

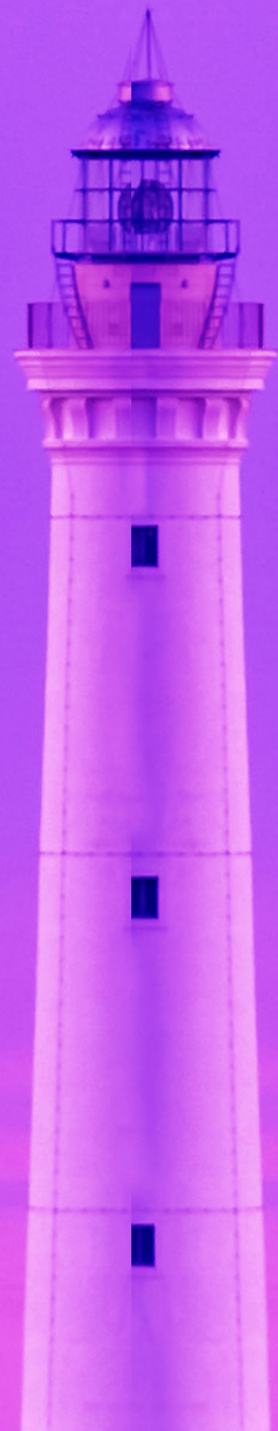
DISTANCE TO DEFAULT

VOLUME 10

Insights into the corporate health
of Australian listed companies

January 2022

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FOREWORD

We are pleased to share with you the tenth 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 June 2021. We have also conducted our D2D analysis as of October 2021 and we observed an increase to the average D2D score (i.e. an improvement in corporate health) between June 2021 and October 2021 from 1.84 to 1.95.

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. We have also seen strong growth in the **Information Technology sectors** which we highlight below.

MARKET OBSERVATIONS

- The latest D2D score of 1.95 is not only better than pre-pandemic levels (1.88 at December 2019) but also the strongest D2D score since 2018.
- The market continues to remain buoyant with strong M&A and deal activity and record low insolvency appointments (c.40 percent lower on average compared to pre-pandemic). These lower than average insolvency levels are despite corporates having been weaned off government stimulus in recent months. There have been a number of key drivers supporting the recovery in the market:
 - low interest rates
 - resilient consumer spending
 - stakeholder support and debt negotiation (Australian Taxation Office, lenders, landlords); and
 - access to debt and capital.
- Looking to 2022, whilst there remains continued expectations of strong M&A and deal activity, there are a number of factors which may impact corporate health:
 - an election to be held before the end of May 2022, and absence of clarity on possible details on spending or tax changes
 - ongoing supply chain bottlenecks and pressure, particularly in certain sectors such as Automotive due to the short supply in semi-conductors
 - inflation and pressures around potential interest rate rises
 - pressure on labour supply and migration skilled and core services workers
 - continued risk of vaccine resilient strains of COVID-19 and ongoing impact of ‘quasi lockdowns’ particularly on hospitality, retail, non-essential health and logistics among others
 - global uncertainty and geo-political tensions particularly across the global superpowers.

SECTOR INSIGHTS:

COVID-19 has been a driver of digital transformation

- This issue we highlight the increase in D2D score for the Information Technologies sector, being the largest increase of any sector compared to pre-COVID (1.31 in December 2019 to 1.59 in October 2021 – 21 percent increase).
- Pre-COVID, many businesses were travelling at varying speeds on a journey towards a digital business model. The scale of the pandemic has forced an acceleration, both in the speed of change and the required investment in digital transformation.
- Not only is digital agility now an operational necessity for organisations to refocus priorities and adapt quickly, but how they do that matters. Many organisations are already building environmental, social and corporate governance (ESG) metrics into business cases.
- According to KPMG’s 2020 global survey, organisations are investing heavily in technology to address immediate concerns like falling revenue and interrupted supply chains, and to build longer term competitiveness and resilience. Seven out of 10 digital leaders in the survey report that their digital transformation efforts have put them months, or even years, ahead of where they expected to be pre-pandemic.



