S&P Global
Ratings

# U.K. Nonfinancial Corporates: Riding The Rollercoaster

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This report does not constitute a rating action


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## Key Takeaways

- The exposure of U.K. rated nonfinancial corporates to domestic economic woes is modest, with only 23% of revenues sourced at home. The U.S. alone accounts for 22%.
- Nevertheless, should political and market volatility persist, concerns for financial stability may grow and U.K. risk premiums may see a structural rise.
- In the near-term, ratings pressure is most likely to be felt in domestic consumer-focused sectors such as retail, consumer products, and real estate.
- Financing conditions remain difficult, with debt more expensive and less accessible. Even so, nonfinancial corporate refinancing needs are modest through 2023.


## U.K. Credit: Key Highlights

| Economic downturn | Rising inflation | Monetary tightening |
|---|---|---|
| **0.5%** | **12%** | **3.5%** |
| GDP contraction by 2023 | By winter 2022, from current level of 10% | By February 2023, from current level of 2.25% |
| **Negative bias** | **Fallen angel risk** | **Weakest links** |
| **14%** | **Transportation** | **Consumer products** |
| Negative bias, compared with 42.8% at peak COVID-19 | Most issuers rated ‘BBB-’, although all with stable bias | Most issuers rated ‘B-’ and below with a negative bias |

## U.K. fixed-income assets are under pressure

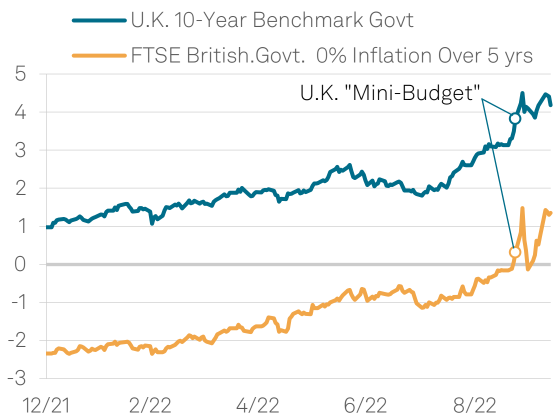
**U.K. debt markets have endured a difficult time in the wake of the government's "mini-budget"** on Sept. 23, compounding an already difficult year. The 10-year gilt rate recently breached 4.5% (see chart 1) and most points on the yield curve are at their highest levels since 2008. Twenty-year gilts (U.K. government bonds) have seen prices fall in excess of 40% (see chart 2). The market environment was already fraught, with sterling falling to a record low of $1.04 on Sept. 19. Of particular concern for credit conditions are the emergence of systemic problems in relation to pension schemes and potential spill over into other parts of the credit markets. Asset-price volatility has created cash flow difficulties for pension funds operating liability-driven investment strategies, necessitating urgent intervention by the Bank of England (BoE). This may yet necessitate cash infusions from corporates into legacy pension schemes. Uncertainties remain as to the final shape of fiscal policy changes, particularly following the abrupt change of Chancellor. For now, U.K. assets are seeing elevated volatility and higher risk premiums.

**This volatility comes in the context of a prolonged adjustment for debt markets to resurgent inflation and rapidly tightening monetary policy worldwide**. In the U.K., we forecast inflation to rise to 12% over the winter and expect the BoE to respond to the challenge of inflation by raising policy rates to 3.50% by early February next year, from 2.25% currently.

Chart 1

### UK Gilt Yields Have Surged Higher...

Redemption Yield, %

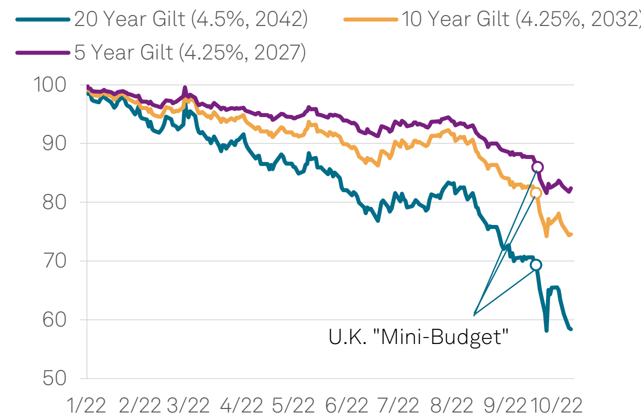



Source: Refinitiv, FTSE, S&P Global Ratings. Data to close Oct. 13, 2022.

Chart 2

### ...With Dramatic Price Falls For Long Duration Gilts

Rebased Clean Price, Jan. 3, 2022 = 100




Source: Refinitiv, S&P Global Ratings. Data to close Oct. 13, 2022.

**U.K. corporate debt markets have inevitably been buffeted by this turbulence**, even at the higher end of the credit spectrum. The iBOXX GBP investment-grade corporate bond index has fallen 29% to date this year, with recent moves seeing underperformance relative to the iBOXX euro investment-grade index (see chart 3). U.K. investment-grade corporate yields are above 7%, their highest level since 2009 (see chart 4). U.K. and European credit conditions face a tough winter ahead, with continuing geopolitical tensions as a result of the war in Ukraine, soaring energy prices, rising rates, and recessionary risks.

