European corporate defaults & Covid-19: Pressure points show uneven crisis impact

The Covid-19 natural disaster is having a distinctive and uneven impact on the operating and financial performance of Europe-based companies, including the distribution of defaults and default risk compared with recent financial crises.

Large, investment-grade European companies have so far shown themselves to be surprisingly resilient, for the most part. The forceful and comprehensive way in which European central banks and governments stepped in to protect workers, households and business has spared them from the worst of the coronavirus crisis's initial economic impact. Emergency measures have included loosening insolvency rules – including moratoriums in German, Spain and the United Kingdom – giving management more time to reorganise businesses and take advantage of other forms of government support.

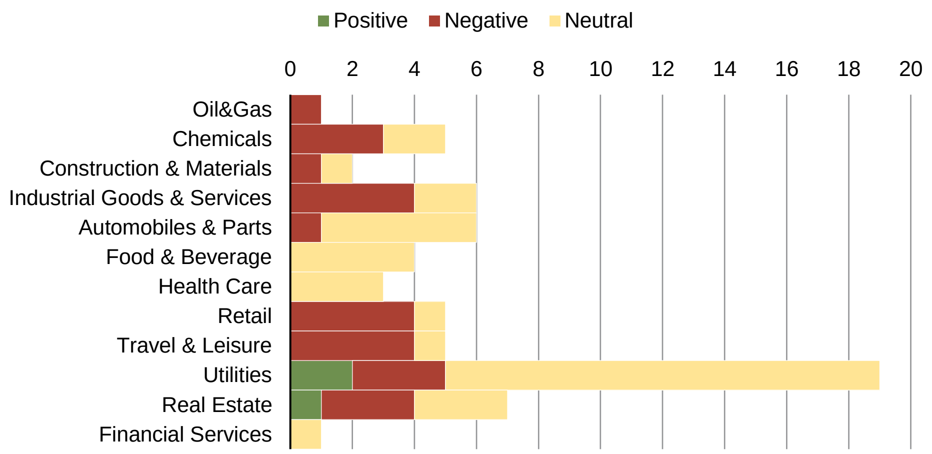
However, the crisis has hit small companies and some sectors hard, leading to an increase in insolvencies, even among larger companies with yearly revenue of more than EUR 50m. Retail has been badly affected. Other high-profile companies, among them some of Europe's biggest airlines including Air France-KLM SA and Deutsche Lufthansa AG (BBB-), have required government-backed rescues.

The longer-term credit outlook critically depends on how strong and broad the economic recovery is - assuming no massive, second wave of Covid-19 infections - as emergency government support for business ends. Particularly vulnerable are those more indebted companies for which the coronavirus crisis has amplified adverse secular and cyclical trends.

Covid-19 corporate impact proves far from uniform

Our initial view as the coronavirus crisis unfolded in February and March was that its impact would range from the severe to mild depending on the sector concerned: the disruption caused by the disease itself, lockdowns and physical distancing varied considerably within Europe even if the overall economic effect has been to trigger the worst economic crisis since the 1930s.

Figure 1: Scope credit rating actions since mid-March 2020



Source: Scope Ratings

Positive = rating upgrades, outlooks changed to positive, under review for possible upgrade
Negative = rating downgrades, outlooks changes to negative, under review for possible downgrade
Neutral = affirmations, no rating action following rating committee

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Bloomberg: SCOP

Defaults clustered in retail, services, automotive sectors

Second-quarter results to date and the concentration of defaults in certain subsectors rather than across the corporate landscape underscore that view.

Our ratings coverage of more than 200 non-financial corporates is not yet fully representative of the European non-financial corporates landscape, but our rating actions over the past four months (see **Figure 1**) broadly reflect the sector vulnerabilities. In this report, we take the temperature of four sectors: retailing, automotive, energy, and capital goods – sectors where many of the larger company defaults took place in H1 2020, according to data compiled by credit insurer Euler Hermes.

