THE A&M DISTRESS ALERT

BALANCE SHEETS IN THE SPOTLIGHT AS RATES HIKE TAKE TOLL ON EUROPEAN COMPANIES

JUNE 2023

ALVAREZ & MARSAL
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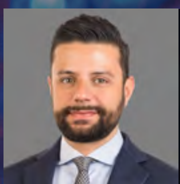
FOREWORD

Corporate distress is increasing across Europe and balance sheets are at their weakest level since 2020. Despite a moderate improvement in performance more recently, driven by pent-up demand and price rises in selected sectors, many of the companies analysed in our study still need to deleverage, turn around their operations or continue their business transformation journeys. The need to shore up finances and transform businesses becomes even more urgent as higher interest rates start to exert their toll on balance sheets and liquidity, and as the global economy enters a period of weaker growth and continued uncertainty.

PAUL KIRKBRIGHT
HEAD OF EMEA FINANCIAL RESTRUCTURING ADVISORY



ALESSANDRO FARSACI
HEAD OF RESTRUCTURING SWITZERLAND

INTRODUCTION

European companies have soldiered on through the difficult days of the pandemic, but three years on, they face a fresh wave of challenges. 2023 has brought fundamental changes to the economic and financial environment, from sticky inflation to "higher-for-longer" interest rates and faltering consumer demand.

Recent turmoil in the banking sector has tightened financial conditions further and raised recession risks, darkening the outlook for businesses across the region as they gear up for the second half of 2023.

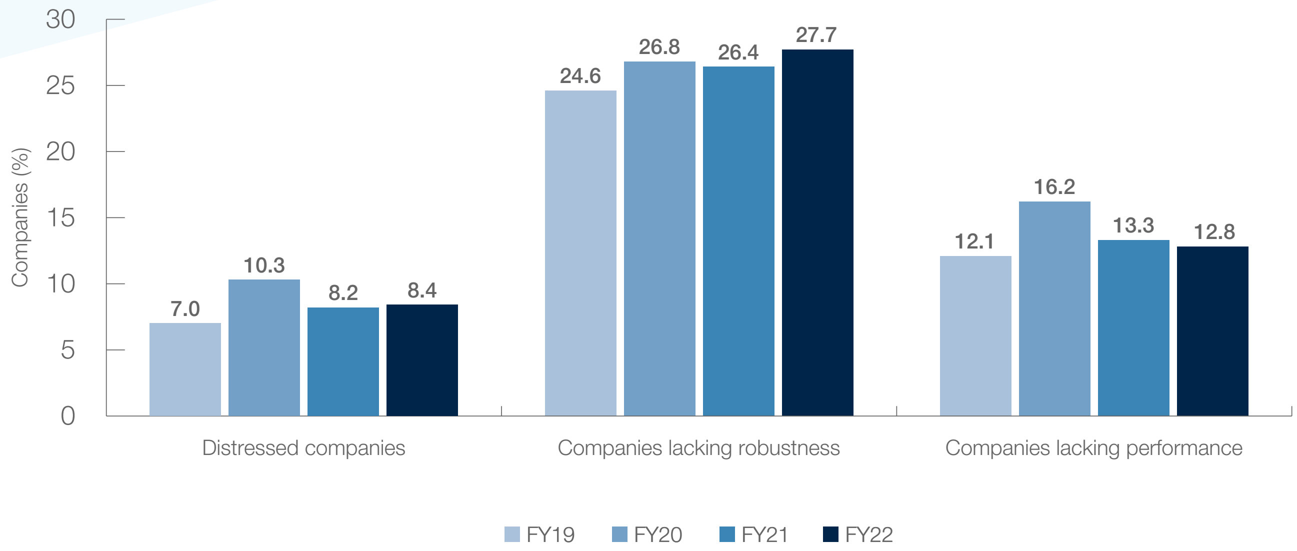
On top of that, broader changes such as digitalisation, the continued rise of artificial intelligence, the global shakeout of value chains and the transition to net-zero have become more palpable in the past two years. Business models are being upended as a result, requiring rapid business and operational transformation and, in some cases, capital structure adjustments.

The A&M Distress Alert (ADA) aims to provide a snapshot of companies' financial health as they begin to navigate this new, and tougher, economic environment.

Our proprietary index considers 18 Key Performance Indicators (KPIs) of more than 7,000 businesses across Western Europe and the Middle East. It assesses the robustness of their balance sheets and earnings, identifying those that are in, or may soon be in, financial distress.

In this report, we will explore the key findings of our analysis and discuss the outlook for corporate financial health in the second half of 2023 and beyond.

EXECUTIVE SUMMARY



Our latest half-yearly analysis shows that corporate financial health has deteriorated in most countries and sectors in 2022 compared to the previous year. The percentage of firms in distress has increased by 20% compared to the year before the pandemic. The proportion of corporates in distress reached 8.4% in 2022 – which equates to 588 companies – up from 7% in 2019.

More critically, the number of business lacking balance sheet robustness has jumped since 2021 and reached a record 27.7% of total companies, representing nearly 2,000 corporates. This is up slightly from 26.4% in 2021 and represents an increase of 12% from pre-pandemic levels. This reflects the amount of debt provided by states during the pandemic, the new financing issued by companies to absorb the shock as well as the losses accumulated during the Covid period.

