PROFIT WATCH UK

August 2019

UK PLC POSTS WEAKEST PERFORMANCE IN THREE YEARS AS ECONOMIC SLOWDOWN TAKES ITS TOLL

- UK plc revenues inched ahead 1.6% in Q2, sustained only by the weaker pound; one-third of companies reported lower sales
- Profits rose 3.1%, but only because the top 40 super-league of multinationals pulled ahead of the rest
- Those outside the top 40 saw profits drop by a third, the fifth consecutive quarter of declines

METHODOLOGY

The Profit Watch UK analyses the latest quarterly and half-yearly results published by all the UK companies listed on the UK main market, excluding investment funds. In order to easily measure the progress UK plc is making we add each new set of results to those reported in the previous three quarters: this creates a full annualised set of figures allowing us to see the true trends clearly. The raw data is supplied by Factset. The Share Centre aggregates the results to consider the collective performance of UK plc. In addition, it analyses consensus analyst forecasts also provided by Factset for each stock (where available), and calculates consensus profit growth.

The Profit Watch UK report comprises detailed, stock-level data for quarterly and semi-annual results back to 2013. To calculate the profit index back to 2007, we used annual earnings data from its original Profit Watch UK.

Two fifths of the UK's listed companies reported results in Q2, meaning our latest report gives a clear picture of the current health of UK plc.

The latest Profit Watch UK looks at company quarterly and half-year results announced between April and June 2019. We call these Q2 2019 numbers.

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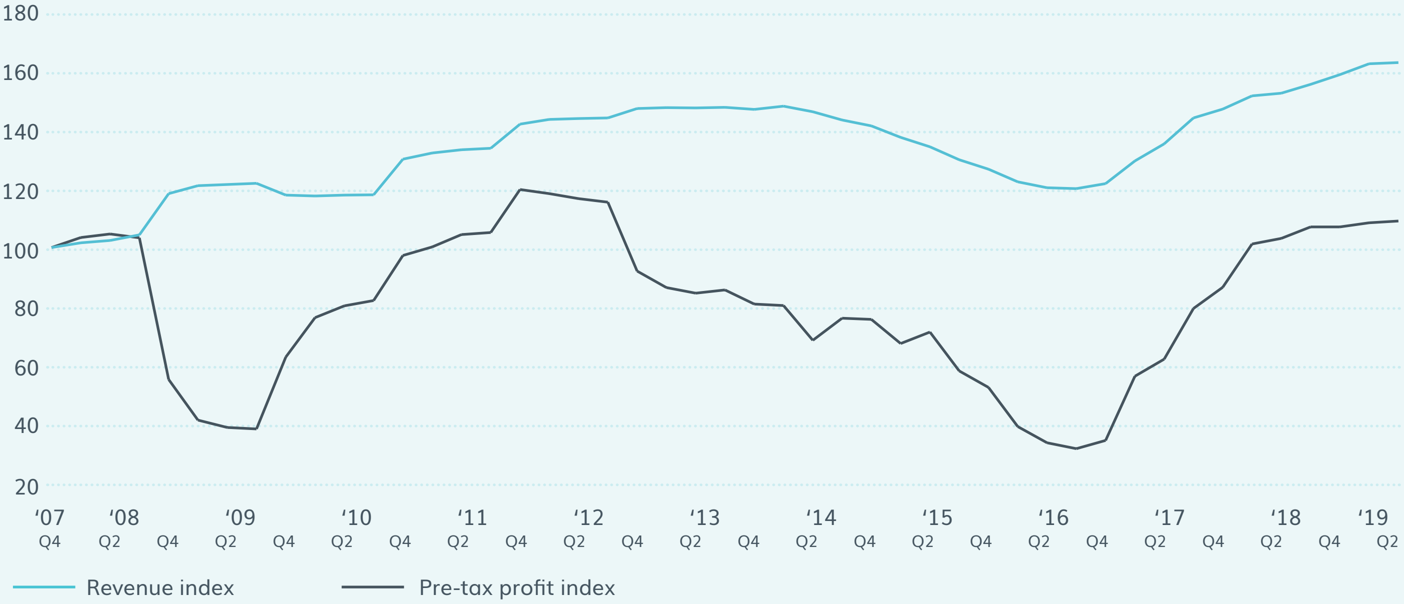
INTRODUCTION

The latest set of results reported by UK plc was the weakest in three years. Revenues and profits grew very slowly and were flattered by exchange rates. Once again, the gap between the biggest 40 companies and the rest widened.

