Weil

THE WEIL EUROPEAN DISTRESS INDEX

MARCH 2023

Weil, Gotshal & Manges (London) LLP

Macro view

- Corporate distress across key European markets has eased marginally in the last quarter, but remains above long-run average levels. In part, this reflects a slightly more optimistic economic outlook since the November 2022 Weil European Distress Index (WEDI).
- Expectations of a deep and prolonged European-wide recession at the beginning of Q4 2022 have moderated, with faster falls in inflation and a stronger boost from pent-up demand leaving room for cautious optimism in some markets.
- Nevertheless, projections for global growth remain well below long-run averages with the latest IMF forecasts (Jan 2023) estimating growth of 1.2% in 2023, rising to 1.4% in 2024 across advanced economies – significantly below long-run averages.
- As such, risks remain firmly on the downside with distress rising significantly on last year's levels. The picture across Europe also remains distorted, with UK corporates experiencing higher levels of distress than those in Germany, France, Italy and Spain.
- Indeed, corporate distress in the UK rose on the previous quarter, now at its highest level since June 2020.
- Conditions have worsened across eight of the ten industry groups covered, compared with the previous year. Corporates remain cautious that the Russia-Ukraine conflict could escalate, and a synchronised tightening of monetary policy could increase global financing costs and worsen debt distress.

Weil European Distress Index Movements

Feb 2023	QoQ trend	YoY trend
+3.1	⬆ +3.0 Nov 22	⬆ -5.8 Feb 22

- In the latest data, distress was pushed higher on the previous year by deteriorating investment metrics and growing pressure on liquidity and profitability. These drivers are expected to continue as support from covid financial packages continue to unwind and debt maturities loom.
- Although financial markets remain resilient across major European economies, support from market fundamentals has deteriorated to its lowest level since September 2020.

Sector view

- The largest driver of distress in the latest data (February 2023) came from businesses operating within 'Real Estate', driven by a squeeze on valuations, liquidity and weakening investment metrics.
- Meanwhile, distress remained elevated across 'retail and consumer' and worsened sharply for 'healthcare' businesses.
- 'Technology, media and telecommunications' (TMT), 'infrastructure' and 'commodities and natural resources' are the only three industries where levels of distress are lower than this time last year.

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

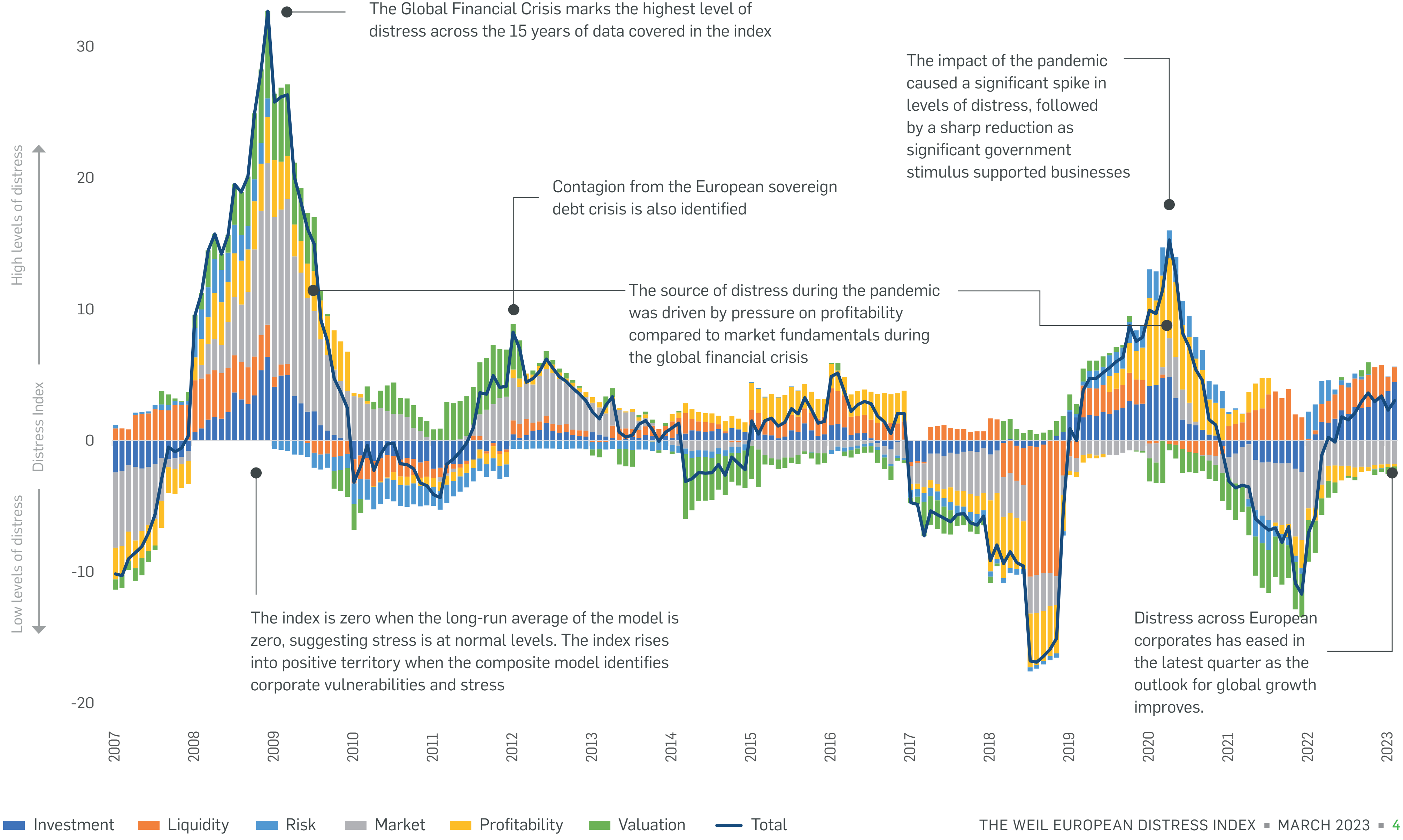
The WEDI is constructed using data from over 3,750 listed European companies and a range of financial market indicators. 16 indicators have been used to construct the WEDI which reflect one or more symptoms of corporate distress based on comprehensive academic and desk-based research.

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.

