Box 1.1

THE INDEBTEDNESS OF THE SPANISH NON-FINANCIAL CORPORATE SECTOR: RECENT DEVELOPMENTS AND ECONOMIC IMPLICATIONS

The crisis triggered by the COVID-19 pandemic has led to a sharp loss of revenue for firms, which has meant that they have taken on greater debt to cover their short-term liquidity needs. This increase in borrowing by the corporate sector, along with the strong decline in GDP, resulted in a significant rise in this sector's debt ratio in H1 2020, breaking the downward trend observed since 2015.

In order to assess the economic and financial implications of the increase in corporate indebtedness, this indicator, which is based on aggregate data, should be complemented with a more granular analysis, to identify firms whose financial ratios exceed certain vulnerability thresholds.

Accordingly, this box shows the results of an exercise which simulates the changes in the distribution of two complementary corporate debt indicators in 2020, under two alternative macroeconomic scenarios.[1,2] The first, more structural, indicator relates net debt (defined as interest-bearing liabilities minus liquid assets and short-term financial investments) to net assets (total assets minus non-interest-bearing liabilities), while the second indicator, calculated as the ratio of net debt to ordinary profit (defined as gross operating profit plus financial revenue), measures firms' ability to meet their debt obligations with the funds generated by their activities.

The first four charts present the results obtained using the first indicator. Chart 1 shows the distribution of firms according to different net debt-to-net asset ratio percentile ranges, before the health crisis[3] and in 2020 under the two macroeconomic scenarios. In 2020, a shift in the distribution of firms towards higher debt ratio values is observed, with the increase concentrated in the upper percentile range (ratio above 0.75). The percentage of firms in this situation rises by six or seven percentage points to 20-21%, compared with pre-COVID-19 levels, depending on the scenario used. In terms of the number of firms and employment, the breakdown by size and sector reveals that the sectors recording the sharpest deterioration would be SMEs and the hospitality and leisure, motor vehicles and, albeit to a lesser extent, transport and storage sectors (see Charts 2 and 3). Lastly, Chart 4 shows that the increase in debt would be more pronounced in the percentile ranges that include firms with lower debt ratios (below 0.25). This is consistent with the fact that smaller firms, which generally have lower levels of debt, would be the most affected by growing indebtedness.

Conversely, in the upper tail of the distribution the increases are very small, to some extent mitigating the incremental risks for financial stability, since it means that the debt of the most vulnerable firms according to this indicator would barely grow. In any event, it should be borne in mind that the volume of debt in this segment is relatively high, close to 20% GDP in 2019.

Charts 5 to 8 show the results obtained using the second indicator, which relates net debt to ordinary profit. Overall, the conclusions are similar to those drawn using the debt-to-asset ratio, although the increase in the number of firms whose ratio is higher than 10 or with profit in negative territory, is more marked (between 16 and 17 pp, depending on the scenario). The breakdown by size confirms that the largest increases, both in the number of firms and in terms of employment, would affect SMEs, although the differences are less marked than for the debt ratio. The most affected sectors would be those already mentioned using the debt-to-asset ratio (see Charts 6 and 7). Lastly, Chart 8 illustrates that, by contrast with the first indicator, the increase in debt is concentrated in the percentile range of firms in a more vulnerable financial position. In any event, it should be noted that these results are strongly influenced by firms' exceptionally low level of income in 2020, which in most cases is not representative of the expected levels for this variable in the medium and long term. Thus, in the current economic situation, this indicator tends to exaggerate firms' solvency problems.

Looking ahead, higher corporate indebtedness may have potentially adverse consequences for economic

1 This exercise was conducted using the annual Integrated Central Balance Sheet Data Office (CBSO) database, which provides individualised information on around 500,000 firms for 2018, the last available year, and extrapolating the results to the corporate sector as a whole. The methodology applied is the same as that used in Occasional Paper No. 2020 Spanish non-financial corporations' liquidity needs and solvency after the COVID-19 shock, by Roberto Blanco, Sergio Mayordomo, Álvaro Menéndez and Maristela Mulino, published by the Banco de España in July.

