Distance to default

A default indicator for Australian listed companies
Background

Financial institutions, or any business heavily exposed to a particular sector, will have a vested interest in tracking the potential for corporate default with stakeholders important to their business.

KPMG is pleased to release our first edition of Distance to Default (D2D), an analysis of corporate health across all sectors in the ASX.

Trends in declining corporate health for certain sectors can trigger episodes of systemic instability and have adverse impacts on lenders, counterparties and investors\(^1\). Understanding these trends can assist stakeholders make informed decisions, and reduce their risk when dealing with companies in a sector experiencing declining or weak corporate health, when compared to the average of all companies listed on the Australian Stock Exchange (ASX).

Information from financial statements is useful when analysing corporate health. However, it is often compromised by the historical nature of the financial information, the frequency of reporting and the time lag between financial close and reporting dates – circumstances in a business can change substantially in the intervening period. By combining market based information (stock volatility) with financial statements, stakeholders are informed on deteriorating corporate health more than either source alone.

The methodical incorporation of forward-looking information from equity markets can enhance the ability to identify and measure corporate health among listed Australian companies. Adopting the Distance-to-Default measure based on analysis used by Reserve Bank of Australia\(^2\) and a turnaround mindset, KPMG Restructuring Services has analysed the information available for the majority of Australia’s ASX listed companies in order to provide meaningful insights into the trends in corporate health across sectors\(^3\).

This publication is volume one of an ongoing series that will be released bi-annually.

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1 Reserve Bank of Australia, 2015, ‘Default Risk Among Australian Listed Corporations’, Sep Quarter Bulletin
2 Moody’s KMV Company, 2003, ‘Modelling Default Risk’
3 This does not take into account any interim FY17 results, which will be included in the next publication.
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**D2D Score**

**Distance from zero**

Based on D2D methodology, the closer to zero, the more likely a particular company is to default. In this analysis the average score has been calculated for each sector.

**KEY:**
- **1-5** D2D Score
- **Industry average second half FY16 actual results**

The Real Estate sector has consistently outperformed the average ASX score over the periods reviewed, with the highest D2D score among all sectors, driven mostly by the Real Estate Management and Development industries, with a compound annual growth rate of 24 percent.

Energy and Materials sectors were impacted by the Oil, Gas and Combustible Fuels and Metals and Mining industries, which both had D2D scores below the ASX score.

Financials includes the Banks, Capital Markets, Consumer Finance, Diversified Financial Services, Insurance and Thrifts and Mortgage Finance industries. The sector was the second highest performing sector (behind Real Estate), consistently outperforming the average ASX score.

The Healthcare, Industrials and IT sectors remained relatively steady, moving largely in line with the average ASX score over the periods reviewed.
Key findings

Energy and Materials
Energy and Materials sectors were impacted heavily by the Oil, Gas and Combustible Fuels and Metals and Mining industries, which both had D2D Scores below 1.

Real Estate
The Real Estate sector has consistently outperformed the average ASX score, with the highest D2D score at 4.4 among all sectors, driven mostly by the Real Estate Management and Development industry.

Energy
- Production growth will likely continue to slow as the Oil, Gas and Consumable Fuels industry enters a declining life cycle characterised by declining industry revenue and a decreased number of industry participants.
- Notwithstanding the long term growth of renewable energy, at least in Australia, thermal coal will remain an important part of the global energy mix for the medium-term.
- Offshore demand and geopolitical factors outside of Australia’s control continue to dictate the market. While it appears the price of coal has come out of the bottom of the cycle, the key question is how long this will last?
- The gas crisis on the east coast is likely to drive further investment in onshore gas exploration, which could have a positive impact on the Oil, Gas and Consumable Fuels industry.

Materials
- Confidence in the global economy remains fragile and metals companies are increasing their focus on cutting costs and performance improvements.
- Metals companies have had to be agile and astute to survive the downturn, and the continued use of robotics, analytics and further collaboration between industry players will have a pervasive effect on the industry. It should mean further investment in R&D and many industry players will focus on driving improvements through new manufacturing technologies.
- Organisations along the value chain (i.e. ports) may not see the volumes that they were originally established on and, accordingly, rapid right-sizing of the cost base and debt stack will be required in order to maintain positive operating cash flow.