For the year ahead, analyst expectations look high, but UK equities are trading at low valuations compared to other markets, so investors should remain focussed on the long term.

Profit performance was far better for the top 40 than for those outside this group; companies outside the top 40 saw profits slump by almost a third, the fifth consecutive quarter of declines.

Revenue vs pre-tax profit



OVERVIEW

UK PLC POSTS WEAKEST GROWTH PERFORMANCE IN THREE YEARS AS ECONOMIC SLOWDOWN TAKES ITS TOLL

The slowdown in the world economy, compounded by a deteriorating picture at home, meant UK plc posted its weakest set of growth results in three years in the second quarter of 2019. Growth of 1.6% on the top line and 3.1% on the bottom was only made possible by a lower exchange rate, which boosted the translated sterling value of revenues and profits earned overseas. Without this effect, both sales and profits would have been slightly lower year-on-year.

The top-line performance was poor for larger and smaller companies alike. The lower oil price was partly to blame, but a number of sectors struggled to grow their revenues, including telecoms, food producers, retailers and the leisure industry. A third of companies reported lower sales. Though the super-league of 40 multinationals managed to grow slightly, those outside this group saw revenues fall for the first time in five years. These tend to have greater exposure to the UK economy which is teetering on the brink of a technical recession.

Profit performance was far better for the top 40 than for those outside this group for the ninth consecutive quarter, rising by 13.3%. By contrast, companies outside the top 40 saw profits slump by almost a third, the fifth consecutive quarter of declines. Overall, more than half of companies reported lower profits.

Our index of revenues was almost unchanged quarter-on-quarter. It inched forward to 162.8 from 162.4 at the end of March, meaning sales have risen by almost two thirds since 2007, an average annual rate of growth of 4.8%. Over the last 12 months, companies have made £2.04 tn in sales. They generated profits of £192.5 bn on those sales, a margin of 9.4%, in line with the average for the last 18 months. This was however just below the seven-year high it reached just under a year ago, and well below 2007. Our index of profits advanced to 109.0, meaning UK plc is only making less than a tenth more in profit than in 2007. With an annualised increase of 0.8% since then, profits have lagged far behind revenue growth, and even inflation.

It's staggering that an extra £787 bn in sales over the last 12 months compared to 2007 is only generating £16 bn more in profits. Each £1 of additional revenue is therefore worth just 2p more in profit. In fact, no sector is now generating a higher pre-tax margin than it did in 2007.

For 2019, analysts expect median[1], or typical, earnings growth of 3.9%, a very slight reduction compared to the outlook at the end of March. For 2020, however, analyst forecasts have actually risen in the last

[1] The median is the rate of growth half way between the fastest- and slowest- growing company; it is not distorted by extreme values and is a helpful way of understanding the typical rate of growth companies are expected to achieve.

Pre-tax profit index

Key information £bn

12 months to:	08Q2	09Q2	10Q2	11Q2	12Q2	13Q2	14Q2	15Q2	16Q2	17Q2	18Q2	19Q2
Revenue	£1,281	£1,518	£1,473	£1,667	£1,799	£1,844	£1,828	£1,679	£1,505	£1,691	£1,906	£2,037
Revenue Growth	19.1%	18.5%	-3.0%	13.1%	7.9%	2.5%	-0.9%	-8.1%	-10.4%	12.4%	12.7%	6.9%
Pre-tax Profit	£184.9	£68.7	£141.7	£184.4	£205.9	£149.3	£121.0	£126.0	£59.5	£109.6	£182.1	£192.5
Pre-tax Profit Growth	-60%	-63%	106%	30%	12%	-27%	-19%	4%	-53%	84%	66%	6%
Pre-tax Margin	14.4%	4.5%	9.6%	11.1%	11.4%	8.1%	6.6%	7.5%	4.0%	6.5%	9.6%	9.4%

three months, with median growth up from 8.3% to 8.7%. This year's forecast is achievable, but for the year after expectations seem too high in our view, given the current slowdown in the world economy and uncertainty in the UK over Brexit. Moreover, any recovery in the pound would act as a significant drag on growth.

