ANALYSIS

From crisis to crisis – companies are once again facing a challenging operating environment

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Russia's invasion of Ukraine in February 2022 has rapidly increased uncertainty related to the economic outlook and financing conditions. The war affects domestic companies' operating environment in several ways. The total impacts will be felt much more broadly than only by companies that have direct Russian exposures in their business. The weakening economic environment, higher inflation and tighter financing conditions may increase companies' refinancing risks. The most vulnerable are the companies that have ties to Russia and energy-intensive companies, as well as industries that will face the new crisis already weakened by the pandemic.

Russia's war in Ukraine will have a broad impact on companies

Russia's war in Ukraine will hamper companies' operating environment in a number of ways. The most direct impact on domestic companies will be felt as trade with Russia decreases or ends. Even though Finnish companies' Russia risk has decreased in recent years, following the decline in trade with Russia, Russia has still been an important market for some companies.[1] Some 2,200 companies are engaged in exports to Russia, and export products from some 500 companies will be directly affected by the export restrictions imposed on Russia because of the war. Due to reputational damage and the higher risks, many companies that are not subject to export restrictions are also withdrawing from trade with Russia.

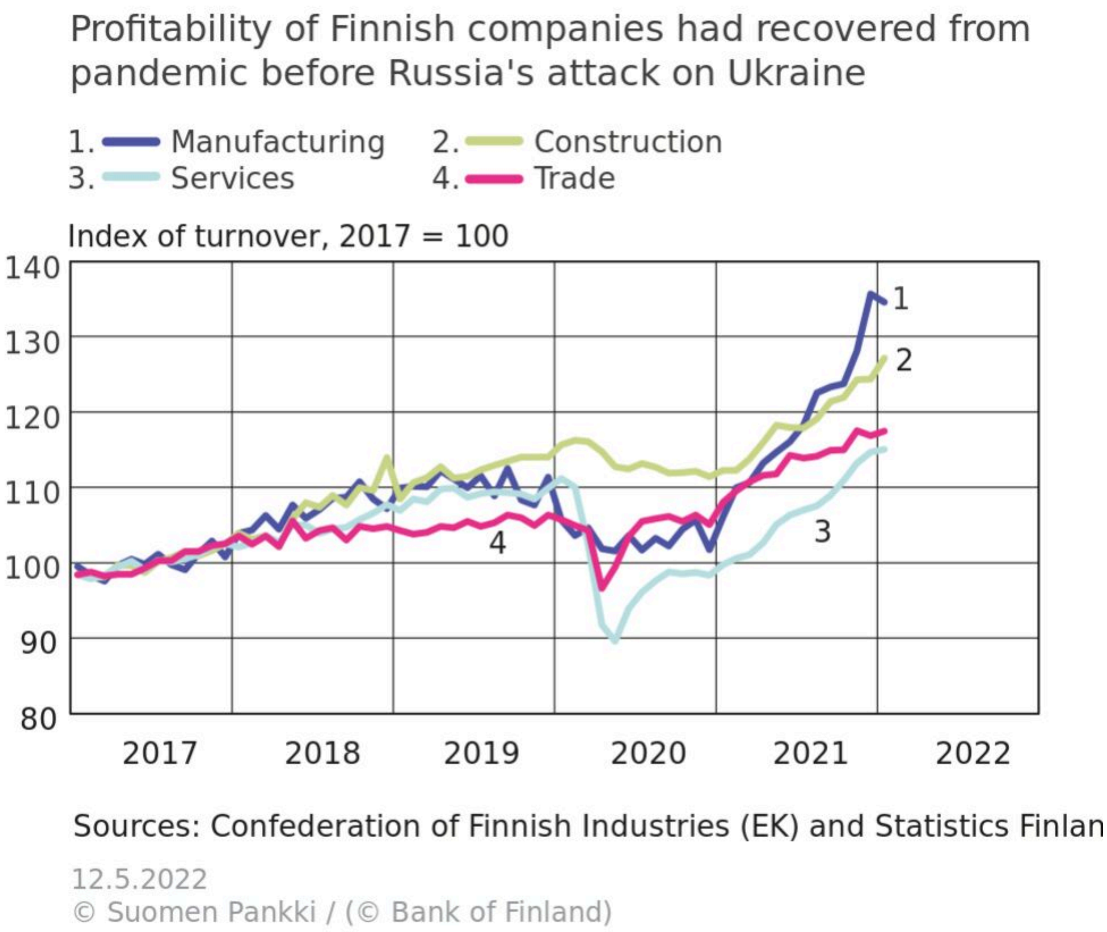
The Bank of Finland has estimated that the direct negative impact on the economy of the war will probably be considerably greater than the contraction in trade with Russia and the country's share of Finland's foreign trade would suggest.[2] The war and the sanctions and counter-sanctions are affecting the availability of many raw materials and industrial supplies and are exacerbating the global supply chain bottlenecks that emerged during the COVID-19 pandemic. The strong rise in energy and commodity prices is fuelling inflation, which has a more broadly based impact on the cost developments of domestic companies. The heightened uncertainty as to the economic outlook and inflation weakens both consumer and business confidence, which will also erode domestic consumption and investment. Companies' business may also suffer due to the sanctions imposed on the Russian financial system or the counter-sanctions imposed by Russia.

