

Deloitte CFO Survey Q3 2023

Debt is out of favour

Higher interest rates are having a profound effect on Chief Financial Officers' attitudes to financing their businesses. The CFOs of the UK's largest companies now rate bank borrowing as being more unattractive as a source of financing than at any time since the CFO Survey started in 2007. Corporate bond issuance is rated as being even less attractive. Higher interest rates have turned a decade-old consensus in favour of debt finance on its head. It is a measure of the shift in thinking that equity finance, which has been out of favour for years, is now seen as being more attractive than either bank borrowing or corporate bond issuance.

Despite uncertainties and a background of weak GDP growth, CFO optimism rose in the third quarter and is now running at above average levels.

CFOs seem to be digging in for a period of high interest rates and see rates falling only slightly, from their current level of 5.25% to 4.75% in one year's time. If realised, this would represent a period of tight monetary policy the likes of which has not been seen since 2008. What marks out current conditions from those seen then, in the financial crisis, is that credit is more available today. While pricing has deteriorated much as it did in 2008, CFOs' perceptions of availability have seen a far less pronounced decline. The financial system is operating and larger corporates can access debt, at a price.

Greater caution about debt finance is apparent in the way in which the balance of opinion on levels of corporate leverage has changed. A net balance of 15% of CFOs see UK balance sheets as being overleveraged, a reversal of the prevailing view of the last 12 years which has seen scope to increase debt levels. The

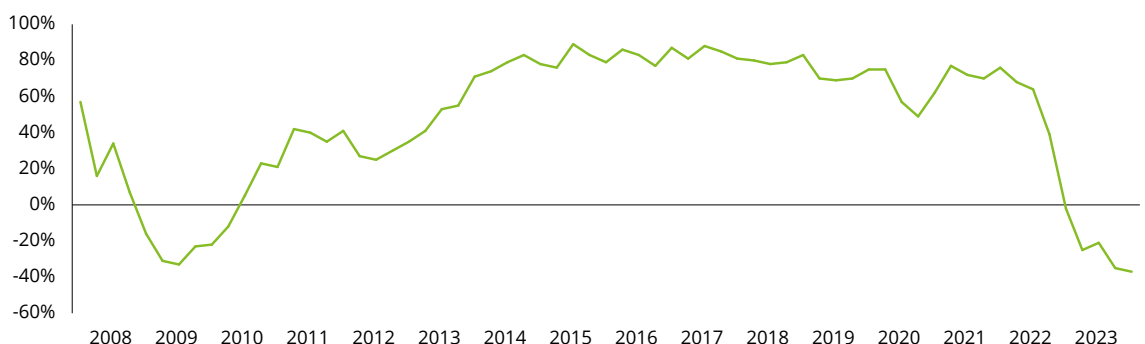
mood has shifted, with 30% of CFOs rating debt reduction as a strong priority, a level that has not been exceeded outside the exceptional circumstances prevailing in the early stage of the pandemic. Underpinning this shift in attitudes are lingering concerns about the outlook for inflation. CFOs see inflation running at 3.1% in two years' time, well above the Bank of England's expectation for inflation to fall to 2.0%. Firms' operating costs have risen in the last 12 months and 84% of CFOs expect them to continue to increase, either significantly or somewhat, in the next year. The counterpart to CFOs' expectations that rates will stay higher for longer is the view that a period of above-target inflation, which started two years ago, has at least two more years to run.

Our special questions this quarter examine views on the transition to net zero and on artificial intelligence (AI). CFOs see government policy as the biggest driver of their own response to climate change, followed closely by customers and employees. This will occasion major changes in the organisation of business. 58% of CFOs believe their businesses will face significant or wholesale change in the move to a low carbon economy in the next ten years; 38% expect some change and only 4% see little or no change. It is nearly a year since ChatGPT was launched (30 November 2022) and, compared with earlier this year, CFOs have become more optimistic about the prospect of AI delivering material improvements to their own business's performance.

CFOs think inflation has peaked for this cycle. They also believe it will take a lengthy monetary squeeze to get inflation back down. That speaks to a new mood of caution about debt finance.

Chart 1. Attractiveness of bank borrowing

Net % of CFOs who rate bank borrowing as a very or somewhat attractive source of funding for UK corporates

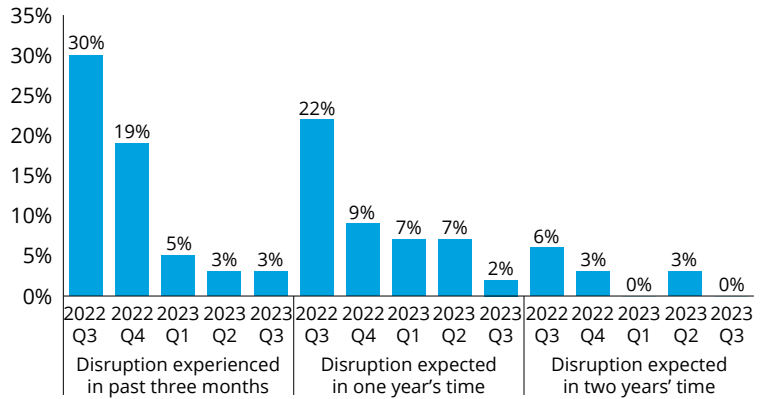


Inflationary pressures ease

The high levels of supply disruption seen in 2021 and 2022 have substantially eased this year with only 3% of CFOs reporting significant difficulties in obtaining inputs in Q3.

