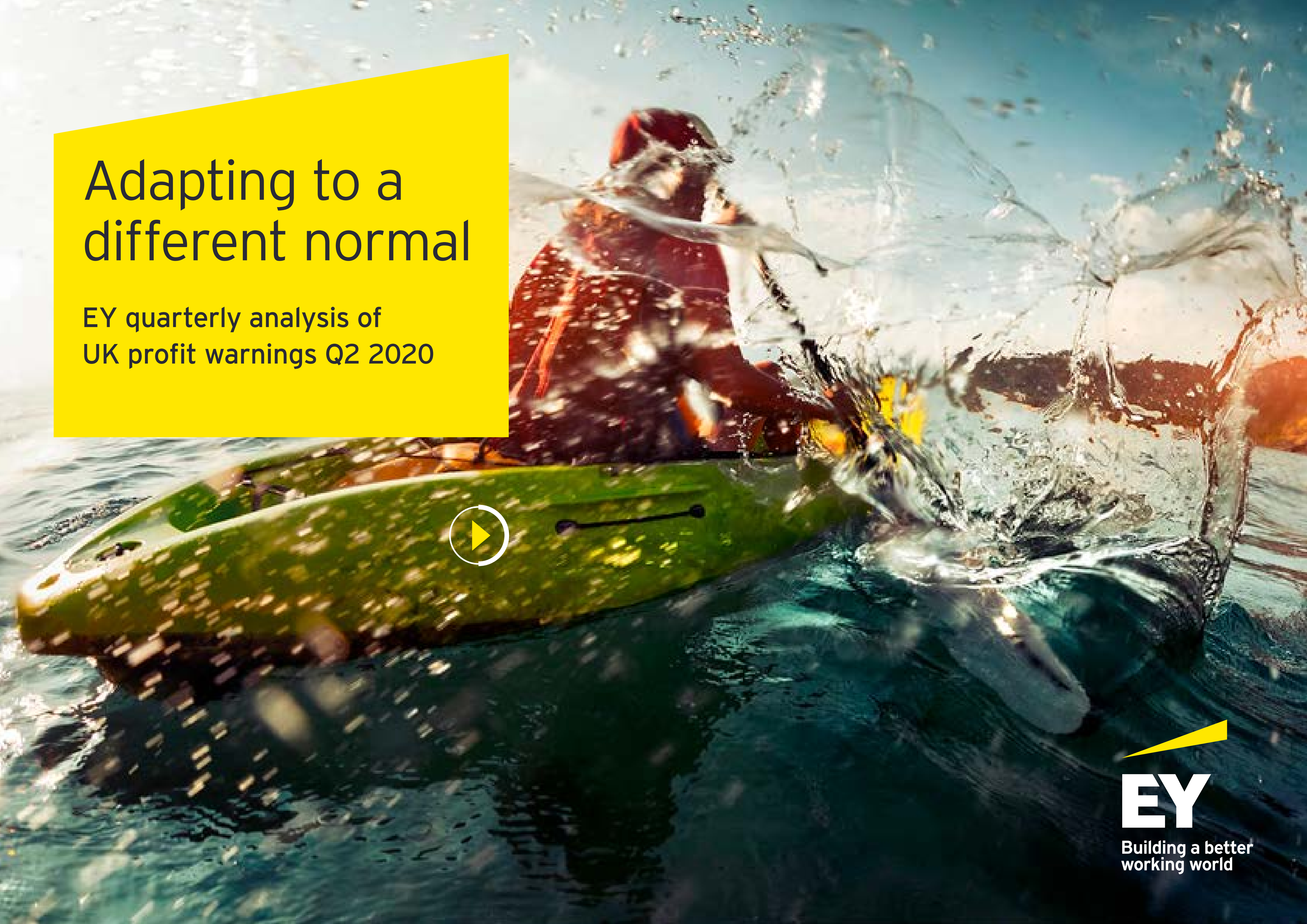
Adapting to a different normal

EY quarterly analysis of UK profit warnings Q2 2020



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Q2 2020 highlights

165

Profit warnings in Q2 2020, up 139% YoY

More than double the 69 warnings issued in **Q2 2019**

33%

UK quoted companies warned in H1 2020

84% of warnings cited the impact of the **COVID-19 pandemic**

42%

FTSE 350 companies have withdrawn earnings guidance

Many companies have **refrained from providing guidance in this uncertain climate**

10

FTSE Oil, Gas & Coal (Non-Renewables) warnings in Q2 2020

Industry warnings hit their **highest levels since Q1 2015** as the sector re-evaluate its outlook

63%

Companies warned in Q2 2020 for the first time in the last 365 days

COVID-19 stresses continued to spread across the economy in the second quarter

2.3%

Median share price fall on the day of warning

Share price reaction hits a new low, with investors looking forward to recovery

highlights

Alan Hudson
EY Head of UK & Ireland Turnaround and Restructuring Strategy

Adapting to a different normal

UK quoted companies issued 165 profit warnings in Q2 2020, almost 100 more than the same quarter last year and another extraordinary total given the record-breaking earnings downgrades we saw in the first quarter. In the first half of 2020 alone, almost a third of UK-listed companies have materially reduced their profit forecasts.