Real Estate
- There have been mixed messages in the media over the past 12 months concerning the state of the Australian property market. While some authorities, including the Reserve Bank of Australia, are concerned about a property bubble, more notably in the residential housing market in Sydney, indicators support a compelling proposition for astute investors in both Sydney and other parts of Australia.
- A property bubble in a certain market (e.g. Sydney residential housing) does not necessarily spell disaster for a different property class in another part of the country, which may present a compelling investment proposition.
A health check of Australia’s listed companies

Our analysis of corporate health considers about 1,900 listed companies in Australia across 11 sectors (approximately 88 percent of the total companies listed on the ASX)\(^2\) at each half-year close date for the 2014-2015 and 2015-2016 financial years.

In order to consider sector-specific performance in context, it is important first to look at how the ASX has, on average, performed over the period reviewed. D2D scores for those companies analysed generally range from 0.5 to 7.5, with some outliers. The average D2D score for the ASX declined from 1.83 as at June 2014 to 1.55 as at December 2015, followed by an increase to 1.67 as at June 2016 in line with December 2013 levels (1.66). Similar fluctuations are noticed when the D2D score for the ASX is compared to the business confidence score extracted from the NAB Quarterly Business Survey\(^4\), noting that the decline in confidence during the second half of FY 2015 to the first half of FY 2016 was not surprising given the more subdued, near-term outlook for the economy at that time, driven in part by declining commodity prices weighing in on incomes. A recovery in business confidence in the second half of FY 2016 was noted off the back of an improving non-mining economy with the largest gains in finance, property and business services\(^5\).

This correlation between business confidence, as measured for example by the NAB, and the D2D score measured across the ASX is not unexpected. Historically, businesses (as opposed to households) have accounted for a disproportionate share of the non-performing loans, and ultimately the losses of banks both in Australia and overseas\(^6\). There are a number of reasons why business lending is inherently riskier than household lending, including the limited liability structure, competitive pressures and the more direct exposure to cyclical fluctuations in economic activity\(^1\). These factors heighten the risk of default for individual businesses and can lead to common vulnerabilities at both the industry level and for the business sector as a whole. The resulting correlation in business sector defaults, in combination with the fact that business loans are less likely than housing loans to be backed by high-quality collateral, means that, on average, deterioration in the financial health of businesses is more likely to transmute into a threat to corporate health of a particular sector, or the ASX as a whole\(^1\).

While the number of companies listed on the ASX currently stands at 2,163 as at October 2016\(^6\), in completing our analysis we were able to extract data regarding 1,887 of those companies for the periods considered. Of the 1,887 companies analysed, sufficient data was available in order to calculate a D2D score for about 76 percent of the data set. Sector-specific observations are included in this paper and have been analysed according to three criteria:

1. The distance from zero.
2. The number of sector companies above 3.0.
3. The number of sector companies below 0.5.

Sectors with an average D2D score closer to zero, and a higher number of companies with a D2D score below 0.5 (when compared to other sectors, are considered to have weaker corporate health and may attract higher default risk among their constituents (sector companies).

\(^4\) National Australia Bank, ‘Quarterly Business Survey by NAB Group Economics’
\(^6\) Australian Stock Exchange Website
D2D score above 3.0

Of the 183 companies with a score above 3.0 as at June 2016, 27 percent were in the Real Estate sector, compared to 14 percent as at December 2013, indicating the Real Estate sector has moved further away from default.

For each half year period analysed the number of companies with a score above 3.0 changes. The ‘above 3.0’ analysis tracks the movement of companies in and out of the top group (generally 200-250 companies), comprising D2D scores that are the greatest distance to default (zero) when compared to all companies captured.

The Financials Sector (mostly the Diversified Financials industry) accounted for the majority companies with a D2D score above 3.0.

The number of Energy companies has decreased steadily from 11 in December 2013 to one in June 2016. There were also only nine Materials companies (one in the Metals and Mining industry) with a D2D score above 3.0 in June 2016.

