ZOMBIE APOCALYPSE LOOMING?

THE DEAD DON'T DIE. WHAT ABOUT THE FIRMS?

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The term "ZOMBIE" has been put back on the front pages recently, mainly because of the last Jim Jarmush's movie: "The Dead don't die" which was presented during the opening ceremony of the last Cannes film festival.

In this hilarious comedy Jarmush revisits the so called "Zombies movies" of the 60's and 70's. A funny and intelligent homage to the old masters like G. Romero (See picture below).

A few months before, the BIS released a report that the public probably never heard about:

"THE RISE OF ZOMBIE FIRMS: CAUSES AND CONSEQUENCES"

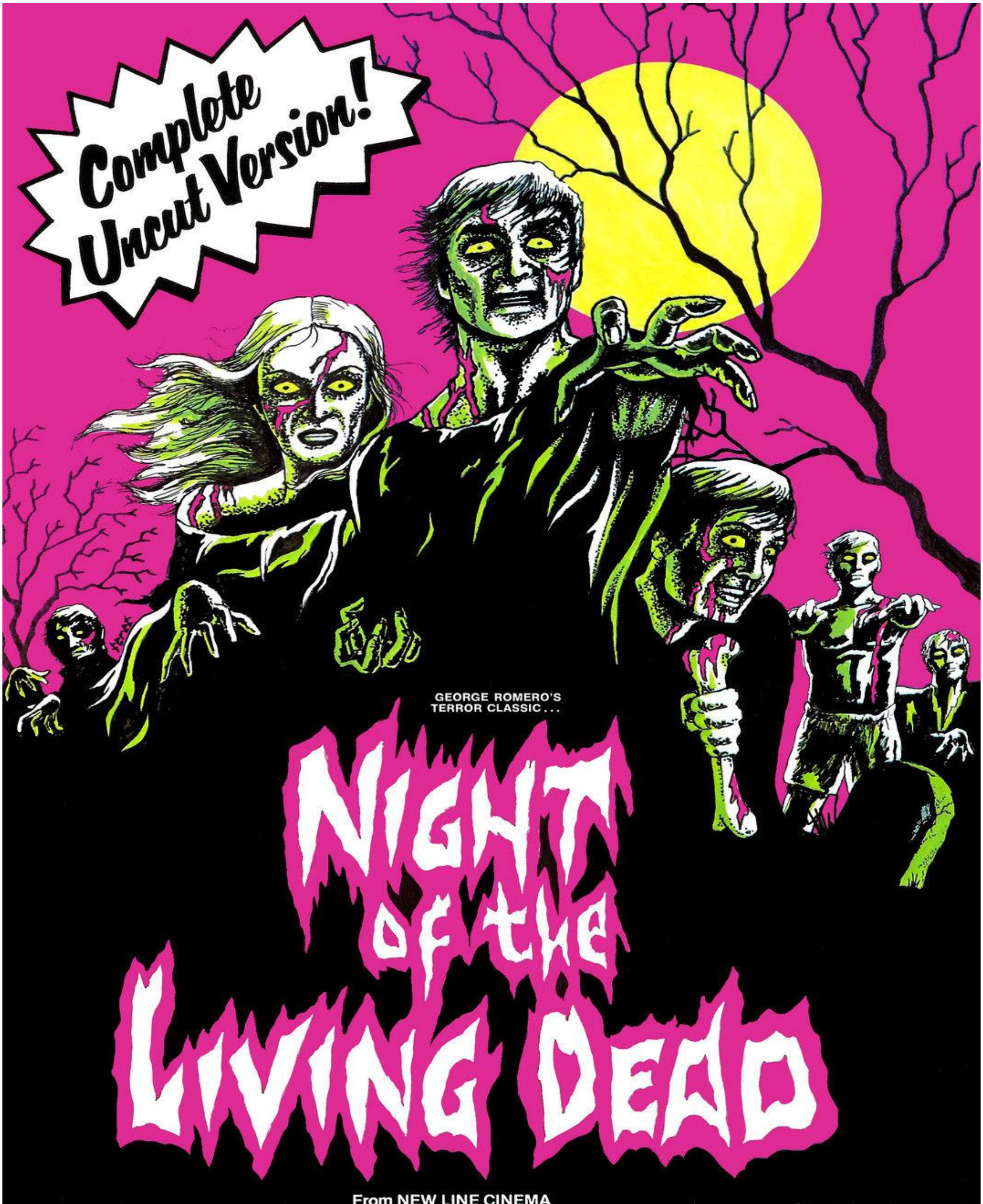
In this very interesting article, the co-authors ask three essential questions:

1/ Is the worldwide increase in the number of zombie firms episodic?

