

# The shape of business the next 10 years

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In a departure from normal CBI work, this is not a policy paper – at the end there are no recommendations for action by business or government. Our intention is to stimulate debate about how business will develop over the next 5-10 years and the implications this could have for the economy.

The views presented here reflect the key trends and messages we have heard from members, but do not capture every view. Nor have we actively sought consensus.

We hope the report will be useful to CBI members in their own planning discussions. Our own next step will be to understand how policy may need to adapt as the shape of business evolves.

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# Key messages

**The business environment of the next decade will be significantly different to what might have been expected just two years ago. The financial crisis and the recession that has followed have altered operating conditions by imposing new challenges and exacerbating existing ones. Businesses will respond across the organisation, moving to a more flexible, collaborative and leaner model.**

Over the next five to ten years, businesses will face major *changes to finance and capital conditions*. Finance will be more expensive and its availability will be constrained by regulation and changes to the banking market. From an era in which finance was cheap and readily available, these changes will be a significant driver of adjustments to corporate finance models and investment behaviour. Businesses will also need to adjust to a *less benign economic backdrop*. The next decade will almost certainly be characterised by a higher level of economic volatility and increased risk – clouding the certainty required for long-term planning.

The financial crisis has accelerated three other existing drivers of change or has changed their character. *Public trust in business and markets, already in decline, is now at a low ebb*. The profit motive is distrusted, and the onus is now on businesses to demonstrate their ethical credentials.

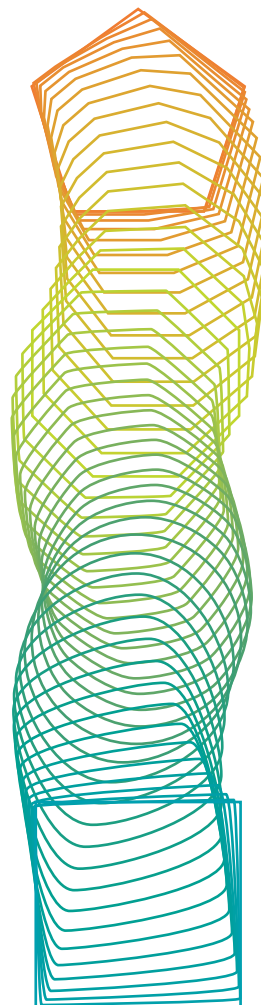
There is greater scepticism about the Anglo-Saxon model of capitalism and its ability to deliver desirable and efficient outcomes; greater political activism, government intervention and supervision can be expected. Businesses' approach to *social and demographic change* will also alter as a result of the recession. Retirement will still accentuate existing shortages of critical skills, but plugging these gaps will have to be the responsibility of business rather than government, whose spending will be constrained. In addition, pension problems will force some to work longer, requiring businesses to manage staff with wider age ranges, expectations and motivations than before. Lastly, the recession has altered the economic climate in which business needs to move to a *low-carbon economy* and improve resource use. The ability and preferences of government and some consumers to pay for this movement have been compromised, raising new questions about the role of business.

At the same time, trends in *technology change* are set to continue, and as over the last decade, will have a significant impact on business models and ways of working.

These drivers will alter ‘business as usual’ and businesses’ actions. In particular, *the shape of business after the recession will be characterised by even greater collaboration and flexibility*. The move to more collaborative, flexible business models, accompanied by other changes, will be reflected in four key operational areas – capital and investment, the workforce, governance and sustainability, and organisation and location:

- **Capital and investment:** Businesses will reduce gearing and their reliance on debt, the attractiveness of which has declined. Wider sources of capital, such as supply chain finance and sovereign wealth funds, will become more important and CEOs will be more cautious in their use of capital for investment and innovation.
- **Workforce:** Businesses will respond to skills gaps by refocusing employee development through collaboration and achieving a greater return on investment in training. A new more flexible work contract with employees will be sought, building on the greater flexibility introduced during the recession.
- **Governance and sustainability:** Sustainability and ethics will be further integrated into the business model rather than as ‘add-ons’ to existing activities. Businesses recognise that demonstrating their accountability will be part of the new ‘licence to operate’ and will take a more extensive approach to governance. For larger businesses this will be an evolution of existing processes rather than a step change.
- **Organisation and location:** New organisational structures will be created in many businesses as they continue to rationalise. Businesses will shift from transactional to collaborative relationships with a wide range of partners, including suppliers, universities and competitors. Supply chain dynamics will be much more complicated as risk becomes a more significant factor in decision-making.

Taken together, the impact on the economy in the short term (the next 3-5 years) will be to create *slower, but more sustainable growth*. But, the UK will maintain and build its competitive advantage as a place for flexible business development. In the longer term, investment in building *flexibility, collaboration and new work structures* will ultimately make UK businesses stronger.



# Introduction

**The environment in which UK businesses operate is changing fundamentally and the shape of business in ten years' time will be very different from what we see today.**

The direct impact of the financial crisis and the ensuing global recession have materially changed the conditions affecting business, but the events of the past few years have also brought into focus other structural trends in the global economy, natural environment and society. Together, these changes are leading many businesses to reassess their purpose, structure and organisation, and what they need to do to ensure sustainable business success. For most, there will be a movement away from 'business as usual'.

Understanding how businesses – both individually and collectively – will adapt to the changing environment, and the wider impacts this will have, will be critical in ensuring the future growth and success of the UK economy. Some of the changes in business structure and operations now underway should in themselves be beneficial for macroeconomic performance, but not necessarily all. If, in the new paradigm, macroeconomic performance is to be maximised, it will require a supportive policy framework, working with the grain to foster changes that are beneficial while mitigating those that are not. The design of such a policy framework therefore requires a thorough understanding of the direction of business change, its origins and its goals.

This study seeks to identify how individual businesses and sectors perceive the external pressures they face and how they anticipate key elements of their operations will evolve over the coming five to ten years in response. As such, it takes a 'bottom-up' approach – building a picture of the coming decade grounded in real, and detailed, business thinking about the future – rather than being a 'top-down' macroeconomic study.

We have highlighted the key changes identified under four broad themes that all businesses will recognise:

- Businesses' capital requirements and investment plans
- Their organisation and location of their operations
- How they interact with their workforce
- Their approaches to governance and sustainability.

The five to ten year horizon was chosen to take us beyond the most immediate considerations of the recession, while being near enough in the future for businesses to have reasonable confidence in how their organisations will evolve.

Our assessment of the changing shape of business starts with a summary of changes in the business environment since the start of the recession and how we envisage these developing.

# The changing business environment





For businesses, periods of recession are the times of most intense change. Many more companies than usual are liquidated during and in the aftermath of recessions, while many new players arise – often on the back of radical innovations that might not have been possible to introduce under pre-recession conditions. The current recession is no exception, but its global extent and nature, compounded by the effects of a number of other key changes, suggest the next five to ten years will see a fundamental and lasting shift in the business environment.

We have identified five key drivers of business change linked closely to the recession. These are:

- Changing finance and capital conditions
- The decline of trust in business and markets
- A less benign macroeconomic environment
- Social and demographic change where the recession will have a major influence
- Sustainability and resource issues.

In addition, we recognise some of the technology trends, which, though not necessarily linked directly to the recession, will also have a major impact on businesses over the next ten years as the backdrop to change – for example, being a driver of change and providing new solutions.





# Changing finance and capital conditions

The legacy of the credit crunch is expected to have significant implications for the cost and availability of bank finance for a considerable period. There are a number of reasons for this:

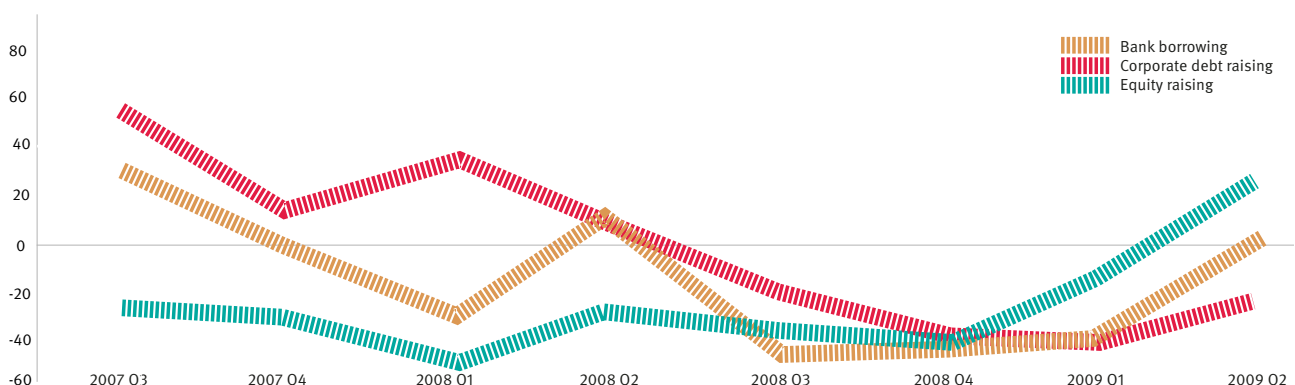
- There will be increased scrutiny and regulation of the financial services industry. Such regulation is likely to constrain banks' ability to take as much risk in their lending practices as they did prior to the credit crunch, which will impact businesses' ability to access credit.
- The capacity of the banking sector has reduced considerably as foreign banks have withdrawn from the UK corporate lending market. During 2007, they accounted for around 60% of the growth in lending to UK businesses.<sup>1</sup> These lenders are not expected to return in such significant numbers, so the aggregate supply of credit available to businesses will remain constrained. While foreign banks were more frequently used by large businesses compared to small and medium size enterprises (SMEs) (85% of which use one of the big four banks), the impact of reduced capacity in the banking sector is likely to affect all businesses seeking finance as lending to large businesses by UK banks will displace some lending to SMEs.
- Bank lending will also be constrained during the lengthy process of balance sheet repair, with capital diverted for some time.
- Finally, the mis- and under- pricing of risk which characterised the period leading up to the recession has already been reversed, and is unlikely to be repeated by the next generation of market participants who were witness to these mistakes. Tighter due diligence requirements and higher borrowing costs for businesses will be the result.

Given these trends, the coming decade will see companies operating in a climate in which the availability, cost and degree of freedom to use capital is more constraining than in the recent past. This is expected to have an impact on companies' finance strategies and may lead them to seek alternative sources and types of capital.

The credit crunch highlighted the extent of overleveraging in UK companies and the dangers to organisations of sudden contractions in credit availability. Outstanding corporate debt is now £484bn, a fall from its summer 2008 peak, but still twice the level it was in 2002.<sup>2</sup> There has already been a marked positive shift in the perceived attractiveness of equity as a source of corporate finance while the attractiveness of bank borrowing has collapsed (*see exhibit 1*). In the first seven months of 2009, UK businesses repaid bank loans of nearly £32bn and raised £25bn in equity, representing a complete turnaround from previous years.<sup>3</sup>

Sovereign wealth funds in particular are likely to be a much more important source of large business finance over the next ten years. Projections are for sovereign wealth funds to double from their current level to around \$8tr in 2015<sup>4</sup> – but the price of businesses accessing these may be loss of control of UK assets to a more diversified investor base, including overseas governments.

