Uncertainty strikes again

EY-Parthenon quarterly analysis of UK profit warnings

Q3 2024

EY Parthenon

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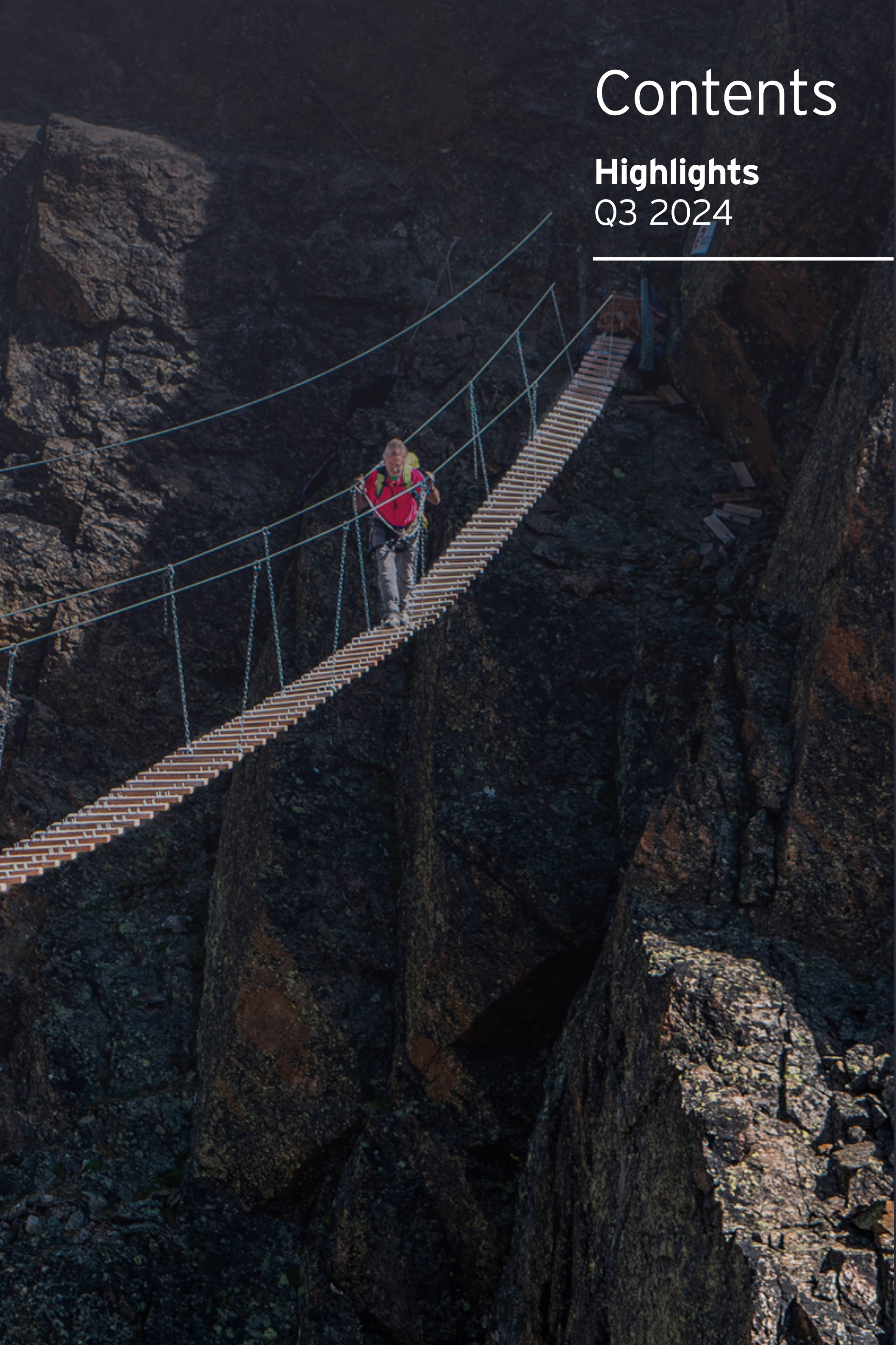

