AUSTRALIAN INDUSTRY GROUP AND DELOITTE

NATIONAL CEO SURVEY

Industry in Recovery Mode in 2010

March 2010

AUSTRALIAN INDUSTRY GROUP

Deloitte.

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Key Messages

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Improving prospects for 2010 with mixed results across sectors

Through a mixture of good management and good fortune, the Australian economy has switched into recovery mode with improving prospects for 2010. This was reinforced with the recent release of GDP figures showing a firm pick up in the closing months of last year. These encouraging signs are certainly much more positive than the prospects we faced this time last year.

While recovery seems set to continue in 2010 aided by a strong contribution from the mining sector, this report suggests that the prospects in the 90% of the economy represented by the manufacturing, construction and services sectors are for a solid albeit not a stellar recovery this year.

The services sector was cushioned during 2009 by historically low interest rates and government stimulus packages aimed at consumers and housing. For 2010, it is the most optimistic of the three sectors, expecting solid growth in sales, exports, employment, research and development and plant and equipment spending.

The manufacturing sector was battered during 2008/09 and contracted by 7.8% over the year to September 2009. From this low base, CEOs expect moderate growth in sales, exports and employment. Indicating caution about the sector's medium-term prospects however, investment in plant and equipment is expected to fall further in 2010.

Following several strong years, growth in the construction sector weakened in 2009. 2010 is not expected to see a sharp turnaround with construction sales and employment growth expected to be relatively softer than in the other two sectors. However, investment in plant and equipment is expected to rise significantly in comparison.

The challenges for policy in 2010 will be to strengthen the recovery while addressing the ongoing requirement to build on the foundations of longer-term growth.

Government support for infrastructure spending is likely to be particularly positive for construction although the removal of the boost to the First Home Buyers Grant combined with higher interest rates is likely to have an impact on the housing sector. More broadly with a large share of the monetary stimulus already withdrawn, there are clear risks involved in an excessive acceleration of the removal of fiscal stimulus beyond the pace already in train.

Heather Ridout
Chief Executive
Australian Industry Group

This Ai Group National CEO Survey underpins the importance of companies being proactive to access their share of the recovery.

Consistent with the messages we delivered to our clients through 2009, this is a time for companies to get on the front foot in a range of areas to ensure they make the most of a solid recovery in 2010.

We believe there are four areas which all Australian companies must consider.

The first is to understand that the global recovery is not likely to be consistent, and that those more engaged with China and India are likely to fare better than those with markets in Western Europe or America. If businesses have not engaged in Asia as yet, these growth patterns underline the timeliness of considering these markets now.

Secondly, companies need to ensure they are harnessing the value of information available to them across a range of issues to understand how their market position may have changed through the downturn. Knowing where they sit against world's best practice, through to appreciating the detail of their market and customer segments will assist companies to seize opportunities as they present themselves.

While the effects of the stimulus package will lessen, the Federal and state governments continue to be active in the areas of industry programs and incentives around investment, research and development and export activity. Companies need to ensure that they are maximising the assistance to which they are eligible to accelerate growth or investment plans.

Finally, companies should revisit their plans regarding rationalisation activity. Asset prices in the wake of the downturn are likely to be significantly different from where they were 18 months ago, and mergers or acquisitions may make sense in the current climate.

As this survey shows, while 2009 was characterised as a year founded on survival, 2010 will create additional opportunities for companies to recover ground. Again, it will be those who are proactive that are most likely to close the year in a stronger position.

Damon Cantwell
Partner
Manufacturing



Executive Summary


Executive Summary

How does business see the recovery?

1 Businesses across the manufacturing, construction and services sectors are confident though cautious about prospects during 2010. The year is looking to be a clear improvement on 2009 as the economy continues to recover at a solid rather than sharp pace.

2 2010 is expected to see improvement in activity in all three sectors though it is likely to be stronger in the services and manufacturing sectors than the construction sector. While improving, growth in manufacturing is coming from a low base following a sharp contraction for most of the past eighteen months.

3 The global economy will see moderate growth in 2010, with those firms exposed to the faster growing emerging economies such as China faring better than those with a focus on the developed economies such as the US.

4 Domestically, firm performance will reflect the impact of positive drivers such as improving consumer confidence in incomes growth and employment prospects, rising household wealth and exposure to strong growth in China. Offsetting these positives will be the fading of Government stimulus, rising interest rates and the adverse impacts of the stronger dollar on import-competing and exporting businesses.

5 Wages and prices growth in all sectors look set to remain modest. This is in line with the forecasts for overall activity outlined by the CEOs in this survey.

Background

6 This report presents the results of Ai Group's annual survey of business prospects for the coming year and has been prepared as part of our National CEO Survey reports undertaken in conjunction with Deloitte Touche Tohmatsu.

