UK Profit Monitor

April 2020

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Contents

Key points

UK plc earnings in steep decline, even before Covid-19 recession begins – there is much worse to come

- UK earnings recession intensifies in Q1 with third consecutive quarter of profit declines – even before Covid-19 effect is felt
- Only 42% of companies reported rising profits in Q1, the lowest proportion since 2009
- UK profits are a third lower than 2007, after accounting for inflation
- On the eve of the last recession, companies made £14 for every £100 of sales; in the last year they have made only £8.30
- Covid-19 - red, amber and green list of vulnerable sectors each represent 1/3 of UK plc profits
- Link Group estimates Covid-19 will lop £170bn off UK profits – the loss of one whole year for UK plc
- But the market reaction appears too severe

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Methodology

The UK Profit Monitor analyses the latest quarterly and half-yearly results published by all the UK companies listed on the UK main market, excluding investment funds and REITs. As well as looking at the latest quarterly results, we also look at the last twelve months on a rolling basis, to allow us to see the true trends clearly.
Link Group aggregates the results to consider the collective performance of UK plc, and to look at sector and industry trends. In addition, the team analyses consensus analyst forecasts for each company (where available), and calculates consensus profit growth.

The UK Profit Monitor report comprises detailed, stock-level data for quarterly and semi-annual results back to 2013. To calculate the profit index back to 2007, Link Group uses less granular annual earnings data.

Just over a third of the UK's listed companies reported results in Q1, meaning our latest report gives a clear picture of the current health of UK plc.

The latest UK Profit Monitor report looks at company quarterly and half-year results announced between 11 December 2019 and 10 March 2020. We call these Q1 2020 numbers.

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Introduction

People invest in equities in the hope they will deliver capital gains over the long term and generate an income through dividends. The stock market crash of March 2020 is a hugely disruptive event, which has destroyed hundreds of billions of pounds worth of value in the UK, and much more than this around the world. Share prices are often very volatile in the short term, but in the long term, it is a company's ability to invest capital efficiently in order to drive profits and cash flow (and therefore dividends) that determines an investor's returns.

The UK stock market has lagged behind its peers in recent times, dogged by sluggish economic growth, political uncertainty, and an unfavourable sector mix. UK profits have been weak too.

The UK earnings recession intensifies in Q1, with third consecutive quarter of profit declines – even before Covid-19 effect is felt.

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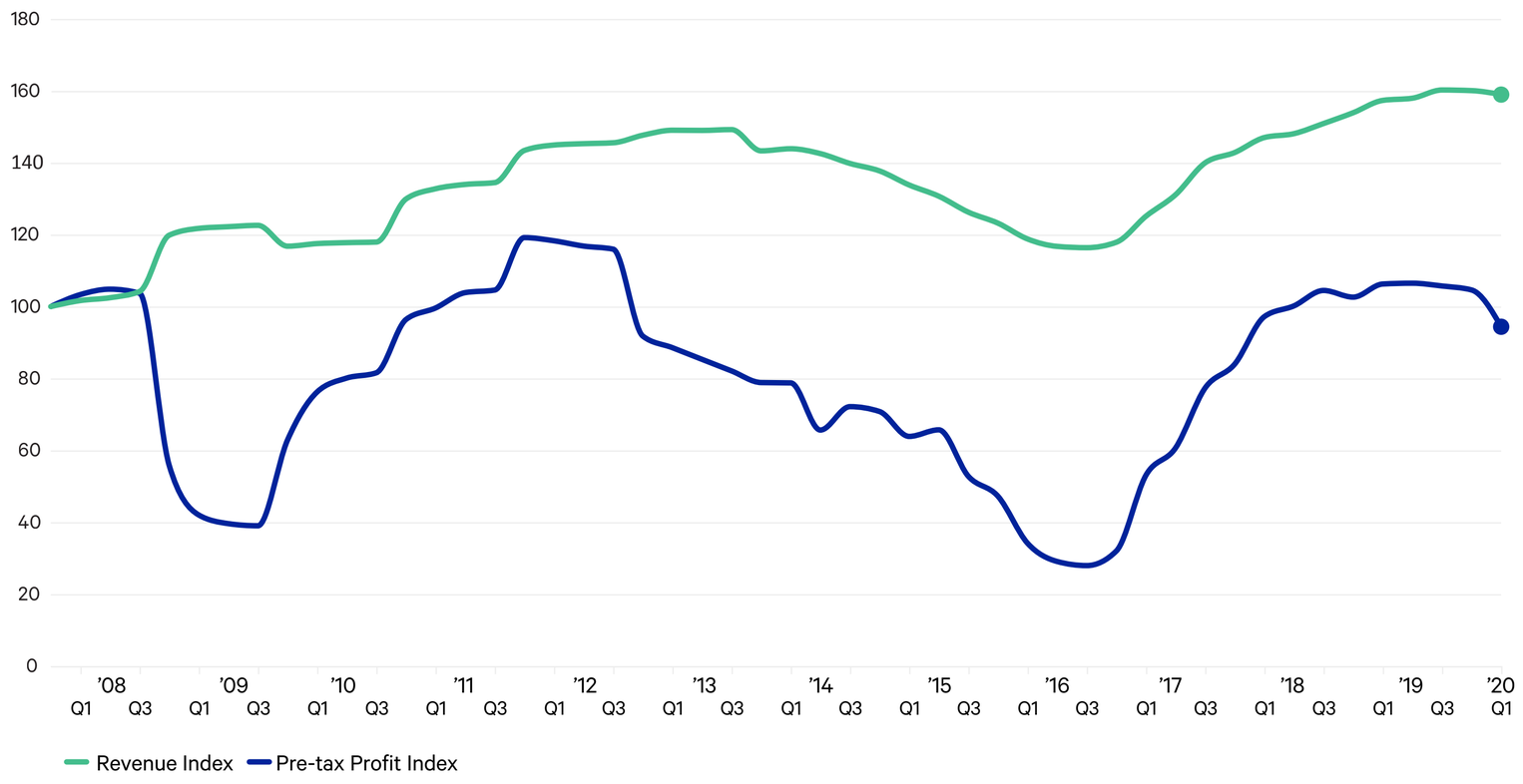
Overview