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D2D score below 0.5

Of the 222 companies with a score below 0.5 as at June 2016, 52 percent were in the Metals and Mining industry, compared to 56 percent as at December 2013, indicating that industry constituents have experienced a sustained period of stress and default risk.

For each half-year period the number of companies with a score below 0.5 changes. The ‘below 0.5’ analysis tracks the movement of companies in and out of the bottom group (generally 250 – 300 companies), comprising scores that are the closest to default (zero) when compared to all companies captured.

The number of Oil, Gas and Consumable Fuels companies with a D2D score above 3.0 has decreased steadily from 11 in December 2013 to one in June 2016. Conversely, the number of companies in the Materials and Oil, Gas and Consumable Fuels industries with a D2D score below 0.5 peaked at 167 and 58 respectively in December 2015.

The number of companies in the Oil, Gas and Consumable Fuels industry with a D2D score below 0.5 increased from 14 percent as at December 2013 to 20 percent as at December 2015, and decreased to 18 percent as at June 2016 indicating that confidence in the industry and performance may have improved.
Spotlight on Energy

Coal production in Australia

As net exporters of coal, Australian producers are highly susceptible to global coal prices and macroeconomic conditions of foreign trading partners. As a result, Australian producers have suffered significantly from the past 5 years of steeply declining coal prices worldwide.

Now, a spectacular run for spot coal prices has invoked optimism for the industry. The question is: how long will the surge continue and is it sustainable?

Offshore demand and geopolitical factors outside of Australia’s control continue to dictate the market

Over the past 5 years, Australian thermal (or steaming) and metallurgical (or coking) coal exports as a percentage of total black coal production have increased from 80 percent in calendar year 2010 to 88 percent in 2015.7 Over the same period, the price of coal has been in a steady, steep decline.

As at June 2016, companies in the Oil, Gas and Consumable Fuels industry accounted for 18 percent of the lower scoring companies in terms of D2D score, up from 14 percent as at December 2013. Over the same period the number of companies that scored in the top ranks, decreased from 11 as at December 2013 to 1 as at June 2016. Expectedly, ratings agencies such as Standard & Poor’s warned of a highly negative credit outlook for Asia-Pacific oil and gas companies in Q3, calendar year 2016, pointing to plummeting profitability and cash flow pressures for smaller players, as well as potential ratings downgrades.8

Late July 2016, the Australian hard coking coal spot price for thermal coal reached US$210/tonne (a 4-year high) driven by increased import demand from China and production disruptions in Australia, which also had an impact on the Metals and Mining industry (discussed later).

Thermal coal spot prices also recovered in the September quarter, counter to the downward trend since early 2011. Australia’s benchmark Newcastle free-on-board (FOB) spot price reached over US$70/tonne in mid-September, the highest in more than 2 years. The recovery was driven by government mandated cuts to supply in China, weather-related supply disruptions in Indonesia and increased demand attributed to high temperatures through China’s summer.9

Where to from here?

- World thermal coal trade is forecast to decline by about 1.4 percent in 2016, largely due to an international focus on reducing carbon emissions (particularly in China)9.
- It is widely known that renewable energy plays a critical role to climate change although, at least in Australia, thermal coal will remain an important part of the global energy mix for the medium term.
- Production growth will likely continue to slow as the Oil, Gas and Consumable Fuels industry enters a declining life cycle characterised by declining industry revenue and a decreased number of industry participants10.

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Energy: A sector in transition

KPMG National Sector Leader of Energy & Natural Resources Ted Surette agrees that Australia’s energy sector is undergoing a huge transition, driven by activity in both global and domestic markets.

With continued interest in renewables, the role of coal and traditional energy sources is certainly under pressure. However, recent events – including the election of Donald Trump as President of the United States (US) – have introduced further uncertainty.

The move to renewable energy

“Right now, in terms of energy policy, the focus on renewables is here to stay,” says Surette. “In a very short period of time we’ve had this massive take-up of renewables, and different states wanting to promote renewables.”

Australia needs a clean energy policy that will bring sustainable, reliable and affordable energy while meeting carbon emission targets.

For example, demand in Australia for the Tesla Powerwall battery increased by 30 times following recent blackouts, demonstrating consumers’ enthusiasm for the new technology.

