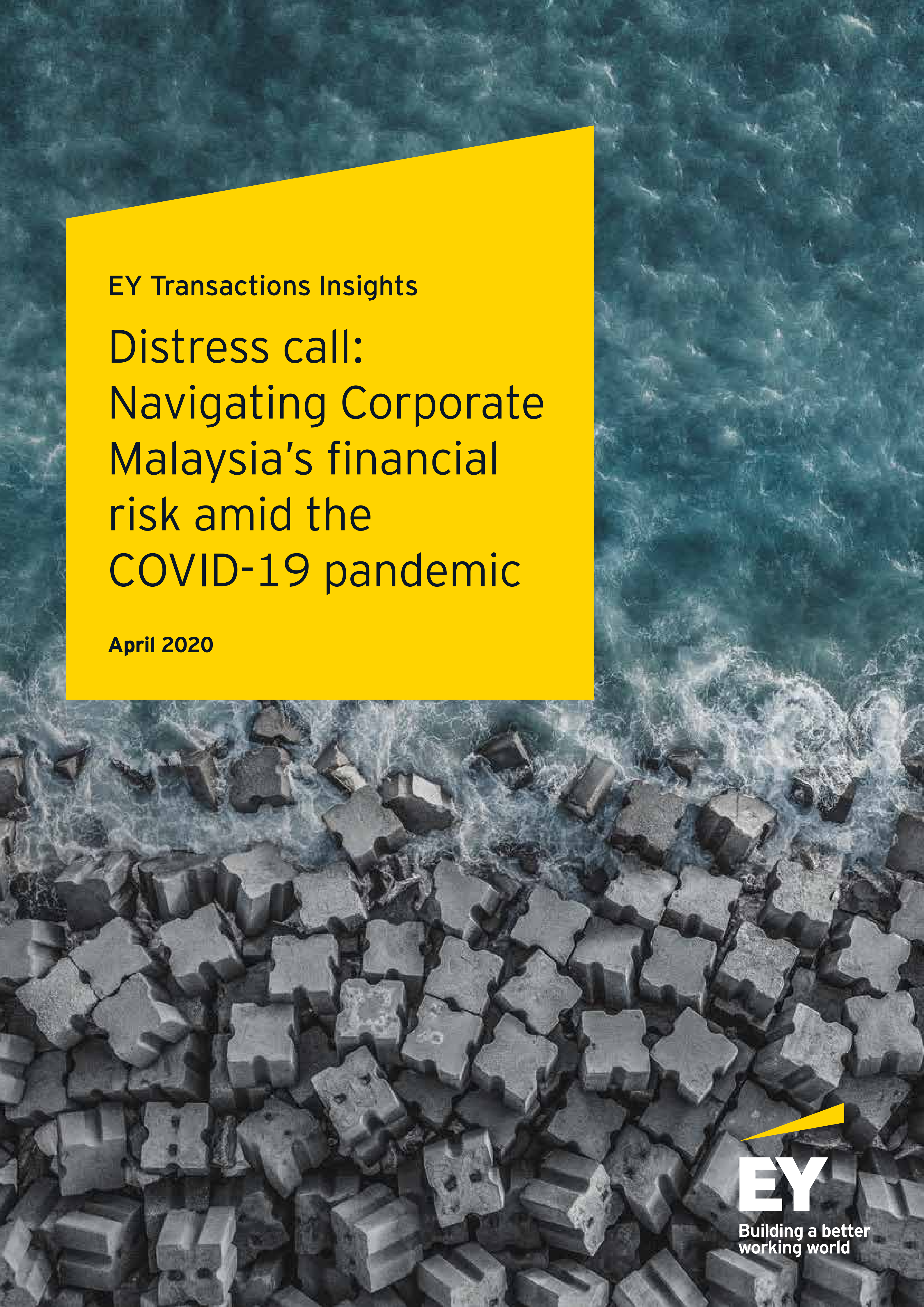


EY Transactions Insights

Distress call: Navigating Corporate Malaysia's financial risk amid the COVID-19 pandemic

April 2020

EY
Building a better working world

The global outbreak of COVID-19 has become a black swan event, impacting people, governments and businesses. Malaysia was not spared as the pandemic has brought the country's economy to a grinding halt.

