Predictably unpredictable

EY-Parthenon quarterly analysis of UK profit warnings

Q3 2022

EY Parthenon

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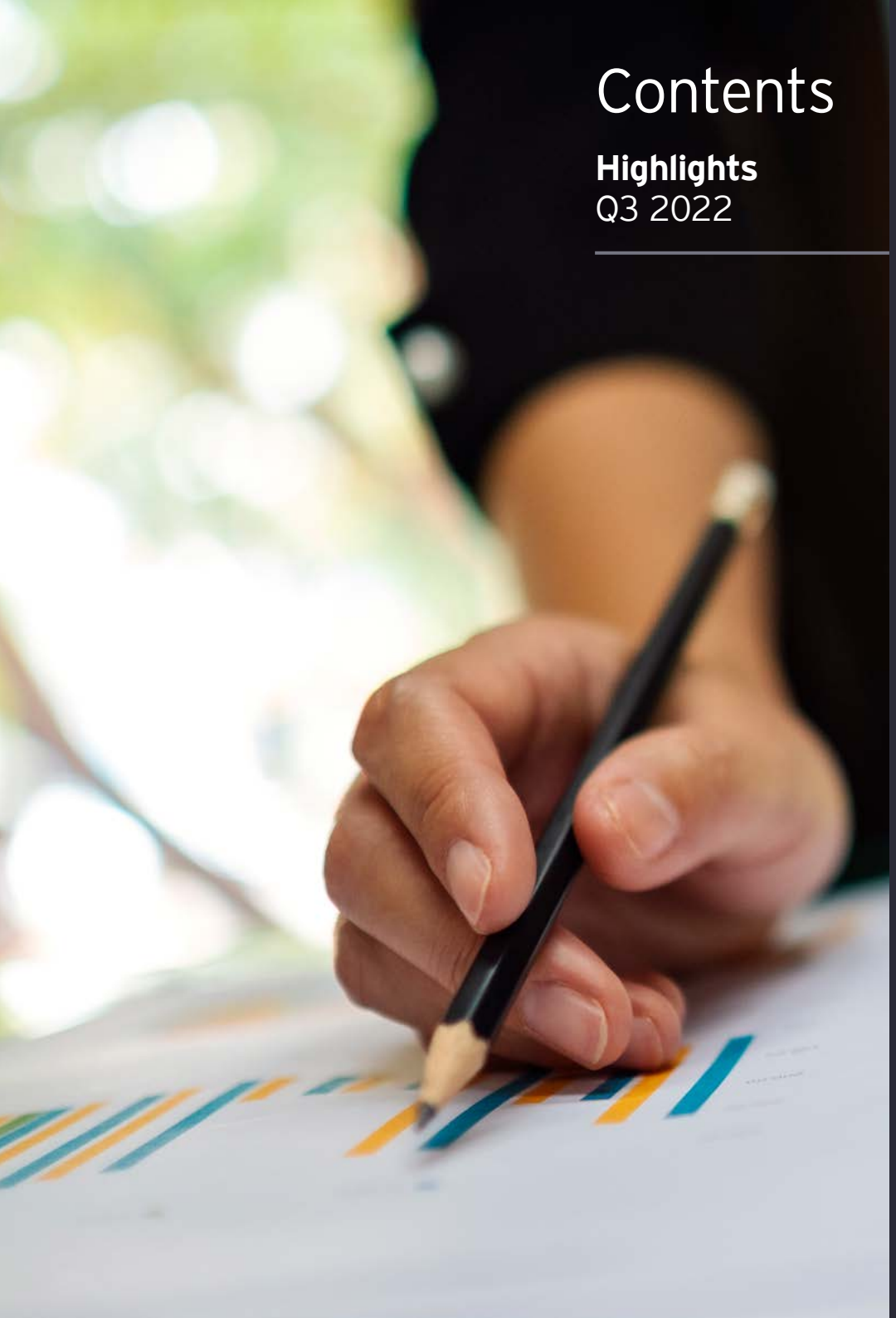

