Warning signs

EY quarterly analysis of UK profit warnings Q1 2019

UK quoted companies issued 89 warnings in Q1 2019, the highest first quarter total since the global financial crisis, a decade ago

EY

Building a better working world

Inside

inside

Q1 2019 highlights

89	91	34%	10	17.6%	10%
Profit warnings in Q1 2019, up 22% YoY	EY Profit Warning Stress Index hits its highest level for ten years	FTSE General Retailers warning in the last 12 months	FTSE Financial Services profit warnings in Q1 2019	Median share price fall in Q1 2019	Brexit-related profit warnings in Q1 2019
The **highest Q1 total since 2009** and well above the 72 Q1 post-credit crisis average	Up four points as **warnings spread into financial and manufacturing** sectors	Rising disposable incomes cannot totally offset **growing structural challenges**	Uncertainty and increasing costs and regulation take **warnings to a seven-year high**	Post-warning share price falls are still **comparable to the height of the financial crisis**	Brexit is just one factor denting confidence, as **global geopolitical and growth concerns multiply**

highlights

Inside

Warning signs

Alan Hudson
Head of UK&I
Restructuring

Protracted uncertainty is taking its toll. The ‘no deal Brexit’ countdown was especially disruptive for businesses exposed to blows to consumer, corporate and investor confidence – as well as those reliant on cross-border EU supply chains and regulation. Services and construction sectors both contracted in March’s purchasing manager surveys, with manufacturing’s expansion partly driven by stockpiling.

Indeed, our data shows manufacturing profit warnings rising as part of a trend that has seen profit alerts spread and broaden out from consumer sectors. This expansion includes a sharp rise in warnings from financial services companies, in part due to growing investor Brexit anxiety, but also wider domestic and international forces.

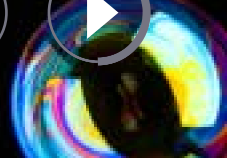
Because, as we’ll explore, Brexit is a substantial, but not isolated challenge for UK plc. It is hard to split out Brexit stresses from mounting global trade and growth concerns. The Federal Reserve’s decision to keep interest rates low for longer may provide some respite, but it also underlines the recent weakening of the global economic outlook and rising concerns over US-China relations.

Meanwhile, whilst a Brexit extension removes immediate ‘no-deal’ anxieties at home, uncertainty remains. The UK economy also has issues beyond Brexit, including uneven regional growth, low productivity, high debt and weak business investment – exacerbated by recent events.

This leaves the UK playing catch-up in an era of unprecedented structural change, when greater investment is required just to keep up. Balance sheet restructuring has brought some breathing space in troubled areas like retail and support services, but unless companies can invest to adjust to new sector dynamics, they’ll hit the buffers again.

With equity investors and lenders showing greater caution, new funding won’t be easy to find in stressed sectors. A decade-high in first quarter profit warnings is mirrored in growing restructuring activity, with more companies running out of cash. Continuous performance and cash flow management are more vital than ever in these turbulent times.

“Protracted uncertainty is taking its toll”



Economic outlook

Escalating challenges ...

Purchasing Managers' Indexes (PMI) survey data points to increasing strain in the UK economy towards the end of the first quarter. Retail sales surprised on the upside at the start of the year, with consumers bolstered by increases in disposable income and low unemployment, but have fallen back in March.

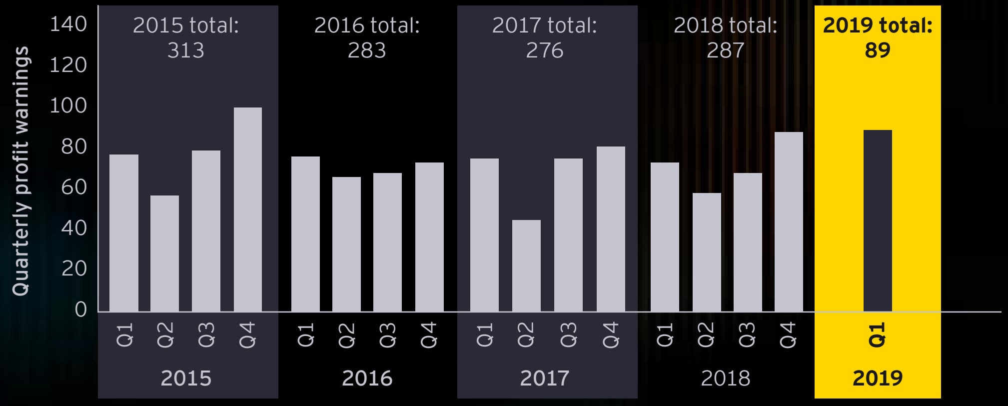
Purchasing manager surveys also showed expansion in services in January and February, but contraction in March – when construction activity also fell for the second month in a row. Manufacturing activity grew, but largely due to record inventory building that could unwind painfully in the coming months. The Brexit extension avoids 'no-deal', but leaves the economy with up to six months of further uncertainty.

