Australian National University

ANU Student Managed Fund

Rebalancing report: Downer EDI Ltd

Creation date: 02/03/2023| Version date: 29/03/2023 (v4.1)

Contents

Notes:

All dollar amounts in this report are Australian dollars.

Glossary

AAE – Active Australian Equities

ANU – The Australian National University

CEO – Chief executive officer

CFO – Chief financial officer

COGS – Cost of goods sold

CPI – Consumer price index

DOW – Downer EDI Ltd

EBIT – Earnings before interest and tax

EBITA – Earnings before interest, tax and amortisation

FY25 – Financial year 2025

GICS – Global industry classification standard

ICAC – Independent Commission Against Corruption

IOZ – iShares Core S&P/ASX 200 ETF

MoS – Margin of safety

R&C – Risk and Compliance

SG&A – Selling, general and administrative costs

SMF – ANU Student Managed Fund

SRI – Socially responsible investing

WACC – Weighted average cost of capital

WIH – Work-in-hand

1H23 – First half 2023

Portfolio recommendation

The Student Managed Fund (SMF) recommends rebalancing Downer EDI (DOW) to the target weighting of 10% after a review conducted by the Active Australian Equities (AAE) team and the Risk and Compliance (R&C) team.

Investment thesis

On 9 January 2023, DOW was placed under a rebalancing review after having moved to more than 3% below its 10% target weighting in the AAE portfolio. At the time of this report, DOW's deviation is around 3.9% below the target weighting.

The significant decline in DOW's share price has been underpinned by two key events:

1. Public disclosure of accounting irregularities within the utilities segment, which triggered a 20% reduction in the share price (8 December 2022); and
2. Missed earnings guidance driven by cost pressures and contract losses also within the utilities segment, resulting in a further 24% reduction in the share price (27 February 2023).

The SMF team is recommending rebalancing to the target weighting on the basis that the underlying fundamentals of the company remain unchanged, notwithstanding a downward adjustment in our forecast that in part reflects previous overstatement of the earnings that we were using as a base. Consistent with the Fund's objectives, our investment thesis looks beyond what we see as transitory volatility. We hence view the underperformance as an attractive opportunity to rebalance our holding of DOW up to the 10% target weight endorsed by the SMF Investment Advisory Committee.

Key risks taken into consideration include DOW's extreme sensitivity to margins and whether the governance issues that resulted in stock underperformance are likely to persist. Importantly, our analysis suggests that the extent to which these risks could materialise is discounted in the market price. The company is also taking action to improve margin performance through efficiency enhancing programs, and address governance related issues through changes in leadership and control/monitoring procedures to prevent further incidents from occurring.

With further conservatism built into forecasts, our valuation produces a margin of safety (MoS) of 14.16%, indicating that rebalancing to the target weighting represents an accretive investment.

Price (at 08/03/2023)	$3.32
Valuation	$3.79
- Inc. franking credits	$5.08
Margin of safety (MoS)	14.16%
- Inc. franking credits	53.31%
Dividend yield (2022)	4.75%
GICS	Commercial and Professional Services
52-Week Range	A$2.97 - $5.88
Recommendation	
Rebalance to target weight	
Key assumptions	
Required return on equity	7.50%
WACC	6.07%

3-year share price history

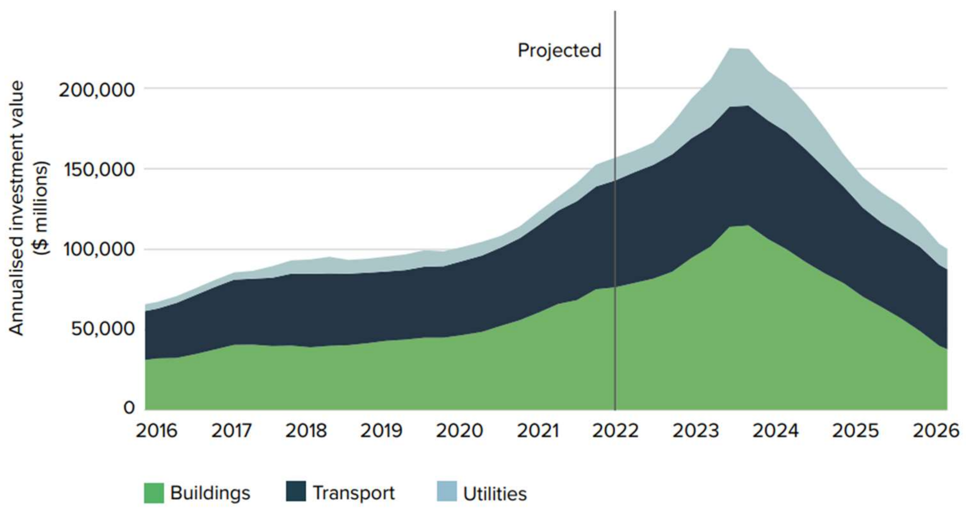
Underlying fundamentals remain intact

Diverse service offering in defensive markets

The original thesis to invest in DOW was underpinned by DOW's business model of providing maintenance and construction services to defensive industries. Its operations are structured over three segments: a transport business (44% of HY23 revenue), utilities business (18% of HY23 revenue) and facilities business (38% of HY23 revenue). These industries give rise to ongoing and growing demand for maintenance and construction services. DOW's operations support the maintenance and delivery of critical community infrastructure that is required regardless of the prevailing economic conditions – roads and rail, power and gas, water, telecommunications, and government facilities (including defence, hospitals and housing). Maintenance requirements will persist for as long as these assets exist. Further, when the assets reach the end of their useful life, replacement assets with new maintenance schedules will be required.