“It’s very clear that the pendulum is switching direction,” says Surette.

The continuing role of coal

However, the rise of renewables does not mean that coal is out of the picture. South Australia’s late 2016 power outages have intensified questions about the security and reliability of Australia’s energy sources.

“The generation mix is under the spotlight right now and it is evident the use of coal for baseload capacity is still very important,” says Surette.

The Independent Review by Dr Alan Finkel (AO) into the Future Security of the National Electricity Market is underway and wide-ranging public consultation has commenced.

The potential closure of plants – most notably Victoria’s brown-coal fueled Hazelwood Power Station – could well give some respite to investors in the market.

“Given Hazelwood supplied 25 percent of Victoria’s base load electricity needs and the state is a net exporter of energy, it’s clear electricity prices are going to increase as a result.”

Surette also highlights the recent energy security review.

“It means that where we might have had a very dire prediction for some of these players 12 months ago, it’s changing – fast.”

Global influence

Recent production cuts in China have resulted in a lift in prices as well. However, Surette warns this could be temporary. On the other hand, international political events could also have a significant impact on the energy industry’s outlook.

“Trump has been quite vocal on the role of base load power on the American energy mix. He will be a promoter of fossil fuels in the US.”

While Surette believes the push for renewables will continue regardless, Trump’s attitude will impact US and global markets.

“The reality is there’s going to be a closer look at traditional means of energy. That could dampen renewables.”

Meanwhile, as the energy landscape keeps on shifting, continued instability in the market is highly likely.

“Players in the energy space are going to be living in a volatile world,” warns Surette.
Spotlight on Materials

Metals and Mining outlook
The Metals and Mining industry has struggled in recent years, underscored by the fact it has been rated the sector most at risk of default since the second half of the 2014 financial year. Yet there is renewed optimism off the back of a recent recovery in some resource classes, including iron ore, and it now appears the industry may have come out of the bottom of the cycle.

Certainly commodity price volatility remains a key issue for Australian miners. It is the sustainability of these improved conditions that will determine the future for the Metals and Mining industry in Australia.

Aftershocks from the mining meltdown likely to be felt far down the value chain
As at June 2016, only one metals and mining company recorded a D2D score above 3.0, while the industry accounted for about 52 percent of the bottom 200 companies in terms of D2D scores. Many smaller producers have struggled to cover costs in light of historical prices and have reported consistent losses. Based on our analysis, metals and mining debt reached its highest point in the first half of FY 2016, meaning the industry had been gearing up to supplement trading losses.

Ongoing cost cutting by resource producers has in turn reduced the output and earnings of mining services companies. High volatility as a result of mixed demand from the industry is likely to extend beyond mining services.

In the KPMG Global Metals and Mining 2016 outlook report, 82 percent of metals and mining organisations said supply chain failure was a potential risk to growth. As metals and mining companies have had to focus on operational excellence in order to stay afloat, looking at who is heavily exposed to the industry in terms of downstream activities (that is, outbound logistics) will be essential in predicting the next wave of distress.

So where to from here?
• Confidence in the global economy is subdued and metals companies are increasing their focus on operational efficiency, strengthening their balance sheets and productivity.
• Metals companies want to expand market share and will adjust their investment strategies to achieve lower costs and improve access to customers.
• Metals companies have had to be agile and astute to survive the downturn, and the continued use of robotics, analytics and further collaboration between industry players will have a pervasive effect on the industry. The industry should experience further investment in research and development (R&D) and many industry players will focus on driving productivity improvements through new manufacturing technologies.
• Organisations along the value chain may not see the volumes that they were established on. Accordingly, rapid right-sizing of the cost base and debt stacking will be required in order to maintain positive operating cash flow.
• Financial institutions highly exposed to the industry may be forced to take a discount on debt in order to give some producers a reprieve from the prevailing market conditions.
The second life of the mining sector

The subdued performance of the mining sector has been well documented over the past few years. Yet, according to Surette, the sector has now come out of the bottom of the cycle and is in the middle of a spectacular recovery.

The main driver of the Australian mining sector’s recent strong performance has been an uptick in commodity prices, says Surette. The cessation of mining operations in China has cut the global supply of iron ore and coal, boosting domestic players.