7 A total of 514 CEOs in the manufacturing, services and construction sectors participated in the survey, which was conducted in the first half of December 2009. Combined, these companies had sales revenue of around $27.9 billion and employed almost 130,000 people.

8 Based on these companies' forecasts, overall industry estimates were derived for national sales, investment, employment, exports and a number of other business indicators.

9 The rates of change in sales, employment, investment in plant and machinery and exports for the years up to and including 2008-09 are based on ABS data, with the 2010 forecast based on CEO survey responses.

10 The rates of change in research and development for the years up to and including 2007-08 are based on ABS data, with the 2009 and 2010 forecasts based on CEO survey responses.

Manufacturing

11 Manufacturing sales and employment are expected to improve in 2010 following the particularly tough year in 2009.

12 Manufacturers anticipate a 5.6% increase in the nominal value of sales in 2010, to around $415 billion. The nominal value of manufacturing export sales is also expected to rise, by 4.1% to $96 billion.

13 Employment in the sector is forecast to grow by 2.9% (29,000 jobs) to 1.02 million, only partly recovering the 80,000 manufacturing jobs lost in 2009.

14 Expenditure on new plant and machinery by the manufacturing sector is expected to decline again in 2010, although spending on research and development and training is expected to rise modestly.

15 Average manufacturing selling prices are forecast to increase by just 3.0% in 2010. Manufacturing wages growth is expected to remain broadly steady, easing from 3.6% in 2009 to 3.5%.

Construction

16 The outlook for construction remains relatively weak, with sales expected to rise by a modest 2.5% in 2010.

17 Following six years of strong employment growth, employment in construction grew by a modest 0.9% in 2008/09. Construction employment growth is again expected to be soft in 2010, rising by only 0.5%.

18 Expenditure on research and development and training is expected to rise marginally, following a sharp drop in 2008/09. Investment in plant and equipment is expected to rise strongly in 2010.

19 Average construction selling prices are forecast to increase by just 3.1% in 2010. Construction wages growth is expected to remain broadly steady, at 3.5%.

Services

20 The outlook for services is positive, with growth expected to accelerate in 2010. Total sales are forecast to rise by 6.6% compared to growth of 4.1% in 2008/09. Services exports are also expected to lift, by 8.2% to $57.7 billion in 2010.

21 In line with the stronger sales outlook, employment growth is also expected to pick up, growing by 2.3% up from 1.6% in 2008/09. Expenditure on research and development is also expected to rise, by 8.2%, in 2010.

22 Selling price growth is expected to fall to 3.5%, down from 4.3% in 2009. Wages growth is expected to ease from 3.6% in 2009 to 3.4%.

23 Spending on training in the services sector is expected to rise mildly in 2010, by 1.9%.



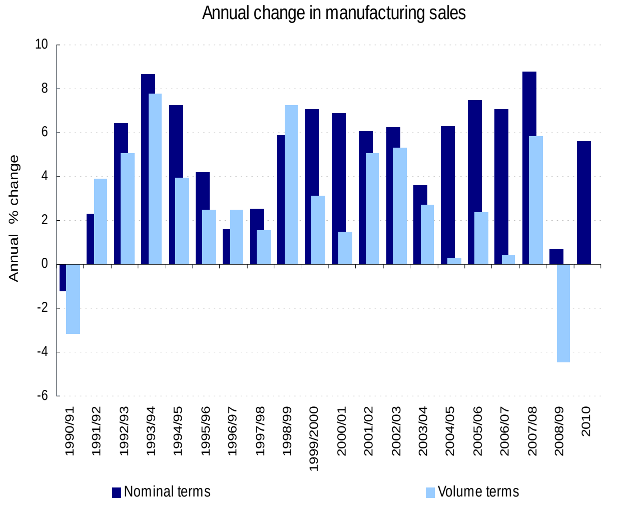
Manufacturing


Business prospects for manufacturing in 2010

Manufacturing sales and employment to lift, while the investment outlook remains poor