**Exhibit 1 The attractiveness of different sources of finance, (%) balances**



(Source: Deloitte CFO Survey, July 2009)

## The decline of trust in business and markets

Public trust and confidence in businesses and markets have been shaken by the magnitude and impact of the financial crisis and recession, and are at risk of remaining depressed over our ten-year time horizon. If these problems aren't addressed, brand loyalty will be affected, companies will face increased pressure to justify their conduct from stakeholders (including consumers and other businesses) and, ultimately, governments will intervene with tougher regulations and tighter control of business and market operations – as has been seen already in the financial services sector.

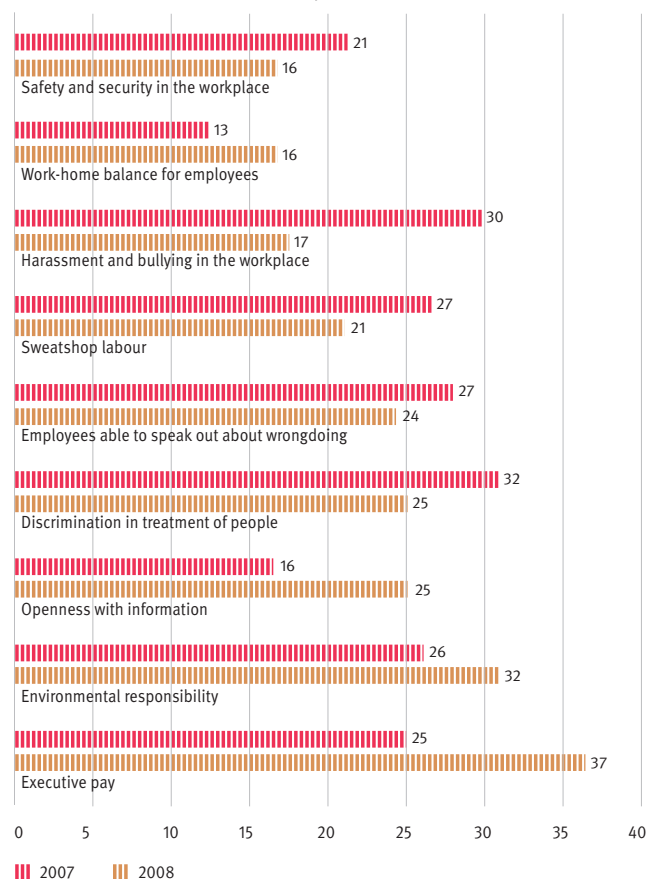
Lightly regulated markets have been a cornerstone of the Anglo-Saxon economic model for 30 years and have been a competitive strength for the UK, but that model is now treated with suspicion. The consensus among policymakers was that, by and large, markets, when left to themselves, deliver an optimal outcome. But the financial crisis has shown some markets to deliver less desirable outcomes and to be less robust than thought. What looked like long-term stable growth in, for example, the financial sector, commodities and house prices proved to be unsustainable bubbles. Greater government intervention and supervision in the long-run is now almost certain. Around the world, there are even signs of moves towards a new era of market protectionism that may linger beyond the immediacy of the recession.

Findings from the Edelman Trust Barometer indicate trust in business in the UK and other western European countries has been relatively low, and on a steadily declining trend, for a number of years – with scores in the range of 34-41% since 2002 when interviewees are asked, 'how much do you trust business to do what is right'.<sup>5</sup> In a supplementary survey in the UK, 79% said they 'don't trust business leaders to put the interests of their employees and shareholders ahead of their own personal interests'.<sup>6</sup> Similarly, research by Experian suggests two fifths of the UK population now believe 'companies are not fair to consumers'.<sup>7</sup>

Research for the Institute of Business Ethics also points to a long-term decline of trust in business to behave ethically. In 2008, just 51% said UK businesses behave ethically, compared to 58% in 2006 – and only 29% thought they behaved more ethically now than they did a decade ago. Executive pay, environmental responsibility and openness with information have surged ahead as the company behaviours most think need to be addressed.<sup>8</sup> (see exhibit 2)

Of course, trust is often an issue of perception, but the loss of trust can have real impacts on business. A small number of 'bad' events can leave a lasting impression and can undermine years of progress. Society is also becoming ever more demanding in what it expects from business, and with the internet, has the tools to find information and bring together a critical mass of activists to pursue companies until they perceive change has occurred. Over the next ten years, businesses will be under the spotlight as never before and this will restrict the degrees of freedom they have to operate.

**Exhibit 2 In your view of company behaviour, which two or three of these issues most need addressing? (% respondents)**



Source: Annual Institute of Business Ethics/Ipsos MORI Survey of UK Adult Opinion on Business Ethics

# A less benign macroeconomic environment

The decade 1995-2005 provided an exceptionally benign economic backdrop to the UK economy and has been termed the ‘nice decade’ (*see exhibit 3*) – although it included a number of shocks, namely the ‘dot-com’ crash and 9/11. For all advanced economies, it was a period of strong GDP growth, low inflation and, perhaps most importantly, relatively high levels of stability in the macroeconomic climate. In the UK, GDP growth exceeded 2.5% in nine of the eleven years between 1995 and 2005, while inflation was contained between 0.5 and 3% over the entire period. But the confluence of factors that delivered this benign backdrop were unique to the period – the disinflationary pressures from globalisation permitting a stance on monetary policy that allowed rapid growth in money and credit, thus fuelling strong GDP growth.

Recent events have swept this away and the next decade will almost certainly be characterised by a higher level of economic volatility and increased risk – clouding the certainty required for long-term planning and generating unpredictable movement in financial and economic indicators.

Against this background, it is clear the major drivers of UK economic growth of the last decade will not play such a significant role in the future:

- Sectorally, the financial services sector is unlikely to contribute as much to the growth of the economy as it did. The sector increase in gross value added (GVA) was, on average, 6.6% over the period 1987 to 2007, while for the whole economy the increase was 2.4%.<sup>9</sup> Without the ‘excess’ growth of the financial services sector, the growth rate of the UK economy as a whole would have been reduced by 0.2% a year.

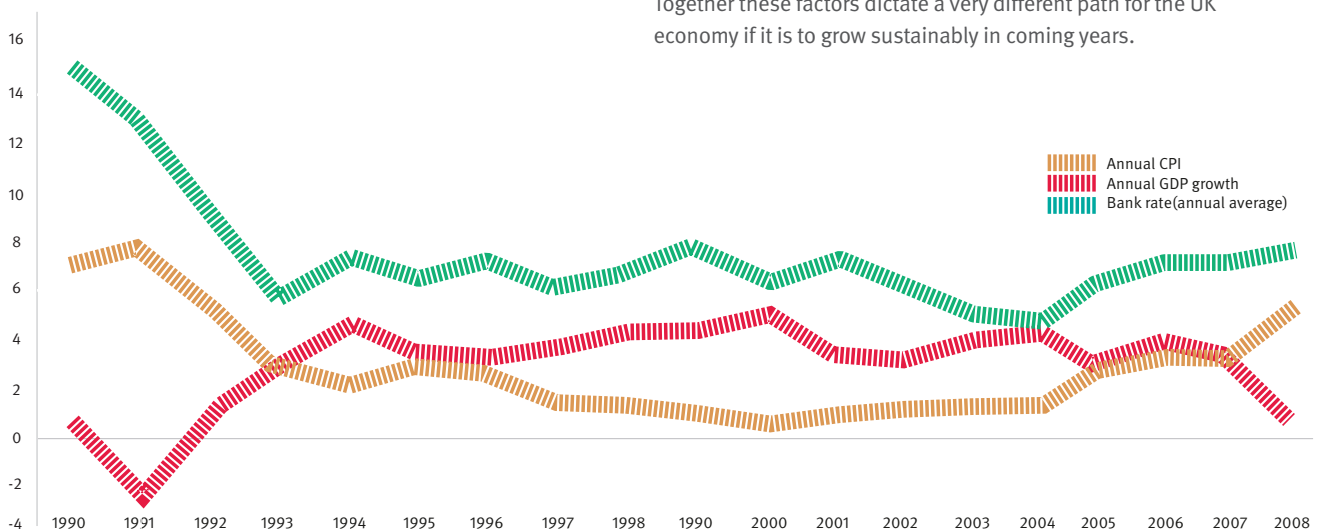
- The balance of demand is also expected to change. The two major components of demand that have driven much of the UK’s GDP growth over the past decade – consumer and government spending, each driven by increasing debt – will no longer act as major engines of growth.

In the 1990s, the average contribution of government spending to GDP was 12%, but from 2000 to 2007 it was 19%. A period of public sector austerity is now in prospect as the government’s deficit is expected to double (to over 12% of GDP in 2010), accompanied by a significant fall in tax income from business because of losses in the recession. To return to a position of greater fiscal sustainability, public budgets will have to be much tighter over an extended period of time and/or taxes will have to rise. With either choice, there will be significant implications for the level of public services that can be offered, the role of the state, and the relationship between the public and private sectors of the economy. It is also expected that public finance pressures will restrict the government’s ability to make funding contributions to necessary strategic infrastructure projects, to support business activity that may have been seen as essential in the past, and to maintain universities and other elements of the ‘innovation ecosystem’ at a level expected by business to keep the UK competitive. Taking radical new approaches to public services may be the only viable answer.

Low interest rates and the under-pricing of risk also led to a significant rise in the levels of household debt over the last decade. Credit card debt alone reached over £54bn in the UK this year and the overall personal debt total in the UK, including other loans and mortgages, currently stands at around £1.6tr – some 114% of income, up from 74% in 2000.<sup>10</sup> Personal savings ratios have fallen dramatically, from an average of 9.2% in the 1990s to 1.78% in 2008.<sup>11</sup> In addition, a quarter of a million households now find themselves with at least £20,000 of negative equity on their properties.<sup>12</sup> Even as interest rates remain historically low, increased savings rates are already being seen and are expected to continue for a number of years, as is renewed effort by consumers to reduce their debts – both actions that will seriously restrict consumer spending.

Together these factors dictate a very different path for the UK economy if it is to grow sustainably in coming years.

**Exhibit 3 The ‘nice’ decade**



Source: ONS

## Social and demographic change

Over the next ten years and beyond, a number of significant social and demographic changes will affect businesses in the UK and elsewhere. Most, such as the ageing population (*see exhibit 4*), are underlying trends not caused by the recession, but their impact on business is now expected to be greater as companies face them while also having to deal with new economic conditions.

