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INJECTING PUBLIC CAPITAL INTO PRIVATE COMPANIES?

Berenberg Macro Flash

- The severe virus shock to the real economy is triggering a – still low key – debate whether governments should take equity stakes in companies at risk.
- Direct capital injections should only be used as a last resort.
- In a worsening crisis, capital injections could nonetheless make sense to preserve financial stability and/or keep viable companies afloat that cannot raise capital themselves and cannot get access to credits to ease a liquidity crunch.
- A direct public ownership stake would put taxpayer money at risk. But if and when equity prices rebound, as they probably will eventually, it would distribute some of the gains from such a rebound from current owners to taxpayers who have taken a stake in a company.

What if liquidity support is not enough?

Central banks and governments are trying their utmost to tide companies over the impending liquidity crunch as revenues slump temporarily while costs cannot and – in terms of employment – should not be slashed much. It will be a challenge to administer such programmes fast and efficiently. Fortunately, policymakers are working hard through their communications campaigns and by making use of technology to make sure that even smaller businesses can find and get the help they need. Expect huge efforts in this direction in the coming days/weeks. The bigger and/or more sophisticated companies may find it easier to fill in the required online forms or paperwork and for banks and governments to funnel the liquidity support to them.

But even for the listed companies, the question is whether liquidity support and other measures such as tax deferrals will suffice. It hopefully will. We nonetheless have to discuss a potential risk that governments may need or want to inject capital directly by taking equity stakes. In an emergency, direct capital injections can make sense:

- to preserve or restore financial stability, as was the case for during the great financial crisis of 2008/2009,
- to support viable businesses who cannot raise funds themselves or access liquidity support despite far-reaching government guarantees and very generous central bank refinancing facilities for banks, and
- to prevent hostile takeovers of technologies critical for security and data protection from foreign bidders who do not meet the required standards.

Our impression is that, for the time being, governments are hoping that their liquidity measures will suffice to ease the strains. Direct capital injections will probably remain a rare exception. Politically, taking direct equity stakes in many companies could be highly controversial. Also, private owners who know their turf tend to be better guardians of productive capital than public servants with a different background and incentive structure. But in these unsettled times, we need to at least consider the potential consequences of last-resort options. The European Commission's pledge to make full use of the flexibility foreseen in the EU's state aid rules has opened the legal door for such options more widely.

Looking further ahead: who will benefit from the rebound?

Outright capital injections would dilute the capital of current owners. The new co-owners, the taxpayers, would then be among the prime beneficiaries of any rebound in equity prices thereafter. After a crisis which is putting strains on public finances on a scale unprecedented in peacetime, one could even see a certain justice in such a scenario where taxpayers reap serious benefits from an eventual equity market rebound.

Of course, the discussion above presumes that equity markets will rebound eventually. Economists are not experts on equity markets. We do not run valuation models and do not look at individual companies. Instead, we can only make general observations. As always, these calls need to come with a disclaimer: we cannot predict the future. We can just come up with likely scenarios based on assumptions we consider reasonable.

The Sars-Cov-2 virus is dealing a dramatic shock to demand and supply in the advanced world. But we can – most likely – assume that it will be temporary. The world economy will recover. Most of what now needs to be switched off – factories, stores, airports etc. – can and will be switched on again, even if the switching back on will take more time than the imposition of tighter lockdowns. Whether or not markets were fairly valued at the end of 2019 is a question economists cannot answer. But we can conclude that, on any reasonable assumption about the outlook for the pandemic and the measures needed to contain it, the productive capital of the advanced world as reflected in equity prices should not be permanently valued 20-30% less than whatever its "fair" value may have been before.

As a result of the crisis, central bank rates and sovereign benchmark yields will likely be lower for longer than would have been the case without the virus pandemic. Big shocks usually dampen the inclination to consume and invest. That the additional central bank money could fuel a money-financed inflationary consumption boom in the foreseeable future seems highly unlikely, to put it mildly. The same applies to a hypothetical risk of surging wage inflation in the wake of a situation in which unemployment could be materially higher for a while than it would have been otherwise. Low yields for longer should matter for comparisons of potential post-Corona dividend yields to bond yields.

Whatever the partly self-reinforcing market dynamics may be in coming weeks, economic logic suggests that equity prices will eventually gyrate back to more normal levels. We may need more clarity about the course of the pandemic first, though.

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