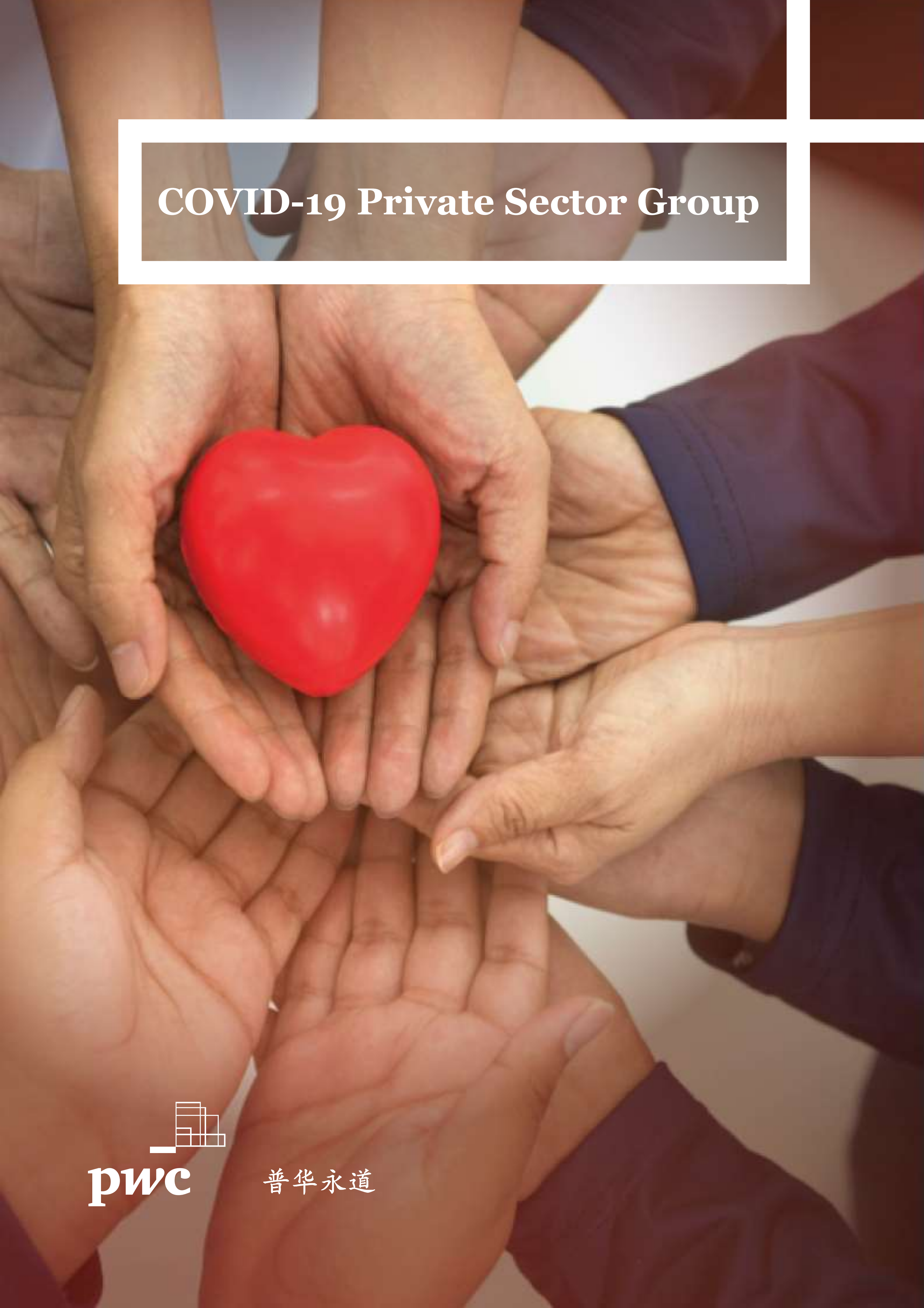
COVID-19 Private Sector Group



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COVID-19 Private Sector Group

Memo from the Fifth Meeting on 14 May 2020

The COVID-19 pandemic has created unprecedented challenges for many businesses, including strains on cash flow. On 14 May, the COVID-19 Private Sector Group (CPSG) held its fifth meeting to discuss “Winning in a crisis: How to ease the cash strain”. PwC’s asset management professionals, CFOs of large foreign enterprises and credit rating specialists gathered together to offer different perspectives and discuss effective options for easing cash strains during the pandemic. The meeting was organised and hosted by PwC as the group’s secretariat. Highlights and insights from the meeting are summarised below.