2/ What are the causes of the rise of zombie firms?

3/ What are the economic consequences of the rise of zombie firms?

This, mainly, academic report triggered a lot of debate and a flurry of private research firms detailed articles. What we propose to do here is to offer you a synthetic view of this issue. The seriousness of this issue having been emphasized very recently, by the near-bankruptcies of Rallye in France, Bristish Steel in the UK and the collapse of the Tesla share price in the US, all three events taking place during the last 10 days of May…



If it doesn't scare you, you're already dead!

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Introduction

But what exactly is a zombie company? In the BIS report they are defined as "Firms that are unable to cover Debt servicing costs from current profits over an extended period". The period of time can vary, the BIS used 3 years for example. And it's quite possible to narrow the samples by using stricter criteria like the firm must be more than 10 years old for instance. It seems that whatever the criteria used in all the reports we have seen, the results are quite similar with respect to the **current** profitability of these firms. ALMOST ALL OF THEM LOSE MONEY! And therefore their ICR (Interest coverage ratio) is very negative (Below -7 for the median ICR in the BIS report compared to a median ICR above four times earnings for NON Zombie companies).
So your typical Zombie firm is losing money, is already heavily in debt and is racking up more debt, as it promises its shareholders that profitability is on its way! So although it is still moving, your typical Zombie firm is either already dead or dying slowly but surely.

Is the worldwide increase in the number of zombie firms episodic?

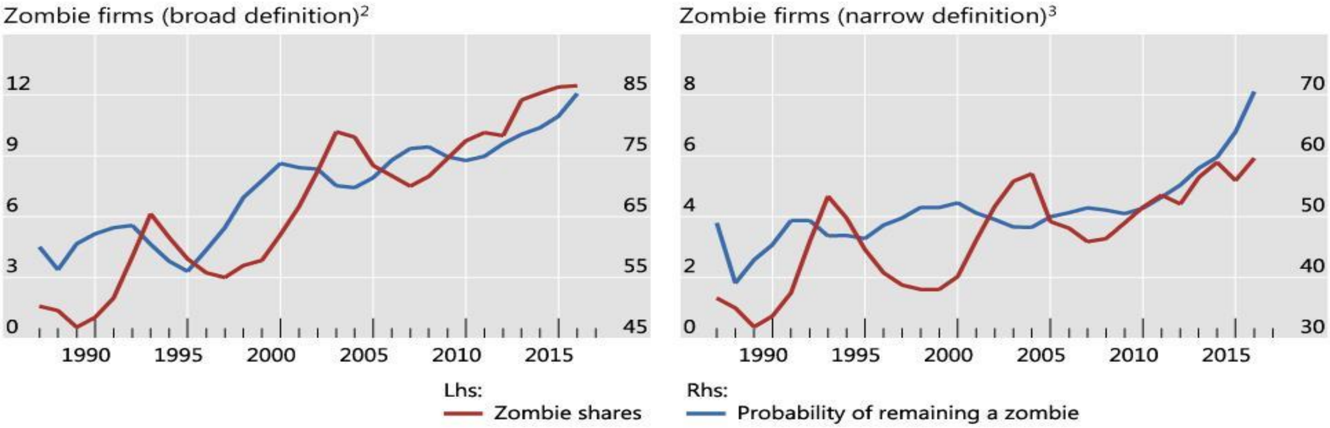
And all the studies on the subject make the same observation: the prevalence of zombies has increased significantly since the 1980s! Across 14 advanced economies, their share rose, on average, from around 2% in the late 1980s to some 12% in 2016 according to the BIS . According to Bank of America Merrill Lynch, 13% of companies in the developed world are "Zombified" (and 16% in the US…), a number that has been rising in the previous decade despite the economic recovery. The number of zombie firms has only ever been higher (by about 15%) during the Great Recession. A short spike in zombie companies during a recession is understandable, but how could there be a sustained rise in "Zombified" firms during good economic times?
So, very clearly, this steady increase is NOT an episodic phenomenon!
But then, what where the causes of the relentless rise in the number of Zombie firms during the last few decades?

