THE WEIL EUROPEAN DISTRESS INDEX

SEPTEMBER 2022

Weil, Gotshal & Manges (London) LLP

weil.com

Macro view

- Corporate distress across key European markets rose to their highest level for two years (September 2020), according to the Weil European Distress Index (WEDI).
- The latest data shows that corporate distress was pushed higher by weaker investment metrics, pressure on liquidity and a deterioration of market fundamentals.
- Support from valuation metrics have also waned recently to their lowest level in over three years.
- UK corporates showed the highest level of distress compared with other European markets measured. The UK is facing its highest levels of distress since August 2020, set against a backdrop of 40-year highs in inflation, the pound hitting a record low, tightening monetary policy and forecasts of recession.
- Germany was the next most distressed market, driven by pressures around investment, liquidity and weaker valuation metrics.
- European markets have continued to face heightened geopolitical risks and a more challenging economic outlook from the cost-of-living crisis and rising interest rates. In many markets, this has manifested in investors shying away from riskier assets.
- The Bank of England raised interest rates to 2.25% in September, now the highest since the global financial crisis. The Bank now predicts that the UK economy will enter recession at the end of 2022 which will persist throughout 2023.
- The European Central Bank (ECB) followed suit, tightening monetary policy at the beginning of September in a highly anticipated move.

Weil European Distress Index Movements

August 2022	August 2021	QoQ trend	YoY trend
4.1	-6.6	⬆	⬆

- Meanwhile, the ongoing impact of supply chain disruptions, rising operating costs, labour shortages and higher borrowing costs suggests a tougher outlook for profitability.
- Added to the heightened volatility caused by the Russia-Ukraine conflict, business confidence has deteriorated in consecutive periods since the end of 2021.

Sector view

- The largest driver of distress in the latest data (August 2022) came from businesses operating within the 'Retail and Consumer Goods' sector, driven by a squeeze on liquidity, weakening investment metrics and renewed pressure on profitability.
- Pressure on the 'Real Estate' market has stepped up, making this the second most distressed sector. Distress drivers are broad-based, coming from weaker valuations, poorer liquidity metrics and high perceived risk.

How do we define 'distress'?

The WEDI provides a measure of the level of corporate distress by aggregating company fundamentals and financial market indicators across key European countries.

Corporate distress can be defined as uncertainty about the fundamental value of financial assets, volatility and increase in perceived risk. It also refers to the disruption of the normal functioning of company financial performance, including their ability to fulfil their debt requirements.

The definition is purposely broad as corporate distress can manifest in different ways, and no two stress events are identical for each company.

Although stress events differ in composition, there are several common characteristics of corporate distress ranging from pressure on liquidity, reduced profitability, rising insolvency risk, falling valuations and reduced return on investment. These company indicators are also set against a backdrop of market conditions that can also indicate levels of distress (e.g. business confidence, rising volatility and rising levels of perceived market risk).

Methodology

The WEDI is a univariate time series that distils information embedded in more than 16 indicators into a summary measure of corporate distress. It can then be decomposed into five markets (Total Europe*, UK, Germany, Spain-Italy, and France), size of company (based on market cap) and 10 industry groups:

- Retail and consumer goods
- Financial services
- Travel, leisure and hospitality
- Oil and gas
- Industrials
- Infrastructure, utilities and power
- Healthcare
- Commodities and natural resources
- Technology, media and telecoms
- Real Estate

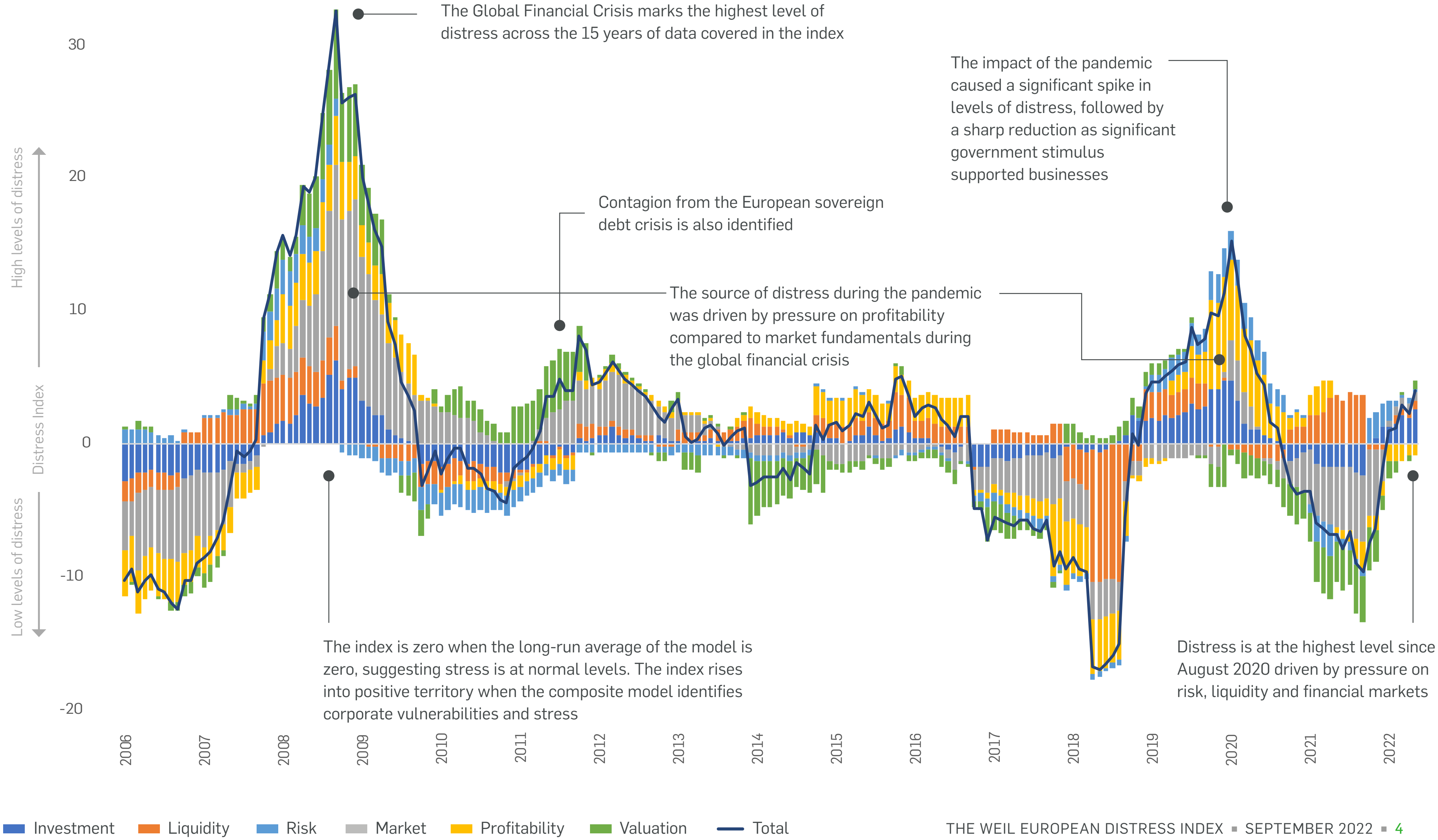
The WEDI is constructed using data from over 3,750 listed European companies and a range of financial market indicators. 16 indicators have been used to construct the WEDI which reflect one or more symptoms of corporate distress based on comprehensive academic and desk-based research.

The WEDI Index uses a Dynamic Factor Model – a statistical approach that captures the variability across the 16 indicators in a single composite index using key company fundamentals going back to 2005, and incorporates over five million data points.