According to PwC’s survey of 824 CFOs of major businesses in 36 countries , including the US, Japan and Germany, conducted in April, 70% expressed concerns over the financial impact of the pandemic in terms of performance, liquidity and capital expenses, among others. When asked what financial measures they intended to adopt, 77% responded that they would control expenditures, while 65% said they would suspend or cancel investments and 48% said they would adjust their financing plans.

The consensus among the CPSG members is that effective cash management requires differentiated and individualised response based on many factors, including the business sector, funding structure, the size of the enterprise, among others. The impact of the pandemic differs from one business enterprise to another, and the exact position of an enterprise in this crisis needs to be systematically assessed in light of its own operational strategy changes, market changes and business changes. Detailed cash management plans should be developed after the cash position is determined in the bigger context. The meeting concluded that in terms of cash management, the cash flow position of a business enterprise can be divided into three stages, namely, survival, reopening and investing in the future. Each stage has its own different key indicators, adjustment strategies and priorities. The members shared their insights on the key points and practical experience of cash management at each stage.

Survival: cash flow forecast and cost control

Following a sudden black swan event, most enterprises are unable to sustain massive cash deficits in the short term, and the first thing is to ensure that the enterprise survives. According to findings released by the Representative Office in China of the United Nations Development Programme (UNDP) in April 2020, 30% of the respondents cannot sustain their current cash flows for more than a month, and no more than 10% are able to survive beyond six months. For those who have not established an effective cash management, the meeting offered the following recommendations.

I. High-frequency cash flow stress testing to fully understand the financial position

Business enterprises that did not pay much attention to their financial management now must put financial management and cash flow management on the top of their agenda for their survival. Cash flow stress testing is the beginning of overall cash management, as the test results will let the business enterprise know where it stands financially, which it will then be able to develop appropriate action plans accordingly. There are two areas where the work must be thorough. The first is the inventory-taking of the financial position must be comprehensive and all indicators must be collectively considered, including debts, receivables, payables, inventories, bank borrowings and reserve funds. Operating cash flows should be fully considered, but not only that, as all six dimensions of cash flow assessment should also be taken into account, including funds from operations, free cash flows, retained cash flows, cash flows before financing activities and cash flows from financing activities. Secondly, as the enterprise adapt to changes in its cash flow needs, high-frequency stress testing is mandatory. Considering the rapid changes in the crisis situation and the overall environment, the cash flow statement should be reconciled by week instead of month, as previously done. An enterprise must assess its chances of survival if it has no cash inflow in one month, three months and six months. After which, it must consider what options are available and what actions to take to ease the strain.

II.Identify and adopt a combination of means and methods to expand sources of income

During the massive lockdown, it was difficult for many industries to generate sales income, but serious efforts should be made to dig deeper and look further to identify other possible sources of income. One can, for example, take stock of its recoverable assets, sort them by contracts, repayment capability and relationship, and develop collection and discounting procedures and methods, as part of a systematic assessment. Some methods, such as advance sales and discount sales, may help collect cash. Cash flows from financing activities may also be generated through partial transfer of share ownership, disinvestment and recovery of investments from disposal of financial assets, among others. For small and medium-sized enterprises, it is more important to fully understand and make the best use of government policies, and obtain any and all government subsidies. Right now, businesses across China are issuing coupons to stimulate retail sales and consumption, and encourage bank loans, among other measures. The Hong Kong SAR government, for example, has established the "Retail Sector Subsidy Scheme" under the HK$30 billion "Anti-epidemic Fund" to assist retail businesses. The enterprise should also start its bank loan management to centrally manage existing loans by maturity, interests and limits, and consider its ability to obtain new loans to help address immediate concerns. The meeting made a special mention that it is important for enterprises to establish their corporate credit during favourable market conditions, through loans and financing and other capital operations, so that they can get assistance from banks and other financial institutions during a crisis.

