A&M INSIGHTS

CORONAVIRUS – THE SUPPLY CHAIN AND TOURISM IMPACT ON U.K. BUSINESSES

Within the space of six weeks the Coronavirus has led to unprecedented restrictions on movement and shut down of industries in mainland China. As shipments can take around six weeks to arrive in the U.K., the impact of this shutdown is yet to be fully felt by U.K. businesses.

As a core exporter of electronics, furniture, clothing and tourists it is likely numerous U.K. businesses will feel the operational and financial impact of the emergency either directly or indirectly through their global supply chains and sales channels. Businesses and management teams must plan ahead to understand these risks, ensure business continuity and resilience to these factors.

Furthermore, businesses should be considering to what extent they need to be taking a front footed approach with stakeholders on any repercussions for the business (notably lenders, shareholders and other market counterparties). We look at those sectors and businesses that could see the biggest impact and how management teams can best navigate the short-term volatility.

Timeline

31 Dec 2019
China reports the outbreak to World Health Organisation ("WHO")

13 Jan 2020
First case confirmed outside of China

23 Jan
Wuhan area quarantined

24 Jan
13 cities on lockdown

25 Jan
Chinese New Year national holiday extended to 10 Feb in some provinces, travel restricted

26 Jan
Hong Kong declares emergency and closes Disneyland

30 Jan
WHO declares global emergency

1 Feb
New cases confirmed around the world including the U.K., Australia, Canada, Japan, Singapore, U.S., U.A.E. and Vietnam

11 Feb
China returns to work but many businesses still suffering service disruption

Immediate future
Sea freight typically takes between 35 to 40 days to arrive in the U.K. from mainland China. This means shipments are still arriving from prior to the shutdown. As we move into late February and March shipments will start to decrease and stocks reduce. From this point onwards, U.K. businesses will start to feel the strain operationally and financially for the following few months.

Long term future
It is unclear how long the shutdown will continue to last and what impact on border controls and movement of people will be. The financial impact could be felt across the world for several months with many expecting the impact to outlast that seen by the SARS outbreak in 2003.

Disruption to the supply chain in the U.K.

The disruption felt by U.K. businesses may manifest in many forms and we take a look at the potential risks and impact here and what businesses can do to mitigate the risks:

Operational Impact

Disruption in supply

- Delays in deliveries from China could cause stock shortages. This in turn can cause U.K. manufacturers' production lines to slow or stop altogether and U.K. retailers to be left with empty shelves and warehouses.

Restrictions on travel and border controls

- Product and people flow across the globe may be confined. A lack of availability of the right people in the right place may cause operational issues for businesses.

Financial Impact

Profitability

- Businesses may look to seek alternative sources of supply in the short term. This could lead to an increased cost both internally (to coordinate) and externally (from the alternative supplier). In some cases, it may not be possible to change the source of supply, either because an alternative is not available or, due to the regulatory environment, the timescales and costs of changing supplier may outweigh the impact (for example in Aerospace).
- In the longer term, prices may rise as Chinese suppliers look to recover from their own disruption having additionally suffered from a scarcity of labour. In addition, global businesses will be desperate to recover stock levels which could lead to an increase in demand and consequently price increases.

Cash flow:

- Once Chinese businesses are operating at full production it is likely U.K. corporates will have to rebuild stock which could create a working capital funding requirement. In addition, any accelerated stock rebuild may necessitate the use of air freight which can be in the region of 10-15 times more expensive.
- When dealing with Chinese customers, cash receipts and/or deliveries may be delayed resulting in a direct knock-on effect to cash flow in the immediate term. Whilst several Chinese lenders have publicly announced their intentions to assist Chinese businesses impacted by the outbreak, there may yet be delays in processing payments and extracting cash whilst trading has been suspended.
- Any loss of, or delay, to sales resulting from the operational disruption may result in a reduction in cash receipts in the future. Businesses that operate an invoice discount facility with their lenders should be particularly wary of this as the impact to cash flow typically occurs more quickly following a drop in sales, as funding is not available on these invoices.
- In extreme circumstances, there may be a direct financial penalty chargeable by customers following a lack of, or delay, to supply. These damage claims from customers, or the cost of closing production lines altogether, can be significant. Whilst some contracts may have clauses that allow these costs to be passed on, this may not always be the case and they may not be enforceable in these situations.

