THE WEIL EUROPEAN DISTRESS INDEX

OCTOBER 2023

Macro view

- Corporate distress rose across key European markets compared with the previous quarter and accelerated on last year's levels according to the latest Weil European Distress Index (WEDI).
- The macroeconomic backdrop remains challenging, with the tightening of monetary policy to combat inflation weighing on economic activity across Europe.
- The latest IMF forecasts (July 2023) suggest that global growth is expected to fall from 3.5% in 2022 to 3.0% in both 2023 and 2024. This remains weak by historical standards.
- Swift action by authorities to contain turbulence in the US and Swiss banking sectors earlier in the year stemmed immediate risks in the financial sector. However, uncertainty remains elevated with ongoing risks from the Russia/Ukraine conflict, the slow recovery in China and associated real estate issues and stubbornly high levels of inflation all weighing on confidence and growth.
- The WEDI showed levels of distress rising across all European markets measured compared with the previous quarter. Germany saw distress rise to the highest level since May 2020 as economic growth stalled in the second quarter as the economy entered recession.
- Weaker purchasing power, contracting manufacturing orders and its reliance on China are all taking their toll. Indeed, Germany's manufacturing Purchasing Managers Index (PMI) recorded its second lowest reading since May 2020 in August, declining at its fastest pace since the initial stages of Covid shutdowns.
- The IMF forecast suggests Germany's economy will contract 0.3% in 2023, the only advanced economy expected to shrink compared with the previous year.

Weil European Distress Index Movements

Aug 2023	QoQ trend	YoY trend
+5.8	⬆ +3.2 May 23	⬆ +1.7 Aug 22

- Elsewhere, the UK saw corporate distress remain at elevated levels, nudging up slightly on the previous quarter. While inflation has fallen sharply in recent months (Jul 2023 6.8% vs. Nov 2022 11.1%), spending power remains under pressure with sustainable growth in real earnings not expected to return until the second quarter of 2024.
- Both the Bank of England and the European Central Bank have increased interest rates to combat inflation, tapering economic growth and raising the cost of financing operations and refinancing existing debt.
- Rising interest payments relative to corporate earnings are making debt repayments more challenging, particularly across highly leveraged capital-intensive sectors.
- Although the drivers of distress remain broad-based across countries, there has been particular pressure felt with weaker investment metrics, pressure on liquidity and squeezed profitability.
- This is particularly the case with small cap businesses who continue to experience the highest levels of distress compared with larger companies.

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 has 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 including pressure on liquidity, reduced profitability, rising insolvency risk, falling valuations and reduced return on investment. These company indicators are 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 & Consumer Goods
- Financial Services
- Travel, Leisure & Hospitality
- Oil & Gas
- Industrials
- Infrastructure, Utilities & Power
- Healthcare
- Commodities & Natural Resources
- Technology, Media & Telecoms
- Real Estate

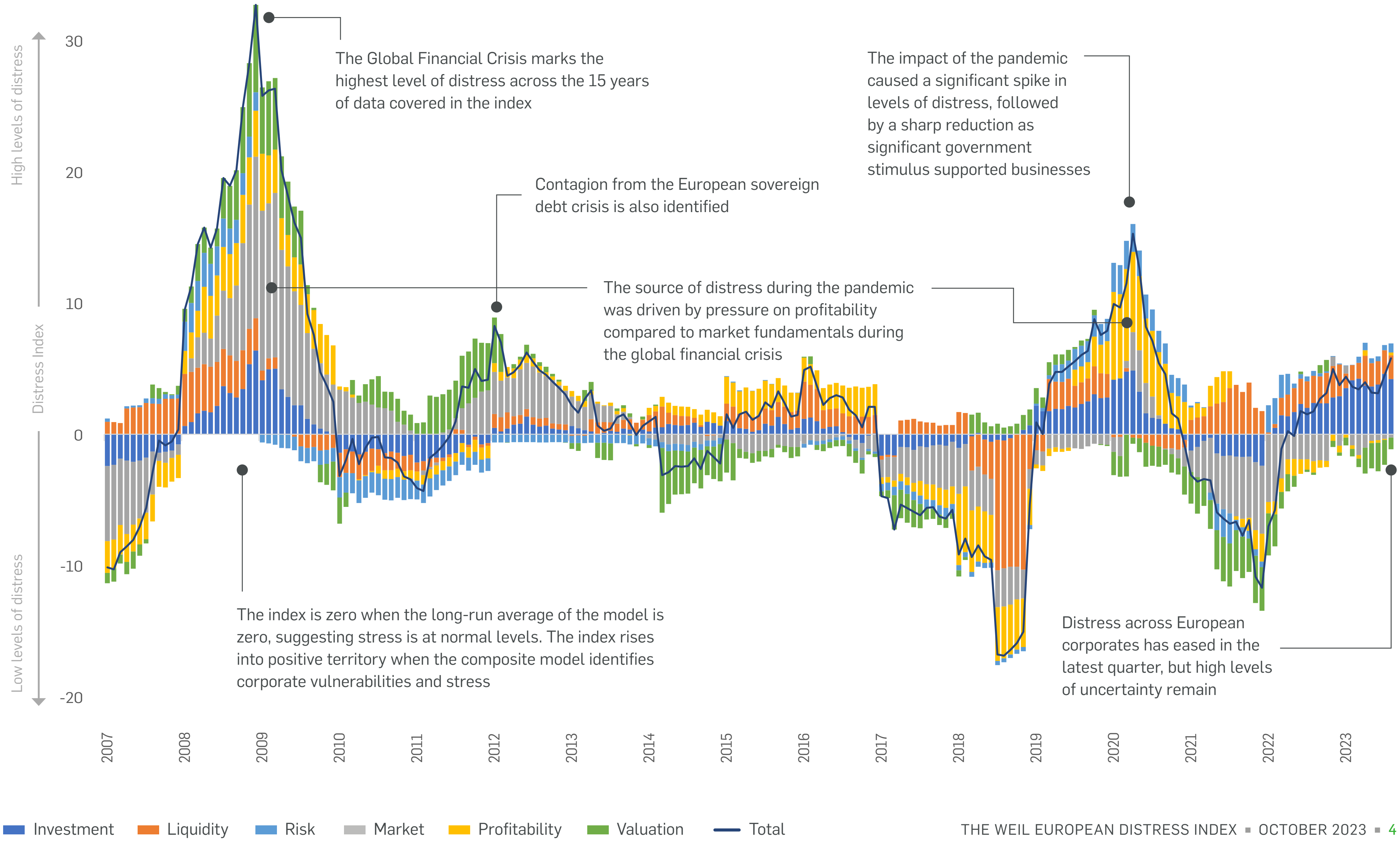
The WEDI is constructed using data from over 3,750 listed European companies and a range of financial market indicators. 16 indicators have been used to construct the WEDI which reflect one or more symptoms of corporate distress based on comprehensive academic and desk-based research.

