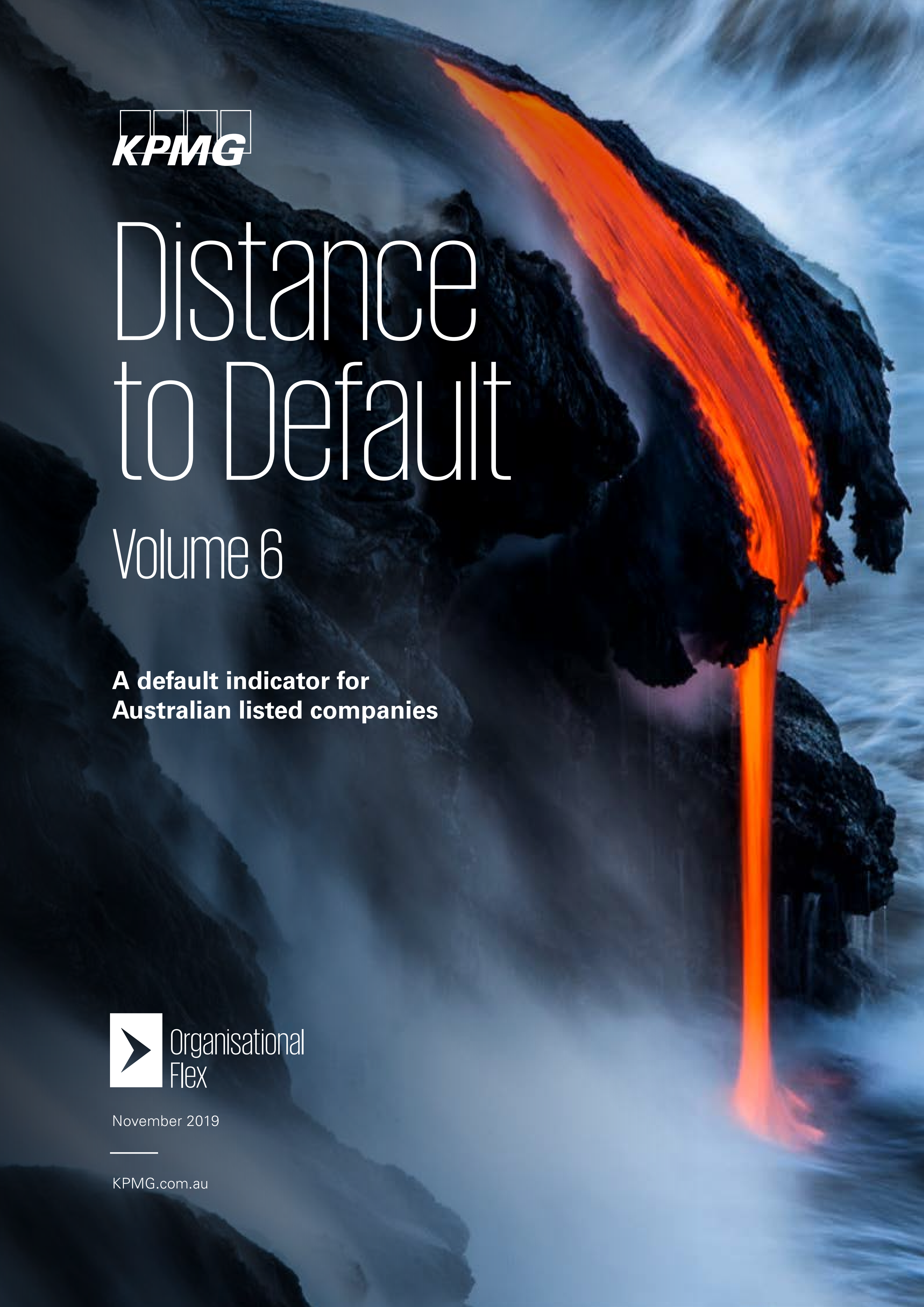


KPMG

Distance to Default

Volume 6

A default indicator for Australian listed companies

Organisational Flex

November 2019

KPMG.com.au

Foreword

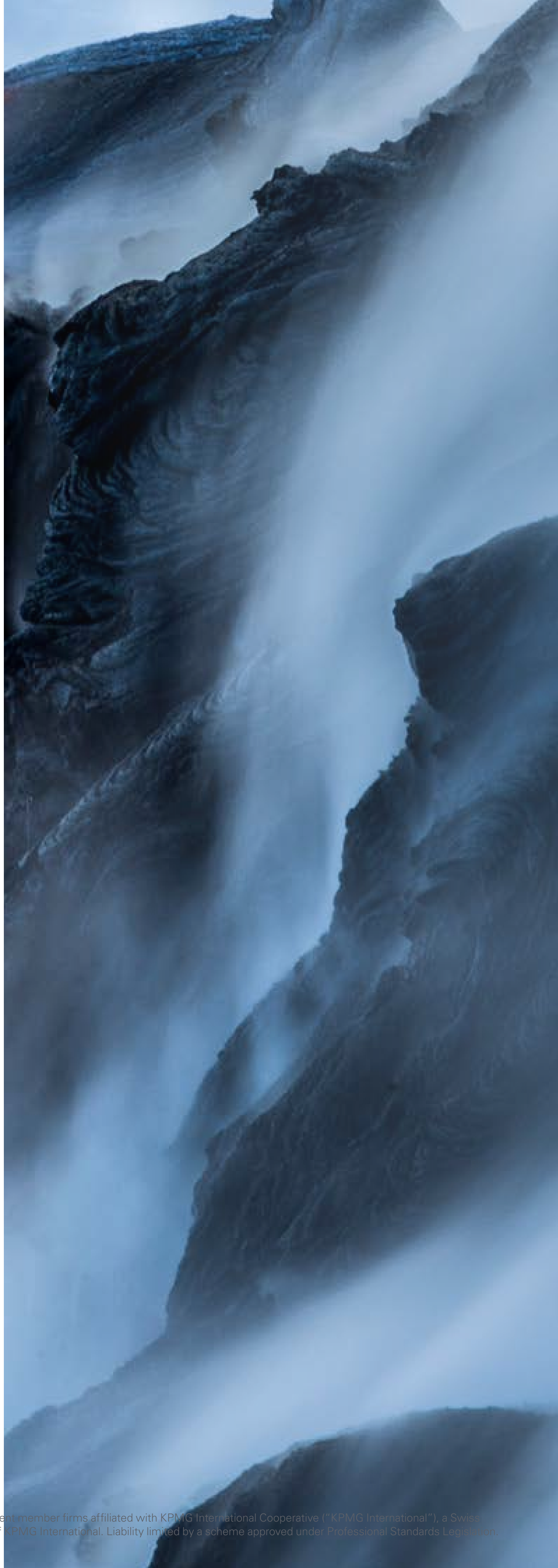
We are pleased to share with you the sixth edition of our bi-annual Distance to Default (D2D) publication. We comment on the changing state of corporate health across all ASX sectors following the end of the reporting season for the six months to June 2019.

Consistent with our last report, our analysis indicates that the Financials and Real Estate sectors continue to display the highest D2D scores (furthest from default), with Energy and Materials sectors displaying the lowest D2D scores, many of which continue to appear on our Zombies list most at risk of default due to the company's persistent proximity to the default line (D2D score of 0).

Overall the ASX average D2D score increased from December 2018 to June 2019 (moving from 1.72 to 1.75). Despite a small boost to the share market from our last publication, half of the sectors analysed experienced a decline in there D2D score. With the falling Australian dollar and political uncertainty over the China/US trade war and the UK Brexit we expect these global headwinds to continue to impact the landscape of Australian business and global competitiveness impacting their D2D scores moving forward.

Gayle Dickerson
Partner,
Restructuring Services,
KPMG Australia

Ryan Eagle
Partner,
Restructuring Services,
KPMG Australia



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Key findings

About D2D

D2D is a metric used to assess a company's 'Distance-to-Default'. The metric takes into account financial information and market data.

The closer to zero, the more likely a company is to default. In contrast, the further a company is from zero, the less likely it is to default.