The Government has unveiled its ambitious Economic Stimulus Packages of up to RM260bn, focusing on the welfare of the 'rakyat' and businesses.

As Corporate Malaysia navigates through an unprecedented economic shock, the resilience of its financial position will be severely tested.

The economy was already slowing down

Even before the outbreak of COVID-19, the economic growth of Malaysia has been slowing down since 2017. In 2020, GDP growth was expected to grow marginally lower compared to prior years, largely due to the slowdown in household spending and the sluggish investment environment.

Malaysia GDP growth (before outbreak)

Source: Oxford Economics, 25 January 2020

As a pre-emptive measure to secure sustainable economic growth and price stability, the Monetary Policy Committee ("MPC") of Bank Negara Malaysia ("BNM") reduced the Overnight Policy Rate ("OPR") from 3.0% to 2.75% in January 2020.

Then came the outbreak

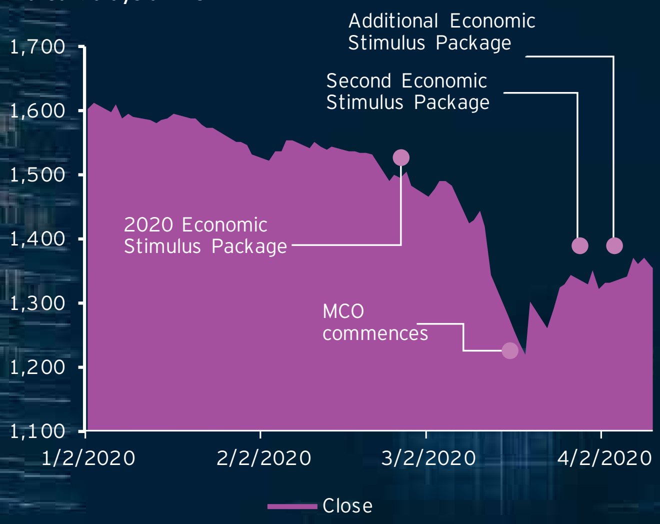
In addition to the economy slowing down, the outbreak of COVID-19 has certainly accelerated the distressed situation in Malaysia. When early imported cases of COVID-19 were detected in late January or early February 2020, the immediate impact was already felt within the tourism and retail sectors. To cushion the challenging landscape, the Government announced its RM20bn 2020 Economic Stimulus Package on 27 February 2020 and MPC reduced the OPR rate further to 2.5% on 3 March 2020.

When the second wave of COVID-19 cases were identified at the end of February 2020, the number of people infected had, since then, exponentially increased. To break the chain of COVID-19 infections, the Government imposed a Movement Control Order ("MCO"), restricting people's movement and effectively shutting down the majority of businesses, save for those deemed as essential services.

It has now been more than 30 days since the commencement of the 'lockdown' on 18 March 2020. The implication has been significant to Corporate Malaysia, causing temporal cessation of operations, supply chain disruptions, liquidity stress and solvency concerns.

Economic and social 'cushion' for all

Bursa Malaysia KLCI



Since the implementation of the MCO, the Government has announced two Economic Stimulus Packages, an extension of the one that was announced in January 2020, increasing the total value of the stimulus package to RM260bn. This stimulus package is the largest amount ever announced, involving allowances for the front-liners, one-off assistance to the lower-income groups, alleviating cash flow pressures and allocating funding solutions. Its aim is to achieve a balance between the economy and social needs.

The outbreak is expected to accelerate the economic slowdown

Baseline economic forecasts

Initial baseline forecast (17 February 2020)

Indicator	2019	2020	2021
Real GDP growth	4.3%	3.9%	4.4%
Domestic demand growth	4.0%	5.2%	4.3%
Private consumption growth	7.6%	5.7%	4.2%
Employment growth	2.1%	2.1%	2.2%
Unemployment rate	3.3%	3.4%	3.3%

Updated baseline forecast (24 March 2020)

Indicator	2019	2020	2021
Real GDP growth	4.3%	1.6%	5.4%
Domestic demand growth	4.0%	3.6%	4.9%
Private consumption growth	7.6%	5.4%	5.0%
Employment growth	2.1%	1.2%	3.0%
Unemployment rate	3.3%	3.5%	3.3%

Source: Oxford Economics, dated 17 Feb 2020 and 24 Mar 2020

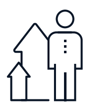
Despite the Economic Stimulus Packages, the general economic outlook has been pessimistic. According to Oxford Economics, the economic baseline has seen a downward trend. BNM itself projected a negative growth, with Malaysia's GDP growth ranging between -2.0% to 0.5% in 2020.

