At a crossroads

EY-Parthenon quarterly analysis of UK profit warnings

Q1 2021

EY Parthenon

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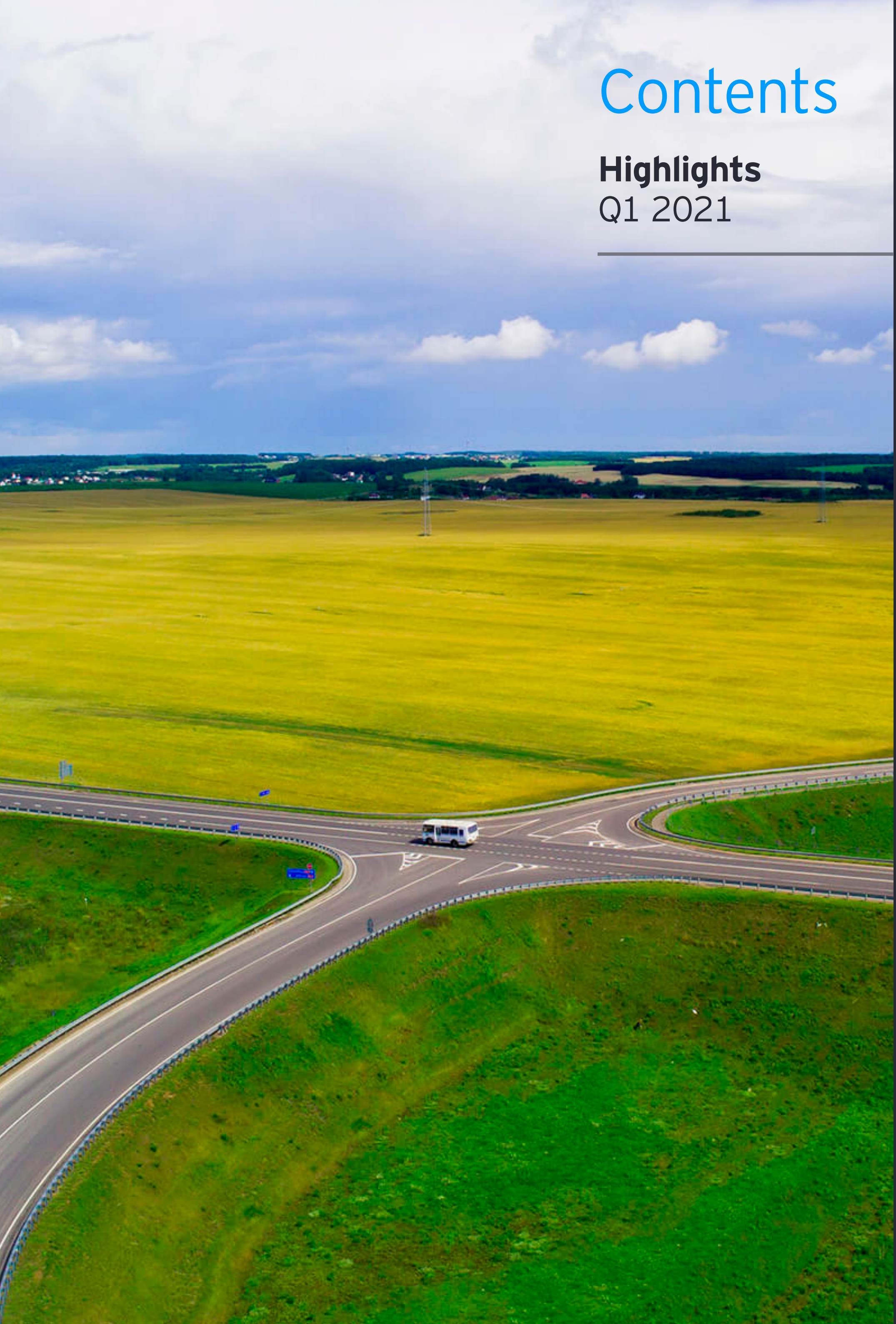

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Q1 2021 highlights

50	64	59%	43%	33%	5.4%
Profit warnings in Q1 2021	UK listed companies in the 'danger zone'	'Danger zone' companies claiming furlough	FTSE Aerospace and Defence companies have issued warnings since 1 April 2020	FTSE Travel and Leisure companies have issued warnings since 1 April 2020	Median share price fall on the day of warning
The lowest first quarter total since 2000	Companies issuing at least their third warning in a 12-month period since March 2020	Percentage of companies hitting the third warning mark who made a furlough claim in January 2021	A complex outlook will put pressure on aerospace supply chains	Recovery from consecutive lockdowns won't be straightforward	Investor reaction remains muted as they continue to price in recovery

UK plc at a crossroads

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Strategy

The contrast couldn't be starker. In the first quarter of 2021, EY recorded just 50 profit warnings, compared with a record 301 in Q1 2020. Hopes of a vaccine led recovery and the UK economy opening up as early as this summer have raised forecasts and lowered profit warnings.

