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Impact of trade-disrupting COVID-19 on South African business

20 February 2020

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Executive Summary

The global economy entered a phase of ‘slowbalisation’ before the world became aware of the accelerating public health emergency surrounding the coronavirus disease 2019 (COVID-19). We recommended that South African CEOs should plan for a variety of scenarios. Humanitarian crises also have significant implications for business, with people being displaced, the movement of goods restricted or suspended, and supply chains disrupted.

Wuhan in China’s Hubei province (the source of the outbreak) is a major industrial and transport hub with 6,000 foreign-invested companies from over 80 countries. The complexity of global supply chains means that businesses may be reliant on Chinese products without being aware of it. (The 2011 nuclear accident at Fukushima, Japan already highlighted unexpected supply chain dependencies.) The scope for COVID-19-induced business disruption in South Africa is vast considering that China is South Africa’s largest trading partner. The construction industry has already reported delays in delivery of construction materials sourced from Asia.

Companies that have built markets on the back of an integrated global trade network need to be aware of, and ready to act on, the vulnerabilities that their trade dependence creates. An effective approach to protecting businesses against the disruption in trade is built on five pillars:

1. Create a view of critical products and suppliers
2. Have contingency plans in place
3. Consider the financial and legal implications
4. Communicate
5. Conduct scenario analysis

Epidemics disrupt economic activity for a short period after which lost output is made up quickly in subsequent periods. Previous Chinese epidemics also suggest the economic impact of COVID-19 will be significant but short-lived. Prior to the outbreak, Fitch Solutions expected the Chinese economy to grow by 5.9% this year. Under a rapid containment scenario, with panic fading rapidly and restrictions on movement dismantled swiftly, growth would decline to 5.7%. Alternatively, the epidemic might not be contained until mid-2020, reducing 2020 growth closer to 5.0%. Effectively, COVID-19 could cut Chinese growth by up to one percentage point.

According to research by the International Monetary Fund (IMF), a one percentage point drop in Chinese growth would reduce South African growth by 0.2 percentage points. Based on the latest South African Reserve Bank (SARB) predictions, this would cut GDP growth to 1.0% this year. This calculation is based on the anticipated impact of trade disruption on the local economy. From an export perspective, for example, under-pressure Chinese steel and copper manufacturing industries will have weaker demand for South Africa’s largest exports – mineral ores – to China.

Many of South Africa’s industries will see an adverse impact from COVID-19, including mobile operators, automotive manufacturers, as well as hospitality and retail establishments. Three out of four Chinese tourists to South Africa undertake personal shopping activities – China has a burgeoning middle class opting to spend money internationally. The size of the potential decline in Chinese arrivals in South Africa is hard to gauge at present. Using some simplifying assumptions, we estimate a potential loss of at least R200 million in Chinese tourist spending.

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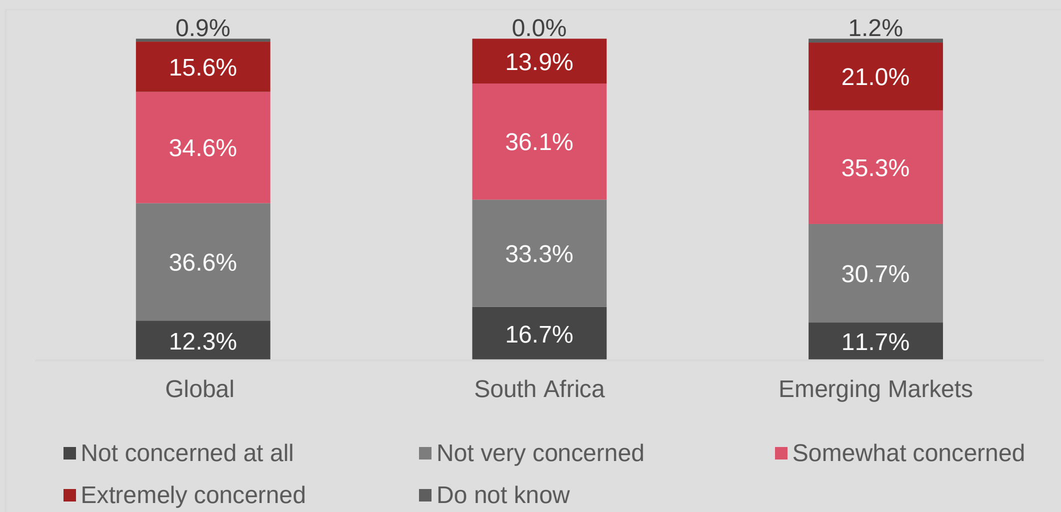
1. ‘Slowbalisation’ and global trade disruption