Investors are only just beginning to calculate the potential effect on profits of the Covid-19 pandemic. Firm evidence will take time to emerge. Results reported during the second quarter, will capture the chilling effect that began from March, but that will cover only about three weeks of the lockdown. The full impact will hit company operations in April and May, so we will see that show up later in the year. In the meantime, profit warnings will pile up, but only once companies have been able to get some measure of how serious the damage is. As these happen, analysts will be able to refine their estimates.

This is, of course, why the stock market is showing such unprecedented volatility. It is impossible to value companies accurately, until investors can nail down with greater certainty the severity and duration of the disruption, and work out how effective the policy response will be, from governments and central banks. Share prices are blown from pillar to post as a result.

Revenue vs Pre-tax Profit



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Revenue vs Pre-tax Profit

Key Information £bn	08Q1	09Q1	10Q1	11Q1	12Q1	13Q1	14Q1	15Q1	16Q1	17Q1	18Q1	19Q1	20Q1
Revenue	£1,286.7	£1,541.0	£1,487.4	£1,680.5	£1,834.3	£1,886.5	£1,821.3	£1,693.8	£1,503.5	£1,583.8	£1,860.8	£1,991.5	£2,012.0
Revenue Growth	19.8%	19.8%	-3.5%	13.0%	9.2%	2.8%	-3.5%	-7.0%	-11.2%	5.3%	17.5%	7.0%	1.0%
Pre-tax Profit	£182.7	£74.3	£134.9	£176.1	£209.2	£156.6	£139.3	£113.0	£60.4	£93.9	£171.9	£187.9	£166.9
Pre-tax Profit Growth	-44%	-59%	81%	31%	19%	-25%	-11%	-19%	-47%	55%	83%	9%	-11%
Pre-tax Margin	14.2%	4.8%	9.1%	10.5%	11.4%	8.3%	7.6%	6.7%	4.0%	5.9%	9.2%	9.4%	8.3%

As the UK's lockdown intensifies, our latest research shows that the UK's listed companies face this unprecedented challenge in an unusually weak state, suffering negative sales momentum and tightening margins thanks to the strangling effect of the Brexit process and to the slowdown in the world economy. Results reported during Q1 show that company revenues fell for the second quarter in a row. As a result, the UK's earnings recession deepened and widened, with pre-tax profits dropping 29.8% year on year. Earnings have now declined for three quarters in succession and at an accelerating rate. If we look at the full 12-month picture, rather than just the latest quarter, UK companies have booked profits of £166.9bn. That's 5.7% less than the £176.9bn they made fully 12 years ago in 2007 – or about a third less once the effect of inflation is taken into account.

Profits have lagged far behind revenue growth, as margins have squeezed.

The most recent big drop in profits was exacerbated by falling oil prices and by a series of large one-off asset write-downs and exceptional charges at some large companies. We can look beyond one-offs, but we cannot ignore them; and in any case, even the underlying trend was weak.

The earnings recession broadened because it affected more and more companies – three in five companies reported lower profits in Q1, the highest proportion since the third quarter of 2009, when the UK was grinding through the later stages of the post-crisis slump. That proportion will now rise sharply. As we enter the Covid-19 economic recession, company profit margins have much less fat in them than they did ahead of the 2008-9 downturn.

Over the last 12 months, UK plc has generated profit of just £8.30 on every £100 of sales, compared to £14 in 2007. The outlook is exceptionally unclear.

Link Group has looked at what happened both in the last recession, and when oil and commodity prices last fell sharply, and has also folded in Covid-19 specific factors such as the hit to retail, travel and leisure. Just as a guide, we have pencilled in a three-quarters decline in UK company profits by the end of this year, before a bounce-back occurs into 2021.

