MARCH 2018

COFACE ECONOMIC PUBLICATIONS

PANORAMA

Companies in France: fewer business insolvencies, but still just as many "zombies"

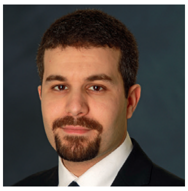
The number of corporate insolvencies in France has continued to decline at the beginning of 2018: -8.3% year-on-year to end of January. This good performance takes place against the backdrop of stronger growth in 2017 (to 2%).

While all sectors benefited from buoyant activity and recorded a decline in business insolvencies, the construction sector performed best, contributing to half of the total decrease recorded. Other sectors – such as services for private individuals, automotive, and clothing – continue to benefit from firm household consumption at the start of this year, driven in particular by the fall in the unemployment rate (8.6% in the fourth quarter of 2017, after 9.3% in the third), a low interest rate environment, and high levels of confidence.

All regions have benefited from this improvement, including Île-de-France, which had recorded four consecutive years of rising company insolvencies. While micro-enterprises saw their situation improve, larger companies posted even stronger performances, reducing the cost of insolvencies, both in financial and employment terms.

The number of insolvencies should continue to fall throughout the year: Coface forecasts a decline of 3.6% in 2018. This somewhat reduced decline will be attributable mainly to the appearance of signs that growth is running out of steam (supply constraints – hiring difficulties especially –,production capacity utilisation rate at its highest level in the last ten years), as well as delayed effects from the large number of business start-ups in recent years. Although 2018 should therefore still follow the impetus of continued recovery, it could also be a turning point, as the French economy is expected to reach a peak in the cycle, as are the other advanced economies.

Moreover, the outlook for French companies is more nuanced than may be suggested by the insolvency rate alone: despite falling significantly since the crisis, even to below its 2007 level, the rate of companies in difficulty remains just as high if we include all those that are unprofitable and insolvent. In a context of low interest rates, which encourage the use of low-cost loans as an "intravenous drip", the proportion of "zombie" companies has in fact increased in recent years.



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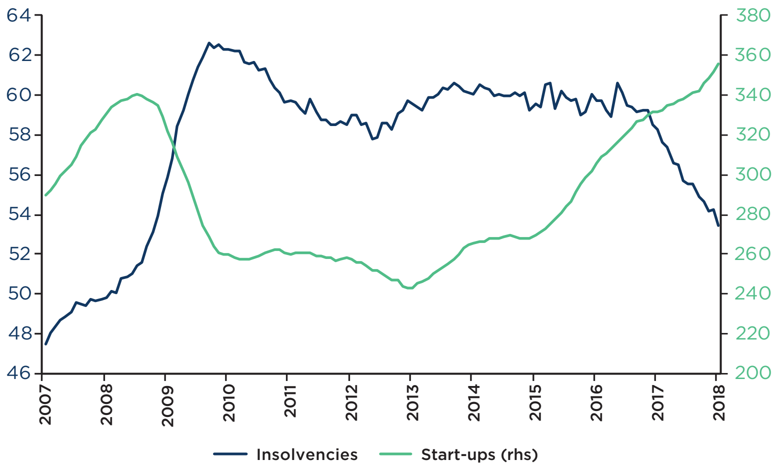
1 OVERALL TREND

Continued decline in business insolvencies at the beginning of 2018

In January 2018, 53,414 businesses went bankrupt year-on-year, a decline of 8.3% over the period. The number of business insolvencies, on a downward trend since the beginning of 2016, is thus at its lowest level since October 2008 (see *Chart 1*).

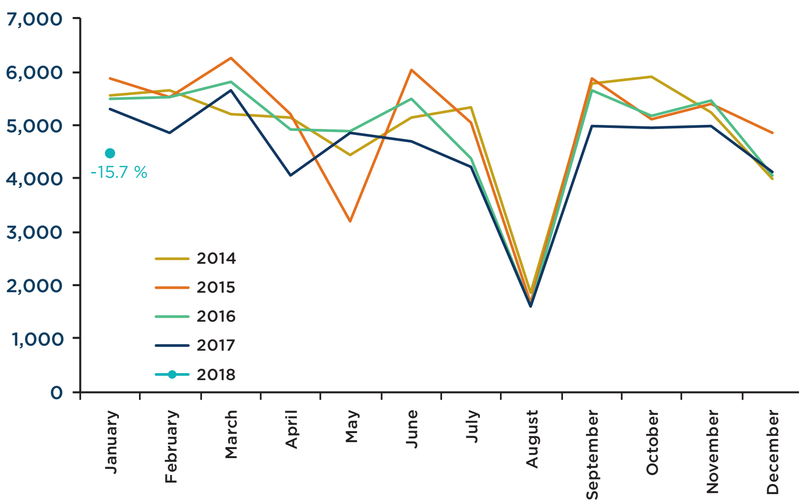
In addition, the short-term trend remains very positive, with 4,457 insolvencies recorded in January 2018 alone – 15.7% less than January 2017, which had already been a very good month compared to previous years (see *Chart 2*).