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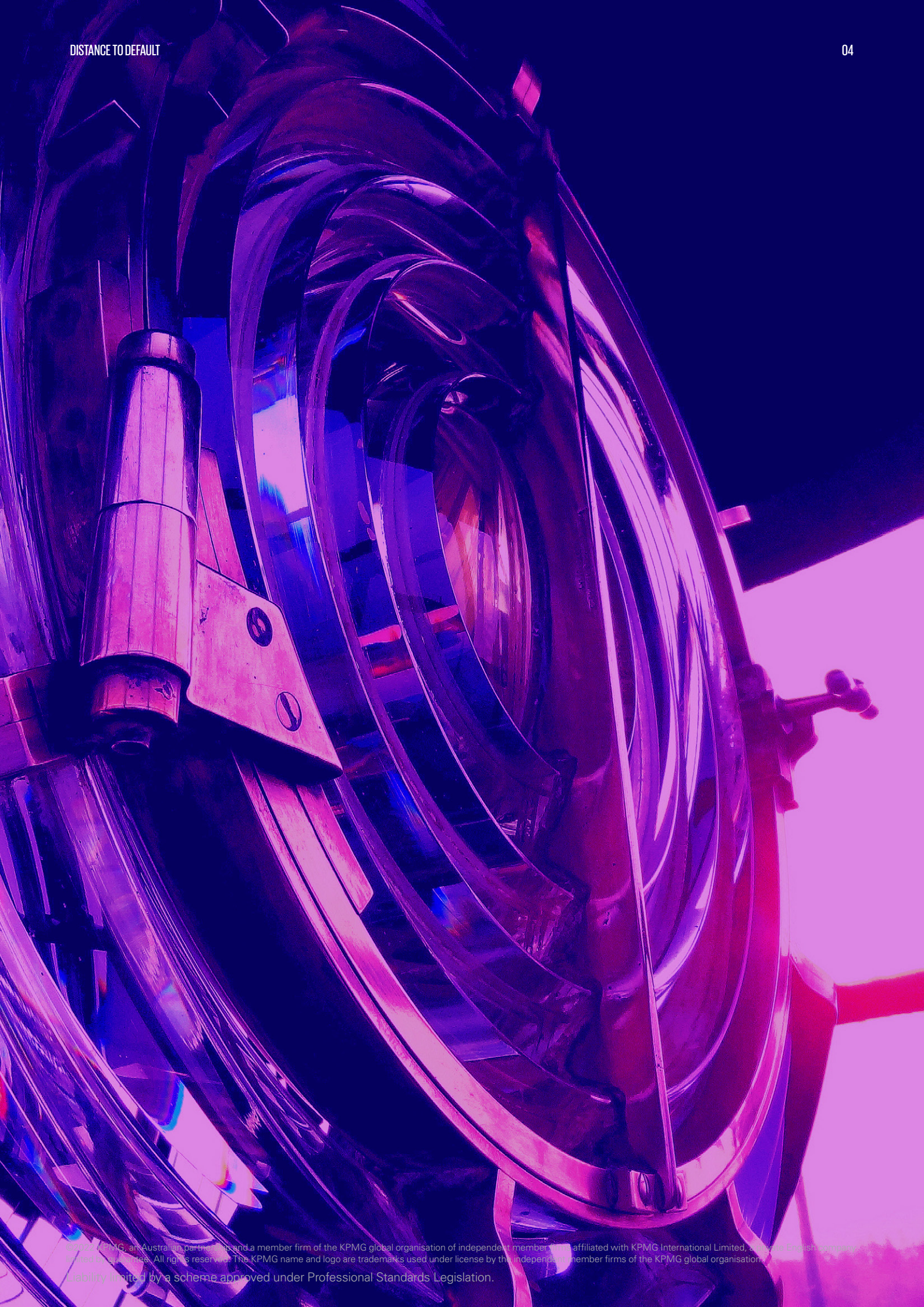


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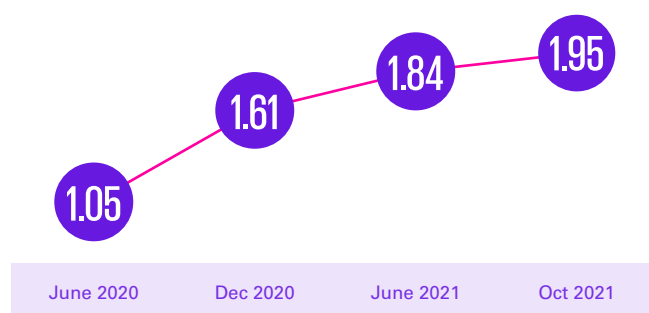
KEY FINDINGS

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

Following the D2D score of 1.05 in June 2020 (immediately post COVID), we have observed a steady increase to a D2D score of 1.95 at October 2021, highlighting the Australian government's efforts toward economic recovery.



KEY MOVEMENTS IN D2D SCORES BY INDUSTRY GROUP

	From Dec 2020 to June 2021	From June 2021 to Oct 2021
Semiconductors and Semiconductor Equipment	36% ↑ (1.27)	2% ↓ (1.25)
Technology Hardware and Equipment	33% ↑ (1.45)	2% ↑ (1.47)
Insurance	31% ↑ (3.82)	3% ↑ (3.93)
Real Estate	29% ↑ (3.49)	3% ↑ (3.59)
Telecommunication Services	25% ↑ (2.16)	2% ↓ (2.11)

NUMBER OF ZOMBIE COMPANIES BY SECTOR AND TOTAL MARKET CAPITALISATION

From Dec 2020 to June 2021			From June 2021 to Oct 2021	
No. of companies	Market capitalisation (%)		No. of companies	Market capitalisation (%)
130	46%	Materials	124	50%
48	17%	Energy	55	25%
19	13%	Information Technology	15	14%

A total of 278 companies representing a market capitalisation of \$12.5 billion are classified as zombies.

