Australian National University

ANU Student Managed Fund

Investment Recommendation

Downer EDI Limited

ASX Code: DOW

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Creation date: 29/04/2024 | Version date: 08/05/2024 (Final)

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All dollar amounts in this report are Australian dollars.

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Glossary

AA – Asset Allocation

AAE – Active Australian Equities

AE – Australian equities

AFI – Australian fixed income

ANU – The Australian National University

CBE – ANU College of Business and Economics

CIO – Chief Investment Officer

CRO – Chief Risk Officer

ESG – Environmental, Social and Governance

FC – Franking Credits

FTE – Full Time Employees

GICS – Global Industry Classification Standard

IAC – Investment Advisory Committee

IE – International equities

IPS – Investment Policy Statement

IOZ – iShares Core S&P/ASX 200 ETF

R&C – Risk and Compliance

RSFAS – Research School of Finance, Actuarial Studies, and Statistics

RT – Relationship Team

SMF – ANU Student Managed Fund

SRI – Socially responsible investment

WIH – Work In Hand

WPI – Wage Price Index

YoY – Year on Year

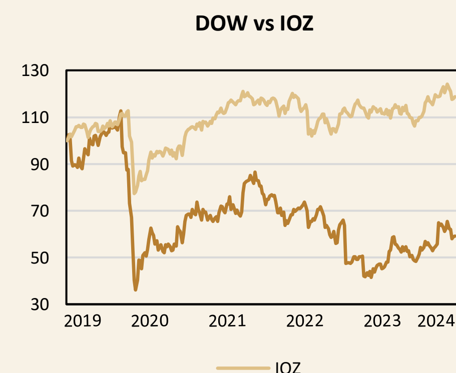
Portfolio recommendation

We recommend that the Student Managed Fund (SMF) **sell** its entire active position in Downer EDI Limited (DOW) within the Active Australian equities (AAE) portfolio and invest the proceeds in iShares Core S&P/ASX200 ETF (IOZ).

The recommendation is subject to the price remaining above $4.20 and expires once the DOW 2023-2024 financial results are released (expected mid 2024).

AUSTRALIA	
ASX code: DOW	
Price (at 8/05/2024)	$4.64
Valuation	$4.20
- inc. franking credits	$4.20
Margin of safety (Mos)	-8.46%
- inc. franking credits	-8.46%
Dividend yield (2024F)	3.16%
GICS	Industrial Services 3520
52-week range	$3.15 – $5.22
Recommendation	**Sell**
Key assumptions	
Required return on equity	8.09%
WACC	7.43%

Five-year share price history



Investment thesis

DOW is an integrated services provider, operating primarily in Australia and New Zealand. The firm designs, builds and sustains core assets, infrastructure, and large-scale construction projects across three operating segments.

The key reason underpinning our sell recommendation is that DOW no longer offers an attractive trade-off between maximising the expected value of funds invested and the risk of sustained loss of value.

The SMF's original investment thesis identified the following drivers of long-term value:

- Cash flow reliability driven by increased government expenditure.
- A strong industry environment underpinned by a shift towards the use of contractors.
- New senior management adopting a comprehensive restructuring of the business.

Since, the initial investment thesis on 1 May 2022, DOW has delivered a time weighted rate of return of -1.78% p.a. since its purchase. The team's investment case for a sell is driven by:

- Persistent cost pressures squeezing margins.
- Short sighted cost-out strategy focus.
- Reputational risk to the SMF.

DOW has reliable revenue streams from their long-term government contracts, dominant market positioning and has undertaken segment rationalization. However, the firm faces persistent cost pressures, have implemented a short-sighted cost-out strategy, and brings reputational risk to the fund. Ultimately, there is an asymmetric skew to downside risks relative to the company's opportunities for both capital gain and dividend inflows. Our DCF model produces a base case target share price of $4.20, implying a -8.46 % MoS (excl. FC).

A key risk to the sell recommendation is our outlook on management's ability to meet its guidance. The market appears to have partially priced in a success in DOW's 4.5% EBITA margin target; a target we consider ambitious given our long-term assessment of the company's value and current operating environment. If management can meet/exceed its targets by FY25, the market would likely react positively, resulting in a share price appreciation. This would provide a better exit point for the SMF. Nevertheless, we believe that the SMF should capitalise upon the short-term market optimism surrounding DOW and avoid exposing ourselves to the risk of management underperforming.

Investment case

Vulnerability to input costs and margin compression

DOW is vulnerable to adverse input cost movements, making the firm susceptible to EBITA margin sensitivity. As such, the ability to pass on costs becomes critical in maintaining a strong intrinsic value. Tight labour markets (where the unemployment < non-accelerating inflation rate of unemployment), covid-induced supply chain bottlenecks and extreme weather events impacting working capacities (La Niña, Cyclone Gabrielle) has catalysed a sharp compression in DOW's operating margin in the last 24 months. With subcontractor and employee benefit expenses accounting for 85% of DOW's total COGS, these headwinds delivered a sharp compression in EBITA margins, with a –20% drop from 3.2% in 2022 to 2.55% in 2023. Despite the implementation of contract price & wage escalation in 96% of its contracts and an additional cut of over 400 full time employees – EBITA margins fell from 3.66% in 2022 to 2.55% in 2023.