But the pandemic's impact won't reverse when lockdown ends. One of the biggest challenges for businesses is to understand where and how they need to reshape their businesses in order to keep pace with enduring and rapid changes in their markets, accelerated by COVID-19 and other global forces – from increased border frictions, to the heighted focus on corporate purpose.

I expect to see three overlapping restructuring waves in 2021. A correction wave as companies that would have otherwise collapsed since the start of 2020 fail when government support and insolvency moratoriums end; a pandemic shockwave as companies weakened by COVID-19 face the withdrawal of this life support; and a structural wave of insolvencies linked to rapid market change.

Our profit warning data highlights these hidden stresses. Since the start of March 2020, 64 companies have issued at least their third profit warning in a 12-month period. Typically, up to 20% of these companies appoint administrators within a year of their third warning – but none have so far, with 59% claiming furlough and 38% also utilising an additional form of support.

EY's recent Capital Confidence Barometer showed that most UK executives recognise this heightened risk of insolvency, whilst also expecting to regain pre-virus levels of sales and profitability by 2022. But this won't happen if companies simply trust in the economic recovery to lift their businesses away from danger.

We've reached a crossroads in this pandemic, where there is still breathing space provided by government support and market liquidity for companies to reshape and put their businesses on a firm financial footing. Some will require radical, multi-faceted action to create, protect and recover value. But the pandemic has provided a unique platform for bold action, whilst legislative changes – such as the new Restructuring Plan – offer new routes to reshape.

And no company can afford to ignore the risk from rising insolvency and the potential impact on their supply chain. The recovery is coming, but companies need to make sure they – and their suppliers – are ready.

“

... the pandemic has provided
a unique platform for bold action ...

Economic outlook

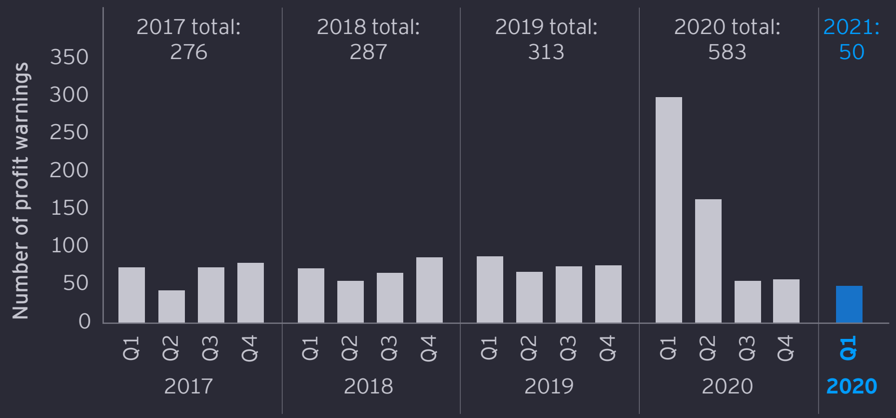
Improving forecasts

Resilience and adaptability helped the UK economy to beat growth expectations in Q1 2021. GDP is still likely to contract in the first quarter, but by much less than expected. Provisional figures show that UK GDP fell by 2.2% month-on-month in January, but rose by 0.4% in February. March also saw an improved set of purchasing managers' surveys for the services, manufacturing, and construction sectors, whilst consumer confidence rose substantially.

