INDUSTRY WATCH

Spring 2011

THE BIG PICTURE

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Although the number of UK business failures dropped sharply in 2010, further falls are expected to be limited.

We are predicting that business failures in 2011 will reduce by 6% from the 2010 total of 22,293. This is in marked contrast to the steeper drop experienced between 2009 and 2010 as the economy recovered from deep recession. The flatness of our forecast can be seen most clearly in the quarterly figures, where business failures look set to remain at approximately 5,000 a quarter as far ahead as 2014.

This is driven by the muted nature of the economic recovery. We forecast that much of the weather-induced output fall in Q4 2010 will be regained in early 2011, but we are still predicting economic growth of only 1.3% in 2011 and 1.6% in 2012.

With tax, inflation and slow wage growth affecting households, we expect consumer spending to enter negative territory, falling 0.7% in 2011 before regaining weak growth in 2012. Unemployment is forecast to reach 2.6 million by the end of 2011.

Consumer-dependent sectors look set to suffer mixed fortunes as Retail continues to hold up reasonably well while more discretionary spend areas like Personal Services and Leisure could see failures edge higher. Amongst other sectors, Manufacturing stands out with a further 17% fall in annual failures expected in 2011.

Risks to our forecast remain high: the increasing likelihood of interest rate rises, growing inflationary pressures, and the full impact of public sector spending cuts.

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RIDING OUT THE LONG TAIL

In the first BDO Industry Watch of the year we look back at 2010 and ahead to a period in which the continuing economic recovery looks set to meet a number of significant headwinds. This, we believe, will create a long tail for business failures with many sectors continuing to experience levels above pre-recession norms for the forseeable future.

Beneath the headlines

The headline figures tell a clear story: business failures in 2010 fell by 15% compared to 2009. Many in the restructuring community, however, will have experienced a significantly sharper drop in the number of firms meeting serious difficulty. The decrease in failures in the mid to large coorporate market is estimated at 40%. This apparent anomaly can be explained by looking more closely at the nature of the figures.

BDO Industry Watch's statistics are based on the most recent data provided by the Department for Business, Enterprise & Regulatory Reform (BERR), which covers UK businesses of all sizes.

Senior banking restructurers and Business Restructuring teams from major accountancy firms will, however, have a natural bias towards larger companies, rather than the small ones that make up such a large proportion of the BERR figures. In 2010, 67% of all UK businesses had four or fewer employees, and 83% had fewer than ten. Given the fragile nature of the smallest firms, particularly start ups, it is fair to assume that there is a 'residual' fail rate among SMEs that thickens the Industry Watch figures.

Survival of the largest?

This divergence looks set to continue as larger firms have a number of current advantages compared to SMEs. Firstly, they are more likely to have international sales and are therefore less dependent on weak domestic demand. Secondly, they are more likely to have alternative routes to finance, whether through the bond or equity markets. In contrast it is estimated that some 97% of small businesses rely purely on bank finance. Given that in our recent 60 Second Survey of senior restructuring bankers and lawyers 40% believed there would be insufficient debt to meet demand and only 20% felt that banks would increase lending to meet demand, a reliance on scarce credit may not be beneficial during 2011.

There is also evidence that re-financing will peak over the next year as five-year deals signed in 2006 and 2007 expire at the same time as the three-year deals lenders were restricting companies to in 2008 and 2009. Banks, who have generally played something of a waiting game, may be forced into making tougher decisions, which could impact businesses, particularly SMEs.

> *Businesses will find themselves under pressure to absorb their increased costs rather than risk losing sales*

The interest rate question

A key driver for business failures in 2011 and beyond will be interest rates, but this is proving a difficult one to call. The Bank of England is under pressure from two opposing drivers: rising inflation and weak growth. January 2011 provided strong ammunition for both sides: Consumer Price Index reached 4.0%, much higher than the Bank's central 2.0% target; while the announcement that GDP had shrunk during Q4 2010 hardly suggested the economy was ripe for fiscal tightening.

With an increasing lack of consensus among MPC members, a rate rise to 1.0% by the end of 2011 is becoming more likely. Even so, we would not expect rates to go above 2% before 2014, helped by the fact that the effects of VAT rises on inflation will drop out of the annual rate in 2012.

