Corporate Banking

UK Transport and Logistics

Sector outlook

First quarter 2012

Summary

- Activity in the transport and logistics sector rebounded in 2011, following a prolonged period of contraction.

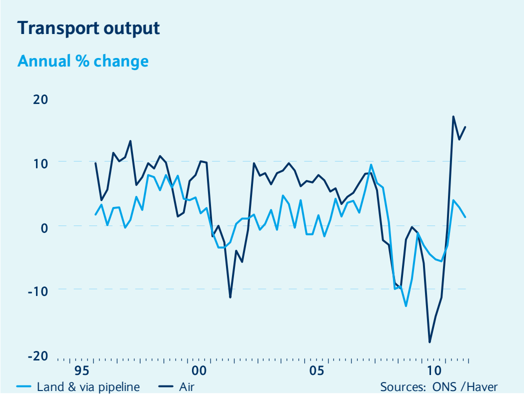
- However, trade volumes have weakened once more, as the recovery in the global economy has slowed, weighing on activity in the aviation and shipping sectors.

- Persistently high fuel costs, as well as regulatory interventions, represent long-term challenges for operators across all segments, particularly for smaller firms that are less able to hedge against energy price volatility.

- These factors, allied to relatively weak economic growth forecasts, continue to pose significant risks to the recovery in transport activity, which is likely to be gradual, with output likely to remain below pre-recession levels in the short-medium term.

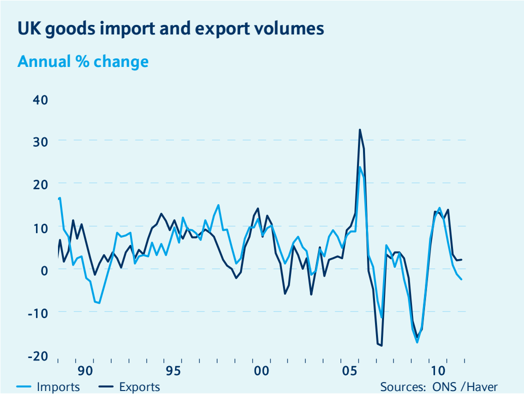
UK Transport and Logistics overview

- The transport and logistics industry consists of the road, rail, water and air transport sectors, as well as related infrastructure management firms and vehicle and equipment leasing and rental companies. Growth in overall transport output resumed in Q2 2011, although land transport activity remains subdued, with growth slowing to just 1.2% y/y in Q4. The strong rebound in air transport growth last year can be partly attributed to particularly weak activity caused by the volcanic ash cloud, the British Airways cabin crew strikes and severe winter weather in 2010, as well as improved overseas traveller numbers. Activity in both sub-sectors remains below pre-recession levels.



Shipping

- Although UK and global goods trade rebounded strongly in 2010-11, it has subsequently weakened. Furthermore, the increasing divergence between global shipping capacity and demand, as ships ordered at the height of the previous industry boom have entered service, has continued to weigh on freight rates. Benchmark rates fell to their lowest level since 1986 at the start of this year, having been adversely impacted last year by disruption to transport and trade networks, due to the Queensland floods and the Japanese tsunami. Reports suggest that freight rates are currently below operating cost levels, indicating that ship operators are chartering vessels at a loss, rather than leaving them docked, which is likely to see further financial stress in the sector.



- The global shipping industry has agreed to implement greenhouse gas reduction measures to be enforced from 2013. New ships built after then, and weighing over 400 tonnes, are required to improve their energy efficiency by 10%, rising to 30% after 2024, whilst existing ships in operation are required to devise and adhere to a ‘Ship Energy Efficiency Management Plan’. However, some developing countries may be exempt from the plan until 2016, which could give rise to new ships being registered in these countries. The EU is also considering including shipping in its emissions trading scheme, but these plans have been rejected by the UK shipping industry.