Chart 3

### U.K. Investment Grade Bond Prices Down 30% This Year...

Rebased Clean Price, Dec. 31, 2021 = 100

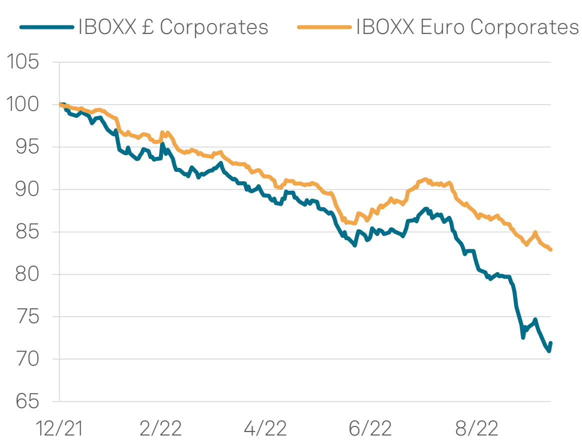
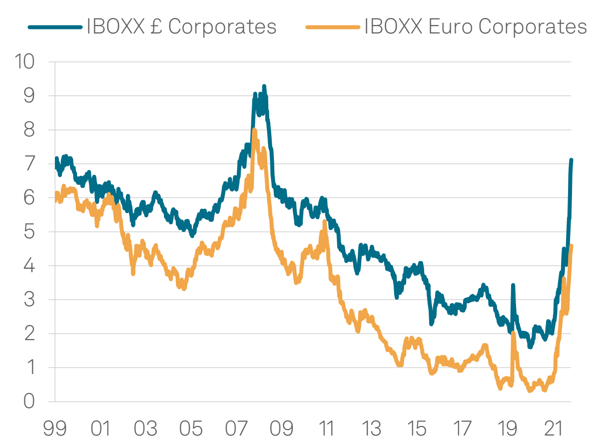



Chart 4

### ...And Yields Have Risen Above 7%

Annual Yield



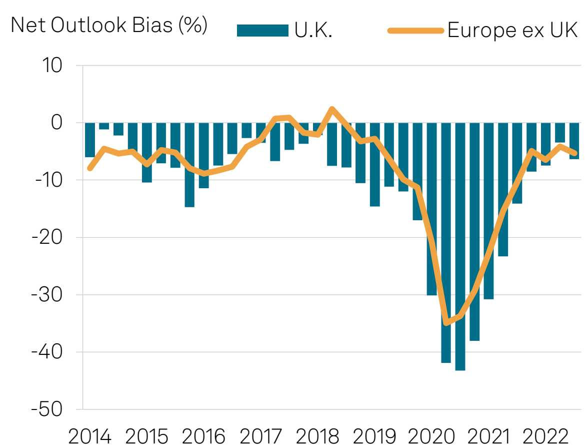

Source: S&P Global Market Intelligence, Refinitiv, S&P Global Ratings. Data to close Oct. 13, 2022.

## U.K. corporate ratings are at an inflection point

**Future rating indicators suggest U.K. nonfinancial rating trends have reached an inflection point.** The net outlook bias--which indicates the likely direction of future net rating actions--turned lower in the third quarter, bringing a sustained period of pandemic-era recovery to an end (see chart 5). As of end-September, 14% of U.K. nonfinancial corporate ratings have a negative outlook versus 7% with a positive outlook (see chart 6).

Chart 5

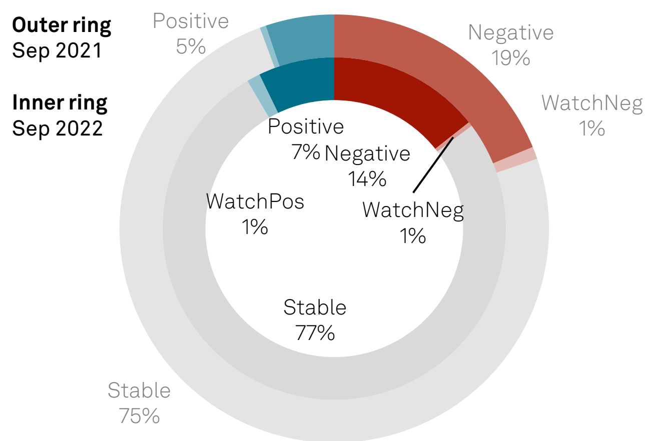
### U.K. Nonfinancial Corporate Net Outlook Bias Trend




Source: S&P Global Ratings. Data as of end-quarter through Sep. 2022

Chart 6

### U.K. Nonfinancial Corporate Ratings Outlook Distribution



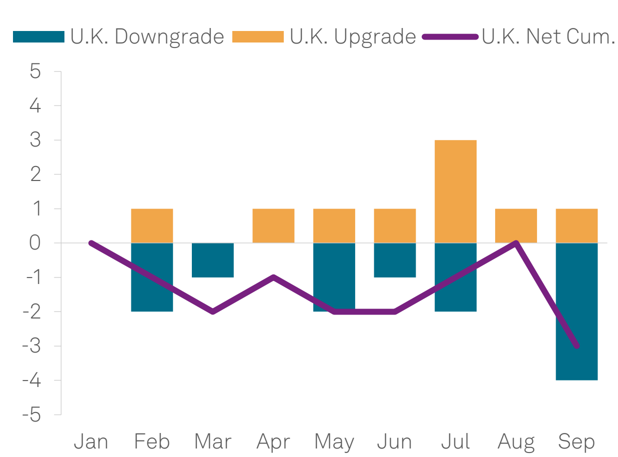

Source: S&P Global Ratings Data as of end-quarter.

