Responding to COVID-19 disruption

Capital markets around the world are shaken as the spread of the novel coronavirus ("COVID-19") continues to impact global supply chains and trade. While China is New Zealand's largest trading partner, the effect on Kiwi businesses so far has been varied and the magnitude of the impact on the New Zealand economy is not yet clear.

Certain industries and businesses around the country are already seeing signs of disruption in their supply chains and decline in demand. Some industries were already facing headwinds (i.e. forestry and farming), and this will amplify that pressure.

Many businesses in China are still currently operating at a reduced capacity and working through the disruption after the Chinese New Year holidays and several weeks of additional unplanned shutdown.

Given the recent spread of the virus, this outbreak will continue to affect several industries in New Zealand (at least in the short term) and businesses need well developed plans in place to manage the potential for ongoing disruption.

The view of Kiwi business

While a lot of businesses are yet to see the full effects of this outbreak, many are expecting to be impacted at some point either directly or indirectly. The magnitude of the impact is driven by each business' exposure to Chinese markets (and other affected consumer markets), customers and supply chains. As the situation evolves, businesses must be mindful of increasing disruption outside of China.

The significant impacts observed to date include:

- **Immediate demand shocks leading to reduced pricing and margin pressure** – the sharp reduction in demand occurred at a peak time of year for certain industries, which required significant discounting to move unsold inventories. This is most pronounced in sectors that are reliant on Chinese consumers, especially crayfish, tourism and international education. In the crayfish industry, the demand (and hence pricing) significantly reduced as a direct consequence of the virus and occurred just when fisheries were ready to airfreight product for the Chinese New Year celebrations. For tourism, the decline in visitors to New Zealand has seen an immediate surplus in hotel rooms that has led to reduced pricing to fill the vacancies. The impact on the sector may be longer lasting due to a likely continued reluctance to travel. Due to the seasonal nature of tourism, this lost revenue will not be recovered even if the virus is short-lived.
- **Supply chain disruption in China** – as businesses have taken extended shut down periods, factories have not been able to fulfil demand, leading to gaps in supply chains and there have been challenges in getting goods in and out of China. This is likely to have future impacts in a range of industries as products, raw materials or components do not make it to New Zealand in time, and this disrupts the users or suppliers of these products (for example, specified componentry larger scale construction projects). Within the forestry sector, this has led to minimal usage of existing inventory levels within China, affecting the demand for replacement of inventory and reduced capacity to accept additional shipments. As a result there has been minimal shipments of logs out of New Zealand, leading to a sharp reduction in logging operations. We understand that ports are now open, although the backlog continues as not all migrant workers have returned to work.
- **Limited capacity of infrastructure in New Zealand** – our agriculture infrastructure is designed to cope with peak season demands. Delays in shipping products out of New Zealand are stretching freezer and cool-store space, and the ongoing drought is adding to this pressure. Horticulture (primarily kiwifruit and apples) will shortly reach peak season, and any delays in shipping product out of the country will see demand for cool-storage capacity outstrip the available supply, leading to either increased costs (with increased storage prices) or reduced selling prices (as suppliers look to sell more produce locally).
- **Disruption to international logistics** – as international flights are reduced, there is more competition for airfreight space. This will constrain businesses' ability to overcome backlogs, maintain normal inventory levels, and may lead to pricing

pressure. Reduced export volumes from China (as well as potentially other countries) may lead to the cancellation of cargo ships and a reduction of capacity in key trade lanes could have a significant effect on New Zealand's exporters and importers.

- **Reduction in contractors and seasonal staff** – many affected businesses have already reduced casual, seasonal or contract workers. In forestry, there are an estimated 2,000 contractors out of work as forest owners decide not to harvest. In tourism, reduced scheduling has led to the early termination of seasonal staffing. In a number of other sectors, overtime has been reduced as products are only produced to order to preserve raw materials.

Some affected businesses will be able to rebound quickly once market access is restored. For example, inventory of red meat in China has been depleted and will require significant volumes to restock the supply chain. Other industries will benefit less from a rebound, i.e. tourism and international education. Larger operators with strong balance sheets will be better placed to weather the storm than smaller ones. The industries affected will need to consider how to support those businesses with less capacity to withstand the financial impacts.

Preparation will provide a competitive differentiation

Strategically considering how to address these challenges will help businesses build plans to navigate any disruption.

Businesses should be considering how they would react under each of the three possible economic scenarios currently being assessed by the New Zealand Government:

1. A temporary but significant demand shock in the first half of 2020 and a return to normal trading in the second half of 2020;
2. A longer lasting impact to the New Zealand economy throughout 2020; and
3. A full global economic downturn in the event that the virus becomes a global pandemic.

With this in mind, we have identified the following areas for businesses to focus on when dealing with this event:

Assess the risk. Identify the expected areas of risk in your business, for example: gaps in your supply chain; reduced demand; consequential impact of financial and supply chain stress on your suppliers and customers (as well as staff).

Focus on liquidity. Keep a close eye on cash flow by maintaining a cashflow forecast, including modelling a range of scenarios, and understand the available levers to generate cash. Strategies you should consider include: cost cutting opportunities; optimising your working capital cycle to accelerate cash conversion; and pricing tactics to drive demand.

Manage your supply chain. Put contingency plans in place for shortages of raw materials or inventory and for disruption in transportation and logistics. Key actions could include: reviewing current lead times and adjusting production plans; finding alternative supply sources; and reviewing contracts and exploring options to renegotiate terms. Those operators who are well connected in the China market, especially those with influential local partners, are best placed to navigate the disruption.

Talk to your bank and other stakeholders. Review your current funding arrangements to consider short-term financial covenants and funding headroom. If there are likely to be any prospective covenant breaches or funding requirements, these should be raised proactively with your funders.

Update your business continuity plans. Ensure this covers how you would operate if your premises were closed or a number of your staff were quarantined and note the health & safety obligations on all businesses. We recommend testing the robustness of these plans before they are relied upon.

Review your longer-term strategy. Consider revising your medium to long term strategy to include: diversifying your customer base and product offering; investigating access to alternative markets and supply chains; and considering strategic partnerships or divestment of business units (or opportunistic acquisitions).

Take a balanced approach but be prepared

Businesses and consumers need to take a balanced approach in light of the low number of confirmed cases in New Zealand and current global mortality rates. While it appears most businesses will be impacted in some way (noting some will be positively impacted), those who have well considered and more mature business continuity plans will be in the best place to proactively deal with any disruption.

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