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EUROPEAN CORPORATES: IT COULD TAKE 5 YEARS TO OFFLOAD COVID-19 DEBT

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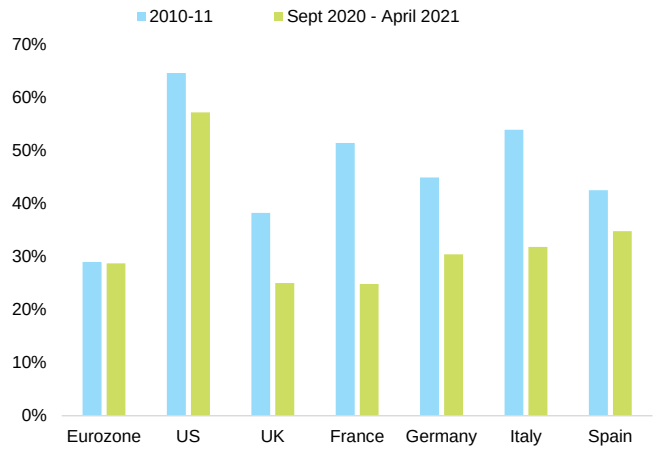
As global trade recovers, accelerating input prices will increase European corporates' financing needs by EUR70bn in 2021, the equivalent of a -3pp loss in margins. Suppliers' delivery times in the manufacturing sector are back to levels last seen during the peak of the Covid-19 pandemic in 2020, while container prices have stood at a five-year high for two months. This coupled with the rise in commodity prices has brought input prices to highs similar to those seen in 2011. In this context, the key question remains the pricing power of European corporates to absorb increasing production costs. In our recent report[1], we showed that most sectors have limited pricing power, with the exception of consumer electronics, pharmaceuticals and airlines. This is also visible in the share of the rise in input prices absorbed by selling prices in the manufacturing sector since last fall (25% in the Eurozone against close to 60% in the US, see Figure 1). Hence, we estimate the cost of the rise in input prices at around EUR70bn for the main European countries (see Figure 2). Part of the rise can be compensated for by the excess cash that non-financial corporates have on their balance sheets, thanks to generous state-support schemes[2]. However, it could still be equivalent to a loss of -3pp of margins.

Figure 1 - Share of y/y increase in input prices covered by selling price increases in the manufacturing sector



Sources: national sources, Euler Hermes, Allianz Research

[1] See our recent report *Pricing superpowers: Which sectors have them in the Eurozone?*

[2] See our recent report *European corporates: Cash-rich sectors get richer*

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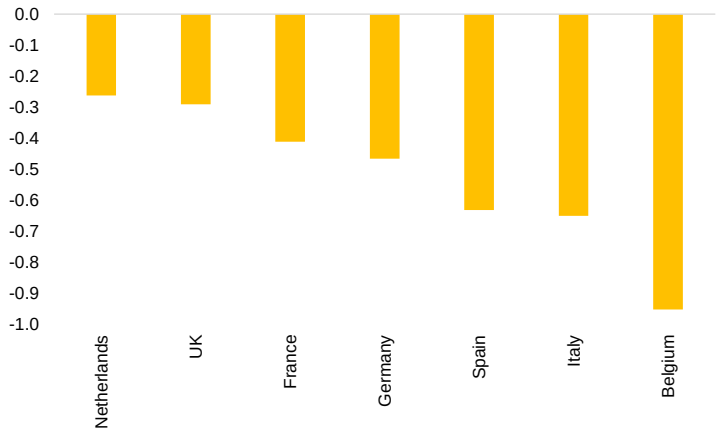
In this context, 2022 could bring a reality check for European non-financial corporates as the grace periods for Covid-19 debt are set to end, along with most state-support mechanisms. This is particularly important as most companies across advanced economies now have less buffers as their debt levels have increased faster compared to their margins over the past decade. The NFC debt-to-GDP ratio was already at a historically high level in France before the Covid-19 crisis. Going forward, the expected increase of low bank interest rates will push NFC interest payments on the upside as soon as 2022 as banks show increasing cautiousness. We calculate that an incremental increase of +100bp per year would be equivalent to an increase of close to EUR30bn in the main European countries (see Figure 2) or an impact of -0.5pp on NFC margins (see Figure 3).