Corporate profits remained resilient last year despite soaring inflation, with many companies successfully protecting margins by taking price action, and others benefitting from strong pent-up demand following the pandemic. The proportion of companies lacking performance declined marginally to 12.8%, versus 13.3% in 2021.

Balance sheets increasingly stretched by hefty debt loads, higher interest

Net debt-to-EBITDA, debt service coverage and interest coverage ratio were the main drivers behind the weaknesses in European corporates' balance sheets, according to our latest analysis. This means that companies' ability to generate profits to pay for higher levels of debt is gradually being reduced.

This trend reflects the increase in base interest rates since last year, which is putting significant pressure on many companies, particularly those who have been impacted by inflationary pressures. There is often insufficient free cash to reinvest in the future of the business, leaving many of them treading water.

Meanwhile, traditional sources of capital have become less available, limiting their refinancing options. Leveraged loan and high-yield bond issuance in Europe have decelerated in the past year, while banks have also turned more cautious about lending. Borrowing costs for high-yield rated companies have spiked.

Weaker rated companies whose business models are not competitive or future-ready are of particular concern. Included in this group are so-called zombie companies, firms that have long needed to address their capital structures but managed to stay afloat due to cheap borrowing available in an era of ultra-low rates. With financial buffers being quickly wiped out and reduced refinancing alternatives, the survival of these companies in the new economic environment comes into question.

As financial headwinds intensify in the months and quarters ahead, we expect companies to increasingly try to pursue deleveraging strategies alongside liability management exercises, including asset sales and amend-and-extend transactions.

Many businesses facing maturities in the next 12 to 24 months have already started this process, but there are many who have not. It is possible that these companies are in the group whose leverage is incompatible with an "on-market" refinancing and will therefore need to contemplate more fundamental changes to their capital structure. Their ability to achieve that is increasingly uncertain with unpredictable debt markets.

In order to maximise their chances of refinancing, we anticipate that more challenged firms will embark on comprehensive operational restructuring programmes to maximise profitability and strengthen their balance sheets for the longer-term.

Pent-up demand, price rises provide temporary respite in earnings

The tally of companies lacking performance contracted slightly in our latest analysis. They now account for 12.8% of total businesses versus 13.3% in the previous year and 16.1% at the peak of the pandemic.

There are several explanations for the earnings resilience. First, some sectors, such as Travel & Hospitality benefited from extraordinary post-pandemic pent-up demand, which boosted sales and profits last year and continue to do so in 2023. Another factor to note is bumper profits in some verticals within the energy sector due to the spike in prices following the Russian invasion of Ukraine.

Secondly, many companies were able to keep their profitability steady in the face of inflation by effectively passing through cost increases to customers. This was especially true in non-discretionary sectors, such as consumer goods, where price rises allowed manufacturers to maintain and even improve their margins. In retail, firms performed better than expected during the Christmas period last year, although growth was driven by inflation rather than volumes.

Finally, European governments have introduced support measures for businesses (and households) struggling to pay for their energy bills, as well as emergency liquidity for power companies facing a liquidity squeeze due the turmoil in energy markets. These schemes provided temporary relief and shielded some companies from the worst impacts of the energy crisis.

EXECUTIVE SUMMARY

Cluster overview*

	2020	2021	2022
Distressed companies	10.3%	8.2%	8.4%
Companies lacking robustness	26.8%	26.4%	27.7%
Companies lacking performace	16.2%	13.3%	12.8%

*as a % of total companies

Weakest Countries

Absolute*	Trend
Middle East	Switzerland
Spain	Nordics
Germany	Italy

*highest % of companies in distress

Weakest Sectors

Absolute	Trend*
Consumer (non-food)	Consumer (non-food)
Media & Entertainment	Healthcare
Energy & Utilities	Energy & Utilities

*biggest increase in % of distress

Key Challenges

- Debt levels still impacted by Covid crisis
- Increase in base interest rates
- Limited refinancing options
- Weakening consumer demand amid inflation

SECTOR TRENDS

Distress has increased across 10 out of 16 industry groups covered in our analysis.

The five most distressed sectors currently are Consumer (Others), Media & Entertainment, Energy & Utilities, Consumer Fashion and Travel & Hospitality, in descending order. Our data also shows a worsening trend for companies in Automotive and Healthcare, with distress levels in these sectors rising in 2022.

In contrast, firms in the Business Services and Food & Beverage sectors showed the lowest levels of distress. In the case of the former, this can be explained by a “recession-proof” business model, characterized by high recurring revenues and strong cash flow.

Meanwhile, Food & Beverage businesses’ earnings have benefitted from higher food prices over the past year, caused by inflation. These companies also produce and sell consumer staples that tend to be largely impervious to business cycles.

We discuss the main drivers behind these findings on the following pages.

AUTOMOTIVE

- Distress in the Automotive sector accelerated in 2022 reflecting the long-term challenges that continue to hit firms' profitability, such as electrification and others that require substantial shifts in business models and investments.
- These issues were aggravated last year by a crisis in the supply of components, which made it difficult for car manufacturers to meet their order books, and the spike in energy prices triggered by the Russia-Ukraine conflict.
- Looking ahead, the decline in the production of cars that rely on fossil fuels will lead to further erosion of fixed-cost coverage ratios. This will affect certain market segments of automotive suppliers more than others; powertrains, that are more dependent on internal combustion (ICE) vehicle sales, will be particularly affected.
- Automotive retailers also face a tough outlook as the so-called "agency model" shakes up their business models, with potential impacts on margins. This new sales model turns the car dealer into an agent between the OEM and the consumer, giving the manufacturer the ownership of pricing.

