



## Corporate Sector Outlook 2008

### Key themes

**Theme: 2008 presents a tougher market for firms selling into the UK market as GDP growth slows to 2.2% from 3.0% in 2007. Firms in the financial services industry may face the greatest challenges. Key questions are: Will UK firms' labour and capital productivity rise to prevent a collapse in corporate profitability? Will UK firms sell more to Europe on the back of the 79p euro? Will UK firms be able to increase export share to emerging markets, which are growing at an average rate of 7% pa this year? So will sectors with a high share of sales abroad relative to the UK fare better than those dependent on sales to the UK market in 2008?**

- Most of 2007 saw good performance of the non-financial corporate sector. Official data available up to Q3 suggest that non-financial corporate sector net rates of return reached record levels and cash reserves continued to accumulate. Manufacturing returned 9.7% on capital employed, services 21.2% and Continental Shelf companies 32.5%. However, it is likely that company performance may have weakened in Q4, not least because of heavy price discounting in the retail sector and price falls in residential housing and commercial property.

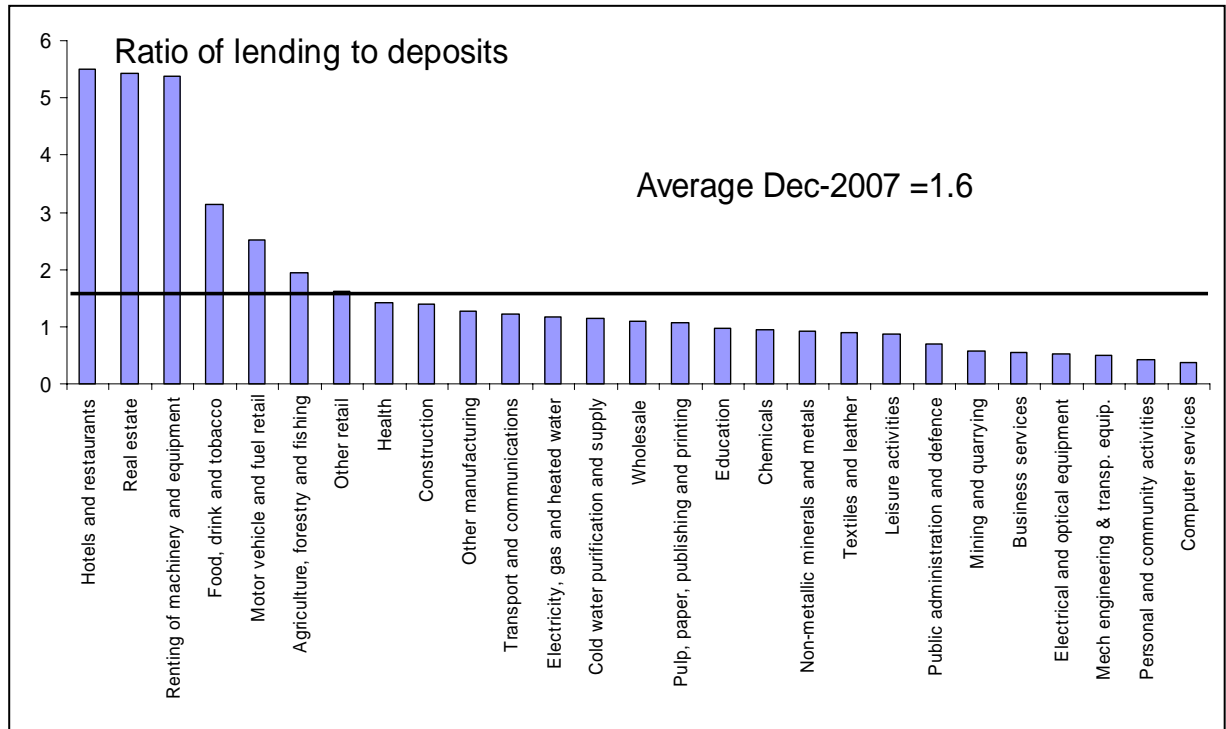
By contrast, financial companies such as investment banks that took large risks in ABS markets and retail banks with high dependence on wholesale funding, for instance, Northern Rock, took the brunt of the pain from credit market tightening with adverse impact on financial performance in H2 2007.

