Regional Insight 2018
Are investors backing the UK?

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Welcome from Aon

On Thursday 4 October, we welcomed guests to Villa Park Stadium to hear expert insights into the economic and political environment and to address the question 'are investors backing the UK?'. We were delighted to have an expert panel including Declan Curry, Expert Journalist, Simon Rockett, Senior Manager for Risk Services at Atradius, David Slater, Director of Trade at KPMG and Aaron Bailey, Client Director at Aon. A huge thank you for their thought provoking and relevant insights.

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The UK economy: the good, the bad and the Brexit

*The story of today's UK's economy is mixed. That was the opening message from financial journalist and broadcaster **Declan Curry** who, in opening Aon's Regional Insights 2018 conference in Birmingham, told delegates: "Growth is mediocre and we're falling behind a number of our major international competitors."*

The good news is, Curry added: "People are feeling a bit richer; wages are finally rising slightly higher than costs; confidence is positive...and we continue to create more new jobs as the number of people in work hits a new fresh high almost every month." He went on to say that the news on the high street isn't uniformally grim either, particularly for those retailers who have managed to make a success of their online operations.

Beware the global risks

"There are though a number of global risks that could dampen our economic activity and reduce trade here and abroad," warned Curry. These global events include recent currency fluctuations in countries like Turkey and South Africa. "When we look at these emerging market crises of today, we remember the lessons from the European debt crisis at the start of this decade and how problems at the edge soon become a problem for the well-established economies in the middle." Other risks include the slow down of China's economy, rising oil prices, a sweeping tide of populism, nationalism and extremism, as well as the global ramifications from Trump's US trade policy. "There is a growing chorus of American businesses warning that they are being harmed by President Trump's trade war with China," said Curry.

Brexit uncertainty

Underpinning all this, added Curry, is Brexit which continues to be a source of uncertainty for UK businesses. "We have no idea what Brexit will look like for business and what it might cost, and what opportunities it might open up for the future. We are told that the Brexit deal is 80% done, but all of us in business know that it's the last 20% that takes up all of the time."

Insolvencies and credit insurance: an update on the UK market

*As the UK came out of recession – following five quarters of contracted growth – the expectation would have been for the number of insolvencies to rise. "That didn't happen due to a number of reasons," said **Simon Rockett** – Senior Manager for Risks Services at credit insurer Atradius. "The UK was far more resilient than expected, with vulnerable businesses helped by HMRC's Time to Pay scheme and also low interest rates."*

Today, the underlying position of insolvency trends shows that in the first quarter of 2018 there was a rise of 12%, while in the second quarter there has been a slight improvement. "It's not so much the volume of businesses failing that is a concern – which is still at quite a low level – but the large businesses that are failing quite regularly," said Rockett. One of the reasons are the increasing costs that businesses are unable to pass on to their customer base. The Producer Price Index for example, which reflects the inflation that manufacturers are seeing in the UK, is running at 10% – far higher than the consumer price inflation rate.

Retail insolvency levels are however better than many would expect. In 2008 and 2012 there were significant peaks but 2018 hasn't reached those levels which Rockett attributes to the company voluntary arrangement (CVA) process. "If it wasn't for CVAs, suppliers would have lost out on a lot more over the last six to nine months."

Exposure in the trade credit market

What exposure is Atradius seeing in the trade credit market? In 2018, the construction industry has so far had the most claims payments at 34% with Carillion representing the highest profile casualty. Construction is always a main contributor to trade credit losses said Rockett, pointing out that potential failures can be quite difficult to spot. "Construction company Lakesmere Group failed in 2017 and, while it looked good as a business, it had a couple of loss-making contracts and failed quite quickly." Other potential weaknesses for businesses across all sectors revealed by recent insolvencies include those companies which were once part of larger, safer groups, being sold off or seen as non-core by their parent, while Atradius has seen at least one business fail as a direct result of the depreciation of sterling.

The torpedo business

Too big to fail? Not so said Rockett who highlighted the example of groceries wholesaler Palmer & Harvey. "However big a business is; however much disruption its failure would cause to that marketplace; companies are not too big to fail. Overall, the last 12 months have been the most difficult for myself and the risk underwriting team – even more so than in 2008-2009. And the big problem we are seeing are those large businesses that are failing quite quickly – or what we call the torpedoes because they are so difficult to spot." Many of them are decent businesses too, Rockett said, that have had one or two problematic contracts but have suffered from a lack of emergency banking facilities so when something goes wrong, cash flow has quickly dried up.