Figure 2 – Expected cost in EURbn on operating surplus from the rise in input prices and interest rates

	Input cost rise impact on margin (EURbn)	Interest rate +100bp differential impact on margin (EURbn)
Germany	21.3	8.9
France	12.2	4.7
UK	15.3	3.6
Belgium	2.4	2.3
Netherlands	5.1	1.2
Italy	8.3	4.9
Spain	5.6	3.6
Total	**70.2**	**29.2**

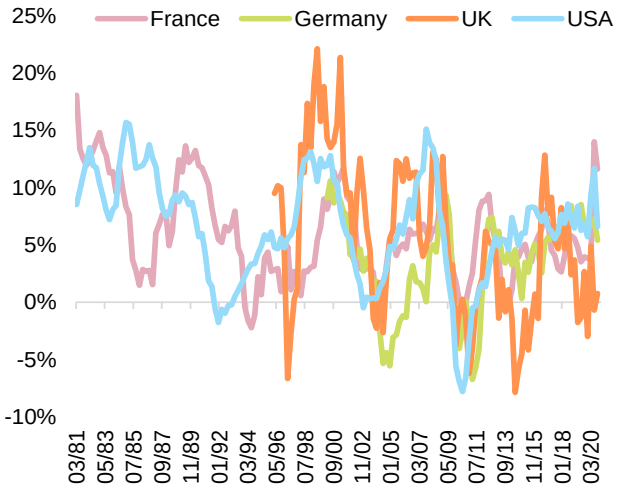
Sources: national sources, Eurostat, Euler Hermes, Allianz Research

Figure 3 - Impact of +100bp increase in interest rates on NFC margins, pp



Sources: ECB, BoE, Eurostat, Euler Hermes, Allianz Research

Figure 4 - Annual change in NFC debt – annual change in NFC margins



Sources: national sources, BIS, Euler Hermes, Allianz Research

Taking into account the expected nominal GDP growth pattern in 2021-22, and therefore turnover growth, we find that corporates' Covid-19 debt will be fully absorbed in the UK, the Netherlands and Germany by the end of 2022. But only 66-67% in Belgium and Italy, 62% in Spain and 58% in France will be absorbed in the same period. Looking at the correlation between nominal GDP growth and NFC turnover growth, we deduct an average quarterly pace of growth from NFC turnover by country for the coming years. Taking this into account, we are able to calculate how much of the Covid-19 corporate debt can be "naturally" absorbed by the end of 2022 (see Figure 5).

Figure 5 – Simulation of time needed to absorb corporates' Covid-19 debt in our baseline scenario

	Increase in debt in 2020, pp of turnover	Expected annual growth of non-financial corporates' turnover until end-2022	Long-term average annual growth of non-financial corporates' turnover	Turnover growth, 2020	Share of Covid-19 corporate debt absorbed at end-2022	Remaining Covid-19 corporate debt to be absorbed after 2022	Covid-19 corporate debt compensated in
Germany	6.2	5.8%	2.8%	-6.7%	100%	0%	2022Q4
France	23.5	5.0%	2.5%	-10.5%	58%	42%	2025Q4
UK	6.3	8.6%	2.0%	-10.5%	100%	0%	2021Q4
Belgium	22.2	5.8%	3.2%	-10.3%	67%	33%	2024Q4
Netherlands	2.8	5.4%	3.3%	-5.1%	100%	0%	2021Q2
Italy	10.6	5.0%	1.8%	-11.3%	66%	34%	2025Q1
Spain	17.9	6.3%	3.5%	-15.4%	62%	38%	2025Q2

Sources: national sources, Eurostat, Euler Hermes, Allianz Research

What could policymakers do to smooth the debt reimbursement process and avoid a disruptive episode of corporate deleveraging that could weigh on medium-run growth perspectives? This question is particularly important as current excess cash reserves will be much needed for short-term financing and for the increasing working capital requirements as companies seek to rebuild inventories and payment terms are expected to increase. Access to additional liquidity could be particularly challenging in an environment where banks are becoming increasingly cautious in the current context of low profitability, deteriorating asset quality and already tightening lending conditions[3].

