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

European companies will have to cover additional interest payments of around EUR 8bn in 2024 in refinancing maturing capital-market debt, having paid a similar amount in extra interest in refinancing bonds this year as rates have risen. Assuming a similar outcome for outstanding bank debt of European corporate borrowers, the extra annual interest paid in 2024 will grow to more than EUR 40bn as European companies are still much more dependent on bank financing than capital market debt funding.

The extra interest cost from durably higher borrowing rates will increase again in 2025 and 2026 as even more corporate debt comes up for refinancing. It is unlikely that inflation will have fallen far enough toward central banks' targets to provide any relief from looser monetary policy and lower rates before 2025.

Rising interest costs will test the resilience of corporate borrowers, from preserving credit ratings to avoiding default. Particularly under pressure are companies which had 3x interest cover or less when interest rates were ultra-low and those which have limited access to (re)financing.

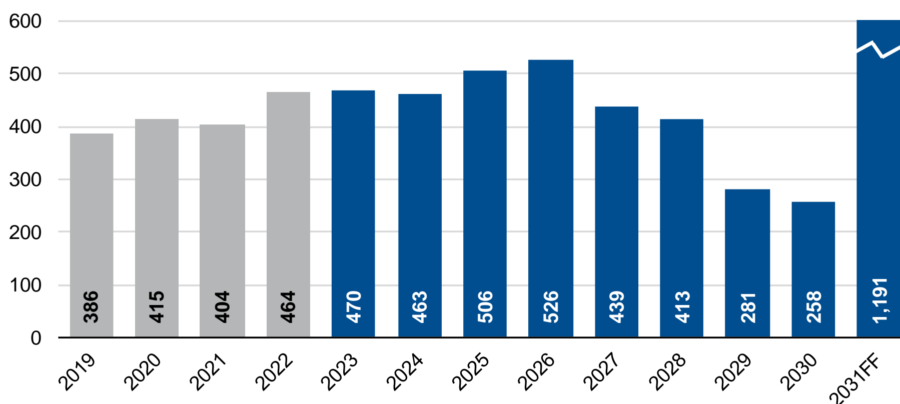
We expect corporate default rates and debt restructurings to rise further across Europe. One reason is catch up from low insolvency rates in 2020-2022. Others include continued pressure on operating profitability and supply-demand imbalances amid unfavourable macroeconomic developments, not least increased refinancing and interest-rate risk as economic growth slows. Defaults are unlikely to plateau before H2 2024/H1 2025.

Refinancing to squeeze balance sheets over the next three years

A look at the public bond market as a proxy for the overall debt market shows the scale of the refinancing challenge. The full effect of increased refinancing volumes, higher interest rates and partially restricted access to external debt funding will be seen in 2024 to 2026 after its already significant impact this year.

Bond refinancing volumes of Europe-based issuers turn upwards particularly in 2025 and 2026 to more than EUR 500bn a year, up from EUR 460-470bn this year and last, and nearly EUR 100bn more than the yearly average in 2019-2022 (**Figure 1**).

Figure 1: Bond refinancing volume of Europe-based non-financial corporates as of Sep 2023 (in EUR bn)



Source: Bloomberg, Scope

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European firms still prefer bank loans to bond issuance

While there is no available equivalent data for maturing bank debt, we assume that the refinancing volume of bank loans is about three to four times higher than for capital market debt as European corporates still use bank financing to a significantly wider extent than US firms.

Cost of floating-rate bank debt exceeds refinancing bonds

In addition, bank lending is commonly used by unrated issuers and SMEs which often have lower credit quality than the average corporate issuer. As bank debt is more commonly contracted at floating rates, so companies reliant on such funding will feel the impact of rising interest rates much faster than those reliant more on refinancing maturing fixed-rate capital-market debt for which effective interest rates will only grow gradually with every bond that needs to be replaced by a new debt issue.

Rising rates combine with bulge in volume of maturing bonds

Median effective corporate lending rates have risen steeply

Companies need to earn the money to cover interest on debt that reflects higher base rates and higher risk premia particular to individual issuers and economic sectors.

As displayed in **Figure 2,** the average (volume-weighted) coupon of new bond placements in 2023 stands at about 500 basis points, which implies a 65% increase on interest when comparing it to the average bond which matures in 2023. Likewise, the median effective corporate lending rate has already more than doubled by mid-2023 to around 4.0-4.5% from about 2% at YE 2022 (**Figure 3**) and is set to rise further as interest rate hikes feed through to the economy and old interest hedges expire.

