SMEs and the Economic Impact of Covid-19

by Peter Brown

This financial crisis is not solely due to Covid-19. Before it appeared, we were experiencing a slowdown in global growth and expectations were of a mild recession. That was due to Trump's trade wars with China, the recovery running out of steam in Europe and of course, the Brexit debacle. All contributing to an end to the growth rally in place since 2011. In fact, Trump's isolationist policies were putting to an end 30 years of globalisation.

In Ireland it was hard to rationalise a slowdown as we had full employment and growth punching 5% plus per annum. We were heading into a current account surplus; our debt interest burden was falling and indeed debt to GBP was down below 60% (depending on the method of calculation). Everything was booming and the outlook, even though our European partners were slowing, and we had the prospect of Brexit, was very rosy. Thousands of quality jobs were available to new entrants and the country was buzzing.

Covid-19 has hit us hard in a miniscule amount of time. Personally, with the effects of lock down and uncertainty, but especially hard and deeply concerning for any SME owners or employees in that sector.

In fairness the response has been swift. Central banks have, in a matter of weeks added stimulus five times greater than the response to the 2008 crisis. Unprecedented amounts of cash and guarantees have been added, flooding the global financial system and in effect nationalising vast amounts of debt.

This rapid response has stabilised financial markets for now and indeed the banking system but lurking beneath the surface will be the phase of differentiation between good and bad assets, not every company will survive.

The length of the lock down will be key, and politicians are now faced with opening economies, risking higher death rates, or maintaining the lock down and destroying livelihoods, no easy call.

The cost of the lock down is an interesting analysis and not all bad news. Prior to this, our finances were in particularly good health. As I said our debt to GDP levels were among the lowest in Europe, German like! The cost of borrowing was close to 0%. National Debt Maturities are being renegotiated continuously, even this year alone, seventeen billion of debt matures at circa 4% being replaced with borrowings at 0.25%, a saving of around €700 million per annum. If Ireland were to spend €50 billion supporting business and employees through the Covid-19 lockdown and subsequent recession, it is a quite manageable figure, if that money is borrowed for ten years at 0.25%. The annual interest bill would be €125 million, a paltry figure. Debt to GDP would rise to around 75%, very favourable compared to 120% we reached in 2012 when interest rates where 8%!

Current monthly expenditure from all supports is hard to establish but estimated to be around €1.6 billion. Of course, we would be running a current account deficit and that would likely last years as tax receipts diminish. But a recovery within a 3 to 5-year time frame would be a manageable scenario.

So, the support money is not the issue. It will be the loss in revenue suffered by lower economic activity and how big the annual budget deficit will become. That is why it is important to support as many viable businesses and jobs as possible through the lockdown period to enable them to return after.

It that regard the Banking sector and the Central bank have a major role to play. They have to date negotiated 45,000 mortgage breaks (about 5% of the market) and are in the process of sorting 14,000 SME loan break requests and 3,200 New Capital SME requests. Importantly, there will be no impact on the Central Credit Register (Central Bank) so credit rating will not be affected. It would be naive to think the relationship with your bank will not be affected long term. Still the advice is to engage early and not leave it too late.

Credit will not be extended to businesses who cannot justify increased debt and whose business case does not stand up to intense scrutiny. Regardless of any guarantees offered by either the Central Bank, ECB or any other source, non-viable businesses will be left to fail. This is the harsh reality for those who own or are employed in any such business. Therefore, substantial closures and permanent job losses will be experienced in hospitality, entertainment, tourism and travel. Anything to do with business travel will be badly hit as we have now learned to conduct business via on-line communication tools. This is just one example of how the world will have changed when we re-open. There will be other areas badly hit which cannot be identified yet. But the changed world will throw up surprises for the SME sector not necessarily all bad; there will be new opportunities.

Everything has changed and anyone who thinks the world will be the same is in denial. From an economy that offered the most exciting opportunities ever to new entrants, it has in two months, been destroyed. This time around there is no emigration release valve as other economies will be harder hit or shut to outsiders. Students who had a bright future two months ago may be on the dole or fruit picking. That could have a major psychological effect on a generation.

For SMEs, the question is about consumer spending and confidence, when it returns and how strong it will be. Businesses that were weak prior will have to go. Many business owners who are close to retirement will not fancy the fight so soon after the last recession and may choose not to re-open.

The Government is looking to the next stage of economic supports and ways in which it can extend direct support to businesses after putting in place a pay safety net for nearly a million workers.

Measures such as tax and rates relief have already been implemented, but in order to ensure that businesses will invest and hire despite the hefty debts on their balance sheets as a result of the lockdown, the State will need to do more. In the end though it will be about viable business models in a vastly changing world.

There is a lot of uncertainty as to the type of economic recovery we might expect to see. This depends on the length of the lock down of course but efforts by Trump to open the US economy despite all the evidence that the virus is not under control will be monitored closely. We are likely to see a 'U' shaped recovery rather than a 'V' shaped one and that means more marginal businesses will go to the wall.

Some major issues yet undetermined are the outlook for property and rent, especially commercial which must be badly hit. With property there is a lot of mixed opinion. Some think prices will be 20% lower when the market re-opens. If that is the case no one will sell, and no one will build, so we will be back to supply and demand again as the determining factor on the residential side. Then there is the argument that the unemployed, if foreign, may leave the country and not come back. Resident unemployed may not be able to afford to rent or buy which reduces demand. On the commercial side there will be a lot of vacant properties and the attitude of landlords will be key to most struggling businesses. For now, the picture is too complicated and unclear.

Employee and consumer attitudes are also unclear. Will all the workforce return to work especially if the Covid-19 payments are still in force? Will we be spending in restaurants and pubs if they re-open? Will we travel? These are all unknowns but important inputs when deciding to close a business or increase its debt liability.

Ireland is heavily involved in Tech, Pharma, Food and Tourism. Outside of Pharma all are challenged. Tech is the honey pot and a serious target for politicians looking for ways to pay for all this stimulus. This industry could soon be on the radar for tax increases; indeed, Australia is already moving in that direction. Food and agriculture still have Brexit to contend with, that has not gone away. The UK economy is open to wild swings in economic performance and that will be reflected in the EUR/GBP exchange rate. So, the advice for exporters is to have your hedging strategy in place.

Tourism will be worst hit no doubt and there will be many closures and jobs losses across the industry.

There is no getting away from the devastation we will experience. Economically however, Ireland is better placed to recover faster. But there are still great unknowns, will we experience a period of global deflation followed by rampant inflation as all the stimulus hits? These economic phases can have massive impacts on the level of exchange and interest rates. So, managing interest rate and foreign exchange exposure will be more important.

We must stay flexible as the challenges unfold before us.

For any questions please contact pbrown@baggot.ie

Peter Brown
Director and founder of Baggot Investment Partners