As a result of the recession and financial crisis, pension values have fallen, threatening the balance sheets of many businesses – and the government – and forcing some people to work longer and/or accept reduced spending power in retirement. The pensions deficit for the FTSE100 companies is now £96bn, up from £41bn in 2008. Falling equity and property values are responsible for the bulk of this, but companies have also had to make adjustments for longer life expectancy and this accounted for 15% of the increase.<sup>13</sup> A deficit at this level is unlikely to be cleared by companies in the next five to ten years, and unless innovative solutions to the problem can be found, it will limit the ability of UK businesses to invest in growth.

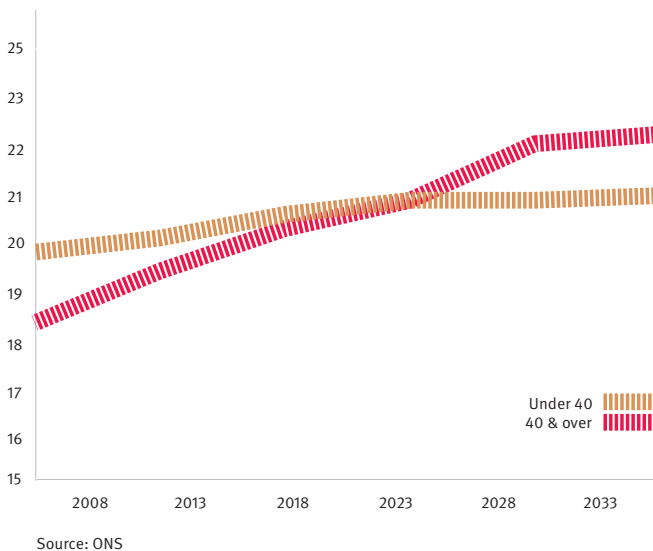
Even with people working longer, the vast majority of labour market movement in the years to 2017 will be accounted for by the replacement of those leaving jobs for retirement. Between 2007 and 2017, it is expected retirements on their own will create 11.5 million job vacancies.<sup>14</sup>

Businesses already face difficulties in securing specialist skills including science, technology, engineering, maths and project management, but demand for these skills will only grow over the next decade. It is estimated an additional 1.3 million people with professional and technical skills and 0.9 million managers and senior professionals will be required by 2017.<sup>15</sup> The challenge for businesses will be to capture the knowledge and experience of individuals effectively before they retire – in particular those in technical and senior management positions – and to retrain other employees, and/or seek new skills from elsewhere. But, funding from government for training, which (in England) has risen steadily over the last decade to £3.4bn today, is now likely to be seriously constrained, placing even greater burden on business.

In the UK and other western countries, health-related trends will start to have a more noticeable impact in the next decade. Projections are for 36% of the UK adult male population and 28% of adult females to be clinically obese by 2015 (rising to 40% overall by 2025), bringing additional healthcare burdens and increased costs for both business and government<sup>16</sup> – again, a challenge as finance to tackle these problems is constrained.

Businesses will also have to contend with new challenges in managing their employees as four different generations, with different motivations and expectations of work, will increasingly

**Exhibit 4 The working age population 2008-2033 (%)**



need to work alongside each other. Although they will only make up a small part of the workforce, employees from Generation Y (those born in the mini baby boom from 1979-1994) are expected to have a major impact on the workplace. This generation typically thinks in terms of a career of different jobs, expects jobs to accommodate their family needs and personal lives and they are the first generation of 'digital natives', making extensive use of new technologies, social networking and other novel ways of sharing information.<sup>17</sup> Businesses will need to adapt if they are to attract, retain and get the most out of this generation as employees, and also secure them as customers.

The rise of Generation Y should bring many new opportunities and there are similar opportunities at the other end of the demographic scale that will drive change in business. An extra 4.5 million people aged over 60 in the UK in 2021 (16.5 million in total) compared to 2001 will create a significant market for new products and services. But the spending power of both groups may now be more restricted as a result of the recession.

Other major opportunities will arise to tap into the growing middle class market in the developing world, in particular if demand in the western markets remains depressed or volatile in the wake of the recession. There were around 430 million people falling into the World Bank definition of middle class in the year 2000, but this is projected to increase to over 1.1 billion by 2030 – the vast majority in developing nations such as China, India and Brazil.<sup>18</sup>

# Sustainability and resource issues

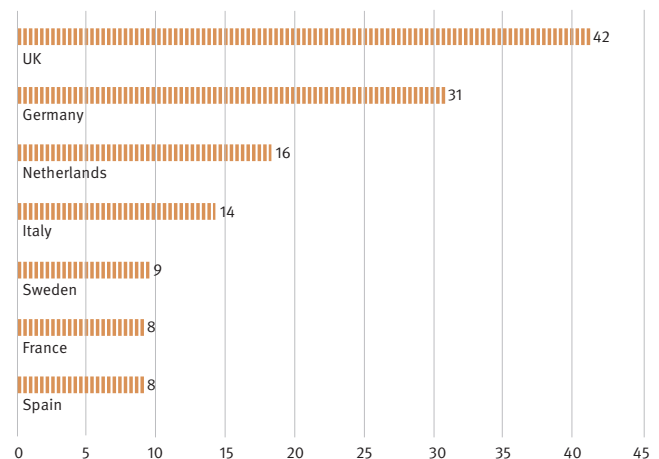
The need to move to a low-carbon economy and reduce resource use has not changed as a result of the recession, but with finances likely to remain constrained for a number of years, the ability of the government and consumers to take action has changed. It is uncertain whether either will be able or willing to pay and this will inevitably have consequences for their expectations of business.

Businesses, populations and governments face the stark choice of tackling the problem of climate change while the cost of doing so is still relatively bearable, or accept a more costly adaptation to the impact of global warming and an increased level of detrimental impact in the future. The Stern Review estimated the current cost of addressing climate change to be around 1% of GDP – compared to a cost equivalent of 5-20% of GDP if action is delayed.<sup>19</sup> Businesses were already under increasing consumer, NGO and regulatory pressure to significantly reduce carbon emissions from their operations and products prior to the recession – now they face doing so when it is not clear whether, or at what rate, global competitors will follow suit.

In addition, growing tensions over potential scarcity and distributional problems for many primary resources (eg food, water, land and oil) will put pressure on business costs and operating models. In extreme circumstances, some of the environmental and population-driven changes (eg affecting food supply) are likely to lead to a rise in protectionism, social unrest and political instability. This will limit access to markets and some key resources, will restrict business' freedom to operate and could put a brake on further development of globalisation trends that have been important for business over the past two decades.

Expected post-recession volatility in the oil price over the next ten years will also be disruptive for business – at the very least, affecting companies' ability to plan and invest.

**Exhibit 5 Expected power plant retirements 2009-2020 (%)**



Source: CBI analysis

In some sectors, the cost and availability of key minerals in the next ten years will be a major driver of innovation and change. For example, world lithium demand was approximately 80,000 tonnes in 2002, is 110,000 tonnes today and is projected to reach nearly 300,000 tonnes per year by 2020, driven predominantly by the demand for electric and hybrid vehicle batteries (*see exhibit 5*).<sup>20</sup> But, while lithium sources are relatively plentiful and the challenge is mainly to produce material of sufficient quality, supplies of neodymium and other rare earth elements required for the high strength magnets used in electric motors has now become seriously restricted. This is because China has placed an export ban on the raw material. Again, the consequences are increased cost and uncertainty for business.

At home, the UK also faces serious challenges in energy security and supply with 42% of the country's power generating capacity due to reach retirement age between 2009 and 2020. This may influence business decisions about the location of certain activities and supply chain elements.

# Technology trends – the backdrop to change

Technological advance has been one of the most significant drivers of change for businesses for the last 200 years and will inevitably form the backdrop to the other business drivers of change discussed above. Businesses will need to adapt, and adapt fast, to make the most of the opportunities that will arise.

The pace of technological change and how fast new technologies are taken up continue to accelerate. This is particularly apparent with digital technologies, the use of which has fundamentally changed business models and the behaviour and expectations of individual consumers and businesses over the last decade.

- A quarter of the world's population of 6.7 billion now use the internet.<sup>21</sup> One hundred and thirteen billion internet searches were conducted in July 2009, up 41% on July 2008.<sup>22</sup>
- In the UK, the average time spent on-line for work and leisure was 13 hours 59 minutes per week in 2008, compared to 6 hours 25 minutes in 2004. Average on-line spending per UK internet user was £416 in 2003 and had risen to £1,475 by 2007.<sup>23</sup>
- In early 2009, 65% of UK households had a fixed broadband connection, an increase of seven percentage points year on year (see exhibit 6).<sup>24</sup>
- The number of mobile phone subscriptions worldwide passed the four billion mark this year, up from one billion in 2002. Mobile access is available to 90% of the world population and true ubiquitous access will be reached in the UK in the next five years.<sup>25</sup>

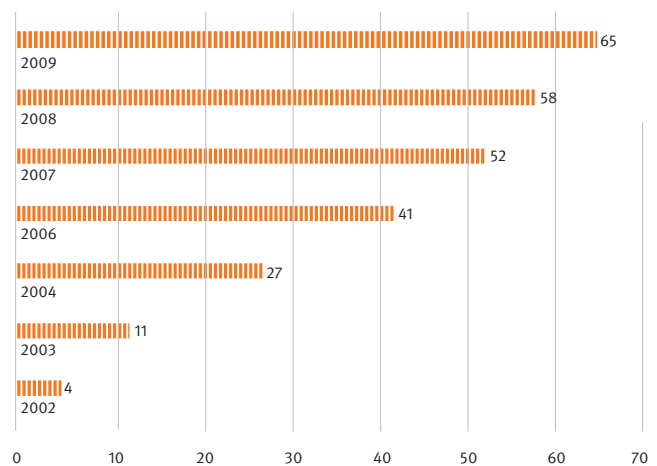
As an example of what can be achieved over ten years, the proportion of UK households with digital televisions rose from 0.9% in 1998 to 89.8% (c. 26 million households) in 2009 – the highest penetration rate in the world.<sup>26</sup> Similar patterns of advance must be expected in the next decade too. Personalised web-based applications, cloud computing, real-time interaction and always-on web features are likely to become commonplace over our 5-10 year time horizon. Other technological areas are also advancing and will have a major impact on business.

