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Vulnerabilities against Economic Headwinds: Prospects for the UK Corporate Sector

Economic conditions have become increasingly challenging for the UK corporate credit environment. A mere seven months have passed since the government lifted all COVID-related restrictions. The UK then entered into a period of inflation, accelerated by the Russia-Ukraine military conflict. With economists forecasting that the UK economy is likely to fall into recession, beset by steepening inflation, declining consumption, and rising interest rates, the corporate credit sector is navigating a complex economic environment.

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Challenge

The end of the third lockdown in England in July 2021 and the Russian invasion of Ukraine in February 2022 spanned a period of only seven months. This period of "normality" between crises was brief, and despite the period of economic growth in late 2021, corporate finances have had little time to repair from the impact of the COVID-19 pandemic.

In the July 2022 Financial Stability Report[1], the Bank of England indicated that for large firms, Interest Coverage Ratios (ICR) were broadly in line with pre-COVID levels. However, potentially vulnerable sectors were identified—those with relatively narrow profit margins, exposed to increasing energy or fuel prices or to lower consumer demand and reduction in real household income. For UK small- and medium-size enterprises (SMEs), total debt increased by over 20% between the end of 2019 and the end of 2021, reflecting the £80 billion of support provided to these firms through UK Government loan schemes.

Given the combined headwinds of elevated inflation, the prospect of declining economic output and rising interest rates, and the impact of these macroeconomic trends on corporate earnings, in this article, we assess the potential impact of the UK corporate sector.

Insights

We base our projections of the impact of macroeconomic factors on the UK corporate sector using the financial statements of over 42,000 public and private firms.
The sample ranges across sectors and size, but is limited to firms with turnover of over £100,000 and with complete financial statements, necessary for the analysis undertaken.

On this population, two forms of analysis are undertaken, both forecasting a firm's probability of default (PD), but achieved in two different ways. The first is a macroeconomic-conditioned forecast. Here, a relationship is established between probability of default and macroeconomic variables, allowing the determination of a firm's PD given different macroeconomic conditions, specifically the baseline and 4% deep downside (S4) scenarios forecast by the Moody's Analytics Economics group[2].

In the second analysis, a more granular forecast is undertaken, which considers the evolution of a firm's financial statement under certain scenarios and assumptions. Again, economic forecasts are used as key inputs, determining how variables impact input cost and output for each firm, to forecast monthly income statements. These are translated into end-of-period balance sheet and profit-and-loss financial accounts.

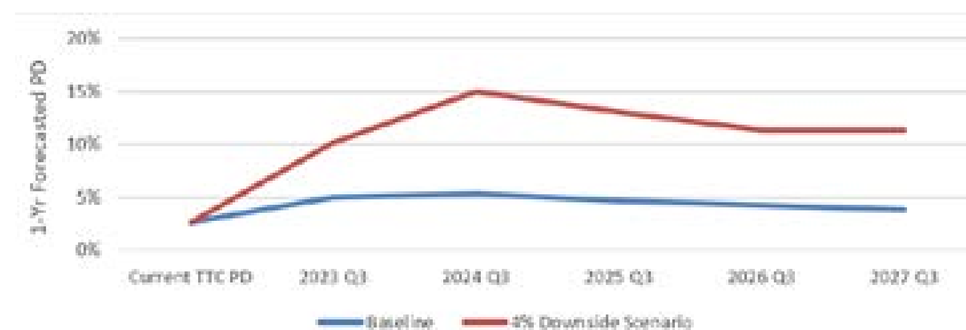
Analysis

Our forecasts indicate a decrease in creditworthiness across the UK corporate sector. Currently, Moody's Analytics estimates the current average PD for the entire sector at 2.65%. Note, this is still above the average PD we measured prior to the COVID-19 pandemic, which was just below 2%.

