



Friday Morning Coffee

Nr. 33 – Beware the zombie firms

In their September quarterly review, the Bank of International Settlements published an interesting piece on the so-called zombie firms, defined as companies unable to cover debt servicing costs from their profits over an extended period of time (*The rise of zombie firms: causes and consequences*, Banerjee & Hofmann).

The study is impressive because it covers a very long time frame since the late 1980's and looks at listed firms from 14 advanced economies. The main takeaways from the authors are that **zombie firms have become more prevalent due to the secular decline in interest rates over the last decades**. The authors also make the point that **zombie firms "are less productive and crowd out investment in and employment at more productive firms"**.

In a simple exercise, we looked at how prevalent zombie firms are in Europe. We define a zombie company as a non-financial company with a market cap above 500 million EUR that has an interest coverage ratio of less than one. We use the Bloomberg definition of interest coverage as EBIT divided by interest over the last year. **Out of 1375 companies in our sample, 8% come out as zombie firms** according to this definition. To put a little more color on the result, they are spread amongst different industries whereof healthcare represents roughly 25% and industrials, consumer discretionary and energy 15% each. So the European corporate world is not immune to zombie firms.

In a second step, we looked at how a portfolio made up of Zombie firms would have performed over time. Here we took the same definition to build an equal weighted portfolio of zombie stocks out of our universe of European companies. We rebalanced that portfolio on a monthly basis and back-tested it over the last 10 years in Bloomberg :



Source: Bloomberg. Simulated portfolio, data from 22/04/2009 to 20/11/2018. Past performance does not guarantee future results.

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We draw **2 conclusions** from this analysis.

- 1) Firstly, **Mr. Market appeared not really to care about the ability of companies to serve their debt since the financial crisis and up to the fall of this year.** Our zombie portfolio had the same performance over this period than the market overall.
- 2) Secondly, **there is currently an important change going on** as our zombie portfolio was severely hit since October this year underperforming the market by 20% over 7 weeks ! To us, this is a clear warning sign that **investors focus is shifting to the quality of the balance sheets and the ability to serve debt.**

As credit conditions start to tighten with the US leading the dance, investors are waking up to the underlying risks of weak balance sheets. As value investors, the quality of the balance sheet is an important part of our due diligence process. The average company in our European portfolio covers its interest by 48 times and we do not own any zombie companies.

Investors will remember in the current environment that debt service is a cost, not a free lunch.

I wish you a great weekend

Léon Kirch, CFA
Partner & Chief Investment Officer
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