DOW's markets are also experiencing significant growth due to increasing urbanisation and population growth within Australia and New Zealand, alongside emerging trends in terms of infrastructure required to support decarbonisation. The 2022 Infrastructure Market Capacity Report from Infrastructure Australia indicates that, since 2021, demand for major public infrastructure has increased by $15 billion, equivalent to 6.7% growth. This growth resulted in the projected total major public infrastructure pipeline peaking in 2023-24 at $237 billion(see chart below).

Infrastructure Pipeline in Australia

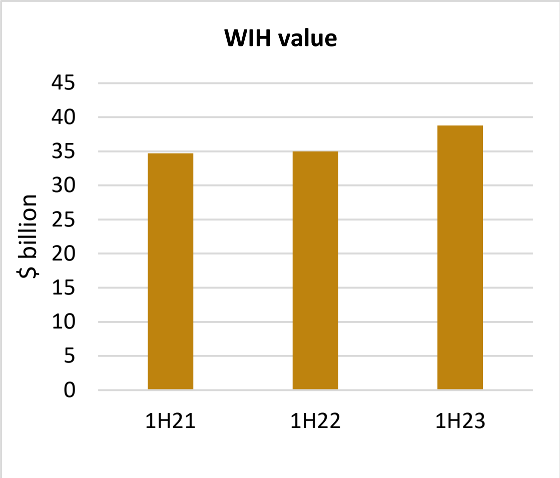


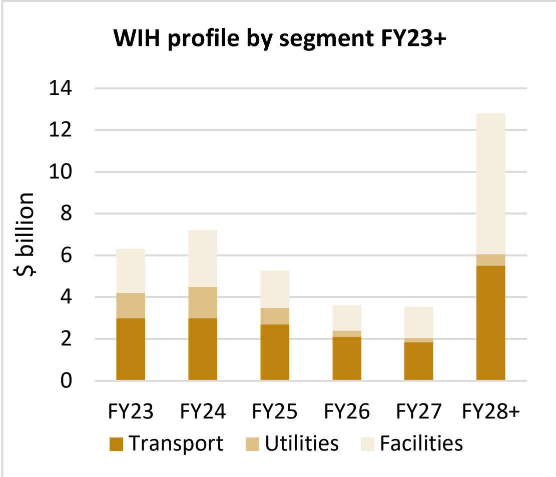
Source: Turner & Townsend and BIS Oxford Economics commissioned by Infrastructure Australia (2022)

This increased investment is expected to widen the pipeline of opportunities for DOW to successfully bid for contracts. We expect DOW to secure a reasonable slice of these opportunities given its scale of operations, existing relationships with Government and established capability in providing services. In addition, the Infrastructure Australia report outlines that capacity pressures are widespread across the infrastructure industry, with over 90% of construction firms operating at capacity, corresponding to a sharp rise in insolvencies during 2022. Noting that DOW has focused on strengthening its urban business segments (discussed further below), this will position DOW to secure contracts on more lucrative terms as the industry navigates through a period of pressure and consolidation. A key performance determinant will be DOW's ability to strike the right balance between winning contracts on attractive terms and managing cost pressures that the industry is experiencing, particularly a shortage of skilled labour.

High revenue certainty with long-term contractual arrangements

An attractive characteristic of DOW that is unaffected by recent developments is the large work-in-hand (WIH) profile the company has established through contracts with customers. Importantly, the overall WIH profile has experienced growth over the last three years (following DOW's divestment of its mining and construction business), with this reaching $38.8 billion as at 1H23 (see left chart below). The WIH profile is skewed to long-term contractual arrangements established across all three business segments (see right chart below).





Importantly, the WIH profile provides a strong degree of certainty of revenue over the intermediate forecast period, underscored by the fact that DOW's counterparties for the transport, utilities and facilities WIH respectively comprise 98%, 81% and 85% government entities. Further, approximately 91% of DOW's WIH profile is service-based, 96% of which includes price-escalation terms that are linked to the consumer price index (CPI) or a blend of relevant CPI, materials and/or labour indices. However, whilst the stability of revenue continues to serve as a significant advantage for DOW, it is clear that cash flows have been markedly less reliable given industry cost dynamics. Further analysis on costs is discussed below.

Cost pressures to subside in the long-term

Downer's ~40% share price fall since December 2022 has been underpinned by two key events:

1. Admission of accounting irregularities that resulted in an overstatement of revenue by $22.2 million over a three-year period; and
2. Earnings guidance being downgraded twice in the last three months due to poor weather, a lost utilities contract and a tight labour market.