Chart 1:
Insolvencies and business start-ups
(in thousands, annually)



Sources: Ellisphère, Insee, Coface

Chart 2:
Monthly business insolvencies

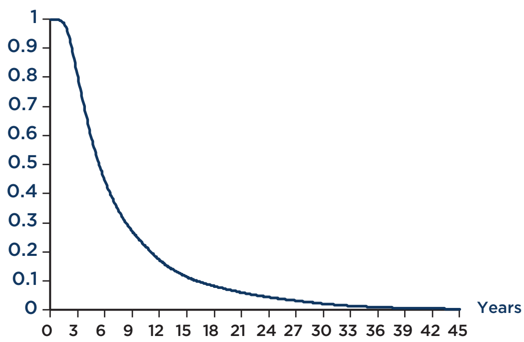


Sources: Ellisphère, Coface

Business Start-ups and Probability of Survival

In line with the particularly favourable economic situation, business start-ups rose sharply (+7.2% year-on-year in January 2018), reaching 356,000 units – excluding auto-entrepreneurs (self-employed people) – (see *Chart 1*), a higher level than before the crisis (340,686 start-ups in August 2008). However, this pattern should be reflected negatively in the evolution of business insolvencies in the medium term. According to our data study based on Kaplan-Meier curve analysis[1], although a company has a 94% chance of surviving the first two years, this probability falls to 80% after three years, 65% after four years, and to barely more than half after five years (see *Chart 3*).

Chart 3:
Probability snapshot of survival



Source: Coface using data from Ellisphère

1/ Curve representing the probability snapshot of business survival.

At the same time, the average age of a failing business stood at 80.88 months in January, almost unchanged compared to 2017 (81.1 months) and still well above the levels recorded between 2011 and 2016. This extension of French companies' lives indicates a greater financial solidity, illustrated, for example, by a margin rate that has remained stable since 2015 at around 32% of added value (31.7% in the third quarter of 2017)[2].

Driven by these vigorous start-ups (see *Chart 1*), the stock of entreprises amounted to 5.14 million units on January 1st 2016, which is 1.2 million more enterprises than January 1st 2009[3]. Therefore, even though the number of insolvencies remains above the pre-crisis level (+7.4% compared to 2007), the insolvency rate is lower: according to Coface's estimates, it amounted to 1.35% in 2007[4] versus 1.14% in 2016 (see *Chart 4*).

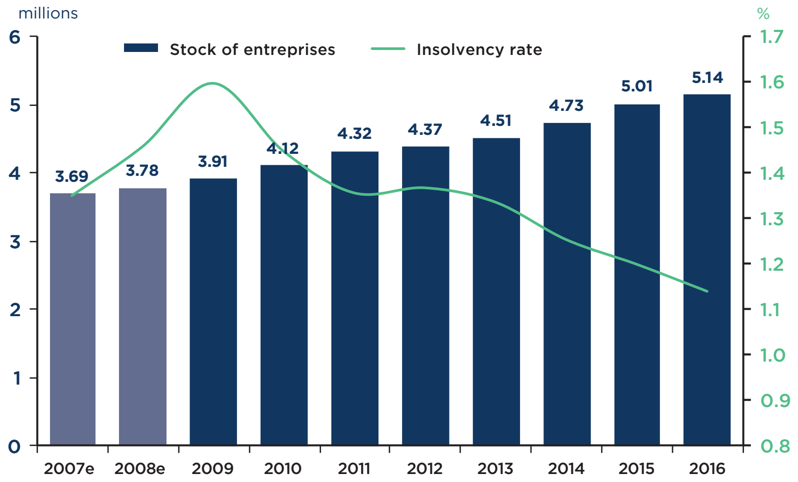
Lower cost of insolvencies in financial and employment terms

The total cost of insolvencies on the economy, measured by the sum of outstanding accounts payable, reached EUR 3.2 billion year-on-year in January, down 15.2% on the same period last year (see *Chart 5*). In addition, the number of jobs affected is also down sharply: 156,673 people were affected by corporate insolvencies over the year, the lowest level since October 2008. In comparison, an average of 175,000 jobs were affected between 2010 and 2016, and more than 210,000 at the peak of the crisis in 2009.

Decrease in the average size of failing companies

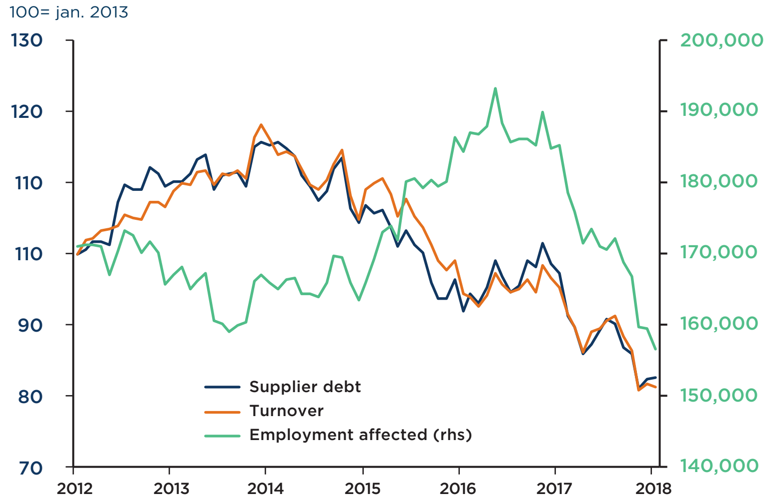
While the improvement in the economic situation has benefited companies of all sizes (see *Chart 6*), those with sales revenue of less than EUR 250,000 (more than 80% of insolvencies) recorded a smaller decline in insolvencies (-5%) than the others (-20%). In total, companies with sales revenue of less than EUR 250,000 accounted for half of the decline in insolvencies – compared with almost 90% in 2016 – with the remainder split between those with revenue of up to EUR 1 million (one third of the decline) and those achieving revenue of between EUR 1 million and EUR 5 million (15%).