... whilst the outlook remains weak

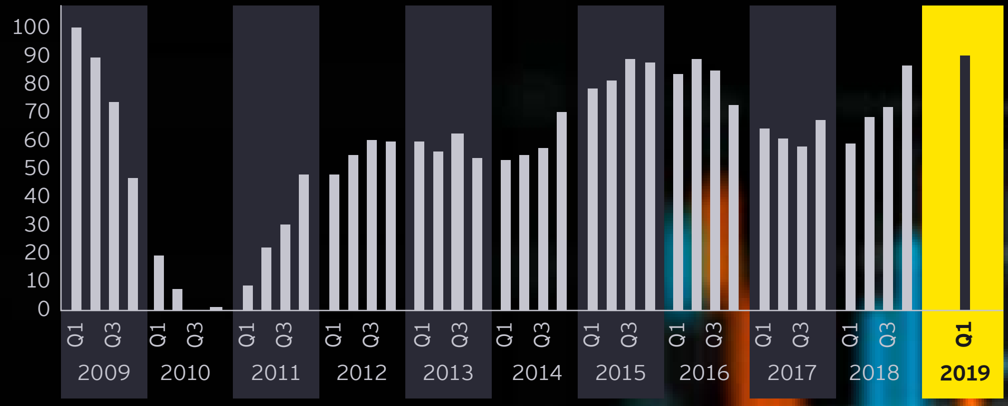
Falling business investment may have bolstered employment, but leaves the UK economy in a weaker long-term position. Debt and deficit will also make it hard to build significant momentum. UK households have spent more than they have earned in every quarter but one since the EU Referendum, whilst every part of the UK economy – consumers, government and companies – were net borrowers in Q4 2018.

Meanwhile, advanced and emerging economies have been slowing since last autumn. US-China trade relations remain strained and the outlook for both major economies is increasingly under the spotlight.

Profit warnings rise to 89 in Q1 2019
Number of profit warnings by quarter



EY Profit Warning Stress Index hits 91
Index based on the percentage of quoted companies warning in the last 12 months