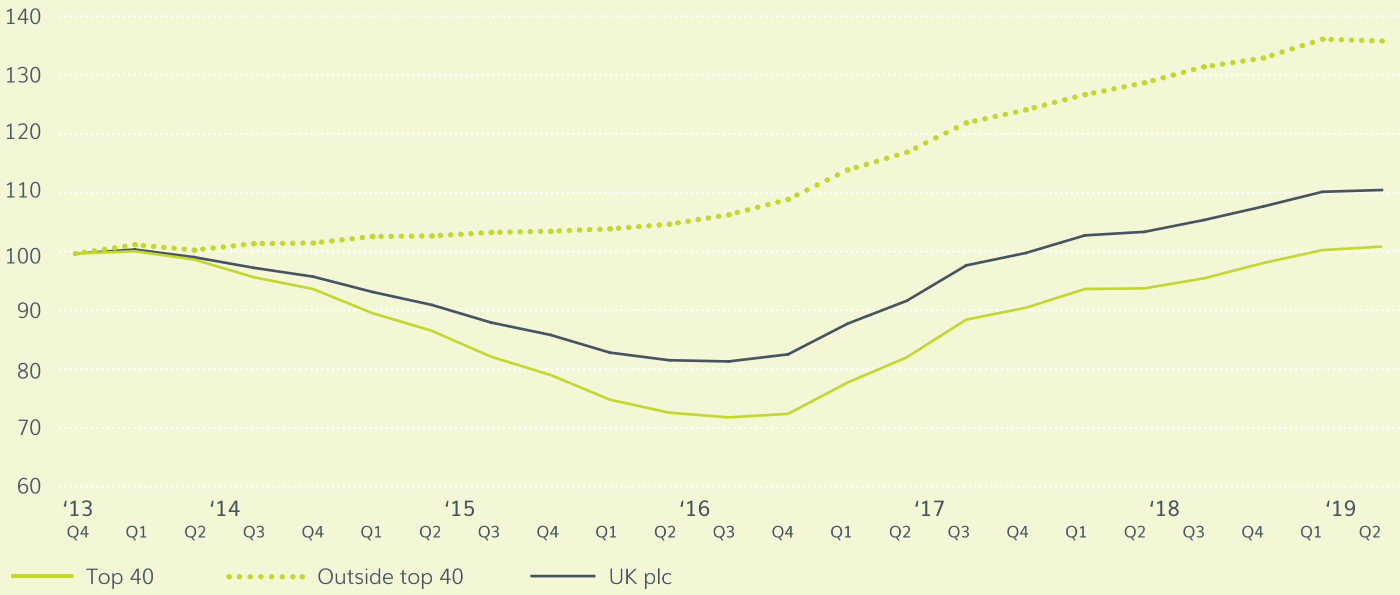
REVENUE

Our index of revenues was almost unchanged quarter-on-quarter, inching forward to 162.4 to 162.8 at the end of March, meaning sales have risen by almost two thirds since 2007, an average annual rate of growth of 4.8%.