Chart 4:
Insolvency rate and stock of entreprises



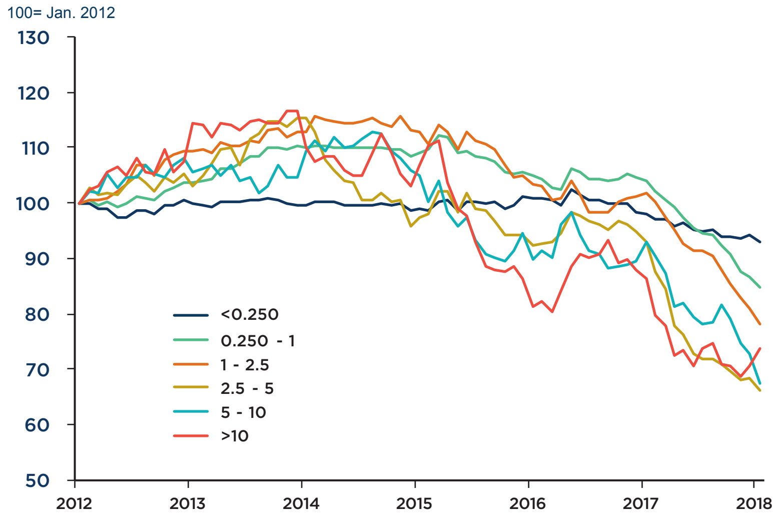
Sources: Ellisphère, Insee, Coface

Chart 5:
Cost of insolvencies



Sources: Ellisphère, Coface

Chart 6:
Insolvencies by turnover brackets
(in million euros)



Sources: Ellisphère, Coface

2/ Over the last four quarters, gains in productivity have contributed to margin rate growth of 1.1 points of added value to compensate for real wage increases.

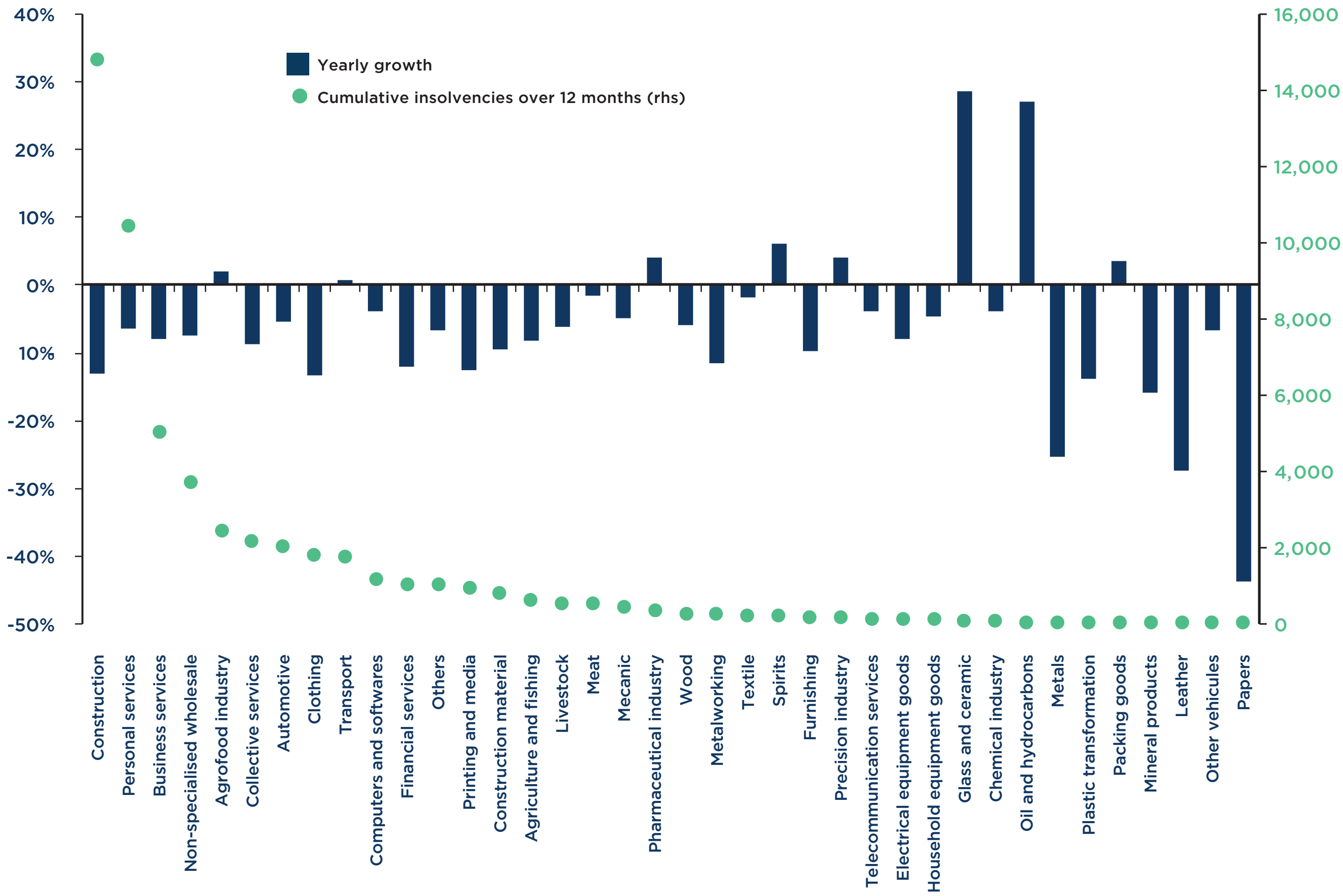
3/ First available data for definitive stock of enterprises on a like-for-like basis published by INSEE, the previous data relating only to the non-agricultural business sector.

4/ The estimate of the stock of enterprises at January 1st 2007 is obtained by applying the ratio of the total number of enterprises to that in the non-agricultural business sector in 2009 and 2010 (1.25) to the stock of non-agricultural business sector enterprises available for 2007 (2,949,173 enterprises according to INSEE).

