FTI CONSULTING

CORONAVIRUS: DEALING WITH SUPPLY CHAIN DISRUPTION

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CORONAVIRUS: DEALING WITH SUPPLY CHAIN DISRUPTION

Reaction to the threat from COVID-19 has already imposed significant economic costs on China and the rest of the world. Hopes for a short sharp shock, characterised as a V-shaped dip and rapid return to business as usual are rapidly fading. Business should brace for second and third round effects.

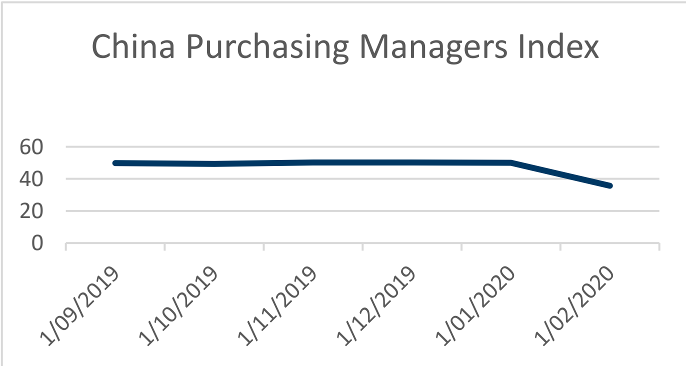
THE NOVEL CORONAVIRUS

According to the World Health Authority, the "novel" or "new coronavirus", a respiratory infection identified officially as COVID-19, has infected some 80,000 people in China. It is reported to have caused more than 3,000 fatalities up to 8 March 2020. The number of new cases in China has been falling since mid-February and only 8 were recorded on the 8 March.

The virus is spreading beyond China to 75 countries and territories, with the largest case numbers outside of China recorded in Italy, South Korea, and Iran. 700 fatalities have been attributed to the virus outside of China, bringing the global total up to 3,805. This compares to the 774 recorded fatalities in the 2003 SARS epidemic.

EPICENTRE IMPACTS

The efforts to contain the virus in China have come at a significant economic cost. The city of Wuhan, the epicentre of the outbreak, was locked down on the 23 January. The number of people in cities across China facing varying restrictions is estimated to have peaked at 760 million at the end of February 2020, or more than half of China's entire population. Schools have been closed. Factories, offices and other workplaces have been emptied of workers for some weeks. The air transport system has essentially come to a halt over the lunar new year period, normally a very busy time for Chinese airlines and airports. Quarantine measures and roadblocks have dampened movement and demand for fuel. Refiners have cut their processing rates by between 10-20%. Coal consumption in China's capital cities has been 30-40% lower than normal over February 2020.



