UK Quarterly Report – Post Brexit

QUARTER 2 2016

September 2016

INTRODUC TI ON

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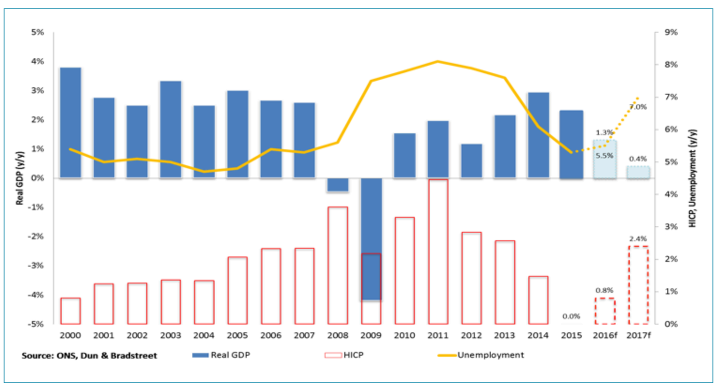
1.0 UK ECONOMIC OUTLOOK

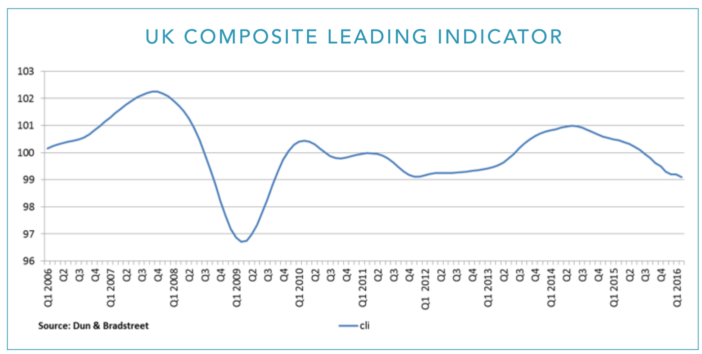
Until the referendum on 23 June, the key risk for cross-border traders and investors doing business with the UK will be the prospect of a British exit from the EU, dubbed 'Brexit'. As opinion polls have not changed substantially since last month, Dun & Bradstreet maintains the country's DB2a risk rating and the 'deteriorating' outlook, and continues to calculate a 35% risk of a Brexit. The Financial Times 'poll of polls' (which combines several polls about the issue) from 27 April showed that 47% of the electorate would vote for the UK staying in the EU, while 41% would opt for Brexit. The remaining 11% is still undecided. Although the error margin is high and British pollsters badly failed to predict the outcome of the last parliamentary election, we continue to recommend postponing all investment decisions at least until 23 June and, if a Brexit occurs, until a new legal framework for trading with and investing in the UK is in place. Indeed, from an external trade perspective a Brexit would require lengthy re-negotiations between the British government and its international partners, not only the EU (as Britain's trade regulations are currently set by the EU). In the light of a potential Brexit, US and Canada-based shippers might not be able to benefit from the TTIP (EU-US) and CETA (EU-Canada) free trade arrangements that are in the pipeline.



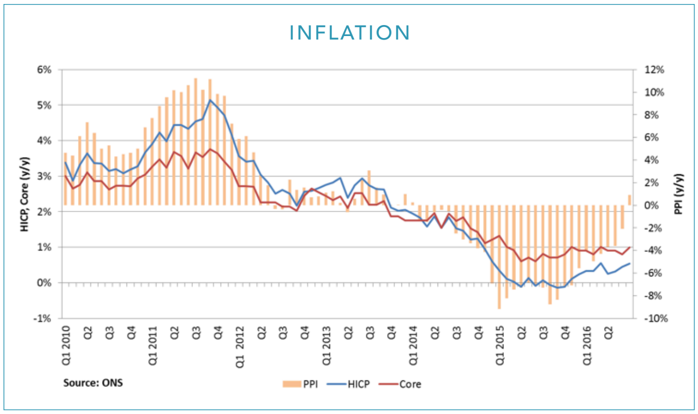
The MPC's decision followed the release of high frequency data that indicated a pronounced cooling of the British economy. Purchasing Managers' Indices in all sectors fell appreciably in July, and are now at levels considerably below the neutral 50-points line that divides an expansion in sectoral activity from a contraction. The manufacturing sector PMI is at its lowest since early 2013, while in the sizeable service sector the Index dropped into contraction territory for the first time since December 2012. For the time being we are maintaining our 0.4% growth forecast for 2017 (below the Bank of England's revised figure of 0.8%). However, as the full economic impact of Brexit is still impossible to measure at this stage, we are prepared to adjust our projections in the wake of new data releases over the coming weeks.

