Navigating the era of higher interest rates

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EY Parthenon

Building a better working world

Key points

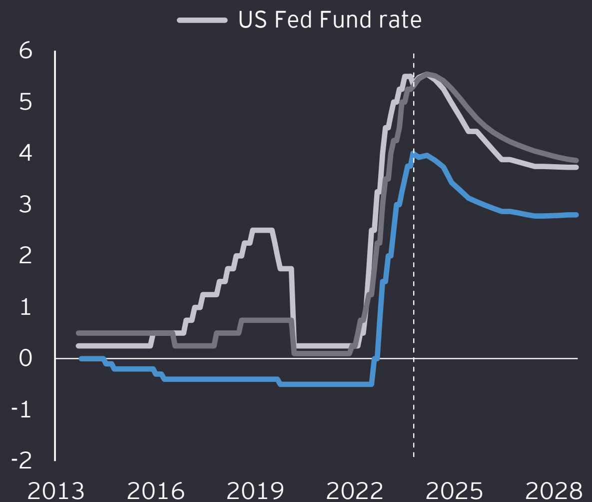
1. Though the outlook is brightening, businesses should not over-rely on interest rates coming down quickly for performance.
2. Even with lower rates, the cost of debt for UK firms has increased on average by 3-6% since January 2022.
3. Some £500bn of corporate debt will need to be refinanced in the UK between 2024 and 2027. The debt service cost will be around 200% higher than currently – or an extra £25bn.
4. This in combination with softening demand in some sectors are now also putting pressure on valuations.
5. To avoid losing value, businesses should take a series of actions including looking to deleverage, reviewing cash intensive activities, improve working capital and continue to plan for different economic scenarios.

Introduction: the end of era of cheap money

In April 2022, the US Federal Reserve Bank increased the base rates by 25bps from a historically low level of 0.25% to 0.5%. This marked the start of the most significant tightening cycle since before the financial crisis almost 20 years ago. By September 2023, rates had increased to 5.25% to 5.5% – the most rapid increase since the early 1980s. The Fed's move started a round of coordinated global tightening, with the Bank of England also taking rates to 5.25%, and the ECB putting through almost 500bps of rate increases in the space of just under 18 months.

This tightening was in the context of surging inflation off the back of post-pandemic supply chain constraints, labour shortages, and the convulsions in energy markets driven by the Russian invasion of Ukraine. Inflation peaked in Autumn 2022, continuing to fall across developed markets, and financial markets are now calling the top of the tightening cycle.

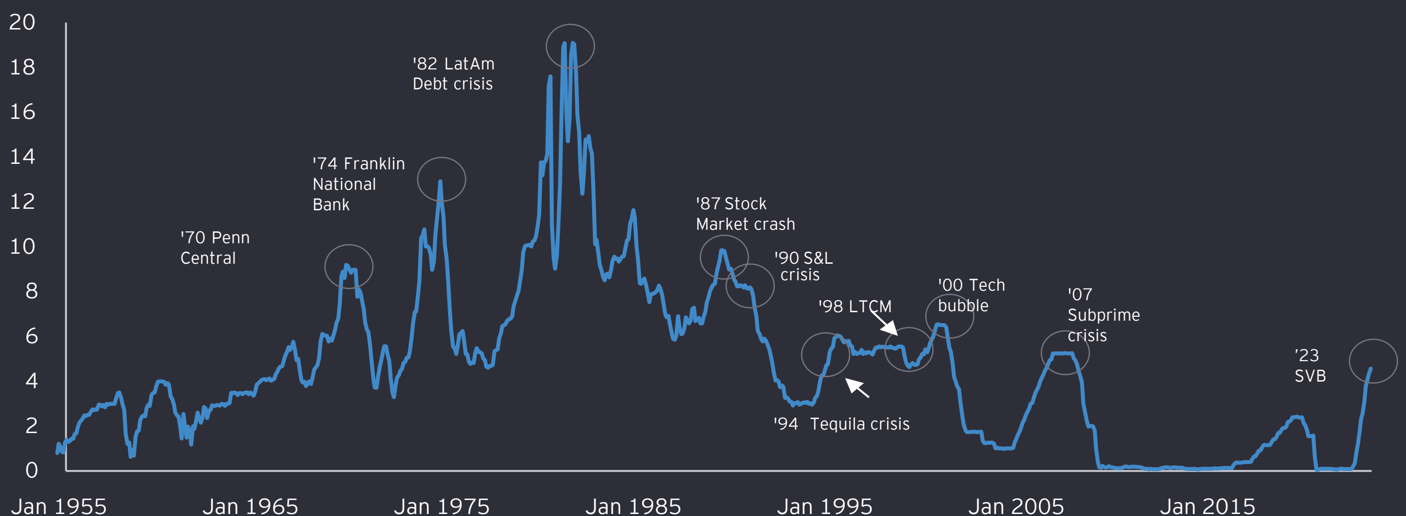
Monetary Policy Base Rates (%)



