# THE WEIL EUROPEAN DISTRESS INDEX

JUNE 2023

Weil, Gotshal & Manges (London) LLP

weil.com

## Macro view

- The Weil European Distress Index (WEDI) showed that corporate distress across key European markets remained broadly consistent compared with the previous quarter. However, distress remained markedly higher than last year's levels.
- While the overall ease in distress since November 2022 marks a general improvement in the economic outlook from significantly depressed levels, macroeconomic conditions remain challenging. Latest IMF forecasts (April 2023) were adjusting for a weaker growth profile across advanced economies and Europe compared with January 2023 forecasts.
- Distress in the financial sector remains a cause for concern. Since the February WEDI report, the high-profile collapse of Silicon Valley Bank (SVB) and the forced sale of First Republic sparked a wave of concern about potential contagion across global markets. While in Europe, the state-backed rescue deal of Credit Suisse to UBS also caused investor anxiety, although risks appear to remain contained, for now.
- Nevertheless, the global economic outlook remains uncertain, with the overall distress index masking more volatile market conditions across sectors, countries and size of organisation.
- Germany, Europe's largest economy, entered a recession in the first quarter of 2023 as a 0.5% contraction in the final quarter of 2022 was followed by a 0.3% contraction between January and March.
- German inflation remains stubbornly high (7.2% in April), above the Euro Area's average, but below the UK (8.7% in April). From all the advanced economies, Germany and the UK are the only countries expected to see GDP fall in 2023, according to the IMF.

### Weil European Distress Index Movements

| May 2023 | QoQ trend | YoY trend |
|---|---|---|
| +3.9 | ↓ +4.1 Feb 23 | ↑ -0.1 May 22 |

- Therefore, despite a mild moderation in distress levels in recent months, the outlook for corporate distress remains high, with the sources of distress having become more broad-based across a wider range of sectors.
- Distress has intensified across eight of the ten industry groups covered, compared with the previous year. In our view, key risks include: an escalation in the Russia-Ukraine conflict; a synchronised tightening of monetary policy; inflation becoming embedded; and stress emanating from the financial services sector and the commercial real estate market.
- Indeed, the European Central Bank earlier this month warned of "clear signs of vulnerability" in the property sector, citing "declining market liquidity and price corrections" as reasons for the uncertainty.

## Sector view

- The ECB's warning is reflected in the WEDI which showed 'Real Estate' as the most distressed sector for the second consecutive quarter, with the sources of distress coming from a squeeze on liquidity, weakening investment metrics, and deteriorating profitability.
- Elsewhere, 'Retail and Consumer' companies remained under pressure, with distress driven from pressure on investment, and valuation and liquidity metrics, against a backdrop of the cost-of-living crisis.
- 'Healthcare' businesses remained in the top three most distressed sectors, as pressure on profitability, investment and liquidity have worsened.

## How do we define 'distress'?

The Weil European Distress Index (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

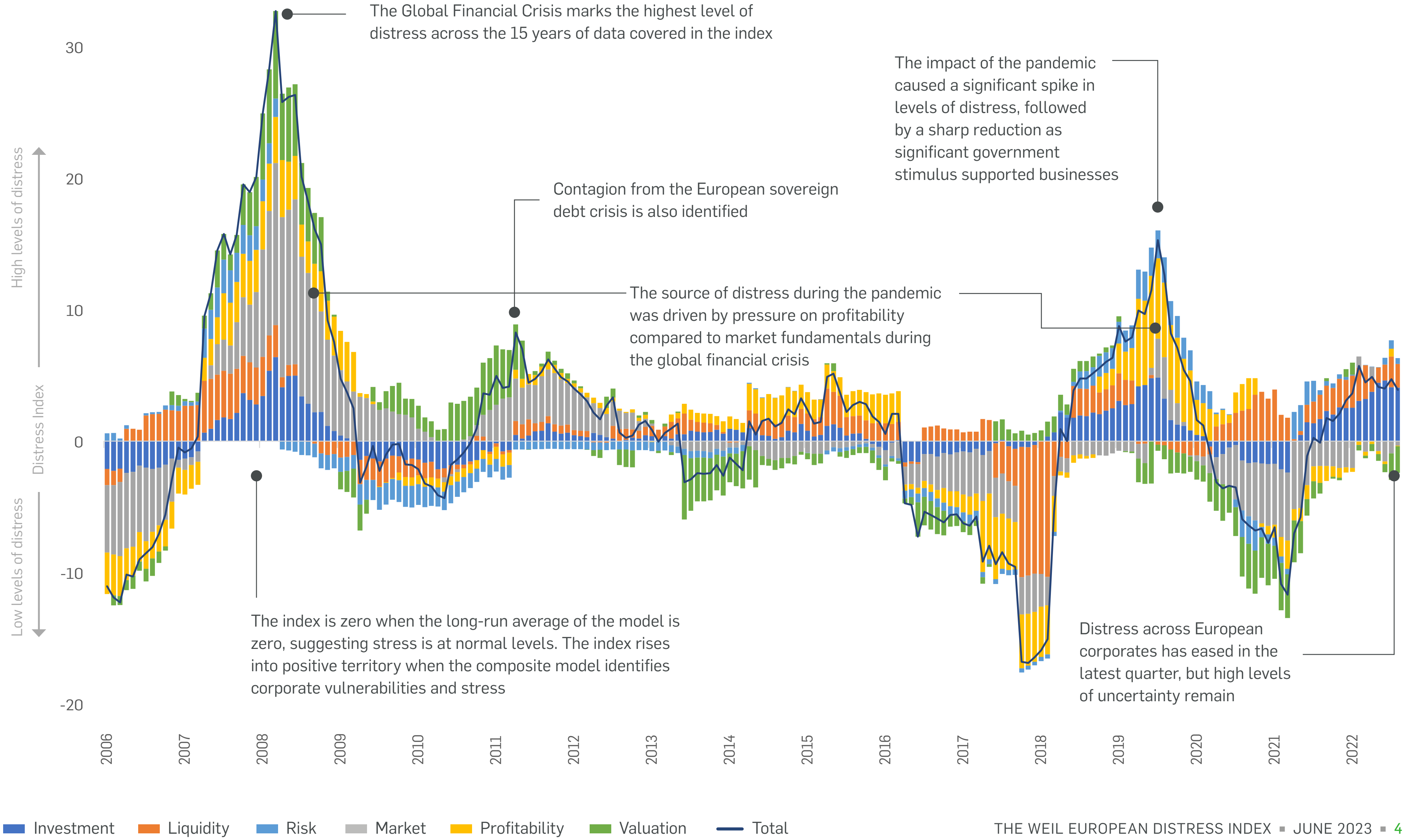
The WEDI is constructed using data from over 3,750 listed European companies and a range of financial market indicators. 16 indicators have been used to construct the WEDI which reflect one or more symptoms of corporate distress based on comprehensive academic and desk-based research.