Inflation and household spending

Bank of England Governor Mervyn King commented recently that UK households are undergoing the most prolonged squeeze on real incomes since the 1920s as above-target inflation and weak income growth hit home. Sustained oil price rises, record prices for raw materials such as iron ore and soft commodities such as cotton are all forcing input prices higher for UK businesses. A combination of poor harvests and increasing demand is also pushing food prices up, driving the United Nations Food Price Index to a record high in January 2011.

As a result businesses will find themselves under pressure to absorb their increased costs rather than risk losing sales to consumers who, we forecast, will have less money to spend in 2011.

Public spending cuts

There can be little doubt that, if fully implemented, £83bn of real terms cuts in UK public expenditure by 2015/16 will present a game-changing landscape for companies. To put this into perspective: since the second World War we have never had more than two consecutive years of reduction in public spending – we now face six consecutive years. This will help to drive the 'long tail' for sectors such as Property and Construction where the limited availability of public contracts will prevent business failures returning to pre-recession levels in the foreseeable future.

Sectors

In contrast, the long tail appears to already be over in Manufacturing, with failures already down 28% in 2010 and predicted to fall a further 17% in 2011 as strong economic indicators and the weak pound set a scene for growth. Indeed, the Markit/CIPS Manufacturers' Purchasing Managers' Index reached a record high in January 2011.

Among consumer-facing sectors, the biggest pressure ahead will remain on those reliant on discretionary spending. Evidence of this

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can already be seen: the big food retailers have continued to trade positively, while sales volumes for household goods stores were down 8.6% in December 2010 compared to the same month in 2009 (according to latest ONS estimates).

Business Services also look to be recovering well, with failures predicted to fall a further 20% in 2011 as the sector benefits from the globalised nature of its markets. The TMT sector has similarly bounced back, although failures may remain above pre-recession levels as the high number of start-ups attracted to the market will thicken the figures.

Conclusion

Inflation, public-spending cuts, constrained lending, a reduction in consumer spending and low GDP growth will all lead to the number of business failures remaining above the long term average. However, bigger companies and those with less exposure to domestic markets and discretionary spending will be more likely to experience failure rates that settle at or below pre-recession levels. But with a number of downside risks already out there, and new ones developing – such as further political turmoil in the Middle East – there is still no end to the long tail in sight.

NOTES

1. Industry Watch is the first study to make projections of total business failures and the business failure rate in Great Britain by sector, based on data for compulsory liquidations, creditors voluntary liquidations, administrative receiverships, administrative orders and company voluntary arrangements provided by the Department for Business, Enterprise & Regulatory Reform.
2. The latest quarterly data for Great Britain is Q4 2010. BERR official company insolvencies by industrial sector are published one quarter in arrears for England & Wales and Scotland. Therefore, the latest sectoral data is Q3 2010.
3. The Department for Business, Enterprise & Regulatory Reform has changed the industrial classification of its insolvency statistics to adhere to the Standard Industrial Classification 2003 (SIC 2003) as per Q3 2007. Historic insolvency data based on the insolvency trade classification is available up to Q3 2006. There is no official insolvency data by sector available for the period between Q3 2006 and Q3 2007. In order to obtain consistent historic data we converted sectoral insolvency data to the SIC 2003 system using the official insolvency industry data up to Q3 2006.
4. Company liquidations comprise of compulsory liquidations (winding up orders made by the court) and creditors voluntary liquidations registered at Companies House. The BERR figures do not include members' voluntary liquidations, as this procedure does not involve insolvency.
5. We also include receiverships, administrations and company voluntary arrangements (CVA). Receivership involves the appointment of an administrative receiver by a secured creditor to take control of the assets of a company. Administrative orders are court orders which place an insolvent company under the control of an administrator who puts forward proposals to deal with the company's financial difficulties. CVAs are procedures which allow debtors to put forward a plan of debt reorganisation to creditors and shareholders.
6. The BDO Industry Watch model uses a range of key economic variables which have been shown to be related to business failures for each sector.

SECTOR SUMMARY
WHAT WILL HAPPEN TO BUSINESS IN 2011?

