

Creditors, taxpayers ride to rescue in 2020 Will shareholders provide credit relief in 2021?



Scope
Ratings

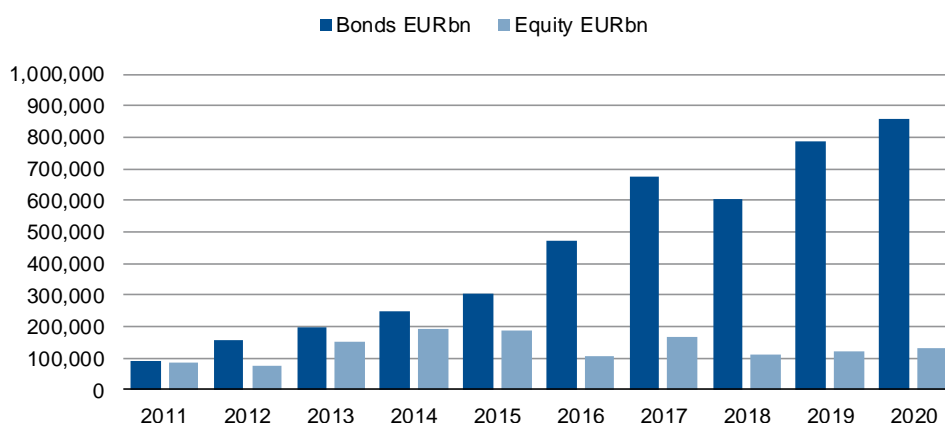
Creditors have done the heavy lifting in funding European companies through the Covid-19 crisis, admittedly with help from taxpayers through various forms of state-backed corporate support. Shareholders have got off lightly.

Might shareholders now step up to the plate and provide fresh equity to bolster corporate balance sheets in 2021? We believe pressure will mount on shareholders in some companies in some sectors as state support falls away. The pressure will be more intense if the economic recovery turns out to be too sluggish or uneven for those companies to sustain the extra debt that they have taken on. Though prevailing low interest rates make debt financing attractive for Europe's corporate treasurers, as does the ECB's expansion of its asset purchase programme to EUR 1.85trn, greater willingness tap equity markets next year would clearly be credit positive considering the pandemic-related jump in borrowing and significant risk of a further squeeze on corporate cash flows this year and next.

Companies have borrowed heavily in 2020 (see **Figure 1**). European non-financial companies, for example, have issued around EUR 850bn worth of bonds so far this year, around double the 10-year average, while many have also applied for emergency financial support from governments and state-linked banks. Companies have raised only modest amounts of equity, running near the 10-year average of EUR 130bn. In terms of sectors, Europe's biggest bond issuers were oil and gas companies at around EUR 80bn, automotive at EUR 65bn, and real estate at EUR 60bn (see **Figure 2**). The overall amount of European issuance is still comparatively modest compared with more than USD 2.35trn of bond debt issued by US-based corporates.

Creditors are increasingly on the line if a post-pandemic economic recovery proves partial and uneven next year (see our [Sovereign Outlook 2021](#)), despite the start of vaccination programmes. Governments are set to steadily withdraw emergency support, whether it is worker subsidies or temporary loosening of insolvency laws. An abrupt end to support measures would rather increase financing risks, thus accelerating default and supply chain risks and deepen the downturn. Pandemic-related delays to capital projects and cutbacks in capital expenditure could ripple through supply chains, leaving companies in sectors such as capital goods short of new orders. The crisis has worsened adverse secular trends in sectors, such as bricks-and-mortar retailing, and exaggerated the cyclical downturn in the [auto sector](#) and volatility in the air-transport sector.

Figure 1: European capital market fund raising 2011-2020



Source: Scope Ratings, Bloomberg

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[Sovereign Outlook 2021](#)

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At best, we expect an asynchronous recovery in corporate performance in 2021 which will require a highly discriminating assessment of credit risk as the aftermath of the pandemic separates strong companies from the weak, even within sectors, particularly among non-investment-grade companies and small and medium-sized enterprises.

