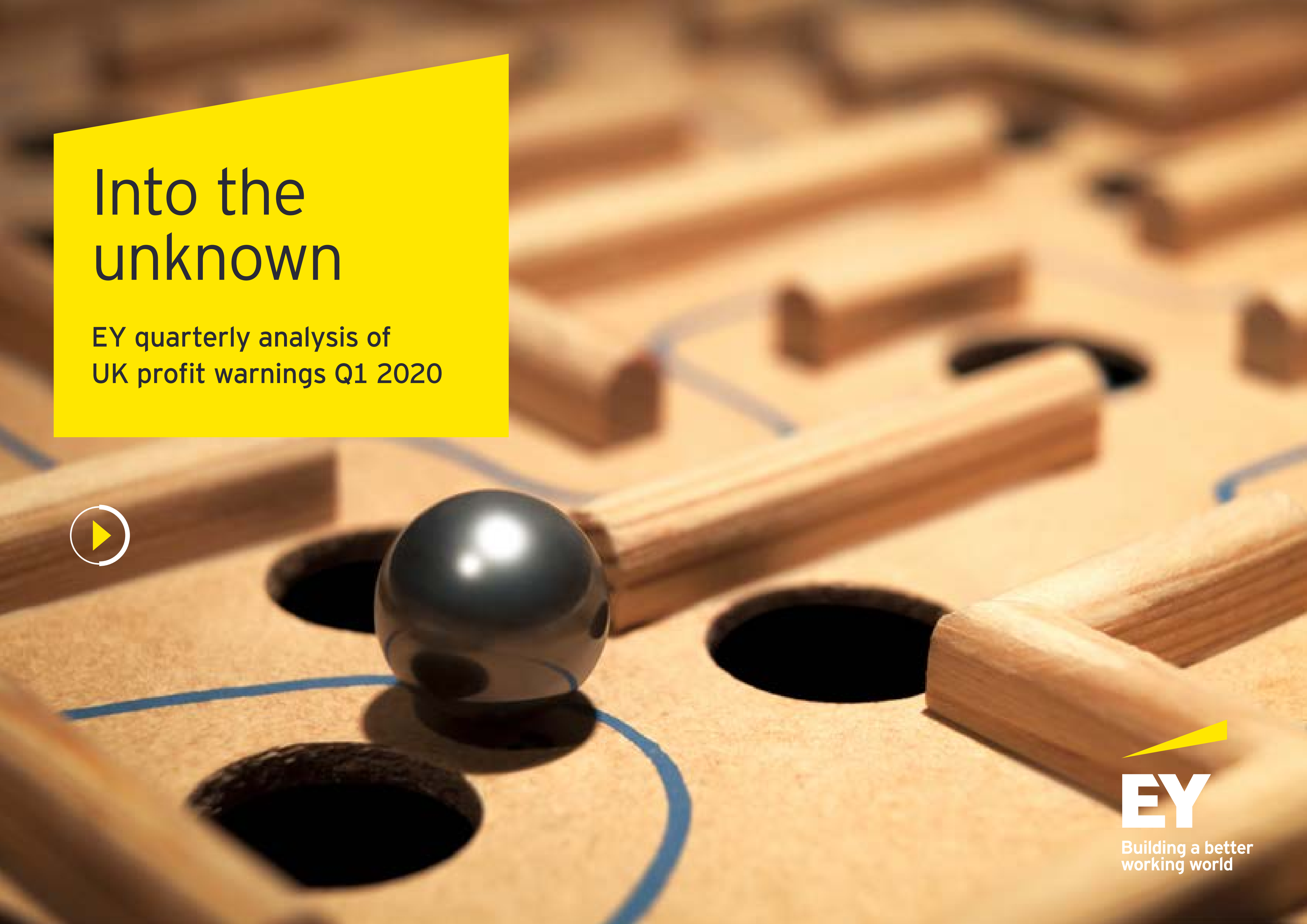
Into the unknown

EY quarterly analysis of UK profit warnings Q1 2020



Building a better working world

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Q1 2020 highlights

301

UK profit warnings in Q1 2020, up 238% YoY

More than double the previous high of 141 in Q4 2001

21%

UK quoted companies warned in Q1 2020

Higher than the percentage of **companies warning in the whole of 2008**

77%

Profit warnings in Q1 2020 cited COVID-19

Warning levels were high before the first virus-related warning, but **downgrades accelerated rapidly from mid-March**

70%

FTSE Travel and Leisure companies warned in Q1 2020

The sector is **one of the most significantly affected by the lockdown**

84

Companies warned for the first time since the start of 2010

COVID-19 stresses are well beyond the norm, hitting usually resilient sectors and companies

7.6%

Median share price fall on the day of warning

Share price reaction hits an all-time low, with markets reacting to events ahead of company releases

highlights

Alan Hudson
EY Head of UK&I
Restructuring

What next?