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Q3 2022 highlights

86	57%	23%	44	28
Q3 2022 profit warnings	Q3 2022 profit warnings cite increasing costs	Q3 2022 profit warnings cite labour market issues	profit warnings from companies in consumer sectors	UK-listed companies in the three warning 'danger zone'
The highest third quarter total since 2008 and a third higher than the post-financial crisis average	The number of warnings citing rising costs remains exceptionally high as companies struggle to pass on price increases	Labour costs, shortages, and the impact of strike action feature in a record percentage of profit warnings	The highest number of consumer-sector warnings since the pandemic	Within a year of the third warning, a quarter of companies have a covenant event and over 10% go through a restructuring process

Escalating pressures

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

UK-listed companies have issued the highest third-quarter total of profit warnings since 2008. An exceptional combination of issues lies behind this extraordinary total and rapid reappraisals of company forecasts and plans. With so much uncertainty and so many challenges to address, where should management teams focus now?

For every headwind that eased over the summer, at least two more seemed to appear. Global supply chains are moving more freely. Oil prices have eased back from their spring high. But some of this easing is due to sudden downturns in demand and confidence that have left many companies with excess inventory. Meanwhile, geopolitical, fiscal, and monetary policy stresses and uncertainties have heightened financial market volatility, weakening the pound, triggering a pensions crisis, and tightening debt markets for companies and consumers.

As we've said before, it's not just the number of headwinds, or even their strength that's the problem. Arguably the biggest issue is the way that they are interacting to leave companies and policymakers facing near-impossible choices. This challenge has escalated through summer into autumn. It is increasingly difficult for companies to balance competing priorities and increasingly challenging for policymakers to manage conflicting demands.

In this paper we explore the issues that have caused so many companies to issue profit warnings and where management teams should focus to avoid further warnings and more profound consequences. The risk of a 'cash crunch' has risen significantly for many companies. We think three of the pressing areas to address now are to use the breathing space provided by the energy price cap, understand how different scenarios will affect cash flows, and reassess their capital needs in the light of market changes.

But, with so many uncertainties in the outlook it's vital that all companies think about how they develop resilience and show a clear understanding of how their business will adapt under different geopolitical and economic scenarios. Options for stressed and distressed companies are diminishing. Increasing uncertainty and risk aversion will accelerate events if companies do not respond to situations swiftly, present sustainable and defendable forecasts, and build stakeholder trust in their ability to turn the situation around.

> "For every headwind that eased over the summer, at least two more seemed to appear.

Economic outlook

New model

The outlook has weakened and become even less certain since our last update. EY ITEM Club's latest forecast predicts that the UK will be in recession until next summer, with a GDP contraction of 0.3% expected in 2023, a significant downgrade from the 1% growth forecast in July.

This should be a shallower downturn than recent recessions. Employment levels are still high. Government support for households and the cap on consumer and business energy bills has lowered the forecast peak of inflation in October to just below 11%, compared with the 15% expected without government intervention. But this still leaves inflation outpacing wage increases until 2024 and household real incomes falling by the greatest extent since the 1970s in the next 12 months.

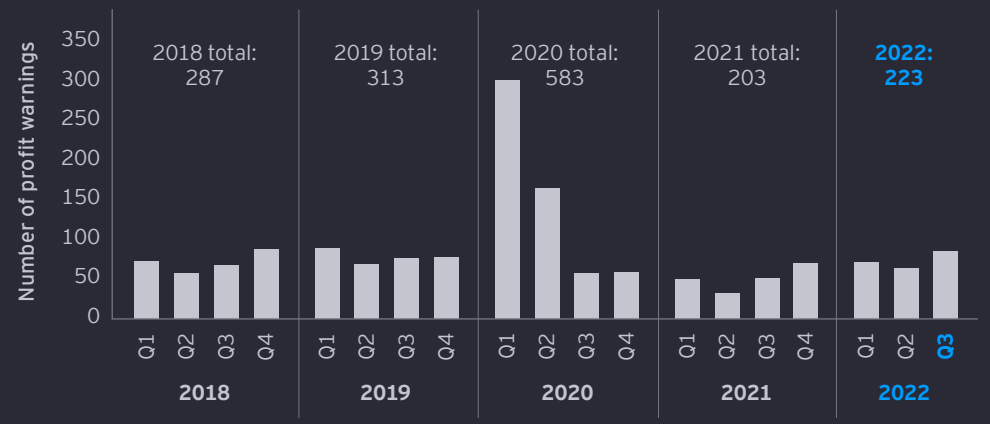
The pressure on consumer spending, that we're already seeing manifest in exceptionally elevated levels of profit warnings, shows no signs of letting up. Alongside the inflationary hit to real incomes and an increasing tax burden, rising mortgage payments will diminish mortgage-holders' disposable incomes as they refinance onto much higher rates. ITEM now expects consumer spending to contract in 2023, compared to an earlier forecast of 0.8% growth.