Corporate defaults on the rise

As it is, the number of insolvencies is expected to rise sharply across Europe in the second half of 2020 and in 2021 – by up to 35% worldwide - according to credit insurers such as Coface and Euler Hermes. Defaults will rise in Germany, the least affected country, by 12% between end-2019 and end-2021 compared with 21% in France and 22% in Spain, 36% in the Netherlands, 37% in Italy and the UK, according to Coface.

We recognise that default rates would be much higher without the forceful action earlier this year, first, of central banks to ensure sufficient liquidity in Europe's financial system and, secondly, of governments in offering a range of support for companies, which also involved capital injections and loan guarantees. Still, the danger is that default rates will shoot higher as government support is phased out in the quarters ahead.

Covid-19: trends from the crisis to date - and ones to watch in 2021

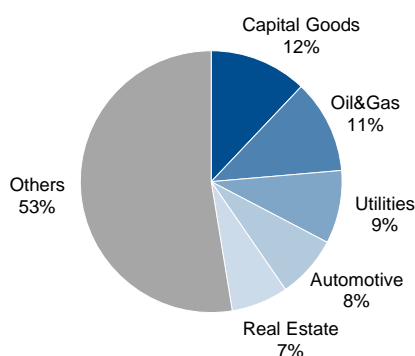
Companies adjust financial policies fast; flexibility will remain vital

Corporate treasurers have demonstrated that they took one lesson from the global financial crisis to heart: the urgency in securing liquidity which a crisis strikes even at the risk of holding excess cash.

Europe's oil and gas sector is a good example. Integrated oil and gas companies (IOCs) faced the double blow of pandemic-related collapse in demand and the shock of tumbling crude prices. IOCs were quick to protect cash flows, from slashing non-essential costs and reducing cash dividend pay-outs to turning to capital markets, even segments which they have ignored in the past. BP PLC contributed nearly half of Europe's hybrid bond volumes in the first six months of the year with an inaugural EUR 10.6bn five-tranche, triple-currency issue. Raising hybrid debt, which has equity-like features, has the advantage of protecting credit metrics without diluting shareholders.

One of the severest hit sectors in 2020 has been aviation. Airlines were also quick to pursue all avenues to protect cash, including grounding nearly all aircraft in some cases during the most restrictive period of the spring lockdown in addition to furloughing staff and deferring aircraft orders. Some of Europe's largest airlines such as Air France-KLM SA and Deutsche Lufthansa AG ([rated BBB-Negative](#)) sought and received direct financial support from government beyond short-time work schemes.

Figure 2: Corporate bond issuance in Europe by sector 2020 (measured by issued debt volumes)



Source: Scope Ratings, Bloomberg

Forceful fiscal, monetary action
forestalls Covid-19 credit crunch

Easy monetary policy could be
storing up credit trouble

Fiscal, monetary policy will continue to support business – up to a point

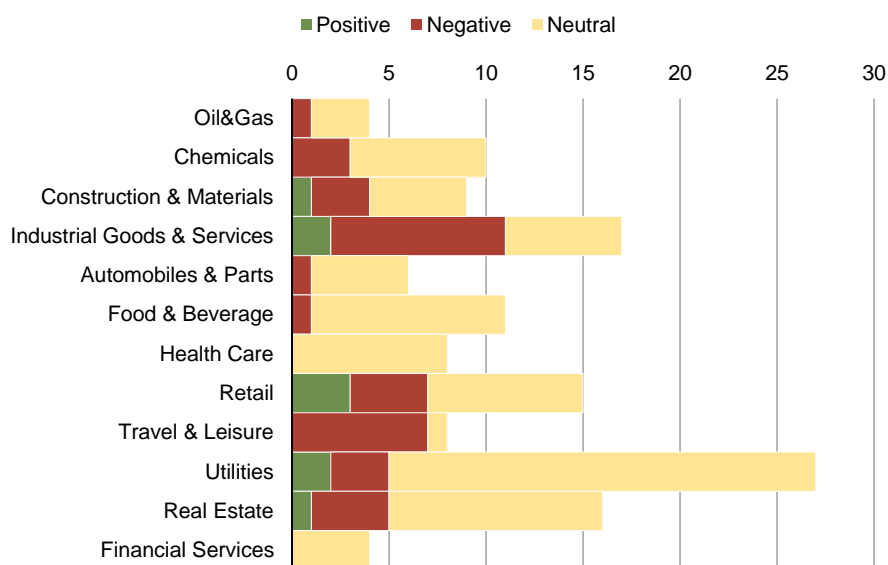
To date, Europe has been spared from a wave of corporate defaults that would have been inevitable had central banks and governments not reacted as forcefully as they did in the spring - by providing massive fiscal and monetary stimulus and loosening insolvency rules - to protect household incomes, save jobs and protect business. In doing so, they ensured that capital markets remained open, preparing the ground for the surge in corporate bond issuance.

