SUPPLY CHAIN DISRUPTIONS & OTHER FINANCIAL EFFECTS OF THE CORONAVIRUS

AMERICAN BANKRUPTCY INSTITUTE

FIRST, A WORD . . . .

This webinar is intended to provide insolvency professionals with a perspective on the evolving coronavirus (COVID-19) situation and implications for their practice. The coronavirus outbreak is first and foremost a human tragedy, affecting hundreds of thousands of people as well as the global economy.

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TODAY’S SPEAKERS

HOW ARE YOU FEELING?
HOW DOES THIS IMPACT YOU?

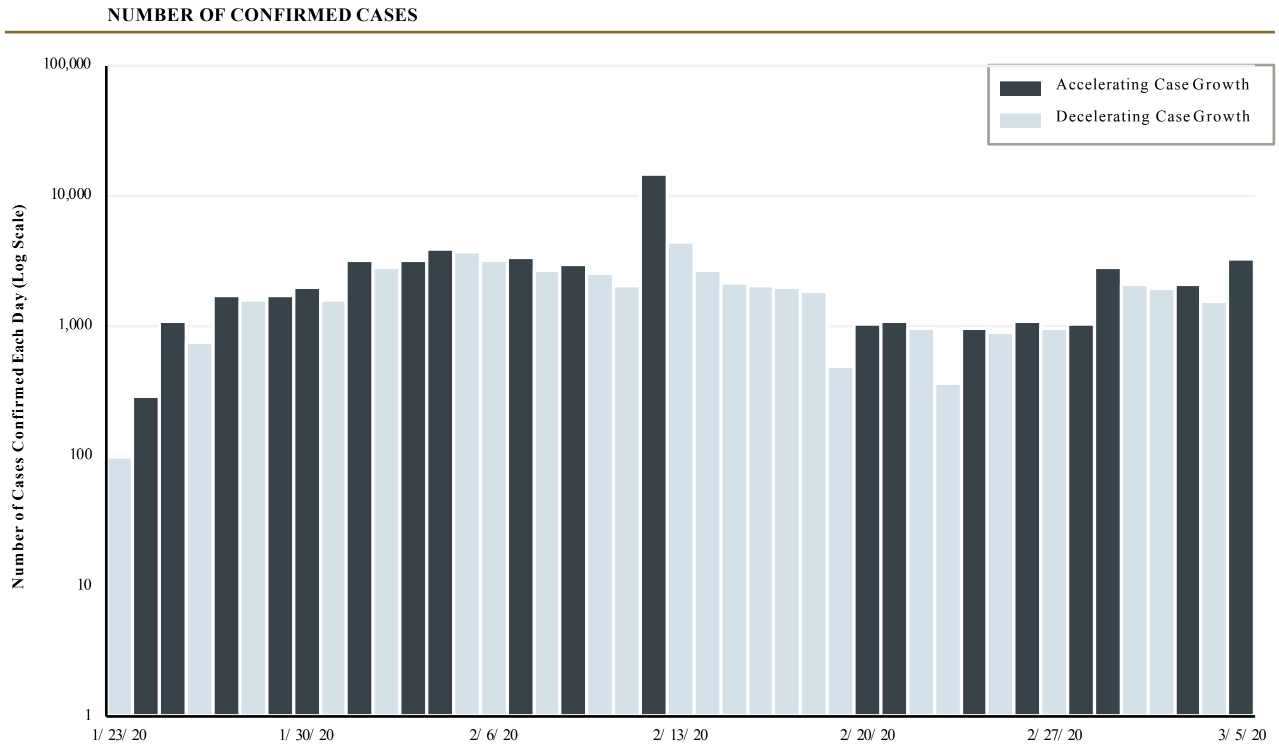
Is your firm considering cancelling an event?

Is your firm cancelling all non-essential travel?

Is your firm cancelling all travel?

Is your firm mandating only essential employees come in to the office?

