SWAN - COVID-19

Its Aftermath on the Mauritian Economy

SWAN

Executive Summary

- COVID-19 has brought the global economy to an abrupt halt, spurring unprecedented financial market volatility & policy responses.
- Mauritius is extremely vulnerable given its **high dependency on tourism**. Tourism earnings are expected to slide from MUR 63bn to MUR 27bn in 2020 (equivalent to **57% decline**).
- The negative economic impact is expected to be higher for Mauritius:
  - It is expected to be 3x worse than the Global Financial Crisis of 2008-2009; and
  - For 2020-2021, compared to the Developed World, our **economic slack will be close to 2x more**.
- **Unemployment rate is likely to hit historic highs** and reach levels (15% - 20%) last seen in 1980's if unattended.
- More importantly, we are even more concerned by the duration of unemployment:
  - The sea, sun, and sand remote island-type destination is poised to be most affected due to travel ban/fear and a significant lag should be expected compared to other types of tourist destinations.
  - Balance sheets will deteriorate for many operators this year, and some companies may reach downgrade/credit triggers especially for institutions that have debt maturing this year. This will impact the ability of companies to retain employees.
  - We expect a **loss of income of MUR 41bn** due to unemployment. This will contaminate the consumer goods sector and create further unemployment.
- We expect financial institutions this year to see sharp rises in modifications and forbearance on loans, higher nonperforming assets and charge-offs, increasing corporate draws on bank revolving credit facilities, and other challenges.
- We estimate that local companies will suffer a **staggering loss of MUR 170bn in revenue, MUR 50bn in profits**, and consequently the State coffers will be **short of corporate tax to the tune of MUR 7.5bn** if the economy cannot be rebooted effectively in a timely manner.
- All-time-high levels of excess liquidity indicate that banks are being extremely cautious in lending in the current environment. With the **massive budget deficit** that the government is expected to run, we suspect that **financing to the private sector will dry out** (crowding out effect).
- An inevitable victim of a weakened economy with little internal financial means is its currency. The main drivers of foreign exchange receipts – global business, tourism, and manufacturing – will be heavily pressured in view of the COVID-19 impact. Interestingly, from a buyer of USD some months back, the Bank of Mauritius (BoM) has turned into a seller as the greenback becomes a rare commodity.
- A massive and prolonged drop in foreign exchange revenue from tourism, manufacturing and global business sectors could lead to a drastic fall in the import cover from 11.8 months currently to 4-5 months.
- Unprecedented fiscal and monetary support are critical to preserve the economic fabric and well-functioning of capital markets, thereby supporting the chances of a stronger path to recovery.
- But it comes at the expense of higher government debt. Our **debt to GDP** is already at its limits and the **budget deficit is expected to reach record levels**. The Mauritian rupee is not a reserve currency and therefore will difficultly support more debts (compared to developed countries which can support above 100%).
- The non-reserve currency status is equally a motivation as to why Helicopter Money should be actioned with caution as it could debase the Mauritian rupee.
- If the BoM considers the Helicopter strategy, we believe it should be actioned preferably if the country has anteriorly secured foreign aids/grants to support the currency.

Is the economic contraction worse than the 2008 Crisis?

Yes, according to the International Monetary Fund (IMF), calling it:
"a crisis like no other ... as the world economy comes to an abrupt standstill".

- While Global and Emerging economies appeared to have recovered their pre-2008 growth levels in 2010 (GDP growth was +5.4% and +7.4% respectively), Mauritius has never achieved the same growth level since (2010 GDP growth was +4.4% and has averaged +3.8% over the last 10 years):

<table>
<tr><th>Year</th><th>Period Selection</th><th>Global GDP Growth</th><th>Magnitude of Impact</th><th>Emerging GDP Growth</th><th>Magnitude of Impact</th><th>Mauritius GDP Growth</th><th>Magnitude of Impact</th></tr>
<tr><td>2008</td><td>Pre-Financial Crisis</td><td>+3.0%</td><td rowspan="2">-3.1%</td><td>+5.7%</td><td rowspan="2">-2.9%</td><td>+5.4%</td><td rowspan="2">-2.1%</td></tr>
<tr><td>2009</td><td>Financial Crisis Impact</td><td>-0.1%</td><td>+2.8%</td><td>+3.3%</td></tr>
<tr><td>2019</td><td>Pre-Coronavirus</td><td>+2.9%</td><td rowspan="2">-4.4%</td><td>+3.7%</td><td rowspan="2">-2.4%</td><td>+3.6%</td><td rowspan="2">-7.8%</td></tr>
<tr><td>2020</td><td>Coronavirus Impact</td><td>-3.0%</td><td>-1.0%</td><td>-6.8%</td></tr>
</table>