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Q3 2024 highlights

84	19.2%	40%	53%	15.2%
UK-listed companies warn in Q3 2024	UK-listed companies warn in the last 12 months	FTSE Beverage companies warn in the last 12 months	FTSE Technology Hardware & Equipment companies warn in last 12 months	median share price fall on the day of warning in Q3 2024
Rising by 11% year-on-year to hit the highest quarterly total for two years	Highest rolling 12-month percentage of companies warning since the pandemic	Industry faces post-pandemic hangover as it navigates evolving consumer demand	Sector warnings reach their highest level since 2001 as it feels the impact of inventory overhang and spending delays	Companies suffer a higher hit to share price reflecting the rise in profit warnings and market volatility

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Blip or trend

UK profit warnings leapt to a two-year high in the third quarter. The 84 profit warnings issued in Q3 2024 represent an 11% year-on-year increase and a dramatic 71% rise from the previous quarter, when warnings hit a two-year low. Is this a temporary spike or part of a longer-term trend? The answer probably lies somewhere in between.

Unusually, this latest rise in profit warnings wasn't triggered by a sudden economic downturn, a one-off event, or a jump in cost or supply chain pressures. Instead, what we tracked this summer was a real-time change in sentiment that companies can pick up in slowing order books before it appears in economic data.

Persistent uncertainty has been a defining feature of the business environment for several years. We've been commenting on the impact of corporate and government spending delays on the support services and software sectors since the end of 2023. However, uncertainty seemed to intensify this summer due to such factors as the speculation around the UK Budget and policy change, heightened geopolitical tensions, and the upcoming US election. A record 38% of profit warnings cited order and contract delays and cancellations in Q3 2024, with the impact spreading across industrial and technology sectors.

If uncertainty lifts, profit warnings could fall. But we think that the volatile macroeconomic and policy backdrop, coupled with profound changes in technology, consumer behaviour, and the climate challenge, will make sudden shifts in earnings expectations more likely. The complexity of the current forecasting challenge is highlighted by the fact that almost one in five UK-listed companies (19.2%) has issued a profit warning in the last 12 months, the highest level since the pandemic and, before that, the highest since 2001.

This quarter's paper focuses on two sectors – technology and beverages – that are at the intersection of macroeconomic pressures and rapid market changes. We also explore the risks associated with energy transition and the rise in going concern issues, linked to increased forecasting challenges and refinancing uncertainties.

In this climate, companies and their stakeholders need to be vigilant and proactive in identifying and addressing emerging issues before they escalate. The restructuring landscape is rapidly evolving, with new solutions offering opportunities for value preservation. However, prompt action is still crucial to securing the best possible range of outcomes.

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Economic outlook

Focus on growth

The UK economy is still on an upward trajectory, albeit at a slightly slower pace than forecast earlier this year. But the uncertainty we've seen in this summer's spike in profit warnings is visible in industrial surveys that also softened in late summer.

After a strong start to 2024, the UK's recovery story is intact, but with caveats. The EY ITEM Club now expects GDP growth for 2024 to be 0.9%, slightly weaker than the 1.1% forecast three months ago. Beyond 2024, the EY ITEM Club has also lowered its growth forecasts to 1.5% in 2025 and 1.6% in 2026, down from 2.0% in its July update.