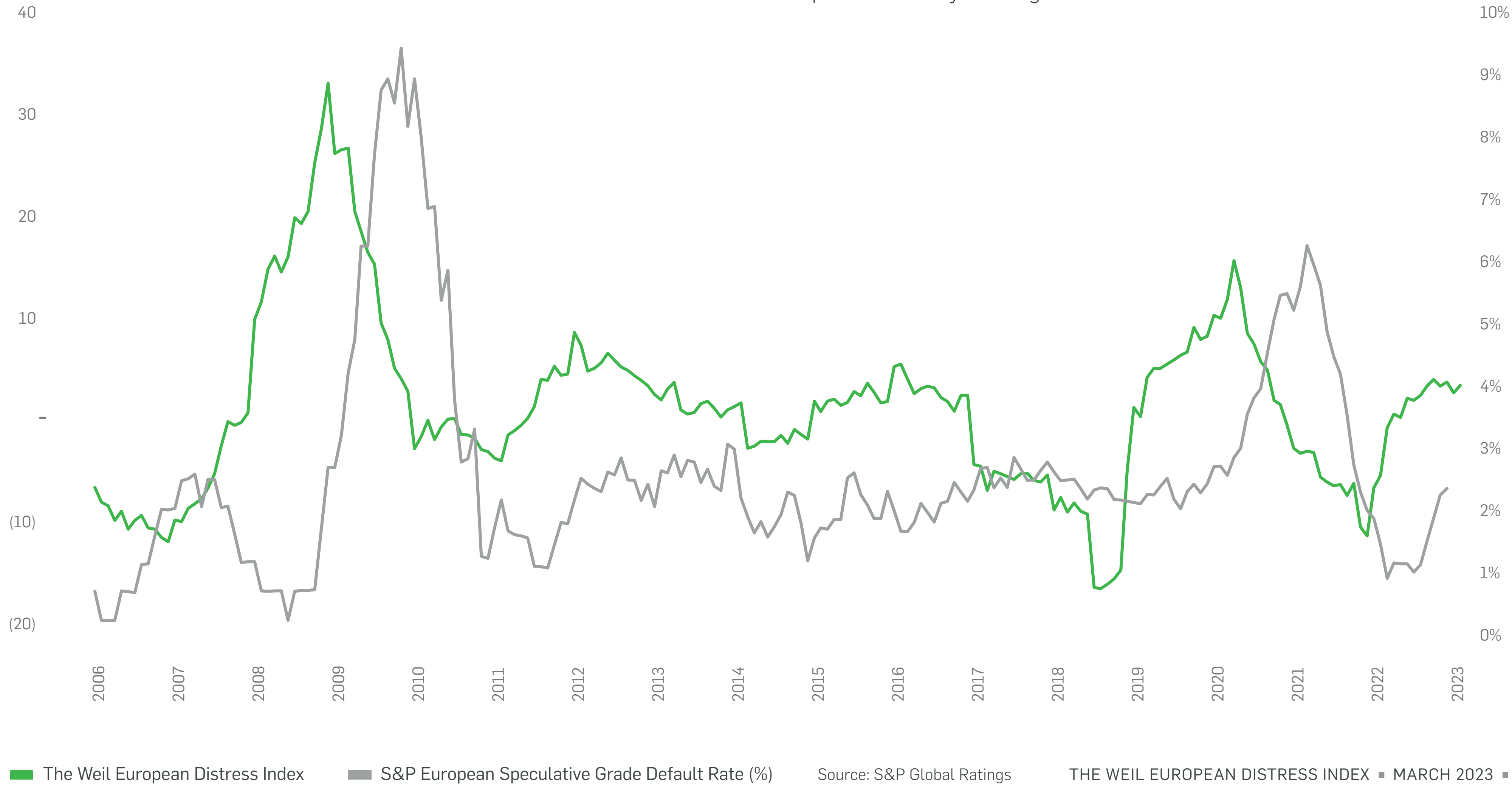
* Total Europe include UK, France, Germany, Spain, Italy, The Netherlands, Republic of Ireland, Belgium, Norway and Portugal

The European Distress Index



The Weil European Distress Index vs Default Rates

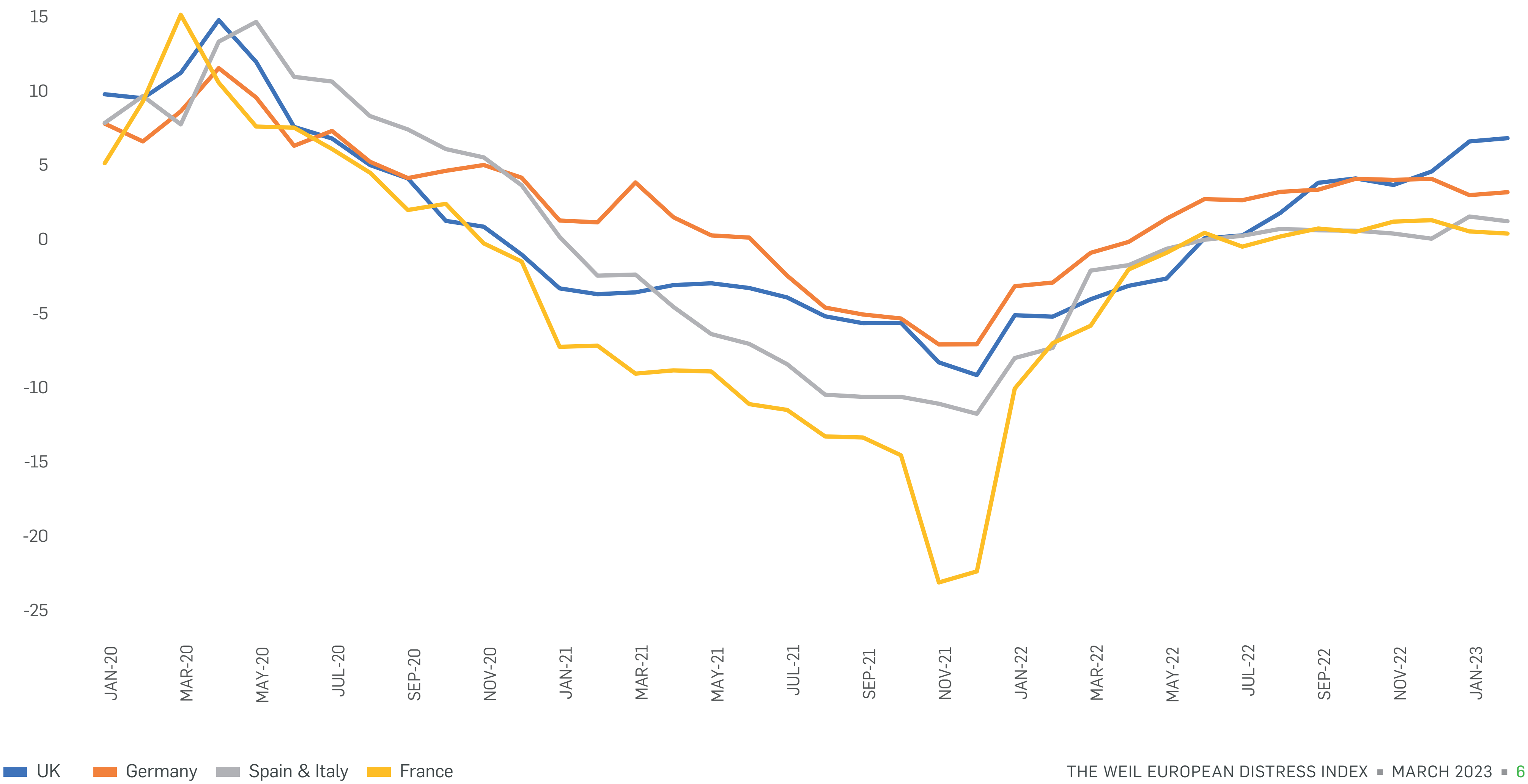
- In the two most major recent crises, the Global Financial Crisis and Covid pandemic we have observed that the WEDI peaks in advance of the S&P European Speculative Grade Default Rate.
- The WEDI tracks the deterioration in financial markets conditions and company performance which occurs in advance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



Source: S&P Global Ratings

Comparison of distress levels across Europe

- Since the beginning of 2023, there has been a clear divergence in the levels of distress being experienced by UK corporates compared to those in other European countries, driven by higher inflation and interest rates than on the continent, as well as a structurally changed trade and labour dynamic following Brexit which will take the UK economy time to adjust to.