METRIC	DEFINITION
Liquidity	Contains measures of liquidity such as the current ratio, quick ratio and operating cashflow metrics which are used to determine a company's ability to pay off current debt obligations without needing to raise external capital.
Profitability	Contains measures such as return on equity, net profit margins and return on assets to assess the business's ability to generate earnings relative to its revenue, operating costs, balance sheet and shareholders' equity over time.
Risk	Contains measures such as debt to equity ratio and interest cover to assess a company's capital structure and current risk levels, often in terms of debt levels and risk of default or bankruptcy.
Valuation	Contains measures such as price to earnings, price to book value and enterprise value to EBITDA multiples, used to assess the relative valuation of a company over time.
Investment	Contains measures such as dividend per share and dividend yield used to assess the potential attractiveness of a business as an investment opportunity.
Financial markets	Contains measures such as index market capitalisation, market volatility, risk, credit default swaps and business confidence which are used to track levels of distress across broader financial markets in key European markets.

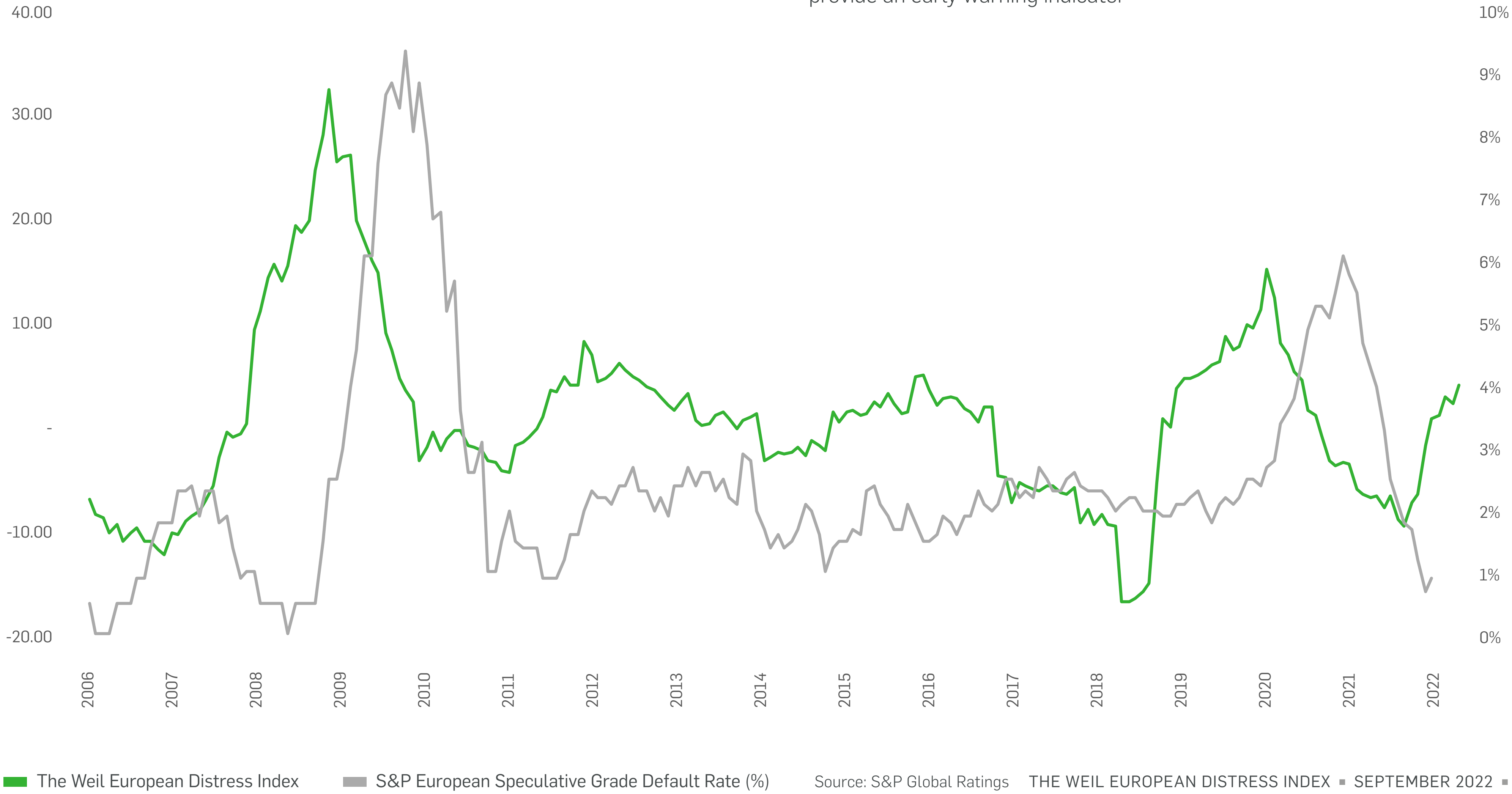
* Total Europe include UK, Germany, France, Spain, Italy, The Netherlands, Republic of Ireland, Belgium, Norway and Portugal

The European Distress Index



The Weil European Distress Index vs Default Rates

- In the two most major recent crises, the Global Financial Crisis and Covid pandemic we have observed that the WEDI peaks in advance of the S&P European Speculative Grade Default Rate
- The WEDI tracks the deterioration in financial markets conditions and company performance which occurs in advance of a default wave to provide an early warning indicator



