Global Liquidity Speaker Series
Managing Liquidity Global Supply Chain in APAC Post Covid
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Attendance List:	Alvin Poh Vikram Sahu Peter Jameson
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Hosted By:	Sharon Hawkins

Coordinator

Good day, everyone, and welcome to the Bank of America Global Liquidity Speaker Series: Managing Liquidity Global Supply Chain in APAC Post-COVID conference call hosted by Alvin Poh. My name is Leslie, and I'm the event manager. During the presentation your lines will remain on listen-only. [Operator instructions]. I would like to advise all parties that the conference is being recorded for replay purposes.

Now I'd like to hand you over to your host for today, Alvin. Please go ahead.

Alvin

Thanks you, Leslie. Good morning, everyone. Thanks for dialing in. We will be discussing managing global supply chain in APAC post-COVID. My name's Alvin, and I'm the Head of Liquidity for GTS Asia-Pacific.

Given that APAC is a key global manufacturing hub, it has caused significant destruction to global supply chain when we went into a sudden lockdown during COVID in early 2020. As Asia is [indiscernible – 38:41] globally, it escalated to an economic meltdown and resulted in a shotgun liquidity crunch. Many companies [indiscernible – 38:49] to ensure there's sufficient liquidity to manage this flex one event.

Joining me today are my colleagues Vikram Sahu, who's our Head of Tech [ph] Research; and Peter Jameson, who's our Head of Trade and Supply Chain Finance for GTS Asia-Pacific. They will share their insights on the impact of global supply chain post-COVID and also the expected changes going forward.

So, Vikram, let's start with you. The COVID pandemic has resulted in an unprecedented challenge to global supply chains. Can you provide an overview on the impact to supply chains in Asia and what are the key developments or trends that you foresee going forward?

Vikram

Alvin, thank you very much for the opportunity to be on this call, and I appreciate the question. Let me start by saying supply chains are moving. Now when you say that to anybody, they'll say that's simpleton talking to you, because supply chains have been moving for decades now. This is just a function of globalization of trade. It's a function of production moving to where the cost arbitrage was the highest and it was part of an effort to maximize REs industry, but the key feature of the shifting supply chains has been the shift directionally from the West to the East. If you were to look at the US and Europe combined over the last three decades, their share of manufacturing value-added has declined by roughly about 25 percentage points; so not quite one percentage point a year but somewhere in that post-COVID. So that's nothing new, but supply chain shifting is nothing new.

What's interesting to us as a house and to our analysts is the direction of travel. About a year ago—actually for the last couple years—our analysts have been working on this topic as have our macro people, and we've been making observations about either individual geographies or in individual sectors, and we decided about a year ago to make a stab at a holistic perspective of what was going on. The headline was that we concluded that there was as I said a few seconds ago that there's a change in direction. And what we found was that supply chains which for the longest time had been in the East and principally to China were moving out of China in the first instance into Southeast Asia and then perhaps as a second location to India.

But what was particularly surprising to our clients when we first started talking about it is that we were seeing signs of reshoring taking place which was forcing the supply chains had sort of ended up in Asia round tripping and getting back closer to where customers were, and this would have been in Europe and in North America. Now in that piece I referred to—we dug into the reasons of why these changes were taking place, and

I'll spend about a minute elaborating that a little bit, and then I'm going to turn to your question about how COVID has affected all of this.

Our findings based on our conversations with companies—and just as a reminder for those of you who aren't as familiar with our research, also we cover something like 3,300 companies around the world and that's with a team of research analysts that's distributed pretty much everywhere—our conversations with our companies give us a sense that what was happening was that there was a shift in mindset taking place which is we were moving from maximizing returns for shareholders to stakeholder capitalism where companies and boards were focused on the interest of multiple stakeholders and those could be governments or could be boards. They could be consumers, and they could be shareholders. And all of these stakeholders their views were converging, and it was underpinning the shift in these supply chains and this reshoring initiative. And in the piece that we published, we articulated this is a shift in the tectonic plates. This elaborative initiative was for post pillars [ph].

