COVID-19 implications for PE portfolio and private companies

EY private equity portfolio company webcast series

20 March 2020

Building a better working world

Agenda

- Introductions
- Supply chain management and tax implications
- Liquidity, working capital and tax impact
- Revenue dynamics and operating model strategy
- Wrap up and Q+A

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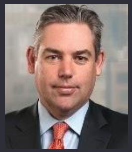

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Operating Model Strategy

Most impacted business and economic areas

- Supply chain resilience
- Third-party service providers

- Business interruption
- Supply chain claims
- Event cancellation

- Infrastructure framework
- Cyber resilience
- Digital customer channels Disruption

- Geopolitical
- Country risk
- Regulatory changes
- Leadership and public policy engagement

- Operational continuity
- Talent initiatives
- Business traveler
- Short-term cost reduction actions

- Safety-based customer experience
- Direct-to-consumer + eRetail
- Packaging + delivery innovation
- Revenue volatility and scenarios

- Tax strategies
- Regulatory/disclosures
- Investor trust
- Liquidity/credit/capital

- Enterprise risk planning
- Risk identification
- Scenario planning
- Continuity and recovery
- Response and monitoring

- Promoting employee safety & well-being
- Public health information (CDC, WHO)
- Support for impacted employees

A portfolio company’s response has to consider the following key dimensions

Key dimensions

Crisis management teams/taskforce risk and response assessment	► Crisis center ► Crisis watch ► Pre-crisis preparation	► Ensure organized response and maintain situational awareness ► Manage information flow(s), cope with the (crisis) and uphold critical business processes
Employee management/ duty of care	► Communication plan ► Communication repository	► Deal with employee concerns regarding risk of virus infections in workplace/client interactions/travel, etc. ► Address crisis communication in cases of employee infections ► Ability to work remotely/maintain business services
Supply chain management	► Risk intelligence monitoring ► Risk response operating procedures ► Major crisis management	► Set-up ongoing risk monitoring and reporting ► Identify risks in SC and define plans for disruptive events ► Manage events w. pre-defined response is not adequate
(Short-term) Liquidity management	► Cash management ► Cash forecasting	► Secure short- and long-term liquidity to fund business operations ► Conduct adequate cash forecasting under crisis scenario
Revenue dynamics and operating model strategy	► Rapid assessment of fluctuations in revenues ► Near-term actions to reduce cost structure	► Understand potential market, product, customer impacts ► Near-term moves to support revenue and possible strategy moves to create sustainable advantages ► Possible moves: RIFs, site closures, reduced third-party spend
Budgeting and business plan effects	► Integrated business plan ► Financing tools	► Full transparency on financials to gain planning security on effects on all three financial statements for the short-, medium- and long-term
Legal topics	► Legal Q&As ► Legal documents (review)	► Provide legal guidelines in terms of employer/employee rights and obligations ► Review insurance policies to understand potential for coverage gaps ► Assess impact on other major contractual agreements

1

Supply chain management and tax implications

Supply chain management and tax implications
Immediate supply chain actions to take in response to COVID-19

SC intelligence and analytics

- Initiate communications protocols and reporting cadence
- Validate current state impact and understanding of COVID-19
- Highlight immediate gaps in current supply chain (manufacturing, suppliers, inventory management, planning, logistics)
- Quantify cost of current and potentials issues driven by supply disruptions and changes in demand
- Overlay current supply chain to COVID-19 WHO tracker for future identification of challenges
- Develop addition hypothesizes on most likely courses of action and worst case scenario planning

Dynamic network optimization

- Identify critical parts and associated 1st to 3rd tier supplier locations required to maintain operations and anticipated production plans
- Consider alternative ports, transportation methods and trade routes throughout the supply chain based on facts and hypothesis. Develop activation plans accordingly
- Determine Production constraints and capacity
- Assess impact of transportation and production labor shortages driven by travel restrictions
- Initiate communications plan for key locations to update status and projected status
- Evaluate channel signals (i.e., increase in e-commerce)

Integrated planning and S&OP

- Reassess demand based on outbreak-driven market adjustments (e.g., new demand driven by supply constrictions, reduced demand from countries closing off from market)
- Review inventory levels to evaluate emergency inventory management strategies (e.g., pooling)
- Adjust and optimize production plans focus to accommodate anticipated disruptions
- Synchronize supply, manufacturing, logistics and fulfillment to meet demand in short-mid terms
- Re-position inventory in known or high potential threat areas

Supplier and commercial management

- Identify supplier options and associated supplier locations required to maintain operations and anticipated production plans
- Collaborate immediately with customers and/suppliers to respond collectively from demand to supply
- Identify and qualify alternative sources of supply
- Monitor lead times to gauge performance
- Build long term implications and issue tracker to de-risk impact to business as usual post crisis event
- Support suppliers with contract compliance and update where possible
- Assess contract financial obligations and actions

