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The Corporate Debt Alarm What's Next

By analyzing the alarming increase in corporate debt, with a particular focus on the Italian, American, and French contexts, the article shows how rising debt affects the economic and capital position of companies, jeopardizing their ability to self-finance and to access new financing. The risks and benefits of possible financial solutions for distressed companies, including factoring and private loans, are assessed. Finally, the future of corporate financing structures is considered, expressing uncertainty about the possibility of a rapid reversal of current trends.

CORPORATE DEBT//FINANCIAL CRISIS//FACTORING//PRIVATE CREDIT,//ALTERNATIVE FINANCING

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A few years ago, as part of an analysis of specific business challenges, I observed the detrimental impact of escalating corporate debt levels on companies' income statements, profits, and, consequently, their ability to self-finance. This surge in debt has exacerbated the complexity of accessing new financing and refinancing maturing debt, even when intended to support investment (Ruozi, 2021). Thus, in the context of an unfavorable economic outlook, the management of a company's liquidity and working capital could become increasingly challenging, aggravated by the growing tendency of banks – the main financiers of Italian companies – to prioritize investments in public securities. This trend has led to a gradual and burdensome reduction in lending to businesses. This situation, prevalent not only in Italy but also in other countries, appears to be worsening, especially if interest rates continue to rise. Such a scenario could create new financial hurdles for companies and exacerbate their economic and capital constraints.

THE AMERICAN CASE

Early warning signs have emerged in the United States (Clarfelt, 2023), where many companies that have flourished in part because of low bank borrowing costs are now confronted with a sudden and substantial rise in interest rates, with a corresponding escalation in overall borrowing costs. Many of these companies face the daunting challenge of repaying or refinancing more than three trillion dollars of maturing debt over the next five years at a cost that is significantly higher than current conditions.

Moreover, the challenges facing U.S. companies go beyond the financial realm. For example, rising interest rates are causing a decline in consumer spending, which directly affects the revenues of goods and service providers, thereby escalating risk, insolvencies, and, in some cases, the likelihood of bankruptcy. The incidence of such events, especially among the most vulnerable companies, is rising sharply, with liquidity crises spreading and intensifying even among large companies.
One notable example is the retail giant Bed Bath & Beyond, which, despite refinancing its debt nine months before filing for bankruptcy, collapsed after more than five decades in business, resulting in the closure of more than 50 stores and the displacement of 14,000 employees.

Against this backdrop, companies that rely heavily on leverage – particularly in real estate and, indirectly, in private equity (Oliver, 2023; Gara et al., 2023) – are more vulnerable than their peers. As a result, they are seeking to restructure their debt positions by extending maturities, offering new collateral, and looking for alternative, nontraditional lenders.

THE FRENCH CASE

In France, the era of abundant and cheap credit has become a relic of the past, as exemplified by the case of Clariane, a prominent group in the European nursing home industry and various segments of the healthcare sector.
Struggling to secure the means to refinance its debt maturing between the end of 2023 and the beginning of 2024, the group was forced to implement a 1.5-billion-euro contingency plan with the support of Credit Agricole Assurances, its main shareholder. Despite exhaustive efforts, including attempts to negotiate with 21 different banks and the offer of substantial real estate assets as collateral, Clariane's attempts to renew its credit lines failed[1], mainly due to the tightening of banks' credit exposures under the supervision of the ECB.

Challenges similar to those faced by Clariane have unfolded at numerous other companies, largely as a result of the banking system's tendency to exercise greater scrutiny when evaluating new concessions and renewals of credit lines (Chaperon, 2023). In France, the economic slowdown has exacerbated the effects of credit rationing and escalating costs: in the third quarter of 2023, the number of distressed companies or companies filing for bankruptcy increased by 23 percent compared to the corresponding period of the previous year.
In fact, the gross debt ratio of French non-financial companies rose to 78.4 percent of GDP in the second half of 2023, above the European Union average of 57.4 percent.