The Causes

Indeed, since the late 1980s, zombie firms have been on the rise, but perhaps more surprisingly, they seem to survive for longer than in the past as shown by the following graph:

Zombie firms are on the rise and survive for longer[1]

In per cent — Graph 2



[1] Simple averages of zombies as a share of all listed non-financial firms in the Worldscope database from Australia, Belgium, Canada, Denmark, France, Germany, Italy, Japan, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. [2] Firms with an interest coverage ratio less than one for three consecutive years and over 10 years old. [3] Broad zombies with a Tobin's q below the median firm in the sector in a given year.

Sources: Banerjee and Hofmann (2018); Datastream Worldscope; authors' calculations.

Chart 1 source: BIS Quarterly review

They seem to face less pressure to reduce debt and cut back activity. And in contrast to what might be expected, the BIS report shows that the main change does not coincide with the GFC, but occurred in the early 2000s!
Post-2000 the zombies' deleveraging speed started to slow down significantly.
As deleveraging has slowed, zombies have been locking in more resources, hindering reallocation. The reduced pressure on zombies does not reflect a relative improvement in their profitability. There was no significant increase in zombies' earnings before interest payments and taxes (EBIT) relative to total assets compared with non-zombies, either since 2000 or since 2009.
See graph below:

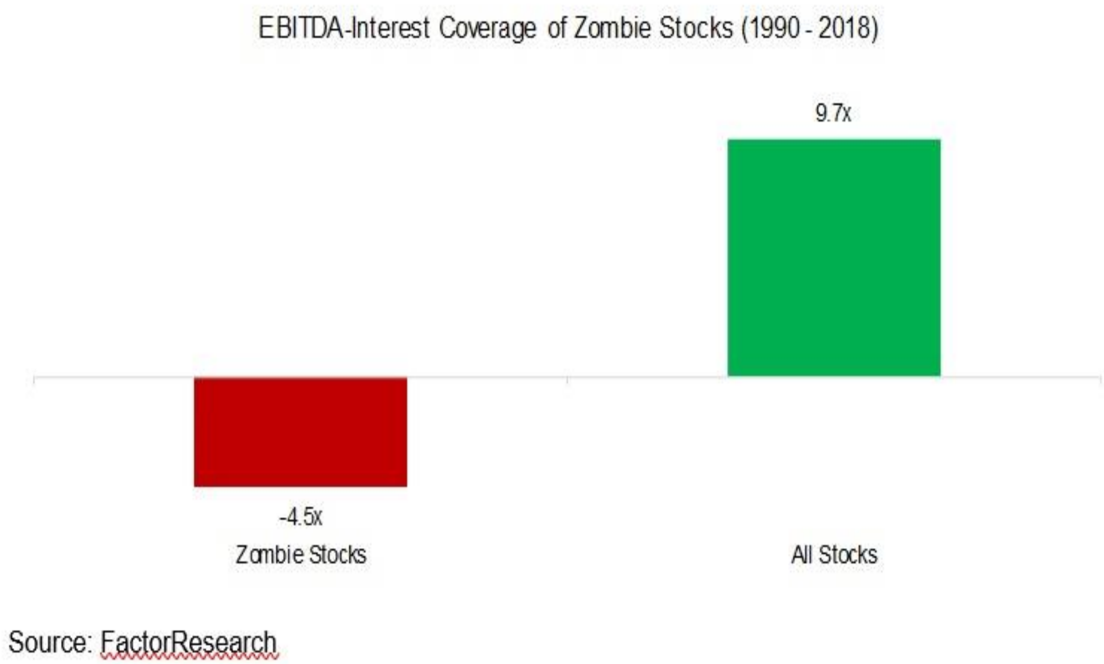


Chart 2 source: FactorResearch.com

Which factors explain this change in zombies' behavior? For the BIS: "An important one is the potential weakness of banks. When their balance sheets are impaired, banks have incentives to roll over loans to non-viable firms rather than writing them off. Formal evidence suggests that weak banks indeed played a role in the wake of the GFC". By inhibiting corporate restructuring, poorly designed insolvency regimes were also at work according to the BIS analysts. But another KEY factor was at play all the time. Which one?

The answer, quite simply, is artificially and historically low interest rates worldwide. The Federal Reserve and other central banks across the world have pushed down interest rates and held them near zero over the past decade. In Europe and Japan, many rates are in negative territory. And this isn't even to mention the unprecedented expansion of central bank balance sheets.

Ultra-loose monetary policy across the world has spawned this zombie apocalypse in two ways: **First**, by allowing companies to borrow cheaply and thus stay afloat longer than they would if rates were in a historically normal range; and **second**, by increasing the attractiveness of chasing returns in speculative assets over and against the ultra-low returns from government bonds.