Global internet searches about COVID-19 accelerated dramatically from the middle of January 2020 as the world became aware of the accelerating public health emergency. Even before then, PwC had already warned that 2020 would be a bad year for global trade dynamics. We suggested globalisation is likely to give way to ‘slowbalisation’, i.e. continued integration of the global economy via trade, financial and other flows, but at a significantly slower pace. (See here for the full analysis.)

We also warned in January that a switch from globalisation momentum to slowbalisation is bad news for South African companies. (See here for the full analysis.) Indeed, nearly 70% of South African CEOs surveyed in PwC’s recently released Annual Global CEO Survey 2020 indicated that they are somewhat or extremely concerned about trade conflicts. In contrast, only 50% of business leaders were concerned about supply chain disruption at the time of the survey (conducted late in 2019). PwC recommended that large businesses with sophisticated supply chains spread across the world should therefore plan for a variety of scenarios, some of which have not been experienced in recent history.

EXHIBIT 1

How concerned, if at all, are CEOs about supply chain disruption?

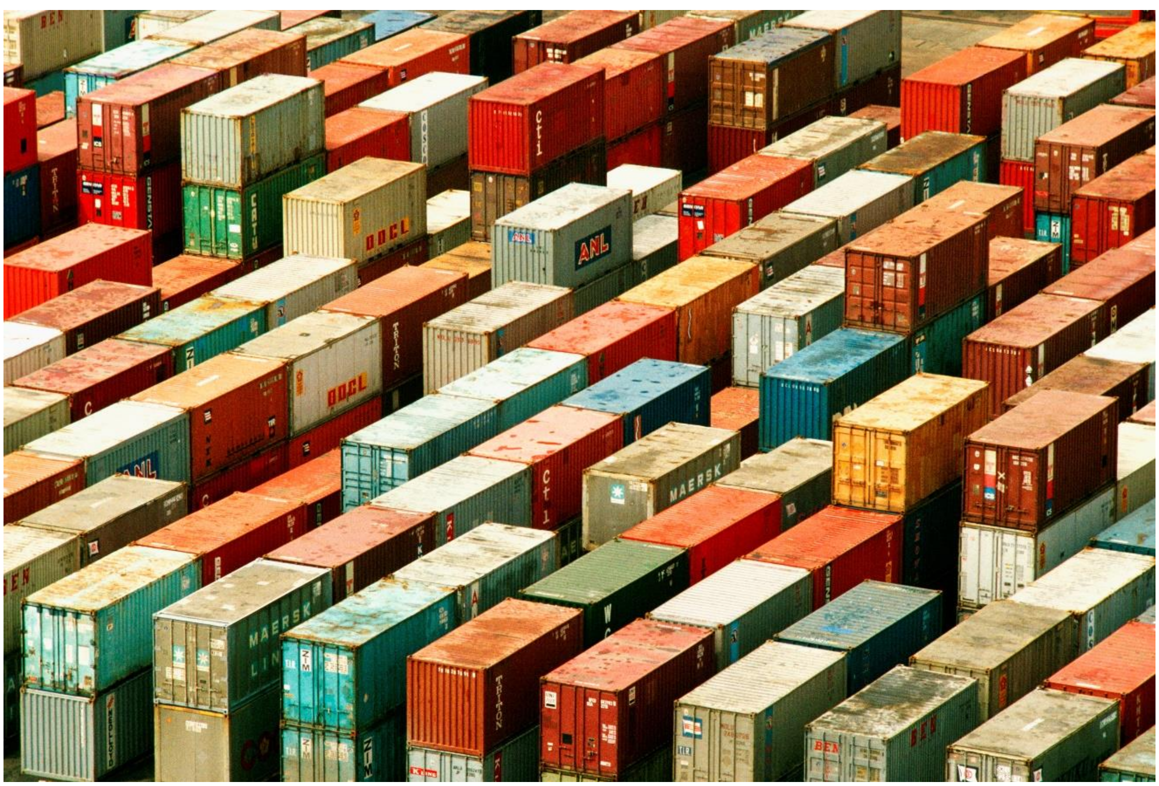


Source: PwC 23rd Annual Global CEO Survey

The ominous warning around scenarios not experienced in recent history naturally includes the potential impacts of a disruption in trade and/or humanitarian crises. The interconnectedness and complexity of global supply chains means that when disruption happens due to a breakdown in logistics networks, natural disasters or disease outbreaks, impacts will be felt on a human, social and economic level. COVID-19 is such a humanitarian crisis and PwC’s Global Crisis Centre warns that it could have significant implications for business with people being displaced, the movement of goods restricted or suspended, and supply chains disrupted.

PwC's Global Crisis Centre also cautioned that many businesses have only a small window of opportunity to plan for what is ahead. Many globally integrated companies with just-in-time operations had only a few weeks supply of goods already in transit when the epidemic hit, enough to provide just a short-term buffer. From a business resilience perspective, having a clearly defined plan in place to deal with such an unforeseen crisis is a critical component to protecting the ongoing success and viability of a business. When a crisis hits, business as usual ceases.

