Europe faces further rise in corporate defaults Insolvencies level off only late 2024, early 2025 amid financing squeeze

Companies will continue to default in growing numbers in Europe at least until late 2024 and early 2025 though the impact of inflation, tougher (re-)financing conditions, high energy costs and sluggish economic growth on corporate solvency will remain uneven. Most pressure will fall on small businesses in those sectors most vulnerable to rising costs and tighter financial conditions.

Rising default rates are more than just a normalisation of the credit environment in Europe after the pandemic. They reflect much greater risks as higher-for-longer interest rates exacerbate pressures on corporate balance sheets in many sectors.

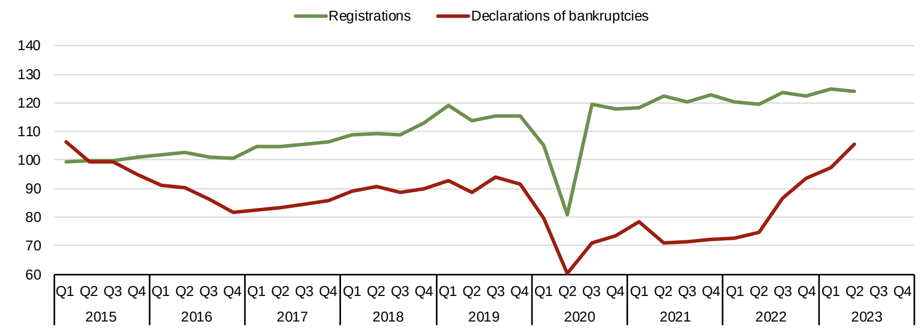
Many companies are struggling with a squeeze on operating profit margins now made worse by more costly financing and refinancing. Firms with low interest coverage ratios, typically measured by EBITDA to interest coverage, will face financial stress or even distress now that interest rates on new capital market debt and bank loans have roughly doubled since mid-2022, affecting floating-rate debt and debt that needs to be refinanced.

Partially restricted access to external financing from bank or capital market segments makes matters worse. We acknowledge that defaults are concentrated among small firms (often with fewer than 50 employees), but we expect the increased operational and (re)financing risk will spread to larger companies.

European companies also have record levels of debt to be refinanced in the next three years. Firms will have to cover additional interest payments of around EUR 8.2bn in 2024 in refinancing maturing capital-market debt, having paid similar interest on refinancing bonds this year as rates have risen. The effect from rising interest rates will even be higher for bank financing which remains the most popular funding source for European corporates. The extra interest cost from durably higher borrowing rates will increase again in 2025 and 2026 as even more corporate debt comes up for refinancing.

Rising defaults partly reflect catch-up from low levels of insolvency in 2020-2022 as governments supported business through the pandemic, but it is the increased macro-economic risks, including higher interest rates and the refinancing wall, which explain why default rates are likely to plateau only in H2 2024/H1 2025.

Figure 1: Corporate stress: bankruptcy declarations rise; growth in new businesses falters



FY 2015 = 100, seasonally adjusted Source: Eurostat, Scope

Our corporate ratings activity suggests pressure on balance sheets is intensifying in some parts of the European economy. Negative rating actions have almost doubled to 25% of the total in the first nine months of 2023 compared with the full-year average in 2021 and 2022. The share of positive rating actions has remained stable at around 15%. Ratings pressure stems from impact of slowing economic growth now and in the future, disruption in specific industrial sectors, as well as rising benchmark rates and refinancing needs. Credit metrics, profitability and liquidity are unlikely to be maintained at a level commensurate with the old rating levels for a significant part of our rating coverage.

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Corporate default rates rebound across Europe