If we are right, the stock market looks cheap at the moment. If the downturn turns out to be much more protracted and much more serious, then share prices could stay low or fall further for some time.

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Revenues and profits

in decline as Britain's earnings recession deepens

The latest set of quarterly results from UK plc were not very encouraging. Taken together, UK plc revenues fall in any given quarter about one third of the time – this relatively high frequency reflects the dominance of highly cyclical oil and mining companies. Volatile commodity prices cause big swings in revenues for these industries.

But there have been only four quarters in the last eight years where the decline in revenues was so broadly spread across different sectors. In Q1, revenues fell 2.4% with the greatest impact coming from the oil sector (suffering lower oil prices even before the price war began) as well as banks and utilities.

Revenue index (Q4 2013 = 100)

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Industries and Sectors by 2019 Pre-Tax Profits

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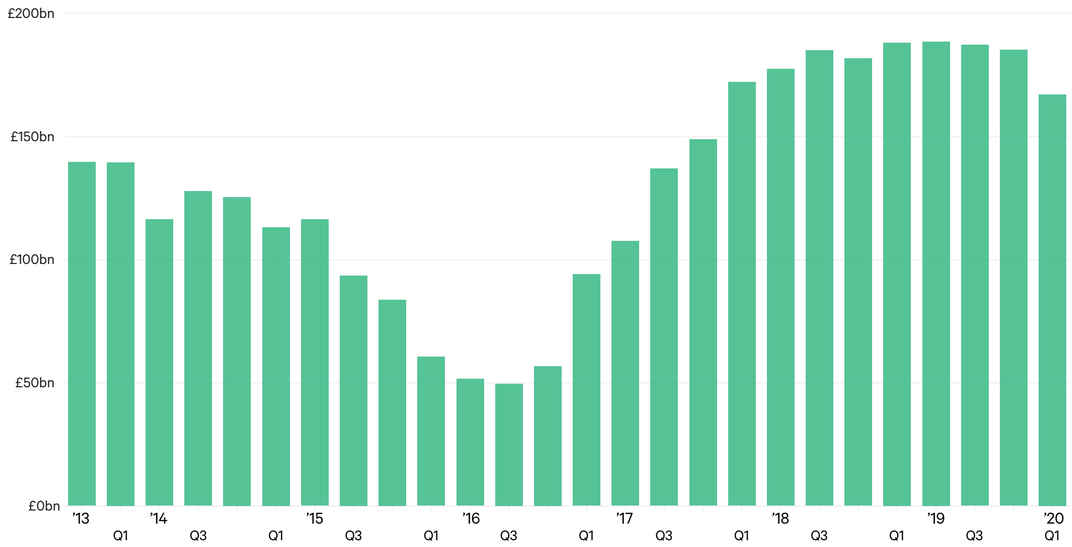
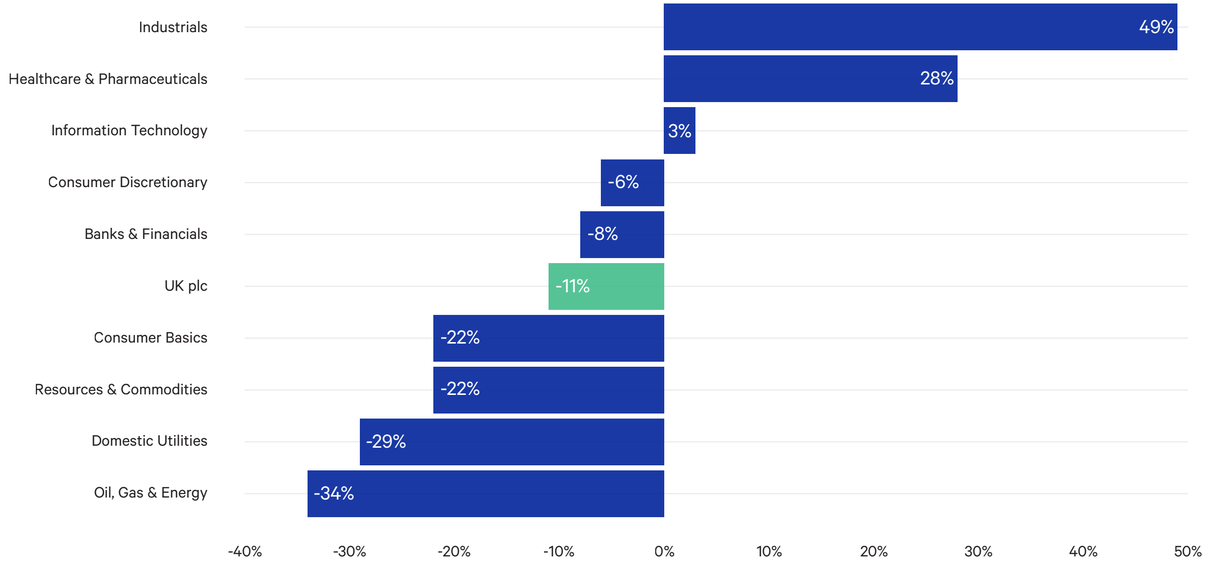
Pre-tax Profit – 12 months



Pre-tax Profit Growth – Last 12 months compared to previous 12



Profits fell harder, down 29.8%. The decline was exaggerated by big one-off charges at companies as diverse as Rio Tinto, Shell, HSBC and Reckitt Benckiser, mainly reflecting the impairment of assets. Companies will usually tell investors to ignore such adjustments as simple accounting artefacts, but they represent a real destruction of value – usually capital spent in the past that is now judged to have been wasted. So, while they don't tell us much about the current operating performance of a company, they do tell us about how wisely a company has invested in the past.