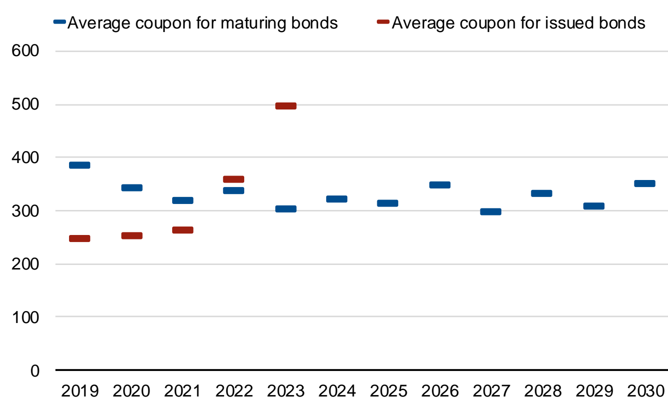
Compounding effect in the higher for longer environment

We should also not forget the effect of compounding because companies have considerably more debt to refinance in 2023-2026 than they did in the preceding years.

Assuming a full refinancing of maturing bonds in 2023 with a volume of about EUR 470bn at the average coupon of 495 basis points (volume-weighted) seen so far during the year will result in annual interest payments of EUR 23.4bn. This stands against interest burden of EUR 14.3bn which had to be paid on the bond volume that matures in 2023. Hence, companies will be burdened by an additional EUR 9.1bn of interest payments just for refinancing. If we assume that new bond issues placed in 2024 (only for refinancing purposes) bear an average coupon of about 500 basis points, issuers tapping the bond market will need to cover an increase in interest payments of 54% or a total amount of an additional EUR 8.2bn a year. Assuming a similar effect from the outstanding, much higher, volume pertaining to bank loans European corporates will face additional interest payments of more than EUR 80bn from refinancing efforts in just two years.

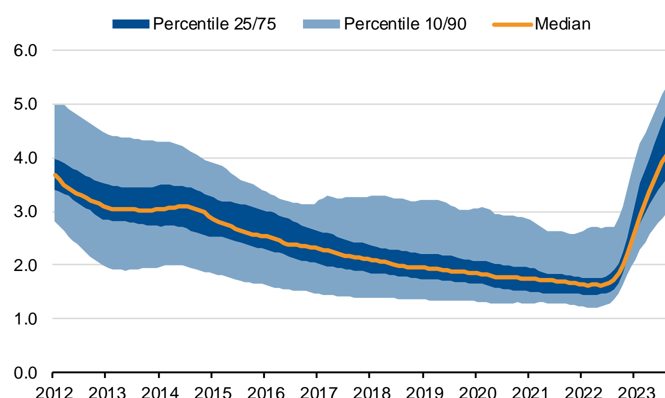
The effect will multiply further in 2025 and 2026 when an even larger amount of capital market debt will need refinancing, should central banks not significantly reduce base rates by then.

Figure 2: Large effect expected on average coupon (volume-weighted) for bond refinancings (in basis points)



Source: Bloomberg, Scope

Figure 3: Cost of euro area bank financing risen steeply (in %)



Source: ECB, Macrobond, Scope

Financing challenge will separate strong companies from the weak

Corporate credit quality set to diverge

Companies with sufficient pricing power that can quickly pass on higher interest cost along with other cost increases, e.g. for personnel and material cost, to their customers will likely maintain their credit profiles. Solid investment-grade rated firms that historically displayed high interest coverage, typically an EBITDA/interest coverage of well above 10x, still have sufficient headroom for increased interest payments.

In contrast, companies with little pricing power and/or those that only had a modest interest coverage ratio of 3x or lower face a refinancing challenge, for which partial or full debt restructuring might be the only option in order to avoid a bankruptcy. The same goes for lower-rated corporates reliant on bank debt whose breaching of loan covenants leads to coupon step-ups which exacerbates the funding pressure.

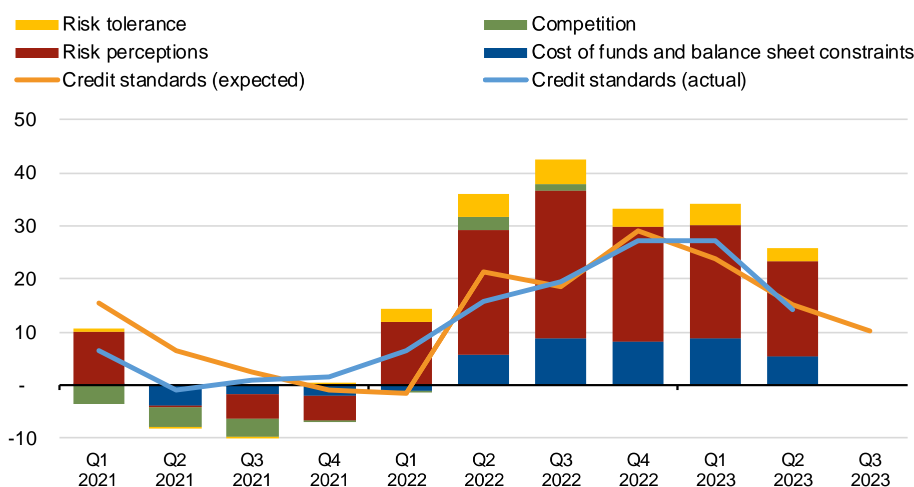
Access to (re)-financing has somewhat worsened