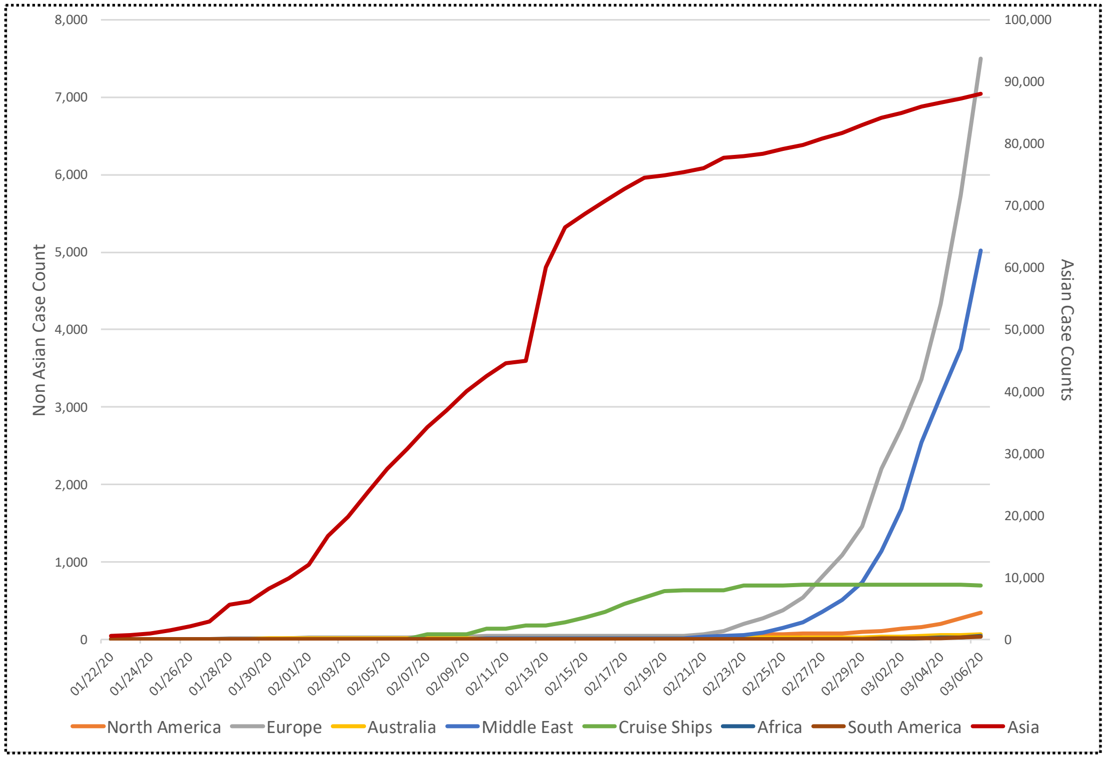
SITUATION OVERVIEW: CORONAVIRUS GROWTH



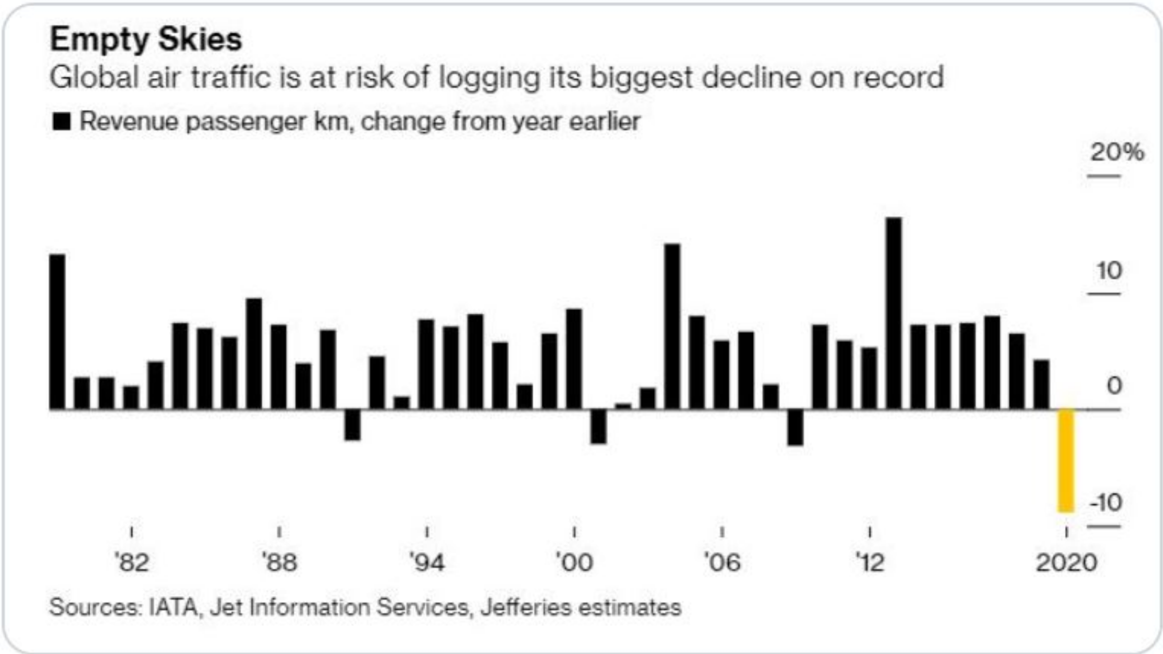
Number of confirmed cases has surpassed 100,000 globally, affecting over 60 countries

Source: Bloomberg

COVID-19 CASES BY CONTINENT



IMPACT ON THE AVIATION MARKETPLACE



WEAKNESS IN TRAVEL

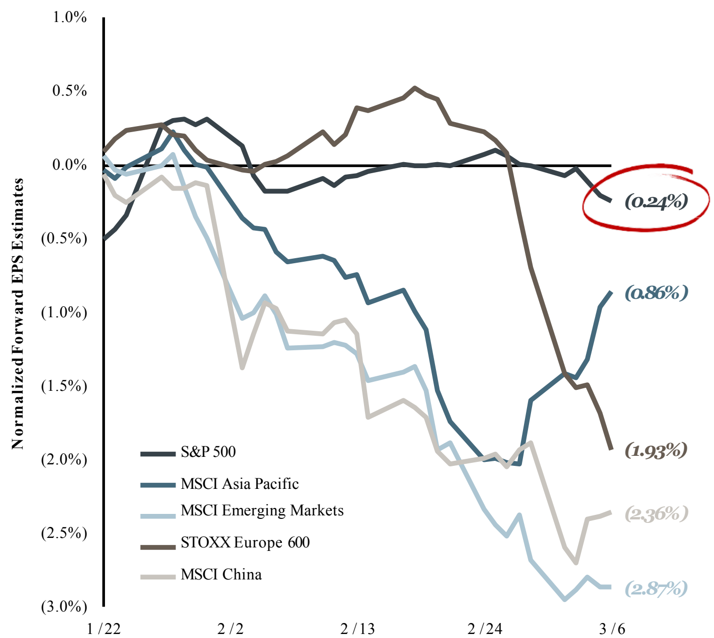
- 16 % of international tourism is from China. Travel disruptions are anticipated to have up to a $10B impact on the travel industry.
- International travel to China was halted by several countries and carriers starting in late January.Over the last several weeks, restrictions on flights to Iran, South Korea, and Italy have been instituted by many carriers and countries.
- Last week, United announced they would be reducing international travel by 20% and domestic travel by 10% in April. Jet Blue followed suit announcing an approximate 5% reduction in capacity.
- On Friday, Air Alaska noted they would be following the United and Jet Blue lead, and also pulled their 2020 annual earnings guidance.
- Air travel losses could top $113B

CONVENTION CENTER IMPACTS

- To date, over 50 US based major meetings/events have been cancelled or postponed.
- 260 meetings in Europe have been have also been cancelled or postponed.
- 9 major tech events included in the cancellations have an estimated impact of $1B
- In Chicago alone, events over the next 90 days represent $460M in economic impact.
- Between tourism declines and event cancellations, the potential impact on the hotel industry is $10B, Hilton has already issued guidance of a $25-50M EBITDA impact.

EQUITY MARKET PERFORMANCE & EXPECTATIONS

FORWARD EARNINGS DIVERGENCE

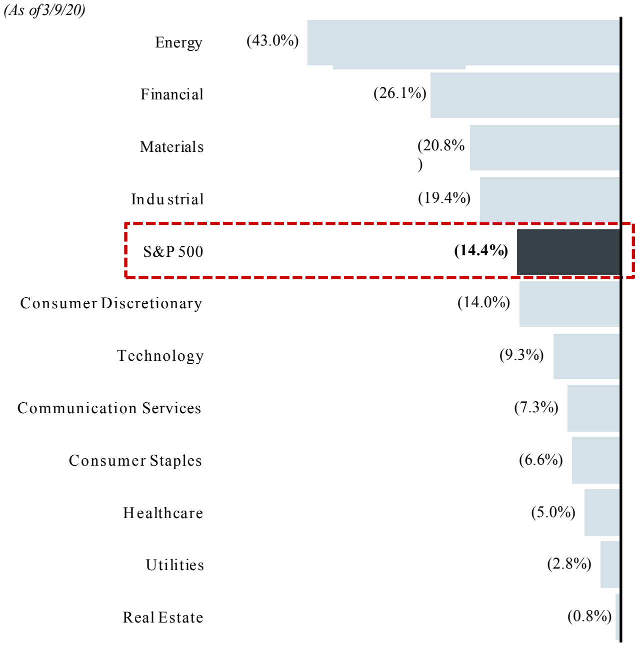


EPS forecasts seeing downward revisions across most major markets; US impact limited… thus far

Source: Bloomberg, FactSet

YTD S&P 500 PERFORMANCE BY SECTOR

(As of 3/9/20)