If you look at it from a perspective of governments, they're driven by the need to maximize employment within their own jurisdictions and also by national security considerations. If you look at it from the perspective of boards, it was about a desire to ensure BCP—and I think when we come to COVID we'll see how that was a bit of a shock to the system—and then also with an eye on the growing assets under management which are invested on an ESG basis. When you look at consumers themselves, there's a desire to have unconsumed products that have a lower carbon footprint, and also there's a focus on the deep aspect of ESG which is how are employees treated, and then shareholders have a matching [ph] of each of these different variables depending on where the shareholders happen to be. So all of those factors were converging to as I said reverse the flow of supply chains.

Now I want to emphasize that about a year ago when we published this, our observation at the time was that this trend was a mile wide. So as you look at the about a millimeter thin—and I'll elaborate on that in a second—so when you look at the sectors that have global supply chains, there's roughly about 12 global sectors with supply chains. In 10 out of those 12 sectors, we were being told by our analysts and the companies that they cover that they were moving their supply chain. So like I said it was about a mile wide.

But what I mean by being a millimeter thin however, was at the time what companies were doing was saying listen, I'm not going to monkey about with a supply chain that has taken me many, many years and in some cases decades to refine and put into place the economies of scale that I'm getting in locations that are principally China unparalleled, and so I'm not going to mess with that, but what they were doing was experimenting with pilots. And so we were calling this a China Plus One strategy where what companies were doing were experimenting with a pilot in another jurisdiction, and that could be Southeast Asia or India or as I said reshoring.

And at the time our view was that the success or failure of these pilot programs would determine the velocity of future change. And honestly when we published this stuff, COVID was nowhere on the horizon and so we didn't anticipate having long-term COVID a couple of months later. And the timing could not be more exquisite, because when you look at the drum beat particularly from a geopolitical perspective it seemed to have died down. On the 15th of January President Trump was standing in the Rose Garden signing a phase one deal. Unemployment in the US was at historic lows, and our view was that these technology shifts would continue in a slow and persistent way. And what COVID has served to do is give a shock to the system as you said in the introduction. It served to expose the fragility of extended supply chains, and based on our conversations we published a follow-on report to that first piece from over a year ago about the middle of this year where we went back to all of our analysts and all of the companies that we cover and said can you give us a sense for what's happening, give us your mindset about shifting supply chains as a consequence of COVID. What we found was that in 83% of instances we were being told that companies expect greater scrutiny about their supply chains post-COVID by governments, from a corporate governance perspective, and also by shareholders.

So just to sum up, supply chains have been shifting for the longest time, except what we started seeing was evidence that they might be shifting direction and this whole reshoring initiative we thought was going to be a slow tectonic move. This was as I said a mile wide and a millimeter thin with companies experimenting with a China Plus One strategy. And what COVID has served to do is it served to act as an accelerant to these tectonic shifts, and our view is that one of the consequences of that—we can elaborate on this a little bit further in the conversation this evening—is our view is we're going to be moving from a China Plus One strategy to companies, Western companies in particular, into the In China, For China but not otherwise.

And like I said we can elaborate at a later point, but let me hand it back to you, Alvin.

Alvin Thank you, Vikram. Thanks for sharing the shifting focus as far as on the reshoring initiative.

Next I'll pass over to Peter. Peter, can you share your observation on the changes in client activities and trends pertaining to supply chain finance during the pandemic?

Peter Yes. Thanks, Alvin. What I'll share is a perspective from within our transaction banking business and specifically trade and supply chain finance, as we have spoken with clients during the course of this year really around what they have been seeing and what we've been seeing as a result of the pandemic. I think it comes back to three main things. Number one is the trends that we've seen in the year, and I'll share some perspectives on that. Secondly, Vikram has touched on it, shifting supply chains and how the clients are looking at that both from a physical supply chain perspective as well as how that tracks to each of their needs from a trade financing point of view. And then the third trend this year is the digitalization of trade finance, which has really come to the fore.

Now what's interesting about all three of these trends, as Vikram has said, is all three of them preexisted the pandemic. In fact, all three of them probably predated even the US/China trade tensions as well, but what's clear to me from the tone of our client conversations is that all three of those things have intensified in terms of thinking and progress this year.

