Getting ahead of COVID triggered recession:

RE

structure

organize

purpose

> "The true test of character is not how much we know how to do, but how we behave when we don't know what to do"
>
> John Holt

As an unexcepted and impactful shock, spread of coronavirus has a large potential to result in wide scale permanent changes in our lives and status quo. As a significant threat for the health & safety, COVID-19 has managed to largely transform government agendas and place contagion mitigation as the top priority globally.

Governments and supranational organizations have spent considerable effort on crisis management. Yet, the past months have also revealed how unprepared the world is for a crisis at such a scale.

Naturally, top priority for the authorities has been contagion mitigation. However, potential economic impacts of the virus have received at least as much attention. Unfortunately, the future does not look bright now, at least in the short to medium term. International Labor Organization (ILO) estimates that globally 400 million full-time jobs were lost in the second quarter of 2020 relative to last quarter of 2019. Furthermore, in its June 2020 World Economic Outlook (WOE) forecasts, IMF projects a -4.9% global growth in 2020, 1.9% lower than its April 2020 projections. While the situation is as such globally, GCC countries have faced further challenges due to "double hit" stemming from historically low oil prices following a sharp decline after March. Undoubtedly, this brings added uncertainty for the region. Naturally, such an uncertainty makes planning substantially more challenging for businesses.

Globally, and regionally, many parties including governments, supranational organizations and corporations have attempted to reduce uncertainty by undertaking various scenario analyses. As a result, many different opinions on the longevity and magnitude of possible economic impacts of coronavirus crisis have been shared. Even though there have been numerous differing opinions, most of them agreed on one point: The virus will have substantial negative economic impact and recovery will be a major challenge. Therefore, it is time to shift the focus away from estimating "how powerful is the storm" towards discussing "what to do for successfully navigating our ships through the storm".

Naturally, the steps to take would differ substantially depending on the business under consideration. The industry a firm operates in, its customer interaction strategy and degree of vertical integration are among the important considerations in this context. For instance, a business operating through online channels would need a vastly different different compared to traditional brick & mortar businesses.

Nevertheless, even though the overall strategy would differ depending on the aforementioned factors, coronavirus crisis has made it clear that there are several aspects that universally holds true for all the businesses, regardless of their size, industry or geographical focus. First and foremost, COVID-19 has shifted the focus away from growth objectives to efficiency improvements. Secondly, it has reminded that business models are prone to change, and the firms that are slow at repurposing and reorganizing their businesses are destined to fail at some point in time. Moreover, the power of cash is realized once again. Performance indicators in accrual accounting tend to hide the importance of being effective at cash collection. Unfortunately, debt obligations are paid with cash instead of net income and the ones that have previously disregarded this important notion are likely to suffer its consequences it in the following months.

Even though coronavirus has had substantial destructive impact on global economy, it has also resulted in one positive development. The virus has unearthed previously unrealized structural vulnerabilities of many businesses. Even though it should be acknowledged that there always are and will be various major uncontrollable external impacts that might put business continuity under jeopardy, it would be unreasonable to assume that a business would go under trouble all at once and solely due to external factors. Instead, it should be realized that previously unrealized issues accumulate and become visible as a result of a trigger. The current form of this trigger is the coronavirus crisis, which presents significantly larger challenges relative to comparable triggers in the past. However, region economy has already been going through turbulent times even before COVID-19 impacts. Especially some sectors of the economy, such as construction, have been suffering from overcapacity. Low level of prices after 2014 has still been impacting the region economy negatively. When simultaneously taken into consideration, these economic realities signal that businesses in GCC are likely to be impacted even more and they need higher structural resilience to successfully navigate through the crisis. Due to the realization of above-mentioned weaknesses, businesses have the opportunity to undergo transformations that would result in long-term performance improvements by tackling these points.

In order to strengthen their positions, tackle identified weaknesses and vulnerabilities, improve their operational and financial resilience and successfully navigate through the coronavirus crisis, firms can opt for various options such as wide scale operational or financial restructuring, mergers and acquisitions, and carve outs. Given the challenges posed by coronavirus crisis for numerous companies in the region, we anticipate a surge in all three of these activities in the next years.

Traditionally, "restructuring" has been associated with "bad news". The primary reason behind such a connotation is the profile of firms that have traditionally opted for restructuring. Major portion of firms deciding to go under restructuring have been ones under distress. Thus, primary aims behind going under restructuring activity have been either postponing the inevitable or getting back on track instead of reorganizing or repurposing for performance improvement. Nevertheless, the approach to restructuring has been rapidly changing in last years. As region companies got more familiar with capabilities of restructuring professionals and have experienced collaborating with them, they started to realize the importance of early engagement with them for seeking their help in reorganizing for achieving superior performance. In other words, there is a tendency towards a more "proactive" approach to restructuring rather than "reactive".

