbers increased, capacity pressures persisted and supply shortages remained widespread, leading to another solid rise in backlogs of work. On a worldwide basis, the number of manufacturers citing shortages of semiconductors was more than seven times higher than before the pandemic.

Higher wages drive record rise in costs

Tech companies recorded a sharper rise in their average cost burdens in Q3. The rate of inflation was the fastest recorded since the survey began in Q1 2003. Increased labour costs, component shortages and higher transport fees were commonly cited drivers of inflationary pressure.

Strong demand conditions and escalating supplier prices encouraged firms to pass on higher expenses to clients. The rate of prices charged inflation accelerated sharply in Q3 to hit a new record high.

Tech firms remain highly upbeat about the business outlook

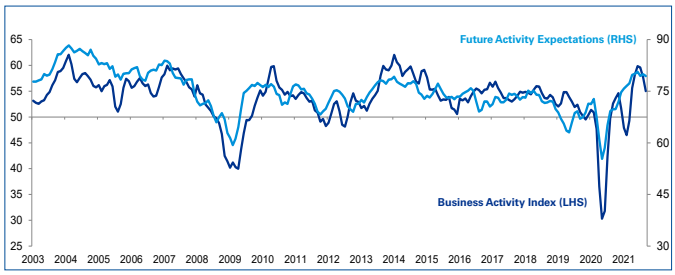
Confidence regarding the year-ahead outlook for business activity remained strongly positive among tech firms in Q3. The level of optimism was among the highest seen since early-2007.

Looser pandemic restrictions, greater corporate budgets for technology investment, new export opportunities and stronger global economic conditions were all expected to support growth in 2022. However, supply chain disruption and rising costs were key concerns cited by tech companies in Q3.

KPMG UK Tech Monitor Index

Above 50 = business activity growth, seasonally adjusted

Above 50 = growth in the next 12 months



Although high wage growth and supply chain issues are driving up the price of technology, which is an issue, the business benefits brought about by investing in digital will far outweigh any costs.

We now operate in an economy that is entirely underpinned by technology, so organisations cannot afford to shy away from investing in digital transformation that will help them successfully emerge from the pandemic, as well as achieve a competitive advantage over their peers.

Lisa Heneghan
Chief Digital Officer, KPMG LLP (UK)

Tech Sector: Demand and Capacity

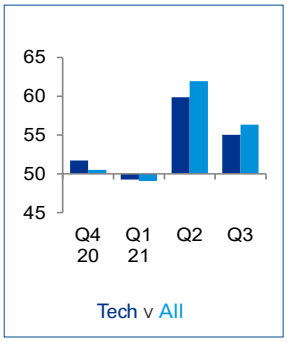
Tech Sector Output: Business Activity Index

Tech sector expands at slower rate in Q3

After rebounding sharply in Q2, business activity across the tech sector rose at a softer, but still strong, rate during Q3. The seasonally adjusted index slipped to 55.0, from 59.9, signalling a second consecutive quarter of growth. The upturn was linked to a return to improved business conditions and increased sales amid the further relaxation of COVID-19 restrictions.

Business Activity Index

Above 50 = growth, seasonally adjusted



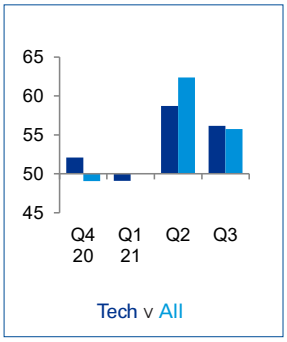
Tech Sector Sales: New Business Index

Tech companies continue to see strong inflows of new work

At 56.2 in Q3, the index measuring new orders received by tech companies fell slightly from a recent high of 58.7 in Q2, but still indicated a further sharp increase in sales. This marked a back-to-back quarterly expansion in new business across the tech sector. The latest increase was attributed to improved market confidence, stronger economic conditions, efforts to rebuild stocks and greater underlying demand for tech products, with cloud-based software mentioned in particular.