Sales

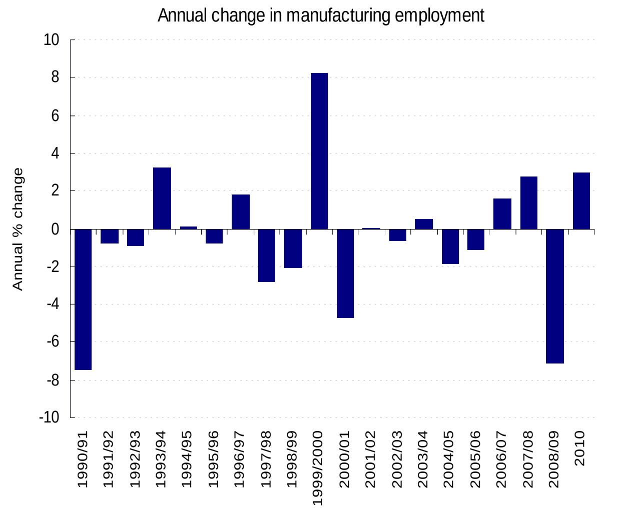
- The downturn in world demand for manufactures in the wake of the global financial crisis constrained Australian nominal manufacturing sales growth (based on ABS data) to just 0.7% in 2008/09. This was the softest rate of expansion in 17 years.
- This weak performance, following four years of strong growth, reflected a 4.5% fall in the volume of manufacturing sales; a heavier decline than the 3.1% recorded in the midst of the 1990/91 recession.
- Sales are forecast to improve solidly in 2010, with the nominal value of manufacturing sales expected to rise by 5.6% (less in real terms), to around $415 billion. However, a significantly higher $A exchange rate, higher interest rates and only a mild lift in world demand will continue to limit growth.



The nominal value of manufacturing sales forecast to grow by 5.6% …

Employment

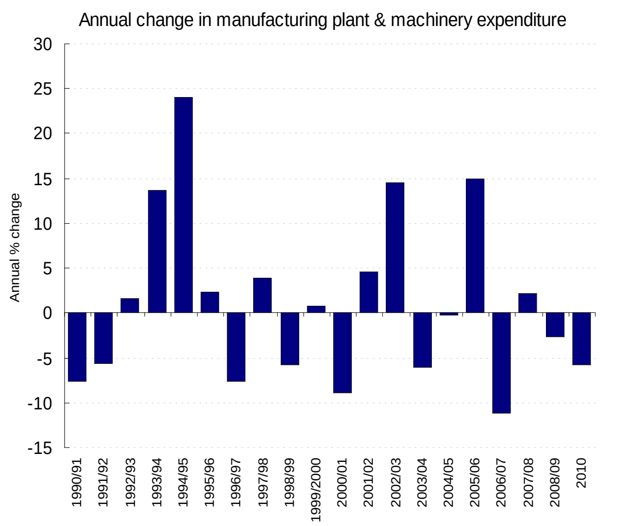
- In 2008/09 manufacturing employment fell by 7.2%, the loss of almost 80,000 jobs from the sector, due to weak demand and ongoing company restructuring reflecting strong competitive pressures.
- Building on gains in late 2009, in 2010, manufacturing employment is forecast to grow by 2.9% (29,000 jobs) to 1.02 million.
- While this would mark the strongest rate of manufacturing jobs growth since 1999/2000, it would only partially offset the number of jobs lost in 2008/09.
- The forecast increase in employment reflects the expected pick-up in demand conditions, both in Australia and globally, over the coming year.



Manufacturing employment expected to rise by 2.9% …

Investment in plant and machinery

- Manufacturers are planning to further scale back their expenditure on new plant and machinery in 2010, following a 2.7% decline in spending in 2008/09.
- ABS data shows that manufacturing investment activity changes considerably from year to year. A weak rise in investment in 2007/08, for example, was preceded by a sharp decline of 11.1% in 2006/07 and a surge in investment in 2005/06.
- In 2010 investment in new plant and equipment is expected to decline by 5.8% to $7.9 billion, confirming the Australian manufacturers' caution in the wake of the GFC and continuing competitive pressures from low cost economies and a substantially higher exchange rate.



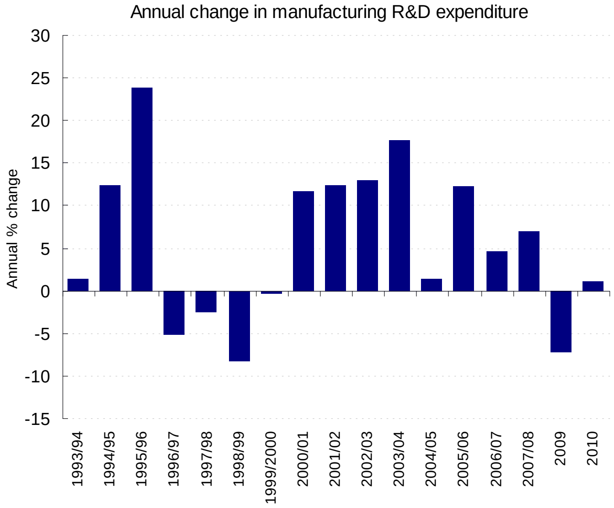
New investment is forecast to be scaled back by 5.8% …