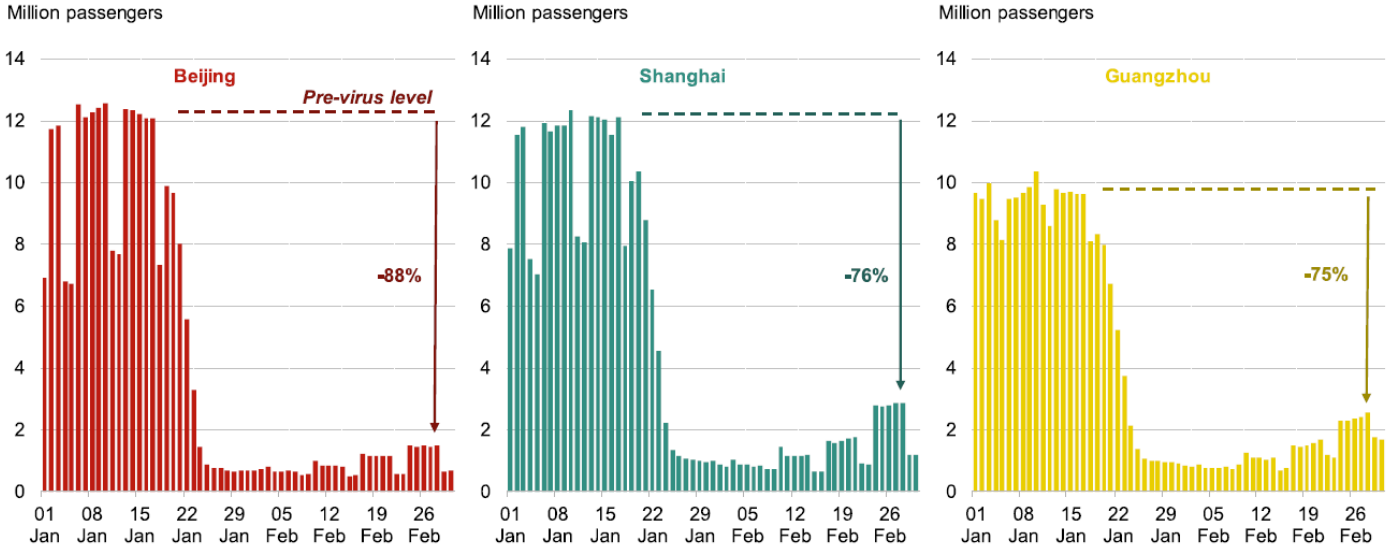
Source: Bloomberg

Chinese consumers have minimised spending, retreating from all but essential purchases. The Chinese Passenger Car Association reported that sales at dealerships had plummeted 92 percent in the first half of February compared with the same time last year. It was hoped that the prominence of e-commerce in China might keep consumption ticking over as consumers avoided malls and restaurants, but Alibaba, the largest platform has observed that the revenue impact in the 1st quarter of 2020 will be negative.[i] The problem is that all supply chains have been disrupted.

Industrial production in China slowed and stalled in many regions. The official purchasing managers index (PMI) tumbled to 35.7 in February from 50 in January, indicating a deep contraction in manufacturing and related activity in China.

Big manufacturing hubs on the Chinese coast are starting to loosen curbs on the movement of people and traffic while local governments are reportedly encouraging factories to restart production. The central banking and financial authorities have announced measures to lift and restore activity. The central bank has cut benchmark interest rates. Employees are being offered bonus payments to return to their workplace. Other measures include rent reductions and lower employer contributions to workers social insurance. There are also expectations of a strong fiscal package including a significant expansion in infrastructure spending. Analysts and commentators were talking about a "V" shaped dip and rebound in economic activity in China at the end of February 2020.

Daily Subway/Metro Passengers: Selected Cities in China



Source: Bloomberg "Covid-19 Indicators, 2 March 2020

DEVELOPMENTS IN THE GLOBAL ECONOMY

China is the world's second-largest economy and as a leading trading nation, the disruption experienced in China is spilling over into the global economy. The impacts are being felt in demand as well as supply conditions in markets.

Losses in Demand

Key examples of impacts on global demand follow.

International air travel

Several countries have imposed restrictions on arrivals from areas reporting large numbers of COVID-19 infections, particularly China. Like SARS, consumers have reacted to a perceived threat and have cancelled or deferred travel plans. Many businesses (including our own) have reduced travel for all but essential matters to or from countries viewed to be at risk. Airlines operating in the Asia Pacific region have curtailed operations over key routes and have reduced costs. Qantas International has indicated that it will reduce its capacity to Asia by 16 per cent until at least the end of May 2020.[ii]

Conferences and events

Trade exhibitions and other gatherings are being deferred or cancelled. Organisers are concerned about the impact of extended constraints on travel especially within the Asia Pacific region.