Long-term economic impact

Economic growth

- U.K. manufacturing was slowing down prior to the outbreak and this crisis may expedite further slow down/contraction in the sector. The Chinese economy achieved its slowest economic growth in a decade last year. The impact on the Chinese economy will be significant and this could have further ramifications around the globe, including the U.K.

Tourism

- Consumers may become less inclined to travel in the short-term as, for example, holiday makers have been quarantined on a cruise ship for several weeks. A reduction in tourism could have a knock-on effect reducing consumer spending further and therefore impacting service industries and the wider economy.

Access to capital

Access

- Stakeholders will have an increased focus on credit risk and correlation to the issues resulting from Coronavirus.
- Reduced overall appetite or changes to specific exposure limits could impact access to debt capital.
- Short-term variations in profitability and cash flow may impact the ability to service debt and meet financial covenants requiring a front footed approach to creditors to explain the nature of the issue and likely impact on the business – this will invariably have challenges around management stretch and the ability to provide as much clarity as possible on the issues.

Sectors most likely to be impacted in the U.K.

The impact of the disruption will likely be felt in most sectors here in the U.K. Larger corporates are already slowing production or taking steps to mitigate supply problems, especially in assembly plant environments. For medium sized businesses the problems may lie in the second or third tier supply base where the supply problem may not surface until it's too late (for example food ingredients, flavourings and other additives, some packaging, metal components etc.) Tourism will also be impacted as Chinese and other international visitors to the U.K. reduce.

In particular, the manufacturing and retail sectors where components and supply chains are often heavily dependent on Chinese exports will see an effect.

These sectors have already been suffering in recent years with U.K. manufacturing slipping into recession in 2019 and the retail sector hit by a number of high-profile casualties and Company Voluntary Arrangements throughout 2018 and 2019. Further disruption could cause increasing stress in these sectors.

When considering whether a corporate might be impacted, it is important to reflect upon the provenance of all products and whether any components may be derived from the affected areas. Criticality of parts is key and can be often overlooked; however, a lack of availability of even a small component can cause production lines to seize and shelves to empty.

The global economy relying on China's exports sectors include:
(Shown as percentage share of global production in China)

54%	46%	42%	38%	38%	35%	29%
Textiles and Apparel	**Hi-Tech Goods**	**Chemical products**	**Machinery**	**Rubber and Plastics**	**Household goods**	**Pharmaceuticals and Medical Goods**

Source: Euromonitor

Management teams and external stakeholders can assess the potential depth and speed of impact by assessing these questions:

Are contingency plans in place?

Businesses and management teams may have pre-prepared contingency plans in the event of a disruption in supply. These plans may need to be adjusted and tailored to the specific situation but an increased readiness to react can often limit the impact on the wider business in these circumstances.

Is there sufficient liquidity to navigate the disruption?

Businesses must assess the potential impact on cash reserves and liquidity in order to identify any short- or medium-term funding requirements triggered as a result of any disruption.

Are alternative suppliers available from outside the Asia-Pacific region?

Businesses with readily available alternative suppliers, or where dual supply is already in place, may benefit as their reliance on the affected region is restricted. It is important to understand the capacity constraints of alternative suppliers as it is likely any such supplier will face increasing demand from customers during the period of disruption.

Is production 'Lean' with deliveries just-in-time?

