Running out of road?

EY-Parthenon quarterly analysis of UK profit warnings

Q3 2023

EY Parthenon

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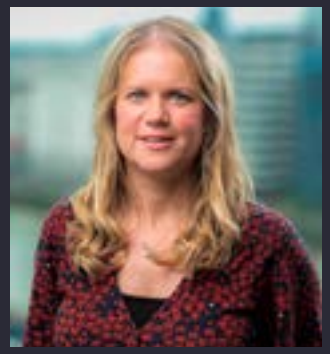
Q3 2023 highlights

76	33%	45%	33%	15.1%
profit warnings in Q3 2023	profit warnings in Q3 2023 cite the impact of rising interest rates	FTSE Household Goods and Home Construction companies warning in last 12 months	profit warnings in Q3 2023 from companies with £200mn–£1bn turnover	median share price fall on the day of warning in Q3 2023
UK profit warnings stay above average levels, but fall year-on-year for the first time in two years	The highest level of profit warnings triggered by changing credit conditions since 2008	The highest percentage of the sector warning over a 12-month period since 2008	The highest proportion of warnings from 'mid-market' companies in almost 13 years	Market moves back towards 'risk off' mode as recession risk factors increase

Navigating a painful transition



Jo Robinson
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UK profit warnings have fallen for the first time in two years, as inflationary pressures begin to ease. But, as we've seen repeatedly since the pandemic, as one pressure eases, another intensifies. Credit-related warnings hit their highest level since 2008 in Q3 2023 as the impact of higher interest rates spread across the economy.

UK companies issued 76 profit warnings in Q3 2023, falling 12% year-on-year, but still 18% above the third quarter average. Cost-related profit warnings have fallen, but this has been partially offset by the increasing impact of higher interest rates. And, whilst cost pressures are easing, inflation remains stubbornly high, increasing the risk that interest rates will be higher for longer.

The broadening and increasing impact of the steepest rise in interest rates in 40 years is increasingly clear in our data. In Q3 2023, a third of warnings blamed changing credit conditions – the highest level of companies to do so since 2008, with warnings coming from 11 different FTSE sectors. The impact is most obvious in the weakening housing market, which triggered a fifth of all warnings in Q3 2023, including housebuilders, but also the wider housing value chain, from construction contractors and suppliers to estate agents and mortgage providers.

This isn't a broad-based, global, systemic crisis like 2008. Companies, banks and consumers all have stronger balance sheets with the financial system also bolstered by increased regulation. Cash buffers and extended debt and mortgage maturities continue to cushion and stagger the impact of the rise in base rates. But long maturities and cash buffers can create their own risks. It can encourage a view that 'something will turn up', rather than companies recognising a need to adapt to fundamental changes in the economy.

And as we saw with last autumn's market disruption, stronger doesn't mean invulnerable. The transition to a higher cost, higher interest rate economy, with greater geopolitical volatility and fast-moving technological change isn't going to be easy. The outlook is still uncertain and the risk of recession higher than our last update. As we explore in this paper, refinancing risks are growing and restructuring activity is rising – especially in the mid-market – as more companies struggle to navigate the transition to a more expensive and volatile environment to do business.

Delaying action risks destroying value. If we take one fundamental lesson from the last few months, it's that we're in this for the long haul. It's not a crisis that will pass.

> "As we've seen repeatedly since the pandemic, as one pressure eases, another intensifies.

Economic outlook

Recession risks rise

The economic outlook looks more troubled than our last update, with recession warning lights flashing in business surveys and new risks appearing as others recede. We may be at or near the peak of UK interest rates, but they are now expected to remain high for longer, whilst growth is subdued, and rising geopolitical tensions add to uncertainty.

Before the summer, a global consensus had started to build around a global 'soft' economic landing based on expectations of rebounding growth and an orderly inflation fall that would allow central banks to start lowering interest rates by early 2024. But, whilst inflation has continued to decline, progress is slower and less smooth than hoped, whilst global growth has also been more sluggish than expected.