The most immediate and dramatic impact of COVID-19 has been felt by companies whose existing structural challenges have been accelerated and exacerbated by the pandemic. But I think it's especially telling that 63% of companies warning in the second quarter hadn't issued a profit warning in the previous 12 months. Even businesses that were essentially sound before the virus struck have been forced to fundamentally reassess their expectations and business plans in response to profound, short-term disruption and the potential for a more enduring change.

It's vital that boards don't underestimate the depth and extent of both the immediate and long-term challenges ahead. The UK economy is opening up, but it's early days. This is still a highly uncertain time for businesses, who are still adjusting to new ways of working and levels of demand, with potential cliff-edges to come in government support and further twists and turns likely in Brexit negotiations. The uncertainty is such that an incredible 42% of FTSE 350 companies had withdrawn their earnings forecasts by the end of the second quarter.

Amid the uncertainty, I think we can make two assumptions: that the recovery will be uneven, and it won't take us back to where we started. The virus has dealt fundamental blows to our economy and many changes in behaviour will persist. In the second quarter, we saw the epicentre of profit warnings shift to reflect the ripple effect of falling demand and cost cutting across the economy, but also something deeper. We saw an increase in write-downs and impairments as companies fundamentally reappraised their future.

This is a pivotal moment for UK plc. Companies could find that previously healthy parts of their business are no longer profitable. Size is no protection with more FTSE 350 companies than ever issuing profit warnings. Boards need to guard against complacency and be ready to take swift and decisive action to reshape their business to face a different future than they imagined just a few months ago.

“This is a pivotal moment for UK plc”

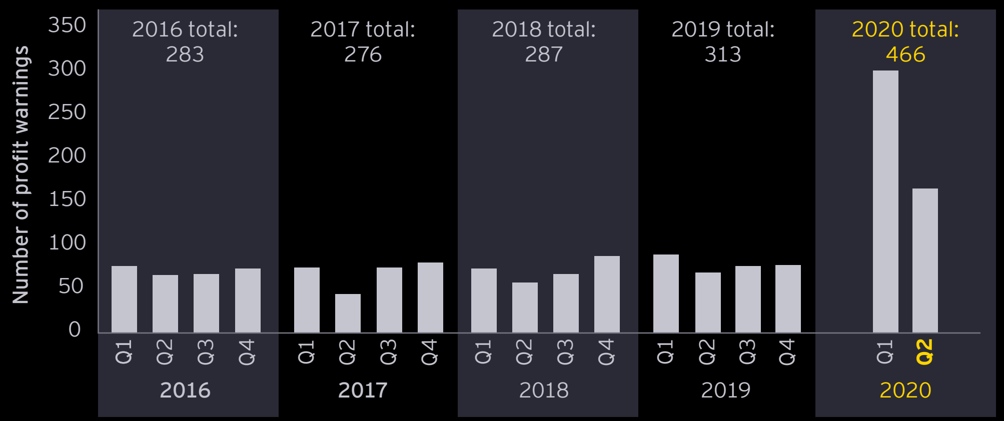
Economic outlook

An unprecedented hit …

The Office for National Statistics estimates that the UK economy shrank by 19.1% in the three months to May 2020, more than three-times larger than the 6.8% per cent peak-to-trough decline in the financial crisis. GDP grew by just 1.8% in May as the UK economy began to reopen after lockdown.

The scale of the economic shock isn't the only issue. Forecasting is an immense challenge. Economic estimates are likely to be revised several times before the year is out given the wide range of unknown variables, from the positive potential of government stimulus to the danger of periodic local and national lockdowns. Beyond COVID-19, there is also Brexit to navigate, which has been overshadowed by the pandemic, but remains a significant variable for many companies.

Profit warnings hit an all-time high in Q2 2020
Number of profit warnings by quarter