The strong performance of the largest companies, attributable to the improvement in the global economy and in particular the resumption of international trade after a gloomy 2016, explains the decline in the size of business insolvencies measured by average revenue, which reached EUR 514,000 at the end of January 2018, down 6.4% year-on-year. However, the number of insolvencies of companies with sales revenue of over EUR 10 million has rebounded sharply over the last two months (185 insolvencies year-on-year in January, +7.6% compared with the threshold reached in November 2017).

The amount of insolvencies in terms of sales revenue therefore fell more (-14.7%) than the actual number of insolvencies, the agri-food sector (+51%) being an exception that confirms the rule. In the last year, three of the five biggest insolvencies took place in this sector: the company WILLIAM SAURIN achieved EUR 303.6 million in sales revenue, and the companies JEAN CABY and MADRANGE generated respectively EUR 274 million and EUR 211 million in revenue. As the other two biggest insolvencies were in the clothing sector, namely AGORA DISTRIBUTION and LILNAT (EUR 250.5 million and EUR 214.6 million respectively), the average size of insolvencies in the textile and clothing sector also grew considerably (+46%).

Chart 7:
Insolvencies by sectors in January 2018



Sources: Ellisphère, Coface

2 SECTORIAL DYNAMICS

Construction: insolvencies collapse

The main sector that drove the reduction in business insolvencies was construction, which recorded 14,784 year-on-year in January (see *Chart 7*) against nearly 17,000 over the same period the year before (-13 %). This sector alone accounts for half of the total decline in business insolvencies. The main activities in the sector contributed to this movement: general masonry and structural work (two out of ten insolvencies, -10.2%), painting and glazing work (1,202 insolvencies, -7.6%), electrical installation work (928 insolvencies, -17.6%) or single-family home construction (816 insolvencies, -12.6%). Real estate activities, such as the lease of land and other real estate assets (1,144 insolvencies, -10.6%) and real estate agencies (361 insolvencies, -27.8%) followed the same trend.

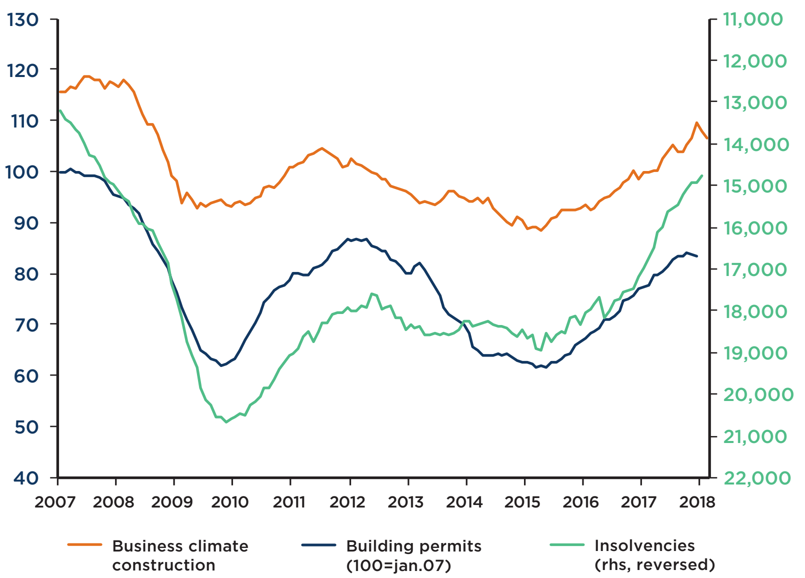
In a context of interest rates that remain very low, and with household confidence at its highest level since the crisis (4 points above its long-term average according to INSEE), the construction sector is particularly buoyant. According to INSEE's monthly survey, the confidence index in the construction sector stood at 107 in February 2018 – a slight fall since the peak reached in December 2017 (110), but still seven points above its long-term average. For 2017 as a whole, the number of housing starts increased by 17% compared to 2016 to reach 406,900 units, the highest since 2011. Building permits issued in 2017 were up 9% (see *Chart 8*). This growth is below that of 2016 (+15%), which suggests that 2018 will be less favourable.

A smooth ride for the automotive industry, mixed situation in transport

The automotive sector recorded 2,009 business insolvencies year-on-year in January, a decrease of 5.4%. This favourable performance is mainly due to the sector's two main activities, which account for eight insolvencies out of ten: maintenance and repair of light motor vehicles (865 insolvencies, -4.8%) and car and light motor vehicle trade (724 insolvencies, -7.5%). These insolvency figures are in line with the good health of the sector in France, as evidenced by the 4.7% increase in vehicle registrations in 2017. Similar to the construction industry, the automotive sector is significantly benefiting from the high household confidence together with particularly attractive credit terms. This impetus should continue in the short term: passenger car orders were up 17% in January compared with the same month in 2017, which had already been very robust.

On the transport side, the situation is more mixed: 1,756 companies in the sector went bankrupt over the period, a slight increase of 0.7 %. However, the activity of short-haul road freight transport, which represents four insolvencies out of ten, recorded a decrease in insolvencies of 10.3%, driven by the revitalisation of trade in the current environment of economic buoyancy. But the difficulties of taxi passenger transport companies – 334 insolvencies over one year, an increase of 32% – remain significant. In a context of strong competition from private hire vehicle firms, the number of bankrupted taxi companies is twice as large as in 2015 (162 insolvencies) and three times more than in 2014 (111 insolvencies)[5].

