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A CreditorWatch white paper

The future of insolvencies: tsunami, torrent or trickle?

SYDNEY, 31 March 2021 – The temporary moratorium on trading while insolvent, introduced last March by the federal government prompted a collapse in the average number of insolvencies on an annual basis in 2020.

This year, a new provision was extended to small businesses with debts of $1 million or less to allow them to work with an insolvency practitioner to negotiate with their creditors and give them a chance to restructure their operations and continue trading. This provision ended on 31 March.

However, a new, simplified, small business insolvency regime came into force on 1 January when the Corporations Amendment (Corporate Insolvency Reforms) Act 2020 (Cth) took force. The legislation is designed to make it easier for small businesses to restructure their debts and liquidate their operations.

New regulations notwithstanding, directors' obligations not to trade while insolvent have now been reinstated. The return to normal regulations has severe consequences for directors of businesses that trade while insolvent.

This is likely to prompt a slew of companies entering administration. This will be compounded by the end of the JobKeeper wage subsidy that has been artificially propping up some 'zombie' businesses – entities that would have otherwise failed without government stimulus and relaxed insolvency rules.

This white paper explores the future for insolvencies from here, drawing on the insights of some of Australia's most senior insolvency and business experts, as well as CreditorWatch's proprietary data.

The story so far

In 2020, the temporary moratorium on insolvent trading led to a substantial reduction in the usual number of companies that become insolvent over the course of the year. According to figures published by the Australian Securities and Investments Commission, each year around 8,000 business are placed into external administration. But in 2020, only 5,000 businesses entered administration, which means 3000 businesses that should have become insolvent last year are due to fail this year.

It appears this trend is turning around, given there has been a jump in the number of insolvencies. According to CreditorWatch's *Business Risk Review* for February 2021, there was a 61 per cent jump in external administrations in February 2021 versus January 2021. The question is how this trend will play out now insolvency laws have returned to more normal settings.

"While insolvency numbers have risen in 2021, it's the increase we needed to see. We need to get back to at least pre-COVID administration levels and away from the synthetic environment we've lived in for 12 months," says **CreditorWatch CEO Patrick Coghlan.**

"We're going to see sustained increases in administration numbers until they reach normal levels. I'm not expecting the tsunami of insolvencies that was talked about last year, but the fact is companies need to be allowed to fail; that's how the economy works. That should be expected and it's a good thing. It means companies that shouldn't be operating are not pulling down the rest of the economy. It's also important to remember we're in a much better position than anyone could have anticipated this time last year," he adds.

McGrathNicol Restructuring Partner Kathy Sozou says the market is in a protective bubble created by the necessary but artificial structures put in place by the federal government to support businesses through the pandemic.

"Companies that should have begun the administration process have been continuing to trade. While this has been necessary to save jobs, the risk is businesses will never be able to recover debts from these 'zombie' companies.

That puts pressure on the entire economy. It's hard to know how this will play out, but if we see more business failures, that will have an impact on unemployment and consumer confidence," she says.

View from the street

Andrew Batch is CFO of LINX Cargo Care Group. The leading diversified logistics infrastructure and solutions provider operates 70 sites across Australia and New Zealand across road, rail, ports and forestry. It has five businesses: LINX, Autocare, C3, Pedersen Group and GeelongPort.

LINX Cargo Care Group employs more than 3,400 people. Each year, it handles more than 22 million tonnes of bulk cargo, 1.7 million tonnes of steel and more than 17.5 million tonnes of forestry products. It also processes 380,000 vehicles for many of the country's largest fleet operators.

With its core business in logistics, freight and cargo, LINX Cargo Care Group operates in some of the sectors that have been most affected by COVID given domestic and international border closures and stay-at-home orders. At the same time, panic buying prompted heightened demand for its services.

Batch says LINX Cargo Care Group has been proactive helping customers manage COVID-19's impact.

"We have spent a huge amount of time understanding our customers' positions and how we can help them through COVID, as well as getting an insight as to what the future looks like. That helps our decision making."

COVID further promoted LINX Cargo Care Group to automate processes and continue to explore ways to increase efficiencies. *"We're implementing strategies now as a result of having that sharper focus on technology so we can provide better solutions to customers as well as a better service."*

As for the future, Batch notes the Group is laser-focused on pursuing all its available opportunities, working closely with customers. *"It's a positive trading environment for us. So now it's about taking people on the journey from a systems perspective. COVID reminded us that our existing focus on collaboration and working closely with stakeholders must continue for our combined success."*

Where to from here?