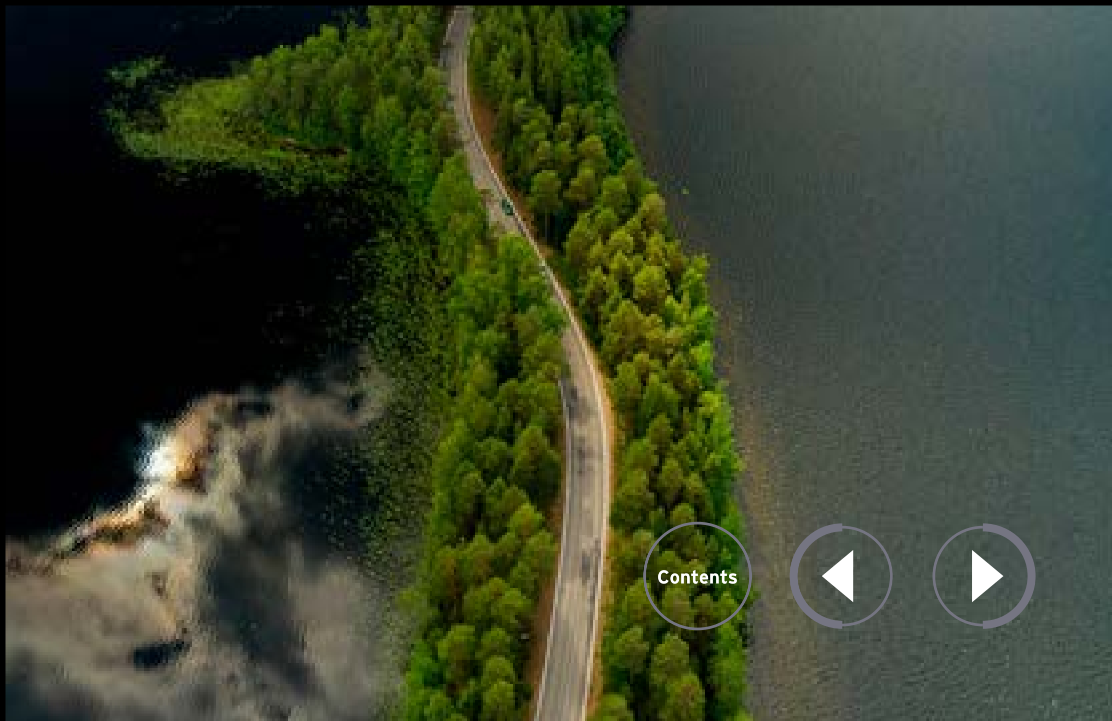


Our profit warning console contains more current and historic data: **ey.com/warnings**

… and a long road ahead

This wide range of variables is likely to create a highly differentiated recovery between and even within sectors, which will in turn create strong regional variations. Beyond the immediate challenges of COVID-19, there is question of the enduring changes that lockdown will make to our economy and the long-term scars it could leave in local, national and global markets.

Employment is a major concern. The Chancellor announced measures at the start of July focused on safeguarding existing employment and promoting the creation of new jobs to replace those lost in sectors that have been fundamentally reshaped by the pandemic. We expect to see further government action here, combined with efforts to 'level-up', build new infrastructure and support the green agenda. A much-reshaped economy could emerge from this crisis, with sharp contrasts between winners and losers.



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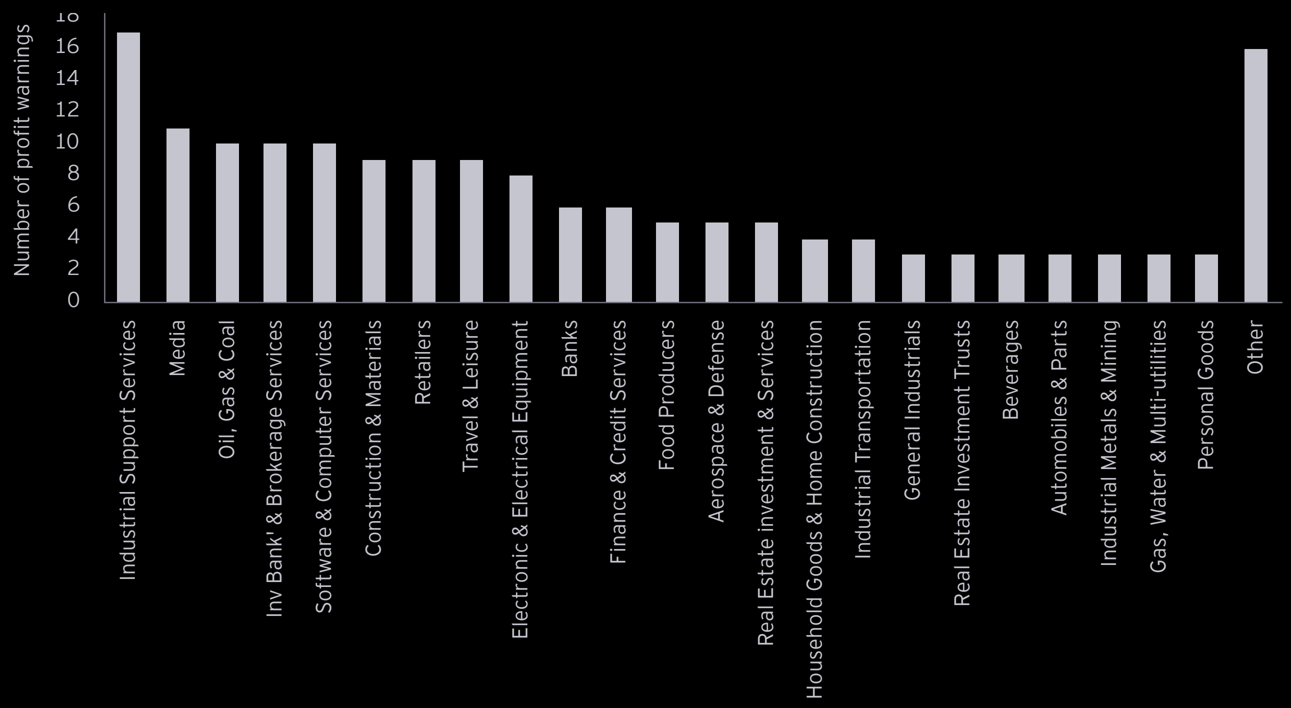
Sector overview

Ripple effects

The top FTSE sectors warning in Q2 2020 were: Industrial Support Services (17), Media (11), Oil, Gas & Coal (10), Investment Banking & Brokerage (10), Software & Computer Services (10).

