EY-Parthenon quarterly analysis of UK profit warnings

Q2 2024

Contents

Q2 2024 highlights

49	18.4%	10	27%	9.7%
UK-listed companies warn in Q2 2024	UK-listed companies warn in the last 12 months	FTSE Industrial Support Services companies warn in Q2 2024	of profit warnings cite rising costs in Q2 2024	median share price fall in Q2 2024
A 26% year-on-year fall and the lowest quarterly total since Q2 2021.	Down from last quarter's high of 18.7%, but still more than the peak of the financial crisis.	Sector warnings rise, bucking the trend, as it continues to feel the impact of cost cutting and its own increasing costs.	Warnings citing cost pressures rise for the first time in over a year as companies feel the impact of rising supply chain and wage costs.	The share price fall on the day of warning falls to its lowest quarterly level since Q2 2021.

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Repositioning for growth

UK-listed companies issued 49 profit warnings in Q2 2024, 26% fewer than the same quarter of 2023 and the lowest quarterly total since Q2 2021. As we saw in 2021, after the pandemic, and 2009, after the global financial crash, a high pace of profit warnings is often followed by a steep fall if economic conditions improve, and more companies meet lowered earnings expectations. But, whilst our data undoubtedly reflects the economic recovery, it also underscores the challenges ahead.

The standout FTSE sectors that bucked the falling trend – Retailers, Industrial Support Services, and Household Goods and Home Constuction – rely on the confidence of businesses and consumers to commit to discretionary spending. Elevated levels of warnings in these sectors suggest that business and consumer confidence is still fragile, and corporate cost cutting is still prevalent, as we can also see in the high number of warnings citing contract delays and cancelations.

This cost cutting has come against a backdrop of earnings pressures that have eased, but not entirely relented. In Q2 2024, profit warnings citing rising costs rose again after falling for over year, driven higher by increasing wage and wage and supply costs. But companies aren't just cutting costs. Our data also shows a rise in the number of warnings citing increasing investment needs.

So, what can we expect in the next six months? This is still an uncertain time with a change in government in the UK, an unprecedented rollcall of global elections and geopolitical risks still high on the agenda. We expect the economy to continue to recover, but slowly and unevenly. We expect geopolitical and technological change to pose more challenges to business models, with more companies falling behind if they don't invest to keep pace, which is increasingly problematic for companies in higher overhead and capital cost environment.

We have started to see more companies coming back to the restructuring table because they haven't made the fundamental changes needed to adapt their operations and balance sheets to new demand, cost, and competitive realities. Refinancing is clearly a growing risk, as we discuss in this paper, with many companies unprepared for the added levels of due diligence and time needed to refinance in this market.

We expect all of this to drive a slow tick up in restructuring, but without necessarily a big upsurge in administration appointments, as more companies tackle their issues through Restructuring Plans and consensual agreements with creditors. The profit warning cycle may have turned, but we are just at the start of the restructuring one.

> “We expect the economy to continue to recover, but slowly and unevenly.

Economic outlook

Turning a corner

The economy has turned a corner; but beyond the headline data, the picture is more nuanced with challenges ahead for companies and policymakers to navigate.

GDP rose at the fastest pace since 2021 in the first quarter of 2024. Inflation final fell back to the Bank of England's 2% target in May for the first month since July 2021. The UK's economic picture is undoubtedly improving, but this more positive outlook comes with caveats.

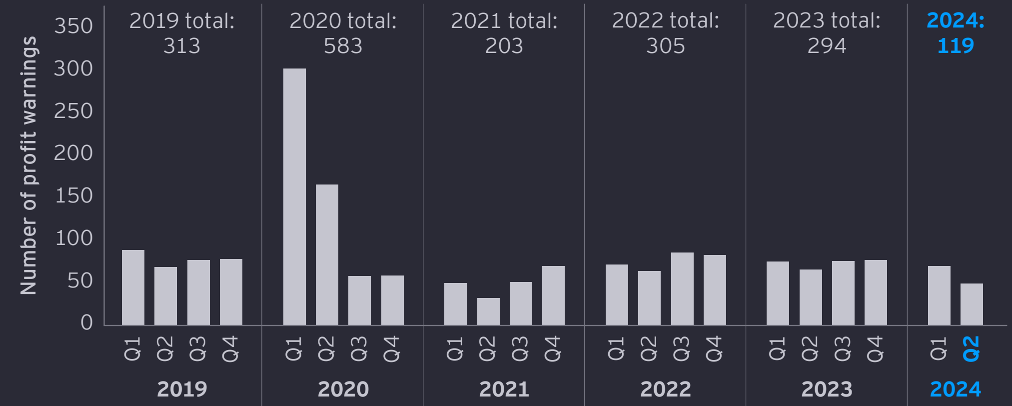
Demand is still volatile, especially in sectors exposed to discretionary spending. Official data shows retail sales volumes rising by 2.9% in May, after a fall of 1.8% in April and a 0.2% drop in March. Some of this volatility is seasonal and linked to the timing of Easter and exceptionally wet weather, but demand fragility is a wider story in economic trends and our profit warning data. Recent PMI (Purchasing Managers Index) surveys in manufacturing and services have also been lumpy, with some evidence of a 'pre-general election seize up across the UK services economy' also hitting in June.

