

Prospects

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FRANCE – Investment and financial health of companies

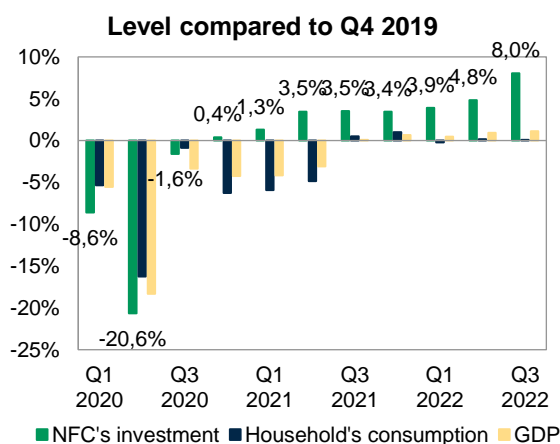
- Business investment has been particularly dynamic since the end of the first lockdown in 2020. Companies have benefited from a favourable environment with abundant government support and particularly advantageous financing conditions.
- The return of inflation could put an end to this dynamic. The sharp increase in production costs and still moderate final demand is limiting company's pricing power, leading to a deterioration in margins in many sectors. At the same time, monetary policy is less accommodative and interest rates are rising rapidly.
- Against this inflationary backdrop, companies are also concerned about the upcoming slowdown in economic activity, encouraging them to take a cautious stance. They are maintaining a significant cash buffer to meet the increase in cash requirements, since, in addition to the increase in production costs, the support implemented during the COVID crisis has come to an end and companies, SMEs in particular, now have to pay back their state-guaranteed loans.
- Corporate bankruptcies are also rising once more. Thus far, this has been something of a return to normal, with receivership procedures resuming after a two-year hiatus. But the trend needs to be monitored to avoid any slippage in a context of economic slowdown.
- Companies have nevertheless remained financially strong so far. At the macroeconomic level, they have not yet started to draw on the cash buffer built up during the crisis and should prove resilient in the coming months.

Investment still strong

Quick rebound and catch-up potential

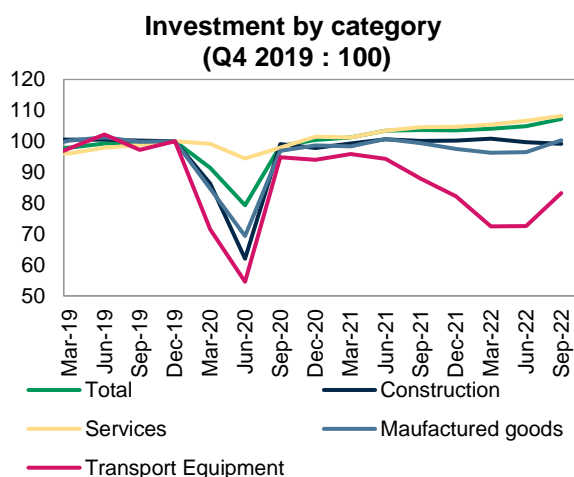
Investment by non-financial companies (NFCs) is the GDP component having posted the fastest recovery following the lockdown in spring 2020. After a mechanical rebound in the summer of 2020, investment was bolstered by public policies but also by opportunism on the part of companies. The latter had long benefited from particularly favourable financing conditions, with an accommodative monetary policy guaranteeing low interest rates on the bond markets, as well as easier access to bank credit and moderate lending rates.

NFC investment thus exceeded its pre-COVID level as of the end of 2020 while consumption was negatively impacted for a longer time by lockdowns and successive waves of restrictions. Some shops were closed during these periods and service consumption remained disrupted for even longer, with curfews, business closures, and a decline in tourism. Since the second half of 2021, consumption has also been hit hard by rising inflation. In third-quarter 2022, household consumption was down slightly, standing at the same level as in fourth-quarter 2019.



Sources : Insee, Crédit Agricole SA ECO.