1 On the Clariane affair, see instead the press release of the Clariane Group, "Clariane Strengthens Its Financial Structure to Overcome a Sharply Deteriorated Access to Financing." November 2023. clariane.com.

THE ITALIAN CONTEXT

Until recent years, the financial challenges faced by Italian companies, particularly SMEs, seemed to have been largely resolved. However, a confluence of factors, including the pandemic, economic slowdown, and inflationary pressures, has brought these issues back to the forefront, despite significant government intervention to mitigate them.

A study of the Bank of Italy published in November 2021 (De Vincenzo, 2021) highlighted the strengthening of the financial foundations of Italian firms over the past decade. However, it also noted a recent deterioration, particularly since the spring of 2021. This decline was attributed in part to the continued support of monetary policy and government loan guarantees, which had enabled firms to sustain themselves through banks. In addition, the study predicted that the pandemic would further increase firms' indebtedness, further weakening their financial structures and limiting their ability to self-finance and make new investments. The paper also highlighted the looming risk of increased corporate bankruptcies as a result of excessive debt, which is sometimes necessary to implement essential restructuring measures. Not surprisingly, the study concluded by emphasizing the need to improve corporate crisis management processes as a key measure to prevent or mitigate potential disasters[2].

The expected disruptions did occur. However, according to a Bank of Italy report focusing on companies in Lombardy (Bank of Italy, 2023), even two and a half years after the aforementioned study, firms' profits remained stable. Moreover, since April 2023, there has been a gradual reduction in corporate debt, which can be attributed to lower demand and stricter supply policies. As a result, despite the economic slowdown and rising cost of credit, the number of defaults recorded by banks remained relatively low for some time. Recently, however, the rate of credit deterioration has increased sharply and is expected to peak in 2024, rising by an estimated 3.8 percent. Thereafter, it is expected to decline to 3.1 percent in 2025, although this would be a relative decline as the absolute amount of impaired loans is still expected to increase (ABI-Cerved, 2023).

Companies are currently facing three serious threats that could have a profound impact on their short- and medium-term prospects: the escalation of energy and various other commodity prices; the rollback of government interventions related to Covid-19; and, last but not least, the rising cost of debt, especially bank debt, coupled with increased challenges in securing it. The latter trend has led to an increase in the number of companies with elevated credit risk or financial vulnerability, which together accounted for 48.7 percent of the total in 2022, a figure expected to exceed 50 percent in 2023 (compared to 41.9 percent before the pandemic). According to Deloitte and Assifact's Cerved Group Score (2023) estimates, in 2022 companies at risk of default held 10.7 percent of total corporate debt, while those in a vulnerable position held 19.5 percent, amounting to over 300 billion euros. A significant portion of this debt will need to be refinanced in the coming years, with smaller and less structured companies, as well as those in the construction, services, and agriculture sectors, considered particularly vulnerable.

REACTING TO THE CRISIS: THE POSSIBLE USE OF FACTORING

The surge in the number of distressed companies has been significant and is likely to continue in the near future unless these threats are effectively mitigated. Specifically, we will address challenges of a strictly financial nature that cannot be resolved through traditional banking channels. Regulatory restrictions on corporate access to credit and problems stemming from the complexity of companies' capital structures, coupled with banks'

