Exceptional costs, exceptional challenges –

the CFO's art of driving business resilience among FTSE100 companies

This research looks at the exceptional costs and restructuring costs that FTSE100 businesses recorded in their two latest annual reports (as filed up until Dec. 31, 2019).

These costs can be used as a rough proxy for the major challenges that businesses have been facing.

For the modern finance team, navigating changes in the external environment, helping to steward a company through its financial or operational restructuring, and building resilience can be one of the most challenging parts of a career and in many ways the most significant part.

Introduction

Our research looks at the exceptional costs FTSE100 companies recorded, breaking down these costs by type; for example, common types of exceptional cost recorded by companies include exceptional restructuring costs or exceptional M&A integration costs.

For a cost to be exceptional, it must be both substantial and unusual — meaning that it normally derives from major change within a business. Looking at exceptional costs can act as a thermometer to assess the risks and emerging issues for the business models and operating sectors of FTSE100 businesses.

As part of this research, we also looked at total restructuring costs, which includes both exceptional and non-exceptional costs. This is intended to inform us about the pressure FTSE100 companies are under to change. How much restructuring is the FTSE100 undertaking? Which sectors are feeling the most pressure?

Exceptional costs tend to spike during periods of economic stress and you only have to look back to the last recession to see how exceptional restructuring costs can almost swamp a business. For example, RBS was hit by over £1.3bn in exceptional restructuring costs in 2008–09. So far-reaching was RBS restructuring in that year that it discussed "restructuring" over 150 times in that year's annual report.

Our research found that restructuring costs are a major consideration for FTSE100 companies, even in today's relatively benign economic conditions — following an unusually long period of global economic growth that only now is stuttering. This suggests the FTSE100 is going through a period of quickening change as boards look to adapt to mounting challenges.

As this report outlines, exceptional restructuring costs represent nearly a fifth of the total value of all exceptional costs recorded, with total restructuring costs also rising significantly over the two years the research reviewed. Over a quarter (26%) of FTSE100 businesses had to undertake a restructuring of their business that was financially and operationally material enough to report to shareholders last year.

Navigating this change falls to a large degree on CFOs and finance directors who play an important role in corporate stewardship, steering a company towards sustainable growth whilst delivering long-term value to shareholders.

Key findings from the research

The research looked at exceptional costs and total restructuring costs (including exceptional and non-exceptional restructuring costs) FTSE100 companies recorded in their last two financial years.

Key findings of the research included:*

- Exceptional restructuring costs were the most frequently recorded type of exceptional cost by FTSE100 businesses last year, affecting 26% of companies.
- Exceptional restructuring costs were also the largest category of exceptional costs borne by companies last year at £2.1bn, up from £1.4bn the year before, suggesting that the need to restructure is increasingly being forced on businesses. Total costs for all exceptional items for the FTSE100 were £7.9bn.
- Total restructuring costs (including exceptional and non-exceptional costs) increased to £8.2bn last year, up 30% from £6.3bn the year before. *Although these costs for many businesses are part of longer-term restructuring plans in place, several also recorded new non-exceptional restructuring programmes last year.*
- Exceptional costs related to the disposal of assets increased four-fold last year to £575m, up from £144m the year before as companies accepted the need to take bigger losses to shed businesses, units and other assets that no longer fit their long-term strategy.
- Exceptional costs related to business transformation costs increased 30% last year to £371m, up from £286m the year before as companies undertake more radical surgery on those business units they intend to keep.
- A new law requiring businesses to equalise the pension benefits provided to male and female workers resulted in FTSE100 businesses recording exceptional costs related to employee pensions of £560m last year, up from just £4m in costs related to employee pensions the year before.
- Sectors that face significant headwinds recorded the largest increases in exceptional costs last year. For example, this includes:
  - Retailers
  - Oil and gas
  - Mining
  - Aerospace and defence
- Sectors that recorded the largest increases in exceptional costs also featured amongst the top five with the largest increases in total restructuring costs:
  - Retailers
  - Oil and gas
  - Pharmaceuticals
  - Banks

- The top five FTSE100 companies with the highest exceptional costs over the last two years included aerospace and energy and mining groups.