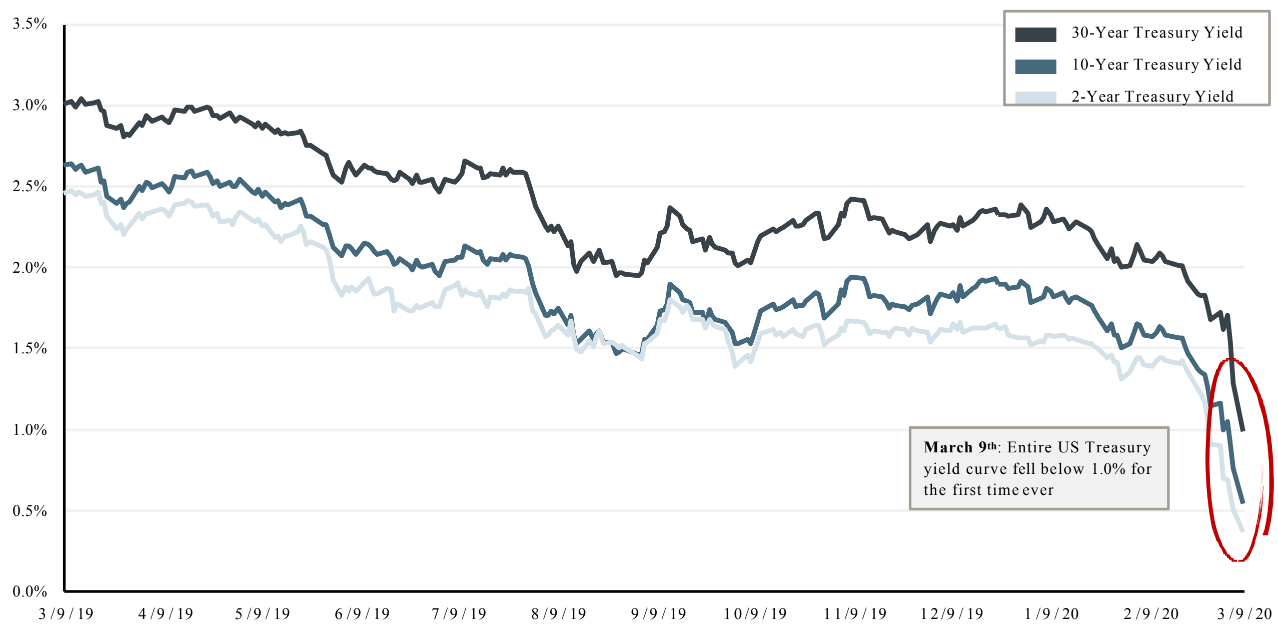


However, US equities continue to sell-off substantially

TREASURY YIELDS HIT RECORD LOWS

Global flight to safety of government debt continues, sending U.S. Treasury yields to historic lows

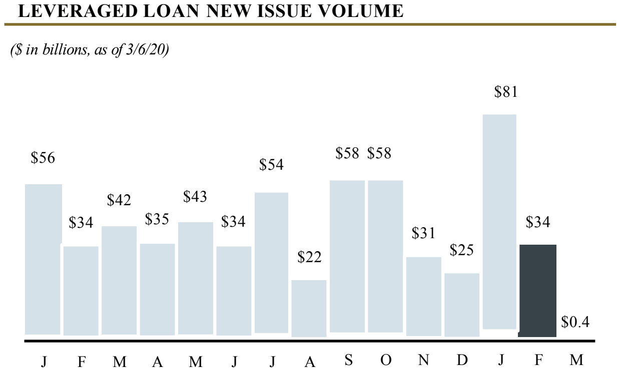
U.S. TREASURY YIELDS

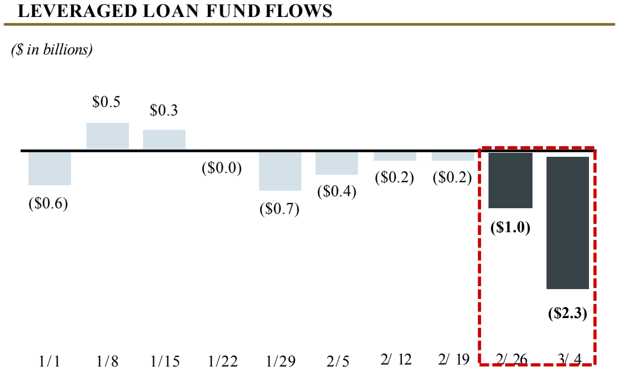


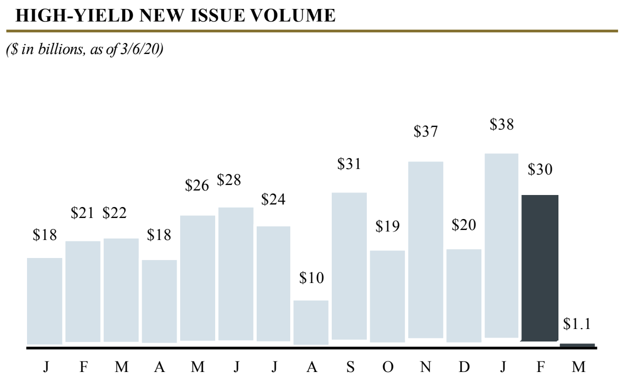
Source: Bloomberg

LEVERAGED LOAN & HIGH-YIELD BOND VOLUMES

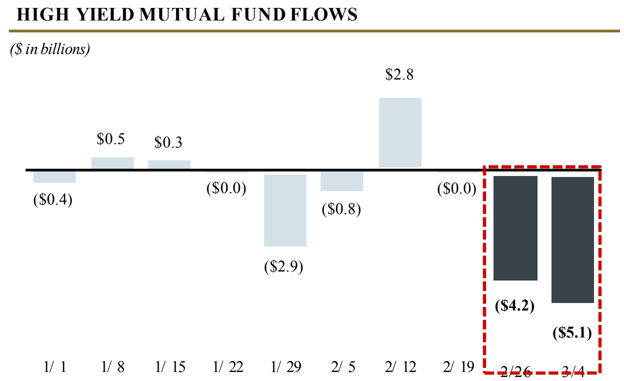
Market volatility has kept issuers on the sidelines while a flight to quality has resulted in significant retail fund outflows







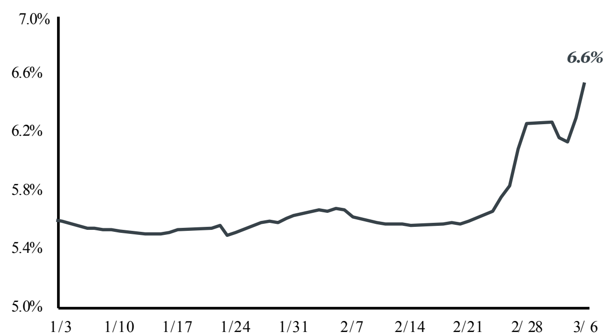
Source: S&P Global Market Intelligence – LCD



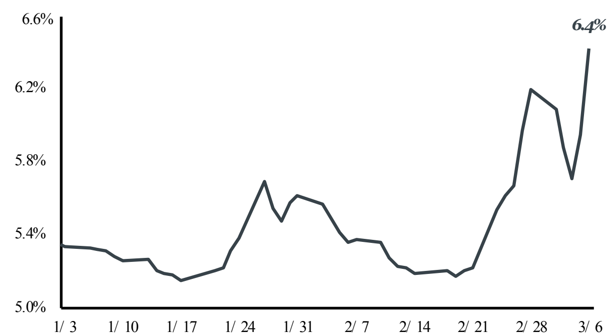
LEVERAGED LOAN & HIGH-YIELD SPREADS

Both markets have seen yields widen significantly over the past few weeks amidst the shrinking supply of new issues