New Business Index

Above 50 = growth, seasonally adjusted



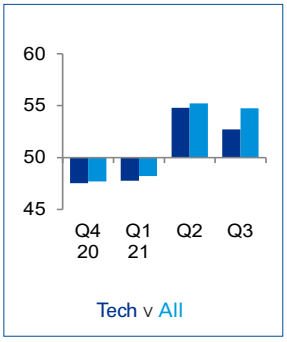
Tech Sector Capacity: Outstanding Business Index

Softer rise in outstanding business

Tech sector companies recorded a further increase in backlogs of work during Q3. The rate of accumulation softened from the unprecedented pace seen during Q2, but was solid overall. This was highlighted by the respective index slipping from 54.8 in Q2 to 52.7 in Q3. Businesses mentioned that rising amounts of new work, component shortages, supplier delays and difficulties finding suitably skilled staff had limited their ability to process and complete orders over the quarter.

Outstanding Business Index

Above 50 = growth, seasonally adjusted



Company Size Breakdown: Business Activity Index

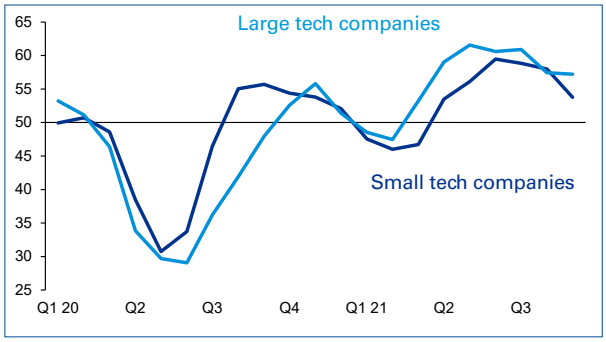
Slowdown in business activity growth led by small tech firms

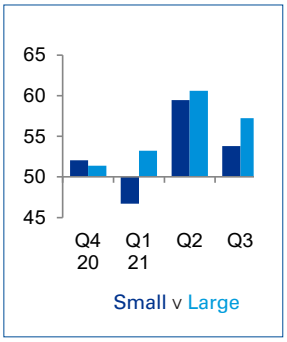
The slowdown in overall business activity growth was broad-based among both small and large tech companies in Q3, though large firms continued to outperform. The business activity index for large tech companies fell from 60.6 in Q2 to 57.2 in Q3. The equivalent index for small tech firms fell from 59.5 in Q2 to 53.8 in Q3.

Larger firms also registered a stronger rise in new business, and subsequently capacity pressures remained more acute compared to small tech businesses.

Business Activity Index

Above 50 = growth, seasonally adjusted





Tech Sector: Jobs and Prices

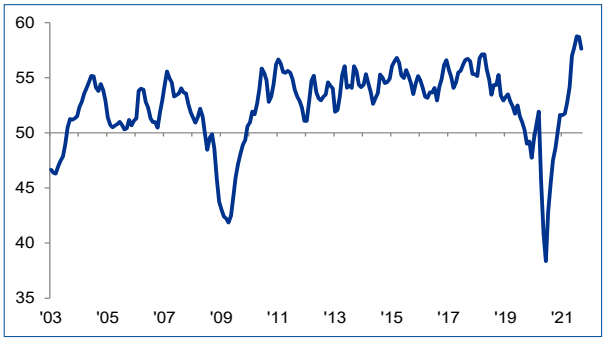
Tech Sector Jobs: Employment Index

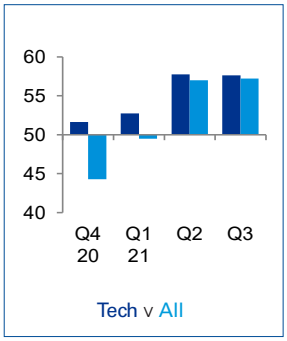
Tech sector sustains near-record pace of job creation

Employment at tech companies expanded in Q3, as has been the case since Q4 2020. The rate of job creation was little-changed from the record pace seen in the previous quarter, with the respective index down only fractionally from 57.7 in Q2 to 57.6. Staff hiring across the tech sector was often attributed to efforts to expand capacity amid rising intakes of new work, as well as forecasts of greater business requirements.