Chart 2. Supply chain disruption

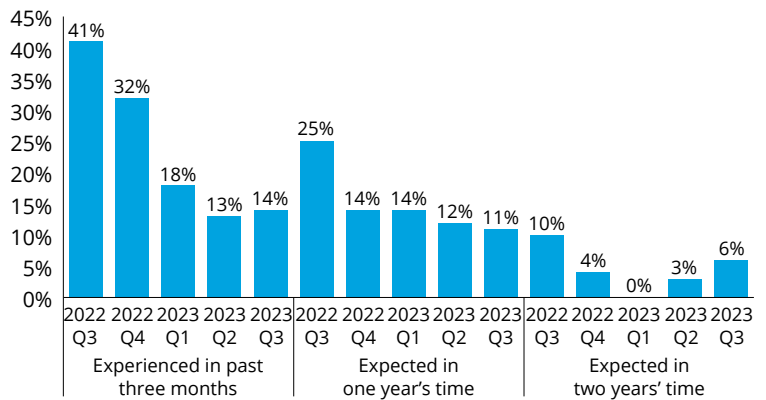
% of CFOs who report significant or severe levels of supply chain disruption experienced by their business over the last three months and those expecting similar levels of disruption in one year's and two years' time



Recruitment problems have eased but not disappeared. 14% of CFOs report that they are experiencing significant or severe labour shortages. Only around one in ten firms report no shortage of labour, a situation that our panel do not expect to change materially over the next two years.

Chart 3. Recruitment difficulties and labour shortages

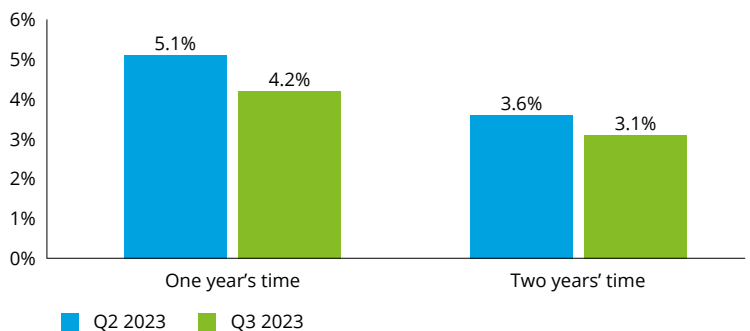
% of CFOs who report significant or severe levels of recruitment difficulties or labour shortages experienced by their business over the last three months and those expecting similar levels of disruption in one year's and two years' time



Finance leaders see headline inflation declining over the next two years but remaining above the Bank of England's 2% target. Notably, they do not see inflation falling as quickly as either the Bank of England or independent economic forecasters predict.

Chart 4. Inflation expectations

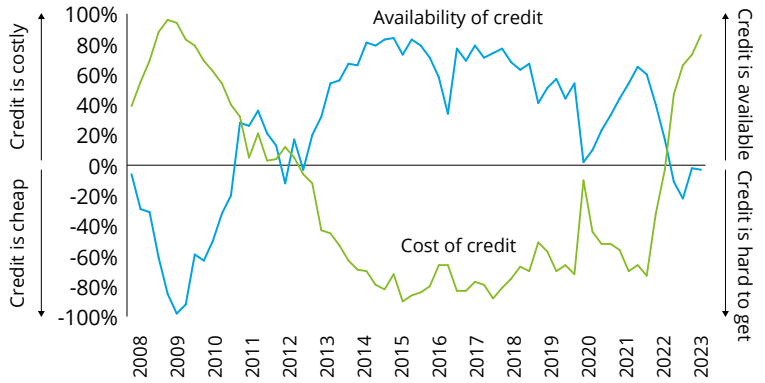
CFOs' median expectations for inflation in one year's time and two years' time



Credit squeeze continues

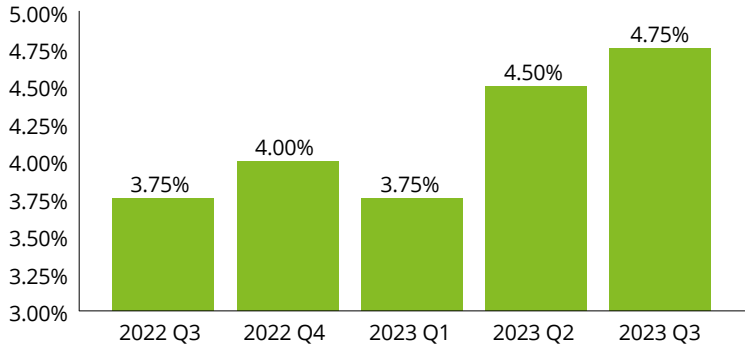
CFOs report that the cost of new credit for corporates remains close to the highest levels seen since the global financial crisis. The availability of credit saw a modest decline this quarter but remains significantly higher than during the global financial crisis.