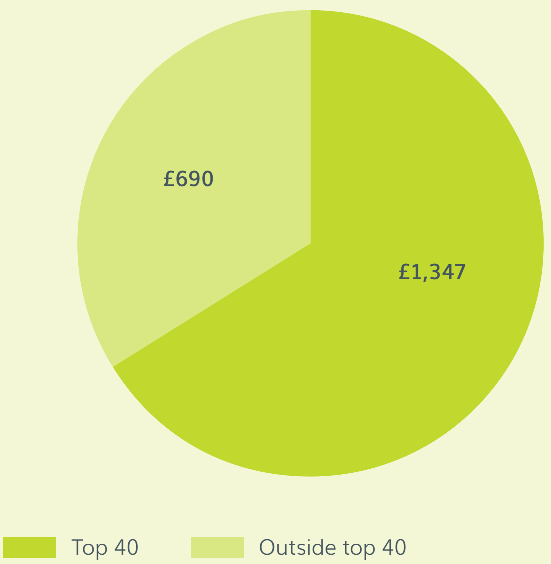
REVENUE GROWTH SLOWS SHARPLY, SUSTAINED ONLY BY THE WEAKER POUND

UK plc revenues rose for a 12th consecutive quarter in Q2, but only just. They inched ahead a mere 1.6% compared to Q2 2018 - their weakest performance in three years. Moreover, many companies with operations around the world experienced a boost from the weakness of sterling. If we allow for exchange rate movements then revenues would actually have fallen year-on-year for the first time since mid- 2016.

Lower oil prices in the early months of 2019 meant BP, Shell and their smaller rivals saw revenues only 1.4% higher year-on-year, equivalent to a fall of 6% on a constant-currency basis. Even if we exclude the oil giants, however, UK plc still only managed 2.2% revenue growth. The slowdown was in fact relatively broadly based - more than one third of companies saw their revenues fall compared to a year ago, approximately twice as many as in 2017. Telecoms performed worst, in particular Vodafone, which struggled with rising competitive pressures and also BT encountered weakness in the business fixed-line voice market and regulatory pressure in the broadband market. Among general financials, half of companies reported flat or falling revenues. CMC Markets, for example, is being hit by a regulatory squeeze on spread-betting. Food and beverage producers were also among the laggards, merely managing to hold revenues flat after Greencore's disposal of its US business was adjusted for. In the general retail sector, only half of companies managed to grow their sales. The biggest negative impact was caused by a decline at M&S and the bankruptcy of Debenhams. Finally, Revenue index (rebased 13q4 = 100)