Our forecast under a baseline economic scenario expects the average PD to rise over the coming 24 months, peaking in Q3 2024 at 5.41% (Figure 1). By way of comparison, this is a higher impact when considering the environment at the outset of the COVID-19 pandemic, where our macro-economic PD forecasts estimated 4.29% average PD in May 2020.

The forecast under an S4 deep downside economic scenario estimates an average default rate of almost 15% in Q3 2024. This is commensurate with the observed global default levels during the Global Financial Crisis, indicating the potential risks associated with the current environment.

Figure 1 UK Corporate Sector Probability of Default Forecast from Moody's Analytics Macroeconomic Scenarios: Firms >£100K Turnover



[1] https://www.bankofengland.co.uk/financial-stability-report/2022/july-2022
[2] https://www.economy.com/

Let's dig a bit deeper into this aggregate view, and take a look at the distribution of Implied Ratings[3] (Figure 2). We observe that the deterioration in credit increases the distribution of firms in the sub-investment grades, with only 13% of firms classified as investment grade by Q3 2024. Moreover, the analysis forecasts nearly 20% of firms under significant distress, with little prospect of recovery.

In our forecast, risk across the aggregate UK corporate population is set to increase. However, the outlook for individual sectors is more varied. Our forecast model considers how changes in macrovariables impact each sector specifically.

Figure 3 shows the change in sector-level average PD from current levels to those forecasted in Q3 2023. The sectors with the largest variance include Construction, Accommodation and Food, Wholesale, Information and Communications, and Manufacturing. There are many factors to consider in what is driving these changes, but sensitivity to CPI and GDP levels are factors to which these sectors are particularly sensitive.

Note, our forecast model also reflects the starting PD for a firm, so the make-up and inherent risk associated with firms in these sectors also contributes to the economic conditional PDs produced by our forecasts.

Figure 2 Implied Rating Distribution: Baseline Scenario, Current vs. Forecast

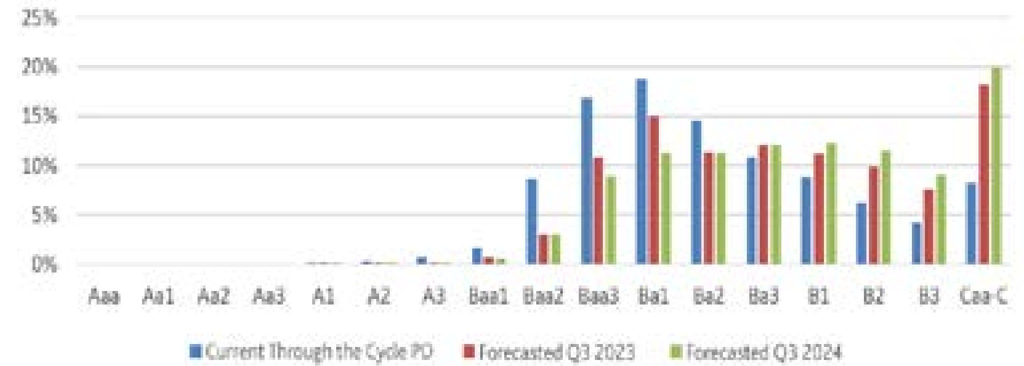
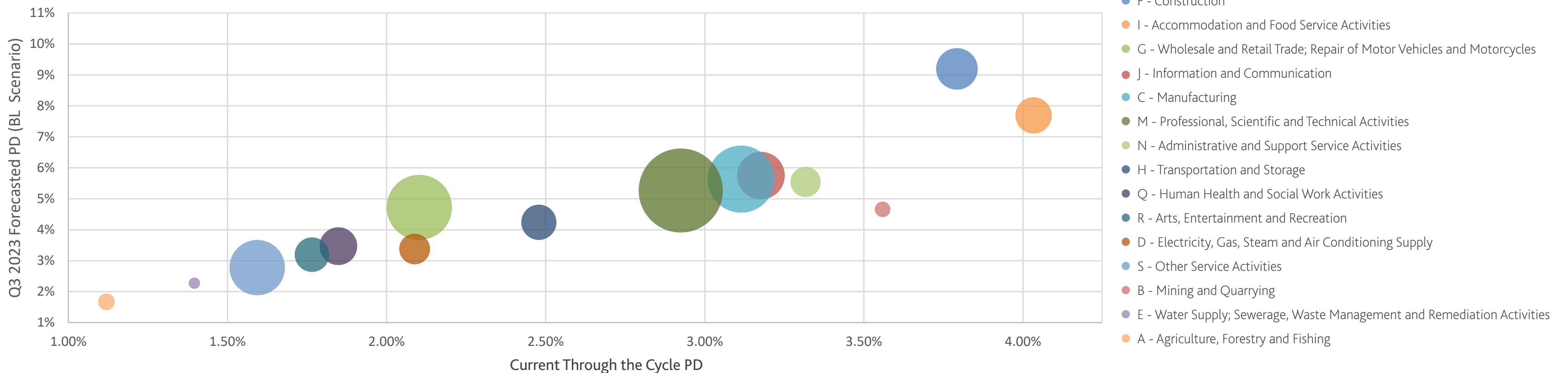