Very briefly, firstly from a trade flow perspective, as we stand here in December I think probably what we've seen within our business is the most significant disruption to manufacturing, consumer demand and transportation all of which impact supply chains and the liquidity management that goes around those. Looking back a little bit in the case of China, we saw this manifest itself in a very sudden supply side shock in February, but then a modest recovery from then on as goods started to flow again, and that manifested itself in how we saw some of our client's supply chain finance programs evolving as well as their broader trade finance needs.

Then of course we saw the demand side shock kick in as many markets in the US and in Europe went into lockdown. And what came with that as you mentioned in your introduction was a significant squeeze in liquidity. Many different patterns in what we've seen in our trade and supply chain business across the region, ranging from South Asia where flows and demand were down very substantially; Southeast Asia a mixed picture; and then Northern East Asia despite the initial shock have actually faired quite well; and in our clients supply chain finance activities and broader trade finance business that has really recovered quite well.

In fact, right up to the present in recent weeks we've seen significant recovery in exports from market such as China and Taiwan. In some cases now reaching levels that they weren't at even in November 2019 before the pandemic. So whether that's a correction as restocking occurs or some form of seasonality that remains to be seen but certainly have shown a lot of resilience.

Interestingly I read quite an interesting article that suggested that US demand particularly from China has continued to be strong not despite of the pandemic but actually because of it, as many consumers have refocused their standing away from services such as experiences and entertainment and replaced it with spending on goods, most of which of course for the time being are sourced overseas. That's an interesting perspective, which we've also seen track through interestingly into demand for shipping corridors, particularly transpacific and freight costs which is a good indicator of that demand. So that's a snapshot of what we've seen from a financing perspective during the year. And in short, I think the extent of the reduced GDP and consumer confidence and the speed of the recovery is really going to drive the direction of trade flows and financing in the year ahead.

Secondly, I won't dwell on it too much, because Vikram covered a lot of these points, but the shifting supply chains is something that we are seeing very much tracking through to the supply chain finance part of the business. And reflective of what Vikram said, many more clients are now thinking about it from a risk management perspective as well as just a cost arbitrage perspective which is what drove many of those shifts in the past. We're seeing it manifest itself in clients seeking to expand supply chain finance programs into new markets, exploring locations where perhaps they didn't have an interest before. Southeast Asia features prominently which I don't think is a surprise; Vietnam in particular and also reshoring.

To Vikram's point about In China, For China and how we've seen that in our business is through the increased demand for domestic supply chain programs in what was historically a business that focused on cross-border imports and export financing. As Vikram alluded to, what we are seeing in our business is lots of review, lots of focus, lots of analysis and exploratory discussions. Have we really seen a significant shift in financing as a result of shifting supply chains? Not yet. I think that's something that we may see more of but certainly not something that we're seeing a lot of execution around.

Final of the three trends is digitalization, and I think this is quite a meaningful one for our clients as they increasingly seek to go digital. I heard it said that the pandemic has probably achieved more for digitalization and trade finance in the last nine months than we as industry have achieved in the last ten years. As I said, this is not new. We've had an ongoing journey of digitalization over the last two to three decades, but the pandemic has absolutely refocused clients on it, not just from the point of view of cost efficiency but more so from the point of view of business continuity planning, risk management and resiliency.

What many of our clients experienced as they came into this year was a reliance on physical paper. In Asia many markets still rely on physical company stamps, and that's a real challenge in a work-from-home environment. What we've seen is a renewed impetus on adoption of digitalization techniques across trade and supply chain finance. It's become a real operational risk and imperative. In fact, a recent survey suggested that 96% of clients felt that their business continuity planning around their trade activities required improvement based on what they learned this year.

So whether it's from moving to wet signature to electronic, the ability to onboard themselves or access new services through digital channels, submission of supply chain related documentation without company stamps, all of these things has risen to the fore. If anything, 2020 will really help both us and our clients accelerate that drive towards digital trade finance which I think is certainly positive.

