Analysis

German insolvencies - 'This time it's different.'


Christof Schiller, Anchor

For years restructuring professionals in Germany have predicted one wave of insolvencies after the next which all had one thing in common: they never came. This time it looks different.

Christof Schiller, a restructuring partner with Anchor in Mannheim, gives his views on the outlook for insolvencies in Germany.

In Germany today, there are numerous threats to business, arising at the same time. Winter is approaching and Covid-19 is not over. There is a general shortage of workers, especially skilled labour is in high demand. Interest rates are rising fast. The car industry is in transition from combustion to electric. And then there is the elephant-in the-room – energy costs.

As to Covid-19, it still has the potential to disrupt supply chains, especially if China sticks to its zero-covid approach and further lock-downs.

A surge in cases in the upcoming winter could also lead to staff shortages. As one business executive put it to me the other day:

> "When my employees come back from holidays, I know that they will be down with Covid in the next two weeks. You can set your clock by it."

The shortage of skilled labour is not a new problem. Business owners have been complaining about this for a long time. But somehow the problem seems to be more acute now. Employees have more of a choice, and staff turnover seems to be increasing. Baby-boomers are leaving the work-force altogether. The complaints about labour shortages grow ever louder.

The counterattack by the ECB and other central banks against inflation will increase interest rates, except in Turkey, but that is a different story. This is a problem for all sectors of the economy if businesses need to refinance, but it is especially serious for the construction industry. Construction is facing higher interest rates, price increases for building material as well as labour shortages. A lot of building projects are being mothballed because the sums don't add up any more.

Rising energy costs hit everything

The transition of the auto industry to electric vehicles is happening fast. Vendors which have been supplying parts to the power-train of combustion vehicles have to change their business model altogether.

On top of these problems are rising energy costs, which have overreaching effects for the entire economy. Energy intensive industries have to face increased costs at an unprecedented level. But energy costs also hit other sectors.

Households have to spend more money on their heating bills. There is less money left to go to restaurants, to do the shopping, to go to movie-theatres.

Both the catering industry and retail are in trouble. And then there are effects which you would not expect it at first. The manufacturers of fertilizers have reduced their production because of high energy prices. One of the by-products of fertilizer production is carbon dioxide, which is used in breweries and for the manufacture of carbonated beverages.

So the brewers are in trouble. Not only because of the energy costs but also because of a shortage in carbon dioxide.

> If the German brewers are in trouble, Germany really has a problem.

The September Ifo-Index has just been published, which measures the business climate for the manufacturing industry, the service sector, the retailers and construction. The Index has deteriorated significantly.

The Ifo Business Climate Index fell to 84.3 points in September, after 88.6 points (seasonally adjusted) in August. This is the lowest value since May 2020. The decline runs through all four sectors of the economy.

The companies rated their current business situation clearly worse. Pessimism about the coming months has increased significantly. In the retail sector, expectations even fell to a historic low. The German economy is slipping into recession.

Temporary relaxation of insolvency rules

In September the German Justice Ministry proposed a temporary relaxation of insolvency rules, to help keep companies afloat that have fundamentally sound business models but are struggling with debts due to high energy costs. The plan would exempt firms from the obligation to file for insolvency if an expert finds they have a 'positive going concern prognosis' for four months, down from the present requirement of 12 months.

Against this dire background I do not think that the reduction of the prognosis period from 12 to four months will have a big impact.

There are two factors when the managing director of a corporation has to file for insolvency: Cash-flow insolvency or balance-sheet insolvency.

Failure to file can lead to criminal and civil liability.

Cash-flow-insolvency is present if a business can no longer cover at least 90 per cent of its due liabilities with cash.

The prognosis period comes into play if a corporation is balance-sheet insolvent, meaning the assets no longer cover the liabilities. In these cases the managing director only has to file for insolvency if it is more likely than not that the corporation will not be able to survive the next 12 – or as proposed now - four months.

This assessment is essentially a cash-flow analysis. Will the corporation be able to make its payments during the forecast period when they become due?

To shorten the forecast-period from 12 to four months does not help if a business just runs out of cash because of – say - high energy costs.

This would lead to a current cash-flow insolvency. And it appears that this is the main risk right now.

It is not so much of a problem if the companies will run out of money in the next four or twelve months, the issues are much more urgent: Do I have the cash now to pay my liabilities?

It remains to be seen if the governing coalition in Germany will come up with a plan to reduce the energy costs for households and businesses. If this happens at least the detrimental effects of the most pressing issue right now would be mitigated, but certainly not eliminated altogether.

But even if that happens, all the other issues remain.

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