KPMG

'COVID-19' Impact on corporate treasury

June 2020

home.kpmg/in

Background

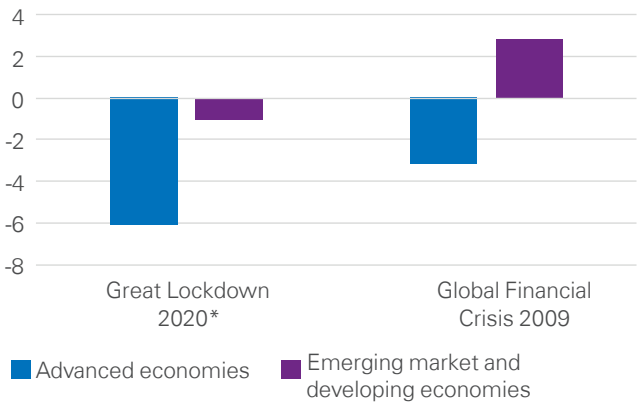
COVID-19 is truly a global crisis considering no economy is spared and a very likely scenario of both developed and emerging economies are looking at prolonged recession emerging.

India was already facing growth challenges during 2019 with GDP growth at the lowest level in past six years at 4.5 per cent.[1] COVID-19 has now compounded the risk with likelihood of reversal in capital flows.

The crisis presents an unusual double whammy in the form of demand and supply-side challenges as emerging market currencies weakened and commodity price volatility increased. Furthermore, managing disruptions in the financial supply chain is proving to be a mega challenge.

On the brighter side, the COVID-19 situation has pushed industries to think of the future of corporate treasury in line with digitisation, integrated risk management, renewed focus on cost optimisation and cash management.

Real GDP growth, year - on - year percent change



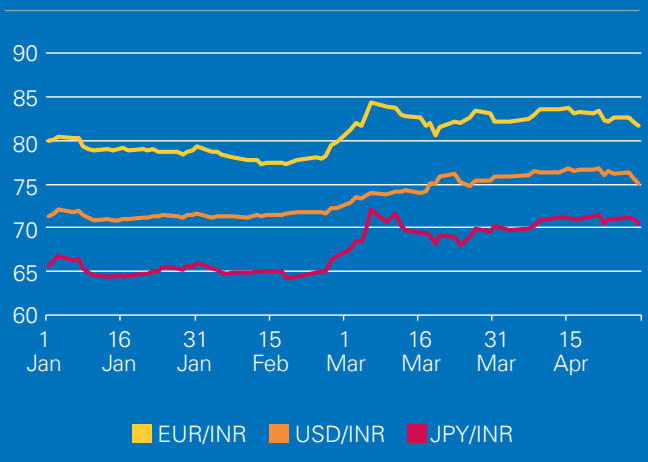
*Expected as per IMF projection

Source: The Great Lockdown: IMF blog, published 14 April 2020, accessed 30 April 2020

Impact on INR

One of the many fallouts of the economic shock resulting from the COVID-19 pandemic is a sharp depreciation of the INR. The currency depreciated by close to 7 per cent (approximately INR4) in 45 days from mid-March 2020 to end of April 2020. This was due to rush for safe-haven currencies coupled with a large fiscal deficit as a result of lower excise and GST collection, monetary stimulus and lower GDP as evidenced in the chart appended below.[2]

Steep INR depreciation

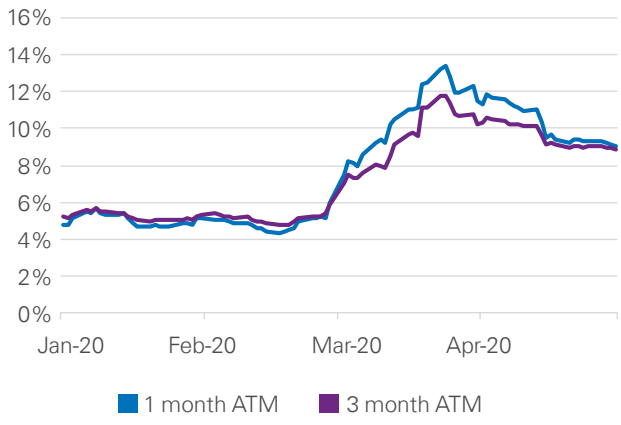


1. Impact of COVID-19 on the mining sector in India, KPMG in India, May 2020
2. Reference rate archive, Financial Benchmarks India, accessed on 30 April 2020