THE WEIL EUROPEAN DISTRESS INDEX
MARCH 2023

SIZE ANALYSIS

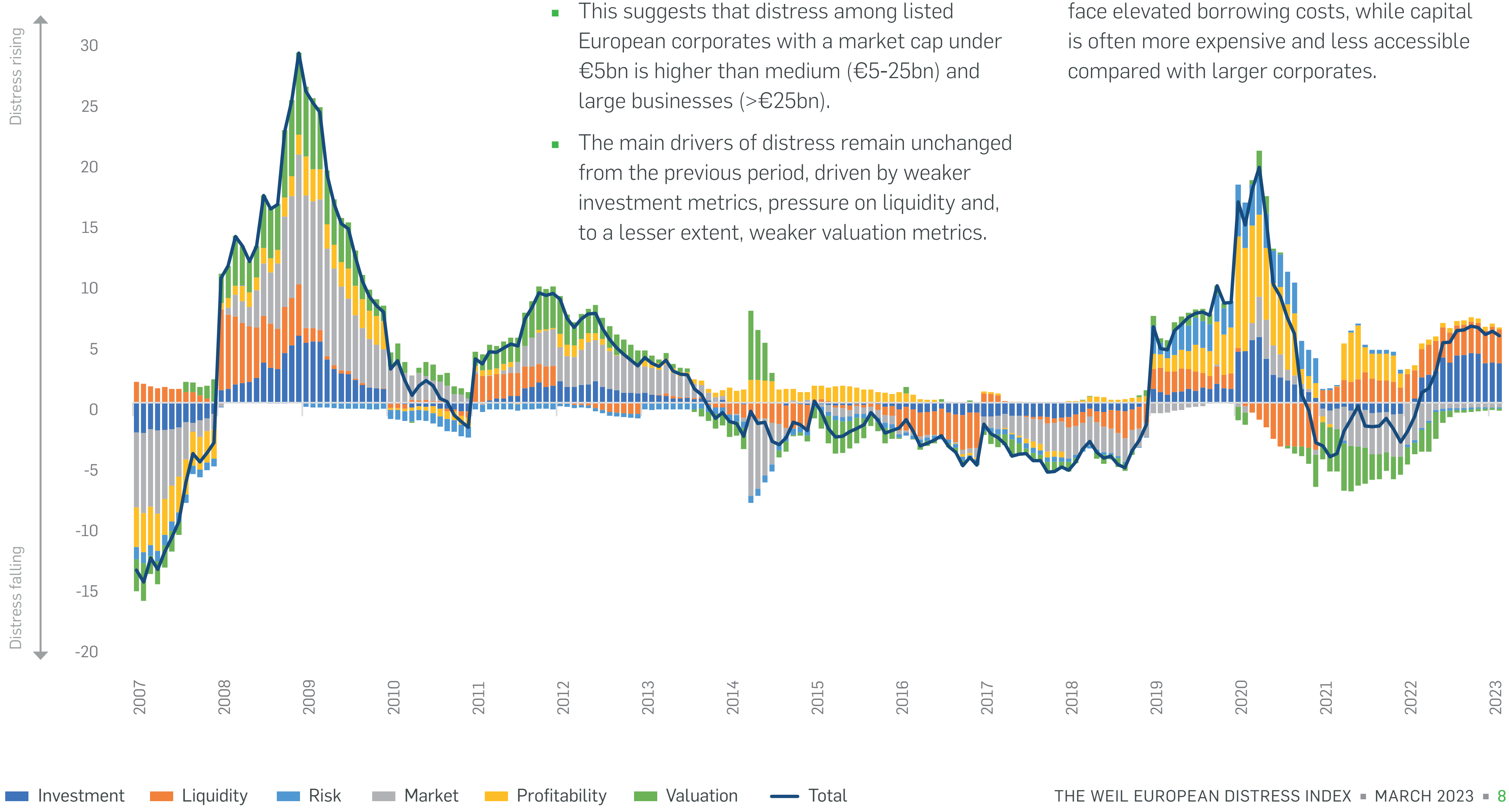
INDUSTRY ANALYSIS

COUNTRY ANALYSIS

Small Corporates

(market cap <€5bn)

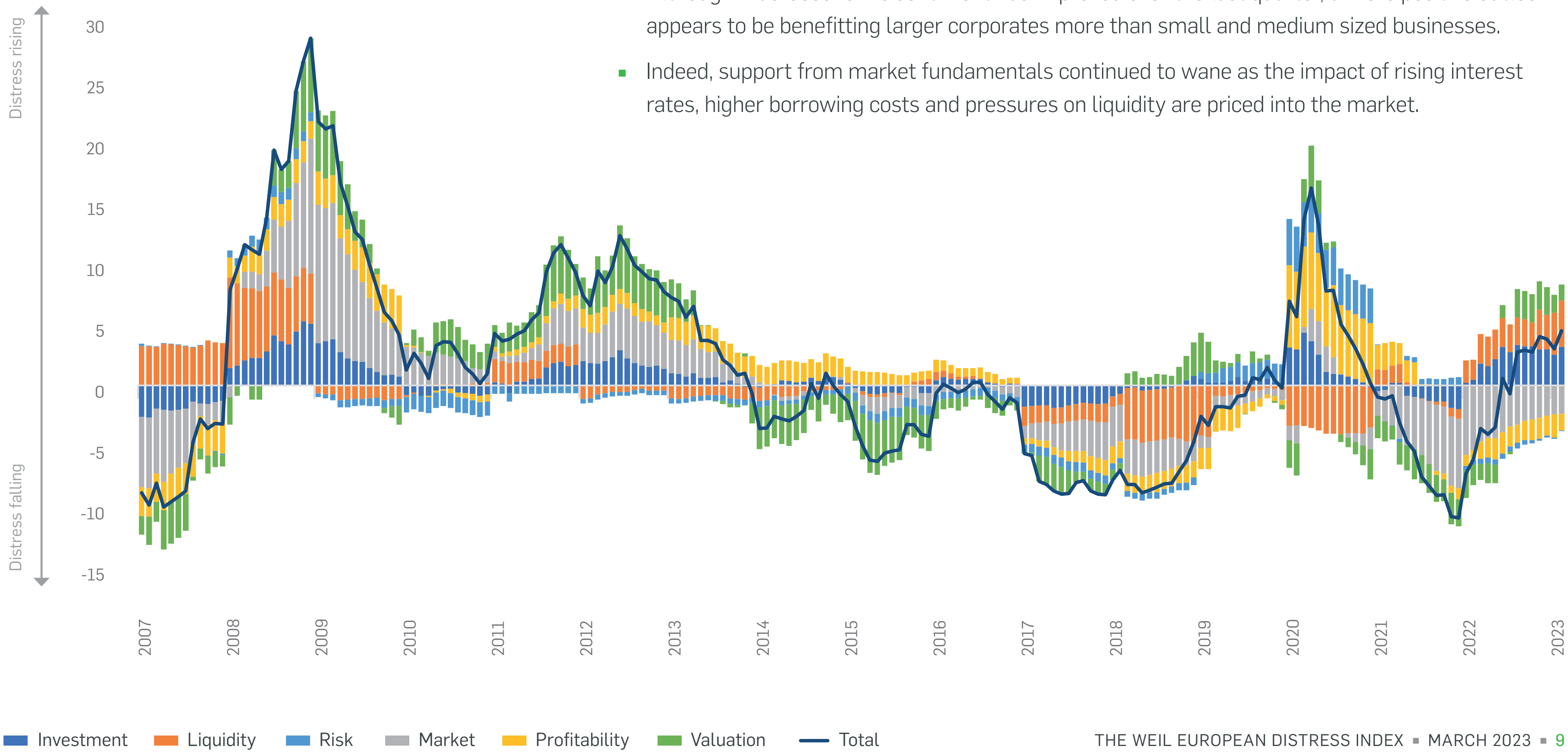
- Levels of distress remains elevated across small European corporates, considerably higher than this time last year and above the long-run average for the twelfth consecutive month.
- This suggests that distress among listed European corporates with a market cap under €5bn is higher than medium (€5-25bn) and large businesses (>€25bn).
- The main drivers of distress remain unchanged from the previous period, driven by weaker investment metrics, pressure on liquidity and, to a lesser extent, weaker valuation metrics.
- Market fundamentals support has also continued to wane.
- Rising interest rates across the UK and EU is likely causing a squeeze on liquidity particularly for small cap firms who typically face elevated borrowing costs, while capital is often more expensive and less accessible compared with larger corporates.