D2D scores across the ASX – June 2021

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 D2D score combines both financial information and market information to determine a company's relative 'Distance to Default' (or D2D score).

KPMG Restructuring Services believes that combining the two types of information detects deteriorating corporate health more effectively than either source alone.

The tenth 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 June 2021. 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 1.84 (compared with 1.61 as at December 2020).

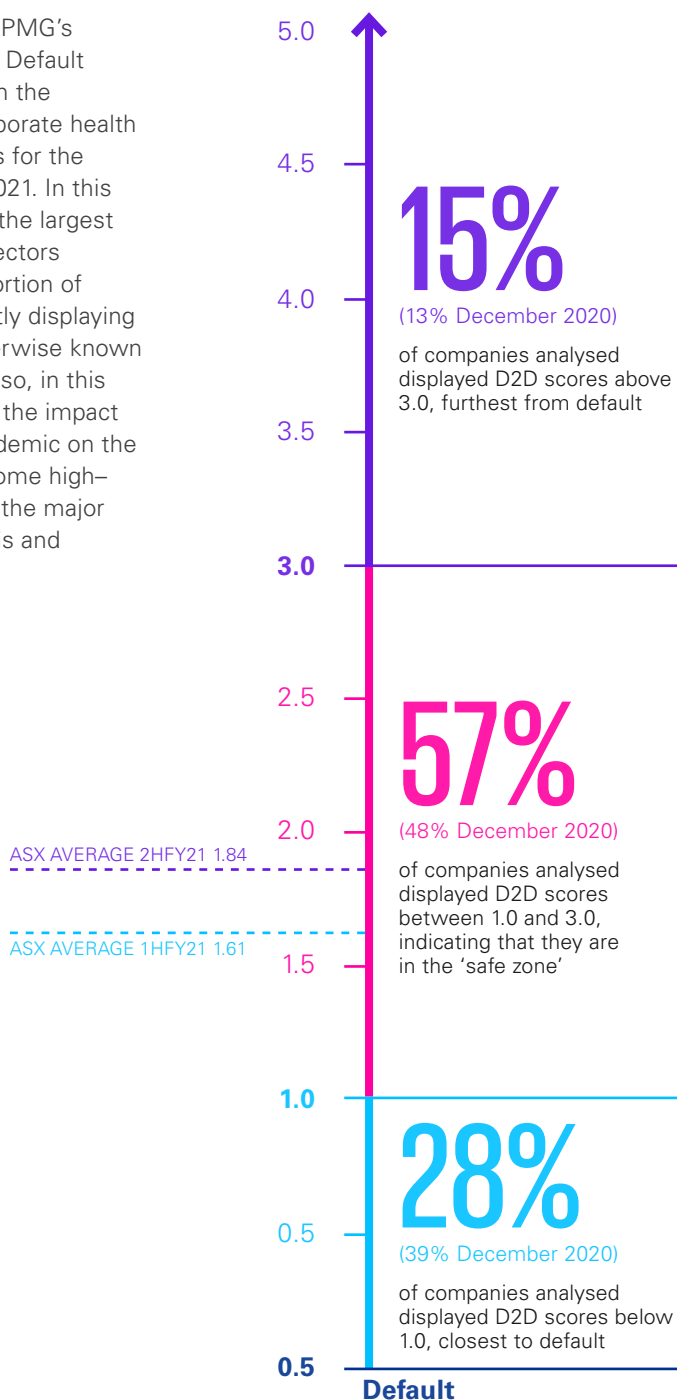
The increase in the average ASX D2D score was underpinned by a divergence amongst companies:

59%

of companies had an increase in their D2D score;

