

**FORE  
CAST**



## FOREWORD —

As we enter 2024, global and domestic inflation and interest rates appear to have peaked, and unemployment remains relatively low. Despite better-than-expected economic conditions and the prospect of a 'soft landing', we predict there will be a number of challenges and opportunities for businesses this year.

From cyber threats to geopolitical risk and an increasing regulatory burden, boards and their executives will be expected to navigate an increasingly complex business environment. New cybersecurity laws and the establishment of a cyber incident review board are some of the changes in an evolving cybersecurity landscape. If reforms to the Privacy Act are passed, class actions arising from cyber attacks are also likely to increase.

AI offers significant opportunities for improving productivity and competitive advantage, it also presents risks. Businesses need to consider their digital readiness for adoption, AI quality, data governance, cyber resilience, and maintaining customer trust.

We are now seeing the impact of an uplift in ATO recovery activity, coupled with the effects of 13 consecutive interest rate rises. Good businesses with poor balance sheets will be well placed to deliver successful restructuring outcomes. However, we do anticipate more insolvencies, particularly in the construction, transport and hospitality sectors, as pandemic-related leniency dissipates.

There is a silver lining. Australia's desirable security and geopolitical profile will further bolster its appeal as an investment destination. We expect pent-up demand from CEOs and business leaders will also translate into greater M&A and strategic investment activity.

Without a doubt, boards and their executives will need to adapt to new ways of doing business this year. With expert advice, organisations can skilfully navigate these challenges and capitalise on opportunities. We hope you enjoy our forecast and outlook for sectors in 2024.



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# Trust, skills, privacy & governance to dominate agendas

Australian companies are navigating a landscape where AI offers significant opportunities but also presents challenges in digital readiness, AI quality, data governance, cyber resilience, and customer trust.

Government estimates an annual GDP AI-boost between \$170bn and \$600bn by 2030<sup>1</sup>. But digital transformation is lagging, with fewer than half of Australian organisations demonstrating the digital maturity levels needed to fully seize the twin AI opportunities of higher productivity and new competitive advantage<sup>2</sup>.

While generative AI is at the peak of inflated expectations, 2024 will see a shift towards more realistic capability assessment by organisations. Competition for talent will also intensify, exacerbating the need to upskill, train and retain the right skills. We expect an increased focus on digital competency in executive leadership and governance roles.

The speed and scale of the AI roll-out has already created low public trust and scepticism as to whether applications are being responsibly developed, tested and safely deployed. If left unchecked, this ongoing perception will act as a



handbrake on business adoption and wider public acceptance. Business leaders must accelerate AI value and at the same time, create trust, manage risks, and address both the level of organisational change and new skills required to implement these technologies.

As AI is successfully integrated into business operations, the need for robust data governance will also become more pronounced. Shadow AI poses a significant cyber threat where staff circumvent organisational policies and

use freely available, unregulated AI tools.

Globally, many countries are already taking steps to develop AI-focused regulations to ensure governance and consumer data protection. In Australia, privacy regulations are less mature than other regions such as Europe's GDPR regime. This will change as local laws are strengthened, necessitating a balance for businesses between leveraging data to improve processes and minimising data collection to only what's necessary.

<sup>1</sup>Source: Taylor et al., 'Australia's automation opportunity: Reigniting productivity and inclusive income growth', McKinsey & Company, 3 March 2019, accessed 12 December 2023.<sup>2</sup>Abbot, B. Tech Republic, 'Big IT Challenges Australia Needs to Address in 2024 to Seize the AI Moment' December 18, 2023.



## Navigating cybersecurity risks and privacy reforms

The McGrathNicol 2023 Supply Chain Risk study revealed cybersecurity as a paramount concern for businesses, second only to financial performance. This was supported by our annual ransomware research, with 56% of surveyed Australian businesses subjected to a ransomware attack in the past five years. Regulatory bodies are putting organisations on notice, urging boards and executives to develop more comprehensive cyber risk management strategies.

The Federal Government has pledged to reform the Privacy Act and further modify the SOCI Act. One of the critical

suggested changes to the Privacy Act would confer on individuals a direct right of action for redress and allow for greater compensatory damages, similar to the GDPR in Europe.

In 2023, there were five class actions filed in relation to cybersecurity data breaches and, if reforms to the Privacy Act are made, this number is set to increase. The legal class actions currently underway will present a salient lesson for the rest of corporate Australia as to how cyber-related damages are to be assessed moving forward.



