

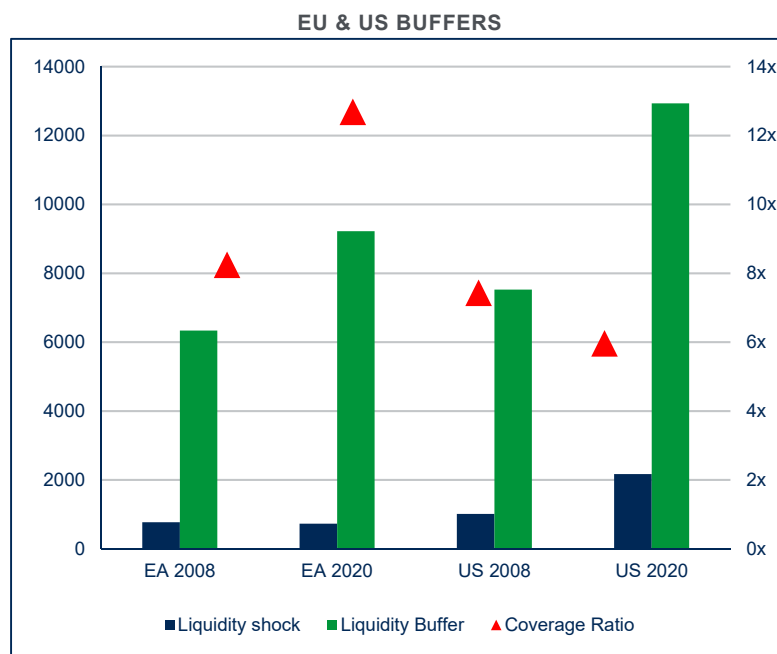
Why it's So Hard to go Bankrupt... And why that will Change

Massive policy response has firms awash in liquidity, but 2021 will bring solvency challenges that investors need to watch closely.

There are times when it's hard to keep a company afloat, and then there's the current global pandemic, when it's apparently hard to go bankrupt. But pay close attention next year, when the world's chief financial officers will face much more complex challenges to keep their firms afloat.

So far, the economic brunt of the pandemic has fallen on small businesses shuttered amid lockdown measures and the millions of people tossed out of work. Comprehensive policy action, however, has managed to keep most firms with access to credit markets awash in liquidity and unconcerned about rolling over debts, even in the face of uncertain demand.

In fact, European and U.S. firms have amassed liquidity buffers that could easily cover a shock many times larger than the Global Financial Crisis in 2008, according to our [analysis](#). European firms have been shoring up their short-term assets over the last two decades, while they and their U.S. counterparts took full advantage of all the cheap credit and subsidies their governments helped orchestrate.



Source: Bloomberg. Haver. As of November 30, 2020.

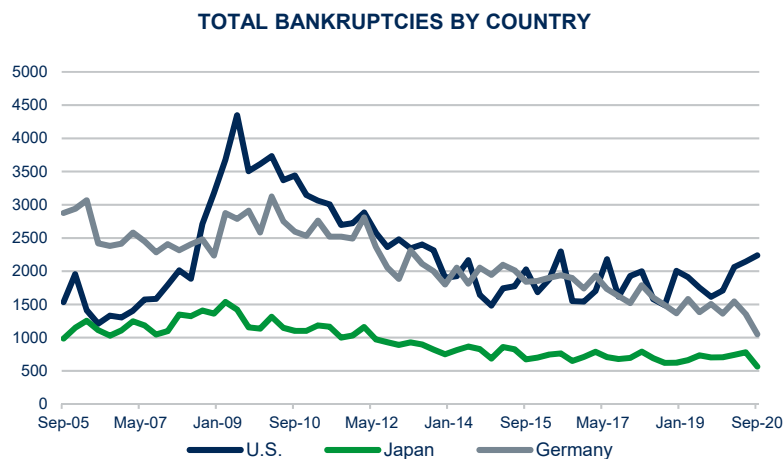
This makes it relatively easy to conclude that a major shock to the system—say, an unexpected mutation of the virus that requires new lockdowns or a sudden outbreak of Middle East hostilities—would be unlikely to trigger a systemic cascade of defaults and bankruptcies. Never say “never,” but it’s hard to imagine.

The much harder question is what will happen under the far more likely scenario as firms return to normal next year and the systemic help begins to fade away? For now, we expect still more support when the European Central Bank [announces its plans](#) for expanded asset purchases on December 10. And Treasury Secretary-designate Janet Yellen signaled she is ready to act to address economic damage she described as “[an American tragedy](#).” Still, firms have to plan on rising calls in the U.S. Congress and elsewhere to begin curtailing government support.

One encouraging element in our analysis is that even with all this short-term liquidity, the maturity of corporate debts has been rising. In the euro area, long-term liabilities have risen to 92% of liabilities, up from 83% in 2008. The average maturity of U.S. investment grade firms now stands above 12 years, compared to 9.5 years in 2004.

Financial markets seem optimistic, too, as equity valuations soar and credit spreads tighten. And most banks look resilient, with a [sampling of 350 in 29 jurisdictions](#) weathering the shock projected by the International Monetary Fund well above their regulatory capital ratios.

But [a fresh study](#) by the Bank for International Settlements offers a note of caution following an examination of the historical relationship between economic growth and expected default frequencies (calculated from asset prices, market volatility and book values). While bankruptcies so far have been lower than previous averages due to government support, favorable markets and lockdown measures that delay procedures, these economists warn that slower growth may drive bankruptcies next year 20% higher.



Whether bankruptcies spike or not, the good vaccine news and a return to normal will immediately create new headaches and far more complex challenges for corporate managers. If this year was about tapping liquidity and reinforcing IT platforms so employees could work from home, next year will bring more expensive money, less predictable consumers and renewed trade friction.

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Inflation remains an aspiration rather than a worry, so interest rates will not spike in even the most bullish scenarios. Still, firms will find it more expensive to hold so much short-term liquidity and they will need to reassess their options. Some will happily buy back stock or pay special dividends, but others will go shopping amid a likely spree of fresh mergers and acquisitions.

Then there is understanding what the new “normal” means. For financial analysis, [one accountant calls it “EBITDAC”](#)—earnings before interest, taxes, depreciation, amortization and COVID-19. But consumer patterns were already changing before the pandemic, and firms need to be fast on their feet to understand the shifting accelerating preferences for more online shopping or less business travel. These will have implications far beyond retailers and transportation to reshape some real estate, manufacturing and even commodities producers.

Finally, next year will bring a renewal of trade tensions that the pandemic (and U.S. elections) put on the back burner. President-elect Joe Biden has already signaled he is [not ready to remove tariffs](#) on China right away and plans to consult allies first. The souring relations between China and Australia, however, suggest the next chapter will likely be anything but smooth.

It may be a stretch to say that corporate managers will look back fondly on 2020, but their choices are about to turn much more complicated as investors shift their attention from short-term liquidity to solvency and sustainable profits.

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