Profit warning data and survey data also show that costs – especially wage and freight costs – are still an issue for many companies. June's Services PMI survey shows that prices continue to indicate a "high degree of stickiness" across the sector. The Manufacturing PMI survey also showed input prices rising at the fastest pace since January 2023, contributing to higher selling prices. The Bank of England may still cut interest rates in August. But without a rise in investment and productivity, the UK economy could remain inflation prone, slowing the pace of further cuts.

This leaves us with a better but still testing environment. The UK economy is still hamstrung by weak growth, investment and productivity. The geopolitical backdrop is also uncertain and significant policy changes are underway in the UK. This is a recovery, but one where several scenarios could still play out and companies need to be prepared for short-to-medium term volatility and a variety of outcomes.

UK profit warnings remain above average

Number of profit warnings by quarter



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Sector overview

Building confidence

In Q2 2024, the total number of profit warnings fell by 26% year-on-year and by 30% compared to the last quarter. But this fall isn't universal and areas where warnings are still high reveal the persisting and developing challenges facing UK plc.

- The FTSE sectors with the highest number of profit warnings in Q2 2024 were: Industrial Support Services (10), Software and Computer Services (5) Retailers (4), Household Goods and Home Construction (4) and Finance and Credit Services (3).
- The FTSE sectors[1] with the highest percentage of companies' warning in the last 12 months were: Personal Goods (67%), Telecommunications Equipment (67%), Chemicals (50%), Household Goods and Home Construction (48%), and Retailers (47%).
- The primary triggers for profit warnings in Q1 2024 were delayed or cancelled contracts (29%), increasing overhead costs (27%), exceptional charges (13%), and weak consumer confidence (10%).

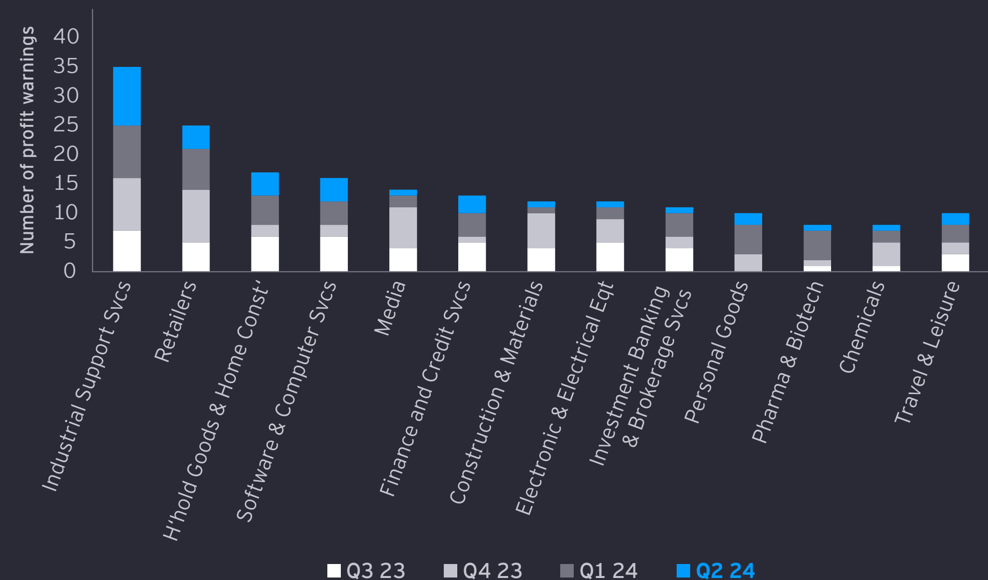
The macro-economic pressures that triggered the exceptional profit warning cycle of the last two years have eased, without being tamed. The re-emergence of cost-related profit warnings, most linked to wage and freight costs, underline that this still isn't a low-cost environment. Earnings pressures also appear to have exposed more internal issues – including accounting and operational problems and more exceptional charges – which collectively appear in 29% of warnings in H1 2024, up from 11% in H1 2023.