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.

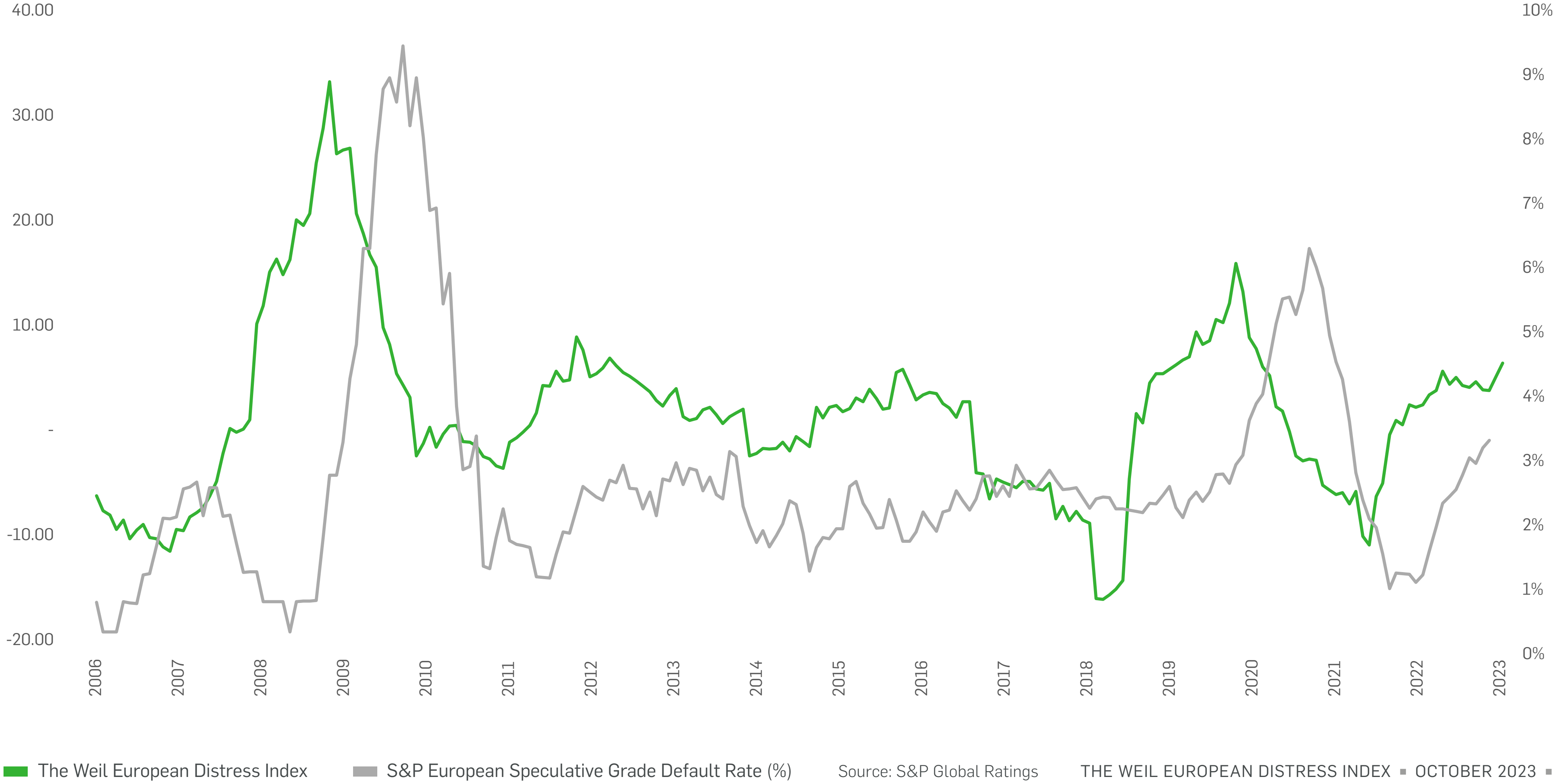
* Total Europe includes UK, France, Germany, Spain, Italy, The Netherlands, Republic of Ireland, Belgium, Norway and Portugal