Road haulage

- Trading conditions in the road haulage industry improved in 2010*, as activity in transport-dependent sectors, such as manufacturing and construction, began to increase. However, hauliers have faced significant fuel price increases during the past 12 months, with a further rise in Q1 2012 weighing on freight loads. Further tensions in the Middle East and concerns over the imbalance between higher global demand, relative to supply, have caused the price of Brent crude to rise above US$120 per barrel, reaching the highest level since the onset of the recession and setting a new record high in nominal sterling terms. Although the government provided some additional relief to hauliers in the Autumn Statement (above those announced in last year's Budget), by delaying the inflation-linked increase in fuel duty and reducing it from 5p to 3p in August, further support measures are unlikely to be provided in the forthcoming Budget.

Rail

- Rail freight activity rebounded on an annual basis in the first nine months of 2011, increasing by 13%, and has returned to pre-crisis levels. Higher fuel prices and government commitments to invest in the freight infrastructure network are likely to boost future activity. Rising petrol prices have also bolstered rail passenger numbers in recent quarters, whilst higher fares saw passenger revenues increase by 4% y/y in Q3 2011. The government recently announced plans to reform the sector, including proposals to lengthen franchising agreements, integrate the provision of services and infrastructure between the network owner and operators and to ensure that more of the running cost of the rail network is funded through rail fares, as it seeks to reduce subsidies to the sector by £3.5 billion a year by 2019.

Air transport

- International Air Transport Association (IATA) estimates suggest that weak global economic growth and the on-going European sovereign debt crisis contributed to a decline in global air transport revenues during 2011, resulting in a fall in aggregate net profit to US$6.9 billion last year, from US$15 billion in 2010. Net profits are expected to fall again (to US$3.5 billion) in 2012. Whilst passenger volumes were relatively strong last year, despite the Japanese earthquake and unrest in the Middle East and North Africa, air freight markets continued to deteriorate, as world trade growth weakened. High fuel costs have also increased pressure on profit margins, which are expected to fall to just 0.6% this year.

- Whilst conditions are expected to be more favourable in the North American and fast-growing Asia-Pacific, Latin American and Middle Eastern markets, the European sovereign debt crisis and an

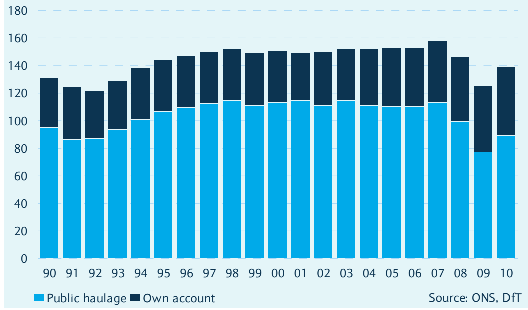
Baltic Exchange Dry Index

Monthly (eop)