“That’s had an immediate impact in terms of Australian trade,” he says.

Yet while he can point to obvious reasons for the sector’s changing fortunes, he admits the turnaround has been “bewildering” in its sheer speed.

“There’s more optimism – cautious optimism – than there’s ever been. We’re seeing major players about to restart major operations because of the surge in commodities.”

And it won’t stop with the major players. The resulting benefits are set to flow on to mining services and adjacent industries.

International players reassessing viability

Given the recent lift in commodity prices, international investors could well revisit Australian mining projects that previously seemed unfeasible, says Surette.

“It’s not as dire as it was 6 or 12 months ago. If overseas players believe that commodity prices will remain at their current elevated levels, they’re likely to reassess the viability of their Australian investments.”

Streamlining operations in a competitive environment

Some overseas players made particularly big investments into Australia, buying at the top of the cycle. It is these companies that will have to consider innovative ways to streamline their operations and increase efficiencies to remain competitive, says Surette.

“There will still be a need for energy players and mining organisations to be at the bottom of their cost curve. That means we will continue to see the widespread use of robotics, analytics, and collaboration between industry players.”

Vulnerability and volatility

Meanwhile, there is the issue of how temporary these gains are. Despite recent gains in the mining sector, volatility remains. While some players who were on the brink of default may now be getting a second life, it could be short lived, warns Surette. That’s because, as always, the mining sector remains vulnerable to the movements of global commodity prices.
Spotlight on Real Estate

Strong fundamentals for a property play

There have been mixed messages over the past 12 months concerning the state of the Australian property market. While some authorities, including the Reserve Bank of Australia, are concerned about a property bubble – more notably in the Sydney residential housing market – indicators suggest a compelling proposition for astute investors in both Sydney and other parts of Australia.

Real Estate leading the pack

KPMG’s analysis shows that the Real Estate sector outperformed the ASX between June 2014 and June 2016. Most notable were the companies that comprised the Real Estate Management and Development industry which achieved, on average, 24 percent compound annual growth in KPMG’s D2D score over the period analysed, which indicates a movement away from default for the sector.

The sector’s historically strong performance was further reflected in above-system average EBITDA margins which increased from 36 percent as of December 2014 to 42 percent as of June 2015\(^\text{12}\) (among the highest of all sectors analysed). The analysis certainly suggests the sector may be hot, however, it may also tell us the sector is close to overheating.

Mixed messages

The outperformance of the Real Estate sector has encouraged ongoing debate around whether Australia is heading for a property bubble (or ‘boom’), which would result in a subsequent downturn (also called a ‘correction’ or ‘collapse’). The OECD’s report in June 2016 supports this negative sentiment, stating that Australia’s housing boom could end in a ‘dramatic and destabilising’ real estate hard landing.

However, it is important to keep in mind that the Australian real estate market is ultimately broken down into many different classes and geographic concentrations, and while all markets may be subject to some macro economic shocks, each market has unique economic drivers and supply and demand enablers which should inform investment decisions in Australia.

Where to from here?

- A property bubble in a certain market (e.g. Sydney residential housing) does not necessarily spell disaster for a different property class in another part of the country, which may present a compelling investment proposition.
- In the event that a property bubble is experienced by a certain class of property in a city or town, a pricing correction generally ensues. During this time there are a number of restructuring options available to both developers and investors. What we have seen previously is industry consolidation, and the early trading of debt to allow financial institutions to crystallise losses and sell problematic debt portfolios.

The Real Estate sector has consistently outperformed the average ASX score over the periods reviewed, with the highest D2D score among all sectors, driven mostly by the Real Estate Management and Development industries, with a compound annual growth rate of 24 percent.

12 Adjusted to exclude outliers in the data set.
13 Companies above the 3.0 mark are considered to be in the top one-fifth of all companies analysed; roughly 60 - 65 percent of companies have a D2D score between 0.5 and 3.0.
Real Estate: a complex picture

While there are those who consider the Real Estate sector on the verge of a correction, just as many contend that it is still in good shape. Certainly, there are few industries that attract as much speculation in Australia – in large part due to its high visibility, says KPMG Partner and Real Estate Sector Leader, Steve Gatt.

