As China continues to manage the outbreak of COVID-19, the impact has broadened from a global health emergency, to causing significant business disruption in China and beyond, with the economic impact yet to be fully understood.

Whatever the impact, past crisis experience shows that China will undoubtedly recover and it is in that recovery that there will be opportunities for value creation. In this article we look to explore the context for the opportunity and highlight key levers for value creation.

**Comparison with prior crises**

The comparisons between past Asia and China crises (1998 Asia Financial Crisis, SARS in 2003, 2008 Global Financial Crisis) and COVID-19 have been made on many occasions since the start of the outbreak, but to understand how industry and the economy will react during the COVID-19 epidemic and in the subsequent recovery, it is important to understand some of the key differences:

- As a global health emergency, COVID-19 has spread much faster, causing significantly higher levels of infections, with fatalities exceeding that of SARS in a matter of weeks, compared to months. While SARS had a much higher mortality rate, the ease of transmission is estimated to be much higher with COVID-19 and infections continue to grow in China and globally.

- China’s economy has exponentially grown from approximately $1.03tn in 1998 and $1.66tn in 2003 to $13.61tn in 2018. Perhaps more important than the absolute size of the economy is China’s importance globally, which has increased from ~3% of global GDP in 1998 and ~4% in 2003, to ~16% in 2018 and now the second largest economy behind the US. (Source: The World Bank Group, 2020)
  In that context, a major shock to economic output, for example in manufacturing production and consumer spending, can be expected to have a significant impact on businesses directly operating in, or somehow dependent on China and that the initial impact may well be greater than that in 2003.
In that context, a major shock to economic output, for example in manufacturing production and consumer spending, can be expected to have a significant impact on businesses directly operating in, or somehow dependent on China and that the initial impact may well be greater than that in 2003.

**What is the impact on operations?**

The initial impact of the COVID-19 outbreak was in some ways delayed as it overlapped with the traditional holiday period of Chinese New Year, where there is always a natural break in production, but the extension of the holiday, coupled with travel and movement restrictions have quickly led to tremendous impacts around supply chain resilience.

Subsequently, China has restarted production, although it is far from being at normal production capacity, with regional operating restrictions in place in Hubei and many other provinces and cities, and travel restrictions in much of the country that require 14 day quarantines when crossing inter country borders.

The impact is being felt in various ways, with a recent survey from the American Chamber of Commerce in Shanghai finding that:

- Less than 25% had sufficient staff to run a full production line, primarily driven by travel restrictions and quarantine rules with the majority only being able to recover capacity to between 50-75%.

- More than 50% anticipating a reduction in demand in the coming months

- The impact is being felt not just through a shortage of staff, but also on logistics and the need to find alternative suppliers for materials

- Approximately 30% are actively moving production to other sites outside of China

These responses suggest operational efficiency and flexibility will be critical to minimizing the impact on operations and will also be differentiators in the recovery.
What is the impact on financing?

The impact on businesses may well be felt most acutely by their ability to access financing in a period of significant operational stress. This is on the back end of the China-US trade tensions which had already strained a number of sectors. When considering this, the private sector, which accounts for ~60% of the economy and ~80% of jobs, will feel the impact most and are already feeling the pain; a survey by the Chinese Association of Small and Medium Enterprises has shown most will run out of cash in only a few months.

Survey of Chinese SMEs – access to cash

Added to this, China has seen a reduction in domestic liquidity and an increase of more than 40% in non-performing loans over the period September 2017 to September 2019, from RMB1,670bn to RMB2,370 (source: CBRI). This trend is likely to be exacerbated by limitations on access to cash unless banks put in place special arrangements.

As a result, working capital management and in particular cash management will be critical for many businesses, as will managing debt obligations.
Where to create value in the recovery

When looking to the recovery, and considering the actions of past crises in China, there are some key policies being implemented that suggest a rapid recovery is what the Chinese leaders are trying to accomplish. For example, China has already pledged to support businesses, including through access to lending and support from the Ministry of Industry and Information Technology. The past is a good indicator of how the leaders will respond:

✨ Looking at GDP performance, in the period 2003 to 2005 China’s GDP grew at an annual rate of ~17% (from $1.66tn to $2.29tn) as compared to global GDP growth of ~10% (from $38.90tn to $47.46tn) in the same period.