**Cumulative net rating actions on U.K. issuers have been more negative than those on eurozone issuers** (see charts 7 and 8), but not by much--with a total of three negative for the U.K., versus 14 positive for the eurozone. Closer inspection of those results reveals that downward rating pressures in the U.K. during the third quarter matched those in the eurozone, with consumer discretionary sectors, including consumer products and media and entertainment, responsible for the largest number of downgrades in both regions.

Chart 7

### Net Downgrades In The U.K

U.K. Nonfinancial Corporate Ratings Actions

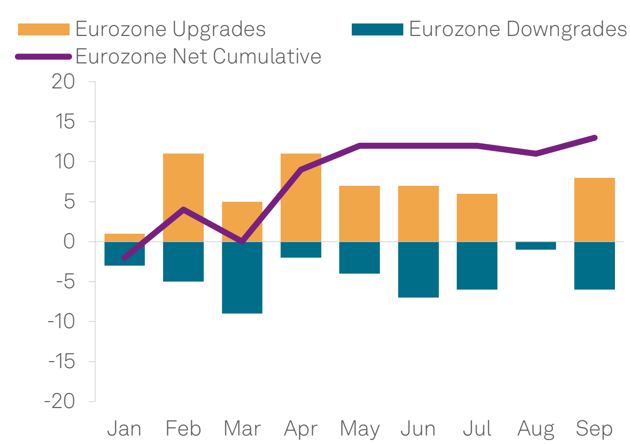



Source: S&P Global Ratings Credit Research & Insights. S&P Global rated nonfinancial corporate issuers. Data through September 30, 2022

Chart 8

### Net Upgrades In The Eurozone

Eurozone Nonfinancial Corporate Ratings Actions




Source: S&P Global Ratings Credit Research & Insights. S&P Global rated nonfinancial corporate issuers. Data through September 30, 2022

## Consumer-linked sectors are particularly vulnerable

**Domestically focused consumer-facing sectors face a particularly difficult operating environment,** with cost-of-living challenges eroding household disposable incomes and sentiment. Contributing factors include soaring energy bills (see chart 9), falling real wages, and rising mortgage payments (see chart 10). This is in conjunction with the febrile domestic political environment--with two years left before the next election--and broader tensions surrounding the war in Ukraine. This has led to a key measure of U.K. consumer sentiment falling to its lowest recorded reading since the survey began in 1974 (see chart 11).

Chart 9

### Heating-Gas Price Inflation

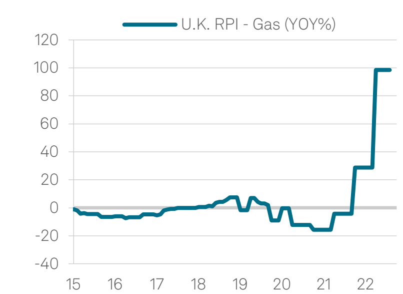



Chart 10

### Real Earnings and Mortgage Rates

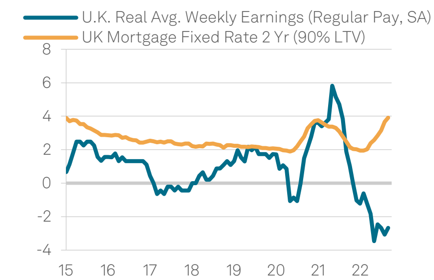
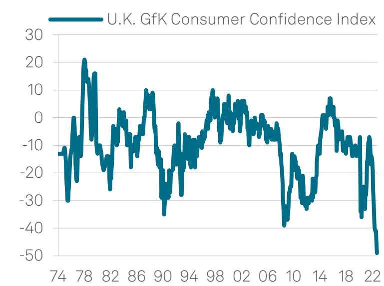