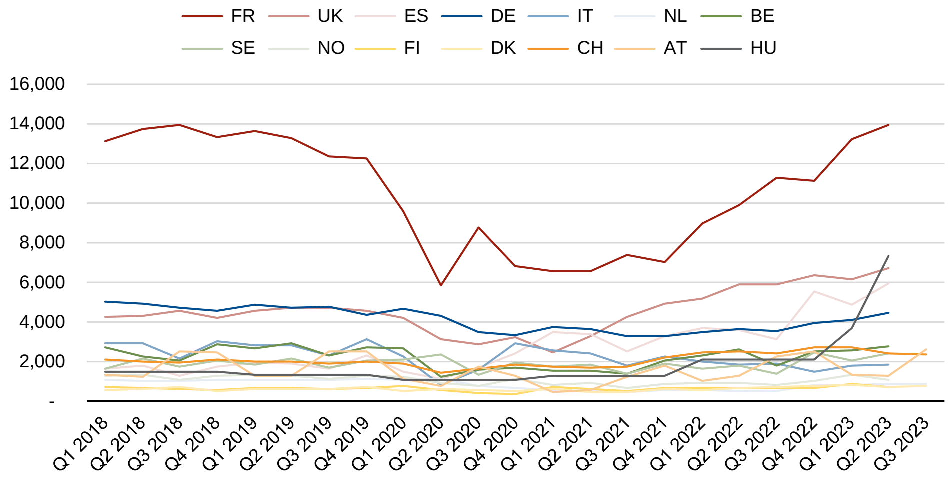
Corporate default rates at an interim peak…

Lagging monthly and quarterly data for major European economies already provides strong evidence that the insolvency cycle has turned. Bankruptcy incidents for non-financial corporates have steadily risen for the past six consecutive quarters. Q2 2023 corporate defaults were at their highest in the EU since systematic data collection started in 2015[1]. July and Aug 2023 data suggest that the rise of corporate defaults has not come to a halt in the third quarter.

… but present uneven picture across Europe

H1 2023 default numbers largely exceeded pre-pandemic levels in United Kingdom, Spain, Sweden, Finland, Switzerland and Hungary. Other markets such as Germany, the Netherlands, Norway, Italy are still way behind pre-Covid default rates.

Figure 2: Quarterly number of registered business failures/defaults in major European countries

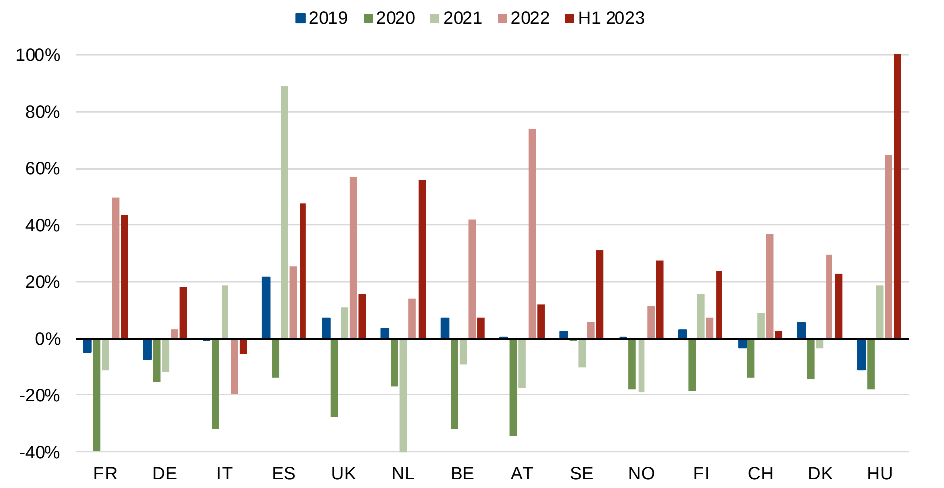


Source: Macrobond, Opten, Cerved, Scope

H1 2023 shows with steep YoY growth in corporate defaults

YoY growth rates in H1 2023 are particularly high in France, Spain, Sweden, Norway and the Netherlands with YoY growth rates between 25% and 50%, and most strikingly in Hungary with an estimated YoY growth rate of more than 100%.

Figure 3: YoY change in company bankruptcies



Source: Macrobond, Opten, Cerved, Scope

[1] EUROSTAT: "Q2 2023: Business bankruptcies at highest level since 2015"

Mounting numbers partly reflect catch-up from lockdown periods

Still the default statistics are to be considered with caution as they include significant catch-up effects from the artificially low default rates in from 2020 until 2022 when corporate insolvencies largely decoupled from economic strength due to relaxation of default triggers and pandemic-related state support.