The war is weakening the operating environment of companies in a situation where they have already experienced two exceptionally challenging years due to the pandemic. Companies were affected by the pandemic in different ways, and some of the industries have already recovered more than others. Correspondingly, companies and industries will be affected by the war and its second-round effects in different ways.[3] In addition to the economic impacts, companies' operating environment will be weakened by the tightening financing conditions. In addition to the rise in risk premia, financing conditions are tightened by the progress of monetary policy normalisation on the global level. This article examines the starting point of domestic companies from the perspective of corporate finance, and the possible impacts of the weakening of the operating environment on companies' credit risks and access to finance, if the war and its negative impacts drag on.

The price of finance has risen for companies that have suffered most from the pandemic

The financial position of domestic companies was on average fairly good before Russia's attack on Ukraine. Finland's economic growth in 2021 was broadly based,[4] and the turnover of industrial companies, in particular, had recovered from the early phases of the pandemic (Chart 1). Demand for services had recovered even though the pandemic dragged on. Another indication of the improved outlook was the stronger employment situation and growth in manufacturing investment.

Chart 1.



On average, domestic companies have not experienced significant difficulties in terms of access to or price of financing since the early phase of the pandemic. The accommodative monetary policy of the European Central Bank has preserved favourable financing conditions by historical standards, and domestic banks' ability to provide credit to the real economy has remained good, supported by a variety of policy measures. The financing conditions have been supported by domestic companies' good profitability and ability to service debt. On average, companies have a relatively large volume of liquid assets in the form of deposits, and large listed companies are not very indebted on average.

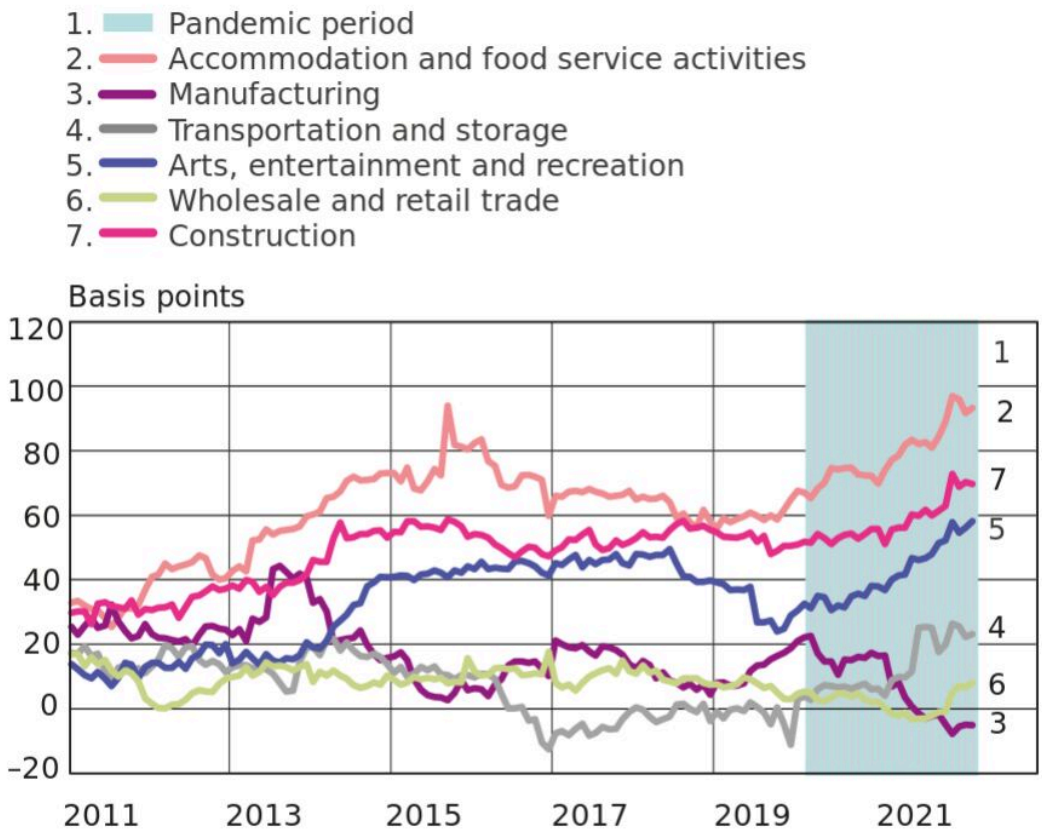
Contrary to previous economic crises, the average credit terms of bank loans to businesses have not tightened significantly during the pandemic. According to the Bank of Finland's s domestic Bank Lending Survey,[5] credit terms have tightened slightly, particularly in the case of the margins on loans with the highest risk rating. The credit terms of loans with standard risk ratings loosened on average in 2021. Otherwise, banks have not seen a significant tightening in credit terms.

