What's Behind The Rise Of French Corporate Debt?

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Key Takeaways

- French nonfinancial firms' debt now represents 175% of GDP, a 40 percentage point increase in 10 years, while corporate debt has declined in other European countries.
- French groups have built up significant cash buffers and taken on more debt to lend to their subsidiaries abroad.
- As long as the expected rise in interest rates is gradual, we expect limited defaults, although external developments could be a threat to indebted French corporates.

At odds with their European peers, French firms' indebtedness has continued to rise since the 2008 financial crisis, reaching more than €4 trillion (175% of GDP) in the third quarter of 2018. At this stage, S&P Global Ratings doesn't see this as alarming in the wider context of firms' global investment strategies. French corporates have not only made use of low financing costs to build up solid cash buffers and invest in France, but also looked for higher returns abroad, taking advantage of the euro's standing as a well-established international currency to invest in higher-yielding foreign assets. Firms' investment strategies increasingly look like venture capitalism and have paid off, as French investments abroad yield more than foreign investment in France and more than offset France's trade deficit.

Although rising borrowing costs are set to test the soundness of indebted companies, the declining ratio of interest payments to gross value added, along with debt maturity extensions, suggests that defaults should be contained as interest rates rise gradually. Nonetheless, French firms' investment strategies abroad expose them to changes in the external environment, such as interest rate differentials and exchange rate fluctuations.

A look at the companies we rate supports our macro findings. Rising indebtedness originates principally from an increase in debt raised by French multinationals and state-controlled companies. These corporates have used the borrowed cash to finance mergers and acquisitions (M&A). They have also held it as "dry powder" to fund capital expenditure (capex) needs or future acquisitions, or as liquidity reserves to fend off takeover attempts, while the costs of holding cash are relatively low.

Banks have played a key role in French corporate credit growth, offering low interest rates to nonfinancial corporations (NFCs) irrespective of their size. Although the accumulation of debt at a much greater pace than French GDP is not sustainable over time, we don't see an immediate risk of a credit bubble for French banks because of their diversified activities, sound asset quality, and increased recourse to models that distribute risks. What's more, the cost of bond financing has gone up, but repricing still needs to happen in bank credit. If this is not the case, it could signify that banks are mispricing risks.

From a sovereign rating point of view, our analysis suggests rising corporate debt is unlikely to affect our 'AA' rating on France in the near term.

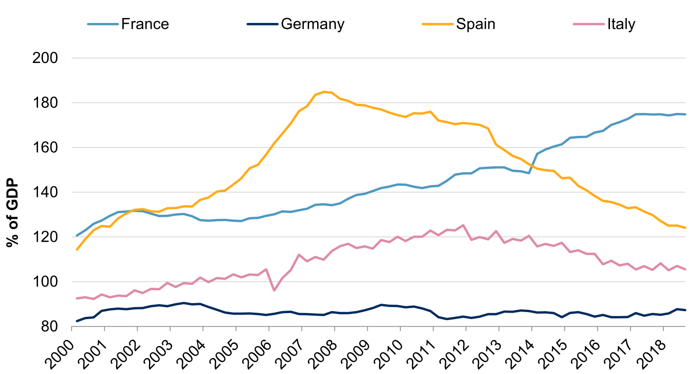
French Firms Have Upped Leverage Since The 2008 Financial Crisis

In third-quarter 2018, according to the ECB, French NFCs' non-consolidated debt, that is, including intra-company loans and trade credit, stood at 175% of GDP, a 40 percentage point increase in 10 years (see chart 1). However, the consolidated data paint a less dramatic picture (see chart 2):

- A large portion of debt is intra-company loans. Consolidating the data brings debt to GDP down to 89.7% in 2017.
- Meanwhile, French firms have built up significant cash piles worth 27% of GDP in 2017. The French statistical office, INSEE, finds that this cash also sits with indebted companies (see "M.B. Kder and C. Rousset (2017), Faut-il s'inquiéter de la hausse de l'endettement des entreprises en France?").
- A much more stable picture emerges when taking into account firms' investments abroad. This suggests that a large part of French corporate debt is backed by assets abroad.

Chart 1

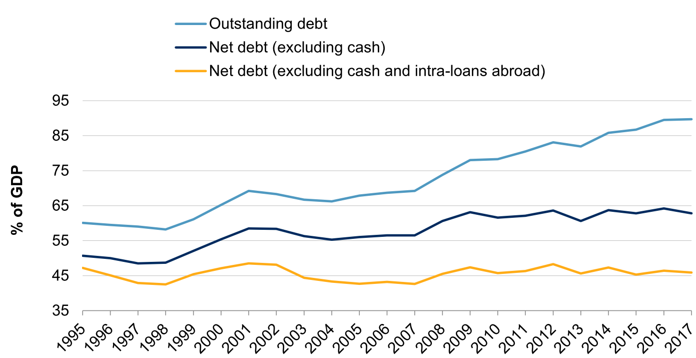
French Firms Have Taken On More Debt Since The Crisis, Unlike European Peers



Source: ECB and S&P Global Ratings. Nonfinancial corporate outstanding debt--nonconsolidated. We calculate debt as outstanding loans + debt securities.

