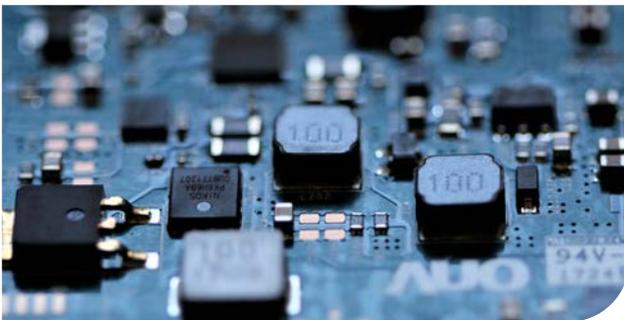


Information and Communication Technology update Autumn 2022



Sector overview

After an exceptional 2021 for many in the I.C.T industry, 2022 has presented several obstacles resulting in subdued or flat demand. Geopolitical challenges stemming from Russia's invasion of Ukraine has seen heavy sanctions imposed, with product destined for this region finding its way to the Middle East and Asia resulting in a glut of slow-moving stock. This in turn has seen a reduction in the average selling price, particularly for the likes of laptops, printers, and peripherals. Distributors sitting on high stock levels will have a test of nerve, either selling out at a potential loss or hoping for a recovery in the average selling price. This is a risky move in the fast-moving tech space.

In Q3 2022 HP reported consumer net revenue decreased 20% with total unit sales down 25%. Rather alarmingly, notebook sales were down 32% for the quarter. The challenging consumer market also impacted Dell, which despite reporting a 9% sales growth in the second quarter, suffered a 9% fall in consumer revenue.

Whilst we have seen a slowdown in physical distribution volumes, enterprise and infrastructure spend remains strong with robust pipelines originating from blue chip, SME and public sector tenders. Dell reported 12% growth in its infrastructure solutions, whilst HPE reported 4% growth (adjusted for currency) in their respective recent quarters.

The semi-conductor industry remains in the spotlight, and with recent sanctions imposed by the US Government

banning Chinese firms from buying advanced chips and chip-making equipment without a licence, we could see renewed disruption to supply chains.

The transition to value-added-distribution and reselling remains the priority for many businesses in the channel. These products typically involve a service offering resulting in reoccurring income and a stickier relationship with customers. This is easier said than done and requires investment into staff to provide the technical capability as well as meeting the core competencies required from vendors and customers.

Tech stocks have had a turbulent year, starting in May when there was a wave of lay-offs and hiring freezes in the sector. The downturn is after years of growth and has impacted the likes of Microsoft, Amazon, Apple, Meta, Google, Netflix, Twitter, and Salesforce. The tech industry typically performs well during low interest rate cycles and was buoyed by an increase in smart phone usage. Due to the current economic challenges however, tech businesses have underperformed.

Social media stocks have struggled due to weak digital app advertising spend because of inflationary pressures, and streaming providers such as Netflix due to increased competition. Even Amazon has seen a 39% drop in share price since the beginning of the year as financially conscious consumers start reigning in spending. Amazon performed strongly during the height of covid in 2020 and 2021, however they have recently announced a cautious outlook as they enter the final quarter of 2022.

Notable trends within the consumer electronic segment appear to be driven by the cost-of-living crisis, with consumers prioritising spend away from brown goods, such as computers, televisions, and radios, to white goods such as electric heaters and air fryers which are reported to be more energy efficient.

Made possible



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Strengths

I.C.T investment into infrastructure and software remains an important spend for businesses to remain competitive and secure. Cyber hacks are an increasing threat to governments and corporations, with providers of this service seeing continued strong revenue growth with reoccurring income as a result. This is in addition to cloud services, data centres and connectivity which remain a business-critical expense for organisations committed to hybrid and remote working practices.

There is likely to be stretch in the effective lifecycle of an I.C.T asset due to business leaders prioritising budgets on newly emerging pressures such as wage inflation and utility costs. With many organisations undertaking a refresh of computer hardware and components in 2020 and 2021, 2022 has seen a slow down in demand, though this is unlikely to be prolonged.