**Theme: Highly leveraged sectors such as real estate are already experiencing declining investor interest. Our evaluation of corporate sector leverage will help inform which sectors may face difficulty and which will continue to grow during the year.**

- 2008 may bring a growing disparity in the cost of borrowing between cash-rich and 'branded' companies on the one hand and sub-investment grade and/or highly leveraged companies on the other. Companies heavily dependent on debt-funded growth may struggle to obtain traditional facilities at rates that they can afford or wish to pay. The challenge facing these firms is to base strategy on a full assessment of markets and economic fundamentals, considering various

scenarios. The challenge facing financial services companies is to target firms 'most likely to get it right', while at the same time minimising losses on companies/sectors heading towards default and to help with financial planning and initiate 'turnaround', where possible.

*Chart 1: Leverage varies among corporate sectors. Highly leveraged companies may be at greatest risk of running into problems in 2008. This is evidenced already in the real estate sector.*



**Theme: As the fallout from credit markets become clearer in 2008, will corporate insolvencies move in line with predictions? Have we been over-optimistic about the longer term effect on economic growth leading to a higher than expected default rate?**

- We expect the UK insolvency rate to peak at the start of 2009 at 1.1% of active companies. This is the highest rate in 5 years, but well below rates of 2.6% recorded in the last recession. It also bears no comparison with the 17% US sub-prime mortgage default rate.

**Theme: Corporate spreads will 'normalise', but the timing of this is uncertain. Lower official base rates may lead to a steady pick-up in medium to long term corporate issues next year as non-financial firms re-start capital spending projects and M & A activity picks up.**

- Investment grade corporate spreads may only start to fall back to their long term average of 100bp, currently around 270bp principally due to financial companies, once the credit crisis shows signs of abating, investor confidence returns and insolvencies peak.

**Theme: The UK business services industry has solid growth prospects outside of supporting financial services. Although cyclical in the UK, there are growing overseas opportunities.**

- Despite the credit crunch, business services will grow at almost twice the level of average gdp in 2008-9, over 4% pa, as support services, accountancy, legal and recruitment services remain in strong demand.

**Theme: Much media focus has been on the potential downturn in the UK distribution and services industries, as they account for the largest share of the UK economy. In particular, the current woes in the retail sector and the adverse impact of slower economic growth and tighter lending criteria on the financial services industry are widely commented on. Competitive manufacturing sectors and many areas of business services have been overlooked. These companies are well placed to benefit from the 10% depreciation in sterling's trade weighted index over the last year, by extending their geographical reach.**

- High level manufacturing sectors will benefit from robust global consumer demand and a more competitive sterling exchange rate in key eurozone markets – consumer electronics and precision and optical equipment, especially. Retail sales so far this year have surprised to the upside.

**Theme: Confidence in the hotel and catering sector is currently weak, but could return due to interest rate cuts by the Bank of England. But the sector may be held back by high gearing.**

- Despite concern that restaurants and catering sector face a difficult period due to slower growth of consumer spending, we believe that the business market and overseas visitors will support hoteliers longer term.

**Theme: Financial services may outperform bleak expectations, as there may be a re-distribution of growth within the sector to savings products and low/medium-term risk acquisition finance. Financial planning, including foreign and exchange risk management, may see strong demand as companies take stock of current credit market conditions and seek to protect against market uncertainty.**

- The impact of the credit crisis on the financial services sector overall may be less severe than markets currently expect. Competition will keep up pressure among UK companies for cost savings through M & A activity and private equity deals (especially those with low to moderate leverage). Also, personal sector borrowing could rise in 2009/10 as long-term employment prospects are robust.

**Theme: Go long on house-building and construction. Lower official interest rates may curtail the short-term slowdown.**

- Medium to long term prospects for the construction sector are better than short term prospects. Factors driving growth include an undersupply of housing new-builds (in relation to demographics in areas of strong jobs growth), repair & maintenance and infrastructure projects such as the 2012 Olympics, Cross-rail and new airport developments.