Key findings

	Automobile Manufacturers	Automotive Parts & Equipment	Automotive Retail
Worst sectors	22.9%	13.9%	5.7%

	Automobile Manufacturers	Automotive Parts & Equipment	Automotive Retail
Worst trend sectors	5.7 pp	1.4 pp	0.0 pp

	FY20	FY21	FY22
Distress in %	10.1%	9.3%	10.5%

Total number of companies **248**

CONSUMER (excluding Food & Beverage and Fashion)

- Levels of distress among companies reliant on discretionary consumer spending, such as electronics or furniture retailers, increased sharply in 2022.
- The percentage rose from 8.5% to 12.8%, the largest increase among all sectors in the analysis.
- A fifth of companies in categories such as Household Products, Drug Retail and Personal Care Products, are struggling financially (approximately 20% of total Consumer Other companies in 2022).
- This reflects the worsening macroeconomic backdrop, with rising interest rates directly impacting consumers' mortgages and reducing their disposable income alongside inflation, a phenomenon that hit retailers and manufacturers reliant on discretionary spend harder.
- Notably, brick-and-mortar retailers face additional pressures, such as onerous rental obligations and arrears, as well as the need to rationalise their store footprint given shifts in consumer behavior.

Key findings

	Household Products	**Drug Retail**	**Personal Care Products**
Worst sectors	22.7%	22.2%	20.6%

	Household Products	**Drug Retail**	**Consumer Electronics**
Worst trend sectors	18.2 pp	11.1 pp	10.0 pp

	FY20	**FY21**	**FY22**
Distress in %	9.1%	8.5%	12.8%

Total number of companies **515**

ENERGY & UTILITIES

- The turmoil in Europe's energy market, which was exacerbated by the Russian invasion of Ukraine in 2022, had quite a binary effect on companies operating in the Energy & Utilities sector.
- Increased price volatility left many energy suppliers struggling to pass on higher rates to customers, especially those that had sold contracts to clients with a fixed price at a historical value. Others achieved higher operating margins following the surge in oil and gas prices, despite an increase in working capital requirements.
- Notably, the percentage of gas utilities companies in distress rose from 6.5% in 2021 to 19.4% last year, according to our data.

Key findings

	Independent Power Producers & Energy Traders	Gas Utilities	Renewable Electricity
Worst sectors	28.6%	19.4%	15.7%

	Independent Power Producers & Energy Traders	Gas Utilities	Multi-Utilities
Worst trend sectors	21.4 pp	12.9 pp	9.1 pp

	FY20	FY21	FY22
Distress in %	11.1%	8.0%	11.1%

Total number of companies **351**

HEALTHCARE

- Healthcare businesses have been particularly affected by recent inflationary cost pressures and higher rates, which have contracted margins and affected free cash flows of highly leveraged firms.
- In one example of the deteriorating outlook for the sector, the share of negative rating outlooks in a portfolio of EMEA companies rated by Fitch rose to 14% in the first quarter of 2023, from 5% in the third quarter of 2022.
- Our ADA analysis shows that within Healthcare, Biotech and Pharmaceutical businesses performed worst, with 21.9% and 12.2% of firms within these sub-sectors considered to be in distress in 2022.
- Healthcare service providers, in particular, face additional headwinds from labour shortages, whilst pharmaceuticals are having to contend with greater drug pricing scrutiny from regulators. This may increase the financial pressure on these firms going forward.

Key findings

	Biotechnology	Pharmaceuticals	Life Sciences Tools & Services
Worst sectors	21.9%	12.2%	9.5%

	Biotechnology	Pharmaceuticals	Life Sciences Tools & Services
Worst trend sectors	6.3 pp	5.6 pp	4.8 pp

	FY20	FY21	FY22
Distress in %	7.4%	6.3%	9.5%

Total number of companies **430**

INDUSTRIALS

- The financial health of Manufacturing firms deteriorated significantly in 2022, both from an income statement and balance sheet perspective. Around 9% of manufacturers were in the distress cluster last year, compared to 7.3% in 2021.
- Broad-based pressures such as the energy-price shock and higher input prices have hit this industry group hard, with a direct impact on profit margins. Many companies also had to cut production last year as they struggled to source semiconductors amid the global shortage.
- A fifth of companies in the Electronic Components business were in distress in 2022, a direct result of the global electronic component crisis, which was at its peak last year. This has eased going into 2023.
- The sustainable energy transition represents challenges to industrial companies, particularly affecting Automotive, Aviation and Plastic Manufacturers. They are tasked with reinventing and actively transforming their portfolios to comply with changing regulation.

Key findings

	Electronic Components	**Agricultural & Farm Machinery**	**Heavy Electrical Equipment**
Worst sectors	20.0%	13.3%	12.0%

	Heavy Electrical Equipment	**Electronic Components**	**Electronic Manufacturing Services**
Worst trend sectors	12.0 pp	10.0 pp	9.1 pp

	FY20	**FY21**	**FY22**
Distress in %	10.6%	7.3%	8.9%

Total number of companies **559**

MEDIA & ENTERTAINMENT

- The level of distress in this sector remains elevated, signaling an industry that has struggled to fully recover from the Covid-19 crisis.
- Companies are having to compete for household budget amid an acute cost-of-living crisis while dealing with inflationary pressures themselves, including the rising cost of producing live events and increasing wages.
- Meanwhile, new technologies and platforms are evolving due to profound shifts in media consumption, resulting in an overcrowded marketplace.
- Smaller events in particular are grappling with venue shortages as well as transportation, labour and energy costs.
- Football clubs suffered from systematically reduced profitability and over indebtedness levels, mainly attributable to a critical management of distressed and default situations.