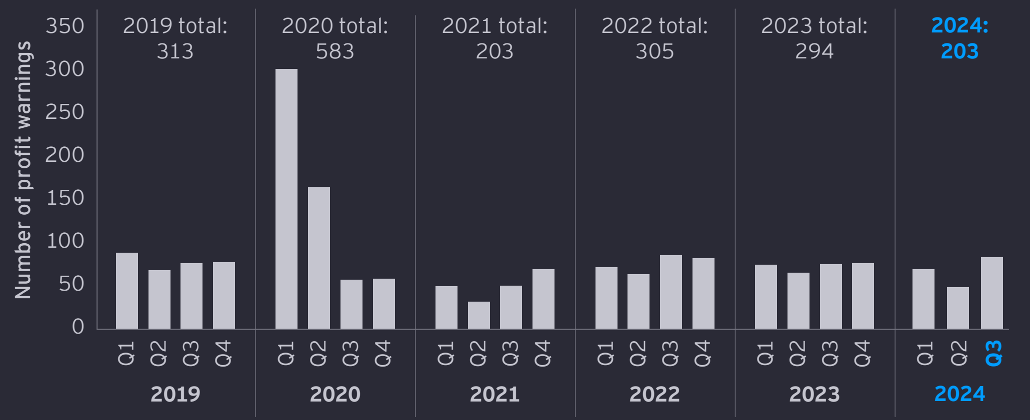
The UK economic outlook is still fraught with 'ifs and buts' and heightened uncertainty, making forecasting a challenging task for economists and companies alike. Pay growth has slowed but is above normal rates. Inflation has also fallen to below the Bank of England's 2% target, but 'sticky' service sector inflation will keep the Bank on guard and limit the pace of rate cuts. Stable inflation and solid pay growth will support household incomes and consumer confidence, but many UK mortgagors will fix to higher mortgage rates in 2025 and 2026. Across the economy, tighter fiscal policy is likely to offset the support coming from loosening monetary policy.

Whilst it's true that uncertainty has been a near-constant theme of this decade, this seems to have been further heightened this summer by UK policy changes, the upcoming US elections, and increased geopolitical tensions. Industry surveys and our profit warning data both tell a story of inventory overhangs, contract delays and slowing order books, as companies paused spending. Consumer spending has held up, helping to support growth, but household savings are also higher than expected.

This leaves us with the potential for a rebound if business and consumer confidence improve, thereby unleashing pent-up spending. But the UK – and other developed economies – face a longer-term problem in slower trend growth, which has fallen to around 2% from 2.75% in the decade before the global financial crisis. There is potential for output growth to improve over the next five years or so, with further public and private investment and enhancements in productivity; however, businesses need the right conditions for investment, innovation, and enterprise.

UK profit warnings remain above average

Number of profit warnings by quarter



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

Sector overview

Industrials and technology dominate

Uncertainty was a primary trigger for profit warnings rising in Q3 2024. Industrial and technology sectors led this rise, with inventory overhangs, contract delays and slowing order books the recurring theme of this quarter's warnings.

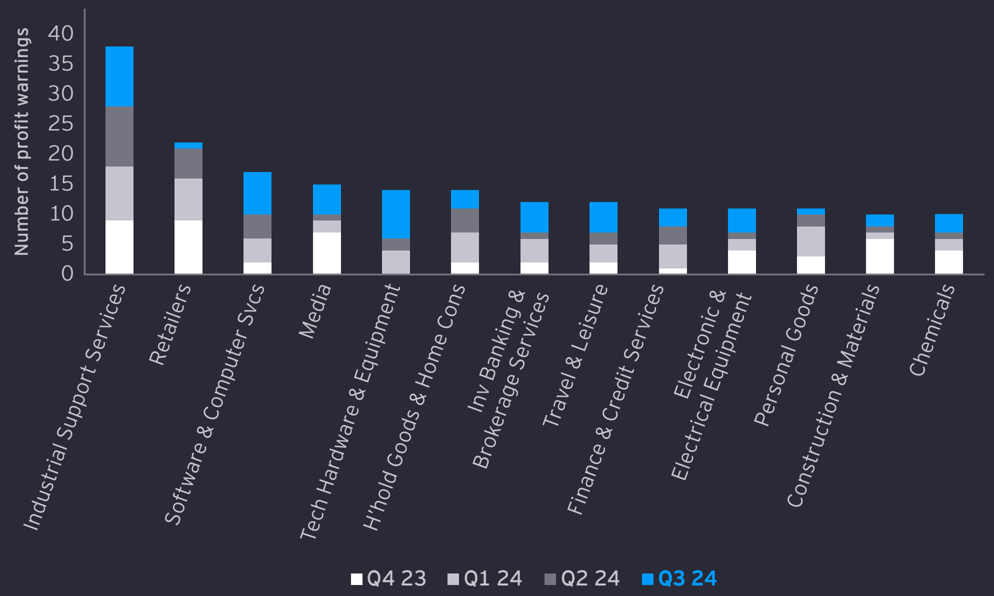
- The FTSE sectors with the highest number of profit warnings in Q3 2024 were: Industrial Support Services (10), Technology Hardware & Equipment (8) and Software and Computer Services (7).
- The FTSE sectors[1] with the highest percentage of companies' warning in the last 12 months were: Personal Goods (75%), Telecommunications Equipment (67%), Industrial Materials (60%), Chemicals (57%) and Technology Hardware & Equipment (53%).