The errors leading to the accounting irregularities appear to have been addressed. Hence, we conclude that DOW is trading at a significantly depressed valuation due to ongoing concerns regarding management's ability to control margin pressures. Following the share price reaction, we see significant upside potential relative to implicit market expectations that seem to place too much weight on cost pressures that are likely to prove transitory, and not enough weight on the initiatives of a revamped management team to relieve margin pressure. The intense market scrutiny over DOW's struggles also creates a pressing need for the company to address accountability and transparency, which will benefit investors moving forward.

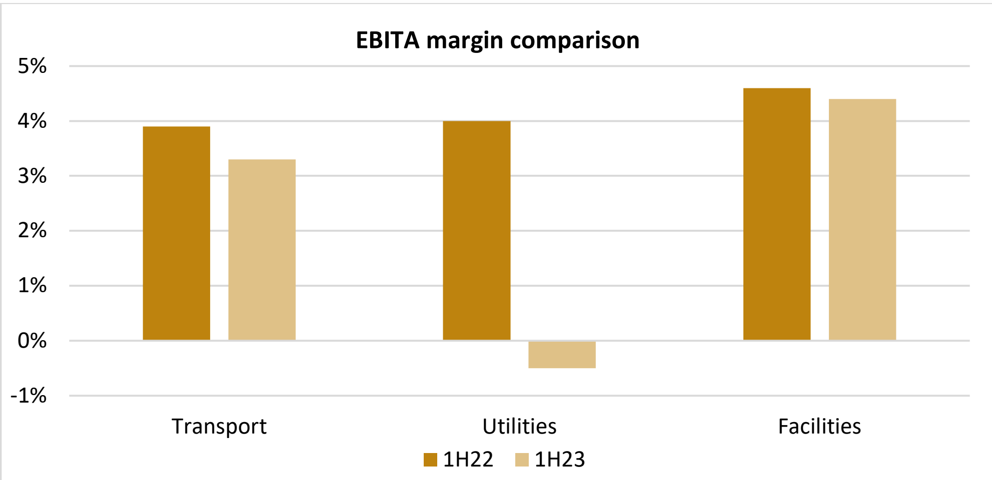
External events to subside and relieve cost pressure

After recording a 21.3% decline in statutory EBITA for 1H23 and adjusting FY23 earnings guidance down by $40 million (18%), DOW pointed towards wet weather events and severe labour shortages as a key cause of inflated costs. The decline in earnings was led by the utilities segment, which recorded a $5.2 million loss (with prior comparable period EBITA of $40.5 million). The transport segment also recorded a 14.5% decline in earnings, while the performance of the facilities segment was largely unaffected. The release of 1H23 results and the accompanying 18% downgrade in earnings guidance was extremely poorly received by the market, as reflected in the 20% decline in share price.

The breakdown of the $40 million downward adjustment in earnings guidance is as follows:

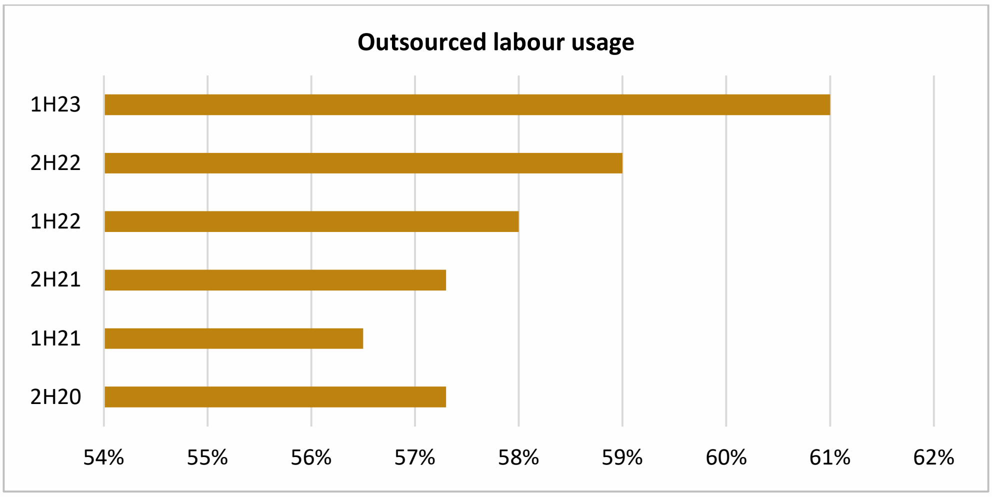
1. Lost utilities power maintenance contract - $12 million;
2. Heightened risk of Water project risk from unrecoverable prolongation costs due to storms and flooding causing site closures - $12 million;
3. Floods and storms in the North Island of New Zealand - $8 million; and
4. Expected slowdown in minor Government capital works - $8 million.

Of the above, only the loss of the $12 million utilities power maintenance contract will have an ongoing impact. Our investment thesis is thus underpinned by the assumption that these supply-side issues are largely transitory. This establishes the foundation for an earnings turnaround that should be only enhanced by a new management team that is focused on relieving margin pressures. The chart below illustrates the severity of margin pressure in 1H23 which led to a 21% decline in EBITA despite revenue growth.