Chart 2

French Firms Have Built Up Significant Cash Buffers And Taken On More Debt To Lend To Their Subsidiaries Abroad



Source: Eurostat and S&P Global Ratings. Nonfinancial corporate outstanding debt--consolidated. We use loans from the assets side as a measure of intra-group loans abroad.

Low Financing Costs And Stronger Investment In France And Abroad Are Behind Higher Debt

We see three reasons why French firms have taken on more debt.

1. To take advantage of low financing costs

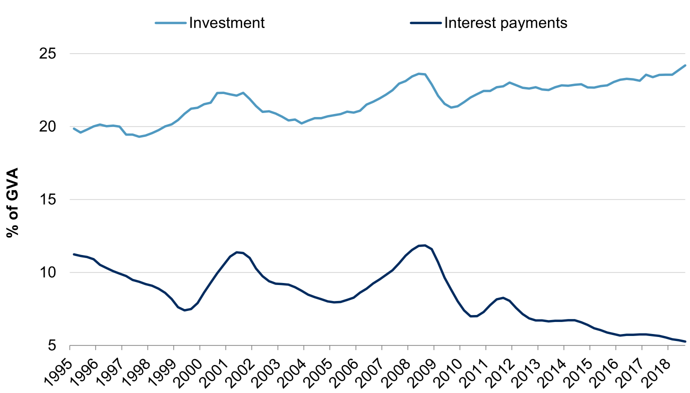
The interest rate for lending to NFCs averaged 1.56% in 2018, its lowest level on record. Small and midsize enterprises (SMEs) have used this opportunity to take out bank loans, while large companies have issued debt easily on the capital markets. Companies have used low financing costs to lengthen their maturity profiles, with long-term debt making up almost all of the increase in corporate debt. Interestingly, despite higher debt, the ratio of interest payments to gross value added (GVA) has decreased to historical lows (see chart 3), showing that the burden of debt has yet to rise.

2. To invest in France

Firms' investment ratios reached a historical high of 24.2% of GVA in third-quarter 2018 and French investment has recovered more quickly than the rest of the eurozone (see charts 3 and 4). Domestic tax incentives, such as a temporary accelerated amortization scheme, partly explain why France performed better than its European peers in this respect.

Chart 3

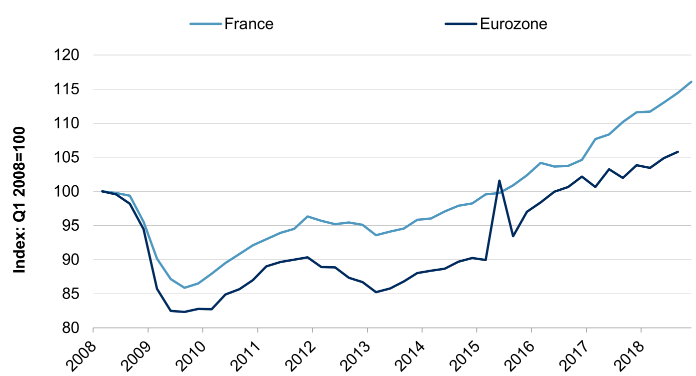
Firms' Investment Ratios Are At A Historical High And Interest Payments At A Low



Source: INSEE and S&P Global Ratings. GVA--Gross value added.

Chart 4

Business Investment Has Been More Dynamic In France Than In The Rest Of The Eurozone



Source: INSEE, Eurostat, and S&P Global Ratings.

3. To take advantage of lower tax rates and higher-yielding investment opportunities abroad

Since creation of the euro, French firms' intragroup loans abroad have more than doubled, standing at 16.9% of GDP in 2017, up from 6.7% of GDP in 1999. France has the highest corporate tax rate in Europe for large companies and one of the highest among countries in the Organization for Economic Cooperation and Development. The development of the monetary union, in a context of high tax differentials among EU members, made it even more attractive for large French firms to take advantage of lower tax rates abroad, by taking on debt in France while generating profits abroad.