Even allowing for big one-offs, earnings were lower, however.

This was the third consecutive quarter to report falling profits, with the decline affecting large and small companies alike. The UK's earnings recession is getting longer, deeper, and broader.

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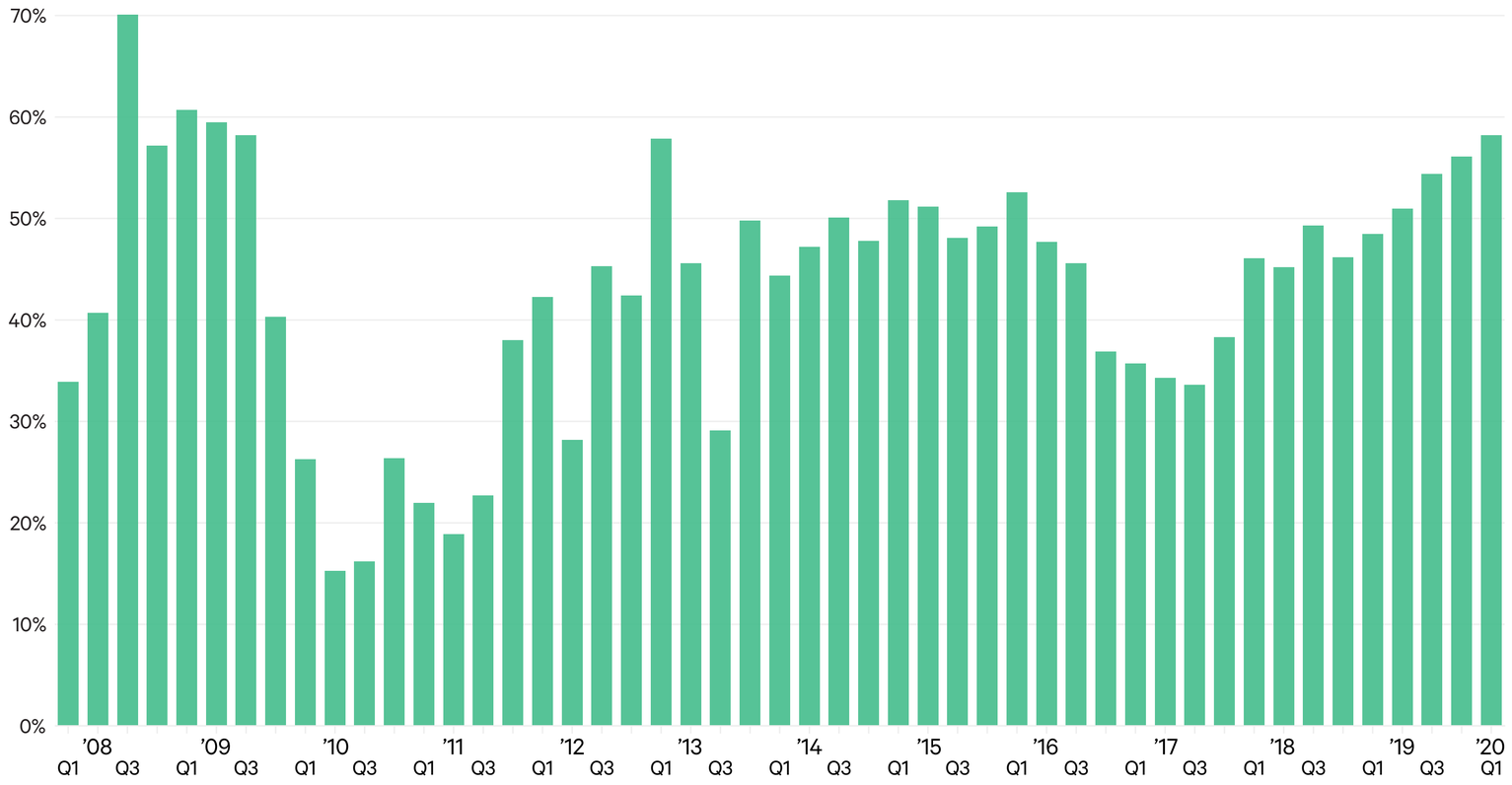
If we look at a company level, we see a steady deterioration in the number of companies posting higher profits too. By the middle of 2010, as the UK emerged from the last recession, 85% of companies reported rising profits. In the last quarter, just 42% have managed to grow their bottom line year on year. That proportion has been in decline, quarter in, quarter out, for two and a half years, and we think it has much further to go. At the worst point in the 2009 recession, less than a third of companies reported higher profits – we are sure to sink to that level again.