- The magnitude of the impact reflects growth contraction adjusted for the duration of the crisis; i.e. the 2008 Financial Crisis is estimated to have had a 1-year impact compared to COVID-19 where many economic experts estimate a re-opening of economic activity in 6 months for emerging economies (as China leads the way) and 9 months for Global & Mauritian economies as a base case scenario.

- Given an already anaemic domestic growth and our high dependency on the tourism sector (accounts for 23.8% of our 2019 GDP), it is no surprise that the virus will have a more severe immediate impact on the country as illustrated above.

Source: International Monetary Fund estimates as at April 2020.

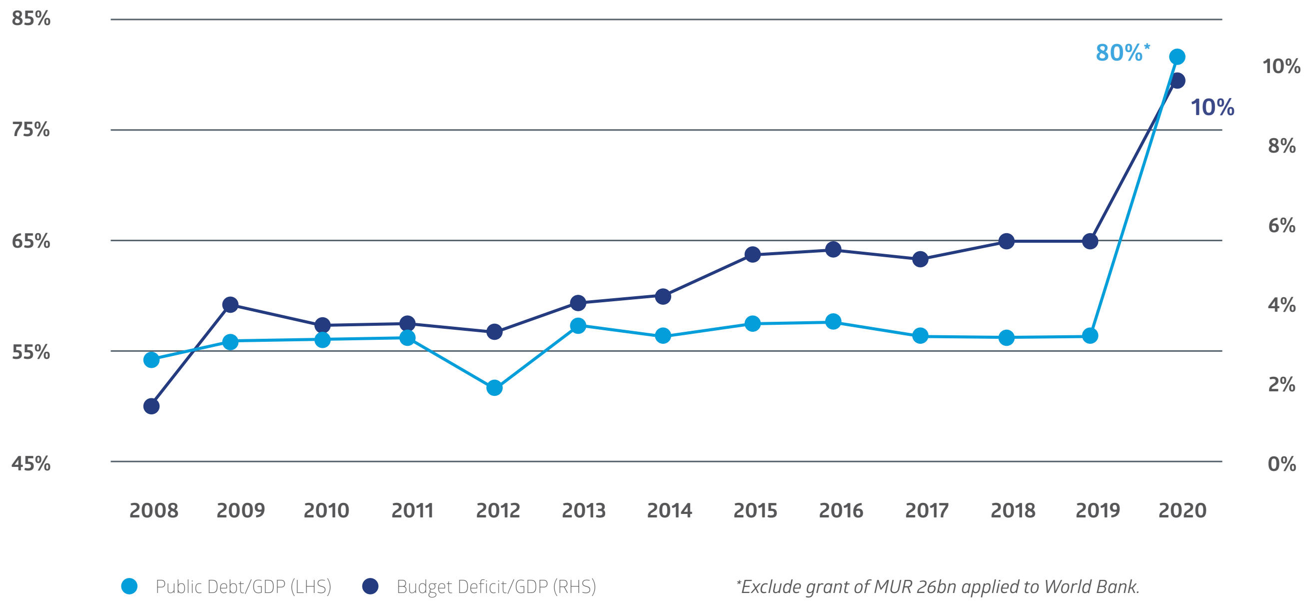
Weak defences impair our resilience this time

(i) Outstripped Fiscal Leeway

- There might be a misconception that debt can be raised cheaply, to carry growing budget deficits. This was on the assumption that liquidity would always be readily available. Indeed, excess liquidity stood at a record high of MUR 38bn as at 31st March 2020.
- Mauritius' high national debt (80% in 2020 is far from the 65% statutory ceiling) limits "its ability to deploy counter-cyclical fiscal policy to buffer the economy in the face of shocks such as the current situation" as highlighted by Moody's recent downgrade of the country from stable to negative outlook.

Bottom-line:

- With 2020 fiscal deficit 3 times more than both 2008 and 2019 levels, who will bail Mauritius out if public debts were to explode?
- Mauritius does not have safety nets, unlike Greece which has European aid and Germany with its flush of cash in the State coffers.