[3] **The ECB Financial Stability Review May 2021 (see here) show that in the euro area corporate credit growth has slowed as of the**

Governments can boost corporate profitability by pursuing fiscal reforms to support NFCs' self-financing capacities. Using a panel data analysis model (see Appendix), we find that NFC margins need to increase by +1.7pp on average in order to absorb the +8.5pp increase in the corporate debt-GDP ratio in the largest Eurozone countries as a +1% increase in gross operating surplus decreases the debt-to-GDP ratio by -0.54pp. However, in some countries, the fiscal support from governments needs to be stronger, considering the high levels of debt. The necessary increase in margin is estimated at more than +2pp in France, Italy, Spain and Belgium (see Figure 6).

Figure 6 – Calculations of the necessary increase in operating surplus and margins to absorb corporates' Covid-19 debt (ceteris paribus)

	Increase in debt in 2020, pp of GDP	Increase needed in gross operating surplus, %	Change in operating surplus (EURbn) needed to compensate for the Covid-19 corporate debt	Increase in margins needed (pp) to compensate the Covid-19 corporate debt	Change in operating surplus (EURbn) needed to compensate the Covid-19 corporate debt, rising input prices and a +100bp interest rate differential	Increase in margins needed to compensate the Covid-19 corporate debt, rising input prices and a +100bp interest rate differential (pp)	LT annual average increase in margins	Maximum historical annual increase	Year of maximum annual increase
Germany	5.0	2.7	19	1.0	49	2.6	0.0	1.8	(2006)
France	14.3	7.7	27	2.4	44	3.8	0.0	1.8	(2019)
UK	6.3	3.4	15	1.2	34	2.7	-0.2	1.4	(1996)
Belgium	9.4	5.1	5	2.1	10	4.0	0.2	2.4	(2010)
Netherlands	3.9	2.1	4	0.9	10	2.2	0.1	1.7	(2005)
Italy	8.6	4.6	15	2.0	28	3.7	-0.4	1.8	(2016)
Spain	10.0	5.4	13	2.2	22	3.8	0.1	1.6	(2007)

Sources: Bank of France, BIS (until Q3 for Belgium and Netherlands), Euler Hermes, Allianz Research

Regarding profit-supportive fiscal reforms, governments have several tools at their disposal: a reduction of employer social contributions, production tax or even corporate taxes. Looking at 2019 NFC payments for France, Belgium, Italy and Spain, a decrease of -3.5pp to -3.9pp in the marginal tax rate for employer social security contributions could help companies in these countries absorb their Covid-19 debt after 2022, as well as provide enough leeway for NFCs to compensate for rising input prices and higher interest rates. In the UK, the Netherlands and in Germany, a decrease of -2.2 to -2.4pp would be needed (Figure 7).

France is the only country where the decrease in production taxes alone could be enough to compensate for corporates' Covid-19 debt, along with rising input prices and possibly higher interest rates in the years to come. France would need to lower production taxes by EUR28bn (see Table 1), taking into account the absorption of part of corporates' Covid-19 debt with the expected revenue growth normalization in 2021-2022. Looking at the required increase in gross profit needed to compensate for rising input prices and higher interest rates, the UK could also lower its production tax by EUR19bn.

On the corporate tax front, Biden's plan of putting a global floor to corporate tax rates at 15% could bring some flexibility to those European countries where the corporate tax is above this level and encourage a convergence process within the EU. While the UK stands at 19%, the other countries in our panel would have more flexibility should they decide to

second half of 2020, reflecting both corporates deferring investment and banks tightening lending conditions.

lower corporate tax rates. For instance, in France, bringing the corporate tax rate down to 23.7% could generate EUR28bn of additional cash, enabling the absorption of the Covid-19 debt, rising input prices and higher interest rates. For the other countries, corporate tax rates should be lowered between -2.8pp and -3.6pp in the UK, the Netherlands, Germany and Italy, while Belgium, France and Spain should lower their corporate tax rates between -3.8pp to -5.1pp (Figure 8).