Key themes to watch out for

- Volatility in the USD spiked from the sub 6 per cent level during end February to 13 per cent by March before retracing to the 9 per cent level. This points towards a lot of sideways movement in the INR.

USD INR Volatility



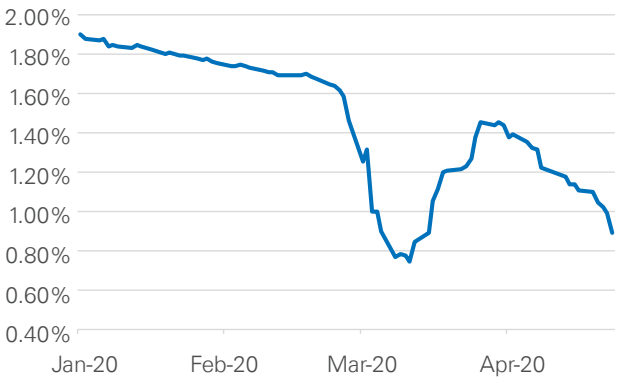
Source: Bloomberg

- Likelihood of further downward pressure on INR on weakening fundamentals.
- Corporates should be on the look out for opportunities to **hedge on dips** and explore and **evaluate** hedging using **structured products.**
- Save on **transaction costs** by improving exposure data collation, exposure tenor and netting, improving processes for margin and **charge optimization.**

Impact on interest rates

Central banks across the globe have taken steps to infuse liquidity by reducing the benchmark rates. This resulted in massive rally in yields post a 150 bps cut by the U.S.' Federal Reserve.[3] The three-month LIBOR rate (the primary benchmark for FC-denominated loans) has dropped to sub 1 per cent levels.[4] Japan and the Eurozone have a negative interest rate regime, which essentially allows borrowing at zero interest rate plus credit spread levels.

3 month USD LIBOR



Source: Intercontinental exchange (ICE)

To support the Indian economy and boost the market sentiment, the RBI used monitory policy intervention to slash the repo rate to 4 per cent and reverse repo to 3.35 per cent. The RBI also did liquidity injection of more than 4.74 lakh crore and eased regulatory supervision measures such as moratorium periods.[5]

The very fact that banks had preferred parking money with the RBI post announcement of the reverse repo cut on 27 March reflected the prevailing risk off sentiment. The response and efficacy of these measures have been largely skewed with top-rated corporates (AAA) being the key beneficiaries of Targeted Long-Term Repo Operations (TLTRO 1.0). The last-mile transmission of the measures thus remains some way from being achieved.

Key themes to watch out for

1. Revisiting the financing mix between INR and FC borrowing.
2. Opportunity for refinancing of existing loans at a cheaper rate.

3. U.S. treasury website, accessed on 30 April 2020
4. Historical LIBOR data, Intercontinental exchange, accessed on 30 April 2020
5. RBI website circular, published and accessed on 22 May 2020

Impact on commodities

The COVID-19 impact on commodities will be based on price variation of key raw materials, production shutdown, cash flow constraints and supply chain and labour force disruption.