Chart 8:
Indicators in the construction sector



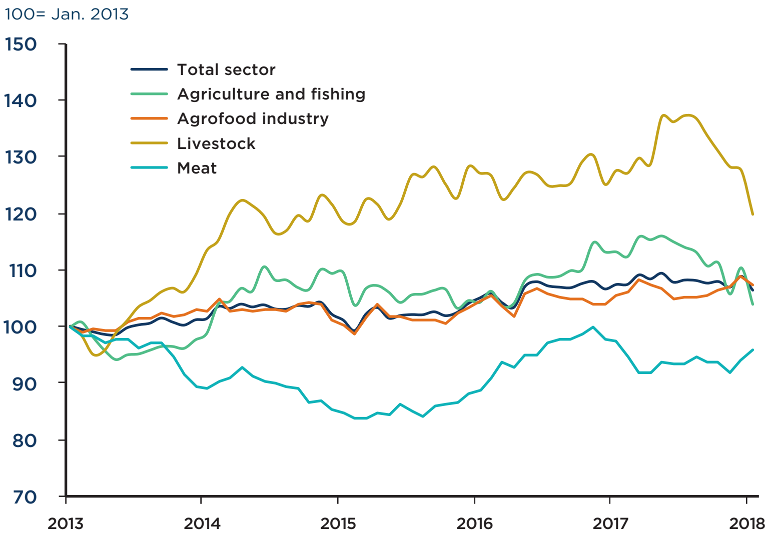
Sources: Ellisphère, Insee, Coface

5/ G. Ripple-Lascout & V. Ternisien, Coface Panorama : *Ubérisation de l'économie en France: une nouvelle arme de destruction créatrice massive ?* Coface, December 2016.

Services to private individuals benefit from household confidence

Services to private individuals (-6.4% year-on-year) took full advantage of strong household consumption driven by purchasing power gains thanks to low inflation (1% in 2017, after 0.2% the previous year). The sector was boosted by the restaurant industry (which represents more than half of insolvencies), both traditional (3,389 insolvencies, -13.1%) and fast food (1,968 insolvencies, -6.5%). A double-digit decline is also observed in hairdressing (893 insolvencies) and beauty treatments (417). On the other hand, hotel insolvencies were more numerous (434 insolvencies, +15.7%), despite a surge in tourism; visitor numbers increased by 7.8% year-on-year in the fourth quarter of 2017. Thus, the activity of the hotel industry seems to be suffering from the growth of alternative forms of accommodation[6].

Chart 9:
Insolvencies in the agrofood sector



Sources: Ellisphère, Coface

Agri-food: the curate's egg

While business insolvencies have slightly decreased in the agri-food sector (4,356 insolvencies, -0.9%), the trends vary relatively depending on the segment (see *Chart 9*). Insolvencies fell in agriculture (631 insolvencies, -8.2%), mainly thanks to vegetable cultivation (61 insolvencies, -30.7%), which made up for the increase in insolvencies in cereal cultivation (171 insolvencies, +4.3%). At the same time, 544 cattle-raising companies went bankrupt, down 6%, which does not, however, allow a return to the level of insolvencies of 2015 that preceded the peak of 2016. Against the background of a rebound in meat prices in 2017 (+3% all livestock combined), all livestock farming – with the exception of sheep and goats (63 insolvencies, +10.5%) – recorded a decline in insolvencies: thus the breeding of pigs (36 insolvencies, -30.8%) and of poultry (46 insolvencies, -11.5%) return to a level similar to that of 2015 after a particularly difficult 2016. The number of insolvencies in dairy farming enterprises also decreased (156 insolvencies, -2.5%) thanks to renewed strength in prices for cow's milk, but remains well above the level of 2015 (101 insolvencies). Agriculture and cattle-raising have thus made it possible to offset the difficulties of the agri-food industry (2,434 insolvencies, +2%), where insolvencies have been on a – slightly – increasing trend for several years. This segment, which accounts for 56% of business insolvencies in the sector, was again mainly driven by bakers and pastry chefs who recorded 1,047 insolvencies, up 1.7%. The latter were particularly affected by the rise in cereal prices in 2017 (+4.6% for common wheat), caused mainly by the poor harvests in 2016, which also explain the aforementioned increase in insolvencies among cereal producers. However, given the excellent harvest of 2017 (estimated at 68.3m tonnes vs 54.2m tonnes in 2016 and 66.9m tonnes on average between 2012 and 2016), cereal prices – especially common wheat, where the harvest was the third highest after those of 1998 and 2015 – began to decline at the end of the year.