The ripple effect of the COVID-19 pandemic on the economy has shifted the epicentre of UK profit warnings from the lockdown-impacted sectors of the first quarter to sectors exposed to the knock-on impacts of changing corporate and consumer behaviour.

Profit warnings by FTSE sector Q2 2020



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FTSE Industrial Support Services and FTSE Software & Computer Services are historically two of the most vulnerable sectors to contract disruption and corporate cost conservation in the short-term – although there is a long-term opportunity in supporting cost reduction and automation. The fall in consumer-facing profit warnings comes only after an exceptionally high level of warnings and forecast adjustments. There are still challenges in the restart and reduced demand and low visibility are having a knock-on impact across many other sectors.

Profit warnings from aerospace companies are already three-times higher in 2020 than the whole of 2019, hit by the fall in air travel. FTSE Media warnings are at record highs following falling advertising spend. Warnings from FTSE Finance & Credit Services companies are up more than five-fold year-on-year, hit by blows to consumer confidence and financial health.

Our data also highlights longer-term changes in outlook. Companies in energy and financial services sectors issued more profit warnings in Q2 2020 than Q1. Both saw a high level of impairments and write-downs in the second quarter as companies adjusted both their short-term and long-term outlooks.

Vanishing guidance

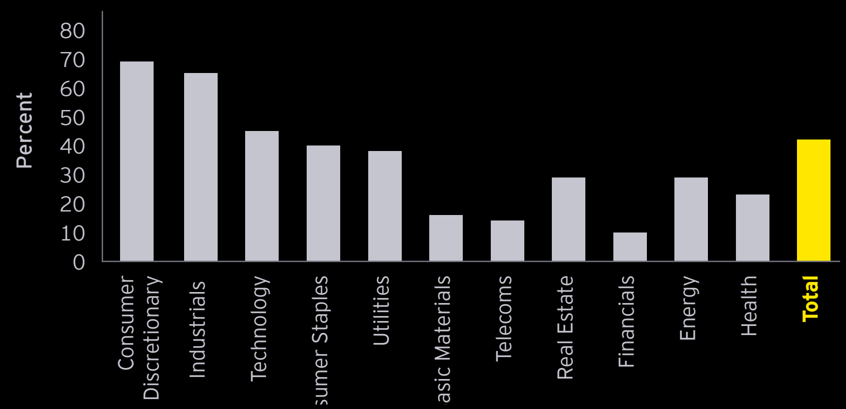
Something extraordinary happened in UK markets in the first half of 2020 — beyond a record-breaking total of 466 profit warnings. In fact, without this phenomenon, the level of warnings could have been even higher.

At the start of March quoted companies started to withdraw their earnings guidance due to high levels of forecasting uncertainty. By the end of the second quarter, 42% of FTSE 350 companies had withdrawn and not reinstated their earnings guidance. In sectors suffering from the highest levels of COIVID-19 pandemic impact and uncertainty, withdrawal levels were much higher.

This trend raises fundamental questions. Our Corporate Governance team's analysis of trading statements since mid-March shows that they have become more transparent and thorough, with more detailed information about liquidity and the balance sheet health than before the COVID-19 pandemic. Arguably in the last few months, companies have been reacting appropriately in providing investors with information on their resilience and ability to weather the whole storm, rather than providing a short-term forecast.

So, will we see more companies provide earnings guidance as the outlook becomes more predictable? The answer will likely depend on investor, analyst and regulatory attitudes. As we're seeing in so many other areas, some changes in behaviour may stick, especially if we continue to see companies shift their focus towards long-term value and away from short-term targets.

Percentage of FTSE 350 with withdrawn guidance*



* UK registered companies, excluding investment instruments, at 30 June 2020

Market reaction

Expectations plummet

The COVID-19 pandemic has radically reset earnings expectations. The question is now whether they have much further to fall and if we'll continue to see profit warnings at such elevated levels.

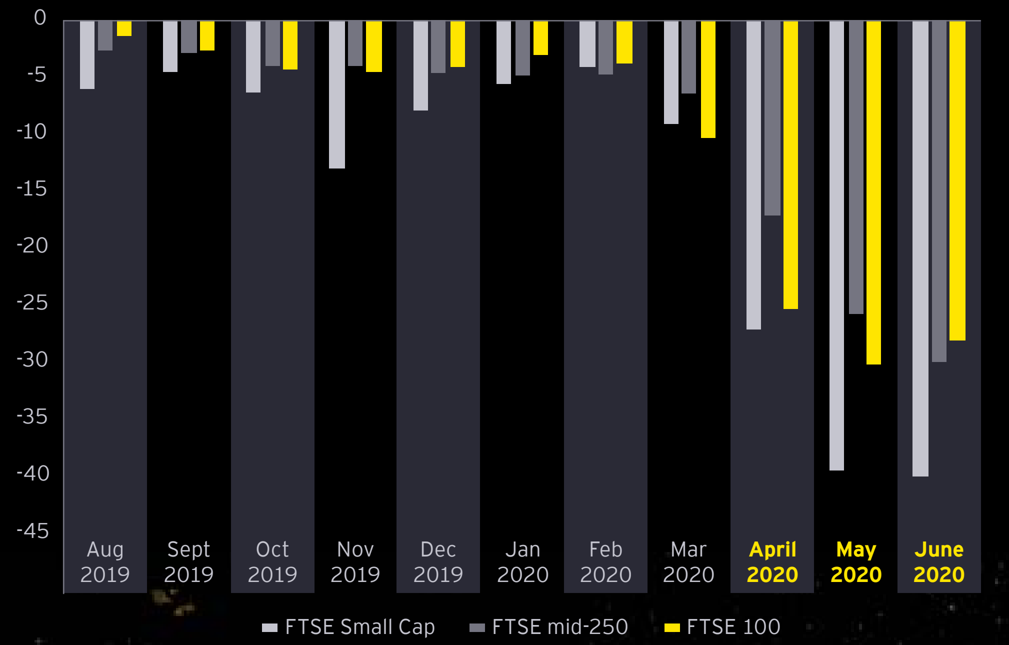
Recent history suggests that earnings expectations tend to adjust too far downwards after a crisis. Hence the significant dips in profit warnings we recorded in 2003 and 2010.