Impact on key commodity classes

- **Ferrous metals:** the infrastructure, construction and automotive sectors are key consumers of steel. A slowdown in these sectors, along with the attendant demand slowdown, would keep steel prices under pressure. A recent spike in iron ore prices due to supply disruptions from Brazil notwithstanding, iron ore futures in the second half of 2020 exhibit backwardation of around 10 per cent for three month futures.[6]
- **Non-ferrous metals:** about 80 per cent of aluminium is consumed by the transportation, construction and electrical sector. The electrical sector accounts for more than 50 per cent of copper consumption. All the sectors are showing slowdown and demand contraction. All base metals, barring zinc, are witnessing a contango (around 0.5 per cent for three months copper to 2.5 per cent for three months aluminium). Zinc is in mild backwardation of 0.2 per cent.[7]
- **Precious metals**
  - Industrial demand for silver, from brazing alloys to electronic and photovoltaic fabrication, is forecast to decline. Silver remains in contango over three months futures.
  - Gold positions in futures were closed to meet margin calls despite being a safe-haven asset in mid March when the crisis was starting to evolve in its magnitude. Post that period, the metal has steadily risen in prices, hitting a seven-year high of USD1760 per ounce. Although physical gold demand is subdued due to lockdowns, the safe-haven appeal of gold during these uncertain times, along with renewed trade tensions between the U.S. and China, is pushing prices to record high levels. Gold remains in contango of around 1.1 per cent for three months contracts.[7]
  - Palladium, used as catalyst in automobiles and plants, continues to remain in backwardation with muted demand revival hopes in the near future.[7]
- **Energy:** crude was facing excessive supply risk with OPEC plus nations not agreeing to cut production initially. Lack of demand and storage saw WTI prices chart into negative territory while Brent crude traded at USD25-30 per barrel. Post COVID-19, reduction of business travel and WFH implementation will dampen the pace of demand return.[8]

Coal prices have sharply declined on the back of estimated demand reduction of 6 per cent in 2020. Both energy commodities are in contango with oil in particular on the back of early signals of economic activity recovery.[8]

Key themes to watch out for

- **Mild recovery** in base metals from the lows owing to uptick in activity as evidenced by S&P base metals index chart.

S&P/TSX Global Base Metals Index

Source: S&P TSX global base metal index, Standard & Poor's, accessed on 18 May 2020

- Increase in inventory levels due to both excess supply, for example crude, and lower demand from industries due to global lockdown (especially crude and base metals)
- Due to sudden movement in commodity prices, corporates have been pushed to rethink their hedging strategy. With rise in volatility, option contracts seem to be gaining popularity as against vanilla forwards giving flexibility to gain from lower prices while protecting against price rises.

6. Exchange data, Dalian Commodity Exchange, accessed on 18 May 2020
7. Exchange data, London Metal Exchange, accessed on 18 May 2020
8. Exchange data, CME group, accessed on 18 May 2020

Impact on financial supply chains

Financial supply chains of corporates have been majorly hit by the lockdown. As per the lead economist at HSBC, it is estimated that every month of lockdown is wiping out approximately 5.6 per cent of the annual Gross Value Addition of India. With both customers and suppliers grappling with shortage of cash, it has become essential to focus more on short-term liquidity rather than long-term solvency.

Depending on cash flow planning and the liquidity position, organisations may also need to consider alternative tactics to generate faster cash flow from receivables and extend payables.

Use of alternative strategies, such as factoring of receivables, may be a suitable solution to improve cash flow swiftly even though comparatively expensive.

Organisations can also implement the advance payment framework by offering dynamic discounting to clients that are able to pay more swiftly.