The authorities' response has also set the conditions for a broad-based economic recovery which should receive an extra boost as mass coronavirus inoculation gets underway in the months ahead after the surprisingly rapid development of Covid-19 vaccines. We expect monetary policy to remain accommodative. European governments are also committing themselves to expansionary fiscal policy in the years ahead in tandem with extra funding at the supranational level, notably the EU's EUR 750bn NextGeneration recovery fund.

Credit metrics: is pandemic-related borrowing temporary or permanent?

In principle, such pro-growth monetary and fiscal policies are credit positive at least in the near term. Longer term, however, the crucial question is whether corporate – [and indeed public-sector](#) - borrowing undertaken during the crisis proves temporary or permanent.

Figure 3: Scope credit rating actions (number) since mid-March 2020 by sector



Source: Scope Ratings

For many investment-grade European companies, the deterioration in credit metrics such as net debt-to-EBITDA multiples has reflected the squeeze on revenues and profit margins rather than sharp increases in debt – a situation which should reverse quickly once the economic recovery takes hold. The [chemicals](#) and some segments of the capital goods sector are good examples. In contrast, in the worst-hit sectors - such as [aviation](#), travel and leisure - it may be years before companies return to pre-crisis leverage ratios, given the extra debt taken on during the crisis and the relatively weak post-pandemic growth prospects.

**Crisis shows supply chains
source of business risk**

**Pandemic impulse for online
retailing**

**Covid-19 buffets commercial
property sector**

**Ceconomy, FNAC-Darty show
omnichannel strength**

Risks lurking in post-pandemic monetary and fiscal policy context

Loose monetary policy raises the problem of moral hazard if it leads to the mispricing of risk and too-easy financing terms for companies whose business models are unsustainable. That in turn could see a sharp deterioration in credit metrics if inflation re-emerges, triggering interest-rate increases which put extra pressure on companies with weaker business models which have failed to pay down debt taken on during the crisis. Such a scenario is more a danger for issuers of high-yield debt and small and medium-sized enterprises than larger, investment-grade companies with ready access to credit lines and capital markets. That said, inflation would boost revenues and operating cash flow, making refinancing easier given the falling nominal value of balance-sheet debt.

Expansionary on paper, fiscal policy will prove less so in practice if not accompanied by [reforms to labour markets](#), [welfare benefits](#), [insolvency regimes](#) to ensure the funds are deployed effectively to foster productivity, innovation and faster growth rather than protect indebted companies with challenged business models. This is particularly true for companies of countries in the euro area periphery such as [Greece](#) and [Central and Eastern Europe](#) which have a poor track record in absorbing EU funds.

Supply chains: beware a second round of credit-related disruption

The initial coronavirus outbreak in China disrupted global supply chains but the impact did not turn out to be as long-lasting as first feared. Worries about the [pharmaceutical sector's](#) dependence on China and India for supplies, for example, didn't materialise. Companies have adapted. One indicator is the sharp recovery in air cargo volumes in the second half of the year. Recovery in demand, partly through restocking, has pushed marine freight rates to 10-year highs this month.

However, the pandemic has also underlined how supply chains can be a source of business risk. Cancellations, suspensions and delays to capital projects can take time to work their way through supply chains so for suppliers of intermediate goods. The coming year could prove difficult if order books are not replenished. If more companies defaulting after the expiry of emergency support from governments, we can expect further supply-chain disruptions which could slow the pace of economy recovery.