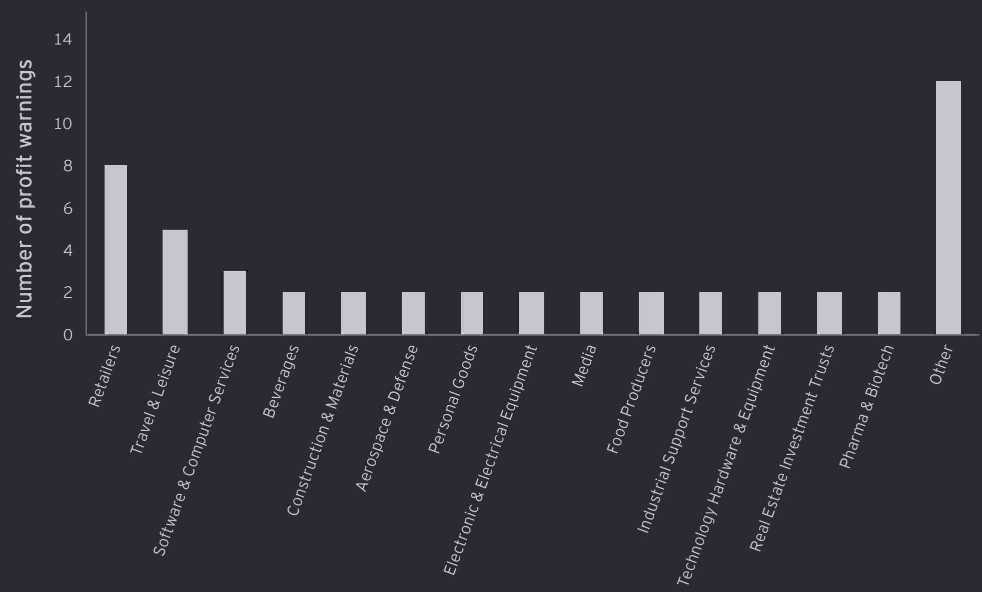
In response, EY ITEM Club has increased its forecast for 2021 GDP growth from 5%, to 6.8%. Their expectation is that this will be a consumer-led recovery, given high savings ratios and lower than expected unemployment. But rising business investment should also underpin the recovery, as companies grow more confident and utilise new tax incentives to invest and reshape their business.

There are complicating factors, including the inherent unpredictability of the virus; bruised corporate and government balance sheets; cliff edges in government support; and additional trade frictions. The differential impact on companies, sectors and regions of this crisis has also deepened divides. This won't be an evenly spread recovery and many companies won't feel its positive impact if they can't adapt to new market dynamics.

Profit warnings hit an all-time high in 2020
Number of profit warnings by quarter



Profit warnings by FTSE sector Q1 2021



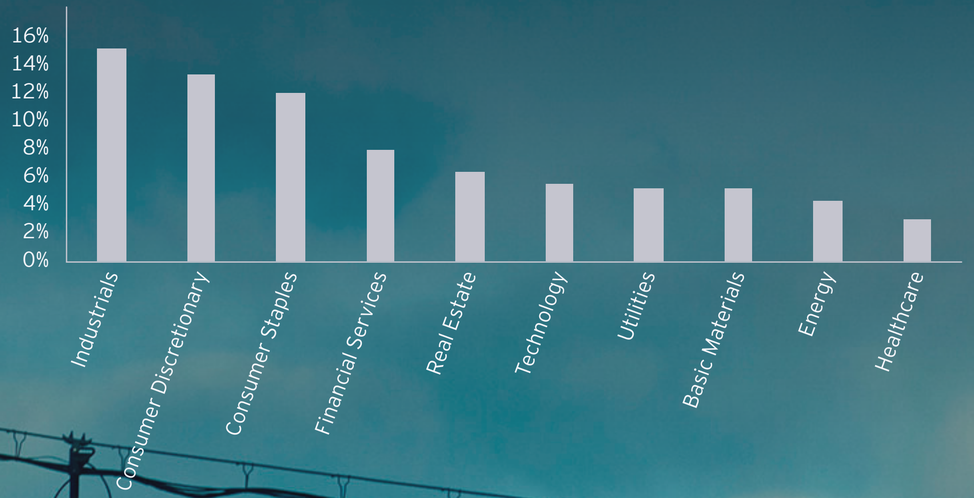
Our profit warning console contains more current and historic data: ey.com/warnings

Sector overview

Positioning for recovery

The top FTSE sectors warning in Q1 2021 were: Retailers (8) and Travel and Leisure (5). By percentage of companies warning, the top sectors were Beverage (22%), Personal Goods (20%) and Retailers (17%).

Percentage of FTSE industry warning, last 12 months



Most FTSE sectors saw sharp falls in profit warning numbers at the start of 2021 as the global vaccine roll out bolstered forecasts. Adaptation and lessons learnt in previous lockdowns also lessened the impact, although pre-Christmas timing clearly hit retail, travel, and hospitality hardest.