Source: S&P Global Ratings

THE WEIL EUROPEAN DISTRESS INDEX
SEPTEMBER 2022

SIZE ANALYSIS

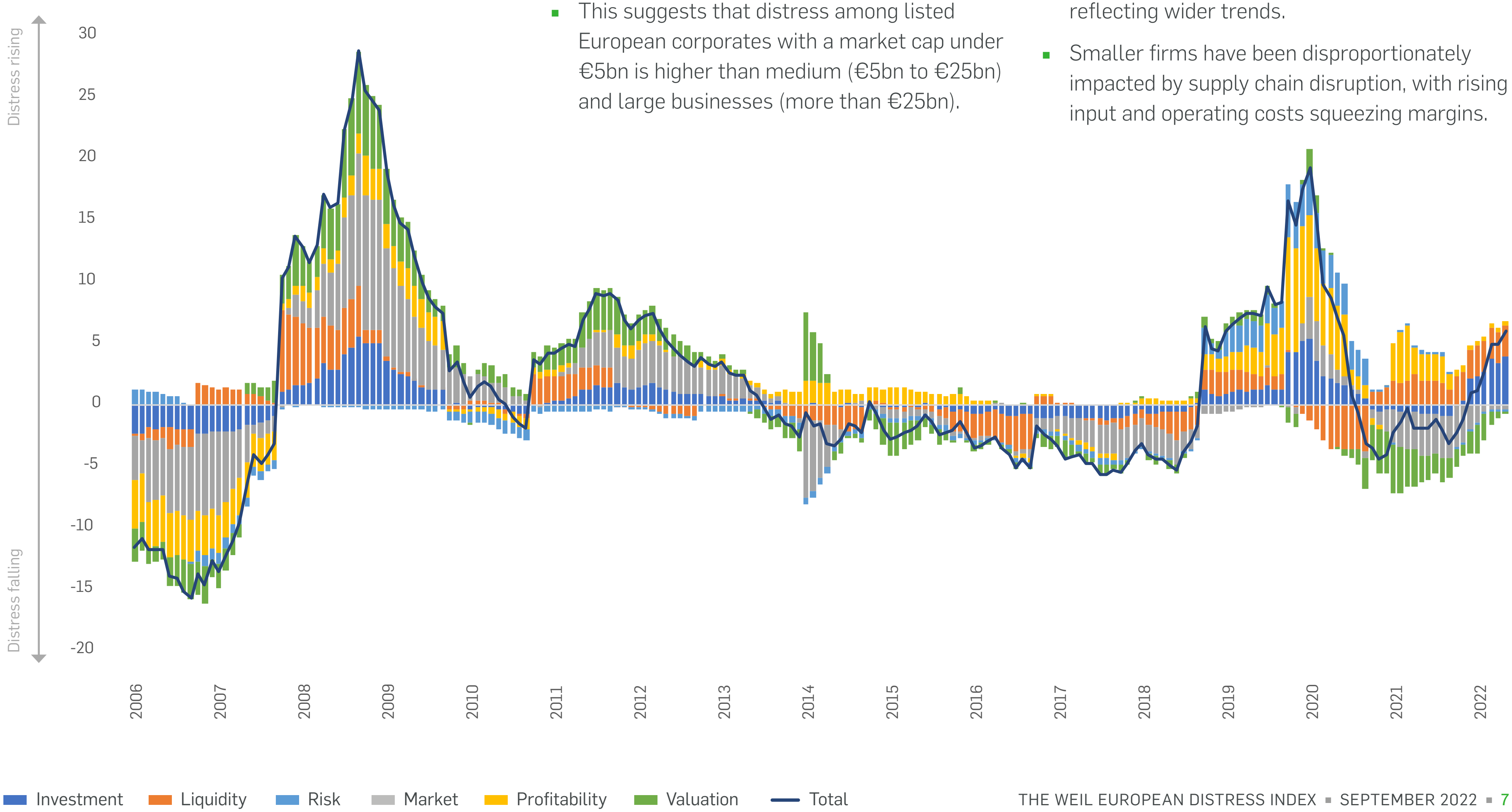
INDUSTRY ANALYSIS

COUNTRY ANALYSIS

Small Corporates

(market cap <€5bn)

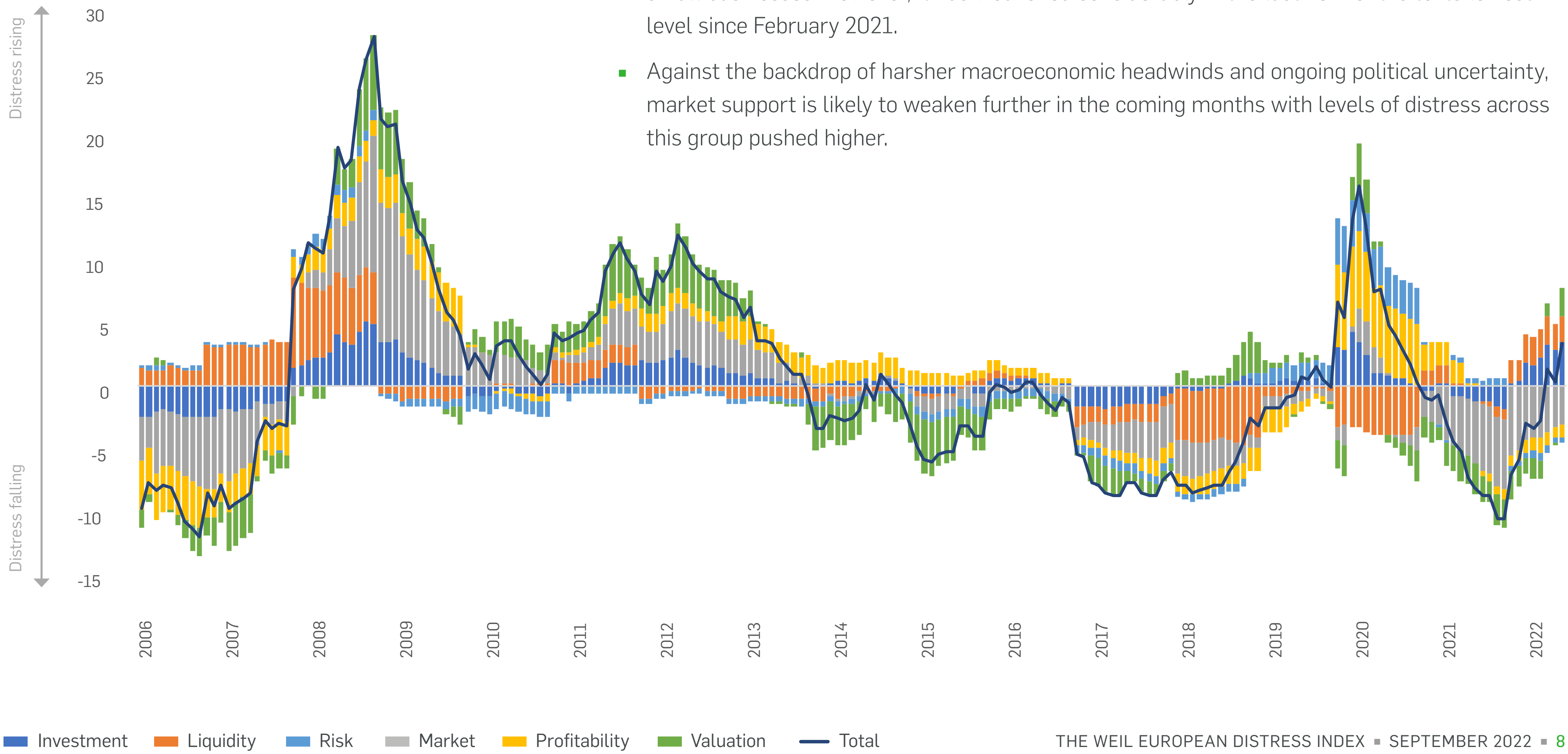
- Distress across small European corporates has risen sharply in the latest quarter, remaining in positive territory for six consecutive months and residing at its highest level since August 2020.
- This suggests that distress among listed European corporates with a market cap under €5bn is higher than medium (€5bn to €25bn) and large businesses (more than €25bn).
- The main drivers of distress have come from weaker investment metrics, pressure on liquidity and lower levels of profitability.
- Support from market fundamentals has also waned considerably since the start of the year reflecting wider trends.
- Smaller firms have been disproportionately impacted by supply chain disruption, with rising input and operating costs squeezing margins.



Medium Corporates

(market cap €5 – €25bn)