FTSE100 exceptional costs – breakdown of the top 5 companies

FTSE100 company	2017–18 (£m)		FTSE100 company	2018–19 (£m)	
BHP Group	£	2,258	Rolls-Royce	£	1,414
Centrica	£	956	BHP Group	£	806
Hikma Pharmaceuticals	£	898	Glencore	£	635
BT	£	590	National Grid	£	624
Rio Tinto	£	488	BT	£	475

- The top five FTSE100 companies with the highest restructuring costs over the last two years included pharmaceuticals groups and banks.

FTSE100 restructuring costs – breakdown of the top 5 companies

FTSE100 company	2017–18 (£m)		FTSE100 company	2018–19 (£m)	
GlaxoSmithKline	£	1,056	Lloyds Banking Group	£	879
Astrazeneca	£	624	GlaxoSmithKline	£	809
Lloyds Banking Group	£	621	Unilever	£	779
BAT	£	600	BP	£	726
Imperial Brands	£	391	Astrazeneca	£	539

'FTSE100 boards have had to accept that they need to take more radical and more expensive steps to get their businesses ready for the challenges they face. What finance directors do to control these rising costs and how they fit with longer-term business plans is a key part of their corporate stewardship'.

'The role of the finance team is no longer to just provide the financial information to enable decision-making and manage risk. The role of the modern CFO is increasingly to help manage the strategic decision-making process that they once just fed their information into, and help their company successfully adapt to change'.

'CFOs and finance directors are also responsible for horizon scanning: spotting upcoming risks to businesses and devising ways to manage and mitigate them'.

– Andrew Harding, FCMA, CGMA, Chief Executive — Management Accounting

What do FTSE100 exceptional costs tell us?

Keeping exceptional costs under control will be the aim of boards and finance directors, especially for those businesses that pride themselves on their scenario planning and risk management skills.

This is an important part of delivering profitable growth and instilling confidence in shareholders and other stakeholders.

Whilst the state of the economy doesn't entirely determine exceptional costs, it's interesting to note that even after 10 years of almost uninterrupted growth, the frequency and value of certain types of exceptional cost are rising.

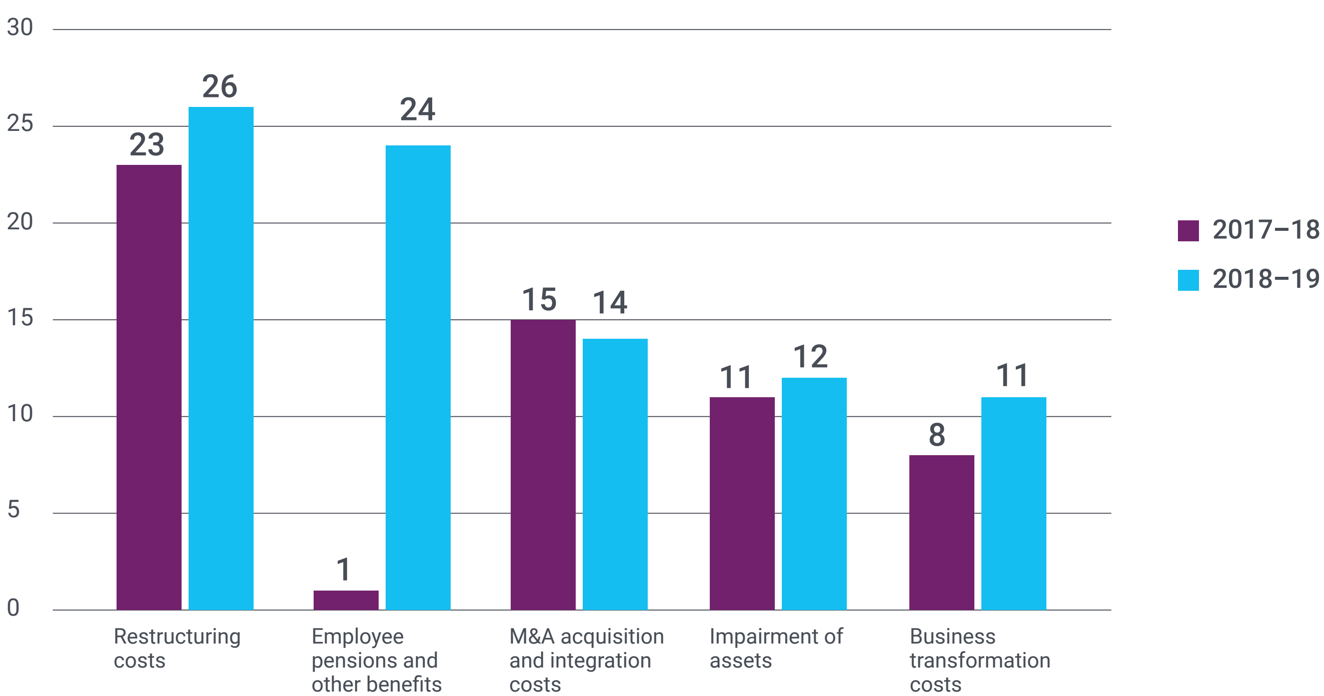
Analysing trends in exceptional costs competitors face in other parts of the economy can play a role as part of effective corporate stewardship by helping CFOs predict where issues may arise and then making changes to their own business ahead of time.