Western Europe posted the largest increase in major insolvencies to 64 in Q2, up 38 from the previous quarter, ahead of North America, which recorded 52 cases, up 30 on quarter, according to latest data from Euler Hermes. Western Europe also remained the largest contributor to the global insolvency count for the first half of the year with 90 cases (up by 21 compared to H1 2019), again ahead of North America with 74 cases (up by 43). Defaults in Europe were clustered in the retail, services and automotive sectors, according to Euler Hermes' data.

As **Figure 1** suggests in displaying rating action in Scope's corporate ratings universe, the automotive, transport, leisure, retailing, services and energy are indeed among the sectors worst affected by the crisis. The pharmaceutical, telecoms, speciality chemicals and utilities sectors are among the most resilient.

Government programmes help companies contain costs

Even so, there have even been positive surprises despite the bleak overall context: some companies have offset sharp declines in revenue with effective cost cutting, admittedly with government assistance such as short-time work programmes; other companies or some of their individual business units have recorded significant revenue growth, particularly related to digital activities.

However, several forces will be weighing down on companies' operating and financial performance in the quarters ahead:

- Our baseline projection is for a gradual and bumpy global and European economic recovery (see Scope's Q3 sovereign outlook) so for many companies it is by no means clear that they will return to 2019 levels of revenue before 2022 or later.
- European governments have prolonged some emergency support measures but most will end in H2 or early 2021, representing a cliff edge for some corporates, particularly those smaller, indebted companies unable to reduce costs fast enough to offset lower revenues.
- The pandemic has exaggerated cyclical trends for the worse in some sectors such as the car industry where demand was already falling from 2017 and 2018 peaks.

Coronavirus crisis makes some adverse secular trends worse

- The crisis is exacerbating adverse secular trends in other sectors, notably in non-food retailing where the shift to online shopping has accelerated, putting second-tier and third-tier companies without established e-commerce infrastructure at a severe disadvantage to other competitors.
- Some sectors which until now have proved resilient may yet fall to prey to secondary effects of the pandemic as smaller companies in their supply chains struggle to survive in the absence of continued government support or a strong economic rebound.
- The pandemic may change long-term consumer habits, presenting challenges - and opportunities - in many sectors, notably retailing, leisure, transport and energy.

Covid-19, defaults and default risk: four sector snapshots

Retailing: credit outlook negative

Wider gulf between e-commerce, bricks & mortar retailing

Europe's retailing sector is reeling from the shock of lockdowns across the region to limit the spread of the Covid-19 pandemic, but the impact on the sector's credit outlook has varied considerably.

The confinement of a large share of Europe's population to their homes and the forced closure of non-essential commerce comes at a difficult time for many companies, but mostly for bricks-and-mortar retailers with substantial fixed costs, such as leases, with little or no revenue to cover them.

Our research shows that there were around 100 bankruptcies among retailers in the EU, UK and Nordic region with yearly revenue of more than EUR 50m in the first half of 2020, compared with 82 for the whole of the previous year, 41 in 2018 and 42 in 2017.

The UK, one of Europe's most competitive markets with a high level of e-commerce penetration, accounted for 50% of the total number of H1 defaults, with high numbers in other countries such as the Netherlands and Ireland – partly a reflection of the fragmentation of these countries' retail sectors.

The outlook remains mixed for the sector, with much riding on the strength of the economic recovery and Europe's ability to avoid a repeat of the drastic lockdowns of earlier this year in its continuing efforts to limit the spread of coronavirus. Another question surrounds possible changes in consumer behaviour: will consumers return to shopping as they used to "pre-Covid" or will there be a long-lasting "post-Covid" shift in purchasing habits?

Question over how much consumers' habits will change

Retail outlets facing the most severe credit risk include owners of tier-2 and tier-3 shops without significant online sales and distribution capacity and dependent on discretionary spending such as mid-market fashion and apparel particularly in large shopping centres. Such retailers without strong brands may struggle to renegotiate leases and also prove more vulnerable to disruptions in supply chains in meeting seasonal demand for different products.

