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The Trading Dead: The zombie firms that threaten Britain's recovery, and what to do about them [1]

Written by **Blog Editor** [2] | Monday 18 November 2013

Zombie firms threaten to cause a ?lost decade? of economic stagnation ? new Adam Smith Institute report

- Up to 108,000 ?zombie firms? threaten to cause a ?lost decade? of stagnant growth and productivity
- Corporate insolvencies are unusually low, suggesting that zombie firms are holding up capital and labour that could be used productively elsewhere
- ?If a business can be saved, it is entrepreneurs who are best place to make the changes required? says OpCapita?s CEO Henry Jackson

Over 100,000 ?zombie firms? are threatening the UK?s recovery from the Great Recession, according to a new report by the Adam Smith Institute.

Record low interest rates and the willingness of banks to show ?forbearance? to unprofitable firms is damaging productivity, undermining competitiveness and preventing workers and money finding its way to the companies of the future.

The Trading Dead: The zombie firms plaguing Britain?s economy, and what to do about them [3], by Tom Papworth, identifies ?zombie firms? as heavily indebted firms that can generate enough revenue to pay down debt interest but not debt principle and are dependent on low interest rates to continue doing so. The paper argues that many of these firms require either insolvency or restructuring for a strong economic recovery to emerge. The report is sponsored by OpCapita, an international private equity partnership that specialises in turnaround through operational change.

The report shows that Britain?s ?productivity problem? may be partially due to zombie firms holding up capital and labour in relatively unproductive sectors, raising the costs of entry for new, innovative firms. The two main factors responsible for the zombie phenomenon are low interest rates and bank capital regulations. Low interest rates may be misdirecting money to unproductive zombie firms, and bank capital regulations (such as Basel III) discourage banks from foreclosing on zombie debtors, which would worsen the liability on their balance sheets. This also discourages business lending by banks in general.

The report finds that private sector rescue of zombie firms is possible, but only for some. This rescue, in the form of corporate restructuring, must also be done in a decentralised ?bottom-up? fashion by individual entrepreneurs and investors such as private equity firms using their local knowledge of specific firms and industries. A government-led drive would likely suffer from chronic inefficiencies.

Tom Papworth, Senior Fellow of the Adam Smith Institute, said ?We tend to see zombies as slow moving and faintly laughable works of fiction. Economically, zombies are quite real and hugely damaging, and governments and entrepreneurs cannot simply walk away.

?Zombie firms stop workers and money being redeployed to more productive uses, they prevent new, better firms entering the market, they undermine competitiveness, reduce productivity and slow the growth of the whole economy. Low interest rates and bank forbearance represent a vast and badly targeted attempt to avoid dealing with the recession. Rather than solving our current crisis, they risk dooming the UK to a decade of stagnation.

?Zombie firms need to be confronted with the reality that they are not profitable. With timely interventions by knowledgeable entrepreneurs, many firms can be restructured and saved. But others must be liquidated to allow resources to feed the growth of the future.?

Henry Jackson, CEO of OpCapita and the report?s sponsor, said: ?Turnaround specialists are uniquely placed to help Zombie Companies to restructure and return to profitability ? a far better outcome than that they continue to limp on indefinitely. And when private equity steps in it is using its expertise and insight to bring the radical changes required for a failing business to survive.?

The report sets out the role of investors in identifying firms that are ripe for restructuring through the seven key aspects of a successful turnaround: crisis stabilisation, new leadership, stakeholder management, strategic focus, critical process improvements, organisational change and financial restructuring.

Henry Jackson concluded:

?If a business can be saved, it is entrepreneurs and turnaround specialists who are best placed to effect the changes required. Private equity firms have the insight and knowledge to do that, and they are prepared to take the risks to get it right. Delivering change in such circumstances is often extremely hard and carries inevitable risk. But genuine improvements in profitability can create long-term sustainable value.?

To arrange an interview with the report's author or for further information, email media@adamsmith.org[4] or phone 02072224995. The report can be read in its entirety here.[3]

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