Market reaction to second quarter profit warnings certainly seems to suggest that most of the bad news is in the in price. The median share price fall in the second quarter was just 2.3% in Q2 2020, compared with 20.5% in the same quarter of 2019. The only sectors showing near-average falls in share price were those without significant numbers of profit warnings, i.e. sectors where expectations hadn't been downgraded as significantly in 2020.

But, whilst pace of UK profit warnings has slowed, it's still well above the seasonal average. Moreover, this crisis looks set to have a more profound impact on many sectors than previous downturns. There is the potential for more setbacks and there are still many unknowns as to how the pandemic will change long-term behaviours. And then there is Brexit, a further unknown to face in the second half of 2020.

Increasing stress and restructuring will also continue to create ripple effects across the economy.

UK earnings expectations fall dramactically
3m % change in 12m forward earnings expectations



Source: Thomson One

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Emerging risks

What does our data tell us about the concentration and spread of profit warnings in the UK economy? Where are risks emerging?

Areas most exposed to the impact of the lockdown and lower consumer confidence on discretionary spending are clearly immediate areas of concern. As well as having exceptionally high levels of profit warnings, the FTSE Retailers and FTSE Travel & Leisure sectors also have the highest number of companies warning three or more times in a 12-month period – which our analysis shows gives a 1 in 5 chance of a distress event* within the next 12 months.

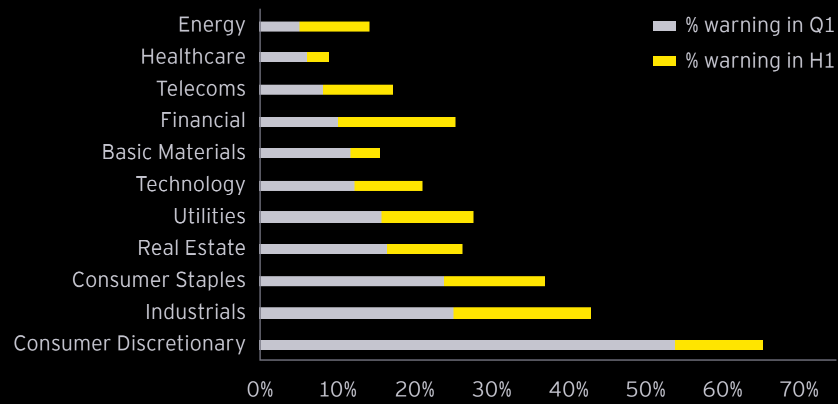
But, the biggest increase in the number and percentage of companies warning in Q2 2020 came in industrial sectors. This confirms what we're seeing on the ground, with stress moving rapidly through industrial supply chains, especially in the aerospace and automotive sectors.

There is evidence of significant supply chain overcapacity, which presents an opportunity for consolidation – but also an increasing risk of vulnerability, not least because of the potentially conflicting challenges posed by Brexit. Companies running low inventory now may need to rethink their strategy this autumn.

It's also worth noting the exceptionally high percentage of profit warnings coming from the FTSE 350 – 35% in H1 2020, double 2019's total. There are large scale restructurings in the market now that could have considerable impacts along supply and value chains. Profit warnings from financial sectors are also rising, driven by increasing concern over credit quality. As we saw in 2008-9, crises of this magnitude have a wide, long and sometimes unexpected impact.

* A 'distress event' includes administration, liquidation, debt restructuring, CVA or distressed sale

Percentage of industry warning by end of Q1 and end of H1



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Sector focus: FTSE Oil, Gas & Coal

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

EY recorded 10 profit warnings in the UK's Oil & Gas sector in Q2 2020, the largest number since 2015 and a higher total than the whole of 2019.

These warnings have come across the entire oil & gas value chain, with the extent and size of earnings downgrades reflecting the rapid increase in both short and long-term uncertainties in 2020.

The biggest short-term issue for the sector is the sharp drop in demand and oil prices triggered by the COVID-19 pandemic. Companies have managed rapid price falls before, and many still have hedges in place. OPEC+ also continues to intervene to stabilize prices, but they are still in $40/barrel range, well below the $65-70/barrel range early January and the $100 plus levels we saw before the downturn.