As the BIS report demonstrated: "More generally, lower rates may create incentives for risk-taking through the risk-taking channel of monetary policy.

Since zombie companies are risky debtors and investments, more risk appetite should reduce financial pressure on them.” Zombie for longer….

This same report suggests that the share of Zombie firms is indeed negatively correlated with interest rates (and, to a lesser extent, the health of the banking system). Their estimates suggest that “the 10 percentage point decline in nominal interest rates since the mid-1980s”, when Fed Chairman Alan Greenspan first stepped in to backstop markets (the famous "Greenspan Put") “may account for around 17% of the rise in the zombie share in advanced economies when evaluated at the average industry external finance dependency ratio.”…

An excellent study by FactorResearch clearly shows that the two economic sectors which have most contributed to the increase are Biotechnologies and Technology. So, two sectors in which companies are often more focused on growth rather than profitability. See chart 3 below.

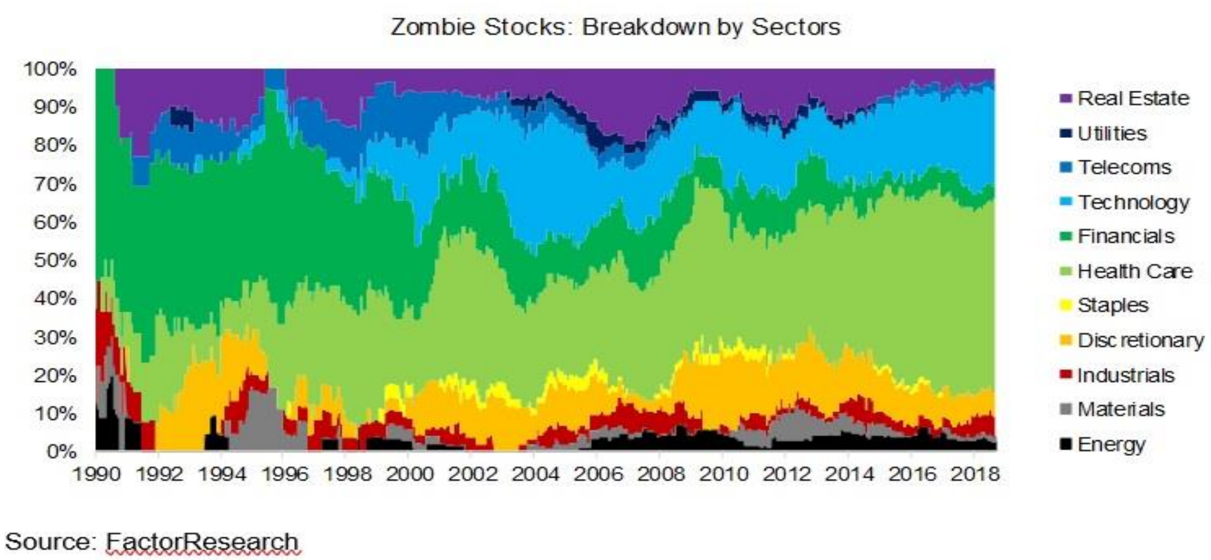


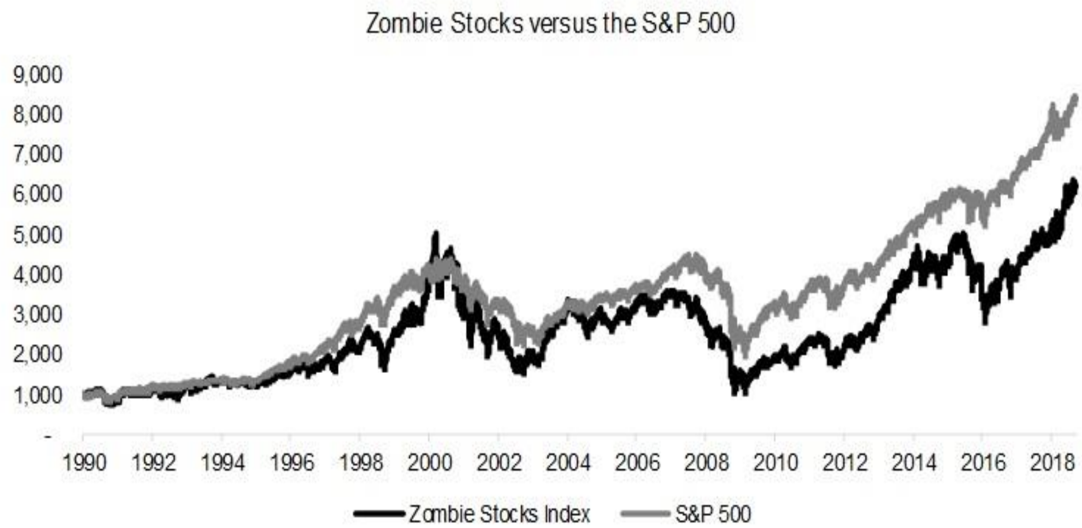
Chart 3 source: FactorResearch.com

Studies on some Japanese Zombies companies seem to indicate that these firms are mainly concentrated among small- and medium-sized enterprises, which likely also holds true in the United States and other developed countries. But zombie companies can certainly be larger, as in the case of some big Chinese SOE.

The Consequences

It is difficult to argue that the surge in the number of Zombies is good news for the economy….

Although one might assume that Zombie stocks will underperform the market, they do surprisingly well, almost matching the S&P500 performance as the graph below will show you:



Source: FactorResearch

Chart 4 source: FactorResearch.com

One might expect as well that these stocks trade at low valuations given their unhealthy financials characteristics. Quite the opposite in fact! They are trading on a much higher price to book multiples than the average stock (especially since 2012) as you can see below:

Source: FactorResearch

Chart 5 source: FactorResearch.com

And it is precisely because of these facts that we can conclude like many economists: “Longer lifespans for “Zombified” companies is not good for the economy”.
In its last study on the subject, the OECD listed three ways in which zombie companies drag down their respective economies (and, indirectly, the global economy). Here they are:

- Crowding Out. The longer a zombie company survives, the longer it will soak up society's finite resources and prevent them from being used on more productive enterprises. "Zombies are less productive and may crowd out growth of more productive firms by locking resources (so-called 'congestion effects')," writes the OECD. "The estimates indicate that when the zombie share in an economy increases by 1%, productivity growth declines by around 0.3 percentage points.". And remember that GDP growth is a function of the productivity growth…..