It is hard for the UK economy to outrun weakness on the consumer side. There are some positives elsewhere as global supply chain and price pressures ease in some commodities. A weaker pound also offers help for exporters, but with the flipside of the impact on dollar-denominated import prices and slower global growth.

ITEM expect the outlook to improve by the end of 2023, when inflation is expected to ease, exports pick up and interest rates fall. But there is a painful adjustment to navigate before then with significant downside risks. For the first time in over a decade, monetary policy is tightening at the same time as fiscal spending.

It is exceptionally difficult for companies to forecast and plan. Businesses need to think about how they build resilience and adapt to different scenarios, whilst also being mindful of the support they provide to their suppliers, customers and employees.

Profit warning levels are higher than average
Number of profit warnings by quarter



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

Sector overview

Tumbling confidence

Companies in consumer sectors continue to issue an exceptional number of profit warnings. But stress is building elsewhere due to the cumulative impact of ongoing cost, labour, and demand headwinds and new uncertainties that are increasing the forecasting and planning challenge.

The FTSE sectors with the highest number of warnings in Q3 2022 were Retailers (11), Travel and Leisure (9), and Food Producers (7).

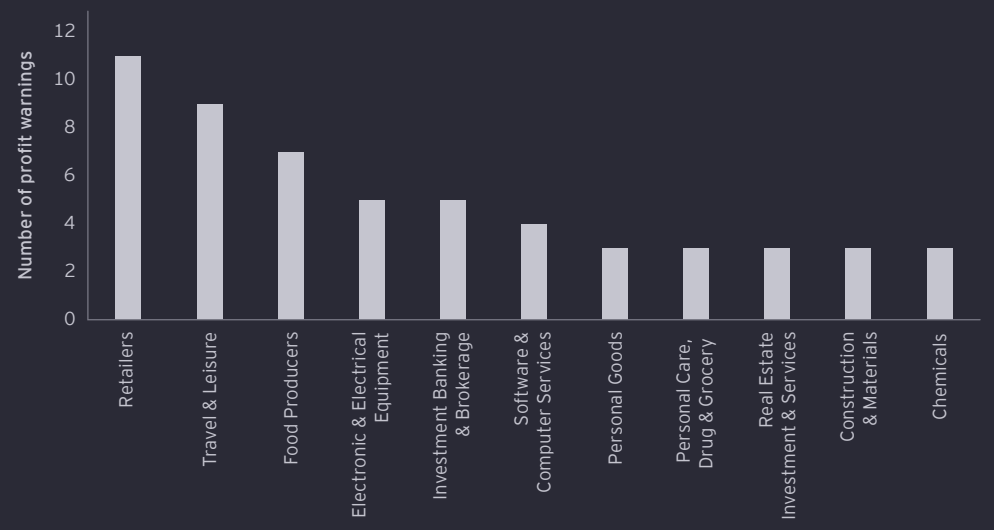
Profit warnings from consumer sectors dominated in Q3 2022, rising almost three-fold year-on-year to reach their highest level since the pandemic. This rise is clearly the driving force behind the 69% year-on-year increase in profit warnings and a 34% increase quarter-on-quarter overall.

Cost issues featured in 70% of consumer sector warnings in Q3 2022, well above the 57% average. Difficulties passing cost increases through to consumers clearly escalated over the summer due to a further sharp fall in confidence. Weaker confidence and changing buying behaviour featured in 50% of consumer sector warnings and almost every retailer warning since mid-August. Inventory issues are an increasing theme due to this whipsaw change in market dynamics – from problems with supply, to a steep dip in demand.

Beyond consumer sectors, pressure is building elsewhere. Cost and labour market issues are still acute and widespread across sectors as diverse as insurance, electronics and construction. Stress often hits first and hardest amongst smaller suppliers and contractors. Although, sectors like construction will be aware of the impact of stress and failure on the supply chain and we are seeing more collaborative approaches to cost sharing.