Source: Baltic Exchange; Bloomberg

Road freight moved by British-registered HGV's

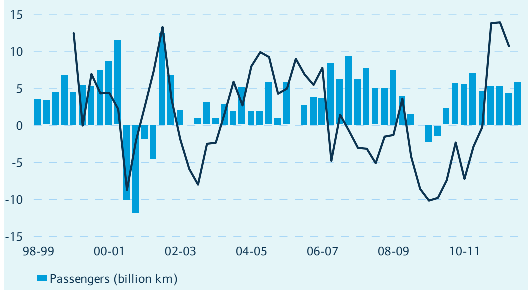
Billion tonne kilometres



Source: ONS, DfT

Rail transport

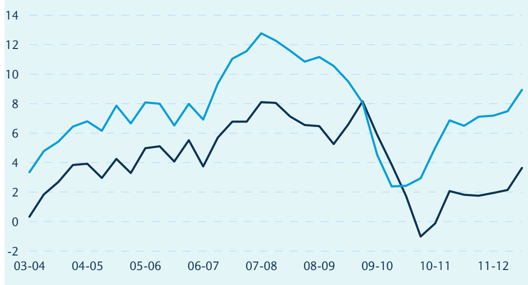
Annual % change



Source: Office of Rail Regulation

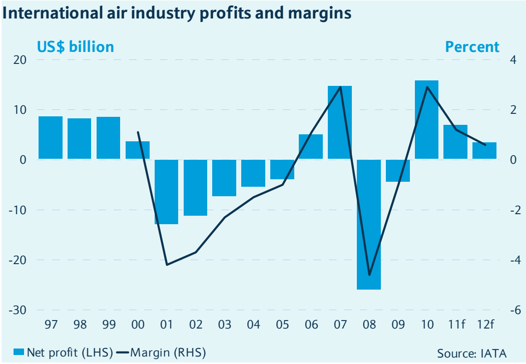
Rail transport: Passenger revenues

Annual % change



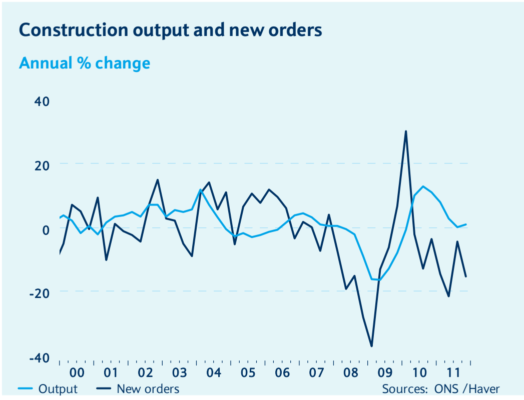
Source: Office of Rail Regulation

*The latest period for which data are available expected economic slowdown in the region are likely to weigh on UK and other European airlines this year. The UK aviation industry also faces pressures from a 10% increase in air passenger duty from this April, and the implementation of the EU carbon emissions trading scheme, with annual costs to the industry estimated at €1.1 billion. The government will also publish its aviation consultation later this month, outlining possible approaches for increasing capacity to support the UK's competitive position in the long-term.



Vehicle rental and leasing

- Vehicle rental and leasing firms benefited from a 3% annual increase in international visitor numbers during 2011. Although relatively weak consumer spending and signs of more cautious business spending are likely to have suppressed domestic demand for vehicle rentals, renting has become more popular for some consumers, as car maintenance costs have increased. Fleet management activity has also improved markedly, as more firms undertook fleet renewals postponed during the recession. Outsourcing by public sector organisations affected by spending cuts is also likely to bolster growth. However, falling used car prices will weigh on re-sale values and margins.

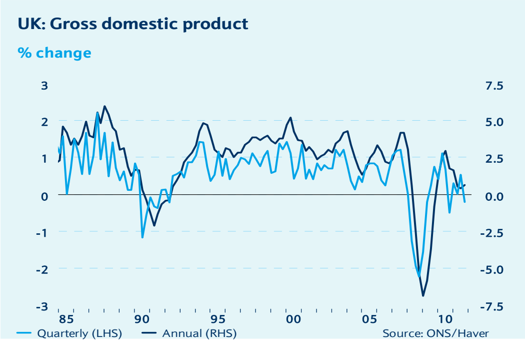


Equipment rental

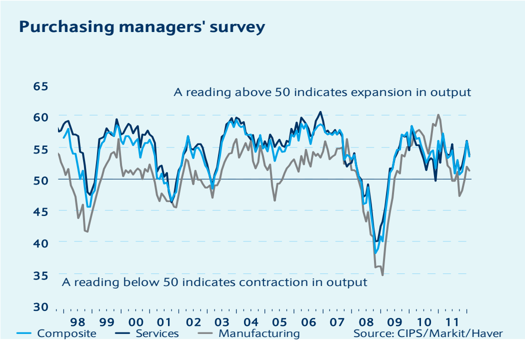
- Weak growth in the wider economy and the uneven recovery in the construction sector last year suggest that equipment rental activity weakened. Whilst infrastructure output supported overall construction activity in 2011 and may continue to do so over the next 12 months, the continued decline in overall new orders and a subdued housing market suggest that output is likely to remain relatively weak this year.