The root cause of this fall also has more uncertain elements than previous crises. We don't know when – but more importantly if – demand will return to previous levels in crucial end markets like air and road transport. Demand may take years to recover and it's possible, by that point, that the transition to a decarbonized society may have reached critical mass. It's even possible that we may have passed peak oil today.

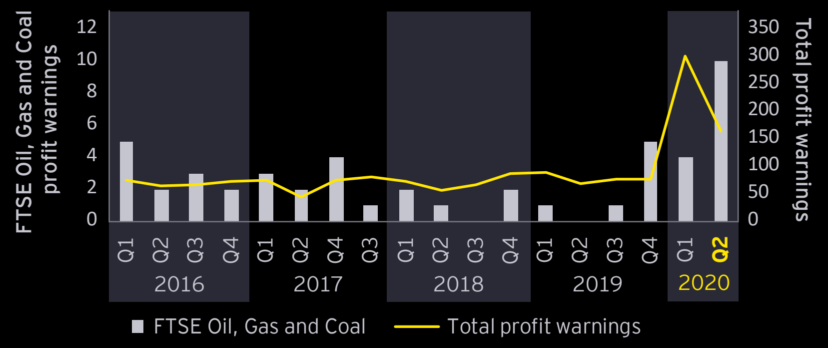
It's this combination of low prices and exceptionally high levels of uncertainty that has led to widespread write-downs as the sector radically rethinks both its short and long-term outlook.

In the short-term, the significant cuts to capital expenditure made by oil and gas producers this year will put even more pressure on the services and equipment sector, which had barely recovered from the last downturn when the pandemic started. Companies still have too much debt and too many assets with too many businesses competing in a now much smaller market.

But, it's important to note that profitability was an increasing issue for the whole sector before the pandemic started. Thus, for some, the next few months will be about survival. The priority for these companies will be cutting costs, managing liquidity and raising capital before debt markets tighten even further.

But there are also reasons for optimism. There will be long-term growth and value for companies able to leverage new technologies, increase efficiencies and invest in new energies, even new sectors, to meet the related challenges of a low-price environment and decarbonization. We expect to see more consolidation and partnerships as companies come together to face this challenging future.

FTSE Oil, Gas & Coal profit warnings



Sector focus: FTSE Media sector

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Profit warnings from UK-listed media companies reached an all-time high in the first half of 2020, with 31 profit warnings from 26 companies. This is a higher total than 2018 and 2019 combined, with three in five FTSE Media companies warning in the first six months of 2020 alone.

This is an extraordinary total, but it a story that needs unpicking because it's also a much more differentiated picture than this total would suggest. In fact, 90% of warnings come from events, publishing and advertising and marketing services companies – with a very low number coming from broadcasting and entertainment sectors.

In the first half of 2020, over a third of all profit warnings came from companies that operate business or entertainment events. Lockdown completely closed these sectors and they will be one of the last to fully reopen under previous conditions. The sector was already evolving in response to changing corporate behaviour and attitudes to travel and expenses, with the COVID-19 pandemic accelerating this need for reinvention.

As we've seen in many other sectors, creative virtual options are fast emerging out of necessity, and some of these virtual events are affording a much wider audience the opportunity to attend, thereby broadening the potential reach of each event and creating new business models.

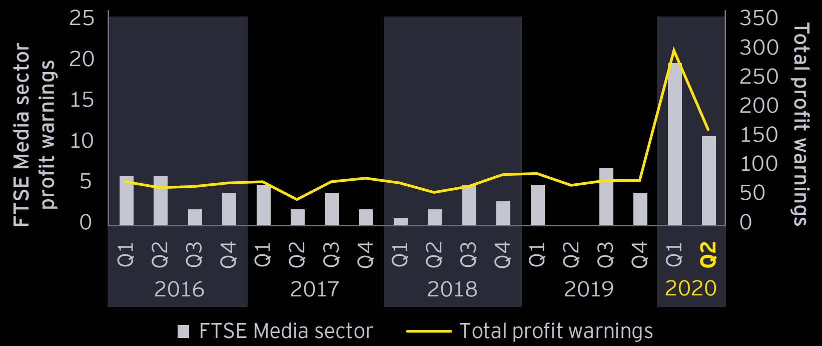
A further 40% of profit warnings came from advertising and marketing services businesses – and their suppliers. The downturn isn't surprising given the significant impact of the pandemic on consumer demand and widespread corporate cost cutting. The fall in consumer demand and advertising is also having an impact on the publishing sector, which was already struggling with falling sales.

Meanwhile, profit warnings from broadcasters and entertainment companies remain at similar levels to 2019. These businesses are not without their challenges, particularly those that are advertising funded. But creativity and subscription opportunities, coupled with an increase in viewing demand during lockdown, seem to have buffered many companies against other pressures – for now.

There are further challenges ahead. TV and film production remain difficult and more expensive under social distancing. The boost in uptake of subscription services may accelerate the shift away from linear programming, whilst falling advertising revenues will eventually hit home.

Change is a constant in the media sector. Some sub-sectors will benefit. Some will struggle. And some of the learning from experimentation during this time will accelerate change, as new concepts are rigorously tested. The question is: which businesses will most effectively rise to this challenge and use it as a catalyst to drive evolution?