Australia's consumer price index has proven to be sticky (with bond traders now only pricing in rate cuts by next year), whilst the labour market has continued to demonstrate resilience – unemployment currently sits at 3.9% with workers' monthly hours worked increasing to 1,929 million throughout March 2024. As such, Australia's year-on-year wage price index and non-residential building construction PPI has risen by 4% and 6.6% in the past year respectively. DOW's labour-intensive business model doesn't allow much flexibility for the company to manage its labour cost. We therefore expect the firm continue to face unfavourable input cost pressures on the labour side. Current labour cost pressures are further escalated by the shortage in specialised and skilled subcontractor workers (in which DOW has an increased reliance on – with subcontractor expenses growing by 11% in 2023). As a result, DOW's current actual project margins have remained, on average, below tendered margins, reflecting the company's inability to pass on these anticipated cost increases. The unfavourable conditions in labour markets, higher raw material costs, increasing frequency of extreme weather events and competition in the contract tendering processes all contribute to an unlikely chance of the management achieving a 4.5% EBITA margin by FY25 (a 190-basis point increase in 18 months).

Short sighted focused strategy

Management's strategy is short-term focused and doesn't align with the SMF as long-term investors. Management's incentive structures prioritise short term strategic thinking with their 'long term' incentives having a two-year time horizon, targeting returns and EPS growth for 2025. This, coupled with new management being hired in 2023, who are eager for short term success in the early stages of their tenure, has led to strategic thinking that sacrifices long term value for short term gain.

The core strategy of current management is to cut costs through reducing full time employees (FTE). Since 2022, FTE has reduced by 6%. This may have two likely outcomes in the long-term. First, DOW may be unable to operate at their current scale, thereby harming revenue and bottom-line profit. Alternatively, to maintain current scale, DOW may turn to sub-contractors, negating the cost saving benefits of reducing FTE and exposing DOW to fluctuations in sub-contractor wages. A second short sighted strategy from management is to runoff low margin projects. Whilst this will lead to short term margin expansion it comes at the expense of long-term value creation; it is not sustainable to grow margins via shedding contracts. The phasing out low margin contracts will decrease EBITA, and in turn FCF.

This short-term thinking does have some benefit. With revenue secured via long term contracts, the margin expansion initiatives should be able to grow margins without significant adverse consequences in the short term. This is reflected in our forecasts, predicting margin expansion to 3.34% in FY25. It is in the long term where these strategies are value destructive, as the adverse effects of reduced scale and less contracts will be more impactful once Downer become more reliant on sourcing new contracts to maintain revenue, rather than relying on existing ones.

Year	FY23	FY24F	FY25F	FY26F	FY27F	FY28F
EBITA margin	2.55%	2.85%	3.34%	3.04%	2.94%	3.1%

Figure 1: EBITA Margin forecast (SMF)

Reputational risk

Holding DOW exposes the SMF to reputational risk. Since the initial investment, DOW has seen significant price fluctuations stemming from a series of events: the revelation of accounting irregularities, profit warnings, the introduction of a 'new' management team and a corruption inquiry. In 2022, DOW was involved in an accounting scandal that resulted in the overstating of $40 million in earnings in their utilities divisions. Consequently, DOW is suing their auditor KPMG for damages related to the irregularities, alleging a lack of *reasonable care and skill* in the auditing of their financial books. More recently, DOW was involved in an inquiry undertaken by the NSW Corruption Watchdog, ICAC, into the awarding of government transport contracts. Amongst published findings, were those employees of DOW and a Sydney council demonstrated *serious corrupt conduct* in the form of *collusive tendering.* For example, DOW had online access to confidential procurements of Transport NSW that gave them a competitive edge in the bidding process. Ultimately, the inquiry highlighted systemic industry concerns arising out of the competitive tendering process. In their annual report, DOW has emphasised the importance of brand reputation in the securing of contracts. Since 90% of DOW's work in hand (WIH) contracts are government related, DOW is vulnerable to changes in government stance and policy. This inquiry has damaged DOW's reputation and may act as a constraint on future earnings or a catalyst for an industry shift towards in-house government project delivery. The series of scandals also exposes the poor governance within its board and management, posing further risk for investors.

Risk to recommendation

Effective implementation of cost cutting

If DOW can deliver on the short-term cost cutting strategies, there is upside to our valuation. The assumption that the cost cutting strategies will be harmful to long term value assumes that DOW will be unable to sustainably operate at a lower cost base at the same scale. If, however, they can maintain scale whilst operating at a lower cost base, management strategies will be value additive in the long run. This threatens our recommendation, as we forecast slight margin contraction after FY25, as the negative effects of a short-term strategy are felt. If these negative effects were not to materialise, the EBITA margin expansion would likely continue, creating significant long-term value. This would have a significant effect on FCF, if EBITA margins were to remain flat from FY25 to FY26, FCF in FY26 increases by 10%. If management were able to prevent margin contraction after FY25, and margins remain constant at the current forecast of 3.34% for FY25 across the forecast period, an additional $80 million worth FCF is created FY26-FY28, producing a target price of $4.79.

Model summary

Revenue

By the end of 2022, DOW divested away from mining and laundry in a bid to lower the capital intensiveness of its business. In doing so, they consolidated their core urban business into three segments: transport, utilities, and facilities. Consequently, we forecasted revenue using a weighted average of (1) segment specific drivers and (2) geographic macroeconomic drivers (GDP and Urbanisation). The initial investment thesis forecasted an average growth rate of 4.68% across a 5-year period. Considering 1H24 results, we expect earnings to decline in 2024 by -1.90%. This is primarily due to the divestment of the Australian Transport Projects (ATP) and asset and development businesses that has outweighed earnings growth in other divisions. Between 2025-2028, we forecasted an average growth rate of 1.86%. This is to reflect a skewed macroeconomic outlook in the short term and weakened earnings due to DOW's focus on cost-cutting as opposed to growing existing segments. From 2029 onward, we forecast revenue growth at 2%, reflective of stable earnings through long-term government contracts.