Energy price caps, falling demand and easing supply chain issues may ease some inflationary pressures through the final quarter. But 2022 has been like a game of 'whack a mole'. As one warning trigger recedes, new ones appear. A weak pound has historically taken some time to translate into a peak of profit warnings due to protective hedging. But in 2008-09, sterling weakness ultimately contributed towards warnings in a wide range of sectors, focussed in businesses that import in dollars – such as retailers, engineers, and technology companies – and major users of fuel, especially airlines. Changing fiscal priorities will also change the amount and distribution of government spending – which had a dramatic impact after the last financial crisis.

Top FTSE sectors warning, Q3 2022



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Avoiding a winter cash crunch

Our profit warning data underlines the increasing risk of a liquidity crunch this winter. What actions can companies take to build resilience and preserve cash?

The intense cost, supply, labour and demand pressures highlighted in our profit warning data underline the increasing risk of a cash crunch this winter due to pressure on and sudden changes in working capital.

Companies that had stocked up on inventory have been left holding excess stock as demand and confidence fell. Companies with a positive working capital requirement have seen their balance sheets balloon as rising costs cause debtor and inventory values to rise. The weak pound, rising interest rates, and funding issues add to these pressures.

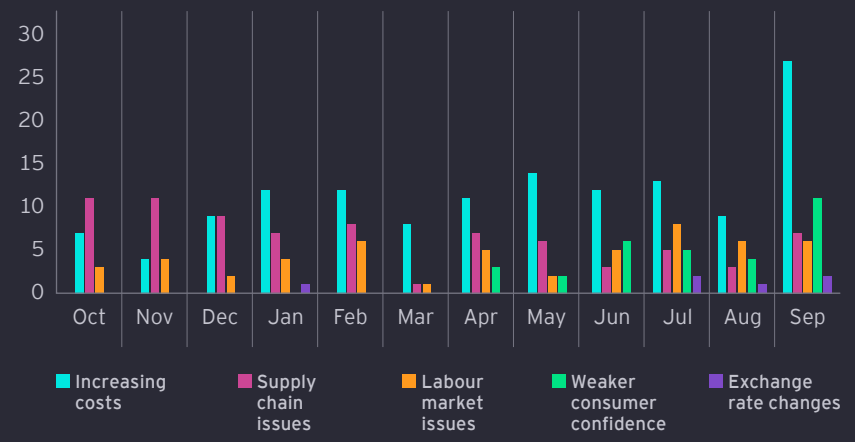
EY's analysis of payment practices data already shows weakening in some pressurised sectors. But whilst delaying payment can help ease pressures on working capital, it is a short-term and often counterproductive measure if it damages vital supplier relationships and causes financial hardship in the supply chain. Companies need suppliers and other key stakeholders on their side.

Credit insurers are already reducing cover which, as we've seen in prior downturns, can have a dramatic impact on corporate cash balances if suppliers tighten their terms. Other areas of soft credit, like cash advances from credit card processors, could come under pressure too, especially in sectors like travel and big-ticket retail, where there is a significant gap between customer payment and the delivery of product or service. We think the three biggest priorities for companies will be:

- The first step for companies should be to use the six months' breathing space offered by the energy price cap to look for ways to lower energy use and costs.
- They need to understand how different scenarios will affect working capital and if they have sufficient liquidity to manage through a range of demand and cost outcomes. Some products and activities can tie up a disproportionate share of the balance sheet. Companies need to assess if it's possible to release working capital – for example by narrowing the product range.
- Companies need to address immediate funding needs and reassess their funding costs in the wake of changing debt market pricing. Extra capital to plug gaps is becoming harder to come by.

Balancing financial and operational impacts can be complex and involve tough decisions, but it is easier to act from a stable position than to wait until action is urgent.

Cost pressures rise and confidence falls



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New benchmarks

The 'risk off' investor sentiment that appeared in the second quarter has intensified. Geopolitical and policy uncertainty, and continuous resets of growth and interest rate expectations have created a febrile market atmosphere. Options for companies looking to fundraise have become more expensive and limited. This isn't a forgiving market for companies that misstep.