In contrast, the pandemic's amplification of the shift toward online and convenience shopping will benefit those retailers with established e-commerce operations, food retailers and niches such as DIY stores.

Automotive: outlook negative

Defaults among the largest companies in the European and global automotive sector remain rare. In recent times in Europe, Swedish car maker Saab is the only significant manufacturer to have collapsed. In the US, the US government bailed out General Motors Co. and Chrysler (now part of Fiat Chrysler Automobiles Corp.) during the global financial crisis.

Pandemic exacerbates auto sector downcycle

The Covid-19 has sped up the cyclical downturn confronting the industry after the peak in global light vehicle sales in 2017 and 2018. Our forecast is for around a 21% drop in sales in Europe in 2020, slightly worse the 15% to 20% decline for global sales overall.

However, the second-quarter performance of the European industry was not quite as bad as we expected, with manufacturers able to offset the steep decline in sales volumes and revenues with significant cost cutting, helping by short-time working programmes and the forced closure of entire factories in response to the health crisis, a change from the reaction to the GFC when managers were tempted to keep production going in the hope that the crisis was going to be limited to the financial sector.

Car-buying incentives likely to bring forward demand

We expect a strong partial H2 rebound in sales in Europe as consumers take advantage of incentives - such as temporary reductions in VAT in Germany – to buy new cars though past experience suggests that changes in taxation and subsidies tends to bring forward rather than create extra demand.

Given the broad economic uncertainty, we expect it take some time for demand to return to 2019 levels, leaving original equipment manufacturers and their main suppliers, while not at risk of default, contending with much reduced operating profitability. Smaller companies in the supply chain may prove more vulnerable as government support ends later this year and early in 2021. According to Euler Hermes, there were 13 Q2 insolvencies in the automotive supplier, retailer and car-rental subsectors in Western Europe and North America.

Integrated oil and gas: outlook negative

IOCs race to conserve cash

Integrated oil and gas companies have acted decisively to conserve cash faced with the double blow of the economic crisis and collapse in oil prices in March and April.

European IOCs have all followed a similar playbook. They used their strong balance sheets to tap bond markets to shore up liquidity, cut back operating costs partly through furloughing staff, and reduced capital expenditure. In some cases, companies have lowered dividends, such as BP PLC which cut its interim payout by half, or offered shareholders a scrip alternative, as Total SE did with its final 2019 dividend. The situation in the US sector has proved more mixed, with domestic IOCs showing their financial resilience, though in the shale sector, exploration and production company Chesapeake Energy filed for Chapter 11 bankruptcy at the end of June.

The operating context for the IOCs now looks considerably more stable, assuming no significant second wave of Covid-19 infections in major economies. One important factor is recent steadying of crude prices around USD 40 a barrel, helped by OPEC+ agreement on production cuts, up from H1 lows near USD 20/barrel for Brent crude

BP successfully placed a jumbo EUR 10.6bn hybrid bond in the second quarter. Total and OMV AG, a smaller company, were able to issue bonds at pre-Covid-19 spreads in May and June respectively, having raised funds in April at significantly wider spreads.

Capex more tightly focused on renewable projects

The pandemic is proving to be a not just a one-off shock to the sector, but also an amplifier of pre-existing trends and possibly the catalyst for shifts in consumption of oil-based products, The overall impact on oil and gas demand is mixed, if not unclear, in short to medium term. Heightened demand for plastic-based products in the health sector and possibly future greater of use of private cars contrasts with the collapse and likely slow recovery in demand for air travel, and with it, jet fuel. The long-term impact will be mainly driven by environmental considerations (not only regulation, but also consumer consciousness/habits) resulting in lower demand.

The IOCs, while cutting back on capex, continue to favour investment in renewable-energy projects and diversifying their business models as environment regulations harden. Take Total's Q2 acquisitions of a 51% stake in the Seagreen 1 North Sea offshore wind project and a portfolio of residential electricity and gas customers in Spain.