The WEDI 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. |

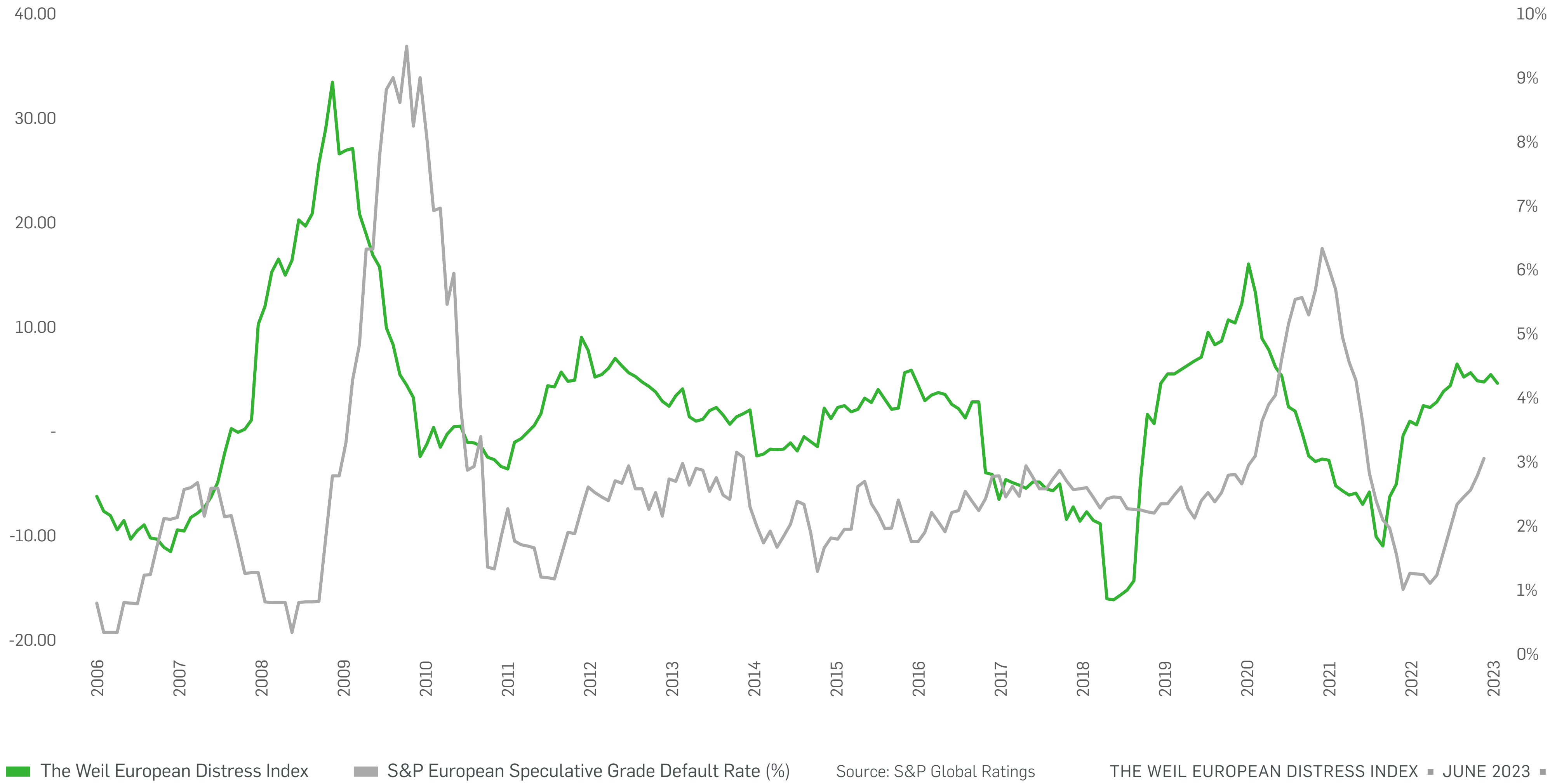
* Total Europe include UK, France, Germany, Spain, Italy, The Netherlands, Republic of Ireland, Belgium, Norway and Portugal