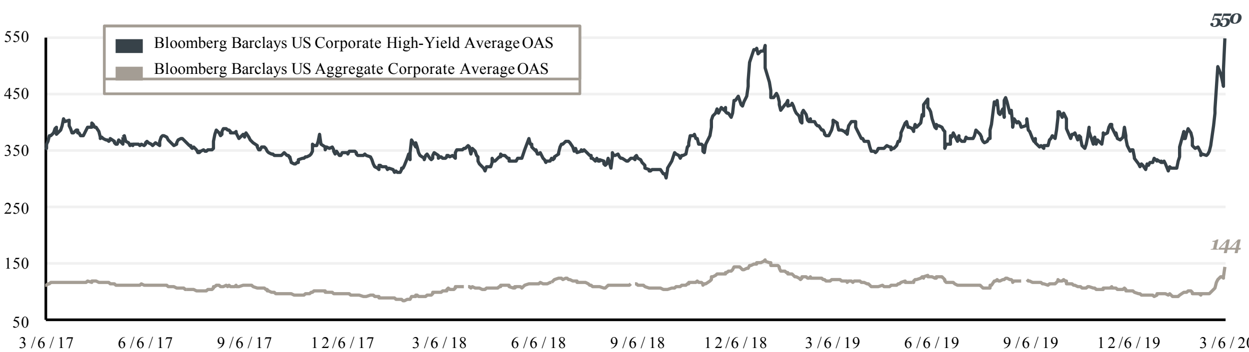
S&P/LSTA U.S. LEVERAGED LOAN 100 INDEX YIELD



HIGH-YIELD ICE BOFA US INDEX YIELD



CORPORATE BOND SPREADS – HIGH-YIELD SURGES



Source: Bloomberg, FactSet

CHINA STATISTICS

- China represents over 13% of global exports, the largest geographical segment.
- Over 50,000 companies have one or more Tier 1 suppliers located in the impacted regions.
- Migration to alternative suppliers is a minimum of 2-6 months, and constrained by capacity in other geographies

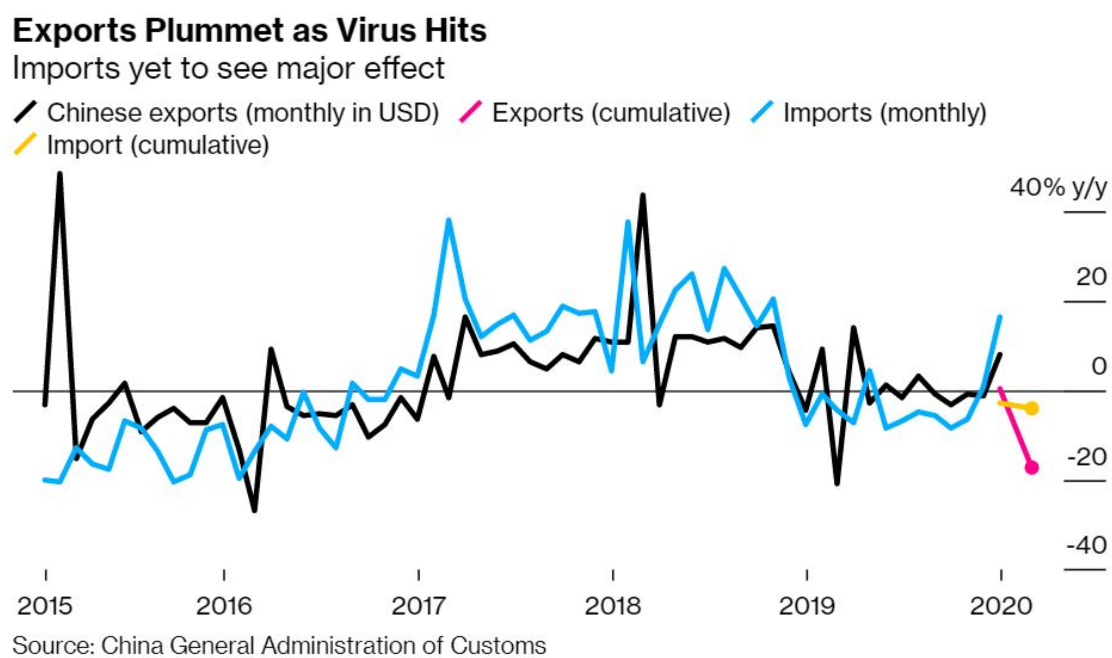
Chinese share of gross worldwide output for both finished and intermediate goods in impacted areas combined are significant:

- Computer, electronics & optical 49%
- Electrical Equipment 59%
- Other machinery & equipment 47%
- Non-metallic mineral products 58%
- Textile, apparel & leather 58%

U.S. LOGISTICS ISSUES

- Maersk – 50 sailings dropped in January.
- Container companies were reported to have lost $1.5 billion in business since the Lunar New Year.
- Chinese Exports to the U.S. fell almost 28% in the first two months of the year due to the virus outbreak and the extended lunar new year holiday.
- Freight Rates - Freight rates to Asia have risen about 20% since the beginning of the year.
- Container imports into the 10 largest U.S. ports dropped 4.1% in January. 60 Container shipments from China to Long Beach were cancelled in February. Of all scheduled sailings, 110 shipments were cancelled out of a total of 200 destined to North America in February 2020.
- There were 2.0 million idled containers in February (versus 1.5 million in 2009). The current back log for refrigerated containers in China is larger than it was for the Great recession. A $2k surcharge is currently being charged for refrigerated containers (effectively doubles the shipping rate)