The consumer is expected to lead the recovery, but consumers are still prioritising experiences. Profit warning data shows more pressure in consumer-facing sectors reliant on discretionary spending in areas like luxury goods and those reliant on the health of the housing market, which are still under pressure due to the prolonged impact of the cost-of-living crisis and extended impact of interest rate rises.

The legacy of prolonged earnings pressure on corporate budgets will also take some time to work through. Many companies are still in cost-saving mode, hence the still elevated level of profit warnings citing contract issues and the trend-bucking rise in warnings from FTSE Industrial Support Services companies. But we also recorded the highest level of warnings triggered by companies' increasing investment needs since 2019, which suggests a budget reallocation as well as cost cutting story.

Looking ahead, companies should be prepared for policy changes following the UK election and a global elections super cycle. The election of a new government could bring more certainty and investment in certain areas, but companies in strategic sectors like defence, technology, critical infrastructure, energy (including renewables), automotive, industrials and agriculture are likely to see a mix of impacts and changing regulatory requirements.

Profit warnings by FTSE Sector



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1 FTSE sectors with more than five constituents

Addressing refinancing risks

Most companies are still refinancing with relative ease – albeit usually at a higher all-in cost. But many businesses are unprepared for the added due diligence and time needed in this cycle. Five key refinancing risk factors are recurring in recent discussions:

1. Weakening credit metrics: Businesses experiencing significantly weaker credit metrics or pressure on financial covenants, before interest rate rises, will struggle to refinance on similar terms.

2. Complex financial structures: Lenders are more cautious when there is other financing, for instance junior debt or preferred equity which may dilute their security and control in a downside scenario, or if there are other debt-like commitments such as pension deficits and HMRC liabilities.

3. Unloved sectors: Lenders are assigning more risk to companies in sectors like retail, construction, and real estate with elevated stress levels. Lenders are also taking a long-term view on ESG risks.

4. Pandemic hangovers: Some companies business models may look vastly different to the last time they refinanced.

5. Volatile financials: Given huge recent variations in demand, cost, labour and supply chain metrics, it can be hard to assess what 'normal' looks like. Management may struggle to present a consistent set of numbers.

How can companies improve their refinancing prospects?

Some risk factors, like sector, can't be altered. But companies can improve their operational and financial fitness and create compelling story for different lender classes.

1. Advanced preparation: At least 18 months before maturity, companies should begin to prepare financially and by starting conversations with advisors and lenders. Many borrowers will need more time in this cycle, especially if they need to increase the size and complexity of their lending group.

2. A compelling case: Companies need a credible narrative, numbers, and forecasts to build their refinancing case. Given recent turmoil, lenders are interested in scenario planning and companies' resilience to shocks.

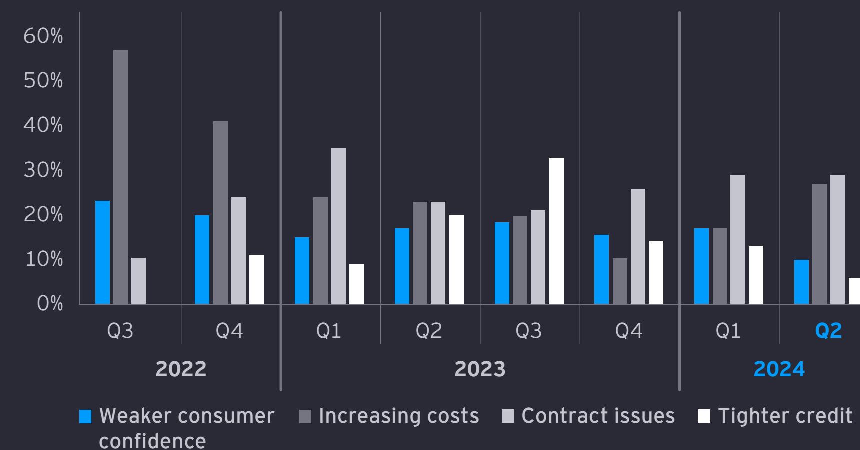
3. Consultation: It's vital to keep stakeholders informed to avoid a last-minute hitch. More borrowers are facing auditor questions, often a year or more ahead of their refinancing date. Companies also may not be aware of all the options open to them, and guidance can help avoid expensive mistakes.