For instance:

- Having become widespread in industrial settings, robots are now rapidly entering the service environment in hospitals, defence, agriculture etc and also in the home. Over the next three years it is estimated nearly 50,000 professional service robots will be installed worldwide, and nearly 12 million service robots for personal use will be sold.<sup>27</sup>
- In materials, the use of composites continues to expand: advanced lightweight composites are increasingly being used in commercial as well as military aircraft, and global demand for carbon fibre, which was around 35,000 tonnes in 2008, is expected to double by 2014.<sup>28</sup>
- In energy, global wind energy capacity increased 29% in 2008 to 121,188MW. Ten years ago, global capacity was just 7,480MW.<sup>29</sup> And, for example, world production capacity of biodiesel increased from 2.2 million tonnes per year in 2002 to 32.6 million tonnes in 2008.<sup>30</sup>

The recession may affect the rate of take up of some technologies, but development will continue and the appetite for the 'right' high-technology products and services appears undiminished. For example, over 25 million iPhones have been sold worldwide since their introduction in 2007 – around half of those in the first two quarters of 2009 alone.<sup>31</sup> Sales of Blackberries and other smart phones have been similarly recession proof.

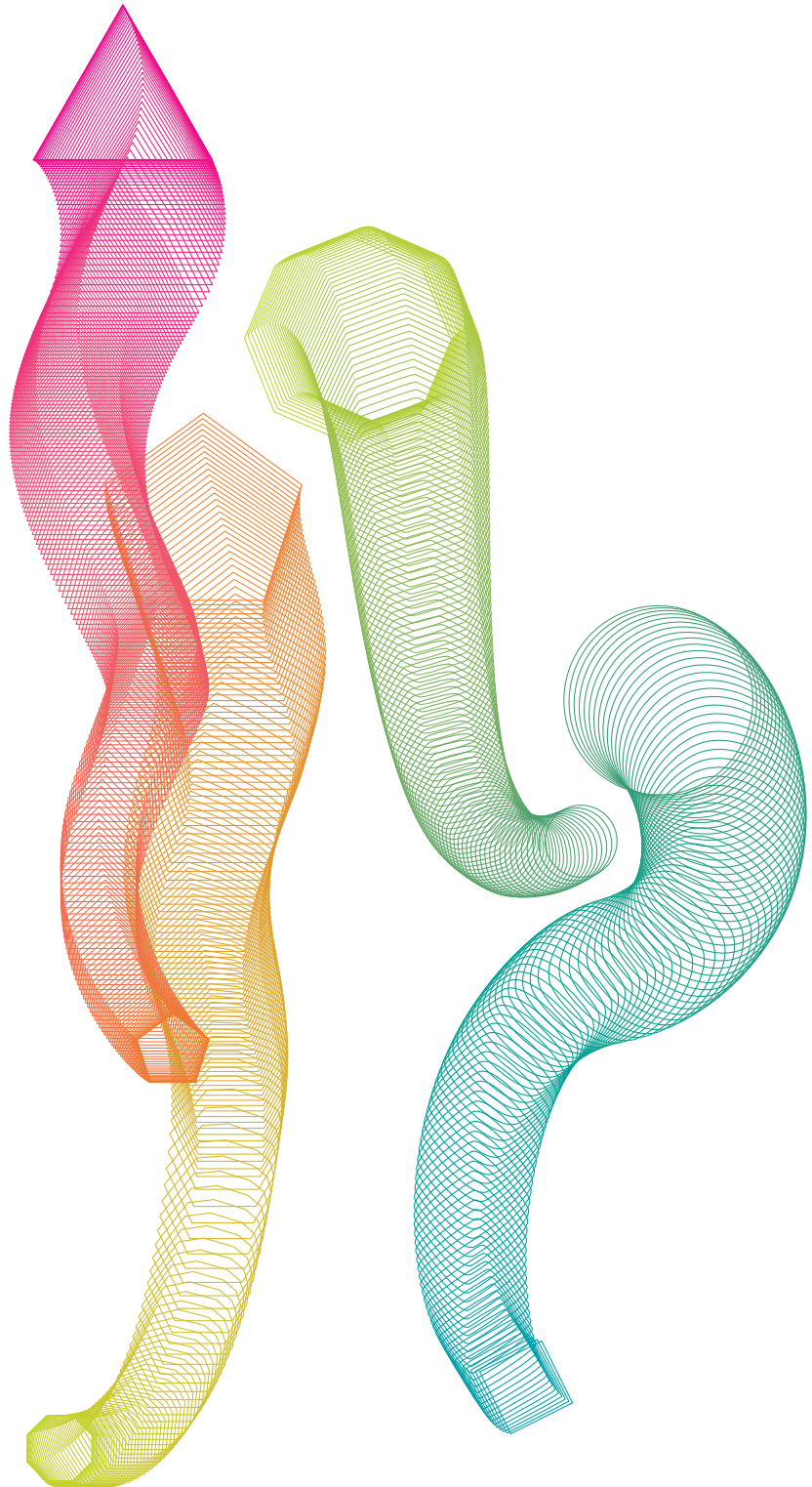
**Exhibit 6 UK broadband penetration, proportion of adults, (%)**



Source: Ofcom



# The business response





## Capital and investment

*Debt will be a less attractive source of finance for business over the next five to ten years. Businesses will reduce current debt levels and will seek a wider range of sources and types of finance, but financing for SMEs will be challenging. Across the board, the cost of capital will be elevated and hence hurdle rates for investment will also be raised.*

*All businesses will be more cautious in their use of funds, expecting better returns on investment and employing more rigorous approaches to innovation projects to reduce risk and bring returns more quickly.*



### Businesses of all sizes will reduce their reliance on debt

In the years leading up to the financial crisis and the recession, businesses were typically structured on the basis of debt financing. Debt was cheap, readily available, allowed higher dividends to be paid out and funded rapid expansion. But debt is now a less attractive source of finance and will remain so at least over the early part of the next decade. It will be more expensive than before the credit crunch and will be accompanied by more conditions and 'interference' from lenders. Just servicing existing debt accumulated in the 'nice decade' will be difficult for many businesses.

In addition, small businesses typically now see debt as a less dependable source of finance and their trust in banks as lenders has declined. These businesses will take steps to ensure they are not exposed to unexpected changes to credit lines in future – business growth and investment will need to be financed in other ways.

Therefore, businesses of all sizes will seek to reduce levels of gearing, which will be done by increased retention of earnings and paying out smaller dividends to shareholders.

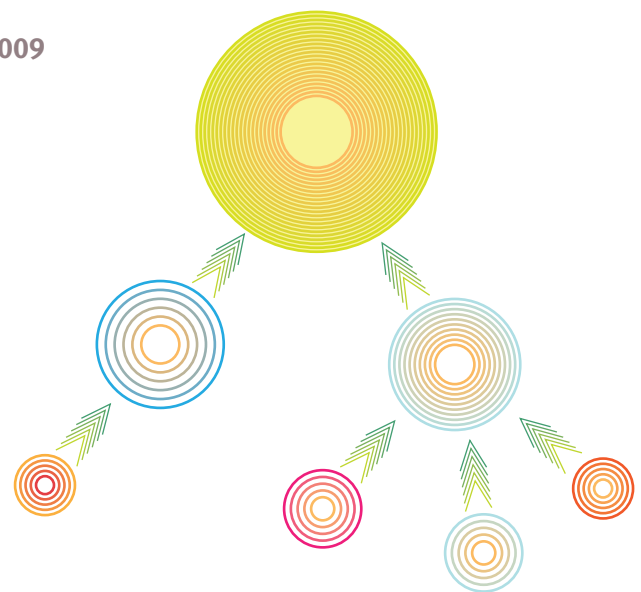
Credit conditions may eventually return to those experienced by businesses before the credit crunch, but the scale of the financial crisis and the amount of debt businesses need to pay down, mean this change to finance strategies will remain for the five to ten year time frame.

There are some exceptions to this trend. Businesses involved in private finance initiatives do not expect to have as many problems accessing debt finance as they have a guaranteed income stream. In addition, businesses with little or no gearing will have a significant competitive advantage over the next decade – they will be able to access debt if required and will be well positioned to finance their customers and supply chain compared to over-leveraged competitors.

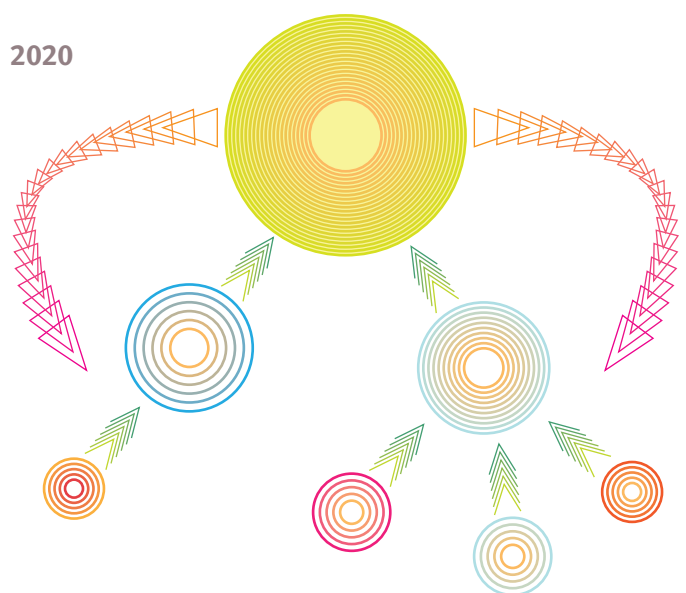
In the long-term, riskier approaches to financing will slowly return and, beyond our ten-year time horizon, businesses expect credit bubbles to emerge again.

### Increased use of supply chain finance

2009



2020



Product flow

Credit flow

### Accessing a wider menu of finance

For the smallest businesses there are few alternative finance options: for many it is either traditional credit or self-financing through retained profit. As businesses get bigger, a wider menu of finance is available, from venture capital to sovereign wealth funds. But businesses will need new skills to access and use these alternative sources of finance – SMEs will find this challenging, while larger businesses will be able to acquire or develop them.

Even before the recession and credit crunch, the financing gap for smaller companies had become acute. Many SMEs now either have difficulty obtaining or don't want bank debt, and few are willing to seek out equity with the loss of control over the business they perceive this brings. Very few even have experience of raising equity – just 2% of SMEs applied for such finance in 2007.<sup>32</sup>

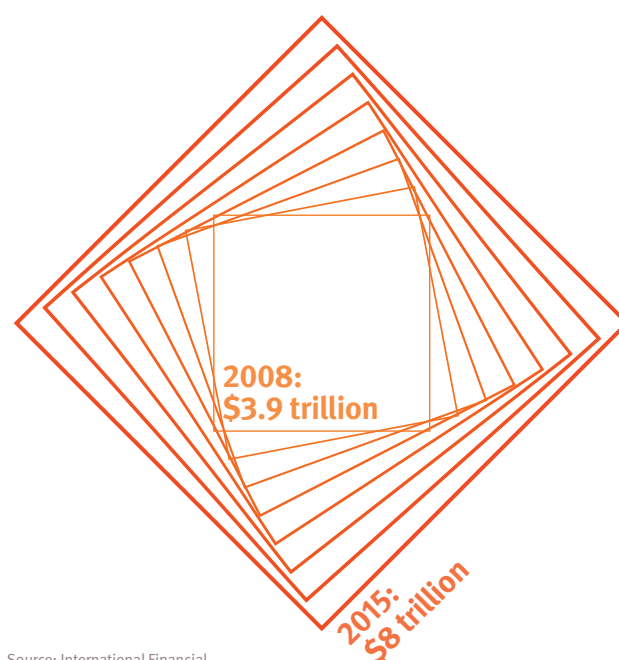
The long-term nature of relationships typically required for factoring and invoice discounting also make these unattractive to SMEs, and the fees on top of interest mean such options are often expensive too. There has also been a loss of faith in trade credit insurance. Ultimately, this leaves many businesses with cashflow difficulties and self-financing as the main source of growth funds.