Historically, rapid rate increases have resulted in financial stress and recession. For example, the sub-prime crisis that almost broke the banking systems was directly preceded by the FED tightening rates to control a housing market boom. Similar rate hikes popped the 2000 tech bubble, and preceded the 1987 stock market crash and early 90's recession. Concerns on the stability of the US banking system were raised last March when first Silicon Valley Bank and then First National Bank had to be rescued, but these turned out to be containable events – so far, we have yet to see wide scale financial stress.

The nature of this crisis is slightly different to those episodes; the surge in inflation was largely driven by "external shocks" rather than from a boom and bust business cycle. Hence households, corporates and banks are not weighed down under the burden of financial excesses. Indeed in many cases household and corporate balance sheets are healthier than they were pre-pandemic, as they have benefitted from significant support provided by governments and central banks.

US Effective Federal Funds Rate (%)



The danger of relying on rates falling quickly

However, there are a few reasons why businesses need to avoid over-relying on interest rates bringing the cost of capital down quickly.

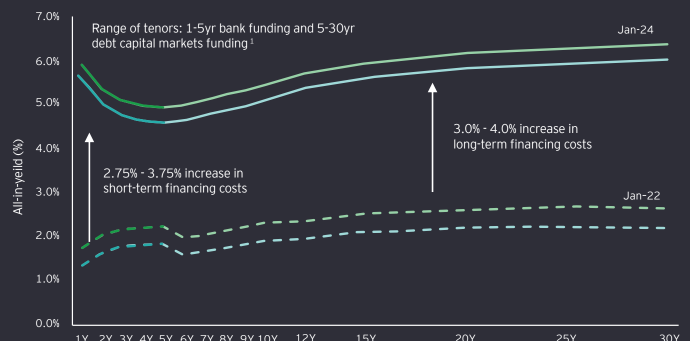
1. Inflation may not fall in a linear way, meaning rates may not be cut as quickly as markets expect. In particular, renewed geopolitical disruption, including in the Red Sea, Israel-Gaza and around Taiwan, risks feeding through to rising oil prices and supply chain bottle-necks, in turn adding new fuel to inflation. 2024 will also see over half of the world's population vote in elections, including in the EU, US, UK and India, with unpredictable impact on a whole host of polices with potentially inflationary impacts, including new protectionist measures.
2. Even with the 100-125bps of reductions that have been priced by markets for 2024; absent further external shocks, interest rates will be well above the levels that businesses and households have grown accustomed to since 2007, requiring adjustment.
3. The pivot to a higher rate economy comes with a lagging effect as debt needs to be re-financed.

For households, for example, material changes in the structure of the mortgage market – e.g., 80% of mortgage holders are on fixed rate deals – means that higher interest rates take time to impact fully.

Similarly, many businesses took advantage of government support and ultra-low interest rates to raise finance in 2020 and 2021, on fixed deals, and hence have been largely insulated from rate increases so far.

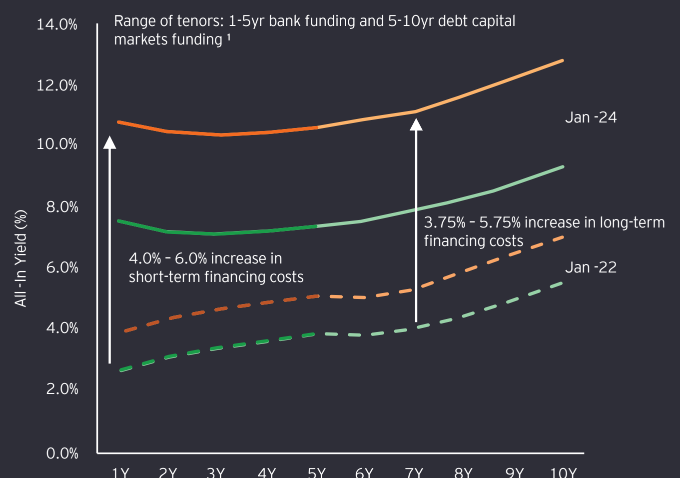
With both underlying base rates and spreads having increased, listed and privately owned businesses now face the twin challenge of rising cost of debt and downward pressure on valuation.

