PERSPECTIVE WORLD

Drowning, wavering: Europe up to its neck in debt

The European equivalent of the US sub-prime crisis is only now beginning to unfold.

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PARIS

More toxic debt could soon come crashing through the global financial system. The surprising source: Europe Inc. Once-stodgy "old world" companies, from cement makers to phone operators to chemical companies, went on an unprecedented borrowing spree over the past decade that has left them up to their necks in debt. Corporate debt in the euro zone stands at more than $US11 trillion ($17 trillion), equalling some 95 per cent of the region's economy, compared with only 50 per cent in the United States.

Hundreds of billions in payments are coming due just as sales are falling in the global economic crisis. In better times, companies might have gone to the bank to refinance. But no more. Bank lending to euro zone companies plunged 40 per cent late last year as the credit squeeze tightened.

That helps explain why Europeans issued $US159 billion in bonds in January, the highest level in two years.

However, the price is steep. Average yields on investment-grade European corporate bonds have almost tripled in the past year, even for relatively healthy companies such as Nokia and German utility group E.ON.

The higher cost of servicing debt "will entail a restriction in hiring, wage growth and investment", a London economist with Bank of America, Gilles Moëc, says. "The amount of debt to roll over is huge."

Many businesses are struggling already. Moody's Investors Service says 249 Western European companies were hit with credit-rating downgrades in 2008, the highest number since 1990.

Thomson, a $US7.2 billion-a-year French video equipment and services provider, acknowledged on January 29 that it was about to breach agreements with lenders on some of its $US2.7 billion debt. Thomson is scrambling to raise cash by selling off businesses such as Grass Valley, a California-based video production equipment maker it bought in the hope of becoming a major supplier to Hollywood.

So, how did Europe get into such a mess? Conservative bank regulations barred most risky mortgage lending, so banks had plenty of money to offer businesses. Private equity funds, smelling opportunity in undervalued old world companies, poured in hundreds of billions more. Interest rates were low and the euro was strengthening, so companies were eager to borrow to finance acquisitions.

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Take Paris-based Lafarge, the world's largest cement maker. It shelled out $US11 billion last year to buy the cement business of Egypt's Orascom Construction Industries. Lafarge now has $US22 billion in debt, and payments of more than $US3.4 billion due this year.

A Lafarge spokeswoman says lenders have agreed to let the company delay all but about $US500 million in payments until 2010. But that may only postpone the day of reckoning, as Lafarge's sales are forecast to drop 2.7 per cent this year on a sharp fall in global construction.

The outlook is even bleaker for companies that were grabbed by private equity funds. Standard & Poor's estimated in June 2008 that 58 per cent of European companies that underwent leveraged buyouts were saddled with higher debt than originally projected, while 56 per cent were running behind forecasts on operating earnings.

Things have got a lot worse since. London-based 3i, one of the region's biggest private equity groups, took a $US942 million write-down on January 28 totalling 21 per cent of the value of its biggest holdings.

Some targets have succumbed already. Edscha, a $US1.4 billion German car parts maker acquired by US private equity organisation Carlyle Group in 2003, declared bankruptcy on February 2. British chemical company Ineos Group just avoided default in December on its $US10 billion debt by convincing lenders to suspend agreements setting a ceiling on its debt-to-profit ratio.

As with sub-prime mortgages in the US, corporate bonds and loans were packaged and resold to investors in vehicles called CDOs and CLOs, or collateralised debt obligations and collateralised loan obligations.

"There was a flood of cheap debt, lower and lower terms," says Jon Moulton, head of London private equity group Alchemy Partners, "and with less and less due diligence."

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