Australian
National
University

ANU Student Managed Fund

Investment recommendation

Downer EDI Limited

ASX code: DOW

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Notes:

All dollar amounts in this report are Australian dollars.

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Glossary

AA – Asset Allocation

AAE – Active Australian Equities

ADF – Australian Defence Force

AFI – Australian fixed income

ALP – Australian Labor Party

ANU – The Australian National University

CIO – Chief Investment Officer

COGS – Cost of goods sold

DCF – Discounted cash flow

DOW – Downer EDI Limited

EBIT – Earnings before interest and taxes

EBITDA – Earnings before interest, taxes, depreciation, and amortisation

EC&M - Engineering, construction, and maintenance

ESG – Environmental, social and governance

EV – Electric vehicle

FC – Franking credits

FY – Fiscal year

GDP – Gross domestic product

GICS – Global Industry Classification Standard

GW – Goodwill

HCMT – High-Capacity Metro Trains

IAC – Investment Advisory Committee

IC – Invested capital

IOZ – iShares Core S&P/ASX 200 ETF

IPS – Investment Policy Statement

JV – Joint venture

LTIFR – Lost time injury frequency rate

MoS – Margin of safety

NOPLAT - Net operating profit less adjusted taxes

PE – Price to earnings

R&C – Risk and Compliance

RBA – Reserve Bank of Australia

ROA – Return on assets

ROIC – Return on invested capital

SMF – ANU Student Managed Fund

SRI – Socially responsible investing

TFIFR – Total recordable injury frequency rate

WACC – Weighted average cost of capital

WIH – Work-in-hand

Portfolio recommendation

We recommend that the ANU Student Managed Fund (SMF) establish a **10% weighting** in Downer EDI Limited (DOW) within the Active Australian Equities (AAE) portfolio, funding the transaction by decreasing the iShares Core S&P/ASX200 ETF (IOZ).

Investment thesis

DOW is a market leader within the integrated services industry, and well positioned to benefit from an increase in government spending on infrastructure projects. It has a strong focus on urban services in Australia and Zealand, operating through its transport, facilities and utilities segments.

DOW is experiencing a sustained lower share price compared to pre-COVID levels, despite long-term prospects remaining unchanged. Our analysis suggests that the company is trading at a price below its fair value, with our base case valuation of $6.14 implying a 10.36% margin of safety (MoS) excluding franking credits (FC).

While this is a modest MoS, it should be considered in light of increases in demand for DOW's services and its strong place within the industry, particularly following the recent divestment of its mining and laundries businesses. DOW is a good fit for the Fund due to its sustainable and reliable cash flows, supported by $35.4 billion work-in-hand (WIH) and long-term operational strategies.

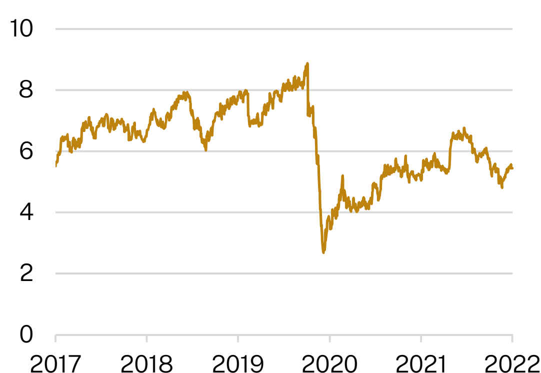
The main considerations underpinning this recommendation are:

- DOW has cash flow reliability, driven by increases in government expenditure, renewable energy trends and the stability of the New Zealand market.
- DOW operates in a strong industry environment, underpinned by a structural shift towards contract work.
- DOW has advantages over its competitors through its scale and differentiated service offering, which has been enhanced by restructuring to focus on its core urban businesses.

Downer

AUSTRALIA	
ASX code: DOW	
Price (at 30/04/22)	$5.56
Valuation	$6.14
• inc. franking credits	$8.50
Margin of safety (MoS)	10.36%
• inc. franking credits	52.81%
Dividend yield (2022F)	2.61%
• inc. franking credits	3.72%
GICS	Commercial & Professional Services
52-week range	$4.79 – $6.87
Recommendation	Buy
Key assumptions	
Required return on equity	7.25%
WACC	6.07%
Carbon intensity	
DOW	54.3
ASX200	236.08

Five-year share price history



The key risks taken into consideration are:

- Potential weaknesses in project tendering activity drive down revenues.
- Changes in the political environment where the government shifts away from outsourcing.
- Margin squeeze if labour and input cost pressures happen to persist longer than expected.

Main considerations

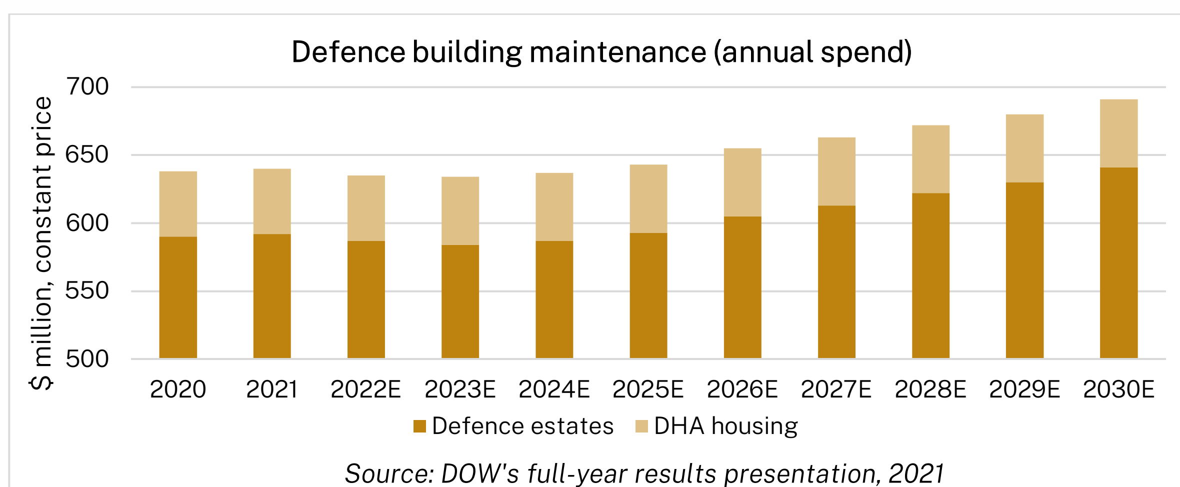
Cash flow reliability

Government infrastructure expenditure

With 91% of DOW's WIH profile coming from government or government-regulated projects, demand for its services largely hinges on a sustainable pipeline of infrastructure investment by government. By committing $120 billion over the next 10 years to infrastructure projects, the Australian Government has signalled its continuing focus on infrastructure spending, with a significant portion of Federal spending being allocated to the states (Gilbert + Tobin, 2022). This suggests that government demand is unlikely to decrease over the forecast period, and has the capacity to increase as the government commits to reducing congestion as well as improving regional roads and national freight capabilities (Infrastructure Investment Program, 2022). The government also needs to shift focus to accommodate the changing trends and preferences of the population post pandemic (KPMG Newsroom, 2022). As a greater number of projects arise as a result of these shifts, DOW will have an opportunity to be more selective and focus on projects that suit its strengths, such as rail maintenance. The latter will be discussed with reference to DOW's differentiated service offering.

Government defence expenditure

DOW has provided professional services as well as military base, estate management and upgrade services to the Australian Defence Force (ADF) for 80 years. DOW was ranked in the top five defence contractors in 2021 by Australian Defence Magazine (ADM[1]), further highlighting its strong presence in defence. The Federal Government achieved its commitment to restoring a defence budget of at least 2% of gross domestic product (GDP) by 2020-2021, and the percentage looks set to rise in 2021-2022. Amid evolving global political tensions such as the Russia-Ukraine war, the government announced $48 billion in funding in the 2022-2023 Federal budget.



Source: DOW's full-year results presentation, 2021

DOW is one of three contractors delivering defence estates maintenance and upgrade services in Australia. As part of a longstanding $575 billion government spending commitment over the decade to 2029-2030, the defence building maintenance budget is projected to increase, with sizable growth expected in the defence estates budget from 2024 onwards. Such commitments present DOW with a valuable opportunity to grow its defence revenue (as part of the facilities service segment), given its long-standing relationship with the Department of Defence and competitive position in winning government service contracts.