CHINESE EXPORTS



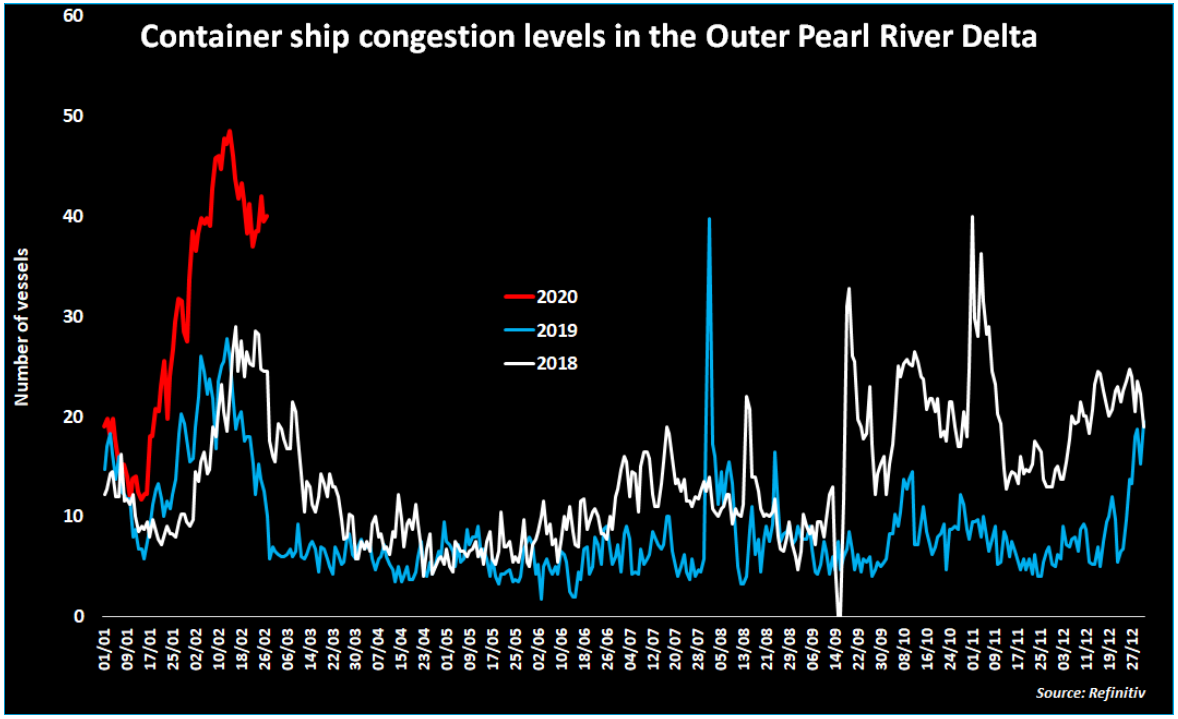
CHINESE LOGISTICS ISSUES

- Chinese trucking Issues
  - In late February, half of the 30 million Chinese truck drivers were not on the road due to travel/quarantine restrictions.
  - Trucking capacity was estimated at a third of normal.
  - Trucking freight rates on select routes are at 2x premium right now.
- Air Transport to/within China Curtailed –
  - Flights of live lobster plummeted in late January after the coronavirus outbreak hit China, down from nine flights per week out of the region to one or two, and those are not always full.
  - International Flights Cancelled.
  - Domestic Flights Materially reduced – Air Cathay is reducing their planned routes by 30-40% and has furloughed a significant number of employees.

CHINESE LABOR ISSUES

- In Late to Mid February, local Chinese governments were chartering planes and trains to bring workers back to major production facilities, like Foxconn.
- These companies were paying workers bonuses of $750 to $1000 to come back.
- But the smaller to mid-sized companies are mostly left out of these arrangements.
- More than 1/3 of China's entire workforce is migratory.

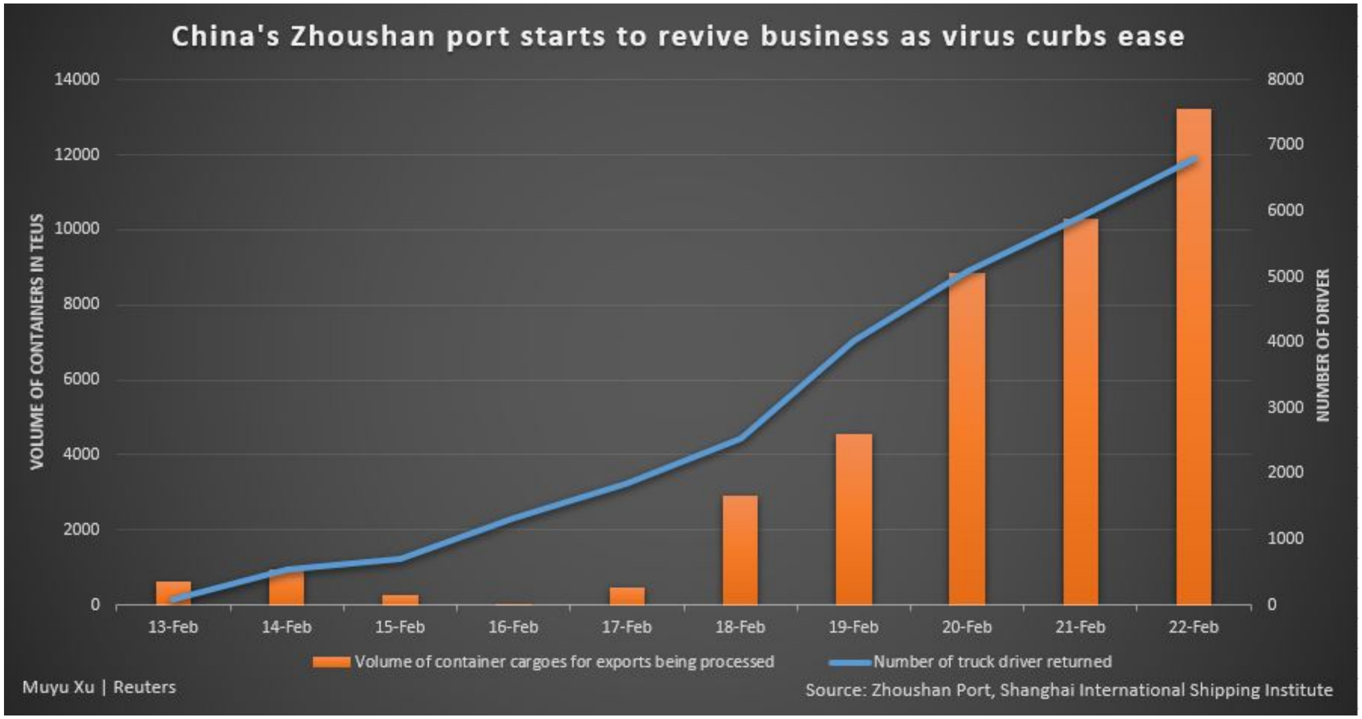
CONTAINER CONGESTION



OF LATE, AN IMPROVING PORT SITUATION IN CHINA

- The average wait time for container vessels at Zhoushan in southern China - the third-largest container port in the world by annual handling capacity - spiked to more than 60 hours in the week of Feb. 11-17, when travel curbs on workers returning from the prolonged Lunar New Year holiday forced ports to operate with skeleton staffing.
- Chinese production capacity "has shown signs of improvement since the end of February," France's CMA CGM, the world's third-largest container shipping firm, reported in a earnings report on March 6, 2020. "There has been an upturn in volumes and a major catch-up effect is expected once the health situation stabilizes, as Western countries will be seeking to rebuild their inventories," the company said. "The Group therefore expects to operate a normal capacity fleet as of mid-March."