Uncertainty isn't a new theme in UK profit warnings. Contract and order related warnings have been elevated since mid-2023. However, the third quarter of 2024 saw these issues intensify to unprecedented levels, with 38% of profit warnings citing delays and cancellations in contracts and orders – the highest percentage in 15 years, with falling sales triggering a further 33% of the quarter's warnings.

Customer reluctance to commit to new contracts and orders was particularly pronounced in the technology and industrial sectors, where over 70% and 90% of the warnings, respectively, were related to either lower orders or contract delays and cancellations. This trend is corroborated by recent industry surveys, such as the Confederation of British Industry's (CBI) Industrial Trends survey, which noted a contraction in manufacturing output with an expectation of further declines in the fourth quarter. Similarly, the S&P UK Industrials Purchasing Managers' Index (PMI) also reported a slowing of growth in industrial sectors in September due to investment and hiring freezes and highlighted the largest fall in UK manufacturing confidence since March 2020.

The biggest rise in industrial warnings in Q3 2024 came in manufacturing sectors, especially engineering and material sectors which are grappling with challenges in two principal end-markets. The commercial aerospace sector is dealing with repercussions from supply chain and production issues at major airline manufacturers, although core demand is stable. The automotive sector, on the other hand, is at a critical juncture, with annual car sales in Europe three million below pre-pandemic volumes and most major OEM factories running below capacity. Whilst not solely attributable to falls in electric vehicle sales (EVs), the fall in EV volumes and uncertainty around upcoming regulatory change have undoubtedly complicated the outlook and created stress across both the broader automotive and EV supply chain and dealership networks.

Profit warnings by FTSE sector



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1 FTSE sectors with more than five constituents

Approaching the energy transition challenge

Energy transition presents a complex and fundamental societal challenge. This isn't just a change in energy sources; it requires a profound evolution in business models, consumer behaviour, and government investment. Yet there is no single roadmap or timetable, or even an agreed destination. Given this unpredictable path, what considerations should companies and their stakeholders prioritise?

There is not one energy transition, but multiple, unfolding at different paces and in different ways across the world. And, whilst change is accelerating, it could easily stall due to the sheer complexity of decarbonising a largely hydrocarbon-powered industrial sector. This poses significant questions for companies who need to take fundamental action to sustain and create long-term value in their business. Meanwhile, companies in renewable sectors are also struggling with the variable pace of change.

Automotive and its supply chain are currently at the forefront of this transition – particularly in Europe – as legislation drives change. The sector is giving us an insight into the challenges companies face in bridging the gap between a legacy and a new business model.

Build resilience against uncertainty: The pace of change is still highly uncertain, with legislative goalposts subject to change. In the automotive sector, the move to battery electric vehicles (BEVs) is well underway, but the pace of change is now in question, leading some companies to wonder if it is better to be an early mover or to wait and see, given the high cost of investment required and the higher levels of competition and lower margins for BEVs. Companies need the agility to pivot and adapt to changing legislation and adoption speeds.