Chart 11

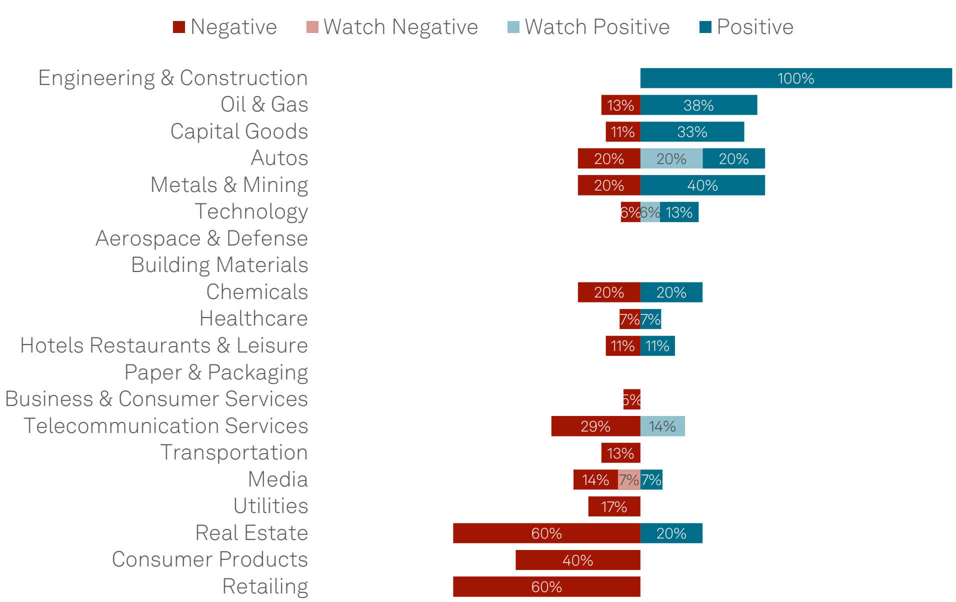
### Consumer Confidence




Source: ONS, Bank of England, GfK, Refinitiv, S&P Global Ratings. RPI, mortgage and earnings data to Aug. 2022. Confidence data to Sep. 2022.

Chart 12

### U.K. Ratings Outlook Distribution By Industry



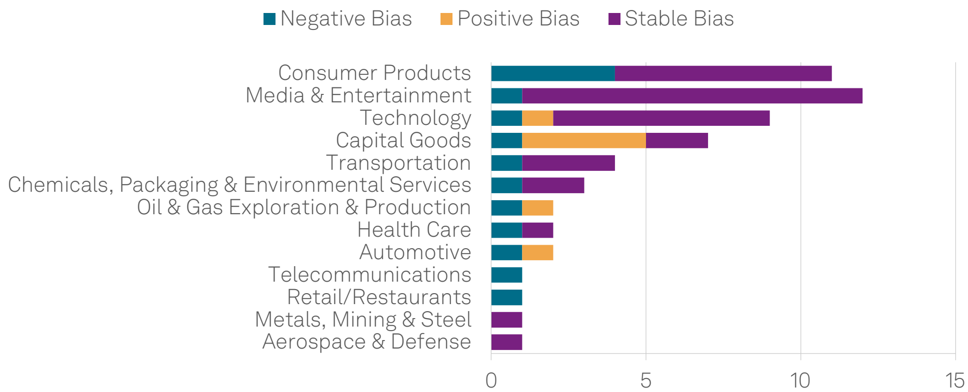

Source: S&P Global Ratings. Data as of end-September 2022.

**The pressure on consumers is reflected in industry net outlook biases**, with retailing and consumer products both with a substantial proportion of entity ratings on a negative outlook (see chart 12). Industrial export-focused sectors (engineering, oil and gas, capital goods, autos, and mining) are the most heavily represented at the other end of the spectrum, with the most positive net outlook biases. Consumer-exposed sectors, such as consumer products or media and entertainment, account for 35% of U.K. nonfinancial corporate speculative-grade issuers.

**The consumer products sector also has the highest number of weakest links** (issuers rated 'B-' and lower with a negative outlook or CreditWatch negative). The sector is one of the most exposed to the inflationary pressures that are eroding consumers' purchasing power. For now, the 'B-' and below rating group in the U.K. is stable, with limited negative outlooks or CreditWatch placements (see chart 13). However, the economy's forecast contraction and the expectation that inflation will remain elevated is likely to put pressure on operating results.

Chart 13

## Consumer Sector Leads With Highest Weakest Link Exposure

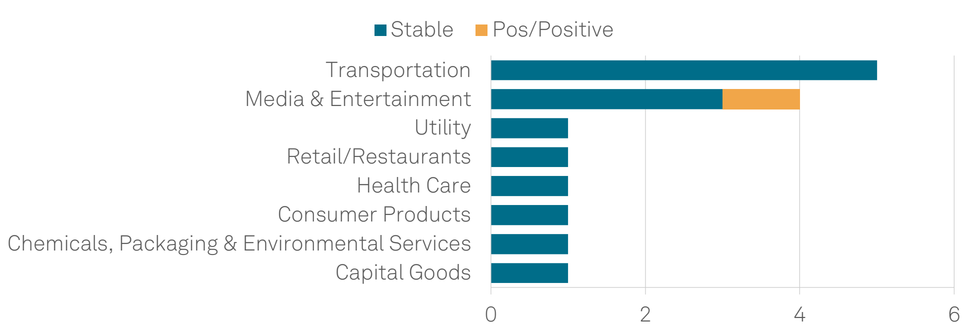



Source: S&P Global Ratings Credit Research & Insights. Note: Includes nonfinancial corporate issuers with either a negative, stable, or positive outlook or CreditWatch. Data through September 30, 2022

**Transportation is the most exposed to fallen angel risk** (see chart 14). That threat had receded with the robust recovery in demand following the pandemic, which supported strong credit metrics for most investment-grade U.K. transportation issuers. However, the sector still has the highest number of issuers rated 'BBB-' and exposed to categorization as potential fallen angels--issuers rated 'BBB-' with a negative outlook or CreditWatch, which leaves them one step away from a downgrade to speculative grade. The slump in consumer confidence and pressure on household budgets may trigger a sharp drop in demand for leisure or consumers' willingness to pay higher ticket prices, both of which could materially degrade the performance of some transportation-sector issuers.