- Overall transport activity is expected to recover slowly, in line with the wider economy. High unemployment and fiscal austerity at home and abroad may dampen growth in passenger numbers, while the recovery in manufacturing and other sectors that generate demand for transport services is likely to remain subdued. Furthermore, rising fuel costs are a persistent pressure on UK operators, particularly for small firms that lack hedging facilities. This suggests that transport activity will remain below pre-recession levels in the near term.

Appendix 1 – Summary of macroeconomic overview

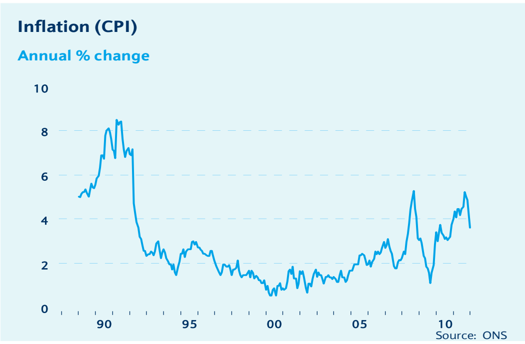


- Official data suggest that the UK economy contracted by 0.2% q/q in Q4 2011, following growth of 0.5% in Q3. The distortionary impact of events, such as the Japanese earthquake, the Royal Wedding and the associated extra bank holiday, resulted in an uneven pattern of quarterly GDP growth during 2011 (events, such as the Olympics and Diamond Jubilee holiday, will result in similar distortions in 2012). However, over the year as a whole, growth slowed to just 0.8%, compared to 2.1% in 2010, with concerns about the pace of the global economic recovery and the escalating eurozone sovereign debt crisis weighing heavily on activity and confidence in the UK (and across the advanced economies), particularly in the second half of the year.

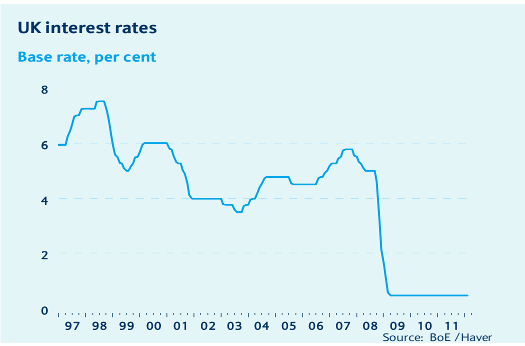


- Large-scale, long-term ECB liquidity provision and progress on a new support package for Greece appear to have eased eurozone tensions, for now, with the more positive tone of recent data from the US further bolstering confidence. Business surveys also suggest that UK economic activity has picked up once more (albeit modestly). However, whilst improving, confidence remains fragile and events in Europe continue to cast a shadow over both the UK and wider global economic outlook.

- The unemployment rate rose to 8.4%, with some 2.67 million people unemployed in the UK, in the three months to December 2011. Weak growth in private sector employment has failed to offset public sector job cuts over the past year and a continued rise in 'involuntary' part-time and temporary employment (by those seeking full-time, permanent posts) suggests that the degree of slack in the labour market is greater than the headline unemployment figures indicate.



- At 3.6%, inflation remains well above the 2% target rate, but has slowed markedly from its recent peak of 5.2%. With domestic inflationary pressures relatively subdued, and the temporary factors that contributed to high inflation last year (such as the increase in VAT and earlier rise in fuel and energy costs) set to fall out of the annual comparison, it is expected to continue to decline, although the recent rise in oil prices highlights the potential risks to this scenario.



- Allied to the weak prospects for the economy, the benign inflationary outlook has seen the MPC maintain interest rates at their historic low of 0.5%. In February, the MPC also sanctioned a further £50 billion of quantitative easing (QE), raising the limit on the Bank's asset purchase facility to £325 billion. Whilst financial markets now expect the MPC to pause QE, Bank Rate is expected to remain on hold during 2012-13.