Business prospects for manufacturing in 2010

Slower growth in manufacturing selling prices and steady wage increases

Research and development

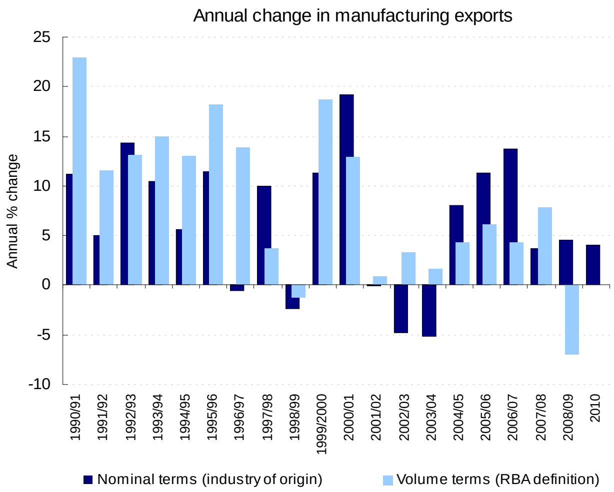
- The latest official ABS data for 2007/08 shows that research and development (R&D) spending in manufacturing rose by 7.0%. The growth in R&D expenditure evident in the period between 2000/01 to 2003/04 was maintained through to 2007/08, albeit at generally lower rates.
- In 2009, the forecast* is for a 7.3% decline in R&D spending, reflecting the significant impact of the global economic downturn on cash flows and the subsequent need for firms to make cost cutbacks in order to marshal available cash resources.
- Manufacturing expenditure on R&D is expected to recover slightly in 2010, rising by 1.1% as firms seek to refocus their sights on becoming more innovative.



Research and development expenditure to lift by 1.1% …

Exports

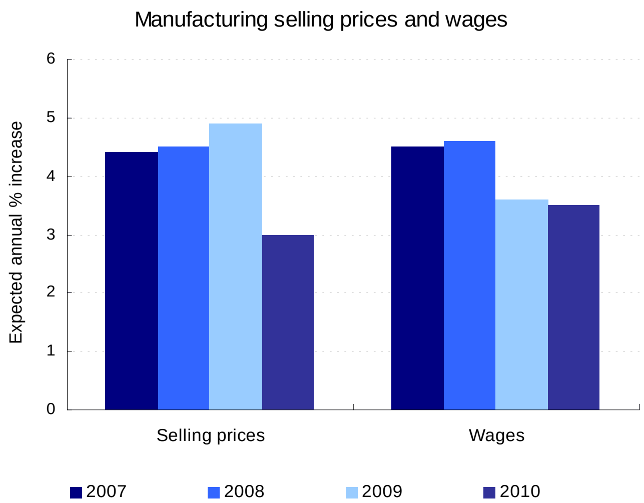
- The lower average Australian dollar exchange rate in 2008/09 helped maintain growth in the nominal value of manufacturing exports, despite a 7.0% fall in their volume.
- The fall in manufactured export volumes in 2008/09 largely reflected weaker demand from Australia's trading partners affected by the GFC.
- Manufacturers are forecasting exports in nominal terms to rise by 4.1% to $96 billion in 2010 (based on industry of origin), a slight moderation from the 4.5% increase recorded in 2008/09.
- The forecast moderate growth reflects expectations of an improvement in world and domestic demand for manufactures. However, the higher exchange rate will keep a cap on exports growth in both nominal and volumes terms.



Manufacturing exports in nominal terms expected grow by 4.1%, …

Selling prices and wages

- Manufacturers expect selling prices to rise by 3.0% on average in 2010, a significant deceleration from the 4.9% rise predicted for the previous year.
- The easing in prices growth may reflect ongoing competitive pressures, moderate expected sales growth, and, on the cost side, the impact of the strong Australian dollar on overseas sourced inputs (which have grown in importance over the last five years).
- Average wages growth in the manufacturing sector is forecast to remain steady in 2010, down slightly from 3.6% in 2009 to 3.5%, in line with modest pressures in the manufacturing labour market.



Selling prices growth to ease, wages growth to remain broadly steady …

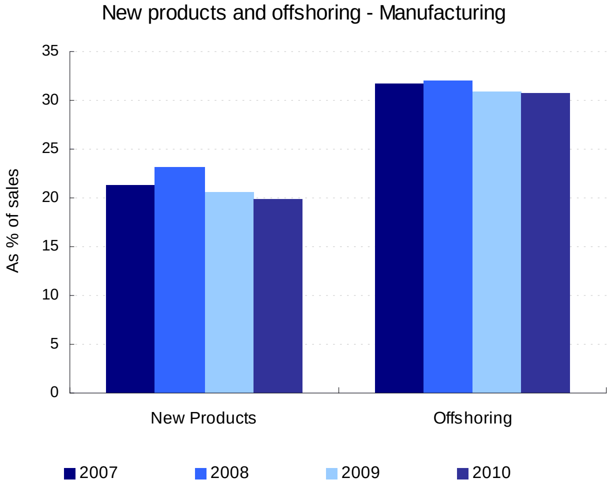
* *Australian Industry Group-Deloitte – A Tough Year Ahead, January*