Medium Corporates

(market cap €5bn – €25bn)

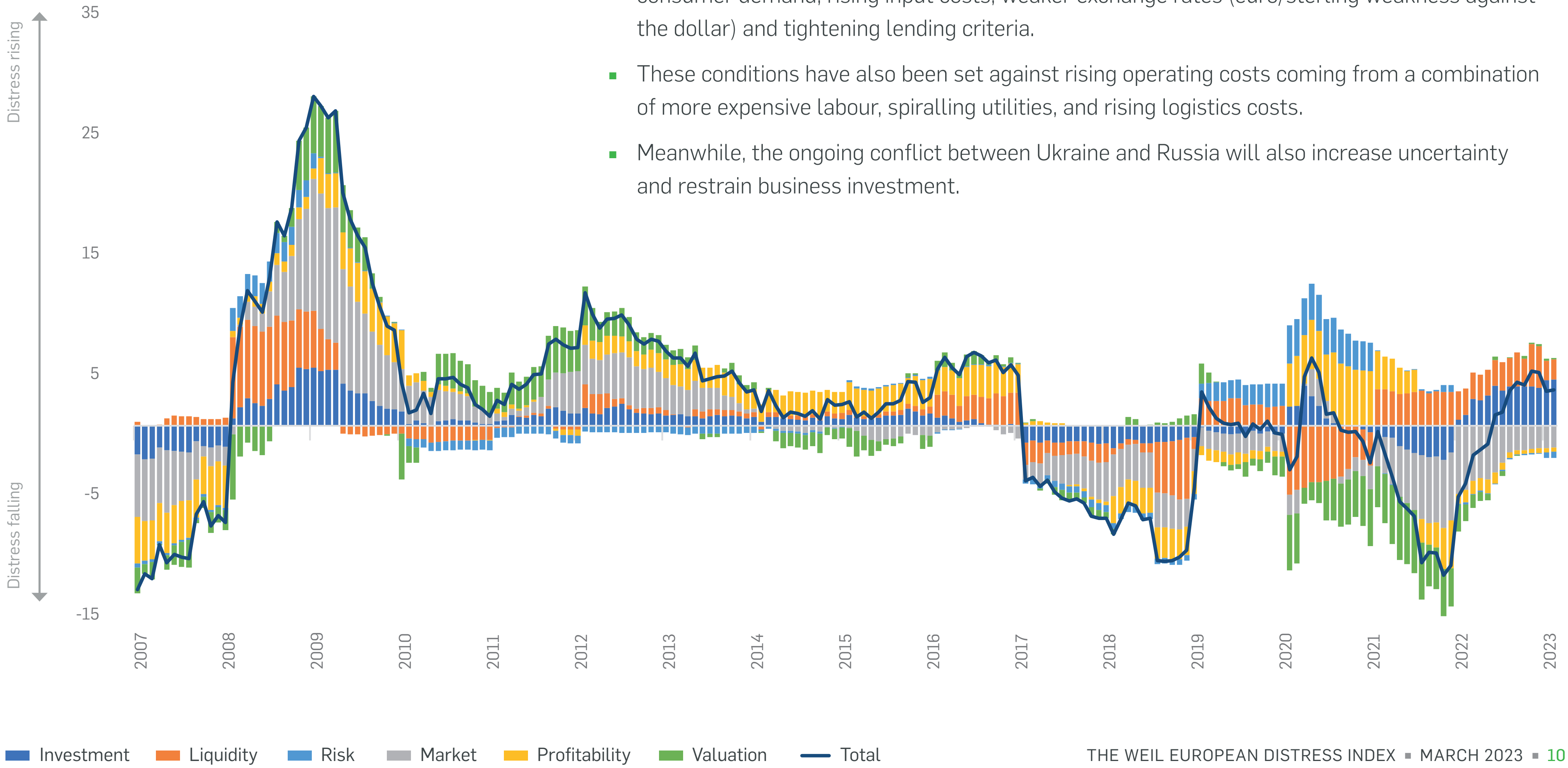
- Medium sized corporates have seen levels of distress rise to the highest level since August 2020 in the latest quarter.
- The main sources of distress continue to emerge from three main areas: squeezed liquidity, poorer investment metrics and faltering valuations.
- In particular, the pressure on liquidity has ramped up in the latest period and is now at its highest level since December 2008 during the aftermath of the global financial crisis.
- Although macroeconomic sentiment has improved over the last quarter, a more positive outlook appears to be benefitting larger corporates more than small and medium sized businesses.
- Indeed, support from market fundamentals continued to wane as the impact of rising interest rates, higher borrowing costs and pressures on liquidity are priced into the market.



Large Corporates

(market cap >€25bn)

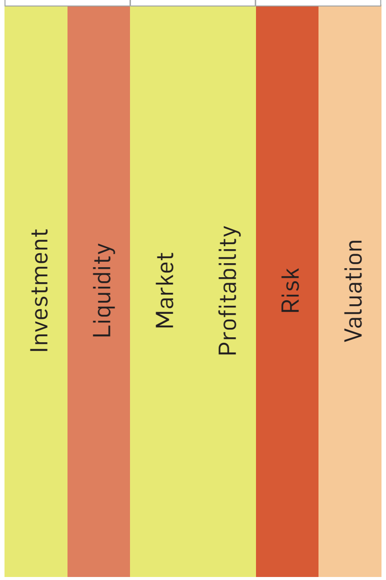
- Distress across large corporates eased marginally according to the latest data, but remains above the long-run average and considerably higher than this time last year.
- Distress has now been detected for the last nine consecutive months, driven primarily by weaker fundamentals across investment metrics, liquidity and valuation – unchanged from the previous period.
- Large corporates are not immune to the pressures caused by rising interest rates, weaker consumer demand, rising input costs, weaker exchange rates (euro/sterling weakness against the dollar) and tightening lending criteria.
- These conditions have also been set against rising operating costs coming from a combination of more expensive labour, spiralling utilities, and rising logistics costs.
- Meanwhile, the ongoing conflict between Ukraine and Russia will also increase uncertainty and restrain business investment.