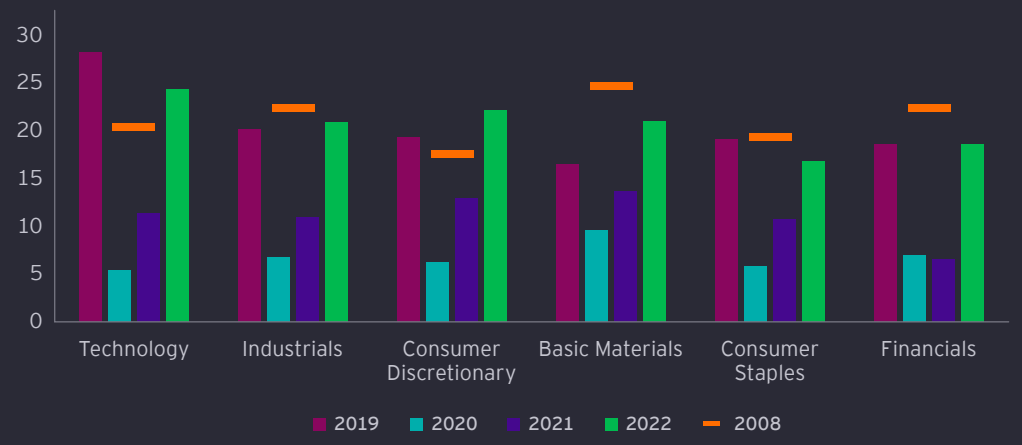
We can see increasing investor differentiation and risk aversion in our profit warning data. First day share price falls are still just below their 2008 peak, where they hit an average of 22.5% in Q3 2008, compared with 21.8% in Q3 2022. But as the chart shows, this isn't the case in all sectors. Companies in FTSE Consumer Discretionary sectors, including retail, travel and hospitality, have recorded average share price falls even higher than the peak of the global financial crisis, as investors react to increasing strain on discretionary spending.

Interest rate expectations and debt market benchmarks have also risen as political uncertainty and investor risk aversion increases and inflationary pressures continue to drive central bank action. By the start of the fourth quarter, average yields on sterling corporate bonds were almost 7%, up from 2% last year. Companies with floating rate bank debt are already feeling the impact of rising interest rates that are forecast to peak at around 5.5% in 2023, compared with a peak of around 4% that was anticipated in mid-2022.

As discussed elsewhere in this paper, options for stressed companies are diminishing rapidly as potential sources of capital – and buyers – delay and wait for greater certainty. Meanwhile, the sheer speed of change and price movements is also increasing the risk that more parts of the market will be caught out by sudden moves – as we saw when the Bank of England had to intervene to prevent a pensions crisis.

Investors are looking for companies that are resilient enough to come through a painful period of monetary and fiscal adjustment and economic downturn. The last eight months of above-average levels of profit warnings have reset earnings expectations, but there is risk of further pain to come, and investors are likely to remain unforgiving of further missteps.

First day share price falls are close to 2008 levels
Average share price fall on the day of warning, %



Diminishing options

In our last paper we showed how the 'rule of three' – the long-standing link between multiple warnings and restructuring – broke during the pandemic but returned in 2021. This quarter we have looked in more detail at the fate of companies who recently issued their third warning, with worrying implications for businesses hitting this unwelcome milestone.

An increasing proportion of companies are issuing their third or more warning in a 12-month period. As of mid-October, 28 companies had issued at least three warnings in the prior 12-month period, a significant increase from 18 companies a quarter ago. Of these companies, two-thirds are in consumer sectors and ten come from the two main retail and grocery sectors – FTSE Retailers and FTSE Personal Care, Drug and Grocery Stores.