Much of the economic deterioration is due to high levels of uncertainty about the UK's future relations with the EU. Negatively in this respect, the new UK government led by new Prime Minister Theresa May has not yet been able to lay out its post-Brexit plan. While it seems increasingly likely that the government will invoke Article 50 of the EU Treaty in early 2017, leading to an exit from the EU in early 2019, it is completely unclear what will replace the current arrangement. Recent comments made by senior government officials hint that the UK will favour control over its borders rather than full EU market access. If such a scenario were to materialise, trading with the UK would become more complicated (as would FDI).

Against a backdrop of rising uncertainty over the referendum result, Dun and Bradstreet's composite risk leading indicator (CLI) for the UK economy continues to suggest a softening in economic activity over the next few months. Anticipating a slowdown in the pace of economic growth, the headline dropped to 99.1 points in June, down by 0.1 points from its February reading:



Meanwhile, inflation rates remain far below the 2.0% target rate set by the Bank of England. Despite the return to solid growth in 2014-15 and unemployment dropping to the lowest value since December 2007, price pressures are not building up because of very low commodity prices and, until recently, the strong domestic currency (which lowered input prices). Our baseline scenario forecasts a gradual increase of inflation rates over the coming quarters, without reaching the target rate until 2018. This will also mean that interest rates are unlikely to go up before 2017 at the earliest. Against the backdrop of subdued consumer prices, the harmonised producer price index (HPPI) also fell in Q1 (down by 4.4% y/y), with the rate of contraction easing somewhat over the past three quarters. Since HPPI measures prices at the producer level before they are passed along to consumers, eight consecutive quarters of falling producer prices suggest that consumer inflation will continue to hover around its low recent values in the months ahead.



BREXIT: WHAT NOW?

The referendum on British membership of the EU ended in an unexpected victory for the "Leave" camp. This has prompted Prime Minister David Cameron to resign, the pound to fall to its lowest level against the US dollar in 30 years, and stock markets around the globe to crash. Although it is too early to assess the full impact of the decision, companies doing business with the UK should brace themselves for an open-ended period of uncertainty. While we expect that stock markets and the pound will recover some of their immediate losses in the coming weeks and months, the uncertainty surrounding the UK's future relations with the EU (its most important trading partner) has led Dun & Bradstreet to downgrade the UK's country risk rating from DB2a previously (on a par with the US) to DB2c, with a "deteriorating" outlook.

THE RESULT

Although polls showed a close race and bookmakers predicted a clear victory for the "Remain" camp, the Leave campaign won the referendum by a comfortable margin (51.9% to 48.1%). A regional analysis shows that the London area, Northern Ireland, and especially Scotland were strongholds for the Remain campaign, while support for leaving the EU was particularly strong in the Midlands and the English North East.

MARKET REACTIONS

Stock markets had rallied in the days before the referendum (when the Leave camp lost its lead in the polls), and the pound had appreciated against the US dollar for similar reasons. However, the FTSE 100 lost 7.4% immediately after the referendum result emerged (the FTSE 250 dropped by 11.7%), while the pound fell to its lowest value against the dollar in more than 30 years.

WHAT NEXT?

The biggest question mark at the moment is over when the British government invokes Article 50 of the EU Treaty and starts the countdown for leaving the EU. Once activated, Article 50 is a one-way street towards exit: Exactly two years after its invocation, EU law would cease to apply in the UK — unless all 28 member states agreed to extend the deadline.