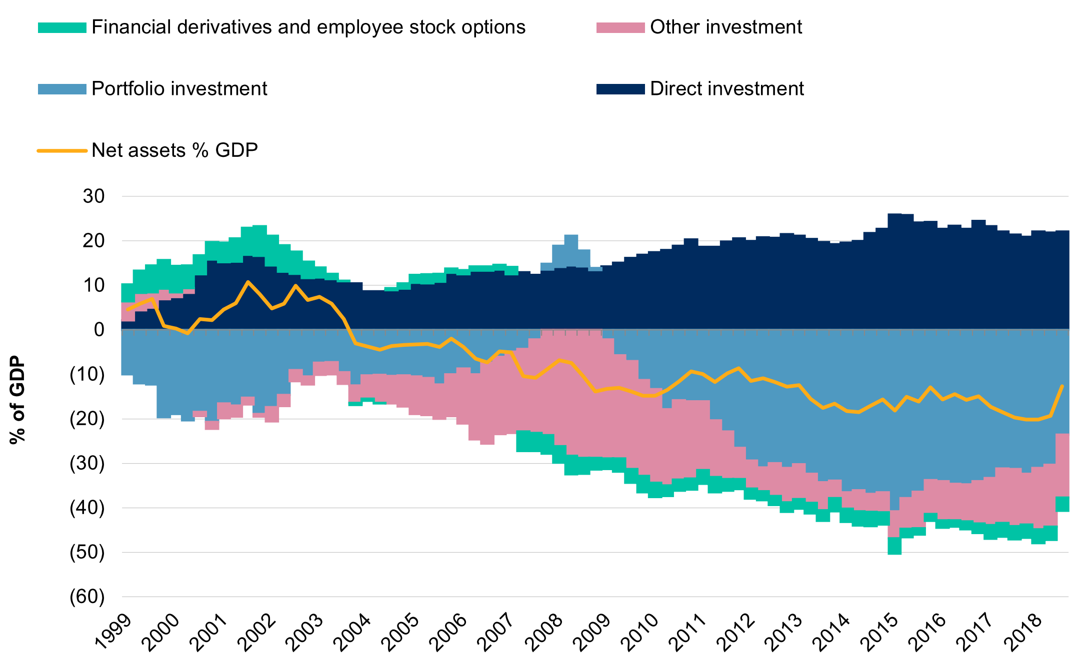
French firms have also taken advantage of having an international currency in an increasingly globalized world to engage in more risky but higher-yielding investment and to set up their global value chains abroad.

Corporates' Strategy Resembles That Of Venture Capitalists

In the context of investments abroad, rising corporate debt stands out as being part of France's maturing capitalism strategy, which increasingly looks like venture capitalism as seen in the U.S., taking advantage of the dollar as an international reserve currency. As such, France's financial accounts show that on balance, French firms favor direct investment abroad--that is, risky longer-term investment--while non-resident investors in France tend to privilege portfolio investment--that is, more liquid but lower-yielding assets (see chart 5). This means that French firms can lend long while borrowing short and derive a sort of intermediation margin from this activity. Despite its negative international investment position, France runs a primary income account surplus (see chart 6). In other words, French investments abroad deliver much higher yields than foreign investment in France.

Chart 5

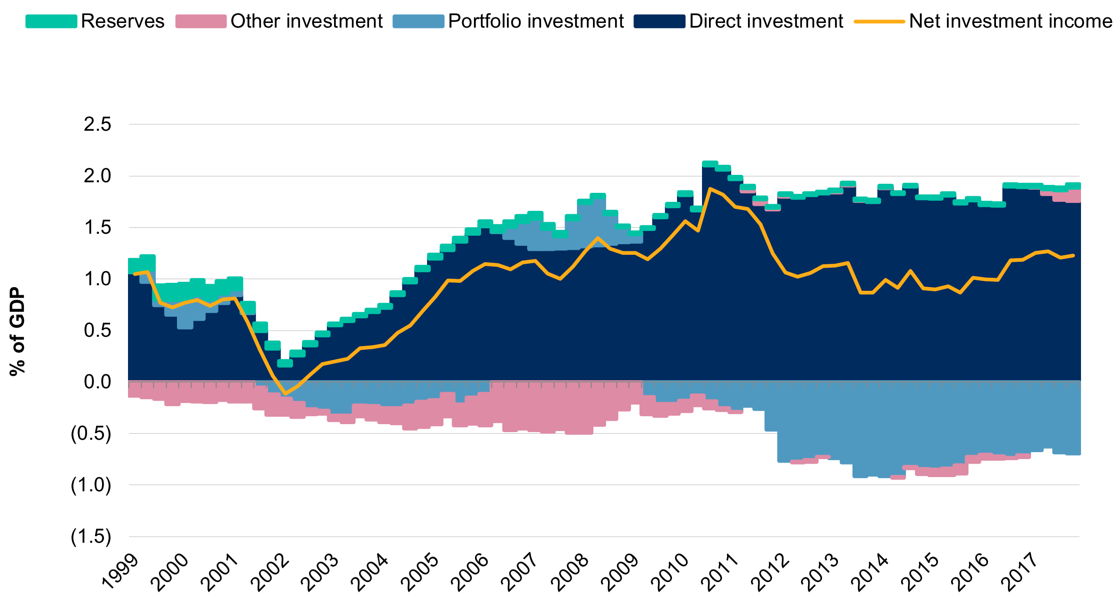
France Invests More In The Form Of Direct Investments Abroad Than Nonresident Investors In France



Source: Eurostat and S&P Global Ratings.The net position of France's financial accounts shows that France receives more portfolio investment than it exports abroad. In contrast, French investments abroad more often take the form of direct investments rather than non-resident investments in France.