Business prospects for manufacturing in 2010

Manufacturing training expenditure expected to rise modestly

New products and offshoring

- New product intensity (the percentage of sales derived from new products introduced in the preceding three years) peaked for the manufacturing sector at 23.1% in 2008.
- In 2010, new product intensity is expected to fall further, dropping from a revised 20.6% in 2009 to 19.8%.
- Offshoring can take two forms: companies moving part or whole of their operations overseas; and/or using a greater share of imported materials in domestic production in order to lower costs.
- Having risen strongly in recent years, the level of offshore intensity (offshore activity as a percentage of sales) is forecast to remain at 30.8% in 2010.



New product intensity to ease to 19.8% …

Training expenditure

- Training expenditure by the manufacturing sector is forecast to grow by 3.5% in 2010.
- While this represents a modest expansion in spending on training, it follows a solid decline in 2009, which was brought on by the global economic crisis and other negative factors that impacted on performance and profitability.

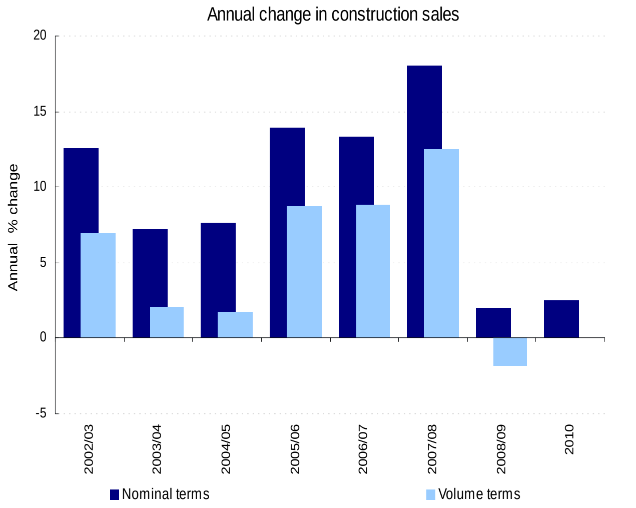
Construction

Business prospects for construction in 2010

Construction sales forecast to rise moderately

Sales

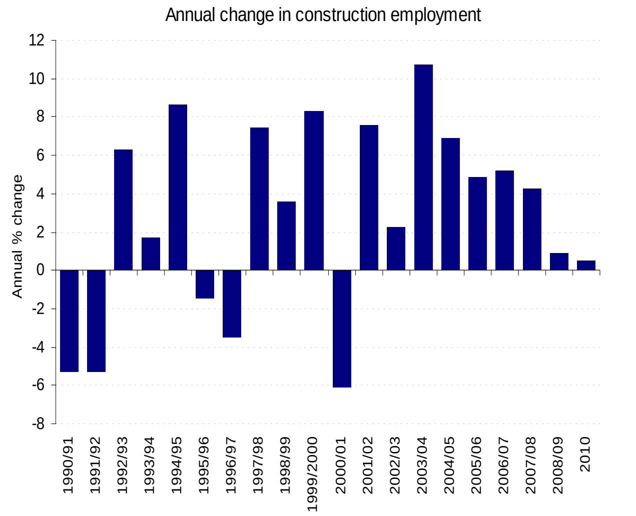
- Nominal sales (based on ABS data) grew modestly in construction over 2008/09, rising by just over 2.0% (but falling by 1.9% in volume terms).
- This reflected growth in infrastructure and mining-related engineering construction spending, which was partly offset by declines in commercial and dwellings construction.
- CEO expectations for 2010 suggest a mild lift in growth, with nominal sales to rise by 2.5% (flat in real terms). This is likely to reflect the adverse impact of higher interest rates alongside improving, though still modest dwelling investment and a pick up in resources sector-related construction.