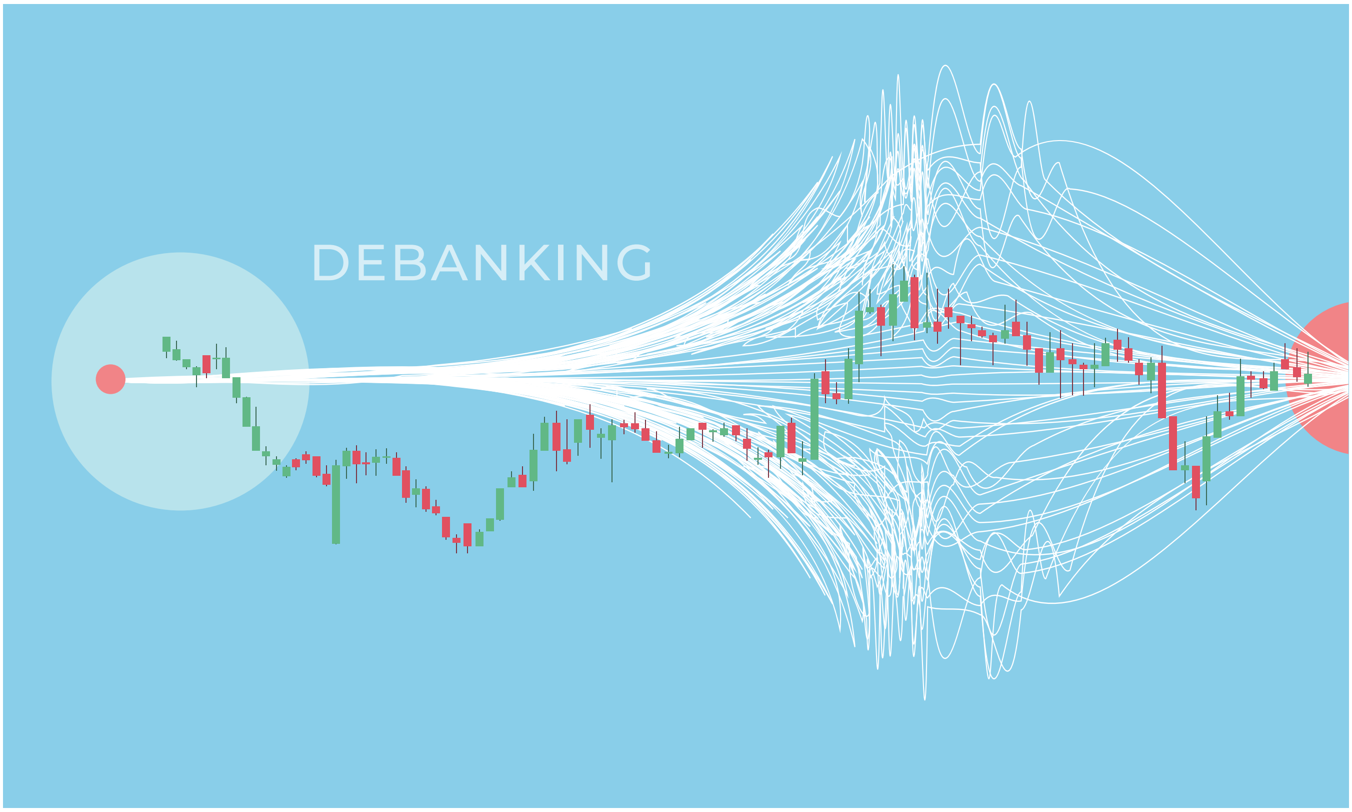
2 The evolution of these problems is analyzed in the Cerved reports for the last four years, from which some of the forecasts included here are drawn.

increased caution in managing risk, do not bode well for an imminent reduction in borrowing costs or an increase in new disbursements.

These considerations are in the broader context of the business model of banks, especially in Italy, where they traditionally and largely operate as "commercial" credit institutions. In this model, the interest margin, which is the main component of their profits, is the difference between the interest earned on loans to customers and the interest paid, mainly on household deposits. However, for various reasons, traditional brokerage is giving way to other activities that are considered more profitable and less risky, such as asset management and insurance products. This shift is giving rise to a new banking business model that involves a reduced appetite for lending.