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
OCTOBER 2023

SIZE ANALYSIS

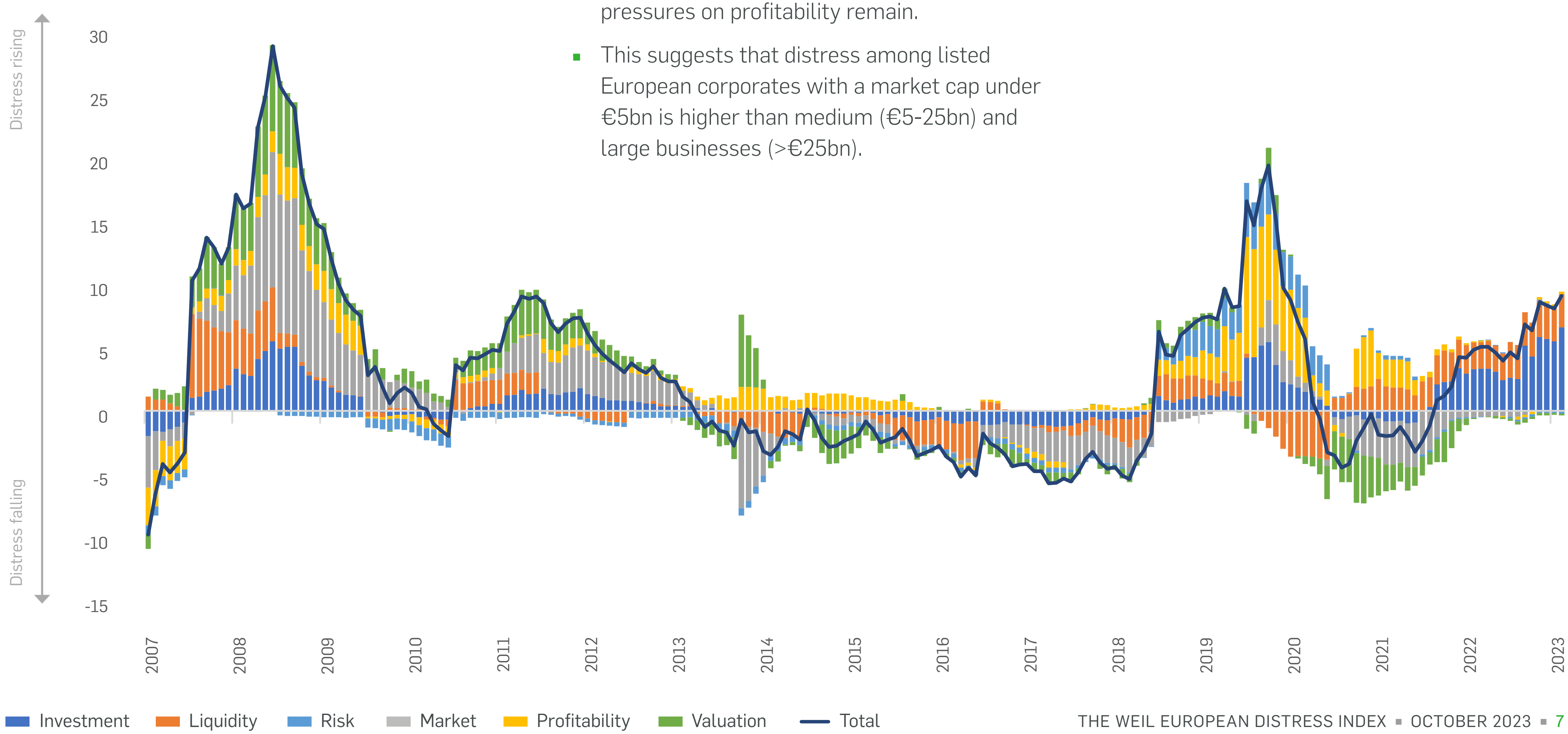
INDUSTRY ANALYSIS

COUNTRY ANALYSIS

Small Corporates

(market cap <€5bn)

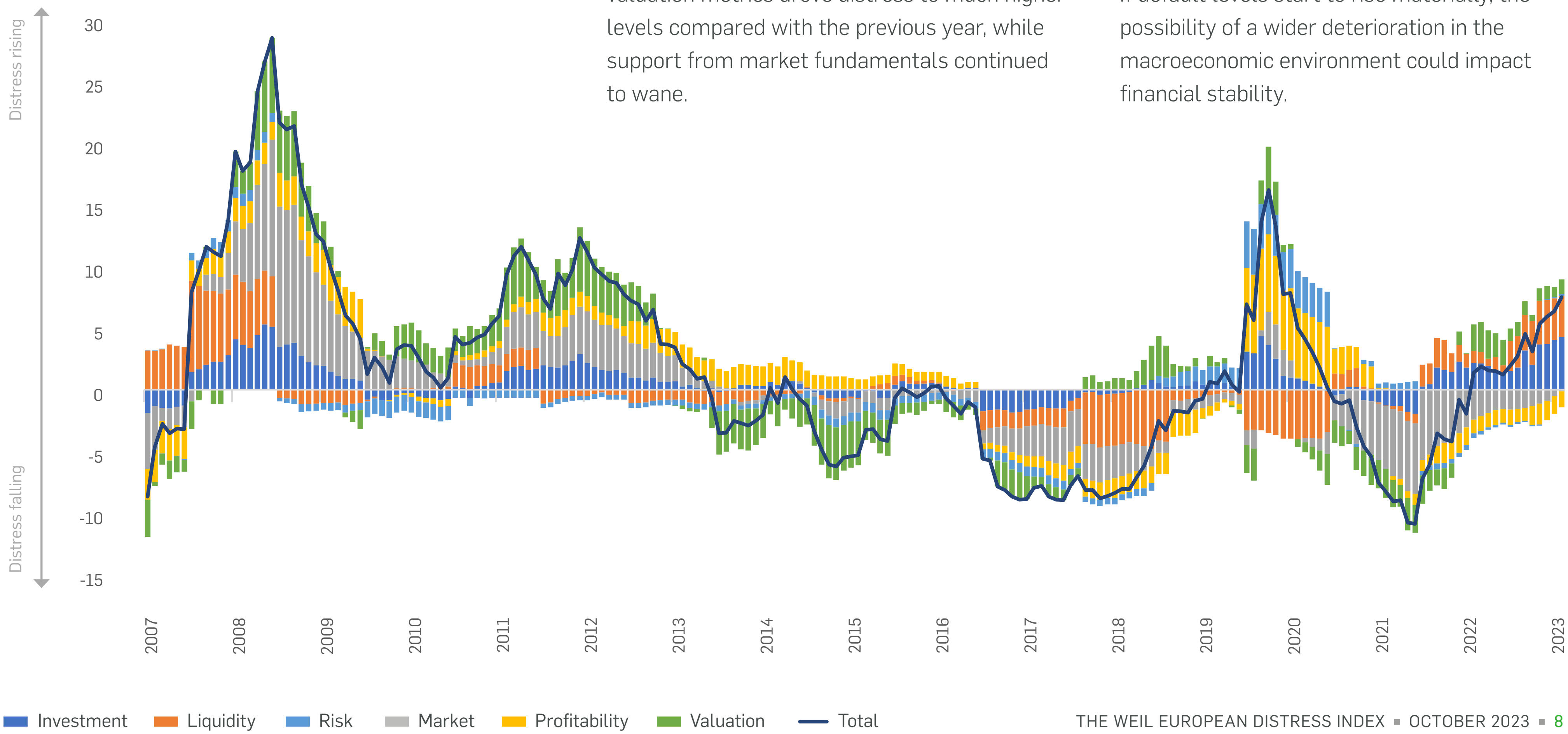
- Levels of distress remain highest across small European corporates and have accelerated on the previous quarter.
- Distress is now the highest since June 2020, rising markedly on the previous year.
- The main sources of distress continue to emanate from weaker investment metrics and squeezed liquidity. To a lesser extent, pressures on profitability remain.
- This suggests that distress among listed European corporates with a market cap under €5bn is higher than medium (€5-25bn) and large businesses (>€25bn).
- In part, higher interest rates across the UK and EU are likely to be bearing down on liquidity, particularly for smaller firms who typically have weaker balance sheets.
- These companies will suffer disproportionately from the impact of higher financing costs compared with larger firms, particularly in capital-intensive sectors.



