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IN FOCUS

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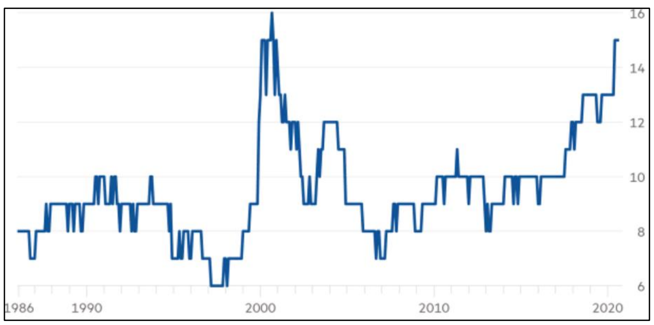
"Zombie" Companies: Background and Policy Issues

"Zombie" companies are mature companies that have not generated sufficient profits to cover their debt borrowing costs over a period of years. Such companies are characterized by prolonged underperformance and poor future prospects and are often associated with low productivity. The number of zombie companies has gone up in recent years. As many as 15% of companies in the Russell 3000—an index of 3,000 publicly traded U.S. companies that make up the vast majority of the investable public U.S. equity market—are considered zombies by some (**Figure 1**). This In Focus addresses basic questions about zombie companies, discusses their effects on the economy, and briefly reviews policy implications and proposals to address them.

Figure 1. Percentage of U.S. Zombie Companies in Russell 3000 Equivalent Index



Source: Leuthold Group and Joe Rennison, "Pandemic Debt Binge Creates New Generation of Zombie Companies," *Financial Times*, September 13, 2020.

Notes: Companies with profits that are less than the interest paid on their debts for at least three years. Data based on the Leuthold 3000 Universe (a Russell 3000 equivalent) as of September 2020.

When Is a Company a Zombie?

Definitions of *zombie company* can vary. Unprofitable companies are not automatically zombies. For example, companies facing temporary earnings challenges, such as young growth companies or companies that are going through a restructuring phase, are generally not considered zombies. The Bank for International Settlements (BIS), an international financial institution for central banks, offers a broad and a narrow definition of the term. The BIS's *broad* definition encompasses firms that have interest-coverage ratios below one for at least three consecutive years and are at least 10 years old. The *narrower* definition incorporates these screening criteria but excludes firms with certain financial characteristics that place them in the upper half of their industries in a given year. Specifically, the ratio between the market value of a firm's assets and their replacement cost (the sum of the market value of equity and liabilities divided by the sum of the book value of equity and debt) must be below the median for the firm's sector in any given year. Accordingly, the BIS definition makes clear that a company is not a zombie merely because it is *unprofitable*. Rather, zombies must demonstrate *sustained* unprofitability and poor future prospects.

What Is the Harm?

One of the main economic concerns regarding zombie firms is low productivity, which in turn can lead to low economic growth. Because zombie companies' profits cannot cover their debt servicing costs, they generally cannot invest in future growth through activities such as research and development. Zombies can also tie up capital and labor, preventing them from being allocated toward higher-growth opportunities. They are therefore viewed as inhibiting *creative destruction*, a term first introduced by economist Joseph Schumpeter in the 1940s to refer to the process in a free economy in which insolvent companies are destroyed to make room for other healthier and more productive companies.

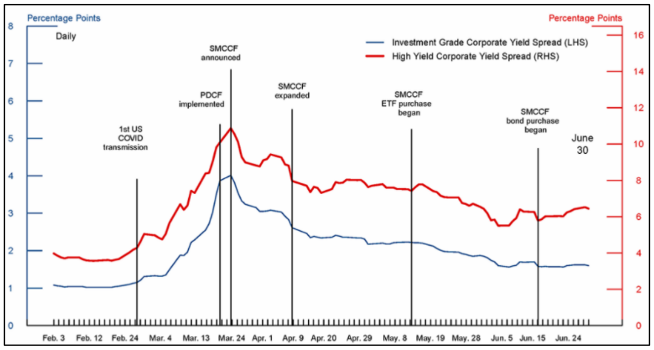
While the methods to keep zombies afloat vary, some observers believe that unless such methods can provide a fundamental cure for low productivity and profits, temporary fixes merely delay insolvency. Furthermore, as zombies proliferate, they could become financial stability concerns: If economic conditions deteriorate or interest rates rise, zombies may file for sudden bankruptcies with effects that cascade throughout the broader economy.

Why Have Zombies Proliferated During the Pandemic?

The number of zombies has increased in recent years, including during the Coronavirus Disease 2019 (COVID-19) pandemic (**Figure 1**). Factors that may have contributed to the formation of new zombies include reduced profits at pandemic-affected businesses and improved credit conditions, including low interest rates, easy availability of funding, and direct government intervention. In addition, existing zombies are remaining in their zombie status for longer, likely because fewer zombies than expected have taken exits through bankruptcies and takeovers.

