Effects of the financial crisis on various uk industries

Economic Report

The above graph shows the FTSE 100 index in the 5 years to the 14th October 2010. The index value at any particular time is based on the share prices of the top one hundred by value with each organisation being ‘ weighted in proportion to its total market value’ (Pike, Neale, p. 38 2009). Despite this index only being a small percentage of the total companies in the United Kingdom it generally reflects the performance of much of the market.

Prior to the financial crisis of 2008 leading to the crash in the markets-shown in the first quarter of 2009-investment in government debt was regarded as relatively risk free. It is a sign of the fragile economy situation globally that investors no longer view such investments as a ‘ sure thing’ (Oakley, 2010). This credit crisis has prompted investors to proceed with caution and despite initial positive trends the principles which underpinned investments in the past have been shattered resulting in large scale political reforms throughout much of the Western World (Future of investing, FT). The suggestion of an unsteady recovery is reinforced by a recent article in the Economist which states that,

‘ Big asset busts are usually followed by years of weakness as the over-borrowed repair their balance-sheets. Experience suggests that several years of slow growth lie ahead.’

Oct. 7th 2010

It goes on to state that the reactive measures will be ‘ the biggest synchronised fiscal tightening on record’. Governments worldwide have had their hand forced in to budget cuts and other measures to sustain growth out of the crisis. Whilst this statement points to and assures uncertainty should be highlighted that ‘ growth’ albeit at a slow pace is thought to be likely.

The current economic situation, specifically in the United Kingdom, is underlined by the massive growth in unemployment. Gilmore comments that the number of workless households has increased to 3. 9 million over the last two years – an increase of 389, 000 (2010, p 39). Furthermore, high profile cutbacks remain prevalent with Boots and Hewlett-Packard announcing combined cuts of 2, 200 workers in the UK alone (Clark, 2010; Felsted 2010). Whilst over the past two years there has been an overall escalation in unemployment there are some signs of improvement. The three months to July 2010 witnessed the number out of employment fall to 2. 47 million (Gilmore, 2010).

It can be said that the current times are very uncertain and on that account the correct investment strategy will be vaguer than ever before. For that reason, the general investment strategy which will be employed is ‘ buy and hold’. Not all investments will be made in this manner, however, for the most part this logic will be applied. The ‘ buy and hold’ approach can be justified by looking at the market trend since the FTSE 100 began in 1984:

It can be seen that after a dip such as in 1987 and in 2000 that the market tends to recover so despite the fragile economic situation a recovery, albeit a slow one as mentioned previously, can be envisaged.

Sector Reviews

Sector: Power

The power sector is one of the main constituents of the FTSE 100. Utilities and Oil & Gas alone make up 14 of the 104 constituents which complete the index, together counting for nearly a quarter of the net market capitalisation for all the industries included. It can therefore be deduced that any reasonable change in the power sector as a whole has a great influence on the performance of the top one hundred FTSE listed companies (FTSE Fact Sheet, 2010).

For consideration, the sector has been split in to three main sub-sectors: mining, water & utilities and oil & gas. All three sub-sectors witnessed their three year minimum around 2009 and have recovered strongly since with one exception to be covered in more detail: oil & gas.

Mining

The recovery can be expected to continue in the mining sector as commodity prices continue to rise. One of the major mined commodities, gold, has seen prices soar in recent times increasing nearly six fold since 2001 (Post1, 2010) to its current levels of $1361. 20 per ounce. The market expects this price will continue to rise amid speculation that the United States government will commence quantitative easing once more (Murchie, 2010). Barrick Gold and Anglo Gold Ashanti have recently raised equity to eliminate ‘ bad hedges’ and does not expect to return to hedging at any price (Yahoo! Finance, 2010). Thus, both organisations expect the price of gold to continue to rise therefore gold companies with proven reserves are likely to increase in value. This theory is reinforced by a Goldman Sachs analyst, writes Alistair Dawber, who predicts that Gold will hit $1, 650 within a year (Independent, 2010).

Water and Utilities

Water and Utilities in the United Kingdom show a strong recovery after the first quarter of 2009 also receiving boosts from an exceptionally cold winter. Profits of ScottishPower rose 7. 9% last year due to the bitterly cold winter and Britain's biggest supplier of gas and electricity witnessed profits soar 46% to £554 million (Macallister, 2010). The Met office commented that it had been the coldest winter in thirty years (2010). Long term forecasts predict that this winter will be colder than average with more precipitation than would be the norm. Should this hold true then share prices will increase on the back of higher demand for gas and electricity which eludes to the sector share prices to trend upwards.