The referendum result in Scotland creates concerns regarding a renewed push for Scottish independence. Given the caveats (such as the requirement to adopt the euro if ever admitted to the EU as an independent state and the current low oil price), the road to Scottish independence would not be an easy one, despite indications from Scotland's devolved government that it will look into this option again.

In Northern Ireland, Brexit could have far-reaching consequences on the peace agreement between loyalist (pro-British) Protestants and separatist Catholics, as well as on the economy (which is heavily linked to that of the neighbouring Republic of Ireland — an EU member). The peace agreement signed by the two groups in the late 1990s is based on EU law, and any attempt to renegotiate the status quo would prompt fierce opposition from the Catholic side.

IMPACT ON COMPANIES

Although media headlines might suggest otherwise, the referendum has not yet changed the legal framework for exporters and importers: The UK will remain a member of the EU for at least two years after Article 50 is invoked, meaning that companies exporting to and importing from the UK can count on there being no changes to the legal framework in this period.

However, the medium- to long-term future is much more uncertain — hence our risk rating downgrade. It is currently completely unclear what a new trade deal between the UK and the EU (as well as the rest of the world) would look like. Every option mentioned by Brexit campaigners has its flaws, and, in a worst-case scenario, the UK will give up access to the EU market in order to maintain control over its immigration policy. In any case, it seems unrealistic to expect that a new deal could be struck within the (very tight) two-year deadline laid out in Article 50; this raises immense concerns regarding market access after 2018.

Worryingly, the referendum outcome will also inevitably cause short-term problems for the British economy, limiting opportunities for doing business in the country. Markets have overreacted in the immediate aftermath of the referendum result, and although a normalisation process will start in the coming days, a recession in H2 2016 is a realistic scenario. The financial sector will be particularly badly affected, but we expect the Bank of England to launch a series of support measures in order to maintain stability in the sector. Furthermore, industries that either rely on foreign labor (services, hospitality, and agriculture) or are heavily integrated into EU supply chains (automotive and other manufacturing) will also face tougher operating conditions. While British exporters will benefit from increased price competitiveness on global markets thanks to the depreciation of the pound, exporters to the UK will face lower demand. As the situation is evolving rapidly, we recommend monitoring developments closely and frequently in the coming days and weeks.

2.0 GLOBAL ECONOMIC OUTLOOK: SHORT-TERM OUTLOOK CLOUDED BY UNCERTAINTY

The short-term global outlook is still qualified by the uncertainty created by the British electorate's vote to leave the EU. Consumer and business surveys in the UK and EU have shown a sharp decline in confidence since the vote, which will transmit into lower spending and investment plans in the short term. Nevertheless, in July, financial market volatility fell from the levels seen in the week immediately after the vote, and even if downgrades to global growth forecasts for 2016 have become the norm, these are not all due to the 'Brexit' economic effect.

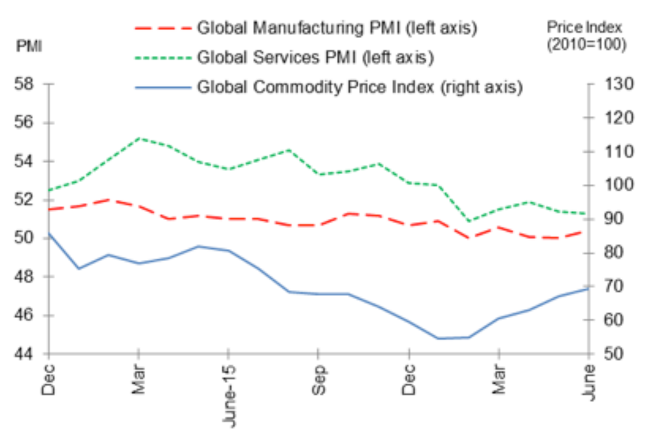
As expected, the US dollar has strengthened, pushing the possibility of any Fed interest rate rise back to December. Meanwhile, the pound sterling and the euro have weakened in line with the 'hunt' for yield as longer and deeper monetary easing is expected, with investors continuing to pull equity funds out of Europe. In terms of commodities, by August oil prices had fallen 20% since the UK's vote, dragged lower by the strong dollar, resilient shale oil supply and prodigious product inventory build-ups; meanwhile gold has strengthened as the zero returns from the precious metal begin to look attractive compared to negative yields on government bond issues. Against this background, we are currently forecasting that global real GDP growth will slow to 2.2% in 2016, from 2.5% in 2015 and 2.7% the previous year; growth in the UK is set to fall to 1.3% in 2016, from 2.3% in 2015.