New cybersecurity laws, including ransomware reporting with no-fault and no-liability stipulations, an obligation for information sharing, standards for 'Internet of Things' technology, and the establishment of a cyber incident review board are also expected to be introduced. Organisations of all sizes should follow these essential steps:

- Conduct periodic cyber risk assessments to evaluate the effectiveness of cyber resilience controls and the use of managed service providers.
- Update supply chain risk management processes to incorporate cyber risk.
- Enhance enterprise risk practices to include broader geopolitical and national security concerns.
- Strategically implement data governance controls to counter attacks from sophisticated cyber criminals.

Companies that fail to address and enhance their cybersecurity and privacy measures may not only fall foul of the regulators; they will likely face an empowered consumer with greater legislative tools to hold them to account.



## Private capital market outlook

Globally, the macro-economic and market backdrop entering 2024 is more buoyant than a year ago. The US economy navigated the soft landing many were hoping for, while export prices and record levels of immigration have so far suppressed concerns of a looming recession in Australia. However, higher interest rates and stubbornly high inflation are creating a difficult environment for private equity to deploy capital and exit portfolio companies.

M&A activity fell to decade-low levels in 2023, with global volumes falling 18% to about \$3 trillion, the lowest level since 2013. M&A transactions involving

Private Equity were down 27% to \$1.1 trillion globally and 58% to A\$10 billion in Australia. ASX IPO volumes also suffered with only one IPO over \$200 million in 2023<sup>1</sup>.

The combination of a challenging market for exits, higher cost of debt and economic uncertainty have combined to slow down buyout fund raising volumes. The consequences of multi-year reduced deployment and exit volumes may result in a structural change to the private equity landscape in the coming years.

Private credit, on the other hand, benefits from many of the factors that inhibit



private equity deployment and we expect private credit activity to continue to increase, given the already 16% uptick in fund raising by these funds in 2023. In Australia, private credit accounts for only 9% of total business lending, compared to 91% and 65% in the US and Europe respectively. Capital regulation and complex cost structures will present challenges for banks lending to fast-growing, smaller businesses.

As we look ahead, pent-up demand from CEOs and business leaders to pursue investment strategies will result in a pick-

up in M&A activity. New opportunities for private equity players to exit their existing investments are slowly starting to emerge, and private credit offers more flexible financing. If US or European growth accelerates, we will likely see an increase in inbound corporate and private equity M&A, as international buyers target local companies for international expansion. Australia's desirable security, demographic, and geopolitical profile will further bolster its appeal as an attractive investment destination.

<sup>1</sup>Source: CapitalIQ data accessed 9 February 2024.



# A heightened geopolitical backdrop

Geopolitics, strategic competition, and a raging battle between authoritarian and democratic ideals stand poised to impact the world in 2024 in ways potentially not seen since the Second World War. The significant number and scale of elections set to be held throughout the year, particularly the US presidential election, may also impact global stability.

China has partnered with Putin's Russia in a 'no limits partnership', which is attracting support from other authoritarian regimes like Iran and polarising the world into competing blocs. With competition between these blocs growing, countries are increasingly

viewing non-traditional security issues as central to their national security and resilience. Australia's critical infrastructure and other economic levers are increasingly a target, via cyber attacks and the use of trusted insiders..

The Russian invasion of Ukraine grinds onwards and continues to pose a challenge to global stability, particularly as the West's support for Ukraine appears to waiver. Hamas' terrorist attack against Israel, the Israeli response, and Iran's increasingly aggressive use of its 'Triple H' proxies (Hamas, Hezbollah, Houthis), demonstrate how quickly the geopolitical environment can shift. Business and



political leaders will be keeping a close eye on the potential global ramifications of regional issues including the devastating human cost, supply chain disruptions, increased cyber risks, and escalating levels of international sanctions. To identify, understand, and mitigate these risks, organisations will need to:

- Actively map out their supply chains to understand their reliance on partnerships and procurement concentration, and clarify alternative strategies.
- Identify their high-risk counterparties and undertake enhanced due diligence, as well as adopt investigative and counter insider risk capabilities.
- Strengthen and actively test their cyber posture, including against advanced, persistent cyber threats.
- Introduce trusted and timely feeds of synthesised intelligence that forewarn executives and boards of triggers for change.