Figure 3 Change in Probability of Default (PD) by Sector: Current Through the Cycle PD vs Q3 2023 Forecasted Baselined PD

Bubble size indicates number of firms in the sector



[3] Implied Ratings are not the same as, or equivalent to, regulated credit ratings issued by Moody's Investors Service. The mapping of a probability of default produced by Moody's Analytics Riskcalc™ model to the credit rating nomenclature of Moody's Investors Service does not transform the RiskCalc model output into a Moody's Investors Services regulated credit rating or their equivalent. The Implied Ratings should not be deemed to imply a Moody's Investors Service credit rating.

In the second area of our analysis, we forecast the financial statements themselves.

First, we look at the picture of risk through the distribution of firm's implied rating (Figure 4). The changes in risk are more subtle than in the previous macroeconomic forecasts. This shouldn't be seen as a contradiction, but rather as an opportunity to interrogate complex dynamics within a firm's performance as well as an opportunity to test different assumptions.

Within this analysis, we observe a complex set of drivers, as within this distribution there are over 30% of firms whose PD actually improved in the baseline scenario, despite the current challenging economic headwinds. This is consistent with observations of some firms' performance during the COVID-19 pandemic, where typical sector-level assumptions broke down, creating 'winners and losers.' Firm performance was often dependent on the ability and speed of adjusting business models to meet changes in demand brought about by the effects of the pandemic.