COVID-19 has completely transformed our lives. Almost overnight, we've fundamentally changed behaviours and redefined principles, from the role of the state to what society values as 'essential'.

Unprecedented upheaval has triggered an unprecedented number of profit warnings. In Q1 2020, we recorded 301 warnings from over a fifth of all UK quoted companies – a higher percentage than the whole of 2008. All but five of the 42 FTSE sectors we track issued COVID-19 related warnings and 84 companies warned for the first time in at least a decade, underlining just how much COVID-19 stresses extend well beyond the norm.

In this paper, we'll explore how the impact of COVID-19 spread, from the first warnings highlighting issues in China, to the fundamental shift in earnings expectations following the March lockdown – with ripples that continue to spread along supply chains. We'll also, as far as possible, look ahead to what comes next.

It's worth remembering that significant parts of UK PLC were struggling before the crisis. Political uncertainties and rapid structural change pushed UK profit warnings to a post-financial crisis high in 2019. In January 2020, warnings increased by 43% year-on-year, before the main wave of COVID-19 warnings broke.

COVID-19 has created new problems, but it's also accelerated existing structural change and exacerbated existing weaknesses. When lockdown lifts, it will undoubtedly ease some pressures, but these underlying issues will remain. And we know from previous recoveries that the upturn can be as risky as the downturn – even without constant uncertainty and the added complications of restarting operations, rethinking operating practices, and reflating balance sheets to restock inventory from a supply chain that is likely to be experiencing similar issues.

Managing cash whilst safeguarding business continuity and the health of employees and customers are evolving and ongoing challenges. Getting the timing right on when and how to restart and invest will be crucial. It's also vital that companies continue to communicate transparently with lenders and other stakeholders and, where possible, support their supply chains.

We don't know when life will return to normal – or what that normal will be. But we expect to see a renewed focus on corporate purpose, long-term value and the interconnectivity between business and society. We are all in this together.

"... the upturn can be as risky as the downturn ..."

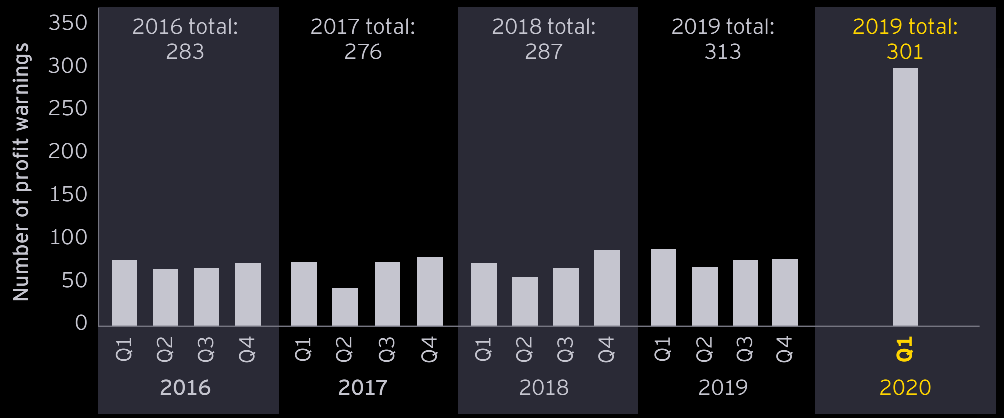
Economic outlook

Unprecedented challenges

All previous forecasts have been supplanted, with COVID-19 set to deliver the biggest blow to UK GDP since the First World War – and possibly beyond. EY ITEM Club estimate that UK GDP will fall by 6.8% in 2020, if the UK lockdown begins to lift at the end of May and the UK experiences a slow ‘U’ shaped recovery without major relapses.

But these are early days. We don't have much hard data from which to forecast and this is no ordinary recession. The Government and Bank of England have taken unparalleled steps to limit the structural damage from major demand and supply shocks. Nevertheless, some long-term impact is inevitable, and it may take up to three years for the UK to regain its previous level of GDP.

Profit warnings hit an all-time high in Q1 2020
Number of profit warnings by quarter



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

A difficult reboot

One of the biggest unknowns is the UK's exit from lockdown. The government will lift restrictions in increments and consumers and companies are also likely to proceed with caution, at least at first. It's impossible to know when we'll see the return of the so-called ‘carefree economy’, where people worked, socialised and travelled freely.

Consumers' limited means and ability to spend will limit the recovery of the dominant consumer side of the economy. Parts of the service, manufacturing and construction sectors have fared better helped by greater opportunities for business continuity, through distanced or home working – but no sector is totally insulted from problems elsewhere.

The downturn will expose geographical vulnerabilities and the impact of reduced business investment and the health of supply chains – both vital for the recovery. It's likely that companies will need further government and central bank support to help support the economic revival.