III. Reduce costs to the maximum and lower operating leverage

One of the most direct measures to improve a cash flow position is to effectively lower costs and expenses. When sales decline, turning fixed costs into variable costs and reducing expenses can effectively lower the operating leverage. Enterprises can also make good use of measures adopted by the government to delay contributions to the statutory insurance schemes and housing fund, tax payments and public utility fee payments, among others, including extension of deadlines for tax payments, extension of interest repayments on bank loans, and postponement in contributions to the statutory insurance scheme and housing fund. For key employees, enterprises may consider incentive stock option plans to not only help reduce expenses for the current period, but also provide incentives for them to stay and invest for a better future. When remote working becomes a norm, operating cost may be further reduced through a big saving in rental expenses.

The meeting also asked enterprises not to make rush decisions to resolve the short-term cash flow shortage, including layoffs or default on suppliers, despite the severe impact from the pandemic. This is because people and credit are the cornerstones for the long-term development of the enterprise, and when they ride out the most difficult time of short-term cash flow crunch, the people and the credit they have retained will enable them to elevate their corporate brand.

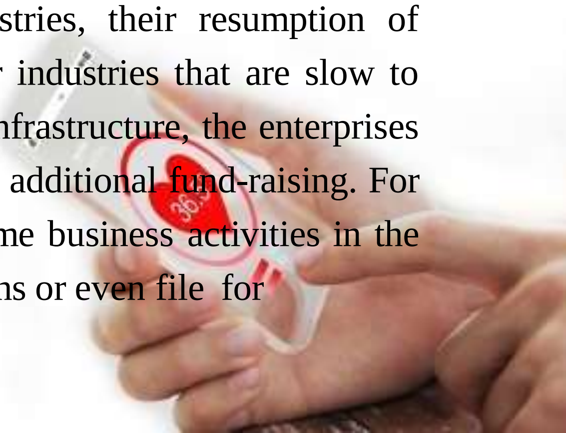
Reopening: A strategic balance between business operations and financial management

In the reopening stage, the financial management function should make major contributions in a leader and driver role. It should, internally, engage different functional lines to conduct analyses, and externally, stay informed about the conditions of the upper-stream and lower-stream business enterprises, to minimise risk exposures. The financial department/CFO should hold regular cross-departmental meetings to update on the funding position and realign the funding as needed, to enable the persons in charge in every business line to stay informed of the working capital status of the enterprise, ensure the smooth flow of cash, and better align the funding stream and business streams.

I. Internally, different functional departments work together to conduct cash flow analysis

Effective cash flow management cannot be achieved without upfront planning for front-office business operations. The financial function should work with their business, procurement and client management departments to take effective actions, including comprehensive inventory-taking of contracts, determining the priority and order of reopening and allocation of productive resources, among other things.

- **Breaking down the business segments and develop separate strategies.** For large corporate groups, the conditions for market and production reopening may vary significantly from one to another. Cash flow planning should be done at the business segment level. For business divisions in the medical industry and other less affected industries, their resumption of business activities should be sufficiently funded. For industries that are slow to reopen and involve significant investments, such as infrastructure, the enterprises should consider replenishing their cash flows through additional fund-raising. For non-principal business lines that are unlikely to resume business activities in the short term, the enterprises may consider spin-off options or even file for bankruptcy or reorganisation.



- **Perform dynamic sales assessments and make plans for different scenarios.** During the pandemic, sales have become one of the most variable factors. The meeting recommends that planning production by sales should be the financial management option that enterprises ought to adopt for the near and medium term. They should use the sales information to plan and manage resources at the production end, including people, funds, processes and contracts, and align them to deliver the best synergies. They can decide whether to use existing stocks or resume production based on the recovery of sales (60%, 30%, etc.). If several factories restart at the same time but at low resumption rates, with costs remaining high, the enterprises will face the frustrating situation of reopening to a loss, and it will create a second blow to the cash flow position.
- **Retain flexibility and adjust financial targets as needed.** During the pandemic, the whole market is full of uncertainties, and financial targets have to be readjusted in a timely manner in response to market changes. Flexibility must be adopted in setting financial management targets. When the targets have changed, the enterprises need to reconsider how best to manage their resources, expenses and capital, and even adjust their business operations to meet their financial conditions.