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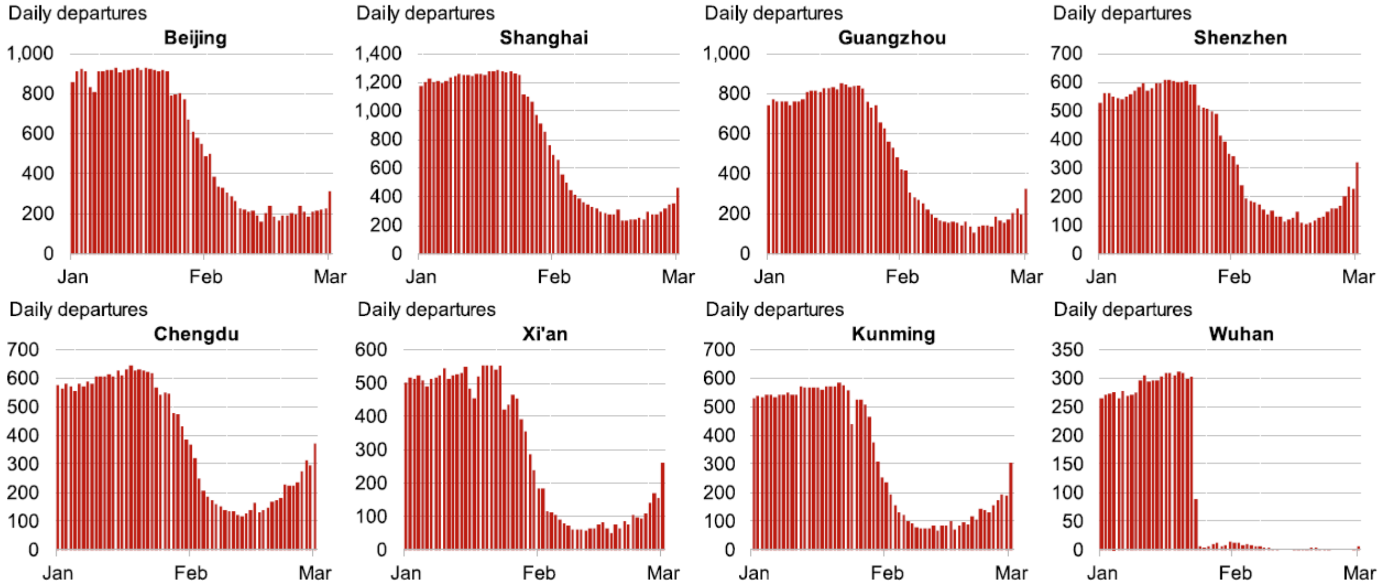
Airport Departures in China



Source: Bloomberg “Covid-19 Indicators, 2 March 2020

Other services

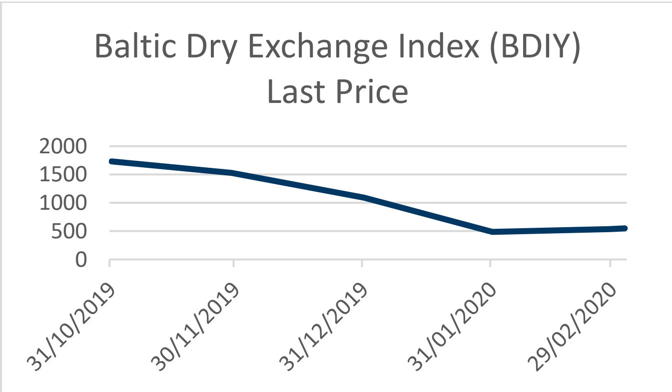
China is a significant source of demand for many services. Educational services delivered in Australia, have experienced years of double-digit growth and Chinese students spend around A$7 billion each full year on fees, travel and accommodation. Some portion of this annual expenditure and income is at risk while travel bans remain in place.

Accommodation and entertainment

Restaurants and entertainment venues are suffering a drop off in demand. In some countries such as Australia this can be attributed in part to a reduction in international visitor numbers. A portion of domestic consumers also appear to wary about public places and crowds.

Shipping

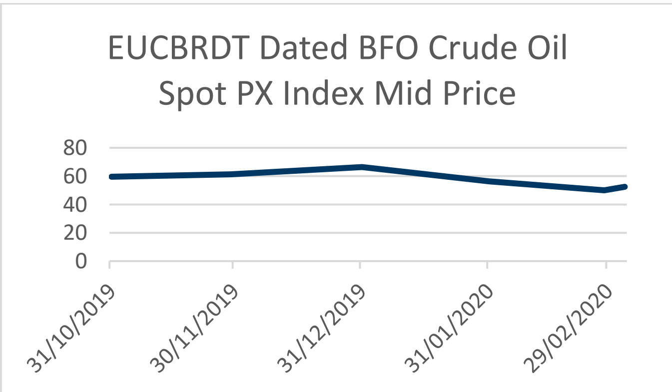
There has been a “sharp hit” to global container volumes and carrier earnings. Chinese port operators indicate that container volumes were down by 20-40% in the three weeks from 20 January to 10 February. Non-Chinese ports are expected to report falling throughput volumes when ships from Asia fail to arrive with containers from China. The Baltic Exchange Dry Index, which measures the cost of shipping major raw materials such as coal, iron ore, grains and other cargoes by sea around the world, posted its worst performance in eight years in January 2020, with the index losing almost half of its value, due to weak demand for ships and particularly muted activity in China. It lifted slightly in February, but the index is still at a low point not seen for 4 years.