34%

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

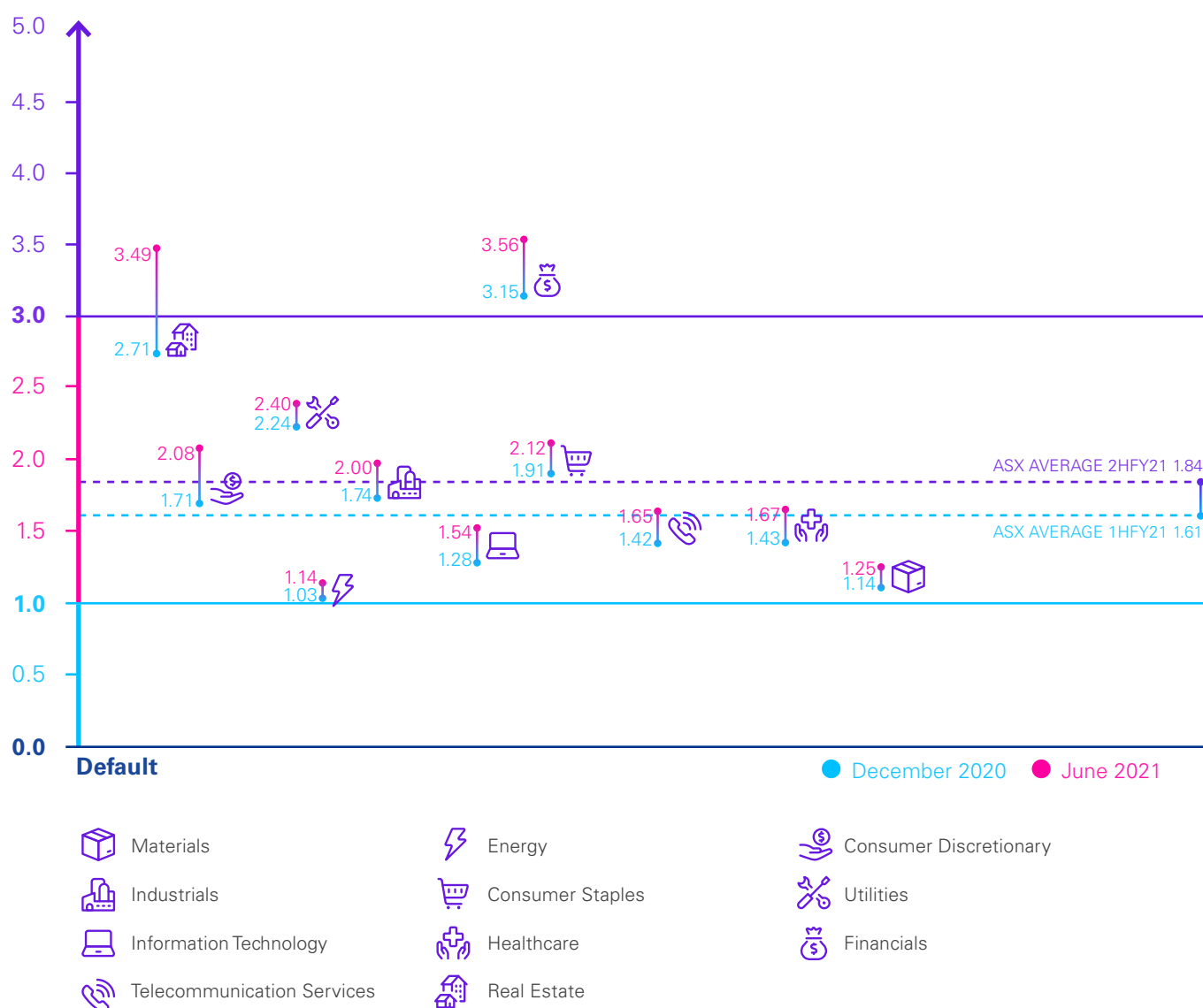


D2D movement by sector – June 2021

Over the past six months up to June 2021:

- the largest sector increase was in Real Estate, rising by 28.9 percent, with a D2D score of 3.49
- all 11 sectors had an overall increase to the D2D score compared with none of the 11 sectors in December 2020 (Volume 9 of this report).

All sectors showed an overall increase in the D2D score in the last six months up to June 2021. The Financials and Real Estate sectors continue to display the highest D2D scores, delivering a score of 3.56 and 3.49, respectively. Energy, Materials and Information Technology continue to display the lowest overall D2D scores, or the scores closest to default.

