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Market Insight | Covid-19: UK business sector outlook. August 2020

Changes in how the population works, relaxes and consumes because of Covid-19 mean business models orientated to deal with pre-pandemic patterns of demand are now wrongly positioned, with likely consequences for cash-challenged and/or subscale going concerns. Whilst this will create economic rebound opportunities for private equity and debt finance, business backers will be required to obtain a deep-rooted understanding of the target's remaining marketplace and its sustainable advantage before committing to transactions. David McClelland, Director at Carlton Strategy Advisors, examines the outlook for six key business sectors: Healthcare, Pharmaceuticals, Retail, Hospitality & Leisure, Industrial Manufacturing and Enterprise Software.

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UK business sector reviews:

Outlook for Public Healthcare

Healthcare enjoys resilient consumption, but Covid has severely tested a strained system of delivery.

There is an opportunity to reset relationships between the NHS, the public and the wider health services community.

Technology will play its part in workflow tools, data exchange solutions and personalised medical care.

As people live longer, the goal is to ensure quality of life.

Public sector healthcare enjoys characteristically resilient and non-cyclical consumption and, as in other countries, demand consistently outstrips supply in the UK. However, Covid-19 has severely tested an already strained system of delivery and the demand shock from the rapid spread of the virus has exposed substantial inefficiencies in the national public health services infrastructure. The public's increased appreciation of the work that healthcare professionals undertake will almost certainly drive greater sector expenditure, but the crisis has highlighted a frequently disparate and poorly focused bureaucracy comprised of governing bodies, regional trusts, local authorities and agencies; and the debate around the long-term direction of funding for a service that in principle is designed to be 'free at the point of delivery' remains unresolved.

Covid's high rate of cross infection and the necessity of social distancing has radically altered the channels through which patients seek medical assistance. Surgeries, clinical centres and A&E units have restricted personal appointments and/or walk-ins in favour of telephone and/or online pre-assessments. Before Covid, filtration through staff receptionists and call handlers was resisted by society's high-held belief that one must be allowed direct access to qualified professionals upon request. Life with Covid and under lockdown has ameliorated that reluctance as patients have become more receptive to pre-assessments where these are understood to be the means to efficiently direct individuals to the sources of the correct attention at time of exceptional circumstances. After Covid, many of these habits can be expected to stick and become the accepted routine, creating a fertile landscape for the wider introduction of electronic triage and other digital administrative methodologies, particularly where such applications reduce costs and improve the efficiency and effectiveness of the patient experience.

Going further, anonymised data can be procured from patients' electronic medical records to provide a national databank for medical research and as an aid to drug development, patient health monitoring and population health screening. National medical records that date back to the formation of the NHS in 1948, provide a huge source of raw material for analysis by means of artificial intelligence, deep data mining and automated programme learning; digital techniques which are increasingly capable of correlating the symptoms of disease with their cause.

In the fields of radiology and ophthalmology, for example, AI algorithms are increasingly able to read multiple pathologies allowing scans from X-rays, MRI and digital retinal observations to be compared and data cross-referenced with a patient's medical history to show if the individual is at risk of other conditions.

Wearable trackers and other types of body monitors which are capable of recording levels of personal physical activity and vital life signs, for example, are finding application in smart phones, watches and other portable devices. These can be deployed to determine which of several pathways to maintain good health work best for an individual, taken together with data examined from biobanks backed up by clinical health validation studies.

The modern age has brought about an increase in non-communicable 'lifestyle' diseases driven by behaviours such as poor diet, smoking, lack of exercise, and overconsumption of drugs and alcohol. Covid aside, these have replaced infectious diseases as the leading causes of death. The total number of confirmed cases of Covid-19 in the UK reached nearly 330,000 in late-August, at the time of writing. As rapid and as worrying as the spread of the virus has been this year to date, the pandemic headlines mask the top-10 chronic diseases which drive UK healthcare consumption: arthritis, hypertension, asthma, diabetes, cancer, bronchitis, heart disease, dementia, blindness and epilepsy.