“The reason it’s so topical? The number of cranes on the horizon, which are visible to everyone,” he says. “Newspapers are telling people that there’s a potential oversupply, and prices are racing ahead. On the front page, people are talking about prices going crazy and clearance rates at auctions.”

KPMG’s D2D analysis shows that Real Estate is the furthest from default of all sectors, with a D2D rating of 4.39 in the second half of FY 2016. Meanwhile, REITs were a particularly resilient portion of the sector, their D2D rating remaining above 4.3 for the past 3 years.

“The REITs are very strong,” agrees KPMG Director, Head of Real Estate Advisory NSW Tim Gavan. “They’re in their ascendency.”

Gatt puts this down to a number of factors. He points to how, in the years following the Global Financial Crisis (GFC), REITs took measures to minimise their exposure to risk, shedding non-core assets. He also notes that domestic properties tend to underlie REIT portfolios, which are fortified by the underlying strength of the domestic economy. Now, he says, “the whole REIT sector is well-capitalised”.

The banks also play an important role, adds Gatt: “The banks have been judicious in their lending to the sector.”

Commercial investment institutions appear to be at particularly low risk of default. However, the other segment in the sector – Real Estate Management and Development – is significantly more vulnerable. The industry’s D2D rating has stayed around 2.5 over the past 3 years, although it rose to 3.82 in the second half of FY 2016.

Part of its underlying fragility, says Gavan, is due to new entrants who have been attracted to Real Estate’s recent price growth.

“There are those people who join the industry because they feel that these are good times. They may not have the same amount of experience.”

A novice developer, for instance, who was encouraged by positive media headlines about property and perhaps a recent success, may not recognise the movements of the property cycle.

“They may start to get into trouble because they bought land at the wrong time and they are up against it in terms of funding and require increasing levels of equity. Plus, because they’re not as experienced, things take a lot longer,” he says.

Issues of timing can be costly, particularly when they quickly spread from unsophisticated developers to builders.

“The developer may not pay the builders on time; they may withhold the last payment; they might have all sorts of delays on the contract which causes angst for the builder’s cashflows,” says Gatt.

“If the contractor has a number of these exposures across different projects, they could find themselves in a cashflow problem very quickly.”

Gatt says experienced contractors are likely to limit their exposure to a certain pool of developers, choosing to spread their contracts across projects in both residential and commercial markets. But those who are less experienced may find themselves with cash flow issues and who has a disproportionate number of inexperienced developers on their books.

New entrants from foreign markets can also introduce an added element of risk to the industry.

“Australia is still very attractive to Asian investors,” says Gatt. “While Sydney and Melbourne may not be global cities today, there’s no doubt overseas investors see Sydney and Melbourne as global cities of the future. It means they are willing to invest money now, ahead of that curve.”

The problem is well-capitalised and less risk-averse Asian investors may introduce disequilibrium into the market. Foreign investors, for instance, may have enough capital to begin large-scale developments without presales. If there is a downturn, says Gatt, those developers may add to the oversupply causing a compound negative effect in the market.

However, for now, it appears that real estate remains one of the more robust industries in the country. The story is always more complex than the headlines however, warns Gatt – and risk remains.
About the analysis

Default risk (or insolvency) is the uncertainty surrounding a company’s ability to service its debt as and when it falls due. Prior to default, there is no way to discriminate unambiguously between companies that will default and those that will not. At best we can only make probabilistic assessments of the likelihood of default.

By applying a turnaround practitioners lens, KPMG provide key insights to inform clients of sector default risk.

Analysis of companies listed on the ASX through the context of sectors or industries can help detect deteriorating corporate health, and hence increasing default risk, because such analysis incorporates more forward-looking information than other data sources such as financial statements. With this in mind, KPMG sought to identify an effective financial metric which we could use to determine the sectors with higher default risk, represented by the aggregate of the different players (companies) which comprise the relevant sector(s).

KPMG has adopted an indicator of financial health used by the Reserve Bank of Australia\(^1\). The model is used to assess trends in financial health for the corporate sector as a whole and, in aggregate, the model is able to broadly match the dynamics of the corporate failures data\(^1\), suggesting that it will be a useful financial metric on which to base our analysis.