Investment in construction picked up rapidly, as did investment in services and intellectual property. After an initial rebound, investment in transport equipment has been undermined by supply constraints since the beginning of 2021. Corporate demand has remained strong, but the lag in the recovery between Western countries and exporting countries, particularly in Asia, has generated tensions in global value chains. It has even led to shortages of certain intermediate goods, with the lack of semiconductors having restricted automotive production. As supply constraints eased, investment in transport equipment recovered in Q3 2022. This was the main driver of French growth in Q3 as NFC investment rose 2.1% in Q3 compared with Q2, investment in transport equipment jumping nearly 15% over the period. But the latter has still to return to its pre-crisis level, though it could gradually recover as production picks up in the sector, even if the obstacles to investment are likely to become more and more powerful.



Sources : Insee, Crédit Agricole SA ECO

Supportive structural factors

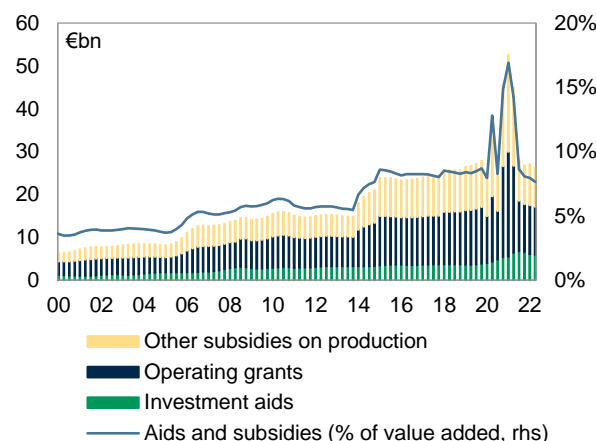
The rebound in investment was facilitated by the introduction of aid in the midst of the pandemic.

Taking the form of exemptions and deferrals of social security contributions and taxes or the implementation of short-time work, government aid relieved the pressure on corporate cash flow during activity stoppages. And because this aid was lifted only gradually during the recovery in economic activity in 2021, margins recovered and corporate financing capacity improved.

With support for the recovery, including the France Relance and France 2030 plans, targeted investment aid also increased, rising a full 69% from €14bn in 2019 to €25bn in 2021 according to companies' accounts released by the Insee. As part of the France Relance recovery plan unveiled in autumn 2020, €3.1bn was invested in the decarbonisation of industry, €2bn in the modernisation of the automotive and aeronautics

sectors. A total of €3.2bn in public support was granted to industrial sectors identified as critical and €6bn was invested in manufacturing sites across the country, the aim being to reindustrialise France.

Subsidies and investment aids



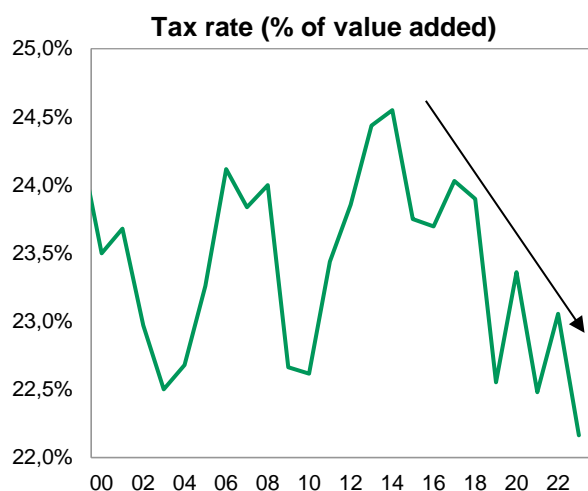
Sources: Insee, Crédit Agricole SA ECO.

The emphasis is on investing in manufacturing, particularly in “industries of the future” and high value-added sectors such as electronics and telecommunications, as well as sectors that are important for sovereignty issues. The production of health products is one of the critical sectors targeted by the France Relance and France 2030 plans, while the war in Ukraine has put energy and food sovereignty at the forefront. Other sectors identified as critical include agrifood and industrial inputs. A further priority is supporting investment to step up the energy transition, including in the hydrogen, renewable energies and nuclear sectors.

Thus, while targeted investment support is expected to slow slightly after particularly high levels in 2021, it will remain durably higher than before the COVID crisis. The amounts committed as part of the France Relance and France 2030 plans will be paid out over several years.