Over the last 12 months, rather than just in the last quarter, UK companies have made sales of £2.01trn; that's an impressive three fifths more than they made in 2007, the last year of the boom that preceded the financial crisis. To put that huge figure into perspective, it's roughly two and a half times the collective income of the UK's population. But the total is moving in the wrong direction. Our index of UK revenues has declined by 1% from its peak in the summer of 2019.

Proportion of UK companies reporting lower profits



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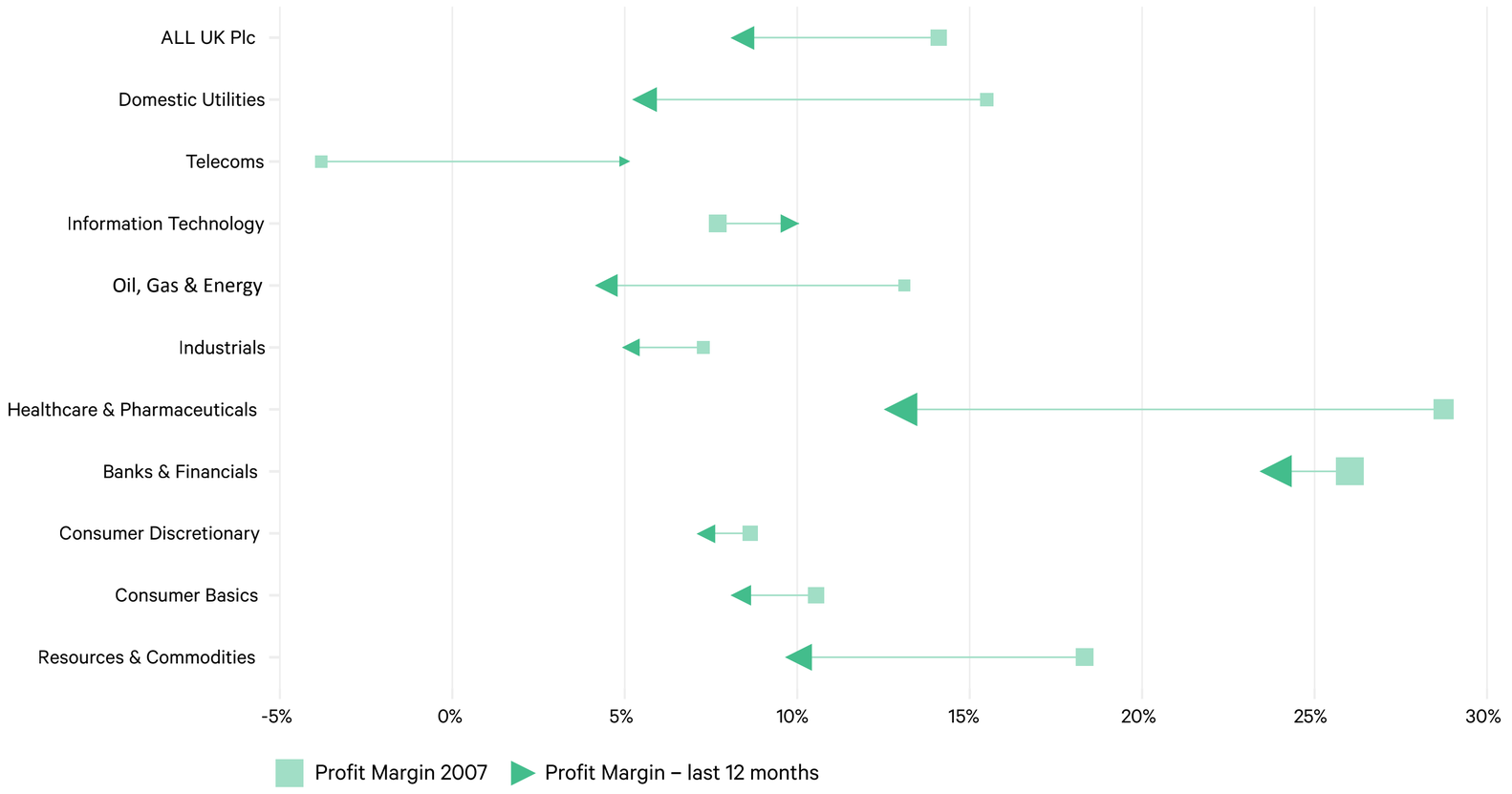
The profit picture shows how companies have failed to convert extra sales to extra profits. Over the last year, the UK's listed companies have made profits of £166.9bn. This is down 5.7% on what they made in 2007, even without taking the effects of inflation into account. Profits have therefore lagged far, far behind sales, and that means a margin squeeze.