II. Externally, enterprises should consider, in a holistic manner, the funding positions of upper-stream and lower-stream enterprises along the supply chains

During efforts to resume work and production, supply chain collaboration becomes ever more important, as the failure in one link of the chain makes it impossible for its upper-stream and lower-stream enterprises to operate. The collaboration also requires steady cash flows to underpin . Medium and large-sized enterprises and multinationals generally have established strict cash flow management regimes, but certain medium and small-sized enterprises, be they suppliers or customers in the supply chains, are facing serious cash flow challenges due to the pandemic. The enterprises' cash flows will suffer when their suppliers or customers have cash flow problems, as they may demand advance payments from, or delay payments, to the enterprises. Accordingly, enterprises need to consider, in a holistic manner, the funding positions of enterprises in the upper and lower streams, and if the enterprises are sufficiently funded, they may provide funding support to their suppliers when necessary. It is particularly important now to maintain a proper balance between risk control and business operations.

- **Stay alert to some key indicators.** During the pandemic, enterprises should maintain adequate accounts payable periods and receivable periods by adopting optimised supply chain funds settlement methods, and ensure a stable supply chain funding by maintaining a safe level of inventories and closely monitoring its inventory turnovers. For the whole resumption period, accounts receivable days, inventory days and accounts payable days are key indicators to monitor.
- **Credit management in receivable collection.** Enterprises should stay informed of their customers' funding positions through constant communications and closely monitoring industry developments, among other ways. The customers' status of operations determines the cash inflows of the enterprises, and the enterprises may be flexible in the credit periods set for their customers during the pandemic, but only if risks are properly managed. It is therefore imperative for enterprises to take the initiative to engage their customers and understand their financial risks. As the situation worsens globally, overseas customers should also be included as major concerns, and enterprises need to plan ahead in accordance with local laws and regulations.
- **Make the best of internal funding arrangements within the group.** Some group companies have adopted a group-based solution to ease their funding strains during the pandemic, including adjustments of collection periods, M&A funding support and advance payments within the group.

The meeting calls for large enterprises to rise to the occasion to position themselves as socially responsible industry leaders, adopt various means and methods to assist the upper-stream and lower-stream small and medium-sized enterprises or suppliers to ride out the difficult times, and promote collaboration along the whole industrial chains in the resumption of work and production, while effectively managing their credit risks.

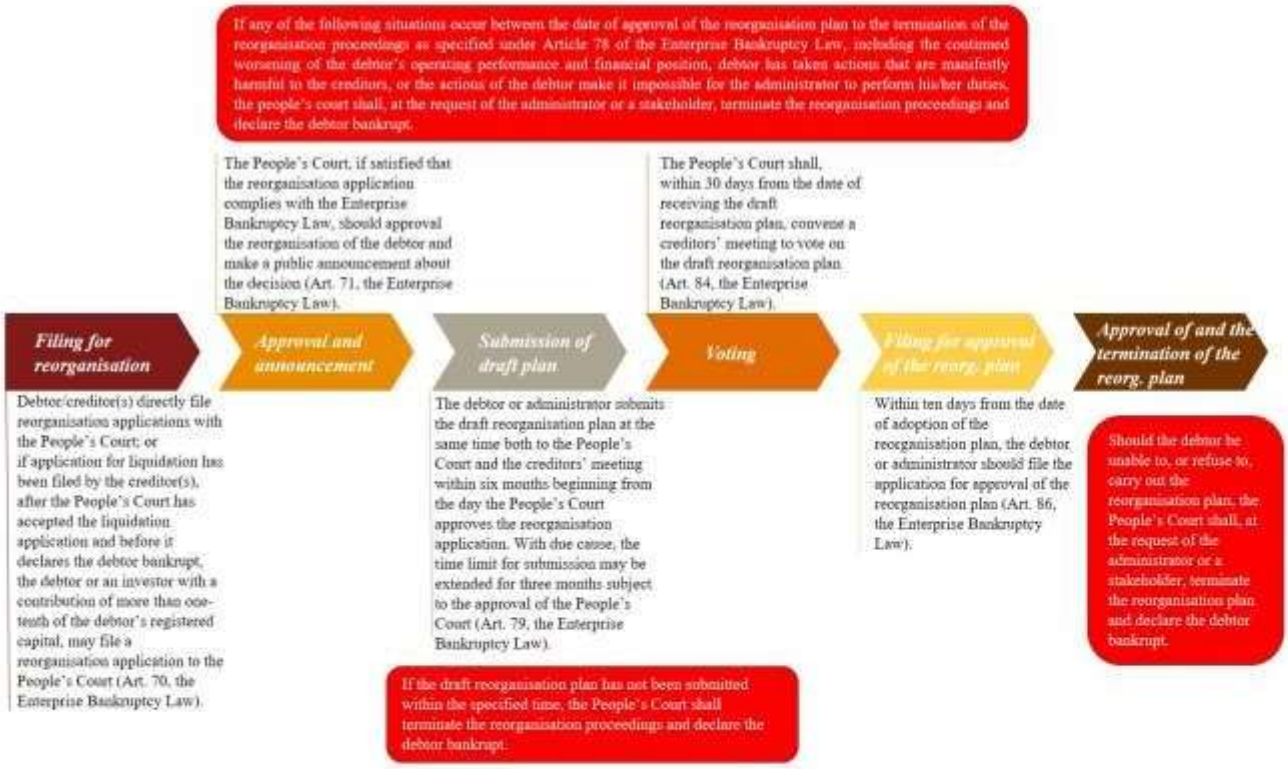
Investing in the future: Looking for greater market opportunities