Chart 5. Cost and availability of credit
Net % of CFOs reporting credit is costly and credit is easily available



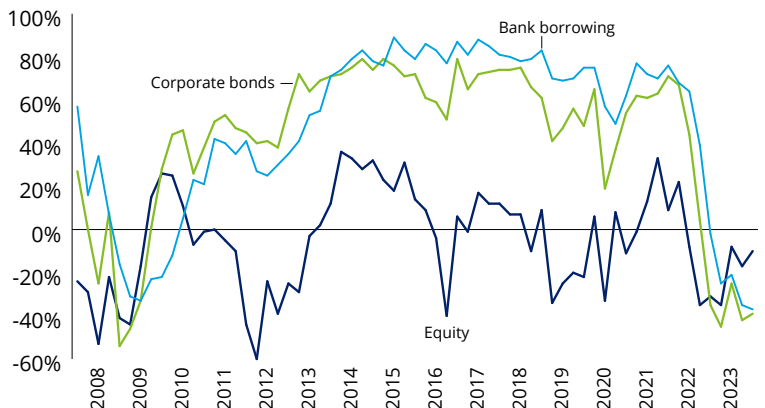
CFOs, on average, see the Bank of England's base rate falling from its current level of 5.25% to 4.75% in a year's time. This is consistent with market expectations that we are at or close to the top of the interest rate cycle.

Chart 6. Interest rate expectations
CFOs' median expectations for the Bank of England's base rate in one year's time



CFOs see both debt and equity financing as being unattractive at present. However, equity was rated as a relatively more attractive source of funding than both bank borrowing and corporate bonds. This is highly unusual – prior to this year, this was only seen in one quarter in 2009.

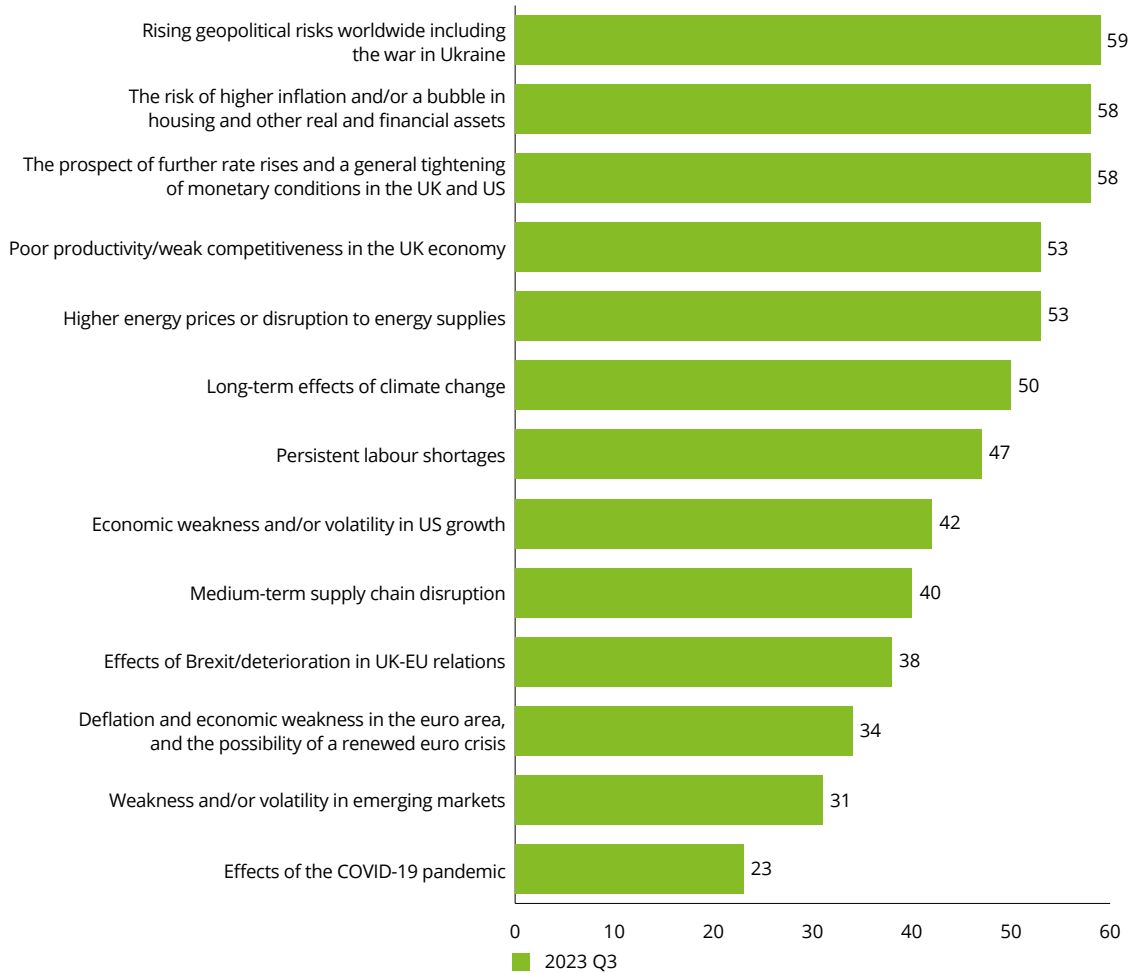
Chart 7. Corporate financing
Net % of CFOs who rate the following sources of funding for UK corporates as very or somewhat attractive