Though UK company margins were lower between 2013 and 2017 than they have been in the last year, they have never returned to the level they reached pre-2008. In the last twelve months, companies have made £8.30 in profits for every £100 of sales. Eighteen months ago they made £9.70. And in 2007 they made £14. Moreover, the squeeze in the middle of the last decade was mainly caused by a small number of sectors, namely banking, mining and oil. Since the 2018 mini-peak, every sector has seen margins fall, except chemicals and insurance. This chart shows the picture at the less detailed industry level. It's clear that UK plc enters the Covid-19 recession on much thinner margins than when it entered the financial crisis, which means profits are very vulnerable.

UK profit margins face this recession much lower than they were in 2007



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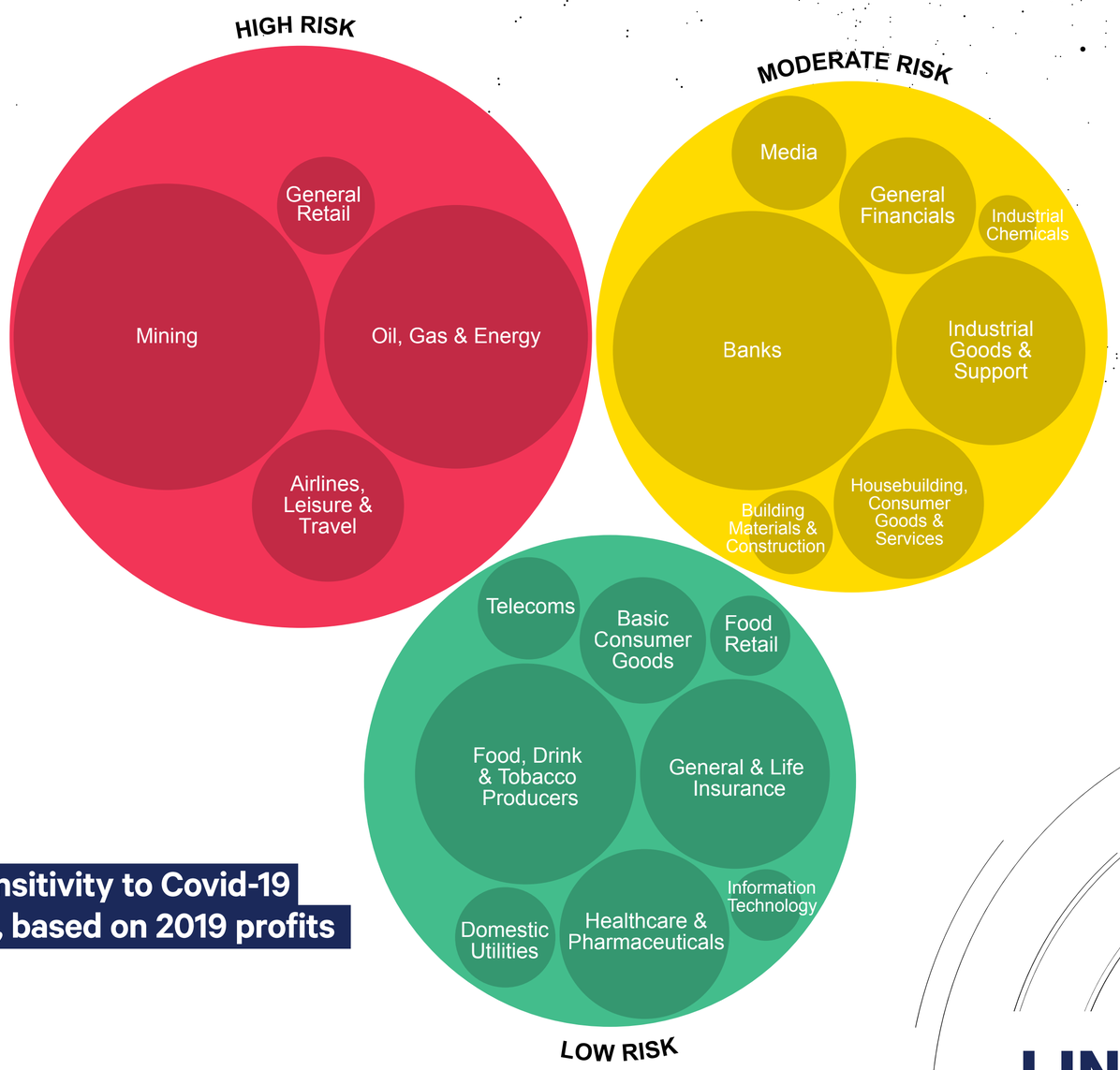
Covid-19

We have categorised UK plc's sectors according to their vulnerability to the Covid-19 shock, and the associated oil price war sparked when OPEC and Russia could not agree production cuts in response to the crisis. The red list of critically, directly affected sectors includes airlines, leisure and travel businesses, retailers (excluding food), miners, oil companies, and the UK's small listed motor sector. The amber group contains those likely to suffer the second-round effects as the economy slows – they will be hit by falling demand and supply constraints (including the supply of labour). These include housebuilders and manufacturers, banks and financials (thanks to company insolvencies and financial turmoil), and media companies (thanks to lower advertising). Those least likely to be affected, our green list, include food retailers and producers and utilities, while some companies may even benefit, such as healthcare.