Sector	Expect business failures* in 2011 to:	Sector update
Manufacturing	DECLINE	The manufacturing sector suffered a significant decline in output during the global economic downturn, though has subsequently bounced-back strongly and, indeed, outperformed the service sector in 2010. Continued export competitiveness is sustaining our positive outlook for 2011 and beyond.
Retail and wholesale	DECLINE	Businesses in the retail sector are struggling with the combined pressures of rising input prices, the rise in VAT to 20% and a continually weak outlook for the consumer in 2011. These pressures are likely to drive some businesses to failure, though we expect total failure rates in the sector to decline as the UK economy gradually recovers.
Business services	DECLINE	The business services sector saw a sharp decline in failures in 2010 and we expect this to continue in 2011. The globalised nature of the UK's business services industry should allow it to weather the worst effects of the squeeze on domestic demand.
Property and construction	DECLINE	We expect failures in property and construction to decline in 2011, though to remain elevated relative to pre-recession levels. This reflects ongoing weakness in the housing market and a sharp decline in public sector construction projects from 2011 onwards.
Technology, media and telecoms	EDGE DOWN	We continue to predict a moderate decline in TMT business failures in 2011, with investment activity remaining subdued and constrained by weak lending growth. Increased interest in high-tech industries could lead to many new start-ups over the coming years – possibly leading to an oversaturated market and a high level of failures.
Personal services	EDGE UP	Personal services are likely to see failures remaining elevated as household discretionary income is eroded by weak earnings growth and the rising price of essential goods such as foodstuffs – leading to suppressed demand.
Leisure	DECLINE	Expenditure on leisure will be constrained by the soaring cost of essential goods squeezing household budgets. Ongoing concerns about job security are also likely to keep demand suppressed.
Transport	DECLINE	We expect failures in the transport sector to gradually return to pre-recession levels over the coming years. The commitment to investing in transport infrastructure, set out in the October Comprehensive Spending Review, should protect the sector from the worst effects of government austerity measures.

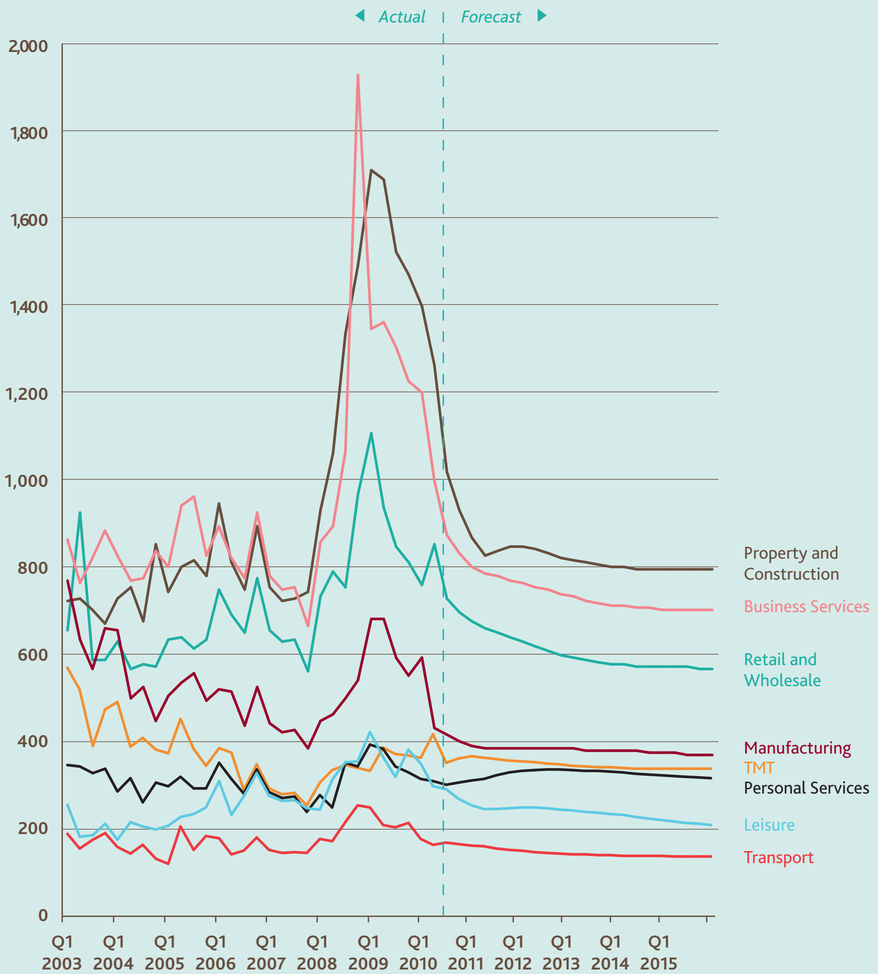
*We have compared forecasts for business failures compared to the previous year: 'Decline' indicates business failures will fall, 'Edge up' indicates business failures will increase by less than 10% and 'Escalate' indicates that business failures will rise by more than 10%.

