

# Insight: A 'critical friend' in times of profit warnings, liquidity pressures, covenant breaches and going concern issues

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**From** our recent conversations with potential clients, financial advisers, lawyers and lenders we have picked up a heightened level of concern from the increase in the number of profit warnings. This is an early warning that can lead to more pressure on liquidity, covenant defaults and ultimately material uncertainty in relation to going concern or business failure.

Whilst these concerns do not automatically mean a company will fail, they act as indicators of the level of distress in a company.

Unfortunately, in many instances, companies leave it too late in engaging the turnaround/restructuring profession to address and resolve the problems which ultimately results in a loss of value, longer-term reputational damage and potential failure.

In this paper, we consider situations where there is enough of a runway that with the right advice and support, a default is avoided and turnaround is possible.

## Levels of distress

**Profit warnings** – whether publicly announced or privately to shareholders and lenders via management reports, this can be the first sign of potential issues. In most cases profit assimilates to cash generation.

**Liquidity issues** – the lack of cash generation from lower profits can pressurise liquidity if it is a sustained issue. Additionally, changes in working capital profiles (e.g. customers delaying payments) can add to this.

**Covenant breaches** – usually covenants are a mix of interest cover, income to debt ratios and/or asset value to debt ratios. Profit warnings impact the income and asset value side of the equations and liquidity the interest and debt side. Therefore, the issues can be magnified in covenant calculations

**Going concern** – doubts around the ability to trade for the next 12 months, or refinance, raise going concern issues which can lead to material uncertainty in the audit report.

## Key implications

**Investor and market confidence** – negative impact on company share price or valuation and limitations on further investment.

**Financing and liquidity** – lenders may tighten credit terms or refuse new loans. Additionally, suppliers may demand upfront payments and/or credit insurance may be removed.

**Reputation and stakeholder trust** – customer and supplier confidence may be harmed, and competitors may

exploit the perceived weakness. Depending on the sector, there may be additional media scrutiny (e.g. retail), regulatory attention (e.g. utilities) or both.

**Regulatory and audit oversight** – increased scrutiny on the company from auditors and regulators, such as the FRC, with more detailed examinations of the directors' going concern assessment and stress tests.

**Governance and director duties** – directors need to ensure they avoid wrongful trading under the Companies Act 2006.

## How MRC is helping

We have found that the majority of our current engagements relate to these issues.

We consider ourselves a **critical friend** to companies in these situations where we can ask the challenging questions and provide honest and constructive feedback. Our ethos is to be supportive, collaborative and hands-on, joining or supporting boards in a turnaround or restructuring.

The first step is to create a runway for the turnaround. This involves optimising working capital and in many instances disposals of some form to generate cash. Several of our current engagements are at this stage.

**Local authority 1** – to deal with the reducing reserves, we are providing hands on expertise to maximise income from regearing leases on their industrial and retail portfolios and disposing of non-core assets.

**AIM listed company** – faced with liquidity and covenant issues we are supporting the board in their discussions with their lenders to waive/reset covenants to allow time for a managed disposal of non-core assets to stabilise the balance sheet.

**Renewables company** – the assets have been handed back by the sponsors and we have taken a board position to undertake an M&A transaction to maximise the repayment to the lenders.

**Industrial company** – joined the board to provide independence and governance as part of a group restructuring and asset sale.

**Local authority 2** – consultancy service and project management of the sale of non-core assets to improve reserves.

In all these situations we focus on supporting the boards/management teams to deliver optimal outcomes. Our complementary skills and experiences allow us to take a tailored approach to any situation.



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