Medium Corporates

(market cap €5bn – €25bn)

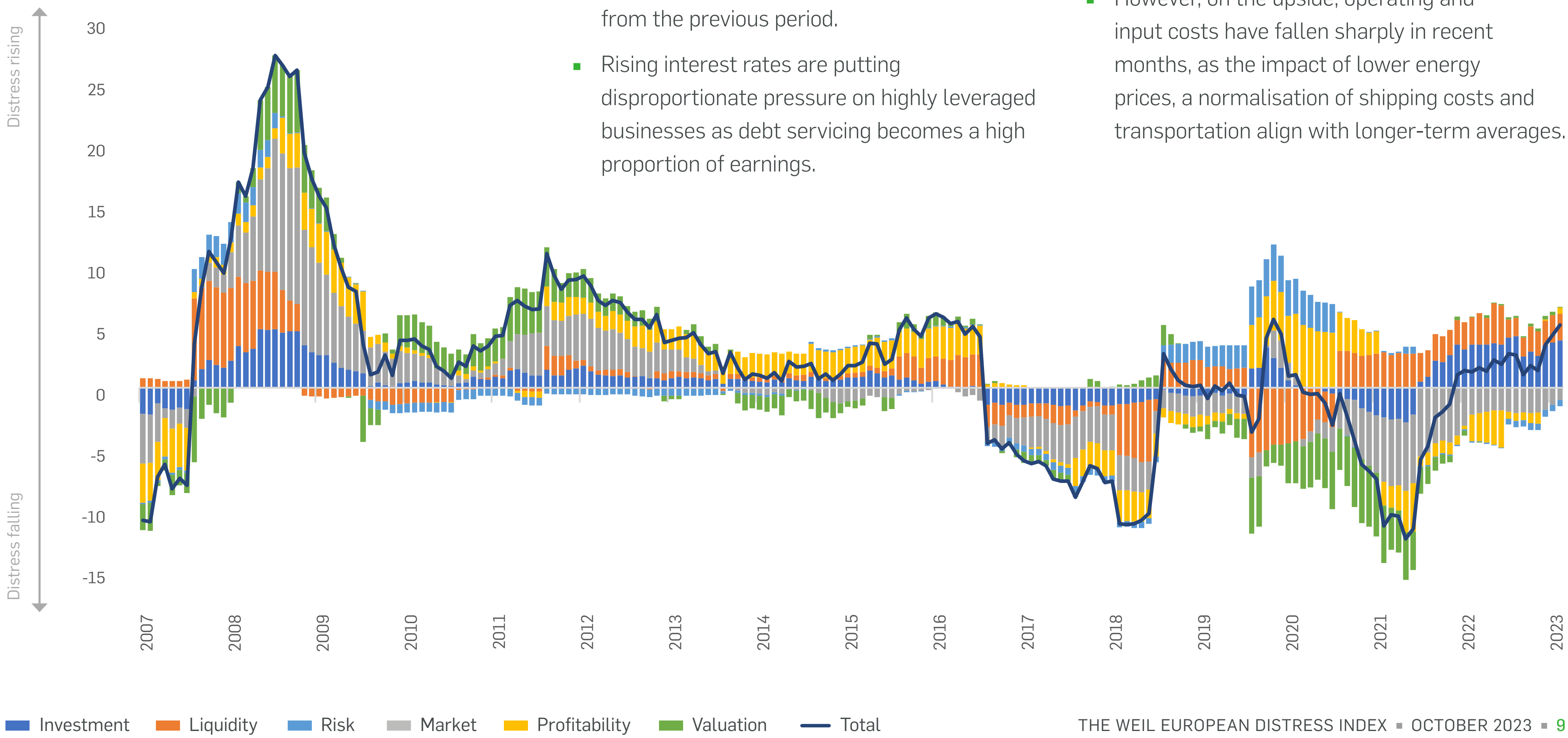
- Medium sized corporates have seen levels of distress rise on the previous quarter to their highest level since July 2020.
- As with smaller firms, poorer investment metrics drove the largest increase in distress which is now the highest since March 2020.
- Additionally, the squeeze on liquidity and poorer valuation metrics drove distress to much higher levels compared with the previous year, while support from market fundamentals continued to wane.
- Medium sized corporates face similar challenges to many smaller companies, battling with elevated financing costs and weaker investor confidence.
- Such pressure will increase the likelihood of defaults, with some firms reducing levels of investment and employment in response.
- If default levels start to rise materially, the possibility of a wider deterioration in the macroeconomic environment could impact financial stability.



Large Corporates

(market cap >€25bn)

- Distress across large corporates accelerated in the latest quarter to the highest level since May 2020. However, distress levels remain materially below levels seen across small and medium sized firms.
- The main sources of distress continued to be driven by weaker investment metrics, squeezed liquidity and pressure on profits – unchanged from the previous period.
- Rising interest rates are putting disproportionate pressure on highly leveraged businesses as debt servicing becomes a high proportion of earnings.
- Indeed, higher debt servicing costs are testing the robustness of some companies with business models predicated on a low interest rate environment
- What's more, global growth prospects have weakened markedly, with risks of a prolonged slowdown in China a growing concern for many.
- However, on the upside, operating and input costs have fallen sharply in recent months, as the impact of lower energy prices, a normalisation of shipping costs and transportation align with longer-term averages.



