Press Release

Euler Hermes: UK economy - the calm before the storm

- *Prolonged uncertainty set to trigger 'bouts of nervousness' in H1 2017*
- *Sterling expected to reach parity with the Euro in 2018, pressuring corporate profits*
- *A 30% increase in 'pending' M&A transactions in last 12 months delays inward investment*
- *After 16 consecutive quarters of declines, Euler Hermes identifies tipping point and an increase in insolvencies for the next three years*

LONDON - 13 OCTOBER 2016 – The resilience of the UK economy following the EU referendum is masking longer term issues that are set to hinder GDP growth, corporate profitability and exacerbate late payment and insolvency issues once Article 50 is triggered, according to Euler Hermes, the worldwide leader in trade credit insurance. It has also identified the second quarter of 2016 as the tipping point at which UK corporate insolvencies started to increase, following 16 consecutive quarters (year on year) of decline.

The immediate risk of recession was delayed by the rapid appointment of the new Prime Minister and effective use of monetary policy. However, future growth prospects and UK attractiveness to future overseas investment are already depressed by uncertainty about the Brexit process.

"This looks like the calm before the storm, should political guidelines to the private sector remain unclear," said Valerio Perinelli, CEO of Euler Hermes UK and Ireland. "Investment is driven by confidence, and uncertainty is the enemy of confidence. The economy should remain relatively resilient until a formal exit from the EU in 2019, assuming Article 50 is invoked in March 2017.

He added: "But businesses need to plan ahead for future risks and understand how Brexit might impact them. Treading water on important decisions now for investment-heavy sectors such as, aeronautics, construction, equipment and metals, and IT machinery means reduced future output and fewer jobs. Currency-heavy sectors such as autos, chemicals and paper are already feeling the impact of higher input costs."

The investment benefits of M&A have declined, given a 30 percent increase in 'on hold" deals in the last 12 months. Many companies are waiting for formal EU exit talks to start before adjusting their current labour force planning and investment plans.

The depreciation in sterling will continue to exacerbate corporate issues as a high proportion of components for a range of UK manufactured-products need to be imported -- leading to upward pressure on costs and prices, and mitigating any benefits for exporters. The problem looks set to get worse: Euler Hermes is predicting sterling will collapse to parity with the euro in 2018.

The resulting squeeze on cash flow and profits is likely to worsen payment behavior, as companies try to preserve working capital by extending payment terms and deadlines as sterling depreciates and domestic activity slows.

This is already evident in several sectors: severity of past dues increased for paper (+42% in 2Q16), services (+38% in 2Q16), construction (+37% in 2Q16), and textiles (+34%), compared to an increase in the average severity for all UK sectors of +4%. However, other sectors such as retail (-28% in 2Q16), transport (-27% in 2Q16) and food (-11% in 2Q16) are faring better.

The impact of late payment on UK business failures will be doubly felt in a 'hard leave' Brexit scenario. The UK is anticipated to experience 20,000 insolvencies in 2016, similar to 2015 (+1%). This will jump to 21,800 in 2017 (+8%) and to 23,100 in 2018 (+6%), mainly due to uncertainty surrounding Brexit. For 2019, Euler Hermes predicts a further increase to 25,170 (+9%) insolvencies in a 'soft leave' scenario and 26,570 (+15%) in a 'hard leave' scenario. The increase in failed businesses will feed into reduced confidence and a slowdown in domestic demand.

Ludovic Subran, chief economist at Euler Hermes, said: "The surprising resilience of the UK economy today is masking underlying issues, such as the decline in non-financial sector profitability since 2015, highly leveraged sectors and companies which are particularly vulnerable to external shocks, corporate late payment and insolvency issues, and over-indebtedness amongst consumers. Uncertainty in the lead-up to the UK's exit from the EU will only add to these growing problems."

Euler Hermes expects these negative impacts to play a bigger role from 2017 onwards. The firm has lowered its 2017 UK GDP forecast to +0.7% (+1.0% previously), and anticipates further bouts of corporate nervousness next year once the Brexit process starts.

	2017		2018		2019		
	Stay	*Leave*	*Stay*	*Leave*	*Stay*	*Soft Leave -* exit with a FTA	*Hard Leave -* exit w.o. a FTA
Real GDP growth	1.8%	**0.7%**	1.7%	**1.0%**	1.7%	**0.2%**	**-1.3%**
Nominal GDP growth	3.3%	**3.2%**	3.3%	**3.0%**	3.2%	**2.5%**	**1.2%**
Goods export gains (GBPbn)	35	**30**	25	**18**	20	**-9**	**-30**
Services export gains (GBPbn)	10	**6**	12	**3**	14	**-5**	**-11**
GBP trend	Stable	**~5% depreciation**	> 5% appreciation	**~2% depreciation**	> 5% appreciation	**> 10% depreciation**	**> 20% depreciation**
Net investment from abroad (GBPbn)	> 50	**< 10**	> 50	**< 10**	> 50	**-60**	**-210**
Firms' turnover (annual growth)	3.5%	**2.0%**	4.0%	**1.0%**	4.0%	**1.2%**	**-1.0%**
Firms' margins (pp)	0.5	**-1.0**	1.0	**-1.5**	1.0	**-1.0**	**-2.0**
Business insolvencies	3.0%	**8.5%**	1.0%	**6.0%**	0.0%	**9.0%**	**15.0%**

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