COFACE ECONOMIC PUBLICATIONS

9 JULY 2020

FOCUS

By Ruben Nizard,
Economist - North America,
based in Toronto, Canada

United States: Two-speed business bankruptcies

EXECUTIVE SUMMARY

The COVID-19 pandemic has hit the United States (U.S.) very hard, inflicting a heavy human and economic toll. The abrupt halt in activity to contain the spread of the coronavirus from March onwards has resulted in a 5% contraction in the first quarter of 2020 year-on-year (YoY), the sharpest drop recorded since 2008, as well as a surge in the unemployment rate. While the economy has already been declared in recession[1], the decline in GDP is expected to be even more severe in the second quarter. The gradual reopening, which began across the U.S. in May, should allow the economy to gradually recover. In its baseline scenario, Coface forecasts GDP to contract by 5.6% in 2020, before rebounding by 3.3% in 2021. Nevertheless, the resurgence of outbreaks in several states - including Texas, Florida and California - in June, which will slow or even reverse the reopening process, exposes this forecast to significant downside risks.

The double economic shock of supply and demand has already resulted in a sharp drop in companies' revenues, pressuring their cash flow. This situation should lead to an increase in the number of companies unable to meet their financial obligations, pushing them into bankruptcy. Nevertheless, similar to the European trend[2], official data from the Administrative Office of the U.S. Courts for the first quarter, and the anticipated publications of the American Bankruptcy Institute (ABI) for April and May, suggest a decline in the total number of business bankruptcies since February. This trend is particularly due to Chapter 7 bankruptcy filings **(see Box)**.

Despite this trend, the increase in the number of companies seeking Chapter 11 bankruptcy protection is worth mentioning, probably heralding an overall rise in bankruptcies from the second half of 2020 onwards. Given the magnitude of the shock and as support measures gradually expire, Coface forecasts a 43% increase in business bankruptcies between end-2019 and end-2021 in the United States. The health of aggregate company balance sheets highlights that the aerospace, retail, automotive and energy sectors are the most vulnerable. Our estimate shows that the number of "zombie" companies, which continue to operate despite precarious solvency and profitability, has increased over the last decade and accounted for more than 6% of companies in 2019. These companies could also be pushed into bankruptcy in the coming months. More importantly, with more companies forced to leverage debt to cope with revenue losses, the threat of a multiplication of distressed companies is added to the risk of bankruptcy.

1 - In the United States, the National Bureau of Economic Research's Business Cycle Dating Committee identifies a recession differently than the traditional method of two consecutive quarters of contraction. On 8 June 2020, the Committee identified a peak in activity in February 2020, marking the beginning of the first recession in the United States since June 2009.

2 - See « Corporate insolvencies in Europe: temporary framework amendments kick the can down the road», by Bruno de Moura Fernandes, Coface Focus (June 2020). https://www.coface.com/News-Publications/Publications/Focus-Corporate-insolvencies-in-Europe-temporary-framework-amendments-kick-the-can-down-the-road

ALL OTHER GROUP ECONOMIC PUBLICATIONS ARE AVAILABLE ON:
http://www.coface.com/Economic-Studies

coface FOR TRADE

Two chapters, two trends

Although the crisis triggered by the coronavirus pandemic interrupted the longest expansion cycle of the US economy since 1854 (10 years and 8 months), the year 2019 as a whole saw the first annual increase in bankruptcies since 2009.

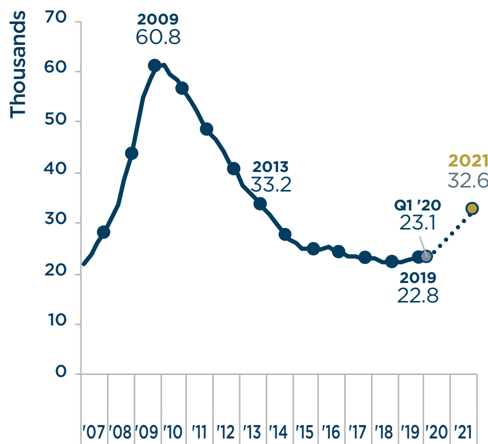
The slowdown in economic activity, led by the manufacturing industries, and the accumulation of bankruptcies in vulnerable sectors such as retail and the US shale industry contributed in reversing the trend. In total, according to data published by the Administrative Office of the US Courts, proceedings initiated in 2019 increased by 2.5% compared to 2018 **(Chart 1a)**. The data published at the end of Q1 2020 show that, after a 21% YoY surge **(Chart 1b)** in January, business bankruptcy proceedings began to decline from February onwards. Despite the implementation of lockdown measures to limit the spread of the coronavirus, they also fell slightly in March and then throughout April and May **(Chart 2)**.

