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Mid-sized company response in a pandemic world.

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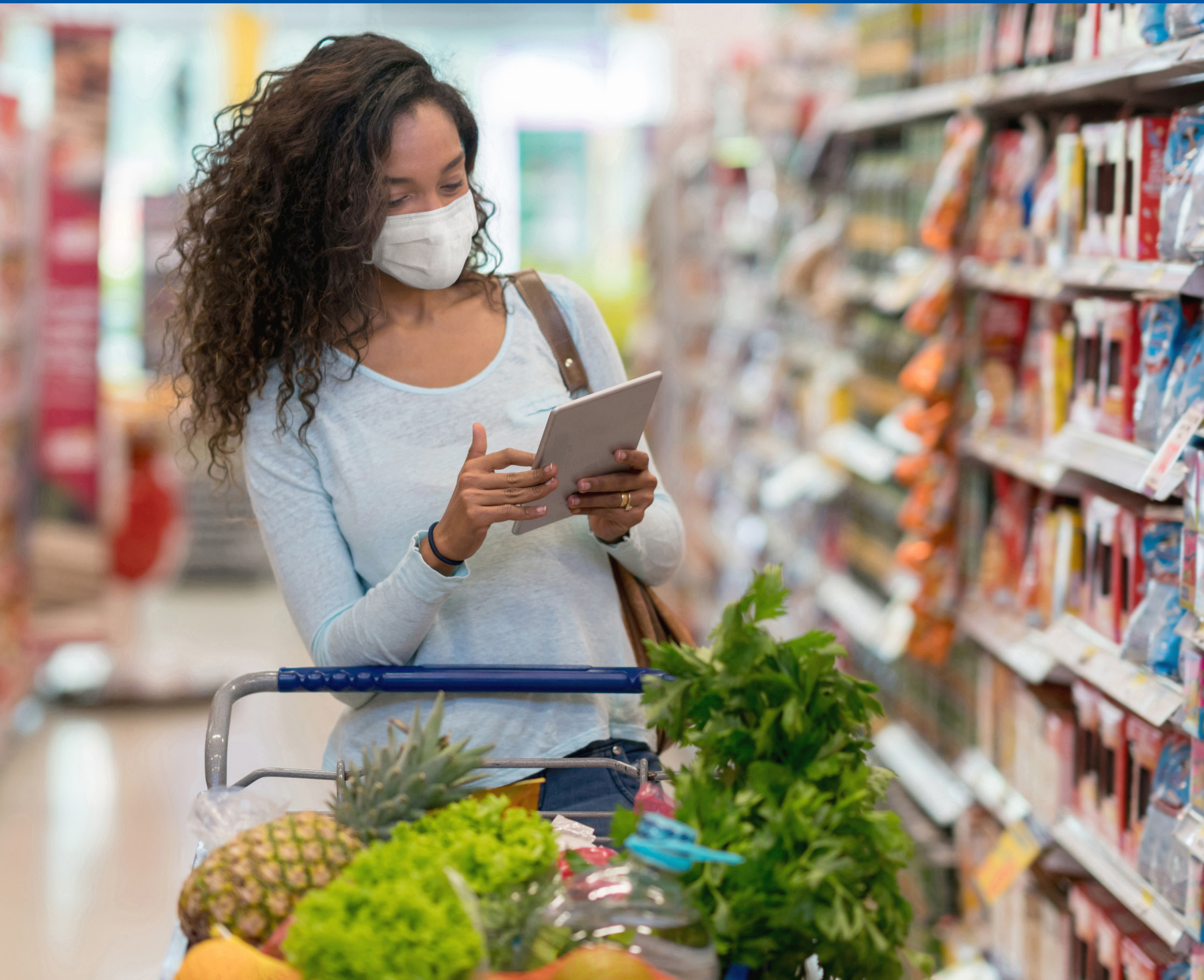


Mid-sized companies are feeling the pressure of COVID-19 and must adapt and reset in response to this challenging period and uncertain outlook.

Effects of COVID-19 on supply chains

Numerous industries across the supply chain have been impacted by COVID-19. Production plants and businesses have been forced to shut down, resulting in disruption of distribution. Companies are having trouble acquiring the materials needed to make products and are struggling to ship their products to stores and wholesalers. Almost overnight, COVID-19 has transformed the way we live and work.

