A crunch year

EY-Parthenon quarterly analysis of UK profit warnings

Q4 2023

EY Parthenon

Building a better working world

Contents

Highlights
Q4 2023

Q4 2023 highlights

18.2%	25	41%	33%	18.8%
UK-listed companies warn in 2023	FTSE Industrial Support Services warnings in 2023	FTSE Chemicals companies warn in 2023	of Q4 23 warnings from companies with revenues over £1bn	median share price fall on the day of warning in Q4 23
The annual percentage of companies issuing warnings in 2023 surpasses 2008 – the height of the credit crisis	Cuts and delays in business spending and recruitment push sector warnings to their highest annual total since 2020	Demand uncertainty and destocking drives sector warnings to a record annual total of 11	Double the average number of larger companies issued profit warnings, as relentless earnings pressures take a wider toll	Investors react to profit warnings with the highest on-the-day share price fall in over four years

Jo Robinson
EY-Parthenon
Head of UK & Ireland Turnaround and Restructuring Strategy

A crunch year

Will the UK's economic clouds lift in 2024? Hopes are pinned on a quicker-than-expected fall in inflation and interest rates, but many moving parts need to fall into place before we can be sure of an economic 'soft landing'. Meanwhile, many companies are bracing for a crunch year of their own as they approach refinancing hurdles. The economy could be growing faster, but insolvency will be increasing too.

Our profit warning data underlines the relentlessness of the earnings and forecasting challenges that faced UK plc in 2023. Over 18% of UK-listed companies issued profit warnings over the course of the year, outstripping 2008's credit crunch total. Smaller companies, which tend to be more vulnerable to demand and margin pressures, dominated warnings at the start of the year. But, by the end of 2023, persistent pressure took its toll and, in the final quarter, a third of the 77 profit warnings came from companies with annual revenues over £1bn, more than double the average figure.

We start 2024 with increasingly optimistic hopes for inflation and interest rates, which would make the earnings and forecasting environment less daunting. But a smooth path to rate cuts and a soft-economic landing isn't guaranteed given the range of challenges ahead, including rising geopolitical tensions, supply chain disruption, electoral uncertainty and what is still weak growth.

Recent profit warning data also sounds a note of caution. At the end of 2023, we saw a rising number of profit warnings from sectors at the foundation of supply chains, like chemicals, and those reliant on business confidence, such as recruitment. Over a quarter of warnings in Q4 2023 cited slowing business decision making, whilst almost a fifth were triggered by weaker consumer confidence, which suggests an ongoing reluctance or inability to commit to discretionary spending amongst businesses and consumers.

As well as growth, capital will be a major challenge for many companies in 2024. In addition to higher financing costs, companies in stressed sectors and those with stressed balance sheets are also finding it increasingly difficult to renew existing finance agreements and face a longer road and high hurdles to refinance, as we discuss later in this paper.

All of which means that the brighter aggregate picture probably won't tell the whole story in 2024. We expect to see increasing disparity between businesses that are positioned to capitalise on still limited growth and those that are hampered by the bruising impact of recent earnings pressures or by the cost of access to capital. It's shaping up to be an easier year for many, but not all UK companies.

> "Over 18% of UK listed companies issued profit warnings over the course of the year.

Economic outlook

Risk and reward

The economic outlook is looking sunnier. After two years of minimal growth, the forecasts for 2024 are more positive. However, this improved outlook is not without its hazards, and there are still obstacles on the horizon.

Increasingly favourable inflation trends, the expectation of larger and earlier than expected interest rate cuts, and potential tax reductions have prompted EY ITEM Club to raise their growth predictions. They now expect a cut of 125bp in interest rates in 2024 – starting in May – compared with 100 basis points worth of cuts predicted in their Autumn forecast. As a consequence, their UK GDP forecast rises for 2024 to 0.9% from 0.7% predicted last October, helped by a 0.9% increase in consumer spending.