Oil and Gas

The first graphic representation shows the FTSE 350 index for Oil and Gas producers. A sustained recovery from the low in late 2009 was seen until Q2 of 2010 which observed a sharp decline. This deterioration is largely due to the Deepwater Horizon disaster and its effects are clear. BP (formerly British Petroleum) are the second largest company in the FTSE 100 index (FTSE Fact Sheet, 2010) so any change in share price will have a large influence on both the sector and the whole economy. The second graph shows the correlation between the BP share price and the FTSE 350 – Oil and Gas. The cost to BP, who are regarded as being ultimately responsible for the disaster, amounts to a pre-tax charge of $32, 192 million. This amount relates to all costs sustained in relation to the Gulf of Mexico oil spill and the commitment to cover any future costs which BP feel they can estimate reliably (BP, 2010). As the cost of the disaster has already been absorbed by the company and the markets, assuming there is no further outfall, it can be expected that the market will continue to trend upwards and back towards it's previous average. On this basis, the sector can be considered as a relatively safe investment.

There is potential for very large returns within this sector however they arise with considerable risk. Those with a higher risk appetite may seek to invest in the companies partaking in the oil exploration taking place in the Falkland Islands.

Investment

Due to the positive nature of all three sectors in this uncertain economic period it has been decided that all three sub-sectors outlined will provide investment opportunities. This facilitates potential for excellent gains but at the same time it utilises one of the main strategies for managing risk, ' diversification' (Jaeger, 2002, p. 235).

Sector: Transport and Leisure

Transport and leisure is a broad ranging sector including companies such as Babcock International Group who specialise in a wide range of areas including defence to organisations such as First Group who are a ' leading transport operator in the UK and North America' (First Group). As it is such a broad sector ‘ transport’ and ‘ travel and leisure’ will be combined due to the similar nature of the two sub-sectors. Food & Beverages has been discounted for ethical reasons.

Aerospace and Defence

As much of this sub-sector’s revenue comes from government spending, Aerospace & Defence at first appeared to be a wise choice for investment although on closer inspection this was proved not to be the case. This sector was eventually discounted largely due to the expected cuts in government spending in the United Kingdom and abroad which will have an influence on companies which rely on this spending to maintain profitability and current share price levels. For example, Babcock International Group’s revenues are 80% U. K based (Hoyos, 2010) which in the current climate is too much exposure to a single market. The FTSE 350 index – Aerospace and Defence shows the volatility across the sector throughout 2010.

Automobiles and Parts

Outside of the main organisations in this sector there is only comparatively small amount of information available outside of the major companies. Where the majors are concerned, a case could be constructed for investment however these are outweighed by the potential risks. In recent times there has been many disrupting events which have an effect on the volatility of share prices within the sub-sector. Three major car manufacturers, including one trading in the UK-Toyota, have announced large scale recalls. Toyota was forced to recall 10. 9 million cars in the US and Canada (Simon, 2010) whilst both BMW and Dailmler AG have recalled a combined 698, 800 vehicles. (Sky News, 2010)(WSJ, 2010). As well as the turbulent recalls demand for new cars in the UK has fallen and it is not expected that they will return to peak levels. Between 2007 and 2009 the amount of new cars purchased fell from 2. 4 million to 1. 9 million-of which 285, 000 were purchased at a heavily discounted level under the Government's scrappage scheme (Sky News, 2010). The article goes on to state that sales figures are not expected to increase above 2 million for the next three years which would allude to a levelling of share prices at current levels.

Food and Beverage

The low which the FTSE 350 – Food and Beverage experienced in March 2009 coincided with the bottom of the FTSE100, however, the dip was not as severe and the immediate recovery was swift and strong. Whilst these are promising signs there has been a stagnation. In Q2 and Q3 of 2010 the index has fallen from it's high of 541. 81 in mid April to a it's current level of 528. 69 (Yahoo finance, 18th October). In the same period the FTSE 100 after suffering from an initial drop recovered strongly and is now showing a positive growth curve in the short term. It can be concluded that the performance of the sector as a whole is not matching that of other sectors which are performing well. An example of a poor performer in this sector would be Punch Taverns which is one of the largest pub companies in the United Kingdom (Punch Taverns, 2010). Shares in Punch Taverns are down over 15% in the last 52 weeks (Interactive Investor Trading, 2010).

Travel & Leisure

A graph of the FTSE 350 index over the previous 5 years is shown. It can be seen that from it’s peak in 2007 there has been a huge loss in market capitalisation across the travel and leisure sector however this was met with a strong recovery from mid 2009 onwards and this trend looks to continue. The upwards movement of this index is underpinned by growth in many of the major companies in the sector such as British Airways, Ryanair Holdings and Easyjet. This shows growing investor confidence in one of the most troubled industries of the past 10 years.

Investment

It is this confidence and steady sustained growth within sub-sector four that makes the Travel and Leisure sub-sector the advised choice for investment however the other sectors will provide some potential for investment should an appropriate company be identified.