Very briefly, number one on the trends very much a u-shaped trend through the year with a recovery back to exceeding levels that we hadn't even seen at this point last year. Number two, yes we're seeing clients focus on what the options are for their supply chains and related financing, but from my perspective not a lot of execution yet with a wait and see approach being adopted. And then thirdly, the big win is clearly digitalization which I think will drive many clients towards solutions that already exist and hopefully some future innovation around supply chain finance as well.

Alvin, back to you.

Alvin Thank you, Peter. It's great to hear that you see a recovery now, and it's nice to end this challenging year on a very positive note.

Going back to Vikram, Asia has been a key manufacturing hub for companies globally pre-COVID. With the disruption in the supply chain experiencing COVID, [indiscernible – 58:21]. How ambitious does that changes the supply chain landscape in Asia going forward?

Vikram

Thank you, Alvin. I think that's a pretty good note on which to go back to the observation I was making earlier about the shift of moving from a China Plus One strategy or mindset with companies to an altered mindset which says In China, For China. What we mean by that is we think we are seeing the suggestions and the feedback and evidence that companies will now be content to be manufacturing in China for the Chinese market, but they will increasingly be reconsidering the manufacturing that takes place in China that's destined for other markets.

A perfect example would be iPhones which we all know for many, many years were manufactured in China, and you can increasingly see the manufacturing of iPhones being moved to other jurisdictions. When you sit down and you quantify what all of this means, the amount that we're talking about equates to contribute to roughly about 7% of China's GDP which is actually a pretty sizable amount. And this has very obvious implications both for the companies who are going to endeavor to move this and then also for the jurisdictions where the supply chains move to.

Let me deal with the first factor which is the cost of moving the stock. When we were first discussing it with our clients with the report we published about a year ago, the media pushback we got when we were talking about the China Plus One approach was to say gosh isn't this going to be ruinously expensive. And there's a very, very good reason why companies are manufacturing in China because it makes economic sense to do so, and so there's no way that you're going to see supply chains substantially moving away. And this whole business of saying well being In China, For China and moving all the other manufacturing elsewhere is not going to happen, and so we ran the math on this.

The reason again we're able to do this is because we actually have the data based on 3,500 companies that we cover around the world. The headline for you is that we estimate that to move all manufacturing from China that's not destined for the Chinese market—in other words all foreign manufacturing in China that's not destined for the Chinese market—will take a capex cycle of about $1 trillion straight over five years. Now whenever I say $1 trillion, I sort of feel like Dr. Evil from one of these *Austin Powers* movies, because it sounds like a huge amount of money.

And in fact, it is a large amount of money but not as much as you might think.

When you look at your returns on capital employed for non-Chinese companies, that $1 trillion capex cycle would reduce ROCEs by 70 basis points. It would go from 8.9% to 8.2%. If you would look at free cash flows over that five-year period, it would be diminished by about 110 basis points, and it would go from 7.2 percentage points down to 6.1 percentage points. So, yes, it would be lessened, but it would still be quite healthy.

Now we have to say that there's obviously going to be a bifurcation over here, which is you may have sectors which have structurally lower returns which would find that kind of dilution to their returns and their free cash flow generation harder to absorb. And then you have other sectors which have structurally higher returns, let's say healthcare or tech, where that sort of compression to their returns would be easier to digest.

The other point I want to make when we I say that we think of this as bible, this is just the headline costs, and we remain very, very conservative in coming to these calculations and even before you take into account the offsetting factor. Just taking a lead from China's book itself in terms of its success of drawing in good investment, there's all sorts of things that can be done. There's going to be tax breaks. There's going to be land subsidies, and then last but not least let's not forget that technology has moved on substantially in recent years, and automation is one way that we think that many, many companies will try to offset higher operating costs by adopting that.

The other thing also worth throwing out there is that the sectors where energy is a significant input factor, this whole reshoring to North America becomes a real consideration especially because of the sheer revolution. North America is considered as a surplus energy economy. So that's the cost aspect.

And then we turn around to what are the implications for the jurisdictions that these supply chains move to, and it has profound implications for them because it has multiplier effects. It has multiplier effects on jobs, on wages, on the creation of R&D clusters and with a greater generation of tax revenues. So when you look at where that wave front is moving which is Southeast Asia, we expect this phenomenon to be very constructive and positive for that region and similarly for all the other jurisdictions where these supply chains shift to.