Employment Index

Above 50 = growth, seasonally adjusted





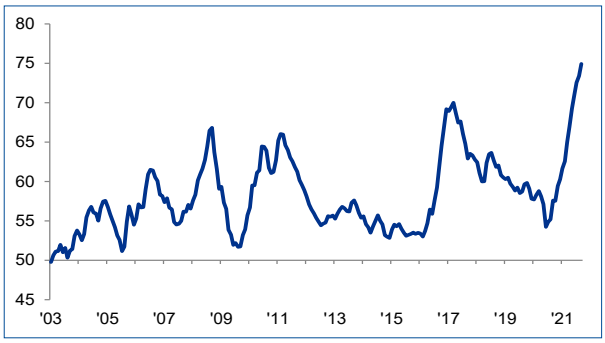
Tech Sector Costs: Input Prices Index

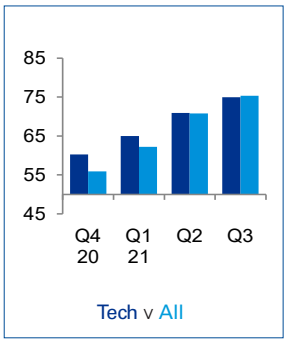
Input cost inflation surges to fresh record high in Q3

UK tech firms registered a sharp and accelerated rise in average input costs in Q3. At 74.9, the respective index was up from a previous peak of 70.9 in Q2 to signal the steepest rate of cost inflation since the series began nearly 19 years ago. Higher salary payments, supplier price hikes, severe shortages of components and greater shipping fees all drove up costs in the latest quarter. Operating expenses also rose at an unprecedented pace across the UK private sector as a whole.

Input Prices Index

Above 50 = inflation, seasonally adjusted





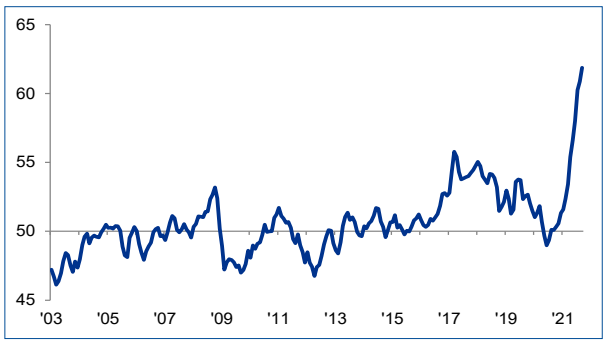
Tech Sector Margins: Prices Charged Index

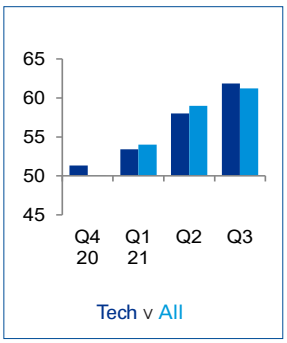
Unprecedented increase in selling prices

Tech firms looked to pass on rising expenses to clients by raising their selling prices again over the third quarter, which was supported by firmer demand conditions. At 61.9, the respective index rose from 58.0 in Q2 and signalled the sharpest increase in charges since the series began in Q1 2003. Output prices also rose at an unprecedented pace across the UK private sector as a whole, though the rate of inflation fell slightly short of that seen in the tech sector (index at 61.2).

Prices Charged Index

Above 50 = inflation, seasonally adjusted





Company Size Breakdown: Employment Index

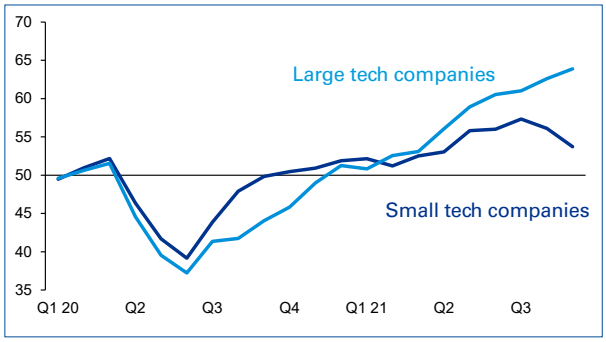
Staff hiring hits record high at large tech companies, but slows at small firms

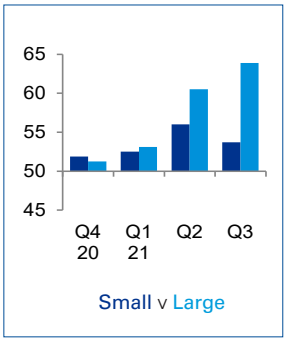
The index measuring employment at large tech firms rose from 60.5 in Q2 to 63.9 in Q3, to signal the strongest rate of job creation since the survey began in 2003. In contrast, the respective index for small tech firms dipped from an all-time high of 56.0 in Q2 to 53.7 in Q3, highlighting a solid but slower rate of employment growth.