[1] ADM is a defence industry guide, reporting the business of defence capability planning and procurement, and the development of infrastructure to support the ADF

Renewable energy trends

DOW is committed to decarbonisation following the divestments of high emission businesses and demonstrates strong capabilities in the 'green' energy space. DOW's utilities segment facilitates the use of renewable energy, including transmission lines, site constructions and adoption of Electric Vehicles (EVs) for fleets and buses. DOW has constructed six solar farms and 14 wind farms. DOW also advises companies in the traditional energy sector, such as Santos, on developing carbon capture, utilisation, and storage technology.

We see DOW's integrated capabilities in this field as an advantage in meeting clients' increasing demand for decarbonising and energy-efficient solutions. These include the facilitation of EVs for transport clients and renewable power integration for customer facilities and estates. These demands align with Australia's Long-Term Emissions Reduction Plan, which outlines a government commitment of more than $20 billion in investments in low emissions technologies by 2030. However, utilities only contributed 20% to DOW's 2021 revenue. Thus, increasing market demand in utilities will help DOW sustain organic revenue growth, rather than creating any extraordinary growth in our base model assumptions.

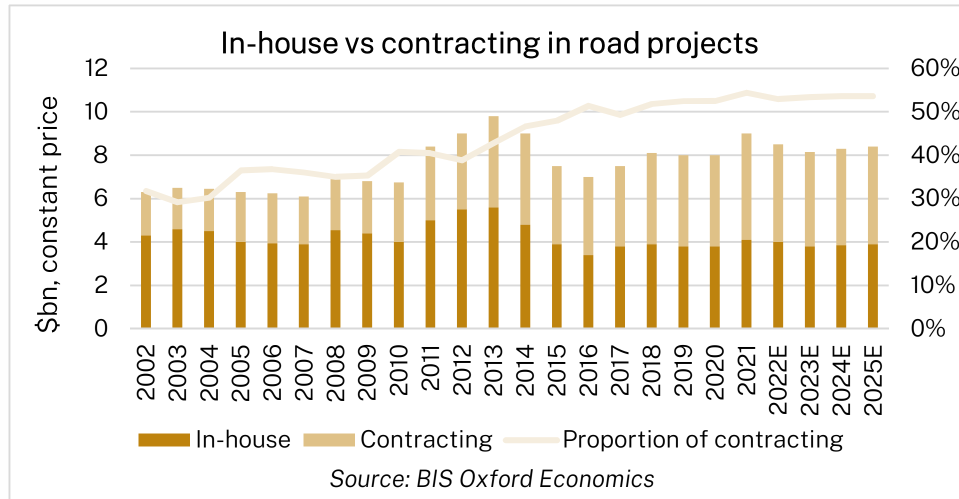
Persisting demand in New Zealand market

DOW is the largest provider of services to asset owners in New Zealand, which contributed 22% to its FY21 revenue. DOW has market shares of 30% in transport, 25% of outsourced services in utilities and 15% in facilities. The integrated facilities management services provided by DOW subsidiaries puts the group in a unique position to secure contracts in public, private and tertiary sectors. Further, New Zealand is one of the world's most highly urbanised countries. In 2021, Finance Minister Grant Robertson signalled a $4 billion boost to the capital allowance for infrastructure development as a part of the government's economic recovery plan. This should translate into persistent demand from the New Zealand market for DOW's services.

Industry environment

Shift to the use of contractors

A shift by the government to using contractors rather than in-house operators should provide ongoing opportunities for DOW. As shown below, the use of contracting in government road projects has increased significantly since 2010. This benefits DOW as the largest non-government owned road service business in Australia. DOW manages over 33,000km of road in Australia and over 25,000km in New Zealand, with a market share of around 5% of the Australian road maintenance industry. DOW has recently won various major contracts from its government competitors, including with VicRoads (managing 10,000km of road across various contracts). Another recent win was the award of two maintenance contracts with the South Australian Department of Planning, Transport and Infrastructure in 2020 following a competitive process. These contracts are valued at $420 million for an initial seven-year term, covering over 8,000km of roads in South Australia. The trend in use of contractors is set to continue over the forecast period, setting the scene for DOW to benefit from sustained levels of contracting even if further increases in contracts offered are offset by policy reversals (discussed below).



Source: BIS Oxford Economics

Competitive advantages

Scale and differentiated service offering

DOW has a competitive advantage as a large scale, vertically integrated company with in-house capabilities across the lifecycle of its various projects. Within its transport segment, which comprises around 50% of total revenue, DOW is one of only three non-government companies with a market share of over 1% in the road maintenance industry. (DOW's share of 5% compares with 3% each for Fulton Hugan and LendLease.) It is also one of the three major players in the rail maintenance industry where DOW, CIMIC and CCCI hold 19.3%, 28.9% and 19.1% market shares, respectively.

DOW's differentiated service offering within the road maintenance industry and its position as the largest non-government company places it in a strong position to capitalise on increased government infrastructure spending. DOW's service offering includes vegetation management and incident response, reflective of its capabilities at different sides of the road maintenance industry. This is evidenced by its recent win of the Melbourne Citylink transport maintenance contract, which utilised these parts of DOW's service offering. DOW's differentiated service offering within the rail maintenance industry allows it to achieve better economies of scale than competitors, with capabilities across all stages of the rail maintenance industry. For example, DOW is the only industry company with capabilities in rollingstock, infrastructure, rail systems, operation and maintenance, and system integration.

Potential for competition is limited in both road and rail maintenance by DOW's specialised capabilities as well as high barriers to entry. Both industries require a high capital outlay, a proven ability to win government contracts and access to new industry technology, which can often be expensive to acquire. These barriers benefit DOW as it has proven government relations, existing capital infrastructure and access to technologies that are less widely available to smaller competitors. Such technologies, such as micro surfacing, are more widely used by DOW than smaller companies and enhance cost effectiveness in bitumen through lower quarrying costs, increased time efficiency and reduced labour costs. Such advantages give DOW the potential to compete for contracts that are suited to its integrative capabilities and drive up margins – a strategy that has been indicated by management.

Competitor comparison is difficult due to structural differences with some major competitors, such as Monadelphous with its larger construction and mining focus. CIMIC is considered DOW's closest major competitor, offering rail maintenance in transport, telecommunications infrastructure in utilities, and facilities management. Comparison of 5-year average EBIT margins hints that DOW may have a competitive advantage over CIMIC (3.9% and 1.1% respectively), although structural differences between the businesses might explain the difference. CIMIC is a larger company with a portfolio comprising of 70% construction compared to 9% for DOW.

Nevertheless, this does indicate the potential benefits DOW may obtain through increased focus on its core urban businesses, rather than heavier businesses such as mining and construction.

Outside of the transport segment, DOW's facilities and utilities operations are more fragmented, and do not provide as much benefit related to market share and specialised services offerings.

Our base case forecast assumes relatively stable margins as DOW retains its competitive position across its segments. This stance recognises uncertainty surrounding DOW's competitors, a lack of information on the specific terms of DOW's contracts, and the potential for increased competition within the facilities and utilities segments. We see more scope for margins to improve than deteriorate due to potential advantages within the transport segment. However, we leave the prospect of variation in margins to scenario analysis.

Divestments of non-core capital-intensive businesses

DOW have adopted a strategy to divest its mining and laundries businesses to focus on the urban services businesses, where it has better market penetration and expertise. This will support sustainable growth by focusing on capital light, lower risk services with more predictable revenues, earnings, and cash flows. This strategy has made significant progress, with total sale proceeds of $778 million since November 2020. DOW will complete its divestments in mining and laundries by the end of FY22 and consolidate its core-urban businesses into three segments: transport, utilities, and facilities.

The mining industry in Australia has medium market concentration, with four major mining companies accounting for 42% of revenue in 2021-2022. The industry is both capital and carbon intensive, and highly sensitive to materials cost movements. DOW does not have significant market share or competitive advantage in this segment, although the reinvestment rate in mining of 23% is higher than the 12% in transport and 3% in utilities. Prior to divestment, mining was less profitable than the other segments, and had a five-year compounded annual growth rate (CAGR) of -1% compared to 10% in transport and 20% in utilities. We view the divestment of the mining business as beneficial for DOW by allowing it to focus on its competitive strengths within its core-urban services.

DOW has completed the sale of 70% of its laundries business, which was cited by CEO Fenn as "one of the most capital-intensive businesses [on] the Downer balance sheet" (NewsnReleases, 2022). Following this divestment, return on assets (ROA) in facilities has increased from 120% to 136% despite decreased revenue due to COVID, indicating that DOW is moving in the right direction with its divestment strategies.