Wet weather resulted in a >40% increase in lost shifts and significant site closures, delays, and productivity impacts. Notably, water projects have been prolonged significantly and the flooding in the North Island of New Zealand has materially impacted operations. Whilst this increases the work pipeline in FY24, project delays still bear significant costs associated with employee expenses and logistics challenges.

The stickier factor causing cost issues and margin pressure is a tight labour market. The Infrastructure Australia report indicates that Australia is 'missing' almost half a million people in net overseas migration because of border closures related to COVID-19. Currently, the annual industry turnover rate is at roughly 20%. As evident in the chart below, DOW has had to increase its reliance on subcontractors, which come at approximately a 15% cost premium to regular employees. In 1H23, DOW's subcontractor expense increased by 16%. This is an industry wide issue that will return to an equilibrium in the long term, with 96% of service contracts including cost escalation mechanisms. Nevertheless, it remains a risk while labour markets are tight, and could work to delay any earnings recovery.



Restructuring and offloading of non-core businesses to drive efficiency gains

Despite management blaming external factors for DOW's poor performance, there has been intense market criticism over the governance and risk management of DOW. Major shareholder, Allan Gray, heavily criticised the company for being "inept in running a profitable and sustainable business". This, along with a lengthy run of poor performance, has seen major shifts in management and strategy going forward in a bid to deliver results under significant pressure. As part of a major cultural reset, the CEO and CFO have both resigned and two members of the board have left, including the chairman. We see recent underperformance and market scrutiny as creating scope for upside from cultural readjustment and implementation of strategies to deliver value by trimming inefficiencies and lowering the cost base.

Looking forward, DOW's strategy is to get its asset mix right by focusing on its key business units. The strategy encompasses shifting away from DOW's industrial roots towards soft services that are less capital intensive and offer more flexibility. Whilst this has been a key focus for years, the disappointing 1H23 results have increased the urgency. DOW has announced the intention to sell both its mineral technologies business and its stake in Repurpose It, a resource recovery company. These divestments follow the recent sale of DOW's Australian Transport Projects business, and the major divestment of the Mining business in 2022.

As DOW continues to divest from non-core business activities, it will be able to increase focus on key operations, which should make for increasingly streamlined operations and better margin control. As well as simplifying its business portfolio, DOW announced a project to merge Australian and New Zealand operating units and optimise the operating model. This project strives to improve scale, capability, and growth potential while reducing corporate overheads and improving risk management through standardisation. By FY25, DOW is targeting >$100 million in benefits per annum from these initiatives.

The primary target of these strategies is to raise the EBITA margin to in excess of 4.5% by FY25. This would represent a 2.2% improvement on the 1H23 results and a 1.5% improvement on 1H22 results. Whilst it is important to consider these objectives with scepticism – our margin forecast sit well below DOW's target – we also place weight on the fact that the new management team is under intense investor scrutiny and pressure to perform. This provides reasonable credibility to the position that the turnaround is likely and offers some hope of an upside surprise.

Accounting irregularities an isolated incident

In December 2022, DOW revealed that accounting irregularities had led to the overstatement of pre-tax earnings by $30-$40 million between 2019 and 2022. It was later revealed that the earnings were overstated by $22.2 million between 2020 and 2022. The overstatement occurred in relation to a maintenance project that had errors within its billing system, leading to revenue being recorded without the work being performed. After an in-depth investigation by external lawyers and forensic accountants, it has been determined that the misreporting was specific to the contract in question. For remediation, the team responsible for the accounting irregularities have been removed from the company and DOW will adopt an internal tender and contracts committee. This committee will monitor how revenue is recognised on significant new contracts and conduct an internal audit within the first six months of new contract commencement. We conclude that DOW has taken necessary actions to reduce the likelihood of further such events occurring, notably the cultural, management and governance adjustments. However, moving forward, these events highlight the need to maintain scrutiny over governance at DOW, and whether more effective risk management processes have been put in place.

Key risk: Susceptibility to external cost pressures

A key risk to our investment case is the sensitivity of DOW's valuation to margins. Operating in the services industry, margins are essential to the financial performance of the company, and changes to these margins can have drastic impacts on the outcome of projects and cash flows overall. This is evident in the significant share price drop over the last few months because of cost pressures that led to a 60bp decline in the 1H23 EBIT margin. Our investment thesis assumes that the cost pressures will prove mainly transitory, while increased management focus on improving the efficiency of operations will further relieve margin pressure. Nevertheless, it is essential to understand the risks associated with ultra-sensitive margins. The sensitivity of the share price and MoS to changes to the EBIT margin in our model is illustrated in the table below.

EBIT margin adjustment	Share price	MoS
0.5%	$5.57	70%
0.2%	$4.5	37%
0.1%	$4.14	26%
0.0%	$3.79	16%
-0.1%	$3.44	5%
-0.2%	$3.1	-6%
-0.5%	$2.1	-36%

We recognise that high sensitivity to margins exposes DOW to downside risk if further external events were to impact costs. However, our prime focus is ability to generate cash flows over the long term. Here our investment thesis is underpinned by the notion that, whilst short term events could have a significant influence, DOW has several competitive advantages that support its long-term profitability, including the scale of its operations, advantage achieved through established relationships with governments, and stable/growing demand profile for its services. These advantages also allow DOW to withstand transitory pressures, that could have greater impacts on other industry participants.