# 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
## JUNE 2023

SIZE ANALYSIS

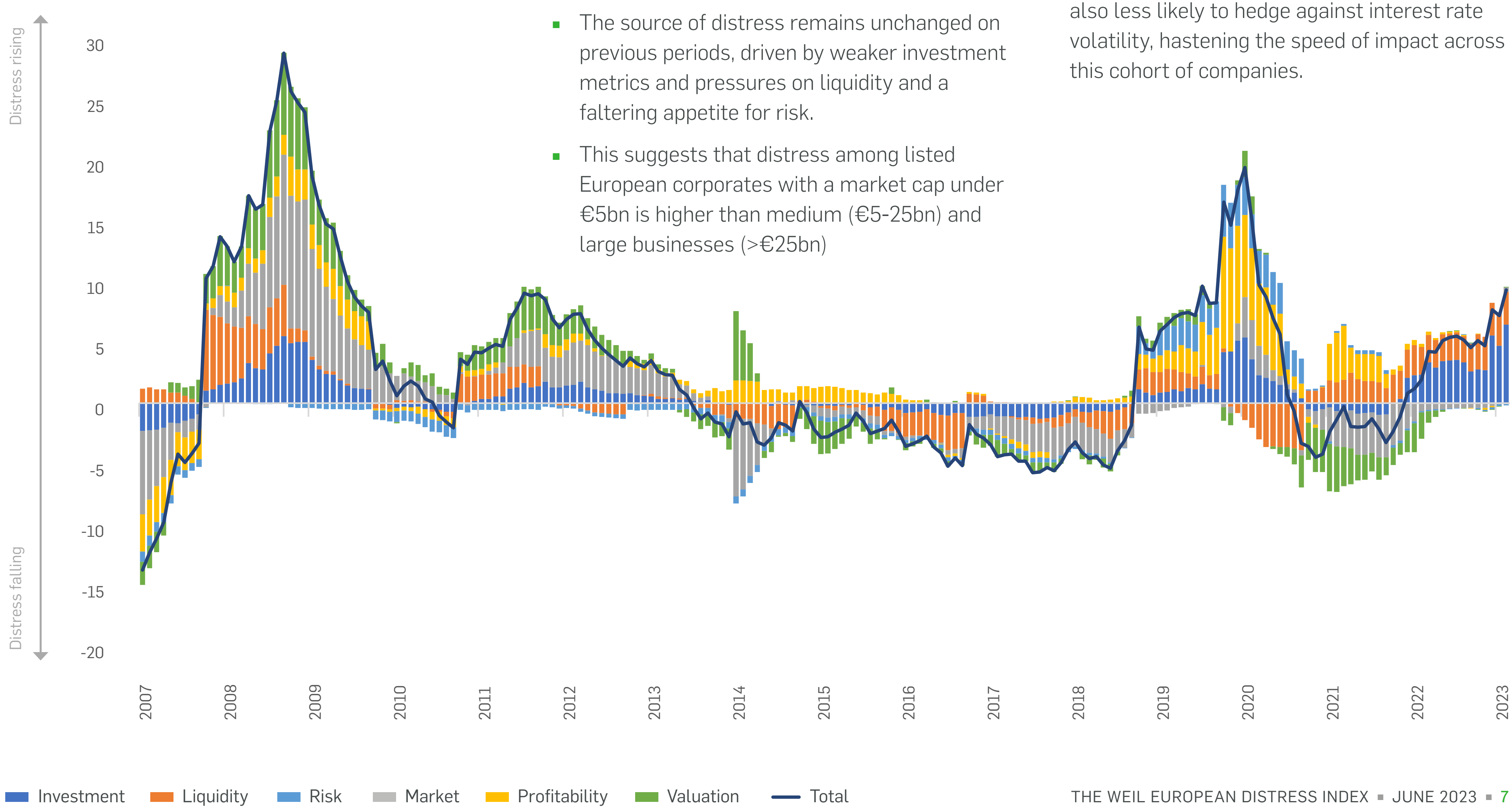
INDUSTRY ANALYSIS

COUNTRY ANALYSIS

# Small Corporates

## (market cap <€5bn)

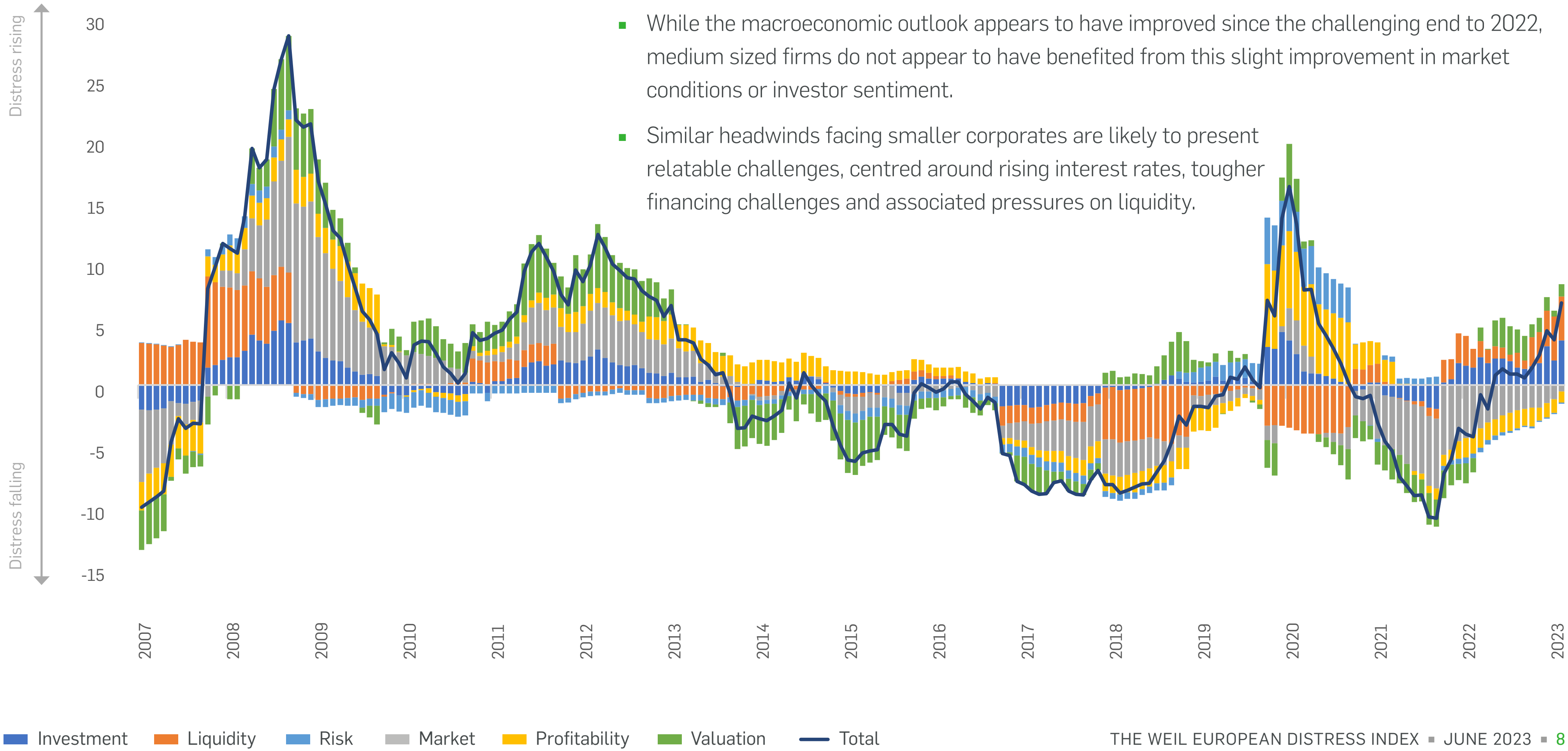
- Levels of distress remain highest across small European corporates and have risen markedly on the previous quarter.
- Distress is now the highest since June 2020, considerably higher than this time last year.
- The source of distress remains unchanged on previous periods, driven by weaker investment metrics and pressures on liquidity and a faltering appetite for risk.
- This suggests that distress among listed European corporates with a market cap under €5bn is higher than medium (€5-25bn) and large businesses (>€25bn)
- Market fundamentals support has also continued to wane over the last few months.
- High interest rates across the UK and EU are likely causing pressures on liquidity as smaller firms face elevated borrowing costs. They are also less likely to hedge against interest rate volatility, hastening the speed of impact across this cohort of companies.