Key risks

Potential weakness in project tendering activity

One potential risk to DOW's revenue is its continued ability to successfully tender for new contracts and deliver on existing ones. With 91% of WIH projects being government related and DOW's major clients being public authorities, any reduction in government tendering activity due to lower prioritisation of government spending or increased competition within the industry would have an adverse effect on DOW's earnings and WIH. There is also a risk that DOW's material contracts may be terminated on short notice or may not be retendered. This risk has been accounted for in our base case revenue forecasts, with growth not exceeding 5% over the forecast period. Our best case scenario allows for revenues to be boosted by increased government infrastructure spending, which we consider a realistic prospect.

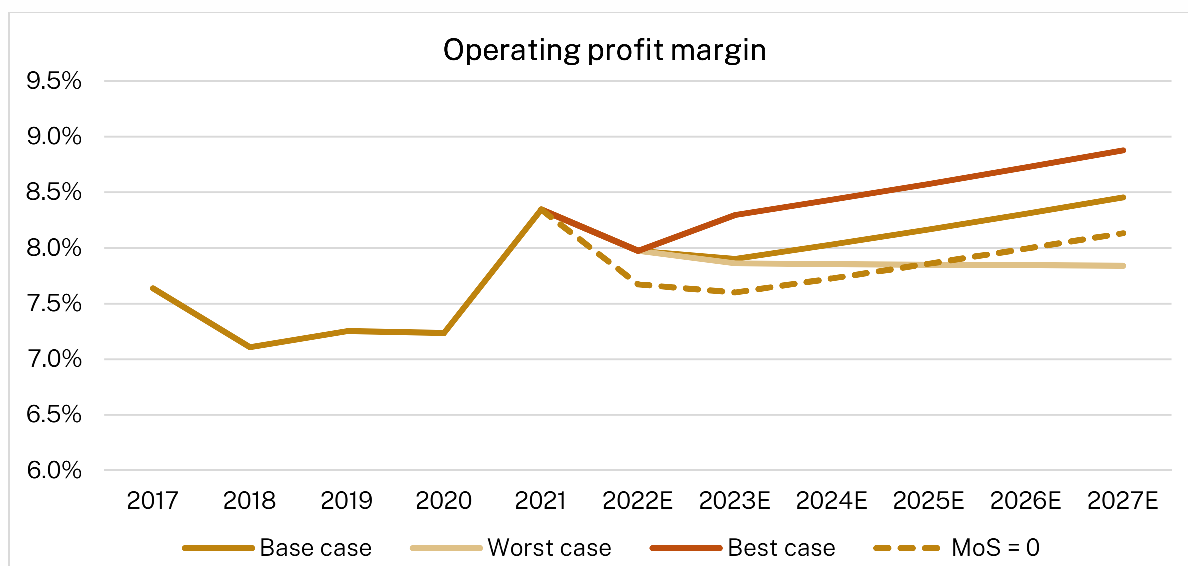
We see relatively low risk of revenues being lower than our baseline forecast, with our base case revenue forecast not incorporating the potential for large increases in the uptake of project tenders compared to historical levels. The government has recently committed significant funding towards infrastructure projects (discussed above), and DOW has large WIH projects placed over the forecast period and beyond. There is also a need to continue to build and maintain transport and utilities infrastructure, especially relating to renewable energy, and an ongoing

need for facilities management. If the government did reduce spending, DOW has some capacity to adjust labour costs in response. Over a third of costs come from sub-contractors rather than employee benefits, a proportion which has been increasing. This should help avert any major impact on margins.

A more significant risk is the potential for increased competition that drives tender contract prices down, resulting in lower revenues and/or margins. This consideration has been incorporated into our worst case scenario, where revenue is not sustained due to shifts in industry competitiveness. Should increases in government outsourcing continue, there could be a trend to smaller companies merging to achieve economies of scale in order to meet the increased demand, and this may result in increased competition for DOW. The impacts of increased competition, however, would likely be offset by corresponding increases in outsourcing raising the number of contracts available. The risk of increasing competition is somewhat lessened by the recent collapse of construction companies such as Probuild, Condev, LP Warren Homes and ABD Group. This could lead to a greater focus by government on the financial strength of tenderers, with more contracts being offered to larger companies such as DOW that have a lower risk of collapse.

Margin sensitivity

The COVID pandemic has created pressures within the labour market, as well as increasing the volatility in materials supply. Labour shortages, lower work capacities and supply chain pressures in the wake of the pandemic and the Ukraine crisis have increased subcontractor, employee, raw materials and consumables costs. DOW management has indicated that these pressures will be temporary and managed via effective cost escalation clauses. However, a lack of information surrounding these clauses creates uncertainty over margin trends. Our base case conservatively assumes a decrease in operating profit margins in FY22 and FY23, before they return to slightly above pre-pandemic levels in FY27. Consideration for a positive view on margins appears in our best case scenario, which assumes that cost escalation clauses are effective and the CPI continues to run ahead of wages to the benefit of DOW's CPI-linked contracts. All scenarios involve a slow decrease in margins (and consequently ROIC) beyond FY27.



Alongside these near-term economic forces, the issue arises over whether labour market pressures may give rise to more structural margin risks. Direct labour and contractor expenses comprised 72.3% of DOW's total costs in HY21 and shifting to a less capital-intensive business mix only raises exposure to labour markets. The first issue is the potential for wage cost rises to squeeze margins because they are not fully passed through to revenues. This risk is only heightened by labour shortages and policy aimed at boosting wage growth (e.g. Reserve Bank of Australia (RBA), and potentially also a Labor government). Management has indicated that cost escalation clauses can mitigate increases in wage costs, although the extent to which this holds

across all contracts is uncertain. The shift towards a higher use of subcontractors provides some flexibility to manage wage costs.

A second issue is the potential impact of labour shortages on contract delivery. For example, where DOW relies on a small set of specialised subcontractors, any inability of these subcontractors to work can impact on project completions. DOW may also have difficulty securing the staff it needs if the labour market remains tight.

In contrast, raw materials and consumables only represent 14.1% of DOW's cost base, decreasing by 26.1% in FY21 due to various contract completions and the disposal of its mining and laundries businesses. Raw materials and consumables expenses decreased at a rate three times greater than DOW's other expenses, and current work-in-hand projects comprise 91% in services and 9% in construction (down from 12% in FY20). This shift in focus away from construction and towards urban services decreases DOW's exposure to material input costs.

Our base case assumes that lower exposure to material costs and the potential for material costs increases to prove transitory are partially offset by potential labour market pressures, enabling a stabilisation of operating profit margins from FY24. The margin risks related to structural labour market pressures are incorporated into our worst case scenario.

Changes in political environment

Given DOW's high proportion of government contracts, it is vulnerable to changes in political policy towards the outsourcing of contracts versus in-house delivery. With contract prices being significantly higher than in-house work, the rationale for the government's shift to outsourcing has recently come under question. Part of the Australian Labor Party (ALP) election campaign policy revolves around the Coalition government's weakening of the Australian Public Service institution, stating: *"Labor is committed to building a stronger public service that delivers better outcomes for the community"* (Australian Labor Party, 2022). However, the ALP's campaign policy is targeted more towards the hiring of private consultancy firms to do work that could be carried out by the APS. DOW's government contracts focus on infrastructure design, construction, and maintenance. It thus may be less impacted if a reversal of the trend to outsourcing is focused elsewhere.

Further, the transport infrastructure and maintenance industry relies on scale and technical expertise, making it much less likely that the government would choose to take these function in-house. For example, the design and manufacture for Melbourne's High-Capacity Metro Trains (HCMT) are not viable to be completed in-house by the Victorian government due to technical expertise and manufacturing costs. DOW has also signed the maintenance contract for the HCMT with Victoria government until 2053. In another example, DOW subsidiary Spotless has provided Australia-wide services to the healthcare sector for over 40 years, with some contracts signed until 2046. Nevertheless, DOW's expertise does not eliminate the contract risks. For example, the recently elected South Australia Premier expressed the intention to reverse the outsourced contract for Adelaide Metro Trams that was signed in 2019. To incorporate this risk into our model, our base case has assumed a stable rate of outsourcing by government as opposed to a continued increase. Our worst case scenario explores the implications of a decrease in outsourcing.

DOW's facilities maintenance business is more vulnerable to a shift in political preferences towards in-house delivery due to lesser need for technical knowledge, low transition costs and modest start-up capital requirements. We thus forecast facilities revenue growth at below the facilities industry expectations, despite the inclusion of the engineering, construction, and maintenance (EC&M) businesses within facilities.

SRI considerations

The SMF Risk and Compliance (R&C) team has reviewed DOW, and formed the view that the company is unlikely to cause an unacceptable level of social injury. DOW also creates social benefits as a key player in the development and maintenance of public transport and renewable energy projects, and has formed plans in line with climate transition, which is a preferred sustainable business activity for the Fund.