- Capital Misallocation. Not only do zombie companies crowd out healthy companies, they also do plenty of wasteful spending themselves. A study of Chinese manufacturing companies demonstrates that zombie firms promote overcapacity — when an industry has the capacity to produce much more than existing demand could satisfy. Many zombies either produce more or build out the capacity to produce more in an attempt to turn a profit, even if the market is not calling for increased production.

- Delayed Technological Diffusion. Another consequence of zombie companies' tendency to misallocate capital and crowd out more productive companies is a gradual fall in investment and innovation.
HSBC senior economist Stephen King agrees with the above line of reasoning that these negative outcomes are a result of ultra-loose monetary policy over the previous decade. The higher asset prices spurred by excessive easing masked company issues and prevented the need for cost-cutting.
"Capital markets were thus no longer able easily to perform their central function, namely the efficient allocation of capital. Too much capital stayed in bloated and inefficient companies leaving too little to support the growth of smaller, more dynamic, enterprises."
This goes a long way in explaining why productivity growth has been slowing since the 1980s and especially since the GFC. It can also explain the lack of a strong bounce in domestic investment after the recession.
King's proposed solution to the problem is simple: "Let already-dead — or 'zombie' — companies collapse."
The OECD concurs, saying, "Reforms that accelerate corporate restructuring can have powerful effects on productivity." It turns out that creative destruction is hampered when the "destruction" part is diminished, but it can be rejuvenated by letting the whole process work.

One way to do this (probably the most straightforward way) would be to normalize interest rates to a historically average range, comes what may in the financial markets. But after the Central Banks coordinated offensive to halt a decline in the stock markets of barely 6% at the beginning of June 2019, don't hold your breath…. It will certainly NOT happen as this would undoubtedly cause significant short-term pain in terms of layoffs and wealth destruction in the markets.

Conclusion

In lieu of such reforms, it appears the rising tide of zombie firms will contribute further to the low-growth, low-inflation, low-rates future we are likely to see. And with the promise of more rates cuts coming soon everywhere, and the re-start of various QE policies in a not too distant future, the odds are high that their number will keep going up AND that they will all survive for longer….. And as N. Rabener from FactorResearch.com put it nicely: "The last three decades in Japan highlight that letting zombie companies roam freely is likely detrimental for economic growth and society, much like in literature and in the movies."
So there is no need to panic just yet, the streets of the financial districts will not look like the picture below anytime soon!

B. SYRMEN
12th of June 2019

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