Revenue £bn – last 12 months

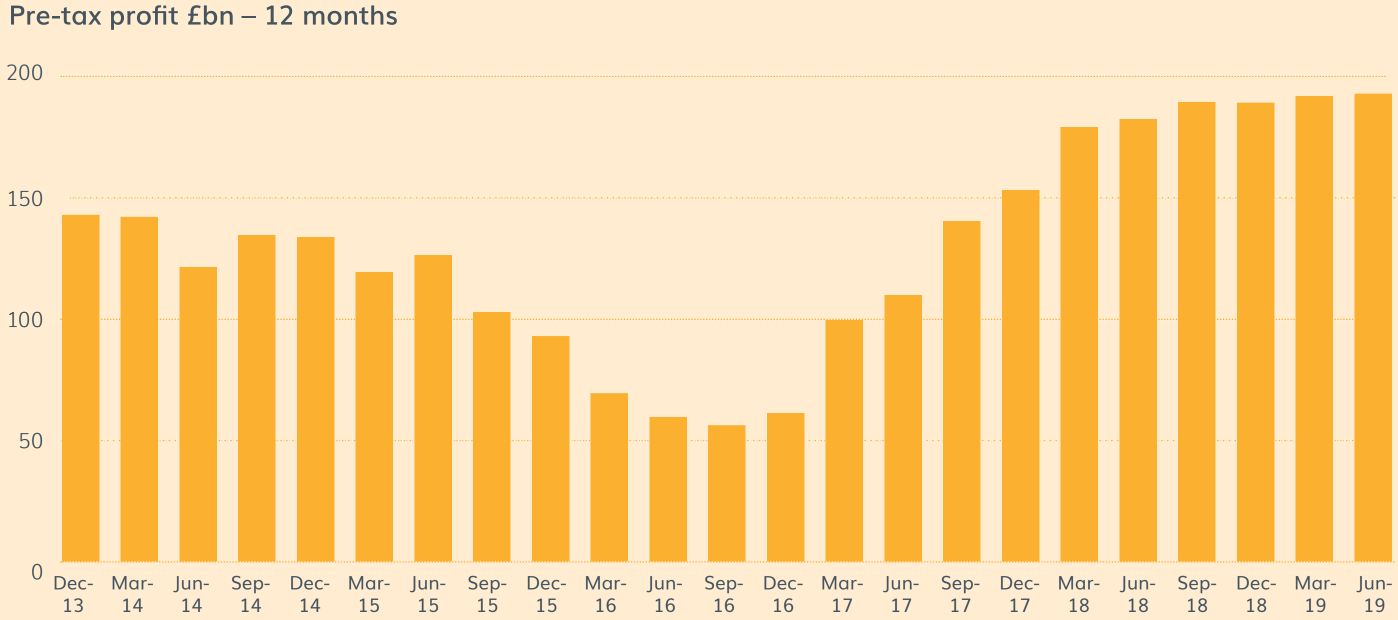


among airlines, leisure and travel companies, it was tour operators who suffered lower revenues blaming Brexit uncertainty, but companies with earnings overseas, like catering group Compass, did better.

The best performing sectors included banks, healthcare, industrial goods and food retail. Banking revenues were driven by a strong performance in Asia for HSBC with an additional boost from the weak pound, while industrial goods and support included a very strong performance by Ferguson, the international plumbing distributor. Turnaround stories explain rising sales from healthcare and food retailers: for example AstraZeneca is enjoying strong product sales from newly developed drugs, while Tesco bounced back from a difficult few years.

The top 40 comfortably beat the rest for top-line growth. The super-league's revenues grew 3.0%, compared to a 1.1% decline for those outside the top 40.Without a boost from sterling's weakness, however, top 40 revenues would also have been lower year-on year. The drop in revenues from those outside the top 40 was the first decline in five years.

Our index of revenues was almost unchanged quarter-on- quarter, inching forward to 162.4 from 162.8 at the end of March, meaning sales have risen by almost two thirds since 2007, an average annual rate of growth of 4.8%. Over the last twelve months, the total reached £2.04 tn.



PRE-TAX PROFIT

The biggest impact is being felt outside the top 40 list of global multinationals. Almost three fifths of smaller companies saw lower profits year-on-year, and 11 out of 18 sectors reporting results saw a decline.