Retailers

UK retail sector employees around 3 million people. It is the 3rd largest in the world after USA and Japan. On a whole the retail sector generates around 8% of the UK GDP. 1 in 10 of the people in employment currently works in the retail sector. Shops account for more than a third of consumer spending; due to this the retail sector is very important to how the economy on a whole performs. Usually if there is a drop in retail, the GDP of the economy would be affected greatly as well.

The year 2007 marked the beginning of the credit crisis which resulted in the UK facing an economic downturn. This affected many companies, including Woolworths. Woolworths before the credit crisis was one of the major companies in the retail sector. Due to the crisis, which lasted from 2007-2009, Woolworths went into administration on the 26th November 2008. During late 2009 market the end of the period of the recession, which allowed the retail sector to improve its growth, as shown in the graph below.

Investment

The retail sector is ideal because of its high growth before the credit crisis, this sector is now quickly recovering and should be expected to be at a high growth as before the credit crisis. There should be high growth especially during the Christmas period.

The House leisure & Personal Goods sector would be an inappropriate option in my opinion because it involves lots of manual and material costs. This sector will also gain lower growth unlike the retail sector, which should have higher growth.

Telecommunications

The telecommunication sector offers a wide variety of jobs and is an important sector for the economy. The UK is one of the leading locations for telecommunication in Europe. In recent times, the competition between telecommunication companies has sharply risen since the early 1990s. This is due to the rapidly increasing use of phone lines, internet and mobiles etc.

This sector also was affected with the credit crisis during late 2007 as shown below on diagram. One of the largest companies in the telecommunications sector BT faced their third-quarter profits had been reduced to 81 per cent. This was due to the poor performance from the BT’s IT network division. BT had also had to write off a lot of its contracts which resulted in a loss of £336 million. But it should be considered that this was due to the credit crisis, now that the crisis is finished, most companies should start to develop more growth in the telecommunication sector.

Investment

Telecommunications is constantly developing through mobile devices, video calling and other services. Today’s technology has an impact on the telecommunication sector, such as Apple, that supplies innovative telecommunication service through its Iphone. There telecommunication service offers many new services, which suggest this sector would be ideal for strong growth

The Tech Hardware sector involves lots of constant research that includes innovation and development, which could involve lots of costs in this sector.

The Electronic & Electronic Equipment sector involves large costs of investment because of the development and material costs involved, you must take into consideration of the current competiveness in the market today. This sector makes up for 4 per cent of the Europeans municipal waste, “ which is growing three times faster than any other waste management system”, as discussed by Waste online website.

It would not be recommended to invest in the Media sector because of the competiveness in this market. Current organisations in the media sector are losing out from customers, due to the vastly availability of free media available online.

Pharmaceuticals & Biotechnology

Sector: Chemicals & General

The pharmaceuticals and biotechnology sector is a massive industry, there are many companies involved with the field. The value of the global pharmaceutical market is expected to grow 5-7 percent in 2011, to $880 billion, compared with a 4-5 percent pace this year, according to IMS Health.

The sector divides itself into two sub-sectors.

Pharmaceutical companies: Develop and manufacture prescription and over-the-counter drugs (aspirin, cold remedies, birth control pills), as well as vaccines.

Biotechnology companies: Create new biological substances for use in drugs and diagnosing tools through research and development.

The sector is mainly occupied by small, extremely specialised, research firms. As these companies don't have a normal income flow, but rely more upon new discoveries to help fund future research any breakthroughs or licensing arrangements. As this can lead to large revenues which may help fund even further research. On the other hand due to the small size of the businesses any delays in acquiring funding may cause cash flow problems. Along with this trading can be very irregular as new discoveries can cause share prices to rocket.

There has been a trend in the pharmaceutical industry whereby small biotechnology companies are carrying out the premature work on new discoveries, before selling their work to the industry leaders, which is quite similar to an outsourcing model. The end result allows the product to be sold in large quantities to a global market.

The industry has seen very drastic changes over the past few quarters, since performance was affected by factors such as generic competition. The next 5 years suggest a major change between the introduction of new products and patent loses. One of the main reasons why the global pharmaceutical market growth, will be limited to 5-8% through 2014 is because over the next five years. Products that generate sales upwards of $142 billion will eventually face competition from generic products. Also upcoming products are not likely to reach the same amount of sales, as products lose their patent protection.

Fig 1.

The above graph shows the FTSE-350 of the Pharmaceutical and biotechnology sector over a period of 4 years. You can see the affects of the credit crisis in the first quarter of 2008, after this there is a slight increase in the market however the market crashes in the first quarter of 2009. Overall the sector produced total revenues of $615. 1billion in 2008.