The entire restaurant supply chain has been affected, as have the people at the center of it. Food packagers and producers that supply restaurants are seeing orders greatly reduced. Farmers are sitting on produce. Food Banks that depend on extra produce from catering companies, stadiums, hotels and restaurants are also looking at major shortages. While these are hopefully not lasting challenges, the short-term impact has been severe.

As meat processing plants struggle to stay operational, food suppliers must pivot their business model to serve the increasing demand from supermarkets. The disruption that COVID-19 has caused to food supply chains becomes very real with images of empty supermarket shelves. The pandemic has caused prices to rise on staples such as eggs, rice, flour and meat; the U.S. Bureau of Labor Statistics reports that April saw the sharpest increase in grocery store prices in nearly 50 years.

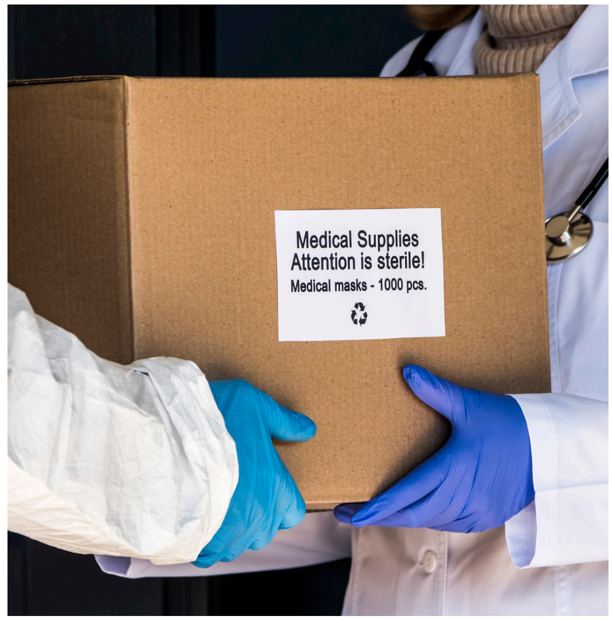
The middle market consists of a significant number of companies that are suppliers to original equipment manufacturers. During the coronavirus pandemic, supply chain troubles have included parts shortages, factory shutdowns and increased freight costs.

Meet the middle market

Middle market companies are predominantly privately owned and have been in business for an average of 40 years. Prior to the onset of the COVID-19 pandemic, middle market businesses with revenues of between $10m and $1b were the fastest-growing companies in the U.S. This group of roughly 200,000 companies – only approximately 1.26% of all U.S. businesses – creates 60% of all new private sector jobs, and accounts for nearly one-third ($10t in annual revenue) of total U.S. private sector GDP. Middle market companies that survived the economic downturn from 2007 to 2010, created more than two million new jobs, while surviving larger companies shed nearly four million jobs. Middle market firms include retail and wholesale trade, healthcare services, manufacturing, and financial services/insurance.

Supply chains after COVID-19

COVID-19 has exposed the vulnerabilities of complex global supply chains. This is particularly true in the healthcare sector, with the shutdown of facilities in China, a global supplier of disposable medical devices like syringes and gloves as well as surgical and protective equipment, which has laid bare the inherent risks of inventory and single-sourcing models. The impact of China's lockdown and its dominance in key areas of manufacturing have further highlighted the problem with modern supply chains. When Chinese factories closed, manufacturers struggled to pivot due to a lack of flexibility in their supplier base.



One likely consequence post COVID-19 is the decentralization of manufacturing activity, with companies looking to bring production home and other companies looking to diversify their supply chains in the future.

Arlo Technologies, a security and video monitoring solution company, has experienced a disruption of supply chain caused by delayed delivery of components from third-party manufacturers and other supply centers located in regions affected by COVID-19. This is expected to result in a significant reduction of the company's revenues and increased product and service costs and operating expenses for the remainder of its 2020 fiscal year.

Adamis Pharmaceuticals has experienced delays in obtaining products and services from third-party manufacturers as a result of the impact of the COVID-19. In addition, the pandemic could result in interruptions or delays in the operations of the FDA or other regulatory authorities, which may impact review and approval timelines relating to new drug applications or other actions relating to product candidates.

Rock-a-Bye Baby, a family owned children's store, has experienced major delays in shipments because of factories shutting down in China due to COVID-19.

Debt-related risks

Middle market companies face existential risk due to their extremely high levels of debt. According to the International Monetary Fund, sixty percent of small to medium sized U.S. enterprises have interest coverage ratios below one. The interest coverage ratio, used to evaluate a company's ability to handle its outstanding debt, is a good indication of a company's financial condition. A good interest coverage ratio is considered important by both market analysts and investors, since a company cannot grow and may not even be able to survive unless it can pay the interest on its existing obligations to creditors.