Detailed Forecast	2023	2024E	2025E	2026E	2027E	2028E
Transport Revenue	5,966	6,033	6,181	6,327	6,504	6,688
Utilities Revenue	2,257	2,146	2,154	2,180	2,198	2,204
Facilities Revenue	3,412	3,234	3,271	3,319	3,366	3,397
Total Revenue	**11,636**	**11,414**	**11,606**	**11,826**	**12,068**	**12,288**
Growth (%)	*8.51%*	*-1.90%*	*1.68%*	*1.89%*	*2.05%*	*1.82%*

Figure 2: Revenue segment forecast (SMF)

Costs

DOW's historically thin operating margins (5-year avg. EBITA margin of 3%) indicate that fluctuations in key input costs and operating leverage ability play a critical role in the firm's NOPLAT generation and valuation. With the current $100m gross cost-out plan central to the success of the targeted 4.5% EBITA margin by FY25, a detailed overhaul to the costs model was undertaken. This involved a weighted blend between two forecasting methodologies. Firstly, as COGS and Revenue have a strong correlation of 0.97, we modelled an implied gross margin across each of the three operating segments (transport, utilities, and facilities) through a geometric mean (given historic stability) to back-out an implied COGS. We then applied the YoY implied COGS growth rate throughout to our detailed forecast – with COGS growing between 1.1% and 2.3% through to 2028. Here, COGS as a % Revenue steadily sits at 92.7%, just below 2023's figure of 94%. Secondly, to account for Australia and NZ's current tight labour market, growing cost of natural disasters, and escalating Producer Price Index (PPI) pressures, we developed a macroeconomic cost overlay – weighted by segment and geographic exposure. We incorporated Aus. & NZ's forecasted CPI, WPI, industry-specific compensation growth rates (private construction, electricity, water and gas waste services, subcontractor costs) as well as the PPI to inform a macro implied COGS growth rate. Lastly, SG&A was forecasted as a % of COGS, gradually decreasing from 12% to 10% by 2028 (in line with Dow's 5-year historical average of 11.45%). Overall, total expenses rise to $12,348 by 2028 with yearly total costs growing between 1.85%-2.48% throughout the detailed forecasting period. We forecast an EBITA margin expansion from 2.85% in 2024 to 3.10% in 2028.

ROIC v WACC analysis

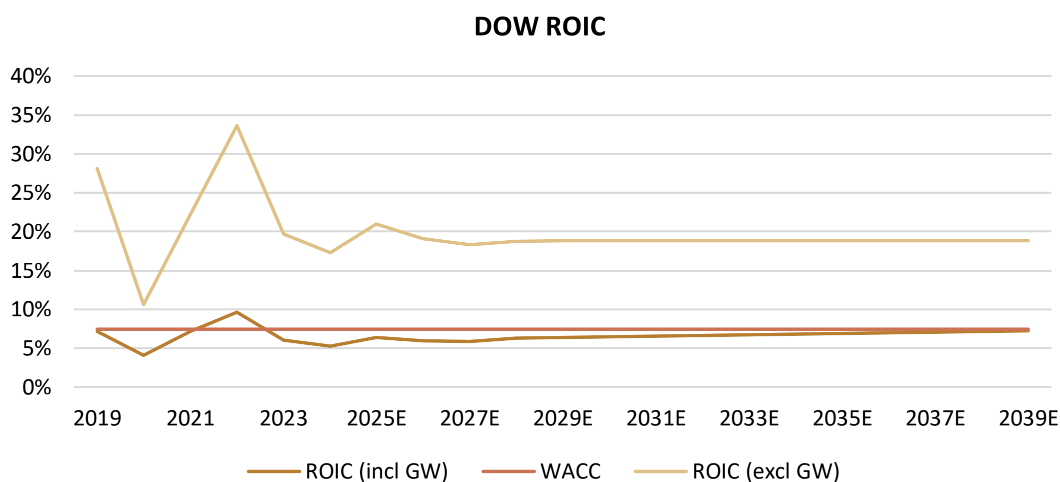


Figure 3: ROIC WACC spread

We use an estimated WACC of 7.43% in the valuation with *Ke* of 8.7% and cost of debt 4.84% based on DOW's BBB credit rating. ROIC excluding goodwill is forecasted as 17.32% in FY24 and ROIC including goodwill is forecasted as 5.28% in FY24. We choose to focus on ROIC including goodwill in our analysis – capturing the business performance post major acquisitions, reflecting management's ability to extract value from a deal. As DOW has a long history of large acquisitions (i.e. Spotless in 2017), this indicator better conveys DOW's return on IC. The ROIC including goodwill is below WACC throughout the forecast period, reaching a high of 6.29% in the next five years, 114 basis points below WACC. However, ROIC excluding goodwill of 17.32% is above WACC, indicating strong underlying performance of its business.

Comparable companies

DOW is currently operating at margins below the industry average. A revenue weighted average of non-mining Australian construction companies EBITA margin is 3.26%. Worley, one of DOW's closer comparable has a 3.2% EBITA margin in FY23, with a four-year average of 4%. DOW's management expects EBITA margin to be 4.5% in FY25. Our EBITA margin forecasts are more consistent with industry averages, 3.34% in FY25 and 3.1% beyond FY25, in line with the broader Australian construction industry.