As an alternative, supply chain finance is expected to develop as a much more important part of future strategies. Larger companies will be prepared to finance their suppliers, and smaller firms will look upstream for funds. In particular, this will become commonplace where businesses have built up mutual trust and developed collaborative relationships (see organisation and location section). Finance agreements in the supply chain are now perceived by many businesses as less risky than bank lending – as customers, large businesses will have a very good understanding of suppliers' peaks and troughs in demand, and they will also be willing to work with them to ensure their survival.

There will be a slight tilt towards venture capital use from growing small and medium-sized enterprises. Venture capitalists are now perceived by many businesses as more trustworthy and open minded in making investments than banks. But it is unlikely all SMEs for whom this finance route is appropriate will experience this tilt. The biggest barrier will be psychological – again, owner managers typically do not want to give up part ownership of their business. Even where CEOs choose to use venture capitalists, they may face difficulty securing investment due to regional gaps in venture capital provision.

Some businesses may also explore options to raise finance through employee partnership schemes.

### The supply of sovereign wealth funds



Source: International Financial Services London

For larger businesses, there is scope for using bond markets and sovereign wealth funds to finance growth. As China, India and the Middle East become wealthier they will want to invest, and whether the UK is seen as an attractive investment destination will be critical. Many businesses expect lower growth rates and a less benign economic environment will cause a shift in the locus of investment away from the US and Europe to Brazil, Russia, India and China. For some businesses, this may mean their future rounds of growth will also have to be in those locations.

### Businesses will use their capital more cautiously

Many smaller and medium-sized businesses will remain focused on revenue capture in the immediate wake of the recession. They will cut back on, or stop, R&D and other projects that are either seen as carrying excessive risk or will only start to produce revenue streams over a period of years. But, businesses will be more risk-aware than risk-averse and they will be willing to invest in R&D etc once they are more certain about their prospects, and if financing can be secured – their willingness to take risk is clearly linked to levels of confidence in the future.

The increased cost of capital for longer-term projects will see some of them delayed. Not because of a lack of desire from business, but because of a lack of suitable finance. Similarly, it may be difficult to finance low-carbon investments as businesses perceive these to be poorly understood by banks.

The need to innovate remains just as great now as prior to the recession and, in general, larger businesses have not lost their appetite. The majority remain committed to their R&D plans and continue to invest for the long term, but more cautiously. Businesses are already using much more rigour in planning and assessing potential projects before significant commitments are made and this will become the norm. More sophisticated approaches to risk analysis will be used, there will be increased focus on assuring return on investment and understanding payback periods (eg with better modelling of sales and revenue projections), and businesses will also spend more on market research. Non-core projects are very unlikely to be supported.

With all of these added levels of internal due diligence, decision-making processes may be longer (also see the section on governance and sustainability) and hurdle rates for investment will be significantly higher than in the pre-recession years. Fewer R&D and innovation projects will be started (or will continue past early stage gates), but once projects are agreed, businesses will move very rapidly to initiate activity and deliver.

### Implications for the economy

Smaller companies have typically been regarded as a major source of innovation because they are willing and able to take risks.

A period of financial retrenchment will restrict this risk-taking, and while it may provide a basis for short to medium-term survival, it will reduce the ability of the economy to grow through innovation. If equity finance is not used, many SMEs will only be able to expand through their own cash generation, making their growth much slower – an outcome with potentially significant negative implications for jobs and economic growth. But, if supply chain financing can be developed more extensively, this would provide a valuable and sympathetic alternative, strengthening the positions of those involved.

With larger businesses, R&D and innovation will continue, but the added rigour in controlling investments should bring greater efficiency in turning funds and ideas into new products, processes and services. In theory, this should bring competitive advantage, with more innovations being commercialised whereas in the past UK and European companies have typically lagged behind the US in converting R&D spend into increased sales. But in many sectors, businesses in the UK already under-invest in R&D compared to our main competitors. Any further squeezing could leave the UK at a long-term disadvantage.

The slower project initiation process, increased investment caution and decreased volume of innovation activities will produce slower growth at least in the short term. This growth will be more sustainable, but the price will be a longer period of high unemployment and a slower climb away from recession. There is also a danger that only ‘safe’ innovations will come to market and that the UK will fall behind on truly radical innovation.

The increase in use of sovereign wealth funds raises a number of issues that need to be considered. They are not a homogenous set of investors – some operate at arms length from their government sponsor, others less so. Their approach to transparency and disclosure varies, and some have more active investment strategies. If the sources of sovereign wealth fund finances are also stable, they will be able to provide the basis for underlying sustainable growth.



## Workforce

*One of the biggest challenges for business over the next ten years will be how to build, retain and make the most of knowledge and experience in the workforce while finances for training are restricted, there are major changes in the make-up of the population available for work and individuals' expectations of work continue to evolve.*

*The skills profile, and hence the supply and cost of some skills, may never be ideal in the UK, but labour market flexibility will remain our real competitive advantage. New forms of partnership and collaboration, and new contractual relationships between employees and employers, are already emerging and will become more extensive. Combined with technology change and new approaches to training, this will strengthen UK competitiveness in flexible working even further.*



### Businesses will refocus their approach to training and development

Businesses will become much more proactive in their approach to talent management, placing greater focus on skill development and increasing returns on investment in training.

To increase focus, businesses will put additional effort into understanding their future skill needs and many will develop detailed skill roadmaps for their organisations (*see case study 1*). These roadmaps will be clearly linked to the businesses' corporate goals.

Businesses will collaborate more extensively with schools, colleges, universities and other education and training institutions to fund and design courses more closely aligned with their needs. In many cases, businesses will part-deliver courses – seeking to combine on-the-job development with formal training. To be sure of applicants' skills capability, some businesses will go further and only accept job applications from those who have trained and learned at the educational institutions (or other businesses) with which they have established partnerships.

Businesses will secure greater return on investment in training employees in a number of ways. Training to enhance business productivity will be the priority: for a training activity to be funded, it will need to be clear where and how it will add value to the business. For example, smaller businesses may seek to combine training with business-relevant R&D activity.

Across the board, funding for 'non-essential' training and general career development training not directly aligned with corporate goals will be scaled down substantially or even stopped. Increased return on investment will also come from lowering the cost of training: the balance will shift so the majority of training is delivered online, or through other virtual learning environments, and in-house, rather than being provided face to face and outside of the workplace. Mentoring and apprenticeship-type schemes (though not necessarily formal apprenticeships) will also be used more extensively as a way of transferring knowledge from experienced older workers on the cusp of retirement to newer, younger workers. And this will apply to management and other service-oriented roles, not just technical positions.

### Case study 1: A|D|S Group – the AeroSpace, Defence & Security trade body

*Over the next 20 years, the UK aerospace & defence industry is set to retire close to 60% of its workforce, an average of 3% a year. This equals a massive loss in experience and a need to increase recruitment by 74% over the same period.*

*The aerospace industry has identified the key technologies that it expects to emerge from research and development programmes over the next 15 years. To ensure the requisite skills will be available when they are needed, A|D|S is building a skills roadmap to identify the skills required to match the new technologies. The roadmap will signal to our industry's firms, the government, training providers, and prospective employees the demand for the skills that are required now, in the next three to five years and in the longer term. A|D|S intends to publish the roadmap in the Autumn.*

There will also be a trend to select and develop employees for a career within organisations rather than for a specific job, reflecting businesses' preference for staff to be multi-skilled.

Businesses will collaborate with each other to provide staff with secondment opportunities to gain skills and experience that cannot be found in one organisation. This will increase as businesses reorganise (see organisation and location section) and in particular will involve supply chain partners and customer organisations working together – employees taking a bit of the company ethos with them with each move, cementing relationships and building trust.

The essential skills businesses will invest in are the same as those today. They expect many young employees to need remedial training and help in adapting to the work environment. Shortages of management and leadership skills are also anticipated and there will be a need for new skills aligned to new markets eg low-carbon opportunities. Leadership skills could be a particular challenge to address given the timescale for investment returns here – typically it can take 3-4 years to see a return on leadership training, which is longer than many businesses expect employees to stay in their organisations.

Businesses will continue to take high value skills from wherever they are available. But the trend will be to look further afield than the EU, which has similar ageing population issues to the UK.

### Case study 2: Professional Contractors Group

*For most people who move into freelancing it is a positive choice. In a recent survey of the sector by the Professional Contractors Group, few reported they became a freelancer after being made redundant and not finding permanent work (13%) or because they could not find work any other way (5%). Instead the desire for a better work-life balance (41%) was the most reported important factor in the decision to pursue freelancing, followed by fulfilling an ambition to run a business (40%) and the desire to continue exercising a particular specialism without taking a step up the employee career ladder (31%). Given younger generations of workers will have a greater appetite for a better work-life balance and employers will favour a more flexible workforce, it is highly likely the sector will continue to grow over the next five to ten years, suggesting a step away from the traditional employer-employee dichotomy for more people.*

### New flexible working contracts will be the norm

Changes in employment legislation over the past decade have allowed many employees to ask for flexible working (eg to manage family, health or educational needs) and Generation Y employees have also sought greater flexibility to meet their own ambitions. But now employers will also increasingly ask for flexibility and will use this as a core part of their business model.

The trend towards flexible working practices has been accelerated as businesses seek innovative ways to cope with the recession and the relationship between employees and employers has already become closer and less transactional. Employers have asked staff to take unpaid leave, to work unpaid, to work annualised hours, or consider pay reductions – and the workforce has been highly responsive.

This enhanced flexibility will remain for a significant proportion of businesses over the next ten years, enabled by ongoing changes in workplace attitudes and use of technology – it may even result in a new employment model. For some sectors – eg in manufacturing – annualised hours contracts will become standard. In retail, zero-based hours (essentially call-up contracts with trusted

individuals) will be used more extensively to manage peaks and troughs in workload. In general, service sector businesses will have more opportunity to maximise the benefits of flexible working, while those in construction and some manufacturing and production industries will find it much more difficult.