The final thing I do want to say is that when it comes to China itself, you might recall a few seconds ago I said that shifting all foreign manufacturing from China that's not destined to the Chinese market that would generate a hole in China's GDP that equates to roughly about 7% of its GDP. And then just as it would have positive multiplier effects for economies that these supply chains are shifting to, there is the negative multiplier effect for the Chinese economy. If you take that and you combine that with China's demographic challenges going forward, you will have to have the Chinese Government implement different strategies to try to offset that, and so it's going to make for a very, very interesting combination of circumstances.

Alvin, I'll hand it back to you.

Alvin Thanks, Vikram, very, very interesting insight. And now lastly, probably I'll pass it back to Peter.

Peter, in this volatile environment where we see increased focus on maintaining a higher level of liquidity and we do see the volatility continue probably even into 2021, what is your view on development of supply chain finance and special [ph] financing too going forward. Peter?

Peter Thanks, Alvin. Listen let me share a few thoughts on that, and I'm also conscious of time for everybody on the line. When you look at the main drivers for embarking on a supply chain finance program; managing risk, increasing working capital, and driving automation, and then you think about the things that have hit many companies in 2020, all three of those things rose to the top of the agenda. We're seeing that very much reflected in the marked increase in demand for supply chain finance and that's ramp up and gross [ph] of existing programs, increased dialogues around expanding them into new markets and supplier bases, and also how to move to more automated supply chain financing capabilities. We're finding that there are very few conversations that don't touch on supply chain finance.

Why is this happening? Well I think a lot of clients saw the impact in Q1, Q2 of a sudden liquidity squeeze, not just on their businesses but also on those of their suppliers. And many of them I think recognize the risk that this introduces, particularly when you have complex cross-border supply chains that depend very much on the health of every supplier and lack of disruption.

And at the same time in a declining credit cycle, the risk is that the cost of financing for those smaller suppliers may increase. So I think that really paves the way for the why there's so much applicability for supply chain finance in these times, allowing the suppliers to take advantage of flexibility on typically the more attractive financing costs of the larger company that they were supplying. At the same time, it allows our clients to maintain their payment terms and not forced to pull in those payment terms to help support smaller suppliers that may require early payment.

Then finally to pick up on your point about volatility, I think one of the benefits clients and suppliers see in supply chain programs is the flexibility to help manage through the cycle and smooth the peaks and troughs of liquidity. Many of the clients that I've spoken to this year who were not previously actively exploring this, they now are, and they see it as critical not just to their own working capital goals but also to solving some of the liquidity challenges that their suppliers face, which in turn will come back and become a risk and business continuity issue for them.

And then finally, I think it's fair to say that supply chain finance programs were historically more within the purview of procurement and sourcing as part of credit and payment term negotiations. That remains the case, but I've seen them this year rise up the agenda of treasurers and increasingly being viewed as another dimension of liquidity management. A way of sourcing working capital from within the company and its supply chain to not only maintain the cash position but at the same time benefit suppliers by enhancing their own cash position.

Just a few thoughts around how this year in particular I think points to the benefits that supply chain finance can bring, and I expect this to continue into next year. The supply chain has continued to grow over the past 10 to 15 years, but the pandemic has definitely shone a spotlight on that, and in terms of the level of interest we're seeing, I expect next year to see even further interest and growth.

Alvin, back to you.

Alvin

Thank you, Vikram and Peter, for sharing your valuable insights. We hope this session has benefited everyone and has provided you a different perspective on how to manage all supply chain and liquidity going forward.

This is our also our last Global Liquidity Speaker Series for 2020. I really look forward to you joining us again in 2021. Thank you for your participation today, and we wish you a great holiday season ahead. Thank you, everyone.

Coordinator

Thank you, Alvin, and thank you to your speakers. And thank you, everyone. That concludes your conference call for today. You may now disconnect. Thank you for joining, and enjoy the rest of your day.

[END OF CALL]