Nominal construction sales to rise by 2.5% …

Employment

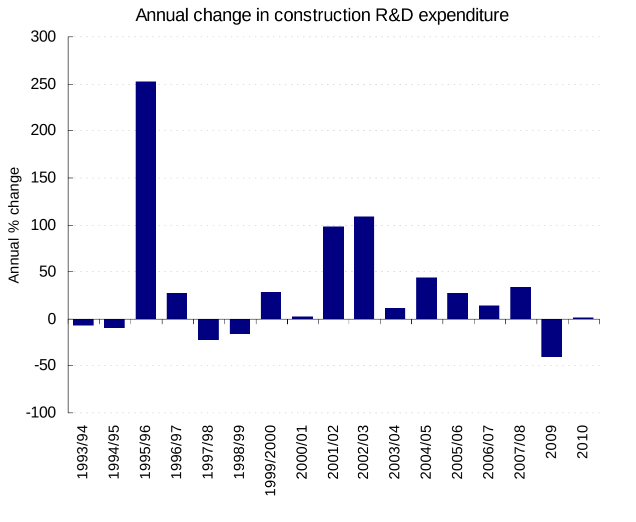
- Following six years of strong employment growth, employment in construction grew by a modest 0.9% in 2008/09.
- Construction employment growth is again expected to be soft in 2010, rising by only 0.5%.
- The relatively weak rise in employment forecast reflects expectations of constrained demand for new house and apartment building due to higher interest rates and weaker housing affordability.
- Constraints on land supply, the fading of the impacts of the First Home Owner Boost and the emergence of skills shortages are also likely to constrain growth.



Construction employment to lift by 0.5% …

Research and development

- Expenditure on R&D in the construction sector can swing widely from year to year.
- The latest official ABS data for 2007/8 shows that R&D spending in construction rose by 34.8%.
- The forecast for 2009 sees expenditure on R&D decline substantially, by 40.7%, as firms cut back on costs to preserve margins and preserve cash flow at a time of moderate sales growth and credit constraints.
- Construction R&D is expected to rise only marginally, by 0.9% in 2010.



Expenditure on construction R&D forecast to rise marginally by 0.9% …

Business prospects for construction in 2010

Competition and modest market conditions keep lid on prices and wages

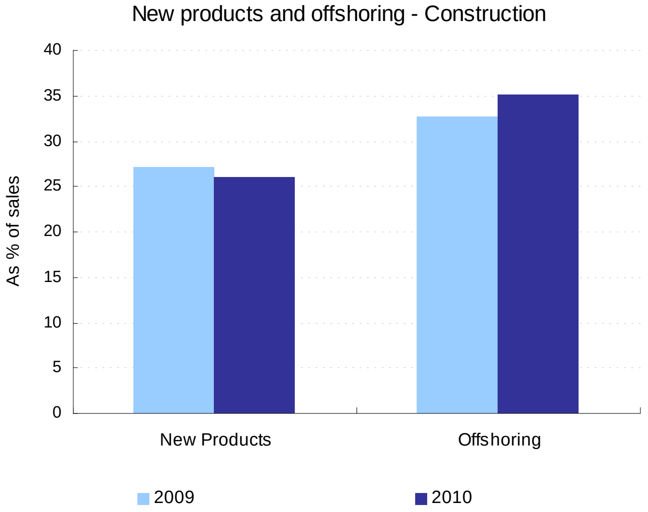
Selling prices and wages

- Constructors expect selling prices to rise by 3.1% on average in 2010, a similar outcome to 2010. The stability in prices likely reflects ongoing competition in an overall construction market experiencing only modest growth.
- The expectation for average wage growth in 2009 is 3.5%. This is in line with expectations of modest growth in construction employment. A risk to this forecast is the potential for the re-emergence of skills shortages should the sector strengthen more than currently forecast.

Average construction wages growth expected to be 3.5% ...

New products and offshoring

- New product intensity (the percentage of sales derived from new products introduced in the last three years) was estimated to be 27.2% in 2009.
- In 2010, new product intensity is expected to fall slightly to 26.1%.
- The level of offshore intensity (offshore activity as a percentage of sales) on average across the survey's respondents is forecast to rise to 35.1% in 2010, from 32.7% in 2009.



Offshore intensity estimated to rise to 35.1% ...

Investment in plant and machinery

- Like R&D expenditure, investment in plant and machinery by construction firms can vary greatly from year to year.
- In 2010, construction investment in plant and equipment is expected to rise by around 28.4%.

Training expenditure

- Construction companies are likely to raise expenditure on training by a marginal 1.2% in 2010, reflecting caution in spending during what is likely to be a relatively modest improvement in construction sector conditions in 2010.