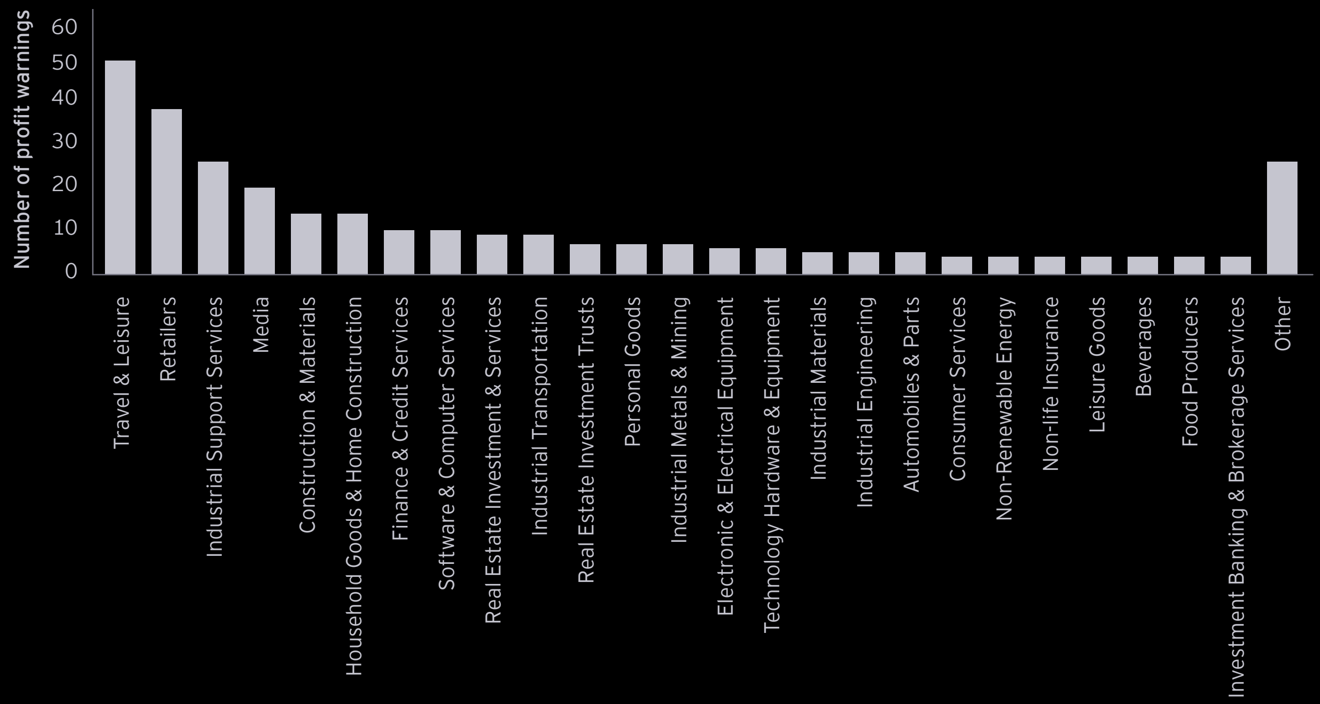
Sector overview

Amplified trends

Sectors with the highest exposure to the impact of national lockdowns and corporate cash preservation issued the highest number of profit warnings in Q1 2020. In many cases they were also sectors that were structurally challenged before the lockdown.

The top three FTSE sectors warning were: Travel and Leisure (49), Retailers (38) and Industrial Support Services (26). By percentage of the sector warning, the top three are: Travel and Leisure (70%), Industrial Materials (63%) and Retailers (61%).

Profit warnings by FTSE sector Q1 2020



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Consumer discretionary sectors have been hit exceptionally hard, due to the nature of their operations, plunging consumer confidence and existing structural weaknesses. Airline travel and holidays have all but stopped. Many retailers have redesigned online operations to protect staff, but this isn't always a viable alternative.

Meanwhile, companies in all sectors are understandably conserving cash, with wide-ranging consequences. Real estate companies report sharp falls in rent collections – down by over 50% in already stressed areas, like retail and leisure. FTSE Industrial Support Services, specifically outsourcers and recruiters, have also issued a high level of warnings as companies delay spending. Falling levels of industrial activity have likewise rippled through supply chains. Overall, the fall in economic activity has lowered oil prices and demand, with further implications for capital expenditure.

Companies can also find themselves on the wrong side of a trend. Supermarket sales have increased hugely, but companies supplying to restaurants and pubs have seen sales plummet. Food and beverage companies have responded by adapting production and distribution channels to access the consumer market. Just one example of an innovative move that could outlast the lockdown.

COVID-19: a profit warning timeline

The chart below shows a high-level sector breakdown of profit warnings, from the early weeks in late January to the picture at the end of last week.

29 February: 15 COVID-19 profit warnings recorded. 40% cite disruption in Chinese supply chains. Other warnings mainly relate to falling levels of global travel.