The latest data illustrate that staff hiring returned to growth more quickly at smaller firms, but large tech companies are now leading the recovery.

Employment Index

Above 50 = growth, seasonally adjusted





Tech sector outlook

Tech Sector Outlook: Business Activity Expectations Index

Optimism towards the outlook remains close to 14-and-a-half-year high

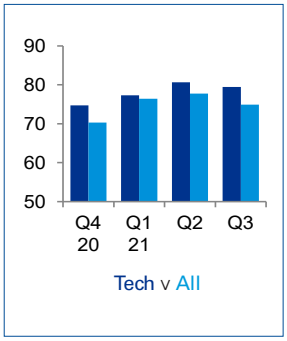
Business confidence regarding the year-ahead outlook among UK tech firms remained robust in Q3. At 79.4, the Business Activity Expectations Index fell only slightly from its 14-and-a-half-year record of 80.6 in Q2 and signalled a strong level of optimism overall. Notably, the degree of positive sentiment continued to exceed that seen across the UK private sector as a whole, which slipped to its lowest since Q4 2020 (index at 74.9).

Growth forecasts were linked to the recovery from the pandemic and removal of COVID-19 restrictions. Some firms cited a boost from workers returning to offices. Tech firms also anticipate that business investment in cyber security and cloud-based services will support higher activity in the year ahead, alongside strong underlying demand for electronics, reduced supply chain disruption and new export opportunities.

Tech companies that took a more cautious stance towards the outlook for the next 12 months cited lingering economic uncertainty and worries about how long it will take to fully contain the virus. Some noted an adverse impact from Brexit on their sales prospects and staff recruitment, while others were concerned about weaker client spending on goods and services related to working from home.

Business Activity Expectations Index

Above 50 = growth in the next 12 months



This report reflects what we are seeing at techUK. As the economy has reopened there has been no let-up in the accelerated pace of digitisation and the tech sector continues to grow strongly. However inflationary pressures continue to build both within the sector and across the economy. This is being driven by skills shortages and rising equipment and distribution costs. Although challenges in global and national supply chains and real concerns about inflation are starting to weigh on the outlook for the wider economy the overall trajectory for the tech sector still remains positive.

Julian David, CEO,
techUK

How is the UK recovery impacting on tech sector prospects?

In this section, we assess the how tech sector prospects are faring as the UK economy recovers from the pandemic.

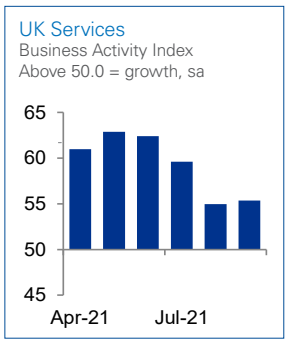
Survey data for the third quarter signalled a sharp slowdown in UK economic growth as the boost from the spring reopening began to fade. At the same time, shortages of materials and staff hindered efforts to build business capacity across the tech sector, which contributed to a weaker speed of recovery in both Software & Services and Technology Equipment.

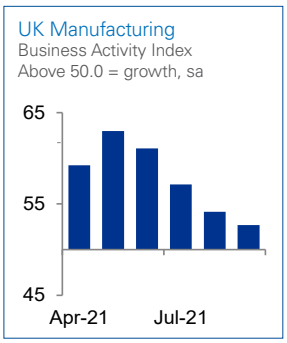
Service providers remained the main driver of growth in the UK economy, despite a loss of momentum from the 24-year peak seen in the second quarter. Manufacturing output rose only moderately and at the slowest pace since the winter lockdown period, largely due to severe supply chain disruption, widespread international shipping delays and escalating input cost inflation.

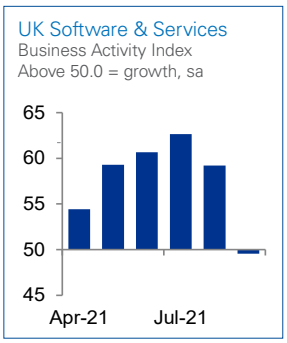
Monthly data illustrated that business activity dipped slightly in the Software & Services sub-sector during September, ending a seven-month period of expansion. Some survey respondents noted that the end of pandemic restrictions had led to lower client spending on digital services, while others commented on constrained activity due to shortages of staff and difficulties ramping up business capacity.