Understanding these trends, which largely falls to CFOs and finance directors, can inform leaders as to whether their business strategy is fit for purpose and whether current operating models leave businesses exposed to undue risk. This demonstrates how CFOs play an integral role in guiding decision-making at the top level.

The most frequently recorded exceptional cost last year was restructuring, followed by employee pensions related costs and M&A acquisition and integration costs.

Also noteworthy is the increase in the frequency of business transformation costs, which refers to spending on fundamentally changing the systems, processes and technology across a business to achieve better operational efficiency and drive better performance.

Figure 1: FTSE100 exceptional costs — most frequently recorded costs



Exceptional costs FTSE100 businesses recorded reached £7.9bn last year, matching the level of the year before. The table below shows the top five largest exceptional costs that were recorded in 2018–19.

Exceptional restructuring costs were the largest category of exceptional costs last year at £2.1bn, up from £1.4bn in 2017–18. This was followed by costs related to operational incidents.

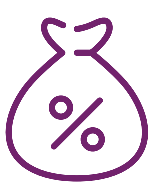
Figure 2: FTSE100 exceptional costs — highest types of cost last year

Exceptional cost	2017–18 (£m)	2018–19 (£m)
Restructuring costs	£ 1,354	£ 2,069
Costs related to operational incident	£ 494	£ 1,836
M&A acquisition and integration costs	£ 922	£ 581
Disposal of assets	£ 144	£ 576
Charges related to employee pensions	£ 4	£ 560

Stiff headwinds in some sectors, such as retail, may have led to the acceleration of restructuring programmes. Retailers faced the biggest bills for exceptional restructuring costs of all sectors, £388m last year, up from just £242m the year before.

Retailers continue to grapple with the shift to ecommerce and the reduced need for large property estates. Total restructuring costs for this sector were also high last year.

Sector in focus: Retail — examples of exceptional restructuring costs

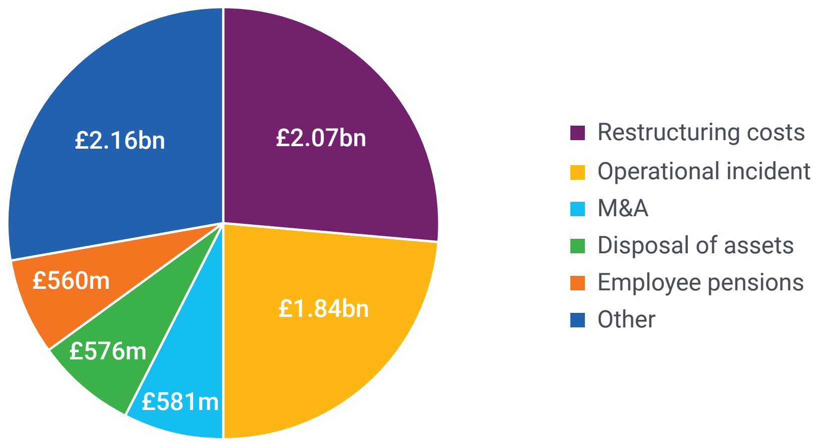


A food retailer recorded exceptional restructuring costs last year relating to 'the simplification of our business and working practices across the group'.