Key findings

	Interactive Media & Services	**Movies & Entertainment**	**Communications Equipment**
Worst sectors	27.3%	21.8%	12.5%

	Interactive Media & Services	**Integrated Telecommunication Services**	**Interactive Home Entertainment**
Worst trend sectors	13.6 pp	4.1 pp	3.8 pp

	FY20	**FY21**	**FY22**
Distress in %	15.3%	11.7%	12.5%

Total number of companies **367**

TRAVEL & HOSPITALITY

- The pressure on Travel & Hospitality businesses across Europe has eased significantly after the pandemic led to severe level of distress in the industry.
- Clearly this has been driven by the strong recovery experienced by the industry as the end of lockdown and travel restrictions released pent-up demand.
- In addition, the pandemic shock, which grounded most businesses to a near halt, also triggered cost-discipline measures to be implemented across the sector. These strategic cost take-outs prepared them for the perfect storm of macro headwinds presented in 2022 and beyond.
- That said, robustness scores for the industry remain very low compared to the total average, suggesting balance sheet issues generated during the pandemic remain present and may need to be addressed soon.

Key findings

	Passenger Airlines	Leisure Facilities	Passenger Ground Transportation
Worst sectors	19.0%	16.7%	14.7%
	Passenger Ground Transportation	**Airport Services**	**n.a.**
Worst trend sectors	5.9 pp	0.0 pp	n.a.
	FY20	**FY21**	**FY22**
Distress in %	34.3%	20.0%	11.0%