Chart 14

## Transportation Leads With Highest 'BBB-' Exposure

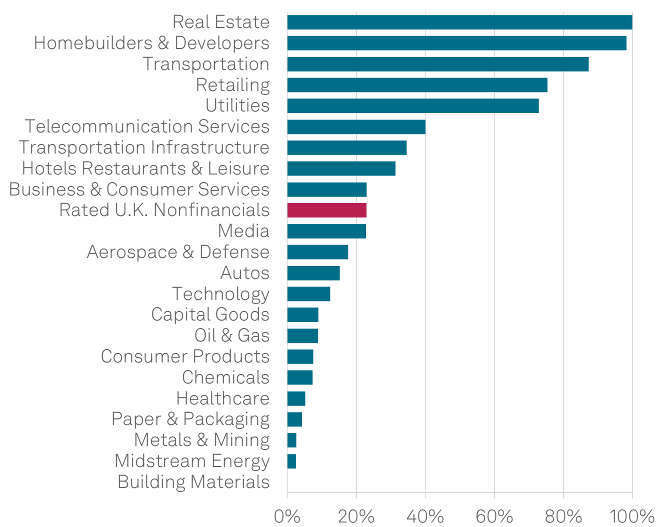



Source: S&P Global Ratings Credit Research & Insights. Note: Includes nonfinancial corporate issuers with either a negative, stable, or positive outlook or CreditWatch. Data through September 30, 2022.

## Multinational sales offset much domestic weakness

Chart 15

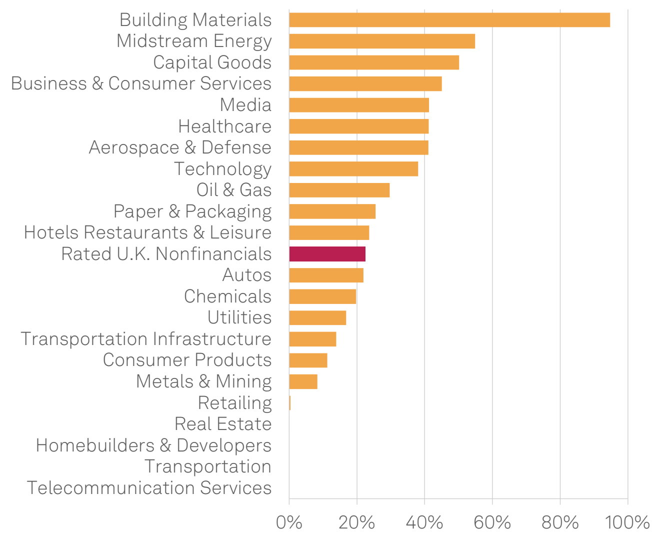
### S&P Global Rated U.K. Nonfinancial Corporates – Percentage Of Revenues From U.K.




Source: S&P Capital IQ, S&P Global Ratings. Last fiscal year where available.

Chart 16

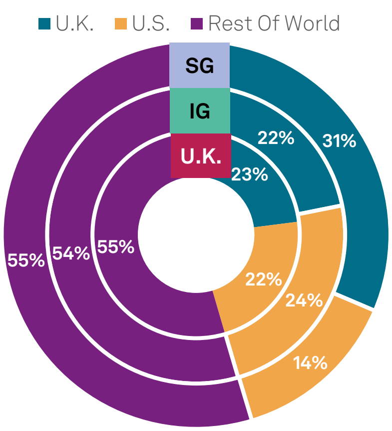
### S&P Global Rated U.K. Nonfinancial Corporates – Percentage Of Revenues From U.S.




Source: S&P Capital IQ, S&P Global Ratings. Last fiscal year where available.

Chart 17

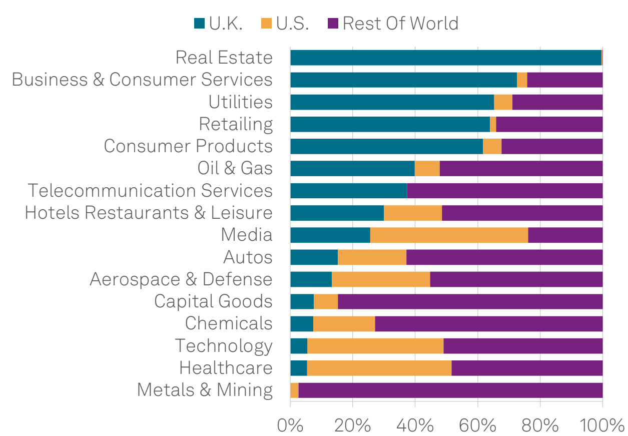
### S&P Global Rated U.K. Nonfinancial Corporates: Geographic Source Of Revenues By Rating Category




Source: S&P Capital IQ, S&P Global Ratings. Last fiscal year where available.