A general retailer recorded exceptional restructuring costs last year principally relating to 'impairments for underperforming stores. This includes 15 stores across our business that we are considering closing in the next two years'.

A food retailer recorded exceptional restructuring costs last year, principally relating to 'changes to the group's in-store operating model, responding to changing customer shopping habits and reducing costs throughout the store estate.'

Figure 3: FTSE100 exceptional costs — breakdown of costs by type last year



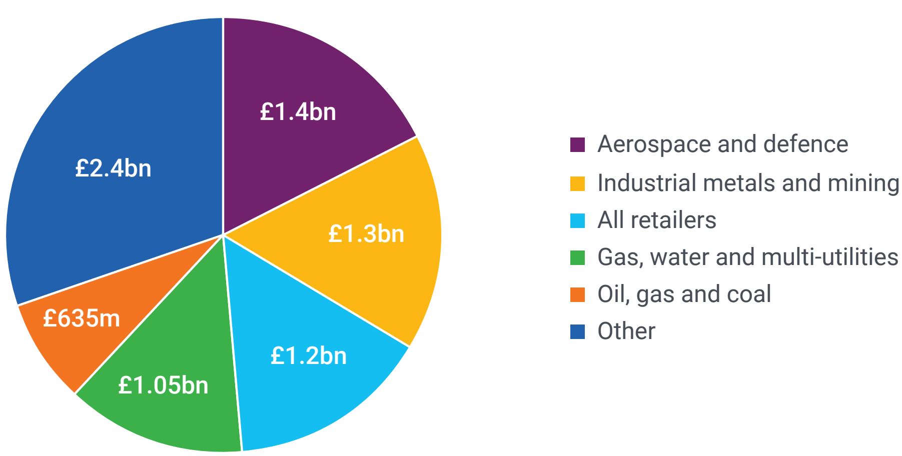
The research also looked at a breakdown of exceptional costs by sector. As the graph below shows (Figure 4), the sector with the highest exceptional costs last year was aerospace and defence at £1.4bn, followed by industrial metals and mining (£1.3bn) and retailers (£1.2bn).

To improve profitability, one FTSE100 aerospace and defence company is undertaking a major restructuring that is driving the high costs the sector overall recorded. The programme is designed to move the organisation away from a centralised control culture towards more dynamic individual business units.

For example, as the company reported in its annual report:** *'As part of our restructuring and simplification work, we have made a good start on the simplification of our management system, removing thousands of spreadsheets …'*

Industries, such as mining, where businesses are often based in emerging markets and inherently dangerous activities, can face some very high exceptional costs caused by lapses in ESG standards. Mining business recorded exceptional costs related to health and safety incidents and even industrial action by employees in certain countries (see box below).

Figure 4: FTSE100 exceptional costs — breakdown of costs by sector last year



Sector in focus: Mining – examples of exceptional costs

A mining company recorded exceptional costs related to a dam failure in 2015 that 'resulted in a release of mine tailings, flooding the communities of Bento Rodrigues, Gesteira and Paracatu and impacting other communities downstream'.

A mining company recorded exceptional costs in 2017 relating to industrial action by employees in Chile where 'negotiations, including government-led mediation, failed and the union commenced strike action on 9 February 2017 resulting in a total shutdown of operations, including work on the expansion of key projects'.

A mining company has recorded exceptional costs relating to 'profits and losses on disposals of businesses and investments or closure of operations, adjustments relating to business combinations, and adjustments relating to former operations'.

'Major restructuring programmes are having to be undertaken across over a quarter of the FTSE100. Such is the current pace of change across so many business sectors that we'll see many more businesses joining them and having to undergo a significant overhaul of their structure or business model to encompass the purpose, values and strategy of the organisation to deliver long-term, sustainable success'.

– Andrew Harding, FCMA, CGMA, Chief Executive — Management Accounting

How does this analysis help inform decision-making by CFOs?

A key finding from this analysis is that restructuring costs are the most frequently recorded cost that isn't a business-as-usual cost and the highest by value. This may prove to be useful information for those businesses that have not yet been required to undertake emergency restructurings but are considering restructuring in the near- to mid-term.

A key part of corporate stewardship for CFOs and finance directors is identifying risks that may be either prevalent in their sector or systemic and making changes accordingly to avoid incurring unnecessary exceptional costs.