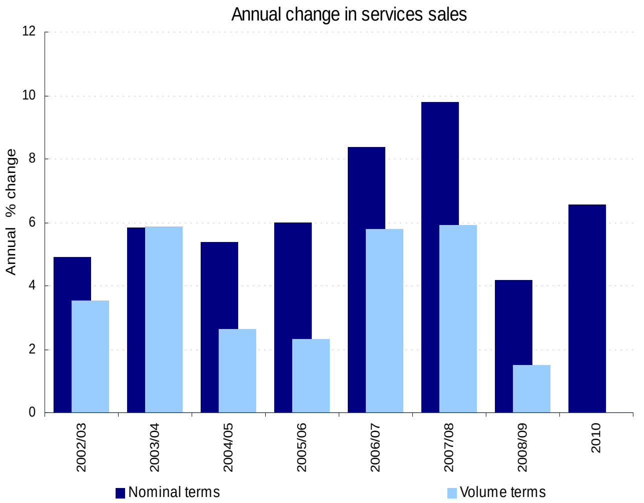
Services


Business prospects for services in 2010

Services activity forecast to pick up solidly

Sales

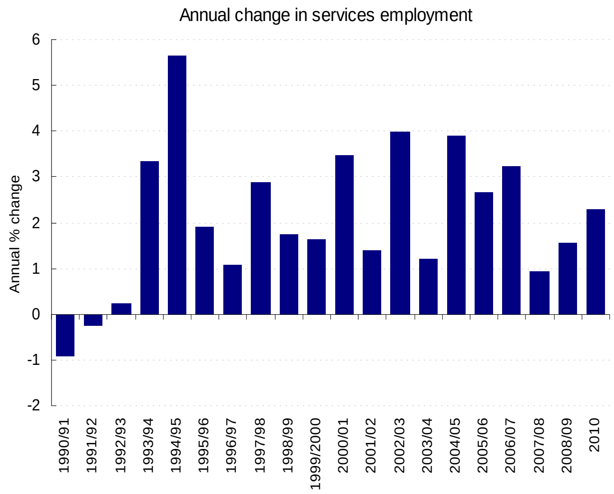
- Nominal sales growth (based on ABS data*) moderated in services over 2008/09, following strong growth in the three years prior to the global financial crisis.
- In 2008/09 sales rose by 4.1% (and 1.5% in volume terms). The better than expected outcome reflected a range of factors, including resilient consumer spending due to the Federal government's cash grants to taxpayers, low interest rates and better than expected employment outcomes.
- Notwithstanding higher interest rates, prospects for 2010 are more optimistic with nominal sales expected to rise by 6.6%, driven by an improving jobs market and higher household wealth as stock markets and housing prices rise.



Nominal services sales to expand by 6.6% …

Employment

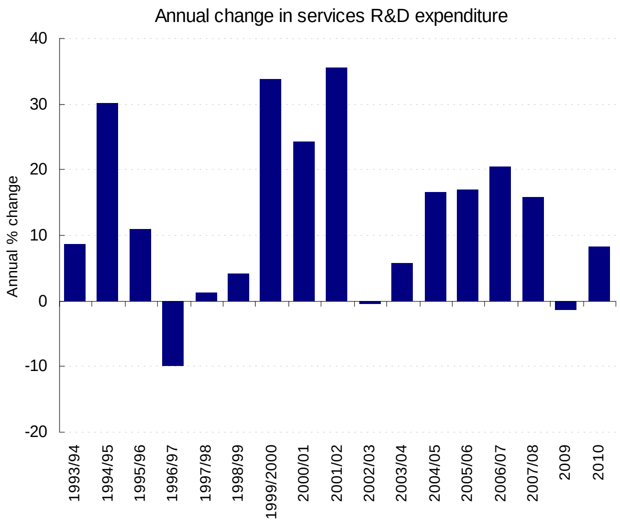
- Employment growth is expected to accelerate from 1.6% in 2008/09 to 2.3% in 2010. Although an improvement, this is below the rate of growth that occurred in the period from 2004/05 to 2006/07.
- The forecast increase reflects expectations of an increase in demand for services from households and businesses, reflecting the factors described above.



Services employment is forecast to grow by 2.3% in 2010 …

Research and development

- The latest official ABS data for 2007/08 shows that R&D spending by services increased by 15.9%.
- However, in 2009 expenditure on R&D in the services sector is estimated to have fallen for the first time since 2002/03 following the fall out from the global financial crisis and its impact on cash flow available for longer-term spending such as investment and R&D.
- The forecast for 2010 suggests a resumption in growth on R&D spending as cash flow improves.
- On average, businesses are expecting to lift R&D spending by 8.2% in the coming year.