Considering the alternatives

Alternative direct lenders like private credit and debt funds are filling the gap for companies who need new lending channels. But this isn't a straightforward like-for-like swap. Private lenders have different risk appetites and often take a more creative 'equity-like' approach, which requires more detailed underwriting, tailored structures, and potentially different and more collateral.

This isn't business as usual, but most companies will refinance if they act promptly, do their homework, and adapt to new lending conditions. The most important message for borrowers is to fully consider all options and to leave enough time to explore those avenues.

Contract issues and spending delays remain the top reason for warning, but cost pressures rise again



Market reaction

Looking forward

UK share prices reached near record highs in the second quarter as the economy moves back to growth and inflation continues to fall. But we could see further volatility in the second half of 2024 if the recovery doesn't pan out as smoothly as investors predict.

The median share price fall on the day of profit warning fell to 9.7% in Q2 2024, from 14.7% in Q1 2024. The average fall also fell to 12.3% from 16.7% in Q1 2024. By both measures, investor reaction is at its lowest level since Q2 2021, when profit warning numbers also fell to unusually low levels. With the economic recovery beginning to look more entrenched, it seems that investors are starting to view profit warnings in the context of recovery, rather than the downturn – just as we saw in 2021. But then, as now, the narrative isn't straightforward.

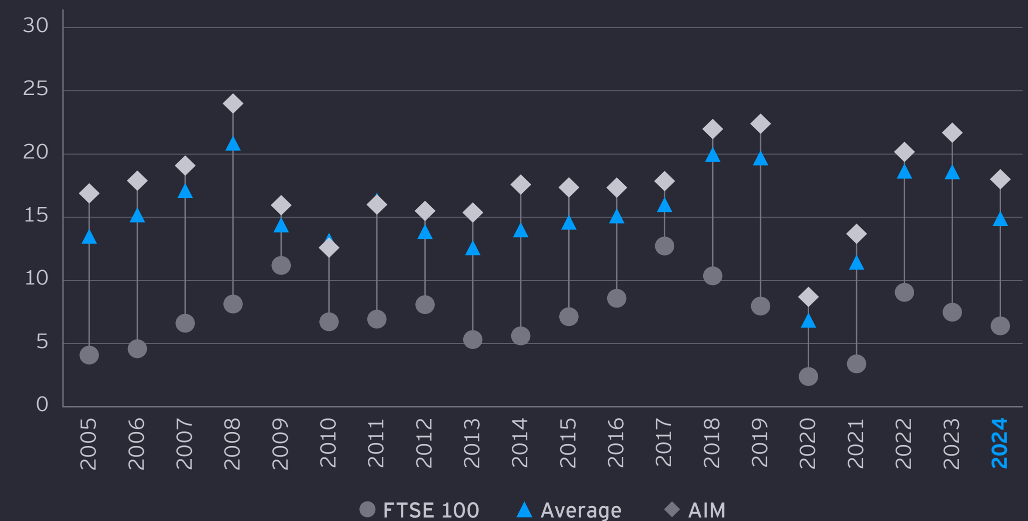
The percentage of companies warning in the last year only dropped to 18.4% in the second quarter, from 18.7% recorded at the end of Q1 2024, despite a 26% year-on-year fall in the number of warnings. This is due to more 'new' companies warning – 61% of companies warning first time in 12 months in Q1 2024 and 50% in Q2 2024 – combined with a 6% drop in the number of UK listed companies in the last year.

Companies are also still feeling the impact of the high-warning cycle, with the rise in stress in the listed company population reflected elsewhere. In the last year, 35 companies have issued their third or more warning in a 12-month period, just one less than last quarter. Of these companies, 12% have already gone into administration or a debt restructuring process, whilst 9% have been sold or are in a sale process.

Capital market confidence is also heavily linked to expectations that growth can still be combined with interest rate cuts, despite the timing and extent of 2024's rate cuts being pushed back several times this year. With inflation back to 2%, the first UK cut in rates may come by August, but service inflation is still higher than the Bank of England's target and the outlook is still somewhat clouded by geopolitical volatility.

Share price reaction to warnings falls, but divergent underlines lingering risks

% average first-day share price fall



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Pensions inflexion point

Defined benefit (DB) pension schemes haven't appeared too often as material stakeholders in this restructuring cycle, but this is likely to change as more companies come under pressure. In the last 12 months, 23% of listed companies with DB pension schemes have issued a profit warning and 11% have warned more than once. Addressing the pension scheme creditor could be hugely different in this cycle. So, what should stakeholders be looking out for?