KEY RISK: FINANCIAL INSTITUTIONS AND INVESTORS LOSE WITH NEGATIVE RATES

Anxiety that Brexit will make for a more malign medium-term picture has given way to a realisation that the global policy stance was not robust or benign even before the British electorate's political decision. Up to one-third of investment-class government debt may now be priced to yield negative returns. The negative interest rate environment – hitherto thought impossible by textbook economic approaches – will put pressure on the balance sheets of financial institutions and pension funds. While only one of 51 European banks would lose all its capital in the scenarios of the most recent official stress test, Greek and Portuguese banks were excluded, as were any risks from sovereign debt. Another study by an academic panel put the actual additional capital requirement of Europe's banks at EUR900bn, far above the official test's estimate, including EUR185bn for UK banks.

Thankfully, emerging markets are gaining relief. Emerging market bond yields fell in July as capital returned, impelled by Brexit calculations and G7 monetary policy easing, including USD14bn entering emerging market bond funds in the first four weeks of July.

KEY GLOBAL GROWTH INDICATORS

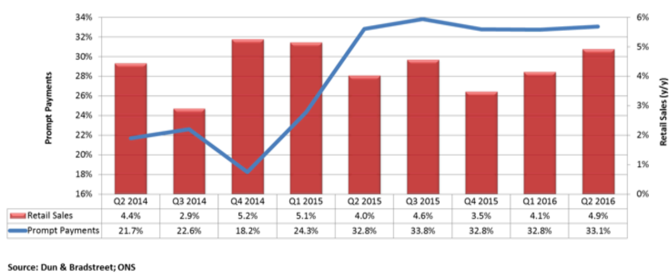


REAL GDP GROWTH (%)

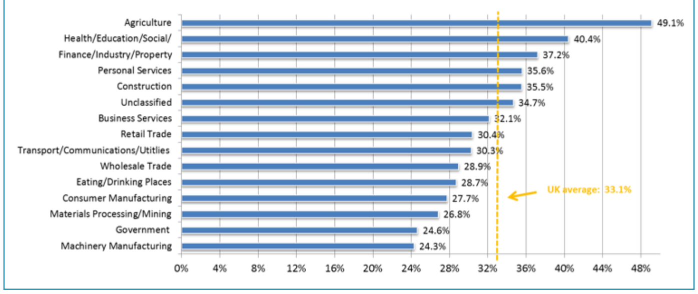
	2015	2016f	2017f
World	**2.5**	**2.2**	**2.7**
Advanced economies	2	1.6	1.9
US	2.4	1.8	2.2
Euroland	1.6	1.5	1.6
Japan	0.5	0.3	1.0
UK	2.3	1.3	0.4
Emerging economies	3.4	3.3	4.3
Brazil	-3.8	-3.7	0.7
Russia	-3.7	-0.8	1.2
India	7.3	7.5	7.9
China	6.9	6.3	5.8