Some companies are, however, still feeling strongly the impacts of the pandemic. The restrictions imposed during the pandemic hit particularly small companies and some of the service and transport industries,[6] as many of the restrictions were in force for a long time.[7] Domestic banks' credit risks have increased in the service industries that were hit hardest by the pandemic. According to the Financial Supervisory Authority, however, these industries account for a relatively small share of banks' stock of corporate credit,[8] and, as a result, growth in the credit risks of the stock of corporate loans has been fairly modest.

The higher level of credit risk has had an impact on the price of finance for the industries that suffered most from the pandemic and some industries sensitive to business cycles.[9] Bank of Finland statistics on monetary financial institutions show that the price of financing for the industries that were hit hardest by the pandemic has increased clearly relative to the average interest rate on corporate loans (Chart 2). The interest rate on bank loans is typically higher the smaller the company (Chart 3). Particularly in the acute phase of the pandemic, the liquidity position of small companies may have been weak. Small companies typically do not have the collateral and capital required for bank financing.[10] The new crisis comes at a difficult time, particularly in the case of the small companies that have suffered most from the pandemic, as their costs are pushed up by not only inflation but also the higher financing costs.

Chart 2.

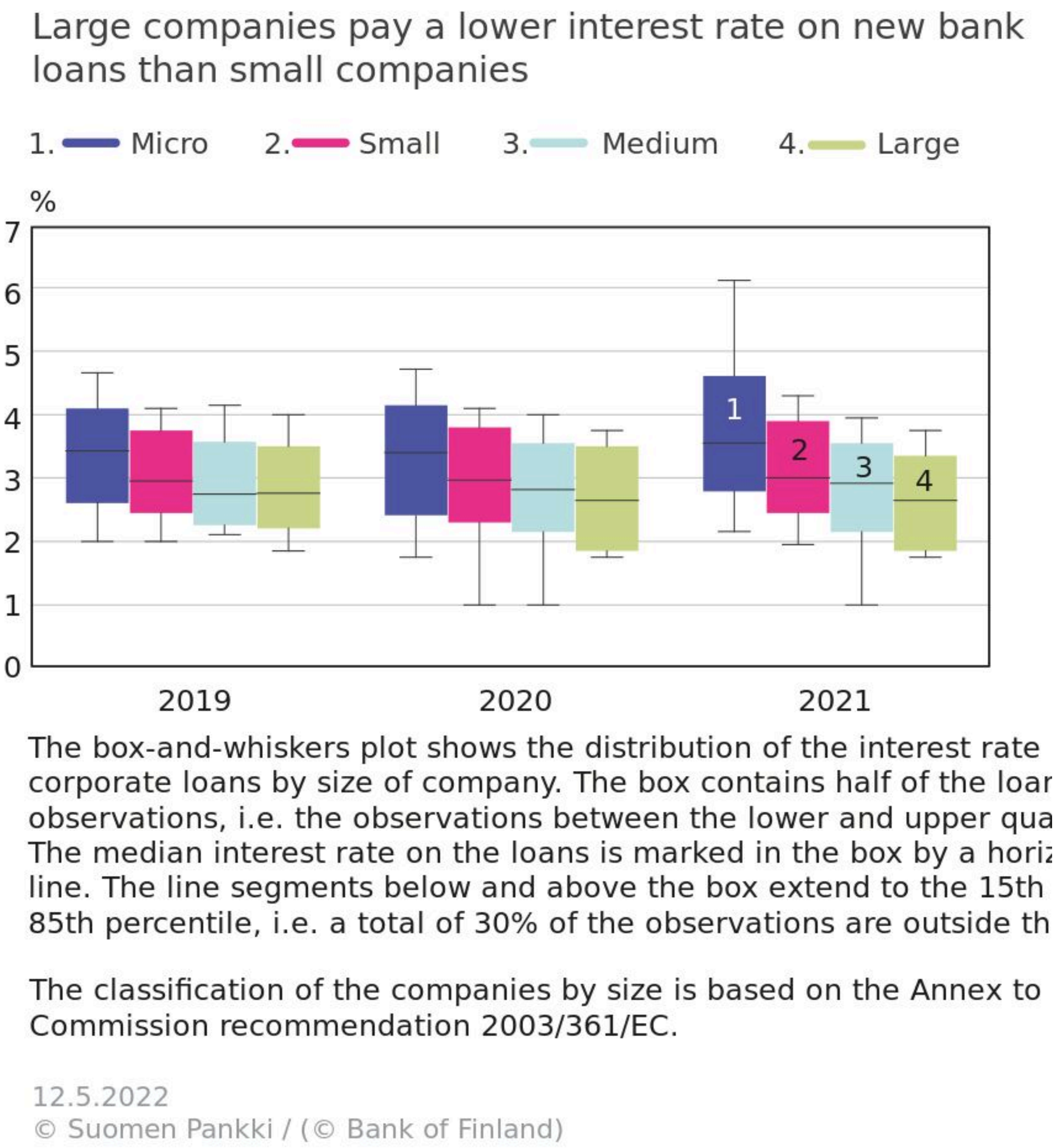
Interest rate spread increased between industries that suffered most from pandemic and other companies



Interest rate spread relative to the average interest rate on corporate
Source: Bank of Finland.

12.5.2022

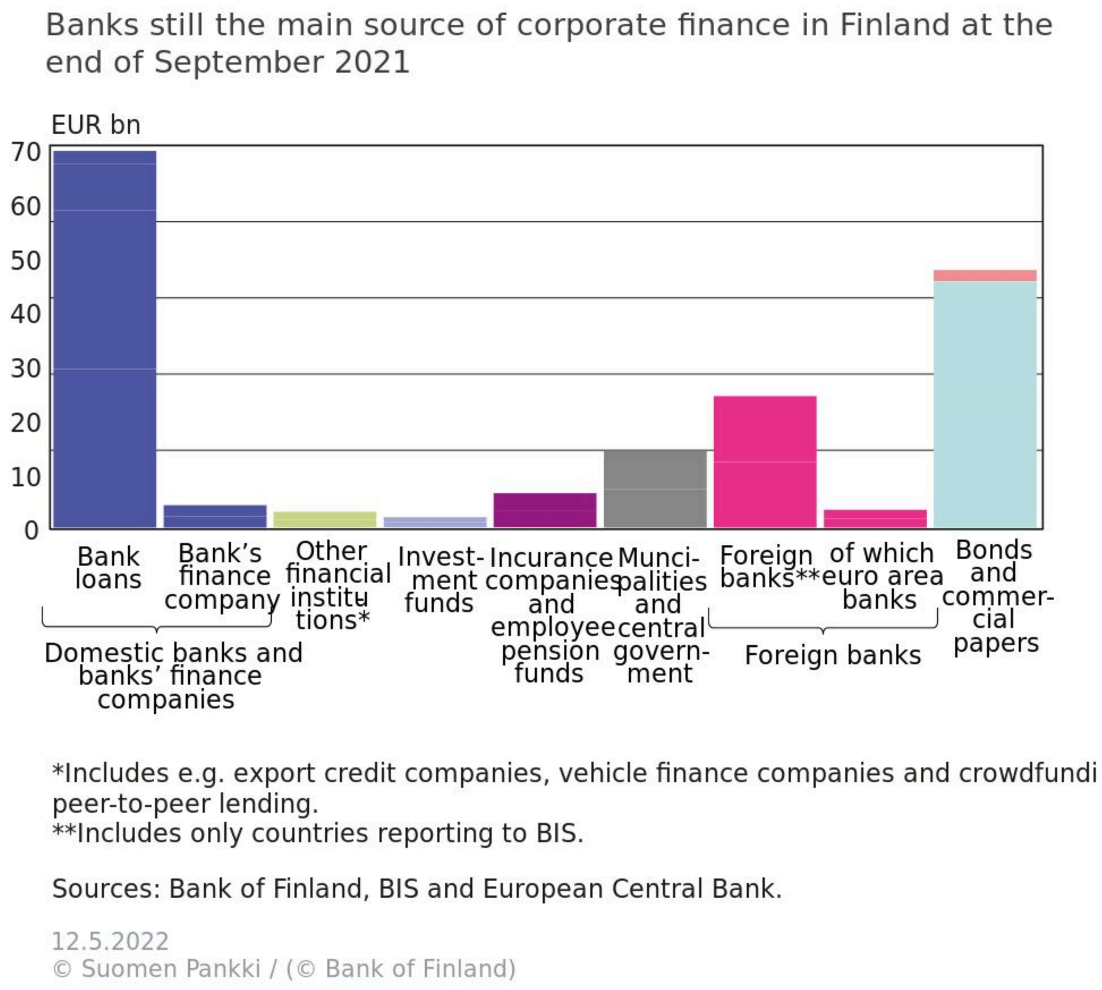
Chart 3.