Geopolitics and inflation top worry list

Chart 8. Risk to business posed by the following factors

Weighted average ratings on a scale of 0-100 where 0 stands for no risk and 100 stands for the highest possible risk

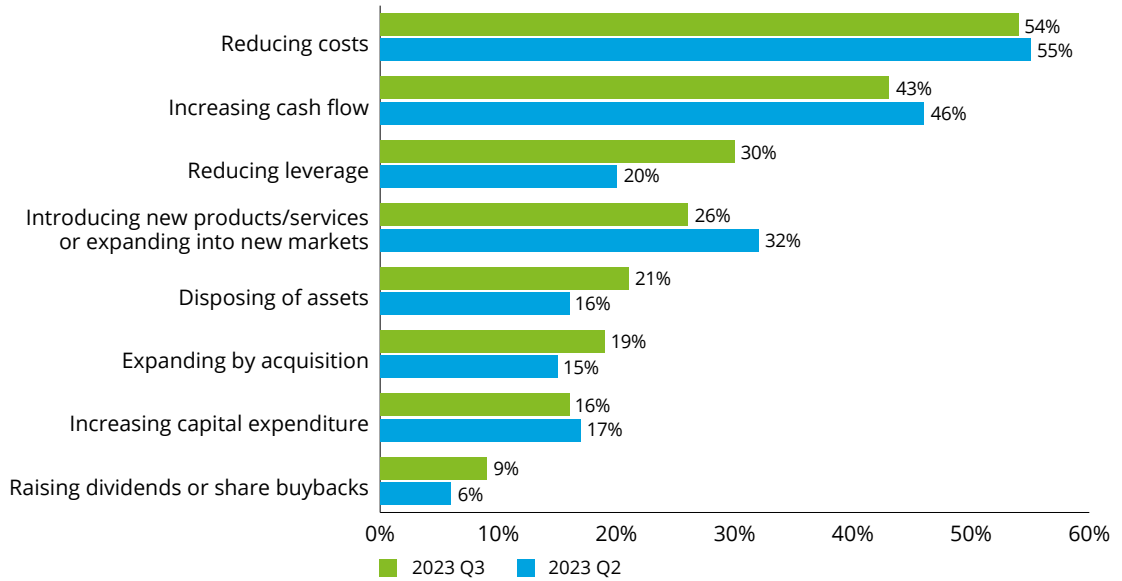


Geopolitical risk, higher inflation and the prospect of further interest rate rises continue to be seen as the most significant sources of external risk facing CFOs' businesses. (The survey took place between 19 September and 3 October, closing before the start of the conflict in Israel and Gaza on 7 October.) In the last 18 months concerns about labour shortages and disruption to energy supplies have eased.

CFOs in defensive mode

Chart 9. Corporate priorities in the next 12 months

% of CFOs who rate each of the following as a strong priority for their business in the next 12 months



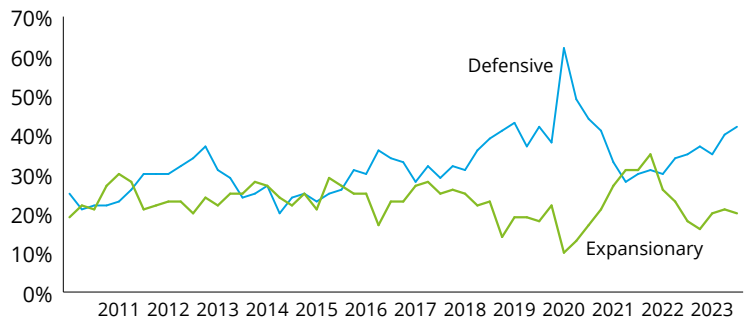
Our panellists continue to focus on defensive balance sheet strategies. Cost reduction and increasing cash flow continue to top the priority list while reducing leverage has assumed a new-found importance. This quarter saw a fall in the priority given to introducing new products or entering new markets to materially below its long-term average. Following a slight increase in the priority ascribed to expanding by acquisition, the importance of this strategy is now in line with its long-term average.