In this analysis, released every 6 months, we analyse the D2D score movements of ASX listed companies (following reporting season of full year and half year results) to draw insight as to corporate health across the Australian economy.

Distance to Default metric, an indicator of financial health used by the Reserve Bank of Australia which is based on the Merton model. This analysis has been prepared using the Moody's Kealhofer, McQuown and Vasicek (KMV) D2D formula, and relies on source data from the Capital IQ database.

D2D score combines both financial information and market information to determine a company's relative 'Distance to Default' (or D2D score). KPMG Restructuring believes that combining the two types of information detects deteriorating corporate health more effectively than either source alone.

The sixth edition of KPMG's bi-annual Distance to Default publication focuses on the changing state of corporate health across all ASX sectors for the 6 months to June 2019. In this report we dive into the largest movers by industry sectors, and analyse the proportion of companies consistently displaying low D2D scores (otherwise known as 'D2D Zombies').

Key findings for the 6 months to June 2019

- The ASX average D2D score increased from December 2018 to June 2019 (moving from 1.72 to 1.75), with significant underlying change in the scores of the companies making up this analysis.
- Only 46 percent of the companies analysed displayed an improved D2D score, with the remaining companies showing a decline or no change in D2D score.
- Financials and Real Estate sectors were the strongest performing sectors (highest D2D score). However, the Real Estate sector displayed the largest decline in D2D scores (decrease of 8.7 percent), whereas the Financials sector improved by 8.6 percent.
- The five industry groups with significant D2D score declines were:
  - Technology Hardware and Equipment – decline of 14.3% to 1.12.
  - Real Estate – decline of 8.7% to 3.38.
  - Commercial and Professional Services – decline of 7.8% to 1.68.
  - Telecommunication Services – decline of 6.0% to 1.50.
  - Utilities – decline of 5.8% to 2.22.
- 394 'Zombie' companies displaying a score below 1 for three or more half year periods on the ASX representing 21 percent of the total companies analysed.
- 68.9 percent of companies displaying a D2D score above 3.00 (furthest from default) were in the Financials (123 companies), Real Estate (46 companies) and Consumer Discretionary sectors (37 companies).
- 68.7 percent of companies closest to default (less than 1.00) were in the Materials (344 companies), Energy sector (87 companies) and Information Technology sector (84 companies).

D2D scores across the ASX

The ASX D2D score increased to 1.75 (as compared to 1.72 as at December 2018). The increase in the average ASX D2D score was underpinned by a divergence amongst companies: 46 percent of companies had an increase in their D2D score; 48 percent of companies had a decrease in their D2D score; and the remaining companies had no movement or were newly listed companies.

46%

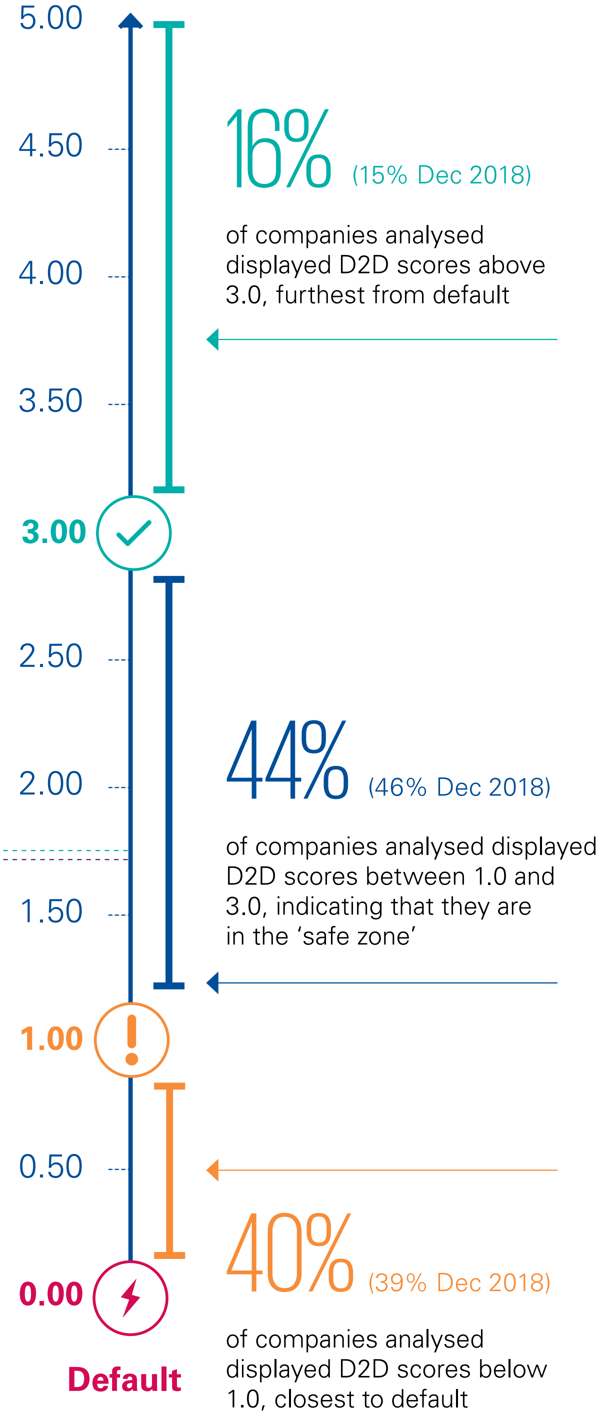
of companies had an increase in their D2D score;