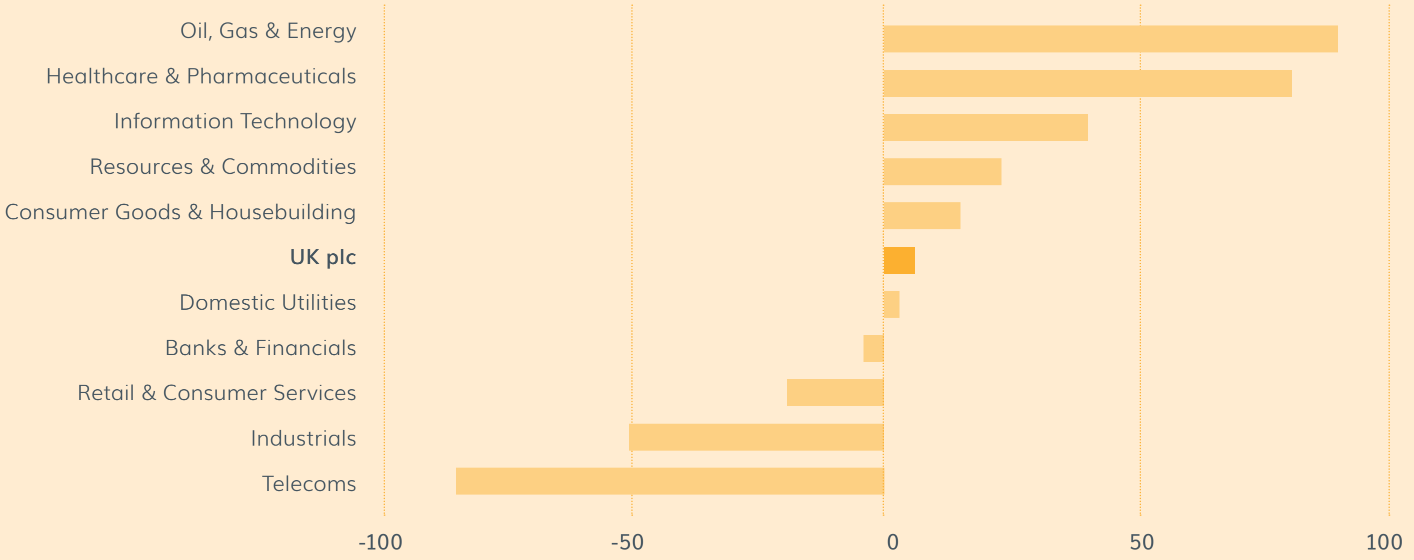
MORE THAN HALF OF UK COMPANIES REPORTING RESULTS SEE PROFITS DECLINE

Pre-tax profits grew for the 11th consecutive quarter in Q2, but only by 3.1%. If we adjust for the artificial boost provided by the continuing decline of sterling, they actually fell for the first time in more than two years.

The biggest impact is being felt outside the top 40 list of global multinationals. Almost three fifths of them saw lower profits year-on-year and 11 out of 18 sectors reporting results likewise saw a decline. Collectively, their profits plunged 31.1% compared to the same period in 2018, a far worse figure than expected and the fifth consecutive quarter to see a fall.

The extent of the decline was influenced by a small number of companies. The median, or typical, fall in profits was a less stark 7.7%, which is more in line with our expectations. Half the collective drop in profits was caused by Thomas Cook writing down the value of MyTravel, after they merged in 2007. Even without this effect, Thomas Cook took heavy losses, blaming falling demand in many of its markets and especially among UK consumers. The company has warned trading remains difficult. Rival TUI also reported falling profits, as did easyJet, which is being hit by rising fuel costs and adverse exchange-rate effects. Profits were also lower among most property investment groups, where British Land has made the biggest impact as it struggles with the decline of high street retailing. Retailers, which are one part of the wider consumer services grouping, saw their profits halve year-on-year.

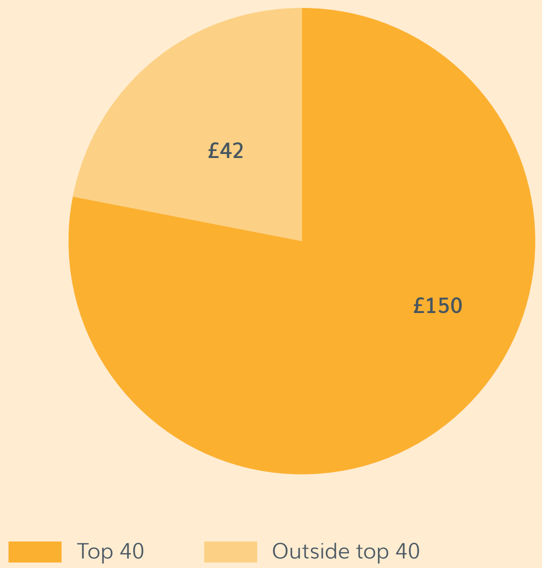
Pre-tax profit growth by industry % – last 12 months

