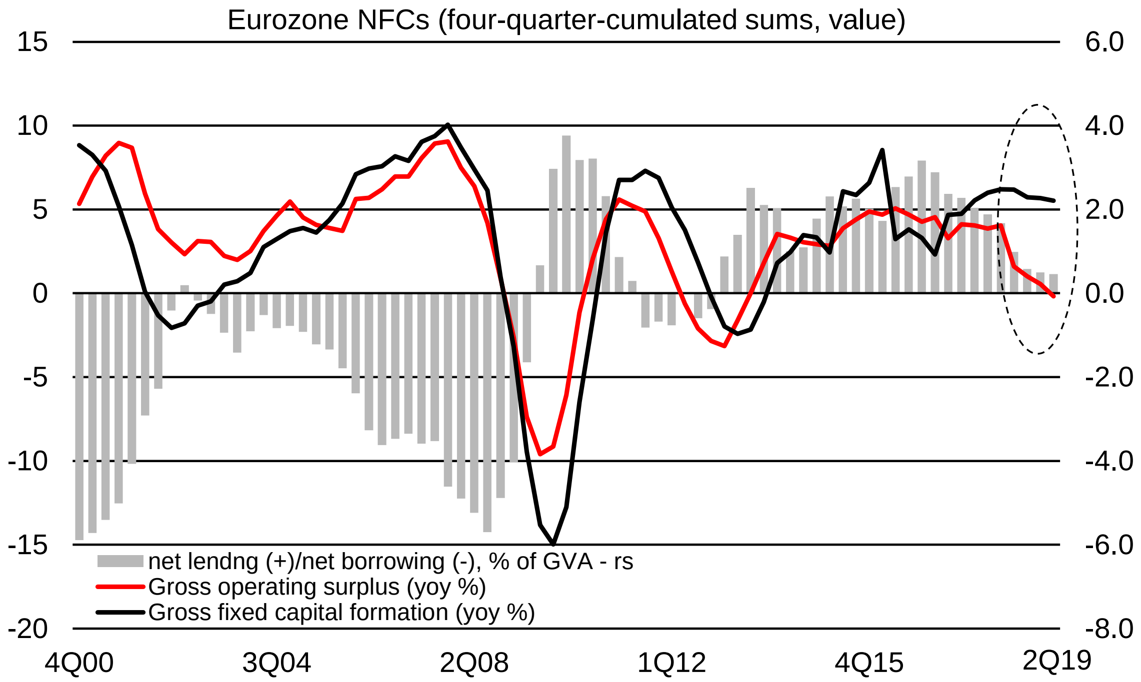
Eurozone non-financial firms: Worsening profitability, resilient investment (for now)



Notes: **1.** GVA: Gross Value Added; **2.** Net lending/net borrowing (or financing gap) is typically negative for NFCs that need to finance investment with external funds; **3.** We have excluded Ireland from the eurozone aggregate due to the extreme volatility of Irish data pertaining to both gross fixed capital formation and the financing gap – this is likely due to the large weight of multinational firms with a presence in this country. When the whole eurozone is taken into account, the trends highlighted in the chart become even clearer, with fixed investment accelerating markedly and the financing gap turning negative (i.e. signaling that NFCs have become net borrowers from the rest of the economy).

Source: Eurostat, UniCredit Research

- Our Chart of the Week shows that investment spending by non-financial corporations (NFCs) in the eurozone has remained resilient despite a material worsening of these firms' profitability. In the chart, our gauge of profitability is gross operating surplus, which is the national-account equivalent of EBITDA.
- With profitability weakening on the back of the slowdown in economic activity and rising unit labor costs, the composition of the financing of fixed investment has progressively changed: less funds are generated internally by firms, while recourse to external sources of funding has increased. This pattern has been mirrored in the evolution of the financing gap, which measures the excess of firms' internal funds over their capital expenditure. Since 2018, the (positive) financing gap has been shrinking rapidly and has now almost disappeared.
- The chart has two main implications. First, unless profitability of NFCs turns around fairly quickly, investment growth in the eurozone is likely to lose momentum going forward, because fixed investment and gross operating surplus cannot decouple on a sustainable basis. Second, and more positively, debt financing flows to NFCs have remained resilient despite the deterioration of the business cycle. This is especially true for debt securities, net issuance of which remains robust. However, the supply of bank credit also remains in good shape. The results of the ECB's bank lending survey for 3Q19, published yesterday, revealed an easing of the credit standards applied to loans to NFCs, from already-accommodative levels. Most likely, the ECB's loose monetary policy is playing a very important role in preserving favorable financing conditions.

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