Against a backdrop of elevated interest rates, CFOs report that they are making greater efforts to reduce leverage. This contrasts with the low priority given to returning cash to shareholders, a finding that is consistent with CFOs seeing equity as offering a more attractive source of finance than debt (Chart 7).

CFOs increased their focus on defensive strategies overall this quarter and reduced the priority attached to expansionary strategies. They have now been placing greater weight on defensive strategies than expansionary strategies for seven consecutive quarters, since the beginning of 2022.

Chart 10. Expansionary and defensive strategies*

Arithmetic average of the % of CFOs who rate expansionary and defensive strategies as a strong priority for their business in the next 12 months



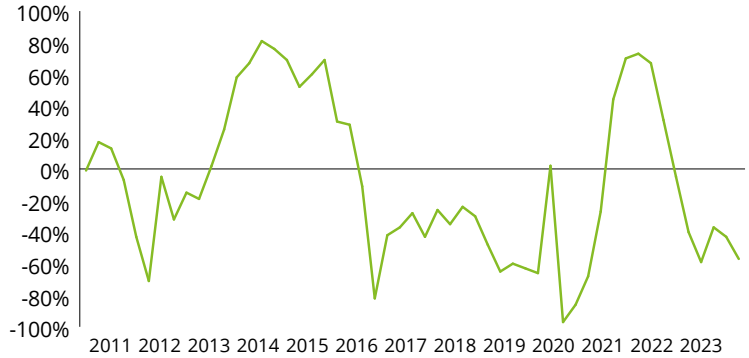
* Expansionary strategies are introducing new products/services or expanding into new markets, expanding by acquisition and increasing capital expenditure. Defensive strategies are reducing costs, reducing leverage and increasing cash flow.

AI optimism grows

CFOs are downbeat about employment prospects, with 56% expecting hiring to decline somewhat in the next 12 months and 7% expecting it to decline significantly. Only 6% of CFOs foresee some growth in hiring over the next 12 months.

Chart 11. Outlook for corporate hiring

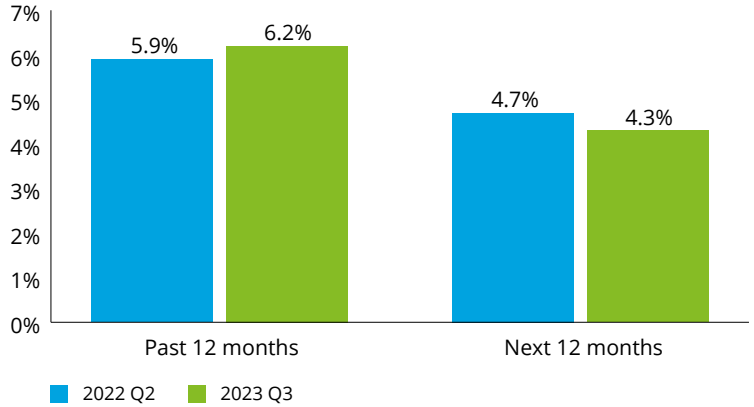
Net % of CFOs who expect UK corporates' hiring to increase over the next 12 months



CFOs think wage growth is likely to slow over the next 12 months.

Chart 12. Wage expectations

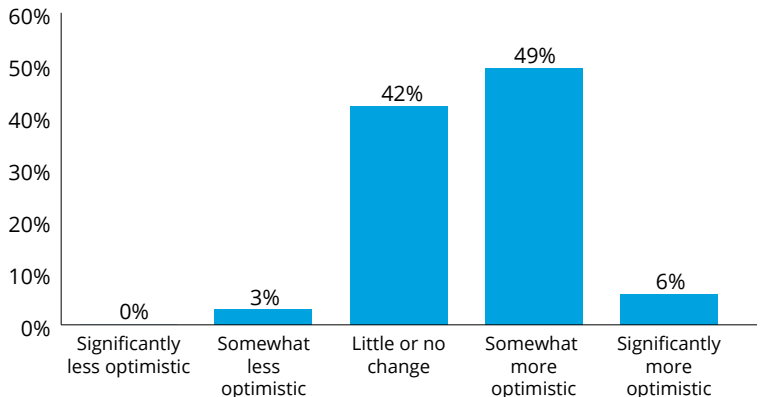
CFOs' median reported increase in average wages in their business over the past 12 months and their expectation for the next 12 months



While some of the excitement around AI may have eased since the launch of ChatGPT almost a year ago, most CFOs (54%) have become more optimistic that AI can deliver material improvements to their business' performance. We also asked them how their understanding of AI and its uses had changed over this year – 86% reported that it had increased.