Chart 18

### S&P Global Speculative Grade Rated U.K. Nonfinancial Corporates: Geographic Source Of Revenues




Source: S&P Capital IQ, S&P Global Ratings. Last fiscal year where available.

**The companies we rate derive most of their revenues from outside the U.K.,** and this is an important counterbalance to domestic economic woes. For the rated portfolio as a whole, only 23% of revenues come from the U.K., and only five out of 23 sectors earn more than 60% of their sales in the domestic market (see chart 15). The U.S. is the largest nondomestic market, and our rated companies derive almost the same share of their revenues from there as from the U.K. (see chart 16 for the split by industry). This high level of international exposure is not confined to investment-grade companies; speculative-grade companies have a larger domestic share of revenues in aggregate (31%), but again, this is concentrated in a small number of sectors (see charts 17 and 18).

**These geographical revenue exposures limit the relationship between U.K. economic performance and credit prospects for entities rated by S&P Global Ratings**. In the current environment of a consumer-led U.K. economic slowdown and sterling weakness, entities with significant domestic-consumer-linked revenue exposure and non-sterling costs are least well placed. Sectors particularly exposed are homebuilders, transportation, retailing, and utilities. Even when sales are largely nondomestic, the relative currency structure of costs, debt, revenues, and hedging strategies is a critical overlay to the geographical source of sales.

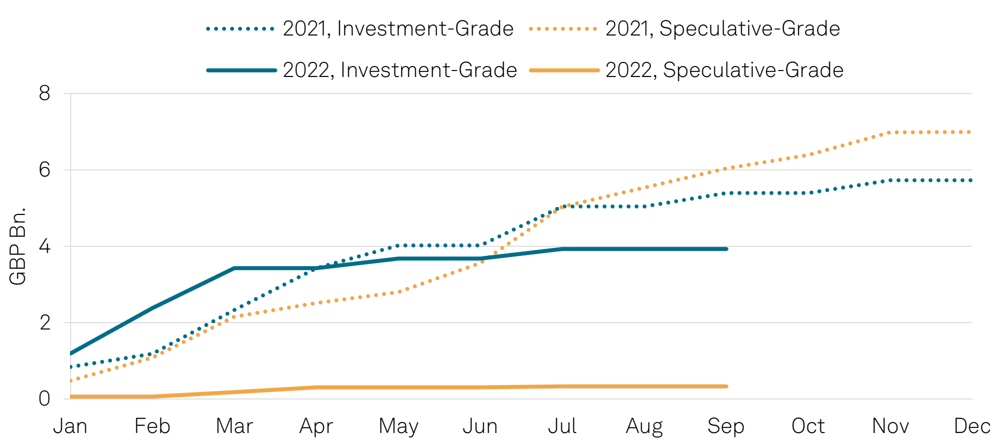
## Refinancing pressures are limited for now, but risks are growing

**U.K. debt-market volatility is making a difficult financing environment worse**, **as debt becomes more expensive and less accessible.** Underlying borrowing costs are rising quickly and will likely continue to do so while the BoE continues to raise rates. Credit risk premium is also rising as investors reassess global and U.K. credit risk in the light of recent developments. In line with global trends, sterling-denominated issuance has fallen in 2022, but, in contrast to global markets, has largely dried up, even for investment-grade issuers, since the first quarter. Speculative-grade sterling markets are effectively shut, squeezing access to new financing and refinancing, particularly for lower-rated issuers (see chart 19). **Does this imply an imminent debt funding crisis for U.K. corporates? In our view, not yet, but risks are growing.** While access to capital markets will remain difficult, bank financing is unlikely take up the slack. The BoE's Credit Conditions Survey for the third quarter highlighted a decline in expected credit availability, and the fourth quarter is likely to see this trend continue. We may see both increased utilizations of existing revolving credit facilities and tightened supply of new facilities.

Chart 19

### Speculative-Grade Issuance in The U.K. Has Flatlined So Far In 2022

U.K. Cumulative Corporate Bond Issuance Issued In GBP

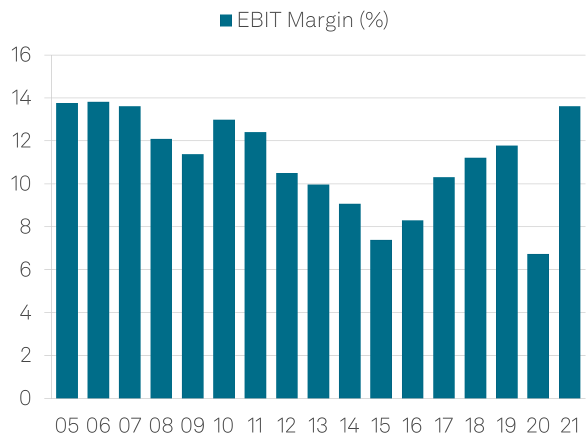



Source: Refinitiv, S&P Global Ratings Credit Research & Insights. Note: Includes nonfinancial corporate bond issuance issued by United Kingdom-based issuers in GBP. Data through September 30, 2022.