3 REGIONAL DYNAMICS

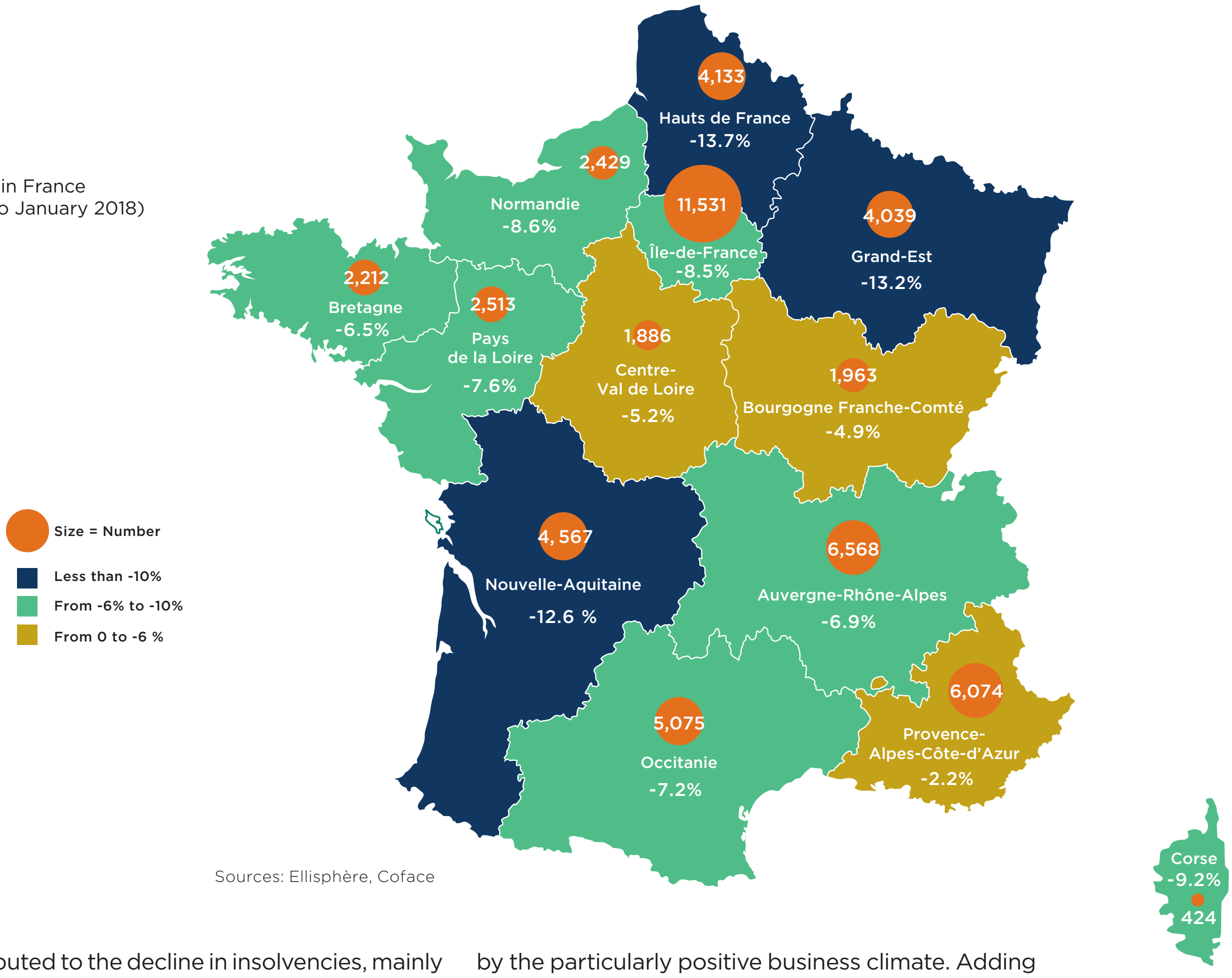
A positive trend that benefits all regions

The number of business insolvencies decreased relatively evenly across all regions: with the exception of the Provence-Alpes-Côte-D'Azur region (-2.2%), every region recorded a marked fall in business insolvencies (*see Chart 10*).

In particular, insolvencies fell in the Île-de-France region (-8.5%), totalling 11,531, or just over one in five, after four years of increases. As on the national level, this improvement in business is mainly attributable to the construction sector (3,572 insolvencies, -11.5%), which accounted for 44% of the decrease in this region. The sector was chiefly driven by the segments of general masonry and structural work and, above all, the construction of single-family homes, in line with the sector's excellent indicators in Île-de-France, the most vibrant region in the country in 2017 in terms of building permits (+18%) and housing starts (+27%). After suffering difficulties between 2013 and 2016, services to private individuals (1,638 insolvencies, -8.3%)

6/ G. Rippe-Lascout & V. Ternisien, Coface Panorama : *Ubérisation de l'économie en France: une nouvelle arme de destruction créatrice massive ?* Coface, December 2016.

Chart 10:
Insolvencies in France
(12 months to January 2018)



Sources: Ellisphère, Coface

also contributed to the decline in insolvencies, mainly thanks to traditional restaurant services (-15%). Business services (1,572 insolvencies, -6.5%) – like engineering and technical studies, where business insolvencies fell by 36% – were also strong, driven by the particularly positive business climate. Adding in the computer and software sector (401 insolvencies, -15.8%), led by computer systems and software consulting, these four sectors contributed to three quarters of the decline in Île-de-France insolvencies.

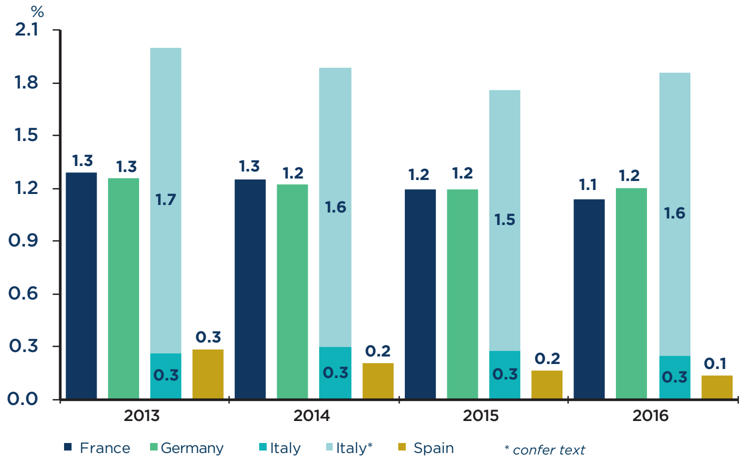
4 ZOMBIES AND INSOLVENCIES

Zombies, Insolvencies, and Companies in Financial Difficulty

The results of the comparison of the insolvency rates[7] among the four largest economies in the euro area are counter-intuitive: while this rate is high in Germany and France (the eurozone economies least affected by the crisis) it is, conversely, low in Italy and Spain (see *Chart 11*).

However, these surprising results must be put into perspective by considering the effectiveness of insolvency procedures: in France and Germany, the high insolvency rates reflect a fluidity of entry and exit from the market. By contrast, in Spain, the insolvency rate of microenterprises is almost nil (0.1%), and that of other companies is more or less equivalent to France (around 1.5%).

