European corporate defaults still months from stabilising

Default outlook remains precarious as steep increase in Q2 defaults shows

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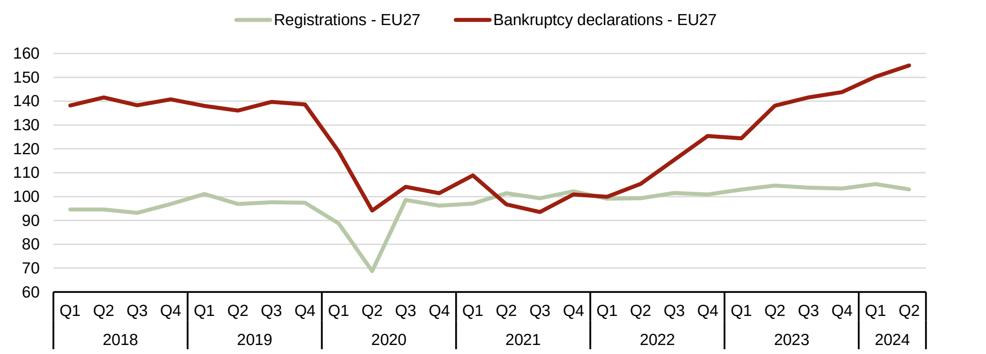
Table of contents

Corporate defaults across Europe are likely to continue rising in the months ahead before stabilising around year-end as credit conditions ease on stronger economic growth, more subdued inflation and companies' self-help measures.

Geopolitical tensions, sluggish economic growth and central banks' caution in reduce interest rates given still high levels of inflation continue to exert pressure on companies, visible in rise in corporate defaults across Europe in the first half of 2024. Latest Eurostat default statistics show a new interim record of company defaults in Q2 2024, more than offsetting the number of new businesses created.

Figure 1: Corporate stress: bankruptcies settle at a high level

FY 2021 = 100 (seasonally adjusted)



Source: Eurostat, Scope

Possible rate cuts, better growth suggest light at end of the tunnel

However, the growing optimism about future interest-rate cuts as inflation subsides will combine with a slow economy recovery towards the end of the year. Output in the euro area will return to more solid growth of 1.0% in 2024 and up to 1.7% in 2025 after stagnation in 2023.

Many corporations are successfully adapting to the challenging environment, with cost-saving programmes beginning to bear fruit. The European Central Bank's latest bank lending survey also indicates easing pressure on the tightening of lending standards, providing some relief to businesses.

These supporting factors suggest that while the risk of corporate defaults remains, the situation could stabilise, with the most severe pressures beginning to abate in the latter half of 2024.

For now, levels of corporate distress remain high. Insolvency rates in the H1 2024 have surpassed pre-COVID levels in nearly all major markets, signalling widespread financial strain. Austria has seen a dramatic 90% year-over-year increase in corporate defaults, marking one of the sharpest rises in the region.

Sweden and the Netherlands have also experienced significant surges, with defaults rising by 34% and 37%, respectively. Germany and France have not been spared, witnessing increases of 24% and 18% compared to H1 2023.

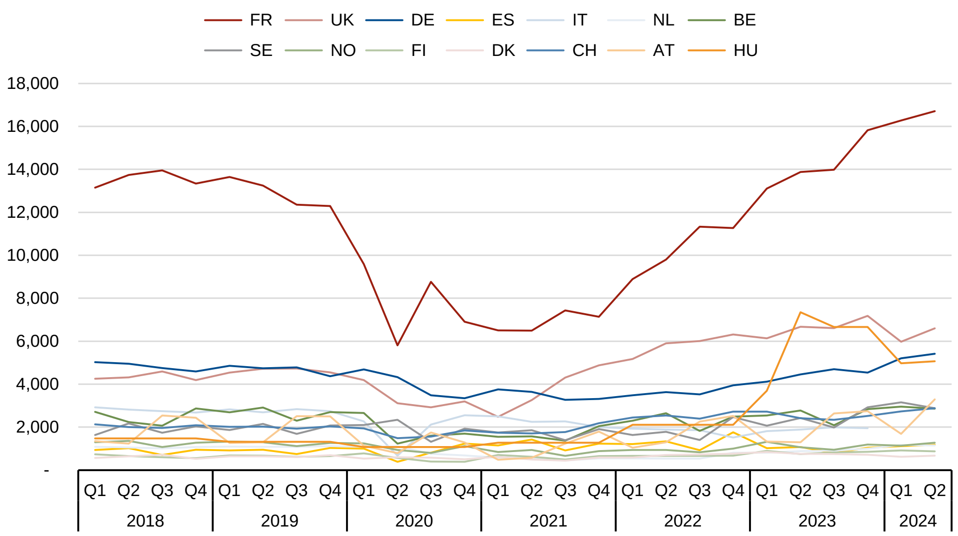
Q2 default rates rise in France, Germany; slight fall in UK

Despite this trend, there are pockets of stability. The UK, for instance, saw a slight 2% year-over-year decrease in insolvencies, Norway's corporate default level stagnated, while Denmark and Hungary experienced a more substantial 19% and 9% reduction, indicating some stabilisation.

These figures underscore the uneven nature of the economic recovery in Europe, where some markets are managing to stabilise, while others continue to grapple with escalating financial pressures.