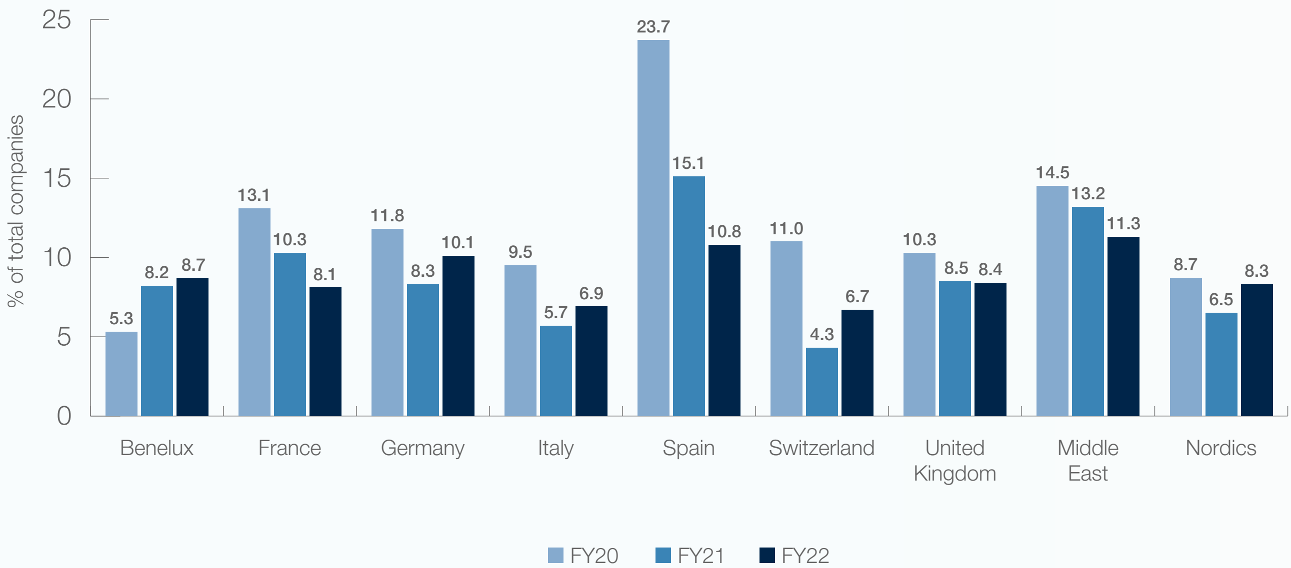
Total number of companies **210**

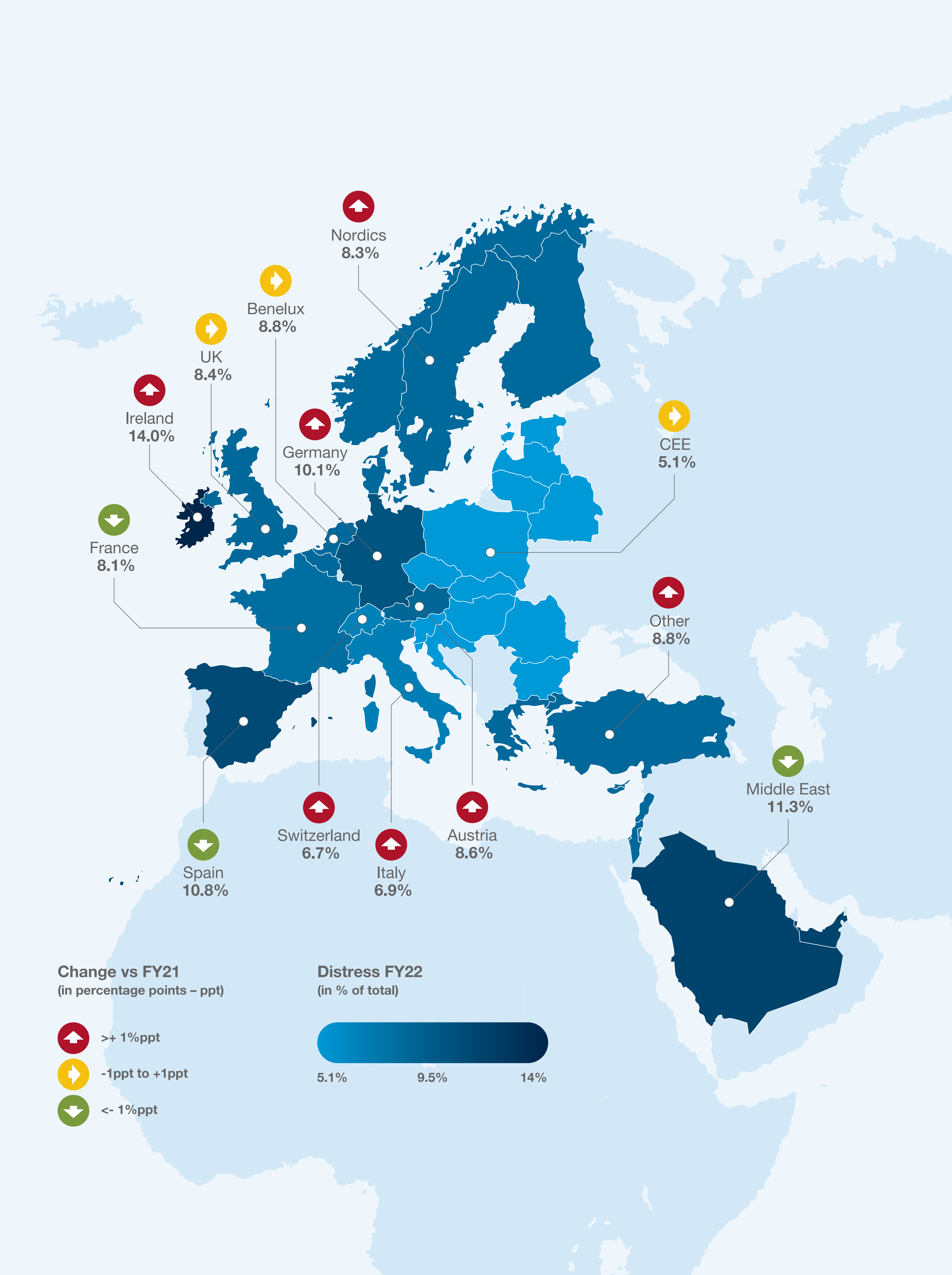
COUNTRY TRENDS

Most countries in our analysis saw an increase in the level of corporate distress in 2022. While distress levels have eased marginally in Spain and the Middle East, they remain the highest among all countries in the analysis, followed by Germany, Benelux and the UK.

Other country highlights from our report are included on the following pages.

Percentage of distressed companies per country




Nordics
8.3%
Benelux
8.8%
UK
8.4%
Ireland
14.0%
Germany
10.1%
CEE
5.1%
France
8.1%
Other
8.8%
Middle East
11.3%
Switzerland
6.7%
Austria
8.6%
Spain
10.8%
Italy
6.9%
Change vs FY21
(in percentage points – ppt)
>+ 1%ppt
-1ppt to +1ppt
<- 1%ppt
Distress FY22
(in % of total)
5.1%
9.5%
14%

BENELUX

- The number of distressed companies in the Benelux is slightly up, and a further deterioration in balance sheet robustness is observed across the region.
- The increase in distress within Consumer (Others) companies is due to a mixture of high debt levels, deteriorating margins and reliance on in-store sales.
- Healthcare companies, one of the worst performing industries in the region, have suffered from the falling away of revenues and profits following the boost of the pandemic years. Furthermore, regulatory changes and technological development are key challenges for industry players. The Benelux region has seen sizeable cases of these issues in this sector.
- The trend of deteriorating balance sheet robustness is expected to continue over 2023 and beyond due to a combination of macroeconomic developments (eg. rising interest rates and availability of capital in the market) and expected deterioration of profitability margins.
- The increased cost of debt due to higher rates, geopolitical uncertainties (eg. war in Ukraine and nitrogen discussions in the Netherlands) and ongoing negotiations on collective labour agreements could potentially further reduce margins.