Sector sensitivity to Covid-19 recession, based on 2019 profits

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Link Group estimates Covid-19 will lop £170bn off UK profits – the loss of one whole year for UK plc.

The profit contribution of each of these groups in 2019 was roughly one third each. In the months ahead, we expect the red group to post losses.

We have pencilled in profits to fall 15-40% for the amber group, while the green group sees profitability flat or modestly up. We set out what this means for overall profits in the Outlook section on the next page.

	2019 Profits £m
Airlines, Leisure & Travel	£7,189
General Retail	£2,968
Oil, Gas & Energy	£21,611
Mining	£29,191
Motor Manufacturing & Parts	£102
Housebuilding, Consumer Goods & Services	£7,023
Media	£4,079
General Financials	£5,819
Property	£81
Building Materials & Construction	£2,191
Industrial Goods & Support	£11,115
Industrial Chemicals	£1,038
Banks	£24,240
Basic Consumer Goods	£4,966
Food Retail	£2,002
Food, Drink & Tobacco Producers	£15,173
General & Life Insurance	£11,192
Healthcare & Pharmaceuticals	£8,966
Information Technology	£1,593
Telecoms	£3,246
Domestic Utilities	£3,126
UK plc	**£166,911**

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Outlook

If we are set to endure a protracted slump, then our estimates for profits are likely too sanguine. But the recovery will come.

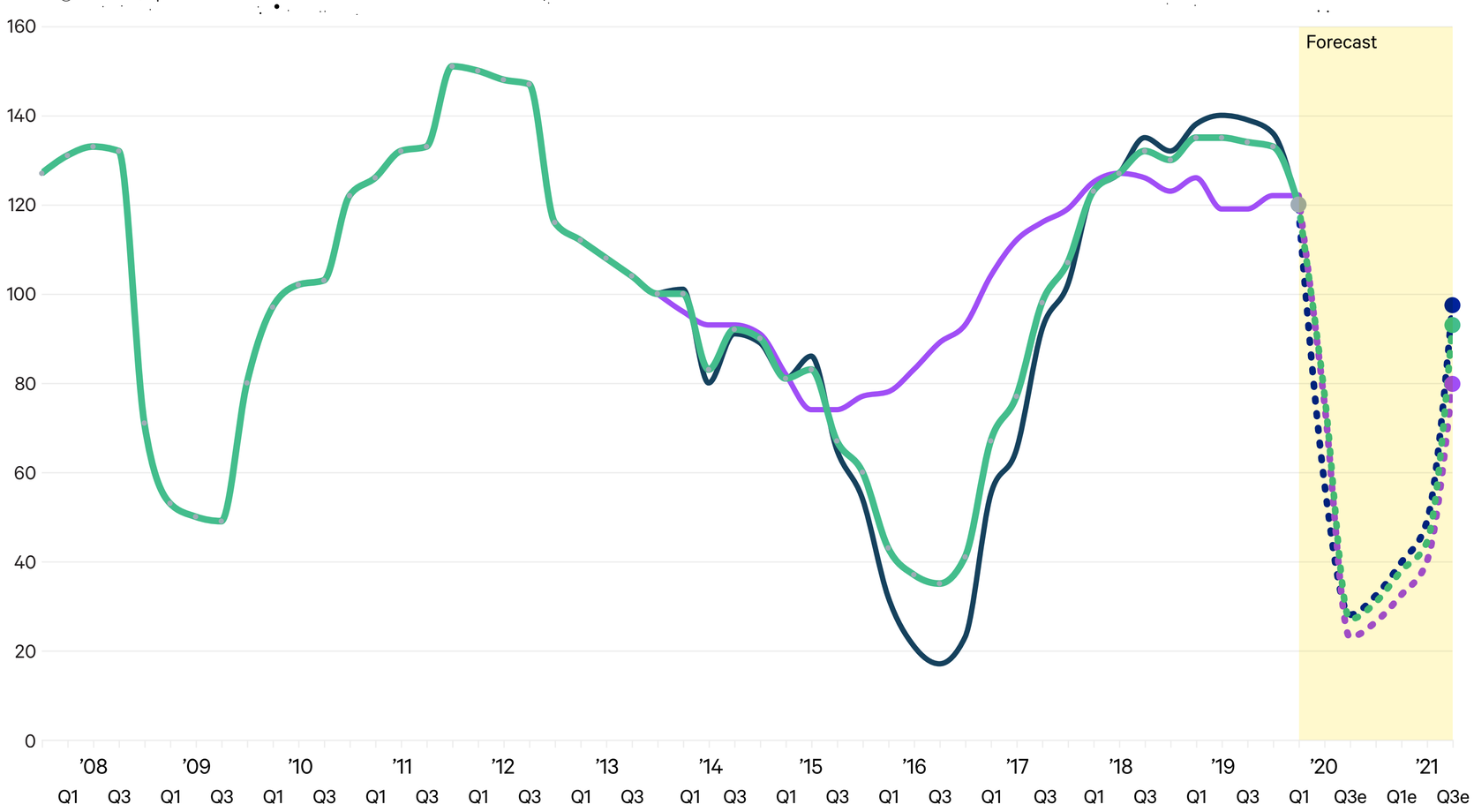
The outlook is exceptionally unclear. As a guide, Link Group has looked first at the 2008-9 recession, and secondly at the impact of the last collapse in oil and commodity prices. Finally, the team has folded in Covid-19 specific factors such as the hit to retail, travel and leisure. We have not attempted stock-by-stock analysis, but have instead undertaken a top-down, sector approach, guided by our red, amber and green lists to give a broad-brush overview. The results of this exercise led us to pencil in a 75% decline in UK company profits by autumn this year, before a bounce-back occurs into 2021. This is significantly worse than the two-thirds drop in 2008-9 and may still be too optimistic.