48%

of companies had a decrease in their D2D score; and the remaining companies had no movement or were newly listed.

1.75 - ASX AVERAGE D2D SCORE AS AT JUNE 2019

1.72 - ASX AVERAGE D2D SCORE AS AT DECEMBER 2018



D2D movements by sector

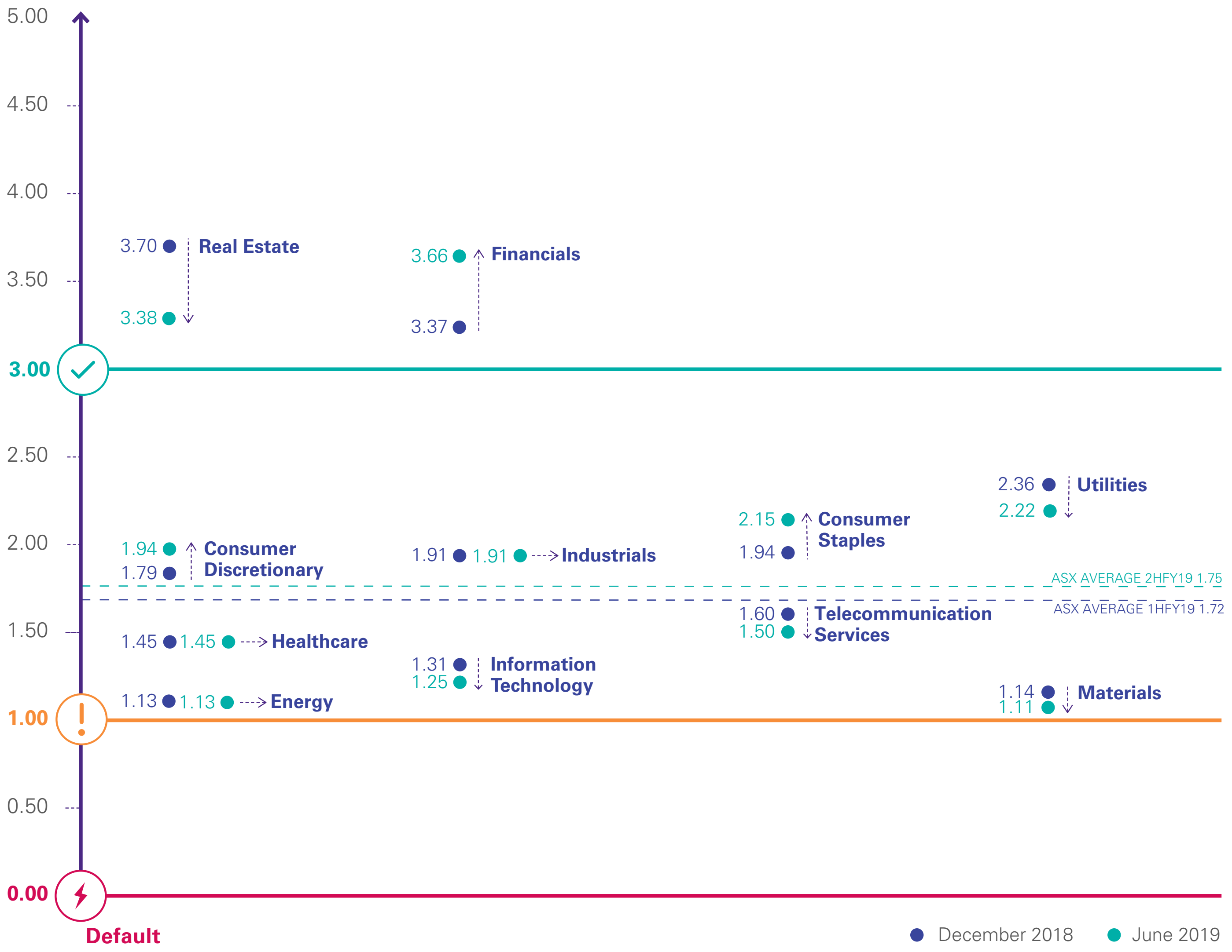
The Real Estate, Telecommunication Services, Utilities, Information Technology, Materials, Energy and Healthcare sectors moved closer to default in the last six months to June 2019. Financials and Real Estate continue to display the highest D2D scores, each delivering a score above 3. Materials, Energy and Information Technology continue to display the lowest D2D scores, or the scores closest to default.