Distress Index February 2023

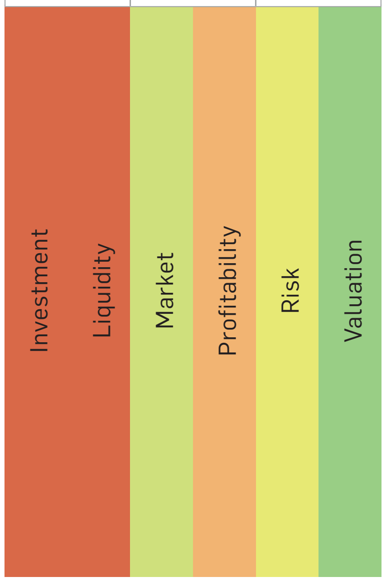
Real Estate

Distress ranking	Index value	YoY trend
1	+4.7	⬆ -2.4 Feb 22



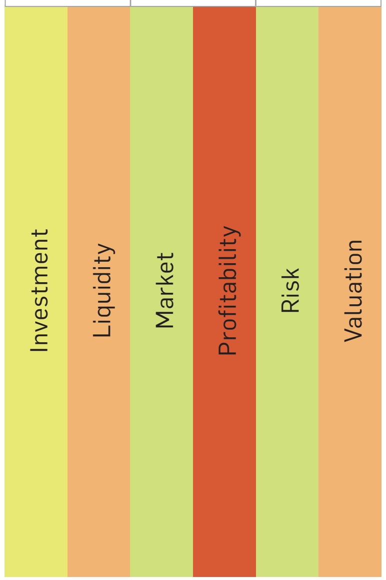
Retail and consumer goods

Distress ranking	Index value	YoY trend
2	+3.8	⬆ -7.2 Feb 22



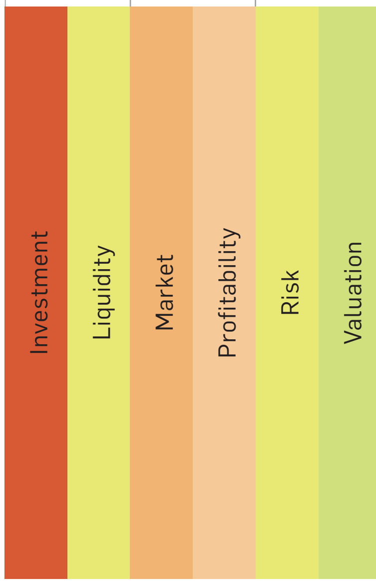
Healthcare

Distress ranking	Index value	YoY trend
3	+3.2	⬆ -3.1 Feb 22



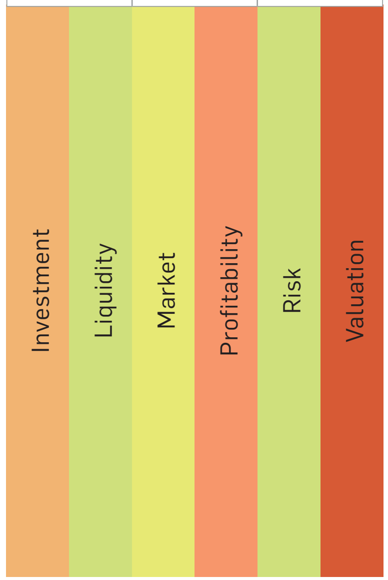
Travel, leisure and hospitality

Distress ranking	Index value	YoY trend
4	+1.9	⬇ +2.7 Feb 22



Industrials

Distress ranking	Index value	YoY trend
5	+1.1	⬆ -0.3 Feb 22

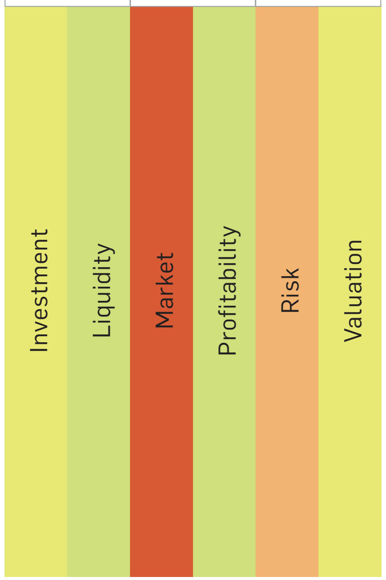


INDUSTRY ANALYSIS

Least distressed | Most distressed

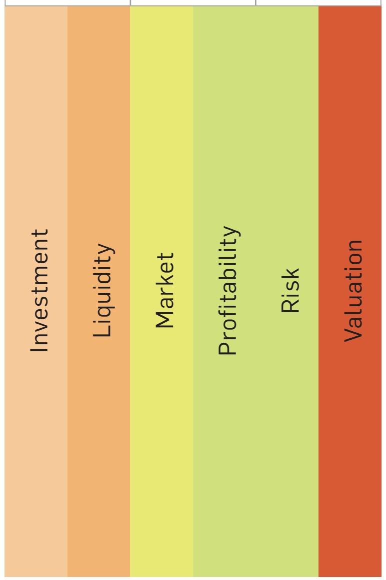
Financial Services

Distress ranking	Index value	YoY trend
6	+1.0	↑ -4.5 Feb 22



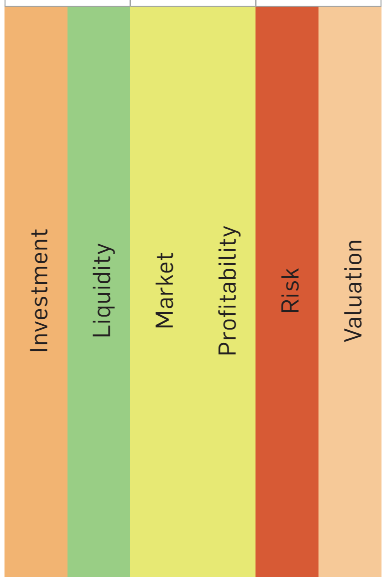
Oil & Gas

Distress ranking	Index value	YoY trend
7	+0.6	↑ -1.5 Feb 22



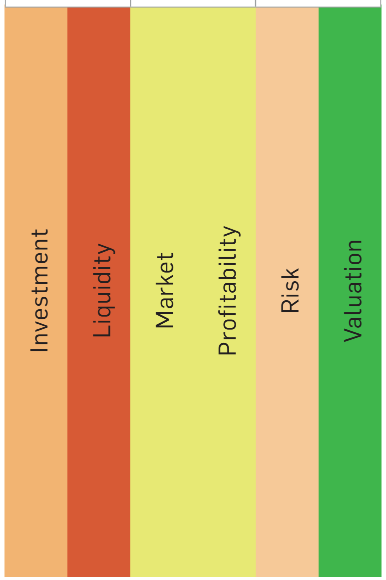
Technology, media and telecoms

Distress ranking	Index value	YoY trend
8	-3.3	↑ -6.5 Feb 22



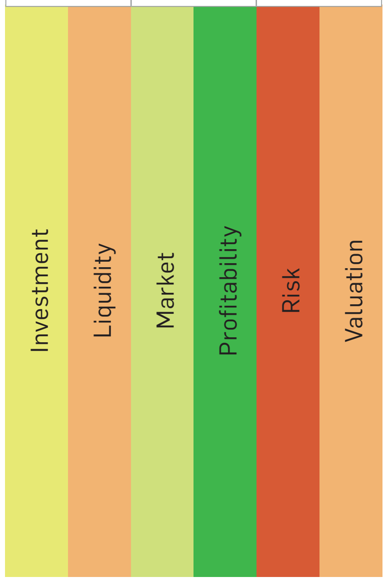
Infrastructure

Distress ranking	Index value	YoY trend
9	-3.5	↓ -3.3 Feb 22



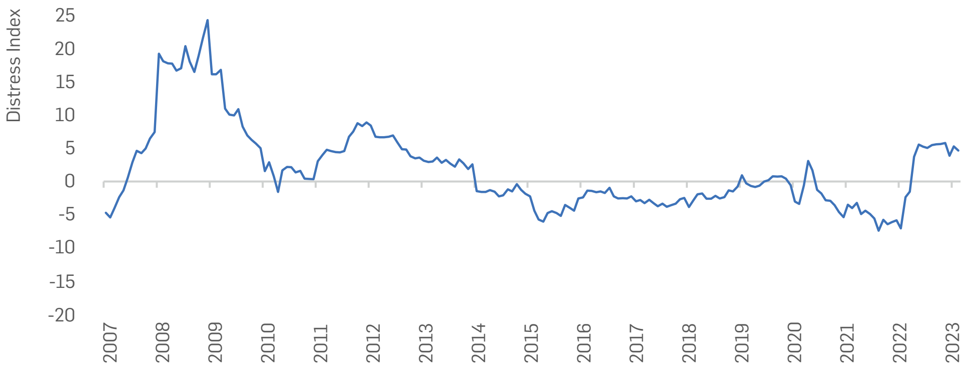
Commodities / Natural Resources

Distress ranking	Index value	YoY trend
10	-4.6	↑ -5.8 Feb 22



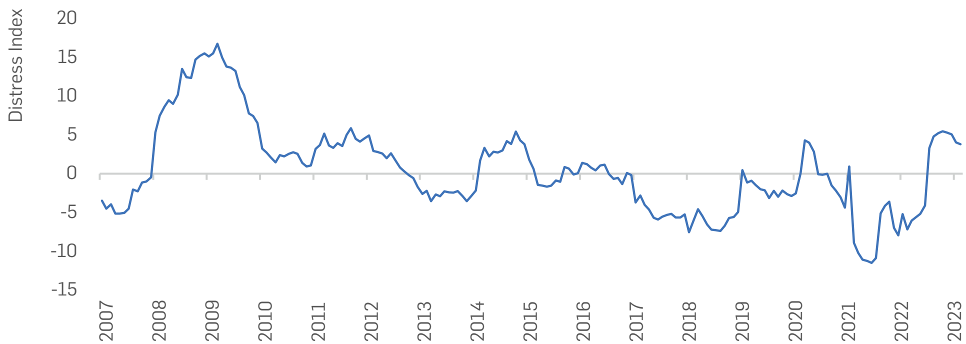
Real Estate

Real Estate companies across Europe have seen levels of distress rise significantly over the last year, driven higher in the latest period by weaker valuation metrics, rising pressures on liquidity and softer investment metrics. Ongoing pandemic impacts, particularly hybrid working, higher borrowing costs, and lower expectations of capital appreciation have all contributed to more challenging conditions.



Retail and Consumer Goods

Retail and consumer goods is the second most distressed sector across our coverage. The immediate pressure on liquidity and profitability remains a key challenge as a weaker consumer outlook is set against rising operating costs, increasing borrowing costs and fierce competition.

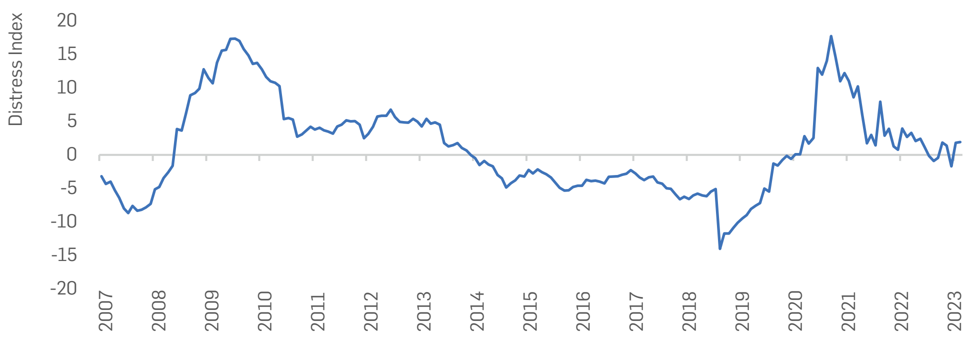


Healthcare