Chart 13. Artificial intelligence

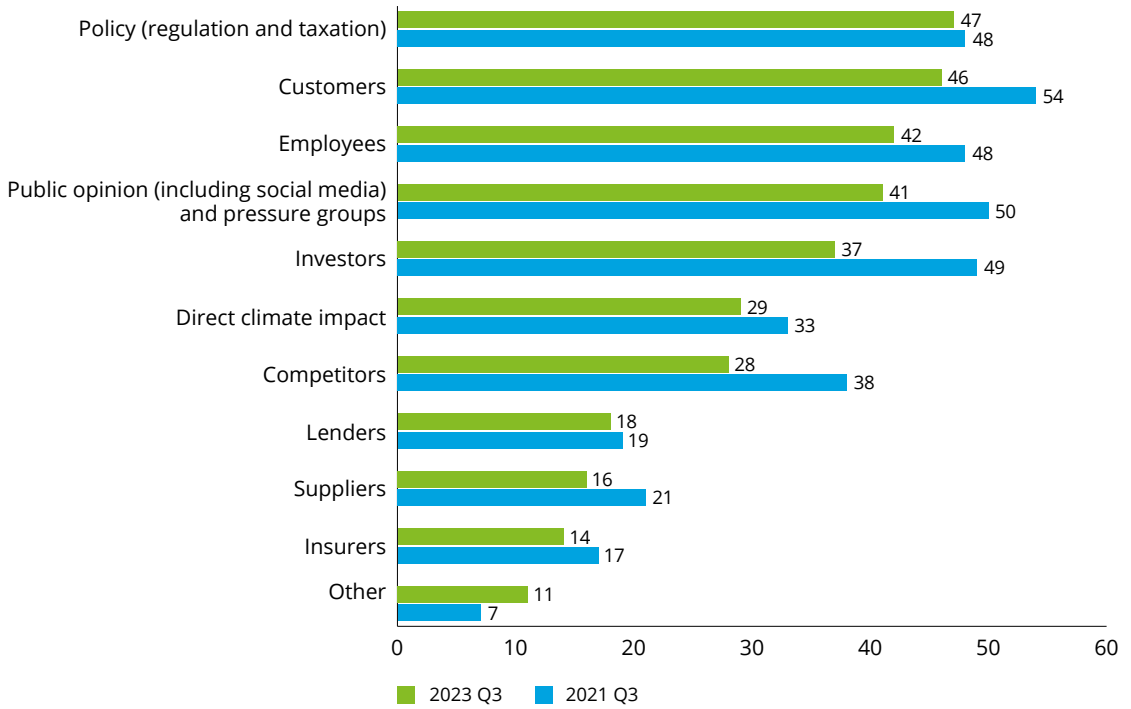
% of CFOs who reported the following when asked if, compared with earlier this year, they are more or less optimistic that artificial intelligence has the capacity to deliver material improvements to their business' performance



Evolving climate pressure for business

Chart 14. Drivers of change

Weighted average ratings on a scale of 0-100 where 0 stands for no driving force and 100 stands for the greatest possible driving force behind the CFO's own firm adapting its operations/business model in response to climate change



This quarter saw us repeat a set of questions on climate that we had previously asked our panel in Q3 2021. CFOs report that policy and regulation continue to be strong drivers of change but, as the chart above shows, compared with two years ago CFOs think that there has been an easing of some of the pressure for adaptation in their operations. This may reflect the measures businesses have taken through adaptation, investment and the development of their own plans to address climate change. This quarter's survey also recorded a modest drop in the proportion of businesses saying that the transition to a low carbon economy over the next ten years would mean significant or wholesale change for their business – a finding that may also speak to the evolution of firms' own climate plans.

Firms see opportunity in climate transition

Chart 15. Scale of change

% of CFOs who expect the following scale of change in their own businesses over the next ten years because of the transition to a low-carbon economy

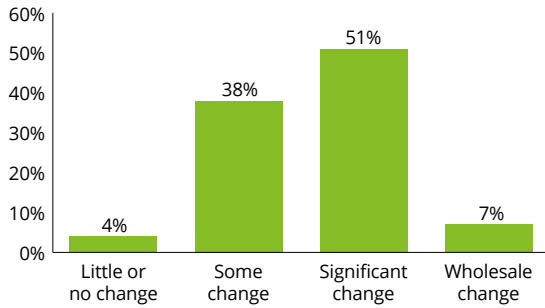
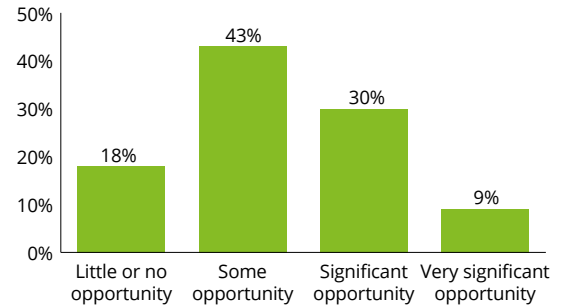


Chart 16. Opportunity

% of CFOs who expect the following levels of opportunity for their own firms because of the transition to a low-carbon economy



Businesses continue to report that significant change is needed to their operations over the next ten years to transition to a low-carbon economy. However the proportion saying that significant or wholesale change is required has dropped from 67% to 58% over the past two years. The vast majority (82%) of CFOs continue to see opportunities in the transition to a low-carbon economy.