Funding and financing: the contrasting impacts of higher interest rates

The pension funding landscape has radically changed, but DB schemes can still be relevant in stressed situations.

Incoming pensions regulation require less well-funded schemes to address, in some cases for the first time, factors like refinancing risk in the sponsoring employer, potentially leading to higher cash demands in already-stressed situations. And whilst many schemes are now better funded, a notional "buy out" level of funding can be a long way from a scheme being able to buy out its liabilities in practice, due to the difficulty of unwinding illiquid asset positions and limited capacity in the buy out market, meaning even a well-funded scheme is a relevant stakeholder in a restructuring.

Legislation and regulation: all change since the last downturn

Changing legislation increases the attention needed to address a pension scheme during restructuring, even in an improved funding landscape. The Pension Schemes Act 2021, introduced in the wake of high-profile corporate failures, increases The Pensions Regulator's (TPR) powers to investigate and potentially prosecute any stakeholder prejudicing the security of pension scheme member benefits without a reasonable excuse.

Trustees will also be unwilling to be kept out of discussions around a company's prospects. The phrase of the moment is "low dependency [on the employer's covenant] is not no dependency".

Since the last downturn, we've also seen the introduction of the corporate Restructuring Plan (RP), which has been used in a small number of cases involving pension schemes. No RP so far has tried to compromise pension scheme obligations, and this may no longer be an immediate issue due to a combination of potential legal challenges and improved scheme funding, which reduces the benefit of "cram down".

Pension endgames and innovation: opening opportunity

One clear upside of better pension scheme funding levels is the increased options available in distressed situations. When Morrison's acquired McColl's out of insolvency, it was practical to take on both of McColl's pension schemes. We've also seen two transactions with Clara, the first pension superfund to have successfully been assessed and listed by the Pensions Regulator.

Some companies are also considering keeping their pension schemes on their balance sheet rather than transferring to an insurer to avoid the accounting hit or to potentially create innovative benefits from the surplus-generating potential of a scheme's pool of assets.

FTSE Industrial Support Services

FTSE Industrial Support Services companies issued ten profit warnings in Q2 2024, with 28% of the sector warning in the last 12 months, compared with 14% at the same point in 2023. Warning levels in H1 2024 more than doubled compared with the first half of 2023, the highest increase of any sector.

Why has this sector come under so much earnings stress in the last 12 months? This is a diverse grouping of companies, but they share a high dependence on business and public sector spending which makes them vulnerable to uncertainty, spending hiatuses, and cost cutting cycles.

Of the 19 warnings issued by the sector so far in 2024, eight have come from business services providers, seven have come from recruitment and training companies, and four from industrial suppliers. Almost all the companies warning cited falling sales or more difficult and elongated contract cycles in their profit warning, as well as pressure on corporate and public sector budgets.

Companies have been battling cost increases in many areas, from equipment and labour to debt. Organisations have also needed to find cash to fund investment in strengthening their supply chains – in response to disruption – as well as investing in new technology in areas like customer relationship management, e-commerce or artificial intelligence. This is all against a legacy backdrop of earnings pressure and uncertainty that has made companies more conservative around their top-line forecasts and spending.

Recruitment companies, often good barometers of business confidence, have issued 12 profit warnings in the last year, compared with just five in the prior 12-month period.

Historically, weak demand has catalysed and exposed contract issues. The long complex nature of outsourcing contracts heightens the risk of snags and delay, whilst also increasing vulnerability to changing circumstances, such as cost inflation – with almost half of the warnings in H1 2024 citing the impact of higher costs. Meanwhile, customers, facing similar pressures, are still pushing for greater value and efficiencies as they look to run and manage contracts more tightly, with increasing competitive pressures and squeezed budgets.

Companies have undoubtedly learnt lessons from prior failures. But weaker demand and higher costs leave less margin for error and boards need to guard against the temptation to lower prices during dips in activity to sustain volumes. Some of the biggest profit warnings and distressed situations in the sector have been triggered by a limited number of rogue contracts that were often flawed in their creation and mishandled in execution. Risk management needs to happen across the contract lifecycle, with constant monitoring and vigilance so companies can mitigate against failure and spot risks early.

The flipside of this exposure to weak demand and confidence is that the sector could be boosted by an uptick in activity, confidence and certainty following the General Election, although the fallout could be mixed depending on the direction of policy.