Government interventions that improved funding conditions. Government interventions in response to the pandemic have supported the survival of many companies, including zombies. For example, the pandemic triggered a corporate debt market meltdown in March 2020. Borrowing became prohibitively expensive, and new corporate bond issuances came to a near standstill. The U.S. Federal Reserve and the Treasury Department provided historic support to credit markets, including unprecedented steps to agree to purchase corporate bonds and bond exchange-traded funds. Following direct capital market interventions and fiscal support from Congress, corporate borrowing costs dropped (**Figure 2**). New bond issuances not only recovered but boomed. Corporate bonds set a new annual issuance record in September 2020. Many observers view these interventions, together with the Fed's low interest rate policies in the years leading up to the pandemic, as having had the unintended consequence of keeping heavily indebted zombies alive.

Figure 2. Corporate Bond Costs and Selected Federal Reserve Emergency Program Announcement Dates



Source: Steven Sharpe and Alex Zhou, "The Corporate Bond Market Crises and the Government Response," *FEDS Notes*, October 3, 2020.

Notes: Spread of corporate bond yields over Treasury yields. Movements in Intercontinental Exchange Bank of America option-adjusted yield spreads for U.S. investment-grade (left) and high-yield (right) bonds around the onset of COVID-19 crisis. PDCF and SMCCF are Federal Reserve emergency lending programs.

Fewer bankruptcies than expected. Calculations from the American Bankruptcy Institute, a trade association that compiles bankruptcy data, reportedly show that Chapter 11 filings at the parent company level are 28% lower for the initial pandemic period (from March 1 to September 30, 2020) compared with the same period a year earlier. By contrast, the bankruptcy rates during the 2007-2009 financial crisis were much higher than average. Some experts attribute the lower-than-expected number of bankruptcy filings to government support, including the small business Paycheck Protection Program; a certain amount of rebound in business activity; and forbearance by landlords, lenders, and suppliers.

Policy Issues and Potential Solutions

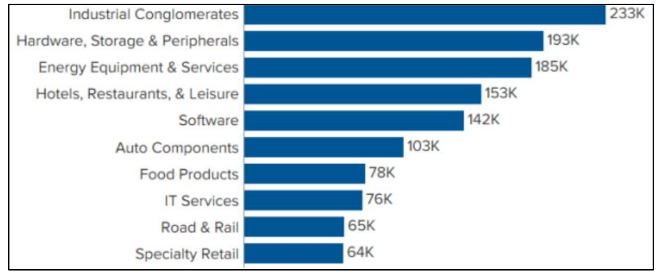
While zombies have the potential to lower productivity and economic growth, the extent of such harm and the policy solutions to address it are complex issues for debate.

Social Costs of Creative Destruction

Some observers argue that the negative effects of zombies are overstated. These commentators view zombies as important sources of employment. If zombies can cover their operating costs and contribute to employment, they suggest, that is a positive. Zombie companies are reportedly responsible for more than 2.2 million U.S. jobs (**Figure 3**). Subject to changing economic conditions, zombies may fail, but allowing them to fail all at once may exacerbate a crisis and pose financial stability concerns. Some experts also argue that zombie companies provide on-the-job training to empower the workforce. Moreover, some economic research suggests that the disappearance of zombie firms may not necessarily lead to the arrival of new and higher productivity firms.

Figure 3. Zombie Companies' Employee Headcount

(Top 10 Industries)



Source: Arbor Research and Jeff Cox, "Highly Indebted Zombie Companies Control More Than 2 Million U.S. Jobs," *CNBC*, May 20, 2020.

Policy Proposals

Faced with a mixture of economic and social demands, many observers have suggested a range of policy proposals for zombies. They include the following:

- **Exclude zombies from government support.** This idea appears straightforward, but some say it faces implementation challenges. Complex program requirements aimed at identifying and excluding zombies may affect program costs and implementation efficiency. Furthermore, by appearing to pick winners and losers, such measures may draw charges of government interference with the free market.
- **Direct government support to workers instead of companies.** Instead of providing financial support for companies, some proposals call for direct support to workers. They suggest government support through well-designed *active* labor market policies to help displaced employees find work rather than *passive* measures that focus on financial benefits. By directly targeting workers, the government programs would avoid the appearance of picking winners and losers. Such support would permit workers to leave zombies for more productive employers.
- **Grants instead of loans.** Government assistance in the form of loans would require interest and principal payments that might only sustain zombies. Grants, however, may have more potential to resolve zombies' debt burdens and kick-start their ability to invest in new initiatives.
- **Recapitalization plans.** Recapitalization proposals call for government to buy shares of equity of zombies on behalf of taxpayers. As alternatives to loans, they would not increase borrowers' debt burden but would grant taxpayers with ownership stake in zombies. These proposals are more popular in Europe.
- **Insolvency regimes.** Some proposals call for streamlining the bankruptcy process or other relevant insolvency regimes so that zombies' assets can be quickly transferred to potentially more productive uses.

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