Chart 6

French Investments Abroad Offer Much Higher Returns Than Nonresident Investments In France

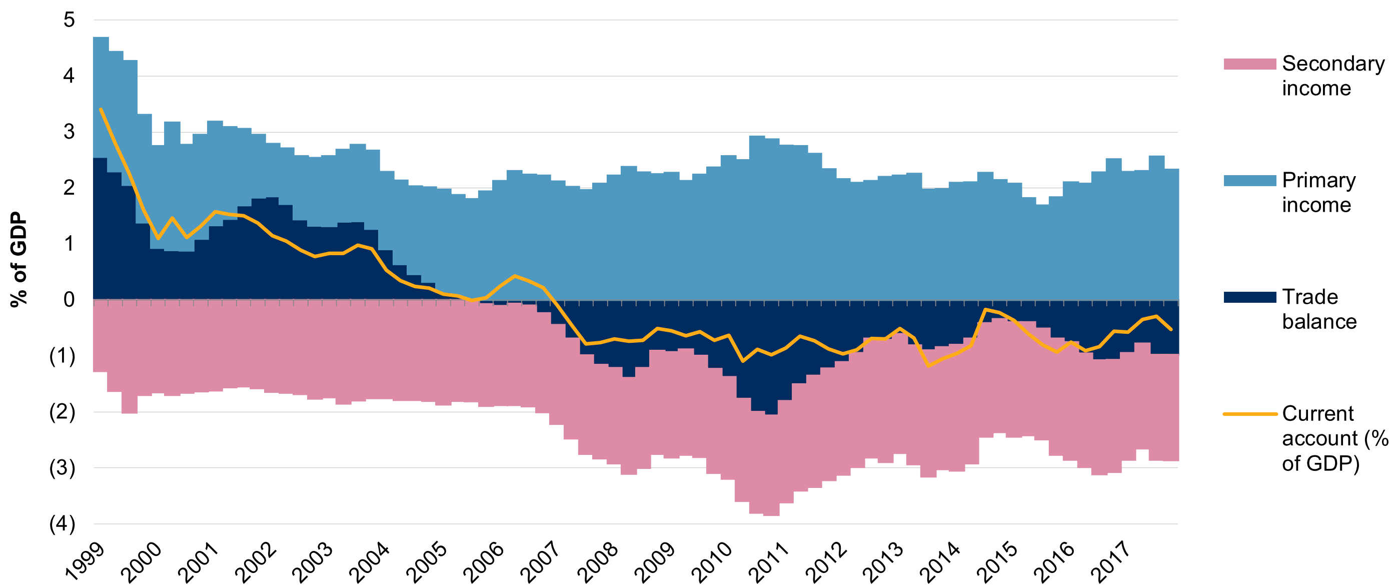


Source: Eurostat and S&P Global Ratings. France's current account balance shows that the country's investments abroad generated net revenues of around 1.2% of GDP in 2018. This is thanks to high-yielding direct investments as France's portfolio investments have generally weighed on the country's investment income balance.

French firms' global investment strategy suggests that rising indebtedness should be viewed in a wider context. With French multinationals earning 52% of their revenues abroad according to INSEE, debt to GDP might not be the best measure of sustainability. What's more, French investments abroad have been so profitable that they now more than offset the trade balance deficit (see chart 7).

Chart 7

France's Primary Income Balance Surplus Now More Than Offsets The Trade Deficit



Sources: Eurostat and S&P Global Ratings.

French Sovereign Ratings: Rising Corporate Debt Is Not Yet A Concern

Despite steady and protracted credit growth in France, we don't expect credit growth dynamics to affect our 'AA' sovereign rating on France in the near term.

This is because we don't consider economic growth to be credit-fueled and we don't see the country's external debt position as problematic. Moreover, the assumption of debt of some corporates owned by the French State (most recently SNCF Reseau) has resulted in a higher net general government debt as a share of GDP. Nevertheless, our current forecast suggests the ratio will likely remain broadly stable over the next few years, albeit somewhat higher.

In accordance with our sovereign rating methodology, we would normally expect vulnerability to a credit-fueled asset bubble when growth is fueled by a rapid increase in bank loans to corporates, and this is combined with sustained growth in inflation-adjusted asset prices. However, for the reasons discussed from different viewpoints in this analysis, we don't consider this to be a danger for the French economy in the near term.

In addition, we don't see France's current external position as a risk to the sovereign rating. An economy's external indebtedness encompasses both external debt of the private sector and the government's external debt. We believe that risks for a sovereign's creditworthiness are particularly acute when credit growth is largely funded externally, which does not appear to be the case in France.

Our key measure of a country's external indebtedness is the ratio of narrow net external debt to current account receipts (CAR). The term "narrow" refers to a more restricted measure of assets than some widely used international definitions of net external debt. Our calculation of narrow net external debt subtracts from gross external debt only the official foreign exchange reserves and liquid external assets of the public sector and all financial-sector assets.

We use this special definition for two reasons:

- Financial-sector assets are generally more liquid than those of the nonfinancial private sector; and
- Most financial institutions manage external assets and liabilities, which is not the case for many nonfinancial private-sector entities, some of which may be primarily holders of assets, and others primarily holders of liabilities.

In a downside scenario, nonfinancial private-sector entities may not repatriate external assets, or they may even transfer their assets in the domestic financial system to foreign accounts.