Looking beyond targeted investment aid, **mandatory levies on companies have declined** since 2013 and the implementation of the CICE tax credit for employment and competitiveness. In addition to the CICE, which costs around €20bn per year and was transformed into a sustainable reduction in social contributions in 2019, social security contributions on low wages have decreased and production taxes have declined substantially. As part of the recovery plan, production taxes were reduced by an initial €10bn, supplemented by the gradual elimination of the CVAE tax on corporate added value, for an additional €9bn. The corporate income tax rate was also reduced, from 33.3% in 2017 to 25% in 2022. While these measures are costly and their effectiveness is often called into question (particularly in terms of their impact on employment

and investment), they nevertheless help to improve the cost competitiveness of French companies and boost their financing capacities. This is particularly true for industrial companies, which are the primary beneficiaries of lower production taxes.



Sources : Insee, Crédit Agricole SA ECO

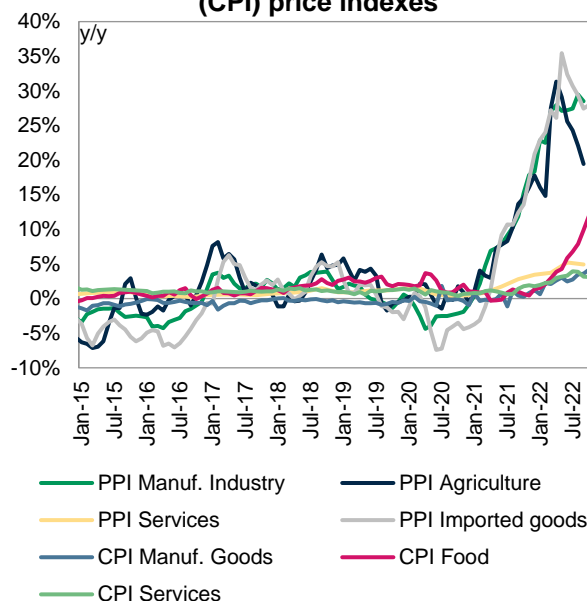
Towards an investment landing?

Deterioration in margins

In Europe, domestic demand remains moderate. As mentioned earlier, household consumption in Q3 2022 was barely equal to that before the health crisis.

While the increase in the import price of industrial products is still above 20% year-on-year, consumer price inflation stood at 6.2% in October. The production price indexes (PPIs) presented below do not exactly match the increase in production costs; rather, they measure changes in ex-works prices. In addition to finished products, the PPIs also include the price trend of certain semi-processed goods and intermediate goods that are then used in other production processes. This makes them relevant leading indicators for analysing the trend in consumer prices, and in particular the pass-through of cost increases to the final consumer. Given sluggish demand, the pricing power of companies is limited. The increase in production costs is therefore only partially passed on to sales prices, and with a significant delay.

Production (PPI) and consumption (CPI) price indexes



Sources : Insee, Crédit Agricole SA ECO

By passing on only a part of the increase in the price of intermediate and commodity goods to their sales prices, companies are under pressure on their margins.

The margin rate of non-financial companies stood at around 32% before COVID, with a slight upward trend following the tax cuts implemented in 2013. After a slight decline in 2020, the margin rate rebounded sharply in 2021, exceeding 34%. Companies were able to benefit from both the rebound in activity and the continued abundance of public support, with, for example, a solidarity fund of €24bn in 2021. NFCs' financing capacity was particularly high, reaching €40bn in 2021 and contributing to the sharp rebound in investment.

Budget impact of supportive measures for companies		
€bn	2020	2021
Furlough	25,8	8,1
Solidarity fund	15,9	23,9
Social contribution exemptions	5,8	2,9
Total	47,5	34,9