Long-term medical conditions affect an estimated 4m older people in the UK. In an aging demography, this is expected to increase to 7m by 2030. However, whereas today's healthcare system is predominantly based on the model of 'become ill/seek treatment', unsupportable costs of delivery together with shifting consumer preferences for convenience and affordability imply that the model of the future will be required to switch to one of 'predictive maintenance/condition monitoring', grounded in genomics and personalised medicine. People are living longer; the goal is to better understand the body's ageing processes, while accommodating individuals' lifestyle choices, to ensure the prerequisite quality of life.

Outlook for Pharmaceuticals

Before Covid, the balance of purchasing power in the pharmaceutical's supply chain rested with buyers.

After Covid, bargaining power may return to suppliers.

Trade protectionism may cause producers to revise supply chain risk exposures to avoid long-distance dependencies.

The Covid-19 crisis paints a mixed picture for the future of the global pharmaceuticals industry. Demand can only increase for precautionary drug therapies designed to mitigate the continuing spread of the outbreak when the alternative of a vaccine is as yet unavailable. However, other therapies may experience faltering demand as non-Covid related hospital procedures and elective surgery are postponed and primary care patients defer contact with general practitioners. Hospital consumption will increase across general anaesthetics and sedatives, together with antivirals able to shorten the time to recovery in adults hospitalised with Covid-19. As hospital procedures for non-Covid patients were deferred, this would have had the effect of altering patterns of consumption from hospitals to prescribing GPs and dispensing or OTC retail pharmacists.

Before Covid-19, the balance of relative purchasing power within the industry's supply chain rested with NHS buy-side negotiators, rather than drug suppliers under the sustained influence of the political powers to reduce public sector costs together with the requirement for the sector to adhere to the terms of the EU's Most Economically Advantageous Tender directive. Consequently, generic medicines account for about 80% of all medicines sold to the NHS, with pricing having become a 'race to the bottom' in line with the aggregation of the supply chain in pursuit of economies of scale. This could change however: Covid-19 patients on mechanical ventilation require substantial does of a cocktail of drugs to keep them in induced comas during the process of their recovery. The need for the ready availability of these drugs, on time and in sufficient volumes of supply – together with political acquiescence in the face of public anxiousness and concern about Covid – may see some restoration of relative bargaining power return to the supply side of the equation.

The dynamics of the pharmaceutical industry's R&D model have shifted in recent years with a plethora of specialist, early stage biotechnology companies emerging across the fields of new molecule discovery and drug development. In pharmaceuticals – as elsewhere – business size matters, with 'large-corp' more favourably positioned in terms of cash reserves and access to financial markets than smaller companies. This will have ramifications for the structure of the industry should the pandemic lead the UK into lasting recession. Small and cash-strapped companies may not have the funds to support their drug development pipelines, with the consequence that a number of attractively priced assets will be brought to market in an industry-wide M&A-led consolidation play.

The industry's focus hitherto was on cost and efficiency, which saw many drug companies' supply chains extend to low-cost producer destinations. India has become one of the world's largest exporters of generic pharmaceuticals and, together with China, is predominant in the production of active pharmaceuticals ingredients. Nation state concern about the need to conserve medical stocks during Covid has served to increase trade protectionism in a number of countries, which has seen restrictions placed on pharmaceuticals exports. Import restrictions, together with prolonged economic uncertainty, will be likely to cause companies to reconsider their business models in a revision of both their supply chain and market distribution risk exposures. This could result in manufacturers repatriating procurement and other operational activities in order to better mobilise functional capacities on a local basis and thus avoid unreliable long-distance, dependencies.

As with healthcare generally, the pharmaceuticals industry will gain from advances in digital technology; particularly in the area of drugs trials where artificial intelligence is able to facilitate the analysis of clinical data gained from multiple trial sites and remote locations. Such programmes represent a potential 'win-win' proposition for medical technology companies, drugs majors and the NHS; particularly if they are able to work in collaboration.

Outlook for Retail Services

The retail landscape is characterised by three confluent drivers: social distancing, online retail and furloughed salary protection.

Covid has skewed retail volumes and their channels of distribution to consumers.

Acquired consumer habits will prove permanent, where online retail is the clear winner.

Retail success rests in 'big data's' ability to yield patterns of demand in real time.