2 The two macroeconomic scenarios considered are those published by the Banco de España on 16 September (Macroeconomic scenarios for the Spanish economy (2020-2022)).

3 The pre-health crisis situation is based on the latest available data corresponding to 2018.

Box 1.1

THE INDEBTEDNESS OF THE SPANISH NON-FINANCIAL CORPORATE SECTOR: RECENT DEVELOPMENTS AND ECONOMIC IMPLICATIONS (cont'd)

Chart 1
PERCENTAGE OF FIRMS BY THE NET DEBT-TO-NET ASSETS RATIO DISTRIBUTION (a) (b)

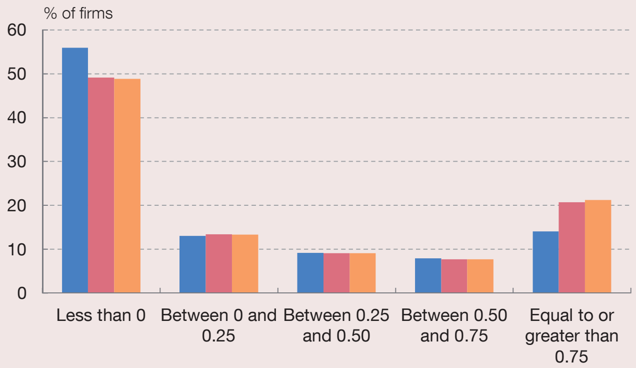


Chart 2
MOST VULNERABLE FIRMS ACCORDING TO THE NET DEBT-TO-NET ASSETS RATIO. PÈRCENTAGE (a) (b) (c)

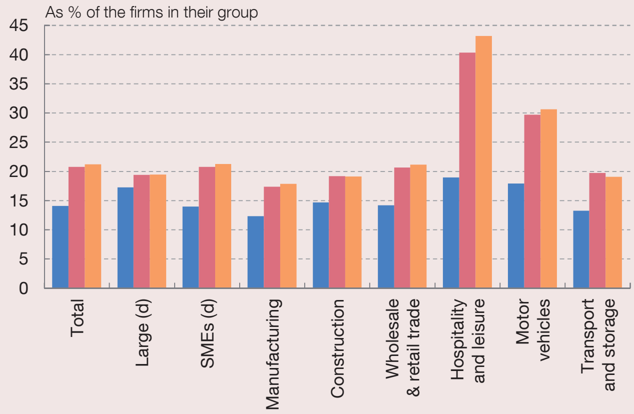


Chart 3
MOST VULNERABLE FIRMS ACCORDING TO THE NET DEBT-TO-NET ASSETS RATIO. SHARE OF EMPLOYMENT (a) (b) (c)

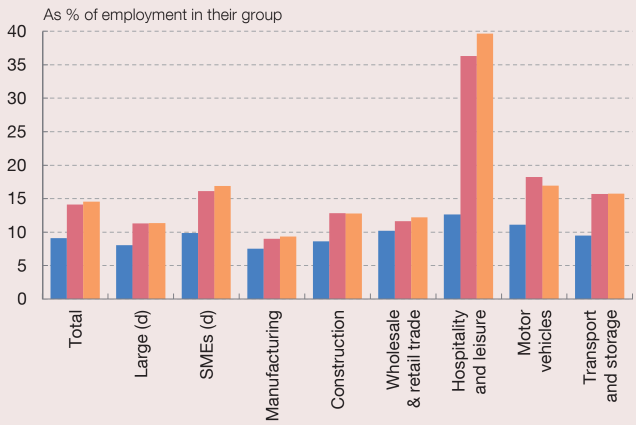
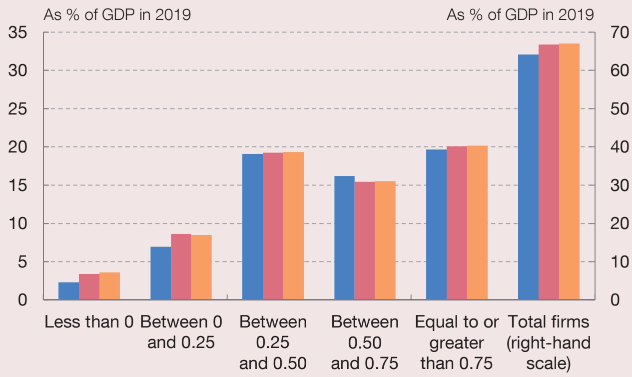