Three key ESG areas were investigated in-depth: modern slavery, workplace health and safety, and climate change and environmental considerations (see Appendix for further details). No major issues were uncovered suggesting that DOW might contravene the SRI Policy. While there have been a few allegations of partnering with companies accused of engaging in modern slavery, DOW's active engagement with external partners and mapping of high-risk supply chains as mitigation strategies against modern slavery. Workplace health and injury issues are perhaps the most material ESG concern, with the injury rate being of particular relevance. DOW's success in achieving its ongoing health and safety targets ameliorate concerns in this regard. Lastly, DOW's climate change actions are considered a positive feature.

Overall, we believe that the residual risks after factoring in DOW's mitigation strategies are not of sufficient concern to prevent investment under the SMF SRI Policy.

Valuation summary

Our discounted cash flow (DCF) model generates a base case valuation of $6.14 excluding FC, and $8.50 including FC. This valuation provides a MoS of 10.36% excluding FC and 52.81% including FC. Our model produces a forward Price to Earnings (PE) ratio of 24x, lower than the average PE of 32x for the Australian infrastructure construction and contracting services industry. This positive MoS and a PE that is lower than the industry average indicates that DOW is currently attractively valued with a buffer for the potential downside risks outlined in previous sections. This presents DOW as an attractive investment opportunity for the SMF, when combined with cash flow reliability, a positive industry outlook and competitive advantages.

Summary of Key Model Inputs

Our DCF model includes the return on invested capital (ROIC) excluding goodwill (GW) rising 18.02% in FY26, which is lower than the pre-COVID level of 19.6% in FY19, before fading to 15.57% by the end of the second stage forecasts. EBIT margin returns to the pre-COVID level of close to 3.5% by FY23, posts further marginal improvement until FY26, and then fades to 3.22% by the end of the second stage forecasts. The margin forecasts reflect DOW's structural change to focus on its core-urban businesses, short-term supply chain risks, and medium-term persistence in labour market pressures. Revenues are forecast based on two models, one relying on the correlation between DOW's core business segments and industry drivers, and the other based upon the relationship between the geographical segments and both GDP and urbanisation. Capital intensity as measured by invested capital turnover (excluding GW) is assumed to remain flat. Capital expenditure is included for existing tangible and intangible assets, with a lower capital expenditure to asset ratio than historical levels to reflect the company's shift to a capital-light, service focused portfolio. A weighted average cost of capital (WACC) of 6.07% has been used, reflecting a cost of equity of 7.25% and a cost of debt of 4.55%.

Appendix

A.1 Key financial summary

Financial year ($million)	2019(A)	2020(A)	2021(A)	2022(E)	2023(E)	2024(E)	2025(E)
Total revenue	12820	12689	11552	11327	11661	12236	12822
Revenue growth	6.34%	-1.02%	-8.96%	-1.95%	2.94%	4.93%	4.79%
EBIT	$439	($115)	$281	$277	$369	$408	$442
EBIT margin	3.42%	-0.90%	2.43%	2.44%	3.17%	3.33%	3.45%
NOPLAT	$266	($221)	$225	$243	$250	$272	$296
NOPLAT margin	2.08%	-1.75%	1.95%	2.14%	2.14%	2.22%	2.31%
Invested capital (ex. goodwill)	$1,163	$2,068	$1,543	$1,468	$1,618	$1,698	$1,779
Invested capital (inc. goodwill)	$4,293	$4,928	$4,326	$4,307	$4,515	$4,656	$4,801
ROIC (ex. goodwill)	19.60%	-19.05%	10.89%	15.73%	17.03%	16.81%	17.42%
ROIC (inc. goodwill)	6.04%	-5.16%	4.57%	5.61%	5.81%	6.03%	6.35%
Free cash flow	$382	($856)	$827	$262	$42	$131	$150
IC turnover (ex. goodwill)	10.17x	7.86x	6.40x	7.52x	7.56x	7.38x	7.38x
Financial year ($ million)	**2026(E)**	**2027(E)**	**2028(E)**	**2029(E)**	**2030(E)**	**2031(E)**	**2032(E)**
Total revenue	13416	14030	14667	15325	16007	16711	17439
Revenue growth	4.63%	4.58%	4.54%	4.49%	4.45%	4.40%	4.36%
EBIT	$478	$495	$512	$530	$548	$566	$585
EBIT margin	3.56%	3.53%	3.49%	3.46%	3.42%	3.39%	3.35%
NOPLAT	$321	$332	$343	$355	$367	$380	$392
NOPLAT margin	2.39%	2.37%	2.34%	2.32%	2.30%	2.27%	2.25%
Invested capital (ex. goodwill)	$1,862	$1,947	$2,035	$2,126	$2,221	$2,319	$2,420
Invested capital (inc. goodwill)	$4,951	$5,036	$5,124	$5,216	$5,310	$5,408	$5,509
ROIC (ex. goodwill)	18.02%	17.83%	17.64%	17.46%	17.28%	17.10%	16.92%
ROIC (inc. goodwill)	6.68%	6.70%	6.82%	6.93%	7.04%	7.15%	7.25%
Free cash flow	$171	$247	$255	$264	$273	$282	$291
IC turnover (ex. goodwill)	7.37x	7.37x	7.37x	7.37x	7.36x	7.36x	7.36x

A.2 SRI considerations

Three key ESG areas were examined as part of the assessment of DOW's compliance with the SMF SRI Policy: modern slavery, workplace health and safety, and climate change and environmental considerations.

Modern slavery

DOW works with suppliers in China through its partnership with CRRC Changchun, which is delivering Sydney's Waratah trains and Melbourne's new HCMT. One of CRRC's suppliers for the HCMT was the subject of public allegations in 2020 concerning the treatment of its workforce with respect to human rights and modern slavery. These allegations have been strongly denied. However, incidents like this highlight the challenges that DOW faces in managing parties outside of its immediate supply chain given the diversity of its services and offerings. Following these allegations, DOW has engaged with CRRC and further developed supplier and subcontractor self-assessment Modern Slavery questionnaires, which are mandatory for prospective and current suppliers. Additionally, DOW is committed to mapping high-risk supply chains beyond direct suppliers on an ongoing basis.

Workplace health and safety

Workplace issues may negatively impact on project contract completions, and result in reputational damage that impairs DOW's ability to retain customer contracts or win new projects. In 2017, DOW received a $1.3M fine after a worker was struck and killed by a street sweeper in 2011. Recognising that workers have a high risk of injuries at its exposure sites, DOW has since maintained a rigorous Zero Harm framework and a strategic plan for critical risk management for its employees. DOW's ongoing health and safety targets include zero fatalities and a commitment to industry leading Lost Time Injury Frequency Rate (LTIFR) and Total Recordable Injury Frequency Rate (TRIFR) performance. Additionally, health and safety training programs have been periodically assessed to incorporate experience-based situational training. The success of these initiatives is displayed by DOW recording zero fatalities, a 0.99 LTIFR and a 2.60 TRIFR in FY21. DOW's actions to promote workplace health and safety align with the SMF's preference for investments that exhibit corporate trustworthiness, including transparency and accountability.

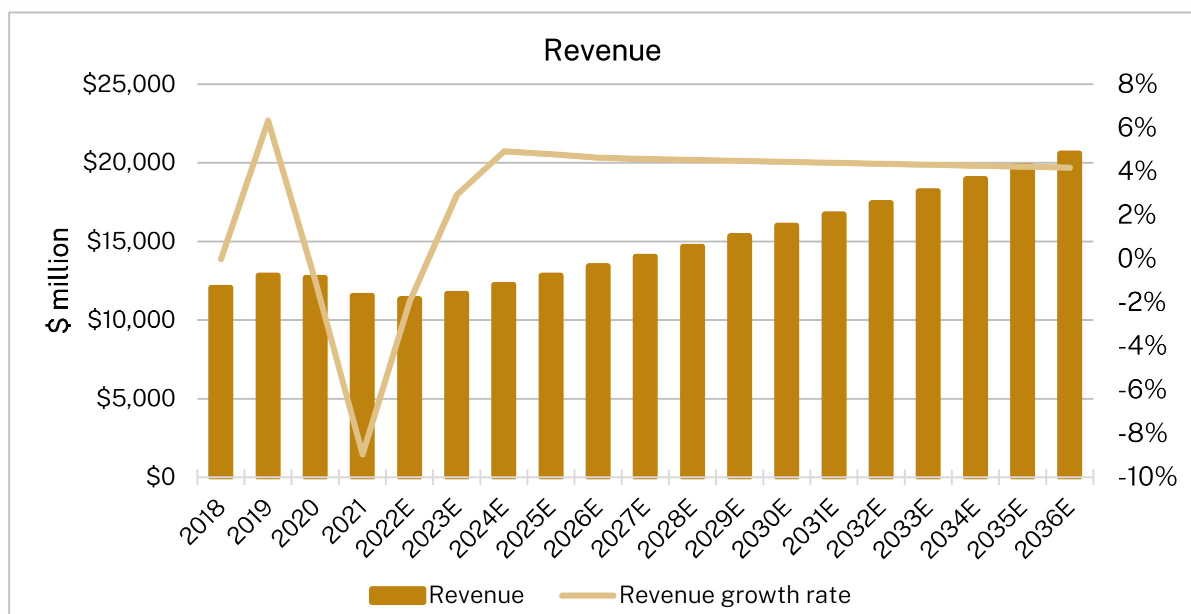
Climate change and environmental considerations