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

Sector overview

Changing dynamics

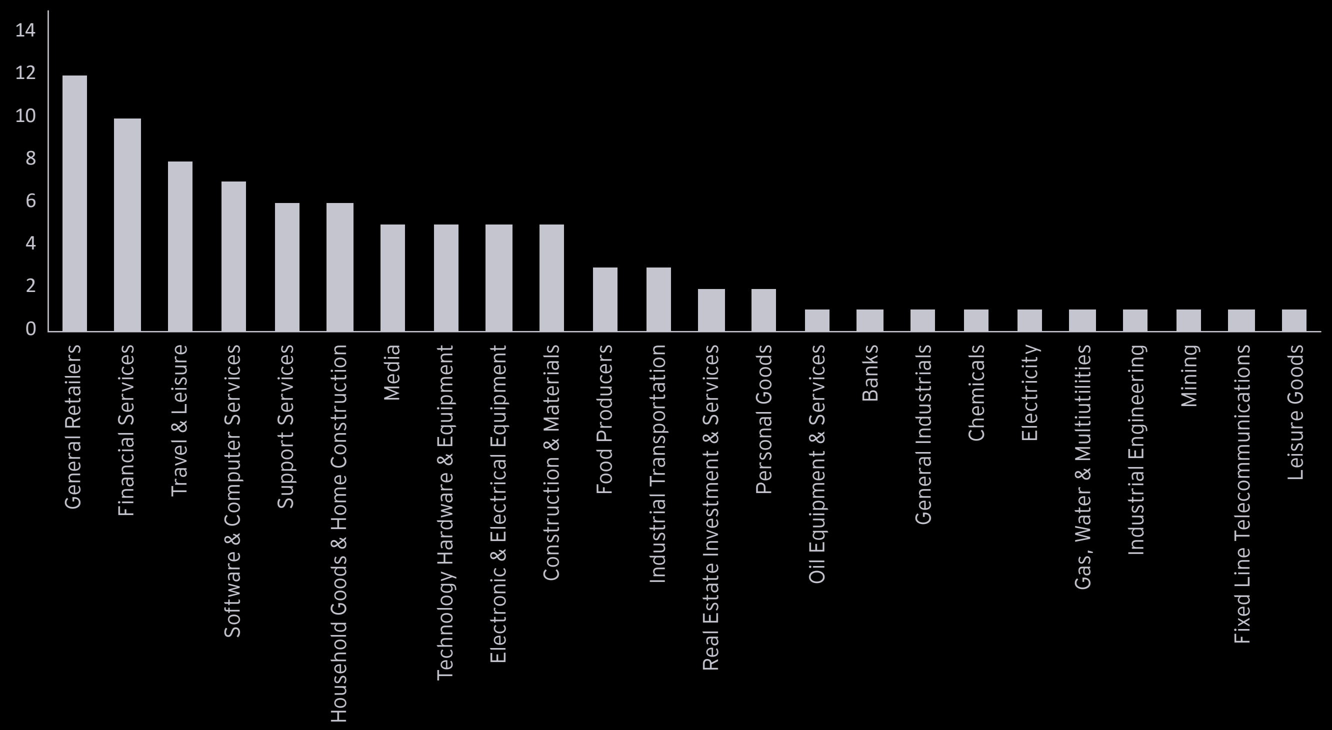
The FTSE sectors issuing the most profit warnings in Q1 2019 were General Retailers (12), Financial Services (10) and Travel & Leisure (8).

Consumer services companies are still issuing a high number of profit warnings, but numbers have remained static and haven't increased in-line with other sectors. In Q1 2018, one in four profit warnings came from a retailer; in Q1 2019, this figure is less than one in seven.

New momentum

Instead, the momentum for this quarter's 22% year-on-year rise in profit warnings came from other quarters and from across a broad spread of FTSE sectors. Profit warnings are increasing in manufacturing – both consumer and industrial, construction, financial services, and technology sectors. This reflects the increasing range of challenges facing UK plc, both domestic and international.

Profit warnings by sector



The changing outlook

- Almost a quarter of FTSE Industrial Engineering companies have warned in the last year, the highest level since 2016.
- In the last 12 months, 44% of the FTSE Technology Hardware & Equipment sector have warned – significantly higher than 2008.
- In Q1 2019, the FTSE Construction & Materials Sector issued its highest number of quarterly profit warnings since Q3 2016.
- FTSE Financial Services warnings hit a seven-year high in Q1 2019, with warnings rising five-fold year-on-year.

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

Inside

EY Profit Warning Stress Index at ten-year high

The spread of profit warnings, across a wider range of companies and sectors, sent our EY Profit Warning Stress Index to a ten-year high in Q1 2019. The index uses the percentage of UK quoted companies warning in the last 12 months to assign a 'stress' score from zero to 100. This increased by 32-points year-on-year to hit 91 in Q1 2019, having only been above 90 twice since 2007 – both times during the last recession.

The UK economy isn't contracting, but UK companies are now subject to an unprecedented range of pressures, which has widened out profit warnings from still-pressurised consumer services sectors.

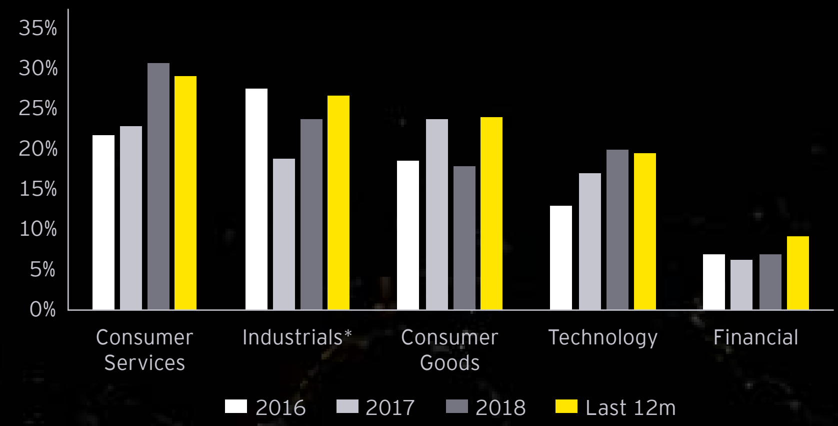
The constant drumbeat that underlies an increasing number of warnings is the accelerating speed of structural change. The tension caused by the increasing struggle to invest and adapt often amplifies other issues, especially in sectors with tight margins.