Are more FTSE100 companies restructuring?

Fifty-one FTSE100 companies recorded restructuring costs last year, up from 49 in 2017–18. Average restructuring costs increased to £161m, up from £128m over the same period. This includes both exceptional and non-exceptional restructuring costs businesses recorded.

Our research shows that total FTSE100 restructuring costs increased 30% to £8.2bn last year, up from £6.3bn in 2017–18. Some sectors are experiencing higher restructuring costs than others, with pharmaceuticals (£1.4bn) coming top, followed by banks (£1.3bn) and retailers (£1.2bn).

The pharmaceuticals sector has several major, ongoing restructuring programmes in place and has recorded high costs across both years. The reason for long-term restructuring plans was explained by one company in its annual report last last year:***

'Within the pharmaceuticals sector, the highly regulated manufacturing operations and supply chains and long lifecycle of the business mean that restructuring programmes, particularly those that involve the rationalisation or closure of manufacturing or R&D sites, are likely to take several years to complete'.

Banks have also reported on new "simplification" programmes that tend to involve the modernisation of IT infrastructure and the reduction of branch and property portfolios. Also included within restructuring costs is the impact of implementing some regulatory reforms.

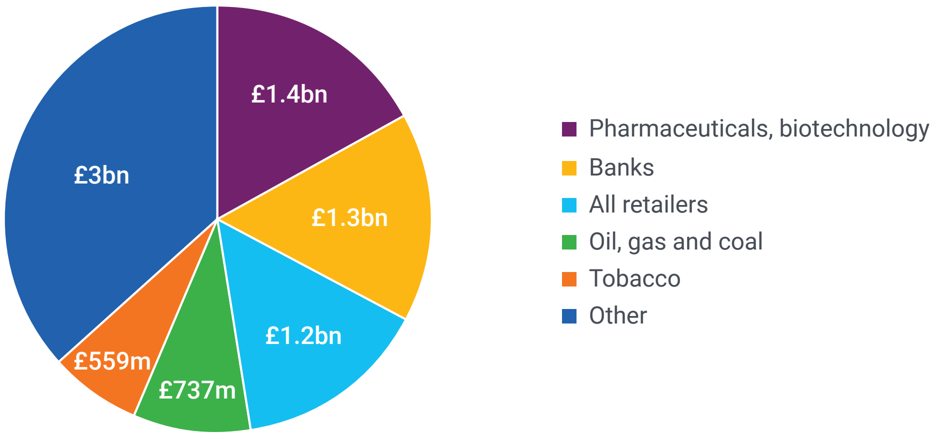
Retailers saw the third-highest restructuring costs which, as mentioned, largely relates to the headwinds the sector is facing from the shift to ecommerce and weak UK consumer spending.

Sector in focus: Pharmaceuticals — examples of restructuring programmes

One pharmaceuticals company has recorded restructuring costs 'designed to significantly improve the competitiveness and efficiency of our cost base with savings delivered through supply chain optimisation and reductions in administrative costs'.

A pharmaceuticals company has recorded total restructuring costs related to a programme that 'consists of centralisation of our global R&D footprint into three strategic centres, transformation of the IT organisation, closure of a number of manufacturing facilities and other activities to simplify and streamline the organisation'.

Figure 5: FTSE100 restructuring costs — breakdown of costs by sector last year



The graph below shows the sectors that have seen the fastest increase in restructuring costs over the last year. Total restructuring costs for retailers saw one of the fastest increases in all sectors at four-fold last year, whilst aerospace and defence also features.