Chart 17. Key benefits from transition

Weighted average ratings on a scale of 0-100 where 0 stands for no benefit and 100 stands for the biggest possible benefit for the CFO's own firm from the transition to a low-carbon economy

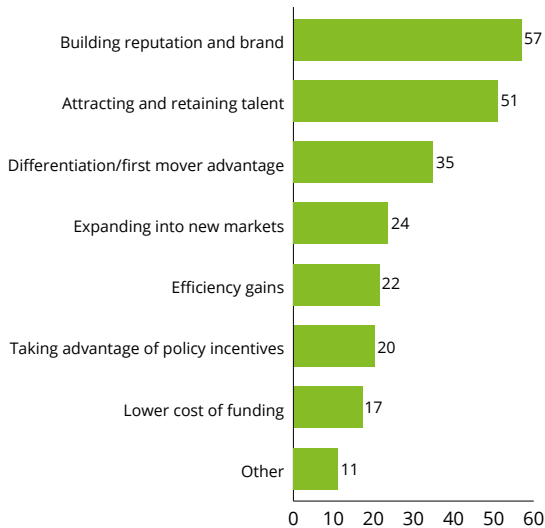
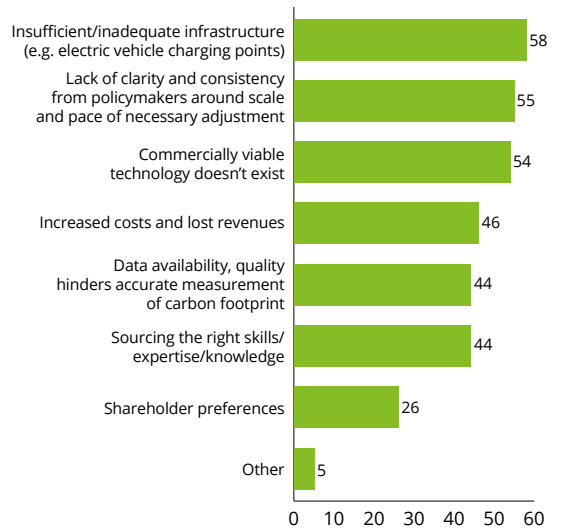


Chart 18. Key challenges to transition

Weighted average ratings on a scale of 0-100 where 0 stands for no challenge and 100 stands for the biggest possible challenge to the CFO's own firm's transition to a low-carbon economy



Finance leaders continue to see the greatest opportunities arising from decarbonisation as generating opportunities for them to build their reputation and brand, attract and retain talent, and differentiate themselves from their competitors or establish a lead over their competitors.

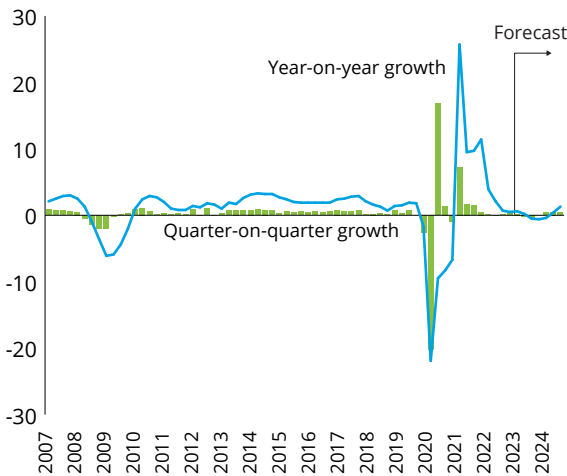
CFOs continue to report that the most significant challenges their own firms face are inadequate infrastructure, policy uncertainty and not being able to source commercially viable technology. Encouragingly, shareholder preferences continue to be rated as the least significant barrier to the transition.