The UK's inflation fall gave the Bank of England enough breathing space to pause in September. We are probably at – or close to – the peak of UK interest rates which, combined with falling inflation and a return to real pay growth, should keep the UK economy out of a technical recession. The EY ITEM Club's Autumn Forecast predicts that the UK economy will grow by 0.6% in 2023, up from the 0.4% growth projected in July's Summer Forecast.

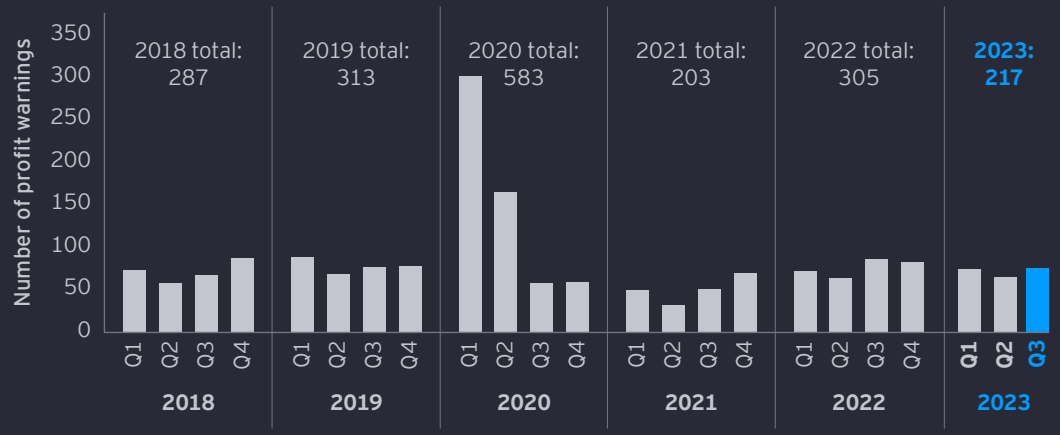
But ITEM has also downgraded GDP growth expectations for 2024 slightly from 0.8% to 0.7%, as the impact of the recent interest rate rising cycle continues to feed through. High oil prices, frozen income tax thresholds, inflation, and a deteriorating labour market will keep additional pressure on consumer spending. Government spending could also become less certain as we move into the electoral cycle.

EY ITEM Club expect interest rates to remain over 3% into 2025-26, by which time the bulk of corporate and mortgage debt taken out at previously low rates will need to be refinanced. If interest rates stay high and growth subdued more companies and households will run out of road.

All of which means that growth will be subdued for some time. UK GDP growth is only predicted to reach 2% by 2026, and this marginal growth won't be evenly distributed. For some sectors and consumers, it will feel recession-like.

UK profit warnings remain above average

Number of profit warnings by quarter



Our profit warning console contains more current and historic data: ey.com/warnings

Credit squeeze hits home

The impact of 14 consecutive interest rate increases is the standout theme in this quarter's data. Companies are feeling the impact most keenly where credit availability had been an important driver of activity and confidence, but our data also underlines the increasing impact on the wider economy.