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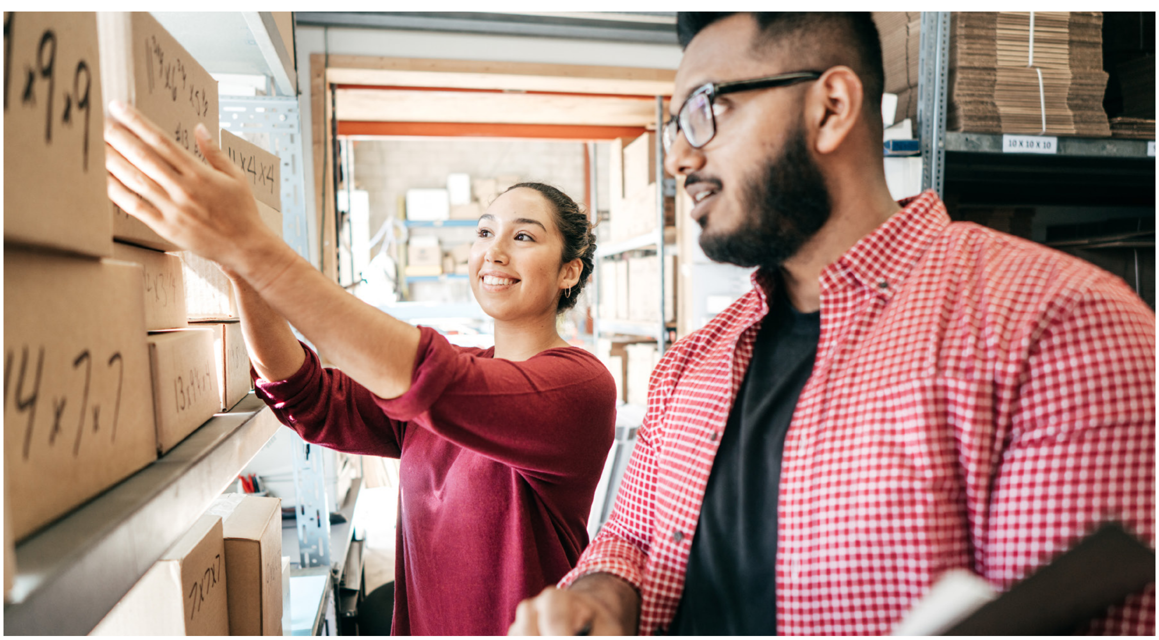
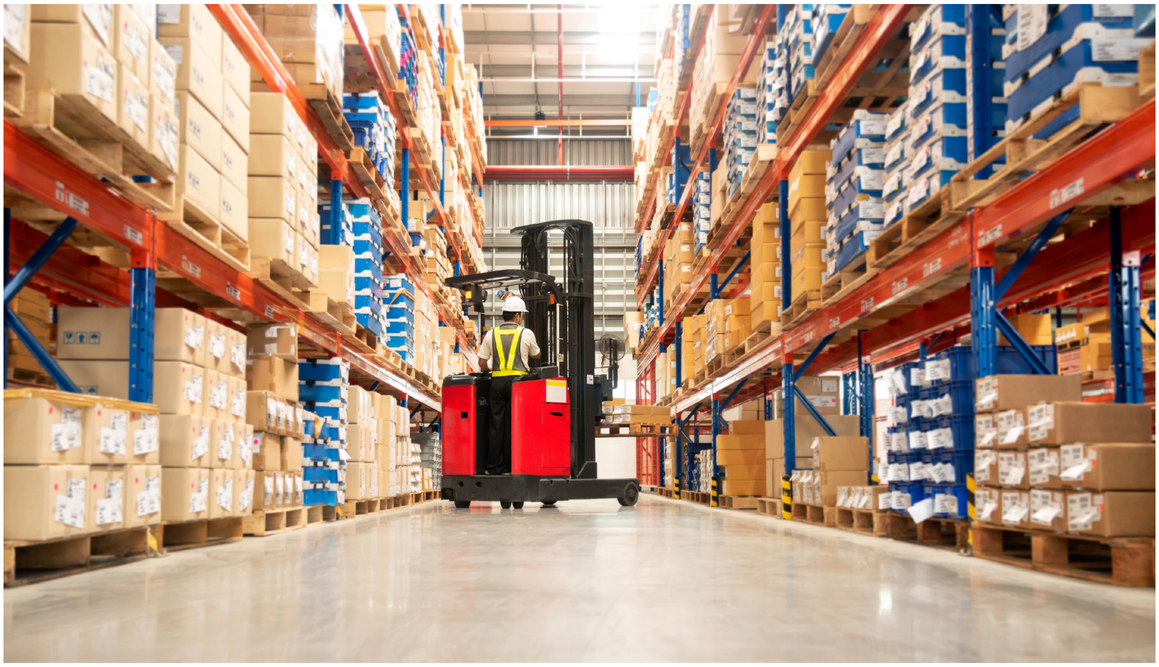
Cash flow liquidity

