



FORECAST 2023



McGrathNicol

Predictions, pressures and planning

Who will be the winners and losers?

Australia may be isolated, but it is not immune from global economic headwinds. Inflation levels are at a 30 year high, interest rates and energy prices are rising and national security and cyber threats see many businesses seeking to understand the extent of their risk.

This year, businesses will operate in the most challenging macro-economic conditions experienced in over a decade. More insolvencies are expected in certain sectors. Businesses exposed to U.S. and European markets may face liquidity pressure more quickly as those markets appear more vulnerable to the current economic headwinds than our domestic economy.

On the retail front, interest rates and the broader cost of living pressures are starting to bite. We expect retail sales to slow down, particularly in discretionary retail. Downward pressure on property prices will also have an impact on how wealthy consumers feel in 2023.

However, there are green shoots. Australia is still an attractive market for offshore investors. Global supply chain issues, shipping constraints and labour shortages are easing, while China is beginning to reopen.

Undoubtedly, there will be winners and losers in 2023. With careful planning and advice, businesses can navigate these challenges and capitalise on the opportunities. We hope you enjoy the McGrathNicol Forecast.

We look forward to working with you in the year ahead.



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The background is a complex digital composition. It features a central, semi-transparent globe showing the continents of North and South America. Overlaid on this globe and the entire scene is a network of glowing blue lines connecting various points, resembling a global communication or data network. Scattered throughout are numerous small, bright yellow and white dots, some of which are arranged in a circular pattern at the top. A prominent, glowing greenish-yellow cluster of dots is located in the lower-left quadrant, possibly representing a specific data point or region of interest. The overall color palette is dominated by deep blues, purples, and greens, with bright highlights from the network nodes and dots.

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Construction



Opportunity for strong players to increase market share

With rising costs and labour shortages eroding margins and adverse weather conditions delaying project completion, 2022 was a perfect storm for the construction industry. The Ai Group and HIA Australian Performance of Construction Index (PCI) revealed a contraction in activity from May 2022 to November 2022. Sector insolvencies also increased 75% from 2021, the majority of which were recorded in the second half of the year.

In 2023, we expect supply side pressures to ease, with input prices and labour demand both stabilising. While overall activity will be more subdued, pockets of demand will create growth opportunities for participants in a strong position to take advantage:

- **Commercial:** Office and retail property investment have remained resilient, with commercial assets staying attractive. This trend is expected to continue in 2023, with a one-off boost in demand linked to above-station rail developments.
- **Residential:** This sector suffered the most from the adverse conditions of 2022 and the challenges are likely to continue, with low demand and a lag of unprofitable projects still to run through. There may be green shoots in apartment developments however, after around \$5.9bn of approved apartment buildings were shelved in 2022. The Build-to-Rent trend is also gaining momentum, as demand picks up from returning international students, record high rents and costs stabilising, providing developers and institutional investors with more confidence.
- **Infrastructure:** While government expenditure and renewable energy investment continues to fuel demand, supply side and productivity pressures are creating challenges, as seen by the high-profile collapses in the sector. Further consolidation is likely, as better performing contractors take market share from failed competitors. These factors, together with discussions on improving risk allocation, will help boost productivity and create a more sustainable industry.

Risk management will continue to be a critical focus for developers, with further insolvencies likely across the sector. Although costs are expected to stabilise, contractors with a large pipeline of low margin or fixed price contracts will continue to face challenges.

This year contractors should pay close attention to counterparty due diligence at the start of projects and throughout. They should also look to tighten working capital management to reduce exposure and build resilience. Critical assessment of growth opportunities from failed contractors will be key. Financial and delivery risks in entering new types of projects, or taking over partially-complete projects, will remain high.

Cyber



Significant data breaches predicted to continue

The 2022 McGrathNicol ransomware survey found that 69% of Australian businesses have now experienced a ransomware attack in the past five years.

The increasing prevalence of cyber attacks has highlighted the need for businesses to better prepare for and plan a response to such incidents. With increased regulatory oversight and legislation being introduced by the federal government, Australian organisations will need to develop robust cyber programs to address cyber risk. A key component of any cyber program must be the development of a rapid incident response plan—and regular testing of this—to ensure that an organisation can effectively respond to a cyber attack when it does occur.