Indicative financing cost for Investment Grade corporates



- A-rated bank funding
- A-rated capital markets funding
- BBB-rated bank funding
- BBB-rated capital markets funding

Indicative financing cost for Sub-Investment Grade corporates



- BB-rated bank funding
- BB-rated capital markets funding
- B-rated bank funding
- B-rated capital markets funding

The debt challenge

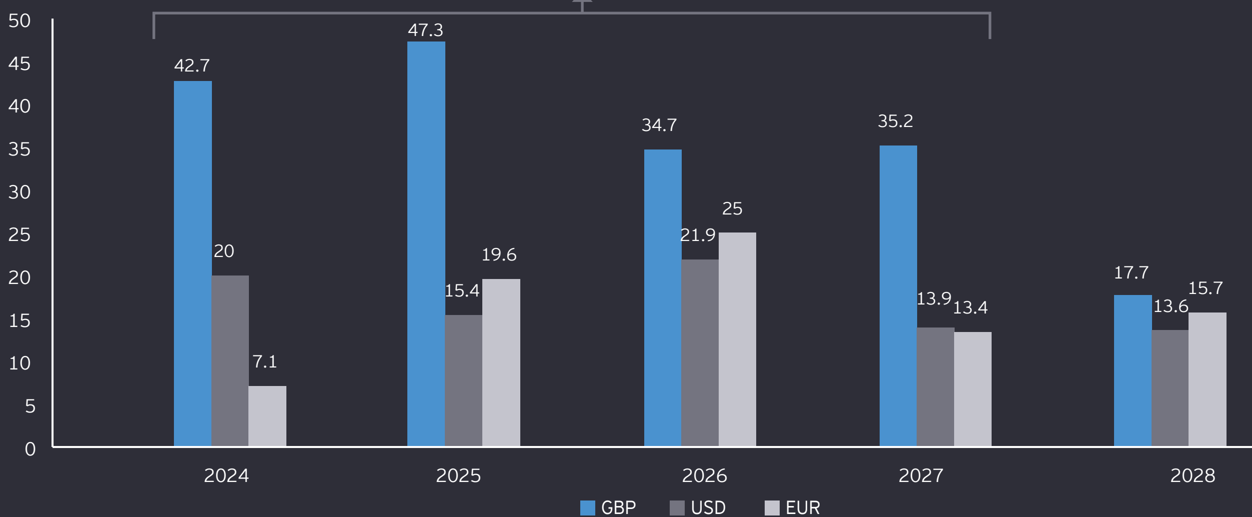
The debt challenge:

Analysis by the Capital and Debt Advisory EY team suggests that the cost of debt financing has increased on average by 3-6% since January 2022 (depending on tenor and credit rating). Even larger increases have been observed for weaker/lower rated credits, hitting those sectors with more highly-levered companies harder than others.

Some £500bn of corporate debt will need to be refinanced between 2024 and 2027 – with £100bn alone in 2024. The debt service costs on this finance will be up to 200% higher than currently – or an extra £25bn that will have to be found from EBITDA.