Chart 11:
Insolvency rate

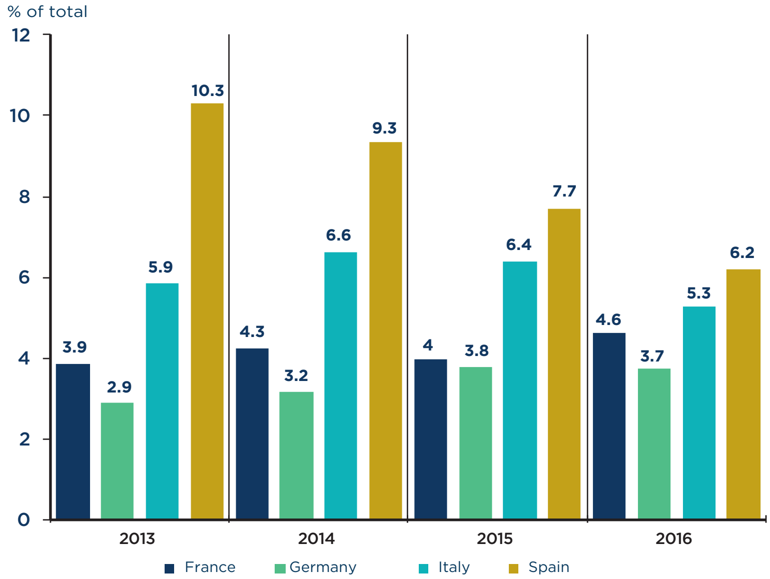


Sources: Destatis, INSEE, Cerved, INE, Ellisphère

7/ The insolvency rate corresponds to the number of companies entering into a situation of business insolvency in year *n* out of the total number of enterprises on the January 1st of the year *n*.

The main barriers, noted in particular by the OECD[8] and the Bank of Spain[9], are the duration and cost of the procedure (lawyers, court fees, duties) as well as the potential personal cost for entrepreneurs who go bankrupt: as the limitation of their liability is only partial, their personal property and future income may be exposed to claims by creditors. In order to circumvent the insolvency procedure, microenterprises prefer mortgage financing (mainly of real estate property) so that, in the event of difficulty in meeting a payment deadline, they can assign the mortgaged assets. The use of this financing method de facto excludes the vast majority of microenterprises with payment difficulties from the number of insolvencies in the strict sense of the term. In Italy, the procedures are also extremely lengthy (seven years on average) and expensive for the debtor: 22% of its assets, compared to 9% in France and Germany (the OECD average[10]). Thus, solvent but distressed companies prefer to initiate voluntary liquidation, which is shorter and less expensive as it does not undergo court supervision. If we add in voluntary liquidation procedures (1.6% of companies) to insolvencies in the strict sense, we obtain a rate of 1.9% (see *Chart 11*) that is a closer reflection of reality – although possibly slightly overestimated as it may include cessations of business for reasons other than insolvency.

Chart 12:
Share of zombies enterprises



Sources: Ellisphère, Coface

Several reforms have been carried out in recent years in Spain and Italy to mitigate these barriers to insolvency which, on the one hand, play a part in discouraging entrepreneurship and, on the other hand, in keeping so-called "zombie" companies alive. Indebted and unprofitable, these companies should naturally go bankrupt, but they keep themselves alive by engaging additional debts, taking advantage of artificially low interest rates. Their existence is therefore encouraged by a fragile banking system: banks in difficulty prefer to lend at rates that are too low, rather than suffer losses on their balance sheets[11]. Several recent studies[12] also show a correlation between rigid insolvency procedures and the proportion of zombie firms. According to Coface's methodology, the share of zombie companies is obtained by identifying companies that have been unprofitable (yield from capital invested less than 1) and insolvent (interest coverage ratio less than 1) for three consecutive years. This shows us that the highest rates of zombie companies are in Italy (see *Chart 12*) and, above all, in Spain, although the latter has seen its rate drop since 2013 thanks to vigorous growth.