# Medium Corporates

## (market cap €5bn – €25bn)

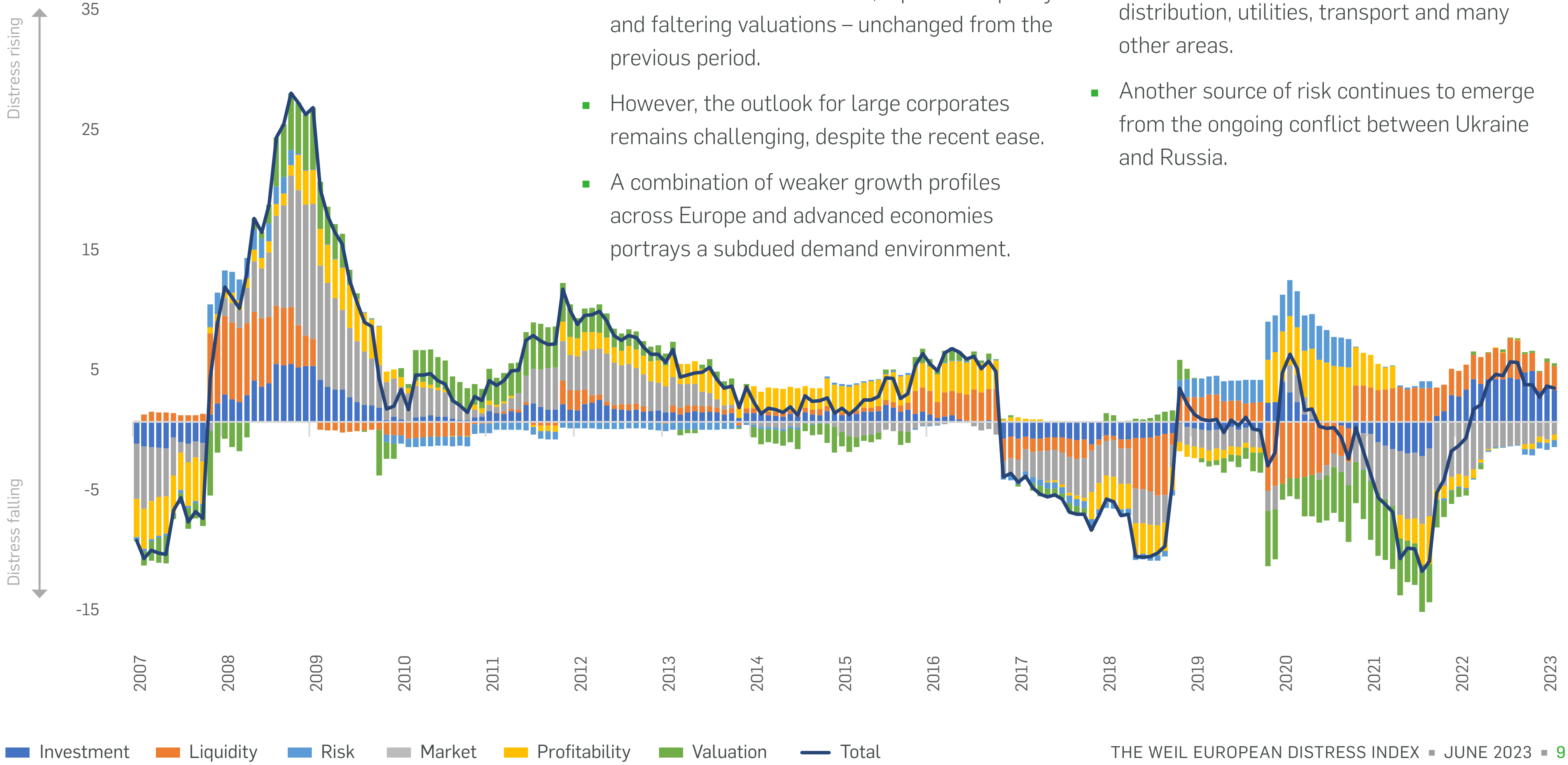
- Medium sized corporates have seen levels of distress rise to the highest level since July 2020 in the latest quarter.
- Poorer investment metrics drove the largest rise, the worst since March 2020 during the beginning stages of the pandemic.
- Elsewhere, a squeeze on liquidity and weaker valuation metrics have also intensified distress across this cohort, with levels running significantly higher than the long-run average and at this time last year.
- While the macroeconomic outlook appears to have improved since the challenging end to 2022, medium sized firms do not appear to have benefited from this slight improvement in market conditions or investor sentiment.
- Similar headwinds facing smaller corporates are likely to present relatable challenges, centred around rising interest rates, tougher financing challenges and associated pressures on liquidity.



# Large Corporates

## (market cap >€25bn)

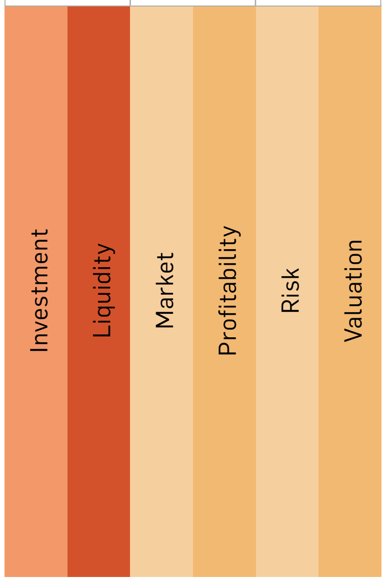
- Distress across large corporates eased in the latest quarter compared with the recent high in November and December 2022.
- Nevertheless, levels remain above the long-run average and higher than at this time last year.
- Overall distress continued to be driven by weaker investment metrics, squeezed liquidity and faltering valuations – unchanged from the previous period.
- However, the outlook for large corporates remains challenging, despite the recent ease.
- A combination of weaker growth profiles across Europe and advanced economies portrays a subdued demand environment.
- But challenges from higher interest rates, exchange rates weakness (against the dollar), and an outlook for weaker consumer demand will all weigh heavily on distress in the coming months.
- These pressures also dovetail with rising operating costs derived from labour, distribution, utilities, transport and many other areas.
- Another source of risk continues to emerge from the ongoing conflict between Ukraine and Russia.



# Distress Index May 2023

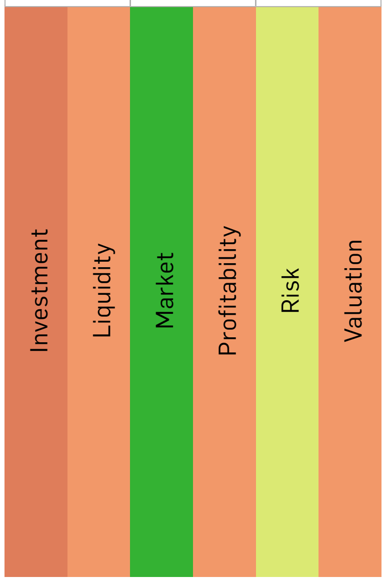
## Real Estate

| Distress ranking | Index value | YoY trend |
|---|---|---|
| 1 | +6.9 | ↑ +4.3 May 22 |



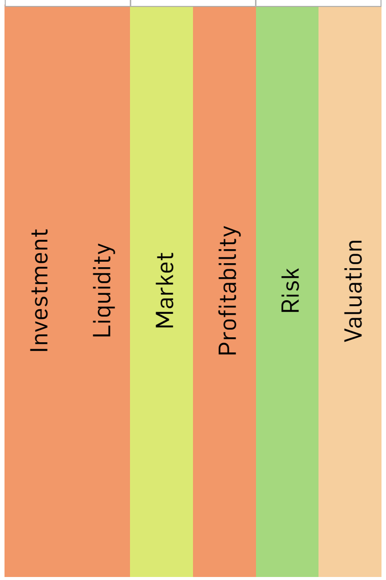

## Retail and Consumer Goods

| Distress ranking | Index value | YoY trend |
|---|---|---|
| 2 | +4.0 | ↑ -5.1 May 22 |



