The emerging insolvency crisis

Some organisations commission me to write very straight, factual, stat-heavy pieces aimed at professionals who already know the subject. In this 2022 piece for the Chartered Institute for Securities and Investment I collated quantitative data, previous articles and original quotes from major interviewees to provide a technical, jargonised article that respected the knowledge of its audience while also bringing readers something new.

CORPORATE insolvencies are likely to surge as government Covid support schemes wind down around the world. A return to business as usual will expose a raft of vulnerable firms no longer able to rely on state loans and handouts to prop up their business models.

But the picture varies in different parts of the world, thanks to a disparity in lockdown measures, a wide spectrum of state support levels and the contrasting rates of economic recovery across the globe – and that's before factoring in the impact of the war in Ukraine. So is a global insolvency crisis coming and if it is, what does this mean for investors trying to identify a sustainable business?

The number of global insolvencies, which dropped 12% in 2021, will likely rise 10% this year and a further 14% in 2023, according to a forecast published on June 1 by trade credit insurance company Allianz Trade (formerly Euler Hermes) *(https://www.allianz-trade.com/en_BE/news/latest-news/insolvency-report-2022.html)*.

"At this stage, we expect one out of three countries to return to their pre-pandemic levels of insolvencies in 2022 and one out of two countries in 2023," says Ana Boata, the company's head of economic research.

France headed the international table last year, with 50,000 insolvencies, ahead of the US (32,000), Germany (23,180) and the UK (20,250). French companies are readjusting following the removal of a €240bn loan support package to 700,000 firms.
However, the bounce-back rate varies. The Allianz Trade report notes the number of corporate bankruptcies in the UK, where businesses received £69bn in Covid support

measures in 2020 and 2021,

(https://www.instituteforgovernment.org.uk/explainers/coronavirus-economic-support)

was up 112% year on year, some 60% higher than its nearest competitor Belgium, with many of the other significant increases also in Europe (43% Denmark, 42% France, 38% Switzerland). In contrast, Far Eastern insolvencies fell 89% in Hong Kong, 52% in South Korea and 19% in China and in Australia the 10-year average of companies going into administration halved from 9,300 to 5,000 – a figure so low that the country's ABC News reported the government's Jobkeeper wage support scheme to keep businesses afloat was being accessed by insolvency companies themselves. In Africa, central and Eastern Europe and Latin America, a combination of lockdowns and less government policy and financial support suggests these territories could already be exceeding pre-pandemic insolvency figures.

Table 4: Business insolvencies – figures available as of May 2022 (selected countries)

Country	Last point (y/y change in %)						
	As of	Last m	Last 3m	Last 6m	Last 12m	Ytd vs 2021	Ytd vs 2019
U.S.	2021 Q4	na	-36%	-40%	-34%	na	na
Canada	03-2022	7%	22%	16%	5%	22%	-24%
Brazil	03-2022	1%	-1%	5%	-5%	-1%	-4%
Chile	03-2022	-40%	-37%	-41%	-29%	-37%	-25%
Germany	02-2022	-5%	-5%	-3%	-8%	-5%	-33%
France	03-2022	42%	34%	16%	8%	34%	-30%
United Kingdom	03-2022	112%	114%	81%	54%	114%	12%
Italy	03-2022	-29%	-25%	-23%	7%	-25%	-33%
Spain	03-2022	-5%	1%	-1%	21%	1%	39%
The Netherlands	03-2022	-3%	0%	-10%	-33%	-48%	-48%
Switzerland	04-2022	38%	37%	30%	17%	37%	9%
Sweden	03-2022	-10%	-9%	-5%	-9%	-9%	-14%
Norway	03-2022	13%	12%	-7%	-7%	12%	-30%
Belgium	03-2022	52%	49%	34%	20%	49%	-14%
Austria	2022 Q1	na	117%	131%	52%	117%	-17%
Denmark	03-2022	43%	-2%	8%	-6%	-2%	-7%
Finland	2022 Q1	na	-8%	18%	16%	-8%	-8%
Portugal	03-2022	-29%	-22%	-17%	-15%	-22%	-25%
Ireland	03-2022	0%	8%	-5%	-22%	8%	-38%
Luxembourg	03-2022	-9%	6%	-1%	7%	6%	-13%
Russia	03-2022	3%	6%	11%	6%	6%	-18%
Turkey	03-2022	40%	21%	29%	21%	21%	-4%
Poland	03-2022	-9%	-15%	1%	34%	-15%	61%
Romania	03-2022	4%	14%	12%	10%	14%	7%
Latvia	03-2022	6%	-5%	-24%	-24%	-5%	-64%
South Africa	03-2022	-16%	-10%	-21%	-11%	-10%	0%
China	03-2022	-19%	-23%	-29%	-30%	-23%	-32%
Japan	03-2022	-6%	-3%	-8%	-17%	-3%	-22%
India	2022 Q1	na	26%	42%	55%	26%	-19%
Australia	03-2022	19%	24%	25%	21%	24%	-42%
South Korea	03-2022	-52%	-29%	-47%	-40%	-29%	-67%
Taiwan	03-2022	53%	16%	0%	3%	16%	45%
Singapore	03-2022	29%	30%	78%	39%	30%	25%
Hong Kong	03-2022	-89%	-36%	-18%	-3%	-36%	-36%
New Zealand	03-2022	-12%	-5%	-12%	-2%	-5%	-27%

