

Corporate Debt & Creative Destruction

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The Bank of England published its quarterly “Financial Stability Report” recently and it is no surprise to find that companies have resorted to borrowing to get them through the Covid pandemic. What is more interesting is the distribution of the increase in debt. It is overwhelmingly in the smaller company sector.

The term “blue-chip” harks back to the days of the old stock market where the top companies were traded using blue chips to denote their standing. The term denotes size and scale, often, though by no means always, associated with “balance sheet” strength.

Britain’s top companies have not needed to increase their debts throughout the pandemic whereas the Bank found that smaller companies had increased their debts by one quarter.

This is important for several reasons: increased indebtedness raises the risks to shareholders. Very obviously, it renders these companies more vulnerable to a rise in interest rates, but it also renders them more exposed to a squeeze on working capital since weak debt ratios raise the cost of finance when it is required to expand production into an economic upturn. The rate of corporate insolvency tends to rise early in economic expansions as firms struggle to finance growth.

Equally, and as part of the package of Covid measures to help business, the legal moratorium on “winding-up petitions,” ceased at the end of September. Throughout the pandemic, creditors have been unable to sue for the recovery of their debts. Companies no longer have that protection, and the Bank of England expects to see a rise in bankruptcies from record low levels, probably leading to an increase in loan-loss provisions at the major banks.

Equally, it seems likely that equity issuance will accelerate for those firms with access to public financial markets. This will strengthen balance sheets but will depress share prices as the supply of equity increases.

It is also likely that we will see the elimination of “zombie” firms, those kept alive by the combination of pandemic assistance and ultra-low interest rates and a rise in unemployment before under-utilised labour is deployed elsewhere in the economy, perhaps as newly trained and highly paid HGV drivers. This “creative destruction” might reverse the decades-long decline in British productivity as inefficient firms go to the wall.

Finally, higher inflation, because of a strong rebound from Covid meeting supply constraints, will bring QE to an end and may precipitate earlier than expected increases in interest rates, putting further pressure on those companies with over-gearred balance sheets. The Bank of England remains confident that UK financial stability is not threatened by these developments but nevertheless, it seems clear that policymakers are bracing themselves for a difficult route out of the hard economic legacy bequeathed by the Pandemic.

Companies with strong global positions, sound balance sheets, and management teams that acknowledge the changing competitive landscape, will benefit from this ‘creative destruction’ by taking market share and preserving pricing power in what has become a more inflationary environment. Tacit strategies are full of such companies and it is interesting to see that the recent share price volatility is differentiating between these two very different types of investment.

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