3.0 PAYMENT SNAPSHOT

PROMPT PAYMENTS TRENDLINE – Q1 2014 TO Q1 2016

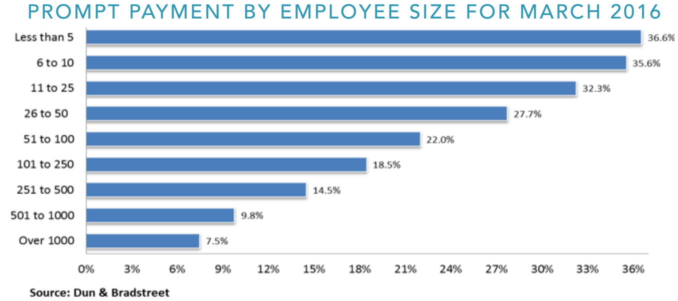


PROMPT PAYMENT BY INDUSTRY, JUNE 2016



The chart above depicts how promptly all UK businesses have been paying their bills over the past nine quarters (blue line). Dun & Bradstreet's data revealed that the proportions of prompt payments increased slightly over the quarter. Such an improvement appears to be consistent with the latest developments in retail sales (read columns): retail sales growth accelerated between Q1 and Q2 2016. Retail sales tend to be well correlated with private consumption, which suggests that the latter is also likely to have increased in the first quarter. That said, we expect prompt payments to deteriorate in the quarters ahead due to rising headwinds triggered by the June Brexit vote.

PROMPT PAYMENT BY EMPLOYEE SIZE FOR MARCH 2016

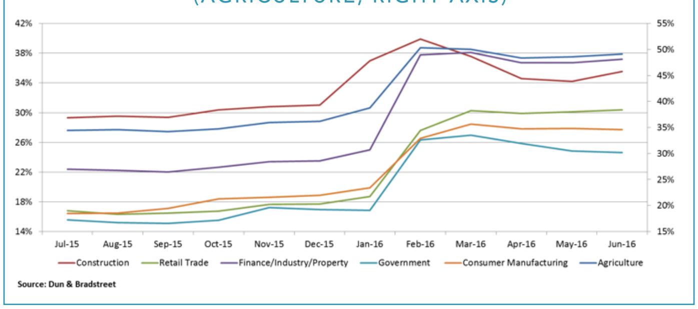


As the data in the chart above reflect, larger businesses continue to squeeze their suppliers by paying in a much slower manner than their smaller counterparts. The differential in payment habits between those companies employing 1,000 workers or more and those employing fewer than five is significant: 7.5% as opposed to some 36.6%.

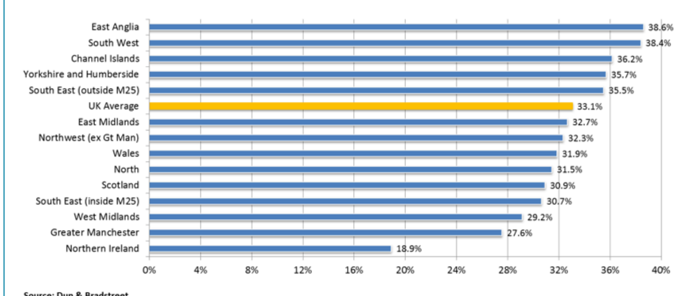
Indeed, late payments continue to be a major problem facing UK-based small and medium-sized enterprises. While legislation is in place to assist small businesses with their struggle against late payments, most businesses, especially Small and Medium Enterprises (SMEs), will elect to take no action for fear of alienating their larger customers. Indeed, according to the Association of Chartered Certified Accountants (ACCA), firms with fewer than 50 employees are typically twice as likely as larger businesses to experience late payment issues. Besides giving rise to tighter financial conditions and higher administrative, transaction and financial costs (external financing may be necessary to manage cash flows), late payments can cause insolvency and ultimately lead to bankruptcy.

Dun & Bradstreet data show significant improvement in payment habits by industry on a quarter on quarter basis in Q2 2016. The data, broken down by industrial sector, reveal that between Q1 and Q2 2016 the largest improvement in payment habits was recorded in the 'Eating and Drinking places' sector, followed by the 'Health/Education/Social' and 'Retail Trade' sectors.