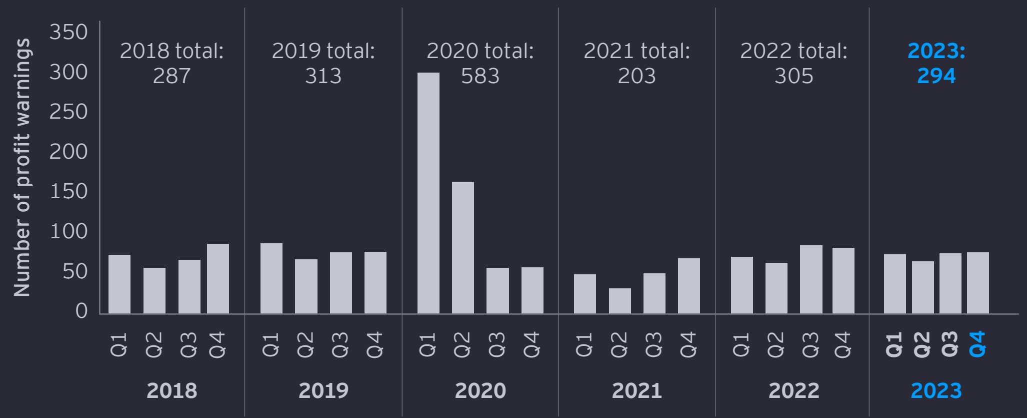
This is positive news, but interest rates would still remain higher than the decade before the pandemic. Moreover, this upgraded growth forecast is still subdued and is still caveated by now familiar levels of uncertainty.

As we start 2024, two of the biggest risks to these forecasts are rising geopolitical tensions and global political uncertainties. Disruption to travel through the Red Sea is increasing the time and cost of trade from Asia. The World Bank has warned that the global economy will slow for the third successive year in 2024 and is now on course for its weakest half-decade since the early 1990s. To add to the uncertainty, voters in more than 50 nations, representing almost half the world's population, will vote in national elections this year with significant policy repercussions.

So, whilst 2024 has more potential silver linings than 2023, companies still need to be prepared for another rollercoaster year. There is still an ongoing tug-of-war between the favourable inflation trends, potential interest rate cuts, and increasing consumer spending verses and on-going geopolitical concerns, policy uncertainties, and the lagged impact of interest rate increases on households and businesses. Companies will need resilience and strategic planning to stay the course.

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

Sector overview

Decision delays

We start 2024 with many of the pressures that have plagued earnings since the pandemic easing, but not relenting. The earnings and forecasting challenge is still acute in many parts of the economy, as our data underlines.

- The FTSE sectors with the highest number of warnings in Q4 2023 were: Industrial Support Services (9) and Retailers (9) and Media (7)
- The FTSE sectors with the highest number of warnings in 2023 were: Industrial Support Services (25), Retailers (24), and Software and Computer Services (21)
- The FTSE sectors with the highest percentage of companies' warning in 2023 were: Leisure Goods (50%), Household Goods and Home Construction (45%), Chemicals (41%), and Retailers (39%)[1]
- The primary triggers for profit warnings in 2023 were delayed or cancelled contracts (26%), increasing costs and overheads (19%), impact of higher interest rates (19%), and weaker consumer confidence (16%)

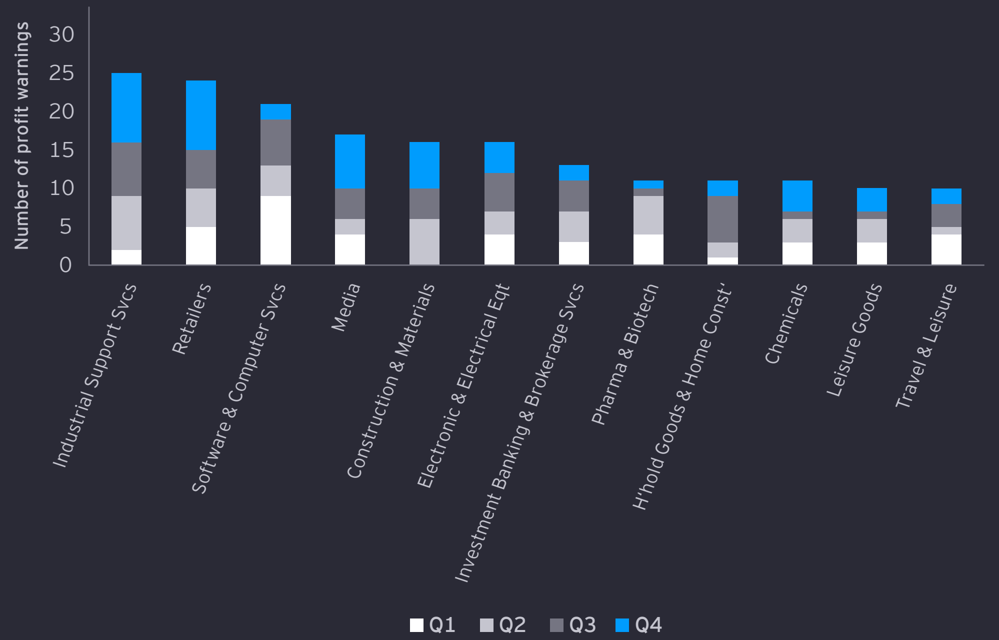
Supply chain disruption, high energy, labour and material costs, and the impact of rising interest rates have one by one contributed to heighted levels of profit warnings in the last two years. We don't normally see so many single factors dominate in succession and it's a measure of the scale of fiscal and monetary support and UK corporate resilience that there hasn't been a more significant increase in corporate failure. But the challenge isn't over yet.