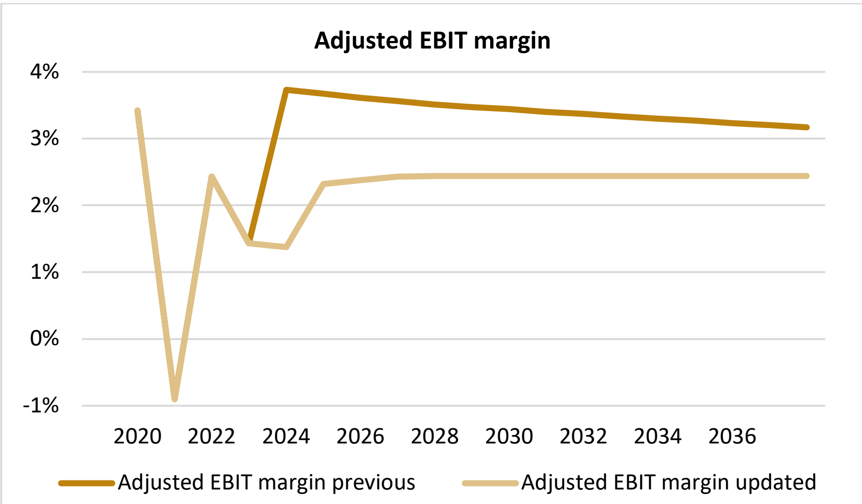
Socially responsible investing review

In addressing whether the Fund's investment in DOW continues to comply with the SMF Socially Responsible Investing (SRI) policy, R&C has conducted an analysis of historical governance issues, and the potential for further mismanagement to cause social injury. We conclude that compliance with SRI policy does not present an issue in the context of DOW's rebalancing.

On 2 March 2023, it was announced that some DOW employees are the subject of an investigation from the NSW Independent Commission Against Corruption (ICAC) for allegations that they dishonestly obtained a benefit by favouring certain subcontractors in awarding work within the 'transport agency'. These contracts date back to January 2017 and, so far, the DOW employees have not been named and ICAC have not specified which transport contracts will be investigated. Based on publicly available information, R&C concludes that this issue is unlikely to lead to an unacceptable level of social injury, noting that the investigation needs to be closely monitored given recent intensification of investor scrutiny. Likewise, R&C has determined that the accounting irregularities outlined earlier in this report do not constitute a policy breach. In both cases, our position is informed by the significant change in company leadership, the stated intent to drive a cultural reset following criticism of governance and risk management practices within the company.

Updated valuation

Two main adjustments have been made to the model since the last revaluation of DOW. First, revenue has been adjusted for the accounting irregularities declared in December 2022. Second, margins have been adjusted downward to reflect the cost pressures DOW is facing. To remain conservative, we assume that DOW's margins remain depressed in perpetuity in comparison to the previous valuation, as well as relative to management's target. Note that we have removed other income from the EBIT calculation due to this income not being classified as operating in nature. This results in lower outcomes for EBIT than what is reported by DOW.



These adjustments lead to a decline in our valuation of DOW shares from $5.51 to $3.79, resulting in a MoS of 14.16%. Importantly, this MoS emerges based on long-term margin assumptions that are quite conservative. Consequently, we see the balance of upside and downside risk versus this valuation as strongly skewed to the upside.

