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Halle Institute for Economic Research
Member of the Leibniz Association

Press Release 10/2020

Halle (Saale), 17th June 2020

High risk of corporate bankruptcy due to the corona shutdown

no press embargo

The Corona shutdown increases the probability of corporate bankruptcy. An analysis based on corporate financial statements from 2014 to 2018 reveals that in the United Kingdom, 73% of shutdown firms are not able to cover interest expenses from earnings before interest and taxes if they lose one twelfth of annual turnover. In Germany, the fraction amounts to 81%.

Since the outbreak of the Corona pandemic many countries have shutdown large parts of their economy. While this helps to mitigate the spread of the virus, the shutdown comes with severe economic costs. One negative consequence of the shutdowns is that firms lose turnover while costs are hardly reduced. In particular, firms need to serve their debt and pay interest to banks. In accommodation, for example, firms in Germany and in the United Kingdom have lost about 50% of turnover in March 2020 compared to one year before. The transport sector, travel agencies and many retail sectors are also heavily affected. The longer a shutdown lasts, the more firms will not be able to cover their interest expenses. In a one-month shutdown, 81% of firms in affected industries in Germany come under financial distress and 73% of firms in the United Kingdom (see Table). Financial distress is defined as a situation in which interest expenses exceed earnings before interest and taxes. If the shutdown lasts longer, about three months, nearly all firms in shutdown industries will face risk of bankruptcy and many firms in the other sectors will be financially distressed as well.

Both Germany and the United Kingdom have implemented furlough schemes which reduce salary payments and social security contributions of firms. This helps to some extent. However, even if the complete cost of employees is refunded by the state to shutdown firms, the risk of bankruptcy increases dramatically. Even in this case the risk of bankruptcy increases to 71% in Germany and to 61% in the United Kingdom. There are small differences between size groups of firms, but in general all size groups will exhibit a severe increase in the probability of bankruptcy.

The occurrence of bankruptcies may be staggered. The full extent will only be visible after some time. This implies huge economic risks. A large wave of bankruptcies might jeopardise the economic recovery and lead to a double-dip recession after the mitigation of shutdown measures has initiated an initial catching-up process. The economic risk should be considered in the design of further official measures to mitigate the Coronavirus pandemic.

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Germany: Federal Ministry of Economic Affairs and Energy, Federal Ministry of Finance, Federal Chancellery, Economic and Finance Ministries of the German States.
United Kingdom: Bank of England, The Office of the Chancellor of Exchequer.

Keywords
bankruptcy, corona crisis, shutdown policy

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Table
Risk of Bankruptcy

Country	Shutdown	Salary - subsidy	Shutdown Duration in Months			
			0	1	2	3
Germany	No	No	0.08	0.76	0.94	0.98
Germany	No	Yes	0.08	0.63	0.85	0.93
Germany	Yes	No	0.08	0.81	0.97	0.99
Germany	Yes	Yes	0.08	0.71	0.91	0.97
United Kingdom	No	No	0.06	0.69	0.90	0.96
United Kingdom	No	Yes	0.06	0.57	0.80	0.89
United Kingdom	Yes	No	0.05	0.73	0.93	0.98
United Kingdom	Yes	Yes	0.05	0.61	0.86	0.95

The table shows the share of firms with interest expenses larger than earnings before interest and taxes (EBIT) depending on the length of the shutdown. For each month of the shutdown, we subtract 1/12 of annual turnover from EBIT. If the entry in column Salary Subsidy is equal to Yes we add 1/12 of cost of employees to earnings for each month of the shutdown. Firms are classified to be shutdown if turnover declined by more than two standard deviations in March or April 2020 compared to one year before.
Source: Eurostat, AMADEUS Financials 2014-2018 and own calculations.

Publication

Holtemöller, Oliver; Muradoglu, Yaz Gulnur: Corona Shutdown and Bankruptcy Risk. IWH Online 3/2020.Halle (Saale), 2020.

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