There is a growing expectation for organisations to demonstrate a high level of cyber security readiness. Recent legislative changes in Australia have led to an increase in penalties for organisations who are victims of a cyber attack. Organisations found to be non-compliant with data protection regulations can now face significant fines. Regulations such as the Notifiable Data Breaches (NDB) scheme require organisations to report certain types of data breaches to the Office of the Australian Information Commissioner (OAIC) and affected individuals. Additionally, the Security Legislation Amendment (Critical Infrastructure Protection) Act 2022 (SLACIP) has introduced a new accountability framework for businesses that operate critical infrastructure, mandating them to meet certain cyber security standards and report any cyber security incidents to the appropriate authorities in an expedited timeframe.

When looking at the types of incidents we responded to in 2022, vulnerabilities were the most significant root cause of data breaches. With a sense of renewed urgency, Australian organisations must implement proactive measures and controls to prepare for and respond to cyber incidents. These steps will help businesses mitigate any financial and reputational damage caused by a cyber attack and allows them to identify and remediate vulnerabilities before they are exploited.

By conducting regular vulnerability assessments and penetration testing, as well as implementing security controls such as firewalls, Endpoint Detection and Response (EDR), and continuous monitoring and detection of anomalous behaviour, organisations can significantly reduce the risk of becoming another cyber statistic in 2023.

Deals



Market volatility and higher cost of debt will impact M&A activity

Australia's M&A market and deal volumes were impacted by economic uncertainty throughout 2022, particularly in the latter part of the year. In addition to the IPO window closing, we saw first-hand the effects of enhanced buyer discipline and due diligence coupled with the increasing cost of debt. Such themes will result in a continued decline in overall activity in 2023.

Despite major headwinds that will challenge activity, we are already seeing some green shoots. Many financial sponsors and cash-rich businesses are looking to take advantage of depressed valuations, where distressed and struggling businesses present a significant upside opportunity. As market volatility impacts larger institutional deals, we predict strong activity in the mid-market. Strategic buyers, local and offshore private equity funds, and growing direct investors from superannuation funds, will be seeking to deploy capital.

We expect financial sponsors to approach the new year with caution, assessing the impacts of macro-economic changes and rising interest rates. Investors still have significant stores of dry powder which should buoy mid-market activity, and there is an expectation that fiscal tightening will ease towards the middle of the year. Given the significant valuations of recent times, financial sponsors will focus on improving the performance of their portfolio assets to ensure exit readiness when activity returns and valuations once again increase.

Social and environmental issues will remain at the forefront of board discussions, with businesses facing mounting pressure to meet net zero targets and commit to energy transition plans. Accordingly, ESG will have an increasing influence on M&A activity as cleaner energy investment continues to increase. In the Asia Pacific region, renewable energy deal activity is already picking up considerable steam.

Australia continues to be an attractive market for offshore investors. It is relatively sheltered but not entirely immune from global economic forces. In 2023, while we expect overall M&A activity to decline further from early 2022 levels, M&A will remain a key strategy for businesses to reach their growth targets.

Financial Crime



Managing the growing threats of financial crime

Cyber threats will continue to be the number one financial crime risk on board agendas in 2023. However, other financial crime risks must be managed as the economy contracts and regulation struggles to keep up.

Don't forget your own backyard

Demands on businesses to manage external financial crime threats will increase. The greatest business risk is the damage that can be inflicted by those that know a company best—the employees, subcontractors and suppliers that work within.

2022 saw rising geopolitical instability, the wind back of pandemic stimulus, record levels of inflation and sharp interest rate rises. There is no question that the current economic conditions are starting to expose commercial pressures on businesses and their supply chains.

These conditions will present fertile ground for fraud, corruption and misconduct as businesses struggle to meet market expectations and maintain the levels of growth that low interest rates and COVID-19 handouts afforded.

Understanding the source of funds

Although the sophistication of Australia's Anti-Money Laundering and Counter Terrorist Financing (AML/CTF) controls within financial institutions are constantly evolving, criminals continue to exploit system weaknesses. Fraudsters are using increasingly sophisticated techniques to circumvent sanction regimes, and target under-regulated industries.

Last year we saw serious allegations of money laundering against major casinos, record fines from AUSTRAC, and widespread reporting of AML/CTF issues. While 2023 is unlikely to bring the long-awaited Tranche 2 reforms, we expect an increased focus on AML/CTF compliance across a broad range of sectors, including gaming, hospitality, real estate and accounting.

Cryptocurrencies in crisis but here to stay

In 2023, any discussion on financial crime will involve cryptocurrencies. 2022 was a seismic year as the industry was plagued by both a "crypto winter" and a relentless storm of scandals.

The year ended with the implosion of one of the industry's major players, FTX. US prosecutors are now drawing comparisons between FTX and Ponzi-style frauds perpetrated by Bernie Madoff and Enron. The fallout, contagion and collateral damage across the sector is yet to be fully realised.