Source: Bloomberg

Oil

China is the world’s largest importer of crude oil. Chinese demand has fallen over the opening months of 2020. The global price for crude oil dropped by around 20% over the same period.



Source: Bloomberg

Liquified Natural Gas (LNG)

LNG demand from industry and power utilities in China, the world's second largest LNG importer in 2019, has reportedly been reduced by 10-14% so far in 2020. There is some talk about importers declaring a "force majeure" clause in their contracts, meaning unforeseen circumstances are preventing them from fulfilling purchases.

Coal

Chinese customers are unlikely to apply force majeure provisions in coal supply contracts because they do need to have coal to fuel power stations. Without the coal there would be no generation of electricity out of many major coal-fired power-stations and the country would come to a complete stop.

Base metals

Iron ore, copper, and zinc dropped initially in 2020, reflecting the deeper than usual drop off in construction activity in China with many major cities effectively shut down. Talk about stimulus packages and reinvigorated investment in infrastructure and construction activity appears to have encouraged a recovery in prices.

Disrupted Supply

Sectors that are already seeing impacts include:

Components and products

With factories in China shut down or operating at reduced capacity, assembly lines in the rest of the world are beginning to run short of essential components. China's main exports include data processing equipment and components, mobile telephones, and integrated circuits, clothes and clothing accessories, textiles. Global businesses operating with lean "just-in-time" supply chains are facing significant challenges from disrupted supplies. Apple Inc and Microsoft Corp and other major producers have announced that they will not meet revenue or financial guidance in the early part of 2020 due to disruption to their supply chains.[iii]

Retail

The virus is adding to many threats being faced by retailers around the world at present including modest income growth and diminishing discretionary spending power. China is a key source of supply for many products sold in retail outlets. It is estimated that up to 40% of some categories are supplied from China. Much of the remainder passes through the global logistical supply chains that are currently blocked or disrupted. Seasonal categories such as fashion and luxury are concerned that the Northern Summer or Southern Winter product range, that would normally be under production now, will not make it to the shelves and display windows this year. Retail outlets are reporting a drop off in foot traffic through their stores. The shift towards e-commerce is well established and it appears that fears about the virus may be encouraging more consumers to try it. Disruption in supply chains is also impacting on e-commerce. Deliveries have been delayed. Goods are being withdrawn or classified as being not available for sale.

Construction materials

China is a major source of supply for key construction inputs including furniture, glass and clay construction materials in Australia and the Asia Pacific. It would be difficult to find replacements for these components for ongoing building projects if the disruption to these materials is extended over the next month or so.

IMBALANCES IN CAPITAL MARKETS

Global stock markets have been extremely volatile while they digest the implications of the COVID-19 epidemic and the response. They experienced the biggest fall in value since the 2008 financial crisis in the last week of February 2020. The "rout" was widely attributed as a global flight to safety. Stocks rebounded sharply in the first week of March 2020, showing the largest gains since the recovery in 2009 following the GFC. Expectations that the central banks would cut rates drove the recovery. Central banks in the US, Europe, Japan, and others signalled that they will "strive to provide ample liquidity and ensure stability in financial markets" or that they will take "appropriate and targeted measures" to combat the economic fall-out from the spread of the COVID-19 epidemic. The Reserve Bank of Australia noted that the coronavirus outbreak is having a significant effect on the Australian economy and it cut interest rates to a record low of 0.5% on 4 March 2020.

WHERE TO NEXT?

We don't have a reliable basis for forecasting the spread of the virus. There are signs that infections in China are in decline. The virus is spreading in the rest of the globe and health authorities are warning that the emphasis will need to shift from containment to case management.

The main economic costs of the new coronavirus are linked to the cost of containment measures and the behavioural response to perceived risk – the so called "pandemic panic".

These costs are linked to decisions made by people and they may follow more predictable paths based on plausible scenarios.

Very few countries will be immune to the flow on impacts. The Australian economy is probably the most exposed nation in the world to economic shocks in China given that China is Australia's largest customer (through exports of goods and services) and largest source of imports (or supply). Most of Australia's other major trading partners such as Japan, South Korea, and South East Asia, are also likely to be impacted by a slowdown in China. We really do need to give attention to the main scenarios about what will happen next.