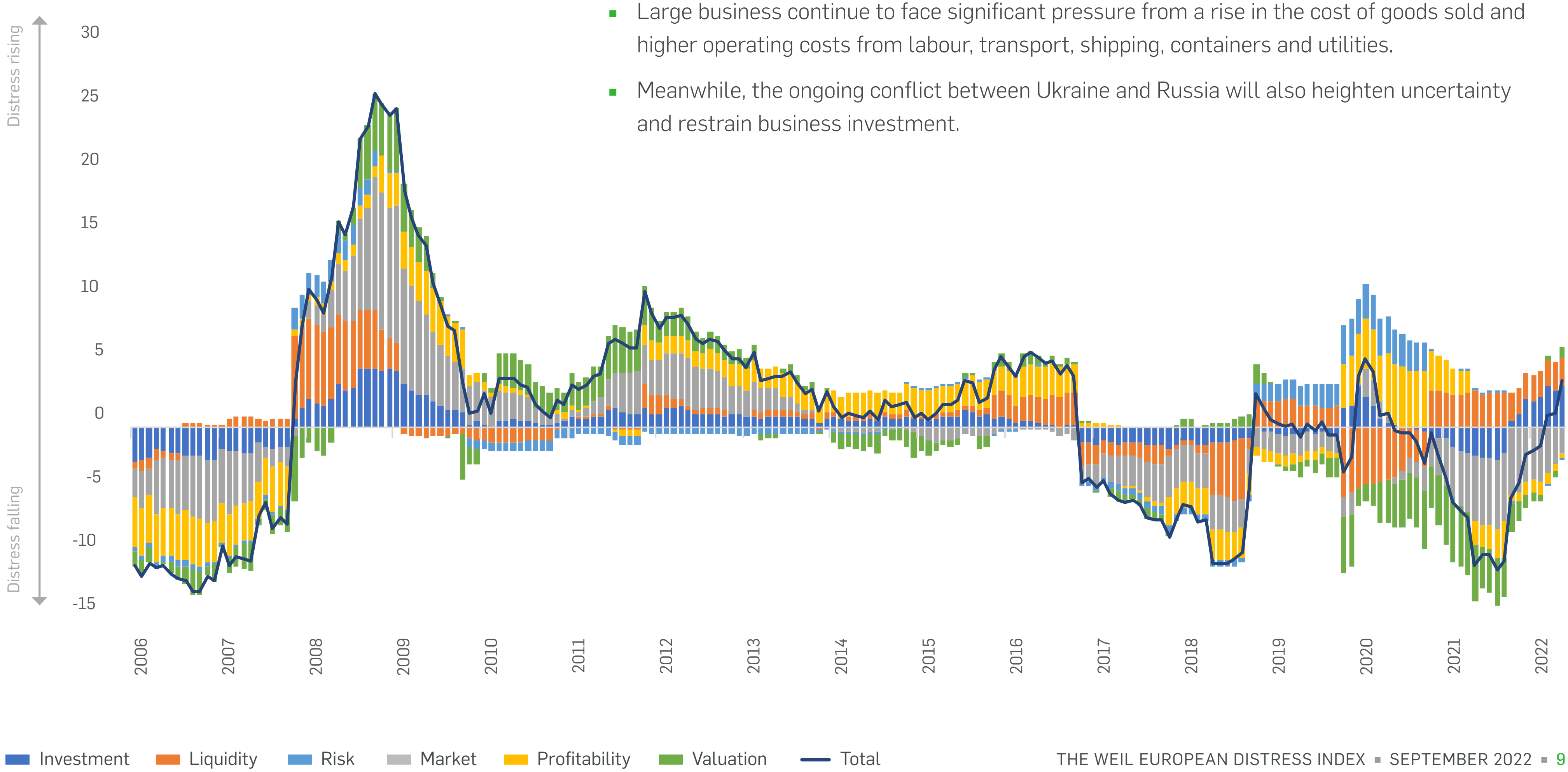
- Medium sized corporates have seen levels of distress rise to the highest level since May 2020 in the latest quarter.
- Distress has been primarily driven by weaker investment metrics, poorer liquidity and faltering valuation measures.
- Support from valuations is at its weakest level since May 2020.
- Market support continues to hold up stronger for medium sized corporates than large and small businesses. However, it has weakened considerably in the last 18 months to its lowest level since February 2021.
- Against the backdrop of harsher macroeconomic headwinds and ongoing political uncertainty, market support is likely to weaken further in the coming months with levels of distress across this group pushed higher.



Large Corporates

(market cap >€25bn)

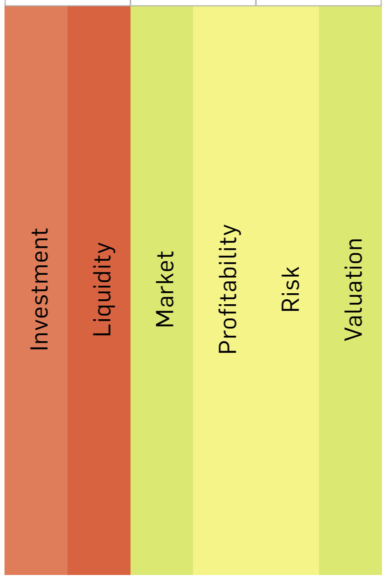
- Distress across large corporates has risen to its highest level since June 2020 in the latest quarter.
- Distress has now been detected for the last three consecutive months, driven by weaker fundamentals across investment metrics, liquidity and valuation.
- Rising operating costs from labour, logistics and utilities against a backdrop of rising interest rates, pushing up the cost of borrowing, is creating a challenging environment.
- Large business continue to face significant pressure from a rise in the cost of goods sold and higher operating costs from labour, transport, shipping, containers and utilities.
- Meanwhile, the ongoing conflict between Ukraine and Russia will also heighten uncertainty and restrain business investment.