Figure 4 Implied Rating Distribution: Baseline Scenario

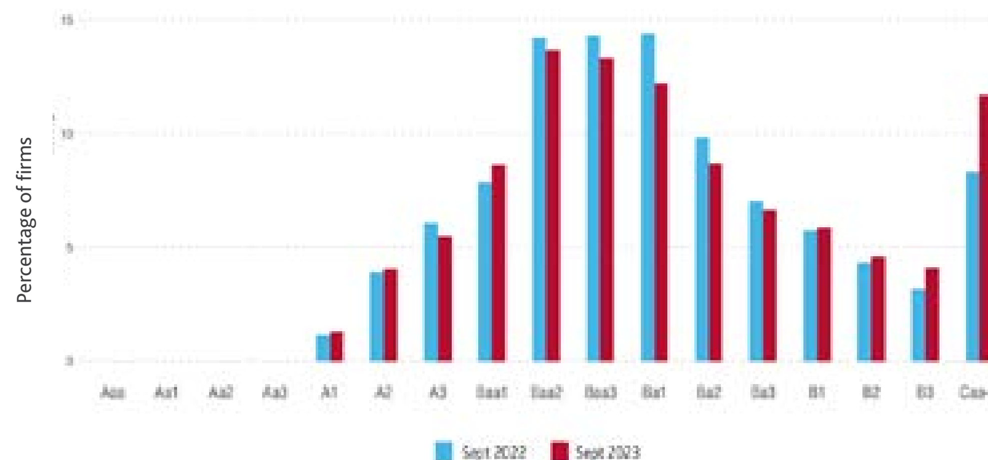


Figure 5 Driver Changes vs PD by Sector

Sector	DRIVER CHANGES, Sept 2022-Sept 2023 (Baseline)			PD		
	Debt Coverage	Liquidity	Profit Margin	Sept 22	Sept 23 - Baseline	Change (%)
(A) Agriculture	-0.61	10.60	-2.51	0.8%	1.0%	22.1
(B) Min, Oil, Gas	-0.17	3.99	6.44	2.8%	2.8%	-0.4
(C) Manufacturing	-0.61	-0.33	-2.05	2.7%	3.8%	39.0
(D) Utilities	-0.33	4.58	-7.75	2.0%	2.3%	19.2
(E) Waste	-0.46	10.15	-0.52	1.3%	1.4%	4.0
(F) Construction	-0.38	9.77	-0.09	2.6%	2.7%	3.7
(G) Wholesale, Retail	-0.60	1.52	-1.45	1.8%	2.6%	45.5
(H) Transportation	-0.39	7.94	0.65	1.8%	1.9%	4.8
(I) Acc and Food Serv	-0.40	27.10	0.15	3.2%	2.4%	-24.8
(J) Information	-0.39	1.58	0.37	3.0%	3.2%	6.9
(M) Prof Serv	-0.45	3.46	-1.13	2.5%	3.0%	18.2
(N) Admin Serv	-0.38	4.97	-1.53	3.2%	3.5%	9.3
(Q) Health Care	-0.97	-32.40	-7.76	1.2%	2.4%	108.9
(R) Arts, Entertainment	-0.26	53.62	3.13	1.1%	0.9%	-16.2
(S) Other Serv	-0.41	1.43	-0.39	1.2%	1.4%	14.9

Our analysis indicates that there are many sectors already facing challenges, such as Construction and Wholesale and Retail Trade. Within these sectors, we consider firms whose management can successfully navigate the complex economic environment.

In reviewing Figure 5, the drivers contributing to the changes in PD across sectors, we observe three key financial ratios: debt coverage, liquidity, and profit margin. From this analysis, we can make three critical observations.