FTSE Media sector profit warnings



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Other sectors to watch

FTSE Retailers

FTSE Retailers issued a further nine profit warnings in Q2 2020, with almost three-quarters of the sector issuing a warning in H1 2020.

Non-essential retail has reopened, but footfall remains well below pre-pandemic levels and the sector won't be returning to its previous 'normality'.

Consumer behaviour has undergone a sea-change, accelerating the technology-led reshaping we saw before the pandemic, especially the shift from physical to online sales and resulting shrinkage of store portfolios.

Consumer confidence remains low and driving growth will tough, with unemployment is expected to rise as the furlough scheme ends.

Whilst operational efficiencies, increasing automation and supply chain reviews are all important to control costs, the key need will be to create a differentiated customer experience to boost demand.

Channel shift will dilute margins until models are fully integrated putting additional pressure on earnings. Widespread restructuring will continue, posing fundamental questions for companies reliant on the sector and its footfall.

FTSE Travel & Leisure

The sector was hit hardest and fastest by the COVID-19 pandemic. A further nine profit warnings in Q2 2020, means that over three-quarters of the sector has warned in H1 2020.

The sector is rapidly reopening but is contending with reduced capacity and lower levels of demand.

Government stimulus is welcome, but its success is dependent on consumers having the confidence to socialise as well as spend.

The biggest part of summer season is yet to come, but it's hard to make up lost ground and commit more capacity given the lack of visibility over consumer behaviour.

We still don't know how much commuting and business travel will return. It's absence is having a severe impact on city centre demand and wider hotel occupancies.

The end of the furlough scheme represents a significant cliff edge. We expect to see more companies reshape their businesses to meet new challenges and increasing levels of insolvency as they struggle to adapt.

FTSE Industrial Support Services

The sector issued 17 profit warnings in Q2 2020, the highest level of sector warnings in the second quarter and the third highest in H1 2020.

The sector is typically vulnerable to contract disruption and short-term corporate cost cutting.

Over a longer horizon, outsourcers able to help companies cut costs, automate and reshape their business will benefit from the cost cutting trend. The challenge as ever will be maintaining contract discipline.

The recruitment subsector was already under pressure from slowing global growth and the impact of IR35. The impact on jobs from the COVID-19 pandemic adds another level of concern, with global unemployment expected to rise substantially by the autumn.

Warnings from industrial suppliers have leapt from one in 2019, to six in the first half of 2020. The rise reflects slowing demand from industrial sectors and underlines increasing concerns around the health and sustainability of supply chains.

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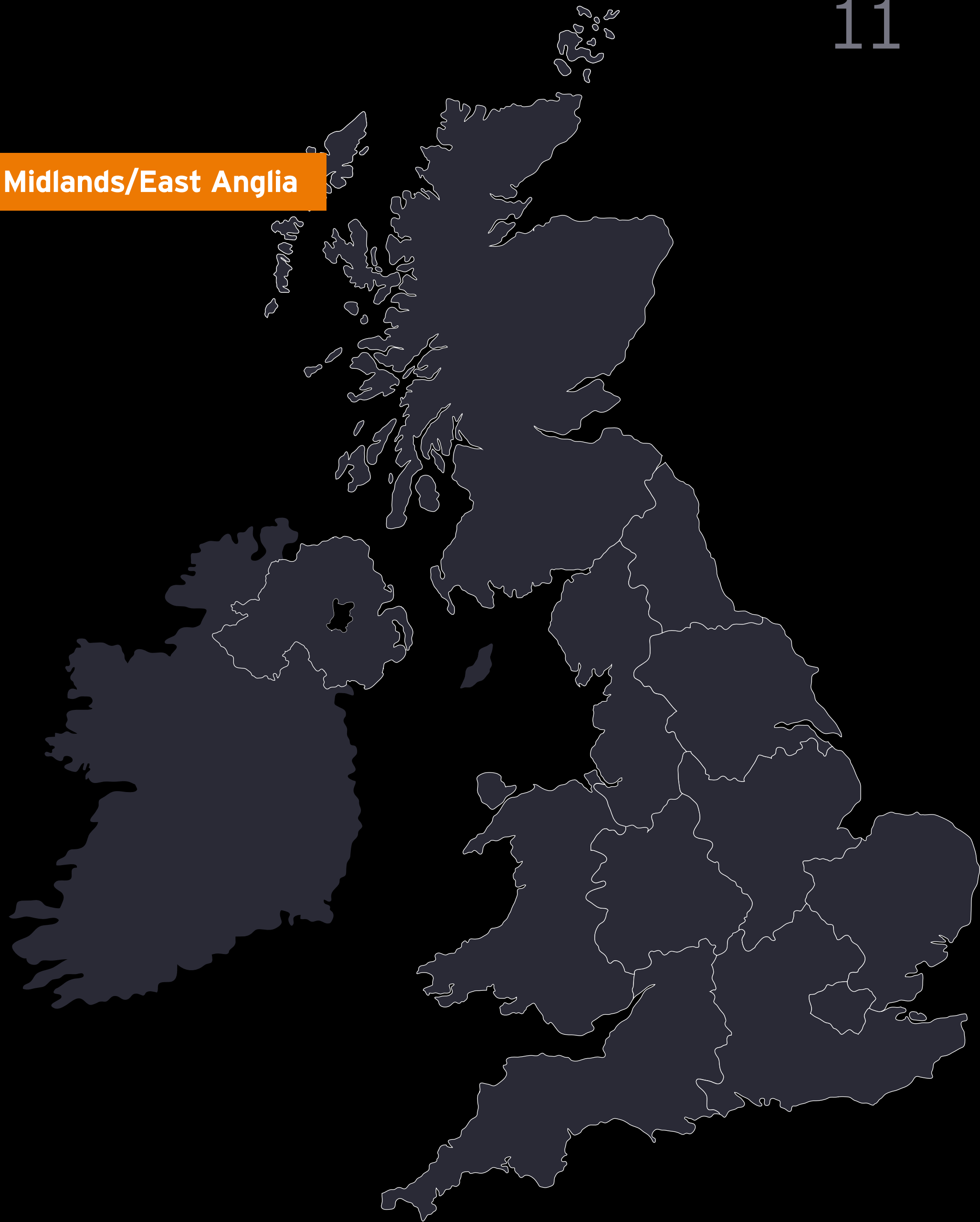
Yorkshire/North East | Scotland and NI | North West