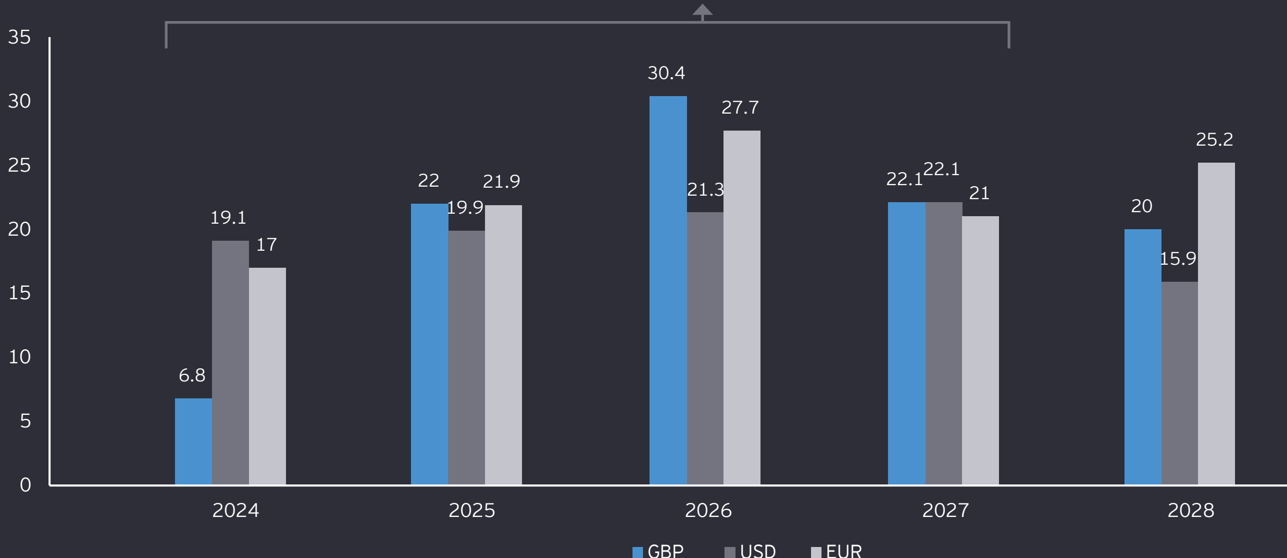
Sum of loans Maturing

Sum of total loans maturing over 2024-27 (in GBP) = £275bn. Assuming a 4%-5% ppt average interest rate increase, this would imply an additional £11-13bn in annual debt service costs



Sum of bonds maturing

Sum of total bonds maturing over 2024-27 (in GBP) = £225bn. Assuming a 4%-5% ppt average interest rate increase, this would imply an additional £9-11bn in annual debt service costs



The valuation challenge

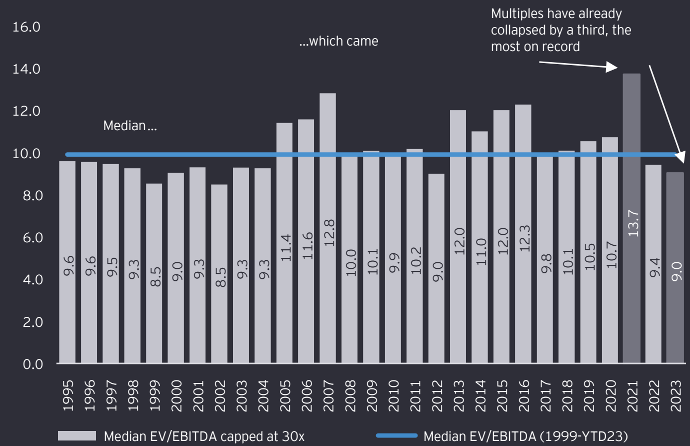
The valuation challenge:

The more negative economic outlook, rise in cost of capital, higher discount rate and softening demand are now also putting pressure on valuations.

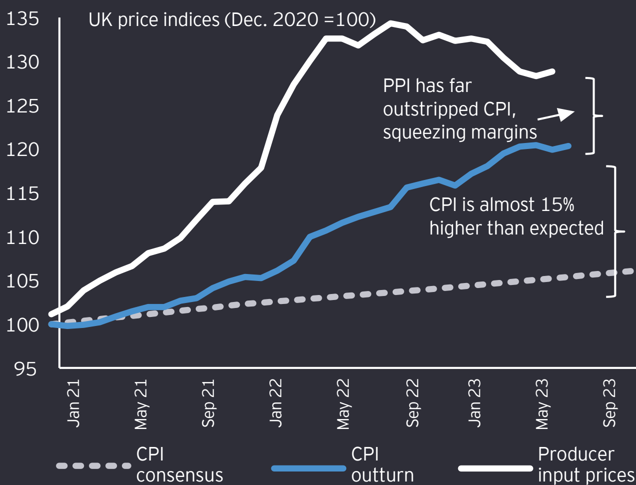
As the UK and global economies emerged from the pandemic in Spring 2021, there was a fair amount of optimism about the economic trajectory. GDP rebounded rapidly, and confidence was high. Finance in many cases was raised on expectations of continued economic growth and stable price levels – the actual outturn since 2022 has of course been very different.