Financial and risk impact mitigation

- Execute risk response strategy for at-risk suppliers and/or their respective Tier N suppliers
- Prepare responses to supplier invocation of *force majeure* clauses
- Identify any non-financial opportunities and threats to the business due to communications or perceived change in operations
- Continue risk and controls assurance as processes and operations shift globally
- Identify current and future contract exposure
- Vendor onboarding process
- Identify any cash constraints and liquidity/ working capital opportunities

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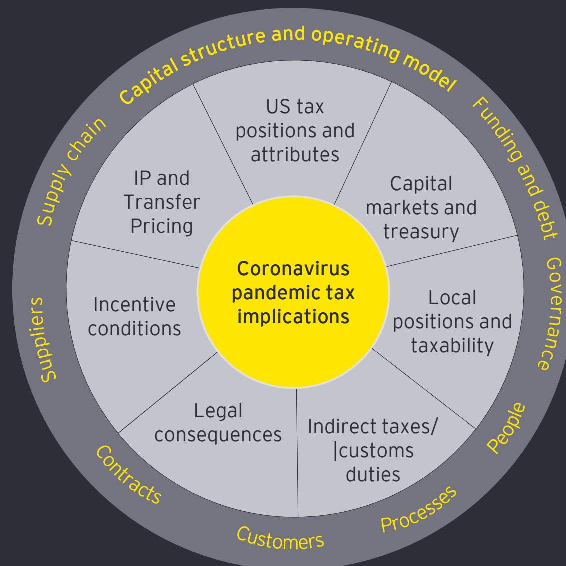
- Command & decision making delegation
- Corporate & supply chain reporting
- Workforce re-planning
- Crisis playbook development
- Define SC resiliency opportunities for long term
- Assess readiness by function (people, process, technology)

Workforce planning, governance and communications

Supply chain management
Assessing and responding to the tax implications of COVID-19

Addressing tax issues as you deal with the unexpected impacts of COVID-19



Short-term
React

Enable business continuity
- Loss forecasting
- Working capital
- Emergency trade procedures
- Legal contracting
- Crisis management
- Scenario modelling

Medium-term
Recover

Tax alignment and efficiency
- Transfer pricing adjustments
- Cost optimization
- Incentive management
- Deductibility
- Substance defense/realignment

Long-term
Grow

Transformation and agility
- Resilient, multisource supply chain
- Value chain analysis and profit splits
- Acquisition and business model change
- Conversion and exit planning

Suggested four-step process for integrating tax into COVID-19 impact assessment and responses

1. Align with business risk assessment
2. Assess tax impacts
3. Prioritization and action planning
4. Implement and continuous assessment

Refer page over for suggested tactical actions

Supply chain management
Immediate and direct interaction with business is critical

Businesses are being effected and company's business leadership have begun discussions and forecasts for potential scenarios

EY teams suggest a four-step process for integrating tax into the assessment and response

1 Align with business risk assessment

- Identify stakeholders and decision-makers
- Review impact assessments and actions to-date
- Join appropriate working groups, committees and decision forums

2 Assess tax impacts

- Tax issues scan and impact assessment
- Input to business scenario modelling
- Outline alternative options and approaches

3 Prioritization and action planning

- Prioritize jurisdictions or issues for immediate remediation
- Align with stakeholders and leaders
- Develop short-term action plans and longer-term strategy

4 Implementation and continuous assessment

- Implement planning steps
- Design working group and process for continuous assessment
- Monitor situation, and message

2 Liquidity, working capital and tax impact

Liquidity, working capital and tax impact
Liquidity, credit and cash management

Liquidity and credit management with embedded cash forecasting is essential in crisis situations

What we do

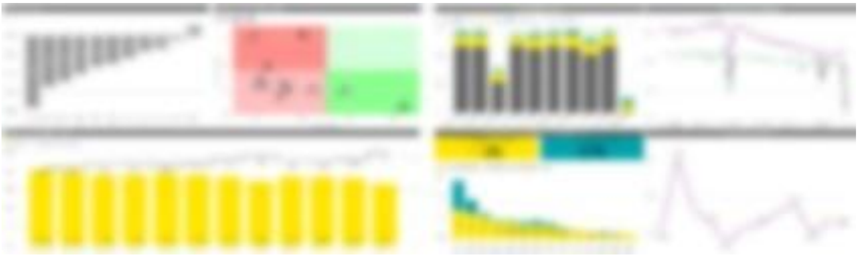
- **Extend liquidity runway**
  - Maximize one-time revenue opportunities
  - Realign and reduce costs
  - Employ working capital crisis management techniques; idle cash-burning operations
  - Defer capital expenditures/R&D
- **Develop crisis contingency plan**
  - Identify COVID-19 (temporary) versus normal-course performance
  - Sensitize cash flows for risk outlook/contingency plans
  - Align operational plan and develop KPI's
  - Real-time reporting dashboard & KPI tracking
- **Stakeholder management**
  - Prioritize and negotiate needs to enable short-term and long-term viability
  - Communicate concise plan to suppliers, customers, lenders, equity sponsors, government and employees
  - Establish credibility and maintain control

