Equity injections and unforeseen state ownership of enterprises during the COVID-19 crisis

29 April 2020

The COVID-19 outbreak and its containment measures including the lockdown of much of the world's population has put corporate balance sheets under tremendous pressure. As observed during the financial crisis 12 years ago, governments are finding it necessary to engage in multiple rescue operations involving companies deemed to be systemically important. Unlike the previous crisis where government interventions mostly concerned ailing banks, interventions relating to COVID-19 have so far mostly focused on insolvency and illiquidity in industry sectors hard hit by the virus, such as aviation and tourism. Other sectors seem bound to follow as the fallout from the crisis spills over into the second half of the year.

The interventions seen so far, as well as any more broadly based government support programmes announced in a number of countries, rely on a mixture of subsidies/state aids to distressed firms; government guarantees; loans at low interest rates and other forms of financing including convertible bonds; and outright equity injections by the state. In a number of cases, governments will find themselves in the role of unintended company owners and indeed a small number of nationalisations have already been undertaken or announced. Table 1 provides examples of specific government measures undertaken or announced to date in support of the airline sector[1].

[1] Airline companies in almost all countries have applied for government support and it is a near-certainty that the list will grow significantly in the coming months.

Table 1. Government support for the airline industry announced or implemented since 1 March 2020

Country	Target	Measures implemented/announced	Equity investment by state?
Company specific interventions			
Belgium	Brussels Airlines	State loan	No
Finland	Finnair	Loan guarantees	No
France[1]	Air France-KLM	Mostly loan guarantees, plus a state loan	No
Italy	Alitalia	Nationalisation	Yes
New Zealand	Air New Zealand	State loan convertible to equity	Potentially
Norway	Norwegian Air	Loan guarantees (conditional on a debt equity swap)	No
Singapore	Singapore Airlines	Equity and convertible debt issuance. The state acts as investor of last instance	Potentially
Sweden[2] and Denmark	Scandinavian Airlines SAS	Loan guarantees	No
United Kingdom	Easyjet	State loan	No
Industry-wide programmes			
United States	Airline industry	Mix of grants, redeemable loans and warrants	Potentially

Notes. This table lists company-specific interventions.
[1] Additional support has been pledged by the government of the Netherlands.
[2] This is part of a broader industry-wide support programme.
Source: OECD Secretariat based on press sources.

This poses an administrative challenge for governments, many of whom did not imagine themselves as owners of commercially active enterprises and who have no institutional structures in place to assume the new shareholding role. Going forward they will be faced with a choice between a rapid reprivatisation of the rescued firms; a more gradual approach guided by the evolving market conditions and pricing of assets; and the possibility that the economic realities of the post-COVID-19 world will have made state-ownership prevalent in some sectors.

A case for equity injection into ailing firms?

Equity injections by the state into an ailing company should generally not be considered unless an informed decision has been made that (1) the company in question is insolvent as a direct result of the crisis; and (2) it is too important to fail, for instance because its failure would trigger a disruption to the supply of essential goods and services. There could be a number of grounds for the latter, including market failures (e.g. if the company embodies important economies of scale or occupies a market niche that no other company can be expected to fill), is vital to systemic stability (e.g. in the case of a centrally placed financial institution), or because its collapse would cause an unacceptable level of social strain among employees and other stakeholders.

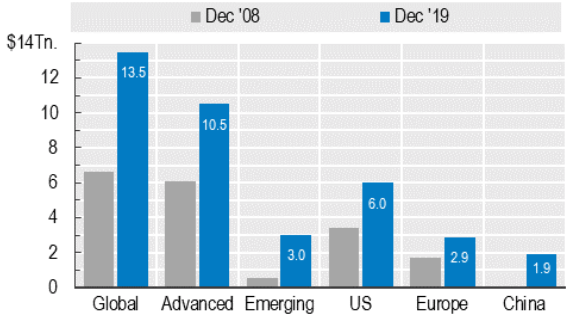
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The state or others?

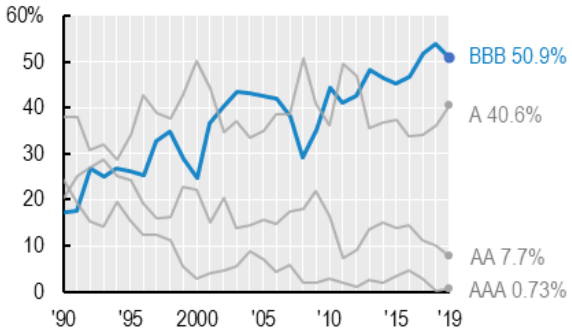
If a company is insolvent, an assessment should be made as to whether it is a case of “technical insolvency” that can be overcome if the company continues operating as a going concern. In this case, private investors would normally be willing to acquire the company and continue its operations, which would be the most efficient and market consistent solution. This in turn raises questions about the nature of national practices for dealing with insolvency: frameworks providing for pre-insolvency procedures enable a more timely and flexible approach at times of crisis, but several economically important countries lack this option which raises the likelihood of corporate failure. The spectre of insolvency is further raised by a concomitant rise in corporate indebtedness and decline in credit quality (Figure 1).