Most of these pressures have eased, but not relented. In Q4 2023, changing credit conditions were cited in 15% of warnings, compared to 33% in the previous quarter, as improving interest rate expectations boosted the mortgage and housing markets. But the pressure from higher interest rates hasn't entirely subsided. Energy, material and labour costs are also higher than what companies might consider normal – though we're still lacking clarity on what "normal" looks like.

This lingering uncertainty is clear in our data. In Q4 2023, over a quarter of profit warnings were triggered by delayed or cancelled business spending. FTSE Industrial Support Services warnings reached their highest level since the pandemic, led by warnings from the recruitment sector. Warnings from FTSE Media companies also hit their highest level since 2020, due to a pull-back in client spending. Destocking drove FTSE Chemicals warnings to a record annual total. Although consumer spending on staples has recovered, an elevated level of warnings from FTSE Retailers underscores the ongoing pressure in discretionary spending – particularly in fashion.

Therefore growth in 2024 could be better than expected if confidence improves. But areas of vulnerability remain as lagged impact of interest rate increases passes through and as some companies continue to struggle to grapple with new cost and demand realities.

Top FTSE sectors warning in 2023



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

1 FTSE sectors with more than 10 constituents

Exploring alternative options

Borrowing costs are predicted to drop in 2024, but a growing number of businesses are still expected to hit refinancing barriers. What's fuelling this trend, what risk factors should companies and stakeholders consider, and how should companies prepare to avoid refinancing pitfalls?

After rising consistently for over a year, the average cost of corporate bank borrowing stabilised at around 7% in Q4 2023, according to the Bank of England. Borrowing costs are expected to fall in-line with the base rate in 2024, but this will still leave the cost of finance significantly higher than December 2021's average rate of 2%. Moreover, it's structural changes in the lending market, as much as the increasing cost of refinance, that's resulting in unexpected refinancing issues.

Banks have de-risked their portfolio in the last decade, which has contributed to bank lending now making up less than 50% of UK corporate debt, from 60% in 2009. Alongside this change in banks' risk profiles, a sharp rise in debt costs – combined with earnings pressures – means that the arithmetic of lending differs notably from the calculations of three to five years ago.

We are working with an increasing number of companies that expected a simple 'rollover' of their debt but have faced closed doors. Risk factors include being in a stressed sector like retail, construction and real estate; high leverage; complicating commitments – like 'Time to Pay'; breaches or forecasted breaches of covenants; poor trading performance; credit insurance issues; and poor management data.

Alternative finance providers have stepped in during the last decade to provide companies with more options, but businesses need to be aware that this may require a different approach, with different levels of data and analysis.

So how should companies tackle the refinancing challenge ahead?

1. **Advanced preparation:** At least a year ahead of time, companies should start refinancing conversations with advisors and lenders, find and address risk factors, and understand their options.
2. **A compelling case:** Companies need credible numbers and forecasts – as well as a strong story – to build their refinancing case. This is going to be a harder process and longer sell in this refinancing round.
3. **Consultation:** Uncertainty can hamper a refinancing and it's vital to keep stakeholders informed. Companies also may not be aware of all the options open or how to approach alternative lenders and guidance can help avoid missteps and expensive mistakes.