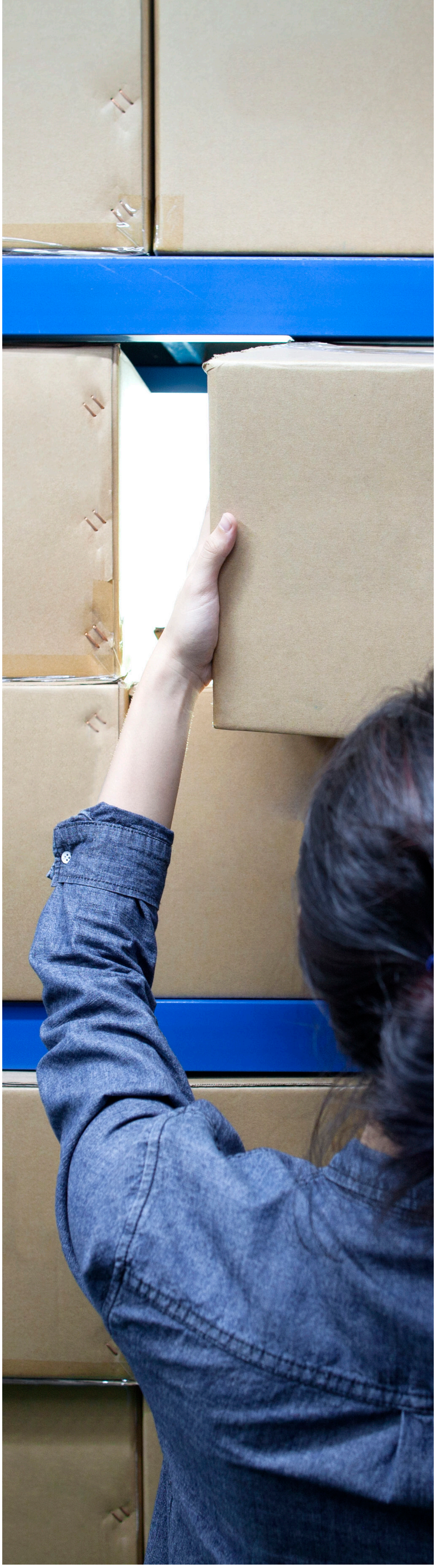
Businesses that operate Lean Manufacturing typically hold lower levels of stock and aim to have components arrive just-in-time to serve the production line. Even small delays to critical parts can cause severe disruption as these may not have the flexibility to be able to maintain supply. We are already seeing this slowing production in several original equipment manufacturers across automotive and manufacturing.

Are the products of a "big ticket" or bespoke nature?

Items with a high individual price and made to order in China will likely be more logistically challenging to change source of supply as orders will be committed and stage payments may have been made to the supplier. Similarly, if deposits or stage payments have been received from customers, delays in delivery or pressure from merchant services providers could place further strain on cash flows.

Is the product of a seasonal nature?

Season stocks (such as autumn clothing) being manufactured now may suffer shortfalls and increased obsolescence in availability or increased costs in sourcing.



How can A&M help?

A&M advisors have extensive situational experience working with management teams to deliver proven results.

Our debt advisory professionals can support in managing existing lenders where an unforeseen change in the business has occurred as well as considering alternative debt products and structures that better fit the risk, credit and funding profile of the business.

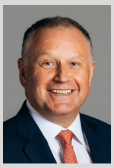
Our Restructuring team help management teams look forward to assess the impact on the business and what actions the business can take to mitigate any increased funding requirement and manage their external stakeholders through challenging times.

A&M has a series of risk assessment and mitigation tools available to help businesses with sourcing materials from alternate markets, logistical mitigation as well as teams on the ground in Asia with situation updates.

A&M can assist businesses within the supply chain impacted directly, or the larger corporate seeking to understand and mitigate their broader risks within the supply chain by:

- Assessing options and sourcing access to short term funding solutions;
- Managing and understanding the short-term impacts on liquidity through robust short-term cash flow forecasting;
- Managing and communicating the impact of the above to stakeholders including lenders, customers and suppliers;
- Review and understand the supply chain to estimate the impact and devise strategies to reduce the financial impact;
- Effective working capital management to maximise the cash position throughout the short-term disruption.

KEY CONTACTS



Mark Firmin
Managing Director - London and Head of Restructuring for the U.K. regions
+44 7801 901133
mfirmin@alvarezandmarsal.com

Omar Mirza
Managing Director - Birmingham

+44 7917 070346
omirza@alvarezandmarsal.com

Paul Flint
Managing Director - Manchester

+44 7831 445038
pflint@alvarezandmarsal.com

Jonny Marston
Managing Director - Leeds

+44 7901 716148
jmarston@alvarezandmarsal.com

ABOUT ALVAREZ & MARSAL

Companies, investors and government entities around the world turn to Alvarez & Marsal (A&M) when conventional approaches are not enough to drive change and achieve results. Privately held since its founding in 1983, A&M is a leading global professional services firm that provides advisory, business performance improvement and turnaround management services.

With over 4,000 people across four continents, we deliver tangible results for corporates, boards, private equity firms, law firms and government agencies facing complex challenges. Our senior leaders, and their teams, help organizations transform operations, catapult growth and accelerate results through decisive action. Comprised of experienced operators, world-class consultants, former regulators and industry authorities, A&M leverages its restructuring heritage to turn change into a strategic business asset, manage risk and unlock value at every stage of growth.

To learn more, visit: **AlvarezandMarsal.com**

Follow A&M on:

ALVAREZ & MARSAL