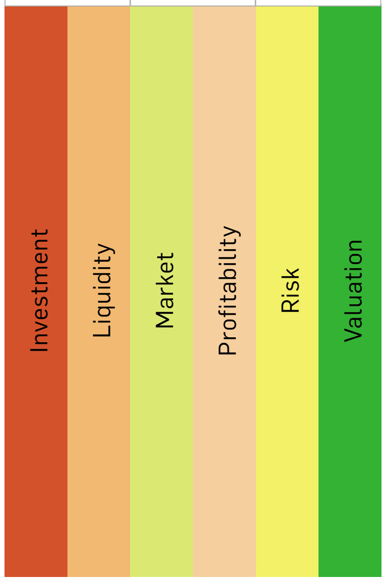
Distress Index October 2023

Least distressed

Most distressed

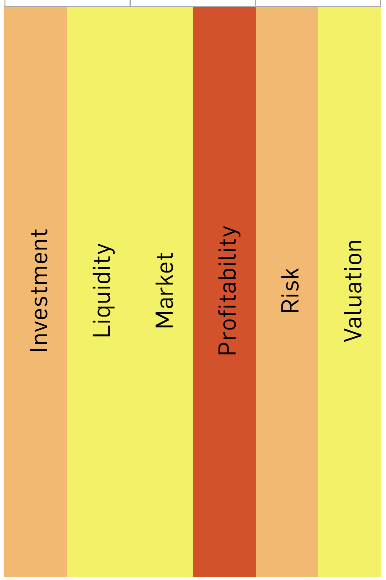
Real Estate

Distress ranking	Index value	YoY trend
1	+7.1	+4.0 Aug 22



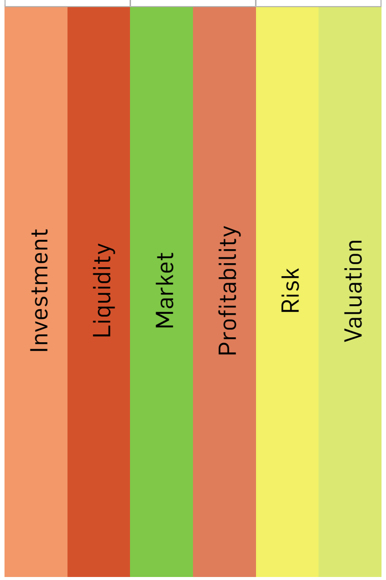
Healthcare

Distress ranking	Index value	YoY trend
2	+5.3	+1.1 Aug 22



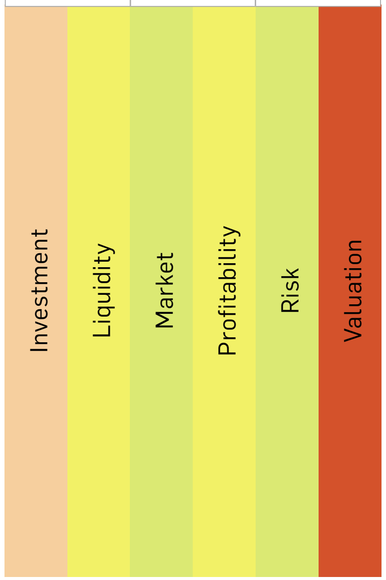
Retail & Consumer Goods

Distress ranking	Index value	YoY trend
3	+3.3	+1.7 Aug 22



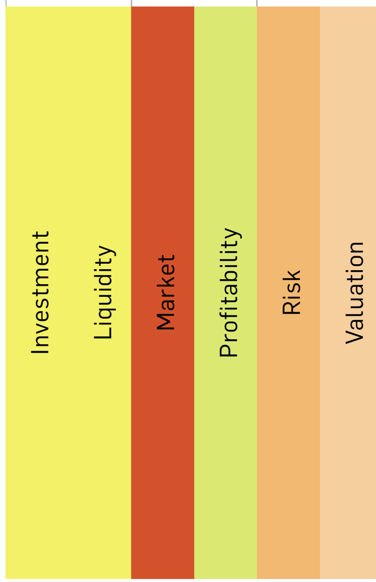
Industrials

Distress ranking	Index value	YoY trend
4	+1.7	+0.7 Aug 22



Financial Services

Distress ranking	Index value	YoY trend
5	+1.0	-1.5 Aug 22



Least distressed — Most distressed

Travel, Leisure & Hospitality

Distress ranking	Index value	YoY trend
6	-1.1	↑ -2.6 Aug 22

Investment | Liquidity | Market | Profitability | Risk | Valuation

Commodities & Natural Resources

Distress ranking	Index value	YoY trend
7	-1.4	↑ -7.5 Aug 22

Investment | Liquidity | Market | Profitability | Risk | Valuation

Oil & Gas

Distress ranking	Index value	YoY trend
8	-2.5	↓ -2.1 Aug 22

Investment | Liquidity | Market | Profitability | Risk | Valuation

Infrastructure

Distress ranking	Index value	YoY trend
9	-3.2	↑ -4.2 Aug 22

Investment | Liquidity | Market | Profitability | Risk | Valuation

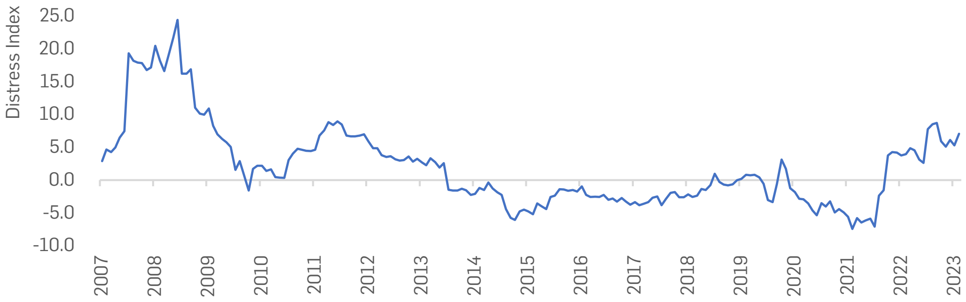
Technology, Media & Telecoms

Distress ranking	Index value	YoY trend
10	-4.6	↓ -1.5 Aug 22

Investment | Liquidity | Market | Profitability | Risk | Valuation

Real Estate

European Real Estate firms face heightened distress due to liquidity strains, weaker investments, and reduced profits. Rising interest rates, increased debt costs, and shifts in the labour market, leading to decreased office space demand, remain key challenges with no obvious short-term solutions. In housing, higher rates challenge affordability, dampening house price prospects.



Healthcare

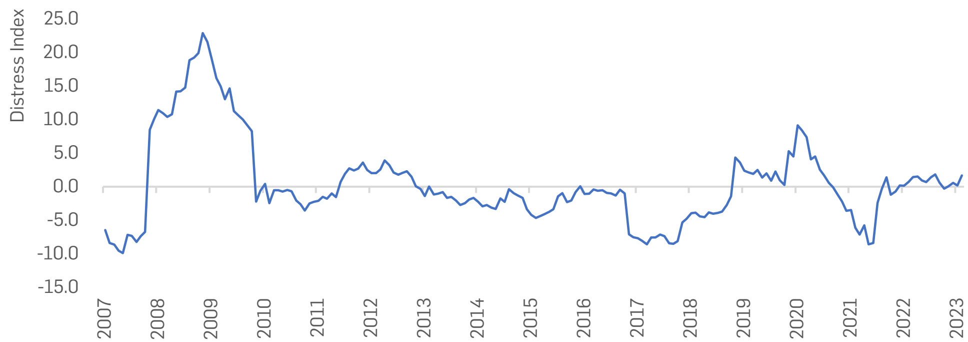
European Healthcare firms faced an uptick in distress last quarter due to shrinking profits, liquidity challenges, and declining investment metrics. The fading pandemic support, coupled with rising operational costs, and weaker asset prices – often tied to real estate – is pressuring profit margins.

Retail & Consumer Goods

Retail and Consumer Goods rank third in sector distress. The cost-of-living crunch diminishes spending power in major European regions, especially the UK and Germany. The impact of rising interest rates has been particularly challenging for many households who have seen housing affordability become more challenging, while falling house prices in the UK and Germany has hit confidence.

Industrials

Levels of distress in the Industrial sector continue to hover around the long-run average. Rising costs and a muted demand outlook seem to be curbing sector-wide interest, while a backdrop of higher interest rates could deter some investors from long-term capital-intensive ventures.