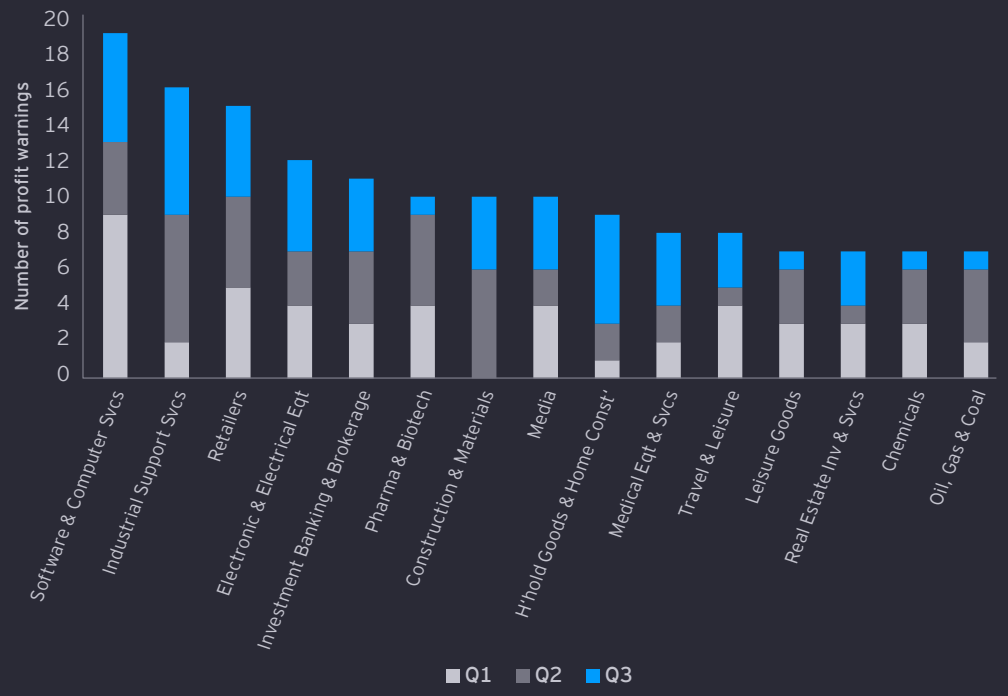
- The FTSE sectors with the highest number of warnings in Q3 2023 were: Industrial Support Services (7) and Household Goods and Home Construction (6) and Software and Computer Services (6).
- The FTSE sectors with the highest percentage of companies warning in Q3 2023 were: Household Goods and Home Construction (27%), Finance and Credit Services (21%) and Food Producers (20%).
- The top reasons cited for warning in Q3 2023 were tighter credit conditions (33%), delayed or cancelled contracts (21%), cost pressures (20%) and weaker consumer confidence (18%).

The number of profit warnings citing changing credit conditions is at the highest level since 2008. The clearest impact is on companies affected by the slowdown in the housing and mortgage market. But, as we noted last quarter, the wider impact on sectors reliant on business confidence and discretionary spending is also growing. Destocking, contract cancellation and amendment are increasingly common themes. Changes in government policy and spending are also in focus – increasingly so as we move closer to a General Election.

We can see this wider economic impact on confidence and business spending in our data. Companies in industrial sectors issued 24% more profit warnings in the first three quarters of 2023, compared with the same period of 2022. Warnings from FTSE Software and Computer Services companies are running 46% ahead of 2022 levels, whilst FTSE Media companies have issued double the number of warnings in 2023 than the same point in 2022. Profit warnings from FTSE Industrial Support Services, look set to reach their highest level in five years in 2023.

Looking ahead, the consumer is also in focus as we move into the all-important Christmas quarter. Consumer spending has held up better than expected on aggregate and should receive a boost from increasing real pay, but this positive is increasingly being offset by the challenge of rising rent and mortgage costs and a less buoyant job market. Consumers usually find a way to spend at Christmas, but the start of 2024 could prove more testing.

Profit warnings by FTSE Sector, Q3 2023



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Refinancing risk

The UK's combined corporate balance sheet looks healthy, but the aggregate picture doesn't tell the whole story. This is a more expensive, but also more complex and less forgiving capital environment and companies need to prepare early to avoid refinancing concerns.

The Bank of England estimates that it will take a further upward shock to borrowing costs of over 200 and 800 basis points respectively for companies to reach the level of debt-servicing stress that we saw during the Global Financial Crisis and dotcom crash – a level of increase that now looks highly unlikely.

But there is a great deal of diversity and vulnerability within this overall picture of health. The Bank's analysis also shows that highly leveraged companies (debt/EBIT>4.5) account for around 60% of corporate debt, whilst holding just 5% of the cash. Just 2% of leveraged lending is due for refinancing this year, but 30% is due for refinancing by the end of 2025.[1]

These figures look increasingly uncomfortable given expectations that interest rates are now unlikely to fall until late-2024. The average cost of new borrowing from banks was 6.97% in August 2023, 494 basis points above the December 2021 rate of 2.03%.[2]

But it's not just the added expense that's problematic. Banks are also increasingly de-leveraging and limiting forbearance to reduce exposure to riskier situations. This is part of a wider trend as banks make up an increasingly smaller part of the lending market. Market-based finance makes up over 50% of the current stock of debt, up from around 40% in 2009. It's also supplied nearly all the £425bn net increase in corporate lending since the end of 2007.[3]