- Despite a brief pick-up in the quarterly data in Q4, official figures show that consumers' expenditure declined by 0.8% during 2011. Falling inflation should gradually begin to ease some of the downward pressure on real disposable income (RDI). However, consumer spending is likely to remain weak over the next 12 months, as households remain heavily indebted, confidence remains weak and, with wage growth likely to remain below the rate of inflation, RDI is likely to continue to decline (albeit more slowly) in the near term.

- Fiscal tightening will also continue to bear down on the economy. Although official data suggest that the 2011-12 fiscal deficit will be lower than originally forecast, the Chancellor's Autumn Statement revealed significant downward revisions to the Office for Budget Responsibility's (OBR) medium-term economic forecasts. As a result, the Chancellor has stated that there will be no loosening of fiscal policy in the forthcoming Budget, which will be fiscally neutral. Indeed, the OBR's revised forecasts suggest that the austerity programme will likely have to be extended to 2016-17 to meet the government's medium-term fiscal targets.

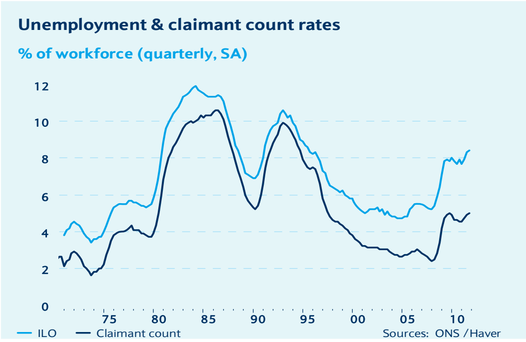
- Business investment was volatile last year, but declined once more in Q4 (by 5.6% q/q and by 2% y/y), resulting in growth of just 0.2% over the year as a whole. The corporate sector has been running a sizeable aggregate financial surplus, raising hopes that investment would provide a catalyst for both the recovery and the rebalancing of the UK economy. However, firms have adopted a more cautious approach as a result of spare capacity and/or the increasingly uncertain outlook.

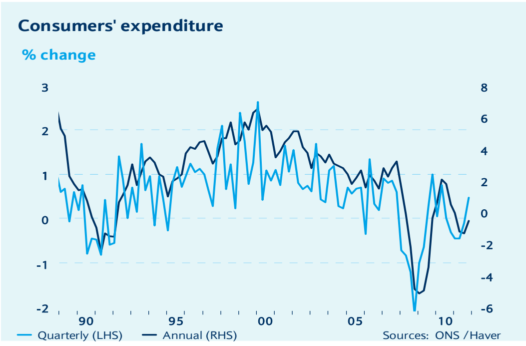
- Bolstered by the earlier sharp depreciation of sterling, the weak domestic UK performance was offset by a relatively strong contribution (1.2% points) to GDP growth from net trade last year. However, growth prospects for the UK's key European export partners have deteriorated markedly as a result of the eurozone sovereign debt crisis.

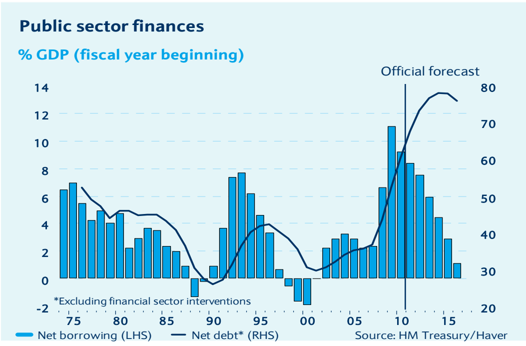
- Industrial production declined once more in 2011, with the pace of decline deepening as the year progressed. Following a period of robust annual growth at the beginning of the year, manufacturing activity stalled in Q4. Mining and oil extraction output also fell sharply (by 15.5%) in 2011, partly due to extra maintenance work in the North Sea, where production is now in long-term decline. Utilities output also declined last year, with relatively mild winter weather resulting in a particularly steep fall (10.9% y/y) in Q4. Annual growth in construction output also slowed markedly in the second half of 2011.

