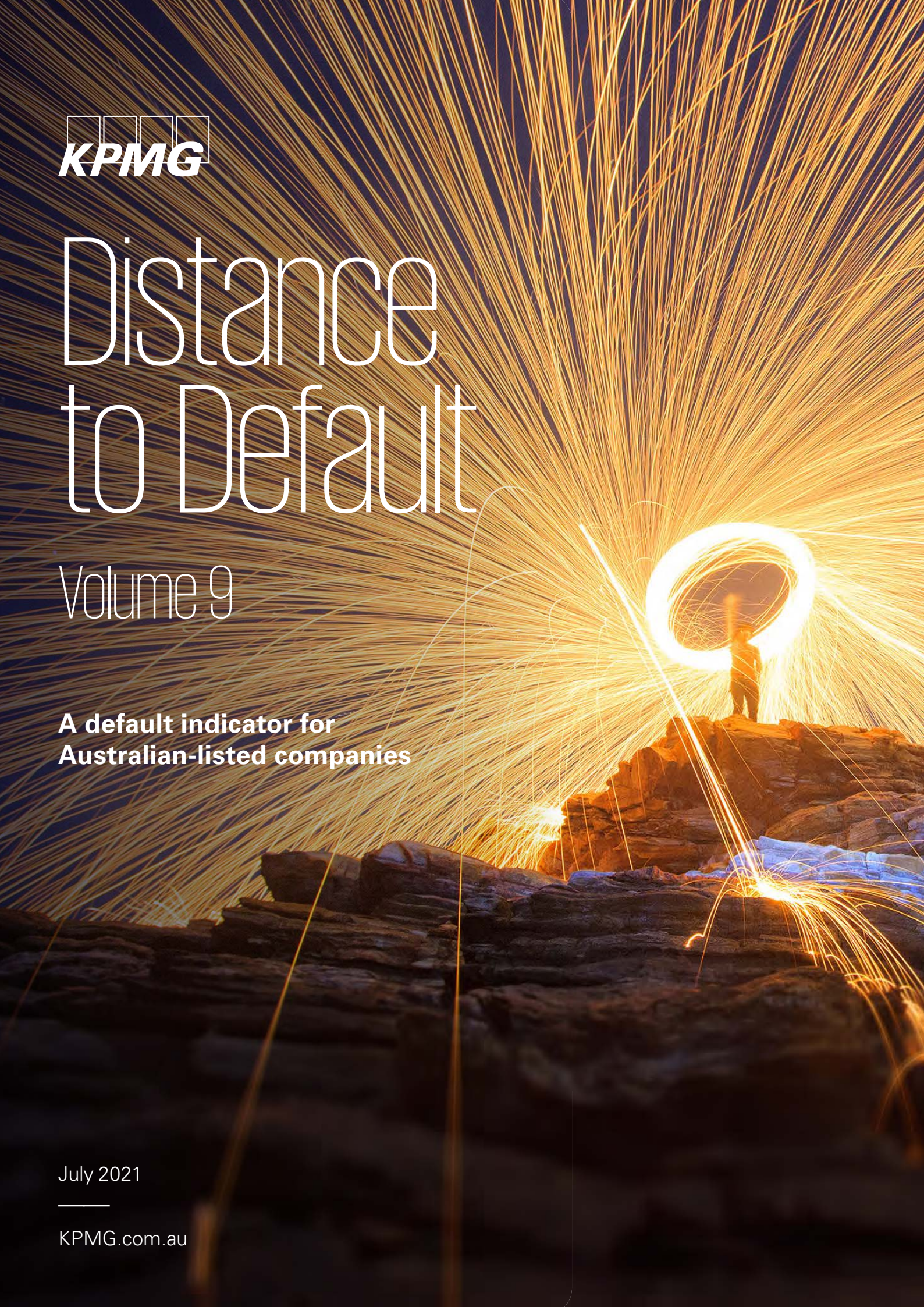

KPMG

Distance to Default

Volume 9

A default indicator for Australian-listed companies

July 2021

KPMG.com.au

Foreword

We present our ninth edition of our bi-annual Distance to Default (D2D) publication. We provide our insights into the changing state of corporate health across all ASX sectors, following the end of the reporting season for the six months to December 2020. We have also conducted our D2D analysis as of April 2021 and we observed an increase in the average D2D score between December 2020 and April 2021 from 1.61 to 1.76.

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 the **Materials** and **Energy sectors** displaying the lowest D2D scores. Further, we have observed in the financial spotlight (page 10) some of the best performing industries have significantly reduced debt and improved cash flows over the last six months.

We have included New Zealand for the first time in our D2D publication, given the close economic ties and banking relationships Australia shares with New Zealand.

The analysis indicates the average NZX D2D score is strong at 3.23 (December 2020) and 3.31 (April 2021). We observed 97 percent of companies displaying a D2D score of 1 or more at April 2021.

Including analysis on the NZX enables our readers from New Zealand or with exposure to the New Zealand market to understand what is happening in the New Zealand market and the trends in the market and sectors over time. We note that certain aspects of the New Zealand market make it difficult to draw meaningful comparisons with the Australia D2D results.

Below are some of our insights

Financial Services:

- The Major Banks reported a half year combined cash profit after tax from continuing operations of $13.8 billion, up 62.3 percent from the previous corresponding half year period.
- The Major Banks, alongside governments, regulators and central banks have underpinned the financial resilience of the Australian economy over the past year, having quickly mobilised operations to support households and businesses. With March 2021 marking the cessation of support measures, the fallout has been more subdued than initially anticipated as a reported 94 percent of borrowers that had been provided with deferral packages have returned to full payments.
- A recent KPMG global survey in the banking sector identified two significant issues at the top of executives' minds, these being revenue loss management and cost optimisation that need to be addressed in the near-term underpinning future financial performance.

Economic outlook:

We are currently operating in a market that has never been seen before with record low levels of insolvency. We expect to see this creep back up in the next 6-18 months to normal levels – counter-party risk is crucial right now as we operate in a "false dawn".

- 2020 proved to be a very challenging year for every industry in Australia. Not very surprisingly, the industries that experienced the highest deterioration in gross value added (IGVA) over 2020 have been front-line service sectors, including air transportation, food services, accommodation and arts and recreation. Conversely, the industry sectors that experienced the strongest performance during the pandemic have been public administration and safety and healthcare, while the retail sector's performance exceeded expectations.
- Economic activity continues to build on the back of the vaccination roll-out, and consumer confidence has been optimistic bouncing back to cross the pre-pandemic levels and reaching 110 on the consumer sentiment index.
- Established house prices appear to be on an upswing. Pent-up demand, a balloon in savings, limited growth in housing supply and ultra-low interest rates are the factors that are likely to drive the short-term upward price pressure within (some) housing markets in Australia. This, in part, is driving a significant increase to the average D2D score observed in the Real Estate sector (currently at 3.06 at April 2021).