In 2023, we will no doubt see further consolidation and government intervention relating to cryptocurrencies, as well as the continued use of digital assets to demand ransoms, pay bribes and launder the financial proceeds of crime.

Government & Security Risk



Australia faces ongoing economic and national security risks

Economic challenges

In its 2022-23 Budget, the Albanese Government outlined the challenges set to face Australia—a global economic slowdown, evolving security threats, high inflation, rising interest rates, widespread skills shortages, significant debt, and more frequent natural disasters. At the time, the Treasurer noted the global economy is at a tipping point, with challenging budgets and days ahead for Australia. A recession will impact national revenue but may well be offset by a return to a more positive international relationship with China.

Implementation and review of programs and initiatives

As the Albanese Government enters 2023, in addition to fiscal responsibility, the implementation of strategic initiatives and review of historic programs will be high on the agenda of government departments.

Defence, health and aged care continue to be areas of focus. New aid programs, particularly providing support to the Pacific are being prioritised to improve Australia's partnerships with Pacific countries. Climate change remains a huge policy and economic challenge, with programs and initiatives to support achievement of reducing emissions by 43% by 2030 and net zero by 2050. The federal government is planning to spend \$20bn to ensure the electricity grid is ready for a renewable future, through low-cost financing for new transmission projects.

Program areas under review include Australia's infrastructure spend pipeline, with \$6.5bn in existing projects being re-profiled, and the National Disability Insurance Scheme, with an independent review focusing on the design, operations and sustainability of the Scheme.

National security

Australia's security environment will continue to be complex and challenging in 2023. Home Affairs and Cybersecurity Minister Clare O'Neil recently warned that Australia faces a raft of national security challenges and emphasised the significant domestic security implications of the "biggest shift in the global world order since the Second World War". We note that 2022 was the first time the Australian Security Intelligence Organisation reported espionage and foreign interference, not terrorism, as the most significant domestic security issue.

Such significant changes in the operating environment may require boards and executives to review their security and resilience settings in relation to supply chains, trusted insiders, state-backed cyber actors, coercion, sabotage and foreign interference.

Insolvency



Will 2023 be the year the insolvency floodgates open?

The challenges ahead for Australian businesses in 2023 must be viewed within the context of the past two years. In 2021, the federal government provided significant stimulus which helped to boost liquidity and bolster a generally supportive financial and regulatory environment—these factors resulted in historically low levels of insolvencies and a “cliff” that never eventuated.

While the availability of credit continued well into 2022, the regulatory environment began to tighten. This coupled with geopolitical uncertainty, supply chain challenges, extreme weather events and labour shortages contributed to distress within certain sectors. The construction industry bore the brunt in particular, topping ASIC’s insolvency statistics for the year.

In effect, 2023 will be the first full year where the impact of these challenges will not be buffered by government support, or the leniency afforded by lenders and regulatory institutions over the past two years. Businesses are now facing inflation levels at a 30 year high, rising interest rates, ongoing supply chain issues, increasing energy prices, prolonged abnormal weather events, increasingly acute cyber threats and sustained increases in the cost of living—amounting to a business environment that is as complex and difficult to navigate as ever.

While insolvency levels are still down, they have been increasing, and in December 2022 we saw a return of insolvencies back to pre-pandemic average levels. To date, much of this increase has been driven by businesses that were likely insolvent for a long time. This trend is indicative of a normalising of corporate failures rather than a result of the current pressures.

2023 presents a challenging outlook for businesses

In addition to a normalisation of the rate of corporate failure, we expect that economic and regulatory factors will lead to more insolvencies. Businesses experiencing distress will have less support from available stakeholders to successfully effect a turnaround.

The key question is whether the broader macro-economic slowdown and challenging environment will result in an increase in corporate failures to pre-pandemic levels, or whether the floodgates will open because of a real decline in liquidity coupled with the most challenging business conditions experienced in over a decade?

Property



Australia's property market on the path to "adjustment"

For property, 2022 was punctuated by a retreat in residential values, transaction volumes and optimism. Borrowing costs are at their highest level in 10 years, driven by the RBA raising the cash rate. Despite this, commercial, industrial, healthcare and logistics assets in prime locations continue to perform driven by the perceived security of these assets and credit availability.