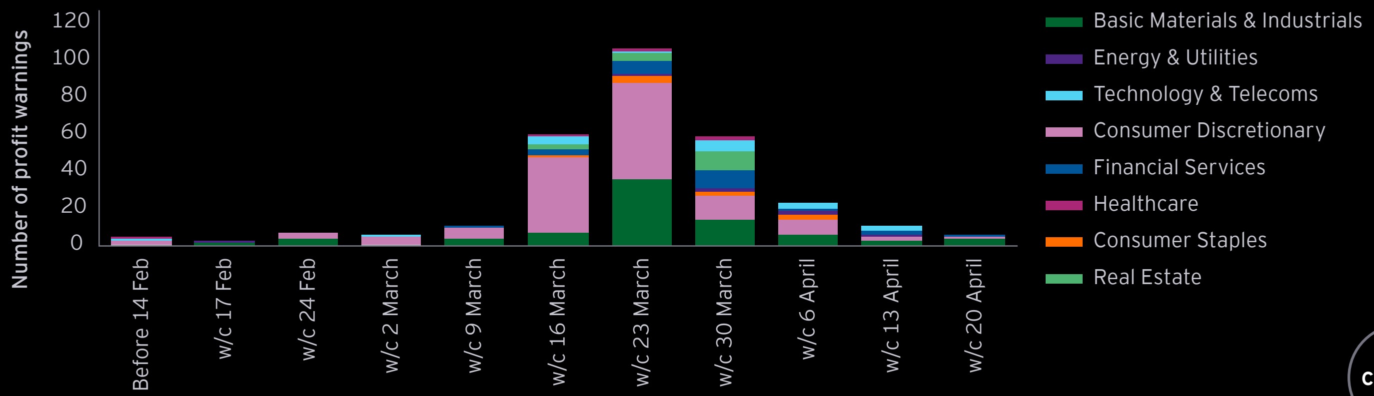
2–13 March: A further 17 COVID-19 warnings. Emphasis shifts from industrial to consumer sectors – especially conference and travel companies. UK businesses continue to report supply chain disruption, but with an increasing focus on Europe. From 12 March, every profit warning cites COVID-19.

16–20 March: A further 60 COVID-19 warnings – double the average for the month of March. Increasing reports of changing consumer behaviour. 40% of warnings come in FTSE Travel and Leisure. Sporting events cancellations hit catering and betting sectors. From here, virtually every warning contains a breakdown of available liquidity and cash conservation measures. Most also withdraw earnings guidance.

23–27 March: A further 107 warnings – one third of an average annual total. UK lockdown begins hitting consumer sectors with mass closures – travel, leisure and non-food retailers. Real Estate also hit by stressed tenants deferring rent on quarter day. Warnings also increase sharply in manufacturing, construction, outsourcing and recruitment.

From w/c 30 March: The impact spreads further into manufacturing, down supply lines, and increasingly into real estate and into the financial sector. Between 1 January and 29 April, 26% of UK quoted companies warn in 38 of 42 FTSE sectors. Many are still assessing their positions.

How the impact spread
COVID-19 profit warnings by FTSE super-sectors



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Market reaction

Beyond earnings

In a quarter characterised by high numbers, there was one extraordinarily low one. Companies issuing profit warnings in Q1 2020 saw a median share price fall of just 7.6%, around half the 15.2% recorded in Q4 2019.

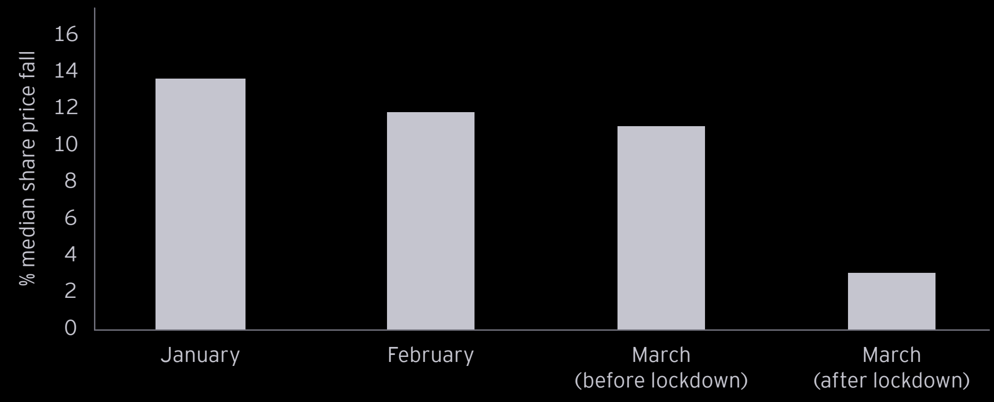
The universal impact of COVID-19 meant that by the time most companies warned, investors had priced in the downgrade. The FTSE All-Share fell by almost a quarter in the three weeks before lockdown. The FTSE All-Share Travel and Leisure index dropped by almost 50%. In contrast, both indices rose between the 23rd and 31st of March, when median share price falls dipped to just over 3%.