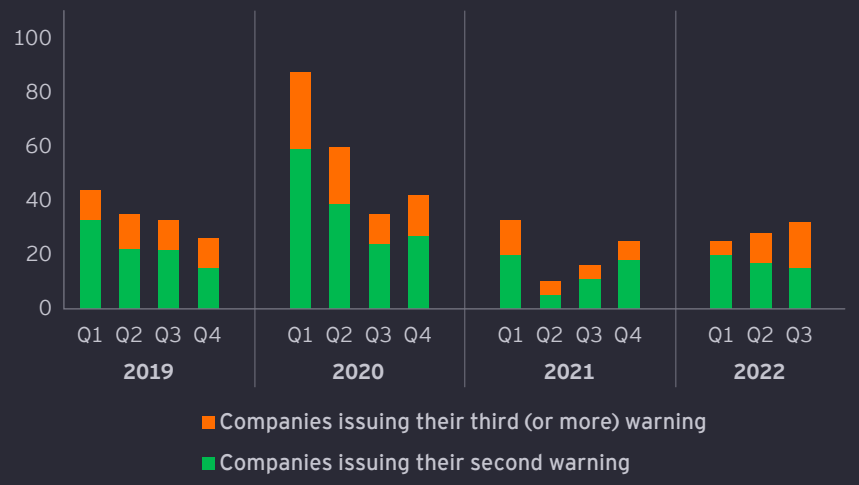
Why is this concerning? Our pre-pandemic analysis showed that 12% of companies that issued three or profit warnings in a 12-month period had gone through a formal restructuring process within a year of their third warning and over 20% had delisted. These numbers dropped dramatically for companies warning in 2020. But our latest analysis shows that, of those companies hitting the three-warning mark in 2021, 13% have been through a restructuring process and 17% have delisted.

If we look in more detail at this 2021 group, a quarter had a covenant event within a year of their third warning – in line with the pre-pandemic average – but just 4% have completed a rights issue, well below the 16% who raised capital after issuing their third warning in 2019 and 35% in 2020.

Some of this fall in equity issues may be due to increased cash balances after the pandemic. But we've also heard privately and publicly from companies that it was becoming increasingly difficult to raise capital in equity and debt markets, even before recent market volatility.

It's not just market anxiety that's making it harder to raise capital. Difficulties forecasting through uncertainty have also made it harder to access capital, whilst also limiting M&A activity. Options for stressed companies are closing, making it even more vital that companies build and show resilience to retain stakeholder confidence.

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



FTSE Retailers

A triple-whammy of demand, supply chain and cost headwinds were already severely testing the sector before this summer's further sharp drop in consumer confidence and the autumn rise in mortgage rates.

- Over 40% of FTSE Retailers and over 60% of the FTSE Personal Care, Drug and Grocery Stores sector have issued a profit warning in the last 12 months. The pressure is such that the combined percentage of companies warning is higher than 2008.
- Many retailers that increased inventory in response to supply chain delays have been left holding excess stock as demand and confidence fell away over the summer. In Q3 2022, 64% of FTSE Retailers profit warnings cited the impact of weaker confidence on consumer behaviour.
- Excess inventory is an especially pressing issue for those that placed orders for seasonal wear, a winter World Cup, and Christmas before the summer downturn. Heavy sector discounting has started well ahead of Black Friday.
- The energy price cap will provide temporary relief. High employment and savings should help support spending. But new challenges like the strong dollar, rising interest rates and strikes at major ports will also join ongoing cost and labour issues to make this a difficult winter.
- Retailers risk the support of key stakeholders, including credit insurers, if they cannot demonstrate their resilience. Issues typically come to a head after Christmas, but events could move quickly given increasing funding pressures.
- To build resilience, retailers need to review pricing strategies and ranges, rationalise their offering, and consider how they can pass price rises on. They need to develop robust plans around cash management and inventory visibility to minimise costly write-offs.
- Retailers will need operational and financial resilience – and capital – to adapt to fundamental changes in consumer behaviour. EY's Future Consumer Index shows that the market is polarised between cash strapped consumers watching every penny and those willing and able to spend if retailers entice them.
- Understanding and adapting to these changes is key to securing long-term growth.

FTSE Travel & Leisure

The sector has been the beneficiary of pent-up demand and exceptionally high levels of consumer savings, but unrelenting costs pressures are hitting home – especially in hospitality, as disposable incomes come under greater pressure.