Guard against supply chain pressure: Larger companies at the top of supply chains are normally better equipped with greater operational and financial flexibility – and buying power – to absorb more of the impact of uncertainty. The highest levels of stress are in supply chains, where companies are dealing with uncertainty – but also, in many cases, the potential redundancy of significant sections of their portfolio. This poses a significant risk for OEMs who still have a need for internal combustion engine (ICE) parts. OEMs need to track and support their supply chain to spot vulnerabilities and intervene when necessary to help support their suppliers' transition.

Address footprint challenges: Companies need to critically assess their manufacturing footprints as demand for traditional products wanes. This could include repurposing facilities – including pipelines and links to the national grid – for new uses that align with the emerging energy landscape. Significant operational restructuring is often needed, for example, to rationalise footprints and right-size back offices to support thinner margin business.

Creating flexible operating models: Companies are caught between two priorities – delivering the significant change that is needed to be successful in the future, while maintaining sufficient focus on current (ICE) operations to extract value while they can. To manage this, they need operating models that are efficient, flexible, and capable of adapting to a rapidly changing demand landscape. Energy transition is an opportunity to redefine a business' future. But companies need to take decisive action to ensure their long-term viability.

Market reaction

Summer stutters

There was always a risk of further volatility in the second half of 2024 given the extensive list of issues on investors' radar. The fears of a US recession that led to the global market's sharp decline in early August were overdone, yet the possibility of further market fluctuations remains, with many uncertainties unresolved.

The median share price fall on the day of a profit warning hit 15.2% in Q3 2024, up sharply from 9.7% in Q2 2024. The average fall also rose, to 19.1% from 12.3% in the previous quarter. By both measures, investor reaction to profit warnings is at its most negative since Q4 2023. This marks a stark contrast to the second quarter of 2024, when the market's post-warning reactions were the mildest since 2021. What has caused this resurgence in investor apprehension, and why is there such pronounced volatility in market reactions from one quarter to the next?

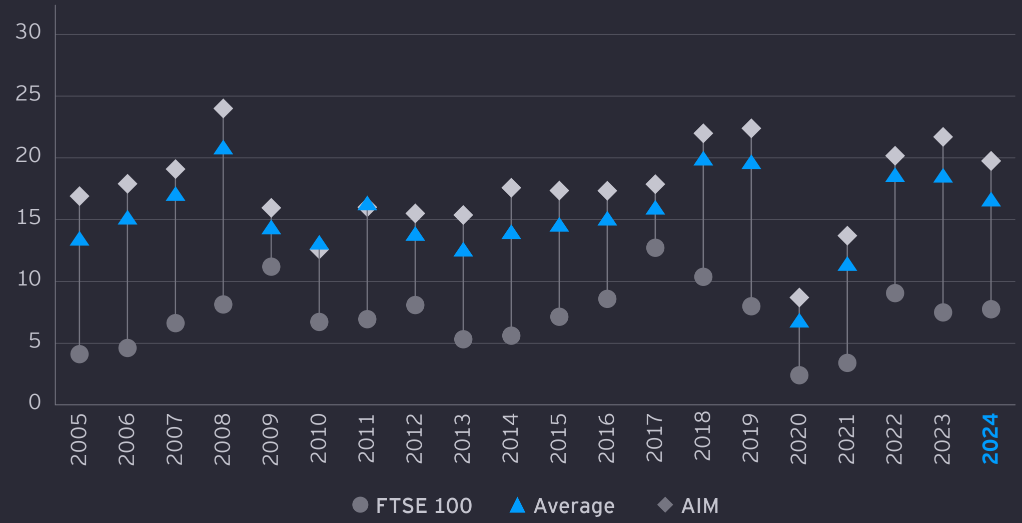
On 5 August, the Nikkei 225 index recorded its largest points fall, even surpassing the Black Monday crash in 1987, with repercussions spilling across global markets. The US recession fears that inspired this fall quickly faded, and global markets finished August in positive territory. But this episode underscores ongoing uncertainties and the fragile state of investor confidence that's behind recent volatile swings in share price reaction.