Exclude grant of MUR 26bn applied to World Bank.

Assumptions:

- GDP was estimated based on the IMF's 2020 forecast;
- Budget Deficit is estimated to increase from MUR 17bn in 2019 to MUR 47bn in 2020 on the back of (i) increased expenditure from wage assistance & COVID-19 fiscal support, and (ii) decreased tax revenue following reduced consumption and corporate profit.
- Increase in public debt is equivalent to the budget deficit for 2020.

Source: Bank of Mauritius (BoM), Ministry of Finance, Economic Planning and Development (MFEPD) and Moody's Report as at 1-Apr-20.

Weak defences impair our resilience this time (cont'd)

(i) Outstripped Fiscal Leeway (cont'd)

- Over the last 4 years, India has provided MUR 12.7bn of grants and MUR 20.0bn of loans.
- Can we continue to expect similar aid, especially given India's downward revision in GDP growth for 2020 from 5.8% initially to 1.8% now?
- While a loan looks more realistic, Mauritius can also apply for an Emergency Financial assistance with the IMF bearing interest of 0.05% p.a.
- Either scenario points to higher external debts, which is highly undesirable as the constant depreciation of the MUR inflates debt figures.
- Furthermore, current debt ceiling limits the scope for additional government capital expenditures, with infra-structure which has been one of the prime drivers of growth.

2 possibilities
can be envisaged:

(i) International grants/loans

(ii) Lender of last resort – the IMF.

Source: MOFED, Budget 2019/2020 & IMF

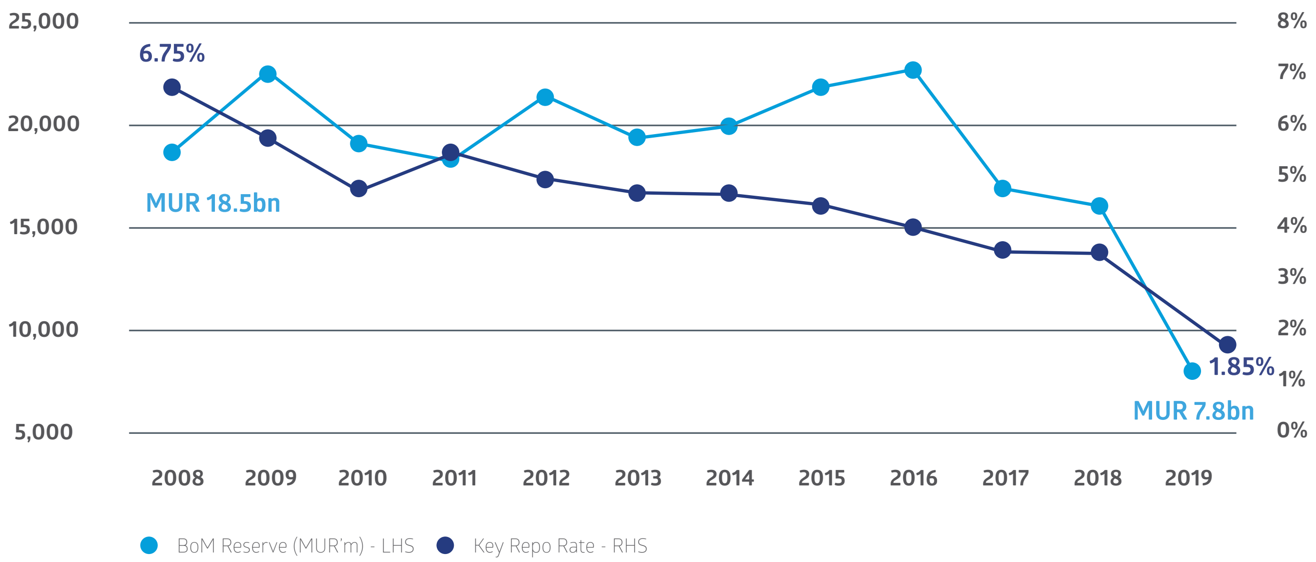
Weak defences impair our resilience this time (Cont'd)

(ii) Constrained Monetary Muscle

- The Bank of Mauritius (BoM) has nearly fully pressed the accelerator and has,therefore,limited ammunition to contain inflationary pressures without historical reserves to back its monetary interventions.
- This will likely weigh on both Mauritian assets and the local currency (as further explored below).