Consumer sectors should benefit from a pent-up release in demand and household savings in 2021 – especially in the second quarter, as the economy opens. But there is still uncertainty over how much consumers will spend beyond this initial release. Moreover, all the issues that pre-dated the virus remain. There is a growing tension between the need to meet increasing consumer demands – in areas like channel shift and sustainability – whilst keeping costs low. The constant need to adapt and position for the recovery also continues, not least for companies who benefited from behaviour changes during the pandemic.

Meanwhile it's interesting to note that since the initial shock of COVID-19, industrial sectors have recorded the highest percentage of companies warning. Automotive and aerospace sectors have both issued a high level of warnings in the last 12 months, partly linked to the pandemic's impact on end markets in travel and retail. But again, there are pre-existing issues in the ongoing need to drive sustainability, and mitigate against rising costs and border frictions.

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

Hidden stresses

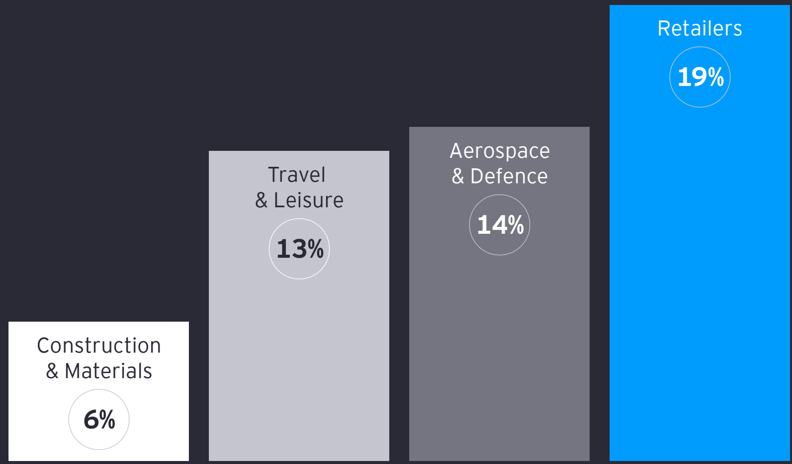
UK insolvency levels remain at record lows, but what does our profit warning data tell us about hidden stresses?

Government support, combined with a moratorium on winding-up petitions, has significantly held back corporate failure. Our analysis shows that if insolvency levels had just continued in-line with a pre-March 2020 pace, over 6,000 more companies would be insolvent today.

Our profit warning data underlines this pent-up insolvency risk. Since the start of March 2020, 64 UK-listed companies have issued at least their third profit warning within a 12-month period – double the pre-pandemic trend. We'd normally expect up to 20% of these companies to enter administration within a year of their third warning. So far, none have. Of these companies, 59% claimed furlough support from the Government in January, and 38% are also claiming at least one other form of government support, including a government-backed loan and/or the deferral of business rates and VAT. Most of these companies are focused in consumer areas, primarily FTSE Retailers (19% of the sector) and FTSE Travel and Leisure (13%).

This summer, several factors will put pile pressure onto firms still reliant on government life support that haven't positioned themselves to capture the benefits of recovery. Furlough tapers and ends, deferred VAT and loan repayments begin. At the end of June, the suspension on creditors issuing winding-up petitions is also set to expire. Pain could pass up and down supply chains if businesses struggle to pay suppliers, or vital parts of the chain fail. We expect to see more businesses make the most of the remaining breathing space and platform to use the new Restructuring Plan to reshape their business. But insolvencies will inevitably rise as some businesses fail to adapt in time.

Percentage of FTSE sector issuing at least their third warning and claiming furlough*



* Companies issuing at least their third warning since March 2020 and claiming furlough in January