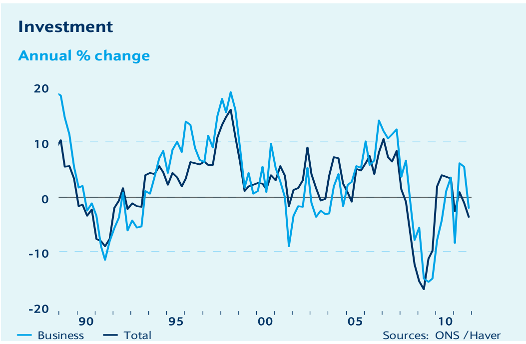
- Annual growth in services activity, which accounts for around 75% of UK GDP, proved more stable in 2011, although the quarterly pattern of growth was somewhat uneven. Growth in activity in this sector accelerated to 1.8% y/y in Q4, resulting in 1.6% growth during the year as a whole. However, performance was highly variable across the service industry's various sub-sectors, with business-oriented sub-sectors generally out-performing consumer-facing sub-sectors.

- UK economic forecasts have been revised downwards, with growth of just 0.5% expected this year and 1.8% next. As a result, recovery is likely to be protracted and weak, with risks weighted on the







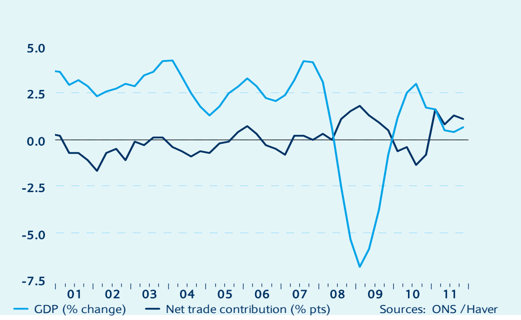


downside, given continued concerns over events in the eurozone, tensions in the Middle East(and the actual and potential impact of these tensions on oil prices) and signs of slowing growth in key Asian economies.

- Although expected to gradually pick up, as pressures on RDI gradually ease, consumer spending is forecast to remain subdued, from a longer-term perspective, during 2012-13, while fiscal tightening will see public sector activity and demand fall. Net trade is expected to continue to make a positive contribution to growth, but weak prospects for the eurozone are likely to see this diminish. However, investment should gradually pick up as economic growth accelerates.

- Unemployment is likely to continue to rise, as a result of further public sector job losses and cautious private sector job creation, but slowing inflation should, in the absence of unforeseen price shocks, enable the Bank of England to keep interest rates low.

Annual GDP growth and net trade contribution



UK consensus economic forecasts: February 2012

Annual % change (unless otherwise stated)	2009	2010	2011	2012f	2013f
Real GDP	-4.4	2.1	0.8	0.5	1.8
Consumer spending	-3.5	1.2	-0.8	0.2	1.6
Government consumption	-0.1	1.5	0.3	-0.4	-1.0
Investment (total GFCF)	-13.4	3.1	-1.7	0.9	4.0
Stockbuilding (contribution to GDP growth)	-1.0	1.3	-0.1	0.0	0.1
Net trade (contribution to GDP growth)	1.1	-0.8	1.2	0.3	0.3
Unemployment rate %	7.6	7.9	8.1	8.8	9.2
Consumer prices (CPI)	2.2	3.3	4.5	2.0	2.1
Base rate (end period)	0.50	0.50	0.50	0.50	0.50

Sources: HM Treasury; Bank of England; ONS; Barclays Corporate Economics

Prepared by Economics Team, Client Capital Management, Corporate Banking, Barclays Bank PLC.

All data and factual information referred to in this report were correct as of March 2012.

Source of ONS data: National Statistics website: www.statistics.gov.uk