By offering flexibility, businesses will seek to differentiate themselves in the market for the best and most talented employees. It will also allow them to tap into the widest pool of resources, including pensioners, the disabled, and people with childcare/elderly care or other significant responsibilities outside of work.

Instead of money, payment in time – eg time off for sabbaticals or charity work – is likely to become the new bonus.

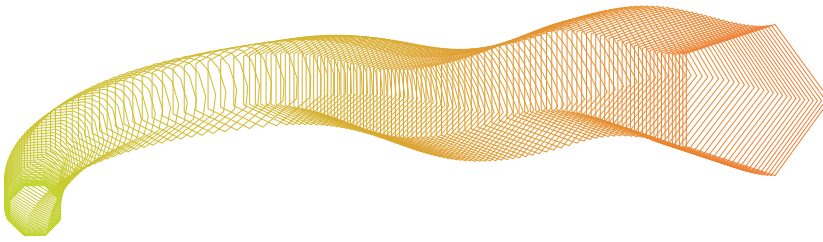
### A more focused core of employees

As a result of the drive towards flexibility, a significant number of businesses will move to a new employment model where the core of permanent staff is smaller and a greater number of freelancers, consultants and temporary workers are used. These will be skilled professionals and undertake activities core to operations when needed (also see organisation and location section).

The move to such a model accelerates an existing trend in the increase of freelancers (*see case study 2*). Freelancing has increased by 14% over the past decade and there are now an estimated 1.4m freelancers in the UK.<sup>33</sup> For many individuals, this model will be mutually beneficial, providing them and businesses with the flexibility they desire. Others will prefer the security and stability of a permanent job, but those skilled individuals who are prepared to work flexibly will get higher rewards.

The skills of these individuals around the periphery of the organisation will be just as vital to business success as permanent employees. A challenge will be to ensure their training is up to date and that they have the relevant experience to drop straight into roles as required – responsibility for this will shift increasingly to the individual and/or agencies and away from the employer.





### Technology will enable new ways of working

Advances in technology are a significant enabler of the move to flexibility. Teleconferences, videoconferencing, webinars and remote working systems are all improving in quality and new entrants into the workforce are more IT literate than generations before. These new entrants use technology in a different way and will expect increased technological capability at work.

In the service sectors and in service-oriented roles elsewhere, remote and mobile working enabled by new technology will become increasingly standard.

Businesses will increase their use of social networking techniques to solve problems – many more companies will use Facebook, Twitter and other web 2.0 developments for research, recruitment and tracking perceptions of public opinion.

Greater use of digital technology will also play a role in businesses' carbon reduction plans by reducing the need to travel for work. Although this has been discussed as a possibility for many years, there appears to be a real ambition with a small but significant number of businesses to move operations away from major centralised offices to shared local hubs 'in the suburbs' – a trend that is likely to start with professional services.

But, businesses also recognise there are limitations as to how much flexibility can be achieved by technology:

- Operations requiring fixed plant (eg in manufacturing) will not be taken mobile
- Use of teleconferences and videoconferences are not preferred for customer facing activities
- Businesses are concerned about the impact of technology on the work/life balance.

Businesses also recognise they will need to invest more in building the corporate culture as a higher proportion of employees work away from central offices and/or reside in the periphery to the core of permanent staff.

### Implications for the economy

Labour market flexibility is one of the UK's greatest assets and the expected changes in business could strengthen the advantage further. It will facilitate the growth of UK companies and be a major factor in the UK continuing to attract overseas investment. Such a move also has the potential to reduce structural unemployment and maximise use of the UK talent pool. But those without the right skills and/or mentality will find it increasingly difficult to secure jobs – in some areas, long-term unemployment among the youth and low-skilled will become a major problem.

The UK population's willingness to adopt new technology and applications (eg smart phones, digital TV, broadband and on-line social networking) also gives us an early mover advantage in mobile, remote and distributed working that can be exploited further in the next few years. But the desire for flexibility may be constrained by the UK's technology infrastructure, which has been described as only 'meeting the needs of today's applications', whereas our main competitors are 'comfortably enjoying today's applications' or are 'ready for tomorrow'.<sup>34</sup> The UK is ranked only 25th in a table of broadband leaders, behind countries such as Latvia and Lithuania.

Greater flexibility, to the extent that businesses will use a new employment model, also has implications for pension contributions and the ability of individuals to secure and service mortgages (and other loans and services) as earnings for many will be less stable. New products and new relationships will be required. It will also have an impact on the UK's perceived weakness in skills quality and availability as businesses are unlikely to fund training for temporary staff.

However, more extensive business engagement with universities and other providers, should mean the permanent core of the UK workforce will become increasingly professionalised, with training much more aligned to real business needs. Businesses, employees and educational providers will benefit.

## Organisation and location

*The need to share risk, invest effectively in developing new innovations, and access finance and competencies will drive businesses to a more collaborative business model over the next five to ten years. The shift from transactional to collaborative relationships will bring about new alliances with a wide range of partners – establishing and maintaining trust will be critical. Organisational structures may change significantly, focused around a central core, and physical supply chains will become more direct and local.*



### Rationalisation to the core

The recession accelerated the need to address inefficiencies and non-core activities across the enterprise. It has also provided the stimulus for companies to re-think themselves and re-evaluate their future – allowing them to make organisational changes that will position them for the upturn and beyond, while building-in resilience and flexibility. It has been a catalyst for change in business that could not have occurred earlier when the focus had been placed too heavily on delivering growth.

Businesses will continue to focus on reducing their costs over the next five years or so, shifting the balance between fixed and variable costs to improve flexibility, paying down debt and shedding activities that had grown gradually during the ‘nice decade’. They will also seek to maximise previous investments in IT and process change. In some sectors (eg IT and professional services) businesses will take opportunities for further consolidation through mergers and acquisition and to make and integrate these more effectively. In manufacturing, businesses will continue to look for plant rationalisation and efficiency improvements. They will also be more willing to explore alternative sectors and new markets for their outputs.

More significantly, rationalisation will create new organisational structures in many businesses. These will be built around a core of permanent employees and unique business propositions, with a much larger group of activities and people located around the periphery of the organisation. This periphery may include finance, accounting, HR, design, legal and many other roles. In effect, this is the next iteration of outsourcing, following the success of moving functions such as catering, logistics and IT services out of the core business. But, some companies are expected to take this much further: outsourcing, and typically off-shoring, major streams of work, leaving the core focused on systems integration, project management and service brokerage.

With the right partnerships, high levels of trust and effective management, these changes should bring even greater flexibility to UK businesses, ensuring they can rapidly adapt to changing requirements, for example if the macroeconomic climate is as volatile as expected over the next decade. However, rationalisation may close down career paths unless businesses work together to develop key employees.

### Movement to a more collaborative business model

The recession has made businesses much more aware of the complexities and interdependencies in their operations, their financing, supply chains and customers, but they are still not able to fully assess or capture these in their business planning. To gain

greater control of these uncertainties, businesses will seek to ‘simplify’ their operations and will enter into more partnerships and joint ventures. In particular, this will be important for businesses moving to a ‘core plus periphery’ model (see above).

These moves will help businesses stay competitive and strategically manage risks. Collaboration will also enable businesses to grow – by partnering with organisations with skills and capabilities they do not have, such as in new technology and access to global markets. And, in turn, this will enable them to provide a more complete product or service to customers, which would not have been possible working alone.

Collaborators will include customers, universities, suppliers and, in some cases, competitors.

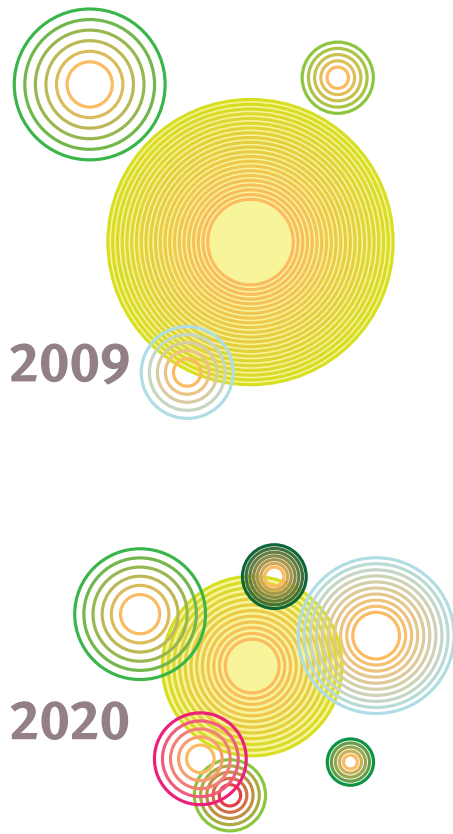
Many businesses already partner with universities to undertake shared R&D, but more businesses will seek to do so as a means of carrying out innovation activity which would otherwise be constrained by businesses’ finances. The trend has already started and universities are positioning themselves to collaborate more widely, although expected reductions in government funding for universities will make this more challenging. There may also be problems around public trust as business engagement with universities increases – the majority of respondents to surveys by the Research Councils already think scientists in universities rely too much on business for funding and that this has a negative effect on their independence.<sup>35</sup>

Collaboration with a partner prepared to part-fund and share the risk of investing in innovation will be an option actively considered – indeed, one of the key reasons for businesses to partner with universities is to leverage funds from public sources. In particular, this is expected to mean more R&D and innovation activity occurring with partners down the supply chain. This may lead to innovation activity leaving the UK if supply chains are located abroad or if UK businesses are unable to compete with foreign partners. The trend to outsource R&D to the supply chain will make the protection of IP even more important. But concerns about the ownership of IP created during a partnership may prevent some businesses working together.

Businesses will also work with the supply chain to improve supplier performance and efficiency.

Where business models similar to cloud computing are used, collaboration with customers will be a must. For providers of cloud computing-type services to be successful, they must have a clear and in-depth understanding of their customers’ patterns of demand – without it they risk investing in too much capacity.

## A rationalised and collaborative business model



More businesses will also collaborate with their competitors, though with great caution so as not to break competition rules (*see case study 3*). As a result, the focus of this collaborative activity will be to reduce costs through shared facilities, such as distribution centres and transport, which will also have a positive environmental impact. Competitors may also work together to share auditing of suppliers, for example to assure their credit worthiness, governance or carbon credentials. But competitor collaboration may have a significant impact on trust in businesses if consumers believe the practice is unfair.

Collaboration is not without risk. Relationship building takes time and investment, without promise that a commercial agreement will be made. Especially in the short term, businesses will take time to evaluate the financial position of partners before commitments are made. Building trust with potential partners will be critical.

Businesses will invest in new management skills to deal with the risks and challenges accompanying collaborative working. They will also take new approaches to IP management. Many businesses will require suppliers to seek formal protection routes for IP as a prerequisite for engagement in collaborative work. A new model for IP sharing, in particular for IP created incidentally during a collaboration, may be needed.