Challenges

Certain customer verticals are likely to be challenging in the short-term. These include consumer electronics, Managed Print Services, and non-value-added distribution. I.C.T as an industry is typically heavily reliant on invoice discounting and supply chain finance. UK interest base rates since 2009 have been <1%, yet with current base rates hikes, it is important companies are able to retain competitive financing lines as well as effectively passing inflationary and financing costs to the end user.

Specialists in these low margin product lines may find this difficult with demand cooling and factions of oversupply in the short term. The notion of a zombie company has been around for some time, but, with low interest rates, we have not historically seen the anticipated spike in insolvencies.

The current economic environment is now beginning to change this with insolvency trends increasing across the UK.

FX volatility for UK distributors remains an immediate challenge. Organisations with a competitive hedge against the dollar as well as interest rates will be well placed.

Without this hedge, businesses operating in a low margin segment can swing to a loss very quickly.

Notable Insolvencies

Insolvencies remain low in the I.C.T industry with only a small handful of recent failures to note including Prestek Computing Limited (£25m turnover) and UKCLOUD Limited (£38m turnover).

Economic Data

Moving into autumn 2022 the UK is hoping to see its economy stabilise following a tumultuous summer, in which we have seen the policy making of a newly elected prime minister and cabinet disrupt markets to such an extent that their tenure was short lived. Rishi Sunak is tasked with unifying a political party and stabilising equity and bond markets, whilst also appealing to an electorate that is struggling with a cost-of-living crisis.

The UK government is also under pressure to balance fiscal and monetary policy which many believe will require a period of austerity and budget cuts to facilitate. For the I.C.T industry, especially those exposed to public sector contracts, this will be of concern.

The recent announcement that Russia plans to renege on its grain deal with Ukraine is likely to fuel the cost-of-living crisis and add further inflationary pressures on household budgets.

At 31/10/2022 the British Pound was down nearly 16% against the US dollar (12-month period). Whilst it can be argued that all other major currencies are performing poorly against the dollar, there are severe consequences for an economy which is a net importer of goods.

The UK runs a large current account deficit which was reported at 5.5% of GDP in Q2 2022 (£33.8bn). This was a £4.4bn reduction from Q1 and driven by an increase in primary foreign investment income. Q3 data is not yet available, though it is anticipated that the recent market turmoil and uncertainty will have had a negative impact on primary and secondary foreign investment income.

UK CPIH for September 2022 is reported at 8.8%, a 20bps increase on August 2022. The largest of the contributing factors to inflation continue to be utility, food, and transport costs.

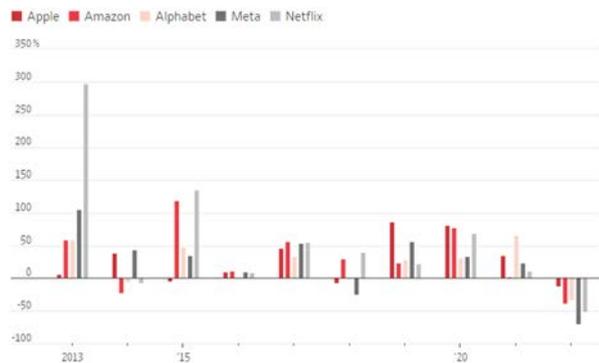
With the sizeable current account deficit, weak economic growth and trade friction coming out of Brexit, it is vitally important that the UK economy stabilizes quickly. This is to reassure markets so that the UK remains an attractive economy to invest in.

Information and Communications Technology update

Underwriting Approach

QBE continues to underwrite the sector with a positive outlook and provide solid capacity. Verticals heavily exposed to consumer electronics retail and wholesalers remain challenging, thus the provision of management information is key.

Annual performance



Note: Figures for 2022 are through Friday
SOURCE - Dow Jones Market Data

Index performance



SOURCE - FactSet

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CPIH, OOH component and CPI annual inflation rates for the last 10 years, UK, September 2012 to September 2022



SOURCE - <https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/september2022>