The phenomenon of "debanking" corporate debt, which began some time ago and has evolved rapidly, is not a new revelation. Of course, this trend has been accompanied by the growth of what's known as the shadow banking system – a diverse array of non-bank intermediaries that perform functions similar to those of banks but operate outside the same regulatory oversight. There has been considerable international criticism of the practices of such entities, particularly following the collapse of certain players[3]. However, it's undeniable that, at least for the time being, their success in certain sectors of the financial market, mainly in the area of credit, is firmly established[4] (Ruozi, 2012).

When it comes to accessing the capital market, Italian companies have mainly relied on the bond segment, which has remained relatively stable and represents a modest share of their total financing sources. However, this level of exposure pales in comparison with that of other European Union



3 As in the case of a large Chinese shadow bank cited by Lockett and Yu (2023) and Hale and Leng (2024).

4 It may be a coincidence, but shadow banking has encountered new complexities during this period, so much so that in the United States, a leader in this sector, the volume of its activity in 2022 declined year-on-year for the first time since 2008. This decline largely reflects a trend in line with banking, although it remains larger on average, as reported by Ninfole (2023).

countries, the United Kingdom, and the United States. Moreover, the prospect of a significant improvement in the Italian capital market in the short- or medium-term seems doubtful, suggesting that it will remain a relatively marginal option for local SMEs for the foreseeable future.

SMEs can derive significant benefits from factoring, as highlighted in a recent report by Deloitte and Assifact. This financial instrument is well established in Italy and is constantly evolving to better meet the different financial needs of companies (Ruozi, 2021). Factoring is increasingly preferred because it offers robust guarantees compared to traditional bank credit lines. It relies not only on the creditworthiness of the clients but also on that of their business partners. While factoring has historically been favored by more financially stable companies, there has been a notable shift in recent years, with even less robust companies embracing it. Some specialized factors catering to these companies have achieved remarkable financial and economic results, occasionally facilitating their listing on the stock exchange.

Furthermore, as the number of financially vulnerable and distressed companies grows, so does the interest in financing them, prompting both specialist and generalist players to step in. Specifically, the latter devote a smaller portion of their portfolios – about 6 percent of their total turnover – to providing financial assistance to distressed companies. The main difference between these two categories of financial players lies in how they focus on financing distressed companies. For specialist players, assisting distressed companies is their core business, while for generalist players it is primarily an opportunity to maintain relationships with clients facing financial challenges.

Access to bank credit and debt financing has emerged as one of the top concerns for companies in financial distress. This access directly impacts their prospects for recovery, placing them in the precarious position of navigating difficult circumstances and potential default risks. In fact,

the struggle to meet financial obligations not only jeopardizes business continuity, but also hinders organic growth and the pursuit of opportunities tied to extraordinary transactions, such as acquisitions. As a result, factoring is becoming a critical tool in ensuring business continuity by providing immediate access to liquidity for companies in precarious situations. In addition, factoring improves the efficiency of the asset cycle by mitigating defaults through effective receivables management and by transferring risk to the factor through non-recourse transactions involving the full assignment of receivables. Acting as an outsourcer in managing the liability cycle, the factor facilitates the recognition of receivables as pre-deductible, providing enhanced protection against potential creditor foreclosure. Finally, factoring helps reduce accounting and administrative burdens by streamlining customer credit scoring processes for greater simplicity and efficiency.

While the benefits of factoring are undeniable, it's important to recognize that this financial tool is not universally applicable. In particular, for smaller businesses and those operating in sectors such as agriculture, factoring may not be a suitable solution for ensuring business continuity. This limitation is due to the often-short collection periods for trade receivables in these sectors, which may not allow companies the necessary time to generate the liquidity they need.