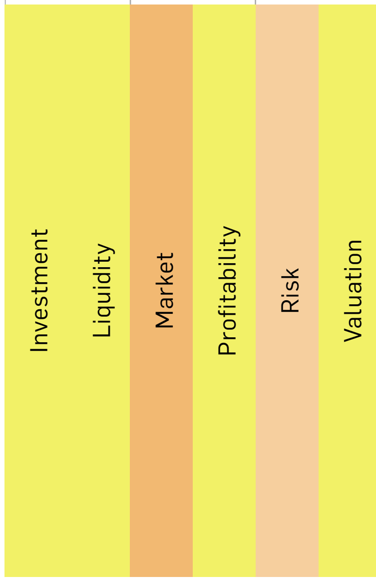

## Healthcare

| Distress ranking | Index value | YoY trend |
|---|---|---|
| 3 | +3.9 | ↑ -2.1 May 22 |



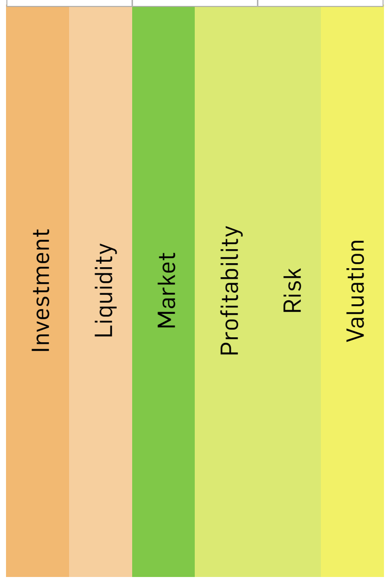

## Financial Services

| Distress ranking | Index value | YoY trend |
|---|---|---|
| 4 | +2.0 | ↑ -1.5 May 22 |




## Travel, Leisure and Hospitality

| Distress ranking | Index value | YoY trend |
|---|---|---|
| 5 | +1.1 | ↓ +1.3 May 22 |



Least distressed — Most distressed

## Industrials

| Distress ranking | Index value | YoY trend |
|---|---|---|
| 6 | +0.8 | -0.7 May 22 |

Investment | Liquidity | Market | Profitability | Risk | Valuation

## Technology, Media and Telecoms

| Distress ranking | Index value | YoY trend |
|---|---|---|
| 7 | +0.8 | -2.2 May 22 |

Investment | Liquidity | Market | Profitability | Risk | Valuation

## Commodities / Natural Resources

| Distress ranking | Index value | YoY trend |
|---|---|---|
| 8 | -0.7 | -5.6 May 22 |

Investment | Liquidity | Market | Profitability | Risk | Valuation

## Infrastructure

| Distress ranking | Index value | YoY trend |
|---|---|---|
| 9 | -2.1 | -4.4 May 22 |

Investment | Liquidity | Market | Profitability | Risk | Valuation

## Oil & Gas

| Distress ranking | Index value | YoY trend |
|---|---|---|
| 10 | -1.1 | -2.6 May 22 |

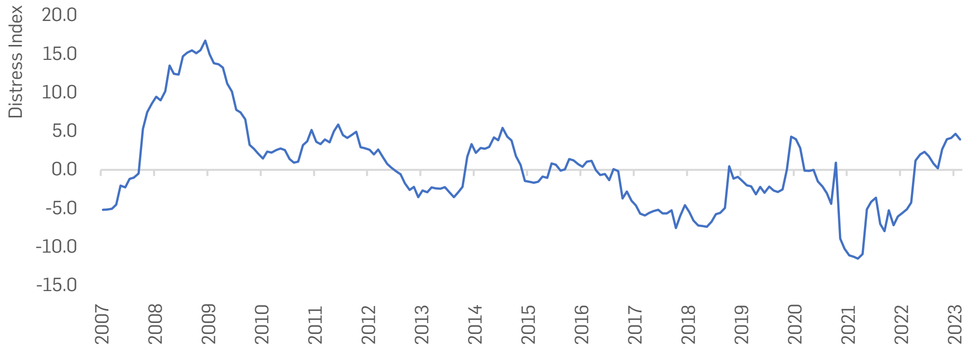
Investment | Liquidity | Market | Profitability | Risk | Valuation

## Real Estate

Distress across European Real Estate corporates remained at elevated levels, driven higher in the latest period by rising pressures on liquidity, softer investment metrics and squeezed profitability. A combination of rising interest rates, higher debt servicing costs and structural changes in the labour market, causing a fall in demand for office space, is putting intense pressure on the market. In the residential market, rising interest rates are also impacting housing affordability, softening the outlook for house prices.

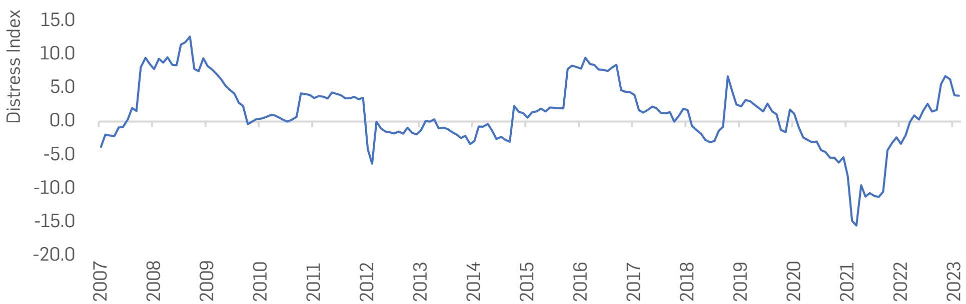

## Retail and Consumer Goods

Retail and consumer goods is the second most distressed sector across our coverage. The cost-of-living crisis continues to erode spending power across key European markets, particularly in the UK, Germany and France. A tightening of monetary policy and the associated squeeze on housing affordability has damaged consumer confidence, constraining further spending.




## Healthcare

European healthcare corporates have seen distress levels accelerate in the last quarter, driven by a squeeze on profitability, weaker liquidity positions, and faltering investment metrics. Higher levels of distress are likely to be driven by unprecedented support from the rapidly waning pandemic, with rising interest rates and operating costs squeezing profit margins.




## Financial Services

Distress across European financial services firms was driven to its highest level since October 2020, with a sharp deterioration in market fundamentals driving the overall rise. This is likely to reflect the recent collapse of Silicon Valley Bank (SVB) and the forced sale of First Republic, causing legitimate concerns over the risk of contagion.