As we've discussed, the third quarter of 2024 was marked by heightened uncertainty, with profit warnings reaching a two-year peak, prompting investors to seek safer havens. The technology sector felt the brunt of investor concern, as warnings from listed technology companies more than doubled both year-on-year compared to the previous quarter. The resulting average share price decline of 29% following technology profit warnings in the third quarter, reflects this increased caution. We can also see caution in the under-pressure AIM market, where share prices fell by 22% on the day of warning.

Whilst one of the foremost concerns for investors – whether central banks can successfully navigate interest rate adjustments, inflation control, and economic growth – has diminished, the potential for new worries remains. With inflation below 2%, a further UK rate cut is expected in November, but service inflation is still higher than the Bank of England's target. Meanwhile, the economic outlook continues to be obscured by fiscal challenges, the possibility of policy shifts, and geopolitical instability.

Increasing and diverging reaction underlines investor caution

% average first-day share price fall



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Going concern risks

EY's latest analysis shows a four-fold increase in auditor material uncertainty disclosures in 2024, compared to the period before COVID-19. 'Going concern' assessments involve many elements, judgements, and forecasts – which makes going concern issues a complex area for stakeholders to navigate, but one that they cannot ignore.

A material uncertainty (MU) opinion may be applied to a reporting entity that considers the 'going concern' basis of accounting to be appropriate, but which faces uncertainties and events that might result in it being unable to continue as a 'going concern'. If an auditor considers company disclosures adequate, it will issue an unqualified report but with a 'Material Uncertainty Related to Going Concern' section in its report, which explains the challenges.

The four-fold rise in MU opinions we've recorded, compared with 2019, stems from the increasing economic and forecasting uncertainty that we can see in this summer's extraordinary level of profit warnings. Accurate forecasting is still a tough process for many businesses. But the rise also has its roots in other factors. Refinancing cost, complexity and risk have all increased. There is a greater focus on working capital sensitivities, which can place greater strain on the sufficiency of cash and financial covenants. In parallel, high-profile failures have intensified regulatory and audit scrutiny – layering this into sectors with elevated levels of stress and regulatory focus, such as construction and utilities, can lead to tougher discussions and outcomes.

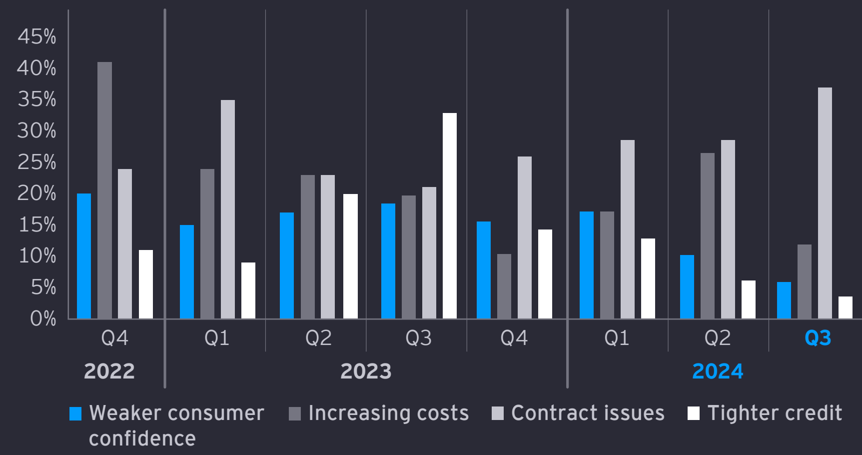
Going concern issues are a complex risk area for stakeholders, who risk being blindsided by an auditor's opinion. This is true even for lenders, who may see a company's downside forecast but not the auditor's scenario, which commonly includes added factors. For some businesses, MU disclosures can affect trading and the confidence of other stakeholders, including suppliers, customers, trade credit insurers, and pension trustees, whose actions, in turn, can hit confidence and further constrain liquidity. Auditors may speak to lenders to gauge support as part of a going concern assessment, potentially pulling them into the spotlight.