Scenario analysis

Bull case

We have centred our bull case scenario analysis on DOW's ability to meet their 4.5% EBITA margin target by FY25. This is underpinned by contract rationalization, labour market stabilization in Australia & NZ (with WPI, CPI & subcontractor cost indexes returning to 10-year historic averages) and DOW ability to sustain revenue at a lower cost base. As such, COGS & Rev fluctuates between 80-82.5%, 250bps below the base case. DOW FTE reduction plan sees SG&A steadily decrease throughout the explicit forecast period – reaching 11% of revenue. Additionally, our bull case further assumes no material legal and regulatory costs from the current corruption inquiry by ICAC and KPMG case. The target price under these assumptions is $6.37, a 37.5% margin of safety. The bull case highlights that there are significant potential upsides to holding DOW provided they can achieve the 4.5% EBITA margin target without negatively affecting revenue.

Bear case

Under this scenario, DOW will not be able to meets EBITA margin targets due to a decline in revenue growth and persistent cost pressures. Such a scenario produces a valuation of $3.58, with a margin of safety of -22.68% (excl. franking credits). Our bear case scenario, accounts for 'sticky' inflation, high input costs, and persistent labour market challenges in our explicit forecast period. Whilst management has indicated that labour market challenges have likely stabilised, there is a possibility of ongoing skilled labour shortages in the industry arising from inefficiencies in the skilled migration system. It also accounts for an increase in the frequency of weather events arising from climate change. In FY23, management reported that La Nina had a material impact on margins, particularly within the transport and infrastructure segment. Furthermore, our bear case scenario accounts for a reduction in infrastructure spending arising from less demand for urban services and a move by the government to in-house contractors. We account for this through lowering revenue growth by dropping the industry growth rate and the urbanisation forecast.

Sensitivity analysis

Three examples of 'what-if' sensitivity analysis were undertaken. Firstly, we analysed the impact of different WACCs on the final implied share price. As at 8/05/23, a WACC of 6.73% yields a 0% MoS – holding all else equal. At all feasible future WACCs (7-12%), Dow has a negative MoS – reinforcing our sell thesis. Secondly, we analysed what YoY NOPLAT and Invested Capital growth would have to be achieved to generate economic value by FY27 – i.e., ROIC (including goodwill) > WACC. Only seven out of one hundred combinations of NOPLAT and IC generates a ROIC above WACC – with the firm having to achieve either a 5-10% decrease in IC and 15-25% NOPLAT expansion to achieve ROIC > WACC. Despite an encouraging H124 trading performance, the probability of this occurring is unlikely. DOW haven't paid a

fully franked dividend since 2017, with the last franked dividend paid in 2019 (at 50% franked). The future franking balance is uncertain, though a low franking credit is likely due to DOW only having $10m in franking balance and slimmed retained earnings (171% decrease to a loss $231m FY23). As such, a sensitivity analysis on the implied share price at different franking rates was undertaken. Please see appendix for detailed results from the sensitivity analysis.

Recommendation summary

Our recommendation to sell DOW reflects an update to future earnings potential, heightened risks to the SMF in achieving its long-term objectives and the possibility of reputational risk. This decision is informed by the overbearing downside risk, driven by DOW's unsustainable gross cost-out plan and vulnerability to adverse input cost movements. Recently, the positive market reaction to H124 result presents a sell opportunity for DOW, capitalizing on short term market optimism and the positive signal of new management plans. We acknowledge there are risks to our recommendation - we may be underestimating management's ability to lead the turnaround or their ability to effectively pass on costs. After evaluating the return and risk trade-off to the DOW investment case, our assessment is that DOW should not remain within the SMF portfolio, as the risk of loss outweighs the potential upsides.