One of the most profitable sectors of the market in 2008 was cardiovascular which was worth 19. 8% of the markets total value. That is equivalent to $121. 7 billion. Forecasts suggest that the growth of the market is set to shrink with a likely CAGR of 3. 6% fro, 2008-2013. This should cause the value of the market to increase to $734 by the end of 2013.

Top ten companies

top 10 pharma bio. jpg

Emerging Markets

Other recent trends include focusing on emerging markets such as the “ BRIC” countries (Brazil, Russia, India, and China). This is due to sales in emerging markets that have been growing at faster rate than sales in the established markets (IMS, 2010). Within the next five years these emerging markets will generate as much revenue as the traditional markets such as the U. S. market (largest pharmaceutical market) along with Europe and Japan.

Source: IMS health

Construction & Materials

Sector: Industrials & materials

This sector includes companies that are involved with discovering, developing and processing raw materials and mining/refining of metals, chemicals and forestry. Due to this sector supplying materials for construction, it heavily relies on a strong economy. This sector can also be very unpredictable as it is vulnerable to supply and demand due to prices of raw materials such as gold.

In general construction activity declined rapidly by 10. 5% in 2009. Estimates backed by fragile private sector housing, industrial and commercial property activity suggest a further fall of 1. 6% in 2010. The most profitable in the sector over the past year was infrastructure and public non-housing (such as schools) which increased by 10% and 25%

Recent data shows slight signs of recovery in the private sector, particularly in new housing. This is backed up by survey evidence which shows a slight increase in housing activity in the final quarter of 2009

construction2. jpg

In 2010, private sector housing activity is expected to show further signs of a gradual recovery, but recent signs of increased investor confidence in commercial property may not translate into stronger activity until 2011. This is shown in the graph below.

contruction 1. jpg

Review

Public housing:

Weak activity in the private sector has caused output in this sector to have fallen in 2009.

However due to the governments drive to help increase affordable housing there are signs of increase in the second half of 2009. Public housing is expected to rise around 6-7% within the next two years.

Private housing:

Output for private housing was forecasted to drop by nearly 30% last year. Forecasts suggest the recovery period will be gradual. Housing indicators also show recovery in house prices and mortgage approvals. Output in this sector is set to rise to 1% this year pushing it to 10% in 2011

Infrastructure and public non-housing:

This sector is continuously growing over the past year this has been due to a number of high- profile projects such as road and rail projects across the UK, the schools building programme and the 2012 Olympics

Private commercial and industrial:

Over 25% of output has plunged since last year in this sector according to forecasts.

Even though there has been interest to investors in this specific sector. Output will likely increase again in 2010, as the commercial sector underperformed industrial, before it returns to normal growth.

Repair & maintenance:

As the current economic situation is slowly recovering, maintenance and private repair are expected to stabilise and eventually grow in 2011. However its different story for public repair and maintenance as its easier to push back spending on this area than make a cut in new high- profile investments

Chemicals & General including:-

Support Services

Tobacco

Industrials & Materials including:-

Industrial Transportation

Industrial General

Industrial Engineering

Sector: Chemicals & General

Sub Sector 1: Chemicals

The chemical industry is very crucial to UK manufacturing as it provides the essential compounds for the manufacturing processes and the also the large number of jobs it creates. The industry is equivalent to 1. 5%GDP. UK’s manufacturing industry total sales of £62. 62bn over the period of 2005 to 2009. However when the economy fell into recession one of the key sectors to be hit by this was manufacturing which the chemical industry is a key supplier of.

This sector is highly competitive which has lead to a great deal of mergers and acquisitions. Majority of the major companies in the UK industry are global players which are focused on ‘ core ` activities which involve specialised synthesis or final formulation of products.

Before the economic recession growth was steady and would have increased over a period of time, however due to the sluggish growth of the UK economy and also globally. Growth will stay reasonably restrained in 2011-2012. Along with the dire state of the government’s finance which will eventually lead to tax rises and spending cuts. Therefore this subsector will not be a profitable investment. However export markets in emerging economies are more likely to successful.

Sub Sector 2: Health Care Equipment & Services

The Healthcare industry is broken down into smaller groups such as medical devices, laboratory equipment, system and technology and associated services such as management, training and education. The majority of companies that operate in the UK are foreign-owned mostly American. This sector exports up to £4bn worth of products and services annually into the global market.

Overall this sector is growing extremely fast as there are so many countries working to improve their health care services and facilities. The main reason to the UKs growing presence in the global market is down to the positive relationship between the government, the industry, NHS and private sectors. Along with the well developed health care infrastructure.

One of the main themes of the healthcare industry has become cost reduction this is due to the difficult economic times. It is very crucial that the organisations look for new ways to help decrease costs. Therefore this sub sector will not be a profitable investment.