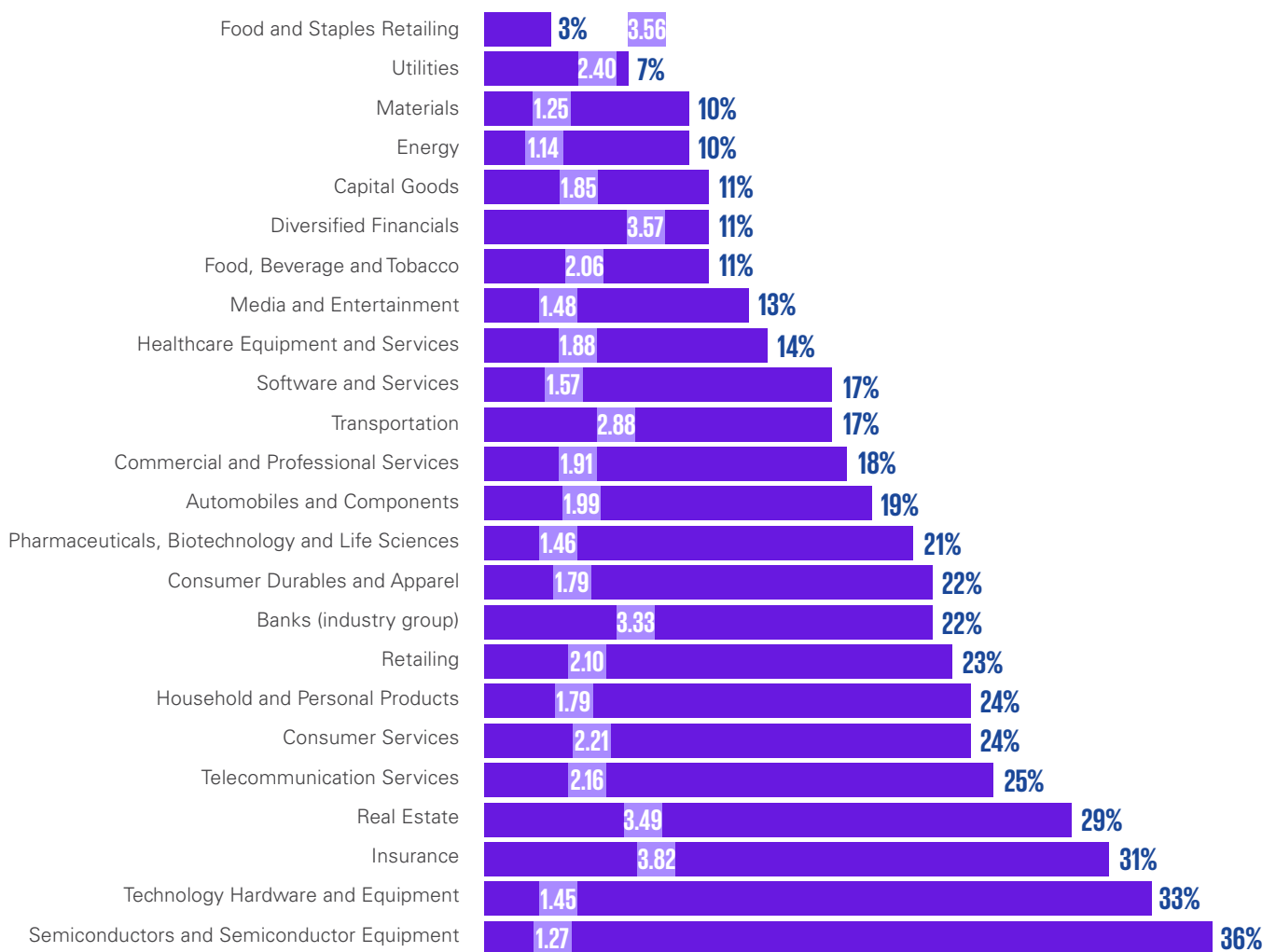


D2D movements by industry group – June 2021

The Semiconductors and Semiconductor Equipment industry recorded the largest improvement in D2D score, increasing by 36 percent, with an average D2D score of 1.27 (up from 0.94 since December 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



Information Technology

Consumer Discretionary

Energy

Real Estate

Industrials

Healthcare

Utilities

Telecommunication Services

Consumer Staples

Financials

Materials












Zombies – Across the ASX – June 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 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 505 (~28 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' (279 companies, 478 in December 2020), representing a market capitalization of \$12.5 billion. (Compared to \$12 billion in December 2020)

Most of the 'zombie' companies are in the Materials, Energy, Information Technology and Industrials sectors (77.4 percent and \$9.9 billion in market capitalisation), with the Materials sector being the single largest (representing 47 percent and \$5.7 billion in market capitalisation).

Number of Zombie companies by sector and total market capitalisation*

		Companies (279 total)		Market capitalisation of (\$12,518 million total)
 Materials	130	<div></div>	45.9%	5,750
 Information Technology	19	<div></div>	13.5%	1,689
 Energy	48	<div></div>	17.2%	2,158
 Healthcare	12	<div></div>	9.4%	1,180
 Consumer Discretionary	11	<div></div>	4.0%	495
 Financials	14	<div></div>	2.0%	251
 Industrials	19	<div></div>	2.7%	336
 Telecommunication Services	11	<div></div>	3.6%	455
 Consumer Staples	5	<div></div>	0.7%	88
 Real Estate	7	<div></div>	0.6%	73
 Utilities	3	<div></div>	0.3%	43