**The strong starting financial and operating positions of many corporates is a mitigating factor.** Aggregate profit margins for our rated U.K. nonfinancial corporates soared back to near record levels last year (see chart 20) and continued to remain resilient through first-half results. We expect some deterioration going forward, but this is likely to be focused on the vulnerable consumer sectors. Cash balances also remain relatively high, bolstered by cheap pandemic-era financing (see chart 21). We also project that U.K. credit metrics will continue their post-pandemic recovery (see charts 22 and 23), although median leverage remains above that of rated companies in Europe excluding the U.K., and median interest cover weaker.

Chart 20

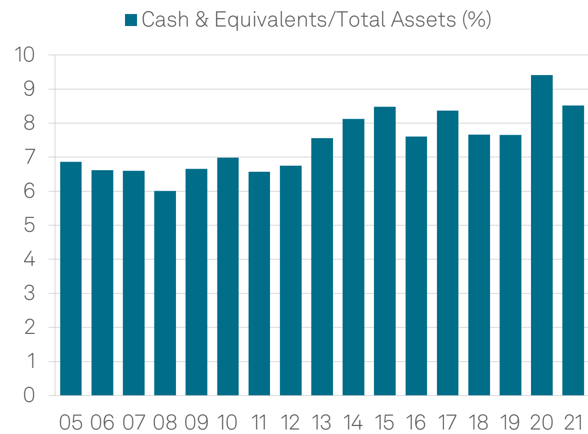
### Profit Margins Have Recovered Strongly




Source: S&P Capital IQ, S&P Global Ratings.

Chart 21

### Cash Balances Remain Elevated

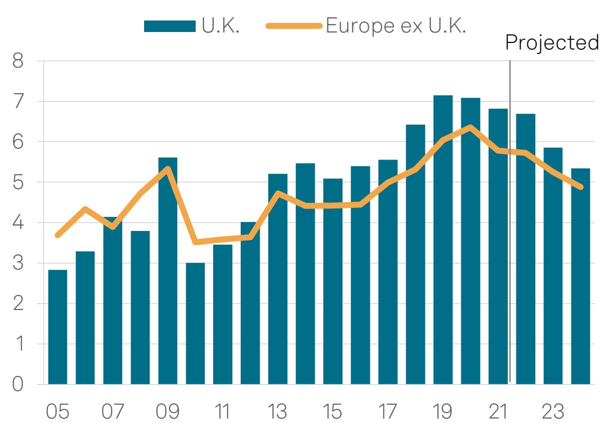



Source: S&P Capital IQ, S&P Global Ratings.

Chart 22

### Nonfinancial Speculative Grade Debt/EBITDA

Median (x)

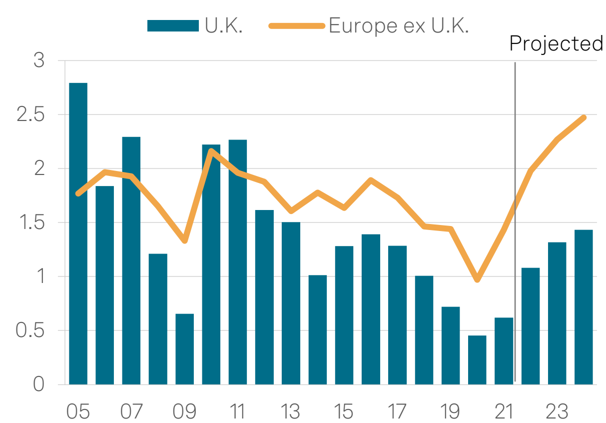



Source: S&P Global Ratings

Chart 23

### Nonfinancial Speculative Grade EBIT Interest Cover

Median (x)




Source: S&P Global Ratings

**Refinancing demands largely appear manageable through 2023**, after companies extended maturity walls during easier financing conditions. We estimate, as of July 1, that $96.3 billion in U.K. rated debt is scheduled to mature through 2023, representing just 10% of total debt outstanding (see chart 24). Of this, only 20% is speculative grade. That said, although lower ratings account for a smaller share of maturities, difficult financing conditions may make that financing challenging, particularly if U.K. risk premiums remain elevated. Furthermore, the sector with the largest volume of maturities through 2023 is the consumer products sector (see chart 25).