Defaults mostly among to micro-sized companies

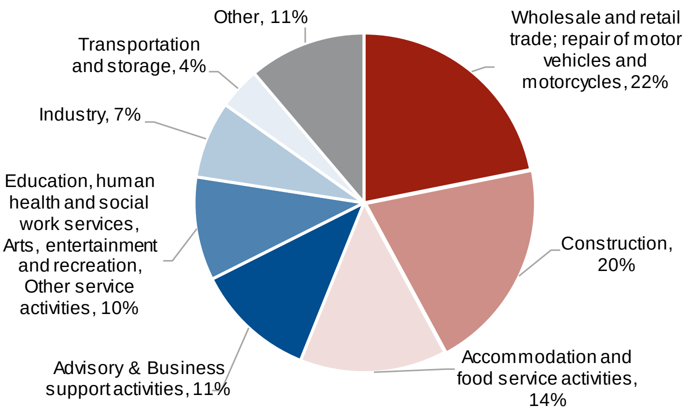
Small companies have been dependent on government-linked financial support, notably those in sectors hit hardest by lockdowns: leisure, entertainment, tourism, and (high-street) retailing. Government support likely propped up some small companies that otherwise would have gone out of business.

While default statistics look worrisome, most business failures relate to micro-sized and comparatively young companies (more than 90%) as such smaller and less-established firms have smaller financial buffers and find it harder to access financing. In contrast, insolvencies of larger corporates – those with annual revenue of more than EUR 100m and/or more than 50 employees – have proved rare up until now though numbers are rising.

Credit risk focused in cyclical, more fragmented sectors

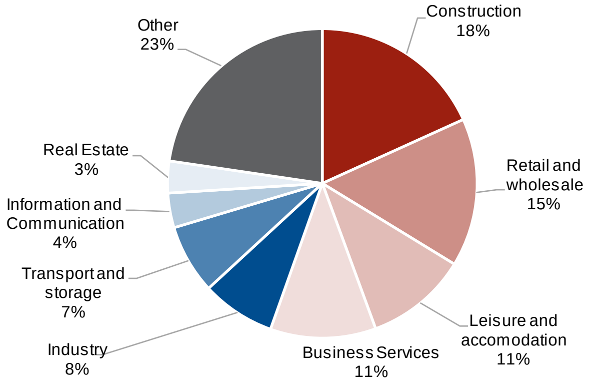
Unsurprisingly, there is a larger concentration among cyclical and sensitive sectors as well as typically highly fragmented sectors, such as construction, wholesale and retail trade, accommodation and food service activities as well as business services and transportation & storage. They make up more than 75% of total corporate defaults (see examples for Germany and France in **Figures 4 and 5**).

Figure 4: Defaults by sector France (LTM as of Aug 2023)



Source: Banque de France, Scope

Figure 5: Defaults by sector Germany 2022 - H1 2023



Source: DESTATIS, Scope

Corporate stress and default risk is further increasing

The rebound of corporate defaults was to be expected, considering the phase-out of government support programmes as well as the impact of continued supply chain disruptions, war in Eastern Europe and continued weak stimulus from China.

However, the increase on corporate stress is amplified by rising refinancing risks over the next few quarters (see our latest research 'European firms face growing interest-cost headache from refinancing', published on 12 Oct 2023). This will likely lead to rising default rates beyond the most vulnerable and among larger companies.

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Corporate defaults hit the headlines

Financial trouble for auto, retailing, consumer goods, real estate/construction firms

Credit stress spreads; some sectors more vulnerable

Prominent business failures and financial restructurings (selective defaults) have taken place across the European corporate landscape in the past 12 months:

Retailers such as Takko (DE), Galeria Kaufhof (DE), Casino Guichard – Perrachon (FR), Makro (UK), BCC (NL), made.com (UK), real (DE), Camaïeu (FR), Joules (UK), Peek&Cloppenburg (DE), basic (DE), Kika/Leiner (AT), Hallhuber (DE), Wilko (UK), Görtz (DE), Reno (DE) and Klingel (DE)

Consumer products companies such as Horst Brandstätter Gruppe the parent company of playmobil (DE), Gerry Weber (DE), VanMoof (NL), Hakle (DE), Rational (DE), Haba, (DE), Cath Kidston (UK), Paluani (IT) or Scotch&Soda (NL)

Real estate and construction companies such as Adler Real Estate (DE), Euroboden (DE), Gerch Development (DE), Eurofinsa (ES), Henry Construction Projects (UK), Schäfer Gruppe (DE), Buckingham Group (UK), Selekta Rakennus (FI) and Jukkatalo (FI)

Automotive suppliers such as Borgers (DE), Geco (DE), Dr. Schneider (DE), BBS (DE), and Allgaier Werke (DE)

Prominent (selective) defaults in a variety of other sectors include: flybe (UK), flyr (NO), Orpea (FR), Gigaset (DE), Vacansoleil (NL), Celsa (ES), Endo International (IE), CineWorld Group (UK), Curata (DE).