Appendix

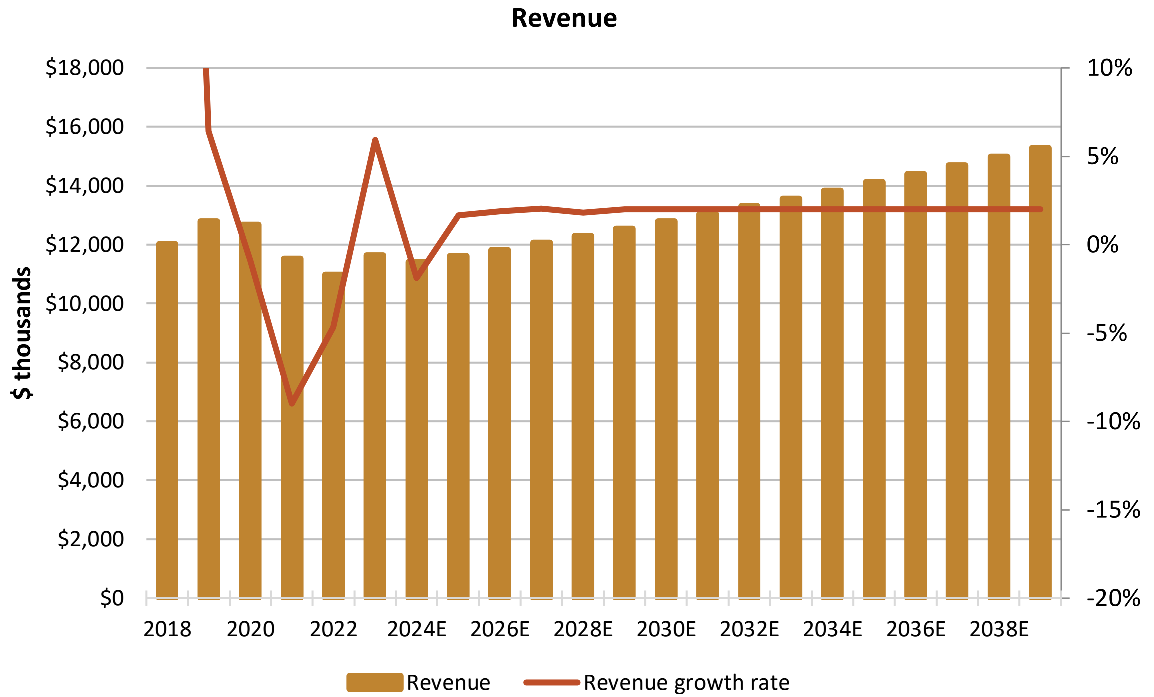
Appendix A: Key Financial Summary

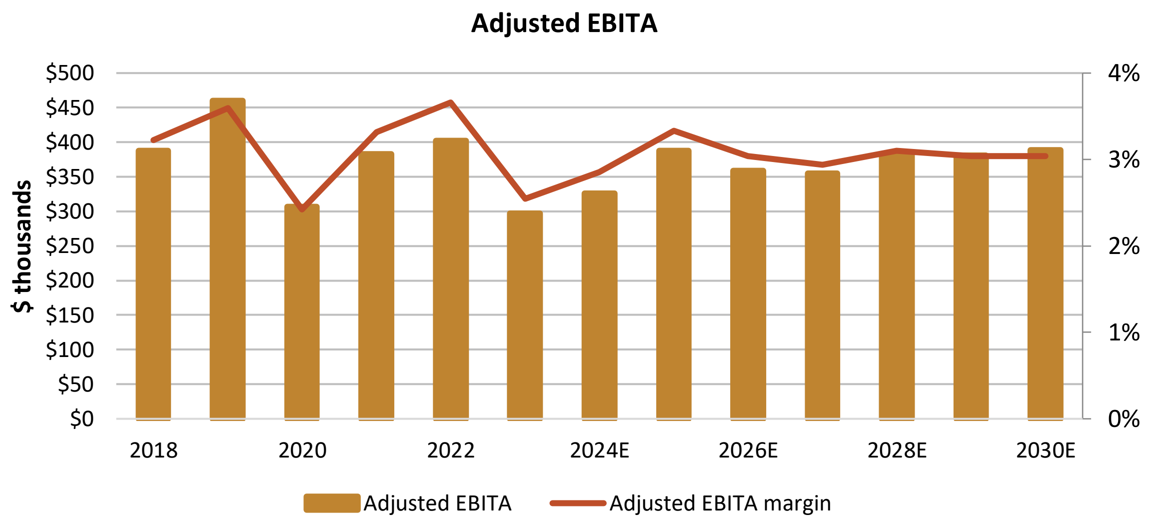
Financial year ($million)	2021(A)	2022(A)	2023(A)	2024(E)	2025(E)	2026(E)	2027(E)
Total revenue	11,530	10,989	11,640	11,419	11,611	11,831	12,073
Revenue growth	-9.0%	-4.7%	5.9%	-1.90%	1,68%	1.89%	2.05%
EBITA	383	402	297	326	387	359	355
EBITA margins	3.32%	3.66%	2.55%	2.85%	3.34%	3.04%	2.94%
NOPLAT	323	410	256	223	267	247	244
NOPLAT margin	2.80%	3.74%	2.20%	1.95%	2.3%	2.09%	2.02%
Invested capital (ex. goodwill)	1466	1221	1300	1286	1275	1295	1332
Invested capital (inc. goodwill)	4501	4266	4267	4214	4165	4145	4143
ROIC (ex. goodwill)	22.16%	33.63%	19.72%	17.32%	20.93%	19.07%	18.34%
ROIC (inc. goodwill)	7.17%	9.62%	6.01%	5.28%	6.41%	5.96%	5.90%
Free cash flow	923	645	255	276	316	267	246
IC turnover (ex. goodwill)	2.56	2.58	2.73	2.71	2.79	2.85	2.91
EPS	0.39	0.48	(0.34)	0.27	0.34	0.33	0.34
Financial year ($ million)	**2028(E)**	**2029(E)**	**2030(E)**	**2031(E)**	**2032(E)**	**2033(E)**	**2034(E)**
Total revenue	12,293	12,539	12,790	13,045	13,306	13,573	13,844
Revenue growth	1.82%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%
EBITA	381	381	388	396	404	412	420
EBITA margins	3.10%	3.04%	3.04%	3.04%	3.04%	3.04%	3.04%
NOPLAT	263	269	274	279	285	291	297
NOPLAT margin	2.14%	2.14%	2.14%	2.14%	2.14%	2.14%	2.14%
Invested capital (ex. goodwill)	1402	1430	1458	1488	1517	1548	1579
Invested capital (inc. goodwill)	4174	4202	4231	4260	4290	4320	4351
ROIC (ex. goodwill)	18.73%	18.79%	18.79%	18.79%	18.79%	18.79%	18.79%
ROIC (inc. goodwill)	6.29%	6.39%	6.48%	6.56%	6.64%	6.73%	6.82%
Free cash flow	232	198	202	206	210	214	218
IC turnover (ex. goodwill)	2.95	2.98	3.02	3.06	3.10	3.14	3.18
EPS	0.38	0.39	0.4	0.41	0.41	0.42	0.43