Sources: national sources, Allianz Research

In the US, the bankruptcy rate has fallen 40% since December. Indeed, the Administrative Office of The US Courts shows the number of insolvencies has fallen consistently from a quarterly 23,114 at the start of the pandemic in spring 2020 to just 13,160 in Q1 2022 –

thanks largely to a combination of the Paycheck Protection Program (a $953bn federal package which, although ended a year ago, still entitles many borrowers to "loan forgiveness") and America's initially spectacular fiscal bounceback – its 5.7% economic growth in 2021 was the fastest since 1984.

At the height of the pandemic, most national governments were propping up companies. An OECD survey of 55 states showed 91% were deferring corporate tax, 87% offered loans, around two thirds offered support with energy costs and introduced debt moratoria. https://www.oecd.org/coronavirus/en/data-insights/what-are-countries-doing-to-support-small-businesses

The removal of such support has been compounded across the world by continuing supply chain disruptions, transportation delays, goods shortages, high energy costs and a global surge in inflation. Yet there are reasons a flood of insolvencies may not happen –at least, not yet. The Allianz 2022 Global Insolvency Report: Growing Risks And Uneven State Support, issued in May, https://www.allianz.com/en/economic_research/publications/specials_fmo/allianz-trade-insolvency-report.html points to the global total cash holdings of listed firms being 30% higher at the start of 2022 than in 2019, and deposits of non-financial corporates being 29% higher in the Eurozone and 57% higher in the US. The report also suggests the number of fragile firms has decreased, with those whose profitability, capitalisation and interest coverage make them likely to default in the next four years reducing across Europe – most significantly in Italy (from 11% to 7%) and France (15% to 12%) but also Germany (7% to 6%) and even, slightly, in the UK (18% to 17%).

These varying rates of recovery make it harder, of course, for investors to differentiate between strong companies and those that have been artificially propped up. "Investors, and importantly the businesses they have invested in, will need to manage cash more closely than ever before," says Simon Longfield, Restructuring Advisory Partner at FRP**.** "Liquidity has never been as critical, and I believe we will see a recalibration of deal metrics to factor in the challenges that businesses are now facing. Lower leverages will be the order of the day, and I suspect businesses will take a more cautious approach to M&A activity."

The still unpredictable nature of the Covid exit is inevitably exposing vulnerable firms. Many of those that survive will have to restructure to do so, which in turn creates myriad opportunities for vulture funds. “If restructuring activity does increase, then there will be opportunities to secure cheaper assets and deal activity will just shift in that regard,” says Longfield. “The fund industry’s attention will switch from business-as-usual M&A activity to stressed and distressed assets, where they will see an opportunity to buy business and assets and debt at discounted levels.”

Individual insolvencies may yet be kept at bay if the banks demonstrate more debt forgiveness. They are arguably in a stronger position than they were in 2008-9, says Chris Kennedy, a managing director at US-based global turnaround specialists Alvarez & Marsal. “The purchase of asset backed securities and the sale of billions of dollars of these products every month to the Fed has given the banks a massive amount of liquidity. This has come to halt and they no longer have that flow of sales or income and quantitative tightening will impact them. But they are much better securitised than last time round.”

Tax regimes have also shown patience (at the end of 2021 the UK’s HMRC was owed a record £65billion) and legislation is also encouraging forbearance – in the UK last year’s Corporate Insolvency and Governance Act, introduced to provide more flexible and efficient tools to enable companies to restructure their balance sheets, will gradually take on more significance and have more impact as support measures disappear – for example, the 20-day initial moratorium could be used more frequently when there’s viable opportunity for a business to be rescued as a going concern. But does this simply prolong the artifice in weaker companies, protecting business owners while putting their investors at risk?

“The insolvency rates may be affected by the business owners’ expectations regarding the future,” says Jean-Daniel Breton, Chair of the Canadian Association of Insolvency and Restructuring Professionals (CAIRP). “If business owners believe the economy will deteriorate, they may decide to stop operations and liquidate, while if they believe the economy will generally get better, they may invest more, undertake restructuring measures or show more resilience.”

