PRESS RELEASE

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# Are corporate balance sheets in Spain and Italy ready for the COVID-19 shock?

**Although the second quarter of 2020 is shaping up to be the most challenging period of the year, there are now good reasons to think that the road to recovery will be long and arduous. Despite immediate tax deferrals, liquidity guarantees, it is likely that many firms will find themselves in difficulty.**

**According to Coface forecasts, Spain and Italy will be among the economies hardest hit by COVID-19, contracting by 12.8% and 13.6% respectively in 2020. Corporate insolvencies are expected to increase by 22% in Spain and 37% in Italy by 2021, relative to 2019 levels. For 2021, Coface forecasts that Spain and Italy's GDP will rebound by 10.2% and 8.9%, leaving the economies 3.9% and 5.9% below 2019 levels.**

## Higher prevalence of vulnerable enterprises in Italy with the spectre of zombie firms

In order to assess the potential impact of this GDP contraction on company balance sheets, Coface ran simulations on the evolution of corporate solvency, using data from the Spanish and Italian central banks that accounts for differences across sectors and firm sizes.

Even though interest rates are extremely low, corporate over-indebtedness is associated with depressed private investment. As a result, the COVID-19 crisis could exert durable downward pressure on a country's growth potential, accelerating the "Japanization" of the eurozone.

With this in mind, the balance sheets of Spanish and Italian companies should be analysed more closely. Examining the distribution of debt and liquidity in the corporate sector in Southern Europe should help to identify pockets of vulnerability.

The current financial situation of companies in Spain and Italy is healthier than on the eve of the 2009 global financial crisis. Since then, Spanish companies have managed to significantly reduce their debt by 20 percentage points, reaching 37% of their assets in the third quarter of 2019. Italian companies have also improved their financial situation since the 59% peak in Q4 2011, albeit to a lesser degree. With a debt ratio of 50%, businesses in Italy are now the most indebted among the major European economies.

The growing mismatch between financing and investment can be indicative of a high prevalence of "zombie" firms in Italy – companies steeped in debt that will not be able to sowing the seeds of future growth.

## Sectors at risk: automotive, construction, and retail

Coface expects the vulnerability of firms to differ according to their sectors and size, not only in terms of the intensity of the shocks, but also given the pre-coronavirus fragility of their balance sheets.

The major car manufacturers could be in difficulty because of their habit of keeping little liquidity: at the end of 2018, cash reserves as a percentage of sales were only 2.7% in Italy and 0.5% in Spain.

As for the retail and construction sectors, with high leverage and low projected interest coverage rates, they appear particularly vulnerable, as do Italy’s small textile manufacturers.

Coface observes a higher prevalence of potentially vulnerable companies in Italy. In most cases, this can be explained by lower initial cash flow, lower profitability, and slightly slower cost adjustments. In this context, many companies would survive only at the cost of substantially higher levels of debt.

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