Rating migration coincides with rising default rates

Sharp rise in number of negative rating actions

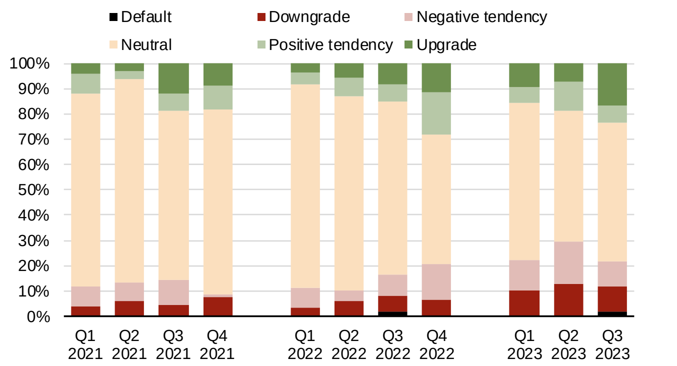
Our corporate ratings activity[2] suggests the pressure on balance sheets is intensifying in some segments of the European economy, regarding particular sectors and rating levels.

The share of negative rating actions[3] conducted has almost doubled to 25% in the first nine months of 2023 compared with the average in FY 2021 and FY 2022. At the same time, the share of positive rating actions[4] has remained broadly stable at around 15%.

Worsening credit metrics, re-financing woes pressure ratings

Slowing economic growth now and in the future, disruption in some sectors, combined with elevated interest rates and the refinancing wall corporate borrowers face in the years ahead present challenging operating and financial conditions for many companies in our coverage. Companies will battle to maintain credit metrics, liquidity and profitability commensurate with the rating levels of the recent past.

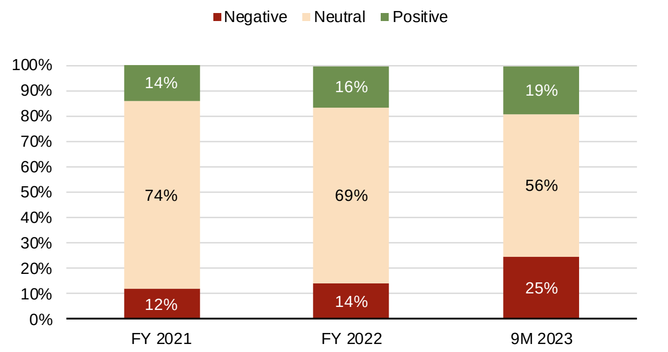
Figure 6: Quarterly rating directions for Scope's rating universe of more than 320 non-financial corporates



Based on 75 rating actions on average per quarter

Source: Scope

Figure 7: Annual rating directions for Scope's rating universe



Source: Scope

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[2] More than 320, primarily European, issuers under coverage across all jurisdictions and sectors. Still Scope's rating coverage has two biases: (1) Large European investment-grade rated companies which are covered publicly and on a subscription basis for investors; (2) European SMEs with a large exposure to the Hungarian market.

[3] Downgrades, negative Outlook revisions and under review placements for a possible downgrade, (selective) defaults

[4] Upgrades, positive Outlook revisions and under review placements for a possible upgrade

Credit ratings show sector-specific default risk

Pricing power remains core credit strength

The high-profile examples of corporate defaults and our credit rating migration show that much of the deterioration in credit quality is sector-specific: logistics and transportation, construction, real estate and retail.