Covid-19 accelerates secular trends in retailing, commercial real estate

The pandemic has accelerated secular trends in some sectors, perhaps most visibly in retailing by providing an extra impulse to the shift to online shopping with three major consequences. First, retailers too reliant on bricks-and-mortar stores have found themselves in deep distress. The collapse in late November of UK clothing retailers Arcadia and Debenhams PLC are good examples of owners of long-established high-street brands which were struggling to compete even before the pandemic struck.

Real-estate companies with a high proportion of commercial property in their portfolios are in less trouble but need to rethink strategy fast. The shareholder revolt at commercial real estate giant Unibail-Rodamco-Westfield SE, partly over its US expansion plans, is an example of the pressures in the property sector from the growth in online shopping. The shift to remote working is a similar example, with an impact on owners of office property.

Thirdly, retailing is also illustrating how the pandemic has turned up some positive surprises, another reminder of the wisdom of avoiding knee-jerk credit downgrades when crises first hit.

Two of Europe's leading electronics goods retailers, Germany's Ceconomy AG and France's FNAC-Darty SA, experienced unexpectedly strong summer trading after a spring slump amid Europe's lockdowns. The companies benefited from the lifting of restrictions and other changes in consumer behaviour. Confined to their homes,

Pandemic worsens auto sector downturn

Europeans have spent more in domestic equipment while the retailers have continued to develop their online and so called omnichannel sales and distribution, such as click and collect. Having initially put Ceconomy's BBB- rating on review for a downgrade, we subsequently confirmed the company's [Stable outlook](#). FNAC-Darty remains under review for downgrade, retaining its [BBB- rating](#) for now.

Pandemic exaggerates cyclical weakness; divides strong from weak

Elsewhere, the pandemic has exaggerated cyclical trends. The automotive sector is a good example. Hard as sales of new cars have been hit this year, with volumes likely to drop by a fifth compared with 2019, demand was already on the decline after a cyclical peak in 2017 well before Covid-19 struck.

The crisis has also dramatically exposed the cyclicity of the airline sector as travel restrictions and physical distancing protocols have drastically reduced demand for business and leisure travel. Severe as the airline industry's troubles are, they are not exceptional. Take the sector's vulnerability to natural disasters – such as the eruption of the Eyjafjallajökull volcano in Iceland in 2010 – to terrorism – such as the 11 September 2001 attacks in the US – and economic as in the global financial crisis. Low barriers to entry, government support of flag carriers, persistent excess capacity have contributed to fierce competition on prices have ensured the sector has a poor record in consistently generating cash, leaving it vulnerable to shocks such as Covid-19.

Europe's leading lower-cost airlines prove their resilience

In Europe, the airline sector is one of the best examples of how the crisis has exaggerated the divide between companies with [strong business models and balance sheets](#) and those with [weak ones](#). EasyJet PLC, Ryanair PLC, and Wizz Air Holdings PLC – Europe's leading budget carriers – had to cut costs rapidly during the crisis but are emerging with only moderately worsened credit metrics.

In contrast, Norwegian Air Shuttle – reliant on medium-haul and long-haul travel - has gone into administration after being denied state aid by the Norwegian government. The governments in France and Germany, in contrast, have been more forthcoming, providing financial support (debt and/or equity) worth EUR 10.6bn for Air France-KLM and EUR 9bn for Lufthansa, both reliant on business-travel and long-haul flights for much of their profit. These airlines will require a strong, sustained recovery in passenger traffic to have any hope of repairing their balance sheets.

Credit risks will intensify in 2021-22 without a strong economic rebound

Full debt tensions may surface only after next year

The corporate credit outlook for European companies looks more stable than it did six months ago, but there remains plenty of uncertainty over whether an economic recovery will fast enough and long enough for companies – particularly small and medium-sized enterprises – to sustain the debts taken on during the recession.

A transition year before 2022's credit test

Government support will taper off next year. The pandemic has induced changes in economic behaviour which might have long lasting adverse consequences for companies in some sectors – retailing, real estate, capital goods – even if there are more favourable trends for others, notably vaccine makers, medical diagnostics, online retailing.

The next 12 months are likely to be a transition period as corporate cash flows recover, with it only being in 2022 when we can tell whether pandemic-related damage to credit quality is temporary or permanent – and whether ratings need to adjust accordingly.



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