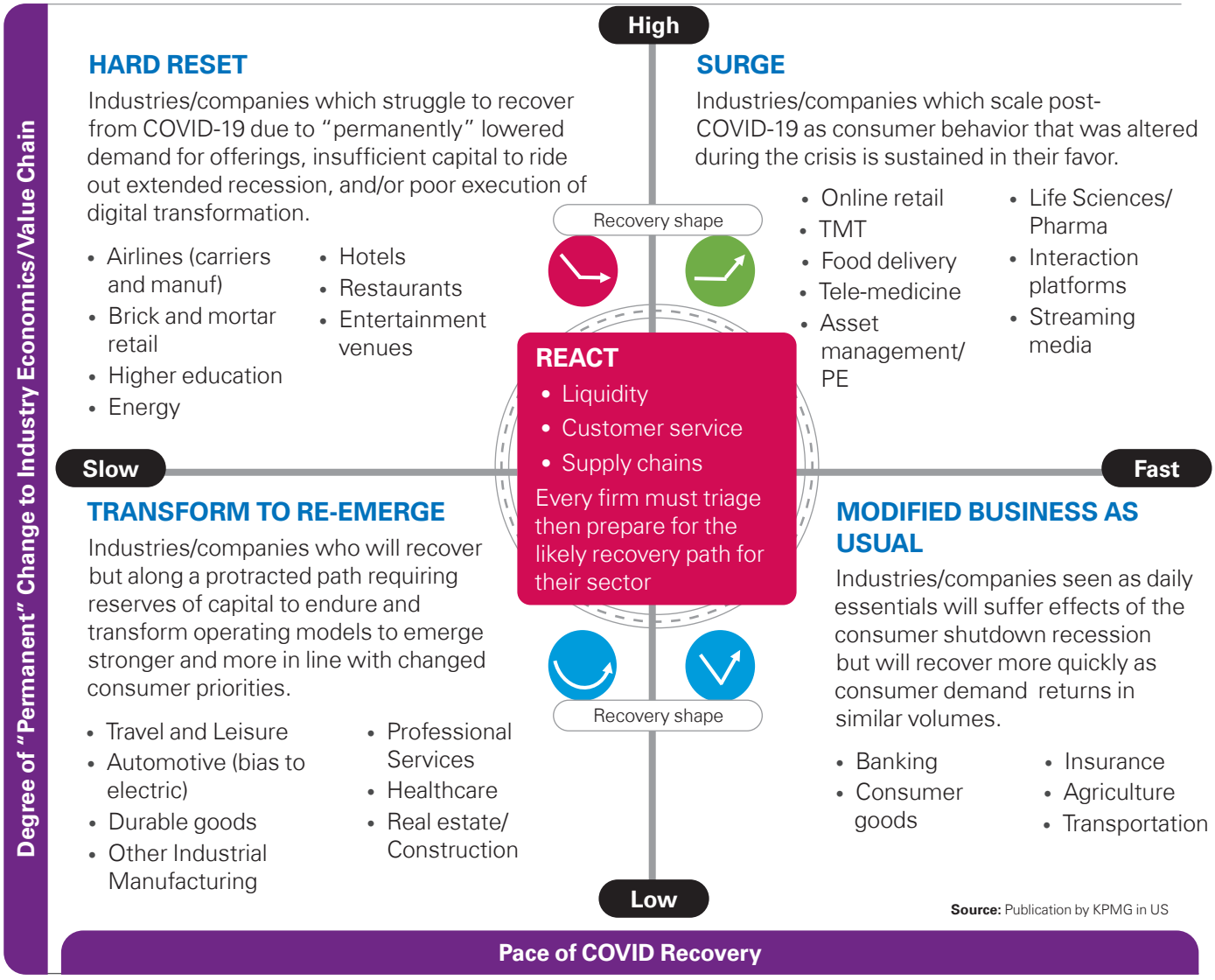
With these tactics, organisations are basically paying clients to provide short-term financing, which can come at a substantial cost. If bank lines are not available, this might be one of the options.

Furthermore, to increase the payable cycle, suppliers' credit can be used to extend the credit tenor. Agreements with strategic suppliers with whom an organisation has long term contracts can be renegotiated and a few other supply chain financing tactics can be implemented over the short to medium term. These include collaborating with key trading partners to optimise cash flow across the extended supply chain.

Sectoral assessment

KPMG in US conducted a study on how we expect recoveries in different industries to be. The following came out as broad patterns.