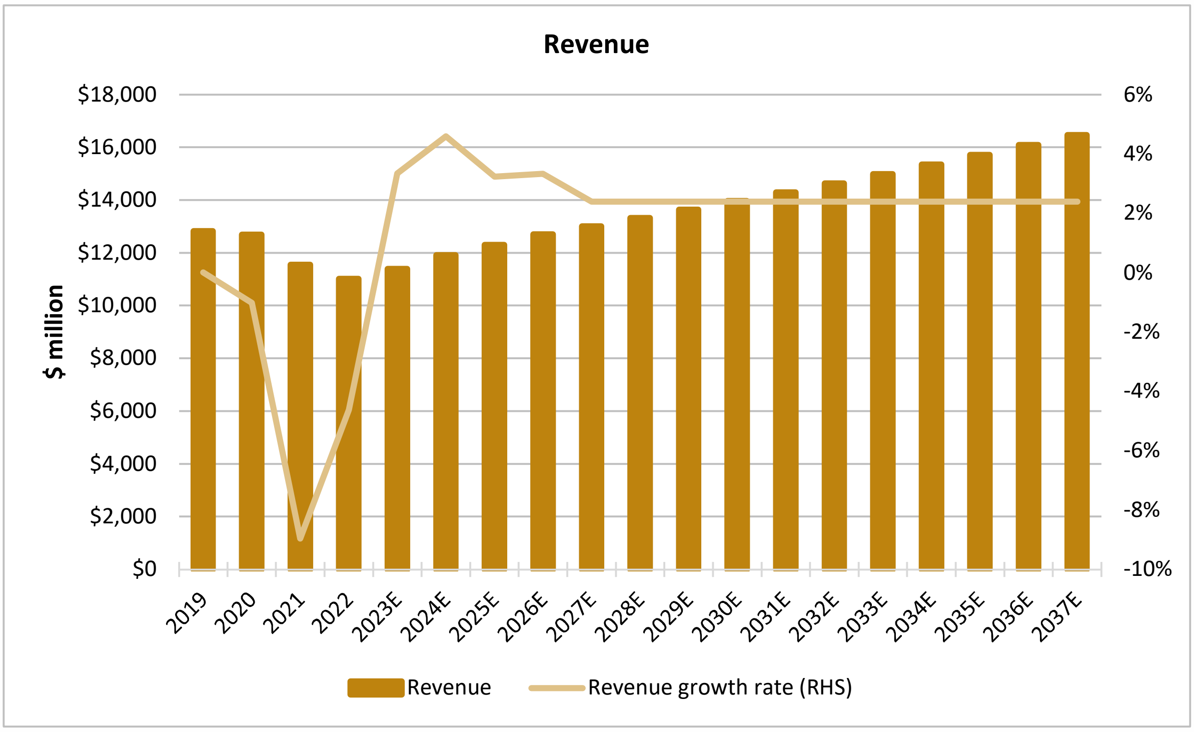
Revised DOW valuation

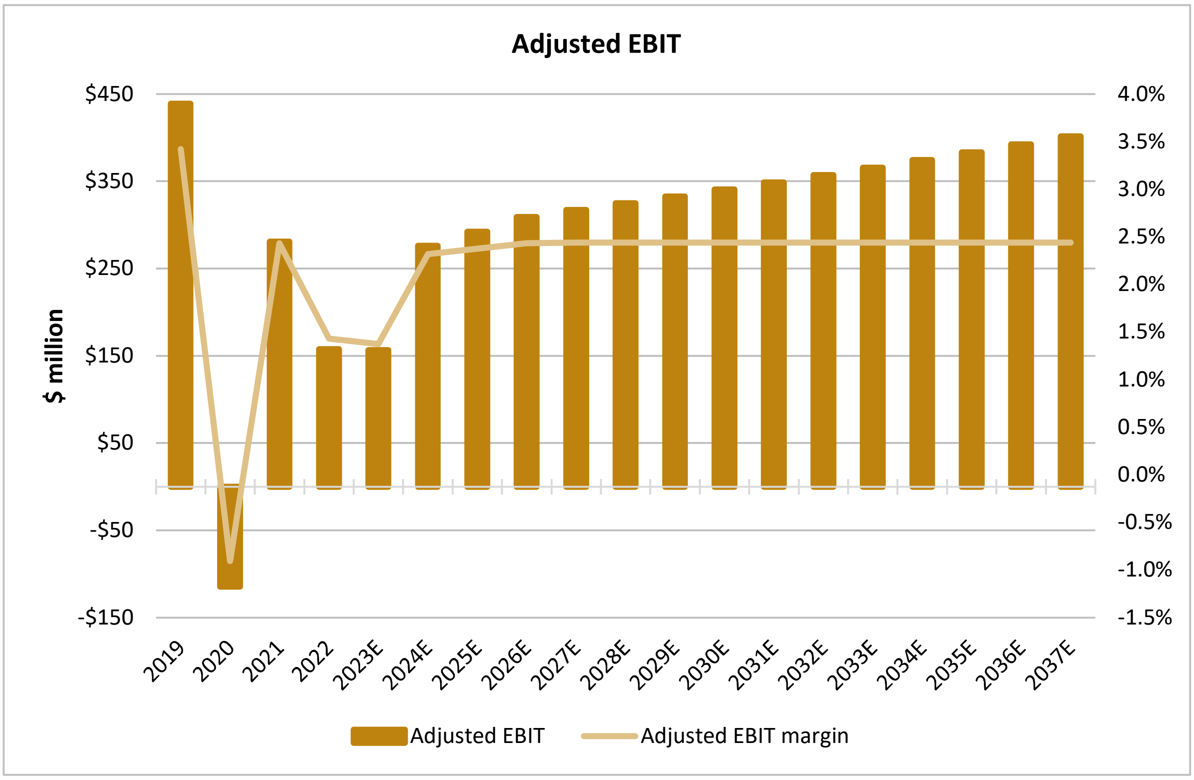
Valuation ex. franking credits	$3.79
Franking credits	$1.29
Valuation inc. franking credits	$5.09
Current share price	$3.32
MoS excluding franking credits	14.16%
MoS including franking credits	53.31%