Previous recessions have seen retail consumers react to the threat of unemployment and loss of income by deferring big-ticket, discretionary purchases in favour of lower-cost, 'value' items. This time around, the Covid-19 induced lockdown has enforced a recession with an almost artificial element to it; the market entity – made up of sellers and buyers – remains in place, but nobody can readily gain access to it by way of the traditionally deployed channels.

The present retail landscape can be characterised by three key confluent drivers: social distancing, online retail and furloughed salary protection. The pandemic has curtailed city centre retail footfall, but served to accelerate consumer acceptance of home delivery and click-and-collect online services paid for by a still spendthrift public. Household savings rose from 6% before the pandemic to 25% in Q2. As savings rates have risen faster than the drop in general incomes, households have a buffer protecting consumption. The bulk of these savings have been on the part of high-income households and consequently those with lower-incomes are likely to cut back on spending as furlough ends and unemployment becomes a pressing concern.

The pattern of advertising industry expenditure serves to indicate the economic effect that Covid has had on a number of business sectors. Airlines, travel and tourism, cars and consumer retail have all seen advertising costs slashed. The few sectors where expenditure has substantially lifted include government and charities in addition to PPE suppliers, online retailers and delivery companies.

Consumer goods businesses can accurately forecast demand under normal trading circumstances where, typically, seasonality and marketing promotions are the biggest drivers of change. However, the virus has skewed both the volumes of goods sold and the distribution channels through which goods are sold to the consumer.

Food retailers have benefited from the crisis in two ways: by recording higher sales volumes generally and, secondly, through higher margins in the widespread absence of discounts and special offers. Covid triggered an initial bout of 'panic buying', but people are also eating more at home during lockdown which necessitates the bigger, or more frequent, shop. Furthermore, there appears to be a new sense of loyalty towards shopping locally at the expense of town and city centres.

Some supermarkets are streamlining shelf space and carrying a narrower range of SKUs. This is a play that, if maintained, could alter the competitive dynamic of the market between premium or full-line grocers and others who carry a limited range of mainly 'value' shelf items. It also potentially allows new (direct-to-consumer) entrants into the market, where such players are able to (digitally) exploit unfulfilled or unguarded positions. Corner shop operators have also experienced higher sales quantities per customer visit, but from a generally lower total footfall with typically fewer marked-up 'impulse' purchases.

In the non-food sector, retailers are experiencing mixed fortunes. People who are on furlough at home, with school children at home, and with generally increased leisure time together with those now working from home have driven demand for computers and on-line connectivity in addition to home entertainment subscription services. On the other side of the coin, lockdown substantially killed retail consumption across hospitality, live events, travel and tourism.

Cancelled sports events have hurt gate receipts, in addition to, on premises consumption of secondary merchandise, food and drink – albeit that some drinks brands have responded to the 'at-home' market with novel take-away drinks packs and 'bar-quality' cocktails. The closure of gyms and other indoor sports facilities renewed the public's interest in cycling, walking and running. Cycling retail stockists, for example, report strong demand for new basic and mid-range bicycles and for repairs, parts and accessories. The government's anti-obesity drive, in a recognition that overweight people are more vulnerable to Covid, has introduced a number of bike purchase and repair subsidy schemes, which is adding a further level of froth to an active market segment. 'Bricks and mortar' bike shops who were previously struggling to compete against online suppliers before Covid have seen in-shop retail volumes rejuvenate; many are currently reporting strong pre-orders ahead of 2021's range of new stock introductions.

A number of the present trends in retail can be expected to reverse in line with the timing and nature of the UK's economic recovery. In the long-term absence of a vaccine or curative for Covid-19, it is likely that certain acquired consumer habits will prove permanent. The clear winner will be online retail as growing numbers of consumers during lockdown become familiar with the plethora of retail platforms increasingly available on the internet and their benefits in terms of product choice, cost competitiveness and speedy-delivery to addresses of choice. Physical retail stores with no online presence in future will only be able to compete in narrow, restricted retail areas where they can profit from defined customer segments or niche markets and where there are sufficient levels of demand for the more specialised forms of product or service better delivered to the customer in person within the shop or other premises than online.