PROMPT PAYMENT EVOLUTION IN CRITICAL SECTORS (AGRICULTURE, RIGHT AXIS)

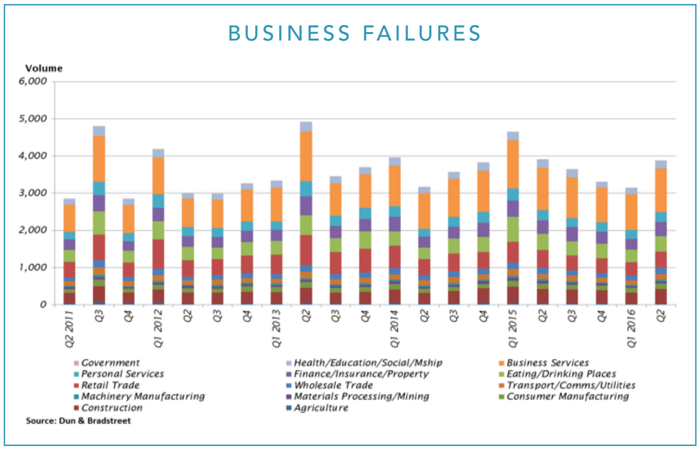


PROMPT PAYMENT BY REGION, JUNE 2016



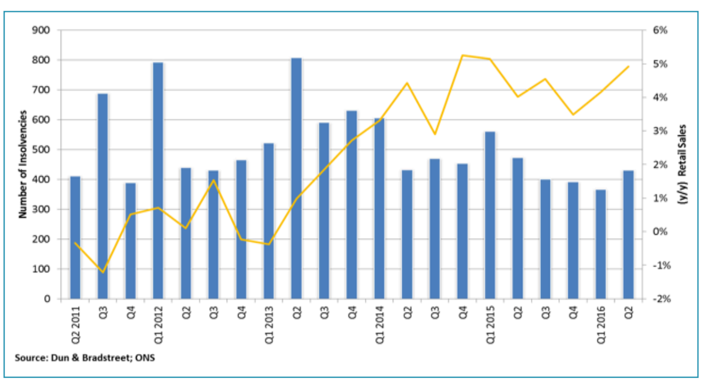
Dun and Bradstreet's data reveal that all the regions (barring the North) have improved their overall payment performance times in Q2 2016. In particular, South East (inside M25) and North West average prompt payments (as a percentage of total payments) rose to 30.6% and 32.2%, respectively from 26.5% and 28.7%, respectively in the first quarter of 2016. Greater Manchester area and Northern Ireland continue to lag behind all other regions, although the former have improved its prompt payments by some 3.2 percentage points (pp) between Q1 and Q2, while the prompt payments of the latter worsened by some 7pp over the same period.

4.0 BUSINESS FAILURES



Dun & Bradstreet data for the second quarter of 2016 showed a significant increase in the amount of corporate insolvencies: some 23% higher than the preceding quarter. However, the number of bankruptcies slightly decrease from the corresponding quarter of 2015 (some 1%), possibly tracking the acceleration in the pace of the economic activity in the first two quarters of 2016. Between Q1 and Q2 2016, corporate insolvencies were up in many important sectors of the economy, with increases of 48% q/q in 'Machinery Manufacturing' and 34.5% q/q in 'Finance/Property/Insurance. 'Government', and 'Materials Processing/Mining' were the only sectors to see a decrease in the amount of bankruptcies, down by 33.3% q/q and 8.2% q/q, respectively.