Investor anticipation isn't the whole story. From mid-March, companies also started to give more detail than usual in trading statements, describing the actual and potential impact of COVID-19; their liquidity positions; and the measures they are taking to conserve cash. Many companies delayed the release of their preliminary results on the advice of the regulator, but still provided comprehensive statements.

Whilst they were giving more detail on their current position, companies were also withdrawing earnings guidance from the market. But, what would normally be considered a major negative by investors, clearly wasn't treated as such if we look at the limited share price reaction. It seems that, for now, the ultimate test of a company's worth isn't its earnings, but its cash and resilience in the face of the COVID-19 threat. The format of companies' statements reflects this.

One measure of a return to normality might be when investors' focus returns to earnings visibility – and companies provide it. Although, it will be interesting to see if conventions change and companies continue to disclose the current high level of operational and liquidity detail.

Markets anticipate lockdown
% median share price drop on day of warning



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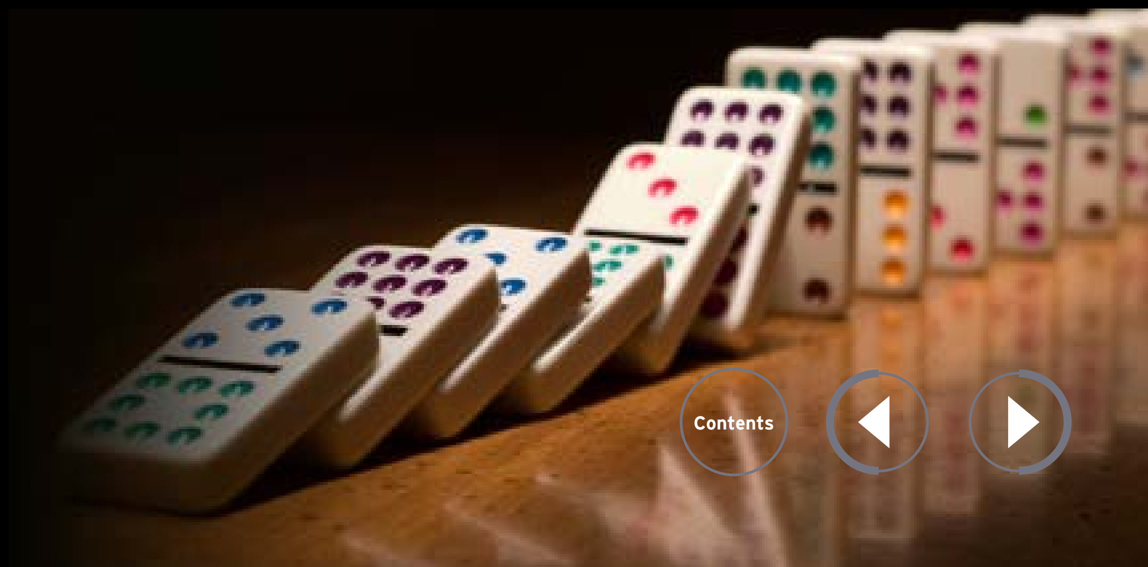

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Meeting the challenge of recovery

With limited capacity for further profit warnings, we expect these numbers to fall, but distress levels to rise — with echoes of 2008-9.

Companies have adapted their operations and amended forecasts to reflect new realities. But, as we're seeing in oil markets, ripples from the initial shock continue to pass through the economy. Seasonal businesses, such as those reliant on summer travel and food production, may also still be facing their most difficult period.

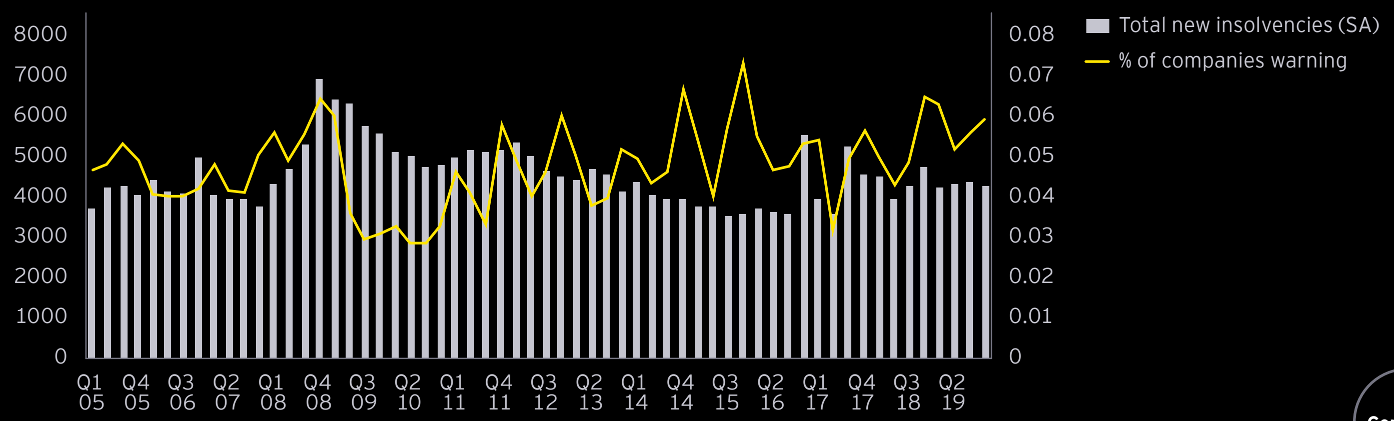
But the challenge doesn't end when the lockdown lifts. We know from previous, less intense, crises that one of the biggest tests comes when weakened companies and stressed management teams need to reflate balance sheets, restock inventory, restart operations, and depend on supply chains that have been similarly tested. There were more insolvencies in 2009 than 2008, with numbers barely falling until the middle of the decade.