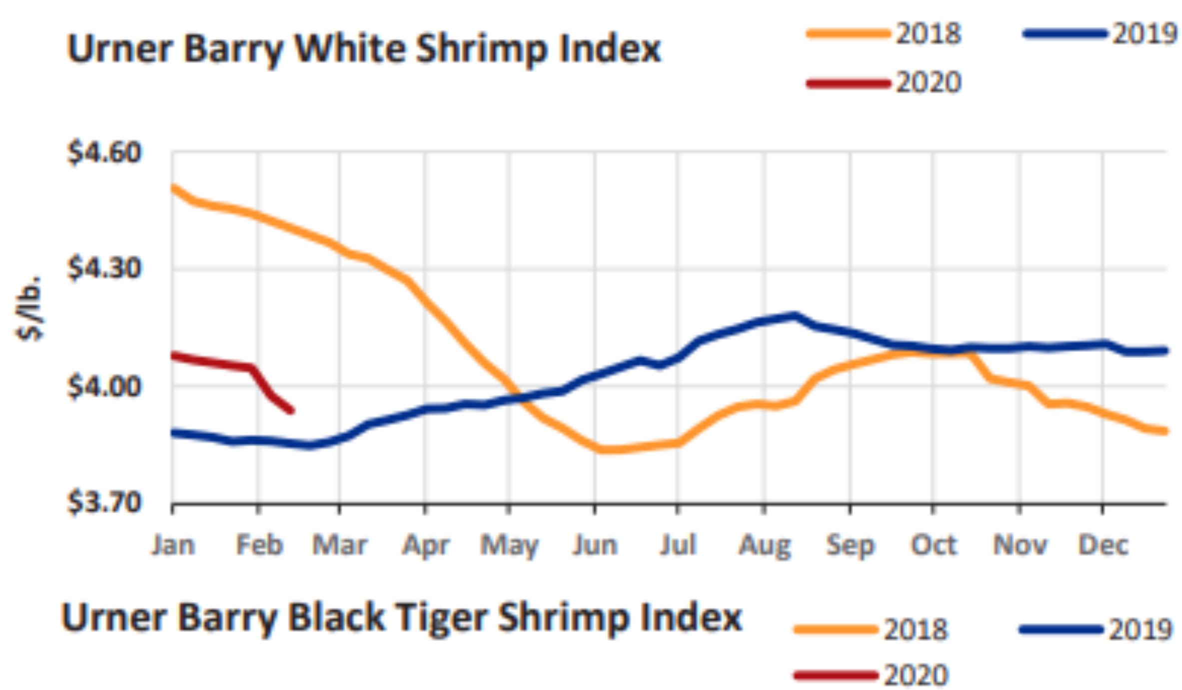
ZHOUSHAN SHIPMENT ACTIVITY



SEAFOOD

- China is the world's largest producer, consumer, importer and exporter of fishery products – handling more than 40% of global production. China imports about $1.0 billion in US seafood currently and exports approximately $1.9 billion in seafood products to the US, much it having been processed in China and then exported to the US as a processed value added seafood products. The US imports approximately 65% of the total seafood consumed in the US annually.
- Imports of some shrimp products into China were constrained in January and February, creating weak market dynamics worldwide. U.S. price of imported white shrimp as reported by Urner Barry declined slightly in January and then trailed off about 5% though mid February of 2020, with further weakness expected.
- Only about 20% of Chinese processing plants had restarted operations by mid-February. Fresh sales down, but frozen and online sales up, with online delivery increasing by a factor of 300 to 500%.
- Lobster (all types – North American, European, Southern, Australian Rock Lobster)– prices 10 to 40% depending on the market.
- Alaskan Geoduck Clam Fishery – shut down.
- Prices for H&G Russian Pollock have come down from $1,600 to $1,325 per MT, in one month.
- North American Spring Harvest dock negotiations (snow crab, Coldwater shrimp, wild salmon) expectations are suppressed.

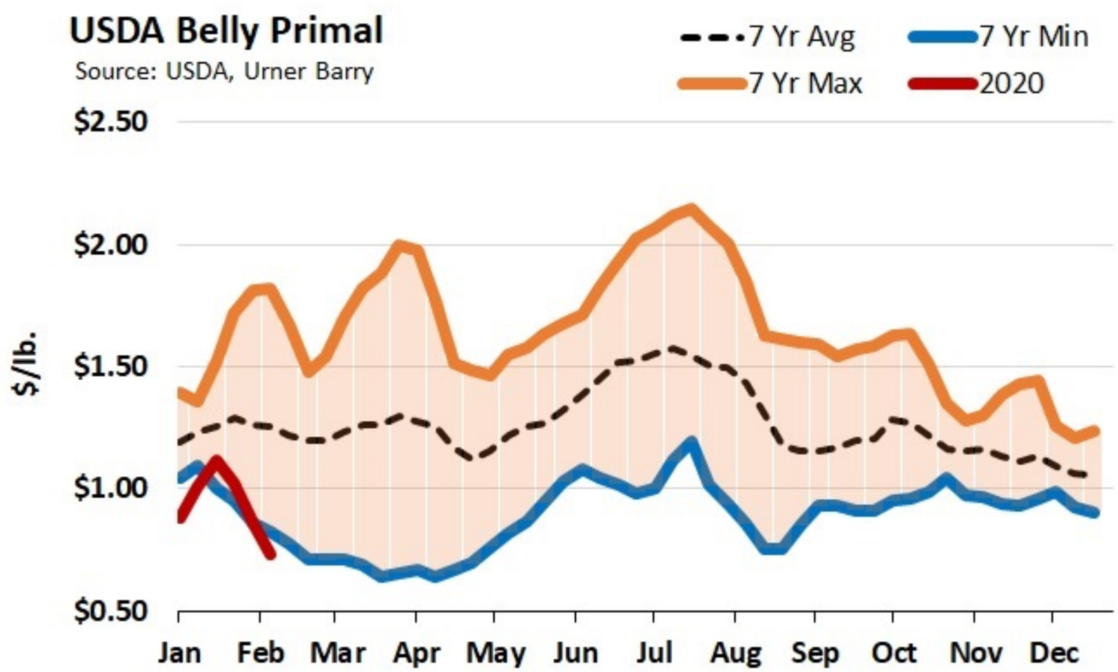
SHRIMP PRICES



PROTEIN SUPPLY SITUATION

- Pricing has been mostly steady in the marketplace, although anticipated export demand for pork due to the Phase I trade agreement and the African Swine Flu situation has not materialized and pork prices, which had been increasing in expectation of improving exports, have fallen.
- Beef - China's beef imports are projected to fall in the first half of 2020 due to fallout from the Coronavirus outbreak. China had a high inventory of frozen beef stored in local markets in preparation for the country's Lunar New Year holiday was not used in January due to the outbreak of Coronavirus, which caused restaurants to close.
- Chicken - Rising quantities of breasts, thigh meat and drumsticks lifted the amount of chicken in U.S. cold storage facilities by 12% over the first month of the year to 957.5 million pounds, the highest level on record for the month of January.
- Pork - The amount of pork in U.S. storage climbed 11% in January 2020 versus January 2019. According to the latest data, the volume of pork exported to China was 1.6 times the volume in January and February 2020 compared to the same period a year earlier.

PORK PRICES



USDA Belly Primal
Source: USDA, Urner Barry
7 Yr Avg
7 Yr Min
7 Yr Max
2020
$2.50
$2.00
$1.50
$1.00
$0.50
$/lb.
Jan
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec