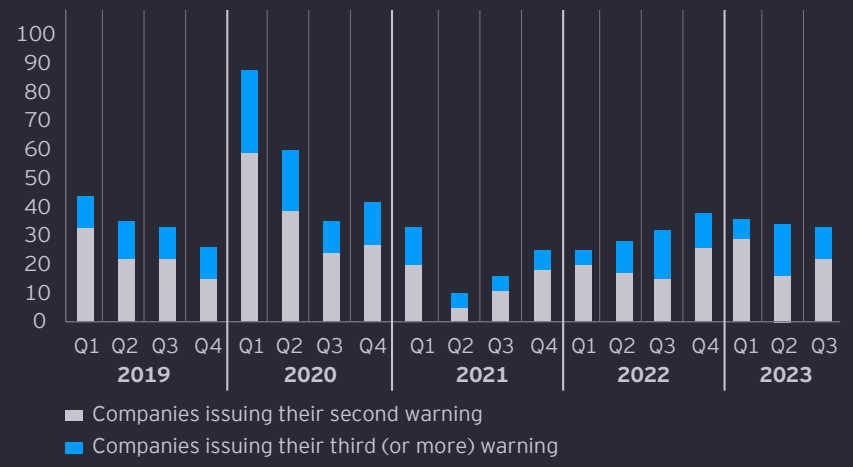
The emergence of alternative providers has filled some of the gaps left by banks and widened the options available, but generally at a higher cost and with added vulnerability to changes in market attitudes and credit spreads. All of which makes 'rolling-over' debts subject to greater uncertainty – as we're seeing with extended timetables and more 'amend and extends'.

So, whilst there is still ample capital available for well-performing companies, refinancing will be more expensive for all and more complex to navigate, especially for the highly leveraged and those in pressured sectors like construction, utilities, education and real estate.

What does this mean for companies? Above all they need to prepare early for refinancing – 12-18 months ahead – to limit risk and reassure stakeholders. We've seen a rapid rise in audit 'going concern' issues where there is financing uncertainty. They need to present a cohesive and investable story to stakeholders that shows how they can adapt, innovate and succeed in a higher interest rate and cost environment.

In 2023, 19% of companies warning have done so for the third or more time in 12 months

Companies issuing their second and third (or more) warning in a rolling 12-month period



1 How large are the refinancing risks facing UK corporates from market-based finance? | Bank of England
2 Money and Credit – August 2023 | Bank of England
3 Financial Stability Report – July 2023 | Bank of England

Market reaction

Mid-market focus

Share price reactions to profit warnings rose in the third quarter, reflecting the increasing risk to earnings of 'high for longer' interest rates. Our data also shows rise in profit warnings and stress building in the 'mid-market'.

Another volatile quarter in capital markets underlined the fragility of investor confidence. Sentiment oscillated between the optimism inspired by falling inflation and the concern generated by the risk of 'higher for longer' interest rates – a risk that appeared to crystallise during the third quarter. The decision by the Bank of England to hold rates in September probably signals the peak, but it will be a long peak, whilst sluggish growth forecasts cast more doubt over the earnings outlook.

Investor reaction to profit warnings in the third quarter increased, reflecting the uncertain mood. The median share price fall on the day of profit warning rose to 15.1% from 11.2% and the average to 18.4% from 15.4% in the last quarter. Most of this increase was driven by increasing reaction to profit warnings in the £201mn-£1bn turnover band, where the average fall on the day of warning rose dramatically from 10.6% to 17.3%.

This rise in reaction reflects the rise in mid-market profit warnings that began in the second quarter and continued into the third. Profit warnings from companies in the £201mn-1bn turnover band made up 33% of all warnings in Q3 2023 compared with 16% in Q3 2022. We are also seeing increasing restructuring activity in the mid-market and this rise in warnings suggests that there is more to come.