Capital goods: outlook stable

Supply-chain uncertainty paramount…

Europe's capital goods sector by and large has so far proved resilient. Europe's larger capital goods companies have mostly reported Q2 results that were better than expected and initially guided, but it is too early to assess the full financial impact of the pandemic. First, many companies in the sector entered the crisis with strong order books. Secondly, further supply-chain disruptions may emerge, if smaller companies struggle to survive without a strong economic rebound as government support measures end late this year and early 2021. The unwillingness of capital goods companies to provide an outlook for 2020 or, as in the case of ABB Ltd., only a very cautious one, demonstrate the still high level of uncertainty in the industry.

…despite some encouraging signals

How order books develop in H2 and how quickly global economic growth rebounds in 2021 will be critical for the sector's performance and credit outlook, with recent purchasing manager surveys in China, Europe and the US showing some encouraging signals.

Investment grade companies can access liquidity

Companies in the sector with strong balance sheets have successfully tapped bond markets to shore up liquidity or received short-term credit lines from the banks. The access to liquidity for smaller companies is more difficult, though many of these companies have taken advantage of government support measures. Liquidity is the crucial issue in monitoring for non-investment grade companies.

Diversity by product, end-market, geography crucial

We generally believe, that large, diversified European capital goods companies such as ABB, Schneider Electric SE and Siemens AG might come through the crisis relatively unscathed given their ample liquidity cushions: significant cash reserves at end-2019 and available credit lines. Measures such as suspension of share buybacks or dividend cuts could also preserve liquidity. The situation is different for small capital goods companies in the non-investment-grade segment, which often have only limited liquidity buffers.

Companies exposed to digital transformation fare better

Management's willingness to continue to invest in the digital transformation and automation of their businesses despite – or indeed because of - the coronavirus crisis is proving one positive trend for capital goods and services companies exposed to the segment.

Renewed executive confidence in the longer-term outlook might express itself in the form of renewed deal-making in the sector. In early August, medical-equipment supplier Siemens Healthineers agreed to buy US radiotherapy specialist Varian Medical Systems for USD 16.6bn.

Bottom-up, qualitatively focused analysis crucial for evaluating Covid-19 impact

Bottom-up approach vital in Covid-19 credit analysis

Understanding the implications of Covid-19 for corporate credit quality is possible only by considering the subtleties of the differing industrial, geographic, institutional and financing contexts within Europe. These factors all influence how companies use debt to finance their activities through banks and corporate bond markets. Such bottom-up, qualitative credit analysis is central to Scope Rating's methodology.

We have refrained from taking across-the-board rating decisions in response to the impact of the pandemic on corporate creditworthiness. We have not mechanistically linked/capped ratings to the sovereign ratings in as much as they have come under pressure. We have examined corporate creditworthiness on a timely and case-by-case basis as the consequences of the healthcare crisis and ensuring economic shock have varied from country to country and from sector to sector.

The avoidance of mechanistic negative rating actions linked to sovereign rating actions stems from our view that i) multinational companies derive significant cash flow contribution from other markets than the home market, ii) companies are better financed better than the state and iii) companies can be less affected by the crisis than the broader economy.