Contrasting corporate failure rates point to Europe's uneven recovery

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



Source: Macrobond, ISTAT, GovUK, Opten, Scope

Rising default among larger companies triggering knock-on effects

In the first half of 2024, corporate insolvencies in Europe have hit particularly hard in the construction, retail/trade, business and consumer services as well as the accommodation and food service sectors. These industries, already vulnerable due to economic uncertainties, have seen a significant uptick in defaults.

Defaults concentrated in construction, retailing, services and accommodation

While most of these insolvencies have affected microcap companies, the landscape has shifted, with a notable increase in both the absolute and relative number of larger company defaults compared to prior years. This trend is especially concerning due to the broader impact these failures have on the economy, leading to second-round effects that ripple through suppliers, customers, and employees.

Increasing number of bigger companies have run into trouble

High-profile corporate failures and debt restructurings (selective defaults) have marked the recent downturn, reflecting the pressures on businesses across various sectors: Germany's retailer KaDeWe, UK-based retailer The Body Shop, fashion labels Esprit, Ted Baker and Scotch&Soda, UK nightclub operator REKOM, France's facility services manager La Financiere Atalian, UK-based energy services company Petrofac, German automotive suppliers Eissmann Automotive, Auto-Kabel Gruppe and Superior Industries or tourism brands such as Germany's FTI Touristik or Norway's Hurtigruten.

High-profile (selective) defaults in various sectors

The trend of larger insolvencies has persisted into Q3 2024, with notable bankruptcies including Germany's book retailer Weltbild, home accessories retailer Depot, Portuguese paper merchant Inapa and auto suppliers Recaro and Flabeg Automotive.

Larger defaults continue in H2 2024

This increase in larger defaults underscores the growing strain on the European corporate landscape, highlighting the need for resilience and adaptation in the face of ongoing economic challenges in the absence of larger state-driven support programmes and fading positive effects from pent-up demand in some sectors such as tourism.

Ratings pressure persists amid signs of stabilisation

Scope's rating actions point to sustain pressure on credit quality

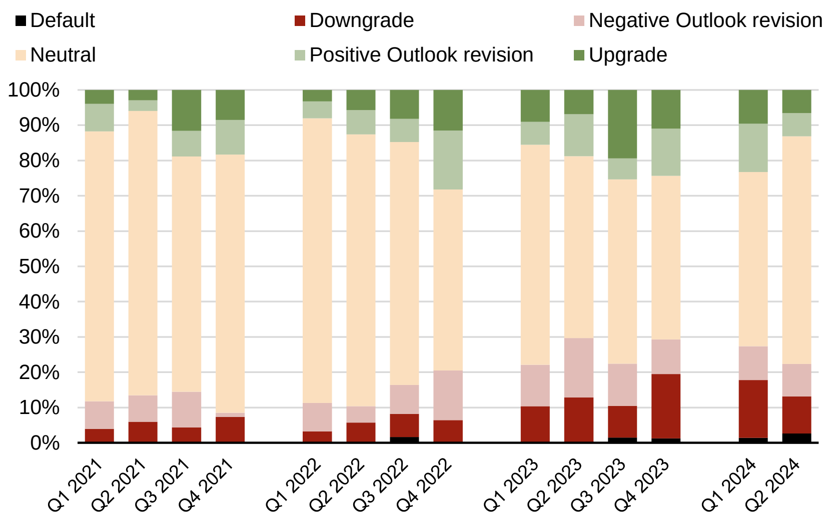
Our assessment of around 300 European companies indicates sustained ratings pressure and elevated default risk, with negative rating actions[1] affecting about 25% of the credit portfolio in H1 2024, mirroring trends from FY 2023. Additionally, we have recorded three selective defaults during this period.

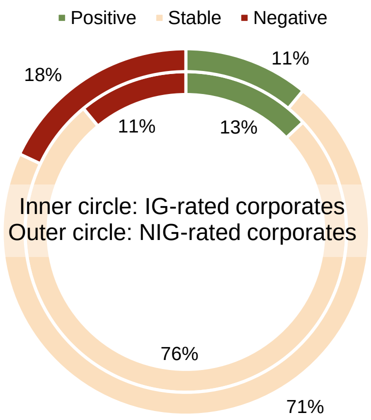
NIG companies' disproportionate share of negative rating actions

Notably, non-investment grade (NIG) corporates are disproportionately impacted, with around 40% experiencing negative rating actions and 20% maintaining a Negative Outlook. In contrast, investment grade (IG) credits have fared better, with positive rating actions[2] outpacing negative ones, and only 10% of IG ratings carrying a Negative Outlook.

This divergence highlights a widening gap between solidly rated corporates, which are generally strengthening their credit profiles, and speculative credits, which are becoming increasingly vulnerable. However, we are confident that the downward pressure on ratings is nearing its peak. Much of the expected negative impact on operating margins, interest coverage, leverage, free operating cash flow, and liquidity has already been accounted for in current ratings, and the most vulnerable companies have either entered insolvency or undergone debt restructurings – hence our expectations of a gradual stabilisation of ratings pressure in the near term.

Figure 3: Rating direction for Scope-rated companies (left); Outlook distribution for Scope-rated investment-grade rated and non-investment-grade companies (right)





Source: Scope

[1] Downgrades, Negative Outlook revisions, Under Review placements for a possible downgrade

[2] Upgrades, Positive Outlook revisions, Under Review placements for a possible upgrade

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EU firms face growing interest-cost headache - Higher rates combine with bulge in maturing 2024-26 capital-market debt, Oct 2023

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