Proactive stance to restructuring aims to reorganize or repurpose the business for maximizing performance. It requires frequent review of internal and external aspects to identify any early signal of trouble or source of comparative disadvantage.

Naturally, the inclination towards such an approach is a major positive development for the health of both individual firms and overall economy. On firm level, it enables companies to take repurpose when they are financially stronger compared to later where they would suffer from the ongoing impacts of unnoticed structural problems. At the same time, it enables firms to have more time for an orderly restructuring process. On the overall economy level, it would result in higher system wide operational efficiency, resulting in higher economic benefits.

In the last years, GCC has come a long way in terms of restructuring frameworks. Following the sharp decline in oil prices in 2014, region governments have been taking major steps to reshape legal systems, enabling orderly and stable restructuring processes. For instance, Saudi Arabia has passed the Bankruptcy Law in 2018 while UAE has enacted its own bankruptcy law in 2016 and Bahrain has introduced its law in 2018. All these frameworks are majorly based on Chapter 11 of US and they prioritize "keeping the businesses going concern". Introduction of these laws is a major positive development for GCC countries. However, these frameworks will be majorly tested in the wake of the crisis.

Owing to current economic conditions, restructuring activity in the region has already started to gain pace and it will remain as a key option for executives.

On top of this, evolving perception of restructuring and increasing trend of executives reorganizing their firms early on for higher performance will further boast restructuring activity in the region. As GCC states have started to introduce their own legal frameworks based on US Chapter 11, we will be witnessing a more stable and orderly restructuring process.

M&A is another path business leaders might opt to follow to ensure survival amidst uncertainty. In the context of current turbulent times, such an attempt can be backed by numerous motivations. For instance, as mentioned before, COVID-19 has reminded business community the importance of cash. Unfortunately, there are many firms out there that actually have strong fundamentals but have short-to-medium to term liquidity problems. In this case, debt financing might not be a sustainable solution by itself. Furthermore, restructuring of cash collections operations might take time to display tangible results. In such a case, if the liquidity problems of the firm under consideration is severe enough, merging with a firm with abundant idle cash might be an optimal solution for both continuing operations and resolving liquidity problems. On the other side of the transaction, a firm with sizeable cash finds an opportunity to deploy idle assets and realize returns. Moreover, it is likely that target could be acquired at a discount. As a result, both parties benefit from the transaction. As evident from the example, M&A is an important tool for business executives to ensure continuity. Thanks to its possible benefits, it is highly likely to witness a wave of consolidation in GCC.

Carve-outs could be another instrumental option for company executives. Naturally, in times of rapid economic growth, firms have been on the lookout for attractive opportunities in order to maximize long-term shareholder returns. As part of this strategy, they have also either acquired other companies or diversified into other industries. Even though these strategic actions have been logical steps at the time, this trend is likely to be reversed. Reorganizing the business by focusing on core activities to boost operational efficiency will be a priority for the executives in the short-term and disposal of underperforming units is one way to achieve this. On top of operational efficiencies, such a strategy would also result in cash-inflow for firms. Given the easy nature of benefits to be realized from this strategy.

it is highly likely to see a surge in carve-out activity across the region, especially across conglomerates. Even though proactive internal measures are of utmost importance for business continuity during crisis time, external support is also vital. Collaboration between firms, financial intermediaries and governments can go a long way for keeping overall economy healthy. Therefore, governments should continue injecting liquidity into the system by prioritizing industries of high systemic importance and most severely impacted. Simultaneously, they should be in constant dialogue with firm executives in different industries in order to not only be prepared for what might come next, but also offer recommendations to them. In fact, governments should involve sector representatives in policy making as much as possible in order to develop effective tailored measures against the crisis.

Banks also are of pivotal significance for mitigating negative impacts of coronavirus. Unlike 2008 financial crisis, where they were the source, banks are important parts of the solution this time. Liquidity injection is done through banks and this brings them both added responsibility and further risk exposure. As the recipient facing part of liquidity injection process, banks have the crucial task of taking sound credit extension decisions and engaging with clients on a continuous basis. Normally more stringent with their credit extensions during economically turbulent times, banks are expected to be even less strict in the current scenario due to their new role. However, this expectation does not translate into credit extensions to all businesses that apply for it. Banks are expected to carefully analyze applications and extend credit to parties that would use the funds effectively and to ones with an acceptable probability to remain as going concern. The criticality of their role does not end there. Banks also need to be in continuous contact with their customers in current times. Through these periodic touchpoints, they should offer recommendations to their clients and reassess their financial position. In fact, these regular contacts could be very useful for the realization of early signals of trouble that could be faced by customers. This way, banks can provide early warnings to their clients regarding potential problems they might face and enable them to reorganize their businesses early on. Also, banks can utilize these early signals of trouble for adjusting their loss reserves accordingly.