BUSINESS FAILURES: RETAIL TRADE

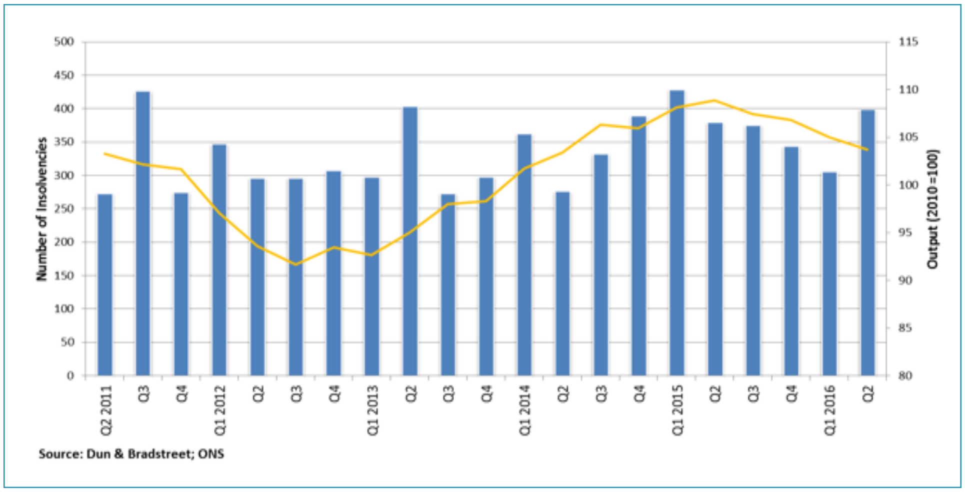


Although the latest (pre-Brexit vote) retail sales data suggest strengthening of momentum in household purchases, the number of insolvencies in the retail sector (which accounts for almost 6% of the UK economy) increased in the second quarter of the year, when it rose by some 18% q/q. ONS seasonally adjusted retail sales volume rose by a robust 4.9% y/y in Q2, following a 4.2% y/y increase in the first three months of the year. Despite remaining robust, we expect retail sales growth to decelerate in Q3, possibly reflecting a slight deceleration in the pace of economic growth on account of the uncertainty triggered by the June's Brexit vote. Lower sales growth could lead to a small rise in the number of bankruptcies in the coming months.

The ongoing decline in our recently compiled leading indicator for the UK economy supports this view, and suggests that a small rise in the number of bankruptcies is likely in the coming months. Against this backdrop, the uncertainty surrounding the retail sales outlook remains high, but risks to the upside and those to the downside are broadly balanced. On the upside, real wage growth and a low unemployment rate will continue to provide a boost to domestic sales volumes. On the downside, a slowdown in overall economic growth and Brexit could weigh on consumer spending.

Meanwhile, December data from the British Retail Consortium (BRC) and KPMG Retail Sales Monitor reveal that UK retail sales grew in June, albeit with total growth slowing to 0.2%. As Helen Dickinson, Chief Executive of the British Retail Consortium observed, the month production was largely driven by a decline in sales in the fashion categories, but this was expected as June 2015 saw record growth in clothing and footwear. On a quarterly basis, food sales performed better than non-food sales, which have seen its lowest growth in more than four years.

BUSINESS FAILURES: CONSTRUCTION

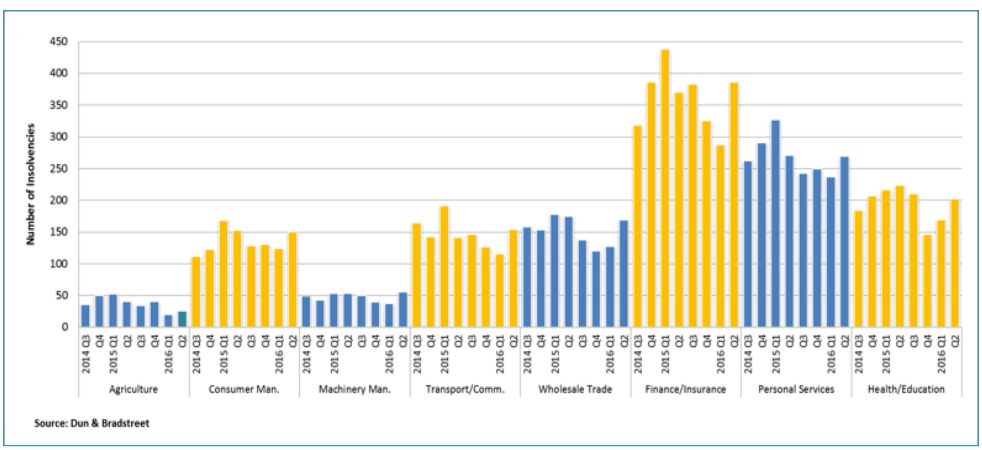


After falling for the previous four quarters, the number of construction companies going bankrupt rose again in Q2: some 399 companies failed in Q2, while some 306 went bankrupt in Q1. The construction industry plays an important role in the UK economy; the entire sector contributes £90bn in gross value added to the UK economy and supports 2.9m jobs. Improved momentum in this sector is likely to weigh on real GDP growth in the quarters ahead.