> "A company's leadership often has mixed levels of confidence about their organisation's business interruption and continuity management capabilities. This lack of clarity amplifies when you move beyond company walls and examine interruption risk among the vendors who provide goods and services for the organisation's critical functions. Even when a vendor (in China, for example) provides information on their business continuity programme and how it will sustain operations during a trade dispute or humanitarian crisis, South African companies are rarely able to understand how the vendor's continuity programme aligns with their own resilience."
>
> **— Werner de Bruin**
> **Governance, Risk & Internal Audit Leader**
> **PwC South Africa**



2. A Chinese epidemic is a big deal

Why is China's healthcare challenge such a big issue for the global economy? Strategically located on the banks of the Yangtze River, locked-down Wuhan (the source of the outbreak) is a major industrial and transport hub, and the capital of Hubei province. The city has more than 6,000 foreign-invested companies from over 80 countries and the province produces 4.5% of China's GDP.[1] Restrictions on the movement of goods and people have also spread rapidly to other provinces. Factories producing what are seen as non-critical goods in at least 13 cities — including megacities Beijing and Shanghai — were ordered to close until at least February 9 and tech manufacturing centres Henan, Zhejiang and Guangdong provinces are all affected.

At the time of writing, nobody knows how quickly the epidemic can be controlled or how widely it will spread. What is certain is that supply chain disruption will be felt by companies across many sectors, both locally and abroad — especially automotive, retail and pharmaceuticals. The difficulty for many businesses is that their reliance on Chinese exports is not always immediately apparent as China is a significant exporter of intermediate manufacturing – i.e. manufactured goods used as inputs elsewhere. According to the Organisation for Economic Cooperation and Development (OECD), more than 52% of the country's exports are of this nature.

The complexity of global supply chains means that businesses may be reliant on Chinese products without being aware of it. We already have an example of how disruptive a disaster in East Asia can be for global supply chains. The earthquake and subsequent tsunami that triggered a nuclear accident at Fukushima in Japan in 2011, for example, had a direct impact on the colours of cars available for sale in the subsequent months. A German chemical company's operation based 80 kilometres from Fukushima was the only factory in the world producing Xirallic pigment, used in producing black (Henry Ford would have been horrified) and red automotive coatings.

[1] The Hubei province economy is similar in size to countries like oil producer Iran or financial services hub Switzerland.