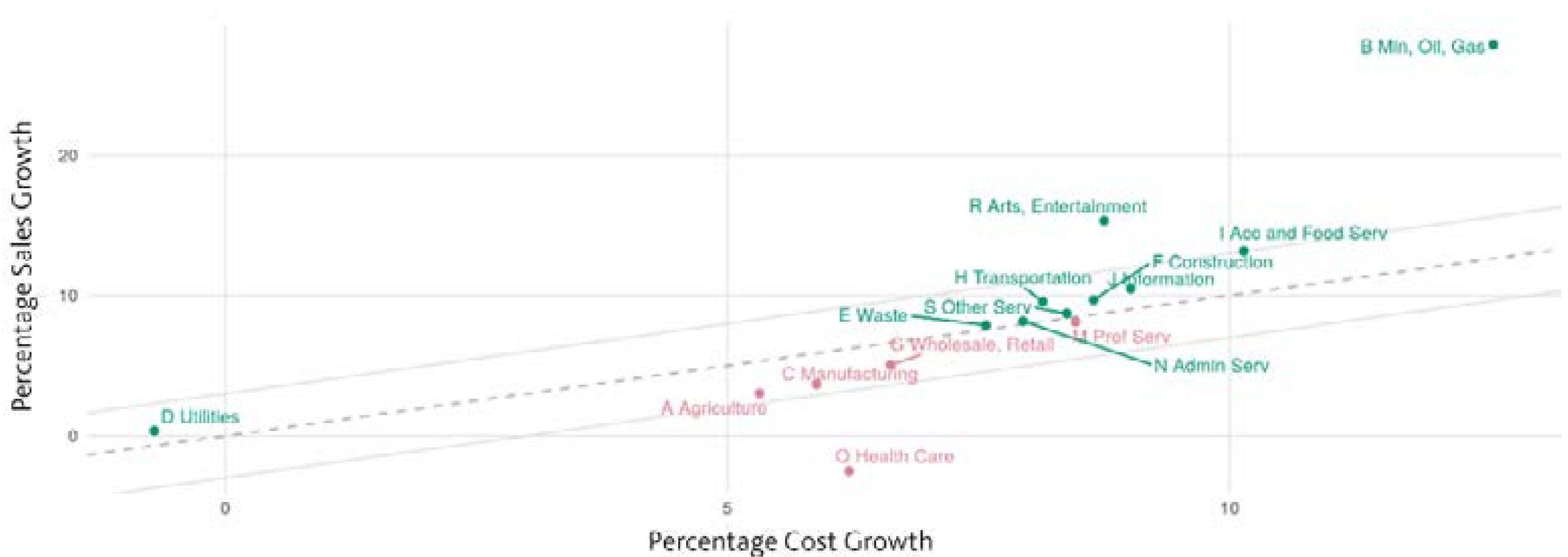
1. The sector level liquidity position is varied, indicating sectors where recovery through late 2021 and early 2022 was strong and consumer demand and spending were positive. This liquidity can provide a buffer for firms operating in the current environment, such as the Arts & Entertainment and Accommodation & Food Services sectors.
2. Profitability is varied across sectors.
3. Across all sectors, debt coverage is falling.

To understand more about a firm's profitability, we look at firms' cost growth against their sales growth. This doesn't necessarily dictate profitability, but it provides a good perspective on operating margins.

In Figure 6, we see that virtually all sectors experience cost growth, with the exception of Utilities, which is expected given declining energy prices in recent months. The causes of cost growth can be clearly attributed to increases of input and input services needed for firms' production, which have significantly increased, again despite the decrease in energy costs. Note, we don't observe labor costs being a factor in this baseline scenario.

For sales growth, however, the position is more varied. Here the tipping point is the reduction of output for some sectors in outweighing their ability to offset cost increases with price increases. This varies significantly firm-to-firm—and goes to the heart of the challenge faced by firms in this environment, explaining why we see disparity in performance within sectors. Firms face a balancing act in managing operating costs in the face of declining demand, and a need to react and adapt.

Figure 6 **Sales and Cost Growth by Sector from Q3 2022 to Q3 2023**



Finally, in terms of debt coverage, we see a combination of low growth and increasing interest rates causing debt coverage to fall across all sectors (Figure 7). Note, our assumptions consider that all firms pay floating rates, which is not the case for all firms. However, given the lean profitability for many firms in our analysis, the timing of refinancing loans at higher interest rates is critical. Debt coverage depends on how adaptable a firm can be in optimising its financial position.

Figure 7 **Percentage Change in EBITA-to-Interest Expense by Sector from Q3 2022 to Q3 2023: Baseline Scenario**

Key Takeaways

UK firms are navigating a complex economic environment beset by inflation, declining output, and rising interest rates. The baseline expectation is that this will increase default rates more than two-fold by Q3 2024.

These economic headwinds are particularly challenging for those vulnerable sectors and firms, where liquidity and profitability is weakening, due to the delta between input and output costs. Low growth is compounded by a higher interest rate environment, increasing pressure on firms who will need to refinance, and the outcome for firms will depend on how effectively they can manage through these tough conditions.

Learn more about RiskCalc™

The RiskCalc solution provides a comprehensive approach for assessing the default and recovery of private firms, financial institutions, and project finance transactions. RiskCalc models generate forward-looking probability of default (PD) or EDF™ (Expected Default Frequency) credit measure calculations, loss given default (LGD), and expected loss (EL) values.

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