European healthcare corporates have seen distress levels accelerate in the last quarter, caused by a deterioration across profitability, liquidity and valuation. In part, is likely to reflect the rising cost of raising and servicing capital and higher operating costs while the positive impacts of demand throughout the pandemic have waned.

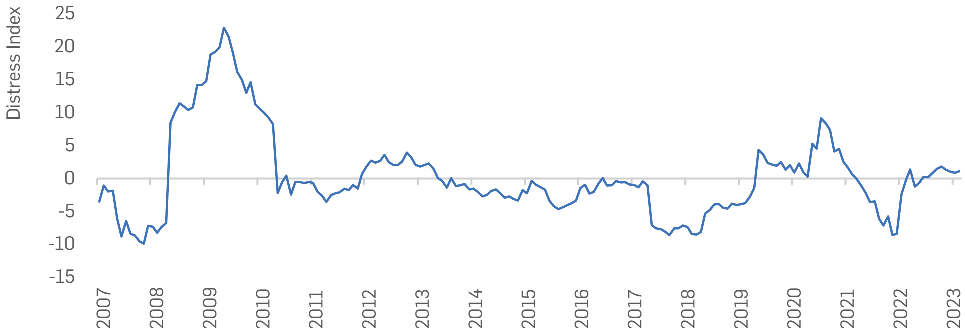
Travel, Leisure and Hospitality

The pandemic drove the Travel, Leisure & Hospitality sector to record distress levels, which have since eased as economies reopen and demand picked up. However, distress remains above the long-term average, likely driven by leisure and hospitality players to a larger extent compared to travel operators who have reported strong demand.



Industrials

In the latest data, the level of distress in the industrial sector remained positive and increased for the ninth consecutive month due to a decline in valuation metrics and a lessening appetite towards risk in this part of the market. Furthermore, companies in this sector are grappling with rising input and operating costs while experiencing a slowdown in global demand.

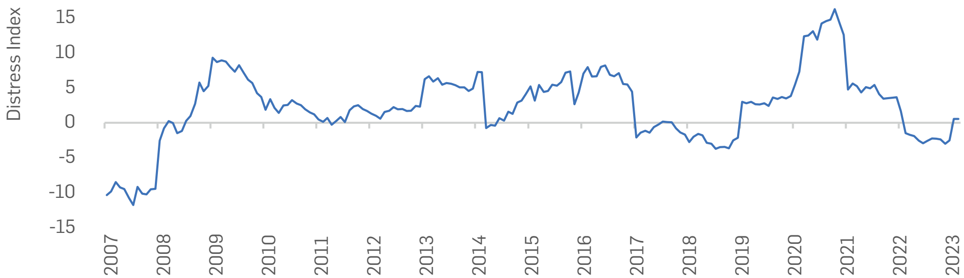


Financial Services

European financial services firms are experiencing an upward trend in distress which has risen to levels above the long-run average for four consecutive months. Overall distress has been driven by weaker valuations, a squeeze on liquidity, and pressure on profitability.

Oil and Gas

In the latest quarter, the distress levels of oil and gas companies have surpassed the long-term average due to weaker oil prices caused by slowing global growth. Additionally, concerns over the impact on industrials and consumer demand are contributing factors.



Technology, Media and Telecoms

The level of distress in the Technology, Media, and Telecommunications (TMT) sector briefly increased to a positive territory before falling below the long-term average. In particular, strong support has been provided by market fundamentals, liquidity and profitability.

Infrastructure, Utilities and Power

Infrastructure, Utilities, and Power companies have experienced a rise in distress levels compared to the previous quarter, but levels remain below the long-run average due to the passing on of higher energy and utility prices to consumers and businesses. The industry is benefitting from strong valuations, solid market fundamentals, and strong profitability.