Increase in uncertainty will probably be reflected in the demand for corporate loans granted by banks

Domestic companies are still largely dependent on bank finance (Chart 4). Particularly for small companies, banks are still the main source of finance. The ability of the domestic banking sector to grant credit under all economic circumstances is thus very important for Finland.

Chart 4.



Bank lending showed signs of picking up in late 2021 as the pandemic began to ease. Demand for corporate loans was boosted by, for example, acquisitions and corporate restructurings, and increasingly by investments.[11] In the most recent lending survey conducted in January 2022, however, banks anticipated a weakening of credit demand in the first half of 2022, which was an indication of heightened uncertainty in the global economy. Russia's attack on Ukraine has increased these uncertainties further.

In a crisis situation, the volume of bank finance may even grow, as large companies take out more loans within the liquidity and working capital limits agreed on earlier. The containment measures introduced to mitigate the impacts of the pandemic resulted in a short-term increase in bank lending to companies in spring 2020 as banks suffering from a contraction in turnover and drying up of cash reserves needed bank loans to meet their acute liquidity needs. A significant portion of these loans matured or were repaid in 2021, which was reflected as a contraction in the stock of corporate loans (Chart 5).

Russia's attack on Ukraine may also increase companies' temporary financing needs. Statistics show that drawdowns of new corporate loans were exceptionally brisk in Finland in December 2021.[12] The large figure is explained particularly by the exceptional factors on the commodities derivatives markets caused by the strong rise in energy prices, which increased the temporary financing needs of energy companies. Russia's attack on Ukraine is maintaining these exceptional market factors.