Offsetting the threats posed by their debt ratios, middle market companies have higher working capital levels in comparison to larger companies, making them better positioned to meet short-term obligations. This enables them to weather any liquidity challenges over the next two to three months. Longer-term disruptions will likely require additional liquidity measures. So far, a relatively robust financial system has been able to provide short-term funding primarily through revolving lines of credit to middle market companies. As the crisis continues, banks are tightening lending standards. With the economic impact of the pandemic likely to last through fourth quarter, middle market companies will be challenged in acquiring additional capital. Those companies that have accessed capital early will benefit from their proactive capital management.





Middle market credit risk

COVID-19 is becoming a major driver of default risk. Firms of all sizes across industries are experiencing significant credit deterioration. Middle market industry segments like Construction, Services and Transportation have seen the greatest increase in default risk due to the pandemic, while Services and Communication remain the riskiest sectors. The greatest increase in default risk due to COVID-19 for large enterprises is also from the Construction segment. Consumer Products, Auto and Trade have the highest default risk for large firms.

Companies across the world are set to make significant changes to the way they source and distribute goods. Currently 80% of all goods are shipped by trucks, with 8% shipped by air and less than 5% shipped by rail. As the trucking industry grapples with the fallout from COVID-19, companies are finding the need to diversify their distribution channels to reduce the dependence on trucking. Trucking costs are currently three times the market average, as transportation capacity in some sectors like Life Sciences and Consumer Goods, is squeezed due to the pandemic. Other sectors like Retail and Industrial firms are trying to deal with a loss of business.

The unprecedented demand in some geographical areas that are hot spots have overwhelmed supply chains, causing companies to reevaluate how much stock they hold and how they distribute it to their customer base. As companies expand and change their sources and distribution of supply, their whole logistics and warehousing network will be impacted, from movement of goods to methods and locations of storage. As they do this, the demand for manufacturing facilities, last mile delivery and fulfillment centers will all increase, changing the industrial landscape for decades to come.

Economic uncertainty and demand

Due to its unprecedented nature and the uncertainty about how long the pandemic will last, the extent of economic damage due to COVID-19, while expected to be deep, remains largely unknown. Record unemployment levels and an unprecedented decline in personal consumption expenditure have resulted in significantly lower sales and earnings for the middle markets.

Jobless claims in the U.S. as of May exceeded 40 million. The unemployment rate in April for Retail and Wholesale Trade, the largest middle market industry segment, was at 17.1%. Sales for Retail and Food Services declined by 14.7% in April. Personal consumption expenditure plunged by 12.6% in April. In addition, economists believe there will be more weakness in consumer spending in the coming months. Middle market companies will need to be determined and adaptable to weather this period.

Industry trends – Outlook

As recently as the beginning of March, middle market companies had a positive outlook on the U.S. economy over the next 12 months. Since the outbreak of COVID-19, as state stay-at-home orders took effect in March, bringing the U.S. economy to a virtual halt, middle market businesses are not as optimistic about their business prospects. In the short run, a large percentage of middle market companies will weather the storm because of their strong current ratio levels. However, in the longer term, middle market companies because of their higher debt levels will be increasingly challenged with their long-term liquidity outlook.

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Conclusion

COVID-19 has created a paradigm shift in the way business is conducted. Although challenging times lie ahead as companies gradually navigate their way through the new normal, the middle market's proven resilience and adaptability shows that they have what it takes to make it through the pandemic and beyond.

About QBE

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Sources: Moody's Analytics, National Center for Middle Markets (NCMM), Alpha-sense, Deloitte consulting, ASUG research, Bloomberg, Bureau of Labor Statistics, World Economic Forum, JLL, International Monetary Fund, CION Investments, AON (The One Brief), RSM US Middle Market Index, Company 10K's