CORPORATE LEVERAGE AS A HEADWIND DURING THE RECOVERY

One of the longer-lasting consequences of this crisis is a forced increase in corporate gearing. A high level of corporate leverage can act as a drag on growth. Research shows that firms with higher leverage invest less than others. This reduces the effectiveness of monetary accommodation. Highly indebted companies may also suffer a lasting loss in competitiveness vis-à-vis their better capitalised competitors. It implies that policies aimed at recapitalising companies should have lasting favourable effects on growth.

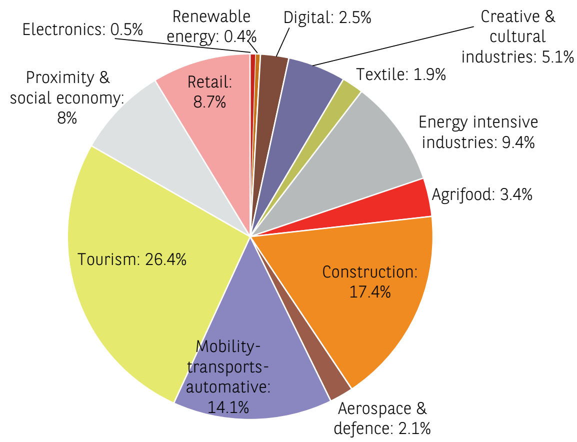
During the lockdown due to the Covid-19 pandemic, many companies have been confronted with a negative scissors effect: the drop in revenues was significantly bigger than the decline in costs. This forced them to cut costs including letting people go, to run down their cash reserves and to draw on credit lines. It implies that one of the longer-lasting consequences of this crisis is a forced increase in corporate gearing. Quite probably, for many, this phenomenon continues despite the gradual easing of lockdown measures.

Combining firm-level data analysis and its latest macroeconomic projections, the European Commission concludes that *"total losses to be incurred by firms could exceed EUR 720bn by the end of the year and would increase to above EUR 1.2 trn in the stress scenario."*[1] Many companies would end with insufficient equity, triggering a need for recapitalisation to reduce corporate leverage or to allow for additional borrowing without causing a huge additional increase in gearing. The amount of 'missing equity' is hard to estimate and depends on two buffers: the initial cash reserves and other liquid assets which can be used to cover (part of) the losses. According to the European Commission, after having exhausted these buffers, between 25% and 35% of EU companies would experience a liquidity shortfall, in a range between EUR 350 and 500 bn. It could concern 180 000 – 260 000 companies employing between 25 and 35 million people[2]. Should it become increasingly difficult to cover the liquidity shortfall by means of a combination of recapitalisation and additional borrowing, the problem would spill over to the household sector, via an increase in unemployment.

Although meeting the financing needs would avoid a negative spiral of losses leading to labour shedding, a decline in consumption and more losses for companies, there could still be a drag on growth if corporate leverage stays very high[3]. A key channel of transmission works via corporate investment. Companies with a high gearing could find it difficult to obtain loans to finance investment projects, or could face higher borrowing costs or stricter covenants. Management could also become more cautious so as to avoid that investments, which would end up not meeting expectations, would put the company at risk. However, the opposite arguments can also be made. When interest rates are low, the quest for yield will force investors to accept ever looser lending standards by investing in covenant-lite loans. Managers of highly geared companies might adopt an all-or-nothing attitude and make riskier investments when their compensation depends on share price performance. When the net effect is theoretically ambiguous, empirical research can provide the answer. A Bank of England working paper has found that during the global financial crisis and the recovery phase which followed, cash-rich companies in the UK invested significantly more than cash-poor firms: *"having a liquid balance sheet when the credit cycle turns thus gives firms a competitive edge that lasts far beyond the crisis years"*[4].

1. *Identifying Europe's recovery needs, European Commission staff working document*, SWD(2020) 98 final, Brussels, 27 May 2020
2. In the adverse scenario the shortfall could end up between EUR 650 and 900 bn and concern between 35 and 50% of companies.
3. For an interesting overview of the literature, see Neeltje van Horen, *Covid-19 Briefing: Corporate Balance Sheets*, BankUnderground, Bank of England, 9 June 2020
4. Source: *All you need is cash: corporate cash holdings and investment after the financial crisis*, Bank of England staff working paper n° 843, January 2020.

EUROPEAN UNION: EQUITY LOSSES PER SECTOR (SHARE OF TOTAL LOSSES)



SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

> **Policies aimed at recapitalising companies should have lasting favourable effects on growth, by reducing default risk in the short run but, in particular, by giving these companies the oxygen allowing them to invest.**

Recent research[5] based on firm-level data shows that during the eurozone sovereign debt crisis, firms with higher leverage reduced their investment more than others, even more so in the peripheral countries. This negative effect lasted for up to four years after the crisis and explains about 40 percent of the observed decline in corporate investment.

These results lead to several conclusions. First, economic shocks can cause a corporate balance sheet recession[6] because a high degree of leverage creates a preference for strengthening the balance sheet rather than investing. A high degree of uncertainty about the outlook would reinforce this attitude. Second, such behaviour reduces the effectiveness of monetary accommodation. Ironically, this effect can be the outcome of an easy monetary policy in previous years which has stimulated companies to increase their gearing. Third, highly indebted companies will suffer a lasting loss in competitiveness vis-à-vis their better capitalised competitors. Fourth, the same applies to cash-strapped companies. Fifth, *"growth-enhancing policies that more directly target the financial conditions of firms may be needed to reduce the debt overhang and stimulate the real economy."*[7] To put it differently, policies aimed at recapitalising companies should have lasting favourable effects on growth, by reducing default risk in the short run but, in particular, by giving these companies the oxygen allowing them to invest. Finally, international differences in terms of starting position and policy reaction can have lasting effects on the competitiveness of countries. All of these points are very much relevant in the current environment.

William De Vijlder

CONSENSUS IBES EBITDA* GROWTH IN % FOR THE NEXT 12 MONTHS FOR EUROZONE COMPANIES

SOURCE: THOMSON REUTERS, BNP PARIBAS

5. Source: *Debt Overhang, Rollover Risk, and Corporate Investment: Evidence from the European Crisis*, Sebnem Kalemli-Özcan, Luc Laeven and David Moreno, January 2020
6. The concept of balance sheet recession was made popular by Richard Koo to explain Japan's Lost Decade after the asset price bubble's collapse in the early nineties.
7. Source: Sebnem Kalemli-Özcan et al., op cit.