EXHIBIT 2
South Africa's largest trading partners

South Africa's largest trading partners, 2019					
Imports			Exports		
Country	Value (R billion)	Percentage of total	Country	Value (R billion)	Percentage of total
China	16.3	18.5%	China	9.6	10.7%
Germany	8.8	10.0%	Germany	7.5	8.3%
USA	5.8	6.6%	USA	6.3	7.0%
India	4.3	4.9%	United Kingdom	4.7	5.2%
Saudi Arabia	3.7	4.2%	Japan	4.3	4.8%

Source: PwC calculations based on Trade Map data

The scope for COVID-19-induced business disruption in South Africa is vast. China is South Africa's largest supplier of imports and biggest buyer of exports. Mobile phones, for example, are South Africa's largest import category by value from China, with the latter supplying 85% of South Africa's mobile phone imports. A disruption in this context would have knock-on effects on the wider telecommunications sector. The construction industry, as another example, reported experiencing delays in delivery of construction materials like metals sourced from Asia. (See below comments from IHS Markit about disruption to steel and copper value chains.) These delays are placing a financial burden on contractors who, under normal circumstances, carry the cost of supply-side delays.

"Feedback from our clients indicates heightened concern about the disruption in global trade already caused by the shutdowns in China. Some have indicated that the supply of goods they import from China on a regular basis, has either been delayed or totally disrupted. This has led to securing alternative sources of inventory in South America and Europe, among others, often at a higher price. Uncertainty also exists about when supply channels will return to normal."

— Lullu Krugel
Chief Economist
Strategy& South Africa

3. Strong offence is the best supply chain defence

Having a clearly defined plan in place to deal with an unforeseen crisis such as COVID-19 is a critical component in protecting the ongoing success and viability of South African businesses. But such plans are not always available, and in such an environment, leaders need to resist the impulse to adopt a defensive pose. They must instead take action that will position their organisation for success. In the current global environment, companies that have built markets on the back of an integrated global trade network need to be aware of and ready to act on the vulnerabilities that their trade dependence creates. (See here for a longer read on how to succeed in uncertain times.)

Based on several sources of information from the wider PwC network, we believe the following five steps will assist South African businesses to protect themselves against the disruption in global trade — both in general (due to slowbalisation) and also related specifically to COVID-19:

1. **Create a view of critical products and suppliers**
   It could be challenging for most organisations to quickly identify every one of their direct and indirect suppliers if they do not already have a transparent view of them (or at least the available data). Focusing on the most critical imported products and top tier suppliers should help to prioritise and expose key vulnerabilities to trade disruption.

2. **Have contingency plans in place**
   What are the options to re-address the balance of supply and demand? Can production be scaled back or amended to protect scarce stock? Is buffer stock or a safe alternative supplier available? The seasonal nature of many retailers' stock, for example, may require a rethink of markdown strategy and inventory control over the coming months.

3. **Consider the financial and legal implications**
   What will be the impact of supply chain disruption on margins, cash flow, loan repayments and terms? Are there legal implications if you're not able to deliver supply to customers?

4. **Communicate**
   Supply chain disruption brings the risk of unintended reputational damage. A clear strategy for transparent communication with customers, external stakeholders and employees, as well as along the supply chain, will be critical and can become a competitive advantage in these situations

5. **Conduct scenario analysis**
   An epidemic like COVID-19 brings specific challenges around the restriction of movement of people and the impact on productivity. However, there are wider implications; over time, consumers might change their behaviour and increase their online retail activity, for example, placing extra pressure on logistics networks. Careful planning, as well as respect for the unpredictability of such an event will help to see businesses through the coming months.

Businesses likely to be affected by the trade disruption caused by COVID-19 should act without delay to assess the potential implications and develop a plan to mitigate risk and remain operational. Admittedly, despite taking action, there is no certainty as to how long we will experience challenges caused by trade disruptions — it could be weeks or months.