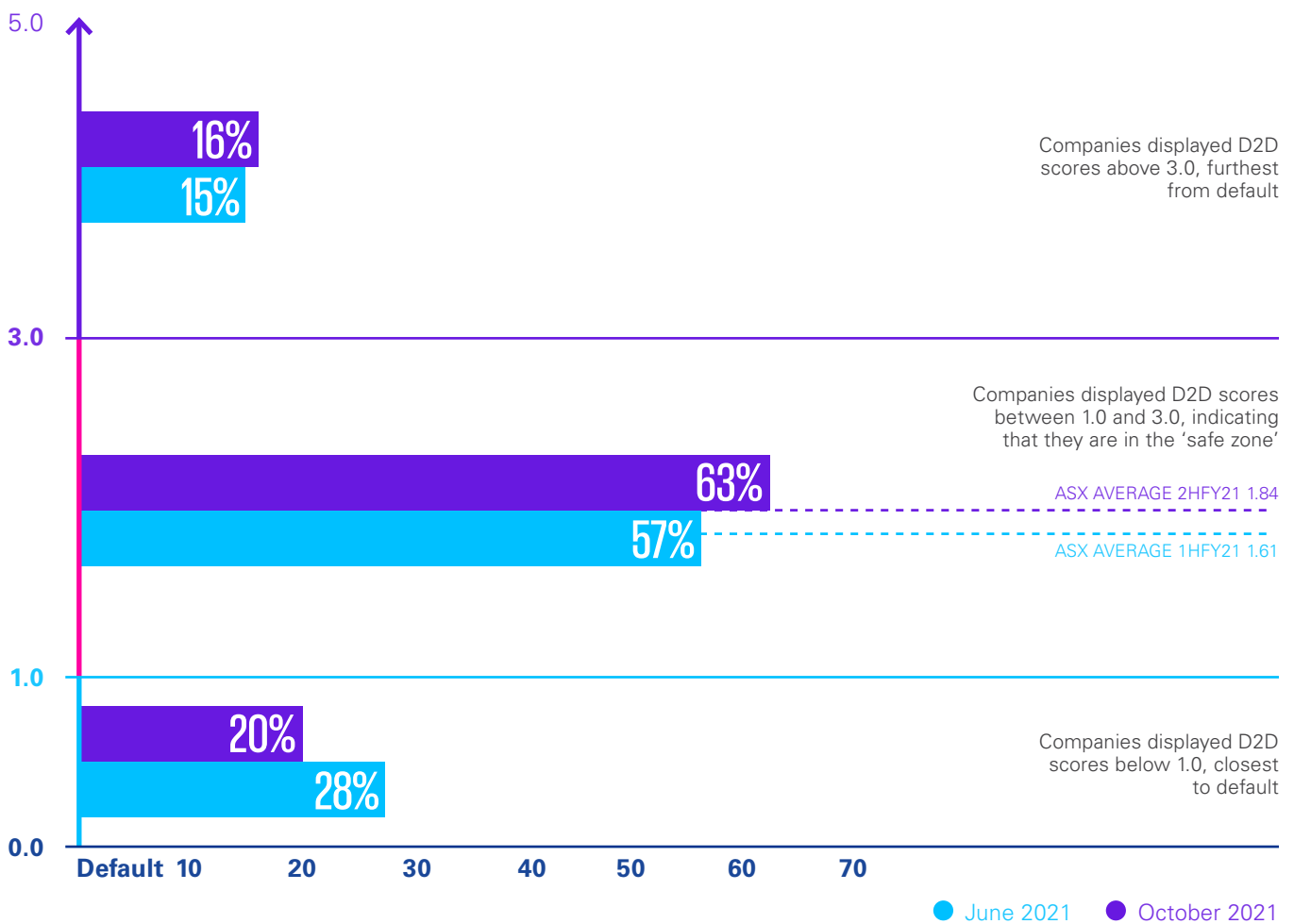
Spotlight on the financial performance of industry groups

	REVENUE CHANGE	CHANGE IN EBITDA	NET OPERATING CASH FLOW	CHANGE IN NET DEBT
SEMICONDUCTORS AND SEMICONDUCTOR EQUIPMENT INDUSTRY (8 company financials reviewed) D2D 2HF 21: 1.27 Change: 36%	50% had an increase in revenue	63% had an increase in EBITDA	0% had an increase in Operating Cash Flow	63% had an increase in net debt
TECHNOLOGY HARDWARE AND EQUIPMENT (29 company financials reviewed) D2D 2HF 21: 1.45 Change: 33%	55% had an increase in revenue	52% had an increase in EBITDA	38% had an increase in Operating Cash Flow	69% had an increase in net debt
INSURANCE (10 company financials reviewed) D2D 2HF 21: 3.82 Change: 31%	90% had an increase in revenue	80% had an increase in EBITDA	90% had an increase in Operating Cash Flow	60% had an increase in net debt
REAL ESTATE (70 company financials reviewed) D2D 2HF 21: 3.49 Change: 29%	66% had an increase in revenue	43% had an increase in EBITDA	84% had an increase in Operating Cash Flow	53% had an increase in net debt
TELECOMMUNICATION SERVICES (17 company financials reviewed) D2D 2HF 21: 2.16 Change: 25%	71% had an increase in revenue	82% had an increase in EBITDA	76% had an increase in Operating Cash Flow	47% had an increase in net debt

D2D scores across the ASX – October 2021

With the current market conditions, the average ASX D2D score increased by 6.0 percent to 1.95 (compared with 1.84 as at June 2021). The change in the average D2D score was underpinned by the significant market upturn that saw 60 percent of companies registering an increase to their D2D score from June 2021.