One in every ten profit warnings now cites the need for additional investment, but this is only part of the picture, with companies also facing new entrants and routes to market. This is increasingly apparent in financial services, where warnings have also risen dramatically in the last six months due to rising costs, increasing regulation and the impact of Brexit on investor confidence.

Confidence is an increasing issue in manufacturing, as Brexit worries mingle with broader geopolitical and growth concerns. UK business investment has weakened from an already low base. Falling Chinese demand is especially concerning for the automotive and technology sectors. Companies are also being forced to re-examine their supply chains.

What happens next depends on the extent to which Brexit anxieties and geopolitical tensions ease and domestic and global economies regain confidence and momentum. But, even in benign scenarios, profit warnings may remain high in many sectors given their underlying structural challenges.

Warnings spread to manufacturing and financials
% of FTSE supersector warning



Inside

Market reaction

Share price falls still at crisis levels ...

Investors facing the unknown clearly want to be backing the fittest companies. In Q1 2019, profit warnings generated a median first-day share price fall of 17.6%, down from last quarter's figure of 18.9%, but still the fifth highest figure we've recorded since the start of 2017.

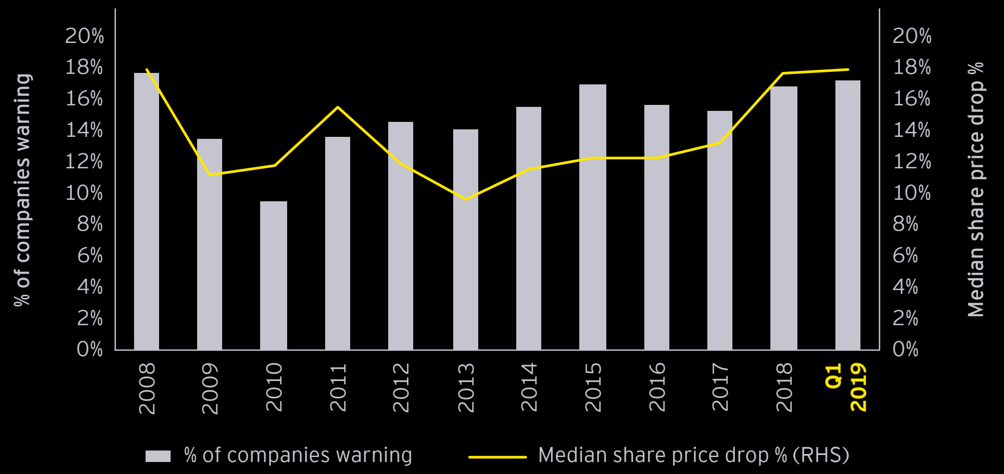
There is an especially marked distinction between the impact of profit warnings on the more internationally-oriented FTSE 100 and other indices. The average first-day share price fall for the FTSE 100 in the last 12 months is just 5.9%, compared with 17.3% for the FTSE mid-250, and 22.8% for AIM.