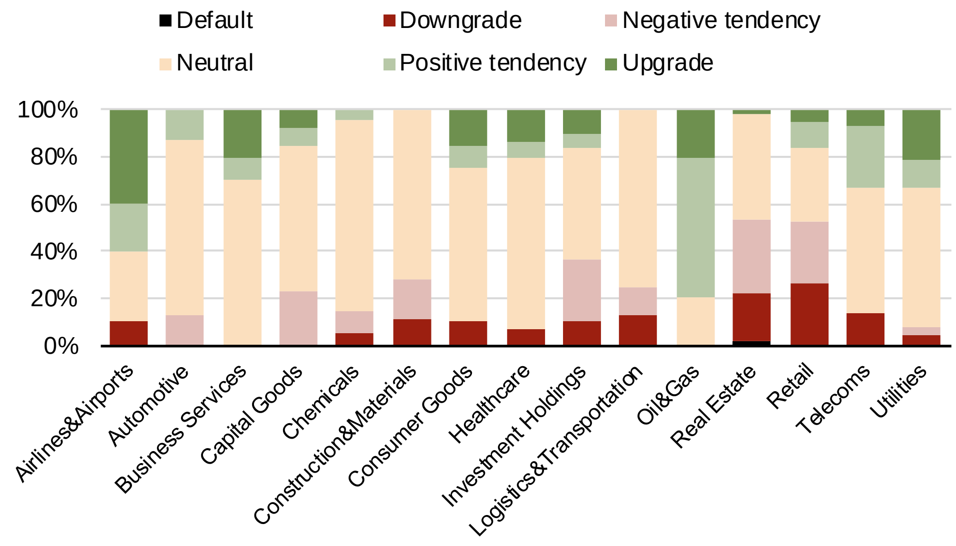
Most vulnerable are those companies lacking the market heft to pass on higher costs to customers and/or sensitive to higher borrowing rates and slack household demand.

Many of these headwinds will continue to blow strongly through 2023 and 2024.

Better context for oil and gas, utilities, healthcare, airlines

However, there are important exceptions to this picture of strained corporate credit quality in Europe as reflected in a wide array of largely positive rating actions and reduced default risks in selected industries. The region's oil and gas producers, utilities with a large share of power generation activities, healthcare companies and airlines & airports are benefiting from one or all the following: high commodity prices, favourable secular and/or cyclical industry-specific trends, high pent-up demand and catch-up effects from the weaker years since the start of the Covid health crisis.

Figure 8: Ratings drift per sector - some positive and negative sector outliers (LTM as of Sep 2023)



Sectors in which Scope had more than 10 ratings

Source: Scope

More fallen angels than rising stars over the past few quarters

Ratings pressure is also mirrored in the rating direction of cross-over credits and the examples of fallen angels and rising stars.

Trailing fallen angels which lost their investment-grade rating over the past four quarters entirely relate to issuers related to real estate, such as commercial property companies as well as asset managers and investment holdings which are largely exposed to the real estate sector. Moreover, BBB- rated entities which are at risk to lose their investment-grade rating as signalled by a Negative Outlook are entirely related to real estate and retailing.

Rising stars which entered the investment-grade territory are to be found the areas of utilities and airlines.

Uneven ratings pressure for IG and NIG credits

Pressure is also quite uneven pertaining to rating levels. Solidly investment-grade (IG) rated corporates benefit from low leverage, high internal cash generation and strong interest coverage, hence their capacity to weather the mix of deteriorating macro-economic conditions and refinancing challenges.

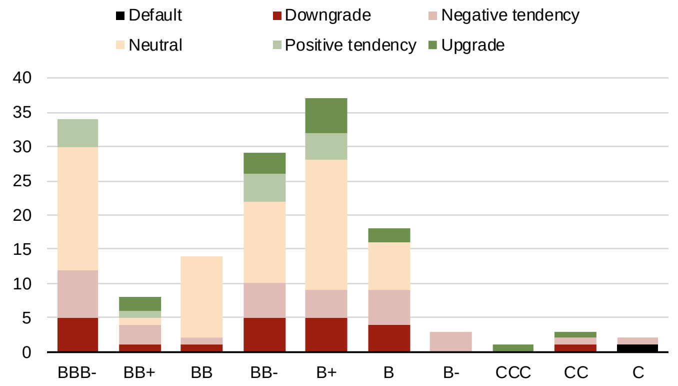
Typically, such companies have pricing power, solid cash buffers, good leverage levels, robust interest coverage and unrestricted access to external funding – in contrast with most non-investment grade issuers.

On the contrary, high yield issuers increasingly face the strain of rising default risk. Negative rating actions for high-yield and cross-over credits covered by Scope amounted to 36% over the last twelve month, well above the overall average of around 22% pertaining to Scope's entire rating universe (**Figure 9**).