Sources: 2023 Finance Bill, Crédit Agricole SA ECO¹

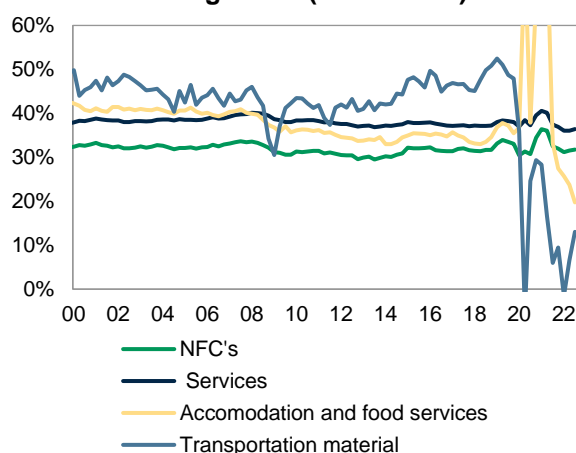
The margin rate has gradually eroded since the start of 2022, dipping below 32%. After rebounding sharply in 2021, the profits of NFCs (margins after taxes, interest and dividends) fell in 2022, the growth overhang at the end of Q3 coming out at -6% for 2022.

This slowdown is affecting most sectors of the economy but is particularly marked in sectors

¹ Does not include state-guaranteed loans and deferred tax and social security payments, which relieve corporate cash flows but do not have a budget impact.

struggling to return to pre-crisis levels, such as automotive (and, more broadly, transport equipment production), and in sectors having benefited considerably from support during the health crisis, including hotels and restaurants. Labour costs are once again borne entirely by companies, with the end of furlough schemes, and production costs are on the rise. Hotels and restaurants are particularly exposed to the rise in food and agri-food products prices as they represent 60% of the sector's intermediate consumption are thus contribute significantly to the contraction in margins.

Margin rate (EBITDA/VA)



Sources : Insee, Crédit Agricole SA ECO

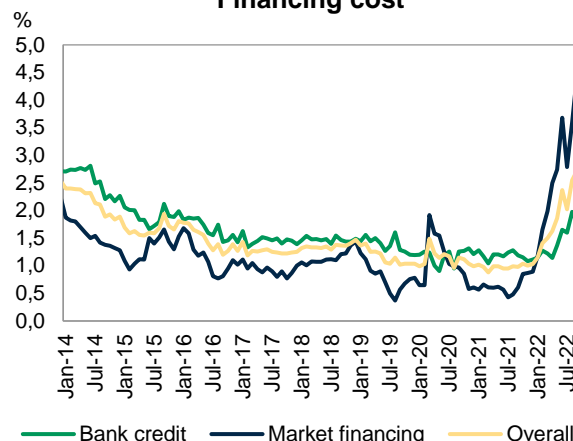
Furthermore, some companies now have to pay back their state-guaranteed loans and the social security contributions and taxes that were deferred during the health crisis. Together, these factors are eroding the financing capacity of businesses.

Rise in interest rates

Despite less accommodative monetary policy since the beginning of the year, investment has thus far held steady owing primarily to the persistence of post-pandemic catch-up effects. These effects will gradually fade and tighter financing conditions could weigh on business investment.

The sudden impact of monetary tightening is particularly visible on the financial markets. The ECB had raised its key rates by 200 basis points since July at the time of writing (i.e. before the likely 50 bp hike in key rates at the December monetary policy meeting). The cost of bond financing for NFCs has thus increased by more than 350 bp in one year to an average 4.5% in September. The cost of bank financing has also increased, though at a more moderate pace, to reach 1.8% on average in September 2022. Since the beginning of the year, we have also seen a shift from market financing to bank financing. Outstanding bonds have stagnated year on year, while bank lending increased by 7% over the same period.

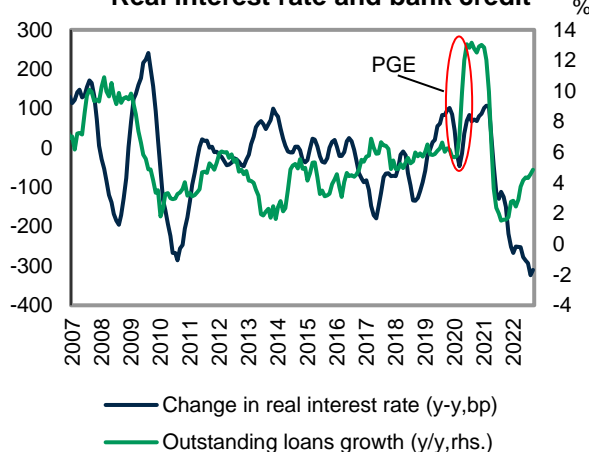
Financing cost



Sources : Banque de France, Crédit Agricole SA ECO

Although real rates remain negative (with interest rates below inflation), the tightening of interest rates should contribute to a sharp slowdown in business investment. Inflation initially pushed down real interest rates. Following the monetary tightening initiated by the central banks and the likely slowdown in inflation starting in 2023, we expect real interest rates to increase. This will restrict access to financing for companies that have already been encouraged to take a cautious stance owing to economic uncertainty and the slowdown in activity.