Based on inflationary pressures, interest rates are expected to keep rising, placing strain on values and sentiment yet to wash through the market. Conservatism is expected from investors, owner occupiers and capital providers, with 2023 predicted to be an "adjustment year" for property. We expect the following key themes to emerge:

- **Additional debt servicing pressure:** With rate rises continuing to bite and capital buffers eroded, borrowers will find it more difficult to service their loans and refinance (noting the RBA estimates around 23% of home loans will switch to variable rates in 2023).
- **Credit availability:** Given interest rates and cost of living pressures, it is expected that residential values will further decline. This is expected to lead to a more conservative approach by capital providers (including wholesale funders), leading to debt becoming more expensive and cumbersome to secure.
- **Enforcement by non-traditional lenders:** While major banks adhere to strict lending protocols, alternative financiers have not had the same constraints. These lenders generally have higher risk loans, increasing market share and are typically more likely to enforce on defaults than the Big 4 banks as a means to recycle capital into more attractive deals. As a result, enforcement and distressed selling will begin to occur and certain non-bank lenders may come under their own pressures from capital providers.
- **"Return to normality":** Despite debt servicing costs and credit constraints, we expect market pressure will be partially mitigated with the resumption of migration and "business as usual" circumstances. Overall, we expect investment into non-residential subsectors to continue on a growth trajectory. Noting higher debt costs and the impact on internal rates of return, this trend will be concentrated in prime locations and asset classes.

To navigate changing market conditions, property sector participants should look to:

- Build equity buffers to navigate the debt and capital value rebalancing expected.
- Focus on key fundamentals including location, quality, and yield.
- Diversify sources of capital and investment.
- Proactively manage relationships with key counterparties including lenders, builders, cornerstone investors, anchor tenants and joint venture parties.

Restructuring



Macroeconomic headwinds to increase restructuring activity

Notwithstanding renewed optimism from the World Economic Forum in Davos, global economies are still reeling in the wake of the coronavirus pandemic and the ongoing Russian conflict in Ukraine. The list of macroeconomic headwinds remains ominous—high inflation, increasing interest rates, soaring energy prices, tight labour markets, disrupted supply chains, and heightened geopolitical risks, to name a few. Combined, these factors have created an economic environment characterised by generationally-high cost of living pressure, corporate profit erosion, revised valuations and weak global growth forecasts.

Assessing these factors, Fitch Ratings has recently raised the low end of its U.S. institutional leverage loan (LL) and high yield (HY) default forecast ranges. The revised 2023 ranges are 2.5%-3.0% for LL and 3.0%-3.5% for HY. This compares to 2022 actual default rates for LL and HY of 1.6% and 1.3% respectively.

The European outlook is similar. Fitch Ratings has forecast 2023 default rates of 4.5% for LL and 2.5% for HY, compared to 2022 rates of 1.3% and 0.7% respectively.

What does this mean for Australian businesses?

We expect 2023 to be a challenging year for many Australian businesses. Higher costs of debt and input prices will intersect with an expected deceleration in consumer spending due to negative real wage growth and falling house prices. Australian businesses exposed to U.S. and European operations may face liquidity pressure more quickly as those economies slow at a greater speed.

In an environment of tightening credit availability, an increase in restructuring activity is likely to be driven by businesses facing liquidity shortages. This will be even more acute for those businesses that fell behind with their statutory payment obligations over the past few years.

Sectors likely to remain, or come under, increased financial pressure in 2023 include property and construction, energy intensive industries, consumer goods, and discretionary spending-exposed businesses including retail, leisure, and hospitality.

Are there any green shoots?

China's recent relaxation of its COVID-19 lockdown policies presents a potential green shoot for the Australian economy, as Chinese demand recovers and supply chain issues improve. There is also a growing consensus that global inflation may now have peaked and evidence of improved workforce availability.

However, the success of the Reserve Bank of Australia's finely balanced strategy to efficiently tame inflation without "the cure proving worse than the illness" remains key to the near-term health of corporate Australia.

Retail



A challenging road ahead for retailers

Buoyed by significant household savings and strong labour market conditions, Australian retail sales remained resilient in 2022 despite consumer sentiment plummeting to levels of pessimism not seen since the GFC. Retail sales grew 11.4% during 2022, compared to 5.5% in 2021 (noting volumes grew more slowly after adjusting for inflation). Retail sales of \$411.5bn represented a 20% increase above 2019 pre-pandemic levels.

In 2023, the retail environment will become more challenging. Rising interest rates, inflation-fuelled cost of living pressures, and falling property values reducing on-paper wealth, will all present headwinds. The tailwinds from high personal savings levels and pent-up demand or "retail therapy" will also unwind. Consumers will become more likely to opt out of discretionary categories.