### Case Study 3: British Retail Consortium

*The trend of collaborating with competitors is already reflected in procurement with well established buying groups servicing independent grocers and chemists. Increasingly retailers are collaborating on the distribution of products, which has the advantages of lowering costs and helping address environmental concerns. In the future there may be an increasing need for collaboration with competitors beyond procurement and distribution, such as innovation and in delivering social change on behalf of government. But currently retailers do not feel confident that such collaborations would comply with competition law.*

### Localism will dominate supply chain dynamics

Over the past decade, cost has been the major driver of supply chain decisions. But the increased awareness of supply chain risk generated by the recession, and the expected increase in energy and transport costs (both financial and carbon costs) will see businesses take different approaches during the next five to ten years.

Risk in its broadest sense will be the major factor in supply chain management. Businesses are concerned about their ability to monitor the quality, sustainability (financial and environmental), and ethics of suppliers and thus will seek shorter, simpler and more direct supply chains. CEOs are assessing risks beyond the first tier of suppliers and in the future suppliers deemed high risk, including those that are highly leveraged, will find it much harder to secure contracts. Many businesses will also consolidate the number of suppliers to reduce risk and the burden of supplier monitoring. There will be some exceptions to this rule. For example, food retailers expect an increase in adverse weather conditions as result of climate change, increasing the likelihood of gaps in supply and necessitating the development of a wider network of suppliers for the same goods.

The most prevalent trend for physical supply chain changes is one of 'localism' – the desire of UK businesses for their suppliers to be close to market, making supply chains regional rather than global (although this may not apply to some highly globalised businesses with dispersed markets). Concerns about operational and reputational risk and energy and transport costs will encourage some UK manufacturers to bring their supply chains closer to home so they can oversee activities, gain more control, and reduce their carbon footprint (*see case study 4*). In addition, as wages in low-cost countries rise, the cost advantages of operating in some regions will narrow, making them less attractive as a supply base.



#### Case study 4: Chemicals Industries Association

*UK chemicals businesses have been benefiting recently from selected customer industries' decisions to focus on local supply chains and strategic partnerships. Companies using chemicals in their manufacturing processes have become more concerned about the safety of transporting chemicals long distances and the product purity and quality issues that have arisen with suppliers in less regulated markets. As a result, UK firms are winning back business and this trend is expected to continue over the 5-10 year time frame.*

In general, whether businesses relocate physical supply chains back to the UK will depend on four factors:

- Where the supply chain involves raw materials and low-value commodities, cost will still remain the biggest driver of location decisions and thus the supply chain will remain abroad
- If security of supply and/or the carbon footprint of transportation are critical drivers, then the UK may become the most attractive option
- If the UK has the relevant capacity and capability in sector supply chains to make the UK a practical option – in many cases the hollowing out of supply chains over the last 20 years means the UK is likely to miss out to countries such as Germany and Italy where key elements are still in place
- The localism agenda implies that should countries such as India or China become a business' biggest market there will be little reason to have production sites in the UK.

The trends in the location of the supply chain for intangibles will also become more complex. Communications technology now allows the supply of knowledge based services to be based anywhere in the world. Businesses expect to move more of their process-driven intangible supply chain abroad to take advantage of lower costs and some higher value jobs will be moved where the necessary skills are difficult to find in the UK.

There are some limitations to this trend:

- Customer-facing activities will stay in the UK, and even move back from abroad, in response to customer demand
- Businesses will also need to be convinced of the quality of skills in other countries before the supply chain is moved
- The highest value core activities will be kept in the UK where businesses can keep control of them. Intellectual know-how is the differentiator for many UK businesses and there are too many risks attached to the security of IP to locate it abroad.

#### Implications for the economy

The trend towards greater collaboration will be a significant advantage for the economy and the UK is well positioned to enable such a change to take place. Our flexible working, flat organisational structures, business investment in IT, history of business-university collaboration and reputation for working well across cultures will all be conducive to collaborative working.

There will be increased opportunities for UK high-value manufacturers as certain supply chains, or supply chain elements, gravitate back to the UK. But the ability of UK manufacturers to capitalise on these new dynamics will depend on their capacity and capability. These do not currently exist in many parts of the manufacturing supply chain due to historic underinvestment in capital and innovation and an inadequate supply of STEM skills. With investment in capital and innovation being cut back by many firms as they struggle to survive the recession, it is unlikely the necessary capacity and capability will exist within the five to ten year time horizon without intervention.

Some high-value service jobs (and possibly even whole service industries) will be lost from the UK. The jobs and activity likely to move are those that might have been expected to stay in the UK just a couple of years ago – including design, research, architecture, forensic accounting, audit, legal, IT and editorial etc. With technology increasingly allowing service offerings to be commoditised, financial services being more tightly regulated and some high-value service jobs moving overseas, overall service sector growth opportunities will be restricted in the UK – perhaps focusing around 'high-touch' services and where supply has to be co-located with demand. Unemployment for those in middle-ranking professional jobs will increase.

The next phase of outsourcing/off-shoring, with companies rationalising activity to a focused core tapping into a wide periphery of staff and other organisations, could go either way. Managed well, it should make the UK even more flexible and responsive and attract further inward investment. The alternative scenario could see significant loss of core expertise from the UK.



## Governance and sustainability

*Businesses already invest significantly in governance and to address sustainability in their operations. The next five to ten years will see this become more central to business with actions taken across all parts of the organisation and beyond. Businesses recognise that demonstrating accountability will be part of the new 'licence to operate'.*

*Key factors driving this change include: the decline of public trust in business; changing expectations of society (in particular younger generations); ease of access to the internet and other tools which make it simple to research company activities and disseminate information; the need to demonstrate compliance for regulatory purposes or to win certain types of contract; and the need to tackle climate change and other major challenges facing society.*

### Businesses will take a more extensive approach to internal governance

In seeking to secure trust, businesses will place a greater emphasis on managing risks to their reputations and operations. They will boost their internal governance activities to make them more extensive, but for most this will be a continued evolution of activity from the current position rather than a major step change.

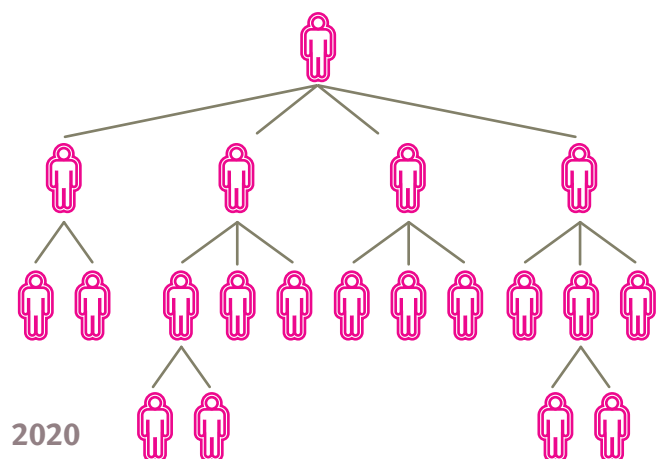
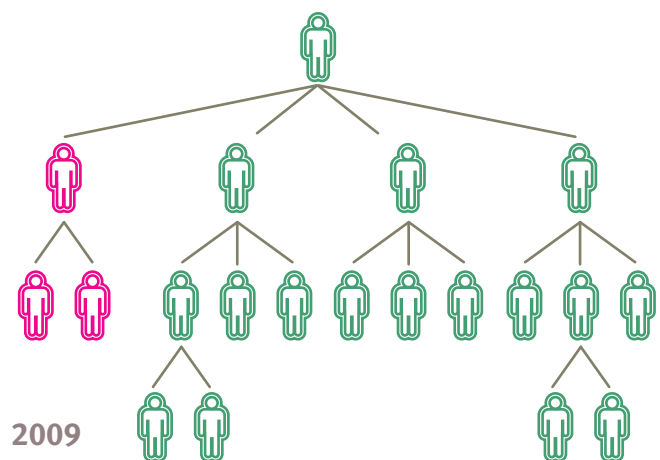
Large businesses and organisations operating in highly regulated industries already have extensive governance structures in place as a necessity. While these systems aren't broken, the new business climate has made it more apparent that additional and/or more exhaustive checks and balances are needed. New policies to demonstrate integrity, manage risk and provide transparency will be the focus. Clear governance structures and processes will be particularly important for large consumer-facing companies and for companies operating in public service delivery where trust (for example, in the use of public information and data), brand integrity and quality will be critical to win new contracts and continue operating. In the future they are also more likely to use governance as a pitch to customers.

Smaller businesses are less likely to have formal governance already in place to the same extent. Over the next five to ten years, they will be put under pressure by third parties to implement governance structures. Those providing funds to smaller businesses will be more cautious and are more likely to require the use of larger auditors, who in turn will want governance processes to be demonstrated. There will be demands for more up-to-date management information and greater scrutiny of appointments to boards and committees. And as the focus on governance evolves in large businesses and public sector organisations, they will demand similar reforms throughout their supply chains. Smaller companies will implement appropriate changes over time, but the pace of response over the next few years will be determined by the extent of more immediate concerns – namely surviving the recession and its aftermath. For many SMEs, additional investment in governance would only add to costs and is not a priority now (nor likely to be in the near future).

Leadership in businesses will be key to developing the new culture, and remuneration for managers will often be tied to performance on compliance. New systems will help drive culture change and there will be more investment in business continuity, risk analysis and mitigation and scenario planning. Monitoring by business of their internet – and in particular their on-line social network – presence will increase.

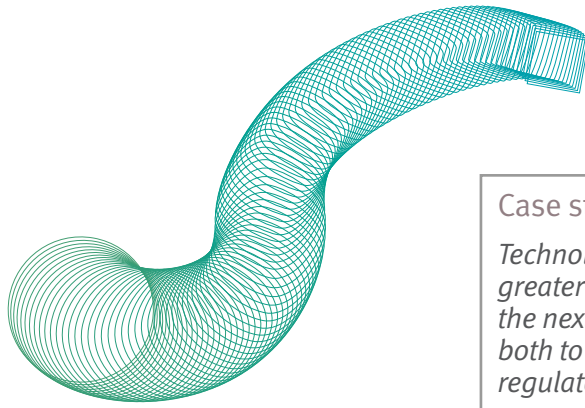
Ultimately, everyone in the organisation will be clear on their governance roles and responsibilities, from the sales floor to the boardroom, with greater controls in place throughout. Non-executive directors will be used more to provide increased independent input into board and remuneration decisions and ensure the long term sustainability of the business. More full-time jobs will be dedicated to compliance and where in the past internal governance and risk management may have been the responsibility of technical staff, these activities are now expected to take up more senior management time.

### Responsibility for risk in the organisation



 = responsibility for managing risk





The implementation of a 'no blame' culture will also be used by organisations to ensure mistakes are quickly uncovered and lessons can be learned.