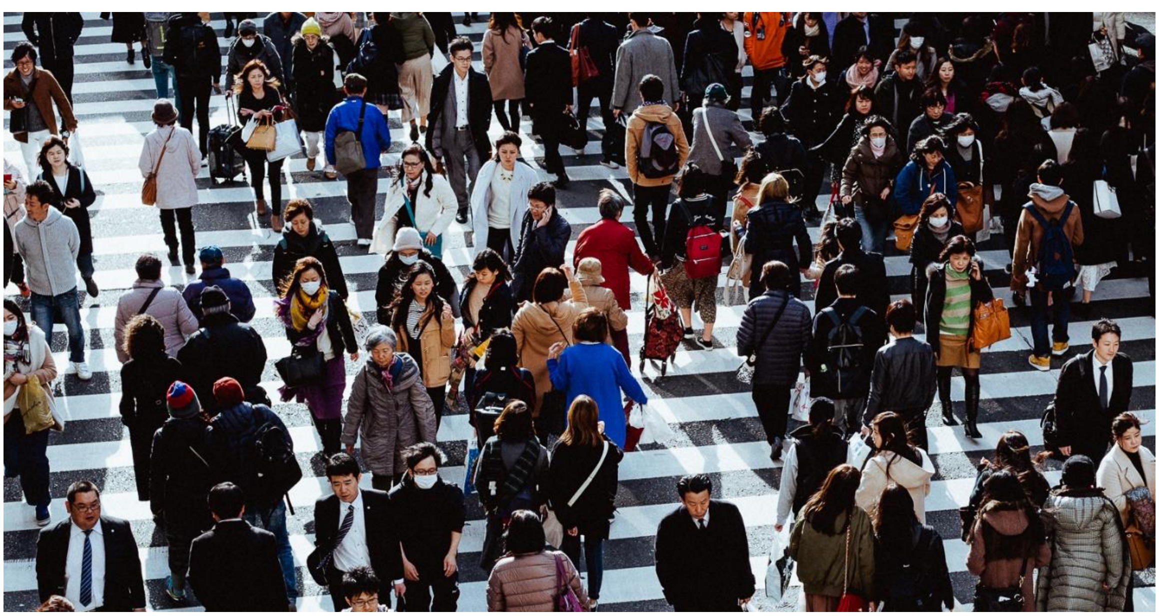
It is therefore important that directors and management in businesses affected by trade disruption consistently review, reassess and where required, reset, their action plans to ensure they remain relevant and focused on the right areas to remain viable. Many organisations already have these processes in place for their supply chain. However, COVID-19 has already unveiled flaws in some.

PwC's Global Crisis Centre hosted an insightful webcast on February 13 entitled 'Responding to the potential business impacts of COVID-19'. A panel of our advisors discussed the areas that businesses should consider as part of their planning and response strategies.

A recording of the webcast can be accessed here:
https://webcastportal.pwc.com/open/ee5f5e44-b54e-44b3-b9a4-7f41d9490506

"We recommend organisations adopt an agile approach to rapidly assessing any vulnerabilities in their supply chain. It is imperative that companies clearly understand the impact of upstream disruptions on the end customer, especially from a health and safety standpoint. This can be done by collaborating with key customers, suppliers and other partners supporting the core value chain of an organisation."

— Keshava Naidu
Operations Consulting Leader
PwC South Africa



4. Impact of slower Chinese economic growth on South Africa's economy

Even before the COVID-19 panic set in and concern was raised about the impact of a crisis on South Africa's largest trading partner, the domestic economic outlook for 2020 was feeble. South Africa is currently in its longest downward business cycle since records started in 1945, with rising unemployment, declining real GDP per capita, and dismal business sentiment. To provide some perspective, we recently revisited our analysis of economic and political scenarios for South Africa published in March 2018 and determined that the current state of the economy represents our downside scenario entitled 'Coming up short'. (See here for the full analysis.)

There is enough historical evidence on the impact of epidemics to know that they disrupt economic activity for a short period and that lost output is made up quickly in subsequent periods. Previous Chinese epidemic episodes suggest the economic impact of COVID-19 will be significant but short-lived. Admittedly, during previous episodes (Bird flu 1997, SARS 2002-2003, Swine flu 2009), China was a much smaller role-player in the global economy — accounting for 9% of global GDP in 2009, compared to around 17% at present. As a result, China's COVID-19-induced growth declined will give the global economy a bigger shock than previous epidemics. The Chinese economy is also not likely to bounce back from this epidemic as quickly as in previous times due to a slower economic growth trend and a much more distressed banking system.