Key findings

	Consumer – Others	Information Technology	Healthcare
Worst performing sectors	25.0%	21.1%	19.0%

	Consumer – Others	Multisector & others	Other industries
Worst trend sectors	17.9 pp	8.7 pp	7.7 pp

	FY20	FY21	FY22
Distress in %	5.3%	8.2%	8.7%

FRANCE

- Distress levels in France have moderated from the highs reached during the pandemic years. In 2022, state support measures to limit energy prices have helped to mitigate the impacts on profit margins of French corporates.
- In addition, business confidence also remains high in France despite persistent inflation and a moderate growth forecast for 2023.
- The Automotive sector is most distressed, followed by the Travel, Hospitality & Leisure, whilst Energy & Utilities sector shows a worsening trend.
- For 2023, it is expected that the Automotive sector's turnover will grow as supply difficulties abate and production volumes rebounds.
- Overall, though, more pressure due to inflation and liquidity constraints is expected in France, especially for local mid-sized companies.
- All levers to mitigate Covid impacts have been activated (both internally or by raising public fundings) and remaining headroom before a liquidity trigger is growing thinner.

Key findings

	Automotive	Travel, Hospitality & Leisure	Energy & Utilities
Worst performing sectors	24.1%	17.6%	16.7%
	Energy & Utilities	**Other industries**	**Construction**
Worst trend sectors	16.7 pp	9.5 pp	7.4 pp
	FY20	**FY21**	**FY22**
Distress in %	13.1%	10.3%	8.1%

GERMANY

- More German companies have fallen into distress in 2022, making Germany the third most distressed country (as a percentage of total businesses).
- Notably, there has been elevated distress in the Energy & Utilities sector as a direct result of the conflict in Ukraine and the reduction in energy supplies from Russia, which German gas companies relied heavily on.
- The German government's support measures, including relief to vulnerable households and liquidity support to firms, helped to offset some of the negative spill-over effects from the war and staved off a full recession last year.
- Despite that, soaring energy and food costs have squeezed purchasing power with a greater impact on the sale of discretionary items. This explains the high levels of distress in the Consumer (Others) and Consumer Fashion industry groups.
- The ECB's monetary tightening in response to inflation has also started to impact directly and across all sectors on capital structures set up in a zero-interest rate environment. The rather "look-forward" tests around liquidity that the German legal framework imposes on management teams may well be the reason why Germany is somewhat ahead of the curve in terms of the pick-up in restructuring activity across EMEA at the moment.
- In recent months, manufacturing orders and sales have improved slightly. However there remains questions around the sustainability of demand for German exports given aggressive central bank monetary tightening by the Fed and the consequent slowdown in the US economy.

Key findings

	Energy & Utilities	Consumer – Others	Consumer – Fashion
Worst performing sectors	41.7%	31.6%	20.0%
	Energy & Utilities	**Business Services**	**Infrastructure & Logistics**
Worst trend sectors	33.3 pp	18.2 pp	16.7 pp
	FY20	**FY21**	**FY22**
Distress in %	11.8%	8.3%	10.1%

ITALY

- Italy has seen an increase in the number of companies in distress in 2022, with Media & Entertainment and Information Technology performing the worst among all sectors.
- Media & Entertainment firms suffered due to the poor performance of some large players in the industry, including communication service providers and large sports club. Football clubs, for instance, have high debt levels historically, while communication providers' underinvestment over the past decade put them in a weak position against new players specialising in new technologies and platforms.
- The information technology industry in Italy experienced a severe slowdown last year compared to the rest of Europe.
- This could be attributed to the lack of investments by most of the major multinational corporations, and to the technology gap between smaller players in Italy and their international competitors.
- Commodities companies have seen an increase in distress too. Oil & Gas operators have been affected by price trends of raw materials and commodities experienced in the last years, while energy intensive businesses such as foundries and metallurgical companies suffered from the rise in the energy prices.

Key findings

	Media, Entertainment & Media Services	Information Technology	Healthcare
Worst performing sectors	21.9%	16.0%	13.5%

	Information Technology	Media, Entertainment & Media Services	Commodities
Worst trend sectors	12.0 pp	9.4 pp	6.5 pp

	FY20	FY21	FY22
Distress in %	9.5%	5.7%	6.9%

MIDDLE EAST

- Our latest analysis suggests declining levels of distress from the peak of Covid. This is consistent with strong economic performance in both countries post-2020, with GDP growth rates in the range of 7% to 9% in 2022.
- The UAE economy has benefitted from both post-Covid trends and inbound capital flows and investment, partly linked to Russia's invasion of Ukraine.
- The Kingdom of Saudi Arabia continues to implement Vision 2030, the government's strategic framework to reduce dependence on oil revenues, and is expanding and diversifying its economy, the largest in the Arab world.
- Pockets of distress are indicated in the Commodities and Consumer (Others) sectors.

Key findings

	Commodities	**Consumer – Others**	**Multisector & others**
Worst performing sectors	23.8%	18.2%	16.7%
	Commodities	**Construction**	**n.a.**
Worst trend sectors	14.3 pp	0.0 pp	n.a.
	FY20	**FY21**	**FY22**
Distress in %	14.5%	13.2%	11.3%

SPAIN

- The Spanish economy grew strongly in 2022 boosted by the spectacular rebound in tourism, an important engine of its economy representing 12% of its GDP. This explains the sharp decline in corporate distress last year.
- Leisure & Hospitality companies experienced strong expansion in the second half of 2022 and are expected to continue growing this year, with several holiday groups anticipating further increase in average daily rates and other KPIs that can surpass 2019 figures.
- Nevertheless, this sector was one of the main focus of state-backed loans. Increased leverage will continue to affect balance sheets in the years to come given high debt service ratios, especially in a higher rates environment.
- In addition, businesses may not be able to fully pass through higher operating costs to customers, which may hinder profitability further.
- The Manufacturing sector has the highest percentage of companies in distress, largely due to low robustness. Firms in the Industrial, Construction and Agricultural sectors saw a decline in turnover in the second half of 2022 mainly caused by an increase in energy costs.