**Theme: Also, go long on infrastructure, which is developing rapidly worldwide involving competition for finance from private and public financial institutions.**

- Long-term prospects for UK infrastructure are good as reflected in above average gdp growth prospects for transport services and communications. The UK has fallen behind in recent years and is now undergoing a degree of 'catch-up'.

**Theme: The commercial property sector is prone to volatility as the sector overshoots in good times and undershoots in bad times. A key marker is the gap between initial yields and five-year swap rates. Already this has turned positive again, suggesting that once the current panic subsides, there could be a speedy return to growth. We are not overlooking the risk of a more serious crash, though, as investors are withdrawing funds for fear of losses akin to those in the early 1990s. The difference now is that UK interest rates are significantly lower than during the last recession, possibly helping avert a prolonged crash.**

- In the commercial property market, the yield gap with 5-yr swap rates (benchmark for borrowing for debt funded companies), has switched back to positive which signals an inducement to invest. UK 5-year swap rates have fallen to 4.97% while initial commercial property yields have risen to 5.4% (IPD index). Last June, 5-year swaps were 6.3%, whereas initial yields were 4.7%, deterring investment.

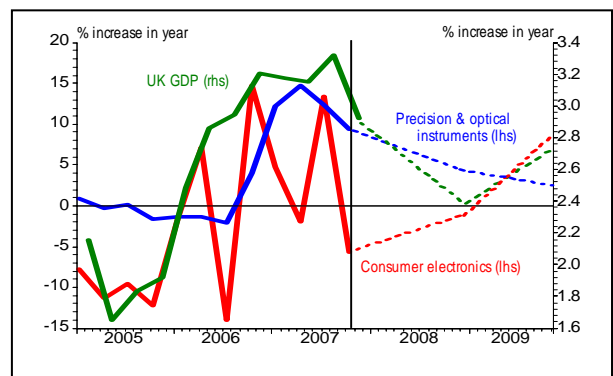
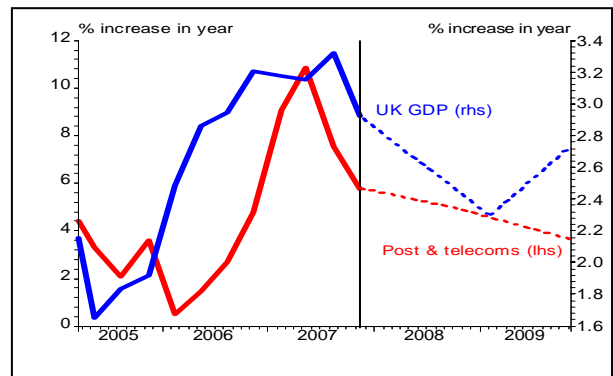
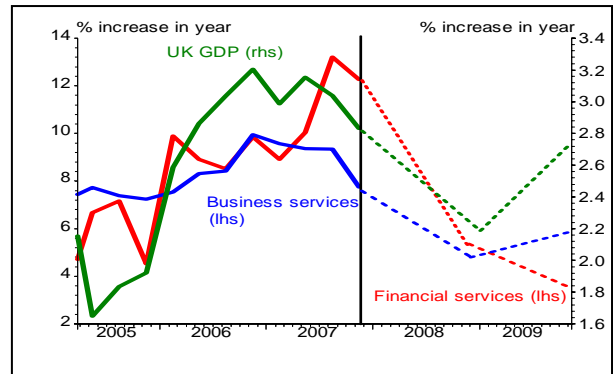
**Theme: Most of the sectors that are top/bottom performing in 2008-9 remain so in 2010-12, suggesting that the structure of UK industry is stable. Are there factors that could change this?**

- Our UK sector rankings of fast and slow growing industries are listed below. Service industries such as financial & business services may have their fast growth rates clipped by the current squeeze in money/credit markets, but will continue to grow well above the all-industry average. Also, post & telecoms and transport services may grow faster than average GDP. Underpinned by business investment growth and consumer purchases of entertainment and information systems, consumer electronics and precision & optical equipment are among the fastest growing industrial sectors in 2008-9. The worst performing sectors include mature industries, such as consumer goods manufacturing and metals production, although there are sub-sectors of these groups that may grow relatively well. Production of many of these goods will continue to move to cheaper sites