Distress Index September 2022

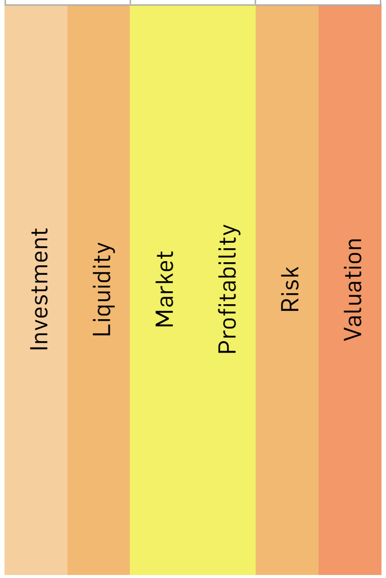
Retail and consumer goods

Distress ranking	Index value	YoY trend
1	+3.2	↑



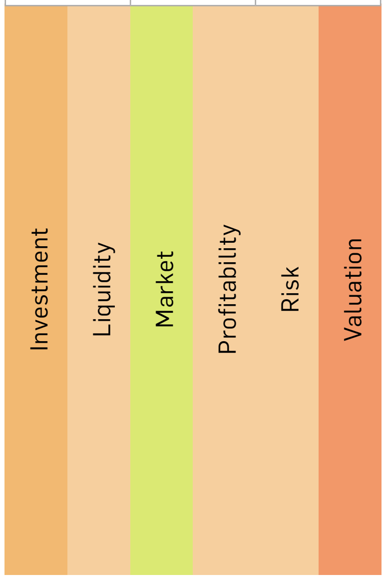
Real Estate

Distress ranking	Index value	YoY trend
2	+3.1	↑



Industrials

Distress ranking	Index value	YoY trend
3	+2.0	↑

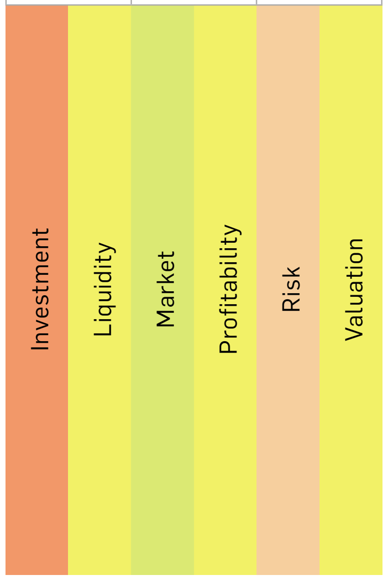


Travel, leisure and hospitality

Distress ranking	Index value	YoY trend
4	+1.7	↓

Healthcare

Distress ranking	Index value	YoY trend
5	+0.2	↑



Least distressed — Most distressed

Oil & Gas

Distress ranking	Index value	YoY trend
6	-1.4	↓

Technology, media and telecoms

Distress ranking	Index value	YoY trend
7	-1.6	↑

Infrastructure

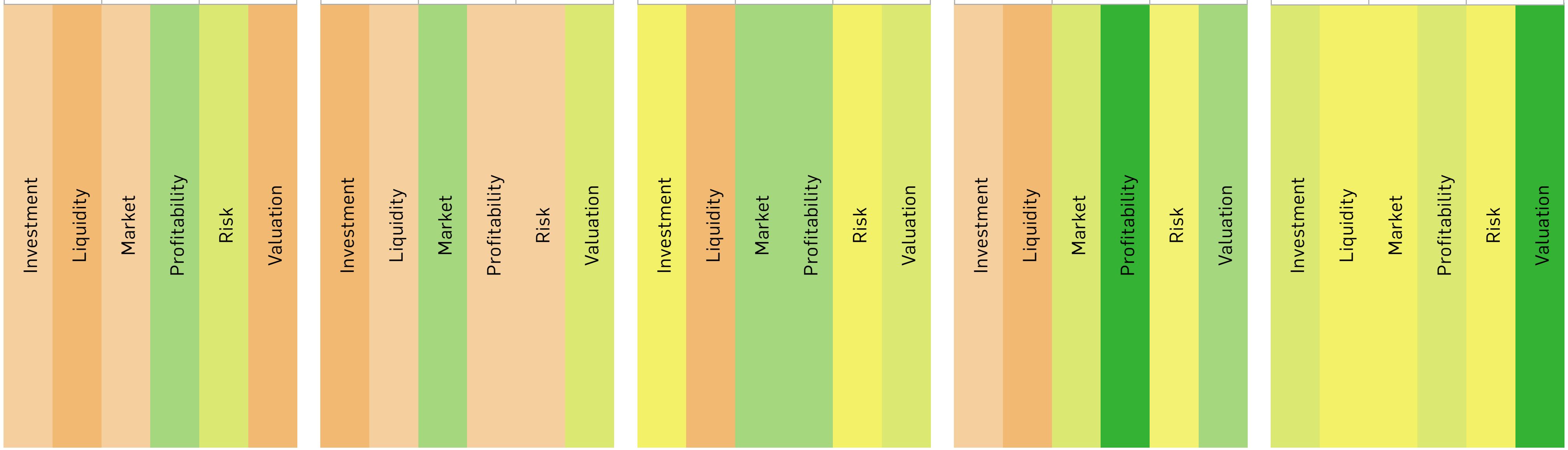
Distress ranking	Index value	YoY trend
8	-2.3	↓

Commodities / Natural Resources

Distress ranking	Index value	YoY trend
9	-2.9	↑

Financial Services

Distress ranking	Index value	YoY trend
10	-4.1	↓

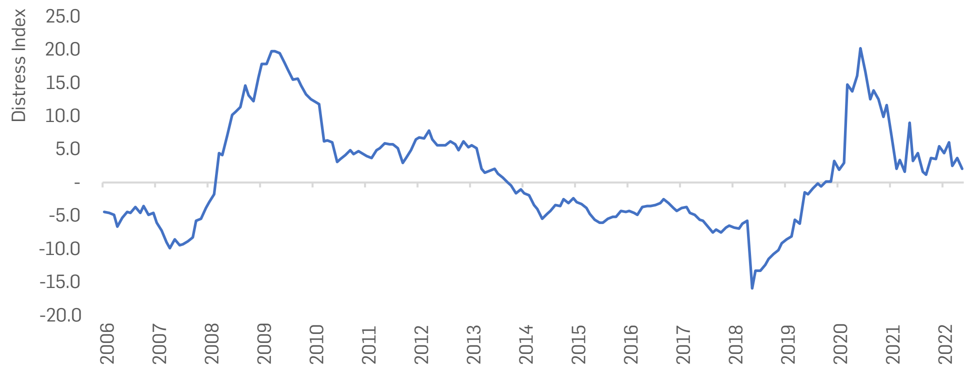


Retail and Consumer Goods

Retail and consumer goods companies are the most distressed across all sectors as the combination of high inflation, squeezed incomes and rising operating costs put intense pressure across the sector. A squeeze on liquidity and weaker investment metrics have driven distress higher in the latest period.

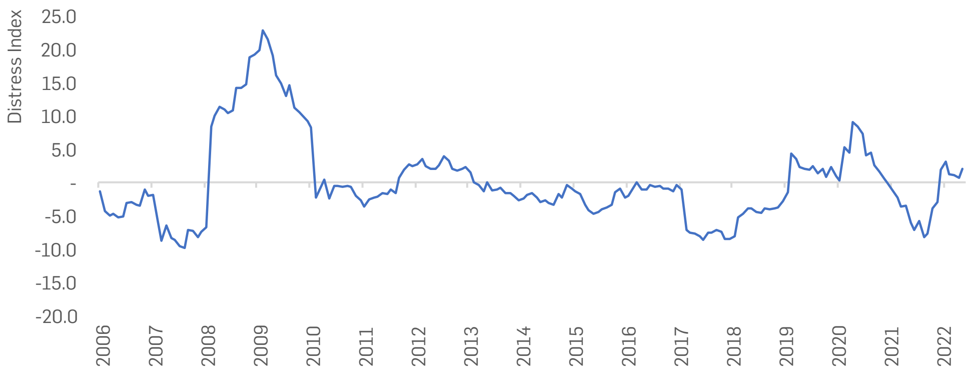
Travel, Leisure and Hospitality

Travel, Leisure & Hospitality saw levels of distress driven to record levels during the pandemic and they have remained above the long-run average for 32 consecutive months. While distress has eased considerably in recent months, a challenging consumer outlook and rising operating costs suggest that distress could rise again in the near-term.



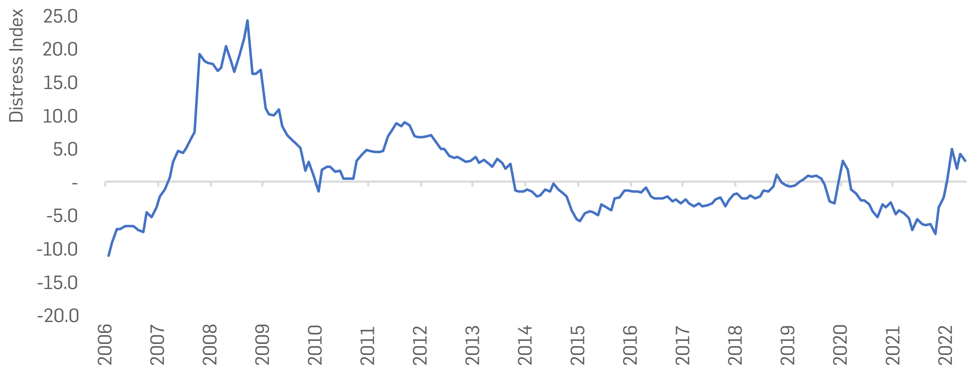
Industrials

Distress remained in positive territory for industrials in the latest data, driven by a deterioration in valuation metrics, weaker profitability and poorer investment metrics. Firms are continuing to face rising input and operating costs against a backdrop of slowing global demand.



Real Estate

Real Estate companies across Europe have continued to experience a rise in distress and are the second most distressed industry according to the latest data. Distress has been pushed higher by weaker valuations, lower levels of liquidity and higher risk. There are ongoing challenges from the impact of the pandemic, rising interest rates and a weaker economic outlook.