OVERVIEW OF INDICATORS

WHAT WILL AFFECT FAILURES IN 2011?

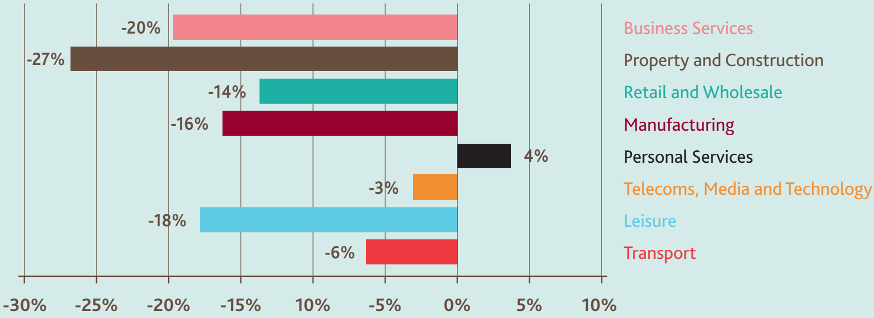
Indicator	Pushing business failures:	Main sectors affected
Gross domestic product (GDP)	DOWN	Economic output in the United Kingdom saw a surprise quarterly contraction of 0.5% in Q4 2010. Although this was partly driven by the snow at the end of the year, the ONS estimates that growth excluding the effects of bad weather was still flat – pointing to a loss of momentum in the economic recovery. Since then, however, short-term and forward-looking indicators point to a bounce back in growth. We expect a double-dip to be avoided, and the recovery to resume, albeit slowly.
Exchange rate	DOWN	While sterling has strengthened against the euro and dollar in recent months, it is still well below pre-recession levels. The boost to exports through this improvement in competitiveness combined with the declining competitiveness of imports will continue to benefit manufacturing and leisure companies. However, domestic production costs will increase where input inflation continues to be imported.
Energy prices	UP	Energy prices are currently a major source of inflation. Brent crude oil recently broke the $100 per barrel mark, amidst political tension in Egypt and Libya. This will ultimately lead to high petrol prices – bad news for transport companies but also for the consumer sector as disposable incomes come under pressure.
Business surveys	DOWN	Business surveys in general are pointing to a continued recovery in 2011, though with widespread variations in confidence across sectors. Businesses in consumer-dependent sectors such as retail, and those in public-sector dependent sectors such as construction, seem to be more concerned about the future than others.
Consumer spending	UP	Household income growth is likely to remain weak, given public sector pay freezes and continued elevated unemployment. Combined with the rising cost of essential goods such as petrol and foodstuffs, household discretionary income will almost certainly fall in real terms – curbing consumer spending growth.
Housing market	UP	Ongoing weakness in the housing market is likely to keep the failure rate elevated in the real estate sector. Continually low monthly mortgage approvals – below half their pre-recession peak – are also curbing demand for household goods in the retail sector.
Tourism	DOWN	Domestic tourism should continue to benefit from the weakened sterling and the resulting disadvantage of going abroad. Meanwhile, tourists should be finding it cheaper to come to the UK, thus providing a further boost. Political crises in popular overseas holiday destinations such as Tunisia and Egypt may also encourage UK households to holiday in the UK.
Business investment	–	Access to credit remains tight, especially for Small and Medium Sized Enterprises (SMEs). Unless credit conditions improve notably over the coming months, business investment growth is likely to remain modest. This will put pressure, among other sectors, on companies in the construction and TMT industry.

ACTUAL AND PREDICTED QUARTERLY BUSINESS FAILURES BY SECTOR



Source: BERR Insolvency Statistics; CEBR forecasts

PREDICTED CHANGE IN BUSINESS FAILURES BY SECTOR: 2011 COMPARED WITH 2010



Source: Cebr calculations based on Cebr forecasts of BERR insolvency data

ACTUAL AND PREDICTED QUARTERLY BUSINESS FAILURES IN GREAT BRITAIN

Source: Cebr calculations and forecasts based on BERR insolvency data

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