Real interest rate and bank credit



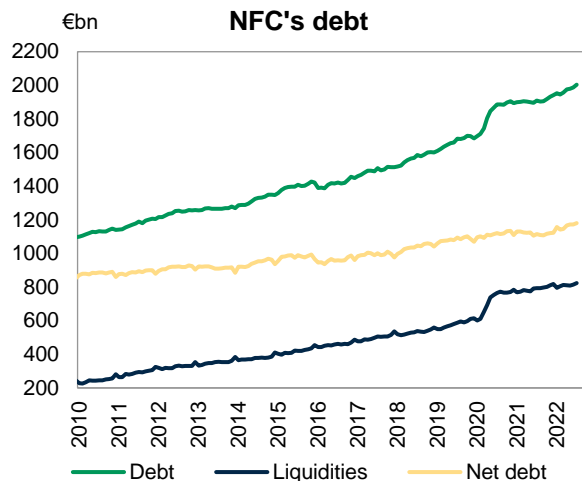
Sources : Banque de France, Crédit Agricole SA ECO

Rising bankruptcies, risk of slippage

Cash requirements are growing

At the macroeconomic level, companies still have a fairly large cash buffer. While they took advantage of favorable financing conditions on the bond markets and state-guaranteed loans to acquire debt during the health crisis, the other support measures implemented at the same time helped to ease their cash flow. As a result, a significant portion of this new debt has been saved as a precautionary measure and added to corporate deposits, and

corporate net debt has increased relatively little, in contrast to gross debt. Companies could thus dip into this liquidity cushion to meet rising cash requirements and deleverage in a context of rising interest rates.



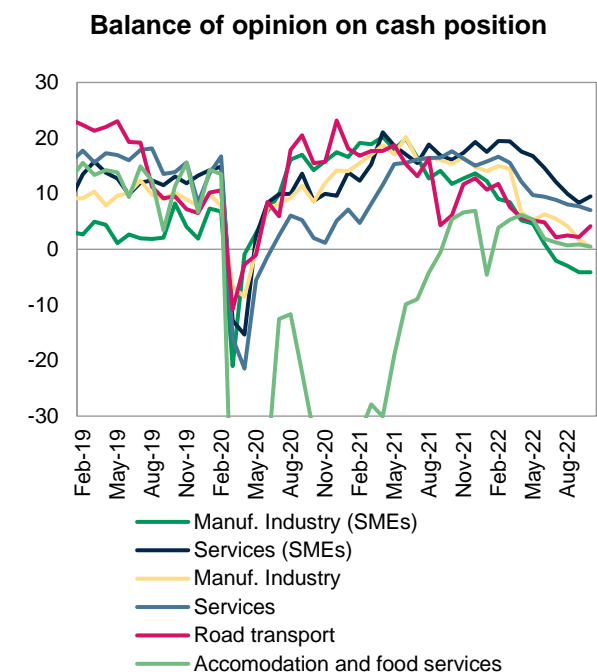
Sources : Banque de France, Crédit Agricole SA ECO

But in terms of sectors, a close eye needs to be kept on the increase in company cash flow requirements, which is another drag on investment and weighs on the financing capacity of financial companies. As mentioned above, with the elimination of the aid put in place during the pandemic, companies are once again responsible for all their wage costs and also have to repay certain social security contributions and taxes. According to the report of the government committee set up to monitor and assess financial support measures for companies facing the COVID-19 epidemic, between the implementation of emergency measures in early 2020 and March 2021, the government granted some €50 bn in social security contribution deferrals. 60% had been paid up and €22bn remained to be repaid at the end of June 2021.