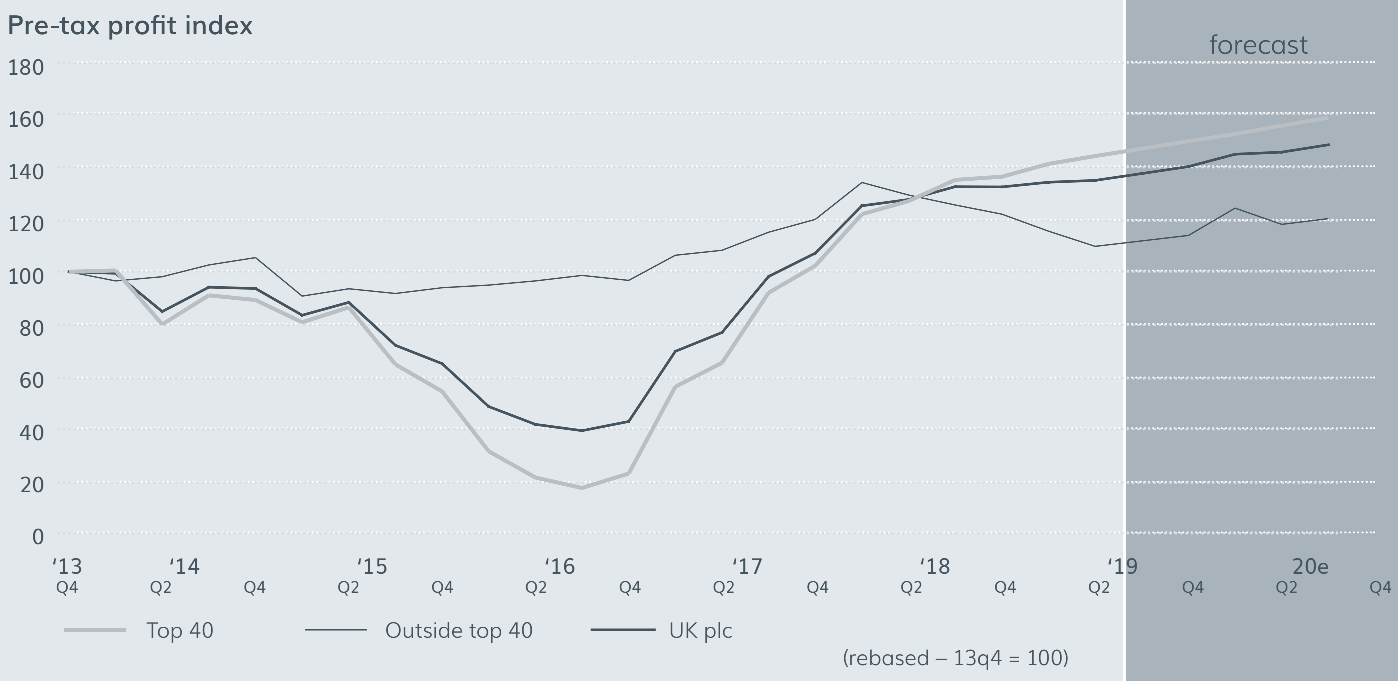


The top 40 fared much better. Here profits rose 13.3% year-on-year, significantly faster than the increase in sales. Some of this is down to positive exchange rate effects, but even so, two-thirds of companies reporting results increased their profit margin. The oil sector's focus on cost control over the last few years meant Shell and BP weathered lower oil prices very successfully. Meanwhile HSBC beat market expectations and took banking profits higher and AstraZeneca's rejuvenated product suite meant higher profits for the healthcare sector too. The biggest negative impact was in telecoms, in particular due to ongoing poor performance at Vodafone and massive impairment charge of its Indian business.

If we consider UK plc's performance over the last 12 months, rather than just the latest quarter, profits have totalled £192.5 bn. This marks an increase of just 0.5% compared to the same figure three months ago, taking our profit index to 109.0, up from 108.4 at the end of March. This means UK profits have grown only 9.0% since 2007.

Pre-tax profit £bn - last 12 months





OUTLOOK

MARKET EXPECTATIONS FOR PROFIT GROWTH LOOK TOO HIGH, BUT UK SHARES ARE CHEAP

It has been noted in previous versions of Profit Watch UK reports that though collective profits seemed resilient, they were becoming increasingly dependent on narrower groups of companies. This trend intensified in the second quarter. The increasingly sharp divergence between the multinationals and those more dependent on the domestic UK market is part of this picture.

With the UK enduring a prolonged squeeze on economic growth caused by global uncertainty and Brexit headwinds all while potentially on the brink of a technical recession, there is not much room in profit margins.

Profits booked in the last twelve months have almost precisely met the market expectations we set out in our report this time last year. However, we think this prescience is unlikely to be repeated over the next year or so. For 2019, analysts expect median earnings growth of 3.9%, a very slight reduction compared to three months ago. Analyst forecasts for 2020 have actually risen since the end of March, with median growth up from 8.3% to 8.7%. This year's forecast is still achievable, but for the year after expectations seem too high in our view given the current slowdown in the world economy and uncertainty in the UK over Brexit. Moreover, any recovery in the pound would act as a significant drag on growth.

The longer-term perspective shows how UK plc has endured a painful margin squeeze. Part of this reflects the structurally tougher economic conditions experienced since the pre-crash boom years ended in 2007 but it also reflects regulatory change, particularly in the financial sector. Another contributing factor is disruption in a number of industries from new competitors or new technologies. Retail is perhaps the starkest example.