For many enterprises in the medical and digital services sectors that have not been significantly affected by the pandemic, the health crisis is, instead, presenting an opportunity. There may be some enterprises that are severely undervalued by the markets, given the greatly lowered expectations for economic growth around the world, violent fluctuations in the capital markets, and significant changes at home and abroad in investment environments, trade relationships and supply safeguard measures. According to the statistics by the American Bankruptcy Institute (ABI), the number of American businesses filing for bankruptcy protection increased 18% in March compared with the same period last year. Large enterprises that have the capability may consider M&A opportunities and other options to improve their business structure, elevate their competitiveness and get ready for the next round of global redistribution of resources.

I. There are advantages in surviving the crisis through bankruptcy reorganisation

During the pandemic, if the creditors and enterprise can agree to reorganise and allow the enterprise to continue as a going concern, it may well be a great option for the creditors to protect their interests during a crisis. If successful, the creditors will have a solid chance of realising better gains through a reorganisation than through liquidation. For the enterprise, a reorganisation offers legal protection under bankruptcy laws, the chance of continuing as a going concern and a higher probability of turning the table. For the acquirer, a reorganisation through bankruptcy offers the following four benefits: the opportunity to directly acquire licenses that may be otherwise hard to come by; the opportunity to acquire a company with a clear debt structure, as it must undergo a systematic overhaul as part of the reorganisation; less liabilities as banks and other creditors may write off certain debts; and the opportunity to obtain protective policies and resources from the government.

Basic procedures and key milestones for bankruptcy reorganisation



II. There are four hidden risks to watch out for in M&A/ reorganisation valuations

M&A/reorganisation has become one major way through which the capital markets can help optimise resource allocation and discover values. At the core of M&A/reorganisation is value discovery and reconstruction, and it cannot be achieved without business valuation. As cautioned in the CPSG meeting, there are four types of risks in cash flow management that demand serious attention. The first is associated with the collection of cash flows, including the collection of receivables, investment returns and principals. The second is the funding gap risk, including a volume mismatch between expected cash inflows and cash outflows, and when investment needs exceed the ability to obtain cash. The third is structural risk, including the timing mismatch between cash inflows and outflows, and maturity mismatch between short-term and long-term debts. The fourth is low efficiency risk when the investments do not generate the expected returns despite abundant cash in hand.

As recommended in the meeting, enterprises should make sure they can manage the associated risks before engaging in M&A/reorganisation to optimise capital structure, improve the leverage effect, enhance their market competitiveness, heighten operating efficiency and facilitate a healthy development of their business.

We express special thanks to the following special guest and representatives of the CPSG member organizations who shared their insights in the meeting:

Xiaoyun Ma, the CFO of Schneider Electric China

Jenny Ai, the VP of China Lianhe Credit Rating Co, Ltd

Chen Lau, PwC China Business Restructuring and Insolvency Services Partner