Healthcare

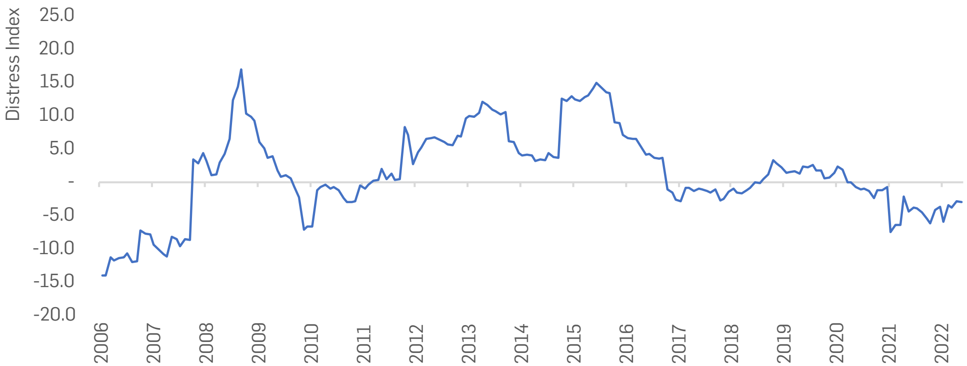
European healthcare corporates have seen levels of distress rise to the highest level since April 2020 as the positive impact from the pandemic continues to weaken. Distress crept into positive territory in the latest period, pushed higher by weaker investment factors and a lower appetite for risk.

Infrastructure, Utilities and Power

Infrastructure, Utilities and Power corporates have seen levels of distress fall on last quarter's levels as higher energy and utility prices are passed on to consumer and businesses. Improvements in profitability, valuation and stronger market fundamentals have underpinned lower levels of distress.

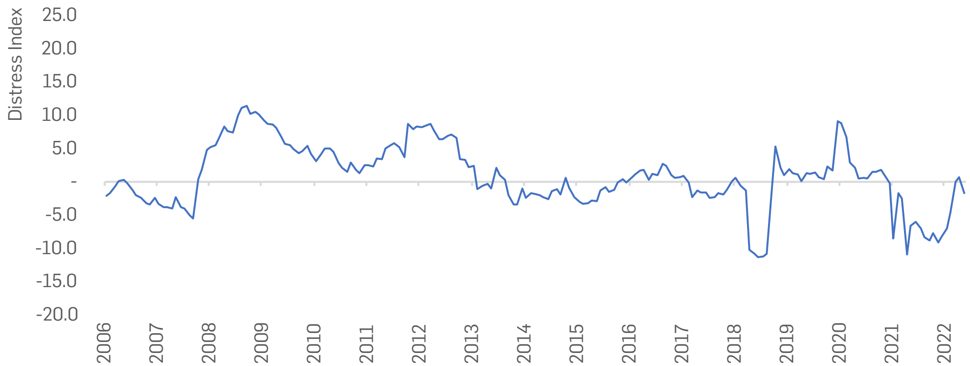
Commodities and Natural Resources

Corporate distress across commodities and natural resources remain in negative territory. The industry continues to benefit from ongoing pent-up demand for natural resources which has helped boost profitability and valuations. However, distress levels have risen on the previous quarter.



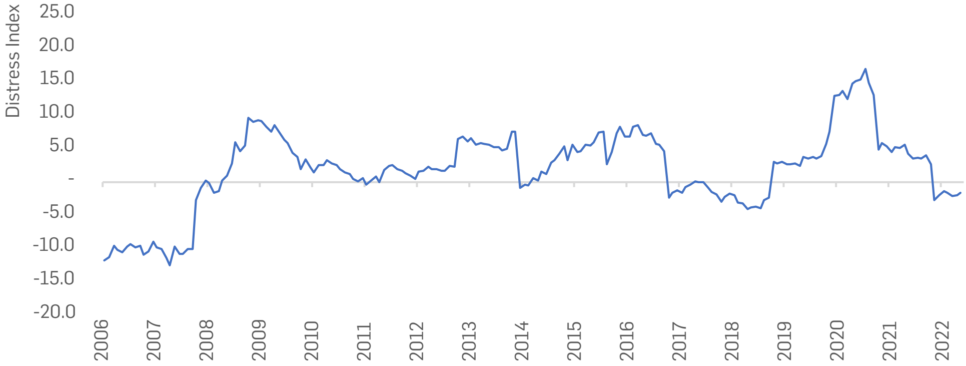
Technology, Media and Telecoms

Levels of distress across TMT rose briefly into positive territory before retreating below the long-run average. Technology companies, in particular, have been under pressure following a reversal in fortunes brought about by the impact of the pandemic, albeit distress has returned to negative territory.



Oil and Gas

Oil and gas companies have seen levels of distress remain below the long-run average. However, distress has risen in the latest quarter reflecting softening oil prices amid slowing global growth and worries of the hit to industrials and consumer demand – particularly across high energy consuming industries.

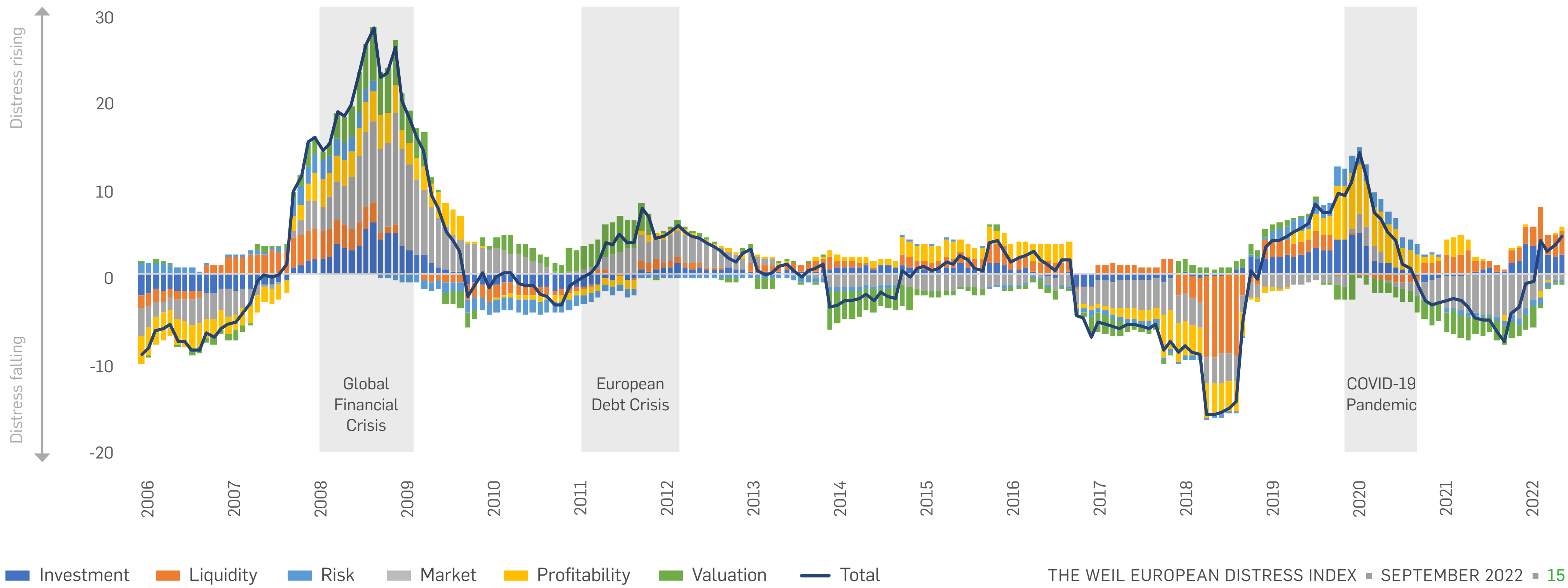


Financial Services

Distress across European financial services firms fell in the last quarter and have remained in negative territory for 20 consecutive months. Financial services is the least distress industry across those measured, supported by strong valuations, profitability and investment.