Spending delays became the main reason for warning in Q4 2023

Market reaction

Investor caution

Companies issuing profit warnings saw their share prices fall by the highest amount in over four years in Q4 2023. Market sentiment improved over the quarter, but this can raise the stakes for companies downgrading their earnings forecasts.

The median share price fall on the day of profit warning rose to 18.8% in Q4 2023 from 15.1% in Q3 2023, making this the highest fall since Q2 2019. The average fall also rose to 20.2% in Q4 2023 from 18.4% in Q3 2023.

This reaction stands in stark contrast to a backdrop of improving market sentiment, especially towards the end of the quarter, as better-than-expected inflation data increased market hopes of more and earlier rate cuts in 2024. By the start of the year, markets were pricing in 1.25% worth of interest rate cuts in 2024 starting in May, compared to October's expectation of 0.75% of cuts starting in July.

This positive sentiment also spread to equity market. The FTSE All-Share rose by 4% and the AIM index increased 6% across the final quarter. So why has negative sentiment towards profit warnings increased?

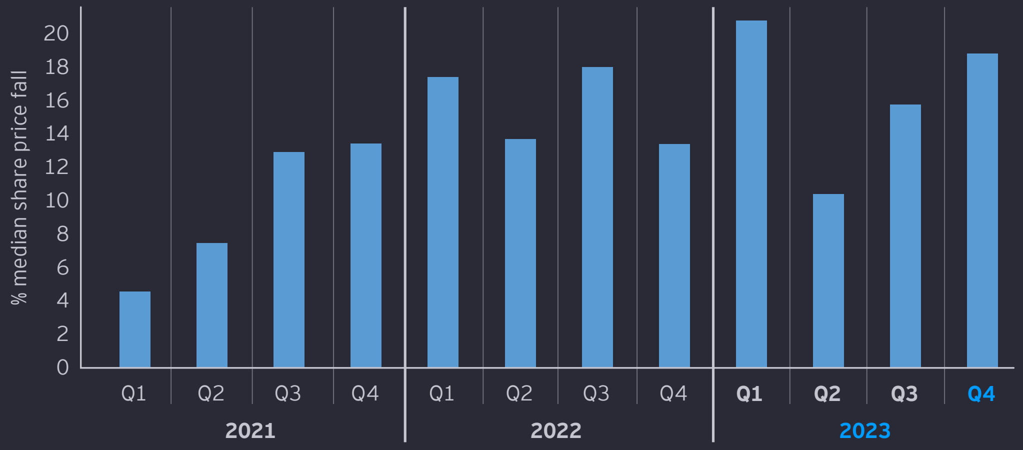
Usually when investor reaction to profit warnings jumps so dramatically, it's when investors are facing uncertainty and seeking safety. This is what we saw in Q2 2019, the last time median share price falls were so high. But reaction can also increase when the economy is recovering – as we saw coming out of the pandemic – when investors start to differentiate between companies set for recovery and those that are lagging.

Companies who have issued profit warnings could find it difficult to raise both debt and equity capital, unless they can retain investor confidence – even if overall market confidence improves. A rising tide doesn't always lift all boats.

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

Investors move back into 'risk-off' mode for warning companies

% median share price drop on day of warning



Warning signals

Our profit warning data can act as a lagging and leading indicator. It reveals the trends of the last quarter but can also help us understand where pressures are building and the patterns that could influence restructuring activity.

Barring another exceptional earnings shock, we appear to have passed the peak of profit warnings in this cycle. This is important because our data shows that we'd normally expect the UK insolvency peak to follow nine-to-twelve months later. There are several factors that make this cycle anything but typical, from pandemic support, to extended maturity cycles to an increase in solvent restructuring and financing options – all of which could elongate and alter the shape of the insolvency curve. But what we can say with confidence is that we haven't seen the peak of corporate restructuring yet – at least not amongst mid-market or larger-cap companies.