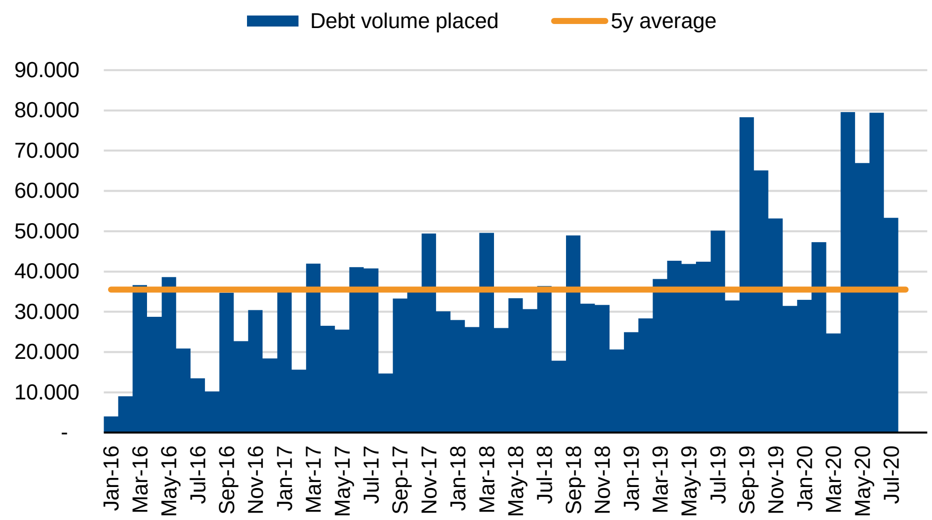
While the most obvious negative rating actions - downgrade, outlook changes, putting on watch for possible future negative rating action - could be seen in the most affected sectors such as travel and leisure, retail and airports (which fall under industrial goods and services), we also affirmed ratings of some companies and, in some rare cases, undertook positive rating actions.

Corporate borrowing surges, with gradual medium- to long-term consequences

Europe's corporate debt market roars back to life mid-2020

The European public debt market came to a near standstill in March as governments implemented drastic lockdowns across most of the region. However, as the market "reopened" from April as the EU and ECB rolled out their multibillion-euro assistance programmes, debt issuance by European non-financial corporates has surged. Bond issuance has been running at record levels of almost twice the 5-year average over the past four months.

Figure 2: Monthly capital market debt placed by European non-financial corporates (in EUR bn)



Source: Bloomberg, Scope Ratings

Near-term liquidity boost, but longer-term debt overhang

In the short term, the surge in borrowing is good for liquidity. However, the staggering increase in the amount of debt is a concern in the medium to long term, particularly if the rise in debt volumes is not matched by an equivalent recovery in operating results – a challenge given the likely sluggish macroeconomic context across much of Europe and internationally.

One silver lining is that corporates have bought themselves time. The average maturity of corporate bonds has been running at around seven years. The coupon payments are less of a credit concern given low prevailing interest rates are given the accommodative monetary policy of the ECB and other European central banks.

Appendix.

Selected Scope Ratings Covid-19-related research and commentary:

Automotive outlook: global demand set to shrink by up to 20% in 2020; car makers show resilience (10 August)

EU budget and recovery fund deal: a significant step to boost Europe's integration and recovery (22 July)

Construction materials sector outlook stable: post-crisis stimulus to help offset Covid-19 impact (20 July)

Europe's hybrid bond market volumes this year to at least match 2019's despite Q1 Covid-19 shock (16 July)

Schuldschein private-debt market set for second-half rebound (13 July)

Sovereign Outlook Q3 Update: gradual, uneven global recovery; meaningful risks remain on the horizon (8 July)

Global Healthcare Quarterly: Covid-19 tests sector resilience but creates opportunities (18 June)

Integrated oil & gas companies cut capex by 25%, tap debt markets in dash for cash amid oil glut (22 April)

Automotive outlook worsens as Covid-19 pandemic chokes demand in US, developing countries (8 April)

Shipping credit outlook revised to negative: cash crunch worsens as Covid-19 disrupts trade (7 April)

Europe commercial real estate: retail-exposed firms can weather Covid-19 crisis in the short-term (6 April)

Airlines fight sales slump, cash crunch Covid-19 hits European carriers hard (1 April)

European telecom credit outlook stable as lockdowns test resilience of operators' networks (26 March)

European chemicals sector credit outlook remains stable: balance sheets strong, China recovers (25 March)

European retailing: Covid-19 separates e-commerce leaders from rest; credit outlook still negative (23 March)

European utilities' credit outlook stable; industry disruption poses longer-term threat (19 March)

Covid-19: corporate credit impact depends on cyclical exposure, scale of government support (13 March)

Airlines: coronavirus outbreak accelerates industry consolidation; conserving cash key to survival (5 March)

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