Bottom-line:

- Prolonged lockdown fuels deeper recessionary pressures thereby leading to Key Repo Rate potentially hitting the 0% floor if no sign of economic recovery appears by the end of June 2020..
- The unprecedented nature of the current crisis and the limited effectiveness of conventional tools should prompt policy-makers to turn to unconventional ones to prevent the economic fallout from worsening.



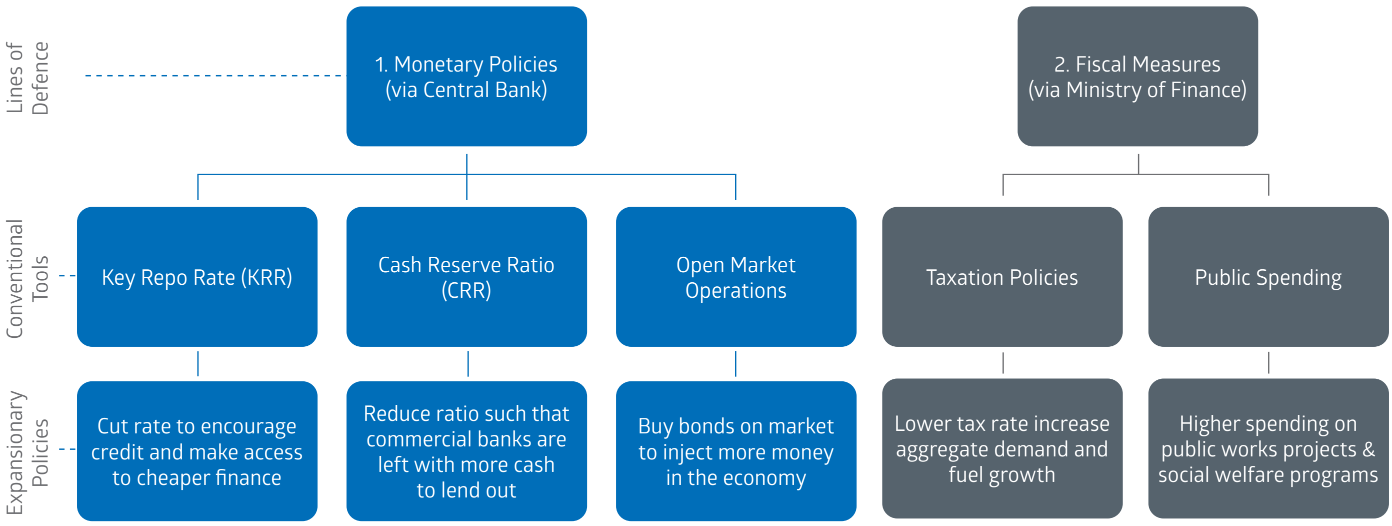
Concluding Remarks:

Monetary policies are near the zero-bound and fiscal policies have been used to their maximum. As there is currently no sign of recovery, with our main pillars still in a vulnerable state, a sustained pick-up post recovery will likely take much longer this time.

Source: Bank of Mauritius (BoM).

Our Ammunition

In a time of crisis, a country has two lines of defence to safeguard the economy:



Our Ammunition (cont'd)

(i) The Monetary Arsenal*

- It was triggered before the lockdown on the 13 March 2020 via:

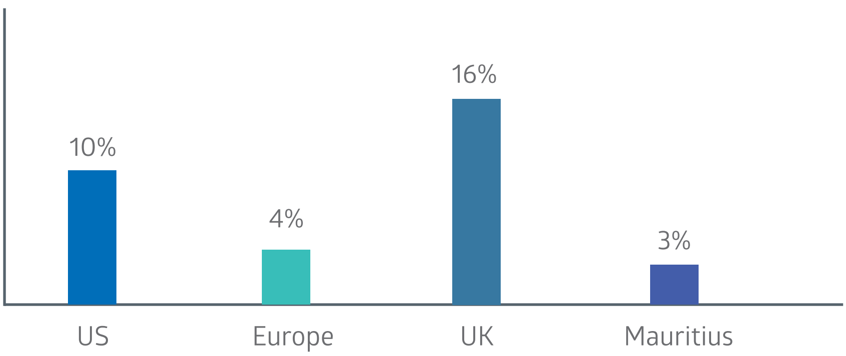
Bank of Mauritius Support Programme* against COVID-19					
Cut of 1.5% in Key Repo Rate (KRR)	Cut of 1.0% in Cash Reserve Ratio (CRR)	Special Relief of MUR 5bn	Moratorium on capital repayment for loans	Easing of banking guidelines	Issue of a 2020 savings bond