This is particularly relevant for the £300bn of deals transacted in the UK in 2021 – often financed on ultra-low rates, with valuations at record levels, and with exit multiples based on assumptions of continued recovery and stable margins – the commercials on some of these deals may well start to unravel.

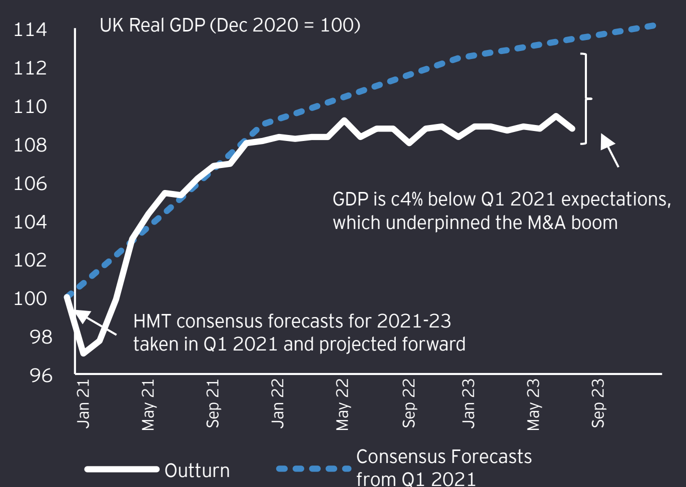
EV and EBITDA multiples capped at 30x for UK



UK price indices (Dec 2020 = 100)

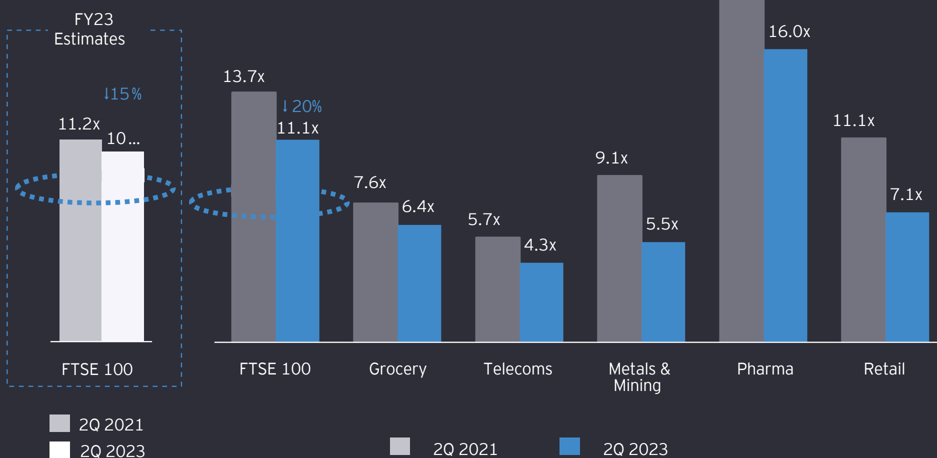


UK Real GDP (Dec 2020 = 100)



Indeed, simple financial mathematics can demonstrate how increases in the risk-free rate could significantly impact the valuation of a business on a discounted cash flow business. EY analysis suggests that every 1% increase in the real risk-free rate could equate to a 10% reduction in the value of a business. Observed EV and EBITDA multiples in public markets, and on recent transactions, are between 20%–30% down on levels achieved in 2021.