The exact trajectory, of course, depends both on how long the lockdown lasts and how effective the policy response is.

What does that mean for the stock market? Lower profits mean lower share prices are justified. But most of the value of shares derives from their ability to deliver profits over the next 15-20 years, not just from the next year. If the damage from the crisis is short term, and if profits start to rebound later this year, then the elimination of almost £800bn of value from UK stocks during the crash is a clear overreaction to the loss of perhaps £170bn of profits over 18 months, with most of that in the next six months. To put this loss of value into context, it took six years (2014-19) for UK plc to make £800bn in profits. Covid-19 will cause a huge amount of social and economic damage, but does it justify value destruction on this scale?

All this does not mean the market cannot continue to fall in the shorter-term. Moreover, if we are set to endure a protracted slump, then our estimates for profits are likely too sanguine. But even if we cannot predict what will happen next with any certainty, simply understanding how the moves the stock market is making relate to companies' ability to generate value over the medium term, should help investors work out when they are confident to dip their toes back in.

Pre-tax Profit Index (full market only pre – 2013)



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Appendix

On the eve of the last recession, companies made £14 for every £100 of sales; in the last year they have made only £8.30.

Revenue

Key Information £bn	14Q1	15Q1	16Q1	17Q1	18Q1	19Q1	20Q1
Resources & Commodities	£284.2	£242.5	£188.5	£213.9	£285.3	£292.4	£304.9
Consumer Basics	£232.5	£214.6	£210.5	£222.2	£247.7	£257.9	£265.7
Consumer Discretionary	£198.4	£202.2	£212.8	£238.2	£264.4	£280.9	£292.2
Banks & Financials	£173.0	£155.1	£151.6	£157.4	£165.6	£170.3	£173.7
Healthcare & Pharmaceuticals	£51.1	£47.5	£50.8	£57.1	£62.8	£63.9	£70.0
Industrials	£191.4	£198.9	£204.4	£224.1	£243.0	£256.2	£262.2
Oil, Gas & Energy	£544.8	£483.1	£328.3	£322.6	£435.9	£528.1	£503.0
Information Technology	£7.1	£7.5	£8.9	£9.3	£11.5	£14.4	£16.2
Telecoms	£59.4	£60.7	£62.5	£62.2	£61.3	£66.5	£66.2
Domestic Utilities	£79.5	£81.6	£85.2	£76.7	£83.3	£60.7	£57.6
Total	**£1,821.3**	**£1,693.8**	**£1,503.5**	**£1,583.8**	**£1,860.8**	**£1,991.5**	**£2,012.0**

Pre-tax profit

Key Information £bn	12 months to: 14Q1	15Q1	16Q1	17Q1	18Q1	19Q1	20Q1
Resources & Commodities	£14.1	£19.1	-£11.6	£14.5	£31.0	£38.8	£30.2
Consumer Basics	£22.5	£16.9	£11.6	£19.4	£24.8	£28.4	£22.1
Consumer Discretionary	£13.6	£16.1	£18.9	£19.4	£24.7	£22.8	£21.4
Banks & Financials	£23.5	£33.3	£22.7	£20.9	£42.1	£44.7	£41.3
Healthcare & Pharmaceuticals	£10.3	£4.8	£13.6	£6.0	£6.1	£7.0	£9.0
Industrials	£9.3	£8.5	£8.8	£5.9	£18.9	£8.9	£13.3
Oil, Gas & Energy	£35.8	£14.5	-£11.0	-£3.2	£13.1	£32.7	£21.6
Information Technology	£0.6	£0.8	£0.9	£1.0	£1.2	£1.5	£1.6
Telecoms	£3.8	-£3.7	£3.8	£3.6	£5.1	-£1.2	£3.2
Domestic Utilities	£5.6	£2.7	£2.7	£6.5	£4.9	£4.4	£3.1
Total	**£139.3**	**£113.0**	**£60.4**	**£93.9**	**£171.9**	**£187.9**	**£166.9**

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