COVID-19 will certainly dampen economic growth in China this year. However, the scale of the impact remains unknown and will be highly dependent on the duration and intensity of the crisis. Prior to the outbreak, Fitch Solutions expected the Chinese economy to grow by 5.9% this year — that in itself would be the slowest growth in three decades. In early-February, the company's macro intelligence researchers considered different scenarios for the impact of COVID-19 outbreak on Chinese economic growth in 2020:

- Under a rapid containment scenario, for example, COVID-19 and its economic impact peaks relatively soon, with panic fading rapidly and official restrictions on movement dismantled swiftly. This would cut economic growth by a small margin of around 0.2 percentage points, reducing GDP growth this year to 5.7%. This scenario appears unlikely at present with daily reported infections and deaths continuing to rise.
- Alternatively, the epidemic might not be contained until the middle of 2020 — a more likely prospect. In this scenario, the Chinese government is likely to respond with a more assertive policy easing response on the fiscal and monetary side — this has already started to happen. In combination, this would reduce China's annual economic growth closer towards 5.0% for 2020.

How would this decline in activity manifest on the ground? The February 2020 edition of the IHS Markit Global Steel Users Purchasing Managers Index (PMI) commented that, with China being a key location for many supply chains, a marked drop in the country's industrial economy "may reverberate worldwide in the coming months". The IHS Markit Global Copper Users PMI warned of "a severe hit" to Chinese copper production in February as producers voluntarily shut down to limit the spread of COVID-19. The March editions of the PMIs will reveal the extent of the outbreak on the global metals industry.

Metals manufacturing requires mineral inputs. From a mining perspective, iron ore, manganese and chrome account for two-thirds of South Africa's total exports to China by value. A Chinese economy with a weaker growth pace and slower metals production will have less demand for these minerals from South Africa. The listed shares of some of the world's largest mining companies have already been hit by this outlook. The industry already had to deal with strong Chinese steel production late in 2019 coupled with weaker demand. As such, steel inventories swelled, and prices were under pressure, prior to the COVID-19 outbreak. The anticipated post-Lunar New Year destocking (from March) is now unlikely to be significant.

Returning to growth prospects, what would a drop in Chinese economic growth — from nearly 6.0% towards 5.0% — mean for South Africa? According to research by the International Monetary Fund (IMF), a one percentage point drop in Chinese growth would reduce South African growth by 0.2 percentage points. Based on the latest South African Reserve Bank (SARB) predictions, this would cut GDP growth to 1.0% this year. This calculation is based on the anticipated impact of trade disruption on the local economy: the adverse effect on South Africa's export revenues and disruption of import-dependent manufacturing and retail supply chains. Whether dependent on trade or not, South African businesses need to consider a 0.2 percentage points cut in growth prospects for 2020 in their scenario planning.

> "Slower growth in China will hit the South African economy through several transmission mechanisms: firstly, there is the demand for our minerals and mining products; secondly, there is the impact on the balance of trade; and thirdly, there is the potential exchange rate impacts. We were expecting slower Chinese growth to hit South Africa at some point towards the end of 2020, but recent developments have accelerated this slowdown and now we are dealing with suppressed demand a year earlier than we initially thought it would happen."
>
> **— Lullu Krugel**
> **Chief Economist**
> **Strategy& South Africa**