These months also highlight a divergence between Chapter 7 bankruptcy filings, which have fallen significantly, and Chapter 11 bankruptcy filings, that have risen sharply. Despite the rise of the latter, bankruptcy proceedings have seemingly declined substantially, echoing the trend in Europe.

Three main reasons can explain this drop. First, even though they continued to operate, bankruptcy courts had to close their doors from March onwards. While it is difficult to estimate the impact of this adjustment on their activity, it is conceivable that it led to a decrease in the number of companies filing for bankruptcy.

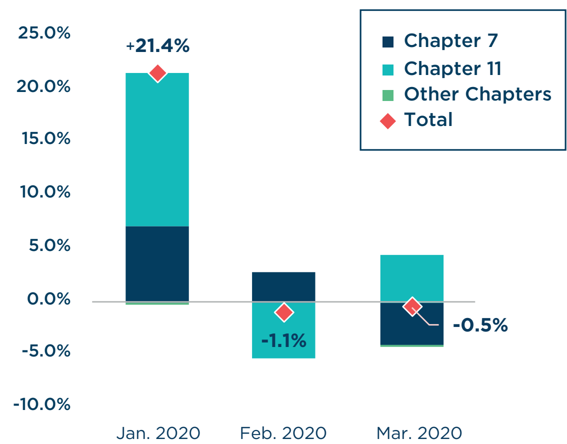
Secondly, this decline may be due to a wait-and-see attitude among debtor companies. Indeed, Chapter 7 of the Bankruptcy Code is a liquidation procedure, whereby the firm (or the individual in the case of a sole proprietorship) discloses all its assets, income, debts and expenses. The judicial representative then sells the assets of the business and the proceeds of the sale are used to reimburse creditors. Through this procedure, the

CHART 1A
Business bankruptcies in the United States (2007-2021), Quarterly, 12-month moving sum



Sources: Administrative Office of the US Courts, Coface

CHART 1B
Percentage change in business bankruptcies in the United States and contribution by chapters, Monthly, Year-on-year change



Sources: Administrative Office of the US Courts, Coface

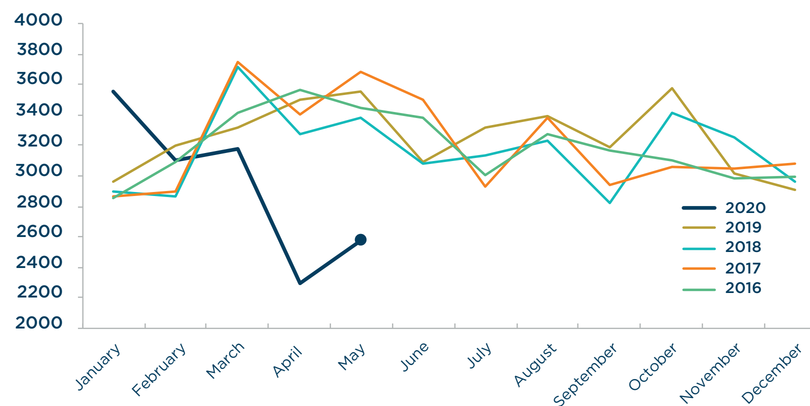
THE U.S. BANKRUPTCY CODE
(Title 11 of the United States Code)

The United States Bankruptcy Code governs the proceedings of companies and/or individuals filing for bankruptcy. Entities seeking relief from some or all of their debt under the Bankruptcy Code may file for bankruptcy under different chapters depending on the circumstances. For companies, the two most commonly used chapters are:

- **CHAPTER 7 – LIQUIDATION:**
  Accounting for nearly 64% of business bankruptcy proceedings in 2019, this court-supervised process involves the sale of assets and the disbursement of sales revenue to creditors by a trustee, in accordance with the priorities established by the Bankruptcy Code.
- **CHAPTER 11 – REORGANIZATION:**
  This process, which accounts for over 25% of proceedings in 2019, enables a company to continue its activity while implementing a debt restructuring.