The fall of the zombie companies

Looking ahead, with GDP growth in the UK forecast to be near the lowest amongst the developed economies, Rockett underlined that the difficult sectors will continue to be retail and construction and, as the interest rate environment trends upwards, there will be more insolvencies particularly amongst those 'zombie companies' susceptible to rising borrowing costs.

Are overseas investors backing the UK?

Although the number of foreign direct investment (FDI) projects has been on a slight downward trend in the last five years, ***David Slater*** *– now a Director of Trade for KPMG and a former diplomat for the British Government, including a spell heading up the UK's relations with the EU Institutions – stressed that FDI continues to be big business globally with the UK still a top destination.*

With something like 13,500 individual projects underway, FDI represents a £580bn global business but one that is hugely competitive. "There is a lot of money floating around the world, looking for somewhere to invest and the UK is in competition with every other country in Europe and in the world. And every region in the UK is in competition with every other individual region. It's a very competitive business," said Slater.

UK remains a key foreign investment target

For the UK, the country is still a top destination for FDI in Europe and is second only to the US in global terms. A challenge however is the London centric nature of investment into the UK, with London attracting 41% of all FDI projects. Scotland is the second highest at 11% which, said Slater, reflects its level of devolved power and how it has been able to make itself more attractive to foreign investment. With the South East (minus London) on 9% and the West Midlands next highest at just 7%, Slater asked: "How do you make sure the rest of the country is able to play in this space?"

The UK sectors attracting most FDI are software and IT, business services and financial services which together, attracted 47% of all FDI projects leading Slater to sound a note of caution: "The service industries are easiest to attract and, of course – in terms of Brexit – they are harder to retain because they can up and they can go."

What is it though that drives investment in a market? Investors look for the size of the market they're entering; the growth potential; the available skills; and then issues like the business environment such as regulation and taxation. For the UK, a skilled workforce stands out as a reason for investment. A point reinforced by Slater: "Over the last five years, most companies ask me about skills availability before they ask me about the market."

Brexit impact

Given these key factors Slater made it clear that, to varying levels, Brexit will have an impact. "I used to sell the UK for years when working for government on the fact that the country is the gateway to the European market. Come to the UK and trade with a market of 65 people and a European market of 500 million people." This opportunity is not so clear cut when a deal about the nature of the future trading relationship has not been agreed. He also added that on the skills side, the 'rhetoric' around Britain no longer being a "friendly place for foreigners" is not helpful. However it has to be recognised that since the EU Referendum large global technology companies such as Apple, Facebook, Amazon, Spotify etc have committed to substantial investments in the UK.

To counter any possible fall off in the UK's attractiveness for FDI, Slater underlined the importance of exploiting each region's unique offering. "We need to make sure that every region is competitive and builds on its strengths. And that it can communicate those strengths around the world whether that's through a figurehead like the local mayor, or through government. The UK's industrial strategy has to work regionally and that means local politicians making sure that whatever polices they have got are thinking about the unique competitiveness of their region. It's why I like the Midlands Engine because the Midlands as a whole is more competitive if you're sat in Shanghai than if you're talking about Birmingham on its own." It's also important that all regions of the UK lever the global appeal of London. "London is an asset for the UK and a magnet for foreign investment."

Remaining cautiously optimistic

Despite the headwinds and the uncertainty surrounding Brexit, Slater said he was cautiously optimistic about levels of future FDI into the UK. "The figures are holding up. We're not seeing a wholescale outflow of FDI and departure from the UK. We can still be proactive and confident about why the UK is a good place in which to invest and to build a business."

Structured and capital solutions: how to unlock working capital

*Delivering an overview of how Aon is helping businesses unlock working capital, **Aaron Bailey** – Client Director, Aon's Credit Solutions, introduced Aon's Working Capital methodology which he described as being about "balance sheet optimisation"; covering four key areas of trade payables; trade receivables; guarantees; and pensions and investments.*

Improve payment terms and cash flow

For trade payables, Bailey explained that there are ways in which corporates can improve their supplier payment terms and cash flow. "How can we utilise available credit insurance capacity on our clients' to facilitate better payment terms from their suppliers, or to underpin a supply chain finance facility?" Using credit insurance for example, businesses can improve supplier payment terms by up to 120 days. "More of our clients are looking for short term liquidity," said Bailey, "and this is where we're seeing our role as a credit insurance broker or intermediary really evolving from just looking at credit insurance, to bridging the gap between our financial institution clients and the corporates who are looking for the capital."