Over the past 6 months:

— The largest sector improvement was in Consumer Staples, improving 10.8 percent, with D2D score of 2.15;

— The largest sector decline was in the Real Estate sector, declining 8.7 percent to 3.38;

— 7 of the 11 sectors had a decrease in their D2D score as compared to 10 out of 11 in Vol 5 of this report.



Zombies – Across the ASX

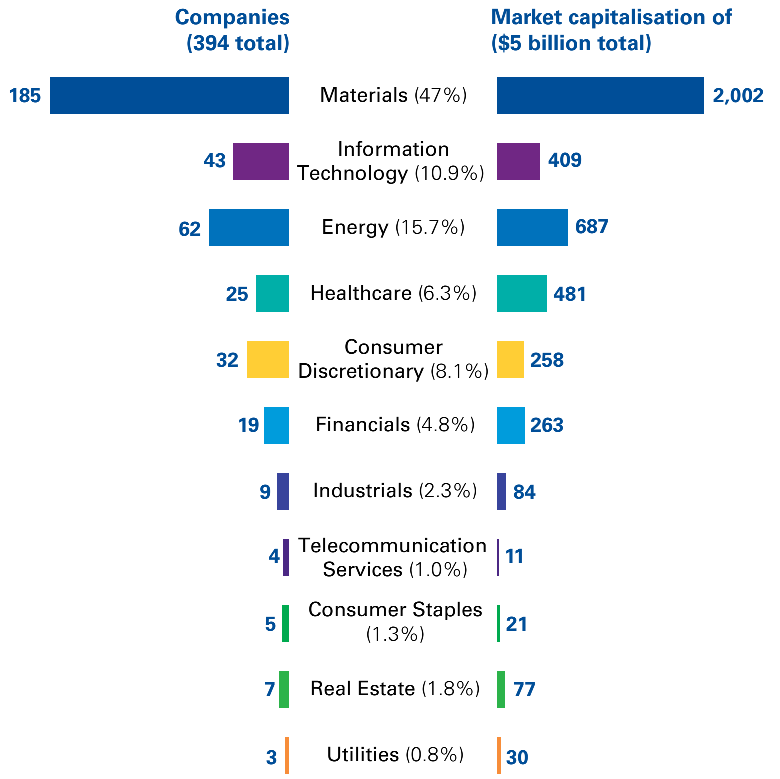
Companies closest to default (D2D score below 1) for 3 or more consecutive periods are considered zombies in this analysis. We consider these companies to be more a risk of default due to the persistent proximity to the default line (D2D score of 0). These companies may already be experiencing distress or working through restructuring strategies.