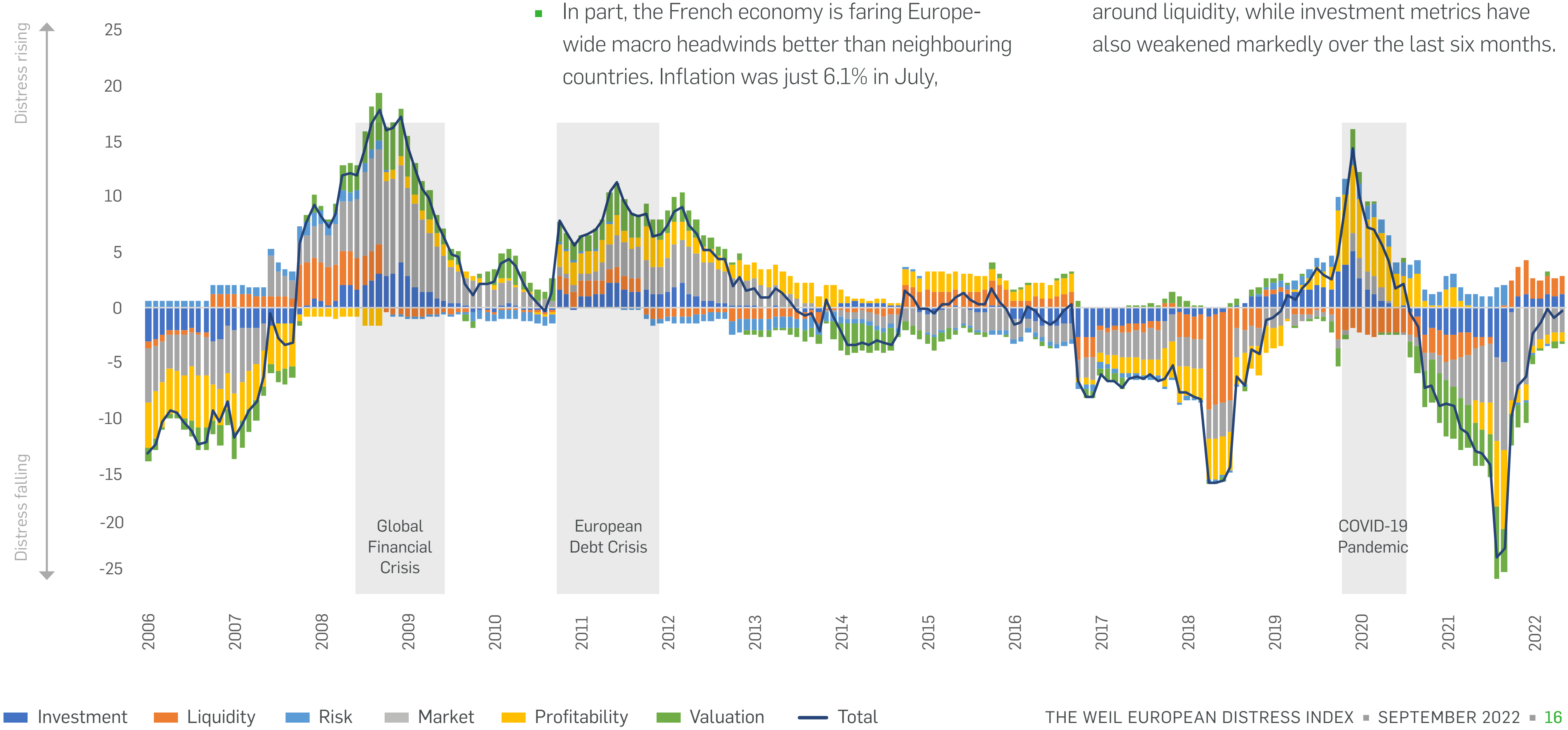
United Kingdom Distress Index

- Distress across UK-based corporates rose on the previous quarter to its highest level in two years (August 2020). The main drivers of distress continue to stem from a squeeze on liquidity, weaker investment metrics and renewed pressure on profitability.
- Over the latest quarter, support from financial markets has continued to wane, now the weakest contribution for two years. Valuation metrics, which had remained relatively robust, have also weakened over the last period.
- The macroeconomic environment has also deteriorated significantly. Inflation reached 9.9% in August, the pound hit a record low in September and the Bank of England has warned that it expects the economy to enter recession at the end of 2022 and for it to persist throughout 2023.
- Interest rates have risen to 2.25%, the highest level since the financial crisis. The base rate is expected to finish the year above 3.5% and could peak close to 6% in May 2023, based on interest-rate derivatives.
- Although recently announced measures to cap energy prices at £2,500 will help ease the burden for many UK households, energy bills are still expected to more than double on the previous year. Consumer confidence hit an all-time low in August, surpassing levels seen during the financial crisis and the pandemic.