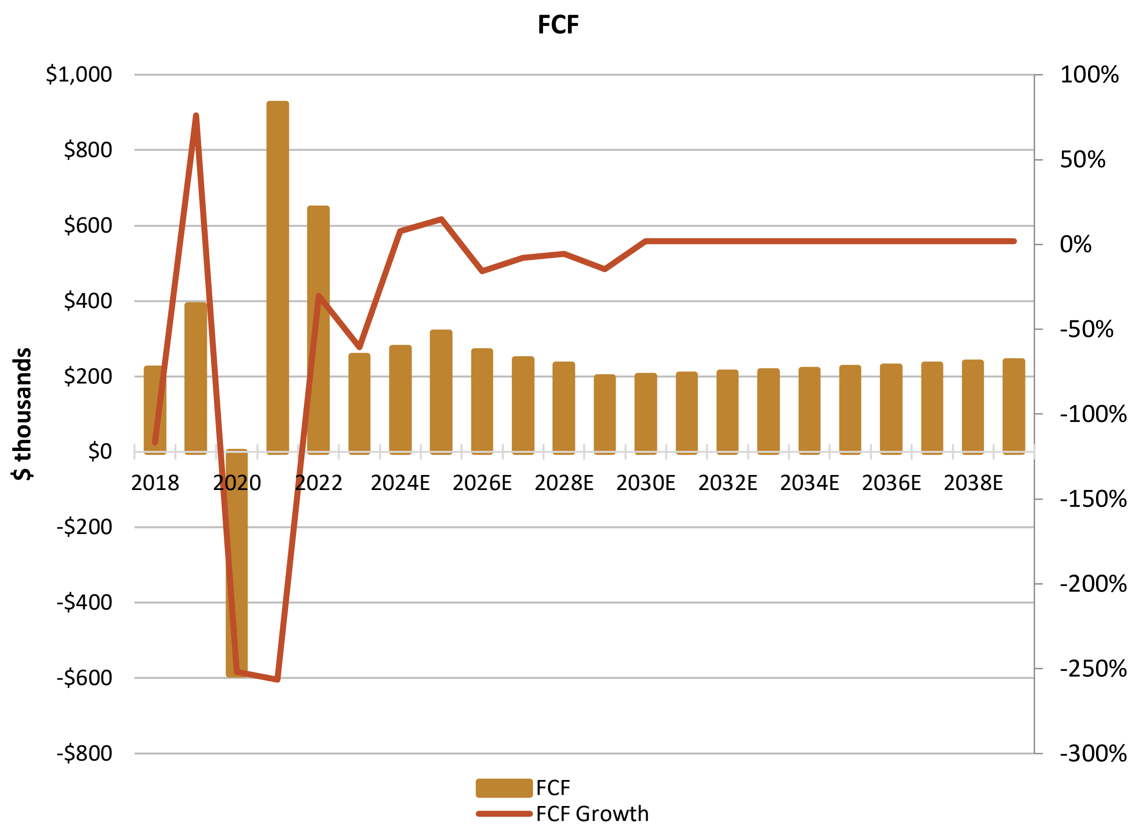
Appendix B: Dividends

Franked dividends provide the SMF with an attractive and recurring income stream that is amplified by our status as tax-free investors. The initial investment case assumed fully franked dividends into the future. We view this is overly aggressive given DOW hasn't paid a partly franked (50%) dividend since 3 September 2019 or a fully franked dividend since 11 September 2017. As of FY23, DOW has a franking balance of $10.7m that is unlikely to support short-term franking. We believe it would be unreasonable to assume franking credits into the future. However, to account for the prospect that DOW may pay franking credits in the future, we have analysed their effects through a sensitivity analysis. Furthermore, DOW has a 5-year average dividend yield of 3.78%, shrinking 1.5% since purchase. We view this negatively given the importance of dividends to the SMF and its ability pay consistent cash distributions for the equity scholarship.