A total of 750 (40 percent) of companies analysed displayed a D2D score of below 1. Of that more than half fall within our definition of a 'zombie' (394 companies). Representing a market capitalization of $4.3 billion.

Materials, Information Technology, and Energy companies still make up most 'Zombie' companies (73.6 percent this period vs 73.1 percent at 1HY19).

Most Zombie companies are in the materials sector (representing 47 percent and $2.0 billion in market capitalisation) followed by the Energy sector (representing 16 percent and 687 million in market capitalisation).

Number of Zombie companies by sector and total market capitalisation

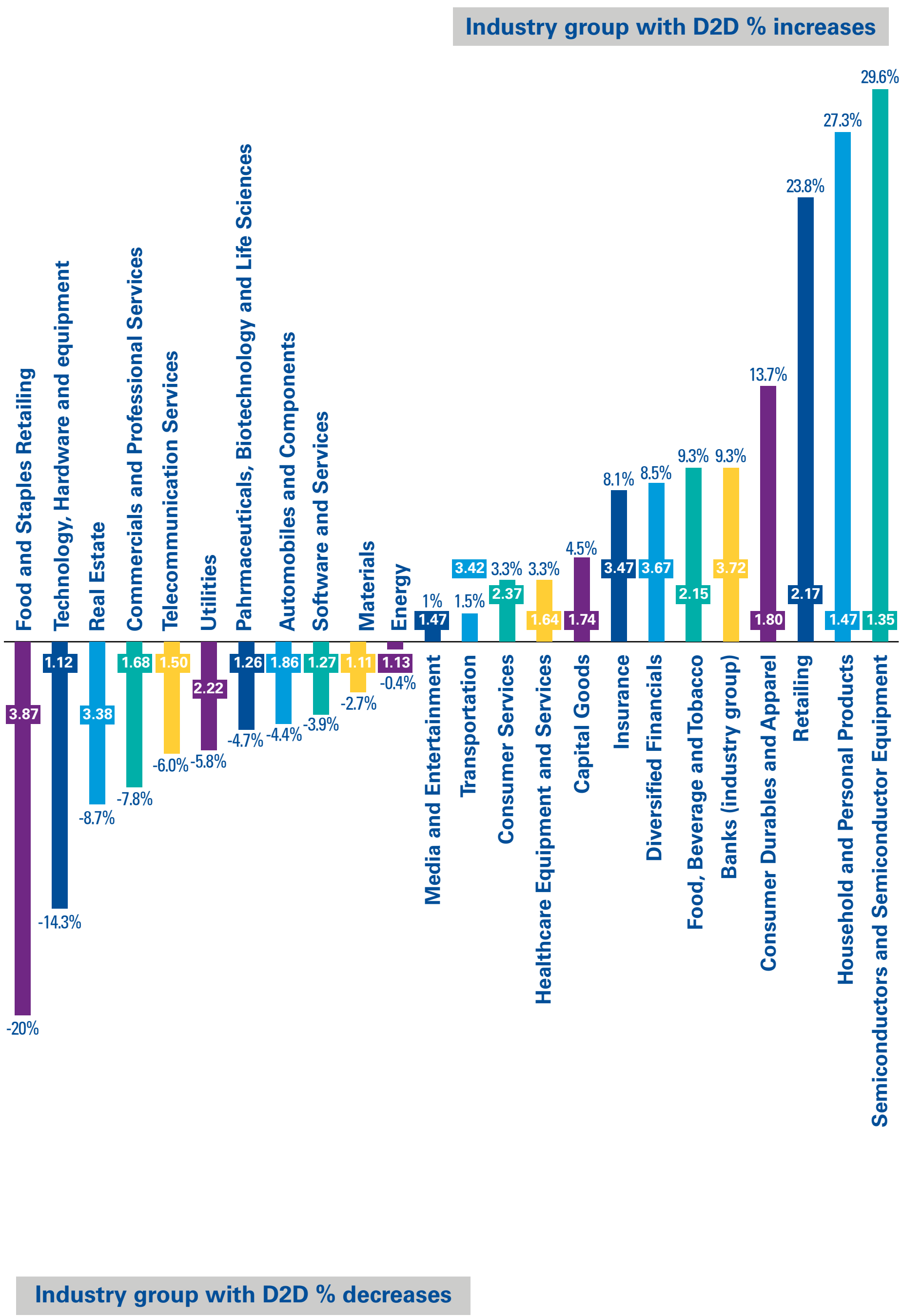


D2D movements by industry group

— Household and Personal Products industry recorded an improvement in D2D score, increasing by 27.3 percent, with an average D2D score of 1.47 (up from 1.16, 6 months prior)

— Technology Hardware and Equipment companies recorded a decline in D2D score of 14.3 percent with an average D2D score of 1.12 (down from 1.31, 6 months prior)

On the following page we dive deeper into the financial performance of the five industries with the largest decline in D2D score.



Spotlight on the financial performance of industry groups

With the largest decline in D2D score

Of the 5 industries with significant D2D score declines, we have reviewed their financial performance from December 2018 to June 2019 for signs of pressure.

	Revenue change	Change in EBITDA	Net Operating Cash Flow	Change in Net Debt
Technology Hardware and Equipment (34 company financials reviewed) D2D 2HY 19: 1.12 Change: (14.3)%	29% had a decrease in revenue	53% had a decrease in EBITDA	53% had a negative Operational Cash Flow	68% had a increase in net debt
Real Estate (78 company financials reviewed) D2D 2HY 19: 3.38 Change: (8.7)%	44% had a decrease in revenue	35% had a decrease in EBITDA	47% had a negative Operational Cash Flow	73% had a increase in net debt
Commercial and Professional Services (52 company financials reviewed) D2D 2HY 19: 1.68 Change: (7.8)%	31% had a decrease in revenue	48% had a decrease in EBITDA	40% had a negative Operational Cash Flow	58% had a increase in net debt