... while markets lose their bounce

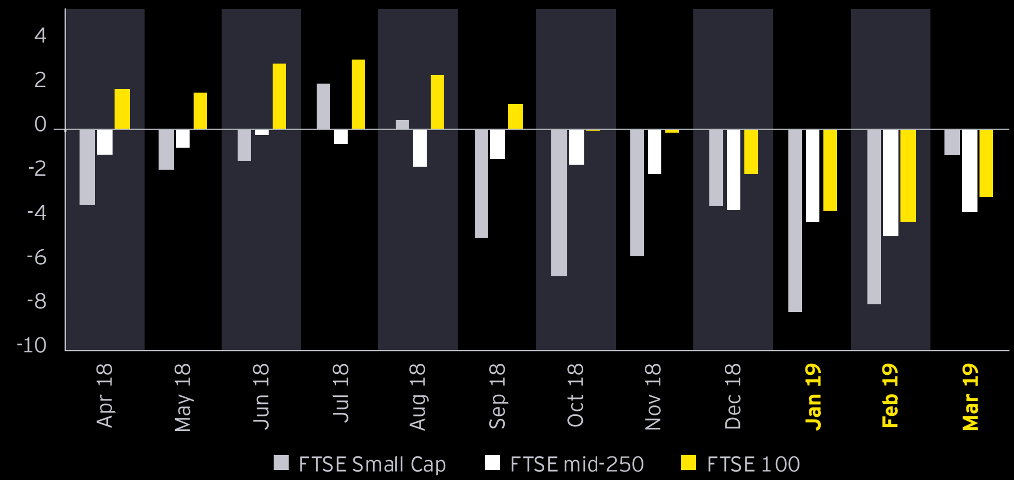
This reaction is reflected in more extensive earnings downgrades below the FTSE 100 in the last year. Although, as global growth prospects fall and agencies like the IMF start to talk about a 'synchronized slowdown', this earnings perspective appears to be changing.

In capital markets there is increasing investor focus on US growth prospects, with their concerns highlighted by the recent flattening of the US yield curve. Recession may not be just around the corner, especially given the recent loose monetary signals given by major central banks, but diminishing investor confidence is feeding into the markets.

Investors remain selective
% median share price drop on day of warning



Earnings expectations drop
3m % change in 12M forward earnings expectations



Source: Thomson One

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

Is confidence in shorter supply?

The number and percentage of profit warnings citing Brexit has risen throughout the last year, from no Brexit-related warnings in Q1 2018, to nine – or 10% of profit warnings – in Q1 2019 and 12% in 2019 up to 10 April.

This might seem like a relatively small figure given Brexit's domination of the news cycle, the prominence of a 'no-deal' Brexit amongst companies' list of concerns and the extent and cost of no-deal preparations. Business surveys also show evidence of delayed investment decisions, of stockpiling, and other supply-chain and export preparations – with the consequential impact on working capital.

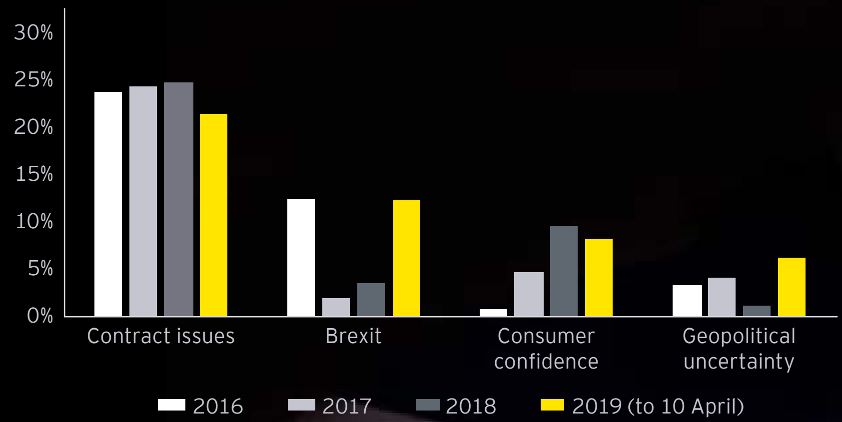
It may be that companies are reluctant to cite Brexit in their profit warnings, given the controversy around the topic. Or more likely, that the impact of uncertainty is still relatively localised and hard to separate from other factors. Consumer spending remained robust in most areas until March, when big ticket areas were amongst the hardest hit. In business-to-business sales, the decision to cancel or delay a contract is likely to be multi-faceted.

Indeed, when we look deeper into the data, the 'Brexit' profit warnings we've recorded in the last year have been strongly focused in sectors vulnerable to sudden dips in confidence. The FTSE Financial Services, FTSE Travel & Leisure and FTSE General Retailers sectors together account for 50% of 'Brexit' warnings in the last year.

In addition, our data, alongside other confidence surveys, also shows a convergence of factors affecting business confidence, with more profit warnings now citing broader geopolitical concerns – as the chart below illustrates.