Varying degrees of COVID-19-driven shifts will result in an "alphabet soup" of recovery patterns



Source: Publication by KPMG in US

COVID-19 has had an impact across sectors in the Indian economy. With auto and aviation facing the bulk of the heat, the lockdown has forced operations across all sectors to a complete halt in the last few weeks. Though the auto sector is expected to gradually revive post lockdown considering the preference to travel in private vehicles as against using public transportation, aviation and hospitality would still be troubled given the likelihood of general avoidance of personal or official travel.

The crisis has also supported the otherwise slowing telecom sector considering the increased bandwidth demand coming from subscribers as everyone adjusts to the new normal of working from home. Same is the case with essential consumer goods and pharmaceutical companies.

Below is a brief snapshot of the risks being faced by different sectors in India.

Covid19 Impact on Indian Industry

Sectors	Liquidity Risk	Market Risk	Operational Risk
Auto	High impact	High impact	High impact
Aviation	High impact	High impact	High impact
Food and agriculture	Medium impact	Medium impact	Medium impact
Oil & gas	High impact	Medium impact	Medium impact
Essential consumer goods	Medium impact	Medium impact	Medium impact
Pharmaceutical	Medium impact	Medium impact	High impact
Power	High impact	Medium impact	Medium impact
Telecom	High impact	Medium impact	Medium impact
Textile	High impact	High impact	High impact
Construction	High impact	Medium impact	High impact
Metal & mining	High impact	High impact	High impact

Low impact Medium impact High impact

Source: KPMG India publication on "Potential impact of COVID-19 on the Indian economy"

Key themes impacting organisations

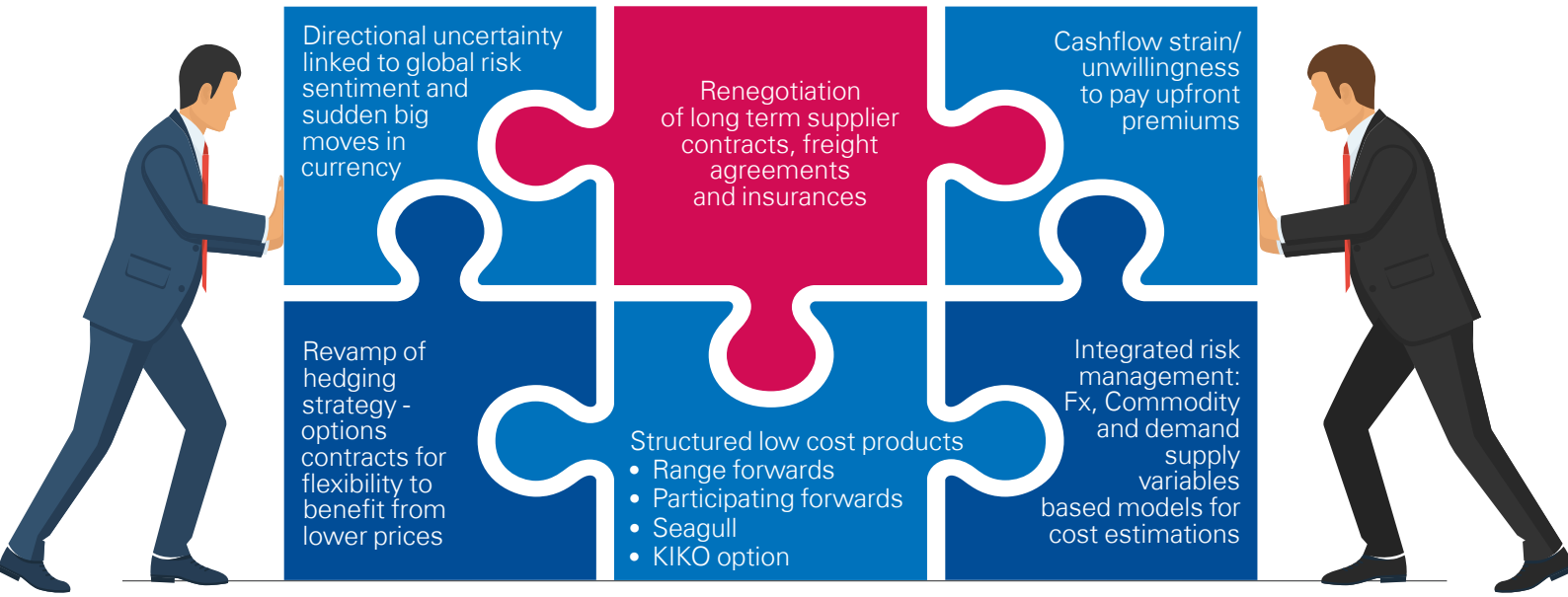
- Supply chain interruptions hampering forward and backward integration
- Slowdown in existing as well as new orders
- Sub-optimal capacity utilisation due to reduced workforce
- Lock-in of receivables due to non-payment by customers
- Increased costs due to IT and infrastructure revamp, BCP
- Increase in cost of goods due to volatility in raw material prices
- Inability to refinance WC limits