We will continue to observe the market over the next six months in the midst of the global COVID-19 pandemic and the vaccine rollout.

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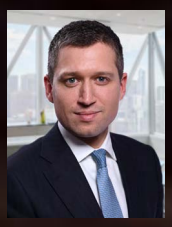

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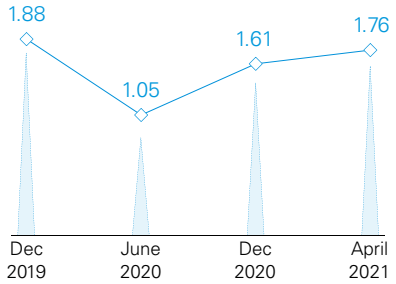
Key findings

The Distance to Default metric is an indicator of financial health and is used to assess a company's 'distance-to-default'. The 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.

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 six months, we analyse the D2D score movements of ASX-listed companies (following the reporting season of full-year and half-year results) to draw insights into corporate health across the Australian economy.

Movements from D2D score across the ASX

We have observed a decline in the average D2D score from 1.88 in December 2019 to 1.05 in June 2020, primarily due to the impact of COVID-19. The average D2D score subsequently rose to 1.61 in December 2020 and 1.76 in April 2021. The government's efforts towards recovery through unprecedented amounts stimulus helping to lift business confidence, consumer spending and economic activity.



Key movements in D2D scores by industry group

	From June 2020 to Dec 2020	From Dec 2020 to April 2021
Food and Staples Retailing	92% ↑ (3.46)	1% ↑ (3.48)
Real Estate	84% ↑ (2.71)	13% ↑ (3.06)
Diversified Financials	77% ↑ (3.20)	8% ↑ (3.46)
Banks	77% ↑ (2.72)	11% ↑ (3.03)
Transportation	76% ↑ (2.46)	11% ↑ (2.72)

Insights

Financial Services:

- Half year combined cash profit after tax was reported 62.3 percent higher than the previous corresponding half year period by the Major Banks.
- The Major Banks, governments, regulators and central banks swiftly mobilised operations to support households and businesses. This has provided financial resilience to the Australian economy.
- Two significant issues identified at the top of executives minds in the banking sector are revenue loss management and cost optimisation.

Economic Outlook:

- Front-line service sectors, including air transportation, food services, accommodation, and arts and recreation experienced the highest deterioration in gross value added (IGVA) over 2020. In contrast, public administration and safety and healthcare delivered the strongest performance during the pandemic, while the retail sector's performance exceeded expectations.
- Vaccination roll-out continued to build economic activity. Consumer confidence has turned more optimistic, bouncing back to surpass the pre-pandemic levels and touching 110 on the consumer sentiment index.
- Established house prices appear to be on an upswing driven by pent-up demand, a balloon in savings, limited growth in housing supply and ultra-low interest rates. This, in part, is driving the significant increase to the average D2D score observed in Real Estate sector (currently at 3.06 as of April 2021).

D2D scores across the ASX - December 2020

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

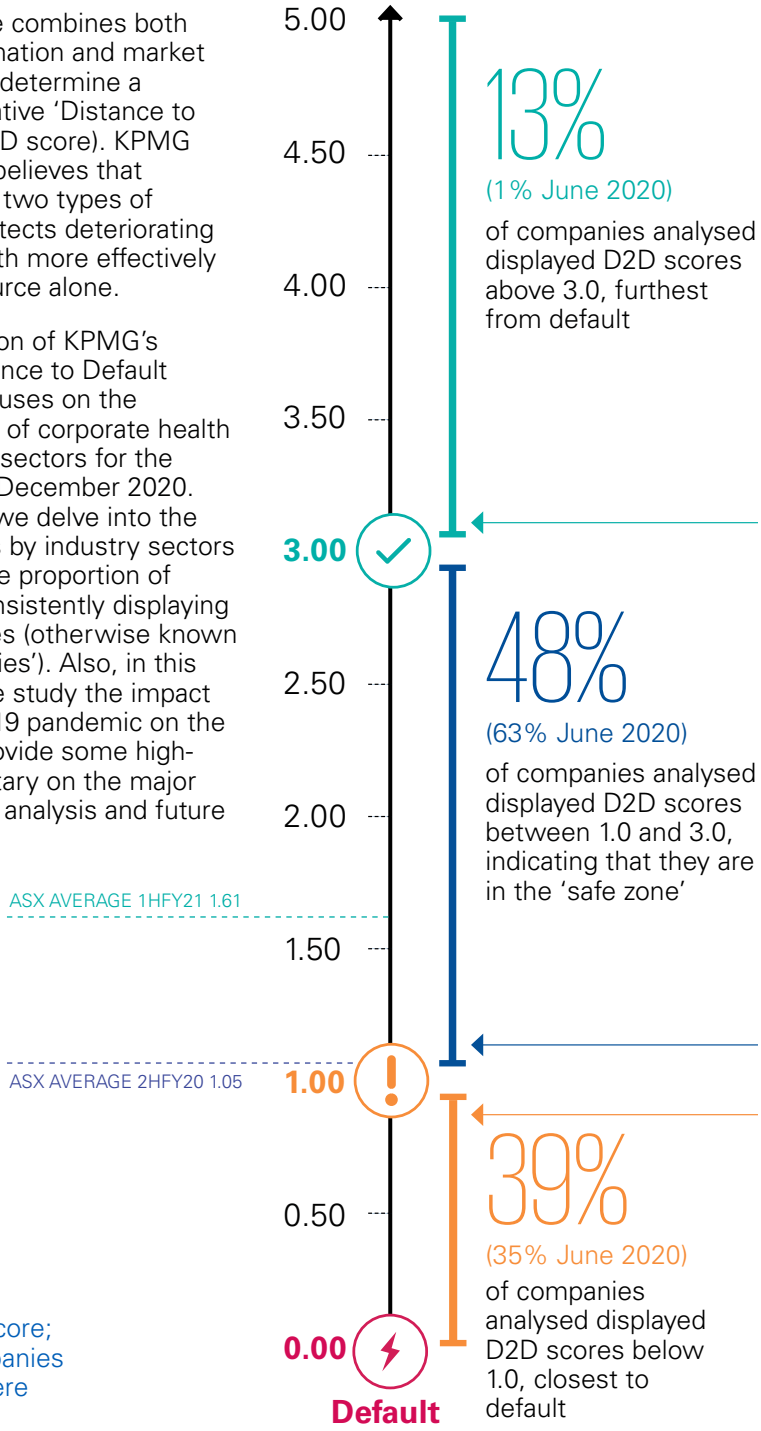
The closer to zero, the more likely a company is to default. In contrast, the further a company is from zero, the less likely it is to default.

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

The Distance to Default metric is an indicator of financial health used by the Reserve Bank of Australia that 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.