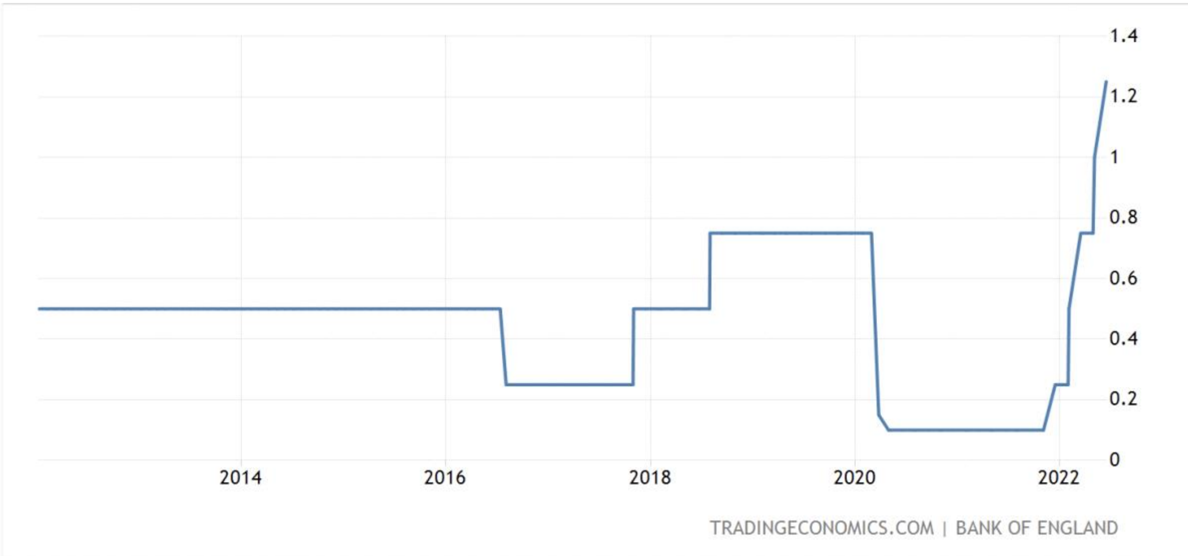
So would a proliferation of vulture funds swooping on vulnerable companies necessarily be a negative outcome – or is it an inevitable byproduct of capitalism that helps make the world go round? The latter, suggests Breton: "We should not be looking at insolvency rates as necessarily being a 'bad thing'. Insolvency is a normal process that denotes a healthy economy. While we strive to keep insolvency rates low, the absence of any insolvency case in an economy would be indicative of a serious problem, namely either that the statutory framework does not allow the possibility of relief if one is in financial difficulty, or if the insolvency laws exist and are fair, that business owners are not taking risks and entrepreneurship is being stymied."

That sentiment is echoed along insolvency practitioners around the world. Roger Mendelson, executive chairman of Melbourne-based Prushka Fast Debt Recovery Service, reacted to new insolvency laws in Australia by telling ABC News: "The idea of proposed changes is noble and I support the thoughts behind it. But will it have any impact in the real world? I seriously doubt it, for the underlying issue that most companies are simply not worth saving when they've reached that point."

Capitalism is by definition about risk and return, and, albeit that Covid was an unprecedented global situation, there are strong arguments that support measures deprive companies the incentive to adapt and adjust their business models – and as long as fundamentally weaker or less imaginative firms are allowed to limp along, that restricts opportunity and markets, exposing better managed companies to greater risk and competition that would not otherwise be there. This is arguably exacerbated by legislation that has provided heightened protection for business owners, for example the UK's CIGA and the Coronavirus Act 2020, which suspended liability for wrongful trading, making it more difficult for insolvency practitioners to challenge directors over their conduct.

Interest rate rises will likely sound the death knell for many unsustainable companies whose future had already been made parlous by inflation. This week's seismic 0.75% hike in US interest rates – the biggest single rise in nearly 40 years, to combat America's fastest rise in inflation (8.6%) since 1981 – follows increases in Brazil, Canada and Australia, while the European Central Bank has outlined plans to follow suit later this summer. The impact of five consecutive months of rises by the Bank Of England seems certain to further accelerate the UK's insolvency surge – even its first two hikes in February and March this year were followed by the country's highest quarterly company insolvencies – 2,114 – since the autumn of 2017. (https://www.gov.uk/government/collections/company-insolvency-statistics-releases)

UK INTEREST RATE RISES



"Inflation is hard to tackle without driving up interest rates and making liquidity less available, which inevitably will be a driving force in many insolvencies." says Kennedy. "Is that a flaw of capitalism? Probably, but what's the alternative? The price of gas is going through the roof, which hikes up inflation, and the way to bring the cost of living under control is to raise interest rates, which makes businesses vulnerable. A lot of leveraged funds will miss margin calls and not be able to sustain positions. But although capitalism definitely exacerbates the gap between the wealthy and the poor, you can't blame capitalism for rising gas prices – that's squarely at the door of the war in Ukraine. Capitalism is flawed but inflation is not being tamed by what's been done so far, the war will not end soon, nor will global supply chain problems, especially with China going back into lockdown – so interest rate rises and an increase in insolvencies are inevitable.”