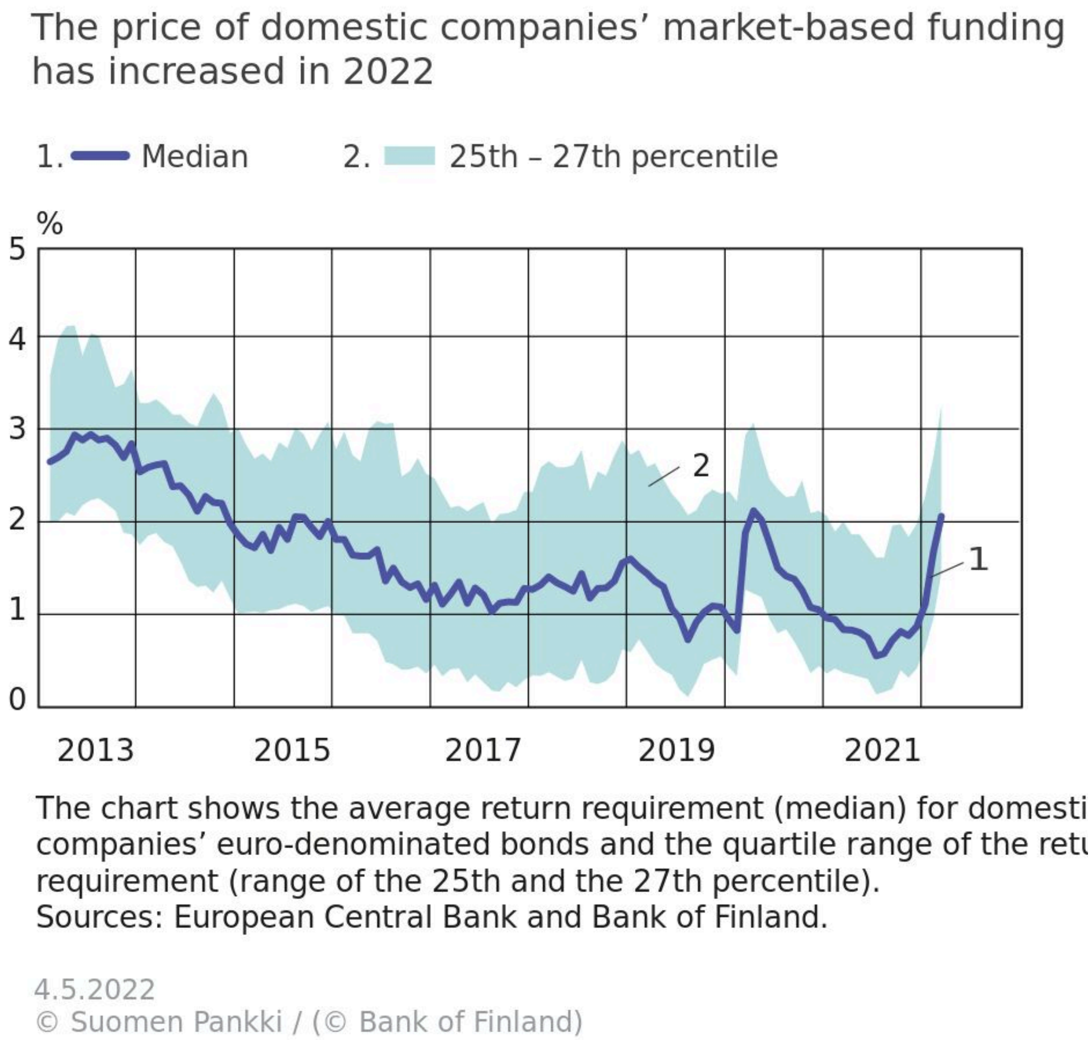
Chart 5.

Heightened uncertainty has increased cost of market-based funding

Russia's invasion of Ukraine has increased uncertainty on the financial markets and pushed up the required rate of return (yield-to-maturity) and risk premia on bonds. The impact has been largest in the companies most exposed to Russia risks. The yield-to-maturity reflects the impacts of the war on the companies’ future profitability developments.

In addition to the geopolitical situation, the tighter financing conditions reflect the expectations for monetary policy normalisation in the main economic regions. Inflation risks were rising already before the outbreak of Russia's war in Ukraine, and central banks have communicated that they are proceeding with monetary policy normalisation despite the heightened uncertainty. The US Federal Reserve (Fed), in particular, has signalled a more rapid pace of monetary policy tightening than expected. The strengthening of interest-rate hike expectations in the United States is reflected in the euro area, too, and the yield-to-maturity of bonds has started to rise on the market (Chart 6).

Chart 6.



The tightening financing conditions are pushing up the price of companies' market-based funding and weakening its availability. This may particularly affect large domestic companies that have in recent years been able to extensively utilise both the domestic and international capital markets in their funding. The stock of bonds issued by domestic companies totalled in January 2022 EUR 31.4 billion, while the stock of corporate paper totalled EUR 3.5 billion. This accounts for a total of 60% of the stock of corporate loans granted by banks.

The increase in the volume of loans granted by foreign banks and foreign market-based funding[13] has expanded the financing base of domestic companies and made it more international. Following the pandemic, foreign investors' holdings of bonds and commercial paper issued by domestic companies have increased considerably, and were in the third quarter of 2021 some 60%.[14] According to statistics by the Bank for International Settlements (BIS), loans granted to domestic companies by foreign banks total at least some EUR 17 billion.