Furthermore, proceedings under Chapters 12 and 13 of the Bankruptcy Code may also be sought to reorganize corporate debt. Chapter 13 (7.2% of business bankruptcies in 2019), which can only be filed by an individual, is mainly aimed at sole proprietorships. Chapter 12 (2.7% of bankruptcies in 2019), very similar to Chapter 13, is aimed more specifically at “family farmers” and “family fishermen”.

CHART 2
Monthly commercial bankruptcies in the United States



Sources: Epiq, American Bankruptcy Institute, Coface

company or entrepreneur is thereby debt-free, but has to cease business operations permanently. Since involuntary proceedings (initiated by creditors who want to be paid) are fairly rare, only the most distressed businesses with no prospect of recovery are likely to have chosen the Chapter 7 route during the months of lockdown.

Finally, it is also likely that support measures for companies have enabled them to keep their cash flow in check. For instance, as early as 17 March, the federal government announced an extension of the deadline for corporate income tax payments to 15 July, instead of 15 April originally. The CARES[3] Act also includes a number of tax and expenditure deferrals to support corporate liquidity during this exceptional period of revenue squeeze. The Paycheck Protection Program (PPP) has also provided small and medium-sized enterprises (SMEs) with cash flow assistance through loans guaranteed by the Small Business Administration, a U.S. government agency. In addition to the federal response, State and local tax authorities have also provided tax relief. More broadly, given the scale of the crisis, companies benefited from more time to settle their debts. Unlike in Europe, the decline in business bankruptcies cannot be attributed to changes in the legislative framework.

Nevertheless, despite this decline, and as mentioned above, courts recorded a significant increase in Chapter 11 filings during the months of March, April and May. According to ABI figures, Chapter 11 commercial bankruptcy filings jumped by 18%, 26%, and then 48% in these months disrupted by lockdown measures. While not offsetting the substantial decline in liquidations, this increase reflects the early effects of COVID-19. Hertz, Le Pain Quotidien, J.C. Penney, Whiting Petroleum are among the companies that were forced into reorganization proceedings during this period.

Besides the activity stoppage, the increase in Chapter 11 bankruptcy filings may also be linked to the implementation, on 19 February, of the 2019 Small Business Reorganization Act. This Act introduces the new subchapter V of Chapter 11, specifically designed to make bankruptcy protection more accessible to small businesses in difficulty, by eliminating quarterly fees and shortening the procedure. The main piece of legislation passed by Congress in end-March to support the U.S. economy, the CARES Act, also includes provisions that temporarily modify this new subchapter V. More specifically, eligibility has been broadened by increasing the debt ceiling for "small debtor companies" to USD 7.5 million, from just over USD 2.7 million previously. Although it is too early to estimate the impact on business bankruptcies, these changes should encourage more companies to seek Chapter 11 protection.

The continuous rise in Chapter 11 bankruptcy filings should be accompanied, in the coming months, by an increase in Chapter 7 filings, since part of the reorganization proceedings will be converted into liquidation. More broadly, with the return of activity, increased pressure on corporate payment deadlines and the expiry of support measures should contribute to a rebound in bankruptcies beginning from the second half of 2020. In total, according to Coface's forecasting model for business bankruptcies, the latter should increase by 43% between end-2019 and end-2021. In comparison, during the last recession, business bankruptcies increased by 54% in 2008, then by 40% in 2009. The number then fell for nine consecutive years before rising in 2019.

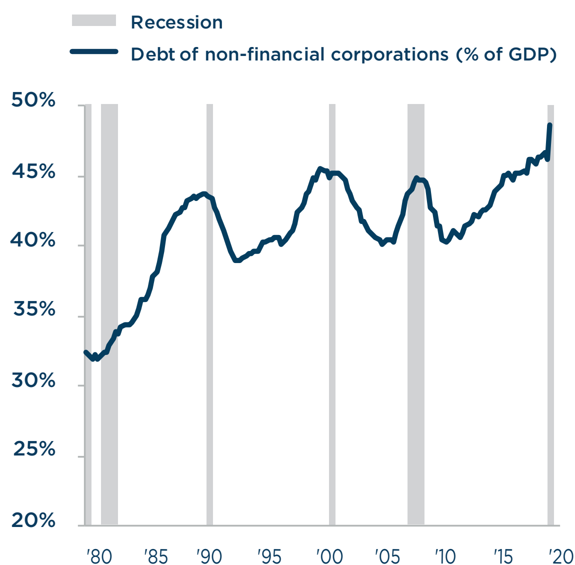
Bankruptcies and "zombification" threaten debt-laden businesses