Key findings

	Manufacturing	**Media, Entertainment & Media Services**	**Consumer – Food & beverage**
Worst performing sectors	28.6%	23.1%	15.4%
	Manufacturing	**Business Services**	**n.a.**
Worst trend sectors	28.6 pp	0.0 pp	n.a.
	FY20	**FY21**	**FY22**
Distress in %	23.7%	15.1%	10.8%

SWITZERLAND

- Overall, corporate distress in Switzerland has increased in 2022 compared with the prior year but remains at low levels compared to other European countries.
- Swiss companies have the most conservative financing structures among European peers (mainly lower levels of debt). This is showcased by an average robustness score of 5.1.
- Moreover, the Swiss state aid package largely succeeded in shielding companies from the negative effects of the pandemic. The so-called Covid-19 bankruptcy gap – bankruptcies that did not occur between 2020 and 2022 due to financial state aid measures – has started to narrow, falling from 2,000 delayed bankruptcies in the third quarter of 2022 to 1,700 April 2023. In addition, bankruptcies were at a record high in the first quarter of 2023, with around 1,800 filings, 22% higher than the average seen in the 2017-19 period.
- Energy & Utilities is the worst performing sector in the country, reflecting deterioration in both performance and robustness caused by the steep electricity price increase at the end of 2021 and their accounting treatments.
- Price hikes have also triggered sudden liquidity needs for utilities firms, forcing the Swiss government to intervene with a support plan. Eventually though, longer term high electricity prices will be positive for utilities.
- The rising cost of interest (as of April 2023 incl. on Covid-19 loans), the skills shortages and overall global economic stability represent the biggest challenges in the short-term for Swiss corporates. Even though the strength of the Swiss franc is closely watched from an exporting perspective, at present the appreciation is less threatening given lower levels of inflation in Switzerland compared to its largest trading partners.

Key findings

	Energy & Utilities	**Consumer – Others**	**Information Technology**
Worst performing sectors	30.0%	25.0%	14.3%

	Energy & Utilities	**Consumer – Others**	**Construction**
Worst trend sectors	20.0 pp	12.5 pp	9.1 pp

	FY20	**FY21**	**FY22**
Distress in %	11.0%	4.3%	6.7%

UK

- Levels of corporate distress stabilised in the UK, albeit at a position that puts the country among the top five distressed markets across Europe.
- Another concerning indicator is the percentage of UK companies lacking robustness in their balance sheets, which is at a four year-high of 27.2%.
- The highest level of distress in 2022 was found in the Other Industries sector, including businesses such as chemicals, paper and plastic packaging businesses, all of which face growing ESG scrutiny and pressure to decarbonise.
- Britain avoided a recession in 2022, with sectors including Telecommunications, Construction and Manufacturing performing better than previously anticipated. Household finances were helped by the government's energy bill support scheme.
- However, looking ahead we expect to see further impacts of the macroeconomic headwinds across all sectors, but notably in Retail, Pharmaceuticals & Medtech, Food, Agriculture and Consumer discretionary companies. Energy intensive industries will continue to struggle with costs.
- Furthermore, given that most UK companies have floating rate debt facilities, we expect to see more businesses struggling with liquidity constraints and the inability to afford debt service payments in a higher-rate environment.

Key findings

	Other industries	**Media, Entertainment & Media Services**	**Consumer – Others**
Worst performing sectors	19.4%	15.9%	12.8%
	Other industries	**Healthcare**	**Infrastructure & Logistics**
Worst trend sectors	12.9 pp	4.9 pp	2.4 pp
	FY20	**FY21**	**FY22**
Distress in %	10.3%	8.5%	8.4%

CONCLUSION

It emerges from the latest ADA that companies are entering what could be a prolonged period of economic turbulence in a vulnerable financial position. More than a quarter of firms across Europe have weak balance sheets, a percentage that has only gone up in the past four years.

What's more, tailwinds that helped preserve profitability in an inflationary environment – such as post-pandemic pent-up demand and cost pass-through mechanisms – are gradually fading for some sectors.

While this weakening trend has not yet materialised into a meaningful wave of corporate restructurings in Europe, we expect that tougher conditions will force more companies to actively pursue deleveraging and restructuring measures.

Corporate borrowers will need to consider alternative options to solve for their outstanding debt. There is dry powder and innovative structures available, albeit at a higher cost of capital.

Alongside measures to regain balance sheets' sustainability, transformational and operational restructurings (eg. closure of locations, disposal of divisions, product offering adjustments, development of new products, workforce reduction, digital transformation, etc.) will also become more frequent.

Key takeaways for stakeholders

- **Liquidity assessment:** Critical review of 13-weeks cash flow forecasting and cash management tools to obtain a robust platform for restructuring.
- **Rigorous business model review:** Only a transparent business plan based on a realistic analysis of the situation can help management and the board understand the impact of ever-changing market conditions and customer demands (eg. is the business model still viable/competitive?) and implement counter measures are needed.
- **Robust three-way financial planning:** The development of a robust, integrated financial plan which combines the business plan and the impact from restructuring measures is vital to evaluate the feasibility of a restructuring against different scenarios.
- **Plan for volatility:** Permanent screening of macroeconomic drivers, peer behaviour analysis and scenario planning should be conducted and modelled in the three-way financial planning. It is not sufficient to rely on a business as usual anymore given the manifold challenges on a global level.