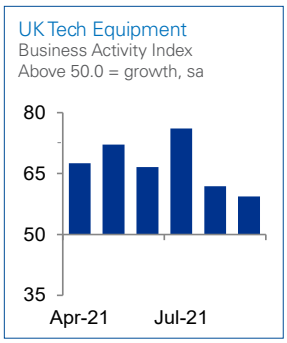
Turning to Technology Equipment, this segment remained far stronger than the rest of the UK manufacturing sector. A lack of critical components meant that production growth was the slowest since February, while input price inflation accelerated for the ninth month in a row to a new survey-record high.

Business Activity Index









Tech sector outlook

Shortages of semiconductors limit global tech sector production

The number of manufacturers citing a lack of semiconductors eased only slightly from the record high seen in the second quarter of 2021, according to data compiled from IHS Markit's Global PMI surveys. Reports citing supply shortages for semiconductors were around 7.6 times higher than usual in September, compared to a peak of 9.1 in May. The semiconductor shortages index remained much higher than in the 15 years leading up to the pandemic.

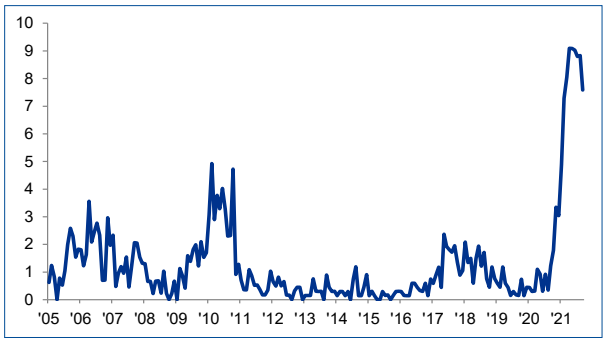
Producers of Technology Equipment have been hard hit by shortages of semiconductors. On a worldwide basis, output growth in this sector was the weakest for 13 months in September. Meanwhile, backlogs of work were accumulated at a near-record pace and surging costs meant that prices charged inflation was the strongest since the index began in October 2009.

Escalating pay pressures accompany the UK recovery in Q3

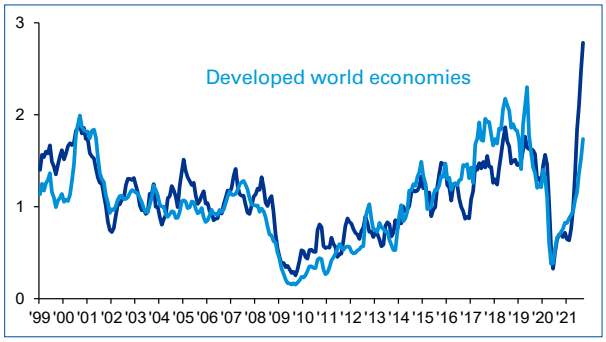
The global supply chain crisis contributed to another round of steep increases in operating expenses for UK businesses during the third quarter of 2021. Staff shortages and subsequent pay pressures have also become a major driver of cost inflation as developed world economies recover from the pandemic.

Survey data compiled by IHS Markit highlighted that the number of UK businesses citing higher wages as a reason for rising input prices was nearly three times greater than usual in September, which was a survey-record high and well above the developed world average (1.7).

Global Supply Chains: Short supply of semiconductors (index, 1 = long-run average)



UK Pay Pressures: Survey respondents citing higher input prices due to wages (index, 1 = long-run average)



UK sector rankings

The tech sector topped the UK sector rankings for business activity expectations. Confidence levels were only slightly weaker than the previous quarter and still higher than any other time since Q1 2007.

Concerns about rising inflation and prolonged supply chain disruption resulted in weaker business optimism across large swathes of the UK economy during Q3 2021.