The 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 ninth edition of KPMG's bi-annual Distance to Default publication focuses on the changing state of corporate health across all ASX sectors for the six months to December 2020. In this report, we delve into the largest movers by industry sectors and analyse the proportion of companies consistently displaying low D2D scores (otherwise known as 'D2D Zombies'). Also, in this publication, we study the impact of the COVID-19 pandemic on the market and provide some high-level commentary on the major findings of our analysis and future outlook.



The ASX D2D score increased to 1.61 (compared with 1.05 as at June 2020).

The increase in the average ASX D2D score was underpinned by a divergence amongst companies:

81% of companies had an increase in their D2D score;

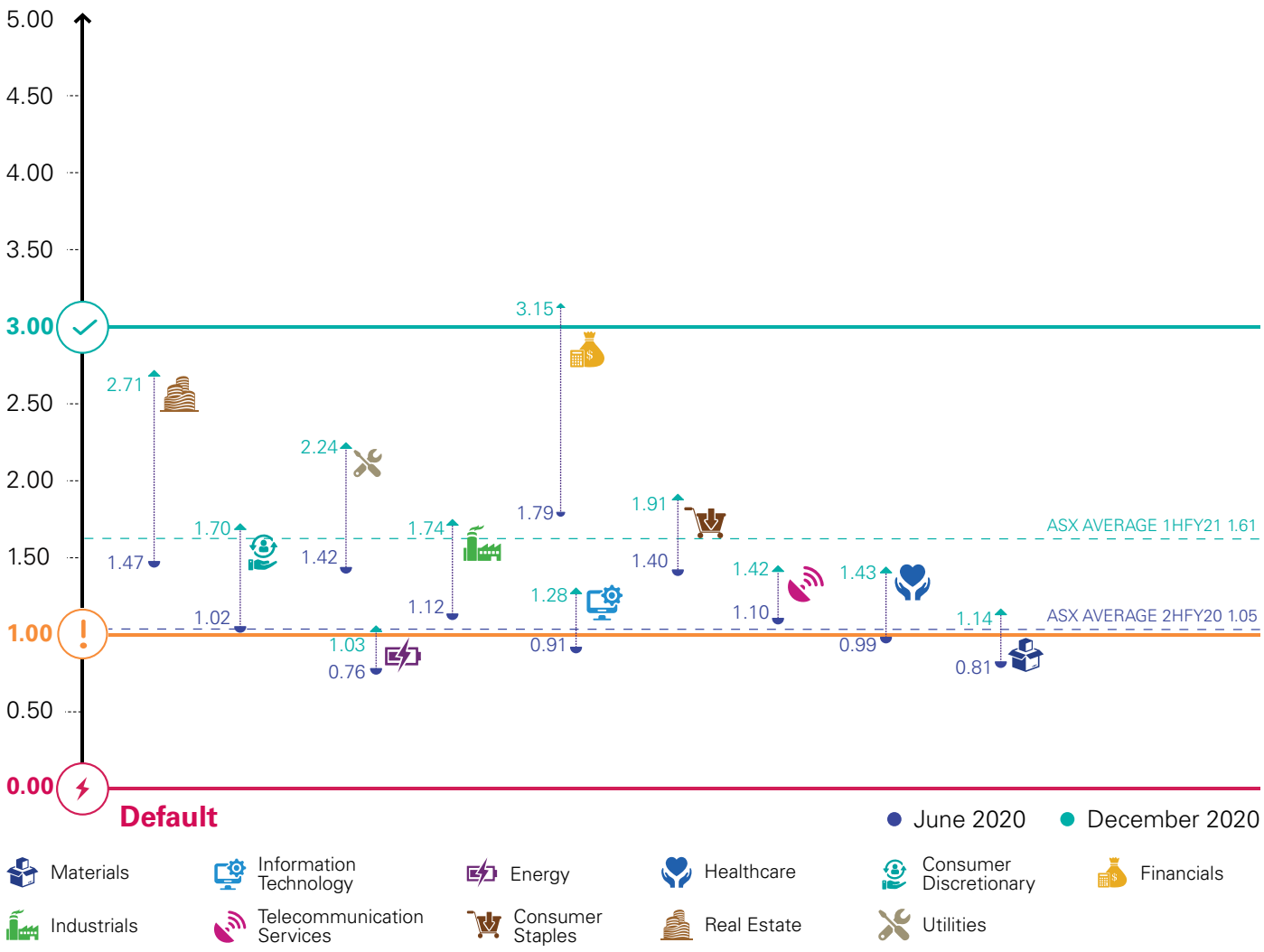
14% of companies showed a decrease in their D2D score; and the remaining companies had no movement or were newly listed.

D2D movement by sector - December 2020

Over the past six months up to December 2020

- The largest sector increase was in Real Estate, rising by 83.8 percent, with a D2D score of 2.71;
- All 11 sectors had an overall increase in the D2D score compared with none of the 11 sectors in June 2020 (Volume 8 of this report).

All sectors showed an overall increase in the D2D score in the last six months up to December 2020. The Financials and Real Estate sectors continue to display the highest D2D scores, delivering a score of 3.15 and 2.71, respectively. Energy, Materials and Information Technology continue to display the lowest overall D2D scores, or the scores closest to default.



Note: The industry groups have been coloured in accordance to their respective sectors.

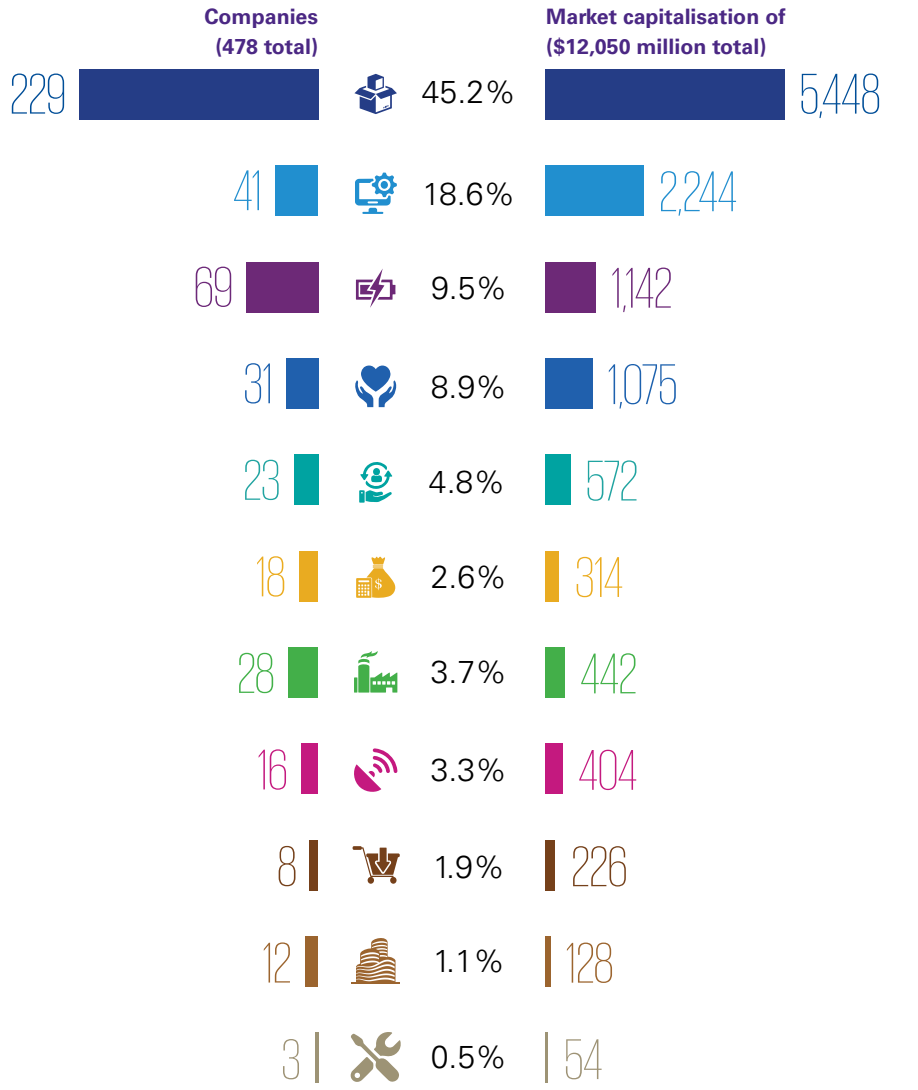
Zombies - Across the ASX - December 2020