HOW A&M CAN HELP

A&M has the most comprehensive suite of services to help companies and their stakeholders through challenging times.

Our Financial Restructuring, Turnaround and Debt Advisory specialists bring decades of experience of working on the world's largest and most complex transactions and gaining consensus amongst multifaceted stakeholder groups to deliver outstanding outcomes against difficult backdrops.

These core restructuring services are supported by complementary skills that can address every aspect of complex transactions from within one team. Our deep strategic, operational and financial expertise, valuations and tax advice combined with cutting-edge contingency planning and bias-to-action culture ensure we can get a transaction done in any circumstances.

METHODOLOGY

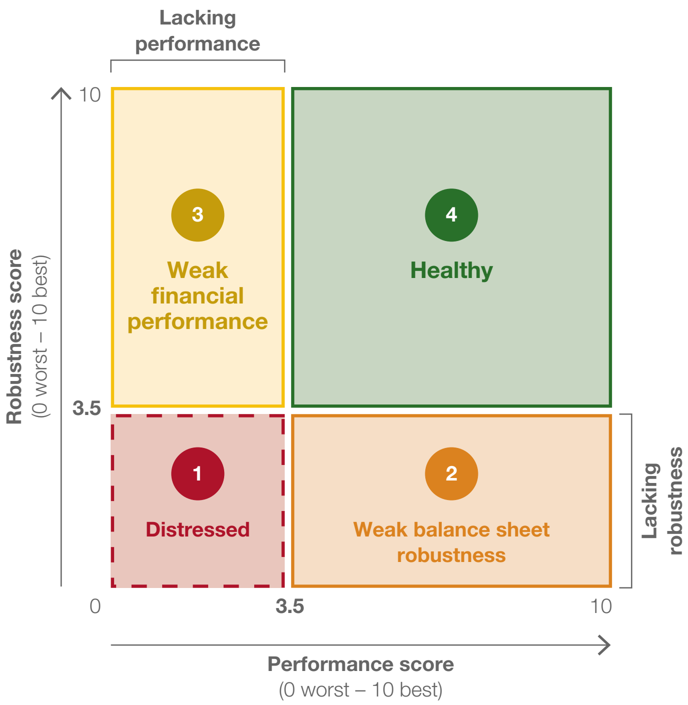
A&M's Financial Restructuring Advisory team has developed a methodology to assess performance and balance sheet robustness of European businesses, aiming to identify those that are in financial distress or may soon be heading in that direction.

The study includes more than 7,000 listed and private companies with over €20 million of annual revenues across 33 countries in Europe and the Middle East that consistently provided data for all years from 2019 to 2022.

The ADA index analyses 18 KPIs to create two sub-scores: the performance score, which is based on the company's own income statement as well as related KPIs measured against its industry peers, and the robustness score, based on detailed balance sheet data.

The scores are applied on a scale from zero (heavily impacted) to 10 (very solid situation). Based on the scoring, companies are clustered into four groups: businesses that are in or on the verge of financial distress because they have significant deficits in both their financial and earnings situations (cluster 1), those with weak balance sheets (cluster 2), those with weak performance (cluster 3) and finally, firms considered to be in a healthy financial position (cluster 4).

Index-based clustering



Explanation ADA and recommended actions:

Distressed (Cluster 1): companies have (significant) deficits in terms of both their financial and earnings situation. These therefore have *insufficient liquidity and/or inadequate and unsustainable capital structures* and, at the same time, *weak/insufficient profitability*. Some of these companies are therefore likely to be in "financial distress".

Weak balance sheet robustness (Cluster 2): companies with a robust earnings/profit performance but insufficient liquidity and/or inadequate and unsustainable capital structures. These companies are in a potential *need of a financial restructuring*.

Weak financial performance (Cluster 3): companies have a fundamentally solid balance sheet but show weaknesses in their earnings or profitability. These companies are in a potential *need of performance improvement measures*.

Healthy (Cluster 4): includes companies that have a solid balance sheet and robust earnings.

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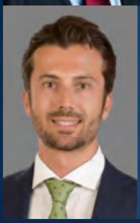

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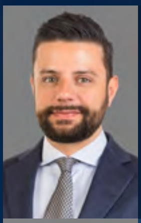

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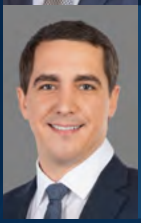

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ABOUT ALVAREZ & MARSAL

Companies, investors and government entities around the world turn to Alvarez & Marsal (A&M) for leadership, action and results. Privately held since its founding in 1983, A&M is a leading global professional services firm that provides advisory, business performance improvement and turnaround management services. When conventional approaches are not enough to create transformation and drive change, clients seek our deep expertise and ability to deliver practical solutions to their unique problems.

With over 7,500 people across six continents, we deliver tangible results for corporates, boards, private equity firms, law firms and government agencies facing complex challenges. Our senior leaders, and their teams, leverage A&M's restructuring heritage to help companies act decisively, catapult growth and accelerate results. We are experienced operators, world-class consultants, former regulators and industry authorities with a shared commitment to telling clients what's really needed for turning change into a strategic business asset, managing risk and unlocking value at every stage of growth.

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