Market reaction

Expectations reset

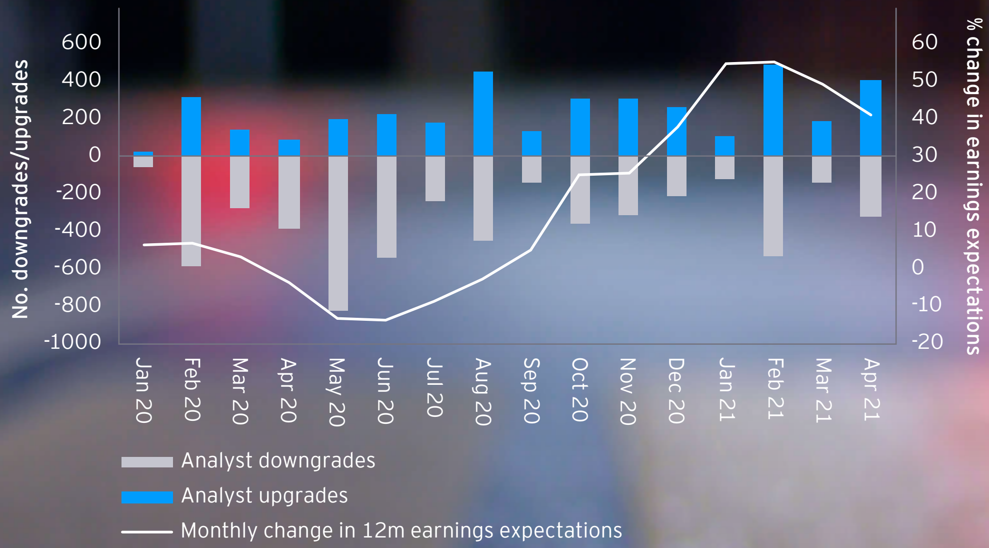
A drastic forecast reset triggered 327 UK profit warnings in March and April 2020. Over the summer, earnings expectations began to rise as the economy opened, but companies continued to withhold forecasts – including 40% of the FTSE 350 by mid-2020. Critically, companies had also adapted business and cost models, with government support also providing a buffer.

These factors contributed to a drastic fall in profit warnings in the second half of 2020. In 2021, we have slightly different dynamics in play. Earnings expectations are still relatively low, which most companies are beating given the better-than-expected recovery and their own adaptations. But we also have forecasts coming back into the market, with the vaccine-roll out boosting activity, but also corporate and analyst confidence in their 2021 forecasts. The increase in analyst activity in February in the chart below reflects this increase in market guidance.

Investors are also indicating their sustained confidence in the recovery in the very muted 5.4% median fall in share price on the day of warning. But this confidence isn't universal. At the end of Q1 2021, around 15% of FTSE 350 companies had decided to fully or partially keep guidance withdrawn. There are still uncertainties around how quickly and where demand will come back – and if global governments will need to alter their roadmaps.

If the recovery continues to show resilience, 2021 should follow the trend of previous periods after economic shocks – such as 2010 – when profit warnings remained low due to expectations lagging the recovery. But this doesn't preclude a rise in insolvencies – as we saw in 2010 – as stressed companies struggle to restart.

FTSE All-Share earnings expectations



Source: Thomson Reuters Eikon

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

Emerging themes

Other themes are emerging or coming back to the fore in 2021, often intersecting with the impact of the pandemic.

Brexit, COVID-19 – and more recently Suez Canal delays, the impact of the 'Texas Freeze' on oil refineries and plastic production, and the global microchip shortage – have underlined the importance of supply chain resilience. Earnings pressures typically amplify as they pass through supply chains, but this isn't a one-way street. One supplier can be a vital part of many ecosystems. Companies need to continue to build deeper knowledge and relationships throughout their supply chain and take a proactive approach to identify and address weakness and build greater resilience into their operating models.

Supply chain issues have also increased the focus on national industrial strategies. Global governments are increasingly making differential investment in critical sectors to improve self-sufficiency. But they are also intensifying protectionist measures to secure supplies. Both measures are part of a trend towards a more policy driven economy – a pre-existing trend that the pandemic has greatly accelerated and normalised.

Global trade has been a deflationary force for many decades, but its downward pressure on prices may be waning just as other inflationary forces are building. Unprecedented stimulus, increased competition for materials and labour in the recovery, and rising domestic spending – amplified by increased domestic tourism – puts inflation risks back on the agenda.

Meanwhile, the social contract between companies and society continues to strengthen. Focus on corporate purpose was increasing before the pandemic, but COVID-19 has created higher expectations across the entire ESG (Environmental, Social, Governance) agenda amongst key stakeholders – including customers and shareholders. Focus on sectors and companies that have benefited from government support is clearly high, but all companies are under increased financial, social, and environmental scrutiny, which will only heighten as the UK hosts the UN Climate Change Conference (COP26) this autumn in Glasgow.

This isn't an all-encompassing list and, if the last few years have taught us anything, it is how quickly other themes can emerge to completely change markets. Companies need to create the agility necessary to adapt at pace to whatever comes next.

Sector focus: FTSE Aerospace and Defence

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Since the start of 2020, FTSE Aerospace and Defense companies have issued 16 profit warnings, more than the previous four years combined. In this period 50% of companies in the sector issued warnings.

This exceptionally high figure primarily reflects the pandemic's impact on the civil aviation sector. Leisure demand should return as travel restrictions lift, driving recovery in the short-haul market. The bigger question is the return of business travel, where the rapid adoption of virtual meetings during the pandemic is likely to reduce longer-term business travel, given increasing corporate focus on cost and carbon-footprints.