DOW's Urban Services strategy has committed to addressing transition to a low carbon economy through reducing its greenhouse gas emissions. This includes reducing Scope 1 and Scope 2 emissions by approximately 45-50% by 2035 from FY18. Transitioning towards a less capital-intensive structure, including divestment of the laundry and mining businesses, will reduce Scope 1 & 2 emissions by 35%. In FY21, DOW's New Zealand business incurred one penalty infringement notice for an environmental breach of the Resource Management Act 1991, which involved diesel discharge into a stormwater drain. This single infringement, however, demonstrates an improvement on DOW's performance over the past five years.

A.3 Valuation summary

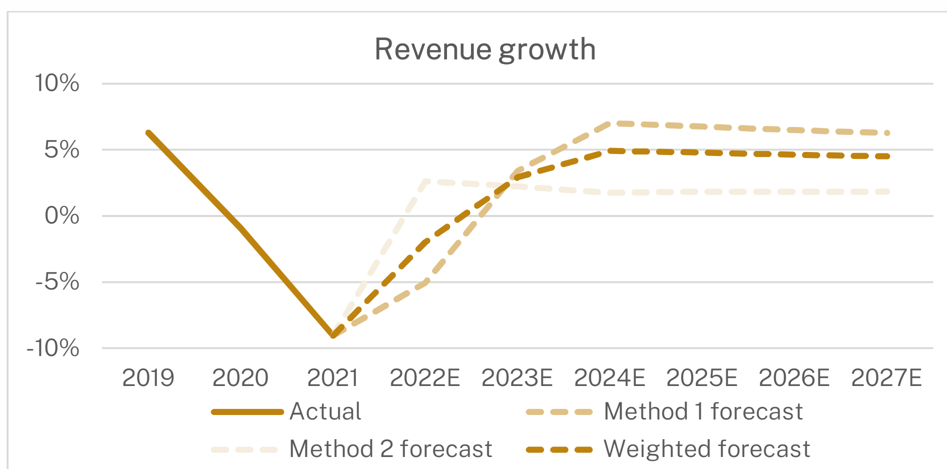
Valuation, ex. FCs	Value
Current share price	**$5.56**
Base case DCF valuation	**$6.14**
MoS	10.36%
Required return on equity	7.25%
WACC	6.07%
Best case valuation	**$7.06**
Best case MoS	27.00%
Worst case valuation	**$3.58**
Worst case MoS	-35.62%

Revenue



Operating revenues are forecast based on two models, one relying on the correlation between DOW's core business segments and industry drivers and the other based upon the relation of the geographical segments with GDP and urbanisation.

DOW also participates in many joint ventures (JVs), which generate additional revenues for the group. However, due to limited information about the JV costs and revenues, we incorporate this into other revenue and forecast as a percentage of operating revenue based on historical levels.



Business segment revenue growth forecast

Financial year ($million)	2019(A)	2020(A)	2021(A)	2022(E)	2023(E)	2024(E)	2025(E)
Transport	3,775.0	4,057.0	4,643.0	4,756.2	5,163.5	5,582.9	6,014.8
Utilities	2,506.0	2,669.0	2,105.0	2,022.0	2,236.4	2,455.1	2,678.1
Facilities	3,383.8	3,308.4	2,983.0	3,087.9	3,183.4	3,282.2	3,384.6
EC&M	1,703.0	1,167.0	865.0	200.0	0.0	0.0	0.0
Mining	1,421.0	1,489.0	1,076.0	400.0	0.0	0.0	0.0

The mining segment is modelled as being sold half-way through FY22; thus, we have forecasted $400 million revenue based on the HY22 financial report. The EC&M segment FY22 revenue consists of asset service revenues associated with both core and non-core businesses in FY22 and is incorporated into the facilities segment from FY23.

For ongoing core-urban services businesses (transport, facilities, and utilities), a regression model was adopted that employs industry revenue data to forecast sales for each of these segments. We used Australian industry revenue data as the majority of sales are generated in the Australian market. Sales in the transport segment are forecasted relative to the road and rail maintenance industry revenue. Sales in the facilities segment are forecasted relative to the facilities management industry revenue. Sales in the utilities segment are forecasted relative to the Total Factor Incomes (GDP contributions) of the electricity, gas, water, and waste services combined industry. The respective industry revenue's growth is forecasted based on the IBIS World industry outlook for Australia over the next five years.

Industry	Five-year CAGR
Road and rail maintenance	2.97%
Facilities management	3.55%
Electricity, gas, water, and waste services	1.98%

The model is built in nominal Australian Dollars, given that about 80% of FY21 revenues came from the Australian market and the exchange rate between the Australian Dollar and New Zealand Dollar has been relatively stable over the last five years.

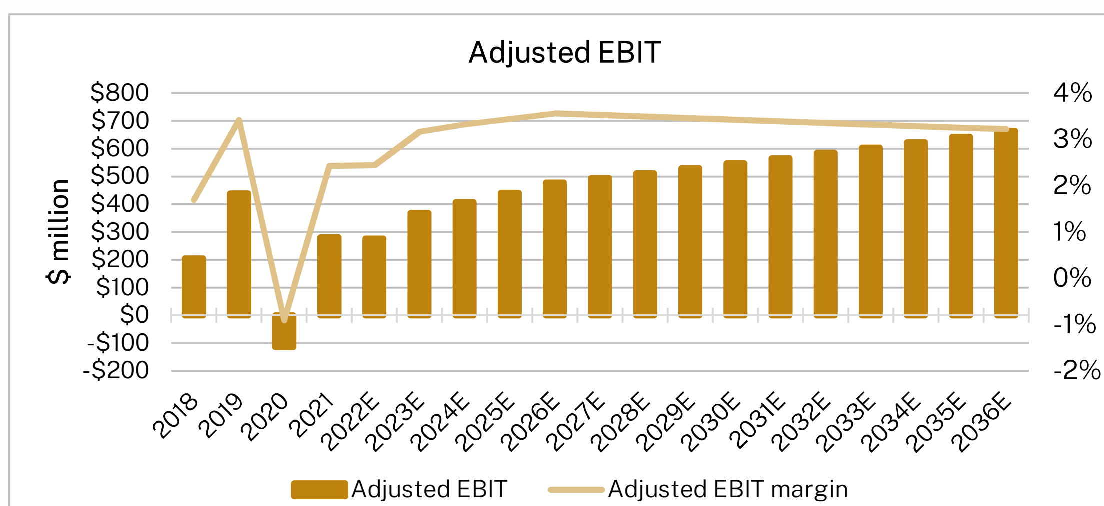
Geographical segment revenue growth forecast

Financial year	2022(E)	2023(E)	2024(E)	2025(E)	2026(E)	2027(E)
GDP growth rate	4.1%	3.0%	2.0%	2.1%	2.1%	2.1%
Urbanisation growth rate	0.36%	1.06%	1.33%	1.51%	1.43%	1.54%
Weighted revenue growth rate	2.62%	2.23%	1.76%	1.85%	1.81%	1.85%

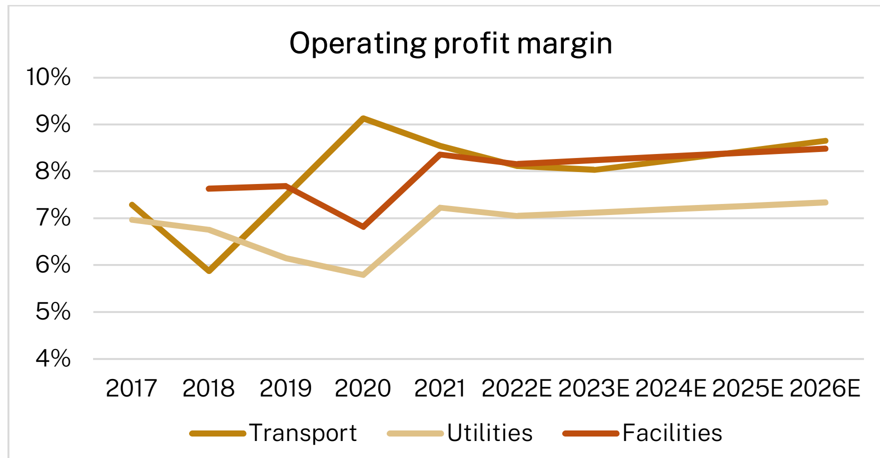
To reflect the maturity of the business, a second revenue model was adopted to capture the strong interrelationships between DOW's core-urban businesses with GDP and urbanisation trends in both Australia and New Zealand. Five-year GDP growth forecasts are based on the RBA's forecast for Australia and the New Zealand Treasury's forecast for New Zealand. Five-year urbanisation rate forecasts are based on Australia and New Zealand historical rates, including adjustments for COVID.