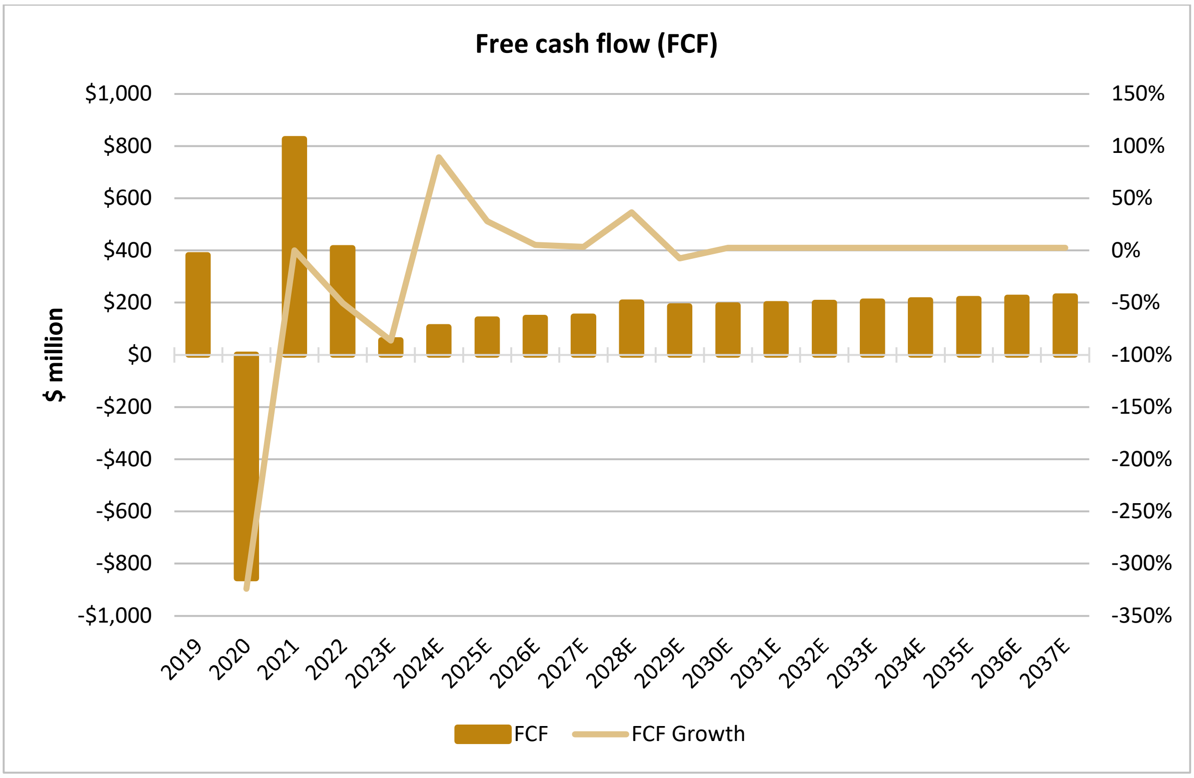
Conclusion and recommendation

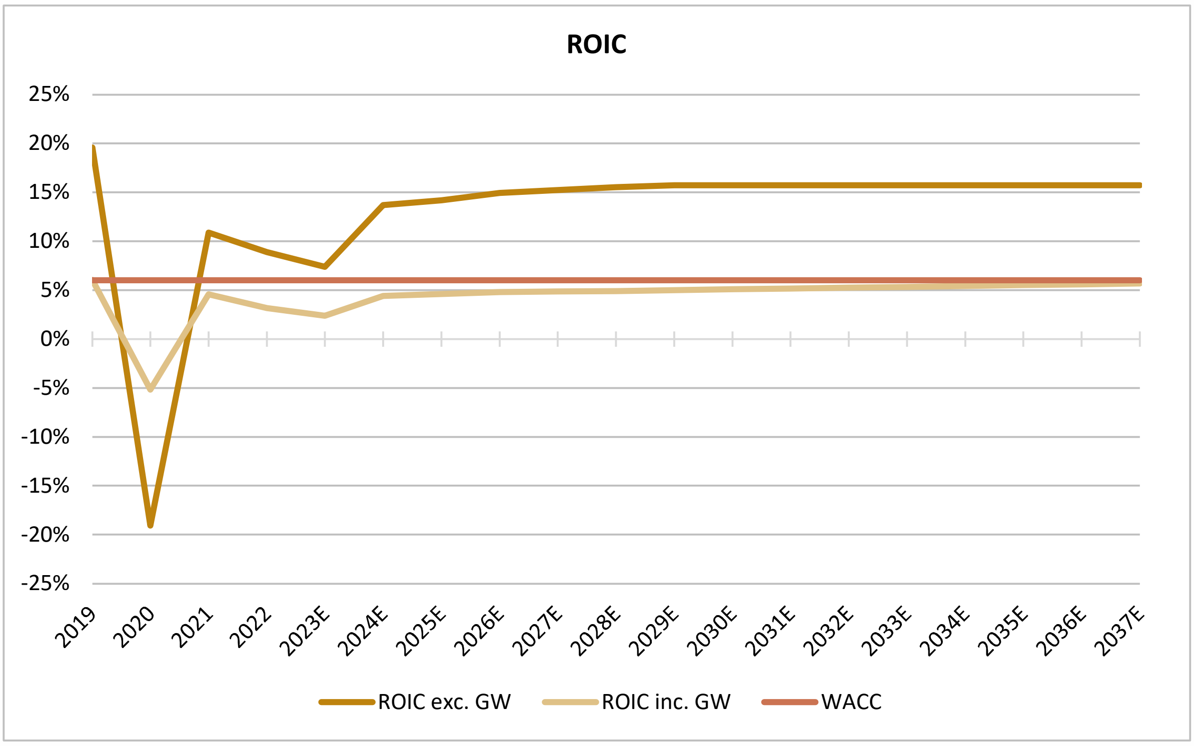
We consider the market to have overreacted to the impact of cost pressures that are likely to prove transitory as well as concerns over governance related matters. This has left the stock attractively priced given its long-term cash flow generating capability and its positioning within stable and growing markets. We further view the intense market scrutiny on DOW as a positive, by placing a high level of accountability on new management and motivating them to improve operations through offloading non-core business units and increasing margins. We recommend that the Fund Convenor purchase sufficient shares in DOW to return to the target weighting of 10%, funding the purchas by selling the required amount of the iShares Core S&P/ASX200 ETF (IOZ).