In a crisis situation, market-based funding may be vulnerable to changes in investors' risk-taking capacity. In the early phase of the pandemic, domestic companies in particular reduced significantly their investments in bonds and commercial paper issued by domestic companies. The largest reductions were accounted for by domestic investment funds.[15] At the same time, the share of domestic institutional long-term investors such as pension funds and insurance companies in bond investments has decreased considerably: in the third quarter of 2021, their share was only some 10%.[16]

Russia's attack increases refinancing risks

Russia's invasion has weakened companies' operating environment considerably. The weakening economic outlook, high inflation and monetary policy normalisation are tightening companies' financing conditions. Uncertainty is still high, and the total impact of the war on the economy and companies' credit risks will depend on the duration and extent of the war, and on the economic policy measures to be introduced to support companies.

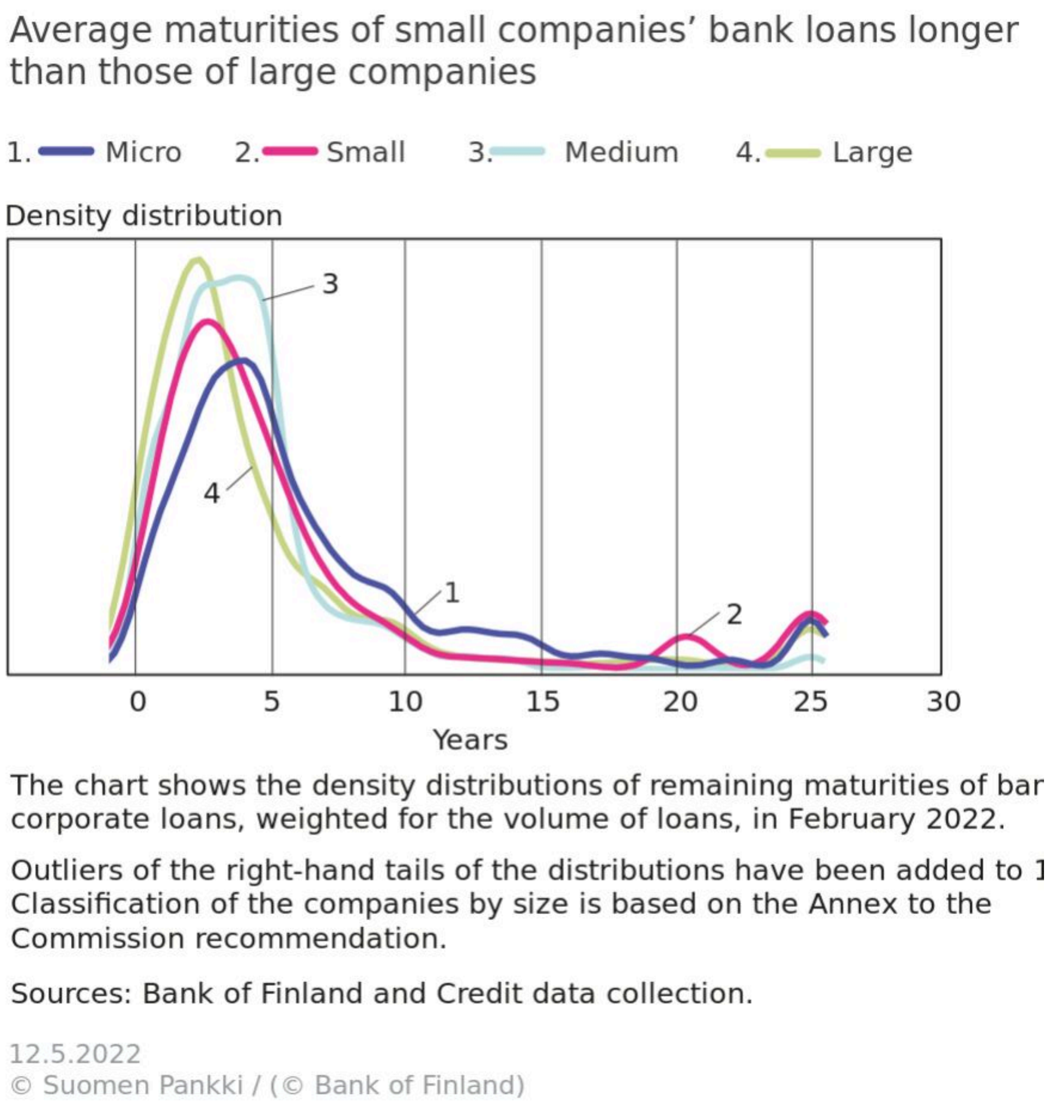
The situation of the companies is however alleviated by the fact that they are facing the new crisis with a good level of debt sustainability on average. The situation is nevertheless challenging, particularly for companies that have large Russia exposures and that are suffering more than average from the side-effects of the war, for example the strong rise in energy and raw material prices, or that are still recovering from the pandemic.