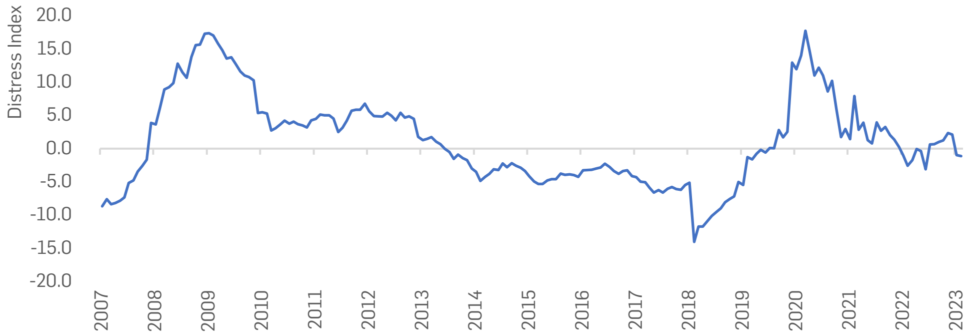


Financial Services

While distress across Financial Services has crept above the long-run average, strong action by US and Swiss authorities appears to have stemmed the risk of contagion that emerged earlier in the year. However, higher levels of distress have been driven by weaker market fundamentals and a faltering appetite for risk.

Travel, Leisure & Hospitality

Following unprecedented distress during the pandemic, the Travel, Leisure & Hospitality sector has rebounded strongly with rising demand in both business and leisure travel. Levels of distress have fallen below the long-run average, although investment metrics appear a weak spot.

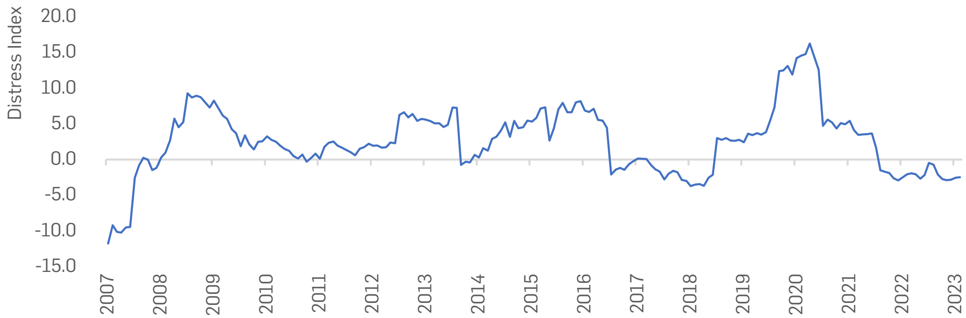


Commodities & Natural Resources

Corporate distress in Commodities and Natural Resources remained in negative territory, steady on the levels of the previous quarter. Lower levels of distress have been upheld by market support and solid profitability.

Oil & Gas

Oil and Gas companies' distress levels, after peaking during the pandemic, now reside near long-term averages. Oil prices have risen to their highest since November 2022, although concerns remain over Chinese demand, growth in Europe and central bank action to tackle inflation.

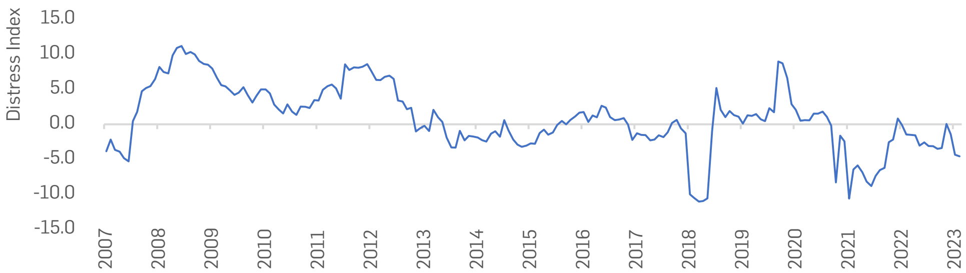


Infrastructure, Utilities & Power

Infrastructure, Utilities, and Power companies have experienced a fall in distress levels compared to the previous quarter, remaining below the long average run. Both market support and strong profitability have helped bolster companies operating in this sector.

Technology, Media & Telecoms

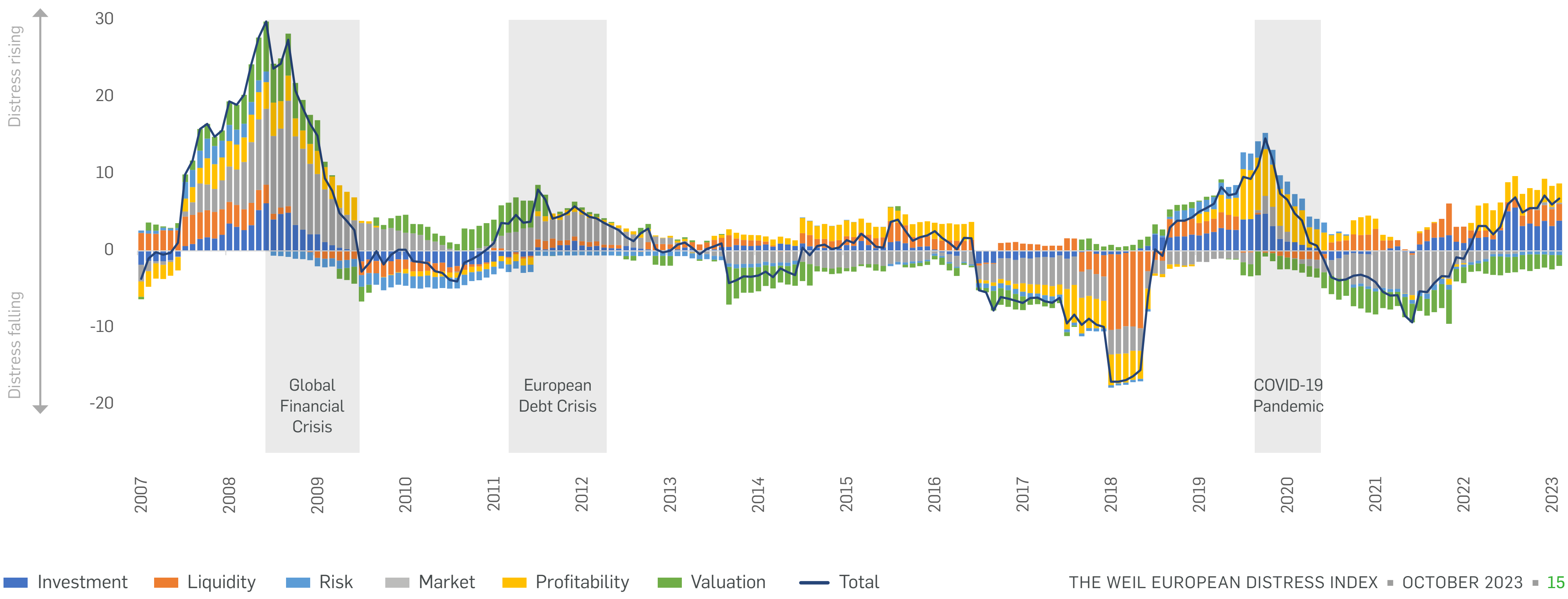
In the latest quarter, distress levels in the Technology, Media, and Telecommunications (TMT) sector have weakened and remain below long-term averages. The limited distress present is primarily driven by weaker valuations and liquidity pressures. However, rising valuations for tech companies engaged in AI may be boosting the overall sector.