Potential social-economic impact

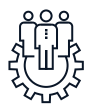
Direct sectoral impact to industries such as air travel, tourism and hospitality

Drop in foreign trade as supply is affected by Government orders

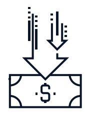
Fall in stock markets due to lower investor and consumer confidence



Reduced consumer spending due to the implementation of the MCO by the Government



Cashflow issues arising from the MCO, leading to permanent or temporary layoffs



Further reduced domestic demand and spending arising from umemployment

The unexpected outbreak has also had an adverse social-economic impact to the country. The activities of several sectors such as aviation, tourism and commodity have been impacted. Global trade has declined as trading partners are imposing similar MCO, affecting supply chain. Unemployment is expected to increase, driving down household spending. On the back of weak consumer spending, the performance of Bursa Malaysia KLCI clearly reflects investors' low sentiment and confidence.

The economic outlook is likely to be bleak in the next 12 months. The Economic Stimulus Packages were necessary to support the economy and provide social support to individuals.

Can Corporate Malaysia absorb the shock?

The ability of a company to absorb economic shocks is dependent on its financial headroom (i.e. ability to meet its obligations when they are due). The historical trends of the last three years may provide us some indication.

If we were to take all the companies listed on Bursa Malaysia and aggregate the total borrowings and interest against the total EBITDA over the last three years, the outcome is apparent.

To fund corporate profitability via leverage, the aggregate debt level undertaken by corporates has increased in the last three years. The leverage trend makes sense when business and economy are growing. But on aggregate, we observe an inverse relationship between profit and debt servicing obligation, suggesting that the promise of higher profit was not delivered and there is now a risk of mismatch between the corporate's profitability and its debt obligation.

Bursa listed companies' aggregate growth or decline rate

(7%)	7%	38%
EBITDA declined between 2017-2019	Debt increased between 2017-2019	Interest increased between 2017-2019

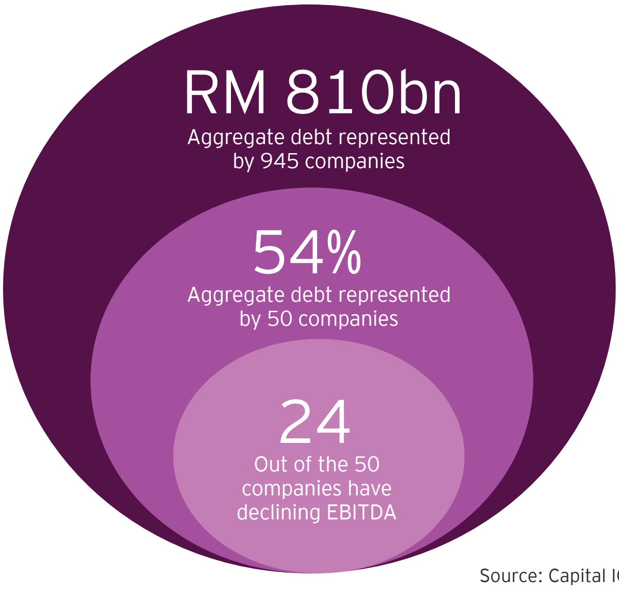
Source: Capital IQ

The trends were observed even before the impact of the outbreak, raising concerns as to whether the debt undertaken in the last few years will amplify the corporates' financial risk in the current environment?

The magnitude of the financial risk

There is a general consensus that financial risk (i.e. risk of default) is expected to increase as a result of the pandemic, but the magnitude of the risk remains uncertain. Again, using the Bursa-listed company as a proxy, we have analyzed 50 Bursa-listed non-financial companies with highest debt level.

Debt profile of the 50 highest debts held by Bursa-listed companies as at 31 December 2019 (excl. financial institutions)



Source: Capital IQ

The outcome of the analysis demonstrates two observable trends: (i) there is a concentration of credit risk as 50 out of 945 companies represent just over 50% of the RM810bn debt and (ii) close to half of these companies analyzed had a declining profit trend in the last year, even before the outbreak.