Over the past year, small businesses have had to live in the moment, meeting their short-term obligations without too much thought for the future, given the reprieve directors enjoyed over their duties not to trade while insolvent.

That approach is no longer viable with the relaxation of insolvent trading rules and artificial stimulus measures such as JobKeeper at an end. So, the onus is on businesses to assess their potential exposure to debtors that may be headed towards insolvency.

“Are your suppliers still financially viable? What are the risks in your supply chain? Look downstream at your customers and assess their solvency,” recommends Sozou.

She expects a rise in company-led restructuring through 2021 and notes conditions in the corporate landscape support this. *“There's capital available for the right businesses. Stakeholders such as the federal government, the Australian Taxation Office and the banks are much more willing to support restructuring solutions than they may have been in the past.”*

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But, says **McGrathNicol Chairman Jason Preston**, over the course of the year, the ATO and banks are likely to become a little more front footed compared to 2020. He notes structural changes in the economy, for instance, the shift away from fossil fuels to renewable energy sources, could also affect insolvency trends, given coal-fired power producers are finding it increasingly difficult to access capital.

“Loan-to-own transactions are a growing trend in restructuring, where the lender takes control of the business using the insolvency process to restart the business and implement a new business model. I think we'll see more businesses use the restructuring and insolvency process to reshape and resize their operations.”

Preston says many companies will face a situation where they need cash to fund working capital for growth. Because existing funding source has disappeared, they have changed their supply chain and they need to carry more inventory.

“Businesses are restructuring not because of markets shrinking, but because they need to adjust their working capital for growth. Often, a business enters a restructuring process not because revenue has dropped off and business is tough, but because the company is growing, but cash flow hasn't been managed and all of a sudden there’s a funding shortfall.”

The options in Australia to secure funding are more limited compared to the US market, where asset-backed lending and lending on debtors and inventory is more common. So, funding choices for a company that hasn't got its working capital right, which needs a solution quickly, can be limited.

Australian banks are conservative about lending against certain companies and sectors. But there is some potential for businesses to raise debt from banks that can take advantage of the federal government's Coronavirus Small and Medium Enterprises (SME) Guarantee Scheme, which supports up to $40 billion in lending to SMEs. So far, it's understood the scheme has had minimal take-up.

In fact, businesses have been reluctant to borrow through the pandemic. Preston says this is due to reticence to take on debt during uncertain times. Government support such as JobKeeper has also reduced small business's need for debt funding.

"The lack of demand for debt from small businesses makes sense and is rational, but it's still surprising, especially with low-interest rates. There has been a small uptick more recently in demand for funding, so it will be interesting to see if that continues. Speaking to customers in the small business alternative lending space, the numbers aren't there in terms of inquiries. They want to lend, but there's a lack of demand."

The way forward

Roughly 8,000 companies are placed into insolvency each year in Australia, however, in 2020 this number fell to 5,000. This means around 3,000 businesses that should have failed in 2020 were protected by the temporary moratorium on insolvent trading and could be expected to be placed into administration in the coming months. On top of this, there will be a cohort of businesses that have failed as a result of the pandemic that are also likely to be placed into administration in the coming months, before the market returns to normal later this year.

There has been an element of uncertainty around what's coming next and some firms have been hanging on in the hope they can trade out of trouble. This is understandable, as there's no turning back once they pull the insolvency trigger and taking that step has very serious consequences. Fear of these consequences often prompts businesses to keep going.

"But hope is not a strategy and directors' hands are going to be forced in the next couple of months as things start to change," Sozou says.

It's recommended businesses in this position work closely with their accountant and restructuring adviser to manage this situation.

Coghlan notes: *"That's the best and only way to work through what is a stressful and tough situation and find a path forward for the future."*

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About CreditorWatch

CreditorWatch is a digital credit reporting agency, headquartered in Sydney. From sole traders through to ASX listed companies, more than 50,000 Australian businesses now use CreditorWatch to make affordable, informed credit decisions, avoid high-risk customers and ensure they get paid on time. CreditorWatch customers can easily search for and monitor the credit history, court actions, payment defaults and insolvency notices associated with any business entity in Australia (including sole traders, trusts and partnerships) giving them an incredibly accurate picture of the risk posed to their business.

The company was founded in 2011 and has offices in Sydney, Melbourne and Brisbane. Find out more at www.creditorwatch.com.au.