This challenge doesn't come in isolation. Airlines have used the pandemic pause to reshape their fleets, retiring older aircraft and building routes around newer, more efficient aircraft in anticipation of recovery. This change in fleet profile, together with other structural changes has wide-ranging implications for the aerospace supply chain. Aircraft deliveries, which dropped by 55% in 2020, are unlikely to recover to pre-pandemic levels before 2025. Whilst longer term the market will grow, it will be smaller than forecast pre-pandemic, with 4,000 fewer aircraft in circulation by 2030 than previously forecast.

There is increased focus on efficiency and sustainability, driven by consumer and government pressure, but an increased focus on costs in the wake of less certain – and possibly less profitable – demand if business travel is permanently reduced. Additionally, sustainability is driving interest and investment in new technologies such as sustainable aviation fuels and hydrogen/hybrid-electric power.

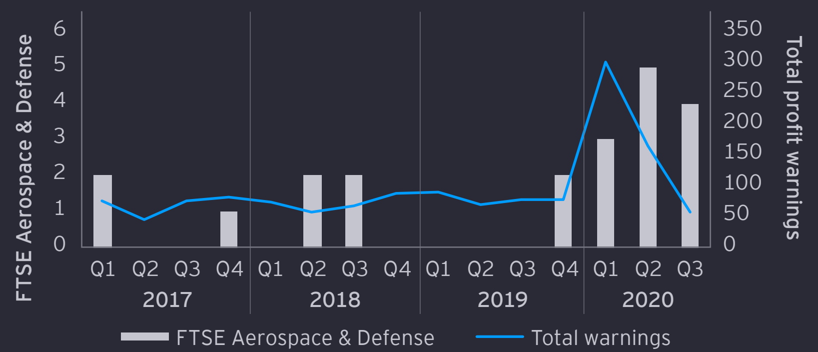
These changing market dynamics, with reduced demand for widebody planes and lower flight hours, will also hit MRO (maintenance, repair, and operations) and aftermarket services.

Customers and investors have increased concern about the civil aerospace supplier base in the wake of these complex and growing challenges. Demand will come back, but in different areas as airlines increase their focus on narrow-bodied, fuel efficient aircraft. Working capital requirements will increase as markets recover, requiring cash and supportive lenders. Moreover, whilst governments have sustained defence spending during the pandemic, budget pressures may change priorities in the medium term. In terms of supplier risk, companies often supply both civil and defence markets, with pressure on one side enough to threaten financial stability, especially in smaller suppliers.

To achieve its efficiency and sustainability goals, the sector needs a strong and innovative supply chain. There are lessons from the automotive sector, where OEMs (original equipment manufacturers) and large suppliers support essential elements of their supply chain in the face of rapid change. A resilient supply chain is critical to aerospace given the high barriers to entry and difficulty in changing suppliers. Actively monitoring the financial health of key suppliers is vital to better understand risks and to intervene quickly to prevent or mitigate against supplier failure.

Companies need to make sure that they – and their suppliers – are ready to position themselves for the future and enable the industry to return to growth.

FTSE Aerospace and Defence profit warnings



Sector focus: FTSE Travel and Leisure

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Almost four in five UK FTSE Travel and Leisure companies have issued a profit warning since the start of 2020. This quarter we're focusing on the hospitality industry, which has been one of the most affected by restrictions on social contact and faces tough choices as it emerges from lockdown.

The good news is that restrictions are easing – and are due to be lifted completely by 21 June. Despite the initially chilly weather, consumers responded to outdoor hospitality very positively, which shows that there is significant pent-up consumer demand. EY's latest Future Consumer Index (FCI) shows that 37% of UK consumers are planning to spend more on out-of-home recreation.

But most restaurants and bars have been unable to open in this first stage – due to lack of outside space – whilst hotels and nightclubs remain mostly closed. Businesses are also facing higher labour costs, given the additional need to check-in individual customers and to provide table, rather than at-the-bar service. The future of cinemas is also uncertain, given consumers' increasing familiarity with streaming new releases and the potential shortening. or even elimination. of the gaps between cinema and home viewing release dates. The mooted introduction of vaccine passports to obtain entry would accentuate these issues.

