Is France the second sick man of Europe?

8 Feb 2024 17:06 GMT | by Francesco Magon, Alessia Pirolo

After Germany, the historically untroubled country is next on the distress watch list

Germany is sick and France doesn't feel so good itself. For some time, the main focus of distress hunters across Europe has been Germany, with its overleveraged companies and banks exposed to commercial real estate. But several reports show that France comes second.

Traditionally the least distressed market in Europe, France ranked second among eurozone countries in the final quarter of 2023 as investment metrics deteriorate and liquidity and profitability weaken, according to the Weil European Distress Index.

At €32bn, France also ranks second for its level of debt funding gap in the eurozone, according to CBRE, while Germany has the highest level at €77bn.

Some distress-related effects have already emerged, especially among vacant offices in the Paris suburbs, resulting in losses for borrower, lender or both.

Nevertheless, market players agree we are still a far cry from the levels of the global financial crisis. As seen in the annual earnings posted over the past week by France's largest lenders Société Générale, Crédit Agricole, BPCE and BNP Paribas, results have been mixed, with lower profits than expected. But French banks still take pride in being solid and having a relatively low level of bad loans on their balance sheets.

"The reality is that the current situation is very different from the one we lived during the GFC, says Francesca Galante, founding partner at financial adviser First Growth Real Estate & Finance. "In 2008 leverage was easily over 80% – which is not at all the case nowadays."

The French commercial real estate crisis is more of a problem for investors rather than banks – for now.

Banks keep going

“The normalisation of French banks’ net interest income is set to continue in 2024,” said Cyrille Rumen, a partner at law firm BCLP Paris. “Unlike for some European peers, rising interest rates have not yet translated into higher profits. Instead, revenues from domestic retail activities are under pressure because liabilities have repriced more quickly than assets.”

French banks pay higher interest to depositors, so they have not benefited as much as their eurozone peers from increased interest rates. “While this led French banks’ revenue to underperform in 2023, we believe it will protect borrowers, and hence asset quality, in the future,” Rumen says. “Moreover, we expect a catch-up in asset repricing in 2024, which will support margins.”

BNP Paribas missed its forecast last week, while reporting a distributable net profit of €11.23bn in 2023, up by 10.2% from 2022, but with a drop in the fourth quarter. The group reported a cost of risk at €2.9bn in 2023, lower than the €3bn in 2022. It reflected €517m releases of provisions on performing loans in 2023 and a provision on non-performing loans of €1.8bn excluding cost of risk at personal finance.

BPCE reported net banking income of €22.2bn, down 7% from 2022. In 2023, the amount of its provisions was €1.73bn down from €1.96bn in 2022. For performing loans, €852m of provisions were booked in 2022 and €112m was reversed in 2023. Provisions on loans with an occurred risk rose to €1.84bn in 2023 from €1.11bn in 2022 – “notably explained by a limited number of specific files and a weakening of the economic environment”. Its NPL ratio stood at 2.4% at the end of 2023, up 0.1 percentage points from 2022.

This publication is intended for use by Francesco Magon at Decision Makers in Transition
It may not be copied or disseminated to others without written permission.

In the fourth quarter, Société Générale's net income was €430m, down 60% compared to Q4 2022, while for the full year it was €2.5bn, up 37% from 2022. The cost of risk for Q4 2023 was low at 24 basis points, €361m. It breaks down into a provision on NPLs of €364m and a slight reversal on performing loans for €3m. At the end of December 2023, the group's provisions on performing loans was €3.57bn, down €197m from 2022. NPLs were €16.1bn, down from €16.4bn quarter on quarter and slightly up from €15.9 in December 2022.

In Q4 2023 Crédit Agricole's net income was €1.3bn, down 25.9% from Q4 2022 while in the full year 2023 net income was €5.92bn, up 11% from the previous year. Provision was stable in Q4 at €762m (of which €669 was on NPLs), compared with €693m in previous quarter and €753m in the previous year. Crédit Agricole's NPL ratio remained low at 2.6%, down 0.1 percentage points from Q3.

The office problem

Despite the lower-than-expected performances from French lenders, the issue is not banks' balance sheets. Globally, lenders and borrowers are losing sleep over the most troubled assets – offices, and France is no different.

"The asset classes least considered by lenders are the riskiest: office and retail," says Damien Giguet, founder at real estate financial advisory firm Shift Capital.

The first issue is high vacancy rate. Properties that have remained partially or totally vacant for a long time are clearly at risk. And Île-de-France has plenty of such assets. The take-up of office space in the Paris region totalled 1,932,000 sq m in 2023, down 17% compared with 2022, according to Immostat.

> *"The asset classes least considered by lenders are the riskiest: office and retail"*
>
> DAMIEN GIGUET, FOUNDER AT SHIFT CAPITAL.

"All the fluctuations that reduce the value of a building have a negative impact on the business plan," says Giguet. "And at the moment, buildings in the Paris suburbs are struggling to achieve it. These buildings were financed at a rate of 60%. Some need to be refinanced at 80% LTV and need to raise capital."

This publication is intended for use by Francesco Magon at Decision Makers in Transition
It may not be copied or disseminated to others without written permission.