Appendix C: Key Valuation Drivers



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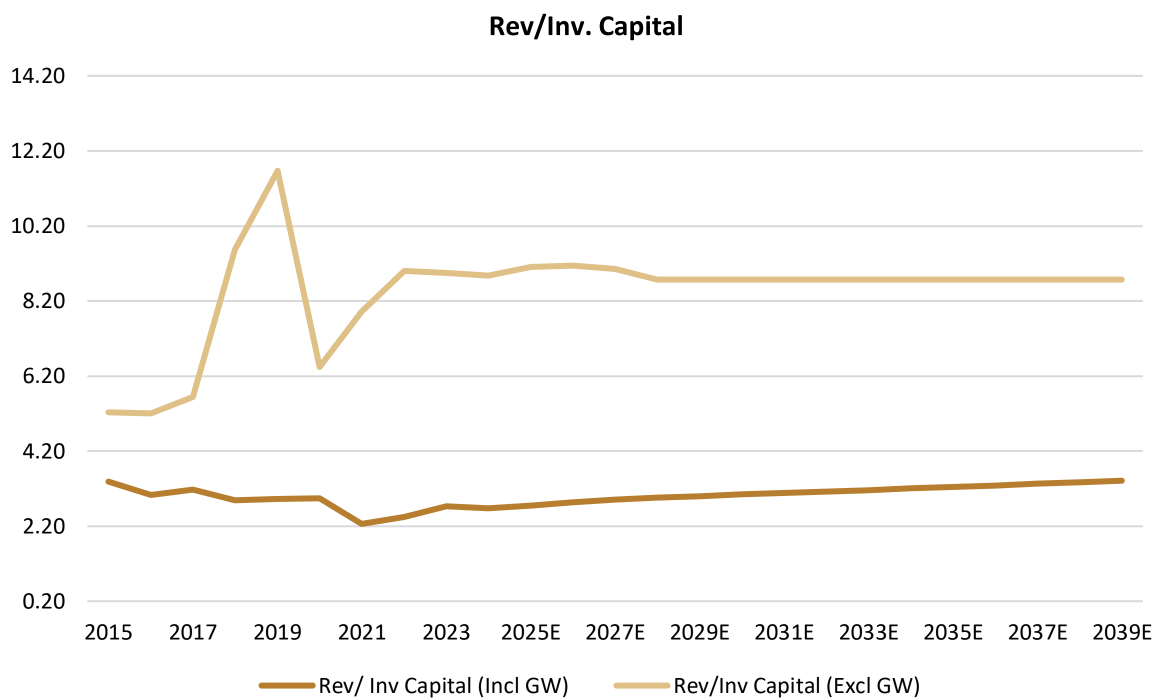
Rev/Inv. Capital
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8.20
6.20
4.20
2.20
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2025E
2027E
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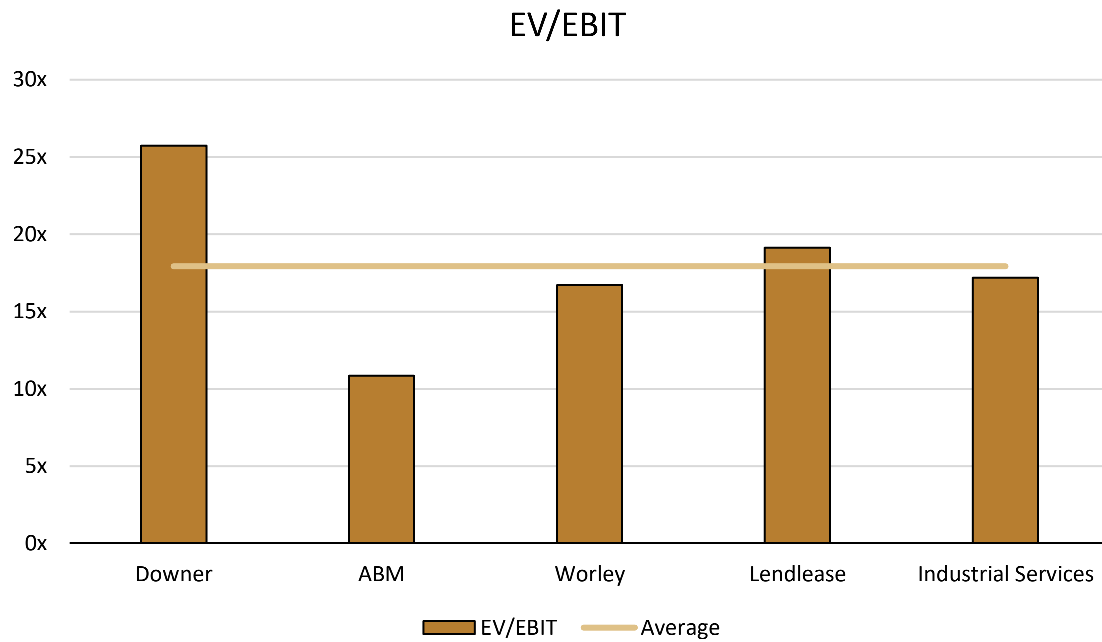
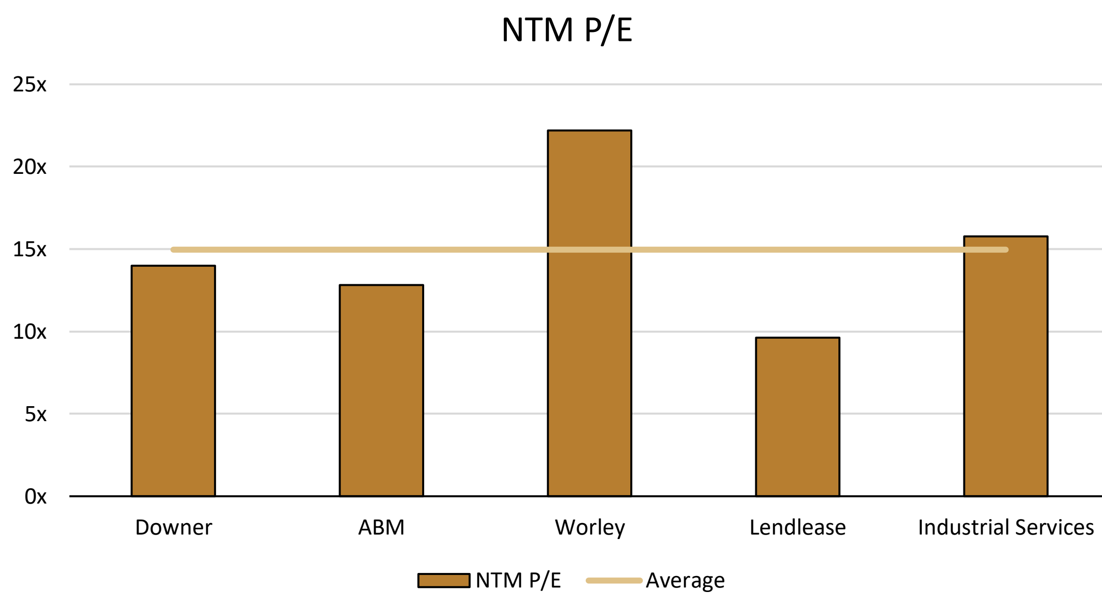
2039E
Rev/ Inv Capital (Incl GW)
Rev/Inv Capital (Excl GW)