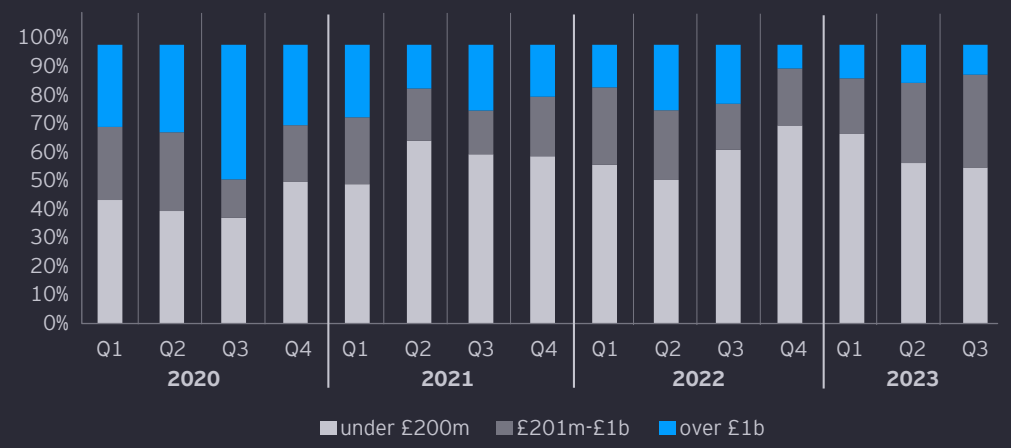
We're also seeing a rise in the proportion of companies issuing multiple profit warnings. Of the 170 companies warning in the first nine months of 2023, 19% (33) have issued their third or more warning in the last 12 months, of which just under half have a turnover over £200mn. Within a year of the third warning, we usually see around a quarter experience a covenant event and around 20% delist, with around half of these due to Administration. We're well within the year for most of these companies, but we've already seen over 10% delist and a quarter report a covenant breach or reset.

Our profit warning console contains more current and historic data: ey.com/warnings

We may be seeing this cycle of earnings downgrades slow, but we're starting to see restructuring activity increase as more companies, bruised by blows to profits, struggle to meet rising interest cost and tighter credit availability.

The proportion of 'mid-market' companies warning increased to the highest level in almost 13 years in Q3 2023

Percentage of profit warnings by turnover band



Insolvency outlook

Insolvency activity has been heavily focused amongst smaller companies since the pandemic. But, as macro and financing stresses build, we're starting to see more activity in the mid-market and see how restructuring could be more company-led in this cycle.

Corporate insolvencies have risen almost every quarter since mid-2021, hitting their highest level since 2009 by mid-2023. However, the bulk of this rise has come from creditors' voluntary liquidations (CVLs) amongst smaller companies, which have consistently contributed over 80% of all insolvencies since the end of 2020, compared with around 60%-70% before the pandemic.

The typical spread of stress from small to mid-market companies has been slow in this cycle. But we are now seeing mid-market stress reflected in profit warnings and in restructuring. More companies, whose balance sheets had been cushioned by extended maturities and COVID-19 support measures, are now facing combinations of the repayment of pandemic loans, higher refinancing hurdles, and relentless supply, cost and interest rate pressures.

This stress is manifesting in rising mid-market administration appointments, but also an increase in contingency planning and board advice. The rise in corporate-led activity is also significant amongst 'large cap' companies, where the focus is still largely on refinancing and liability planning.

The increase in corporate-led restructuring is partly due to extended maturities and cash balances that, whilst diminishing, are still giving many companies breathing space – as are increasing capital options. Light or absent covenants also lowers the lender-triggers we saw in the last crisis, leaving more companies to find their own path forward. And lender attitudes are changing, with banks taking a more advisory-led approach, rather than taking control.