- Excess liquidity in the banking system has increased by MUR 13bn which testifies to limited activity in credit markets.
- To make up for the decrease in demand, the use of 'Helicopter money' by the Government has been heralded by several economists. Helicopter money refers to the situation where a central bank finance the fiscal expenditure of a government which in turn directly hands out money to those most affected in this crisis.
- This should cure the symptoms of the underlying structural issues of our economy. But given that the MUR does not enjoy the status of a reserve currency, any excessive helicopter would provoke a debasement of the MUR.

(ii) The Fiscal Package:

- The broad principle is to increase the money supply in the economy, i.e., leave more monies in the hands of corporates and individuals who will, in turn, spend more through consumption and investments and thus spur economic activity.
- In situations of severe crisis, government support is expected to be at least 10% of GDP for a speedy recovery.
- Given that damage is higher in Mauritius, we would expect the support to be north of 10%. Yet, Mauritius is currently at 3%:

Government Support**



*Source: Bank of Mauritius. For more information, please refer to: https://www.bom.mu/media/actions-regarding-covid-19/bank-mauritius-introduces-support-programme-accompany-local-economic-operators-covid-19. **Fiscal and monetary stimulus of each country as gathered from central banks action as at 25-Apr-20 divided by respective GDP for 2019.*

Cost of Unemployment

- The moderate level of unemployment over the last 10 years has helped Mauritius to **operate close to its full economic potential**.
- A high level of employment makes its way to the real economy through a high level of spending. As at the end of December 2019, for every rupee earned, **above 90% was spent by householders, with only 9.5% being saved**.
- Given the ultra low-level of savings in the economy, any job loss has a profound effect on consumption and a significant ripple effect on the economy at large through the multiplier effect.
- Based on IMF and figures from the Ministry of Finance, **the unemployment rate will rise from 6.4% in 2019 to reach 17% by end of 2020**. This means that **an additional 63,000 Mauritians will be without a job**. We have to go very far back in history to see similar numbers, i.e., in 1982- 1984 period where unemployment averaged 20%.
- Even if a gradual recovery in economic activity is expected as from 3Q 2020, Mauritian companies have a very rigid cost structure because of lesser business-friendly labour laws.
- It is substantially more difficult to cut labour expenses and lay-off workers in Mauritius. For instance, in terms of flexibility, **Mauritius has scored only 52.1 out of 100 under the category 'flexibility of its labour market'** in the 2019 Global Competitiveness survey by the World Economic Forum. This rigidity will undoubtedly flatten any recovery.

Below table shows the impact on income and output before Mauritius again reaches its pre-crisis unemployment level:

Year	Projected Unemployment rate	Loss of Income (MUR)	Loss of output (MUR)	Loss of output as a % of GDP
2020	17.0%	24,907,685,174	52,997,993,003	11%
2021	12.1%	13,427,678,078	28,571,101,003	6%
2022	7.7%	3,119,100,279	6,636,749,003	1%
Total		41,454,463,531	88,205,843,009	

- The assumptions in our model are:
  1. The average wage rate of circa MUR 29,000/month earned by those losing their jobs;
  2. For each job forgone, we have assumed that they would have otherwise contributed to around MUR 840,000 of output per annum based on GDP per capita of the working population; and
  3. Loss of output in absolute and relative terms is based on 2019 GDP figures.
- We think that these factors affecting our labour market, as explained earlier, can be observed in the historical unemployment figures. In the mid 80s, the booming years of the Mauritian economy, our best 2 years pointed to a reduction of 9.3% in unemployment. Using this data to make inferences, Mauritius unemployment rate could fall from the expected 17% in 2020 to 7.7% by the end of 2022 which is back to normalcy for Mauritius.