The transition to more extensive governance will be difficult and the result will be less flexible, more rigid organisations at a time when chief executives will be trying to build more flexibility into their businesses. With these changes it will be difficult for companies to retain their agility and focus and there will be increased tension between delivering on governance and conducting core business. Businesses will have to find new ways of adapting to often rapidly changing consumer needs and consumer demands without this damaging profitability – innovation is expected to play an important role.

### Actions on ethics and sustainability will engage business more with all communities

As transparency increases and businesses expect the baseline of acceptable practices to rise, their ethical and sustainability credentials will increasingly come under the spotlight. The onus will be on businesses to demonstrate they are good corporate citizens and make a positive contribution – not just to the economy, but to UK society and the environment. The need for globalised businesses to demonstrate positive impacts on society and the environment overseas – eg through supply chain operations – will also continue to grow (*see case study 5*).

Companies will need to be – and be seen as – genuinely committed and consistent in their implementation of corporate values and ethics to attract and retain customers. Demonstrating good corporate citizenship will also be necessary to recruit the next generation of employees, who will have different expectations of business values and ethics.

Taking action, for example to address climate change, will see businesses undertaking more than just 'add-on' activities to what is otherwise business as usual – it will mean change throughout the organisation. Investments in environmental sustainability will be significant but, even in larger businesses, they will be made only when there is a clear link to improved business performance (eg lowering the cost of doing business through waste reduction and leaner practices) and where the payback is expected in the short to medium term.

### Case study 5: Intellect

*Technology-based businesses will place a greater focus on their environmental impact over the next five to ten years. This will be a response both to customer demand and to growing regulatory pressure.*

*Companies are already taking steps to increase transparency in terms of their carbon footprint. To do this, they will be investing in the capability to measure emissions and asking their suppliers to measure their own emissions. Suppliers unable to account for their carbon may therefore find that their contracts are at risk. The technology sector is also leading the way in exploring and implementing more innovative solutions to improve efficiency. The recent growth in uptake of virtual presence technologies as travel substitutes suggests that larger companies, particularly those with geographically discrete operations, are looking at longer term alternatives to travel. Another notable change relates to business models within the sector. We are seeing a movement away from traditional customer/supplier relationships and towards partnership approaches and service provision. For example, instead of selling printers, companies now offer a managed print service. Such approaches mean that it is in everyone's interests to be efficient and the overall result is that supply chains begin to become more circular than linear (cradle to cradle rather than cradle to grave).*

*The sector already plays an important role in reducing emissions across the wider economy, by improving the efficiency of existing processes, by enabling new, lower impact approaches and by replacing physical processes with virtual equivalents (dematerialisation). In the longer term, the intelligent use of ICT will be critical in the UK's movement towards a low carbon economy, one estimate suggesting it could reduce overall emissions by 15%. However, such technologies are currently under-deployed, particularly in the UK.*

Businesses will begin to implement action plans to achieve more stretching environmental objectives and targets. Steps will include changes to the choice of products produced, processes and materials used, packaging and other factors. Businesses will also work collaboratively with non-competing partners, and even with competitors, so their collective actions can have a greater impact on sustainability aims than working alone (see organisation and location section).

But those who will need external finance to fund key sustainability investments expect to find it difficult to secure as they believe not enough funders have a sufficient understanding of such investments.

On the ethical agenda more broadly, businesses will take steps to demonstrate they are part of their communities and are driven by values. Commercial relationships with those who demonstrate the same ethical values and quality standards will be prioritised and greater use will be made of third parties to evaluate adherence to these values and standards.

Again, leadership in organisations will be vital to the implementation of this agenda and the expectations placed on employees will rise to ensure businesses can meet, and even exceed, public expectation. The importance placed on ethics and values will permeate throughout the workforce and it will be the subject of new codes of conduct and offences that can lead to dismissal.

Businesses will increase activities with their local community (including communities overseas where these are key to the supply chain) from sponsoring local youth projects and staggering shift times to reduce road congestion, to increasing voluntary work (in the professional services) and working with local charities. Businesses recognise the post-recession landscape will be challenging for many, so larger businesses not overly constrained by regulation and/or their own survival imperative will seek to take a more active part in helping to tackle problems outside of what is necessary for their business operations.

For the largest global companies, expectations are much higher: initiatives that go further and tackle problems across society are now part of their license to operate. These will continue over the next five to ten years but a more focused approach will be taken to investments as a result of tight finances.

## Implications for the economy

Some sustainability, ethical and governance investments will result in a direct and tangible payback over a period of time (eg in building brand loyalty, supporting recruitment and retention), but many of the actions businesses intend to take will increase their operating costs. Customers are unlikely to be able or willing to pay for increased standards, and they will seek out businesses that can combine higher standards and lower prices. These competitive pressures mean businesses will have to absorb most of the cost of their investments. But businesses are clear – although these investments may be costly, the costs of not investing in sustainability and governance are much greater.

There is a risk that differences in implementation of governance and sustainability reform across countries could result in UK businesses being less flexible and with a higher cost base compared to competitors. While greater action compared to competitors on climate change and sustainability could be a competitive disadvantage in the short term, in the long run global action on climate change is a near certainty and UK businesses will be ahead of competitors.

The increased role of business in society will have a positive impact on rebuilding trust and, for consumer-facing organisations in particular, could strengthen their competitive position in the UK and overseas.

But, with more extensive and complex systems to manage governance and sustainability, there is a danger decision-making processes will be slower and more risk-averse. As a result, businesses may miss out on new opportunities, especially where radical step changes are involved. This may put the UK at a competitive disadvantage and restrict our potential for growth.

If SMEs and others struggling to survive scale back on progress in addressing sustainability, ethics and governance issues they may lose out to larger companies. Ultimately, this could damage the UK's enterprise and entrepreneurship base, and could lead to a rise in unemployment.

The extra compliance activity will create new opportunities in the service and public sector economy – a competitive advantage for the UK if we can capitalise on this and export our expertise and services, but a burden if the net impact is to add additional cost to the existing business base.

# Conclusions

The next decade will be one of fundamental change for businesses in the UK and the actions business takes will begin to have a significant impact on the shape of the UK economy.

In ten years time, businesses will typically be involved in a range of collaborations, partnerships and joint ventures, supporting investment finance, R&D and innovation, training and new organisational structures. There will be much more rigour in identifying investment and innovation projects for funding and businesses will have outsourced the next level of activities, including many specialist tasks. The workforce will be more diverse, highly flexible and mobile, making the most of new ways of working and using more business-relevant professional skills. This will leave organisations focused on a smaller core of people and projects, supported by a much wider range of individuals and businesses around the periphery. Building and maintaining trust with business partners and the public will become critical to the smooth operation of these structures, and compliance with governance and sustainability standards will be a major objective. Effective management will be the key determinant of survival and success.

These changes will have a range of implications for the UK economy, which have been highlighted in the previous section. Taken together, we identify the following as the main areas of concern and opportunity:

- In the short term, the UK will see slower (but more sustainable) growth and a longer climb out of recession, with elevated unemployment for an extended period, and the socio-economic consequences this will bring
- An increased number of burdens coalescing on business at the same time will increase business costs, reducing profits and tax revenues
- Until new systems of governance, collaboration, risk management and SME financing come into place, and start to work effectively, businesses are likely to miss opportunities for more radical innovation and the UK may fall behind some of its competitors
- But, by the middle of our five to ten-year time frame, these same systems will make the UK more productive and competitive and our expertise in implementation will be valuable in its own right
- New business structures, new ways of working and new relationships with employees will make businesses even more flexible and this will enhance what is already our most important competitive advantage
- Towards the end of the decade, some key aspects of the UK economy may ultimately fall under the control of overseas governments, and as market opportunities shift, current prominent businesses in both services and manufacturing may move substantially overseas.

# Annex

This report has been prepared with input from around five hundred CBI members, including 50 trade associations, through a series of in-depth workshops, committee discussions and one to one interviews with CEOs. Every region in the UK has been involved.

We would like to thank everyone who has contributed to this project, but in particular members of our thought leaders' panel and trade association partners and who helped to frame this piece of work and provided us with the initial insights to test more widely with members.

## Members of our thought leaders' panel:

**Ian Smith**, formerly CEO, Reed Elsevier

**David Callaghan**, senior vice president, Oracle

**Lucy Armstrong**, CEO, The Alchemists

**Gary Sturgess**, executive director, The Serco Institute

**Dean Gilmore**, managing director, PRTM

**Andreas Goss**, CEO, Siemens

**Steve Holliday**, CEO, National Grid

**Ray King**, CEO, Bupa

**Keith Attwood**, CEO, e2v

## Members of our Trade Association Council subgroup:

**John Higgins**, director general, Intellect – representing the UK technology industry

**Richard Barker**, director general, Association of the British Pharmaceutical Industry

**Steve Elliott**, CEO, Chemical Industries Association

**Paul Everitt**, CEO, Society of Motor Manufacturers and Traders

**Ian Rodgers**, director, UK Steel, EEF  
– the manufacturers' organisation

**Michael Ankers**, CEO, Construction Products Association

**Melanie Leech**, director general, Food and Drink Federation

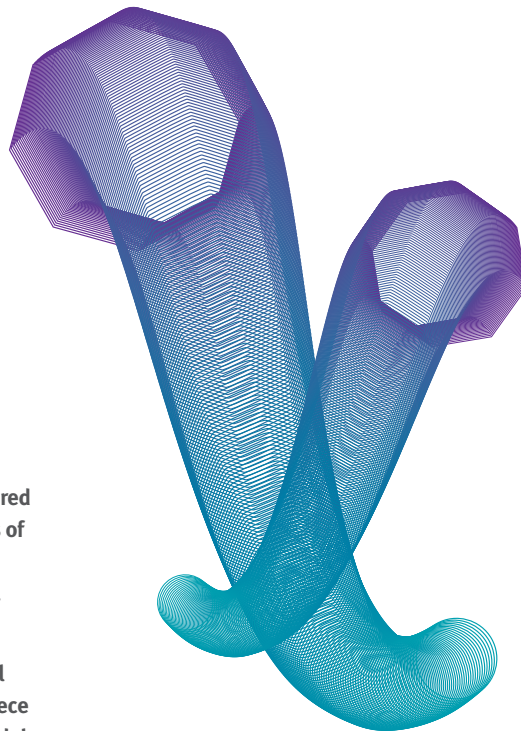
**Trisha O'Reilly**, communications director, Oil and Gas UK

**Theo de Pencier**, CEO, Freight Transport Association

**John Letizia**, director of government affairs,  
British Bankers Association

**Ian Godden**, chairman, A|D|S Group – the AeroSpace,  
Defence & Security trade body

**Jane Milne**, director of Business Environment,  
British Retail Consortium



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