Companies closet to default (D2D score below 1) for three 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 688 (~39 percent) companies that were analysed, displayed a D2D score below 1 (compared with 1,064 companies in June 2020). Of these, more than half fall within our definition of a 'Zombie' (478 companies, 554 in June 2020), representing a market capitalization of $12 billion. (Compared with $8.5 billion in June 2020)

Most of the 'Zombie' companies are in the Materials, Energy, and Information Technology sectors (73.3 percent and $8.8 billion in market capitalisation), with the Materials sector being the single largest (representing 45 percent and $5.4 billion in market capitalisation). We note many of these businesses are exploration companies.

Number of Zombie companies by sector and total market capitalisation*



Percentage figures are for market capitalisation

Materials | Information Technology | Energy | Healthcare | Consumer Discretionary | Financials
Industrials | Telecommunication Services | Consumer Staples | Real Estate | Utilities

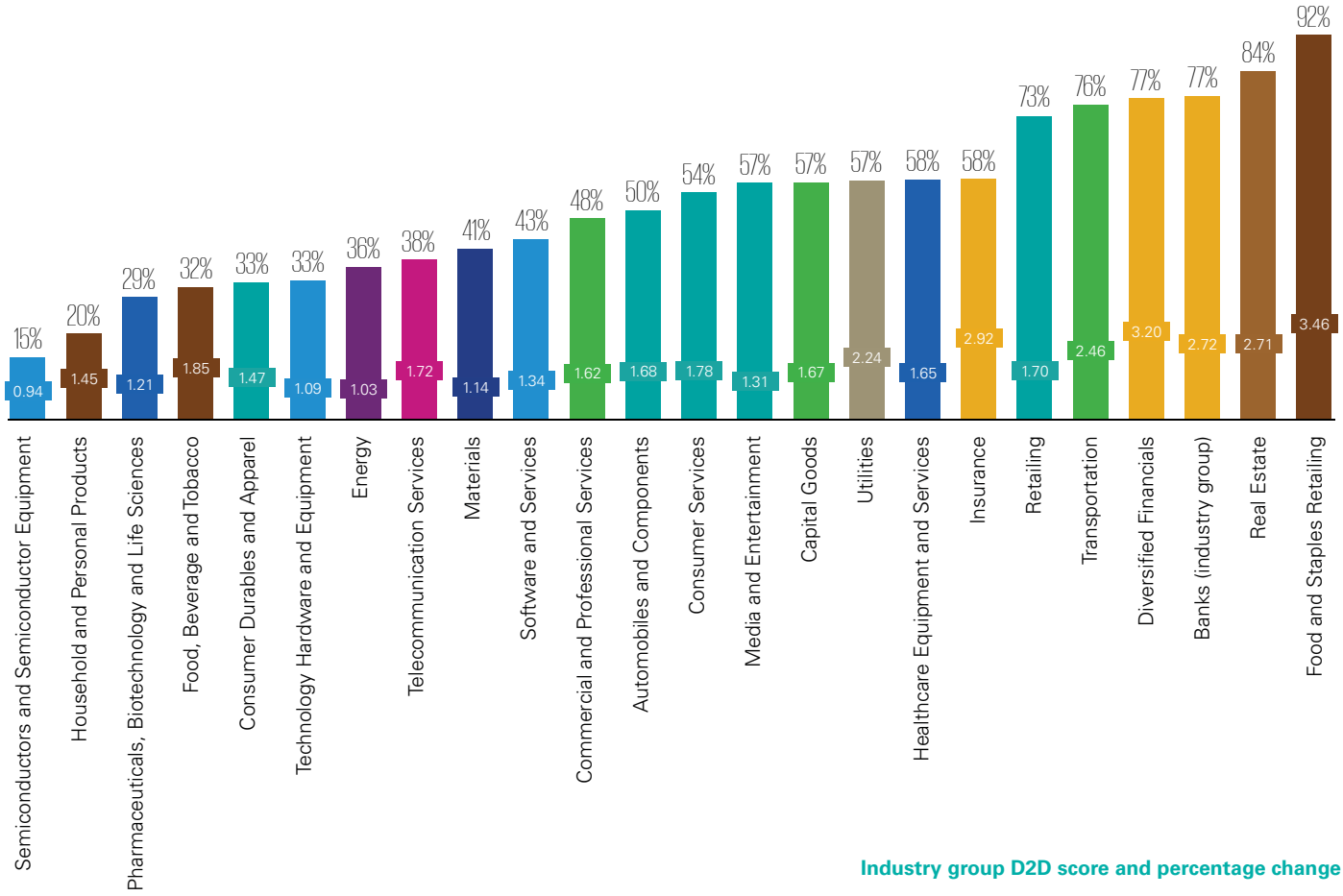
Note: The industry groups have been coloured in accordance to their respective sectors.

D2D movements by industry group - December 2020

The Food and Staples Retailing industry recorded the highest improvement in D2D score, increasing by 92.0 percent, with an average D2D score of 3.46 (up from 1.8 since June 2020).

In the following page, we dive deeper into the financial performance of the five industries with the highest increase in D2D score.

Industry group D2D score and percentage change



Industry group D2D score and percentage change

Information Technology · Industrials · Consumer Staples · Consumer Discretionary · Healthcare · Financials · Energy · Utilities · Materials · Real Estate · Telecommunication Services

Note: The industry groups have been coloured in accordance to their respective sectors.

