Tough times need unorthodox solutions, like Covid hybrid equity

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As our political leaders grapple with the immediacy of the COVID-19 crisis, it is important that they move from a very crowded dance floor of current issues onto the balcony to think strategically about the measures needed to support our economy when it starts the journey of recovery.

This is particularly urgent in the case of our small and medium-sized enterprises, the vast majority of which have been weakened by the pandemic — a weakness that could be a heavy handbrake on the potential for recovery.

Thousands of SMEs will find themselves saddled with increased liabilities, conservatively estimated at $40bn, by March 2021. No poor management here, just sheer bad luck that goes beyond any description of a “Black Swan” event.

The $40bn of incremental liabilities could be described as COVID or unproductive liabilities in that they were incurred without creating any corresponding value. More accurately, SMEs will have been hit with a “Triple U virus” of unplanned, unwanted and unproductive liabilities.

While medium-term reform supporting SMEs is important, the most urgent task facing many is survival.

Most SMEs will come out of this crisis saddled with bank debt, lessor, landlord, tax office and other creditor liabilities, and the fact that interest rates are at an all-time low is irrelevant given the magnitude of this liability mountain.

Among the many challenges facing our battle-weary SMEs will be navigating their relationship with their banks, which have so far played an admirable role as part of Team Australia. It is fair to assume, however, that the tone from the banks will be different when freed from the politically charged COVID environment.

In thinking about this problem, there are two broad options: the orthodox or the unorthodox.

Banks are orthodox institutions and solving the problems facing their SME customers is not something that they are equipped to do. It has been many years since our major banks have faced conditions remotely close to what we see today and since then, banks have become very different institutions, as the royal commission highlighted.

Many banks are working frantically to beef up their distressed debt teams, hurriedly training staff in this complex craft. The danger is, given the scale of pressure placed on banks, the result will be an industrialised, one-size-fits-all policy with an emphasis on recovery rather than turnaround.

Although mindful of reputation risk, inexperienced bankers will have targets to “churn” files, force asset sales in the hope of recovery before asset prices weaken. The result is a classic “prisoner’s dilemma” problem caused by a lack of a co-ordinated industry approach: each bank looking after their interests with no regard for system-wide considerations, let alone national interest, and ultimately causing an avoidable market correction in asset prices.

The unorthodox approach is based on the premise that in extraordinary times, extraordinary measures are needed.

We are in extraordinary times and market forces will not solve these problems. Hence, a public policy intervention is essential, first to ensure industry co-ordination and avoid the carnage that can result from the prisoner’s dilemma problem, but also to take a more strategic and national-interest approach. This is what is being considered by the British government and it is what should be considered here.

There are a few options to solving the issues faced by SMEs as a result of the pandemic, but the most pragmatic one is to convert some portion of the unplanned, unwanted and unproductive debt to a private-public sector COVID hybrid equity vehicle.

This will provide inherently viable SMEs access to hybrid equity capital, so minimising the deadweight of “zombie” firms and avoiding damaging the future borrowing prospects of entrepreneurs through damaged credit data. Absent this, many viable businesses may be subject to effective foreclosure.

Those who argue that no SME will want government as an equity investor are simply out of touch. They miss the point and provide little by way of an alternative.

The investing entity can be at arm’s length from government and mandated to support viable SMEs that might otherwise struggle. The nature of the hybrid equity instrument would allow the SME to redeem it when its finances return to a stronger position.

Some will argue that government should not interfere with how our banks operate in a market economy. This argument is deeply flawed as banks largely fund themselves on the back of taxpayer-guaranteed deposits, and they look to government should they ever get into difficulty. Banks are essentially quasi-nationalised institutions, so it is legitimate that they play their part in addressing this problem.

Extraordinary times need extraordinary solutions, and this means unorthodox policy.

The Australian government has to date been decisive, substantive and targeted, but this next phase, framed from the balcony in the national interest, will be every bit as important. Otherwise the post-COVID world will see SMEs trapped by the prosecution of individual interests, in an unhelpful triangulation of higher debt, lower profits and reduced investment.

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