COVID-19: financial resilience - restoring value

A private equity lens

The response from HM Government to the COVID-19 outbreak has been wide ranging and continues to evolve, many of the crucial support options available to fund the loss making disruption period have significant longer term consequence for balance sheets. A build up of trade, Crown and debt financing liabilities have the potential to erode medium and longer term equity value.

> "We know that many private equity houses have worked exceptionally hard to help businesses within their portfolio respond to the COVID-19 funding challenge. Whilst implementing the tactical short term measures required to sustain day-to-day liquidity, they must also take the time to elevate above the crisis and look ahead to understand the longer-term impact on balance sheets.
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> We are already supporting a number of houses modelling scenarios with increased debt and liability levels, identifying funding requirements for the recovery phase as well as the potential levers available to protect shareholder value.
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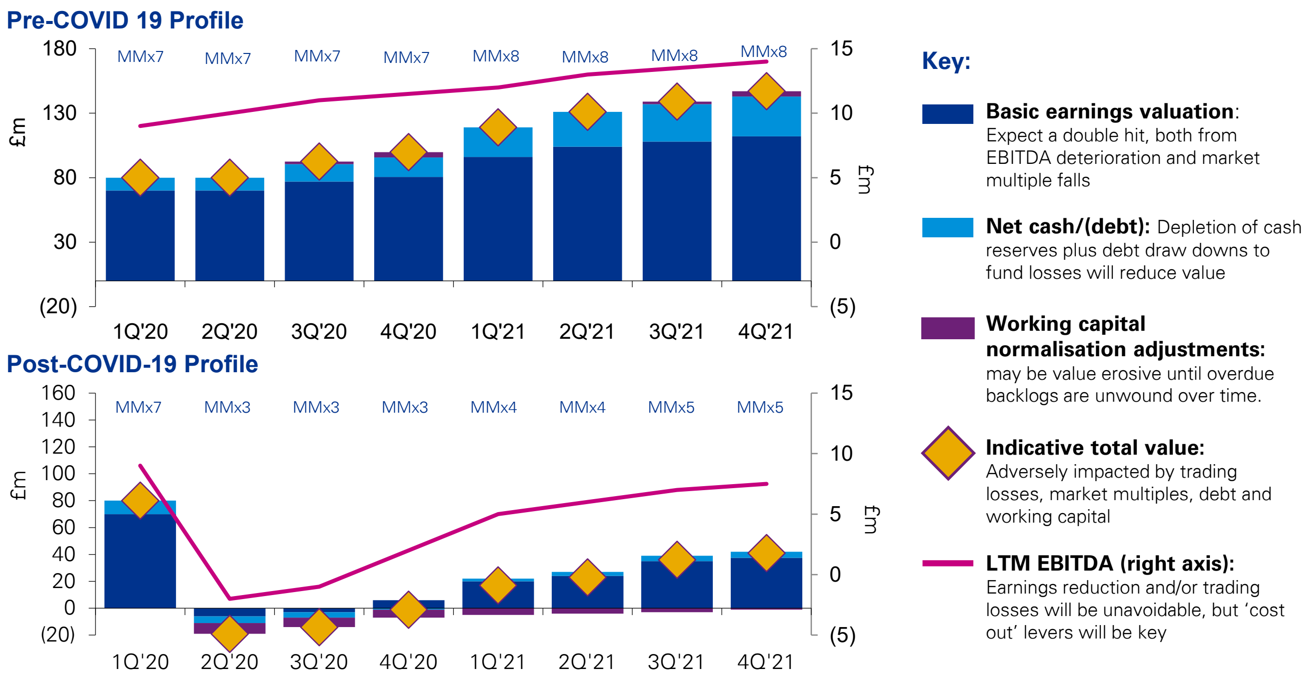
> **Rick Harrison, KPMG partner and private equity leader for restructuring**

Step 1 Understanding the post-COVID-19 balance sheet

- Do you and/or your portfolio company management understand how different their balance sheet is likely to look as the economy emerges from the acute disruption period?
- Have you assessed the sustainability of that model, and the assumptions that have been used?
- What assumptions have been made around the unwind, and are these realistic e.g. sustained low/no interest loans, rapid uptick in demand, cost reductions? Have the assumptions been fully stress tested?
- How does the servicing and amortisation of the total debt burden (including trade creditors, Crown arrears and external borrowing) impact on ongoing working capital requirements?



Step 2 Identifying alternatives to debt funding support options

The recovery phase will place incremental funding requirements on portfolio balance sheets from growth trajectories, working capital unwind and debt servicing. Additional debt capacity is likely to be limited – other options might include:

Reset the cost and working capital base
- Embed 'forced gains' on cost and cash as sustainable BAU where possible
- Revisit 'normalised' working capital parameters

Additional equity injection
- Unlikely to be attractive if just funding deferred losses
- Short-term cover may become long-term

Full disposal
- Sub-optimal outcome – limited range of buyers
- No/low equity value remaining

Partial disposal
- Potential impact on lender security
- Subdued buyer appetite
- Impact on and/or value of residual operations

Financial restructuring
- Debt-for-equity and similar likely to disproportionately impact PE owners
- Only covers financial debt, not Crown/trade debts

Strategic factors
- As-yet-unseen strategic response from HM Gov to corporate re-capitalisation
- The fiscal response over the long-term to 'claw back'

Step 3 Consider contingency options to kick-start equity value recovery

Material equity value erosion from COVID-19 may be unavoidable given trading losses being incurred in the disruption period. Delaying a recovery of that equity value or enduring the burden of a value deficit in the longer term is not.

Company Voluntary Arrangement (CVA)

CVAs are a contract between a corporate entity and its creditors to compromise present and future liabilities in a stressed or distressed situation where no solvent solution is available.

CVAs are most useful for entities with a viable underlying business but which need to compromise only some of its liabilities (e.g. long-term property or other asset leases) or where a business is seeking to write off debts in a tax-efficient manner.

Administration (including 'pre-pack' appointments)

In some cases administration may be an appropriate step for businesses that have immediate and significant cash constraints whilst facing a prolonged period of business hibernation. One possible exit option would be a sale out of administration once the acute phase of economic disruption recedes.

'Pre-pack' administrations may be suitable where there are few potential buyers and a sale to the existing owner will maximise return for the creditor body.

In all situations it is critical to seek expert Restructuring advice before committing to a course of action, as not all possible options will be suitable for every business.

Insolvency legislation is also being reviewed to adapt to the extreme economic circumstances, which may open up options to protect stakeholder value and more effectively support employees, customers and suppliers.

Step 4 How KPMG can help

- **Financial Modelling** Our team can support you or your portfolio model and stress-test immediate or longer-term cash forecasts and underlying assumptions
- **Cash and working capital** – Identify and implement significant working capital savings using our unique "data heavy" tools
- **Options Analysis** Although the environment is extreme, our robust and proven methodology can support PE owners work through the financial, legal and practical implications of each option.
- **End-to-end implementation** We can support PE houses navigate this uncertain economic environment and protect stakeholder value.

Key contacts

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