Spotlight on the financial performance of industry groups

Of the five industries with significant D2D score increase, we have reviewed their financial performance from December 2019 to December 2020 for driving factors.

With the highest increase in D2D score

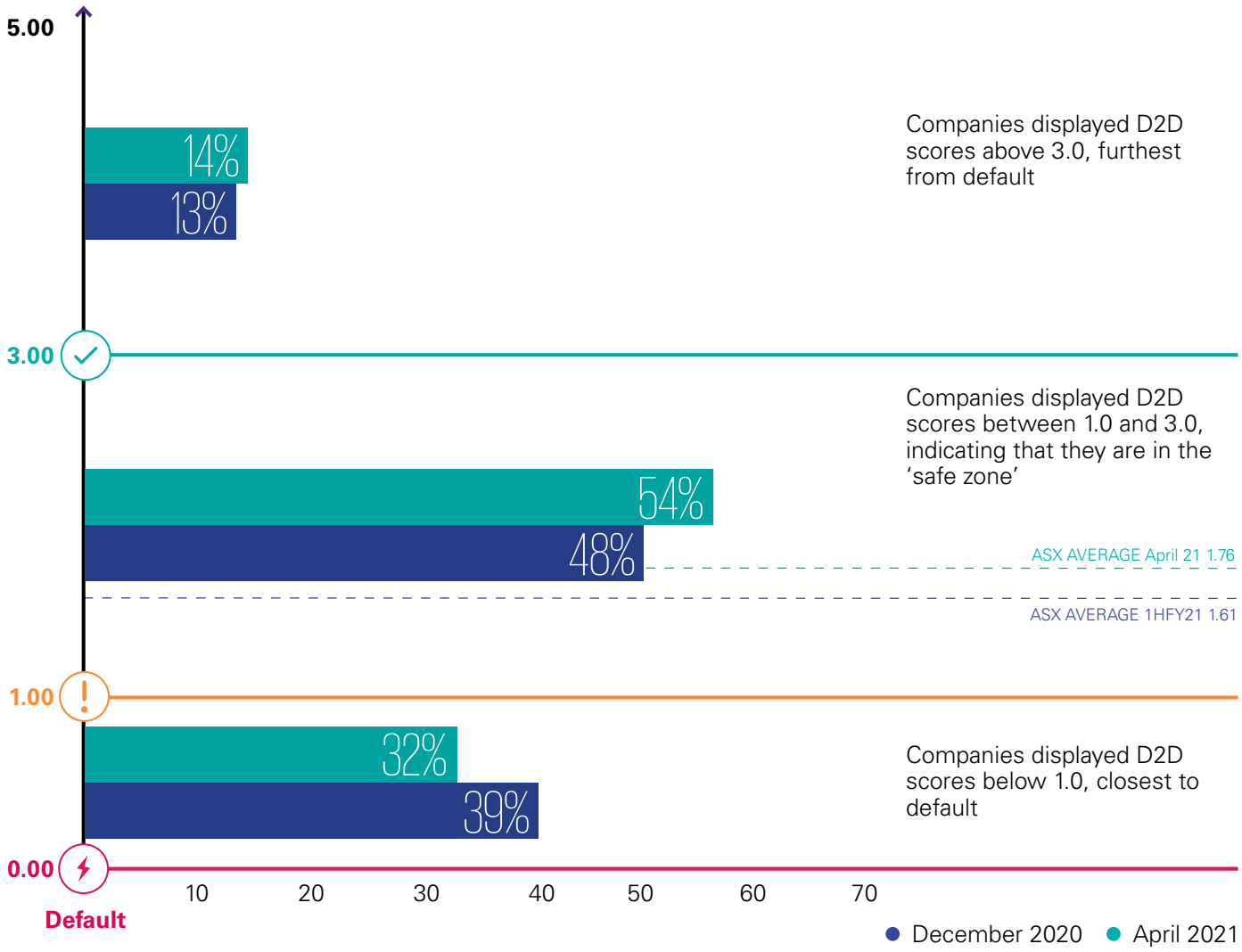
	Revenue change	Change in EBITDA	Net Operating Cash Flow	Change in Net Debt
Food and Staples Retailing (5 company financials reviewed) D2D 1HF 21: 3.46 Change: 92.0%	80% had an increase in revenue	80% had an increase in EBITDA	100% had a positive Operational Cash Flow	100% had a decrease in net debt
Real Estate (81 company financials reviewed) D2D 1HF 21: 2.71 Change: 84.0%	57% had an increase in revenue	28% had an increase in EBITDA	59% had a positive Operational Cash Flow	44% had a decrease in net debt
Diversified Financials (191 company financials reviewed) D2D 1HF 21: 3.20 Change: 77.0%	55% had an increase in revenue	17% had an increase in EBITDA	40% had a positive Operational Cash Flow	42% had a decrease in net debt
Banks (industry group) (17 company financials reviewed) D2D 1HF 21: 2.72 Change: 77.0%	47% had an increase in revenue	12% had an increase in EBITDA	71% had a positive Operational Cash Flow	71% had a decrease in net debt
Transportation (16 company financials reviewed) D2D 1HF 21: 2.46 Change: 76.0%	50% had an increase in revenue	38% had an increase in EBITDA	56% had a positive Operational Cash Flow	56% had a decrease in net debt

D2D scores across the ASX - April 2021

With the current market conditions, the average ASX D2D score increased by 9.3 percent to 1.76 (compared with 1.61 as at December 2020). The change in the average D2D score was underpinned by the significant market upturn that saw 63 percent of companies registering an increase to their D2D score from December 2020.