## Travel, Leisure & Hospitality

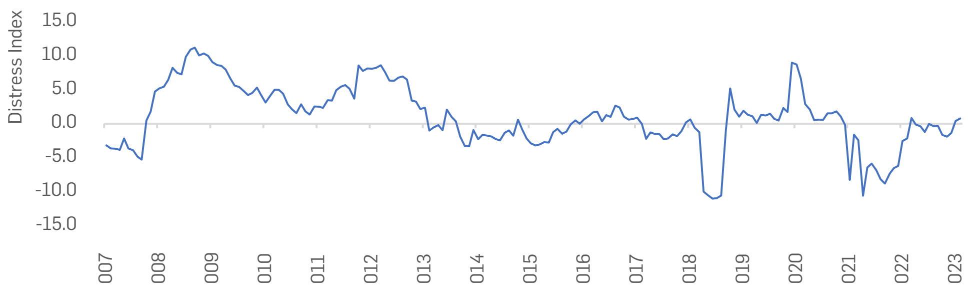
Following record levels of distress during the pandemic, the Travel, Leisure & Hospitality sector has made an impressive recovery as both business and leisure travel demand has recovered well. However, there is likely to be significant differences that emerge within this category, with the overall average masking a hospitality sector under pressure from weaker consumer demand and squeezed margins.


## Industrials

Level of distress in the industrial sector remained positive for the twelfth consecutive month as weaker valuation metrics kept it in positive territory. A combination of rising input and operating costs and a softer outlook for demand is likely to be holding back demand across the sector.


## Technology, Media & Telecoms

The level of distress in the Technology, Media, and Telecommunications (TMT) sector briefly increased into positive territory, pushed higher by weaker valuations, pressure on liquidity and faltering investment metrics. The industry continues to adjust to a post-covid era where many tech companies are rolling back investment following softer than expected demand.

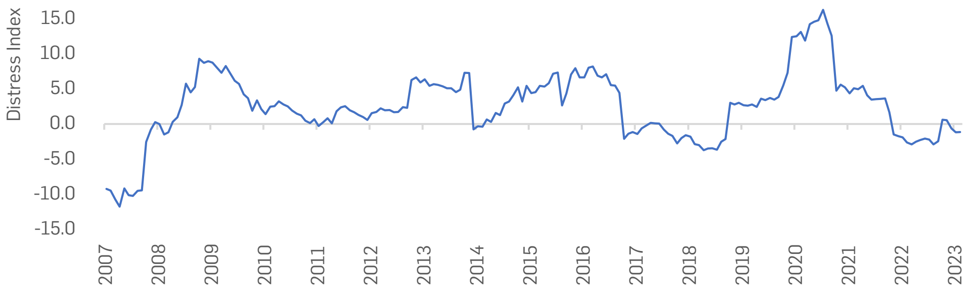



## Commodities & Natural Resources

Corporate distress in commodities and natural resources remains in negative territory but has risen sharply in the latest quarter. The main driver of distress in this sector is from weaker investment metrics, but firms remain underpinned by solid market fundamentals.

## Oil & Gas

Distress levels of oil and gas companies continue to hover around the long-run average having fallen markedly since all-time highs experienced during the pandemic. The outlook is uncertain, with key economies reporting a slowdown in economic growth against the backdrop of tightening monetary policy.



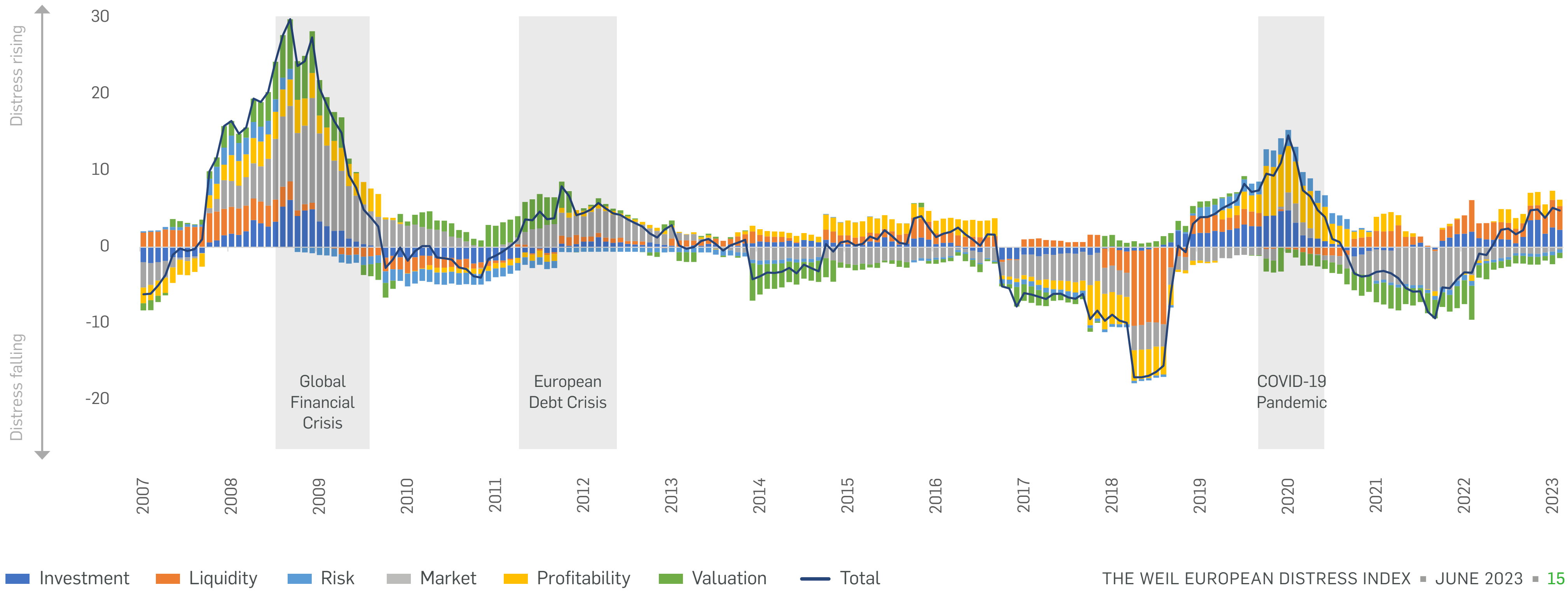

## Infrastructure, Utilities and Power

Infrastructure, Utilities, and Power companies have experienced a fall in distress levels compared to the previous quarter, with levels remaining below the long run average. Firms within the sector continue to benefit from higher energy costs and utility prices being passed on to businesses and households.

| May 2023 | QoQ trend | YoY trend |
|---|---|---|
| +4.8 | +4.9 Feb 23 | -3.3 Feb 22 |