In the case of France, narrow net external debt has hovered at 250%-300% of CAR during the past 10 years and hasn't increased by the same proportion as overall corporate debt. While this level of narrow net external debt is high, France has significant and liquid nonfinancial private sector external assets, income-earning net direct investment abroad, and net portfolio equity investment abroad. As a result, the net international investment position (IIP) is more favorable than the narrow net external debt position by over 100% of CAR. Indeed, France's net IIP position--while being negative--is relatively contained. As a result, France's current external position is not putting the sovereign rating at risk.

Indebted Corporates Are More Vulnerable To External Developments Than To Rising Rates

We expect borrowing costs to rise from their historically low levels, testing the soundness of indebted companies. As the European Central Bank (ECB) is normalizing monetary policy, the first interest rate hike is now approaching (see "The ECB's New Normal And How We Might Get There," published Nov. 29, 2018). For now, defaults and doubtful debt remain close to their lowest levels since 2008. At the macro level, debt repayments appear manageable as a result of firms' extension of their debt maturity profiles and given that the ECB is set to increase rates only very gradually.

That said, the "venture capitalist" strategy, while yielding high returns, also exposes French corporates to changes in the external environment:

- If interest rates start to rise faster at home than abroad, the interest rate differential that firms can extract from their debt-financed foreign investments will likely shrink. This situation is likely to unfold when the ECB starts to hike rates while the U.S. Federal Reserve (the Fed) is near the top of its tightening cycle.
- Appreciation of the euro will weigh on asset returns through its impact on valuations. This is also likely to happen in the second half of this year when the monetary policy gap between the ECB and the Fed starts to shrink (see "Euro Weakness Is Not Over Yet," published Sept. 26, 2018).

A bit less than half of French investment abroad goes to the eurozone, partly shielding firms from these risks. However, the other major recipient of French investment is the U.S., suggesting we could see a decrease in France's primary income surplus from the end of 2019.

Rated Corporates Largely Reflect The Macro Findings

Tax optimization strategies are unlikely to disappear, despite the French corporate tax decline

The rise in corporate borrowing is partly the result of tax-efficiency planning by French multinationals, with debt raised in France and earnings taxed abroad. Global operations are funded through intercompany loans and earnings are taxed outside France, generally at a lower rate.

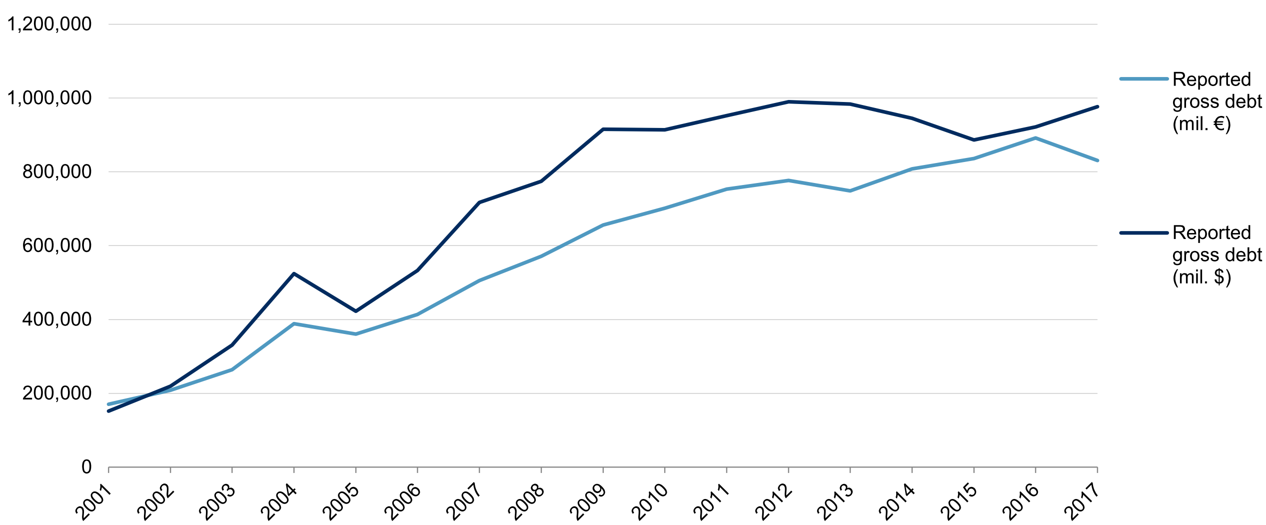
We don't anticipate a rapid change in this strategy, despite the expected corporate tax rate decline in France to 31% in 2019, and then 26.5% by 2021, from 33% in 2018. The rate remains higher than in many other countries, including in Europe (Poland at 19%, the U.K. at 19% and due to fall toward 17%, and even Sweden at 22%) and foreign direct investment remains a long-term decision for a corporate.

Among rated corporates, leverage has climbed at multinationals and public-sector firms

The increase in gross debt at rated corporates over 2007-2017 was similar to that for the French economy as a whole. Over the decade, the increase for rated French corporates was steep (+64%) with a jump to €831 billion by year-end 2017, from €506 billion in 2007, reflecting higher leverage for rated groups with global outreach, as well as greater penetration of public ratings in France, even for smaller entities. The bulk of the increase for the French corporates we rate took place over 2008-2011, similar to what we see at the macro level (see charts 2 and 8).