63%

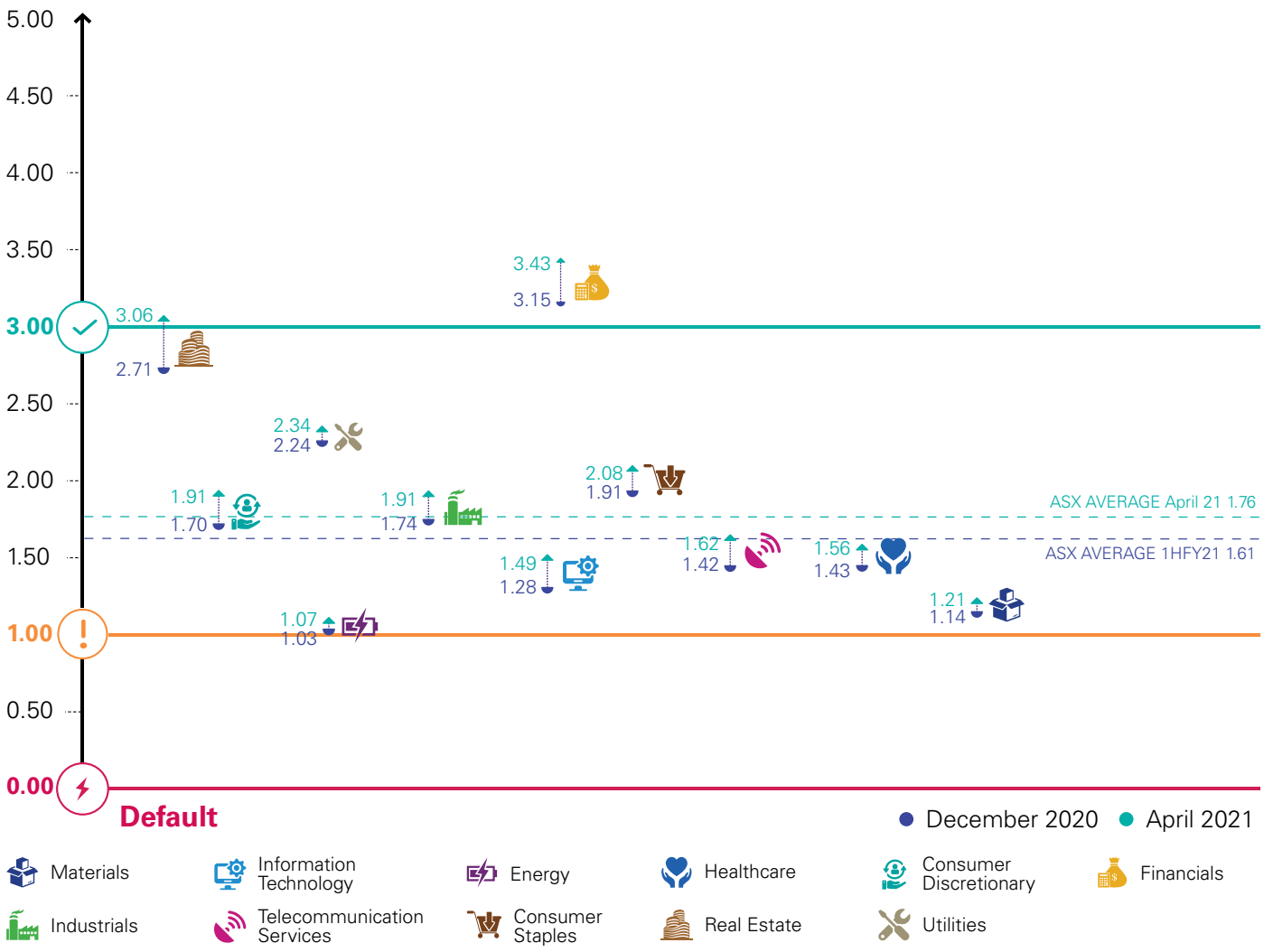
of companies showed an increase in their D2D score from 31 December 2020 to 30 April 2021



D2D movement by sector - April 2021

All the 11 sectors analysed showed an overall increase in their D2D score from December 2020, with the largest sector increase being:

- Information Technology (16.5 percent with a D2D score of 1.49);
- Telecommunication Services (14.1 percent with a D2D score of 1.62); and
- Real Estate (13.2 percent with a D2D score of 3.06).



Note: The industry groups have been coloured in accordance to their respective sectors.

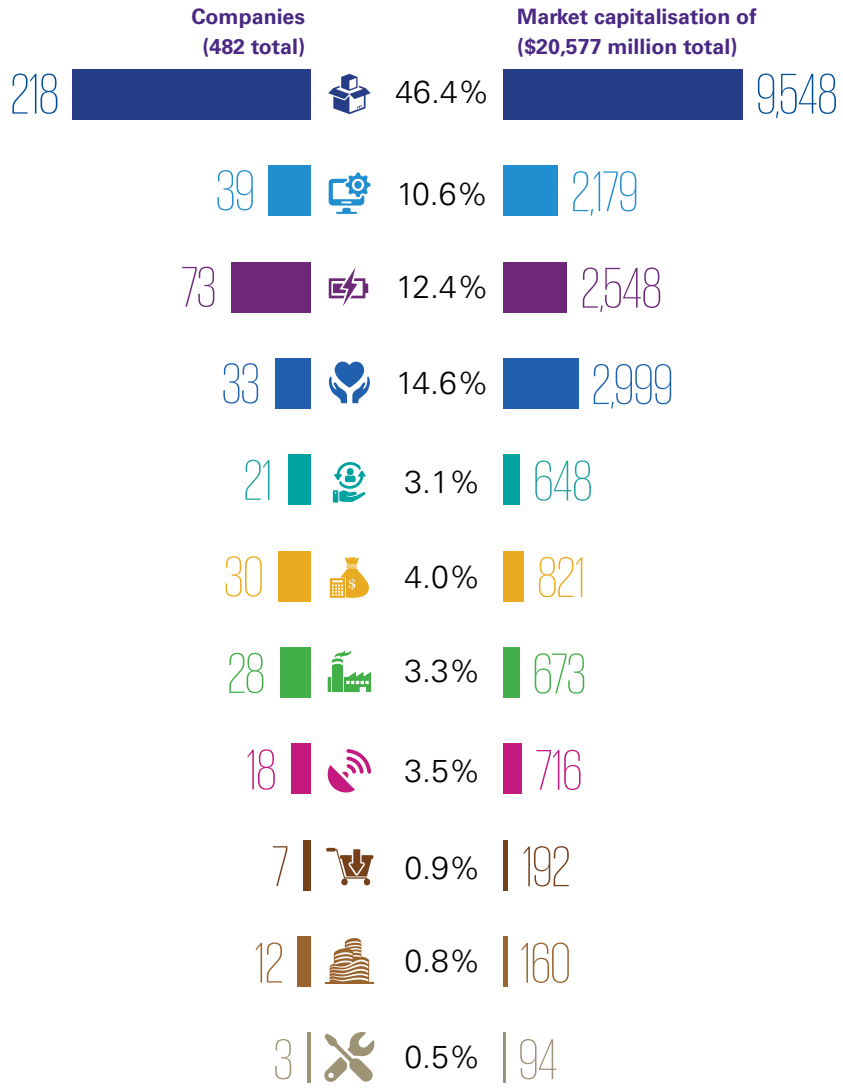
Zombies - Across the ASX - April 2021

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

A total of 573 (~32 percent) companies that were analysed, displayed a D2D score below 1 (compared to 688 companies in December 2020). Of that, more than half fall within our definition of a 'Zombie' (482 companies, 478 in December 2020), representing a market capitalization of $20.6 billion. (Compared with $12 billion in December 2020)

Most of the 'Zombie' companies are in the Materials, Energy, and Information Technology sectors (69.4 percent and $14.3 billion in market capitalisation), with the Materials sector being the single largest (representing 46.4 percent and $9.5 billion in market capitalisation).