The revenue split between Australia and New Zealand is assumed to be constant based on the FY21 figures (79:21) for the duration of the forecast period.

EBIT and operating expenses



EBIT is projected based on forecasts for costs as a percentage of operating revenues across continuing segments, and then reviewing the resulting EBIT margins. DOW's cost structure consists of two major components: Selling, General and Administrative cost (SG&A), including wages and sub-contractor costs; and Cost of Goods Sold (COGS), which is the cost of raw materials and consumables. 74.55% of DOW's FY21 operating revenue is spent on SG&A and 13.85% on COGS. The high SG&A proportion reflects that 91% of DOW's current portfolio comprises services contracts. As a result, the DOW cost structure is exposed to labour markets, with some impact from material costs. Material cost pressures are forecast to persist until FY22-23, before a gradual stabilisation back to pre-COVID levels. COGS is forecasted to remain lower than historical pre-divestment levels due to lower materials requirements for DOW's restructured portfolio. Labour cost remain a key uncertainty, as discussed in the main body of this report. The cost assumptions in our base case model lead to margins that display short-term pressures and long-term stabilisation.



Our model increases operating profit margins from FY23 onwards to rise from 7.90% in FY23 up to 8.45% in FY27. We see potential for higher margins but restrain the increase to account for uncertainty surrounding DOW's cost escalation clauses and potential for labour market pressures. Within the transport segment, increases in labour costs and material prices is forecast to decrease operating profit margins (calculated using EBITDA) for FY22 and FY23 based off FY21 levels. However, lower exposure to material input costs and the potential of cost escalation within DOW's contracts to pass on labour costs, as well as stabilisation in supply chain issues from FY24, mean that margins will then recover and stabilise. The transport segment margins grew from 5.88% in FY18 to 9.13% in FY20 (without the assistance of JobKeeper payments) before decreasing slightly to 8.54% in FY21 due to lockdowns and rising input prices, which is suggestive of a recovery in margins once pandemic impacts subside. The overall upward trend from historical levels is supported by DOW's shift to lower capital-intensive businesses, consolidation in the market and increased government spending, which give DOW the opportunity to be more selective in focusing on contracts which suit their strengths through enhanced integrative capabilities.

DOW's COGS decreased from 17.05% to 13.85% between FY20 and FY21, largely due to the commencement of its divestment strategy. The completion of these divestments over the coming financial year will continue to have a downward impact on COGS. Offsetting the decreased exposure to segments with higher COGS will be an increase in COGS as a result of the current increases in material prices to the extent they are not passed through into revenues. This will leave total COGS stable in FY22, before decreasing in FY23 as the benefits of divestments begin to outweigh commodity price increases. COGS are assumed to remain stable from FY24 onwards but could decline if any adverse materials price impacts prove transitory. Our best case scenario reflects the impact of further COGS savings because of the divestment of both the mining and laundries businesses, in combination with an easing of labour market pressures and some effect from reversal of material prices.

Capital expenditure and acquisitions

Capital expenditure (capex) is forecasted for existing tangible and intangible assets (software and technology), assuming a lower capex-to-asset ratio than historical levels to reflect the company's shift to a capital-light, service focused portfolio. Total capex required to support maintenance and growth in the business is forecasted to increase to pre-COVID rates, at 4.8% of revenues. Based on its historical performance, we believe that DOW will be able to maintain its sustainable organic growth in line with the current capex assumptions in our model. We view the divestment of capital-intensive mining and laundries businesses as giving DOW more flexibility in allocating capex to investments such as cyber resilience, production facilities and workforce management. This is reflected by the increase in capex for intangible assets (excl. goodwill) to a constant level at 24% of net other intangible assets.

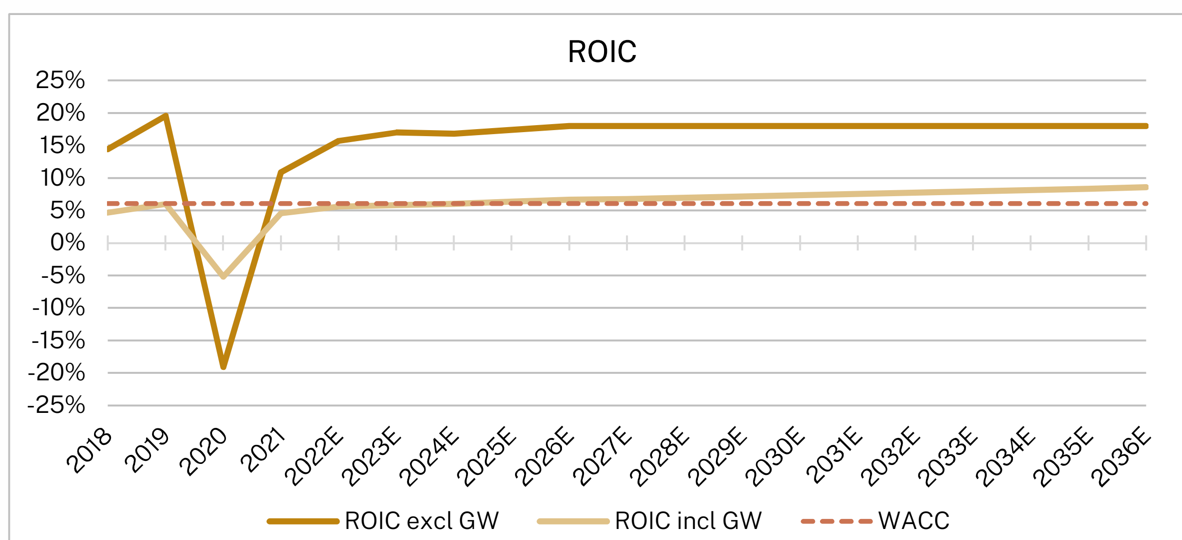
Apart from significant acquisitions such as Spotless and Hawkins, DOW maintained a low level of bolt-on acquisitions prior to COVID. DOW's management has indicated that they will resume

their bolt-on acquisition strategy post-COVID to support growth. Some historical small bolt-on acquisition examples include:

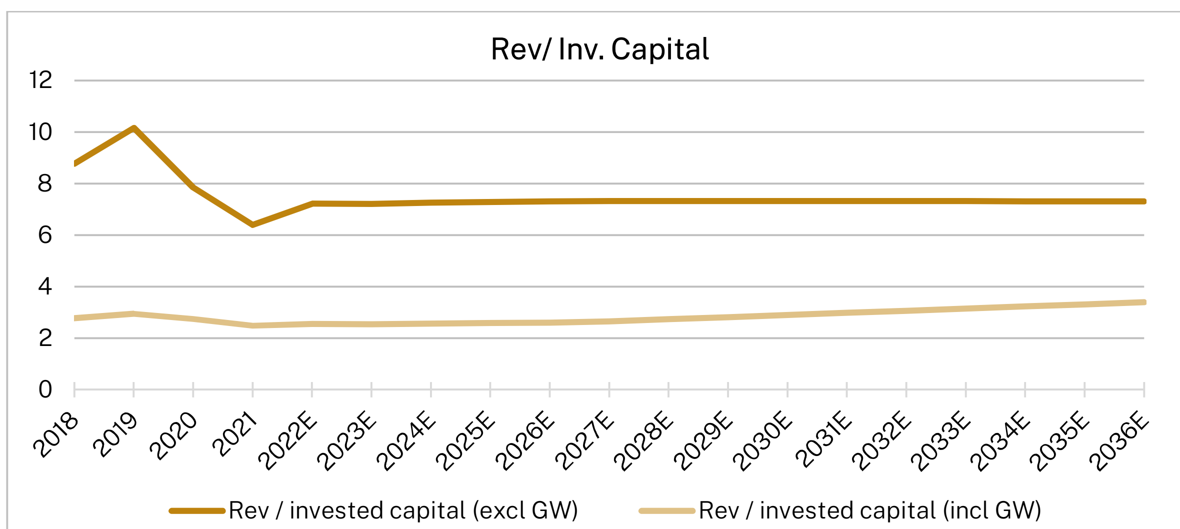
- Rock N Road (a road surfacing business in Mackay) in 2019, costing $17.9 million.
- Boleh Consulting (engineering services to the railway industry) in 2019, costing $1.4 million.
- Envar Group (integrated mechanical and electrical business) in 2019, costing $25 million.
- RH Lismore (Fulton Hogan's Road surfacing business in Lismore) in 2019, costing $1.8 million.
- Urban Grid (Western Australia water, energy, and communication network) in 2018, costing $12.5 million.
- ITS PipeTech (pipeline bursting, civil maintenance, and robotics) in 2017, costing $45 million