At the present time, as the UK approaches its seventh month of Covid, many retailers remain in a mode of basic commercial survival as they strive to consolidate operations, conserving cash and stave off staff redundancies. For those continuing to trade, phase-II business development plans will involve 'right-sizing' newly revised business models to capitalise on the different patterns of consumption as these emerge in the future. B2B distribution channels and long-distance supply chains, for example, could modify to accommodate B2C retail effort and greater local provenance with potentially superior operational speed and security – rather than give greatest emphasis to lowest SKU cost.

Digital technology, and now Covid, have accelerated a decline in society's use of cash and the need for ATM dispensers in favour of contactless payment systems. Retail, front of shop EPOS systems already exist to record transactional information and connect product sales to stock levels, re-order quantities and supplier deliveries. However, the more widespread public adoption of digital payment technology as a result of Covid generates a significantly greater quantum of data from which to gain knowledge and original insight about consumer purchasing habits; data which is valuable in determining marketing direction, asset allocation and capital investment. As consumers become more brand promiscuous in the internet age, retail success will increasingly be a direct function of the retailer's relative ability to extract from 'big data' the emerging patterns of demand as they occur in real time; data which then enables the retail offering to be precision tuned to match the tastes and requirements of an ever changing marketplace.

Outlook for Hospitality, Leisure and Tourism

The leisure and hospitality sector is commercially hamstrung.

In the absence of the means to very substantially reduce costs, business will go under.

City centre locations will be most detrimentally affected, but the regions may fare more favourably.

Few sectors have been as badly affected by the coronavirus pandemic as hospitality, leisure and tourism. The introduction of social distancing, designed to break the spread of the pandemic, barred mass public gatherings and severely restricted public transport and private travel. At a stroke, airlines, hotels & restaurants, sports stadia, gyms, cinemas and pubs were forced to close. Where allowed by the government to selectively reopen, many remain commercially hamstrung due to the need to adhere to customer and staff protection guidelines.

Much of the sector operates on tight margins, calculated on cash receipts from a level of utilised capacity and break-even against fixed overheads. In a socially distanced world, many of those business will not see the volumes of returning

customers needed to generate sufficient revenues to meet break-even. In the absence of the means to very substantially reduce their costs, a significant proportion of these businesses will go under and, consequently, the sector is likely to undergo significant structural change.

UK 'staycations' will replace foreign airline travel and ships cruises, for example. The branded, themed and franchised casual restaurant trade, ubiquitous of every high street, will give ground to individually styled outlets able to right-size' and better accommodate 'post code' demographic tastes. Nationally branded gyms and fitness centres will see clients lost to the livestream 'at home' market and, more simply, nature's open spaces where walking, running and cycling is permitted. Similarly, livestreaming/subscription services can be anticipated to replace cinema, theatre and live stadia. In all of this, it will be the city centre locations that are going to be worst affected to the benefit of the regions.

Outlook for Industrial Manufacturing

Present activity in manufacturing is a function of widespread depressed demand in end-user markets.

Brexit adds to the slowdown.

Nation state protectionism may see regionally distant supply chains revised to favour local suppliers.

Workforce distancing and other pandemic mitigation measures within the factory environment will accelerate developments in automated process control and robotics

Writing about the activity of the manufacturing sector quickly boils down to the prospects for original equipment sold in often cyclical downstream, end-user markets. Aircraft manufacture, for example, enjoyed a decade of global growth, largely driven by demand from budget airlines before the advent of the coronavirus crisis. Whilst the airline sector is unlikely to see passenger demand recover until at 2023, or later, one may hypothesize that consumers' yearn for overseas travel will rebound amongst UK outbound passengers and inbound passengers, especially in line with rising economic wealth in Asia and other developing economies. The outlook for UK car manufacturing is less clear. Although production plants and downstream car show rooms were mothballed during lockdown, killing supply to the market, consumer demand for private travel may see car build volumes at least partially recover as the travelling public remain wary of the risk to health from the often crowded public transportation network.

The pandemic coming on top of the existing trend towards greater nation state protectionism may see the globally complex and extended 'just in time' supply chains that are typical of the automotive manufacturing industry alter in favour of a more diverse range of locally sourced supply partnership connections. However, the issue that is beyond the scope of this article, remains overcapacity in global car production and the bigger question of whether foreign marques will retain facilities in the UK after Brexit.