Number of Zombie companies by sector and total market capitalisation*



Percentage figures are for market capitalisation

Materials · Information Technology · Energy · Healthcare · Consumer Discretionary · Financials · Industrials · Telecommunication Services · Consumer Staples · Real Estate · Utilities

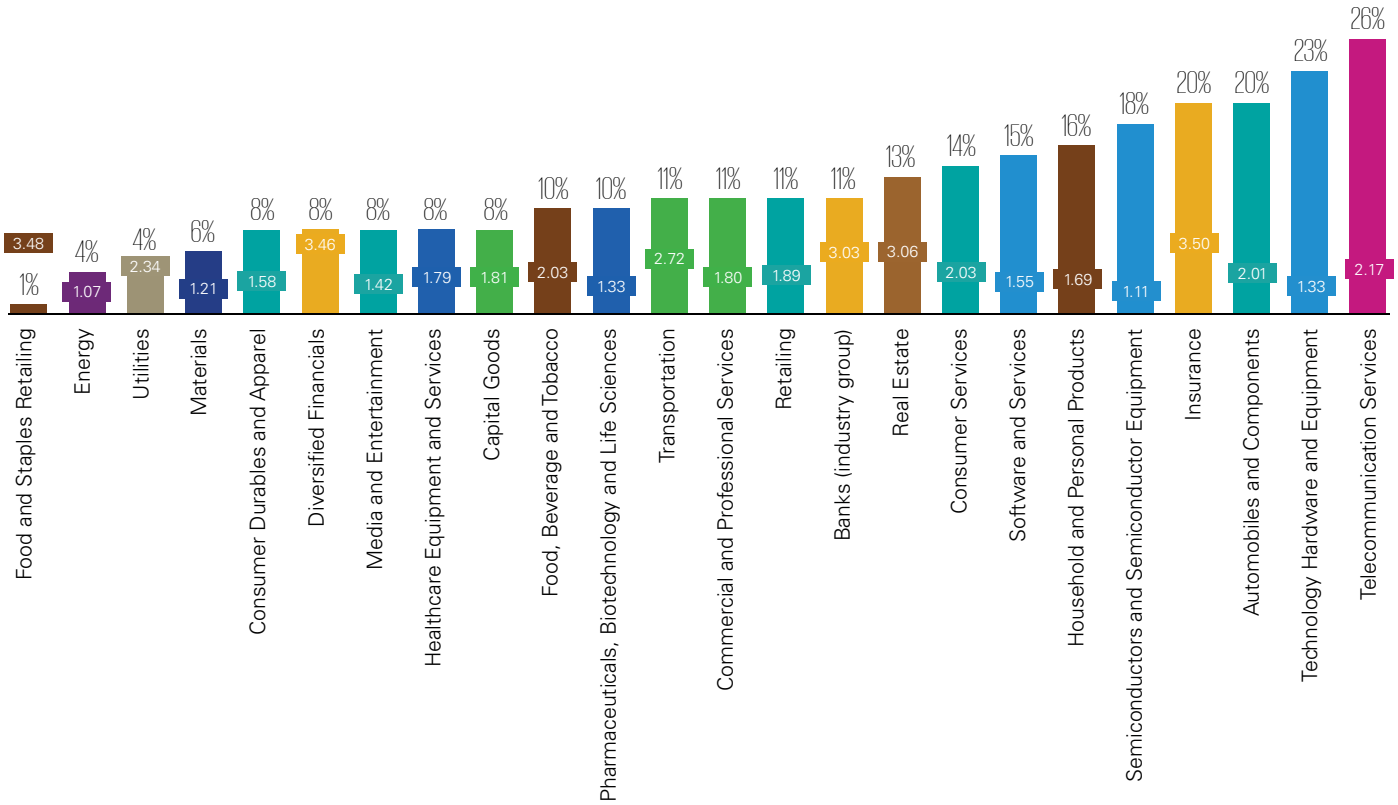
Note: The industry groups have been coloured in accordance to their respective sectors.

D2D movements by industry group – April 2021

All industry groups analysed showed an overall increase in their D2D score from December 2020 with the largest industry group increase being:

- Telecommunication Services (26 percent with a D2D score of 2.17);
- Technology Hardware and Equipment (23 percent with a D2D score of 1.33); and
- Automobiles and Components (20 percent with a D2D score of 2.01).

Industry group D2D score and percentage change



Industry group D2D score and percentage change

Information Technology · Industrials · Consumer Staples · Consumer Discretionary · Healthcare · Financials · Energy · Utilities · Materials · Real Estate · Telecommunication Services

Note: The industry groups have been coloured in accordance to their respective sectors.

New Zealand

We have included New Zealand for the first time in this publication, given the close economic ties and banking relationships Australia shares with New Zealand.

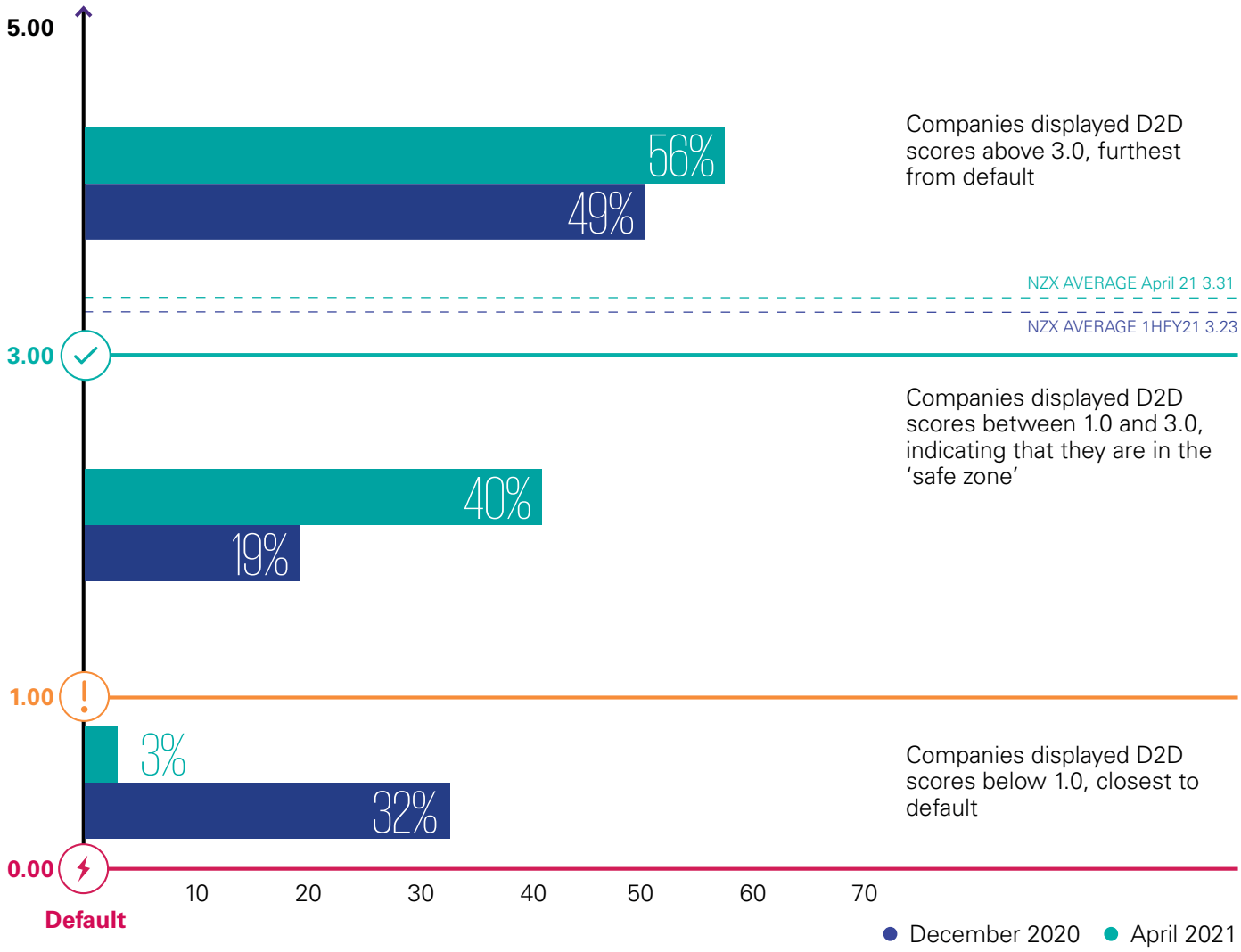
Including analysis on the NZX enables our readers from New Zealand or with exposure to the New Zealand market to understand what is happening in the market and its relevant sectors, over time. We note that certain aspects of the New Zealand market make it challenging to draw meaningful comparisons with the Australian D2D results; in particular we note that the New Zealand economy is smaller and the NZX has a significantly smaller sample size which means sector and overall results can be distorted by outlier performance. Therefore, we caution readers on drawing too much comparison between the NZX and ASX.