All of this underlines the importance for stakeholders to identify issues early, taking advice and engaging with the company to clarify expected approaches and the level of preparedness for going concern discussions, and to consider early options, mitigations, and red lines. Some lenders may have restrictions around direct contact with auditors and should consult internally prior to any engagement.

Key questions to ask:

- What is the background to the audit opinion and how does the Company intend to manage any associated risks?
- What is the wider impact of any adverse audit opinions and/or disclosures on existing or upcoming financial relationships, suppliers, customers, trade credit insurers, and pension trustees?
- What are the longer-term credit implications and how might current concessions preserve future optionality?

Uncertainty triggers more profit warnings linked to contract issues and spending delays



FTSE Beverages

FTSE Beverage companies issued three profit warnings in Q3 2024, just one fewer than in the whole of 2023. In the last 12 months, 40% of UK FTSE Beverages companies have issued a profit warning in a more challenging domestic and global market.

Part of the challenge is demand. Brewers, distillers, and winemakers have found themselves squeezed by a pincer movement created by a post-pandemic hangover and a cost-of-living crisis. Inventory built up during the supply chain challenges of 2021-22 created a stock overhang that didn't unwind as expected due to falling demand as drinking behaviour normalised and consumers felt the pinch of the cost-of-living crisis.

But this isn't just a volume issue. After years of premiumisation and luxury being the main growth driver, especially in the spirits industry, growth in premium brands has stalled. Companies that focused on a premium theme of drink less, but drink better have been forced to reflect on their strategy. Drink fashions are also changing more rapidly than we've seen in the past. The rapid growth we saw in premium tequila has cooled and gin has seen a rapid decline in demand.

Even more fundamentally, the next generation is increasingly focused on wellness, with a third of adults aged 18-24 choosing not to drink at all. And there are fewer places to drink, with more than 3,000 pub closures in the UK over the last six years. Compared to 2019, the volume of total drinks consumed at on-licence premises has materially fallen from 37% to just 27% in 2023. Our recent survey of workout bankers picked 'restaurants and bars' as the sector with the biggest increase in stress in 2025.

Strategic export markets have also been hit by falling consumer confidence due to economic pressures and geopolitical tensions, adding to the challenging environment. Russia was a top 10 export market for Scotch, and there is nervousness around the potential for more US tariffs.

Significant consolidation in the sector in recent decades has created large producers with the portfolio range and size to absorb these changing demand patterns – and the capital to develop and market non-alcoholic alternatives. However, many smaller producers and those with a narrower portfolio, especially newer businesses that ramped up production during the pandemic and have less experience of downturns, are struggling. Smaller gin and whisky producers, in particular, are suffering from oversupply in their category and an underestimation of the working capital required to build a brand and sustain momentum.

FTSE Technology

Technology companies have been increasingly prominent in UK profit warning data in 2024. The FTSE Software & Computer Services sector ranks second highest for profit warnings so far this year. Meanwhile, over half of FTSE Technology Hardware & Equipment companies have warned in the last 12 months alone. The long-term growth story is intact, but these warnings highlight internal stresses and cyclical challenges that cut across this diverse sector.

The universe of listed technology companies is diverse, however a universal profit warning theme emerged this summer – spending delays. This theme isn't exclusive to technology profit warnings. But it's a trend that seems to have disproportionately hit companies in FTSE Software & Computer Services and FTSE Technology Hardware & Equipment sectors, where 70% of warnings cited spending cancellation and delays compared to 38% across all industries.