The values of offices in Paris' banlieues have plummeted. The areas that have experienced the biggest drop in value between Q4 2022 and Q4 2023 are the Paris districts outside the CBD (from €11,190/sq m to €9,602/sq m), the Première Couronne districts (from €5,073/sq m to €3,409/sq m) and Croissant Ouest/La Défense districts (from €6,200/sq m to €4,550/sq m), according to Immostat.

At the moment other sectors are less at risk. "High street retail, retail parks and supermarkets that have a good track record and are less exposed – except for certain such as Casino – are favourably considered by lenders," says Giguet. "For residential, the main challenge is to achieve yields allowing debt to make sense. It's not about distress."

The destiny of troubled assets

For some of the French offices that have already showed signs of distress, banks and borrowers have several options. "For troubled assets the preferred scenario is restructuring," says Giguet.

An agreement to extend and potentially change terms of the loan is a potential temporary solutions, especially in case of buildings that would struggle to be refinanced from other lenders. "Banks would only do so if there is a reasonable chance of generating some equity payback. This is a positive option for investors," says Giguet. "On the other hand, this kind of position will obviously involve a cost. Banks have to put extra capital in and they're not always willing to do that."

Banks are obviously more willing to find agreements with strong sponsors. Last December, BNP Paribas agreed with Blackstone to a three-year extension with lender of the financing on the Tribeca and Kara buildings in Paira. These assets were bought in 2018 for €180m with a €100m five-year maturity loan, expiring in Q3 2023. Blackstone's refinancing options were limited in the midst of a market with much higher interest rates than five years before.

In other cases, lenders have not be willing to negotiate and the market is already seen borrowers forced to attempt fire sales. For instance, EQT Exeter is trying to dispose of the Concept office, which has a 85% vacancy rate, and is located in Clichy, a troubled Paris banlieue.

"Lenders would push borrowers to get rid of buildings if they thinks they can be repaid. The problem is that it's hard to get a market price," says Giguet.

This publication is intended for use by Francesco Magon at Decision Makers in Transition
It may not be copied or disseminated to others without written permission.

"Potential buyers are aware of the building's debt situation, so they try to make lower offers."

Indeed, in the case of the Concept, EQT is negotiating with Weinberg Capital Partners, which offered €20m, less than the debt pending on the property. EQT Exeter is also trying to sell the Smart Parc in Courbevoie, but so far has received offers below the €60m asking price and below its financing.

A third scenario is returning the building to the lender. "We are increasingly seeing restructuring and borrowers giving back keys to lenders," says Firth Growth's Galante.

Le Pélissier, Malakoff (Image: PSS Archi)

One of the most notable recent cases was JP Morgan recently returning the keys of a four-asset estate in Malakoff, south Paris, to BNP Paribas.

"This is the most complicated option, because once the banks have got the keys back, what can they do without losing money too?" says Giguet. "They can do asset management themselves. But internal asset management is expensive for their balance sheet, and they don't always have a department specialising in it."

Other offices remain in limbo. The loan backing River Green Finance 2020 DAC, which is linked to the River Ouest building on the outskirts of Paris, fell

This publication is intended for use by Francesco Magon at Decision Makers in Transition
It may not be copied or disseminated to others without written permission.

into default in January.

Primonial REIM failed to sell the Nanterre office complex Eureka, on which it has a €58m loan provided by PBB Deutsche Pfandriefbank expiring in 2025. Bids were a quarter or less of the original €100m acquisition price and were rejected by the seller.

The ghost of NPLs yet to come

If the worst comes to the worst, for troubled assets there is the possibility of being turned into NPL sales. “Alternatively, banks can sell distressed/NPL portfolios. In other words, distressed properties sold as a collection,” Giguet said.

Very few believe we are there yet. Historically, French banks have had a proportionally low level of NPLs. But now France has by far the highest NPL volume among European countries, which reached €116.8bn at the end of Q3 2023 from €115.5bn at the end of Q2 and much higher than the second-placed Spanish banks’ €77bn, according to the EBA’s *Risk Dashboard (RDB)*.

Nevertheless, NPL ratio – showing distressed loans over the total loans held by banks – remained at 1.9%, in line with European average and still on the low side.

For this reason, in the past decade NPL portfolio sales in France have been a rarity.

“Between 1997 and 2000 there were a lot of NPL portfolios in France, bought in particular by US funds which came to France for this market opportunity. That was the last time there were substantial NPL portfolios in France,” Giguet said.

Something to keep an eye on, though, is the increased volume of commercial real estate NPLs.

Compared with Southern European banks, which are keeping the deleveraging activity they have become expert in since the global financial crisis, German and French banks are going in the opposite direction.

For the first time, in Q3 2023 Germany was the county holding the highest level of CRE NPLs, €9.7bn up from €8.1bn quarter on quarter and €6.2bn year on year. But France wasn’t far behind, with €8.8bn up from €8.6bn quarter on quarter and €7.6bn year on year. Germany had a CRE NPL ratio of 3.4% and France 3.1%.

This publication is intended for use by Francesco Magon at Decision Makers in Transition
It may not be copied or disseminated to others without written permission.

The proportions are not yet at a troubling level – but the uptick is expected to continue.

This publication is intended for use by Francesco Magon at Decision Makers in Transition
It may not be copied or disseminated to others without written permission.