In the absence of any credible interventions, the credit risk for the 24 companies with declining profit will worsen under the current environment and there is a higher probability of the remaining 26 companies falling into the same bucket this year. This magnitude of RM437bn is just a high-level view of these companies' financial risk. With the likelihood of a recession, the magnitude of the financial risk may be higher.

What now, what's next and what is beyond?

Corporate financial risk can be assessed over three stages: Now, next and beyond

Corporate Malaysia's challenges for each period

Now

Reliance on cash reserves in the absence of revenue while cost obligations remain

Next

Resumption of business is critically dependent on availability of working capital

Beyond

Need to critically assess the long-term impact of the pandemic on debt sustainability

Now – during the MCO

Corporate Malaysia has undoubtedly started to review its financial position and its optionality amid uncertainty over the operating landscape. With the temporary cessation of operations, liquidity is now a priority and most corporates have started or should have started planning for their liquidity in the next three months.

In the absence of revenue, corporates will have to rely on their own cash reserves and available credit facilities to cover ongoing obligations (e.g. salaries). Of course, the Government's intervention measures such as EPF deferment, HRDF exemption, wage subsidy and lower electricity costs will certainly ease corporates' cash flow.

Next – MCO eases

When the MCO eases and businesses are allowed to resume, this will be the most crucial period for corporates and their entire supply chain eco-system.All stakeholders will aim to resume operations immediately with minimal disruptions. But there are challenges.

Firstly, there will now be increased funding requirements after a period of inactivity. This is where Danajamin-sponsored funding and the six months interest and debt repayment moratorium will help to ease the corporates' cash flow.

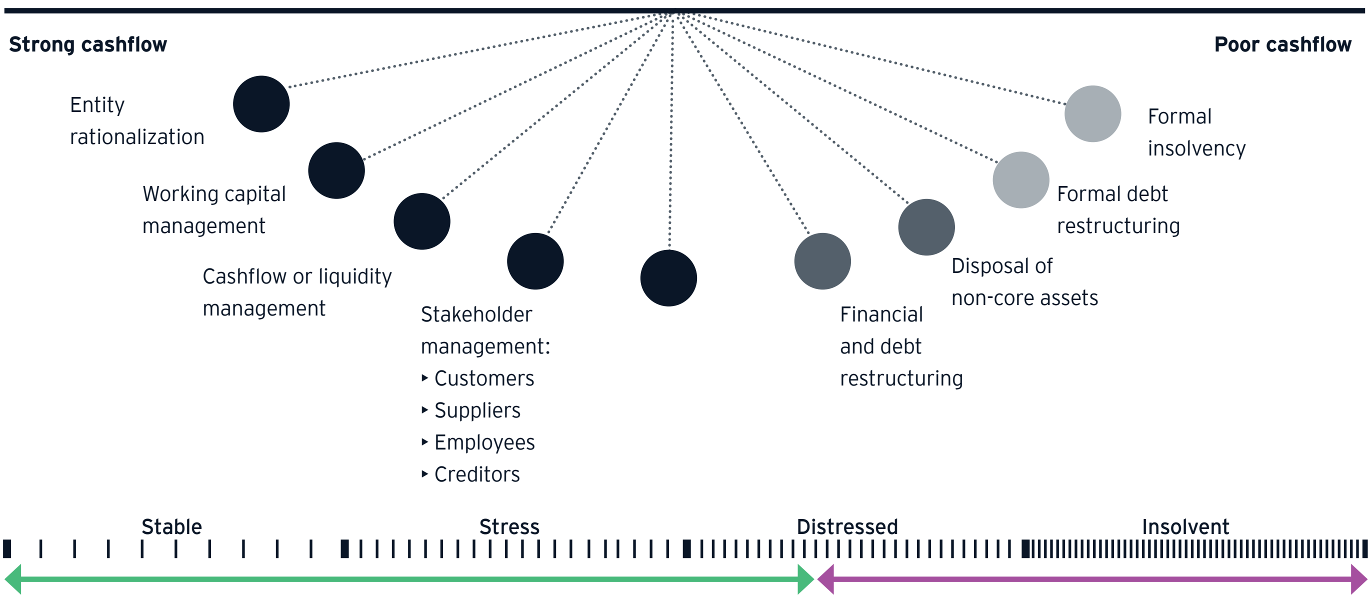
Secondly, smaller scale suppliers themselves may be financially challenged, potentially disrupting the supply chain system. Whilst corporates attempt to conserve cash, they will still need to ensure the long-term viability of their suppliers are not affected.