Chart 8

S&P Global Ratings Rated French Corporates -- Gross Debt Evolution



Source: S&P Global Ratings.

Our observation is based on reported consolidated debt for all French groups that we rate, not just on statutory filings for France-incorporated legal entities. For multinationals, it captures group debt and not simply debt borne in France by a group's top holding or parent company.

By entity, the most notable trends are:

- The increase in public-sector debt through France's largest government-related companies: EDF, SNCF Réseau, and La Poste--although the increase at La Poste relates to the growth of its banking operations. This rise is largely attributable to sustained capex needs to renovate or modernize essential infrastructure in France, such as the domestic rail network and the country's nuclear power capacity.
- Higher leverage in certain industries where French corporates have established a worldwide reputation and made large investments abroad, such as luxury and consumer goods, autos, real estate, oil and gas, and healthcare (see table 1).

Table 1

Main Increases In Consolidated Debt At French Rated Multinationals And Public-Sector Firms

	Debt	
	2007	**2017**
Government-related		
Electricite de France S.A.	€28 billion	€63 billion
SNCF Réseau	€28 billion	€55 billion
La Poste	€5 billion	€36 billion
Luxury and consumer goods		
LVMH Moet Hennessy Louis Vuitton S.E.	€6 billion	€12 billion
Danone	€12 billion	€19 billion
Autos		
Renault S.A.	€30 billion	€50 billion
Valeo S.A.	€2 billion	€4 billion
Real estate		
Klepierre S.A.	€5 billion	€10 billion
Unibail-Rodamco SE	€8 billion	€17 billion
Oil and gas		
Total S.A.	€20 billion	€52 billion
Healthcare		
Sanofi	€7 billion	€25 billion*
Industrial gases		
L'Air Liquide S.A.	€7 billion	€15 billion

*At year-end 2018.

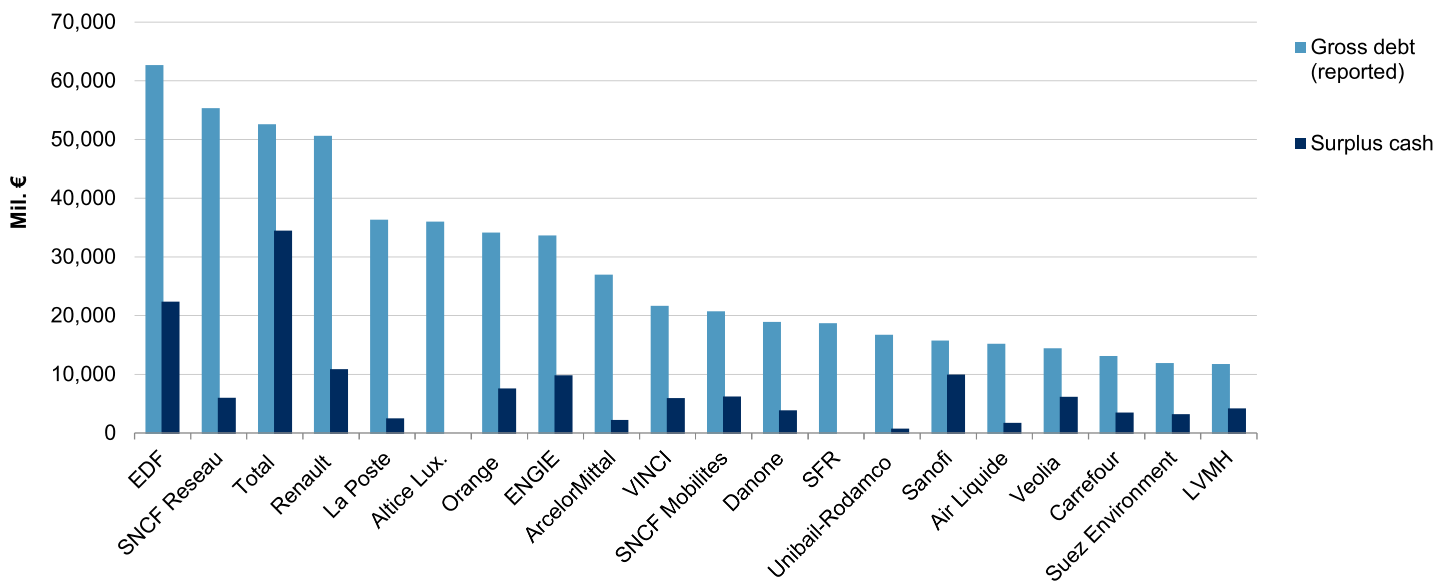
The leverage hike also reflects M&A

M&A is another reason why large French groups have taken up extra new debt over the decade. L'Air Liquide's debt doubled in 2017, for instance, following its takeover of U.S. rival Airgas for US$13 billion. Klepierre's higher debt since 2014 results from its incorporation of Corio's assets in Spain and the Netherlands. Similarly, Unibail-Rodamco's takeover of Westfield Corp. will be noticeable in its debt figures for fiscal 2018. Sanofi's debt also significantly increased at year-end 2018 to about €25 billion, following two sizable acquisitions that will boost the group's pipeline.