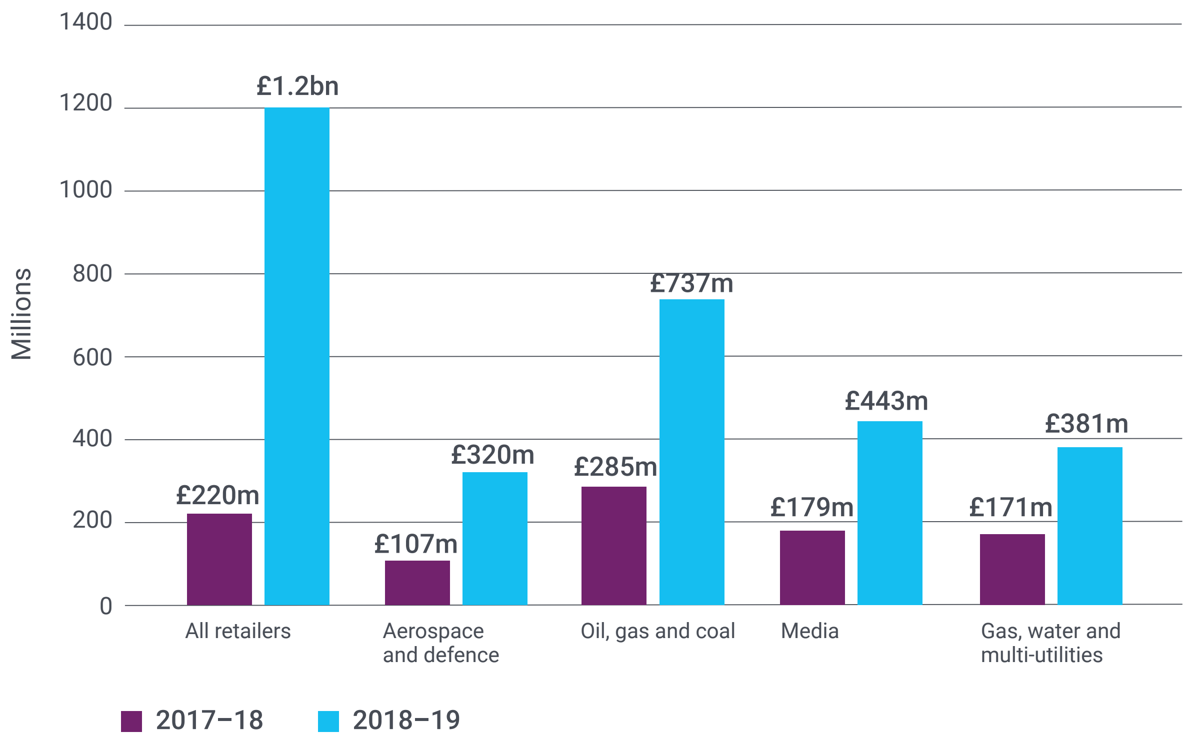
Oil and gas companies saw restructuring costs more than double last year. The fall in oil prices in 2014 kick-started restructuring programmes at some oil majors as they looked to reduce their cost bases to remain profitable long-term. New phases of these programmes have been implemented in recent years.

Looking ahead, commentators have suggested that the next major challenge these businesses face is how to adapt and remain profitable as the shift towards deriving a greater proportion of the world's energy from more sustainable sources gathers pace. The new CEO of BP, for example, has stated that the company will go through a major internal restructuring as it shifts to lower its net carbon emissions.

The media, which includes broadcast and advertising, also saw high restructuring costs last year. Businesses in this sector identified similar issues as other sectors, namely the need to reduce cost bases, simplify operating models and improve efficiency amidst stiff competition — partly from the continued move of consumers to new media.

As one media company outlined in an update on their restructuring,**** *'The restructuring costs relate predominantly to staff redundancies and the net cost of property rationalisation. Included in the property rationalisation is the impact of the consolidation of our property footprint in London which resulted in a charge for onerous leases'.*

Figure 6: FTSE100 restructuring costs – sectors with fastest increasing costs last year



When reviewing the findings and annual reports of FTSE100 businesses, the core reason for implementing restructuring programmes appears to have been to lower cost bases. Lowering cost bases was approached in different ways but common steps taken included:

- Upgrading IT infrastructure
- Reducing headcount in countries where high severance packages are required
- Closure of underperforming stores and plants
- Centralisation of operations and assets to simplify business models
- Back office change programmes to improve efficiency including the digitalisation of certain functions, such as billing

When looking at the top five companies that reported the highest restructuring costs last year, pharmaceuticals companies feature heavily.

Are more FTSE100 companies restructuring? What is the key takeaway for CFOs from this analysis of restructuring costs?

Restructuring activity appears to have picked up over the last year. There may be many reasons for this, but broadly this could be explained by businesses in under pressure sectors, such as retail, energy and aerospace and defence, accelerating restructuring programmes.