The latest seasonally adjusted Markit/CIPS UK Construction Purchasing Managers' index (PMI) tallies with the suggested worsening of momentum in the sector. The PMI index posted a reading 45.9 in July, well below the 50-point expansion threshold. Markit's report reveals that the slowdown in sectorial activity largely reflected the steepest fall in commercial building for over six-and-a-half years, alongside a drop in civil engineering activity for the first time in 2016. Residential construction also declined at a solid pace in July, but the rate of contraction eased from June's three-and-a-half year low.

July data on confidence in construction are in line with lower sectorial activity. The confidence survey released monthly by the European Commission revealed that pessimism in the sector grew to -3 points from -0.5 previously.

BUSINESS FAILURES: OTHER SECTORS



The chart above shows the number of business failures in several critical sectors. Insolvencies rose by by some 33.1% q/q in 'Wholesale Trade' and by some 21.5% q/q in 'Business Services'. Bankruptcies decreased in the 'Government' sector by 33.3% q/q.

5.0 RISK OF FAILURE AND PAYMENT DELINQUENCY – INDUSTRY SECTOR COMPARISON

		RISK OF FAILURE	
		RISK (Rating 1,2,3) Minimal to above average risk	**HIGH RISK** (Rating 4)
RISK OF VERY SLOW PAYMENT	**HIGH RISK** (Delinquency Score <=11)	**CASH CULTURES** UK AVERAGE – 27% RETAIL – 23% CONSTRUCTION – 10% Offer discount for prompt payment Charge interest on late payments Reset payment terms accordingly Improve relationship with client to induce prompt payment	**TROUBLE – LET YOUR COMPETITORS HAVE THEM** UK AVERAGE – 3% RETAIL – 3% CONSTRUCTION – 4% Increase prices to cover risk Reduce exposure - stop orders until paid Take guarantees Monitor vigorously Avoid new clients with this profile Up-front payment
	RISK Minimal to above average risk (Delinquency Score >=10)	**IDEAL CUSTOMERS – CULTIVATE** UK AVERAGE – 69% RETAIL – 73% CONSTRUCTION – 85% Push for more sales Strengthen relationship with client	**MONITOR CLOSELY** UK AVERAGE – 1% RETAIL – 1% CONSTRUCTION – 2% Reduce exposure – minimise outstanding orders Monitor vigorously Take guarantees

Dun & Bradstreet's statistical analysis reveals that some 3% of UK businesses are deemed to be at high risk of failure and are highly likely to pay in a severely delinquent manner, while 69% offer a low risk of failure and of slow payment. Sales emphasis towards these latter businesses will enhance opportunities and enable suppliers to reduce risks of non-payment. Additionally, some 27% of UK businesses fall within the lower risk categories (minimal to above-average risk) and are thereby less likely to fail; however, the payment habits they exhibit are somewhat slow, and while suppliers can be fairly secure in the knowledge that the business will not fail, payment may be somewhat protracted.

DUN & BRADSTREET'S OVERALL RECOMMENDATIONS

- Note that we have downgraded the country's risk rating by two quartiles to DB2c in the aftermath of the Brexit referendum; further downgrades are possible.
- Expect the government to invoke Article 50 of the Treaty of the EU (the legal base for EU exit) in early 2017, which would set the exit date for early 2019.
- If the UK leaves the EU (which is our current core scenario), expect some form of UK-EU trade agreement to be in place by the end of this decade.
- Exporters from the US should expect falling demand in 2017-18; the UK economy will slow down and import demand will shrink on the back of a very weak GBP.
- Expect credit risk to rise in 2016-18, especially for companies whose supply chains are geared towards the US (and to a lesser extent, the euro zone) given the weak GBP.
- Watch developments in the banking sector closely; support from the central bank will have a stabilising impact but further turmoil cannot be ruled out.

dun & bradstreet

Marlow International
Parkway, Marlow
Buckinghamshire, SL7 1AJ

+44 (0) 800 001234