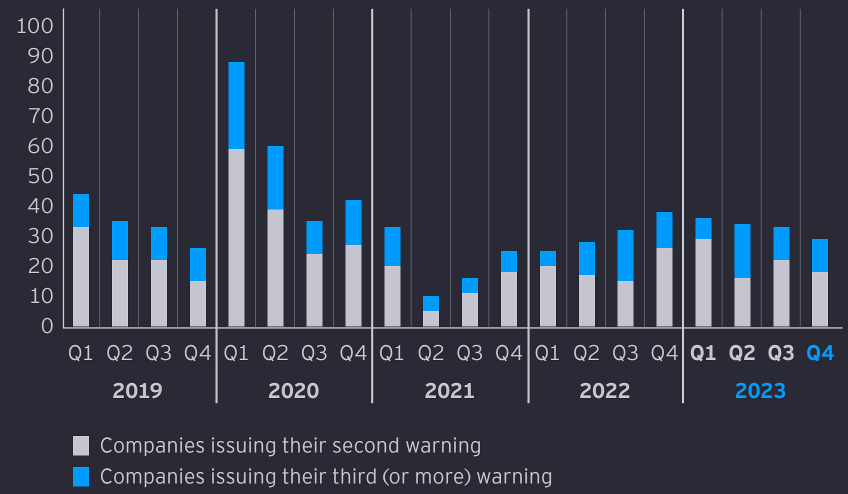
This size distinction is important. Insolvency levels have already risen sharply, but this is predominantly due to a surge in Creditors Voluntary Liquidations (CVLs), triggered by the delayed impact of the pandemic and escalating costs that hit smaller companies first and hardest. Our profit warning data in 2022 and early 2023 reflected this focus of pressure on smaller companies. But, from mid-2023 persistent earnings pressures took a wider toll and we started to see profit warnings and restructuring activity expand in the mid-market and beyond. The near doubling of profit warnings amongst businesses with annual revenues over £1bn is a signal that we have more larger restructurings to come.

This might seem contradictory to recent, more positive economic data. But what we often see at this point in the cycle is a growing divergence between companies able to catch the wave of recovery and those too caught up in financial or operational issues to benefit. This means that we can see fewer profit warnings, but also a higher proportion of those warnings coming from companies issuing multiple profit warnings. The number of companies issuing at least three warnings in a 12-month period rose to 39 companies in 2023, compared with 31 companies in 2022 and 23 in 2021. Of these companies we'd normally expect 20% to delist within a year of their third warning – 10% due to insolvency.

Where is this pressure building? The sector focus of profit warnings has shifted continuously in the last two years and overall stress has been broad based, driven by situational factors – like a refinancing need – as much as sector trends. We expect this to continue in 2024. But there is one standout trend in our data to watch now: the reluctance of businesses and consumers to commit to significant discretionary spending – from recruitment to fashion – with pressure building in vulnerable sectors like software, business support services, media and non-food retail. It's a trend that also suggests, whatever growth there is in 2024, it will be hard won.

In 2023, 18% of companies warning have done so for the third time in 12 months

Companies issuing their second or third warning in a rolling 12-month period



Sectors to watch

FTSE Media

FTSE Media companies issued seven profit warnings in Q4 2023, the highest quarterly total since the start of the pandemic. An exceptional intersection of cyclical and structural challenges — that's hit both' traditional' and 'new' media sectors — has created this exceptional rise in profit warnings. There were 17 warnings in total in 2023, a threefold increase compared to 2022, with 35% of the sector warning.

A storm of adverse factors hit almost all points of the media sector in 2023 The 14 companies warning are split between the advertising and marketing sector and publishing, with publishers split evenly between 'traditional' and 'new' media. The events category was an unusual bright spot, as it continued to recover from pandemic disruption. But elsewhere low consumer spending and confidence led to companies prioritising short-term and tactical advertising, hitting advertising agencies and companies that depend on advertising revenues, such as publications and broadcasters. The US writers' strike hit many TV and film companies. Meanwhile, changes in search engine third-party cookies and social media algorithms, which adjusted how advertising and news are displayed on their platforms, had a widespread impact.

The US writers' strike has ended, but relief from 2023's other challenges won't be straightforward. Companies are cautiously waiting for consumer spending to pick up before increasing their advertising spending. The declining inflation rate and major 2024 sporting events like the Olympics and Euro 2024 offers some optimism. However, EY ITEM Club forecasts a relatively slow growth in consumer spending this year at 0.9%, only increasing to 1.8% in 2025. Further boosts could come in late 2024 from the US election and a possible UK election, but companies reliant on advertising spending may face some challenging months ahead.