The key is speed and compromise - speed as both engagement with the banks and suppliers should start now ahead of the lifting of the MCO; compromise because both banks and suppliers need to understand that the situation is unprecedented and credit terms may need to be extended to ensure preservation of value for all.

Beyond – after business resumes

When businesses resume, the financial position of corporates is likely to be weakened following the disruption caused by the pandemic. Recession is likely. Demand may still be weak as consumers are cautious with their spending. Likewise, investment decisions are more likely to be conservative. This will likely affect the corporates' business and their ability to meet their debt obligations.

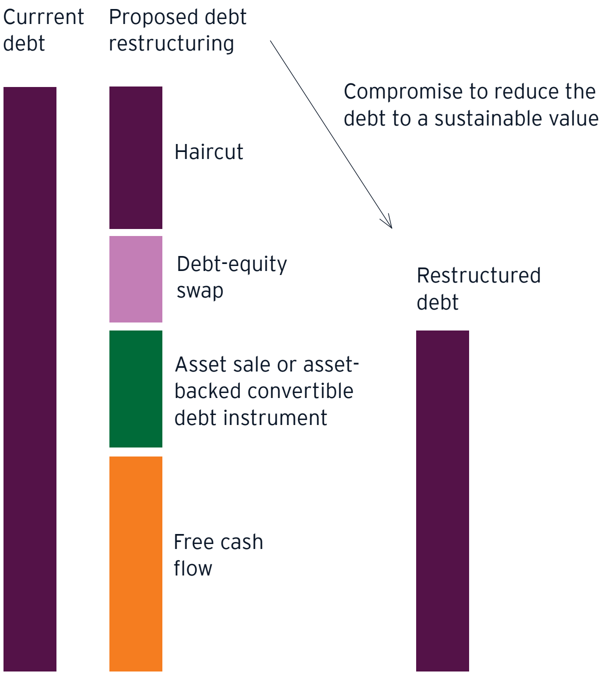
EY Stress Pendulum Framework



It is our view that as we move beyond the MCO, there will be a higher chance that a corporate may need debt restructuring and this includes exploring strategic considerations for the business and options.

There will be businesses that may no longer be fit for purpose so corporates should exit. There will be debts that are no longer sustainable. And finally, the business model may need to be revisited and a new strategy may need to be explored. All these factors will drive debt restructuring with the aim of reducing debts to a sustainable level.

Intended restructuring outcome (illustration)



More importantly, there is a need for early assessment and intervention as they help the corporate to preserve optionality and control. In the absence of such initiatives, corporates can fall very quickly into a distressed or insolvent situation.

> “There is a need for early assessment and intervention as they help the corporate to preserve optionality and control.

A pragmatic approach to preserve Corporate Malaysia is key

The Economic Stimulus Packages announced are certainly necessary to cushion the impact of COVID-19 on Malaysia's socio-economy and businesses. Corporates need to sustain through this challenging landscape in order to preserve employment and drive household spending. To cushion the recession risk is perhaps, the accessibility to funding to support viable and sustainable corporates, subject to meeting certain criteria to work-out or rehabilitate the corporates.

Conclusion

The Malaysian economy has already shown signs of slowing down. The outbreak of COVID-19 has accelerated the distressed situation, placing unprecedented stress on Corporate Malaysia's debt capital structure.

The declining profit trends, coupled with large-scale debts undertaken by corporates, point towards risk of breaches in debt obligations. Most of these corporates are operating within capex-driven sectors, where large-scale debts have been raised.

As time is of the essence, quick intervention actions by corporates are needed to stay resilient and to preserve optionality. In the absence of such actions, it is almost certain that control and optionality will diminish and will place the corporates' solvency at risk.

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Talk to us

The EY Restructuring team has been supporting a number of corporate clients in addressing their adverse financial performance and challenging debt obligations. In the last three years, we have been involved in complex debt restructuring of Bursa-listed companies totaling a debt of RM4.6b.

We have the skills, experience and robust relationship with various stakeholders (regulators, lenders) to provide the necessary support.

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