Chart 24

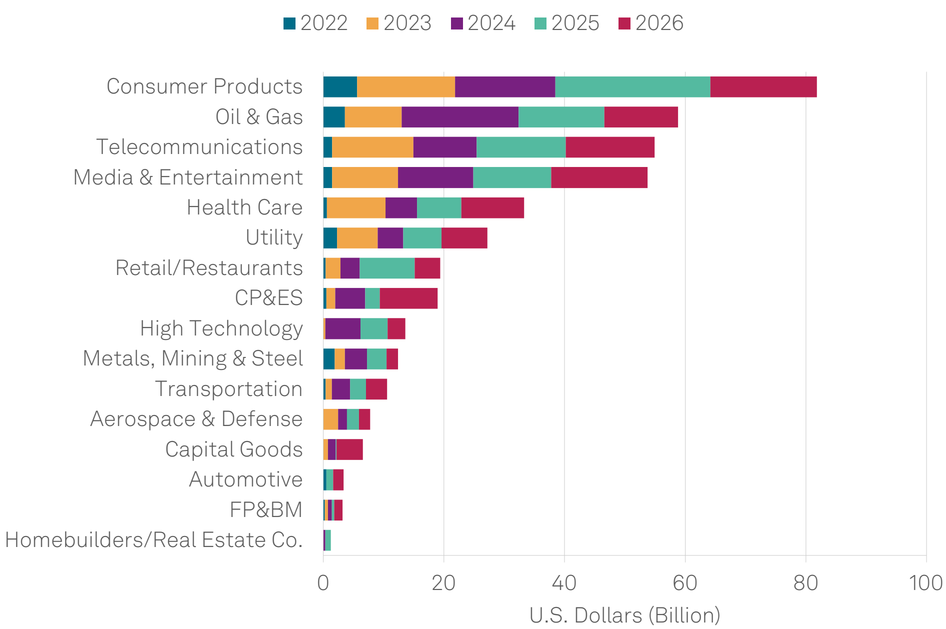
### U.K. Nonfinancial Maturities: Manageable Near-Term But Ramp-Up In Later Years

| Debt maturing in the next: | 18 months | Three years | Five years |
|---|---|---|---|
| **Total debt maturing** | $96.3 bil. | $260.9 bil. | $456.7 bil. |
| Percent of total debt | 10% | 28% | 49% |
| Speculative-grade share | 20% | 35% | 44% |
| Amount rated 'B-' and lower | $5.7 bil. | $35.2 bil. | $66.1 bil. |

Source: S&P Global Ratings Credit Research & Insights. Data as of July 1, 2022. Includes bonds, loans, and revolving credit facilities that are rated by S&P Global Ratings from U.K. nonfinancial companies.

Chart 25

### The Consumer Products Sector Leads U.K. Corporate Maturities Through 2026

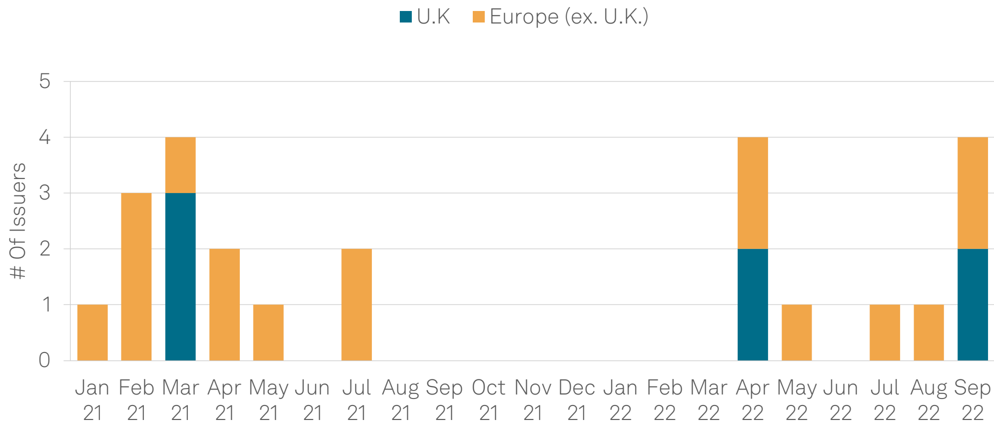



Source: S&P Global Ratings Credit Research & Insights. CP&ES--Chemicals, packaging, and environmental services. FP&BM--Forest products and building materials. Media and entertainment includes the leisure sector. Includes bonds, loans, and revolving credit facilities that are rated by S&P Global Ratings from U.K. nonfinancial companies. Data as of July 1, 2022

**The U.K. has accounted for one-third of all defaults in Europe over 2022** (see chart 26). Most defaults in the U.K. this year have been in the media and entertainment sector, and all but one has been in the form of a distressed exchange. We expect this trend to continue as we forecast that the European 12-month trailing speculative-grade default rate will increase to 3% by June 2023, from 0.9% as of September 2022.

Chart 26

U.K. Accounts For One-Third Of 2022 European Defaults Through September




Source: S&P Global Ratings Credit Research & Insights. Note: Data through September 30, 2022

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- Default, Transition, and Recovery: The European Speculative-Grade Corporate Default Rate Could Rise To 3% By June 2023, Aug. 22, 2022
- European Corporate Credit Outlook Midyear 2022: Lights Dimming, July 28, 2022
- Industry Top Trends Midyear 2022: Relapse, Recession, Resilience, July 25, 2022
- Recession Risk And Ratings: What Recession Could Mean For European Speculative Grade Nonfinancial Corporates, June 23, 2022