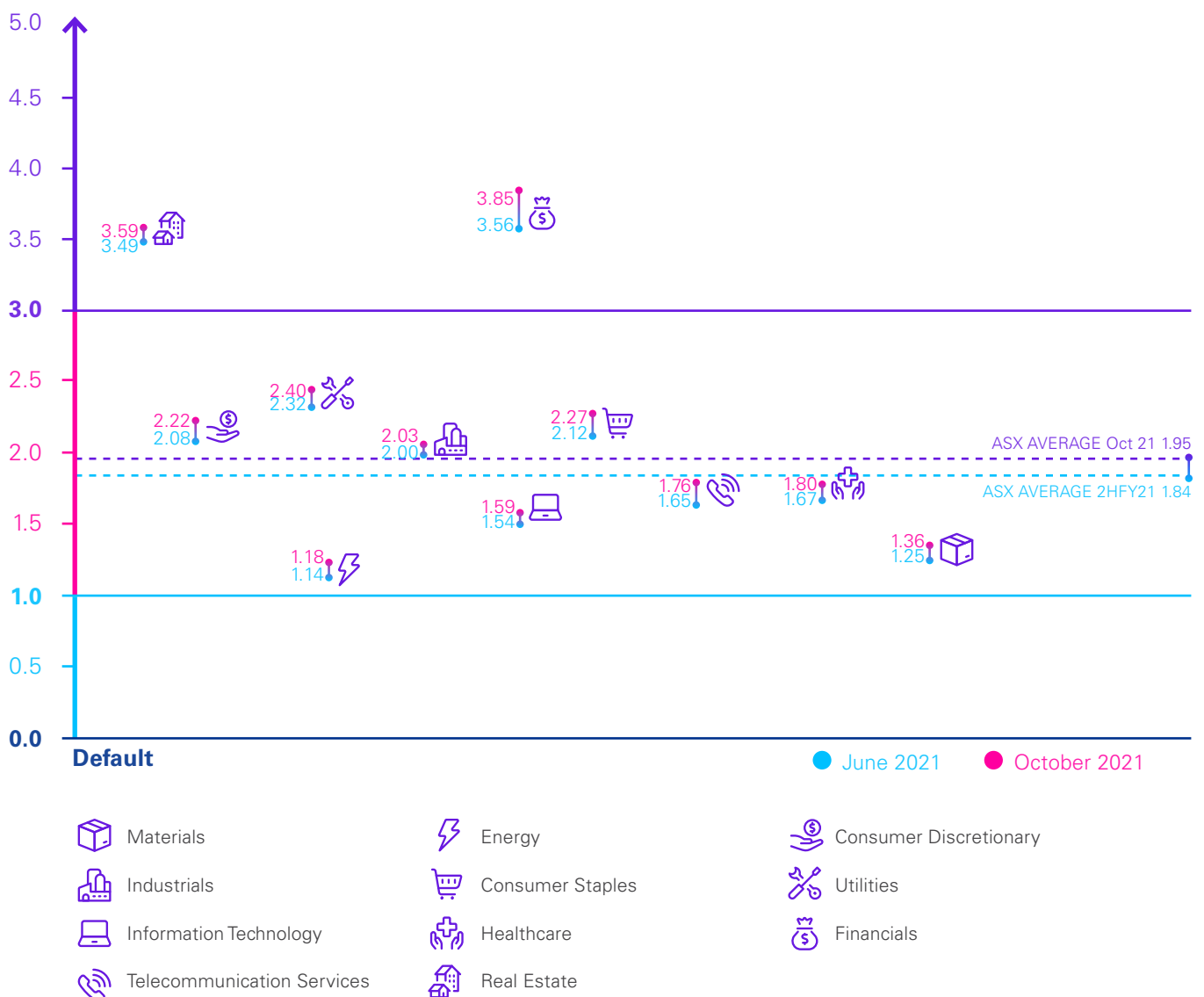
60% of companies showed an increase in their D2D score from 31 June 2021 to 30 October 2021.



D2D movement by sector – October 2021

10 out of the 11 sectors analysed showed an overall increase in their D2D score from June 2021 with the largest sector increase being:

- Materials (8.4 percent with a D2D score of 1.36)
- Financials (8.0 percent with a D2D score of 3.85)
- Healthcare (7.8 percent with a D2D score of 1.80).