Credit insurance can also be used to underpin a supply chain finance facility which allows clients to extend their Days Payables Outstanding, whilst accelerating payments to suppliers. Bailey also pointed out that such solutions can be implemented on an unsecured basis, meaning that the facility doesn't sit as additional debt on the balance sheet.

More than just covering bad debts

Turning to trade receivables, Bailey explained that the use of credit insurance can be more than just covering bad debts, asking the question: "How can we help our clients access cheaper finance by using an insurer's balance sheet?" Giving the example of an automotive manufacturer who had announced a strategy to increase its range of cars, Bailey outlined how Aon partnered with a bank to provide the manufacturer with a £150m account receivable finance facility which allowed them to offer their distributors and retailers up to 360-day payment terms, with a credit insurance wrap allowing them to access that finance at a more competitive rate. "It goes beyond risk mitigation," said Bailey, "it's about credit enhancement."

Finding an unsecured alternative

The third element of Aon's Working Capital 360 model is Surety Bonds and Guarantees, where Aon looks to replace traditional letters of credit/guarantees with an unsecured alternative. "If you have a £100m facility supporting trade and need to issue bank guarantees, this could potentially restrict a company's access to working capital by a sum equivalent to that of the bank guarantees," said Bailey. "We look to replace that with an unsecured alternative to free up working capital." In one example, Aon worked with a UK corporate involved in the acquisition of a competitor business. The acquirer had paid £50m at the close of the deal with a further £30m deferred for a period of three years. "The seller requested a bank guarantee from the buyer for the £30m, which in turn would then have restricted the buyer's access to liquidity by that amount. We replaced the £30m bank guarantee with a deferred consideration bond issued by an investment grade insurer. The seller received an investment grade security, while the buyer was able to use the otherwise collateralised or ring fenced £30m to invest in other areas of the business" said Bailey

Reducing annual pension contributions

The final part of the Working Capital 360 model is around pensions and investments, this could be using a credit or surety solution to support defined benefit pension scheme payment plans, or securing our clients overseas investments through the use of Political Risk insurance. Bailey provided an example of how a UK corporate with a defined benefit pension scheme could reduce payments to the scheme; "following a triennial assessment of the scheme, the actuary calculates a £30m deficit. A plan is agreed whereby the employer pays £10m per year. At the next appraisal the actuary calculates a £30m deficit, which means that the business has effectively paid £30m to remain constant. So trustees can seek additional support to help plug the gap."We can look to use the insurance market to support this payment plan with a surety solution," concluded Bailey, "this could enable the company to reduce their annual contribution to the fund and also to spread out the contributions to make it less capitally intensive."

Plugging the productivity gap

Wrapping up the conference, ***Declan Curry*** *drew delegates' attention to the issue of productivity and how the UK, as a nation, needs to improve. "For a considerable period of time, we have been less productive than our competitors. We deliver far less than the Americans, French and the Germans." While pointing out that productivity has improved in recent months – the latest figures showed an increase of 1.5% over the year – Curry asked, "Why are we less productive than other nations?"*

Even though workers in the UK put in some of the longest working hours in Europe, there are fundamental flaws in the UK economy which are driving down productivity. "To fix those flaws," said Curry, "we need to invest more in infrastructure, technology and skills. This investment needs to be from government and businesses, and we have an individual responsibility to keep our skills up to date."

Take a risk

In addition, Curry said, business owners and managers need to take more risks in areas such as exporting. And doing nothing is not a risk-free strategy either. "There is a risk for instance in not exporting and putting all your eggs into the domestic basket." Businesses also need to work smarter; be more imaginative; and more collaborative, whether that's within their own organisation or with partners outside their business. Their processes and systems also need to be at world class standards. "The CBI estimates that if there was a more widespread use of existing technology, the UK could add another £100bn to its economy," said Curry.

New technology will also help drive productivity through the use of automation and robotics, while industries are already increasing their use of virtual reality and artificial intelligence into existing work practices. Businesses can't rely on the status quo added Curry: "Companies need to think beyond their usual horizons and recognise that the competitive threat is not necessarily from their same old rivals but that it can come from disruptors outside their sector."

The fourth industrial revolution

Curry reaffirmed the positive role that businesses will play in the future of the UK as they "adapt, adopt, seek out opportunity, and create jobs and wealth for the nation," particularly given the UK's leading global role in the rush of new technology in areas such as block chain and nano-technology. "The fourth industrial revolution is here and it is happening now," concluded Curry, adding that we should be optimistic about the opportunities that these new technologies present.

Speakers

From left to right:
Bhav Chandegra, Simon Rockett, David Slater, Declan Curry and Aaron Bailey

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

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