- FTSE Travel and Leisure companies issued 22 profit warnings in the first three quarters of 2022, double 2021's total. The nine warnings issued in Q3 2022 is the highest since Q2 2020.
- This is the first quarter since the economy fully opened after the pandemic where falling demand has been a significant feature of the sector's profit warnings.
- Spending on travel and leisure has historically been 'sticky', even during a downturn and travel demand in particular has been robust in 2022. But real incomes are set to experience their greatest hit since the 1970s at a critical time for the sector.
- The travel sector benefited from strong summer demand, but disruption at UK airports dampened the recovery for tour operators and airlines.
- Traditionally, winter was when tour operators took in summer travel deposits. But, in recent years, consumers have tended to book later and later, stretching company balance sheets, and making it hard to gauge demand. Bookings could be delayed even further this year by consumers worried about 2023 finances.
- Christmas is also a vital period in hospitality, which should also benefit from a winter World Cup. But many businesses don't have enough staff to meet normal levels of demand. Companies also face the dilemma of how much to increase buying and staffing levels given uncertain demand.
- Weak demand makes it harder to pass on rising costs – a feature of two-thirds of the sector's warnings in Q3 2023. The six-month energy price cap eases the immediate pressure on businesses and consumers, but other overheads remain high, exacerbated in many areas by the weak pound.
- Companies in the sector need to make the most of periods of high demand, and keep building operational and financial resilience to face more difficult times yet again.

FTSE Food Producers

FTSE Food Producers issued seven profit warnings in Q3 2022, the highest quarterly total since 2001, with 30% of the sector warning in that quarter alone.

- The food sector has faced unprecedented supply chain and inflationary pressures. But, whilst these challenges have been unrelenting, the sector had benefited from strong demand through the 'eat at home' pandemic era and beyond.
- Suppliers have also worked hard to rethink, reformulate, and find internal efficiencies to keep prices down. But it has become progressively harder to find new cost savings and to repeatedly negotiate price increases with supermarkets, especially in the case of smaller suppliers.
- All but one of 2022's 11 FTSE Food Producer sector profit warnings has cited the impact of rising costs. Over half have cited rising labour market issues. Some costs may ease but others – like energy transition – are structural.
- Food retailer and hospitality profit warnings underline the pricing challenge. Food is one of the most resilient areas of consumer spending, but it's not invulnerable, especially in discretionary categories. Excess inventory is a growing issue as forecasting becomes more demanding.
- Therefore, it's vital that companies focus their efforts on products that match consumers new priorities and that they also focus on holistic cost reduction to address input and labour cost issues.
- There is clearly an increasing focus on value. Survey data shows growing use of discount supermarkets, rising levels of downtrading – including downtrading from eating out to eating in – and increasing purchases of own label products.
- But value is only part of the story. EY's Future Consumer Index shows that lower income consumers are looking for help with household budgets, but higher income consumers are willing to spend on the right combination of quality, convenience, sustainability, and brand.
- Food producers need to build more resilient and agile operations and supply chains to be clear about how they will adapt their offering to a K-shaped market.

Consumer Goods

Profit Warnings from FTSE Leisure Goods are at a five-year high. Warnings from FTSE Personal Goods and FTSE Household Goods and Home Construction are at their highest level since the pandemic as pressure builds in the consumer product supply chain.

- Pressure on disposable incomes enviably passes along supply chains. The significant rise in profit warnings from retailers is matched by warnings from their suppliers, especially in areas of discretionary spending.
- Consumer products companies have found themselves squeezed on both sides, hit by rising cost and supply issues, whilst retailers and consumers push back on pricing.
- Cost and supply issues were cited in almost 80% of these three sectors' profit warnings in 2022 as companies found it increasingly hard to pass price increases through.
- The pressure on global supply chains has begun to ease but many consumer product companies are reliant on manufacturing and imports from East Asia, where supply chains are still periodically interrupted by lockdowns. UK strikes also threaten to disrupt imports in the critical run into Christmas.
- Inflationary pressures are also easing in some areas, but new pricing pressures are appearing – including the impact of the weak pound. The effect often isn't instantaneous, due to company hedging. But in 2009 prolonged sterling weakness against the dollar contributed to a third of the profit warnings of the three sectors listed above.
- There is further risk as retail credit insurance levels come under pressure. Suppliers with direct retail exposure may need to make tough decisions about who they continue to supply to – and on what terms.
- This is going to be a difficult winter. Inventory levels are building as consumers cut back. But a K-shaped market also provides an opportunity to target products to specific income groups and differentiate beyond value.
- EY's Future Consumer Index shows that consumers haven't abandoned sustainability. This doesn't just mean sustainable products. Shoppers are also thinking about how products are shipped, how they can enjoy a second life, and where they can reduce waste.

UK overview

[Please click the buttons to find out more]

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Midlands/East Anglia | Yorkshire/North East | North West

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