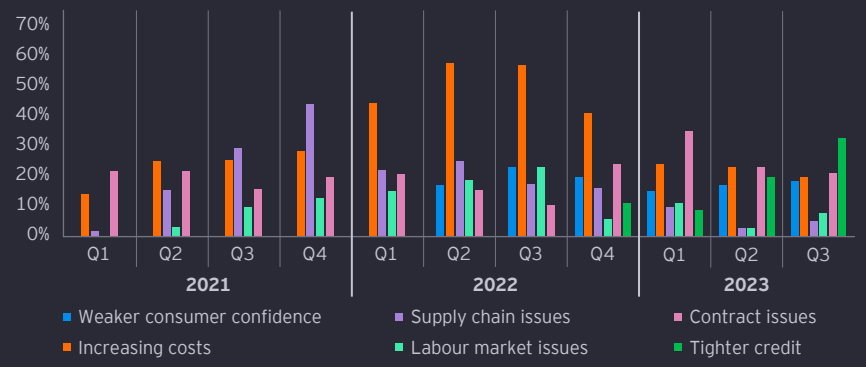
This more consensual approach also reflects the changes in the legal restructuring landscape. Between 26 June 2020 and 30 September 2023, 22 companies had a Restructuring Plan (RP) registered at Companies House, with more companies outside of England and Wales also using RPs, and other cases resolved solvently out of court that might otherwise have gone into Administration. As new cases come to court, they will continue to raise interesting questions and set precedents around the principle of fairness and treatment of different classes of creditors, potentially encouraging greater use.

But the fundamentals of restructuring remain the same. Companies still need to adapt their financial and operating structures to fundamental changes in their market and the cost of capital. Delaying action risks destroying value.

What triggers should companies and their advisors look out for?

- **Liquidity-driven** – often accelerated by soft credit or working capital issues, as much as underperformance.
- **Refinancing-driven** – when this is harder or more expensive than the company anticipated.
- **Going concern-driven** – when audit sign off shines a light on, or accelerates, issues coming down the line.

Tightening credit became the main reason for warning in Q3 2023



FTSE Household Goods and Home Construction

FTSE Household Goods and Home Construction companies issued six profit warnings in Q3 2023, equalling the number issued in Q4 2022, the quarter after the 'mini budget'. The impact of rising interest rates is clear in the home construction sector, but stress is most prevalent in the wider supply chain.

How are housebuilders weathering the storm?

In the last 12 months, 45% of FTSE Household Goods and Home Construction companies have issued profit warnings – the highest percentage to warn over a 12-month period since 2008. Of the ten companies that have warned, six are in home construction and four supply household equipment or furnishings.

All the home construction warnings of the last 12 months cite the impact of last autumn's mortgage market disruption or rising interest rate rises on volumes and prices. Falling sales have made it more difficult to pass on higher costs and, whilst input cost inflation is falling, price and demand will remain under pressure well into 2024. EY ITEM Club expect house prices to broadly flatline this year, before falling by around 4% in 2024 as the impact of higher interest rates continues to feed through. This implies a peak-to-trough drop in prices of around 10%.

But there isn't the same level of price or land value shock that we saw in 2008-9 and the sector is in a stronger position to weather the storm. Most major housebuilders have lower operational leverage and stronger balance sheets than 2008. Indeed, many have been battening down the hatches for some time by limiting new phases of development, controlling their cost bases, and strengthening their balance sheets. This has left most with net cash and sizeable undrawn facilities. So, whilst stress and insolvency has increased amongst smaller, regional operators, there is a limited risk of widespread failure amongst major housebuilders.

Why is the supply chain more vulnerable?

It's a different, more troubled picture in the wider construction sector. Of the 27 profit warnings citing the slowing housing market in their profit warning in the last six months, the biggest group affected is FTSE Construction and Materials. In this period, eight of the 10 profit warnings issued by FTSE Construction and Materials sector – which doesn't include house builders – reference the slowing housing market.

Most construction subcontractors and material suppliers run on tighter margins and with higher operational gearing than house builders. But profit warning and insolvency levels have risen dramatically since the pandemic amongst smaller and increasingly mid-size and larger construction companies, who've felt the brunt of unprecedented cost, labour, and supply chain stresses in the last two years – with weaker housing activity now exacerbating these stresses for the most exposed. Overall, construction cost inflation is lower than last year but costs remain elevated and some major contractors are asking for price cuts from their subcontractors and suppliers to offset the impact of falling demand, pushing stress down the supply chain. Projects are also taking longer to develop, adding to costs.

The medium-term outlook for the housing sector is supported by the commitment of all UK political parties to address the undersupply of UK homes. But there is short-term pain ahead for the housebuilding sector, which also looks set to fall heavily on its supply chain.

FTSE Travel and Leisure

FTSE Travel and Leisure companies issued just eight profit warnings in the first nine months of 2023, compared with 22 in the same period of 2022. This is an exceptionally low level of warnings, but new risks are emerging.