The rise in business bankruptcies in the coming months seems all the more inevitable as the accumulation of debt by non-financial corporations has been very fast since the last crisis, peaking at a record level of almost 47% of GDP at the end of 2019 **(Chart 3)**. With companies struggling to secure sufficient liquidity to cope with the coronavirus crisis, debt accumulation is continuing to escalate and has already reached a new all-time high of 48.7% at the end of Q1 2020[4].

The historically low interest rates of the Federal Reserve following the 2008-2009 recession have encouraged this debt accumulation, which increases financial vulnerabilities. Particularly, those with short-term financial obligations will be highly exposed to bankruptcy given the shock on income and cash flow. To identify the most vulnerable sectors, we use the Quarterly Financial Report published by the US Census Bureau, which provides aggregate information by sector, on financial results and balance sheets of companies with more than USD 5 million in assets. More specifically, we look at the two following indicators:

- Leverage ratio[5], to identify the sectors that use debt the most to build up their capital. The higher the ratio, the greater the company's reliance on debt to finance its assets;
- Quick ratio[6], which provides information on a company's ability to meet its short-term commitments with its liquid assets. A low ratio means that a company has fewer liquid assets to meet its commitments.

CHART 3
Debt of non-financial corporations (1980-Q1 2020), in % of GDP



Sources: Federal Reserve, BEA, Datastream, Coface

3 - Coronavirus Aid, Relief, and Economic Security Act (CARES Act) promulgated by President Donald Trump on 27 March 2020.

4 - The debt of non-financial corporations is taken from the Flow of Funds series of the Federal Reserve and is defined as the debt securities and loans of the non-financial corporate sector. According to data from the Institute of International Finance (IIF), the debt of non-financial corporations in the United States reached a record level of 73.9% of GDP at the end of 2019. This is higher than in Germany (59.7%) or Italy (68%), but lower than in France (155.8%), Canada (112.4%), Japan (104.7%), Spain (94.5%) and the United Kingdom (80.2%). See also "Are corporate balance sheets in Spain and Italy ready for the COVID-19 shock?" by Marcos Carias, Coface Focus (June 2020). *https://www.coface.com/News-Publications/News/Are-corporate-balance-sheets-in-Spain-and-Italy-ready-for-the-COVID-19-shock*

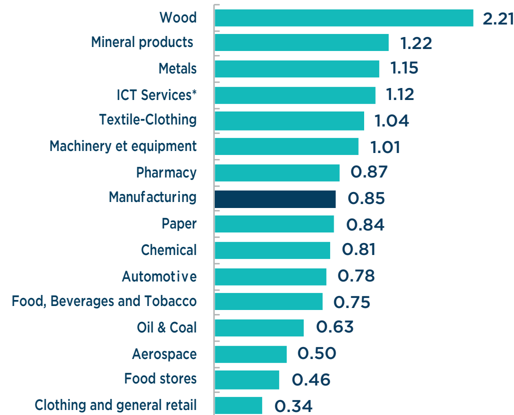
5 - Leverage ratio = $\frac{\text{Total Liabilities}}{\text{Total Assets}}$

6 - Quick ratio = $\frac{\text{Currents assets - Inventories}}{\text{Current Liabilities}}$

CHART 4A
Leverage ratio, by industry, 4th quarter 2019

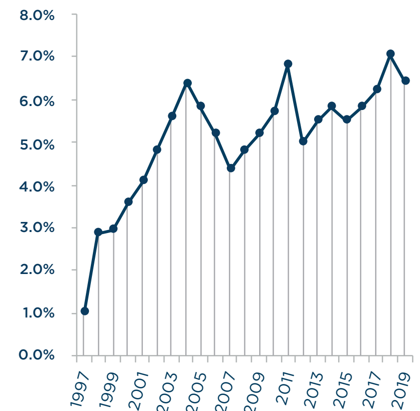
*ICT= Information & communication Technology
Sources Charts 4A & 4B: US Census Bureau, Coface

CHART 4B
Quick ratio, by industry, 4th quarter 2019



*ICT= Information & communication Technology

CHART 5
Estimated share of "zombie" companies, listed companies in the U.S.