Variants of the Merton model are widely used in commercial settings. We have used the Moody’s Kealhofer, McQuown and Vasicek (KMV) D2D formula for the purposes of conducting the analysis, and relied on many inputs from the Capital IQ database. The indicator uses information on liabilities from financial statements together with a company’s market capitalisation to assess credit risk. Individual companies’ probabilities of default can be aggregated to assess risk for particular industries or for the business sector as a whole. The key simplifying assumption underpinning the model is that a company is more likely to default if the market value of its assets falls below the book value of its liabilities. The difference between the value of assets and liabilities determines the company’s probability of default (PD).

The D2D score combines three key credit issues: the value of the company’s assets, its business and industry risk, and its leverage. Moreover, the D2D score also incorporates market value of assets and volatility, the effects of industry, geography and company size.

Our analysis, not dissimilar to that undertaken by the Reserve Bank of Australia, focuses on listed companies, primarily because of data limitations but also because listed companies are on average larger and more likely to directly contribute to a systemic shock. Financial statements are the main source of information about corporate health used, supplemented with market-based information, such as equity prices and volatility. In that regard, a strand of the existing literature on corporate credit risk suggests that combining the two types of information detects deteriorating corporate health more effectively than either source alone.\(^14\)

How KPMG can help

In this rapidly changing environment, every company faces challenges. A step in the wrong direction can sometimes have significant effects on corporate performance and company value. KPMG’s integrated team of specialists guides you through difficult times to deliver real results for your stakeholders.

Inspire a turnaround

To assist in overcoming operational or financial challenges and improve performance, you need to quickly stabilise your cash and liquidity positions and take a realistic view of current options. We can support your transformation with services that help you move from crisis to value realisation.

1. **Option identification**: How can I quickly and effectively assess all my options? (Fixing, selling or closing the company can all provide pockets of value).

2. **Stabilisation**: How can I stabilise the business and assess its financial position? (Transformation begins by identifying what needs to be done and who needs to do it).

3. **Transformation Strategy**: What financial impact might I realise through the various options? (A strong plan recognises stakeholder concerns and needs).

4. **Execution**: How can I execute my turnaround plan? (Rebuilding trust between the company and its stakeholders can be a key benefit of a well-executed plan).

5. **Value Realisation**: How can I make sure my plan delivers value? (Significant value can be realised – or lost – at this stage).

Financial restructuring: meet challenges head on

When a company is experiencing financial difficulties, stakeholders often look for additional information or resources to help rebuild their confidence. We can help you master financial restructuring with services designed to enhance value for both borrowers and lenders.

1. **Appraisal and stabilisation**: Do I have enough funding to keep operating while a solution is being developed and implemented? (Effective stakeholder communications is essential at each step to help ensure a successful outcome).

2. **Options assessment**: What do I need to do and when?

3. **Stakeholder negotiations**: How can I keep everyone fully engaged in negotiations? (Tolerable compromises should be considered on both sides of the table).

4. **Development of solutions**: What is the new capital structure? (Develop more than one plan to address possible contingencies).

5. **Implementation**: How can I implement the deal according to plan? (Make sure the new capital structure supports tax efficiency).

6. **Ongoing monitoring**: Am I out of the problem zone? (Sometimes more than one deal is needed to ‘get it right’).

Solvency strategies: make the complex manageable

When a company is in distress, the management team faces many competing challenges. We help create clear solvency strategies by assisting insolvent companies and providing support at every phase of insolvency.

1. **Distressed corporates**: How serious is the problem? (Now is the time to ask the hard questions).

2. **Insolvency planning**: What are my options? (Consider the relative merits of each option or combination of options).

3. **Commencement**: What needs to happen if/when my company is in a formal protection process? (The right communication can help you anticipate issues before they become problems).

4. **Implementation**: How can I maximise value? (Insolvency often requires a number of plans executed concurrently).

5. **Exiting a Formal Process**: How do I get back to normal? (For an insolvency company with limited funds, settlements are often preferable to expensive litigation).