

## Zombies - the living dead



A survey by KPMG finds lenders are increasingly concerned about 'zombie' companies that lack the cashflow and profits to pay down the debt on their balance sheets. With viability questionable, these businesses may become the focus of a new round of insolvencies.

High profile business failures are always shocking events but the headlines and analysis that inevitably follow the collapse of a Habitat or Jane Norman provide only a partial picture of the economic threats that lie ahead. Despite a string of administrations in recent weeks, the UK's insolvency figures have remained relatively low, suggesting that despite hugely challenging economic conditions the vast majority of businesses have successfully weathered the storm.

But a lower than expected rate of insolvencies does not necessarily mean that corporate Britain is in anything close to good health. As a survey of over 400 lenders by KPMG has discovered, financial institutions are increasingly concerned about the rising number of so-called zombie companies. Such businesses are living a 'hand to mouth' existence, generating sufficient cash to carry on trading and paying their bills, however their poor financial position and low levels of operational net cash flows render them unable to repay borrowings. Unless acceptable restructuring solutions can be identified, the study survey suggests that these zombies could trigger a new wave of insolvencies in the medium to longer term.

### On Permanent Life Support

Just as the zombies of myth and legend are dead but still walking, the corporate equivalent exists in a space just above outright insolvency but well short of true viability. Broadly speaking, a zombie is a business in intensive care, requiring ongoing financial support from lenders and investors in order to continue trading. Zombies aren't necessarily loss making. Typically they will be break even or even generating a small profit. However, while they have sufficient revenues to meet operational expenditure, they are not in a position to repay borrowings. Clearly this is concern to lenders.

Aware of the unease amongst lenders, KPMG canvassed opinion on the zombie problem. Initially conducted in the North of England and later expanded to cover the rest of the country, the results of the survey paint a worrying picture. At best, the findings suggest that businesses will find it harder to secure a solvent solution, ideally a refinance. At worst, there are indications that an increasing number of businesses will be forced into insolvency.

### A cycle of dependence

From the perspective of lenders, the primary risk is that zombie businesses will remain trapped in a cycle of dependence. Lenders questioned for the survey were concerned by the lack of profitability and working capital in these underperforming businesses and with consumer demand in many sectors still slack there is nothing on radar screen to suggest that the situation will improve. Consequently, there is little optimism that zombies will be able to pay down debt in the immediate future.

What's more, the situation could well be worsened by macro-economic events, with lenders warning that deteriorating economic conditions or a hike in UK interest rates would make it even harder for already marginal companies to return to genuine viability.

### Exit options

Faced with these circumstances, it's hardly surprising that lenders are concerned about their own exit options.

Looking back over the last three years, lenders taking part in the survey reported that solvent exits - notably through refinancing or restructuring - were much more common than insolvent exits, involving CVAs or administrations. Over the past twelve months solvent exits have remained the solution of preference with debt compromise increasingly part of the picture.

Looking ahead, the outlook is mixed. On the plus side, lenders believe that solvent solutions will remain their preferred method for dealing with zombies over the next twelve months. However, they do expect refinancing to become more difficult, particularly for businesses with smaller levels of borrowing (£3m to £10m) continuing a trend that's been apparent over the past five years. At the same time, it's taking longer for the banks' business support units to resolve the problems facing stressed companies. Two years ago, these units were holding cases for an average of 6-18 months. Today, 12 to 24 is the norm. In other words, resolving the issues facing zombies is becoming even more challenging.

With refinancing and other solvent solutions becoming more difficult to secure, lenders are expecting a rise in insolvent exits, particularly in cases where the cash situation of the business is poor and/or management is inadequate. Some sectors are more at risk than others. For instance, 'food and drink' and 'travel, tourism and leisure' were cited by lenders as the industries where insolvent exits were most likely to take place.

### A shot across the bow

The survey findings represent something of a shot across the bow for businesses characterised as Zombies. As Richard Fleming, UK Head of Restructuring at KPMG observes, the future for many of these businesses could be bleak. "In many cases it's hard to see how they can work their way out of the situation," he says. "They are waiting for an uptick in business and if that doesn't happen they won't be able to move the business forward."

And that's certainly true if the businesses in question fail to recognise the problem. "In some cases the business models are fundamentally broken," Fleming adds.

Failing to recognise the problem could have serious long term implications. As refinancing becomes harder to obtain, businesses that relied on support from lenders may instead be looking at insolvency or a radical restructuring of their operation. Less dramatically, a business that has insufficient cash to pay down debt to invest, will be

less able to take advantage of the opportunities presented by economic recovery than a competitor with healthier balance sheets and better margins. "Those businesses will be vulnerable to competitors," says Fleming.

In that respect, KPMG's survey provides not only a snapshot of the current challenges faced by lenders in terms of their loan portfolios, it also furnishes companies with valuable insights into the thinking of financiers and will perhaps also spur them to review their trading strategies.

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## Contact us



### Richard Fleming

UK Head of Restructuring

T: +44 207 694 3990

E: richard.fleming@kpmg.co.uk

[www.kpmg.co.uk](http://www.kpmg.co.uk)

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