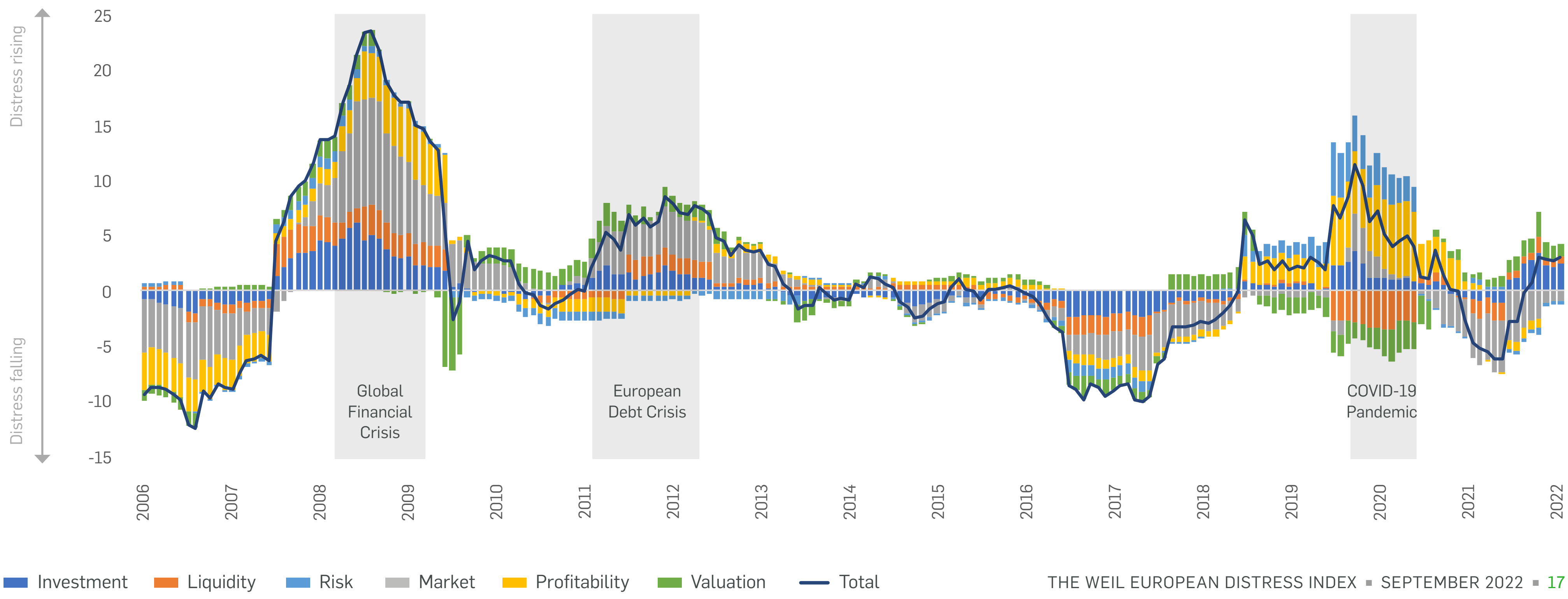
France Distress Index

- Levels of distress across corporates in France rose in the latest quarter but remain slightly below long-run averages.
- Across all the markets included in the index, corporates in France are the least distressed, buoyed by stronger market fundamentals, solid levels of liquidity and healthier investment metrics than other markets.
- In part, the French economy is faring Europe-wide macro headwinds better than neighbouring countries. Inflation was just 6.1% in July, considerably lower than other economies, helped by Government subsidies which have limited the rise in electricity prices to just 4% this year.
- Resultantly, disposable incomes are under less pressure and consumer confidence remains much stronger in France than other European countries.
- Nevertheless, there has been a sharp deterioration in recent months, driven by ongoing constraints around liquidity, while investment metrics have also weakened markedly over the last six months.



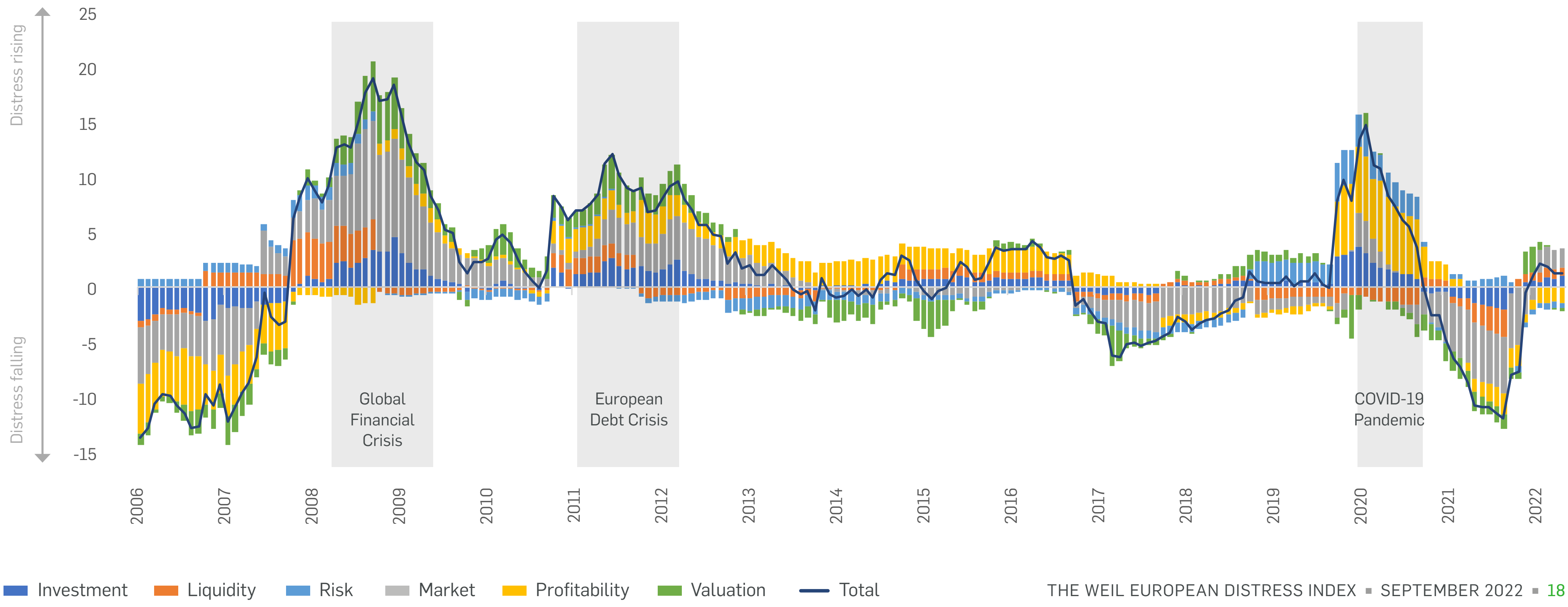
Germany Distress Index

- Corporate distress in Germany was the second highest among the countries covered in the index. Distress remained in positive territory in the latest quarter, with weaker investment metrics, lower valuations and pressure on liquidity all contributing to distress.
- Support from market fundamentals continued to evaporate as a weaker economic outlook is factored into expectations. The contribution from market metrics is now at its lowest level since early 2021.
- Industry-specific supply chain issues across the auto sector is likely to have played a role given the country's high exposure. New car production in Germany is near its lowest level in over 20 years.
- Inflation also remains a key concern, rising to 7.9% in August, the highest level since the 1990s. Businesses continue to face supply chain disruptions and rising operating costs which is placing pressure on profitability and weakened investment metrics.
- Meanwhile, the impact of the Russia-Ukraine conflict continues to feed through supply chains, raising levels of uncertainty.



Spain and Italy Distress Index

- Corporate distress across Spain and Italy remained in positive territory for the fifth consecutive month according to the latest data.
- A sharp deterioration across market fundamentals over the summer has been the main driver of distress, although weaker investment sentiment and pressure on liquidity have also contributed over the last quarter.
- Both Spain and Italy have suffered supply chain disruption and rising energy costs which has pushed up the cost of living in these countries. Inflation in Italy (+8.4%) and Spain (+10.8%) have risen to uncomfortable levels, while the labour market in both countries is significantly weaker than other European nations. Indeed, the latest data showed the unemployment rate in Spain at 12.5% in July, albeit an improvement on previous months.
- In addition, support across profitability metrics are likely to wane due to rising operating costs, raising the prospect of corporate distress.



KEY RESTRUCTURING CONTACTS

London

Andrew Wilkinson
Partner
+44 20 7903 1068
andrew.wilkinson@weil.com

Neil Devaney
Partner
+44 20 7903 1199
neil.devaney@weil.com

Matt Benson
Partner
+44 20 7903 1009
matt.benson@weil.com

Jenny Davidson
Partner
+44 20 7903 1438
jenny.davidson@weil.com

Lois Deasey
Partner
+44 20 7903 1702
lois.deasey@weil.com

Mark Lawford
Partner
+44 20 7903 1050
mark.lawford@weil.com

Gemma Sage
Partner
+44 20 7903 1419
gemma.sage@weil.com

Paris

Jean-Dominique Daudier de Cassini
Partner
+33 1 4421 9797
jean-dominique.
daudierdecassini@weil.com

Anne-Sophie Noury
Partner
+33 1 4421 9797
anne-sophie.noury@weil.com

Germany

Gerhard Schmidt
Partner
+49 89 24243 101
gerhard.schmidt@weil.com

Britta Grauke
Partner
+49 69 21659 664
britta.grauke@weil.com

U.S.

Matt Barr
Partner
+1 212 310 8010
matt.barr@weil.com

Gary Holtzer
Partner
+1 212 310 8463
gary.holtzer@weil.com

Ray Schrock, P.C.
Partner
+1 212 310 8210
ray.schrock@weil.com

Asia

Kathleen Aka
Partner
+852 3476 9000
kathleen.aka@weil.com

Weil

WEIL.COM

SEPTEMBER 2022