A small, constant level of bolt-on acquisitions is assumed over the next five years based on this historical trend and the stated management strategy. These investments may place DOW in a better position to consolidate its core-urban businesses, potentially improving operational efficiency and margins moving forward. This assists EBIT margins trending back to pre-COVID levels of above 3%.

ROIC and investment capital turnover



ROIC (excl. GW) is projected to trend back to pre-COVID levels between 15-18%, recovering from observed lows experienced in 2020. Such an increase is driven by the recovery of NOPLAT post-pandemic and the complete divestment of mining and laundries businesses by the end of FY22.



Invested capital (IC) turnover is set at a lower level than seen prior to the change in accounting standard in FY20 to include right-of-use assets. IC turnover is projected to increase in FY22 after the complete divestment of the capital-intensive mining and laundries businesses. Our projections see IC turnover remaining stable excluding GW, but trending higher including GW. This implies the underlying business maintains a constant level of capital intensity, while IC including GW trends higher because GW increases only by a small amount in the next five years (bolt-on acquisitions) and remains unchanged in the second stage forecast.

Weighted average cost of capital

The SMF baseline cost of equity is 7.25%, reflecting the Asset Allocation (AA) team's estimate of the implied expected return on the Australian equity market. A 7.25% discount rate also happens to align with the return required for the SMF to achieve its target absolute return of inflation plus 4.5%. Adjustments were considered for both the industry that DOW operates and confidence in cash flows. The commercial and professional services industry is considered medium risk, and DOW is low-risk within the industry given 91% of its contracts are government or government-regulated, generating reliable cash flows. This resulted in maintaining the baseline cost of equity of 7.25%. The cost of debt is 4.55%, reflecting a 1.52% premium on Australian 10-year bond yields, based on DOW's implied credit rating from Eikon. The resulting WACC is 6.07%.

A.4 Scenario analysis

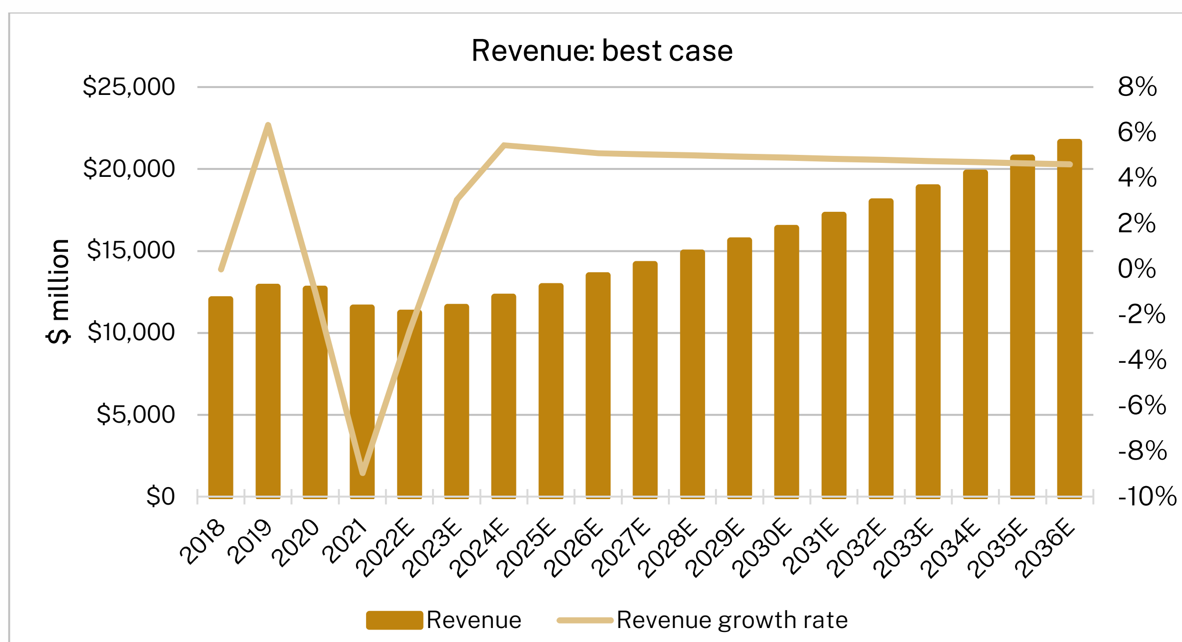
Best case – revenue and margin improvements continue

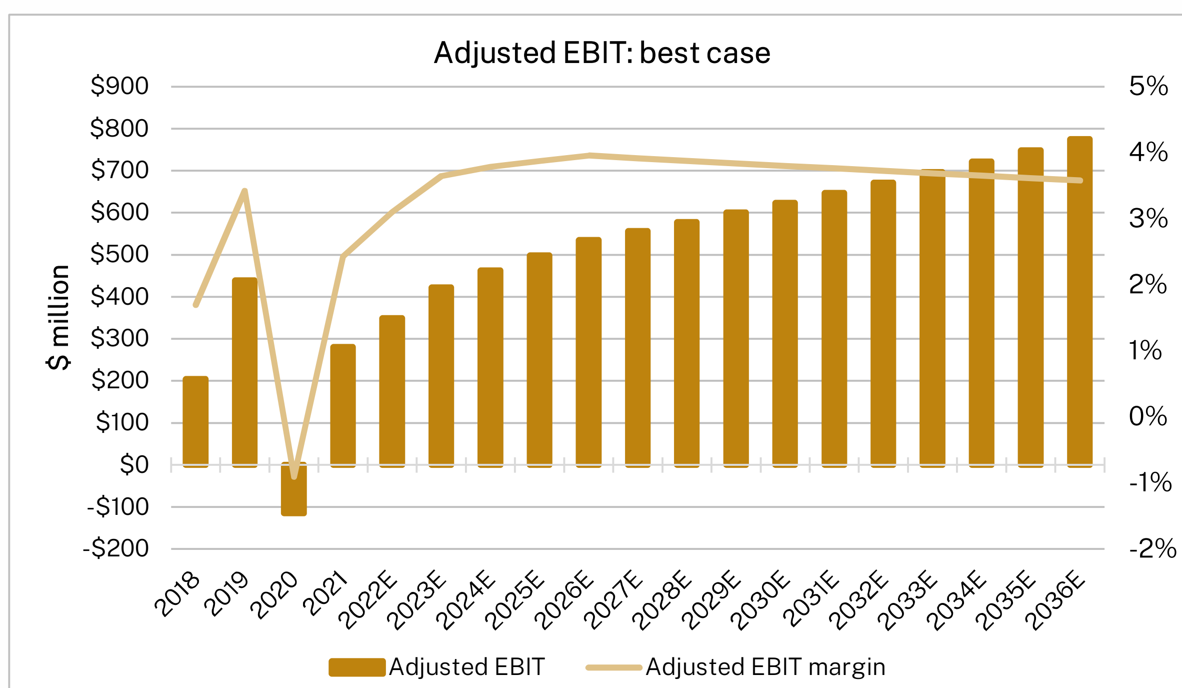
Our best case scenario produces a valuation of $7.06, with a MoS of 27.00%. In this scenario, we forecast more optimistic operating margins enabled by a higher level of bolt-on acquisitions and capex to improve operational efficiency, an ebbing of cost pressures and the benefit of adding more long-term contracts.

With the advantage of operating at scale and divestment of capital-intensive businesses, DOW can increase growth capex to capitalise on more opportunities and consolidate its market position in core-urban businesses. Our best case assumes that DOW will invest more in improving its integrative capability (with intangible capex increasing to 30%, compared to 23% in our base case). The further improved integrated capability will allow DOW to improve margins, commit to more contracts and achieve higher revenue.