Even so, UK equities are trading on the most attractive (lowest) multiples in the developed world, and companies continue to generate cash and return it to their shareholders. Investors should in any case take a long-term view and acknowledge that shares can provide opportunities for both income and capital growth over time.

RICHARD STONE,
Chief Executive

Richard's responsibilities include all aspects of oversight, including the Group's strategy for growth, and encompass control and management of the Group's business.

A chartered accountant, he joined Share plc in April 2006, from his previous role as a Director of Huntswood - an outsourcing business serving the financial services sector. His earlier investment market experience as an equity research analyst with the US investment bank, Robertson Stephens, included involvement in a number of initial public offerings across Europe. Prior to 2014, Richard was Group Finance Director and Chief Operating Officer.

BASED UPON THE FINDINGS IN THIS REPORT OUR INVESTMENT GUIDANCE TEAM HIGHLIGHT THE FOLLOWING STOCKS TO WATCH:

- MINING: BHP Group
- HEALTHCARE & PHARMA: GSK, AstraZeneca
- OIL & GAS: BP, Shell
- FINANCE: HSBC, RBS, Lloyds, Barclays
- GENERAL FINANCIAL: Hargreaves Lansdown
- HOUSE BUILDERS: Barratt Developments
- GENERAL INDUSTRIAL: Smiths Group
- FOOD PRODUCERS: Associated British Foods
- BEVERAGES: Diageo
- GENERAL RETAIL: Sports Direct

APPENDICES

Revenue £bn	12 months to: 14Q2	15Q2	16Q2	17Q2	18Q2	19Q2
Resources & Commodities	£283.0	£243.0	£187.6	£216.3	£287.4	£290.3
Consumer Goods & Housebuilding	£141.5	£131.9	£136.7	£158.4	£177.3	£182.6
Retail & Consumer Services	£299.8	£296.8	£303.2	£333.0	£356.4	£377.5
Banks & Financials	£172.9	£161.3	£158.5	£167.2	£174.0	£181.8
Healthcare & Pharmaceuticals	£50.2	£47.6	£52.0	£60.4	£62.5	£65.6
Industrials	£202.0	£204.1	£211.1	£237.3	£256.0	£269.3
Oil, Gas & Energy	£533.1	£440.1	£309.9	£364.8	£446.2	£530.1
Information Technology	£6.3	£6.7	£7.5	£8.3	£10.5	£13.2
Telecoms	£59.8	£63.6	£58.6	£67.6	£68.4	£65.5
Domestic Utilities	£78.9	£83.9	£79.8	£78.0	£67.8	£61.6
Total	**£1,827.5**	**£1,679.0**	**£1,505.0**	**£1,691.4**	**£1,906.4**	**£2,037.3**

Pre-tax profit £bn	12 months to: 14Q2	15Q2	16Q2	17Q2	18Q2	19Q2
Resources & Commodities	£13.4	£19.0	-£12.4	£14.8	£31.4	£38.6
Consumer Goods & Housebuilding	£21.4	£19.5	£21.8	£23.9	£28.5	£32.7
Retail & Consumer Services	£15.0	£6.8	£17.1	£17.1	£22.0	£17.8
Banks & Financials	£26.2	£40.8	£30.0	£24.6	£46.5	£44.8
Healthcare & Pharmaceuticals	£9.3	£13.9	£4.3	£7.2	£4.5	£8.0
Industrials	£10.1	£8.3	£9.4	£6.4	£19.3	£9.7
Oil, Gas & Energy	£22.3	£10.5	-£17.2	£2.6	£18.0	£33.9
Information Technology	£0.7	£0.6	£0.5	£0.6	£0.7	£1.0
Telecoms	-£3.0	£4.1	£3.0	£4.9	£6.7	£1.1
Domestic Utilities	£5.6	£2.5	£3.0	£7.5	£4.6	£4.8
Total	**£121.0**	**£126.0**	**£59.5**	**£109.6**	**£182.1**	**£192.5**