Structural changes to search engines and social media platforms are another ongoing challenge to online advertising and content. Browser and search-engine withdrawal of third-party cookies has made it more difficult for advertisers to track potential consumers' web activity, significantly affecting remarketing efforts. Social media platforms have also altered their algorithms to prioritize platform content over news content. These changes pose problems for traditional media companies expanding their digital footprint and new media companies, many of which are facing their first significant challenge to their business models.

But, whilst many media companies — 'traditional' and 'new' — face similar short-term obstacles, their responses need to reflect their unique long-term challenges. Across the sector, companies need to reassess market structure changes and prioritize strategic investments. For traditional media companies this will mean balancing the managed decline of certain segments while expanding digitally and competing with more agile competitors. New media companies, on the other hand, need to think about how they sustain growth amid sector maturation and new competitive dynamics.

Despite these challenges, the media sector holds substantial growth potential, with expectations for further growth, more innovation, and increased deal activity.

FTSE Retailers

FTSE Retailers issued 24 profit warnings in 2023, a third fewer than the 36 warnings issued during an exceptionally challenging 2022. However, retail was still one of the hardest hit sectors last year, with two out of every five companies issuing warnings. The strain on disposable incomes is easing, but slowly, and discretionary spending looks set to remain under pressure in 2024.

It feels like a tale of two Christmases. The grocery sector is the main winner of a tough festive period as it continued its earnings recovery. Profit warnings from the FTSE Personal Care, Drug and Grocery Stores sector, which includes supermarkets, dropped from 16 in 2022 to just three in 2023. BRC (British Retail Consortium) data shows food sales rising 6.8% during the three months to December.

This rise contrasts sharply with a 1.5% drop in non-food sales over the final quarter after another difficult year. Profit warnings from FTSE Retailers dropped at the start of 2023 after 50% of the sector had warned in 2022. But in the final quarter of 2023, profit warnings surged again back to nine – equal to the final quarter of 2022 – underlining the difficult run into Christmas. Over half of these nine warnings came from fashion retailers, who were hit by a combination of pressure on discretionary spending and the mild autumn weather.

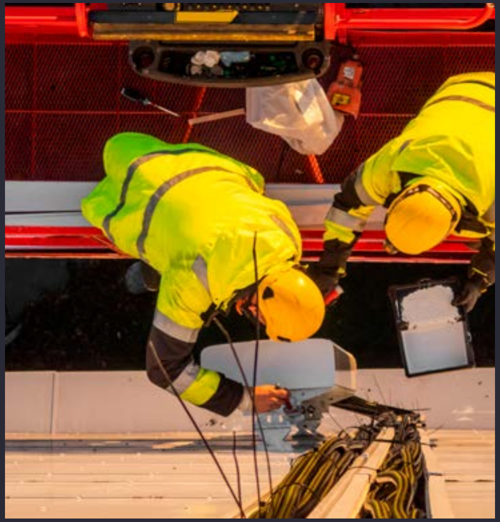
Some relief is coming. EY ITEM Club expects consumer spending growth to rise to 0.9% in 2024, up from 0.7% projected in the Autumn Forecast and 0.6% estimated growth in 2023. The improvement in the forecast is due to their expectation that nominal household income should comfortably outpace inflation in 2024, with growth also supported by low unemployment. But there are some risks to this forecast and, whilst inflation is falling, consumers are still facing significant pressures on their budgets from over a year of above wage-growth increases. In 2024, 1.5m mortgages will also need to be renewed at significantly higher interest rates, with an average increase in annual housing costs of around £1,800.

So, whilst consumer spending growth will improve in 2024, the improvement will be limited, and growth in consumer spending will remain well below the 2% and above we saw before the pandemic. And whilst cost pressures on retailers are falling, gain they are still relatively high and they will need to contend with the April rise in business rates, as well as the implication of supply issues, if disruption continues in the Red Sea.

All of which means that growth still be hard won for retailers in 2024. The post-Christmas earnings season shows that there can be winners even in this tough market. As we've seen before, when spending comes under pressure, a gap often opens between retailers that have the proposition to capture limited consumer spending and those that struggle to adapt their business model to customer needs.