An aerospace and defence company mentioned “restructuring” 110 times in their latest annual report, a pharmaceuticals company mentioned it 109 times and a media group 69 times.

FTSE100 businesses appear to be going through a period of change — restructuring to remain profitable and be better equipped to meet new challenges. Delivering an effective restructuring programme on time is a key skill in steering a business to succeed long-term.

Conclusion

Our research found that whilst the growth in exceptional costs for FTSE100 companies has been kept largely under control, the costs of restructuring are rising.

This suggests the sudden shocks to profitability, that create exceptional costs, are at a relatively low frequency at the moment. However, the already identifiable problems that demand restructuring longer-term are costing significantly more — 30% more in a year.

Conventional competitive pressures are almost a constant presence — so what newer features have been causing this latest rise in restructuring costs?

1. The sudden acceleration in the shift to both ecommerce and digitalisation is continuing to demand expensive restructuring across retail, and media and publishing. This is not just affecting the usual suspects of high street retailers; for example, the determination of students to cut down on the purchase of textbooks is partly to blame for a restructuring at one of the FTSE100's largest media groups. The rise of tech-focused challenger banks is also put forward by the banking sector as one driver of their restructuring.
2. Tentative restructuring now seems to be occurring in response to the growing shift towards a low-carbon economy and various climate policy initiatives. The sale of fossil fuel assets, particularly coal, is becoming more frequent amongst energy and mining groups looking to derive a greater proportion of revenues from clean energy. We are likely to see just how committed businesses are to this shift towards a low-carbon economy in the coming years.
3. Within financial services, the more intrusive approach by regulators, both nationally and internationally, is driving restructuring costs. Banks reported significant costs related to implementing regulatory reforms in recent years and ever closer scrutiny of the sector means this approach is unlikely to change for the foreseeable future.

Digitalisation, the shift to sustainable and responsible business models and increased regulation are trends that CFOs can't afford to take their eyes off. Although these trends are showing up as costs amongst certain groups of businesses more than others, they are spreading to new sectors.

For finance professionals who play a critical role in informing decision-making at the highest levels, the need to restructure in response to these trends is well-established. In addition to understanding business performance to guide future strategy, the role of finance directors has a much wider remit in deciding that strategy and seeing that it is implemented properly.

Identifying upcoming challenges and growth opportunities and restructuring to meet those changes is key in delivering sustainable long-term value. Perhaps what the dramatic financial cost of restructuring shows is a willingness and determination by UK PLC to adapt and change.

Notes to the text

* Information on exceptional costs and restructuring costs as reported in the latest two annual reports published for each FTSE100 company

** Rolls-Royce Annual Report 2018

*** GlaxoSmithKline Annual Report 2018

**** Pearson Annual Report and Accounts 2018

1. Sector in focus – retail, companies referenced as follows:
    - Tesco Annual Report and Financial Statements 2019
    - Kingfisher Annual Report and Accounts 2019
    - Sainsbury's Annual Report and Financial Statements 2019
2. Sector in focus – mining, companies referenced as follows:
    - BHP Group Annual Report 2019
    - BHP Group Annual Report 2017
    - Anglo American Annual Report 2018
3. Sector in focus – pharmaceuticals, companies referenced as follows:
    - GlaxoSmithKline Annual Report 2018
    - AstraZeneca Annual Report 2018

Appendix — Breakdown of exceptional costs

Exceptional cost	2017–18 (£m)		2018–19 (£m)	
Restructuring costs	£	1,354	£	2,069
Costs related to operational incident	£	494	£	1,836
M&A acquisition and integration costs	£	922	£	581
Disposal of assets	£	144	£	576
Charges related to employee pensions	£	4	£	560
Impairment of assets	£	1,944	£	480
Debt repurchase or restructuring costs	£	104	£	466
Legal and regulatory costs	£	191	£	452
Business transformation costs	£	286	£	371
Costs related to growth or expansion	£	–	£	156
Tax matters	£	2,323	£	141
Impairment of assets held for sale	£	57	£	111
Other NEC	£	102	£	80
Brexit related costs	£	2	£	28
Redundancy costs	£	–	£	12
Exceptional staff costs	£	–	£	6
Total	**£**	**7,928**	**£**	**7,925**