## More insolvency pain to come

Higher interest rates, increased cost of living and reduced credit availability will all contribute to tougher operating conditions for businesses in 2024. In addition to the broader economic indicators, we expect that a more active credit collection environment, in particular from the Australian Tax Office seeking to recover over \$30 billion in overdue small business tax, will lead to an elevated level of insolvency appointments.

Total insolvencies in calendar year 2023 exceeded pre-COVID averages by approximately 15%, with December quarterly appointments 30% higher

than the corresponding pre-pandemic benchmark. In part, these elevated numbers were driven by a normalisation following artificially low appointment numbers in both 2021 and 2022. However, the factors listed above have also been driving insolvency appointment numbers, many of which we expect to continue.

From an industry perspective, the construction sector led insolvencies in 2023, accounting for around 28% of all appointments in the calendar year. We expect this trend to continue as ongoing margin pressure and delays, coupled with the contagion impact of supply



chain failures, hinder activity for small to medium businesses in the sector. We also expect that industries dependent on discretionary spending, such as retail, accommodation and food services, will come under further pressure as consumers close their wallets.

Whilst many of the corporate failures over the last six months have involved small to medium enterprises, we expect that tighter credit conditions may also lead to larger corporates requiring restructuring, in some cases via the voluntary administration process. In particular, we expect that there may be an 'unwind' of a number of the private equity-led, highly

levered transactions that have taken place over the last few years, where the low-rate environment resulted in excess liquidity.

The outlook for 2024 is that there is more pain to come. As the credit leniency available during, and immediately post the pandemic period dissipates, we will see more businesses in distress. A larger proportion will be unable to solvently restructure as a result of both a decline in liquidity and less support from key stakeholders.



# Favourable conditions for financial restructuring

The outlook for the domestic economy in 2024 appears rosier than many would have predicted. Despite some recent softening consumer spending remains buttressed by record migration, a defiant housing market and a bull run on global share markets. Global and domestic inflation are easing and the Reserve Bank has paused its monetary tightening strategy, having perhaps pulled off a seemingly improbable 'soft landing'. Labour is easier to attract and retain, and post COVID supply chain disruptions have largely abated (domestic port and Red Sea related challenges aside).

Despite the improved economic outlook and prevailing market optimism, we predict many businesses will need to finally face up to excess leverage and unsustainable legacy debt over the next 12 months.

ATO recovery activity on record arrears continues to pick up pace and conventional theory supported by latest inflation and retail sales data tells us the full impact of 13 consecutive interest rate rises over the past 18 months is starting to really bite. Fitch Ratings are forecasting corporate high yield and leveraged loan default rates to rise in 2024 by 50bps



(3.5% to 4.0%) and 200bps (5.0% to 5.5%) respectively. We believe we are only now seeing the beginning of the fallout.

There is a silver lining. Businesses with decent prospects but for excessive leverage and/or unsustainable legacy debt (the historically rare 'good businesses with bad balance sheets') are well-suited to successful restructuring outcomes. We are already seeing an uptick in the use of the safe harbour regime, consensual debt restructure, solvent schemes of arrangement and deeds of company arrangements to facilitate balance sheet rehabilitation.

Whilst we expect insolvency numbers to be elevated throughout 2024, we also anticipate a significant increase in the number of large businesses able to restructure solvently. Candidates for these processes would do well to engage early with their advisors to understand their options.



## Ongoing challenges but conditions to improve

In 2023, the construction sector faced a challenging year, with insolvencies increasing by 33% from July to November, compared to the monthly average of the previous year. The industry encountered raging inflation, supply chain disruptions, labour shortages, regulatory pressures and tightening credit markets. Many of these headwinds will subside, and we expect a gradual reduction in distress and insolvency. However, relationships will continue to be tested in 2024, particularly between developers, financiers, and head contractors.

The McGrathNicol Working Capital Report 2023 highlighted the working

capital metrics of large construction companies. In recent years, there has been a trend of larger contractors slowing supplier payments where possible to improve their own cash flow. Our 2023 analysis showed a reversal of that trend, with average Days Payable Outstanding at the lowest it has been in six years. This suggests that additional support was provided to subcontractors to deliver projects and achieve financial stability.

Post-GFC, offshore lenders and the Big 4 banks reduced their construction sector exposure, paving the way for private capital growth. These private capital providers (and their borrowers) have



been largely untested in recent times, but they are now facing their first significant market challenge. Historically easy-going private capital providers are expected to shadow borrowers and require more progress reporting to ensure project delivery this year while potentially claiming a larger share of project profits due to delays and breached covenants.