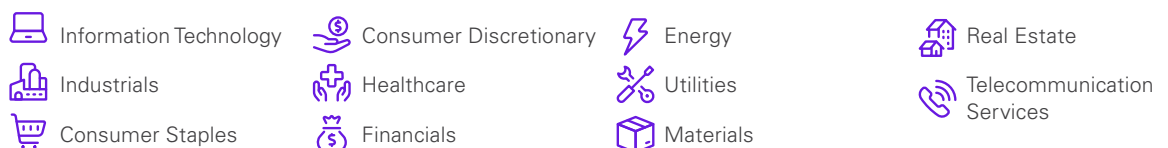
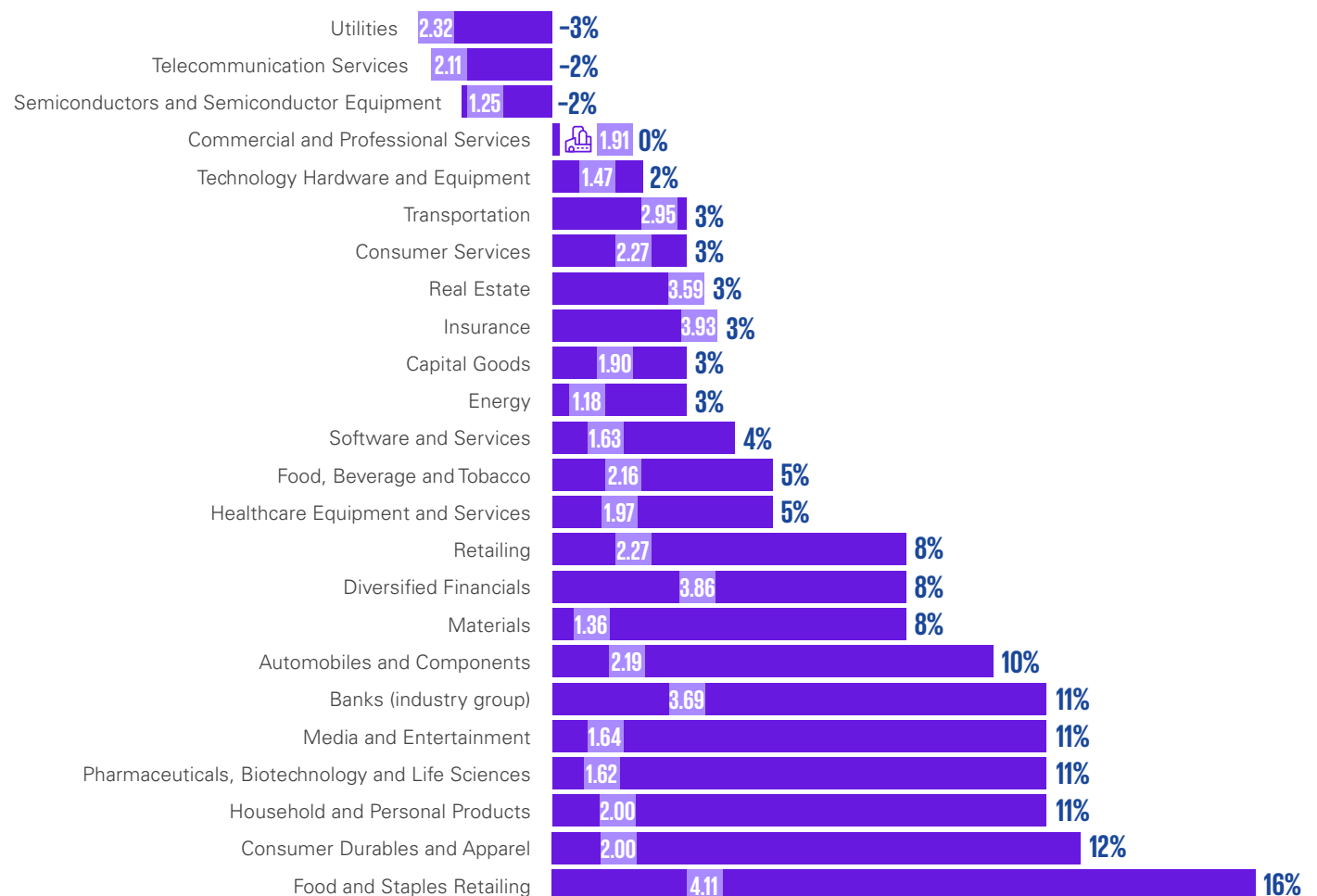


D2D movements by industry group – October 2021

Most of the industry groups analysed showed an overall increase in their D2D score from June 2021 with the largest industry group increase being:

- Food and Staples Retailing (16 percent with a D2D score of 4.11)
- Consumer Durables and Apparel (12 percent with a D2D score of 2.00)
- Household and Personal Products (11 percent with a D2D score of 2.00)

Industry group D2D score and percentage change*














Zombies – Across the ASX – October 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 score of 0). These companies may already be experiencing distress or working through restructuring strategies.

A total of 377 (~20 percent) companies that were analysed, displayed a D2D score below 1 (compared to 505 companies in June 2021). Of that, more than half fall within our definition of a 'zombie' (272 companies, 279 in June 2021), representing a market capitalization of \$12.0 billion. (Compared to \$12.5 billion in June 2021)

Most of the 'zombie' companies are in the Materials, Energy, Financials and Industrials sectors (79.0 percent and \$9.6 billion in market capitalisation), with the Materials sector being the single largest (representing 45.6 percent and \$5.9 billion in market capitalisation).

Number of Zombie companies by sector and total market capitalisation*

		Companies (272 total)		Market capitalisation of (\$12,002 million total)
 Materials	124	<div></div>	49.5%	5,945
 Information Technology	15	<div></div>	13.9%	1,674
 Energy	55	<div></div>	25.3%	3,034
 Healthcare	7	<div></div>	1.2%	143
 Consumer Discretionary	13	<div></div>	1.5%	181
 Financials	18	<div></div>	2.4%	292
 Industrials	18	<div></div>	3.2%	388
 Telecommunication Services	11	<div></div>	1.4%	170
 Consumer Staples	3	<div></div>	0.4%	48
 Real Estate	5	<div></div>	0.4%	46
 Utilities	3	<div></div>	0.7%	81

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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