Sources : Refinitiv, Datastream Worlscope Coface

For most industries, the leverage ratio **(Chart 4a)** is above 0.5, indicating that assets are financed primarily by debt. The hierarchy, however, shows that the retail, transport (aerospace and automotive), paper and pharmaceutical sectors are the most leveraged. While this ratio has always been among the highest for the aerospace sector over 20 years of historical data, which may indicate a sectoral structure rather than increased vulnerability, it is worth noting that it has been steadily increasing since 2010. This upward momentum can also be observed in the clothing and general merchandise retail sector (particularly since 2011-2012) and seems consistent with the numerous Leveraged Buyout (LBO) transactions experienced by the sector over the period.

However, while this indebtedness indicator provides an initial view of the level of vulnerability of each sector, it does not identify which sectors are likely to be most immediately exposed to financial pressures because of the coronavirus shock. The quick ratio **(Chart 4b)** is, in this regard, more informative. It points to a fragile liquidity situation in the retail sector prior to the COVID-19 crisis. Therefore, the numerous recent bankruptcies in this sector do not seem surprising considering the balance sheet situation in the sector. The aerospace industry, also hit hard by the crisis triggered by the pandemic, appeared particularly illiquid. Although they did not look particularly indebted, manufacturers of oil and coal products could also run into difficulties to meet their financial obligations. Slightly lower down in this hierarchy is the automotive sector.

In this context, this increase in debt also fuels fears of a rise in the number of "zombie" companies. These are indebted and unprofitable companies that keep themselves alive by borrowing, taking advantage of low interest rates. According to our estimate, based on a sample of listed companies in the United States, the share of "zombie" companies has indeed increased in recent years, accounting for more than 6% of companies in 2019 **(Chart 5)**. Although we favor a broader definition for this estimate (an interest coverage ratio[7] of less than 1 for three consecutive years) the share could be higher because SMEs are likely to be more affected by this phenomenon.

The accumulation of debt to offset the revenue shock observed in the first quarter lays the foundations for an increase in zombie companies. Literature suggests that less productive zombie firms tend to crowd out investment and employment in more productive firms[8]. This shock could also lead to the bankruptcy of businesses in this situation prior to the crisis. Retailer J.C. Penney, mentioned above, was widely regarded as one of the zombies that eventually began restructuring its debt. "Zombification" will be a risk to monitor in the coming months.

DISCLAIMER

This document reflects the opinion of Coface's Economic Research Department at the time of writing and based on the information available. The information, analyses and opinions contained herein have been prepared on the basis of multiple sources considered reliable and serious; however, Coface does not guarantee the accuracy, completeness or reality of the data contained in this guide. The information, analyses and opinions are provided for information purposes only and are intended to supplement the information otherwise available to the reader. Coface publishes this guide in good faith and on the basis of commercially reasonable efforts as regards the accuracy, completeness, and reality of the data. Coface shall not be liable for any damage (direct or indirect) or loss of any kind suffered by the reader as a result of the reader's use of the information, analyses and opinions. The reader is therefore solely responsible for the decisions and consequences of the decisions he or she makes on the basis of this guide. This handbook and the analyses and opinions expressed herein are the exclusive property of Coface; the reader is authorised to consult or reproduce them for internal use only, provided that they are clearly marked with the name «Coface», that this paragraph is reproduced and that the data is not altered or modified. Any use, extraction, reproduction for public or commercial use is prohibited without Coface's prior consent. The reader is invited to refer to the legal notices on Coface's website: https://www.coface.com/Home/General-informations/Legal-Notice.

7 - It is a ratio of interest payments to operating margin. It is used to estimate the ease with which a company can pay interest on its debt.
8 - "The rise of zombie firms: causes and consequences" by R. Banerjee & B. Hofmann, BIS Quarterly Review (September 2018). https://www.bis.org/publ/qtrpdf/r_qt1809g.pdf

July 2020 - Layout: Cécile Bélonie - Photo © Shutterstock

COFACE SA
1, place Coste et Bellonte
92270 Bois-Colombes
France

www.coface.com

coface FOR TRADE