How much Brexit grows in profit warning prominence in 2019 clearly depends on what happens next. Brexit's path is still uncertain. What we do know is that, even if a no-deal scenario is taken off the table, certainty over our future trading relationship with the EU is still years away. Extended uncertainty will continue to weigh on confidence and investment – and therefore growth – for some time.

Confidence indicators
% of profit warnings citing...



Sector focus: FTSE General Retailers

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

FTSE General Retailers issued 12 profit warnings in Q1 2019, one fewer than Q1 2018. In the last 12 months, 34% of the sector has warned, slightly less than the 41% in the year to Q1 2018. Have retail profit warnings peaked?

One important area is improving. Wage rises continue to outstrip inflation, employment is at record highs and consumers are better off than this time last year. The Asda Disposable Income Tracker has been rising since the start of 2018.

In first two months of 2019, this rise in real wages seemed to trump consumers' Brexit concerns. Official figures show retail volumes rising by 0.4% month-on-month in February, outstripping the forecasted 0.4% fall.

But retail sales remain volatile and confidence is still fragile. The variable timing of Easter makes March a volatile month. But, even taking that into account, the latest data suggests a marked decline in sales. If this fall was triggered by Brexit concerns, we may see sales start to rise, but uncertainty won't lift entirely.

Underlying pressures remain

Improving disposable incomes – combined with restructuring to cut stores, improve balance sheets and reduce costs – may provide some breathing space. Nevertheless, the sector is still contending with the same underlying pressures that have made it hard to translate sales into profits. Retailers who don't use this time to adapt their core business to changing market dynamics will soon hit trouble again.

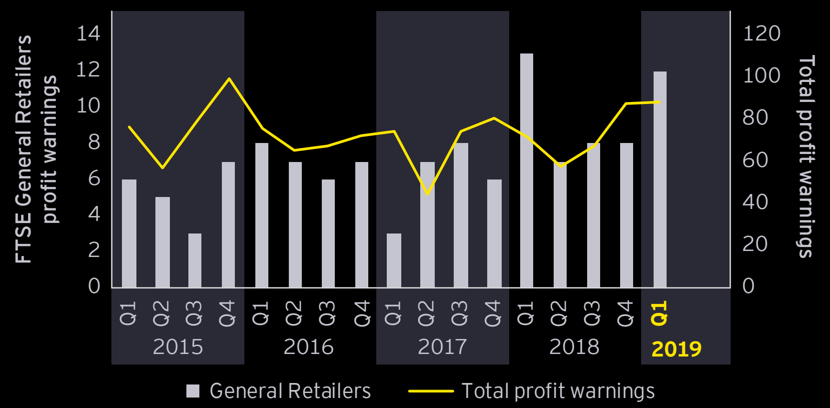
The speed of change is accelerating. Companies can find their core markets turning sour incredibly quickly. Online growth and development is relentless, requiring continuous investment when margins are tight. Consumers are still reluctant to pay full-price.

In Q1 2019, 40% of profit warnings cited pricing pressure, a problem that is often exceptionally acute in the New Year as retailers' discount to clear inventory.

This pressure is most evident in apparel, which issued half of the retail sector's warnings in Q1 2019. The weather has been kind, but the clothing sector remains over-supplied and the increasing cost of returns adds an extra burden. Retailers that lack distinctiveness will continue to struggle.

All of which underlines retailers' need to understand their customers and get their offering right. It's important to remember that this is a dynamic process. Retailers need to be constantly adapting their offering and strategy to build loyalty and remain relevant.

FTSE General Retailers profit warnings



Inside

Sector focus: FTSE Financial Services

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

FTSE Financial Services companies issued 10 profit warnings in Q1 2019, equalling 2018's total in just one quarter. Brexit, regulatory change and technological disruption clearly make this a more difficult market to navigate. But, thus far, there is little evidence of widespread sector distress. Will this change in 2019?

The FTSE Financial Services sector encompasses Consumer Finance, Asset Management, Specialty Finance and Investment Services. Of the 19 sector profit warnings issued in the last 12 months, more than half have come from the Investment Services subsector, whose broker, deals and exchange businesses been particularly buffeted by market, regulatory and technological change.

Investment Services companies need market movement to generate trades. But, when the political backdrop becomes this unpredictable, investors are more likely to stay on the side-lines, with the lack of activity lowering fees. All but one of the warnings from Investor Services companies in Q1 2019 cited the impact of Brexit or geopolitical uncertainty.