Chart 4
FIRMS' DEBT BY NET DEBT-TO-NET ASSETS RATIO DISTRIBUTION (a) (b) (c)



PRE-COVID-19 2020 - SCENARIO 1 2020 - SCENARIO 2

SOURCE: Banco de España.

- **a** Findings after December 2019 obtained on the basis of assumptions on two alternative macroeconomic scenarios, published by the Banco de España on 16 September *(Macroeconomic scenarios for the Spanish economy (2020-2022))*.
- **b** Net debt is defined as interest-bearing borrowing minus cash and other equivalent liquid assets and short-term financial investments. Net assets are defined as total assets net of non-interest-bearing borrowing.
- **c** The most vulnerable firms are those whose debt ratio exceeds 0.75. Excludes holding companies and financial services sector firms.
- **d** The definition of sizes is in line with European Commission Recommendation 2003/361/EC.

growth and financial stability. First, higher debt levels increase the debt burden arising both from interest payments (whose average rate will tend to rise ceteris paribus) and from principal repayments, which may diminish funds destined to finance new investments or for new hires. These contractionary effects will tend to ease depending on the speed at which firms are able to recover their pre-crisis activity levels, allowing them to generate profits and gradually reduce their debt levels.

Given the current macroeconomic projections, which suggest that pre-crisis GDP levels will not be attained before 2022, presumably not all firms will be able to

Box 1.1

THE INDEBTEDNESS OF THE SPANISH NON-FINANCIAL CORPORATE SECTOR: RECENT DEVELOPMENTS AND ECONOMIC IMPLICATIONS (cont'd)

Chart 5
PERCENTAGE OF FIRMS BY THE NET DEBT-TO-(GROSS OPERATING PROFIT + FINANCIAL REVENUE) DISTRIBUTION (a) (b)

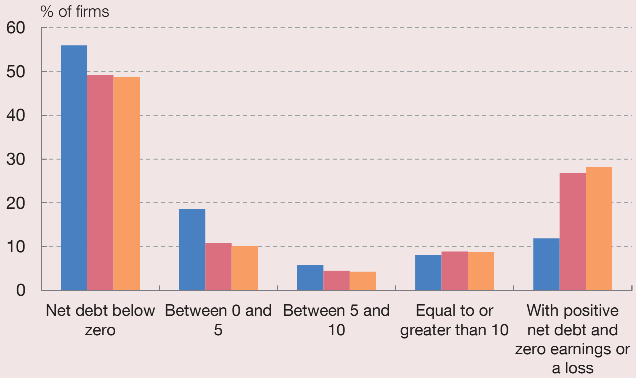


Chart 6
MOST VULNERABLE FIRMS ACCORDING TO THE NET DEBT-TO-ORDINARY PROFIT RATIO. PERCENTAGE (a) (b) (c)

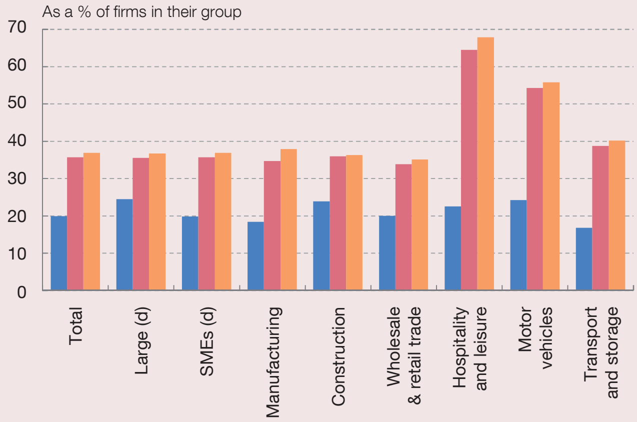


Chart 7
MOST VULNERABLE FIRMS ACCORDING TO THE NET DEBT-TO-ORDINARY PROFIT RATIO. SHARE IN EMPLOYMENT (a) (b) (c)