Banks to cherry pick corporate borrowers

Refinancing risks are amplified by selectively stricter lending processes of banks or limited access to external funding for selected groups of companies even if credit remains readily available overall. Commercial lenders will do more cherry-picking (**Figure 4**) as they can earn better margins on sound borrowers than high-yield issuers. Alternative sources of lending will likely only partially fill the gap.

Figure 4: Bank lending standards tighten for corporate lending as shown by the ECB's regular bank lending survey

Changes in credit standards applied to the approval of loans or credit lines to enterprises, and contributing factors (net percentages of banks reporting a tightening of credit standards and contributing factors)



Source: Macrobond, ECB, Scope

Zombies and high-yield corporate borrowers in the front line

Default rates to worsen; high-yield issuers look vulnerable

Overall, the repercussions of higher refinancing rates and more limited access to refinancing will ripple through the market in different ways according to the circumstances of different companies and sectors.

As for so-called zombie companies, typically ones with interest coverage of less than 1.0x for two consecutive years and reliant on reserves or new funding to cover interest costs, they will increasingly go belly up as refinancing will be hard to come by.

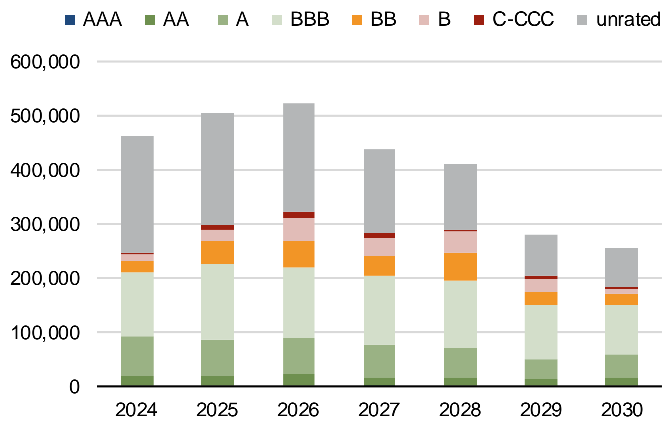
High-yield (HY) corporate borrowers will face a squeeze too. Around 10-20% of upcoming European bond refinancing volume pertains to HY issuers and 40-45% to unrated issuers for the next three years (**Figure 5**). We assume the proportion of high-yield or generally weaker borrowers reliant on bank lending is significantly higher. If such borrowers

manage to secure refinancing, it will likely provide further downward pressure on their credit assessments. If not, they will likely join the growing number of corporate defaults.

Significant bond refinancing volume in cyclical and sectors

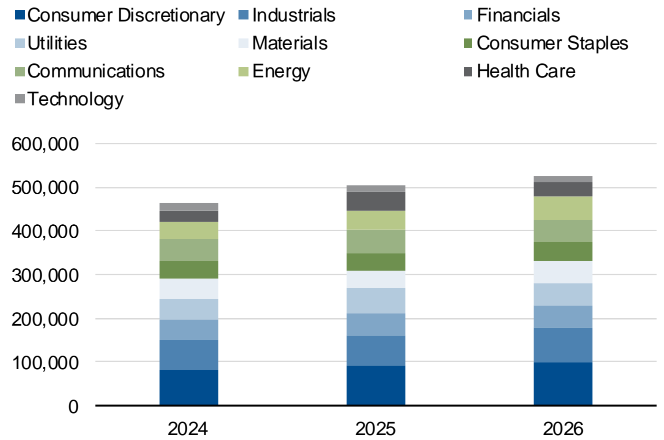
The same is true for bond refinancing for companies in cyclical and sensitive sectors such as consumer discretionary, industrials, materials, real estate, energy and technology (**Figure 6**). Aggregated bond debt referring to such sectors amounts to more than 50% of the bond debt that is currently scheduled to mature over the next three years.

Figure 5: Bond refinancing volume (in EUR bn) by Bloomberg rating composite until 2030



Source: Bloomberg, Scope

Figure 6: Bond refinancing volume (in EUR bn) by sector



Financials: primarily includes real estate corporates and to a lesser extent non-FI financials

Source: Bloomberg, Scope

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