New debt may also result from leveraged buyouts (LBOs), which hit a peak in France in 2018. Examples are Ceva Santé Animale, Foncia, or the nursing home operator HomeVi. We particularly note LBOs in the healthcare services segment, where a significant number of analysis laboratories and private clinics have been taken over by equity sponsors.

Chart 9

Top 20 Rated French Corporates By Gross Debt



Source: S&P Global Ratings.

Our current pool of rated companies is larger than in 2007. Over the past decade, we have assigned new ratings to existing French groups with sizable outstanding debt for example, SFR (€18.6 billion at year-end 2017), Altice, Tivana (€3.6 billion), Loxam, FNAC, and Altarea.

Groups are holding cash liquidity buffers

Part of this extra debt is being held by French groups as cash, despite the cost of doing so. Most French groups have built sizable liquidity buffers since the 2008-2009 recession. This extra layer of cautionary savings is typically centralized in France or another eurozone country as part of group-wide cash pooling agreements. It stems principally from the availability of pre-financing at historically low interest rates. French treasurers are aware that funding conditions are likely to change in the coming two-to-five years and that companies would suffer in an economic downturn or a new eurozone crisis. The cash is generally held to fund capex needs, future acquisitions, or takeover targets, or as a liquidity reserve to fend off takeover attempts that could jeopardize the existing shareholding structure.

Sizable cash positions help maintain relatively solid liquidity profiles

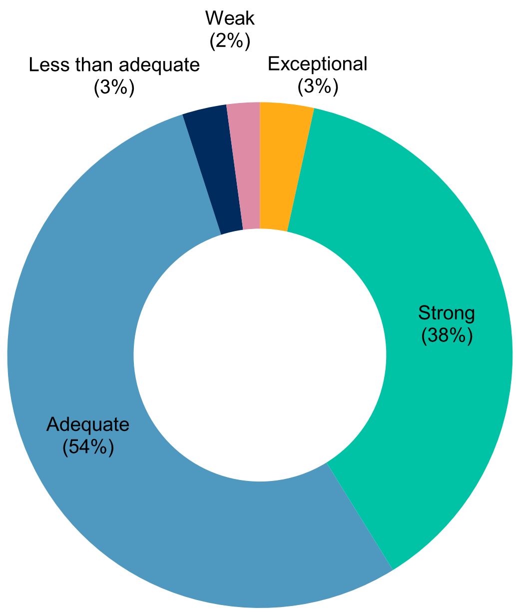
Over 85% of rated French corporates have at least adequate liquidity, based on our assessments at year-end 2017 (see chart 10).

Under our methodology, an adequate liquidity assessment means that a group's liquidity sources cover at least 120% of its liquidity needs over the coming 12 months. Sources are primarily the sum of i) cash; ii) forecast positive funds from operations; and iii) the undrawn, available portion of committed credit facilities maturing beyond the next 12 months. Liquidity needs are mainly the sum of i) upcoming debt maturities; ii) capex; and iii) committed dividends and contracted acquisitions.

If the excess of sources to uses is less than 20%, we classify liquidity as less than adequate--3% of rated French corporates. We assess liquidity as strong if our calculation indicates a 50% buffer or more. Weak liquidity assessments--when we see a shortfall--represent only 2% of rated French corporates.

Chart 10

Most Rated French Corporates Exhibit Relatively Solid Liquidity Profiles
S&P Global Ratings' liquidity assessment at year-end 2017



Source: S&P Global Ratings.

Dynamic Financing Supports Banks' Earnings While The Cost Of Credit Remains Low

In October 2018, the outstanding credit volume granted by French banks to NFCs moved above €1 trillion. French bank's credit to NFCs is expanding by 4%-6% per year, much faster than French GDP. Growth is irrespective of the NFCs' size, with strong growth in bank credit to SMEs.

French banks' diversification supports resilience

Corporate lending is part of the universal banking model that French banks pursue, with well-diversified activities tailored to all customer segments, including retail banking, investment banking and capital markets, asset management, and insurance. Given this model, large French banks tend to have pockets of risk in more vulnerable sectors, segments, or jurisdictions, but we believe the diversification supports their resilience to more adverse conditions.