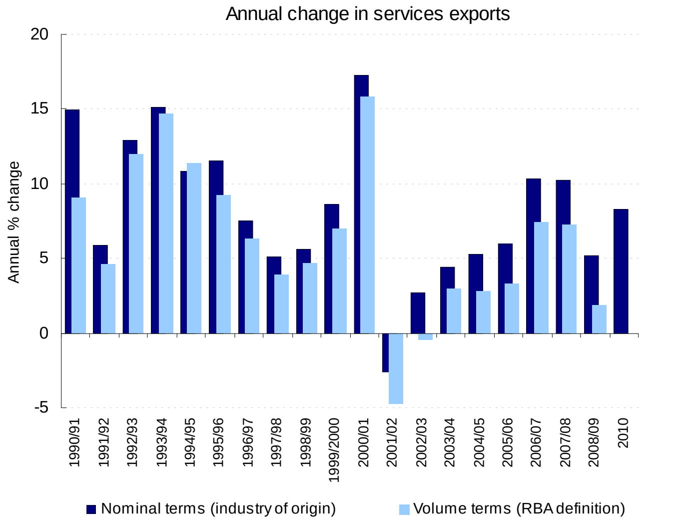
Expenditure on R&D by the services sector expected to lift 8.2% …

Business prospects for services in 2010

Service exports expected to grow moderately despite the higher $A

Exports

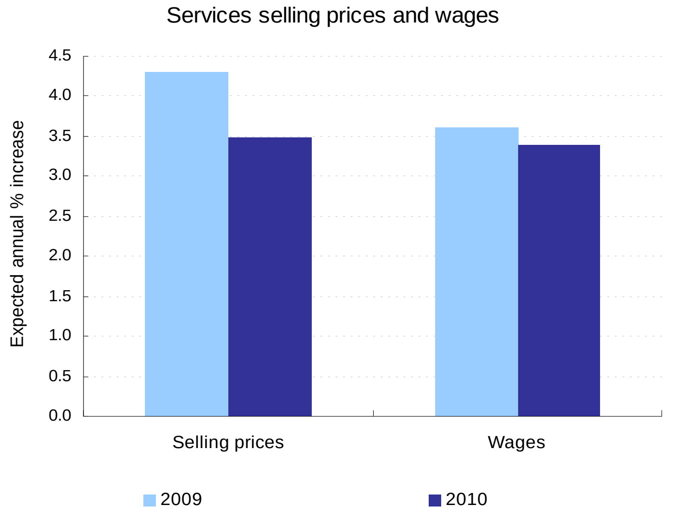
- In nominal and volume terms, services exports have grown over the last six financial years, with growth moderating in 2008/09.
- Service companies are forecasting export growth in nominal terms to increase to 8.2%, bringing total exports in 2010 to around $57.7 billion.
- This is a reasonably strong forecast given the anticipated effects on competitiveness of the higher value of the Australian dollar.



Growth in the value of export earnings to accelerate to 8.2% …

Selling prices and wages

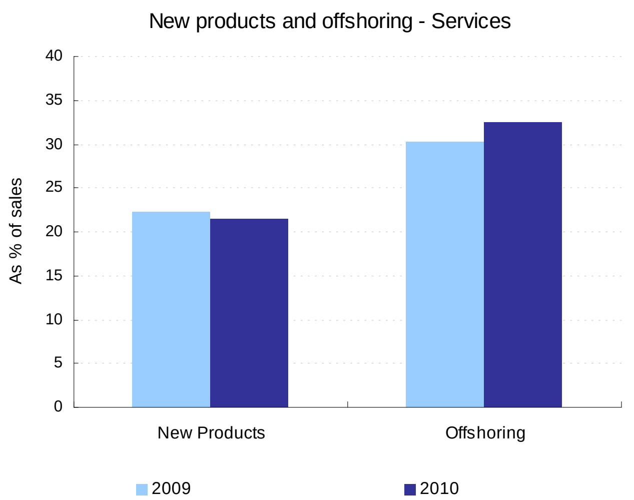
- Selling prices in the service sector are forecast to ease slightly to 3.5% on average in 2010, below the 4.3% increase anticipated for 2009.
- The expectation for average wages growth is expected to moderate slightly from 3.6% in 2009 to 3.4% in 2010.
- This is consistent with expectations of subdued labour market conditions in the coming year. The potential for the emergence of skills shortages poses upside risk to the wages forecast.



Selling prices growth forecast to ease to 3.5% …

New products and offshoring

- New product intensity (the percentage of sales derived from new products introduced in the last three years) is forecast to remain at similar levels dropping slightly from 22.0% in 2009 to 21.5% in 2010.
- The level of offshore intensity (offshore activity as a percentage of sales) is forecast to rise slightly from 30.2% in 2009 to 32.6%.



Level of offshore intensity to lift to 32.6% …

Business prospects for services in 2010

Services firms anticipate a lift in discretionary spending

Investment in plant and machinery

- Like R&D expenditure, investment in plant and machinery by services firms can vary greatly from year to year.
- In 2010, services sector investment in plant and equipment is expected to lift by around 5.5%.

Training expenditure

- Services companies are likely to increase expenditure on training by 1.9% in 2010, following a slump in training expenditure in 2009.

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