Nearly €150bn in state-guaranteed loans were also granted, including €120bn between spring and summer 2020. Companies could benefit from a one-year deferral of any repayment and an additional year during which only interest was to be paid. Since the spring of 2022, we have reached the end of these two years of deferred payment and companies now need to start repaying their state-guaranteed loans. According to the Banque de France, only 3% of the companies having taken out a state-guaranteed loan will struggle to repay the loan, while according to survey data, 9% of companies say that they will struggle to meet their repayment deadlines. Both of these percentages are modest.

However, the same concerns are expressed by companies in the latest business surveys. The consensus among business leaders on their cash

position remains at historically high levels but has deteriorated in the last few months owing to the rise in production costs and the other cash requirements discussed earlier. This is particularly true in hospitality and catering, which benefited from 15% of the total state-guaranteed loans granted, and among SMEs in the manufacturing sector.



Sources : Banque de France, Crédit Agricole SA ECO

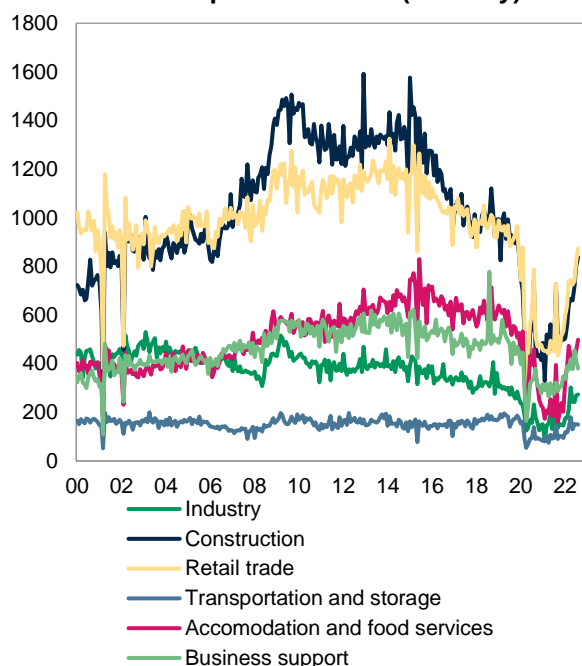
When will defaults return to normal?

Defaults have risen sharply since the beginning of 2022. With the end of support measures and the resumption of receivership procedures, nearly 10,000 defaults were registered in Q2 2022, up 49% year-on-year but still 20% lower than in Q2 2019 (pre-COVID).

However, according to a recent study by Altarès on defaults in Q2 2022, the rise in defaults is faster for SMEs than for VSEs. And even though companies with fewer than three employees accounted for more than 75% of company defaults, in Q2 2022 the number of bankruptcies among companies with 19 to 100 employees returned to its Q2 2019 level. Banque de France data confirms that defaults among small businesses (with up to 50 employees) are returning to pre-crisis levels at a swifter pace. However, a more precise analysis of corporate demographics is needed to better interpret these substantial increases. First of all, business creations have reached record levels, with 2.6 million businesses created in three years according to INSEE, including 700,000 commercial companies. These new commercial structures account for 85% of business failures. The majority of these are companies that have never been viable or that were in difficulty, and we are not yet seeing a sharp rise

in defaults among businesses that were viable before the health crisis, but rather a catch-up in defaults avoided or delayed for more than two years by public support.

Corporate failures (monthly)



Sources : Banque de France, Crédit Agricole SA ECO

Nevertheless, close attention will need to be paid to the escalation of defaults in the coming quarters, as the number of bankruptcies could quickly return to pre-crisis levels. With the upcoming slowdown in economic activity, those levels could even be exceeded in some sectors, particularly those reporting cash flow difficulties or whose margins are rapidly eroding, such as hotels and restaurants. However, public support measures such as the tariff shield will also benefit VSEs and, to some extent, SMEs (with a price cushion rather than a real price freeze from January 2023). These measures should mitigate energy price shocks and, as a result, smooth cash flow requirements for smaller companies that are often more vulnerable (as evidenced by shifts in consensus on the cash position).

At this stage, we do not expect a wave of defaults in 2023. Cash reserves remain abundant and have yet to be eaten into, which should bolster the resilience of businesses in the coming months despite lower profitability and a likely slowdown in demand. ■

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