Pressure on our Mauritian Rupee

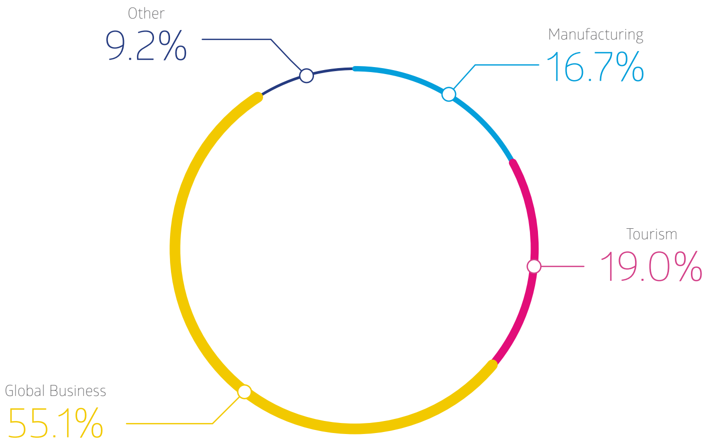
- **The economic model of Mauritius is mostly import-based** and to finance these imports, we rely on 3 main sources of forex: Global business, manufacturing exports, and tourism. Before this crisis, these sources of forex sufficed to finance our imports.

- With the slump in these activities, we are faced with a scarcity of forex. The impact is a gradual **depletion of the BoM's forex reserves** which dropped from USD 7.6bn to USD 7.0bn in the last 2 months. The capacity of a country to maintain its level of imports is defined by the Foreign currency reserves of its central bank as a percentage of the monthly imports volume. The **BoM currently holds forex reserves to cover 12 months of imports**. If forex inflows do not recover as per previous levels, our import cover will fall below 5x by December 2020.

- In the last 2 months alone, the **MUR has depreciated by 7%**. Given a lack of forex locally, the BoM will have to sell rupees in return for foreign currencies. This puts pressure on the MUR.

- An even weaker MUR can be expected since the Government could be tempted to devaluate the MUR in an attempt to artificially increase our Hotel and Manufacturing sectors earnings in MUR terms.

- A **downgrade of the Mauritian Sovereign Credit rating** is not excluded and this will be a blow to the Global business sector.



Month	Official Reserve (MUR'm)	Import Cover
Apr-20	259,791	11.83
May-20	239,477	10.90
Jun-20	219,163	9.98
Jul-20	198,848	9.05
Aug-20	178,534	8.13
Sep-20	158,220	7.20
Oct-20	139,736	6.36
Nov-20	121,252	5.52
Dec-20	102,768	4.68

Source: Bank of Mauritius.

Impact on Corporates

(i) Earnings Side

- The unprecedented fall in Mauritius' GDP will have cascading effects on corporate revenue and earnings. Corporates will scramble to cut costs as best as they can, but will remain short vis-à-vis the shrinking revenue velocity.
- The wipe-out in profits this year across listed and unlisted companies in Mauritius is likely to be in the order of MUR 40bn to MUR 60bn.
- In turn, this will reduce an important source of income for the Government, i.e., Corporate tax which we anticipate will fall by around MUR 7.5bn
- Companies typically spend in line with their revenues and profits: therefore, we expect lower revenues and profits to flow through to spending cuts.
- There is a good chance that in 2020 we will see the lowest levels of capital expenditure and financial spending in more than 20 years.

MUR (in million)			
	Corporate Tax	Corporate Profit	Corporate Revenue
2019	**14,500**	**96,667**	**498,508**
2020	**6,935**	**46,232**	**373,881**

Source: The Coronavirus's $20 Trillion Hit to Global Corporations by Bridgewater

Impact on Corporates (cont'd)

(ii) Debt Financing Side

- Left with much lower profits and a shortfall of cash, companies are likely to come out on the other side of the Coronavirus with a much higher need for debt.
- With the increased perceived risk of corporates, refinancing for the latter will be harder to find.
- Banks are not ready to lend yet as can be observed by the peaking excess liquidity in the financial system.
- Also, institutional investors are more willing to consider safer international bonds from the US which benefit from the full support of the FED.
- We also expect funding available to corporates to dry out given the massive budget deficit that the Government will run which will crowd out corporate financing.
- On the other hand, even those that are relatively less encumbered are likely to remain more cautious about their level of capital expenditures, business expansion, and financial spending than they have been in years past.
- The more that businesses focus on deleveraging and cutting spending, the harder it will be for economic growth rates and corporate profitability to return to what they were before.