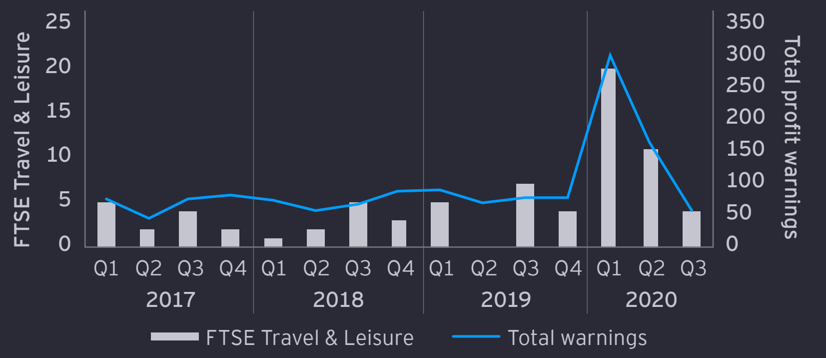
There are also question marks around the long-term viability of some sites, even when they can fully open. Footfall in city centre locations may not recover to previous levels if – as expected – a significant proportion of employees spend more time working from home. This issue is especially acute in London, where an increase in domestic tourism is unlikely to offset falls in inbound tourism and business travel.

Consumer demand may also take some time to recover fully. Over half (55%) believe that their daily lives will only return to normal when most of the population are vaccinated.

And, whilst the economy is opening up, companies are also likely to face the tapering and removal of government support this summer. The end of the rent moratorium in June is the most acute issue – and the Government needs to take careful note of the industry consultation currently taking place on how to exit from current protections: a simple end to all measures currently in place will be damaging, and the introduction of a binding non-adjudication is favoured by many in the sector. Additionally, the end of furlough is likely to come ahead of a full recovery in demand – especially in hotels, where most industry commentators do not expect a recovery to 2019 revenues until 2024, even if business travel levels return to pre-COVID 19 levels.

Hospitality operators need to recognise and understand where there has been a permanent shift in consumer preferences and continue to adapt to accommodate these changes, which may require radical action on staffing and tough decisions on which sites to preserve. The more a business can adapt and innovate, the better chance it has at remaining resilient.

FTSE Travel and Leisure profit warnings



Other sectors to watch

FTSE Beverages

Over 50% of the FTSE Beverage sector have issued a profit warning in the last 12 months. The 12 warnings issued since the start of 2020 are more than the previous eight years combined.

The primary trigger for the huge leap in sector warnings is clearly the impact of successive lockdowns, which closed entertainment and hospitality venues.

Industry data suggests that UK consumers lowered their alcohol consumption in the last year and sales through 'at home' channels haven't offset the rapid drop in 'on-trade' sales – which also tend to be more profitable for manufacturers.

In the UK, IWSR estimates that total alcohol volume consumption fell by -10% in 2020. Most major categories posted volume losses, but sales of wine, low- and no-alcohol offerings, and RTDs (ready-to-drink products) rose.

The industry has innovated to tap into new consumer preferences and behaviours, increasing their use of e-commerce to sell direct, focusing on creating more low ABV (alcohol by volume drinks), as well as responding to consumer and regulatory demands for healthier, lower sugar beverages.

The initial signs for pent-up demand are good. But most of the sector predicts a cautious outlook for the rest of the year as drinkers make a gradual return to hospitality venues.

FTSE Construction and Materials

44% of the FTSE Construction and Materials sector issued a profit warning in the 12 months to the end of Q1 2021. The sector had a better-than-expected year in many ways, but clearly still has problems beyond the pandemic.

Most construction sites have remained open since the initial lockdown, but the additional time and material cost of adapting to COVID-19 – alongside delayed project starts and approvals – have hit profitability and feature in most warnings.

But many warnings also cite contract problems that pre-date the pandemic, underlining the importance of maintaining discipline in contract selection and execution as demand picks up and increases competition for materials and labour.

The government's 'Build back better' initiative will underpin recovery, although commercial property demand – especially in retail and offices – won't bounce back as quickly.

The end of government support could put extra pressure on some suppliers working capital. Large contractors need to maintain visibility over key parts of their supply chain.

It's also important to keep sight of the long-term picture and the need to be innovative to improve productivity and support the net zero agenda, an underlying issue that is increasingly gaining momentum across the industry.

FTSE Automobiles and Parts

The automotive sector was under pressure before COVID-19, but the pandemic has severely exacerbated demand, cost, and supply chain pressures.

The sector faces navigating a structural shift away from combustion engines, whilst also contending with the negative impact of the pandemic on balance sheets as well as intensified price and supply challenges.

In addition to Brexit and the temporary Suez Canal disruption, 2021 has brought yet another supply challenge in the form of a worldwide semiconductor shortage that has left automotive companies forced to cut production as they struggle to secure supply.