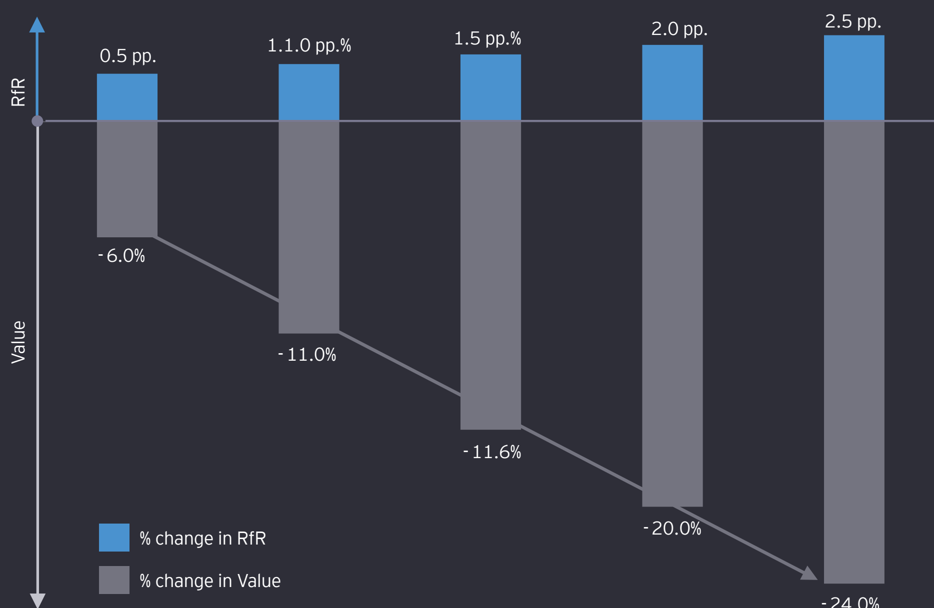
Market multiples



Source: CapitalIQ, EY analysis

- For FTSE 100 companies, EV/ EBITDA multiples – a common valuation metric – have fallen by around 20% over the past two years.
- Estimates of 2023 EV and EBITDA multiples on transactions have also fallen by around 15% over the same period – a significant drop in valuations since the 2021 M&A boom.

Discounted cash flows



- Higher interest rates should in theory (all else equal) mechanically translate into lower valuations, via heavier discounting of future cash flows
- We estimate that every 1%-pt increase in the risk-free rate decreases the present value of corporate earnings by just over 10%.

How should business respond?

1

More challenging macro environment

The post pandemic surge in inflation, followed by rapid tightening of interest rates, has meant that economic activity has stagnated since late 2021

2

Weaker corporate performance

Pressure on top line revenue growth, costs and debt servicing, putting pressure on underlying profitability

3

Debt rollover risks

UK PLC annual debt servicing costs could rise by £20-25bn – this will put pressure on underlying profitability, debt covenants and hence raises the risk of restructuring/ insolvency

3

Valuation gap

A higher discount rate, combined with more challenging operational performance and higher debt service costs could undermine company and asset valuations – for both reporting and exit purposes

How should business respond?

The more challenging macro-environment, continued inflation uncertainty and geopolitical risk, in turn resulting in weaker corporate performance, create both debt roll over risks and potentially a valuation gap between book and market values. This is particularly true for assets acquired in the pandemic era mergers and acquisitions boom.

To avoid losing value, and to protect the balance sheet, businesses should take a series of actions.

1. Where leverage is high, look at deleveraging opportunities ahead of refinancing or critical events, with disposals or equity solutions.
2. Look for the opportunities to improve liquidity to reduce debt requirements – reviewing cash-intensive business activities, addressing underperforming elements, capturing working capital improvements and looking for non-cash alternatives.
3. Stress test and scenario plan, to understand the resilience of the business in the face of continued economic uncertainty and develop the strategy to address risk.

1 Stress test and scenario plan

- The external macroeconomic and geopolitical environment remains exceedingly uncertain, with a range of plausible pathways and large tail risks – markets have consistently under-priced rates staying higher for longer
- Business should macro scan to identify external market and geo-political events most relevant and correlated to underlying business performance
- Develop plausible scenarios for key drivers and link to cash flow and balance sheet modelling of firm financials
- Quantify impacts on debt sustainability, cash flows, profitability, ability to obtain and extend credit, and ability to invest

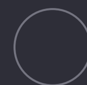
2 Identify impacts and strategies

Identify impacts, strategic options and ways forward:

- Shift focus from value creation to value preservation
- Renewed focus on liquidity and "cash is king"
- Ability to invest and business and strategic planning

3 Execute the business response

- Get a grip on key drivers of cash burn
- Prioritise quick wins
- Execute turnaround plan – e.g., internal restructuring to improve cash flow via tax restructuring including legal entity or intellectual property rationalisation exercises
- Pre-investment diligence, alternative financing options
- Carve-outs, asset sales, additional equity injections
- Debt restructuring if in value recovery phase (covenant relief, amend and extend, etc.)



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