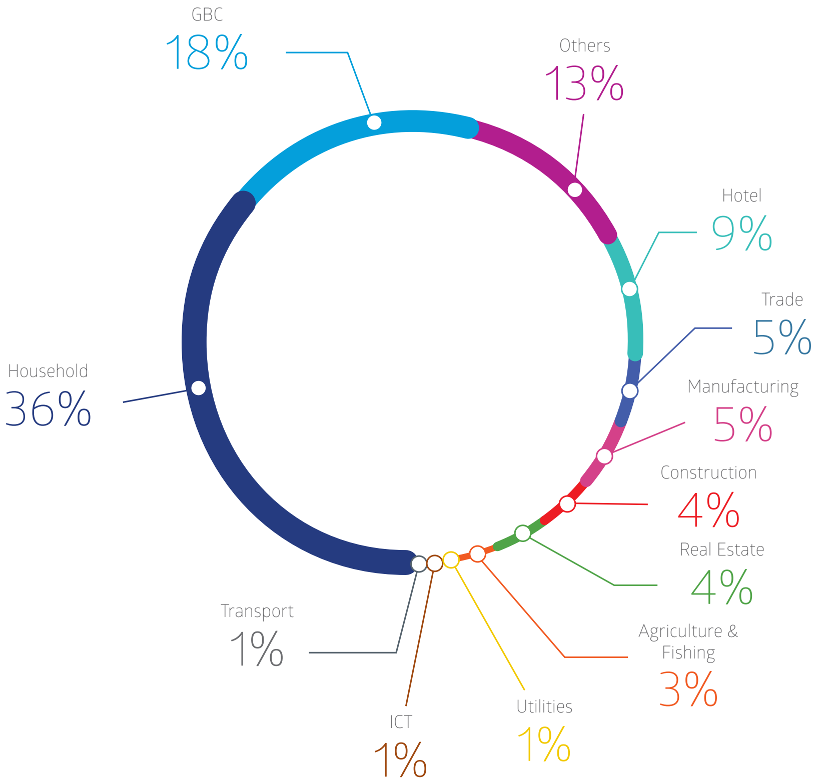
Source: The Coronavirus's $20 Trillion Hit to Global Corporations by Bridgewater

Cracks in our Main Pillars

(i) Banking Sector

- The largest single exposure of Banks is Households: this segment accounts for 36% of Banks' loan books as illustrated by the pie chart.
- BoM support measures[1] to Households as at date include:
  - 6 months capital moratorium as from 1st April 2020; and
  - 3 months interest payment by BoM as from 1st April 2020.
- The COVID-19 crisis may undermine debt servicing beyond BoM relief period. There may be a need to renew moratoriums for another 6 months in order to enable individuals and corporates to recover.
- While support is essential in this time of crisis, the impact on Banks is expected to be severe in terms of foregone income and capital.
- Banks' non-performing loans and allowance for credit impairment is expected to increase to unprecedented levels.
- On the other hand, the BoM also announced the delayed application of IFRS 9. The latter coupled with moratoriums will project only a blurred image for the financial health of individuals & corporates. There may be a need for rescheduling of debts subsequently.