Brexit uncertainty is also having a fundamental impact on the broader shape of the financial services sector. The latest EY Financial Services Brexit Tracker shows that 52% (74 out of 143) of the universal banks, investment banks or brokerages, wealth and asset managers and insurers monitored have publicly confirmed, or stated their intentions, to move some of their operations and/or staff from the UK to Europe.

Beyond Brexit

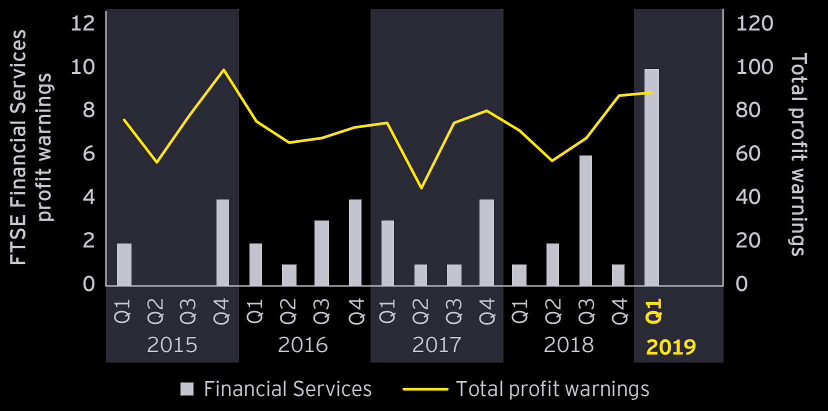
Beyond the impact of Brexit and other geopolitical uncertainty, the sector is also dealing with changes to the regulatory landscape, with a knock-on impact on income, costs and the complexity of their compliance operations. A quarter of FTSE Financial Services profit warnings in the last 12 months cite regulatory changes.

Rising costs is a broader theme that encompasses almost half of sector warnings in the last 12 months, with reasons ranging from the rising cost of compliance, the increasing cost of customer acquisition and the increasing imperative to invest to battle cybercrime and keep pace with change. Financial Services is the third most disrupted sector in The EY Disruption Index.

This is a robust sector accustomed to managing and adapting to change. Even with these challenges, just 11% of the sector has warned in the last 12 months, compared to the all-sector average of just over 17%. But this isn't a time for complacency. Even if political uncertainty diminishes, the sector faces significant challenges and further market dislocation could cause more widespread distress.

Companies need to focus on managing regulatory change, risk and volatility and consider how their business model will adapt to changing markets.

FTSE Financial Services profit warnings



Inside

Other sectors to watch

FTSE Technology Hardware & Equipment

The sector issued a further five profit warnings in Q1 2019, with 44% of companies warning in the last 12 months.

The global technology sector is under pressure from declining electronics and vehicle sales – especially in China.

Demand for consumer electronic goods worldwide is falling as upgrades become more marginal and economic growth comes under pressure.

Companies are reporting excessive global inventory is in areas like chips and displays, displays, which is putting additional pressure on prices.

FTSE Travel & Leisure

The sector issued a further eight profit warnings in Q1 2019, with 29% of companies warning in the last 12 months.

It's been an especially turbulent time for airlines and tour operators due to increasing costs, over-capacity and one-off events, such as labour disputes.

Some headwinds are easing; but the sector still faces weaker confidence and increasing technological disruption, requiring increasing investment.

In travel, size increasingly matters. It is getting harder for small carriers to survive, which increases the vulnerability of smaller regional airports.

FTSE Support Services

The sector issued five profit warnings in Q1 2019, with 17% of companies warning in the last 12 months.

The percentage of Support Services companies warning has been declining since 2017, due to increased sector restructurings and lower profit expectations.

Business and balance sheet restructuring has brought breathing space, but the sector's weak margins and other underlying weaknesses remain.

Continuing economic uncertainty will affect clients' willingness to enter into long-term commitments – a problem that is also affecting the construction sector.