Aug 2023	QoQ trend	YoY trend
+6.8	+5.6 May 23	+0.9 Aug 22

United Kingdom Distress Index

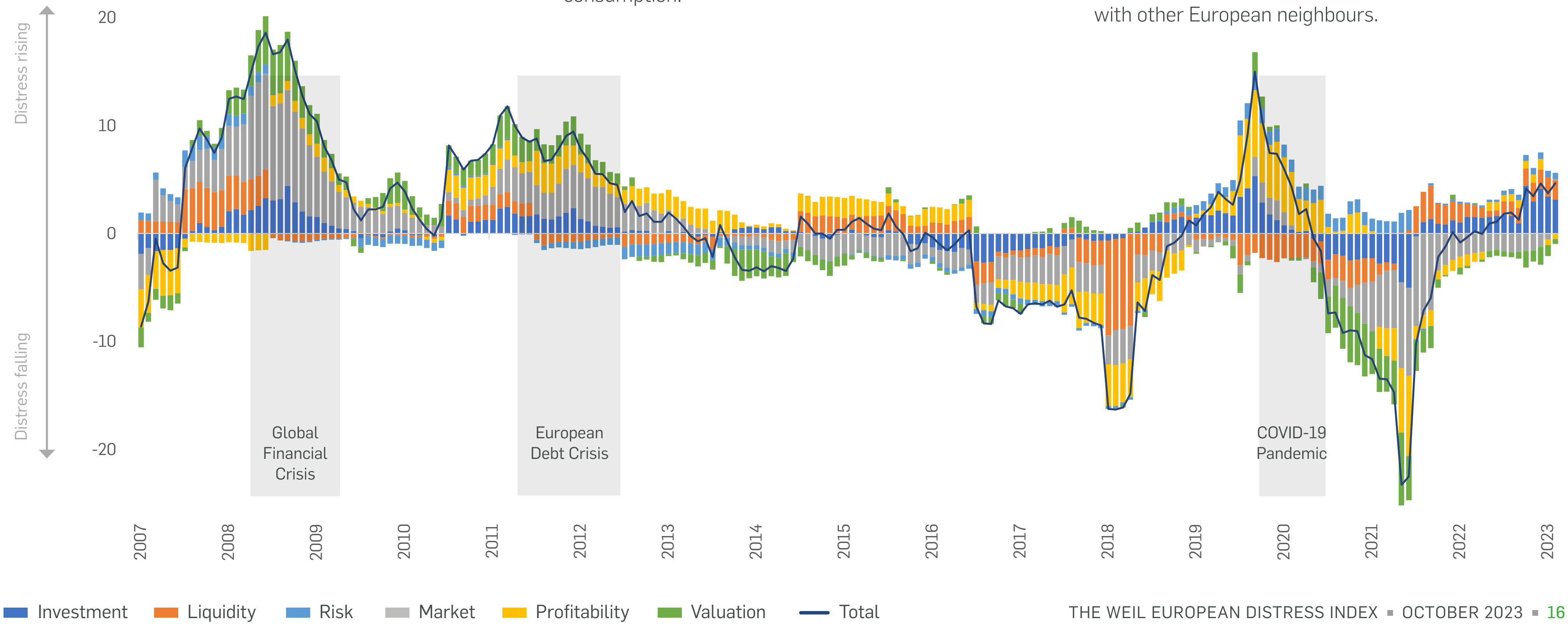
- Corporate distress in the UK accelerated on the previous quarter and remains significantly higher than levels experienced last year.
- Weaker investment metrics were the primary driver of distress this quarter, followed by pressure on profitability and squeezed liquidity. Overall, the UK was the second most distressed market in our coverage, behind Germany.
- The outlook for the UK economy remains challenging. Interest rates have risen aggressively to curb inflation, while subduing growth.
- The S&P Global/CIPS UK Manufacturing PMI represented the lowest point since May 2020, indicating a significant deterioration in operating conditions. The rate of output decline accelerated to its steepest in a year and ranked among the fastest in the survey's history, indicating the significant challenges in this part of the market.
- Meanwhile, although earnings growth overtook inflation for the first time in over two and a half years in June/July, further pressure on real disposable household income is expected to continue until the first quarter of 2024.



Aug 2023	QoQ trend	YoY trend
+4.6	+3.5 May 23	-0.3 Aug 22

France Distress Index

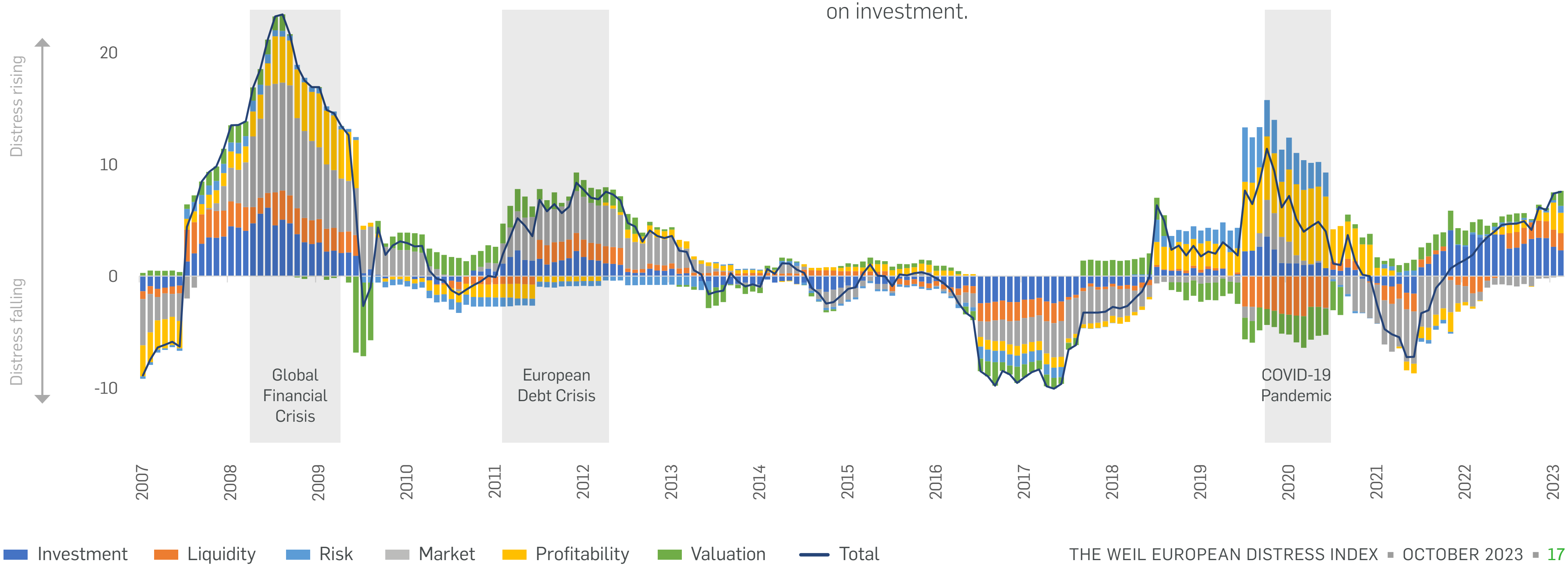
- France is the least distressed country covered in the WEDI according to the latest data. However, levels of distress remain above the long-run average for the 10th consecutive month.
- Indeed, levels of distress across corporates in France are now at the highest level since July 2020.
- The sources of distress were the same as those experienced in the UK, driven by weaker investment metrics, and pressure on liquidity and profitability.
- Nevertheless, the French economy grew by 0.5% in the second quarter of 2023, beating expectations of a 0.1% rise despite the backdrop of sluggish household consumption.
- Indeed, a better-than-expected boost in exports (+2.6%) was enough to shrug off faltering household consumption which was down 0.4%.
- There was also positive news with inflation. The year-on-year rise in prices stood at 4.3% in July, compared with 4.5% in June. This was due to a further fall in energy prices and a slowdown in food prices for the fourth consecutive month.
- Another surprise was the return to a slightly positive trend in business investment (+0.1%, compared with -0.4%) indicating more positive confidence compared with other European neighbours.