Bank Loans to Non-Financial Corporations & Households as at Feb-20

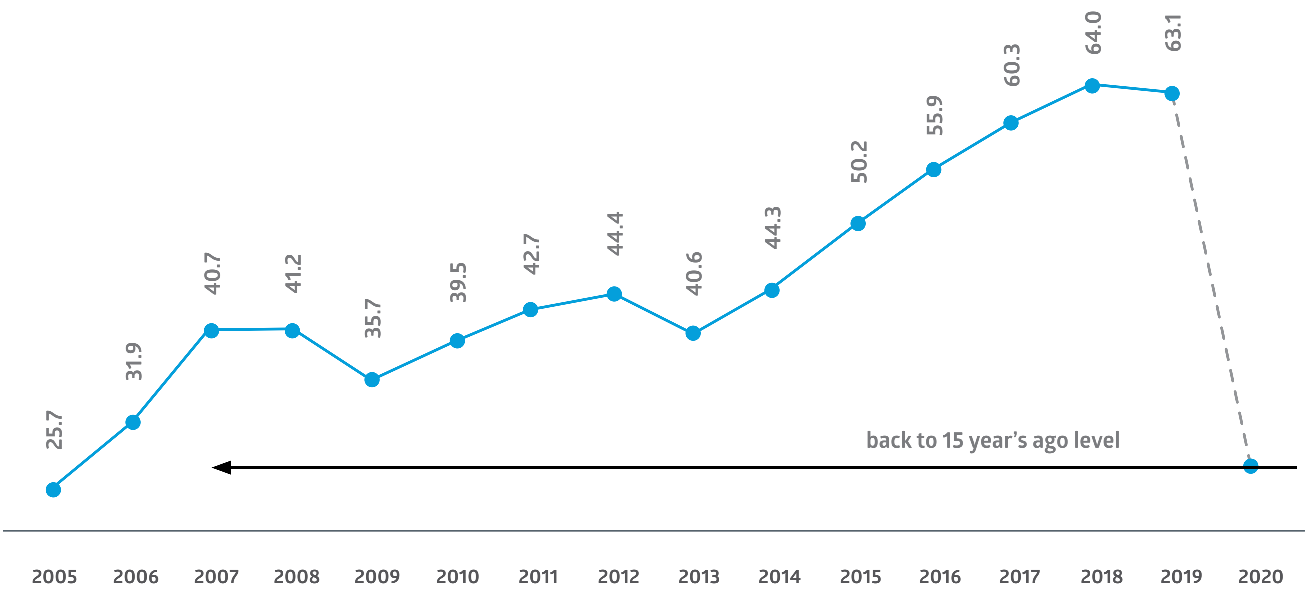


1 Applicable for household earning up to MUR 50k as monthly basic salary.| IFRS 9 / Bank of Mauritius Guidelines on the subject outlines minimum prudential requirements with regard to asset classification, provisioning requirements and income recognition, which financial institutions are required to follow. | Source: Bank of Mauritius

Cracks in our Main Pillars (cont'd)

(ii) Tourism Sector

- Represents 8.2% direct & 23.8% including indirect contribution to 2019 GDP;
- Accounts for 22% of employment and 35% of total exports;
- **Base case scenario:** With quarantine measures & travel bans in most European regions (our main market), we assume (i) zero tourist earnings for April to September 2020 and a discounted tourist spending of 25% in 4Q 2020;
- Total tourism earnings for 2020 approximate MUR 27.6bn (similar level as 15 years back) and are equivalent to MUR 35.5bn loss in tourism receipts when compared to 2019 figure (i.e. equiv. to 7.6% of 2020 forecasted GDP).



(iii) Foreign Direct Investments

- **Air Mauritius Limited** was the first to bite the dust as it recently went under voluntary administration following (i) revenue erosion from travel bans & dampened travelling mood, and (ii) a heavy debt burden of EUR 914m (EUR 749m for banks & EUR 165m for creditors). Given the misfortune of its creditors, foreign institutions are expected to exercise caution when extending credit.
- According to IMF's April 2020 report, nearly USD 90bn in investments from emerging and developing economies have already flown out of emerging markets, far more than during the financial crisis.

Source: Bank of Mauritius (BoM) and Moody's Report as at 1-Apr-20.

Asset Class Views

Local Equity

- Whilst a series of economic measures have been announced, we believe the local bourse will remain weak for a prolonged period on the back of (i) an erosion of its safety nets traditionally enjoyed by the country with tourism and offshore as the latest victims, (ii) unproductive debt coupled with artificial cost (such as Workers' Rights Act and sticky oil cost) and (iii) subdued investor (both local & foreign) sentiment.

Local Fixed Income

- The yield curve is currently below the 3% given record level of excess liquidity (MUR 43bn in April 2020) & repo rate as well as high indebtedness & low investments.
- As at December 2019, outstanding Government instruments were at 79% of Public Debt. Increased open market operations are expected to heighten the public debt burden and suppress yields further.

International Equity

- Unprecedented aggressive and synchronised fiscal and monetary measure should prove supportive of the asset class.
- While timing is key when rebalancing, we prefer an up in quality stance and favour economies with ample policy leeway.

International Fixed Income

- Support from major central banks (FED, ECB, BOJ) is expected to mitigate the risk associated with widening credit spreads.
- Risk-reward is now screening much better bonds, especially in short maturities and current valuations are cheaper. It is the time to seize attractive yields on solid IG names as well as the finest of the HY universe.

For more information, please contact Swan Wealth Managers Ltd at wealthmanagers@swanforlife.com.

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