The ability of small companies to acquire financing in a crisis situation is weaker than that of large companies, as, in contrast to large companies, they do not have already negotiated credit agreements that they can use to secure liquidity in a crisis situation. In addition, the majority of small companies have limited possibilities to acquire domestic market-based funding or else such funding is very expensive. During the pandemic, small companies thus resorted mainly to a range of support for businesses and costs.[17] The pandemic also increased significantly the amount of loans guaranteed by the Export Credit Agency Finnvera.[18]

The tightening financing conditions will be felt by companies when they apply for refinancing as their old loans mature. Some companies may then have to pay a higher price for financing or, in the worst case, refinancing may be jeopardised.

Domestic companies' refinancing needs will increase in the immediate years ahead. A significant share of large companies' stock of bank loans will mature already in a couple of years. The maturities of loans by small and micro enterprises are on average slightly longer than those for medium-sized and large enterprises (Chart 7).

Chart 7.



The financial market impact of Russia's invasion of Ukraine has already partly materialised. As the war drags on, the situation of market funding may also weaken further. There is a risk of a broadly based weakening of confidence in domestic companies, for example as a result of higher country risk or an increase in the credit risks of companies exposed to Russia risks. The vulnerabilities related to country risk have been aggravated by the increasing use of foreign finance. Companies' refinancing risks in market-based funding are, however, reduced by the good starting point and debt sustainability of the companies, and because a relatively small amount of domestic companies' market-based funding will mature in the immediate years ahead.

Footnotes

1. In a survey by the Confederation of Finnish Industries (EK), 8% of respondents reported that the economic sanctions are having a significant impact on business. Nearly 34% of companies are of the opinion that the economic sanctions will cause some damage. See EK_kriisikysely_tulokset_03-2022-final.pdf (in Finnish only). ↑
2. See https://www.bofbulletin.fi/en/war-in-ukraine-will-slow-finland-s-gdp-growth-and-increase-inflation/. ↑
3. Metal, forest and chemicals industries are the most sensitive to the weakening in exports to Russia. The tourism industry was already hit hard during the pandemic, and, at least from the perspective of tourism from Russia, the situation is not set to ease. The rise in energy and raw material prices will hit hardest manufacturing and energy-intensive industries, for example transportation and agriculture. ↑
4. Adjusted for working days, output went up by 4.5% in December 2021 from a year earlier Statistics Finland – Trend Indicator of Output (stat.fi). ↑
5. Bank Lending Survey | Bank of Finland. ↑
6. Tourism and food and beverage service activities, transportation and transport, arts, entertainment and recreation. ↑
7. The majority of the different COVID-19 restrictions were lifted in Finland on 1 March 2022. ↑
8. Financial Supervisory Authority, Suomen pankkisektorin häiriönsietokyky Euroopan vahvimpia (helsinki.fi). (Finnish banking sector's resilience among the strongest in Europe; in Finnish) ↑
9. For example construction. ↑
10. See https://www.yrittajat.fi/tutkimukset/pk-yritysbarometri-1-2022/.(SME Barometer 1-2022, in Finnish). ↑
11. Bank of Finland's domestic bank lending survey. ↑
12. New drawdowns amounted to as much as EUR 6.5 billion. ↑
13. Bank for International Settlements (BIS) Consolidated Banking Statistics. ↑
14. The ECB has also increased its holdings of domestic corporate bonds, under the Corporate Sector Purchase Programme (CSPP). ↑
15. Before the pandemic, domestic bond funds' total share in investments in domestic corporate bonds and commercial paper was clearly larger than in the euro area on

average. ↑

16. As recently as the end of 2012, the corresponding share was 25%. ↑
17. According to the Ministry of Economic Affairs and Employment, direct business subsidies granted in Finland by 17 January 2022 totalled EUR 3.6 billion, while loans and venture capital investment totalled EUR 0.64 billion. The different guarantees available from Finnvera amount to some EUR 12 billion, of which some EUR 2.9 billion have been granted. ↑
18. Finnvera's role as an alternative and supplement to bank loans is considerable; in the SME barometer, nearly a fifth of the companies planning to apply for financing report that they will apply via Finnvera. ↑

Key words

corporate finance, credit risks, energy price