Retailers will therefore face:

- Increasingly "value-conscious" consumers, reducing their ability to pass on price increases and amplifying the importance of pricing/discounting strategies and product mix.
- Heightened competition for share of wallet from other sectors.
- Increasing margin pressures as input costs rise, in particular utilities and staffing costs.
- Consumers wanting to understand a brand's values, including sustainability commitments.
- Inventory challenges when operating in a lower demand environment, reverting to "just in time" management.
- The need for investment in an omnichannel strategy as online shopping momentum continues.
- The threat of cyber attacks as retailers digitise operations and store vast amounts of data.
- An easing of global supply chain issues, alleviating cost pressures.

Retailers can improve their operations and capture opportunities by:

- Maintaining market momentum by keeping brand awareness strong.
- Engaging with consumers through authentic brand values.
- Reviewing company structure and fixed cost bases.
- Implementing comprehensive pricing and marketing strategies to capture "value conscious" customers.
- Reviewing cyber security strategies to ensure resilience against attacks.
- Optimising working capital management to drive supply chain improvements.

Supply Chain



Offshore problems are being replaced by local challenges

While 2022 was marred by manufacturing shutdowns, freight congestion and capacity constraints, and increased costs, these issues are normalising as supply and demand dynamics adjust. In 2023, we are already experiencing an improvement in shipping confidence and reliability.

Offshore problems are now being replaced with local challenges—lack of equipment, detention and demurrage charges, record low warehouse vacancy rates, and domestic transport constraints—all of which continue to impact costs and lead time.

The inventory “whiplash effect” is well documented and often a result of supply shortages resulting in companies overordering to mitigate customer service outcomes. In the McGrathNicol Working Capital Report 2020, we noted that “critical and regular assessment of demand patterns will be vital post COVID-19 to avoid overstocking and unnecessarily locking up cash in working capital”. Australia’s historically inflexible supply chains have struggled to adapt fast enough resulting in increased inventory holding and working capital. The most recent Working Capital Report 2022 identified that Australian companies had increased their average inventory outstanding from 88.9 days (FY21) to 100.8 days (FY22). This is nearly three times the international average increase over the same period.

Looking forward, excess discounting, where necessary, will likely impact earnings in 2023. Resulting cash burn may also increase this year due to the end of historical repayment holidays, higher costs of borrowing, and increased inventory holding.

The changing supply chain landscape warrants an increased focus on network redesign and a need for improved transparency to identify the true cost of operations. Numerous other events including trade route blockages, geopolitical and military activities, natural disasters, consumer channel shifts, and a trend back to insourcing of critical activities, has necessitated further refinement as firms seek increased resilience, heightened customer service, and greater flexibility.

Continued investment in technology and automation, while highly beneficial when executed correctly, increases exposure to cyber threats and security infiltration points for the unprepared. Legislation linked to cybersecurity and critical infrastructure is being introduced to strongly encourage and/or mandate sector proactivity in response. The convergence of supply chain operations and risk will continue to grow in importance throughout 2023, with greater attention from the boardroom. Supply chain risk has become a key priority area for many firms.

Underpayments



Why underpayments will still dominate headlines

As we look ahead, wage underpayments will once again be front and centre for corporate Australia. Despite the attention over the last few years, why will this continue to be a significant issue?

Firstly, there is the reality of the time it takes for underpayment matters to be investigated and addressed. This involves a complex process of legal interpretation, data collection, recalculation and review that needs time to get right. We will continue to see underpayment investigations reported that have been on foot for many months, if not years. This will keep the issue in focus and serve as a prompt for those yet to embark on their journey of investigation.

Secondly, the Fair Work Ombudsman (FWO) now has a continuing and unwavering focus on underpayments. In 2021-2022, the FWO instigated 137 company litigations, reinforcing how seriously the Ombudsman takes the issue and its willingness to act.

The FWO's 2021-2022 annual report disclosed that it had recovered \$532m in payments, of which \$279m related to 267,000 employees of large corporates. This is more than six times the figure of the previous year. As FWO reports, large corporates are coming to grips with the legal landscape, uncovering potential underpayments, rectifying these, and reporting noncompliance to the regulator. This will likely be the case for some time to come, particularly as the FWO continues to highlight industries of focus, such as large corporates and universities.

Add to this, the fact that the October 2022 Federal Budget allocated an additional \$75.2m in funding to the Ombudsman. The majority of this funding is to enable FWO to assume the Australian Building Construction Commission's role in enforcing the Fair Work Act, including underpayments. This may well result in an increase in the incidence of self-reporting from the building sector.

Lastly, we cannot ignore the economic times we face. As the cost of living increases, so will the political and public pressure to ensure workers are paid in full for the work they do and when they do it. If Australian workers struggle with affordability, the pressure to return to them their lawful earnings will be even more of a priority for all.