Aug 2023	QoQ trend	YoY trend
+7.6	+6.2 May 23	+1.9 Aug 22

Germany Distress Index

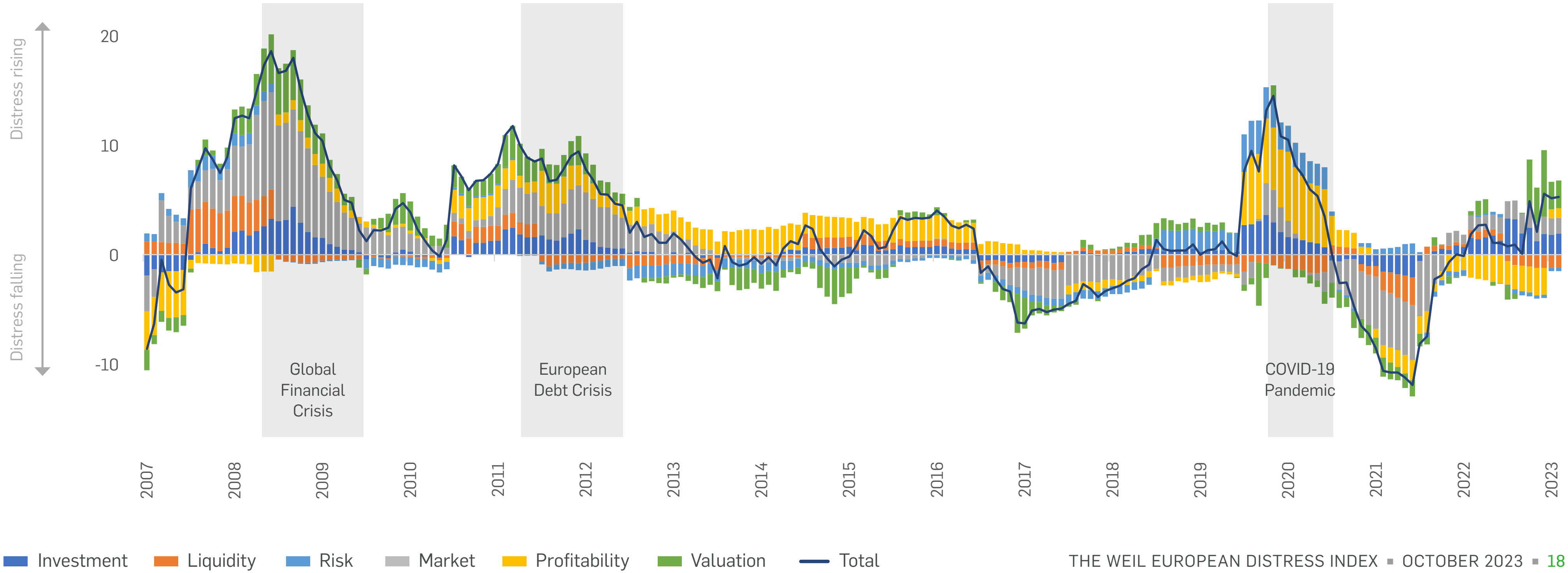
- Corporates in Germany, the most distressed of all countries covered in the WEDI, saw levels of distress rise to their highest since May 2020.
- Distress was pushed higher by poorer investment metrics, pressure on liquidity and faltering profitability. Indeed, the drivers of distress were more broad-based than other countries, reflective of a more challenging economic environment as the economy remained in recession. The latest IMF forecasts suggest that GDP will fall 0.3% in 2023, the only advanced economy to register a decline.
- The HCOB Germany Manufacturing PMI reported the second-lowest reading since May 2020 and still firmly inside contraction territory. Output declined at the fastest pace since the initial COVID shutdowns in spring 2020 and new orders dropped the most for over three years against a backdrop of growing consumer uncertainty, weakness in the construction sector and a general lack of appetite for investment.
- Meanwhile, house prices in Germany fell at a record rate of 6.8% in the first quarter of the year as higher borrowing costs, inflation and weaker economic growth took their toll on Europe's largest property market.
- With the economy reliant on manufacturing, a more lacklustre outlook for global demand, specifically from China, is likely to weigh heavily on investment.



Aug 2023	QoQ trend	YoY trend
+5.3	+1.9 May 23	-0.7 Aug 22

Spain and Italy Distress Index

- Corporates headquartered in Spain and Italy also experienced a tightening in levels of distress over the quarter.
- Although levels are higher than those experienced by French corporates, they remain below those seen in the UK and Germany.
- The deterioration in conditions was primarily driven by poorer valuations, lacklustre market metrics and weaker investment.
- The economic outlook for Spain and Italy appears more upbeat than the UK and Germany. GDP is expected to rise by 2.5% in Spain, and 1.1% in Italy in 2023, according to the IMF.
- Indeed, Spain is expected to be the fastest growing advanced economy in 2023 of countries covered by the WEDI, helped by a recovery in international tourism and the positive impact of lower energy prices.
- Additionally, inflationary pressures have eased considerably in the last few months for both economies, with CPI in Spain just 2.6% in August, with Italy's rate reportedly 5.4%.



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