KPMG

COVID-19: Considerations for financial due diligence

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With increased focus on forward-looking areas of scope, we believe there will be limited value in presenting a COVID-19 adjusted earnings before interest, tax, depreciation and amortization (EBITDA) in the majority of cases. Forecast results, particularly for FY21, will be more critical than ever. We consider the focus of due diligence should be on the shape of the recovery and forecast cash flows.

COVID-19 adjusted EBITDA

We believe that for businesses adversely affected by COVID-19 there is limited value in presenting FY20 adjusted revenue, and earnings as if COVID-19 had not occurred. Any such numbers would be somewhat arbitrary.

The discounted future cash flows of target businesses are fundamental for valuation purposes. EBITDA was only ever a proxy for this. Therefore, in times of material disruption, this proxy diminishes in relevance.

Not all sectors will be affected by COVID-19 in equal measure. In addition, COVID-19 may have accelerated the shift toward a more digital business model. This may have required increased levels of investment/capex but with sustainable efficiency/business model gains and upsides post COVID-19.

Analysis of FY20 trading

In the majority of cases, FY20 is likely to be too distorted a baseline from which to propose add backs. This may also apply to FY21 depending on the duration and extent of the pandemic.

However, it will be important to explain the impact of COVID-19 on the business across all touch points, the levers available and remedial measures taken. This will highlight the relative resilience of the business model and the quality of the management team.

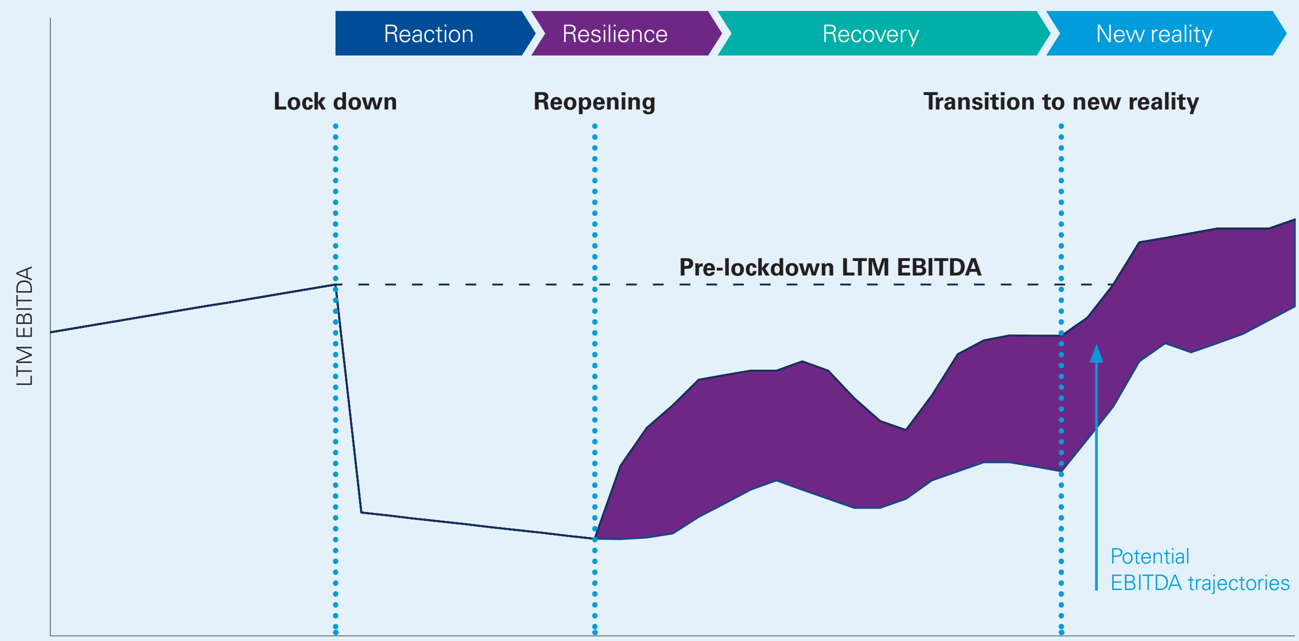
Analysis of FY21 forecasts

With an increased focus on forward-looking areas of scope, particularly the achievability of the FY21 budget, the key areas of scope will include:

- Multiple cases/sensitivities/scenario plans stress tested/ dynamic financial modelling – flexible set of input assumptions/scenarios to drive a range of 'what ifs' in an uncertain recovery environment. Interrogation and analysis of real-time market data/intel
- What is Q4-20 run rate or Q1-21 and what is FY21 shape/ recovery trajectory and rationale?
- Review high frequency, leading indicator key performance indicators (KPIs) to understand customer patterns/ structural shifts
- Review rate of order intake/pipeline/order book
- Market trends/customer demand, with strategic and commercial input being key. Long term impact of COVID-19 on business model
- What is the digital readiness/maturity of the business?
- Is the value creation roadmap/plan clear?
- Cost drivers need to be understood and corresponding cost right-sized, is it 'fit for the future'. How does the business secure the cost benefits of COVID-19?

Key considerations when analysing the earnings profile of the business

- To what extent does EBITDA decrease during "Reaction" and "Resilience"? How long will "Reaction" and "Resilience" last?



- To what extent does EBITDA change during "Recovery"? How long will "Recovery" last? What will the shape of the path through "Recovery" look like?
- To what level of EBITDA does the business return in "New reality"?

Key additional due diligence work to be performed

If the FY21 forecast EBITDA is the baseline for assessing earnings, the following areas will be a key focus of due diligence work, which will need to be more commercially focused:

1. FY20 budget and bridging to FY21B

- Assessing the original FY20 budget as an additional pre-COVID data point, with an increased focus on historical long term budgeting accuracy
- Bridging last twelve months (LTM) and FY20 budget EBITDA to FY21 forecast EBITDA, with key revenue and cost bridging items broken out
- For due diligence performed in Q2 and Q3 2020, it will be key to understand the business trends since FY19, the FY20 outlook, and whether the effects of COVID-19 are temporary or more permanent.

2. Current trading

- Assessing current trading and current run-rate (e.g. Q4-20, Q1-21) including latest weekly financial information up to the date of issuing analysis/reports
- Analysing the extent to which the first period post COVID-19 includes any catch up in sales or costs
- Understanding the impact of COVID-19 on the cost base will be important in assessing projected EBITDA. What is the adjusted normal level of cost by profit and loss line item to be able to model forward from?

3. KPIs, forward orders and real time market data

- Analysing high frequency leading indicator KPIs including a comparison of pre and post COVID-19 KPIs, to assess reasonableness of FY21 forecast
- Assessing market trends, long term customer demand and possible structural business model changes. The strategic and commercial due diligence view will be key
- Analysing current order book/pipeline (and historical conversion to sales), and current rate of order intake.