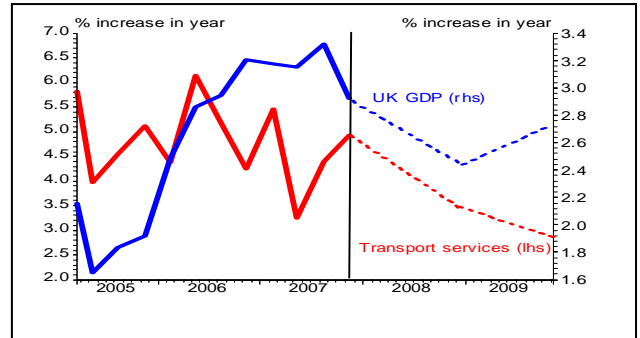
in Eastern Europe and Asia. The construction sector is also expected to weaken after a period of strong growth, but could rebound strongly in the medium term.

### Detailed industry commentary

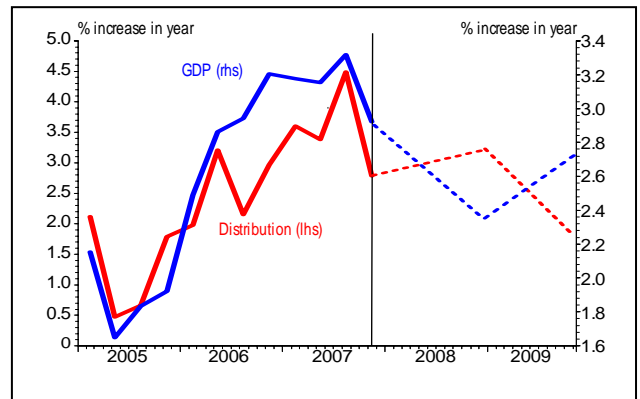
- Business and financial services may have their fast growth rates clipped by the current squeeze in money/credit markets, but will continue to grow at a rate above the all-sector average. Advertising, marketing, accounting, PR, consultancy recruitment, law and business process outsourcing are rapidly developing international business.
- Telecommunications will grow strongly on the back of healthy global business activity and consumer demand for new media, as new technologies continue to stimulate demand. Profitability in the industry is generated by productivity improvements and premium service offerings, including securing rights to audio/visual content, as the potential for price growth is curtailed by regulation and intense market competition.
- The fastest growing UK sectors in 2008-9 include those in the higher value added end of manufacturing, including consumer electronics and precision & optical equipment.



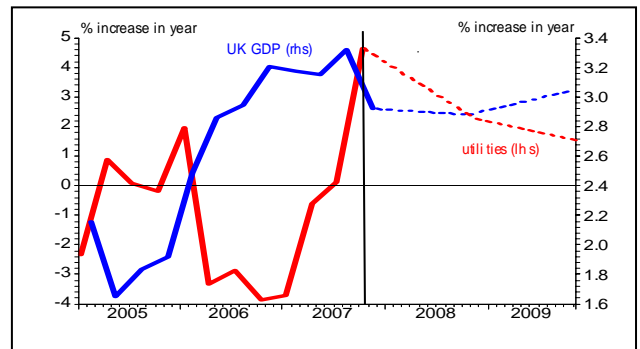
- Transport services, including air, road and rail transport, will continue to benefit from strong global GDP growth with 'nimble' carriers continuing to win market share.



- Distribution & repair output growth will slow over the next two years as UK consumer spending growth declines. Recent retail sales data have been surprising strong, driven principally by food, department and clothing and footwear stores. Non-store retailing and repair, including internet sales have shown strong growth in recent months. Many larger companies in the sector are strategically focused on overseas expansion.



- Electricity, gas & water output is expected to grow just below the average GDP rate in 2008-9.