Client issues we are seeing

1. **Contingency planning:** abrupt sales decline and uncertainty resulting in need for cost cuts/revised guidance/scenario planning
2. **Credit squeeze:** vendors requiring scheduled payments, customers not paying - thereby driving hasty behavior under duress to shore up liquidity
3. **Covenant compliance:** reduced headroom, limited ability to access new/existing capital sources
4. **Supply chain disruption:** distressed suppliers requiring special assistance
5. **Access to capital:** sector based challenges emerging; refinancing uncertainty; insurance policy review

Tools and enablers

Comprehensive toolbox incorporating advanced analytics programs



Liquidity, cash management and tax impact
Establishment of a cash management/liquidity office

Objective	Actions
Manage liquidity on a daily basis	► Meet three to four times a week to review liquidity initiatives and near term cash flow needs, e.g., payroll, AP, interest, rent, etc. ► Manage disbursements through a daily meeting to review and approve all disbursements ► Instill discipline in management to focus critical liquidity needs
Short-term forecasting	► Create a rolling daily cash flow forecast (~90 days) to manage short term liquidity needs ► Review and manage inflows and outflows against forecast and make adjustments on at least a weekly basis ► Identify potential areas to pursue cost savings initiatives and release additional cash, e.g., review all long-term contracts to determine ability to renegotiate ► If needed, review short term forecast with lenders to demonstrate control of short term liquidity needs
Other liquidity enhancements	► Review existing financing agreements to determine flexibility with upcoming principal and interest payments ► Review existing capital structure and identify any need for additional short-term financing ► Review outstanding accounts receivable and develop disciplined approach to pursue cash collections ► Manage working capital and identify areas of liquidity enhancement (e.g., propose vendor discounts for prompt payment) ► Create headroom for unanticipated cash needs

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Liquidity, working capital and tax impact
Liquidity and capital structure considerations in response to COVID-19

Companies need to quickly and robustly evaluate ability to fund future operations due to uncertainty.

1. Capital planning

- Review current capital structure, focusing on possible upcoming maturities/debt payments, covenant issues and ability to borrow if/when needed
- Thoroughly stress near-term and longer-term liquidity needs
- Sensitize future cash flows and operational risks/opportunities
- Identify key financial ratios that may be impacted by future impacts to business
- Coordinate with key financial partners and begin dialogue early on possible issues/needs

2. Capital raising

- Are there any concerns with current lenders meeting funding obligations
- Higher cost of financing/ availability could thwart potential near-term M&A plans
- Must be able to meet reps and warranties in credit agreement in order to borrow under revolvers
- Evaluate if company will be able to meet covenant compliance following Q1
- Consider proactively accessing capital sooner if potential to need it in future

3. Capital restructuring

- Address potential upcoming compliance issues early
- Plan for worst case outcome in order to maximize flexibility and avoid repeated amendments
- Identify possible contingency plans if unable to achieve necessary outcome
- Partner with key stakeholders across capital structure to avoid surprises
- Engage counsel and advisors early to secure assistance if needed

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Liquidity, working capital and tax impact
Debt buybacks and refinancing - tax implications

Debt buybacks

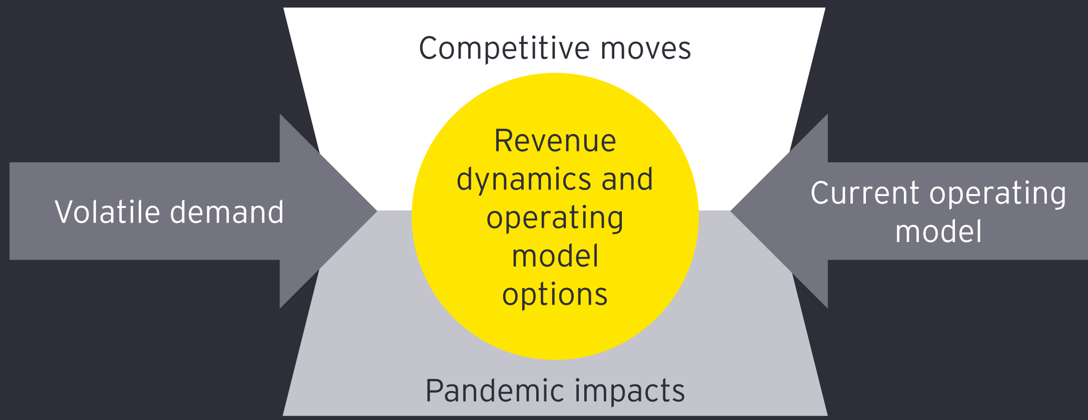
- When debt trades at a significant discount to its face value, the distressed debt markets create buying opportunities for third parties (e.g., hedge funds), for debtors themselves (e.g., PE Portfolio companies), and for the shareholders of debtors (e.g., PE Funds). But the US tax rules can cause the debtor to recognize taxable cancellation of debt income ("CODI") if the buyer of the distressed debt is considered "related" to the debtor.
- When PE Funds acquire the debt of their portfolio companies, they are often viewed as "related" to the debtor, potentially triggering taxable CODI. This was a significant issue that arose during the 2008/2009 financial crisis, and we expect this issue to come up again. Our PE ITTS specialists have spent a lot of time in this area devising structures to reduce the amount of taxable CODI and identifying tax attributes CODI