Figure 1. Growth in corporate bond borrowing, declines in credit ratings

A. Total outstanding amount of non-financial corporate bonds



B. Composition of investment grade bonds



Source: OECD (2020) Corporate Bond Market Trends, Emerging Risks and Monetary Policy.

A case for state involvement can be made, firstly, if potential buyers are competitors of the distressed company and a takeover would lead to the assets leaving the market, thereby creating an unacceptable level of market concentration. Secondly, if all potential buyers are foreign, concerns may arise either if the company operates in a strategic sector, or to avoid a ‘fire sale’ of assets if equity prices in the domestic economy are temporarily depressed.

Types of capital

If there are doubts about whether a company’s equity shortage is of a transitory nature the government could inject equity assistance in the form of convertible debt – i.e. bonds with options or warrants attached that allow for their conversion into common stock, either if they are not redeemed or at the option of the bondholders. This has the advantage that it incentivises the company and its shareholders while providing time for an orderly corporate turnaround. At the same time it helps ensure that the risk and potential rewards are shared by state and the shareholders. Governments choosing this course need to plan their future course of action, developing options for a timely exit from the companies and at the same time preparing for the eventuality that the rescue is ultimately unsuccessful leaving the state as the enterprise owner for a longer period of time than originally envisaged.

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The state together with others?

The state may want to consider injecting equity capital not alone but in conjunction with professional investors such a private equity firms and hedge funds. Another option is sovereign wealth funds which could be owned either by the state itself or by foreign sovereign governments. In a corporate rescue operation the expertise of these experienced enterprise owners can be complementary while also ensuring broadly aligned incentives. However, if the various investors' involvement is of a longer duration, the state should be resourced to act as an active and informed company owner, to ensure that information asymmetries between the private sector investors and the state do not compromise the public interest.

The state as an owner

If a company's troubles are manifestly not transitory, and it is deemed indispensable to the domestic economy, nationalisation may be the only option. If the state finds itself as an "accidental" enterprise owner of a number of enterprises, it needs to implement good practices for ownership and governance according to commonly accepted good practices, such as the *OECD Guidelines on Corporate Governance of State-Owned Enterprises*. The government may well have the intention to re-privatise the new state-owned enterprises (SOEs) as soon as possible, but experience shows that the process of privatisation can often take significantly longer than foreseen. In the interim period having good ownership practices in place will help ensure the efficiency and transparency of the firms, and eventually pave the way for a smooth and value preserving divestment.

A rationale for state ownership?

According to the SOE Guidelines, a key consideration for all state owners of enterprises is to clarify the rationales for ownership and, as a corollary, not remain owners if or when this rationale is no longer present. This in turn has implications for the privatisation timetable: if the rationale for ownership is simply to stave off a corporate calamity then actions to divest can be taken as soon as business conditions normalise. If the rationale was to stabilise certain markets or avoid adverse social consequences of corporate failure, then the state's exit needs to be more carefully prepared and perhaps staged in phases. When a government equity investment or corporate takeover is planned as a temporary measure, a clear exit strategy should be developed. These measures should be transparent and communicated to the market and the general public. The instruments employed in the rescue operation and the subsequent divestment (discussed below) should closely reflect the strategy envisaged at the outset.

Might the state retain its ownership role in the longer term?

In some cases, a government may conclude that a rescued company should remain part of the state's SOE portfolio. The post-COVID-19 corporate environment could have changed significantly, creating new rationales for state ownership. For instance, the outlook is for a growing concentration among fewer enterprises in a number of sectors, which might induce the government to stay involved as an owner to protect the integrity of the marketplace. The crisis has further highlighted some strategic concerns where the quest for corporate profitability led to decisions that were not aligned with the broader public interest: for example the globalisation of value chains and the reduction of corporate inventories associated with the just-in-time concept have left many countries with shortages of vital supplies. Going forward this will lead to a stronger state involvement in corporate activities deemed to be of overriding societal importance. This should preferably take the form of independent market regulation, but where this is not feasible a continued state ownership of certain companies may be the outcome.

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Elements of good ownership practices

The OECD recommends that the state should preferably establish a specialised and autonomous state ownership agency entrusted with this function. However, if the number of temporary SOEs is small or the state is confident that re-privatisation is imminent, it may not be worthwhile to establish a new institutional structure. But ownership should under all circumstances be exercised on a whole-of-government basis and not be left at the discretion of individual ministries. Another crucial consideration is the separation of powers to avoid conflicts of interest: those state institutions that exercise ownership rights should not at the same time be those that wield regulatory and other powers over the same state-owned enterprises[2]. Maintaining high standards of transparency and disclosure is also of great importance. This cannot be limited to financial (and non-financial) reporting by the SOEs themselves: the government must report regularly to the legislative powers, and the general public, on the performance of its SOE portfolio.