# United Kingdom Distress Index

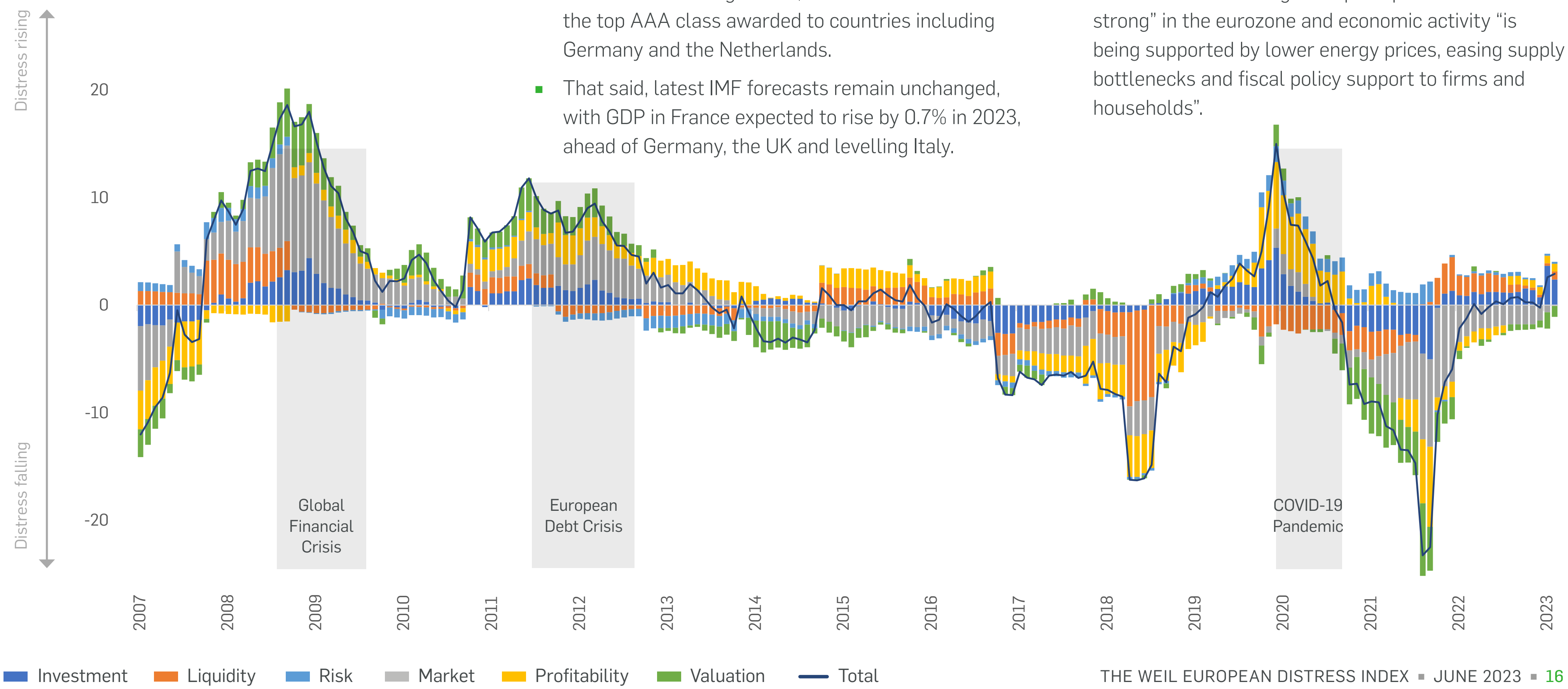
- In particular, inflation remains stubbornly high and its fall towards the Bank of England's target rate of 2.0% is slower than expected. In May, inflation remained at 8.7%, unchanged from the previous month and the highest in all the European countries covered in our index. Concerningly, core inflation (which strips out the more volatile components such as energy and food) continues to rise, up 7.1% in May from 6.8% in April, raising concerns that inflation has become entrenched.
- The Bank of England responded by rising interest rates by 0.5 percentage points, a markedly more aggressive rise than markets had expected before inflation data had been released.
- The Institute of Fiscal Studies (IFS) has warned that rising interest rates could see 1.4 million mortgage holders lose more than 20% of their disposable incomes with under 40s likely to be hit the hardest.



| May 2023 | QoQ trend | YoY trend |
|---|---|---|
| +2.9 | +0.2 Feb 23 | -1.2 May 22 |

# France Distress Index

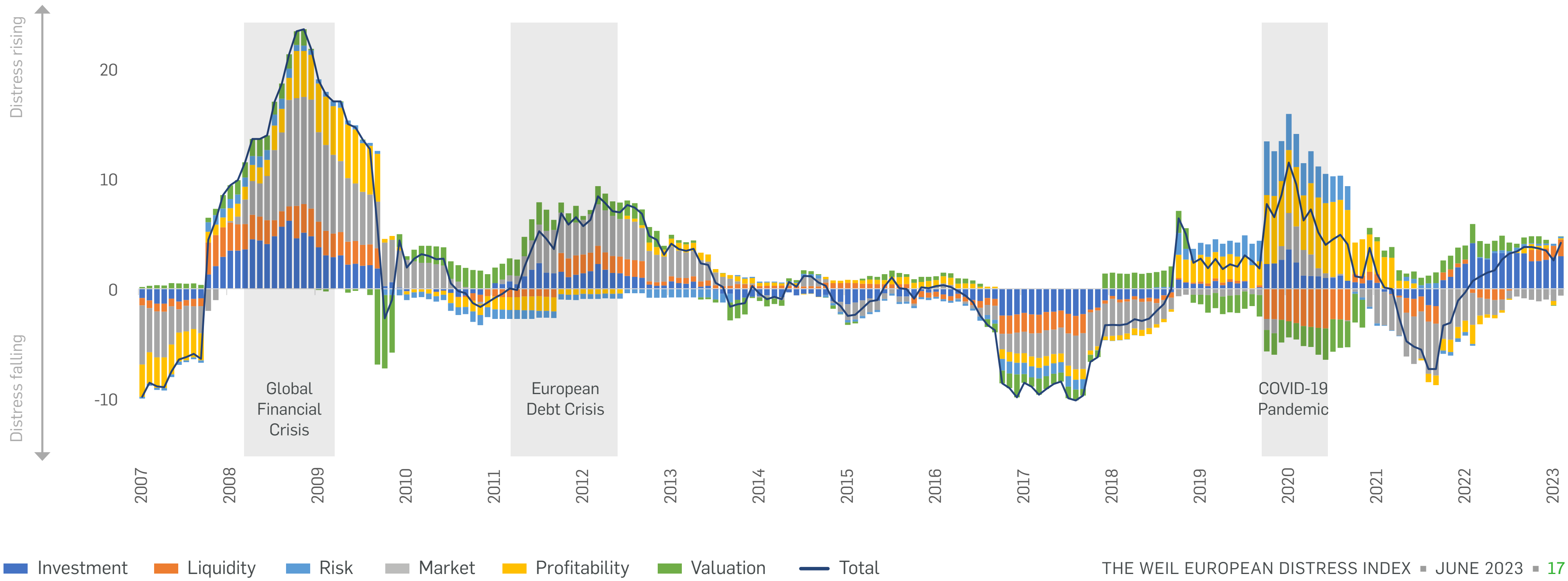
- Levels of distress across corporates in France rose sharply in May, now at the highest level since August 2020.
- The sources of distress were the same as those experienced in the UK, driven by weaker investment metrics, and pressure on liquidity and profitability. Support from market fundamentals also waned in the latest period to the weakest since August 2020.
- Concerns around France's fiscal deficit were raised during this latest quarter as Fitch downgraded France's debt rating to AA-, several classes below the top AAA class awarded to countries including Germany and the Netherlands.
- That said, latest IMF forecasts remain unchanged, with GDP in France expected to rise by 0.7% in 2023, ahead of Germany, the UK and levelling Italy.
- However, inflation remains a key concern in France and for the wider Euro Area. The Producer Price Index in France, an indication of inflationary pressures in the pipeline, was reportedly up 7.3% in April, significantly higher than other European nations such as Germany (+3.9%), Italy (-1.2%) and Spain (-4.5%).
- ECB president Christine Lagarde hinted towards another rate rise citing that "price pressures remain strong" in the eurozone and economic activity "is being supported by lower energy prices, easing supply bottlenecks and fiscal policy support to firms and households".