CFO Survey: Economic and financial context

The macroeconomic backdrop to the Deloitte CFO Survey Q3 2023

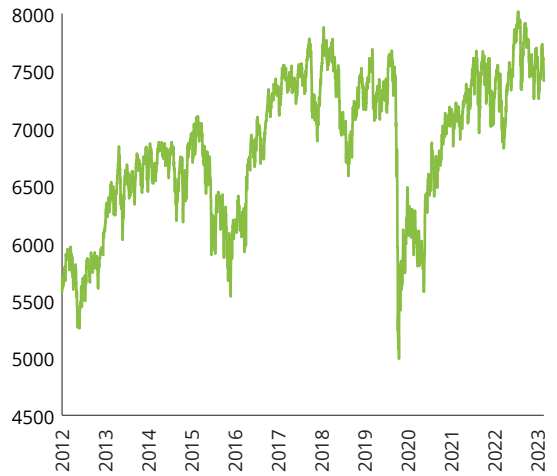
Although still above the 2% target, headline inflation in the UK, the US, and the euro area has fallen from its peak in late 2022, with core inflation heading downwards. This progress has coincided with the Federal Reserve and the Bank of England pausing their hiking cycle, keeping interest rates at 5.25% - 5.5% and 5.25% respectively, while the European Central Bank raised rates to 4%. Longer-term interest rate expectations have edged higher consistent with messaging from central banks that rates will remain "higher for longer". Against this backdrop, the growth outlook for advanced economies has softened. Despite past upside growth surprises which led to upgrades to GDP growth in 2023, economists expect the strong growth in the US to slow down and the UK and the euro area to enter a mild recession in late 2023. Labour markets remain relatively tight but showed signs of softening through attrition and a slowdown in hiring. Unemployment rates in the US and the euro area have remained relatively stable, however, unemployment rates in Germany and the UK have now increased significantly from the historic lows in 2022. World growth has been supported by emerging market outperformance, in part due to falling inflation and some amount of monetary easing. Yet, China's recovery continues at a slower pace than expected after the end of its zero-Covid policy.

UK GDP growth: Actual and forecast (%)



Source: Refinitiv Datastream, Deloitte calculations

FTSE 100 price index



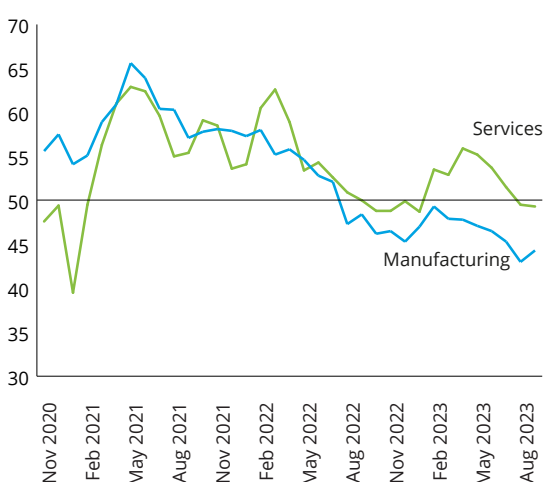
Source: Refinitiv Datastream

GfK Consumer Confidence Index (UK)



Source: Refinitiv Datastream

Markit Purchasing Manager Indices (UK)

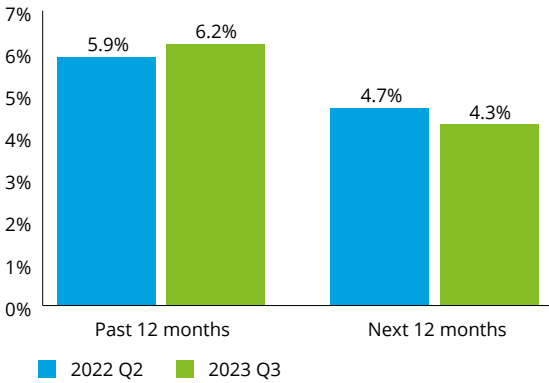


Source: Refinitiv Datastream, readings above 50 indicate expansion

Two-chart summary of key survey messages

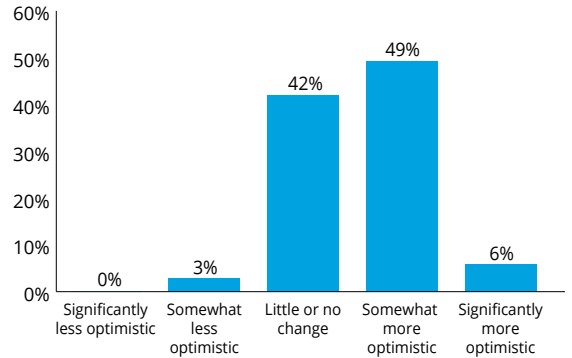
Wage expectations

CFOs' median reported increase in average wages in their business over the past 12 months and their expectation for the next 12 months



Artificial intelligence

% of CFOs who reported the following when asked if, compared with earlier this year, they are more or less optimistic that artificial intelligence has the capacity to deliver material improvements to their business' performance



About the survey

This is the 65th quarterly survey of Chief Financial Officers and Group Finance Directors of major companies in the UK. The 2023 third quarter survey took place between 19th September and 2nd June. 70 CFOs participated, including the CFOs of 13 FTSE 100 and 26 FTSE 250 companies. The rest were CFOs of other UK-listed companies, large private companies and UK subsidiaries of major companies listed overseas. The combined market value of the 43 UK-listed companies surveyed is £345 billion, or approximately 14% of the UK quoted equity market.

The Deloitte CFO Survey is the only survey of major corporate users of capital that gauges attitudes to valuations, risk and financing. To join our panel of CFO respondents and for additional copies of this report, please contact Elaine Hoang on 020 7007 4717 or email ehhoang@deloitte.co.uk.

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For current and past copies of the survey, historical data and coverage of the survey in the media and elsewhere, please visit:

www.deloitte.co.uk/cfosurvey



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