The "V" shaped rapid dip and rapid recovery appears to be increasingly implausible

It is taking time to restart production in China and to unclog disrupted logistical supply-chains. People and goods are beginning to move again within China's major cities, but activity is still very subdued. While it may be feasible to work through the backlog of orders for goods, it is likely that disrupted services will never be recovered.

A "W" shaped or double dip adjustment is likely

The global economy has not yet felt the full extent of the disruption to supply and demand. The next phase is likely to involve dealing with a dip in income. Larger, well capitalised business will be able to bridge gaps in their cashflow. SMEs and start-ups may well struggle. Workers experiencing reduced hours or layoffs will have less to spend in coming months. Cocooning households may deal with uncertainty by postponing holidays and deferring consumption.

"U" or "L" shaped curves cannot be ruled out

Economic managers such as the IMF warn that the impacts may still take more time to run through the Chinese and global economies. Illness and disruptions in the ability to work and to consume are to be expected as the rest of the word deals with the spread of infection. This should be manageable if sensible public health precautions are taken. The effect will be to lengthen the duration of the impacts, although they should not be as deep or extensive as the cost of the "peoples' war" against the virus outbreak in the epicentre of the outbreak.

WORKING ON PLAN B

Headlines about the cost of the epidemic in terms of lost GDP or a recession involve spurious accuracy over a difficult to forecast set of events. It is more useful to think about what actions and activities that business and governments are likely to employ now that Plan A has been derailed.

Cash flows have been disrupted. Some businesses are cutting costs. Others may take longer to pay bills. Smaller, less well capitalised businesses may use debt to bridge the gap until the return to "normal" trade. There will be a need for debtors to restructure external debt/relationships with creditors in most businesses' new Plan B.

It seems likely that in the absence of other interventions from governments, insolvencies and bankruptcies will accelerate, especially regarding SMEs that are already struggling with other shocks recently (such as the bushfires in Australia, or the worldwide decline in discretionary spending and retail activity).

It is likely that there will be an uptick in claims for damages and loss, including failure to deliver, or to deliver on time from disrupted supply chains.

Many commercial contracts have "force majeure" clauses which are designed to protect companies from unprecedented events. Businesses should look closely at what events trigger force majeure clauses. Some commentators note that force majeure conditions in China are not entirely clear and may allow exemptions. SARS was deemed to be a force majeure, but China was a less sophisticated economy then. In addition, it may be the case that it has been the lock downs that imposed problems and this policy response may be deemed an "act of Government".

Disputes are likely and they may not be straightforward. Businesses should be collecting evidence of disruption to their supply chains just in case the worst-case scenarios do play out and this is needed to substantiate claims.

Just like SARS, the COVID-19 epidemic is highlighting that globalisation entails risks that must be managed. Driven by the constant search for competitive advantage business has embraced lower cost supplier options and selling into the markets that have consistently shown strong growth. Businesses are clearly overexposed to these sources of supply and demand.

Wise businesses and governments will be drawing on the lessons from the most recent epidemic and consider a range of measures that would include:

- Review and restructure of supply chains looking for agile and responsive solutions
- Raising geographic diversification of suppliers and customers
- Raising transparency about key high-risk events and management actions
- Reaching pre-agreement in the next set of supply contracts about how disruption will be handled
- Seeking greater guidance from policymakers about how they plan to act and react to evolving events now and in future
- Greater co-operation and pooling of resources within supply chains to minimise disruption and maximise efficacy of the response to disruption

[i] Chen L.Y., Lindberg K., Huang Z. "Alibaba: Coronavirus is having a broad impact on China's economy" Bloomberg 14 February 2020, downloaded from https://www.aljazeera.com/ajimpact/alibaba-coronavirus-broad-impact-china-economy-200213204347210.html.
[ii] Ryan P. and Chalmers S. "Qantas slashes flights to Asia as it warns coronavirus outbreak could cost it $150 million" ABC News downloaded from https://www.abc.net.au/news/2020-02-20/qantas-slashes-flights-to-asia-up-to-$150-million-hit/11982994.
[iii] Linnane C. and Lee J. "What Apple, Microsoft, GE and other U.S. companies are saying about the coronavirus outbreak" published 7 March 2020 downloaded from https://www.marketwatch.com/story/what-apple-walmart-and-other-us-companies-are-saying-about-the-coronavirus-2020-02-18

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