Recent experience in Italy highlights a remarkable expansion of the factoring market, partly due to operations with distressed companies. Not only has this sector experienced significant growth, but it also offers significant opportunities for further expansion, involving companies of various sizes and operating in different sectors. Both specialist and generalist firms have been affected by this growth, albeit to varying degrees. While specialist companies have shown a greater willingness to adapt to these changes, generalist firms have approached them more cautiously, mainly due to technical and legal concerns. It's worth noting that the fears of generalist factoring companies about the increased risk associated with financing distressed companies appear to be unfounded. Data on the net NPE ratio for 2022 – which measures the ratio of the total value of impaired loans to the total stock of loans disbursed, including both non-performing and performing loans – confirms a low level of risk. Overall, the net NPE ratio for the entire factoring market was 1.83 percent, with companies specializing in distressed financing having an even lower ratio of 1.62 percent.

This performance is no accident; it reflects the dedicated efforts of factoring companies that have excelled in financing distressed companies. These companies have distinguished themselves by deploying highly specialized and professional teams capable of conducting detailed analyses quickly and cost-effectively, securing adequate financial resources and insurance coverage, and providing prompt lines of credit. It's important to recognize, however, that this is no easy task, as it involves significant legal, credit, operational and reputational risks, each of which requires careful consideration. In today's increasingly sophisticated and innovative financial landscape, it's inevitable that certain risks must be taken, controlled, and managed to prevent them from manifesting themselves as detrimental outcomes for both clients and the intermediaries that finance them (Deloitte-Assifact, 2023).

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PRIVATE CREDIT

In today's more sophisticated financial markets, distressed companies have access to alternative options that go beyond the traditional sources of credit, including what is commonly referred to as private credit. This sector has grown substantially in recent years, reaching remarkable levels of both volume and quality in countries such as the United States, the United Kingdom, and several Asian countries. Private credit differs from bank loans, leveraged finance, and bonds in that it is provided directly to businesses by non-bank entities rather than by banks, banking syndicates, or the financial market. In operational terms, private credit funds are as investment vehicles that deliver financing directly to companies, circumventing traditional bank intermediaries.

The U.S. market, the largest in the world, makes extensive use of this type of financing, particularly among medium-sized companies. Despite the lack of official data for precise quantification, estimates suggest that the total value of the market exceeded $3 trillion by the end of 2021, highlighting its significant size. This is in stark contrast to Italy's private credit market, which totaled only 3,224 million euros in 2022. However, this is a remarkable 43 percent increase from the previous year, highlighting the potential for growth even within Italy. Efforts must be made to raise awareness of this financing option among companies, while identifying investors and channels that promote optimal synergy between companies and financial operators. Although it is difficult to make reliable predictions in this area, the available evidence suggests a justified sense of optimism regarding its development[5].

Private credit funds carry relatively high risk in all countries, but are currently yielding 12 to 15 percent annually, making them particularly attractive to investors with deep pockets and a robust appetite for risk. Despite the inherent caveats, these funds are widely promoted, even by leading investment banks in the asset management sector[6] such as Goldman Sachs, which highlight four key advantages in their prospectuses:

- ***High Performance***: These funds offer the high returns mentioned above.
- ***Lower Average Loss Ratio***: Compared to high-yield bonds, private credit funds have a lower average loss ratio.
- ***Potential for Higher Returns***: There's potential for higher returns, especially in a declining interest rate scenario.
- ***Diversification Tool***: Private credit funds serve as an effective diversification tool for investment portfolios of sufficient size. While they may be illiquid assets in the short term, their relative usefulness becomes apparent over the medium to longer term[7].

When examining the motivations behind firms' use of private credit, there is a degree of consistency across countries, although differences in the economic landscape clearly influence the supply and demand dynamics of this financial instrument. In the United States, for example, lenders in this sector operate without the regulatory oversight that applies to banks. In contrast, the United Kingdom treats these lenders as asset managers, subjecting the funds they manage to specific regulations and controls. This includes requirements to disclose a range of performance and risk management data to ensure transparency and accountability within the sector.

There is no doubt that companies need to look for financial alternatives beyond the traditional ones, especially to avoid insolvency or precarious economic situations. In this context, private credit is an extremely attractive instrument, especially because of its technical adaptability. In a market with

5 To understand how these activities fit into the broader financial market, see Board of Governors of the Federal Reserve System (2023). As for the size of the phenomenon, there are also those who believe it is contained within $1 trillion, such as the Financial Stability Board (2023), and those who estimate it at $40 trillion, such as Gaw (2023).