Workforce distancing and other pandemic mitigation measures within the factory environment will accelerate the development of the automated process control and robotics sector. Process automation engineering businesses can be characterised between those who offer customers standardised machinery and equipment installation services or, alternatively, bespoke process engineering solutions.

After Covid, one may see manufacturing automation follow the ethos of 'greatest added resilience' to ongoing operations. This core principle is anticipated to reduce demand for comparatively low added-value 'build to print' engineering services, ie where an installation is designed to a customer's given specifications and delivered outputs measured in terms of basic process efficiencies and cost reduction objectives. In its place, demand is predicted to rise for the full-service type of project and where there is greater emphasis on customer needs identification, design, build, installation and after care, ie end-to-end manufacturing process redesign, where the key delivered outputs are measured across productivity, product time-to-market and lifecycle extension.

High volume, high value and often tightly regulated products such as pharmaceuticals, medical equipment and electronics lend themselves to high-end manufacturing automation. After Covid, OEM customers will increasingly recognise pre-qualifying and nominated suppliers as their strategic partners, which will generate possible repeat earnings for those suppliers in the form of the initial sale of a primary capital expenditure item in addition to potential secondary revenues from aftermarket sales of repairs and maintenance services, staff and operatives training services, and further consumable items associated with daily operations.

Outlook for Enterprise Software

Enterprise software is comparatively resilient to macroeconomic downturn.

Barriers to entry are high and systems not easily substituted.

Much market spend is from larger corporates better able to withstand recession than smaller businesses.

After Covid, vendors can expect demand to recover as enterprises adapt IT to accommodate changes within the customer base, supply chain and distribution networks. And as employee workloads transition off-premises.

Corporates invest in IT to realise cost savings and maintain efficiency, and to remain competitive. Consequently, the sector is expected to weather the economic storm brought on by Covid better than many.

Corporate enterprise software automates information from a range of business processes to create a set of interconnected data modules that improve performance in the organisation and across functional operations such as finance, HR, sales, purchasing, manufacturing and distribution, and externally within the organisation's supply chain.

Enterprise customers may procure a software package from a principal vendor, trusting it will integrate as intended on installation across the requisite functional operations. User integration is key to the success of the installation package and while 'out-of-box' solutions permit levels of integration, other vendors are frequently brought in to the equation as Value Added Resellers or Independent Software Vendors for their additional, often specific applications expertise, eg custom data processing functions, product upgrades and other consulting advisory services.

The software industry's ability to generate client up-sales or market vertical cross-sales are a key sector revenue driver, which provides a measure of 'decoupling' from the general direction of the economy. Sales agreements with customers are typically based on a product subscription model, which affords business continuity and forecast predictability. The alternative model based on the outright sale of a product licence is increasingly out dated because of its discretionary nature, dependent on the customer committing to proceeding with the purchase of any new product releases when these are offered by the vendor.

The software sector is general more resilient to the effects of macroeconomic downturn where vendor applications are deemed to be a critical aspect of the customer's business operations. No more so than where the software is so embedded within the customer's process infrastructure as to be not easily substituted or subject to cost reduction measures undertaken by the customer. Resilience is also a feature of the fact that a majority of the sector's income is derived from sales to larger sized corporate customers who are generally better able to withstand economic recession than many smaller companies.

Despite enterprise software's inherent market resilience, the lasting shadow of Covid could create inevitable challenges for the development of the sector. Fast-growth, early stage applications development firms, a characteristic of the sector, may face liquidity challenges hindering market traction and new product introductions. Larger and established vendors may see revenue streams become more volatile as customers go under and because of reduced product user numbers on volume-linked licencing applications, where clients curtail operational expenditure. However, those same larger vendors could benefit from retained legacy software, as client's delay or postponed modernisation and new implementation plans.

After Covid, vendors can expect demand to recover as enterprises adapt their IT to accommodate possibly multiple changes in the structure of their customer base, supply chains and distribution networks. New and adjusted software solutions will also be required to accommodate physical distancing and personal protection between employees in the workplace and additionally, as workloads transition off-premises.

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