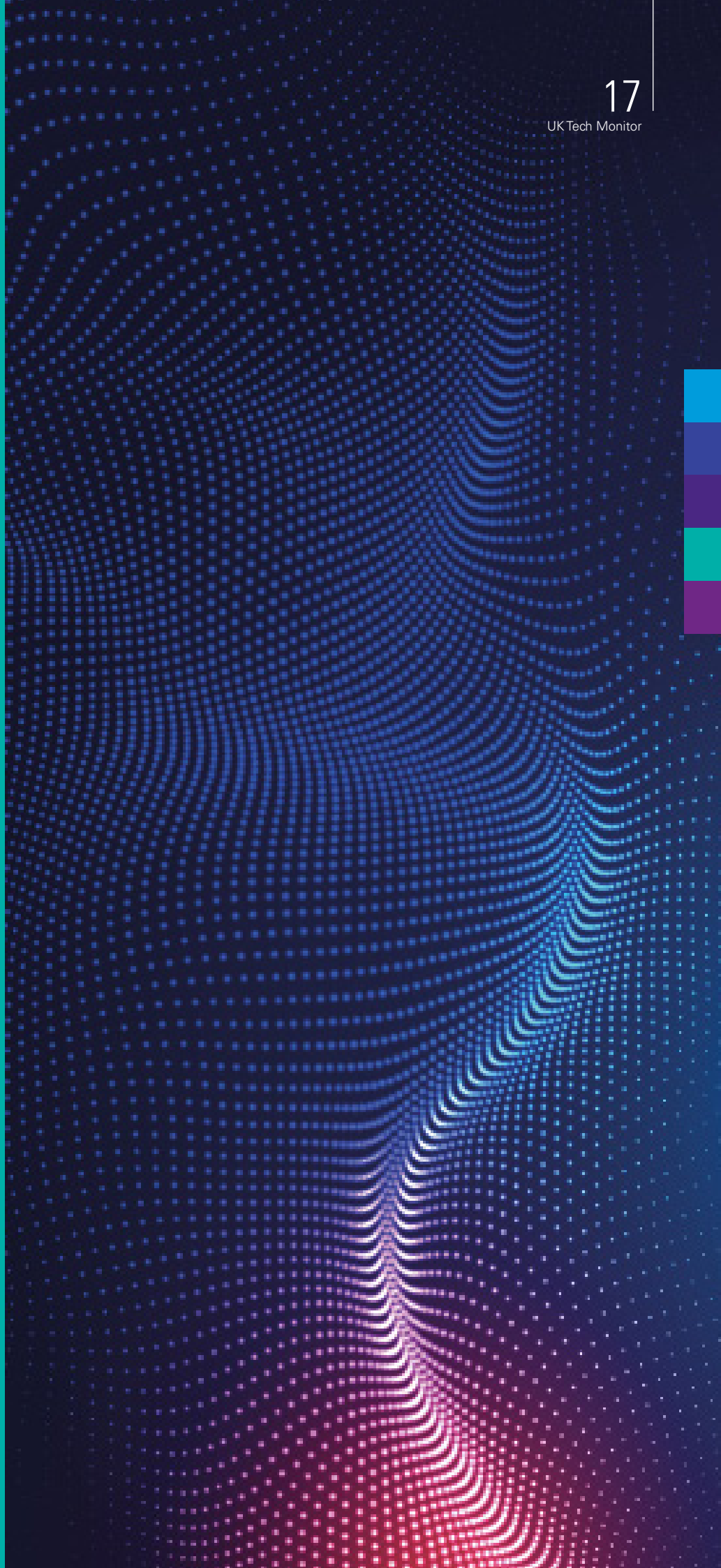
Five out of six categories recorded lower growth expectations for the next 12 months, with Business Services the only sector to hold its ground.

Hotels & Restaurants saw the greatest loss of confidence, with the business expectations index down by 17 points since the previous quarter. Survey respondents in this category noted that acute staff shortages, strong pay pressures and the end of the staycation boom would hinder their growth prospects in 2022.

Transport Services remained a relatively subdued part of the UK economy in Q3, with softer growth projections linked to a lack of available staff and surging energy prices. However, some firms noted that looser international travel restrictions were set to deliver a considerable boost to demand in the next 12 months.

Business Expectations Index by sector
Above 50 = growth in next 12 months

	Q3 2021	Q2 2021
Tech Sector	79	81
Manufacturing	79	81
Business Services	73	73
Financial Intermediation	71	75
Transport Services	68	72
Hotels & Restaurants	63	80



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About KPMG

KPMG LLP, a UK limited liability partnership, operates from 21 offices across the UK with approximately 16,000 partners and staff. The UK firm recorded a revenue of £2.3 billion in the year ended 30 September 2020.

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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.

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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