# Germany Distress Index

| May 2023 | QoQ trend | YoY trend |
|---|---|---|
| +4.1 | +3.6 Feb 23 | +0.7 May 22 |

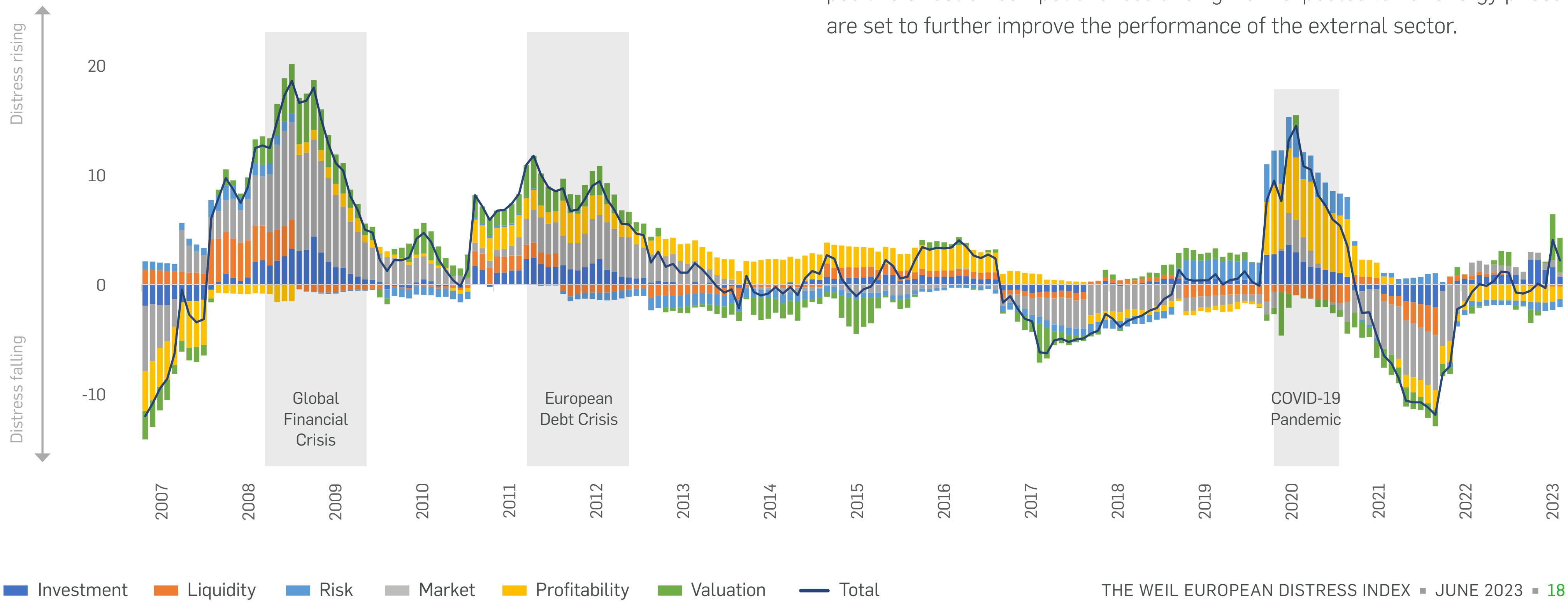
- Corporates in Germany remained the second most distressed country across the European markets measured. Levels of distress rose on the previous quarter, now at their highest level since November 2020.
- Distress was pushed higher by poorer investment metrics, pressure on liquidity and lower appetite for risk. The uptick in distress reflects a weaker than expected recovery in the German economy which fell into recession in the first quarter of 2023.
- German output shrank 0.3% in the first three months of the year to mark a second straight quarter of negative growth, notably weighed down by a 1.2% fall in household spending that contrasted with modest gains in France and Italy.
- Painful levels of inflation has hit consumer confidence hard, with shoppers holding back their spending, which is particularly problematic given household consumption accounts for approximately half of GDP.
- What's more, with the economy also reliant on manufacturing, ongoing softness in global demand continues to play a key role in distress expectations for German corporates.



# Spain and Italy Distress Index

| May 2023 | QoQ trend | YoY trend |
|---|---|---|
| +2.2 | -0.1 Feb 23 | -0.7 May 22 |

- Corporates headquartered in Spain and Italy saw levels of distress rise fall in the latest monthly period, but rise on the overall quarter, remaining well below levels seen by their European neighbours such as the UK, Germany and France.
- However, the deterioration was driven by weaker valuations, dwindling market sentiment and pressure on investment metrics, a divergence from other European markets.
- Indeed, the economic outlook for Spain and Italy appears more upbeat than the UK and Germany. GDP is expected to rise by 1.5% in Spain, and 0.7% in Italy, according to the IMF.
- Additionally, inflationary pressures have eased considerably in the last few months for both economies with CPI in Spain (Apr 2023:4.1% vs Nov 2022:7.1%) and Italy (Apr 2023: 8.3% vs. Nov 2022: 11.6%). They are past their peak rates and on the path towards more moderate levels.
- The full recovery of international tourism to pre-pandemic levels and the positive effect on competitiveness arising from expected lower energy prices are set to further improve the performance of the external sector.



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