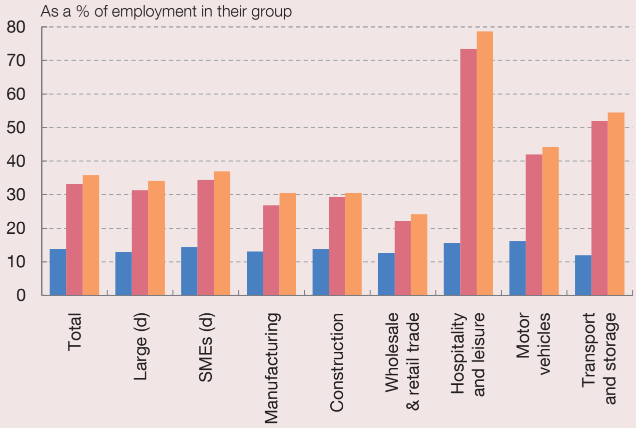
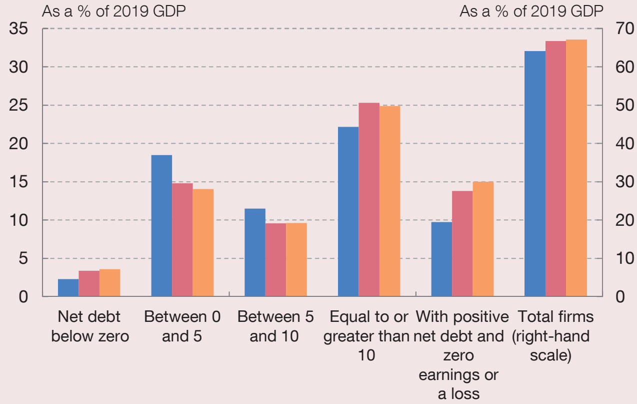


Chart 8
FIRMS' INDEBTEDNESS BY DEBT RATIO DISTRIBUTION (a) (b)



PRE-COVID-19 2020 - SCENARIO 1 2020 - SCENARIO 2

SOURCE: Banco de España.

a Findingsafter December 2019 obtained on the basis of assumptions on two alternative macroeconomic scenarios, published by the Banco de España on 16 September *(Macroeconomic scenarios for the Spanish economy (2020-2022)*.
b Net debt is defined as interest-bearing borrowing minus cash and other equivalent liquid assets and short-term financial investments.
c The most vulnerable firms are those whose ratio of net debt to ordinary profit is higher than 10, or with positive net debt but zero earnings or a loss. Excludes holding companies and financial services sector firms.
d The definition of sizes is in line with European Commission Recommendation 2003/361/EC.

return to their pre-pandemic activity levels, at least in the short term. Firms with a weaker recovery or a higher accumulation of debt could face difficulties in meeting their financial commitments.

For firms in this situation whose viability is not compromised in the long term, a feasible alternative could be debt restructuring (by means of grace periods, extended repayment periods, debt reductions or the conversion of debt into equity). Although this would entail losses for creditors, in many cases such losses would probably be lower than those incurred if the firms were wound up. Moreover, a firm's survival would prevent the economic cost of closing it down, in terms of job losses and depletion of the productive system.

Box 1.1

THE INDEBTEDNESS OF THE SPANISH NON-FINANCIAL CORPORATE SECTOR: RECENT DEVELOPMENTS AND ECONOMIC IMPLICATIONS (cont'd)

By contrast, firms with viability problems will have to close down and liquidate their assets, entailing short-term costs both for creditors, who will have to assume losses, and for the economy as a whole, as a result of the destruction of jobs and of part of the productive system. The swift resolution of such processes would favour economic growth in the long term, enabling resources to be reallocated to more productive firms or firms with greater growth potential.