Debt refinancings

- Most taxpayers generally think taxable CODI can only be triggered when a debt instrument is settled for less than it's face amount.
- But even a mere change to the interest rate, the time when a payment is due, a change to a financial covenant or the payment of a consent fee can trigger taxable CODI (even when the face amount remains unchanged). This typically occurs when the debt instrument:
  - Falls within the US tax definition of publicly traded (which covers almost every debt instrument listed on a financial quotation system)
  - Was issued with PIK, or
  - Was already refinanced
- And if a taxable CODI event occurs, future interest deductions can be deferred and in some cases permanently disallowed under the applicable high yield debt obligation rules. This generally occurs when an issuer is in financial distress and its debt is trading at a significant discount.

3 Revenue dynamics and operating model strategy

Revenue dynamics and operating model strategy
Companies face multiple pressures on their performance due to the COVID-19 environment



Agile approach

1. **Visibility:** For what level of demand should management plan? How does this differ by region? Product? Customer type?
2. **Agility:** What moves can management make to secure as much short-term demand as possible? Greater Sales focus? Pricing? Promotions? Better terms? Do opportunities exist to make strategic moves (e.g., acquire a competitor) or lean into new business models?
3. **Optionality:** How can management "variablize" the operating model to match revenue declines? RIFs? Reduced third party spend? Closed sites?

Example actions

- Changed inventory strategies
- Greater focus on specific customers or regions

- Accelerate new business models
- Acquisition of a competitor

- Stopping all projects
- Cuts to discretionary budgets

Management will need to take immediate actions to support profitability.
A clear-eyed view on revenue dynamics and operating model options will greatly enhance decision making.

Revenue dynamics and operating model strategy
Near-term checklist for managing revenue and aligning operations

Revenue dynamics

- **Assess health of customer end markets** and evaluate implications
- **Evaluate adaptability of current business model** to meet current customer needs
- **Identify new opportunities where demand is stable** or growing that can be targeted
- **Establish benchmarks to enable daily and weekly monitoring** for key commercial metrics over the 30 days, quarter, and 1-3 year period including:
  - Revenue, gross margin, and price
  - Segmentation by region, product/service category (at granular level)
  - Customer segmentation by end market, size segment/ concentration level, and key account
- **Develop and Regularly Update a Realistic Forecast and Scenarios** for key commercial metrics for the next 90 days **– and compare to performance:**
  - Identify key demand driver assumptions (e.g., renewal rates, pricing, and consumption patterns)
  - Conduct discussions with sales leaders to understand if dropping demand can be stimulated by immediate actions
  - Consider adjusting pricing, extended terms, promotions, added sales focus
- **Review key strategic objectives that could be accelerated and monitor the competition** due to stressed environment (e.g., opportunistic M&A, competitive share gain, and talent acquisition)

Operating model

- **Assess implications of changes in business strategy** to operating model requirements
- **Segment costs via zero-based-budgeting** into essential, preferred and discretionary buckets
  - Review of impact of cutting each non-essential cost item
- **Identify immediate "no regrets" actions,** as well as, **2nd and 3rd wave of actions** that can be executed in the coming weeks
- **Identify which operating activities are impacted** by changes to labor practices or adjustment to operating model strategy
  - Mitigating actions required for maintaining essential operations
- **Define and evaluate several operating model options** that achieve varying degrees of reduced weekly operating expenses
  - Definition of specific actions involved, the timing, and one-time costs on each move
- **Complete scenario analysis (linked to revenue analysis)** evaluating weekly operating expenses by sub-function of SG&A
  - Fixed vs variable
  - Contractually committed vs. not
- **Develop benchmarks and establish regular integrated tracking between operating costs and revenue** aligned with model changes

4

Wrap-up and Q+A

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