An increase in disputes is also anticipated, driven by historical activities and current economic conditions. These disputes are expected to become more frequent and prolonged without necessarily reaching court hearings. There is a growing trend of parties,

including developers, contractors, and financiers, negotiating to share financial burdens to ensure project completion. Whoever holds the most leverage in these negotiations will determine which party feels the most pain.

While the construction sector is set to face ongoing challenges in 2024, there is still cautious optimism. Among larger industry participants, there is a growing sense that if you have survived the past few years and you are able to both continue to deliver into an undersupplied market and re-price your pipeline, the worst may be behind you.

# What to expect post the 2023 Defence Strategic Review

With the Defence annual budget exceeding \$50 billion for the first time in 2023-24, and with further increases expected as a percentage of GDP, the Government continues to invest heavily in Australia's defence capabilities.

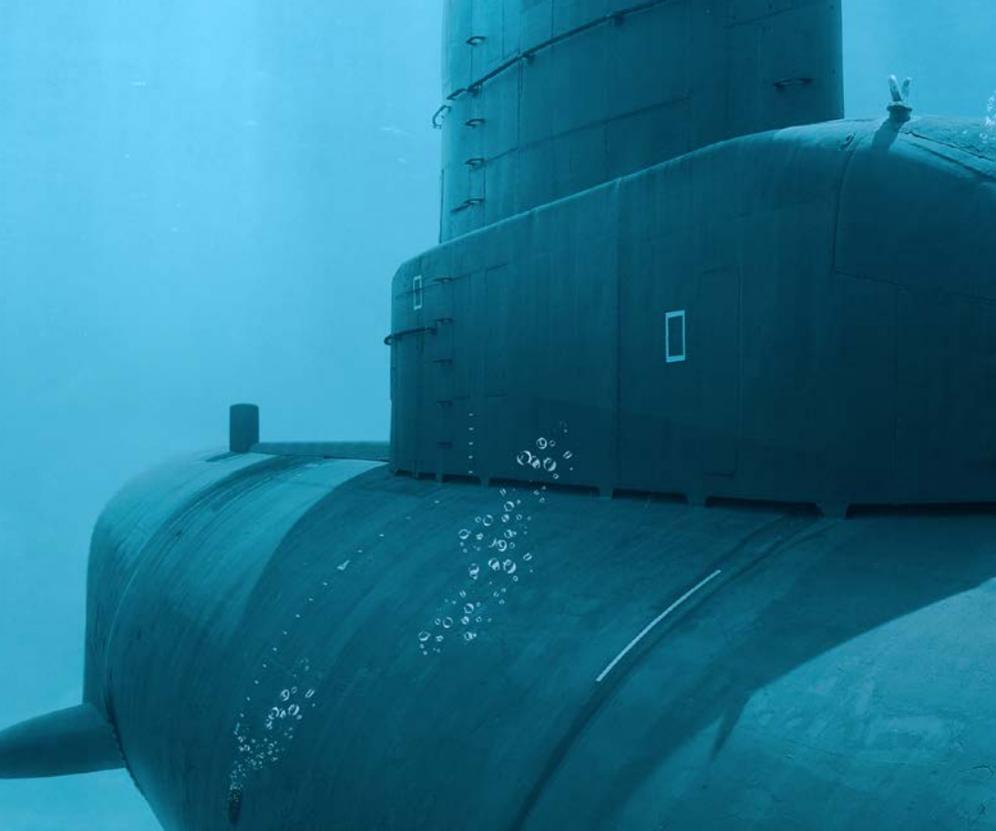
However, following the 2023 Defence Strategic Review, the focus of investment has shifted and challenges for security readiness have emerged. These challenges include:

- advancements in technological capability;
- instability within our region and competition for power in the Indo-Pacific region;

- national security threats including cyber, espionage and insider risk;
- climate change and the impact of more frequent natural disasters;
- military force design and structure to meet future challenges; and
- re-prioritisation of committed spending.

As a result of this shift, we expect numerous impacts to businesses operating within Australia's Defence industry, including the following:

- Shifting future spend to areas that better align with the 2023 Defence Strategic Review and AUKUS priorities. Defence is seeking to rationalise



existing contracts and arrangements and difficult decisions will need to be made regarding the reprioritisation or cancellation of projects that do not align with this strategy.