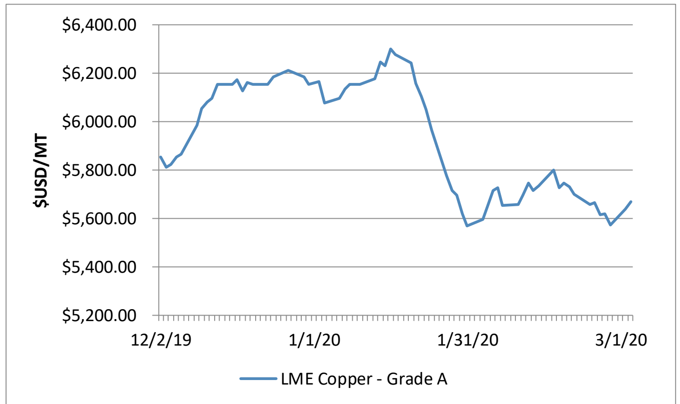
IMPACT ON COMMODITY PRICES

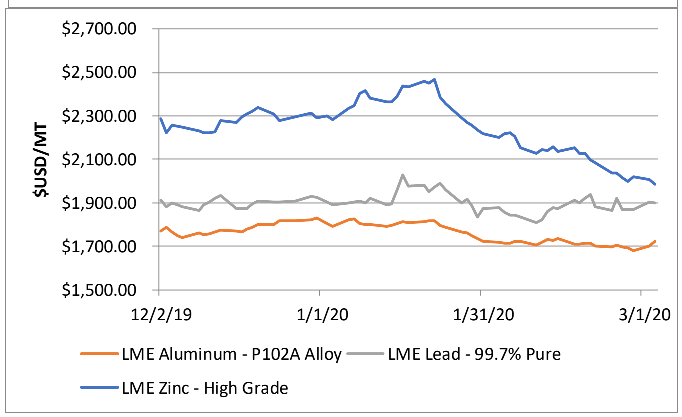
- International Commodities impacted by lowering economic outlook: Metals, Oil, Pulp, among Others
- First market reactions in the commodity markets have indicated deflationary trends, but it seems unlikely that would be the case if there are widespread shortages of goods in the future.
- Iron ore is down more than 10% this year. Copper is down about 8%, as is nickel, a key ingredient for stainless steel. Zinc and aluminum are both down more than 5% in 2020.

METAL PRICES

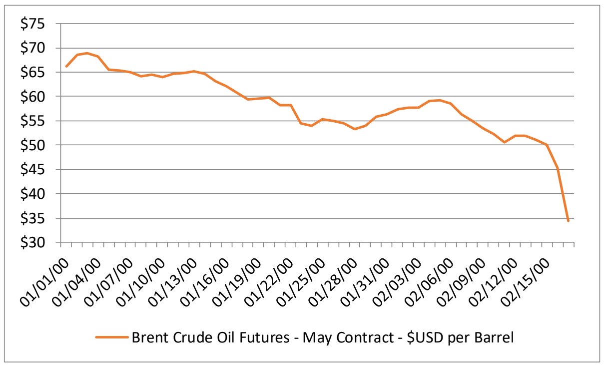
- Chinese supply constrained due to Labor Shortages and Logistics
- Multiple force majeure filings in China to protect producers from contractual obligations
- Inventories Rising in China due to limited industrial consumption.
- But some positive Indicators in China in early March as domestic consumption starts to rise.
- Constrained European Demand, due to relatively weak European economy (predates Coronavirus) and outbreaks in Italy and Germany
- Some Strength in certain metals including precious metals due to financial instability, and supply constraints for certain types of additives with a high proportion of productions centered in China
  - Manganese – Price up 20-30% - mined in various places, but 97% of secondary processing occurs in China
  - Silicon – Prices up 15% - 64% of the world's silicon comes from China; 7% from US

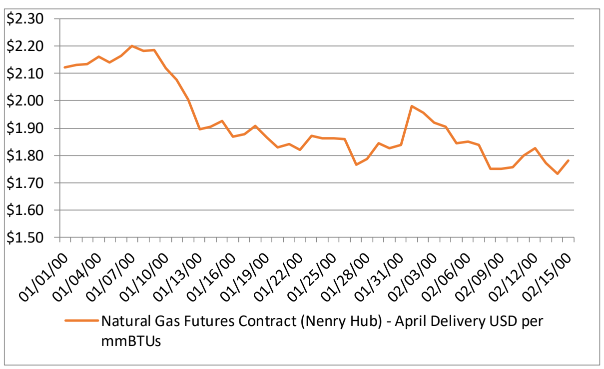
There is an expectation of a "New Normal" of volatility due to Coronavirus: "This virus scare is picking up steam, this may be the most volatile year in a long time for stocks and commodities." American Metal Market – 3/7/2020





CRUDE OIL/NATURAL GAS





- Crude oil futures down 48.1% as of yesterday from the beginning of the year.
- Saudi Aramco is already supplying China with 500,000 barrels a day less than normal in March due to the outbreak.
- Oil could fall below $30 a barrel if OPEC fails to agree to a production cut.
- OPEC and allied producers were expected to agree to a possible 1.0 million-barrel per day cut last week. No agreement was reached as of Friday.
- Natural Gas Exports are (temporarily?) down – "Now, thanks largely to those export terminals, the global market is glutted. The fuel, which is used to heat homes, generate electricity and make chemicals, is fetching historically low prices from the Netherlands to China." Wall Street Journal – March 2, 2020

KEY RECENT ECONOMIC INDICATORS

- Chinese Sentiment - A Chinese government index that tracks sentiment among purchasing managers at manufacturers fell to its lowest level on record in February, dropping deep into territory that indicates a contraction. China's National Bureau of Statistics said Saturday that its 15-year-old index tumbled to 35.7 from 50.0 in January—below even the lowest level recorded during the global financial crisis. (March 2)
- The Institute of Supply Management's (ISM's) New Export Orders Index registered 51.2 percent, a decrease of 2.1 percentage points as compared to the January reading of 53.3 percent. New export orders remained in expansion territory, but at weaker levels compared to the prior month. Many respondents reported that their operations were impacted by the coronavirus outbreak.
- The ISM's Imports Index registered 42.6 percent, an 8.7-percentage point decrease from the January reading of 51.3 percent. "Imports returned to contraction territory, with the index recording its weakest performance since May 2009, when it recorded 38.5 percent. Respondents noted the combined effects of the Lunar New Year as well as the coronavirus.

SUPPLY CHAIN ISSUES

- Based on the latest Export information, China's exports plunged 17.2% in the first two months of 2020 compared with a year earlier.
- U.S. supply chains will be impacted in a variety of sectors shortly (automotive OEM, automotive aftermarket, aftermarket repair parts, apparel, various retail sectors, pharmaceuticals, and others)
- As the supply chain interruptions become apparent there will be a negative impact on these sectors.
- Realistically prices will likely increase in the face of shortages
- Short term impact on inventory asset values may be minimal or positive, but cash flows will be negatively impacted.

AUTOMOTIVE

- Reports of OEMs flying parts in to avoid plant closures.
- OEM supply chains are often only three-six weeks for imported high demand parts. Domestic supply chains are typically only several days.
- The first production plants outside of China to be impacted by parts shortages were in Japan and South Korea. That meant operations for Nissan Motor, Hyundai Motor, Kia Motors and GM had to temporarily shut down. The problem has since grown to Europe and poses eventual problems for North America.
- Overall vehicle sales are expected to decline by 3.5 to 5.5% in 2020 – Commerzbank AG expects a 5.5%, Goldman Sachs – expects a 3.5% decline in 2020.
- Auto sales in February fell 80% in China, 20% in South Korea, 10.7% in Japan, and 8.8% in Italy.
- Flat US market – Feb sales up 8.5% in based on leap year numbers.

NORTH AMERICAN INDUSTRIAL LIQUIDATIONS

- Increased demand and pricing for Cleaning Materials, Health, and Safety goods.
- Seeing Larger "primary" tier companies participating in the surplus consumer marketplace.
- Supply is drying up in the surplus market.
- Buyers are limiting travel to major shows.
- Trade Show cancellations impacting the market.
- Export market for large used capital goods being impacted by travel issues.
- Auction market still functioning due to online nature of the marketplace.