## 2008/09 UK forecast

### Fastest growing

| % change on year earlier        | 2007  | 2008-09f |
|---------------------------------|-------|----------|
| Business services               | 7.1   | 4.4      |
| Post & telecoms                 | 8.3   | 4.2      |
| Financial services              | 11.1  | 3.6      |
| Precision & optical equipment   | 12.2  | 3.6      |
| Transport services              | 4.5   | 3.1      |
| Distribution & repair           | 3.6   | 2.1      |
| Consumer electronics            | -18.9 | 2.1      |
| Electricity, gas & water supply | 0.1   | 2.0      |
| Chemicals                       | -1.2  | 2.0      |
| Non-market services             | 1.9   | 1.9      |

### Slowest growing

| % change on year earlier           | 2007  | 2008-09f |
|------------------------------------|-------|----------|
| Motor vehicles & parts             | 4.4   | 0.4      |
| Mechanical engineering             | 4.5   | -0.1     |
| Media equipment                    | 2.2   | -0.2     |
| Electrical Machinery               | 2.3   | -0.4     |
| Agriculture, forestry & fishing    | 3.2   | -0.5     |
| Metal products                     | 0.9   | -1.0     |
| Electric components                | -4.3  | -1.5     |
| Mining & quarrying, incl oil & gas | -1.7  | -1.7     |
| Textiles & clothing                | -2.2  | -3.9     |
| Computers & office equipment       | -23.7 | -5.3     |

## 2008/09 US, Western Europe & Japan forecast

### Fastest growing

| % change on year earlier             | 2007 | 2008-09f |
|--------------------------------------|------|----------|
| Electric components                  | 12.3 | 14.6     |
| Computers & office equipment         | 16.7 | 9.2      |
| Media equipment                      | 7.9  | 6.6      |
| Consumer electronics                 | 7.9  | 6.6      |
| Precision & optical equipment        | 3.0  | 4.5      |
| Post & telecoms                      | 3.7  | 3.9      |
| Financial services                   | 4.2  | 3.5      |
| Business services                    | 2.9  | 3.0      |
| Transport equipment, incl. aerospace | 5.3  | 2.9      |
| Distribution & repair                | 2.5  | 2.9      |

### Slowest growing

| % change on year earlier            | 2007 | 2008-09f |
|-------------------------------------|------|----------|
| Construction                        | -0.5 | 2.0      |
| Non-market services                 | 1.5  | 1.6      |
| Agriculture, forestry & fishing     | 0.9  | 1.2      |
| Solid & nuclear fuels, oil refining | 0.8  | 1.2      |
| Food, drink & tobacco manufacturing | 2.2  | 1.1      |
| Pulp, paper, printing & publishing  | 0.5  | 1.1      |
| Basic metals                        | 1.1  | 0.9      |
| Wood & wood products                | -2.1 | 0.9      |
| Mining & quarrying, incl oil & gas  | -0.4 | 0.6      |
| Textiles & clothing                 | -2.8 | -3.2     |

#### Disclaimer

Issued by Lloyds TSB Bank plc of which Lloyds TSB Financial Markets ("LTSBFM") is a division. This document has been prepared by LTSBFM and contains indicative rates and data only. These rates and data are provided for information purposes only, as an accommodation and without charge, and are intended solely for your use. LTSBFM specifically disclaims liability for any use you may make of any rates. These rates and data do not represent the actual terms at which new transactions could be entered into. This document has been prepared from information believed to be reliable however such information has not been independently verified and no guarantee, representation or warranty, express or implied, is made as to its accuracy, completeness or correctness. This document should under no circumstances be treated as an offer or solicitation to offer, to buy or sell any product. Providing rates to you on one or more occasions does not create any obligation for LTSBFM to continue to do so in future. Lloyds TSB Bank plc's registered Office is at 25 Gresham Street, London EC2V 7HN and it is registered in England and Wales under no. 2065. Authorised and regulated by the Financial Services Authority and a signatory to the Banking Codes, Lloyds TSB Bank plc represents only the Scottish Widows and Lloyds TSB Marketing Group for life assurance, pension and investment business.