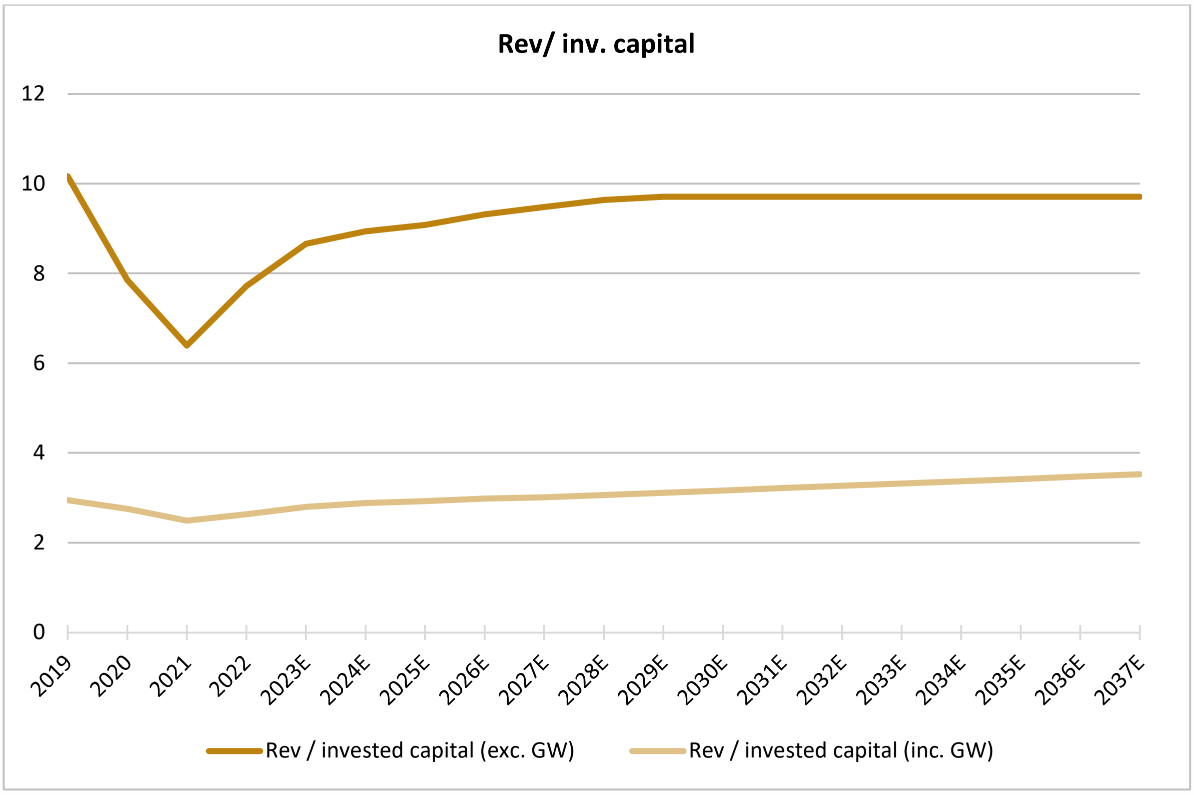
Appendix: Key financials






Free cash flow (FCF)
$ million
$1,000
$800
$600
$400
$200
$0
-$200
-$400
-$600
-$800
-$1,000
150%
100%
50%
0%
-50%
-100%
-150%
-200%
-250%
-300%
-350%
2019 2020 2021 2022 2023E 2024E 2025E 2026E 2027E 2028E 2029E 2030E 2031E 2032E 2033E 2034E 2035E 2036E 2037E
FCF
FCF Growth


ROIC
25%
20%
15%
10%
5%
0%
-5%
-10%
-15%
-20%
-25%
2019 2020 2021 2022 2023E 2024E 2025E 2026E 2027E 2028E 2029E 2030E 2031E 2032E 2033E 2034E 2035E 2036E 2037E
ROIC exc. GW
ROIC inc. GW
WACC


Rev/ inv. capital
12
10
8
6
4
2
0
2019
2020
2021
2022
2023E
2024E
2025E
2026E
2027E
2028E
2029E
2030E
2031E
2032E
2033E
2034E
2035E
2036E
2037E
Rev / invested capital (exc. GW)
Rev / invested capital (inc. GW)

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