Why is the technology sector feeling an outsized impact? Technology companies act as service providers across the entire economy, making them susceptible to broader market slowdowns and reduced spending. The post-pandemic landscape has exacerbated this vulnerability. Organisations had to quickly adjust to remote operations and enhance customer connectivity during the lockdown. In many cases, this brought planned forward spending and put pressure on later year budgets. Pressure on client budgets also makes it harder for technology companies to pass on price increases – including increases in labour and raw material prices.

Artificial Intelligence (AI) introduces another layer of complexity. Whilst AI's growth benefits many technology companies, the pace of change makes it harder for clients to know when to push the button on their investments. Clients are hesitant to commit to technology that may become obsolete in a year or less. Also, AI gives more clients the ability and opportunity to develop their own in-house solutions, eating into the sales of some developers. AI has also prompted investors to look more closely at companies with regards to AI-substitution risk.

The impact of these pressures varies within this diverse sector. Smaller companies, particularly those with turnovers under £200m – which account for over 90% of the profit warnings in 2024 – are more susceptible to demand fluctuations due to their limited product range and client base. However, resilience can be found in companies that offer 'sticky' products–those that are essential, deeply integrated into clients' workflows, and not easily replaced. Resilience also stems from maintaining operational and financial discipline, which can buffer against the sector's inherent volatility.

Companies that can provide indispensable products and manage their operations with strict discipline stand a better chance of weathering any demand storms and capitalising on the sector's long-term growth trajectory.

Other sectors to watch

FTSE Construction and Materials

FTSE Construction and Materials companies issued four profit warnings in the first nine months of 2024, compared with 10 in the same period of 2023. In the last 12 months, 22% of the sector has issued a profit warning.

Demand has improved in 2024, and cost pressures have eased, but the systemic challenges of low margins, variable costs, and the inherent unpredictability of the construction process remain.

The size and broader portfolios of larger contractors should enable them to absorb risk, if well-managed. An increasing focus on risk management throughout the contract lifecycle, from pricing to delivery, on internal controls, and on forecasting to limit risk should allow companies to identify and address problems earlier.

Nevertheless, contractors remain vulnerable to any slippage in these disciplines, which can, in turn, create a snowball effect as clients and trade and financial creditors lose confidence.

Meanwhile, margin stress and risk continue to cascade through the supply chain. It is in these areas where risk and margin pressures have become concentrated, and where there have been the most profit warnings and distress.

Sector insolvencies have also dampened the appetite for trade credit insurance and bonding and increased cost – whilst also intensifying scrutiny from stakeholders.

Additionally, there are longer-term issues for the sector to address in labour availability and skills gaps, as well as an increasing need to deliver sustainability targets within their own businesses and for their clients.

FTSE Retailers

In the last 12 months, 42% of FTSE Retailers have issued a profit warning, up from 33% in the same quarter of 2023. The consumer outlook is improving, but retailers still face challenges in the critical Christmas quarter and beyond.

The consumer environment is improving. Real incomes are rising, inflation is falling, and retail sales rose across the quarter. However, consumer confidence is still fragile and the pressure on disposable incomes is easing slowly.

The EY ITEM Club expects subdued consumption spending growth of just 0.8% in 2024 – up only marginally from 0.7% in 2023. They have also reduced their 2025 forecast to 1.9%, from 2.5% forecast three months ago.

Retailers will need to work hard to unlock additional spending. As we've seen in previous years, Black Friday may encourage consumers to delay purchases. Retailers are preparing with strategic discounting to stimulate spending. But the balance between timely promotions and the risk of premature discounting is delicate; retailers must navigate this with care to avoid stock shortages or overstock.

Beyond the immediate challenge of Christmas, the sector faces existential challenges. Technological advancements, particularly in AI, are enabling smaller businesses to compete with larger retailers by building digital infrastructure more affordably. Sustainability and ethical practices are also an increasing influence on consumer choices, pushing retailers to adopt more transparent and responsible business models.

UK overview

[Please click the buttons to find out more]

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Yorkshire/North East

North West

Scotland and NI

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