Figure 7 – Simulations of how much social contributions would need to be lowered to compensate for corporates' Covid-19 debt, higher input costs and +100bp increase in interest rates on new loans taken in 2020

	Employer social security contribution (EURbn)	Employer social security contribution marginal tax rate (2020)	Decrease of marginal tax rate needed to compensate remaining Covid-19 debt, rising input prices and higher interest rates
Germany	251	19.9%	2.4
France	291	35.9%	3.5
UK	121	13.8%	2.2
Belgium	43	27.1%	3.9
Netherlands	36	12.7%	2.2
Italy	148	31.6%	3.9
Spain	111	29.9%	3.8

Sources: national sources, Eurostat, Euler Hermes, Allianz Research

Figure 8 - Simulation of how much corporate tax would need to be lowered to cover for Covid-19 corporate debt

	Corporate tax NFCs (EURbn)	Required amount to compensate for the Covid corporate debt (EURbn)	Decrease of marginal tax rate needed to compensate remaining Covid-19 debt, rising input prices and higher interest rates	Current official corporate tax	Corporate tax rate needed to compensate remaining Covid-19 debt, rising input prices and higher interest rates
Belgium	14	6	4.4	25%	20.6%
Germany	83	30	3.6	32%	27.9%
France	52	28	3.8	28%	23.7%
Italy	29	18	3.5	24%	20.5%
Netherlands	25	6	3.1	25%	21.9%
United Kingdom	45	19	2.8	19%	16.2%
Spain	19	14	5.1	25%	19.9%

Sources: national sources, Eurostat, Euler Hermes, Allianz Research

APPENDIX

Panel data analysis to find the elasticity of corporate debt ratios to profitability and self-financing capacity

We run a panel data analysis to investigate the main drivers of corporate debt accumulation in Europe. Our sample covers the period 2000-2019Q4 (quarterly data) and six countries (France, Germany, Italy, the Netherlands, Belgium and Spain).

The results show a significant and negative relationship between profit growth and debt to GDP ratio in the long term. The associated coefficient of 0.054 suggests that, 1pp increase in gross operating surplus diminishes the corporate debt to GDP ratio by -0.5pp.

In the short term, we find a positive relationship between corporate profits and debt, suggesting that banks prefer to lend when corporate profitability is high. On the other hand, as expected, self-financing capacity appears to be negatively associated with corporate debt. In other words, loan take-ups decrease with greater self-financing capacity of enterprises.

Long term equilibrium: $\ln(\text{debt/GDP})_t = \alpha - 0.54 \ln(\text{Gross Operating Surplus}) + \varepsilon_t$

Short term dynamics: $\Delta\ln(\text{debt/GDP})_t + \beta - 0.016$ (error correction term t-1) $+ 0.005\,\Delta\ln(\text{Gross Operating Surplus})_{t-4} - 0.0004\,\Delta \ln(\text{self-financing capacity}) + 0.2\,\Delta\ln(\text{debt/GDP})_{t-1}$ + country dummies

Cross-sections included: 6
Total panel (balanced) observations: 450

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.117004	0.052906	2.211543	0.0275
D(LOG(CORPORATE_DEBT_ADJ_GDP...	0.200864	0.039972	5.025074	0.0000
D((SELF_FINANCING_CAPACITY(-4)))	-0.000351	0.000150	-2.332793	0.0201
D(LOG(GOS_SA(-4)))	0.046033	0.018325	2.512037	0.0124
LOG(CORPORATE_DEBT_ADJ_GDP_...	-0.015689	0.006543	-2.397752	0.0169
LOG(GOS(-1))	-0.008593	0.005227	-1.643984	0.1009
DUMMY	0.217445	0.016965	12.81750	0.0000
DUMMY2	0.113271	0.016987	6.668152	0.0000

Effects Specification			
Cross-section fixed (dummy variables)			
R-squared	0.382079	Mean dependent var	0.003604
Adjusted R-squared	0.365111	S.D. dependent var	0.021095
S.E. of regression	0.016809	Akaike info criterion	-5.305364
Sum squared resid	0.123468	Schwarz criterion	-5.186653
Log likelihood	1206.707	Hannan-Quinn criter.	-5.258576
F-statistic	22.51755	Durbin-Watson stat	1.856485
Prob(F-statistic)	0.000000		

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