✨ Following SARS, M&A rebounded with 2004 seeing ~50% increase, compared to 2003 (from $35bn to $52bn) according to M&A Asia, which demonstrated the significant opportunity following that crisis – this was driven by restructuring of State Owned Enterprises (SOEs) and inbound investment across industries following deregulation enabling greater foreign investment. The latter being a trend that has continued, with recent changes as a result of the Foreign Investment Law (FIL) (in effect from January 2020) and phase 1 of the US-China trade deal yet to be fully felt.

✨ While the Global Financial Crisis shook global GDP, which slowed to ~2%, for China it was more of a speed bump, with GDP growth from 2008 to 2010 “slowing” to ~15%. Similarly, as global M&A deal value fell dramatically by ~16% from 2007 to 2010 and deal volumes reduced by ~2%, over the same period, China saw deal value grow by ~21% and deal volumes by 6%, even accounting for a slight dip from 2008 to 2009. (Source: PwC Asia Pacific M&A Bulletin 2010)

We believe that given the tremendous liquidity pressures faced by the small and medium enterprises, that policy coming out of the crisis will be favorable to PE and MNC across a number of industries. From a strategic standpoint, companies should consider potential options. What the past experience of the post crisis boom has shown is that some of the best strategic opportunities that eventually came to fruition were completed with the first six months after the crisis.
Additionally, while there should be confidence that there will be strategic opportunities, the question may be which levers to pull to access more immediate organic value creation opportunities. Outlined below are some perspectives on potential areas to consider in current or future portfolio companies:

<table>
<thead>
<tr>
<th>Supply base</th>
<th>Logistics</th>
<th>Working capital optimization</th>
</tr>
</thead>
<tbody>
<tr>
<td>As many private businesses are facing limitations on cash, optimizing working capital will be critical to keeping the lights on. Many businesses do not have full visibility of their cash requirements and certainly not on the daily basis that may be necessary currently.</td>
<td>As outlined above, many businesses have been impacted by workforce restrictions. By improving processes to reduce the reliance on labor, operations will be more resilient to workforce reductions and limit the impact from future workforce supply constraints (or labor cost increases).</td>
<td>As many private businesses are facing limitations on cash, optimizing working capital will be critical to keeping the lights on. Many businesses do not have full visibility of their cash requirements and certainly not on the daily basis that may be necessary currently.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Workforce efficiency</th>
<th>Fixed costs</th>
<th>Credit opportunities</th>
</tr>
</thead>
<tbody>
<tr>
<td>As outlined above, many businesses have been impacted by workforce restrictions. By improving processes to reduce the reliance on labor, operations will be more resilient to workforce reductions and limit the impact from future workforce supply constraints (or labor cost increases).</td>
<td>With production not at full capacity, businesses are still facing cash shortages, in part due to their fixed costs. A review of the cost base to understand the drivers of fixed costs and implementing a non-manpower fixed cost reduction program will increase flexibility in the operation, while also limiting unnecessary spend.</td>
<td>As businesses default or are in need of access to cash, there may be greater opportunities for taking control in debt to equity swaps that can open the door to an operational turnaround.</td>
</tr>
</tbody>
</table>
Where to focus next

When looking ahead, the immediate focus should include:

Delivering on demand

- **Supply base** – Review suppliers in China to understand the status of their operations, including ability to meet demand based on current capacity, as well as the stock of parts held in own warehouses and by suppliers. This will enable risk based planning to determine the time before operations will be impacted. Additionally consider an assessment of alternative suppliers outside affected territories and the potential short-term impact on cost of goods from use of an alternative supplier.

- **Logistics** – Review the logistics chain for opportunities around transportation flexibility (e.g. air vs sea), warehousing changes through the use of third party logistics and movement through free-trade zones to limit the impact of import duty and tariffs.

Focus on cash

- **Working capital optimization** – Review the actual cash flow position and the drivers that will enable greater cash conversion. This should increase visibility of the requirements for areas including debt servicing, labor costs, suppliers and customers, while highlighting opportunities to improve access to cash.

Increase efficiency

- **Workforce efficiency** – Review the key operational processes to understand rapid opportunities to maximize utilization while the workforce is sub-optimal.

- **Fixed costs** – Complete a rapid analysis of the cost base to identify fixed costs that can be eliminated, including a focus on reducing non-manpower costs.

Managing debt portfolio

- **Mitigating the impact of covenant breaches** – Complete a rapid review of current loan portfolio to identify loans that have or may shortly breach debt covenants. This will enable a strategy to be developed for managing those at risk and to engage with debtors putting in place remediation, such as mandating rapid independent reviews to identify optimization opportunities.