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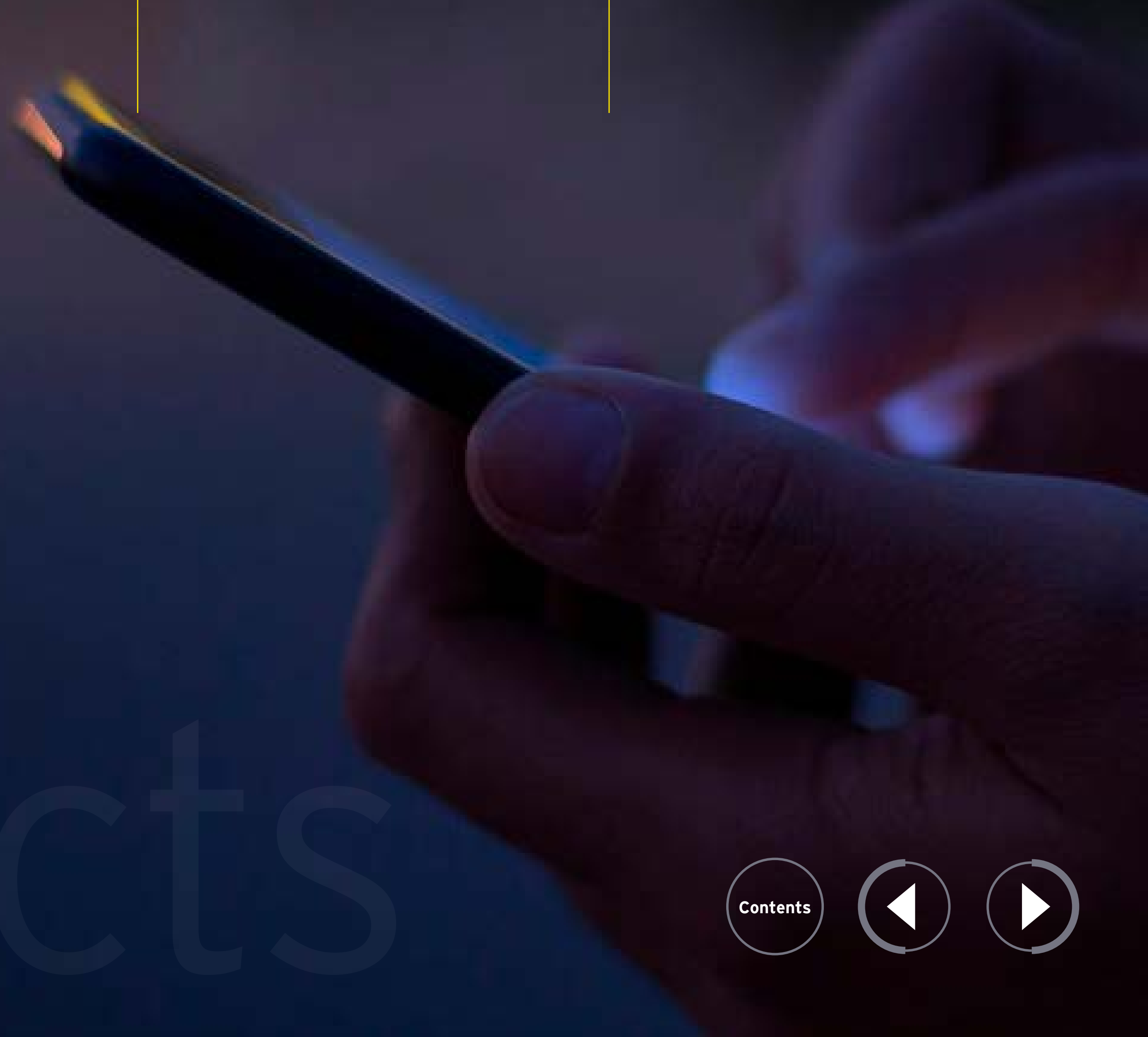

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