As a result of their new role of "financial institutions as capital injection mechanisms", banks are expected to be less stringent with their credit decisions and extend credit to customers whose applications might not have been approved in pre-crisis times. It is likely that less stringent credit decisions of banks would result in a client profile with higher average risk. This translates into a likely deterioration in asset quality of banks. As a natural consequence of this, business community has already started to raise questions regarding the financial resilience of banks. Concisely, it is clear that banks will also be negatively affected due to coronavirus and their "new role" will amplify the risks even further. Therefore, just like businesses in other industries, banks also need to be on the lookout to improve their positions in the medium to long term. On top of the possible negative impacts of their "new role", there are some other signals of

GCC has been experiencing an overcapacity in banking. Excluding Qatar, there are approximately 120 banks serving a population of around 50 million. Normally, larger number of players translates into a smaller piece of cake for everyone. Nevertheless, this fact has not posed a problem until recent years, as there was "enough room" for all. However, its effects have recently started to become visible last year, even before coronavirus. In the midst of unfavorable economic conditions, smaller banks have suffered more than their larger peers and they have been struggling to remain liquid. Lacking the scale to accumulate big ticket assets, they have had a higher exposure to SMEs, especially in real estate. Due to the recent downward trend in real estate prices fueled by oversupply, small banks have experienced a sharper deterioration in their asset quality. These trends have only been exacerbated as a result of coronavirus.

In addition to the new role banks and the overcapacity in the region, sensitivity to oil prices also pose an added risk for the banks in the region. The GCC economies are relatively more sensitive to the developments in oil prices

compared to other parts of the world. This is a valid statement for banks as well. Oil prices impact banks GCC banks via very different channels. Nevertheless, the one through the exposure to governments appears to be the most striking. After oil prices experienced a record drop in between 2014-2016, region governments experienced deterioration in their budgets. UAE, for instance, moved from a 5% surplus to 3.9% deficit. In order to preserve the spending levels, governments resorted to their deposits in region banks, which means banks took a large hit on their ability to lend. Given the historically low oil levels of oil prices after the advent of the coronavirus outbreak, it is highly likely to observe such an impact at a far greater magnitude in the upcoming months. Of course, it is also expected that governments will not aim to preserve their pre-COVID level of investments and some projects will be on hold. Still, overall, governments are expected to resort to their funds in regions banks and this might impact overall bank liquidity.

In the recent years, GCC has witnessed a wave of bank mergers. For example, National Bank of Abu Dhabi has merged with First Gulf Bank to create First Abu Dhabi Bank. Potential impacts due to new role of banks, overcapacity in region banking, and negative effects from high sensitivity to oil prices collectively signal a possibility of a second wave of mergers in the region. If became a reality, this would be a positive sign for the region financial services industry. Through the merger activity, institutions can diversify their loan books into other industries. This would mean lower risk due to lower percentage exposure to a single industry. Additionally, a possible merger might strengthen liquidity levels of banks.

On the other hand, changing customer interactions might also induce banks to acquire Fintech companies. The quarantine, social distancing measures, and reluctance of people to visit branches caused important disruptions in bank operations. Departing from this, it is no

surprise that bank executives started to think on how to reorganize their business, especially front-office related functions. This has been an ongoing trend even before coronavirus. In this respect, as the popularity of Fintech increases, banks are no longer bound to innovate internally. Instead, they may carry out the process through partnerships with the startups. Currently, the choice between organic innovation and partnership stands as a crucial decision that could have a significant impact on the outcome of substantial effort and investment. Therefore, firms must be cautious about the advantages and disadvantages of each option before making a decision. Nevertheless, since inorganic innovation enables fast access to already developed technologies, banks might consider this option to gain an immediate competitive advantage relative to their peers.

As an unexpected shock, coronavirus has had and is expected to continue having substantial negative impacts on global economy. After a long period of trying to estimate the longevity and magnitude of possible economic impacts of coronavirus, it is time to shift the focus on how to navigate through the crisis instead of discussing its likely impacts. In order to successfully navigate through the crisis, the executives need to focus on how to repurpose and reorganize their firms for achieving higher operational efficiency. In this regard, they might opt for different options such as restructuring, M&A or carve outs. Given the current economic state and prevailing uncertainty, it is highly likely that we will observe a surge in the activities.

Although these activities will be instrumental in ensuring survival during the crisis, they are not going to be sufficient per se. External efforts from governments and financial institutions will also be needed. In this respect, financial institutions will have a key role in the distribution of funds under liquidity injection initiatives. This role will bring additional risks for banks due to likelihood of increased NPLs. When taken into consideration together with high sensitivity to changes in oil prices and overcapacity in GCC banking, this might result in a second wave of bank mergers in the region.

Bhavin Shah

bhavin@truenorthmatters.com
bhavin-shah-truenorth

True North Management Services DMCC
PO Box 507281, Dubai, UAE | contact@truenorthmatters.com | www.truenorthmatters.com