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

Alan Hudson
Partner

+ 44 20 7951 9947
ahudson@uk.ey.com

Lee Watson
Partner

+ 44 20 7951 3274
lwatson3@uk.ey.com

Jon Morris
Partner

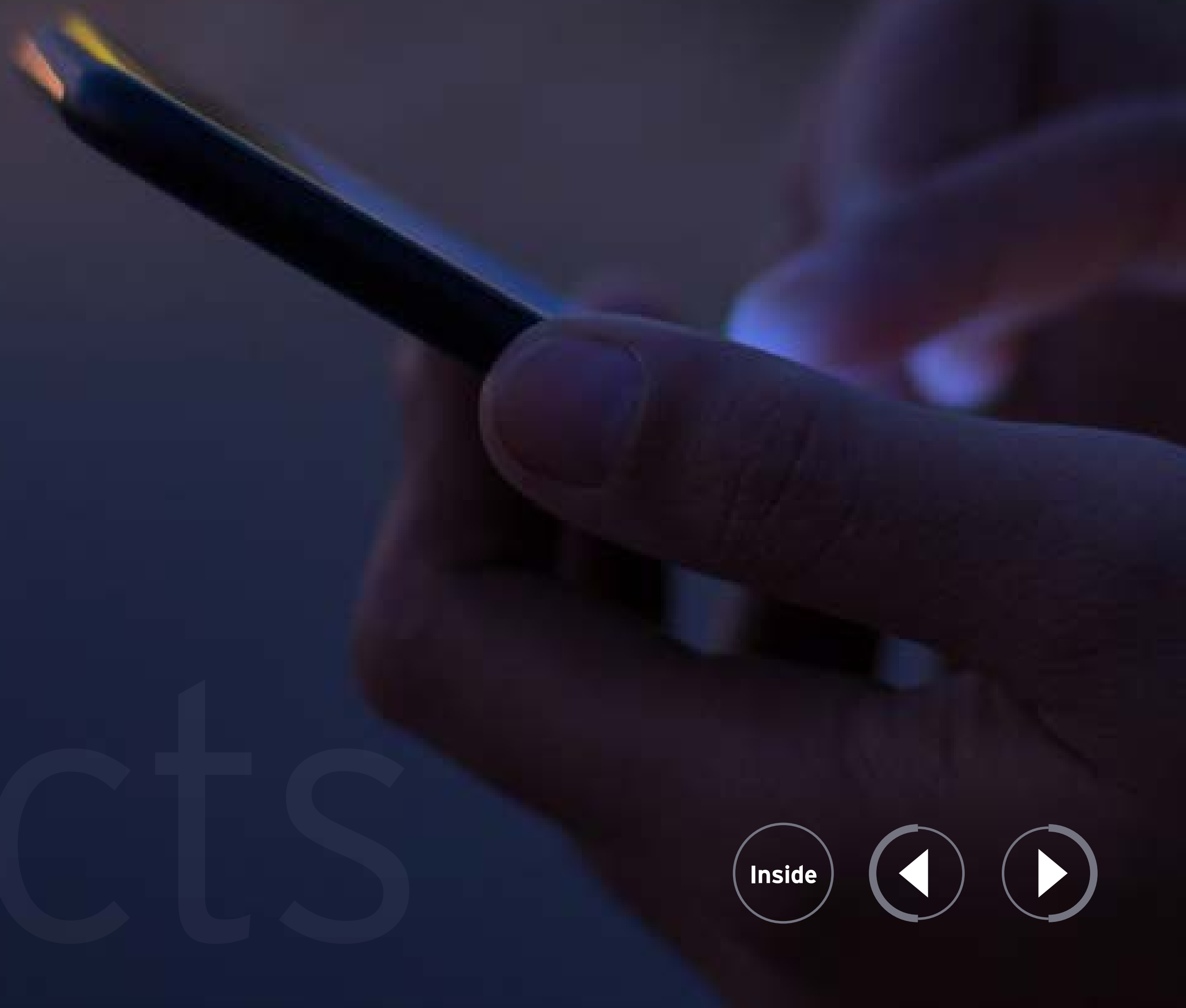
+ 44 20 7951 9869
jmorris10@uk.ey.com

Kirsten Tompkins
Market Analyst and Author

+ 44 121 535 2504
ktompkins@uk.ey.com

Our profit warning console contains more current and historic data:

ey.com/warnings



contacts

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

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.

ED None

EY-000091753.indd (UK) 04/19. Artwork by Creative Services Group London.

In line with EY's commitment to minimise its impact on the environment, this document has been printed on paper with a high recycled content.

ey.com/uk