Whither a level playing field?

Governments should be mindful of the effects of capital injections and other forms of government support/interventions on the competitive landscape. The initial intention is to rescue a competitor who might have been forced by the crisis to leave the market, which may have negative or positive effects depending on the degree of market concentration. Subsequently, as an enterprise owner the state needs to observe best practices of 'competitive neutrality' to ensure that no enterprise has undue advantages, or disadvantages, in consequence of its ownership. This concerns, among other things, preferential access to financial resources, regulatory and tax treatment, market-consistent rates of return and an adequate costing and compensation for any public policy objectives that the state-owned firms are required to perform. The principle of competitive neutrality is widely accepted among policy makers, but the will to translate principles to practice has sometimes been lacking, for instance where companies are perceived as "national champions". Forthcoming guidance by the competition and trade policy communities might be useful to carefully calibrate state support and intervention in this regard.

Safeguarding integrity and avoiding corruption

Fighting corruption in SOEs is a high priority, not least as they are generally found in segments of the economy where large public procurement contracts are common and the lines between the commercial and political spheres are at times blurred. Transport and logistics is already one of the sectors of economy most impacted by COVID-19. These sectors have been found among the most susceptible to corruption even prior to the pandemic.[3] The state will need to demonstrate that the scarce funds have not been lost to corruption and other misappropriation. Similarly, the SOEs will need to demonstrate that their anti-corruption and integrity measures function well. This can be done, inter alia, by rigorous implementation of the *Guidelines on Anti-Corruption and Integrity in State-Owned Enterprises* and other related legal instruments of the OECD.

[2] During the 2008 financial crisis, this principle was violated in a number of countries as central banks and other financial sector authorities became entrusted with exercising ownership in large financial institutions.

[3] Based on a 2018 OECD survey of anti-corruption and integrity in SOEs.

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The state and "corporate citizenship"

If the state assumes a significant position as an owner of firms it should be mindful of broader policy priorities in the area of responsible business conduct: the state will effectively be setting "the tone at the top" within the business sector. As such it could use its shareholding position to encourage environmental, social and governance standards in line with its international policy commitments, including the OECD's *Guidelines for Multinational Enterprises* and related recommendations. These recommendations are voluntary for individual companies, but they have been formally endorsed by the governments of OECD's member countries as well as non-member adherents who are committed to their implementation. Going forward, to build trust in both governance and business it is of major importance that the state is seen to fully implement its commitments and ensure policy coherence in its role as an enterprise owner.

The state as a part-owner

In some cases the capital injection may only result in part ownership by the state.[4] When the state acts jointly with other shareholders, it should respect the rights of these shareholders according to commonly agreed international good practices. The state should not be privy to corporate information that is not available to other investors. If the state requires the company to pursue non-commercial objectives (PSOs) in the public interest, consultation and adequate information sharing with other shareholders should be ensured. At the same time PSOs should not be overcompensated to avoid undue competitive advantages on the market.

Divestment and privatisation

Notwithstanding political pressures to re-privatise rapidly, experience shows that the most successful privatisations and divestments are those that are well prepared. OECD area experiences suggest that policy makers should consider the following points:

- Careful consideration of the transaction's impact on the company, market and wider economy should be given to ensure appropriate staging of the transaction. Clear rationale for nationalisation or reprivatisation should be communicated to the public to avoid the appearance of improper motives.
- Sound competition should be in place prior to embarking on the transaction. In particular, the state should take care to avoid replacing a public monopoly with a private one.
- Policy makers should carefully consider the relative merits/demerits of various sales options, including their relative costs, staging, complexity and potential exposure to risks of corruption/illicit behaviour.
- The role of privatisation advisors is crucial. Special care should be taken to ensure a competitive selection process among a sufficiently large number of candidates, and to avoid conflicts of interest, including by separation of sales and advisory mandates.
- An appropriate company valuation and sales price is an important condition for success and is commonly based on the principle of fair market value. Should a government sell at below market value the reasons should be clearly identified, justified and transparent at the outset to ensure the integrity of the process.

[4] According to OECD legal instruments, a minority shareholding by the state only qualifies a company as an SOE if law, rules and ownership arrangements confer "a similar degree of control" as majority ownership of the voting shares.

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- The nationalisation and reprivatisation phases involve large transactions, long-term commitments of public funds and engagement of a large number of stakeholders, making them vulnerable to corruption and warranting particular caution. For guidance and the set of concrete actions to consider, the states should consult the G20 High-Level Principles for Promoting Integrity in Privatization and Public-Private Partnerships.

Further reading

OECD (2020) Corporate Bond Market Trends, Emerging Risks and Monetary Policy.

OECD (2019), "Anti-Corruption and Integrity Guidelines for State-Owned Enterprises", Paris.

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