- Accelerating procurement activities and taking on an appropriate amount of risk to facilitate more rapid procurement while staying firmly within legislative and probity requirements. The aim is to deliver minimum viable capability within the shortest time.
- Partnering with sovereign organisations that can be trusted to deliver on government priorities.

The Federal Government will shortly issue the 'Defence Industry Development Strategy' which will outline how Defence will engage with the wider industry to deliver on recommendations from the 2023 Defence Strategic Review.

The agenda set by the 2023 Defence Strategic Review and the focus on AUKUS requires a significant shift in priorities – this will be driven by Defence, however Australia's Defence industry will also need to actively embrace this change.

# An industry not for the faint-hearted

Australia's national energy transformation is at a turning point, with evolving investment priorities, technological change, shifting community sentiment and market volatility creating unpredictability in sections of the market. Increased complexity in government policy, intervention and regulation also presents risk across the energy value chain.

Whilst the extreme energy price volatility of 2022 appears to be behind us, we are now seeing more structural issues and diminishing renewable returns as the energy transformation continues. Generator valuations are under particular

pressure in coal and large-scale solar (without storage solutions), and retailers continue to have their margins squeezed as consumers shop around for the cheapest price and invest in rooftop solar.

Meanwhile, new transmission infrastructure remains significantly behind what is required to facilitate the transition. The delivery of current grid and storage projects is placing upward pressure on construction costs, labour capacity and skills availability, causing project delays and cost blow-outs.

Stakeholders will also be impacted by governments looking to protect critical energy assets from foreign ownership



and interference. We expect further regulation to manage risks in cyber, supply chains, physical security and insider threats.

We anticipate increasing levels of distress in the energy market, particularly where development projects experience ongoing construction delays and cost pressure, large-scale wind and solar grapple with negative pricing or curtailment, and financial players lose bets in the ensuing pricing volatility. Some new projects are unlikely to proceed to construction as the economics become unviable, or they struggle to find willing off-takers.

Opportunities will exist for those with higher risk appetites or differing investment horizons to current asset owners, particularly in energy trading, investment in storage, forced wind and solar asset sales, and new technologies.

We are just at the beginning of the unprecedented national energy transition project and the path is only going to accelerate and become more complex. The energy industry will not be for the faint-hearted in 2024 and beyond.



# Evolving health, aged care & disability service sectors

The health, aged care, and disability services sectors are undergoing significant transformation, driven by regulatory changes, an aging population and patient expectations for hyper-personalised care. We anticipate that the heightened deal activity observed last year will continue. As organisations seek scale to balance increased back office and compliance costs, further market consolidation is expected.

Over the next 40 years, Australians aged 65 and over will make up 23.4% of the population, according to the 2023 Intergenerational Report. Significant

funding will be needed to house these individuals and convert existing facilities to better suit an aging demographic. Innovative aged care providers will gain from this influx of new capital. This year, the Federal Government is also expected to introduce a new co-funding model and many investors are already assessing the sector's potential for growth.

Unlike the aged care sector, the disability services sector is at the start of its regulatory reform journey. The disability services sector is highly fragmented with no single peak body or entity responsible for ensuring quality, safety and oversight.

In late March, the Federal Government will announce its response to the Royal Commission into Violence, Abuse, Neglect and Exploitation of People with Disability and the NDIS Review. Without a single authority responsible for the sector, the reform journey will make slow progress. While uncertainty around government reform remains and many operators rely on their balance sheets to continue operating through challenging financial conditions, some smaller operators may fail in 2024.

Professional investors, including superannuation funds and private equity companies, are showing keen interest in the health care sector, recognising the current demographic shifts and increased demand for healthcare services. This financial injection will support infrastructure development, and underscores the sector's attractiveness as a maturing investment.



## Price volatility, cost escalation & geopolitical events to continue

Elevated levels of volatility in many commodities persisted through 2023 and we expect this trend will accelerate in 2024. Accelerated boom-bust cycles are now more likely to occur in certain commodities and are currently being driven by geopolitical disruption, the ongoing energy transition and associated investment cycles.

Increased complexity in ESG investing strategies and government intervention, such as FIRB presents additional risk and opportunity for stakeholders.

Whilst iron ore prices remain relatively strong against the long term average,

uncertainty regarding the state of the Chinese economy in particular is likely to cause a level of volatility.

Meanwhile coal prices have broadly returned to long term averages, with price support coming from demand through what will be a multi-decade energy transition and supply constraints due to trade flow impacts and declining investment due to ESG pressures.