Demand and price shocks are an especially acute problem for lower tier suppliers, where low margins and supply chain interconnectedness amplify the impact of falling demand.

To thrive in a rapidly changing industry, suppliers must navigate short-term risks whilst planning for a long-term future. It's vital that they quickly enhance liquidity, recapitalise and secure OEM (original equipment manufacturer) support to help bolster resilience.

UK overview

[Please click the buttons to find out more]

London

South East

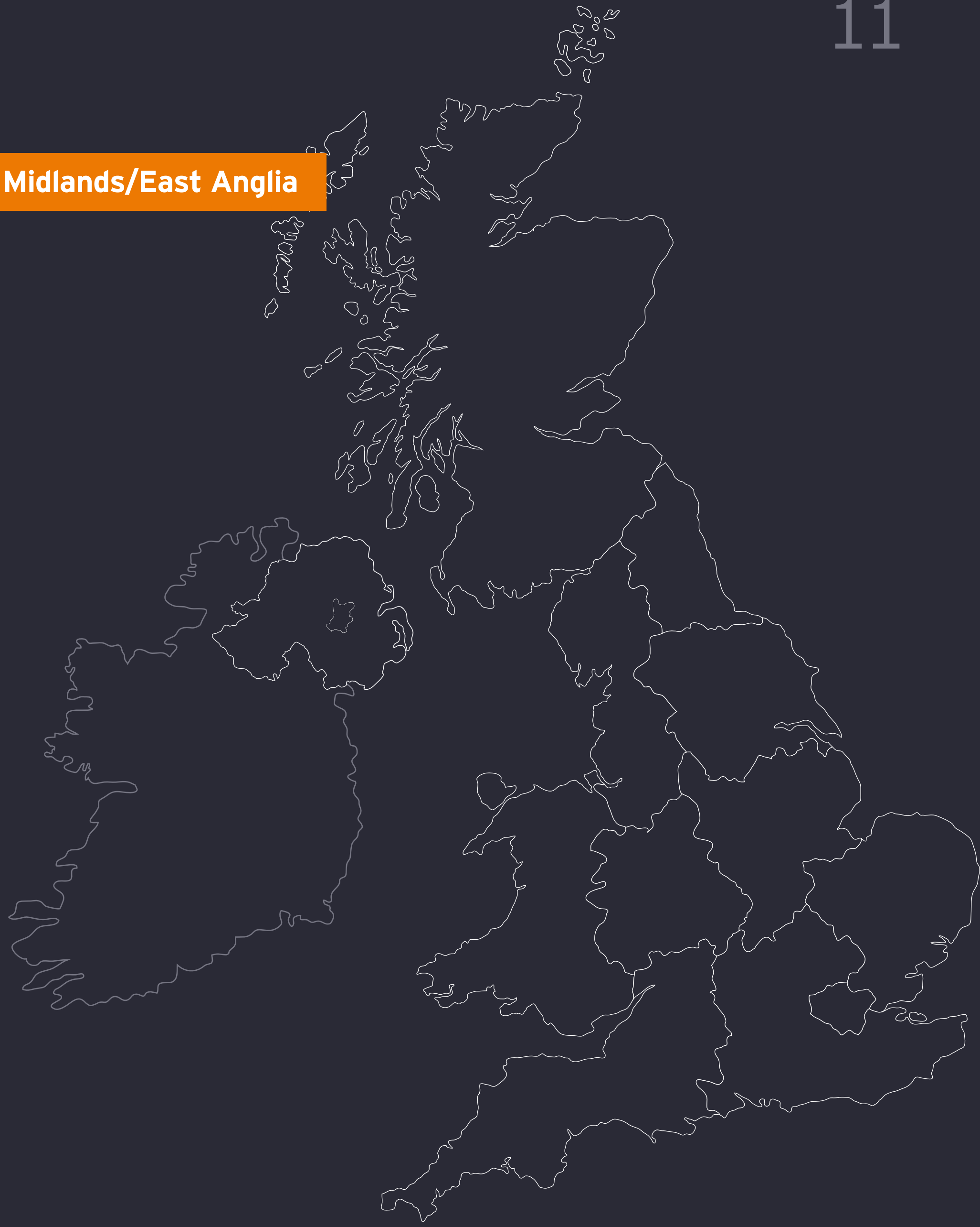
South West/Wales

Midlands/East Anglia

Yorkshire/North East

Scotland and NI

North West



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