IMPACT ON RETAIL/CONSUMER PRODUCTS

- Consumer sentiment in China and store closures there have resulted 1-4% Q1 sales declines in retailers operating there. Chinese consumer demand is currently down 20% and anticipated only to recover very slowly through 2020.
- The luxury retail business is particularly impacted as China represents 35% of global luxury goods sector in sales.
- Sourcing disruptions and delays have already extended to 6 weeks, and most factories are only back to 60% of capacity. Impacts will extend into Q2, mostly in the form of product delays.
- Many companies have suspended on-site inspections, including the FDA, and are counting on end point sampling. This could result in further consumer impacts.
- Most retailers are counting that on-line sales make up for brick and mortar sales declines.

RISK MITIGATION TOOLS

- Although there is significant upheaval in the markets, companies can mitigate the financial impact of coronavirus by: (1) examining their insurance policies that may transfer these losses to their insurers; and (2) consider provisions that may relieve them of their contractual obligations.

- **Insurance**
  - There are several types of insurance that may respond to the coronavirus outbreak, including but not limited to:
    - Civil authority coverage;
    - Traditional business-interruption coverage;
    - Event insurance (predominantly travel and entertainment industry); and
    - Trade-disruption insurance.

- **Force Majeure Clauses**
  - Companies may benefit from or be harmed by the triggering of a force majeure clause, but as the coronavirus becomes more pervasive and impactful, arguments that this is not a force majeure event are weakened.

TYPES OF INSURANCE POLICIES POTENTIALLY RESPONSIVE TO CORONAVIRUS

- **Civil Authority Coverage**
  - This coverage typically exists in property policies and provides coverage where a "civil authority" (government) prohibits or impairs access to the policyholder's premises. This coverage may require that restriction to access property arise from "physical loss," but the physical loss does not necessarily have to occur at the policyholder's own property.

- **Business-Interruption Coverage**
  - There generally are two types of business-interruption coverage: (1) traditional business-interruption coverage; and (2) contingent business-interruption coverage.
  - Traditional business-interruption coverage protects businesses from loss of income resulting from disruptions in their operations.
  - Contingent business-interruption coverage provides coverage for financial losses resulting from disruptions to a business's customers or suppliers.
  - Both traditional business-interruption coverage and contingent business-interruption coverage typically require "direct physical loss of or damage to" insured property.

- **Event insurance (predominantly travel and entertainment industry)**
  - This coverage typically transfers the risk to the insurer if an event has to be cancelled or postponed due to an occurrence "outside the control" of the policyholder.
  - These policies, however, note that the mere threat or fear of an occurrence is not sufficient to trigger coverage under these policies

- **Trade-disruption insurance**
  - Trade disruption insurance (TDI) covers the consequential loss that results from a loss of earnings, extra expenses and contractual penalties incurred because of delays or disruptions in trade flows.
  - TDI differs from the standard business interruption coverage afforded by marine cargo or property forms by not requiring that there be a direct physical loss to goods or their conveyances.

OBSTACLES TO OBTAINING INSURANCE COVERAGE

- There are at least two significant obstacles to obtaining insurance coverage under some or all of the policies listed above (but there certainly will be others that insurers will raise).

- **<u>Communicable Disease Exclusion/Endorsement</u>**
  - After the 2003 SARs outbreak, the insurance industry included an exclusion for communicable diseases.
    - There are multiple iterations of this exclusion – some exclusions are only for bacteria, while others are for bacteria and viruses.
  - Insurers have also issued endorsements that negate the exclusion and allow for coverage of communicable diseases.
    - For example, with respect to event coverage, this endorsement typically "extends to cover the necessary and unavoidable Cancellation, Abandonment, Curtailment or Rescheduling of the Event as a sole and direct result of an outbreak of a communicable disease during the period of insurance."
    - However, these endorsements also provide that the insurance does not cover any loss directly or indirectly arising out of, contributed to or caused by or resulting from or in connection with any threat or fear, whether actual or perceived, of any communicable disease.

  - Companies should review their policies to evaluate whether a communicable disease exclusion is included in their policies and, if so, whether that exclusion only bars certain events or all bacteria/viruses.
    - Companies should also evaluate whether they purchased an endorsement for communicable diseases. If this endorsement is purchased, there is still uncertainty regarding whether coronavirus is a covered loss because insurers may argue that there is only "threat and fear."
    - However, we view this argument as weak given prevailing rules of insurance-contract interpretation, where ambiguities are construed against the insurer and in favor of coverage.

OBSTACLES TO OBTAINING INSURANCE COVERAGE (CONT'D)

- **Requirement of Physical Loss or Damage**
  - As noted above, most business-interruption coverage requires "physical loss or damage."
    - Insurers will likely contend that the coronavirus did not cause physical loss or damage and, thus, there is no coverage. This argument, however, is not well based.
  - While the spread of coronavirus does not independently suggest "physical damage" to property, the loss of use of property that has become uninhabitable or unusable because of coronavirus contamination may (under some circumstances) be considered "physical loss" for purposes of a commercial property policy and any accompanying business interruption coverage.
  - Indeed, numerous cases have held that similar circumstances constitute "physical loss or damage," including where e-coli bacteria impaired the use of property. *See, e.g.*, *Motorists Mut. Ins. Co. v. Hardinger*, 131 Fed. Appx. 823 (3d Cir. 2005) (finding a fact issue precluding summary judgment on a claim for "physical loss" relating to a home rendered uninhabitable by a well contaminated with e-coli bacteria).
    - In fact, there is a body of case law addressing insurance coverage for property that is not physically injured, but is physically lost. *See, e.g.*, *Sentinel Mgmt. Co. v. New Hampshire Ins. Co.*, 563 N.W.2d 296, 300 (Minn. Ct. App. 1997) (loss by asbestos contamination); *compare Pentair, Inc. v. Am. Guar. & Liab. Ins. Co.*, 400 F.3d 613, 616 (8th Cir. 2005) (factories without power following an earthquake). Because the cases are fact specific, corporate policyholders will need to carefully consider whether coronavirus-related losses constitute a "physical loss" under a commercial policy.

FORCE MAJEURE CLAUSES

- Thousands of Chinese or China-based companies have already invoked force majeure clauses to excuse performance due to the coronavirus outbreak and the government's reaction.
  - Whether these force majeure declarations will withstand judicial scrutiny is yet to be seen, particularly given that the language of force majeure clauses can vary widely from contract to contract.
  - Specifically, whether the coronavirus constitutes a force majeure event may vary depending on whether the clause: (1) limits force majeure events to circumstances that prevent performance (i.e., performance is legally or physically impossible); or (2) includes events that merely hinder or delay performance (a standard far less onerous than "prevents performance").
  - In addition, in situations where business interruption coverage is available, the declaration of a force majeure event by a supplier or the availability of force majeure to the insured as a defense to contractual performance may lead to disputes over the amount of the policyholder's loss or the efficacy of the policyholder's mitigation efforts.
    - Therefore, it is also important for corporate insureds to review its supply and vendor contracts to balance invoking or challenging the force majeure clause against the possible recovery of business-interruption insurance.

Q&A

CONCLUSION

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