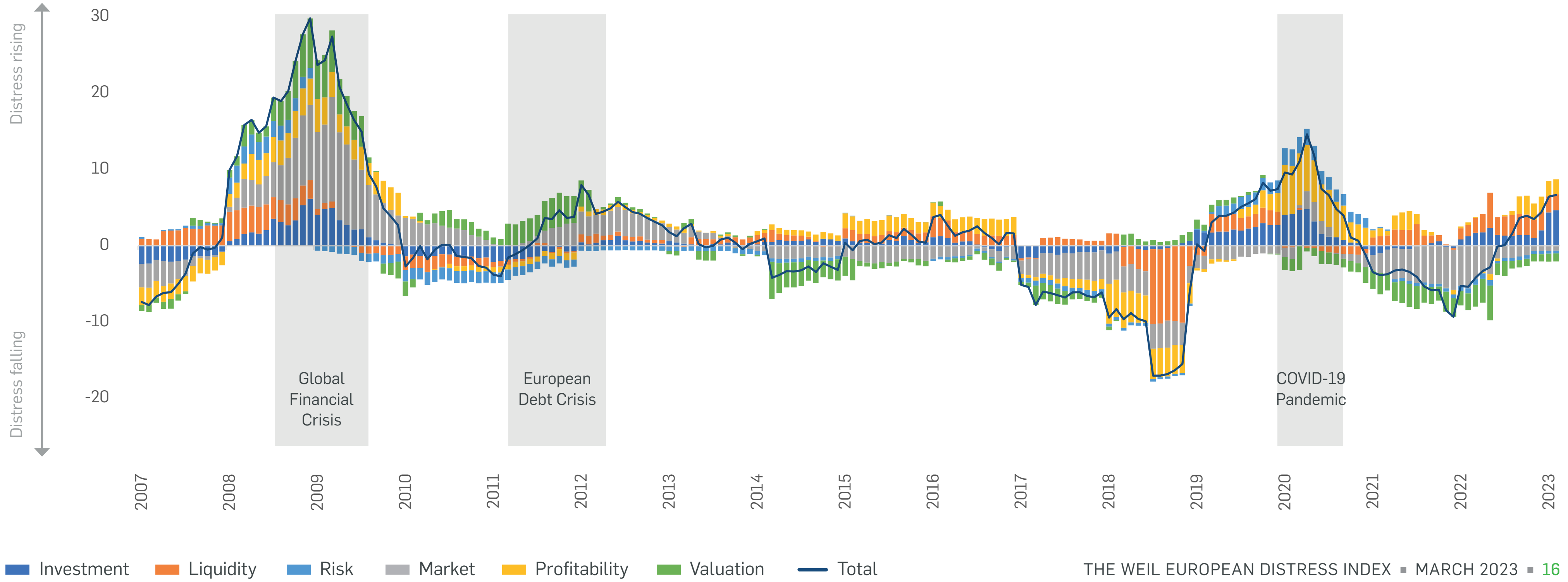
Commodities and Natural Resources

Corporate distress in commodities and natural resources remained in negative territory in the last quarter, stabilising near current levels. The industry is experiencing a period of strong profitability and supportive market fundamentals and investment metrics.

United Kingdom Distress Index

Feb 2023	QoQ trend	YoY trend
+6.7	+3.5 Nov 22	-5.4 Feb 22

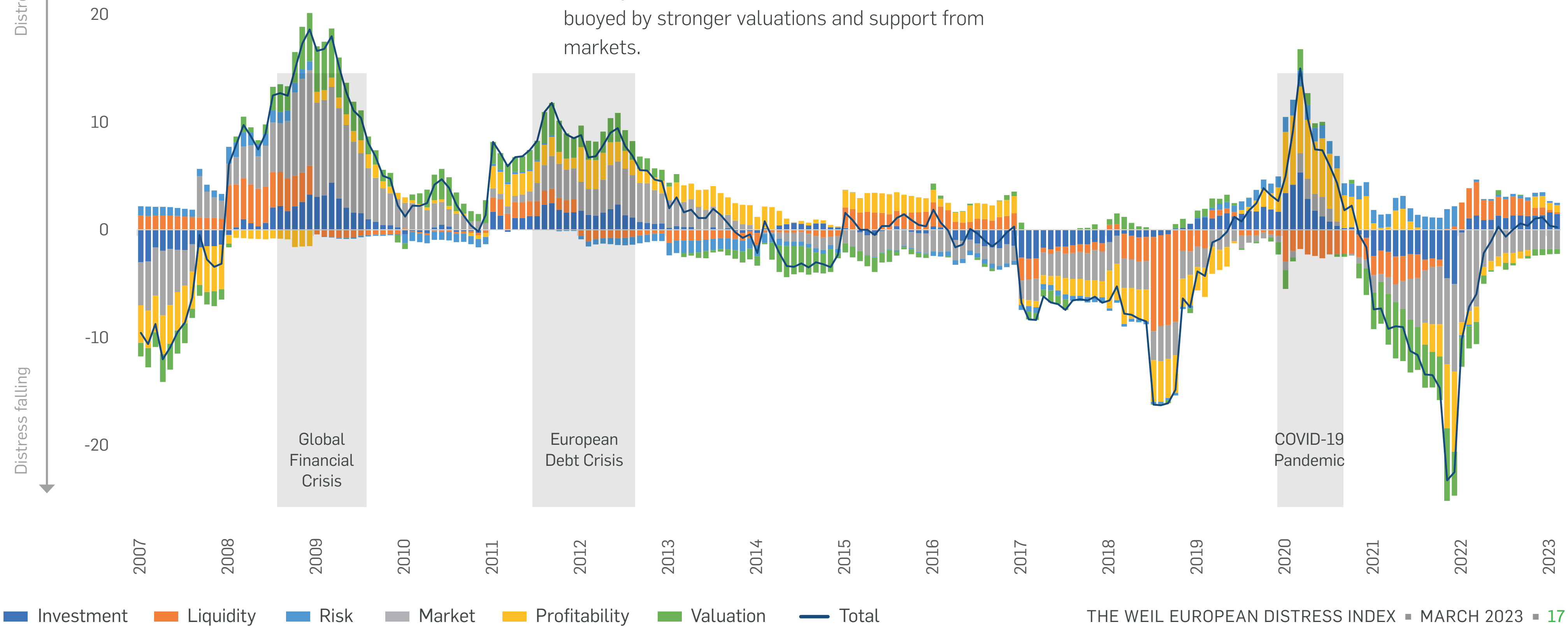
- The UK remained the most distressed market across the European markets covered, with levels rising on the previous year and previous quarter. The UK is now the most distressed since June 2020, with the main drivers stemming from weaker investment metrics and ongoing pressure on liquidity and profitability.
- Although the outlook for the UK economy has improved over the last quarter, the Bank of England expect the economy to enter recession in 2023 which is expected to persist for the remainder of the year. Indeed, the latest IMF forecast suggests that the UK is the only major industrialised country expected to see its economy shrink this year. However, more optimistic forecasts from the OBR in the Spring Budget suggests that the UK will narrowly miss a technical recession, although still forecasting for the economy to contract 0.2% in 2023.
- UK-based corporates continue to face significant headwinds from stubbornly-high inflation, rising input costs, escalating interest rates and pressure on operating costs (e.g. labour, utilities, logistics). In addition, the cost of servicing and raising debt has risen considerably, while lenders are applying more caution.
- Adding to pressures, real household disposable incomes are expected to fall by c.3% in 2023 (Bank of England) as inflation across core staples (e.g. food, energy, transport), rising housing costs (mortgages and rents) and tax hikes displace spending from discretionary areas.