FTSE Retailers

FTSE Retailers issued five warnings in Q2 2024 taking the sector's first half total to 12 warnings, higher than the ten issued in the first half of 2023. In the last 12 months almost half (47%) of the sector has issued a profit warning.

The economic backdrop is undoubtedly improving for retailers in 2024 with disposable incomes and consumer confidence both rising. But retailers are still reporting increasing costs and supply chain issues in their profit warnings, as well as volatile sales patterns. Unseasonable weather has contributed to this volatility. But, with money still tight, consumers also still appear to be prioritising experience spending and waiting for the sales.

Profit warnings are especially concentrated this quarter in discretionary areas like luxury goods and DIY and furnishings – a theme we see repeated in related sectors. But across retail we're seeing how low and volatile demand is differentiating the sector by creating intense competition for a limited share of wallet, amplifying the advantage for retailers that have moved quickly and assertively to reshape their business to customer demands.

As a result, we are still seeing elevated levels of retail failure, although it's notable that this is affecting fewer stores than earlier peaks – 971 in 2023, compared with over 2,000 in 2022 and more than 6,000 in 2009. This is partly due to the profile of affected retailers. Many of the failures have come in the mid-market or online retail, which have been caught in the crossfire of changing buying patterns, the cost of rising returns, and the impact of intensifying overseas competition.

But the relatively smaller number of stores per retail failure could also be linked to the 'failure' of past restructurings. Many of the rent rebases from CVA's agreed in 2019-21 have now expired, whilst debt costs have risen. Cutting store numbers and rent alone isn't enough if the businesses fundamentals are wrong and a high debt burden is just rolled forward. We're also seeing the sector's version of 'long-covid' as legislation that stopped landlords acting against tenants who couldn't pay their rent due to the impact of the pandemic expires.

New challenges to business models are also coming thick and fast as technology continually challenges retailers to rethink their offering and the way they relate to consumers. Our experience with retailers suggests that reshaping needs to come in three areas.

1. Treat customers as unique individuals: understanding their needs and how they behave to present a winning offer and deliver a convenient and personalised experience.
2. Keep pace with rapidly evolving trends: spotting trends early, decoding the implications of these to remain relevant and competitive.
3. Close the gap between expectation and reality: delighting customers whose growing expectations are increasingly outpacing what brands currently deliver.

But many retailers haven't had the operational, financial and management bandwidth to reset their business. We're seeing more businesses essentially surviving day-to-day, unable to generate enough escape velocity to move forward. This is still going to be a tough year for retailers, and we expect to see more stress and failures.

Other sectors to watch

FTSE Household Goods and Home Construction profit warnings bucked the falling trend, with companies issuing nine profit warnings in H1 2024, tripling their total from the same period in 2023. Just under half (48%) of the companies in this FTSE sector have issued a profit warning in the last 12 months.

The balance of warnings in the sector has shifted in the last year from housebuilders to household goods manufacturers and suppliers. The impact of higher interest rates on mortgage payments is still passing through and interest rate cuts have been delayed longer than predicted at the start of 2024. But most housebuilders have been able to adjust their business models and have been helped by easing cost pressures. Those that are still warning are mostly wrestling with delivery issues on legacy projects.

But a slower pace of transactions in the housing market as a whole – and pressure on discretionary incomes – is clearly being felt strongly across the household goods sector. As discussed, retail sales are exceptionally volatile and consumer confidence, whilst rising, is fragile. As well as citing falling demand, almost all the 2024 warnings from this household goods side of the sector quoted cost pressures, specifically increasing labour costs, which have been hard to pass through to cost-conscious consumers.

FTSE Finance & Credit Services companies issued seven profit warnings in H1 2024, In the last 12 months over a third (36%) of the sector has warned, compared to 8% at the same point in 2023.

As we discussed last quarter, the financial sector's challenges aren't systemic, but we are seeing localised pockets of stress triggered by rapid changes in macro conditions and regulation. Debt stress levels are well below historic peaks, but they are rising, and the full impact of rate rises hasn't played through yet to lending books created during an extended period of low rates and low risks. The FCA is also entering the final year of its 2022-25 strategy in which it set out to reduce and prevent serious harms. We have seen this manifest with assertive supervision and intervention.

Interest rates should start to fall in 2024, but not to pre-pandemic levels and almost every company and consumer will refinance at a higher rate. Default and insolvency rates are rising, so understanding portfolio risk will be key. Funding and operating costs will remain relatively high. Companies need to think about how they will adapt their business models to this changed environment, and communicate this change and a clear purpose to customers, investors and supervisors.

UK overview

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