Why focus on travel and leisure now?

By almost any measure travel and leisure companies have rebounded strongly since the pandemic. After defying economic gravity in 2023 with record profits in many cases, they will be hoping for another year of stretched consumers continuing to prioritise 'experience' spending. Demand has held up so far, but recent hospitality profit warnings and a rise in profit warnings in the global airline sector highlight growing risks.

What risks lie ahead?

Travel and leisure spending have benefited hugely from pent-up demand and high household savings levels, which created strong enough sales and price elasticity for companies to pass on their own rising costs. There are still positive sales expectations going into 2024, but persistently inflated costs – including oil prices – will continue to pressure margins, whilst persistent cost of living pressures could affect price elasticity, especially in the most squeezed income groups.

The latest EY Future consumer Index shows that the proportion of households putting affordability first has risen most sharply in low-income households, up from 42% in June 2022 to 54% in April 2023, compared with a rise from 24% to 39% for middle-income consumers and a rise from 11% to 17%. in the high-income bracket.

As well as rising oil prices, there is another potential source of cash pressure on the horizon for the travel sector. The CAA's final deliberations on ATOL (Air Travel Organisers' Licensing) reform are due this autumn, which will likely require changes in the way that companies under the scheme can use customers' cash. It now appears unlikely that the CAA will require all companies to fully segregate customers' cash until after their holiday, but some protection is inevitable. Long standing models that enabled companies to use customers' cash to pay for expenses that are usually charged upfront – like hotels – will need to change, which will tighten working capital positions and the debt capacity of companies that don't already use trust account models.

What proactive steps can companies take to prepare?

Companies serving the consumer need to keep adapting to the increasing differentiation their markets, factors influencing their customers' behaviour, and the changing level of demand and price elasticity in different market segments. Travel companies not currently using trust accounts – or equivalent – should be modelling what this means for their business and planning how they can adapt.

Companies also need to keep engaging with stakeholders. Auditors are asking more questions around going concern risks. Lenders may be more reluctant to commit to new facilities – especially if cash models are changing.

Companies in these sectors have adapted incredibly well to everything that has been thrown at it since the pandemic, but that need to adapt continues.

Other sectors to watch

FTSE Real Estate Investment and Services companies issued seven profit warnings in the first three quarters of 2023, compared with three in the same period of 2022. The percentage of companies warning in the year-to-date is still low – 13% – but this is a sector that is clearly exposed to stress in residential and commercial property sectors. Four of the nine warnings issued in the last year relate to the slowdown in the housing market. In commercial property, sums aren't adding up in the way they did in the years of steady building costs and ample credit.

FTSE Media companies have issued 10 warnings in the first three quarters of 2023, compared with five in the same period of 2022, with most warnings coming from the media agencies sub-sector. Two significant forces have taken media profit warnings to their highest level since the pandemic. Challenging macro-economic conditions and uncertainty have made customers more reluctant to commit. Meanwhile, macro-economic pressure on key search engines and social media sites has meant that they have prioritised customer engagement on their sites, ahead of third-party publishers.

FTSE Retailers have issued 15 profit warnings in the first three quarters of 2023, compared with 27 in the same period of 2022. Some cost and supply headwinds have eased, increasing EY ITEM Club's forecasts for consumer spending growth to 0.7% in 2023, from a flatline forecast before the summer. But rising oil prices, still-high inflation, and a weaker labour market are expected to keep pressure on consumer spending and we're seeing stress build across the sector. Brands and retailers need to meet the differences in spending patterns and attitudes between the cash-strapped and those willing to spend.

FTSE Industrial Support Services companies have issued 16 profit warnings in the first three quarters of 2023, compared with 13 in the same period of 2022. The pace of warnings is increasing, with four more in the first three weeks of the fourth quarter. The sector is often a barometer of business-to-business spending and confidence. Almost half of these warnings in 2023 came from employment and training agencies, reflecting the softening jobs market. Professional services companies, from facilities management to data management issued most of the remaining warnings.

UK overview

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South East

South West/Wales

Midlands/East Anglia

Yorkshire/North East

North West

Scotland and NI

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