Some metals critical to the energy transition, such as lithium and nickel have seen significant price falls, with consequences already evident in domestic nickel operations. Meanwhile,



the Federal Government has committed funding towards critical minerals deemed essential to the national renewable energy transition, as well as to the manufacturing and defence industries.

We anticipate increasing levels of distress in 2024, particularly where over-leveraged mines have recently ramped up production and projects in development experience ongoing construction cost pressure. Distressed and non-distressed M&A will increase markedly, as assets change hands between debt and equity investors with different pricing, timeframe and strategic objectives. Funding sources

will continue to diversify, including from key customers with connected offtake agreements, alternative capital and offshore strategic investors.

We expect 2024 will bring an increase in contested transactions, opportunities for complex and interesting restructurings, and challenging disputes. Significant value will be both available and at risk for industry participants.



## Expected underperformance in retail and commercial

Prevailing macroeconomic conditions and development-hindering red tape present ongoing challenges to most segments of the property market. Industrial property remains the outperformer, and the outlook for the year ahead remains strong, albeit creeping yields will ultimately translate to softening values. In the present high cost of living environment, unlocking efficiencies in the delivery of affordable housing is critical to improving the present supply and demand imbalance, driving both increasing values and rental costs.

The high cost of capital, a baked-in construction cost surge post COVID, reduced LVR acceptability, tightened liquidity, and trade labour shortages

present ongoing challenges to new developments and downward pressure on development land values. The non-bank lending sector is likely to experience more borrower defaults and will need to manage some projects carefully. We expect the following themes in 2024:

- Residential: Housing supply shortage and migration to drive residential property prices and rents higher despite ten-year high borrowing costs and sustained costs of living pressures. Pressure on Federal and State Governments to deliver affordable housing should contribute to a rethink of red tape as well as planning restrictions on density and height.



Build-to-rent projects will continue to gain pace.

- Office: Ongoing flight to quality in CBDs and surrounds with Premium and A-Grade buildings to perform well. Sub-grade buildings susceptible to increasing vacancy rates, complete refit requirements and downward valuation pressure will lead to potential investor and financier stress.
- Retail: Retailer insolvencies and/or financial stress will require landlords to manage vacancies and undertake tenant re-mixing and repurposing. Sub-regional malls and shopping strips will face higher tenant risk.

To navigate volatility, market participants are encouraged to be:

- Well-prepared with cash flow forecasts, financial models and governance structures.
- Engaged with investors, lenders and statutory bodies as creditor oversight and enforcement actions rise.
- Prepared for downside valuation risk.
- Proactive with alternate funding options to ensure adequate capital and liquidity.
- Think laterally to adapt investment strategies (e.g. asset re-purposing).
- Actively informed of federal and state government policy direction.



## “War for wallet” will intensify before conditions improve

According to the Westpac Melbourne Institute Index of Consumer Sentiment, 2023 was the second most pessimistic year since 1974 (when records began) due to sustained cost-of-living pressure from rising interest rates and inflation in basics such as rent, fuel, utilities and groceries. Despite the difficult backdrop, retail sales grew 3.3% (seasonally adjusted) in 2023. However inflationary pressures drove much of this increase, with demand and volumes falling.

Challenging conditions for retailers are likely to persist, at least during the first half of 2024, before the prospect of any meaningful interest rate cut or tax relief

comes into play. We expect retailers will face an intensifying “war for wallet”—not only from competitors increasing promotional intensity to attract a more value-conscious consumer, but also from travel and leisure as consumers return to, or even prioritise, experiences over discretionary retail spend.

We also expect a continuation of challenging operating conditions, including an uncertain geopolitical environment which will impact supply chain reliability and cost. Closer to home, we expect elevated operating and input costs, including higher wages. These factors will make it difficult to



forecast and maintain margins and manage working capital. Retailers will need to simultaneously offer value for money, and meet consumers' already high expectations for service standards, personalisation, convenience, and low friction customer experiences.

In this environment, retailers can improve their operations and capture opportunities by:

- Better leveraging data to enable programmatic and personalised promotion to capture consumer spend, while maintaining healthy margins.
- Maintaining a focus on cyber risk protection.
- Ensuring access to robust, timely integrated financial information, regularly updated forecasts based on recent data rather than historical trends, and practical contingency plans should forecasts not be achievable.
- Relentless pursuit of operational excellence by understanding and driving the levers available to them to trade their business "harder" and continue to improve efficiency.