Government support has been more extensive this time, but there is a limit to its capacity. The restart-challenge is also considerably larger. A quarter of UK businesses have stopped trading. They will need to mobilise with no certainty over what demand awaits them, from a standing start, whilst re-engaging staff and implementing social-distancing measures that could fundamentally test the feasibility of their business.

Meanwhile, structural change continues — no doubt altered and accelerated by changes in lockdown behaviour. Companies will need to realign and adapt their business to ensure that they're well positioned for recovery.

EY have created a four-stage framework for managing through the 'recovery' phase, focused on 'people engagement', 'operational realignment', 'financial agility' and 'recovery leadership'. Find out more **here**.

UK Insolvency and UK profit warnings



Sector focus: FTSE Travel and Leisure

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

FTSE Travel and Leisure companies issued a record 49 profit warnings in Q1 2020, more than double the number issued in the whole of 2019. Over 90% of these warnings cite COVID-19, which has hit the sector harder than any other. In fact, one in five COVID-19 profit warnings issued in Q1 2020 came from a FTSE Travel and Leisure company.

Businesses across the sector were already contending with constrained consumer spending, overcapacity, and rising costs. But COVID-19 has dealt companies a challenge far beyond anything we could have envisaged at the start of 2020.

The nature of the FTSE Travel and Leisure sector means that it was hit hardest and fastest by the necessary actions designed to socially distance the population and limit the spread of COVID-19. Affected companies have acted quickly to mothball operations and conserve cash, accessing government support as it became available. Where possible, companies have adapted – for example, restaurants running 'dark kitchens' and establishing takeaway operations. But similar options clearly aren't open to all.

The cumulative impact of the lockdown continues to take its toll on balance sheets – which will make the next step even harder. In fact, the biggest test for many companies won't be closing down, it will be opening up.

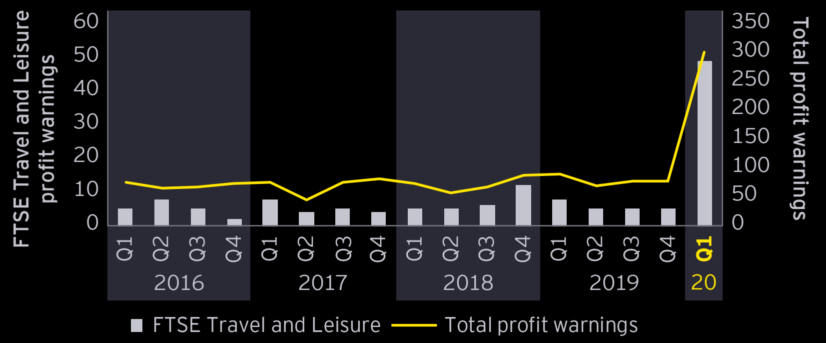
Businesses that rely on physical customer interaction will need to assess if they can still operate businesses safely – and profitably, if they need to reduce capacity. They'll need to think about how quickly they ramp up staffing levels and increase inventory given the potential for a period of uncertain and volatile demand. Data from Asia shows that hotel occupancy stayed well below normal after lockdown ended.

We expect demand will vary significantly between consumer and business markets, linked to confidence and appetite to spend; and between domestic and internationally oriented markets – not least because travel restrictions will likely relax at different times.

Operations with high fixed costs and limited scalability who run a 'business as usual' model will risk being unprofitable for some time. Finding a middle road will be key. This is a particular challenge for the hospitality sector, where labour costs are a significant proportion of overheads and the ability to furlough staff is likely to be severely restricted once sites start to reopen.

Companies will need to plan carefully for this next stage – and start thinking about what new 'normal' looks like, for customers and suppliers, reshaping their businesses accordingly. One of the biggest unknowns is how much of a long-term impact the lockdown will have on consumer and corporate behaviour. We could see significant declines in business travel as remote working proves its effectiveness.

FTSE Travel and Leisure profit warnings



Sector focus: FTSE Real Estate

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The FTSE Real Estate sector breaks down into FTSE Real Estate Investment and Services and FTSE Real Estate Investment Trusts (REITs). Both sides of the sector have seen a significant increase in profit warnings as a result of the COVID-19 outbreak with the number of warnings issued so far in 2020 already exceeding the high set in 2008.