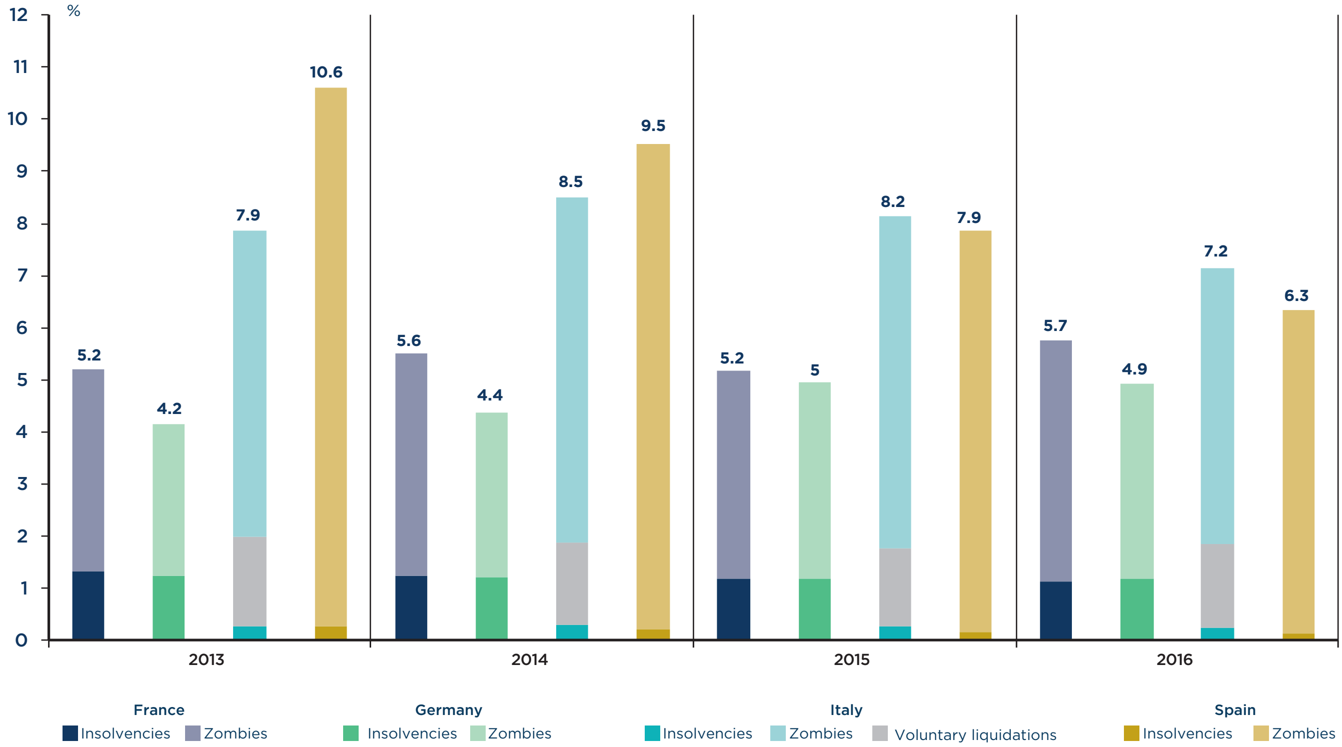
Barriers to insolvency lead to a blockage in the process of creative destruction by artificially keeping alive low-performing businesses that monopolise a share of capital. This inefficient allocation of capital, in theory intended for more productive firms, lowers total-factor productivity, and ultimately the growth potential of an economy[13].

A simple analysis of the insolvency rate can therefore give a biased image of the fragility of companies in an economy. It would appear that the analysis of the rate of companies in financial difficulty, obtained by adding together the rate of zombie companies and that of failing companies, reveals a more correct view of the proportion of companies in difficulty in the main economies of the eurozone (see *Chart 13*).

According to this indicator, while Germany has the lowest rate, Spain has recorded a marked improvement since 2013 whereas France and Italy have seen their respective rates stagnate.

8/ M. A. McGowan, D. Andrews & V. Millot, *Insolvency regimes, technology diffusion and productivity growth*, OECD, 2017
9/ M. Garcia-Posada & J. S. Mora-Sanguinetti, *Why do Spanish firms rarely use the bankruptcy system? The role of the mortgage institution*, Banco de Espana, 2012
10/ OECD, op. cit.
11/ D. Andrews & F. Petroulakis, *Breaking the shackles: zombie firms, weak banks and depressed restructuring in Europe*, OECD 2017
12/ M. A. McGowan, D. Andrews & V. Millot, *Insolvency regimes, zombie firms and capital reallocation*, OECD, 2017
13/ D. Andrews & F. Petroulakis, *Breaking the shackles: zombie firms, weak banks and depressed restructuring in Europe*, OECD 2017

Chart 13:
Share of distressed enterprises



Sources: Destatis, INSEE, Cerved, INE, Ellisphère, Orbis

Business Insolvency Forecast for 2018

According to Coface's forecasting model, the number of business insolvencies is expected to decrease by 3.6% in 2018 (see *Chart 14)* to stand at 52,396 insolvencies:

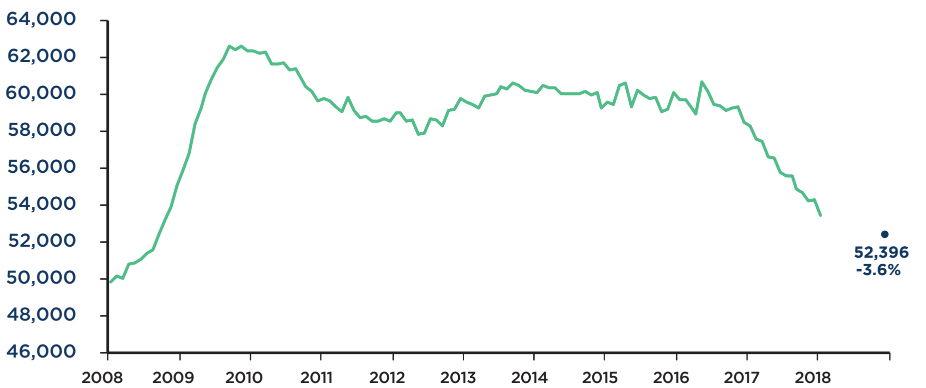
$$Insolv_q = -404.2GDP_{q-2} + 0.36Insolv_{q-1} - 171.5ConstructionConfidenceIndex_{q-1} + \varepsilon$$

(0.03) (0.02) (0.01)

This drop in the total number of business insolvencies is mainly due to GDP growth, which should remain buoyant this year, but also to the construction confidence index, which will deteriorate gradually throughout the year after reaching a peak at the end of 2017 — but will remain above its long-term average.

The significance of the business climate in construction[14] can be explained by the sector's weight in total business insolvencies, as mentioned above.

Chart 14:
Business insolvencies over 12 months



Sources: Ellisphère, Coface

14/ The variable "change in the construction sector confidence index in the previous quarter" is significant within a 99% confidence interval. Likewise, the variables "GDP growth two quarters before" and "change in business insolvencies in the previous quarter" are significant in confidence intervals of 97% and 98% respectively. Therefore, the forecast model is significant in the standard 95% confidence interval.

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