Feb 2023	QoQ trend	YoY trend
+0.23	+1.04 Nov 22	-23.3 Feb 22

France Distress Index

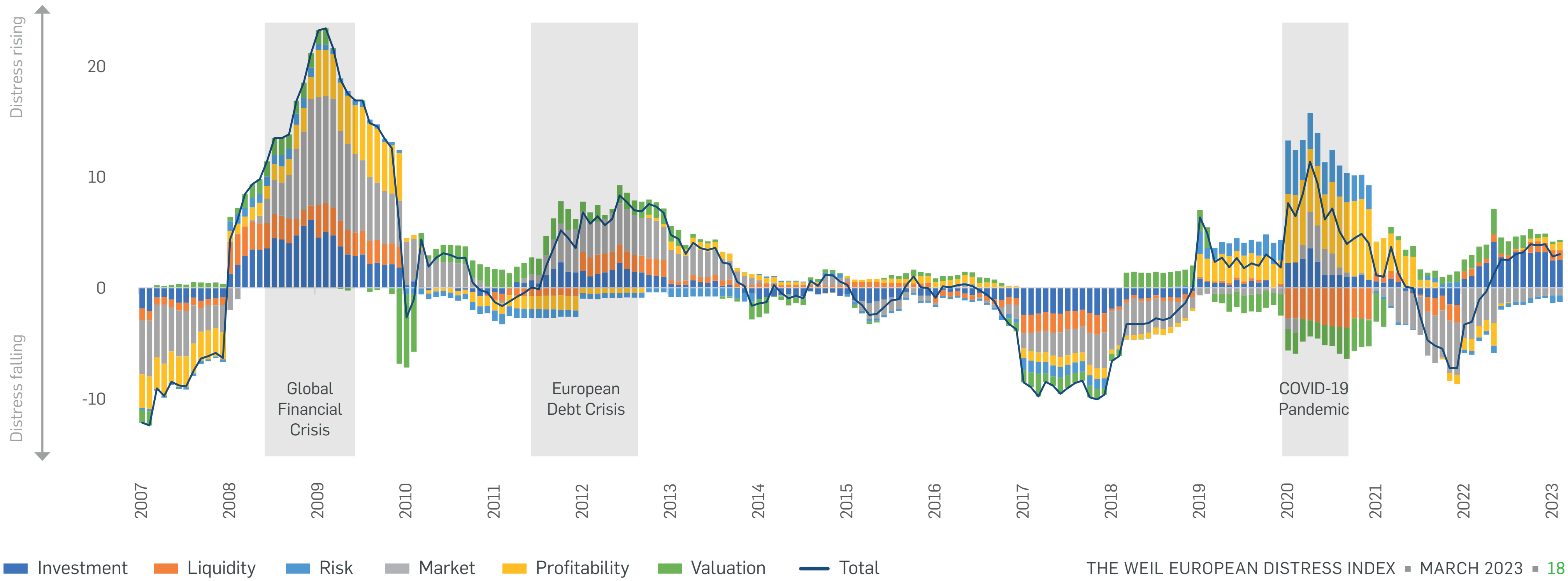
- Levels of distress across corporates in France remained in positive territory for the seventh consecutive month, albeit just slightly above the long-run average.
- The sources of distress were aligned to those experienced in the UK and Germany, driven by pressure on investment metrics, profitability and liquidity. However, support from market fundamentals remained robust, with the CAC 40 rising 13.7% since the start of the year, dragged back by 'consumer non-cyclicals' and 'basic materials'.
- However, France remained the least distressed country across the territories included in the index, buoyed by stronger valuations and support from markets.
- France has also introduced a cap on power and gas price increases to 15% to soften the impact on consumers. The Government will also continue with grants for the least affluent impacting 12 million households.
- The macroeconomic environment in France appears more positive than many neighbouring European countries. The IMF has forecast economic growth of 0.7% in 2023, ahead of the UK, Germany and Italy.



Feb 2023	QoQ trend	YoY trend
+3.0	+3.9 Nov 22	-3.1 Feb 22

Germany Distress Index

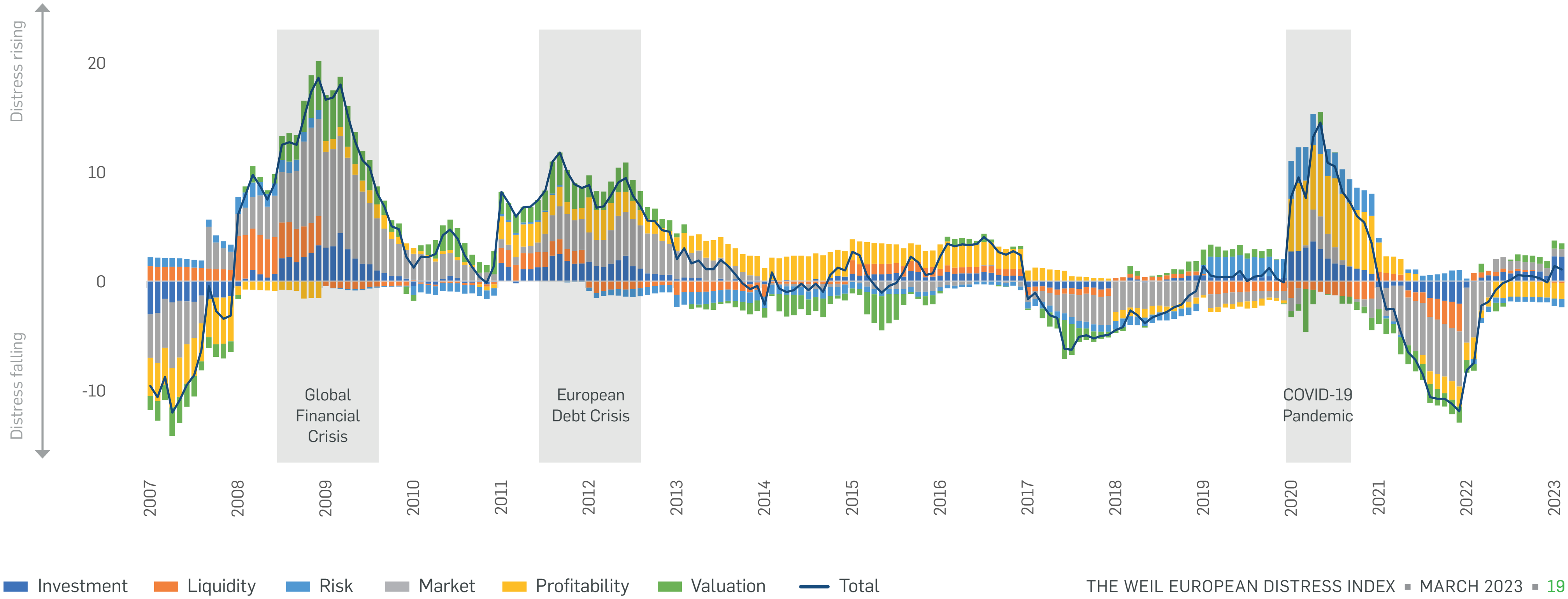
- Corporates in Germany were the second most distressed group across the European markets included, but saw levels of distress moderate mildly on the previous quarter.
- This is likely to reflect a more optimistic outlook for the economy, given the expected avoidance of recession and stronger financial markets. The IMF upgraded their forecasts, now predicting growth of 0.1% in 2023 (2024: 1.4%). Albeit this remains considerably lower than the Euro Area of (2023: 0.7%, 2024: 1.6%) as a whole.
- The DAX has also rebounded strongly, with the 40 largest listed companies rising 12.2% since the start of the year. Nevertheless, distress remains considerably higher than the previous year driven by pressures on investment metrics, squeezed liquidity and weaker profitability.
- Inflation also remains a key concern, rising 8.7% in February, above market expectations of 8.5% and well above the target rate.
- With the economy 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

Feb 2023	QoQ trend	YoY trend
+1.1	+0.3 Nov 22	-7.5 Feb 22

- Corporates headquartered in Spain and Italy continue to see levels of distress rise on the previous year, driven by pressure on investment metrics, weaker market fundamentals and poorer valuations.
- The greatest change on the previous quarter was seen across investment metrics which saw a sharp increase and now at its highest level since May 2020. Unlike other markets, pressures on liquidity appear to have eased in the latest data, albeit very marginally.
- However, distress remains lower than levels seen in the UK and Germany which could reflect a stronger economic outlook. Economic growth in Italy (2022: 3.9%, 2023: 0.6%) and Spain (2022: 5.2%, 2023: 1.1%) have outpaced that of the overall Euro Area (2022: 3.5%, 2023: 0.7%) and are projected to do the same in 2023.
- Additionally, inflationary pressures have eased considerably in the last few months for both economies with CPI in Spain (Feb:6.1% vs Jul:10.8%) and Italy (Feb: 9.2% vs. Oct: 11.8%) seemingly past peak rates and experiencing sharp disinflation.



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