The FTSE Real Estate Investment and Services sector issued nine warnings in Q1 2020, up from just two in the same quarter of 2019. FTSE Real Estate Investment Trusts issued seven warnings, equalling their annual 2019 total. All warnings issued in Q1 2020 cited the impact of COVID-19.

This was always going to be a testing year for a significant element of the real estate industry – especially those exposed to the increasing strain on tenants in the retail and leisure sectors. The impact of COVID-19 has significantly amplified these stresses – and added new ones.

Most Real Estate Investment Trust (REIT) profit warnings have unsurprisingly come from companies exposed to the travel, retail and leisure sectors – where we've also recorded the largest drop in rent collections. There is also a cluster of warnings in student accommodation, where major providers have waived final term rents – putting pressure on others to follow suit.

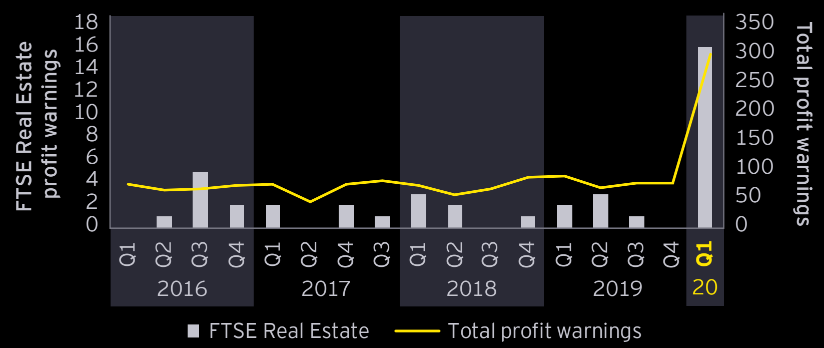
FTSE Real Estate Investment and Services companies have been hit by a sharp decline in activity in the housing market, with the lockdown hitting the supply and demand side of the sector. This market should bounce back relatively quickly, given the strong underlying demand for housing in the UK. The impact of COVID-19 on consumer confidence and incomes might delay the recovery, but structurally the market remains undersupplied.

The same cannot be said elsewhere. The lockdown has caused further structural damage to retail and leisure sectors, further accelerating the decline in tenancy demand through insolvency and the further reshaping of retail space. Student accommodation markets are also vulnerable to falling numbers of international students, which make up a high proportion of tenants in student accommodation blocks.

We expect to see further profit warnings from real estate companies in 2020, as more companies are hit by tenant insolvencies and delayed or missed rents. We also expect to see more sector distress. Whilst some of the larger, diversified companies in the sector have the portfolio and balance sheet strength to withstand a prolonged fall in income, many of the smaller, more leveraged companies do not.

The sector is also exposed to some of the great unknowns of what happens after lockdown. Beyond the impact on retail and leisure sectors, we may see a reshaping of other sectors where remote working and studying have become the norm.

FTSE Real Estate profit warnings



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Other sectors to watch

FTSE Media

The sector issued 20 profit warnings in Q1 2020 – four more than the whole of 2019. In Q1 2020, 70% of warnings cited COVID-19.

The impact of COVID-19 varies significantly between different industry sub-sectors and will affect companies depending on their ability to manage their liquidity and their exposure to falling company and consumer spending.

The sports and events sector are the most impacted. Early in the outbreak, COVID-19 led to widescale postponements and cancellations. There is no certainty as to when activity will restart or the appetite of consumers and corporate customers to reengage.

Despite the rise in TV and content consumption, the dramatic fall in advertising revenue is having an affect along the entire industry value chain. Marketing agencies are being hit hard, as are companies reliant on advertising income, particularly newspapers but also TV and online.

We anticipate widespread restructuring, especially in areas where the lockdown has altered behaviour.

FTSE Construction and Materials

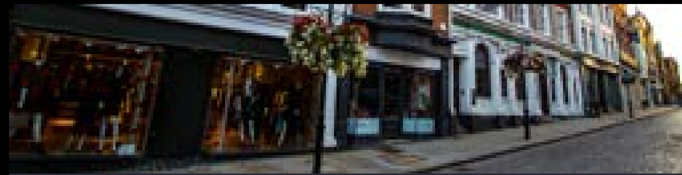
The sector issued 14 profit warnings in Q1 2020 – up almost threefold on Q1 2019. All but two warnings cited COVID-19.

The impact of COVID-19 has varied substantially. Tier-one contractors have fared best, due to their ability to continue operating – albeit with modifications that may increase costs and delay some programmes.

Warnings have risen highest amongst building materials companies, who face the challenge of modifying their operations amid falling sales, especially from the shuttered housebuilding sector.