4. Other key considerations

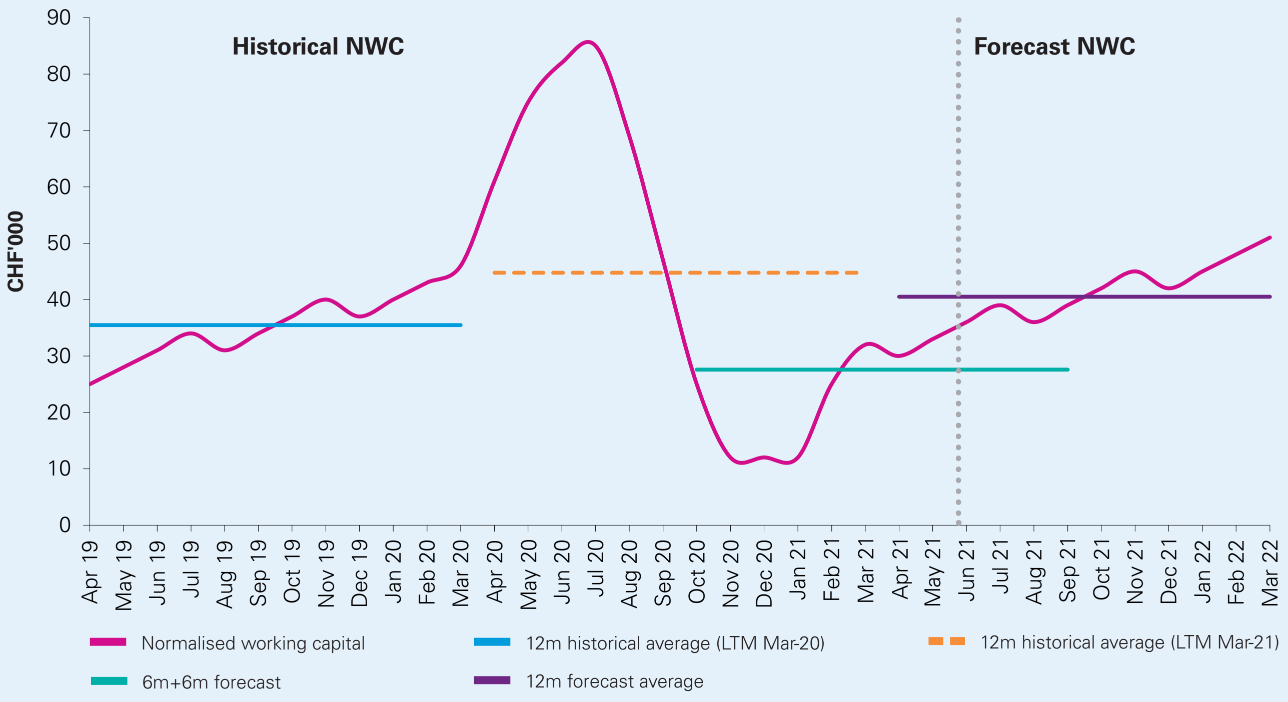
- Articulating the 'road to recovery' if the business is likely to be affected by longer term restrictions (i.e. into FY21)
- Assessing how to position a business which accessed public money via various governmental support schemes
- Analysis will need to be case-by-case as businesses will have been affected differently – proforma Q of E may be appropriate for those that exhibit more of a V shape/quick recovery with modest long term effects or businesses showing steady and predictable improvement.

Net debt and cash flow considerations

Additional debt-like or cash-like items relating to COVID-19 could include customer/supplier/employee claims, litigation, onerous contracts, one-time re-start up costs, CLBILs/CCFF, catch-up holiday pay above normal levels, VAT/corporate tax deferrals, catch-up rent payments, capex catch-up amounts, deferred bonus/pay awards, treatment of pension deficits/ contributions withheld, and leases (if modified).

FY20 cash flows could be distorted reflecting the impact of emergency measures taken by management to preserve cash.

Monthly NWC (assuming March 2021 = last historical month)



Increased focus on 26 week rolling short term cashflow forecasts.

Forecast cash flows will need to take account of the unwinding of each of these measures.

Working capital considerations

Average normalised working capital (NWC) should be calculated for the same period used for baseline EBITDA. Benchmark NWC, therefore, may move away from an adjusted LTM to synchronise with a normal level of earnings i.e. FY21.

Forecast NWC is likely to be derived from first principles i.e. underlying days payable outstanding (DPO), days sales outstanding (DSO) and days inventory outstanding (DIO) plus other working capital receivables and payables in the "New reality" (what is the new normal level of inventory holding and bad debt provisioning required in a likely recession).

For forecast NWC, it will be key to assess assumed DSO/DPO/DIO against pre-COVID metrics but also taking into account possible supply chain/customer changes. It will also be important to understand what is in the opening balance sheet and how that might unwind/convert to cash i.e. are there agreed extended payment terms to clear legacy balances?

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