6 Interesting news on private credit in Italy can be found in: AIFI (2016; 2021) and various earlier editions; J.P. Morgan (2023).

7 For all, see Sperlinga (2023). Similar considerations are also made with respect to Asian markets, whose situation may soon approach that of the United States qualitatively and quantitively, as shown in Dillard et al. (2023). For the activity of private credit in pension funds, see Singh (2023).

limited financial alternatives, private credit stands out as a highly valuable form of financing.
Key elements contributing its attractiveness include:

- ***Direct Relationship***: Private credit fosters direct interaction between lender and borrower, facilitated by rigorous due diligence. This lays the foundation for lasting relationships built on trust.
- ***Flexibility***: Loans offered through private credit channels are inherently flexible, allowing for easier renegotiation and modification in response to changing market conditions and business needs.
- ***Customized Financing***: Private credit allows financing solutions to be tailored to the precise needs of potential borrowers. Unlike bank loans, which often adhere to pre-determined standard terms for processing large volumes, private credit offers a more customized approach.
- ***Speed***: Private credit excels in rapid analysis, decision-making, and disbursement of both new and renegotiated terms, facilitating quick responses to evolving financial needs.

In essence, private credit takes a variety of forms, including secured loans, corporate cash flow support, infrastructure investment, rescue operations, venture or commercial debt, among others. Direct engagement between parties can also facilitate voluntary financial crisis management transactions, avoiding potentially devastating bankruptcy proceedings that could threaten the survival of the companies involved[8]. Overall, the success of private credit is undeniable, benefiting both borrowers and lenders. So far, it has effectively met the needs of both parties, taking advantage of favorable financial market conditions and tighter bank lending standards. The development of interest rates has been central to its growth, leading to speculation about the sustainability of this expansion should market conditions reverse. Such a scenario raises questions about the potential resurgence of traditional financing and investment models.
Predicting the future of the financial sector is indeed a complex and speculative endeavor. Improved economic, capital, and financial conditions for businesses may ease access to bank credit, possibly signaling a gradual, albeit difficult, return to increased bank lending. Conversely, if companies fail to improve their financial position and struggle to renegotiate debt, the likelihood of survival and rising non-performing loans (NPLs) become critical concerns. The availability of multi-year private credit financing in the medium to long term remains uncertain. Significant investments in recent years, particularly by insurance companies, could pose challenges with far-reaching consequences. While the growth of private credit and related funds may support the current expansion, its sustainability depends on market dynamics and regulatory changes. In addition, the emergence of new business models and increased risk appetite may allow banks to partially replace private credit mechanisms. However, the interaction of these factors and their impact remain uncertain9. It's important to recognize that financial trends rarely undergo sudden reversals, suggesting that current challenges are likely to persist for years to come. Adaptability, foresight, and prudent risk management will be paramount in navigating the evolving financial landscape.

MANAGERIAL IMPACT FACTOR

- **Increased demand for factoring**: factoring has evolved to cater to a wider range of companies, even those historically less inclined towards it.
- **Emergence of private credit**: with higher returns and flexibility, private credit offers a viable solution for businesses seeking immediate liquidity and tailored financial assistance.
- **Shift in banking business models**: traditional banking models are transitioning away from lending towards more profitable and less risky ventures such as asset management and insurance.
- **Uncertain future dynamics**: the future of both factoring and private credit remains uncertain, dependent on various factors including market conditions, regulatory changes, and evolving business models.

8 For details, see Alternative Credit Council (2023). For the United States, see instead Block et al. (2023) and Loumioti (2019).

9 Among others see: Van Steenis (2023); Goss (2023); Platt et al. (2023); Gara (2023).

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