Key metrics to focus on

1. **Cash flows at risk:** cash flows from operations, financing and Investments are at risk
2. **Earning at risk:** with volatility in cash flows and higher costs, downward pressure on earnings
3. **Economic value add (EVA):** EVA of organisations will be impacted due to changes in profit margins along with changes in shareholder returns
4. **Debt service coverage:** deterioration in profit/ change in cash flow may put pressure on DSCR and ICR

Moving from fragmented risk management to integrated risk management

- Use of Forwards and vanilla options for hedging owing to simplicity and regulations
- Commodities costing on spot or trend basis
- Not factoring of extreme volatility scenario
- Transaction cost not managed in optimized fashion
- Fx, rates and commodities exposure hedging in silos
- Scope for digitization in Exposure recognition



Future of corporate treasury

As the world fights COVID19, voices around strategic, structural and operational changes in treasury are intensifying. Treasurers across the globe are putting their vision to work around how treasuries would look like post COVID-19. Considering the facts that existing scenarios might become the new normal in coming years, treasurers are working to establish resilience, agility and an adaptive nature within the treasury function. This enables organisations to maintain and support business operations, credit reputation and capital growth plans.

Corporates will now be focussing on shifting their business strategy to more being cash centric and focusing on value addition v/s profitability. Let us look at some treasury approaches for the post COVID-19 world.

Liquidity crisis management

- Planning of liquidity buffers for crisis like these
- Establish dedicated mid to long-term credit facilities for crisis scenarios
- Integrated liquidity stress testing by performing VaR and CFaR analysis at different confidence levels incorporating correlations between asset classes

Investment strategy

- Redesigning the investment strategy with focus on investment products having highly liquid market
- Assessment of counterparty credit worthiness and evaluation of investment exposure to each
- Putting data analytics at the centre of strategic decision-making.

Crisis cash management

- Creation of crisis cash reserve ratio (CCRR)
- Robust cash flow planning across maturity scale
- Introducing technology for predicting cash flows, use of AI, ML, etc.

Digitisation

- Introducing blockchain technology in converting paper-based to electronic-based treasury operations such as digitising letters of credit from issuance to utilisation
- Digitised reconciliation solutions using distributed ledger technology.

Treasury as a service

- Solutions in collaboration with fin-tech companies to provide data analytics on sales, inventory positions, payment cycles, etc.
- Integration with third party technology and service providers for automating and outsourcing back-office treasury operations.

Acknowledgement

We would like to acknowledge the efforts of the following in conceptualizing and developing the paper:

- **Anshul Babbar,** Associate Director
- **Salil Bapat,** Associate Director

KPMG in India contacts:

Rajosik Banerjee
Partner and Head
Financial Risk Management
T: +91 98203 03556
E: rajosik@kpmg.com

Shamina Valjee
Director
Financial Risk Management
T: +91 98206 05563
E: shaminavaljee@kpmg.com

home.kpmg/in

#KPMG josh

Follow us on:
home.kpmg/in/socialmedia