4.1 Industry focus: Fewer inbound Chinese tourists

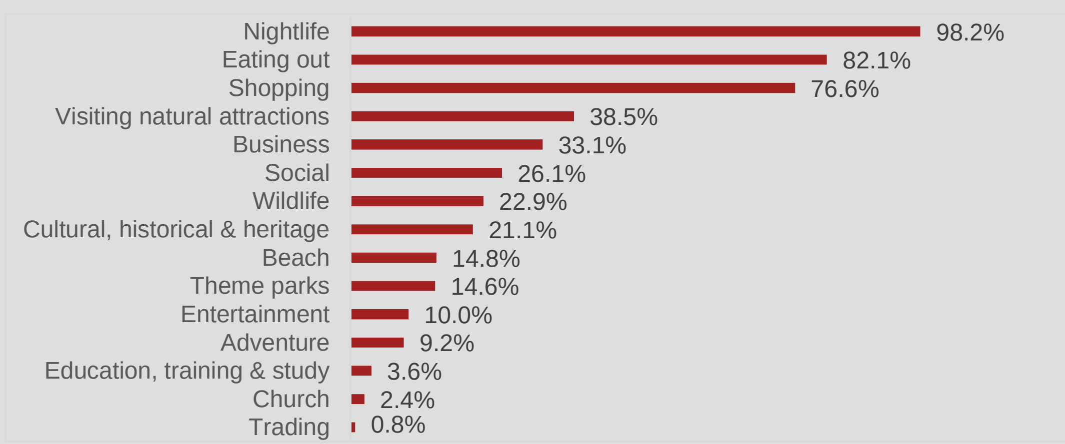
Apart from the mobile phone and construction sectors mentioned above, there are many other South African industries' growth prospects that will be hit by trade disruption. For example, global automotive companies — several with manufacturing operations in South Africa — have highlighted the big impact that force majeure on delivery of a single component could have on major production lines. ("You can't make a car with 99% of the parts" read one media headline.) From a consumer perspective, local retailers are already starting with planning for Black Friday and Christmas 2020 supplies and will experience disruptions with their Asian suppliers. For local logistics providers with global operations, cargoes will experience delays in normal shipping routes, increased screening at ports, cancelled voyages, quarantines, etc.

From a tourism perspective, South Africa received nearly 97,000 Chinese tourists in 2018 (latest available official data) and was the seventh-largest origin of foreign visitors. We previously determined that Chinese visitors to South Africa primarily associate the country with the mining industry, followed by tourism and manufacturing as the other key industries. Some 32% of Chinese tourists visiting South Africa are here on business with the remainder largely focussed on the leisure market. Those who are doing business in South Africa, or are considering doing so, cite positive factors like the availability of raw materials and resources as an attractive feature. (See here for more information on tourism and investment from BRICS countries.)

The average international tourist spent nearly R11,500 in South Africa during 2018. Chinese tourists that come to South Africa for personal shopping stay in the country for a longer period compared to the average shopper visitor — this is supportive of the retail sector. China has a burgeoning middle class opting to spend money internationally, and anecdotal evidence suggests that Chinese tourists in South Africa spend a lot of money on jewellery and other luxury goods. Chinese nationals are also taking advantage of South Africa's growing reputation as a destination for medical tourism — South Africa is an affordable alternative to more expensive healthcare systems in the northern hemisphere.

EXHIBIT 3

Activities undertaken by Chinese tourists (reported by percentage of visitors)



Source: PwC calculations based on South African Tourism data

PwC has identified tourism as the top potential driver (out of all industry classifications) of economic growth and job creation in South Africa. This is based on the multiplier effects of tourism spending and investment on economic activity and employment. Our calculations show that for every R1 million spent in the sector, five jobs (one skilled, two semi-skilled and two unskilled) are sustained. The same R1 million in expenditure results in an added R1.26 million to the economy (directly) and an additional R350,000 added due to downstream linkages (indirectly).

The size of the potential decline in Chinese arrivals in South Africa is hard to gauge at present. Realistically, the full impact from the Chinese market and a possible overall decline in global travel will only materialise in the next couple of months. So far, many analysts have looked back at the Severe Acute Respiratory Syndrome (SARS) epidemic of 2003 or the swine flu outbreak of 2009. In the latter instance, Chinese arrivals in South Africa declined by nearly 15%.

However, this time things are different as travel bans are far more stringent. While South Africa has not instituted travel bans for Chinese nationals, Beijing has banned outbound group travel from China. The country's aviation regulator also instructed local airlines to offer refunds to passengers wanting to cancel their travel. As such, the decline in Chinese tourist arrivals in South Africa could be more than 15% in 2020 – we just don't know yet. Based on recent tourist expenditure trends and some simplifying assumptions, a possible decline of more than 15% in arrivals this year translates into a potential loss of R200 million in Chinese tourist spending.

> "The number of Chinese tourists — and the South African jobs that they create — are actually small compared to the impact of other major origins countries in Europe and North America. However, disruption in the Chinese economy will have a much wider impact on global travel and the local hospitality industry. For example, the postponement of international sporting events and cancellation of large conferences and trade shows will impact on conference venues, hotels, restaurants and other businesses that operate within the hospitality sector."

Pietro Calicchio
Hospitality & Gaming Industry Leader
PwC South Africa

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