Due to input cost volatility throughout the pandemic, large companies such as DOW will be less willing to bear cost risks. In our best case scenario, we argue that DOW's strong relationships and historical delivery of high-quality contracts with government clients enable it to negotiate for better contract terms, either to increase sharing of cost fluctuations with clients or to provide some compensation when taking on cost risk. Such terms would either eliminate or offset some of the downside cost risks for DOW. Further, our best case assumes DOW will realise the benefits

of its cost escalation clause in its current contracts, to effectively mitigate persisting labour market pressures. There is also some reduction in COGS stemming from reduced materials prices. This will result in further operating margins improvement than historical levels from FY24, compared to our base case which is more heavily impacted by cost pressures.





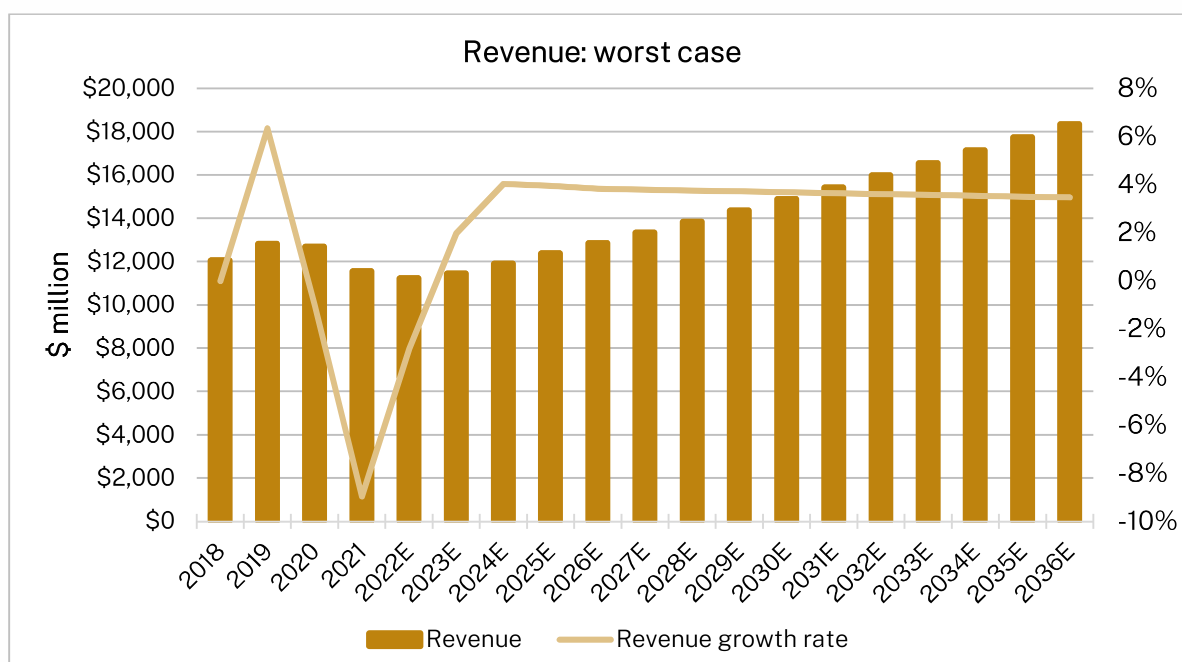
Worst case – persisting pandemic issues with no rebound

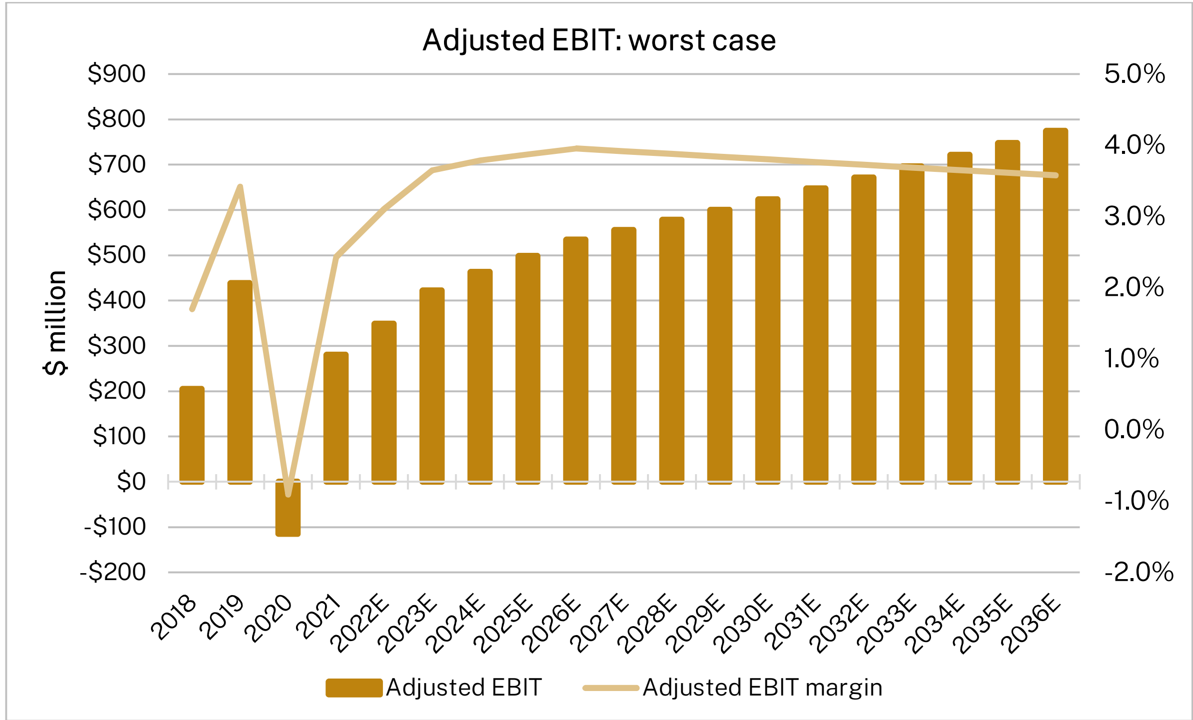
Our worst case scenario produces a valuation of $3.58, with a MoS of -35.62%. However, this scenario can be seen as a crisis state, as the assumptions underpinning the scenario are considered highly unlikely over the forecast period. This scenario involves a significant decrease in infrastructure spending by the government. This might occur, for example, in response to a permanent shift to a hybrid working culture that decreases urban public transport demand and stymies any rebound in urbanisation post-pandemic. This state of affairs is combined with

persistent increases in input prices and labour shortages without any ability for cost escalation, as well as a switch back to insourcing or increased use of smaller, specialised firms.

Under this scenario, we lower revenue growth through dropping the industry growth rate as well as halving the urbanisation forecast. Operating expenses are assumed not to rebound and normalise to pre-pandemic levels due to an inability to pass on any costs to clients, with expenses staying at levels forecast for FY22 and FY23. A further decrease was not applied to expenses in FY22 and FY23, as current input prices and labour shortages are seen as indicative of this worst case scenario and its impacts on price.

We perceive this scenario as relatively unlikely to occur for a variety of reasons. Even if a greater proportion of the population begins working from home permanently and urbanisation slows, there is bipartisan recognition of the importance of infrastructure to Australia's economy and future prosperity, suggesting government reductions in infrastructure spending are unlikely. The pandemic has provided an opportunity to focus on infrastructure projects that are more efficient and better for the environment, priorities that exist even with changing population trends. Further, any trend away from outsourcing seems unlikely to greatly impact on DOW given the specialised nature of its operations. The assumptions surrounding the probability of DOW being able to pass on any costs are explored in the margin sensitivity discussion in the main body of the report, which adds to probability of the worst case at the margin. Whilst this worst case could eventuate, management confidence in cost escalation clauses and consensus opinions suggest that DOW is well placed to deal with increasing wages and labour costs, with decreased material cost exposure providing an opportunity to offset labour cost increases.




Adjusted EBIT: worst case
$ million
$900
$800
$700
$600
$500
$400
$300
$200
$100
$0
-$100
-$200
5.0%
4.0%
3.0%
2.0%
1.0%
0.0%
-1.0%
-2.0%
2018
2019
2020
2021
2022E
2023E
2024E
2025E
2026E
2027E
2028E
2029E
2030E
2031E
2032E
2033E
2034E
2035E
2036E
Adjusted EBIT
Adjusted EBIT margin

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