Other sectors to watch

FTSE Industrial Support Services companies issued 25 profit warnings in 2023, 50% higher than 2022. The sector is often a barometer of business-to-business spending and confidence and the rise in warnings reflects a broader message in our data, which suggests a cautious approach to business spending and recruitment commitments. Almost half of the nine warnings issued in Q4 2023 came from employment and training companies. Professional services companies, from facilities management to data management issued the remaining warnings.



FTSE Real Estate Investment and Services companies issued eight profit warnings in 2023, compared with five in the same period of 2022. In 2023, 16% of companies warned, which is still low compared with other sectors. Falling interest rate expectations have also increased sector NAV (Net Asset Value) and eased concerns in the housing market, which contributed almost half of the warnings issued in the last year. But in many parts of the real estate sector, especially commercial property, sums aren't adding up in the way they did in the years of steady building costs and ample credit.

FTSE Chemicals companies issued 11 profit warnings in 2023 and four warnings in Q4 2023, with 41% of the sector warning over the course of the year. This is the highest annual total we've recorded since we started recording data in 1999. Cost pressures are diminishing, but most warnings relate to slowing sales, with demand uncertainty causing customers to delay spending and reduce inventory. The sector's position in the supply chain means that it reflects growth and confidence in the broader economy, so a pick-up in both will help the sector.

FTSE Leisure Goods companies issued ten warnings in 2023, the highest annual total since 2007. Over the course of 2023 50% of the sector issued a profit warning, the highest level across all 42 FTSE industry groupings. This sector includes a diverse group of companies, but they all have in common their exposure to under-pressure consumer discretionary spending. This includes companies in the gaming sector, which benefited from elevated levels of demand during the pandemic but now face slower demand, fast-moving markets and increasing competition.

UK overview

[Please click the buttons to find out more]

London
South East
South West/Wales
Midlands/East Anglia
Yorkshire/North East
North West
Scotland and NI

Your EY contacts

Jo Robinson
UK & Ireland Turnaround and Restructuring Strategy Leader
+ 44 20 7951 9817
jrobinson1@parthenon.ey.com

Alan Hudson
UK & Ireland Turnaround and Restructuring Strategy Partner, Global Insolvency Leader
+ 44 20 7951 9947
ahudson@parthenon.ey.com

Amanda Blackhall O'Sullivan
UK & Ireland Turnaround and Restructuring Strategy Partner, Credit Advisory Lead
+ 44 20 7951 7847
ablackhallosullivan@parthenon.ey.com

Simon Edel
UK & Ireland Turnaround and Restructuring Strategy Partner, Insolvency Lead
+ 44 20 7951 9904
sedel@parthenon.ey.com

Sam Woodward
UK & Ireland Turnaround and Restructuring Strategy Partner, National Markets Lead
+ 44 161 333 2616
swoodward@parthenon.ey.com

Kirsten Tompkins
Market Analyst and Author
+ 44 121 535 2504
ktompkins@parthenon.ey.com

Silvia Rindone
UK & Ireland Strategy & Transactions Leader, Retail Sector Lead
+ 44 20 7951 4157
silvia.rindone@parthenon.ey.com

Jon Morris
Private Equity Value Creation Partner, Cash and Working Capital Lead
+ 44 20 7951 9869
jmorris10@parthenon.ey.com

Meg Wilson
UK & Ireland Reshaping Results Partner, Travel Sector Lead
+ 44 20 7760 8192
meg.wilson@parthenon.ey.com

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

contacts

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

About EY-Parthenon

EY-Parthenon teams work with clients to navigate complexity by helping them to reimagine their eco-systems, reshape their portfolios and reinvent themselves for a better future. With global connectivity and scale, EY-Parthenon teams focus on Strategy Realized – helping CEOs design and deliver strategies to better manage challenges while maximizing opportunities as they look to transform their businesses. From idea to implementation, EY-Parthenon teams help organizations to build a better working world by fostering long-term value. EY-Parthenon is a brand under which a number of EY member firms across the globe provide strategy consulting services. For more information, please visit ey.com/parthenon.

Ernst & Young LLP

The UK firm Ernst & Young LLP is a limited liability partnership registered in England and Wales with registered number OC300001 and is a member firm of Ernst & Young Global Limited.

Ernst & Young LLP, 1 More London Place, London, SE1 2AF.

EYSCORE 000634-24-UK
UKC-032191.indd (UK) 01/24. Artwork by Creative UK.
ED None

ey.com/uk