D2D scores across the NZX – April 2021

With the current market conditions, the average NZX D2D score increased by 2.5 percent to 3.31 (compared with 3.23 as at December 2020). The change in the average D2D score was underpinned by the significant market upturn that saw 55 percent of companies registering an increase to their D2D score from December 2020.

55%

of companies showed an increase in their D2D score from 31 December 2020 to 30 April 2021

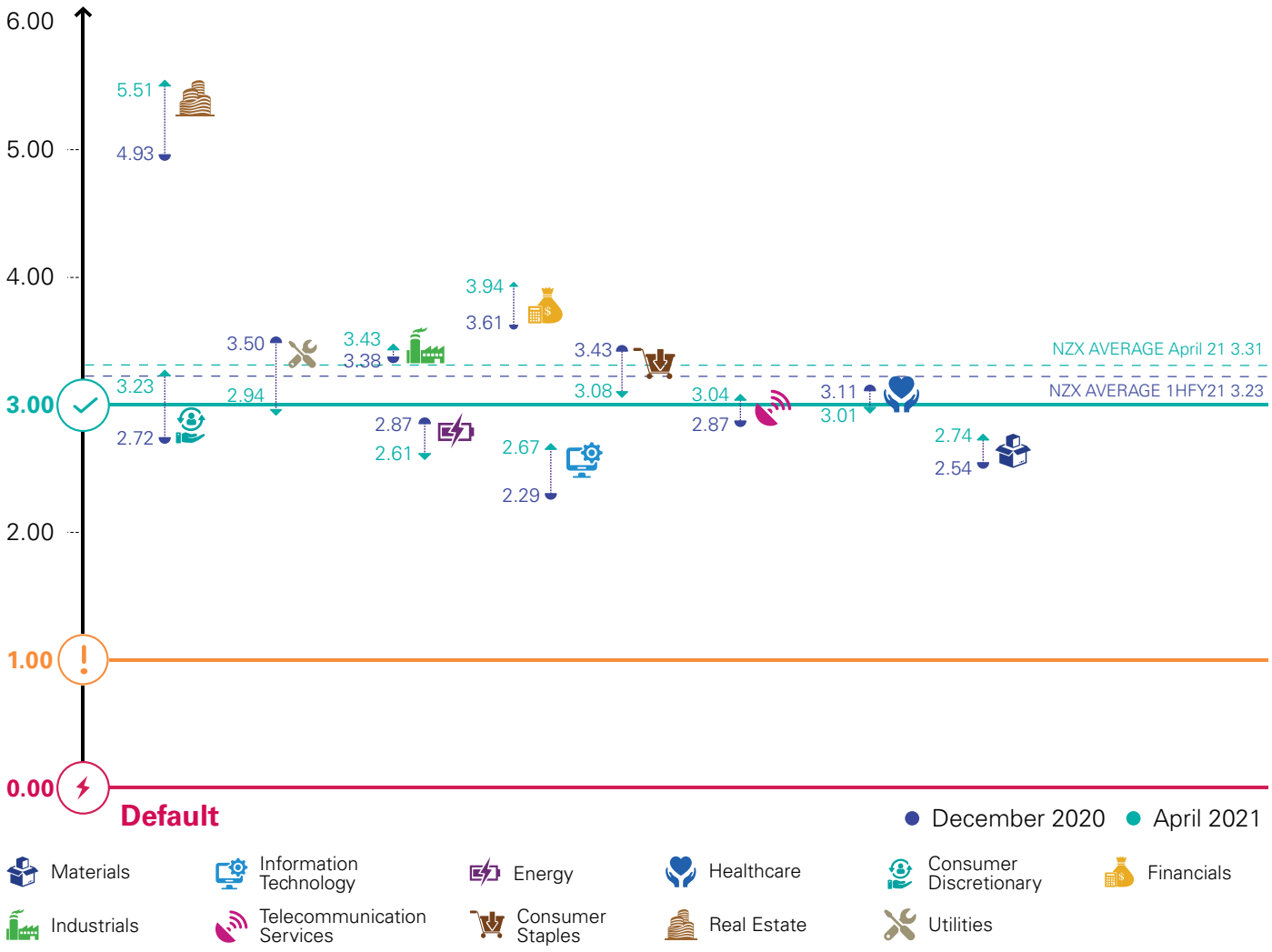


D2D movement by sector - April 2021

Of the 11 sectors analysed, seven showed an overall increase in their D2D score from December 2020 with the largest sector increase being:

- Consumer Discretionary (18.9 percent with a D2D score of 3.23);
- Information Technology (16.4 percent with a D2D score of 2.67);
- Real Estate (11.8 percent with a D2D score of 5.51).

The remaining four sectors showed a decline in their D2D score for the period with the largest sector decline being Utilities (16.1 percent with a D2D score of 2.94)



Note: The industry groups have been coloured in accordance to their respective sectors.

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 impact 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 are 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).

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