Losses from a credit bubble are unlikely at this stage

Overall, although the credit exposure to NFCs comes with associated risks for the banking sector, at this stage we don't anticipate a credit bubble that would damage large French banks' balance sheets. The reasons are as follows:

- Although corporate single-name concentration exists, these single-name exposures are typically in the investment-grade category. In the case of French exposures, they are large blue chips forming the main Paris Stock Exchange index (CAC 40). For banks with large corporate banking activities, their top 10 corporate exposures (net of financial collateral) are around 40% of our measure of total adjusted capital; for other banks, around 25%.
- In 2018, the High Council for Financial Stability capped banks' exposure to the most indebted companies based in France at 5% of the banks' capital. Highly indebted firms are defined as those with net debt equivalent to more than 100% of cash and equity.
- Large French banks continue to exhibit good asset quality overall in their domestic operations. In fact, their overall cost of risk reached record lows in 2018, and we expect it to increase slightly this year (see chart 12). The domestic cost of risk could rise modestly in SME exposures, and more rapidly if economic growth decelerates more drastically, but from low levels. We note that some sectors to which French banks are exposed, like automobiles or retail, are weathering some pivotal changes and could be more vulnerable in the coming years.
- Although we see some overheating in the high-yield segment, banks have moved to a less-capital-intensive, "originate to distribute" business model. Banque de France estimated leveraged finance at €128 billion at the end of June 2018 for the large French banks, between 7% and 12% of their corporate exposures. That said, after origination, individual exposure is estimated to be lower, at around €50 million. Leveraged funds have to a large extent replaced banks in this segment.

Credit volume has supported banks' earnings

French banks have welcomed credit volume to support their earnings. It has helped them offset margin compression and resulting revenue pressure, in particular on the back of a wave of residential mortgage renegotiations that peaked in 2018, and more generally very low interest rates. Combined with competitive pressures and lower risk perceptions, these factors have contributed to an easing of credit standards.

Bank credit rates remain low, but may be mispriced for the future

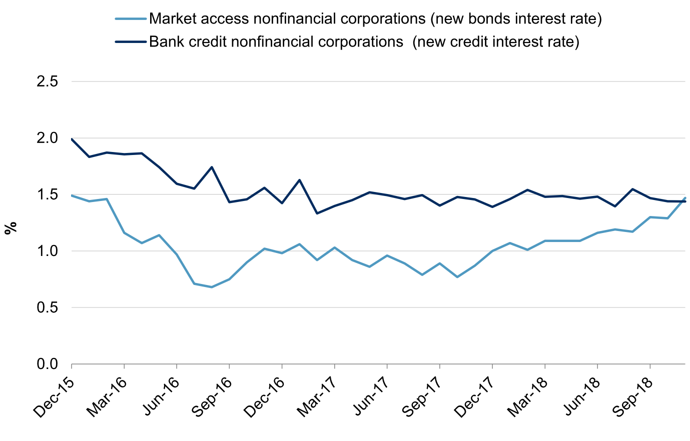
NFCs continue to benefit from low interest rates and low credit costs. Pricing of bank credit is already low for SMEs. Such pricing has somewhat limited disintermediation prospects in this segment and the use of securitization. The costs of bank credit (typically more weighted by smaller corporates) and bond financing (mostly larger corporates) have in fact converged (see chart 11).

In our view, this is not the result of an aggressive decline in the cost of bank credit--which is already historically low--but more a rise in the cost of capital market financing. Uncertainties in the economic outlook, a possible turn in the credit cycle, and investors anticipating the end of the ECB's accommodative policy, have led to higher bond margins. We note that a similar shift has not yet happened in bank credit, but is likely at some stage. If it does not happen, banks are likely to misprice risks, which would harm their future earnings trajectory.

Finally, corporate indebtedness continues to attract the attention of the French regulators, which in 2018, introduced for the first time a countercyclical capital buffer for French corporate lending of 25 basis points on banks' risk-weighted assets in France from June 2019. However, these measures have not curbed the pace of credit growth.

Chart 11

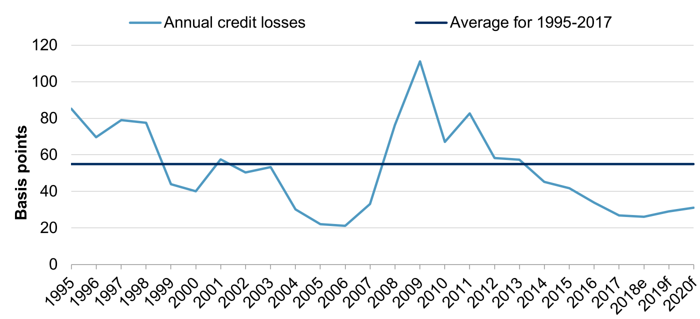
Bank Credit Now Cheaper Than Market Funding



Sourc: Banque de France.

Chart 12

Credit Losses To Average Customer Loans For The Largest French Banking Groups



Source: S&P Global Ratings. e--Estimate. f--Forecast. Data based on customer loans weighted average for BNP Paribas, Credit Agricole, Societe Generale, BPCE (data prior to 2008 are based on Caisse d'Epargne Group and Banque Populaire Group), and Credit Mutuel (only since 2012).

Related Criteria

- Sovereign Rating Methodology, Dec. 18, 2017
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014

Related Research

S&P Global Ratings' research

- The ECB's New Normal And How We Might Get There, Nov. 29, 2018

- Euro Weakness Is Not Over Yet, Sept. 26, 2018

Other research

- M.B. Khder and C. Rousset (2017), Faut-il s'inquiéter de la hausse de l'endettement des entreprises en France?

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