Telecommunication Services (20 company financials reviewed) D2D 2HY 19: 1.50 Change: (6.0)%	33% had a decrease in revenue	43% had a decrease in EBITDA	48% had a negative Operational Cash Flow	90% had a increase in net debt
Utilities (23 company financials reviewed) D2D 2HY 19: 2.22 Change: (5.8)%	35% had a decrease in revenue	39% had a decrease in EBITDA	52% had a negative Operational Cash Flow	74% had a increase in net debt

Ready to go with KPMG

Inspire a turnaround, execute a financial restructure, or understand options using solvency strategies with KPMG Restructuring Services.

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

Inspire a turnaround – view the eBook

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). We frequently employ a Rapid Opportunity Diagnostic tool to facilitate discussions at the option identification stage to identify enterprise value uplift and cash release opportunities at deal speed. Our unique approach is focussed on identifying cash improvement, revenue upside and cost reduction opportunities in a risk-adjusted way.
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 – view the eBook

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 – view the eBook

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).

Contact us

Matthew Woods
Joint National Head of Restructuring
E: mwoods1@kpmg.com.au
P: +61 8 9263 75152

James Stewart
Joint National Head of Restructuring
E: jstewart13@kpmg.com.au
P: +61 3 8667 5728

Sydney

Peter Gothard
NSW Restructuring Partner
E: petergothard@kpmg.com.au
P: +61 2 9458 1562

Ryan Eagle
NSW Restructuring Partner
E: ryaneagle@kpmg.com.au
P: +61 2 9458 1559

Gayle Dickerson
NSW Restructuring Partner
E: gdickerson@kpmg.com.au
P: +61 2 9295 3982

Brisbane

Will Colwell
QLD Restructuring Partner
E: wcolwell@kpmg.com.au
P: +61 7 3237 5458

Melbourne

Brendan Richards
VIC Restructuring Partner
E: bjrichards@kpmg.com.au
P: +61 3 9288 6484

Adelaide

Martin Lewis
SA Restructuring Partner
E: mlewis7@kpmg.com.au
P: +61 8 8236 7204

Perth

Martin Jones
WA Restructuring Partner
E: martinjones@kpmg.com.au
P: +61 8 9278 2003

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