Housebuilders – part of FTSE Household Goods and Home Construction – saw warnings rise sharply to eight in Q1, just one fewer than the whole of 2019. With the housing market in virtual lockdown – and revenue reliant on consumer sales – activity is just starting to resume.

Time will tell if this period of disruption leaves long-term scars on a sector that was starting to see stronger order books and improving margins.



FTSE Retailers

The sector issued 38 profit warnings in Q1 2020 – six more than the whole of 2019. 74% of warnings in Q1 cited COVID-19.

The non-food retail sector was already under significant structural pressure. Ten companies had issued warnings unrelated to the virus by the end of February.

Many retailers have adopted modified online services during lockdown, but capacity limits and falling discretionary spend have restricted sales.

Restart is a double-edged sword. Retailers need to sell seasonal stock, but demand is uncertain and restocking inventory and restarting payroll will put weakened balance sheets under further pressure.

We expect structural change to accelerate due to increased financial pressures and lockdown-stimulated changes in consumer behaviour. Stronger operators may also use this opportunity to reshape their store portfolios.

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South East

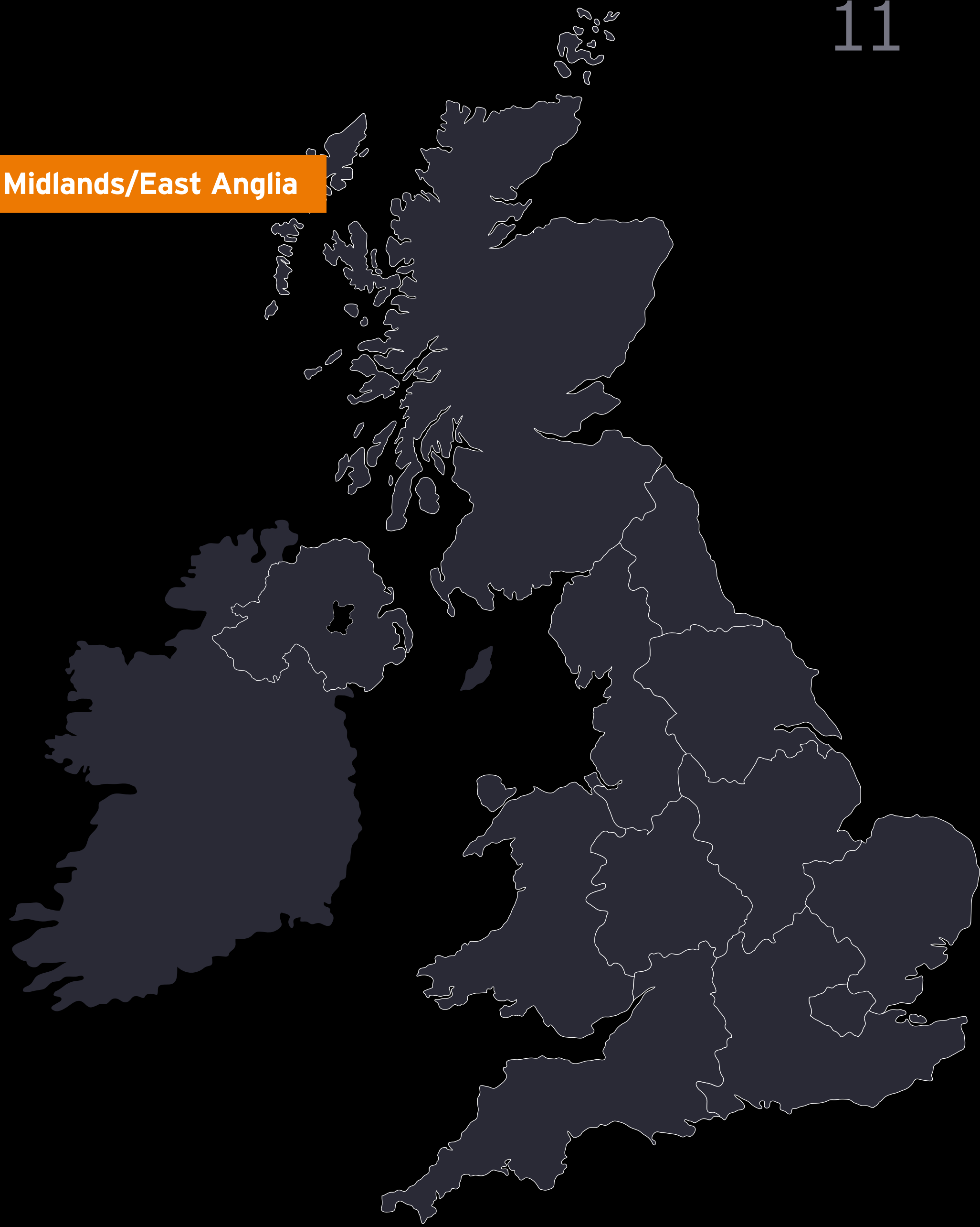
South West/Wales

Midlands/East Anglia

Yorkshire/North East

Scotland and NI

North West



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