Widening credit quality gap between IG and HY issuers

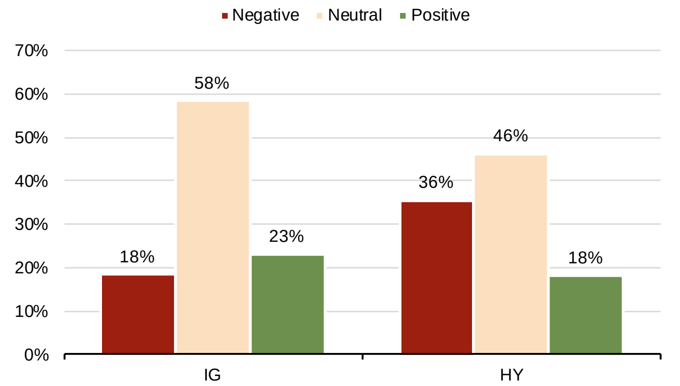
In fact, we see that the ratings gap between covered investment-grade companies and companies with a high-yield credit profile is widening as depicted by a higher share of positive rating actions and less negative ratings pressure (**Figure 10**).

Figure 9: Rating actions for high-yield and at cross-over credits (trailing LTM data) – number of rating actions shown as actions related to prior rating levels



Source: Scope

Figure 10: Rating direction of high-yield and cross-over credits (trailing LTM data)



Source: Scope

Large unhedged variable interest rate exposure is weak spot

High-yield issuers will particularly be challenged by interest coverage, refinancing conditions and covenant compliance if they cannot monetise higher funding costs any better than rising expenses through raising prices on products and services. Moreover, the cancellation or delay of urgently needed investment that would ensure competitiveness due to detrimental funding opportunities may result in a further deterioration of credit conditions.

Companies which only had an EBITDA interest coverage of 3-4x during the times of ultra-low interest rates, will likely struggle to adjust to the adverse interest rate environment: they are more vulnerable to much higher benchmark rates and rising risk premia for refinancing notably if they are exposed to a large share of unhedged variable interest-rate debt. The companies with this exposure face a drastic deterioration in credit metrics whereas those with fixed-rate refinancing face a more gradual pressure on credit metrics. However, such pressure is amplified for companies whose profitability and EBITDA are shrinking due to adverse cyclical trends, industry disruptions and pricing/cost pressure. Such situation can quickly be amplified by the lack of compelling (re-)financing options and additional strain on liquidity.

Outlook: European firms face several difficult quarters ahead

Default rates expected to plateau in H2 2024/H1 2025

The next quarters will likely remain tough for the corporate sector considering i) higher interest rates and refinancing conditions/options, ii) continued inflation, iii) sluggish economic growth and iv) absence of widely rolled out support programmes as during the pandemic. This will likely translate to even higher corporate default rates than those typical before 2020.

Such rates are likely to end up materially higher than pre-Covid given the less buoyant macro-economic conditions and refinancing challenges, plus the catch-up effects from the past three years. Defaults of any larger corporates will make matters worse by spreading financial distress through the value chain, particularly for smaller suppliers and potentially some customers. We expect default rates to plateau only in H2 2024/H1 2025. Rising default rates are more than just a normalisation of the credit environment in Europe after the pandemic. They reflect substantially increased risks as higher-for-longer interest rates exacerbate pressures on corporate balance sheets in many sectors.

Toughest conditions for the followings groups of corporations:

- Highly indebted sectors in which companies are most exposed higher interest rates, refinancing.
- Cyclical sectors which are vulnerable as the economic rebound stalls
- Price-taking sectors in which companies cannot easily pass on higher costs to customers are also sensitive to interest rates.
- Suppliers will need to absorb the cost pressure on their customers in sectors such as auto suppliers and others facing profound structural shifts such as retailing.
- Zombie companies had been kept semi-alive by ultra-loose monetary policy, state support and benign economic conditions, including companies still recovering from the shock of the pandemic. That has now changed.

Default rates will slow as strong firms consolidate sectors

Notwithstanding our expectations of rising defaults, we highlight that consolidation in the most affected sectors as well as restructuring efforts of defaulted companies will ultimately result in slowing default rates and better chances for survival for the remaining market players. Moreover, we believe that governments will remain on the sideline, reluctant to renew guarantee and state support unless default rates climb even more steeply and hit larger non-financial firms.

Central banks are also likely to keep interest high only as long as required to bring inflation back to target rates. There will likely be a tipping point at which positive and negative effects of high interest rates will become more balanced, to avoid widespread damage to Europe's corporate landscape.

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