Appendix D: Multiple Valuations





Appendix E: Sensitivity Analysis

1) FY27 ROIC Input Assumptions

YoY NOPLAT Growth (%) (columns) vs YoY IC Growth (%) (rows)

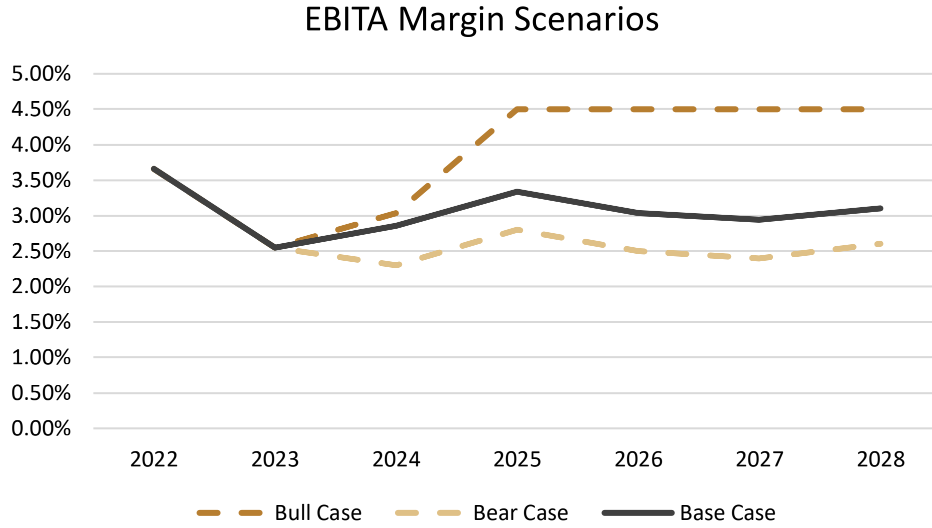
YoY IC Growth (%)	-20%	-15%	-10%	-5%	0%	5%	10%	15%	20%	25%
-10.0%	5.21%	5.53%	5.86%	6.18%	6.51%	6.83%	7.16%	7.49%	7.81%	8.14%
-7.5%	5.07%	5.38%	5.70%	6.02%	6.33%	6.65%	6.97%	7.28%	7.60%	7.92%
-5.0%	4.93%	5.24%	5.55%	5.86%	6.17%	6.48%	6.78%	7.09%	7.40%	7.71%
-2.5%	4.81%	5.11%	5.41%	5.71%	6.01%	6.31%	6.61%	6.91%	7.21%	7.51%
0.0%	4.69%	4.98%	5.27%	5.57%	5.86%	6.15%	6.44%	6.74%	7.03%	7.32%
2.5%	4.57%	4.86%	5.14%	5.43%	5.72%	6.00%	6.29%	6.57%	6.86%	7.14%
5.0%	4.46%	4.74%	5.02%	5.30%	5.58%	5.86%	6.14%	6.42%	6.70%	6.97%
7.5%	4.36%	4.63%	4.90%	5.18%	5.45%	5.72%	5.99%	6.27%	6.54%	6.81%
10.0%	4.26%	4.53%	4.79%	5.06%	5.33%	5.59%	5.86%	6.12%	6.39%	6.66%
12.5%	4.17%	4.43%	4.69%	4.95%	5.21%	5.47%	5.73%	5.99%	6.25%	6.51%

2) WACC & Franking Rate

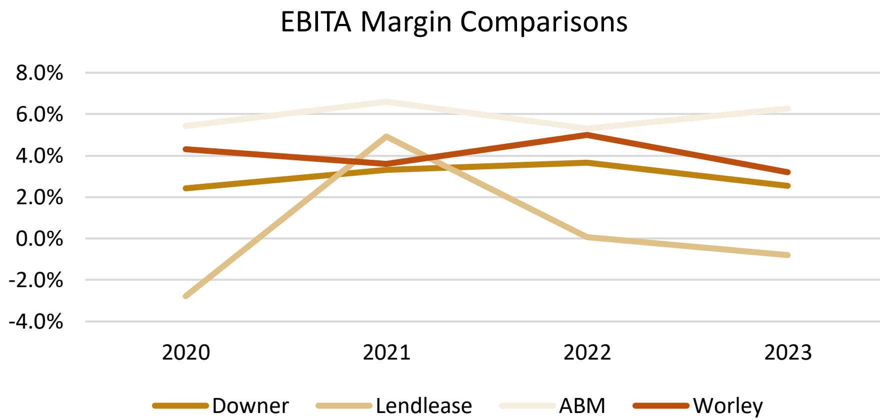
WACC	Target Price	MoS
5.41%	$5.63	21.87%
5.91%	$5.21	12.69%
6.41%	$4.83	4.64%
6.91%	$4.50	-2.50%
7.43%	$4.21	-8.94%
7.91%	$3.94	-14.69%
8.41%	$3.70	-19.96%
8.91%	$3.48	-24.78%
9.41%	$3.27	-29.21%
11% (JPM)	$2.98	-35.39%

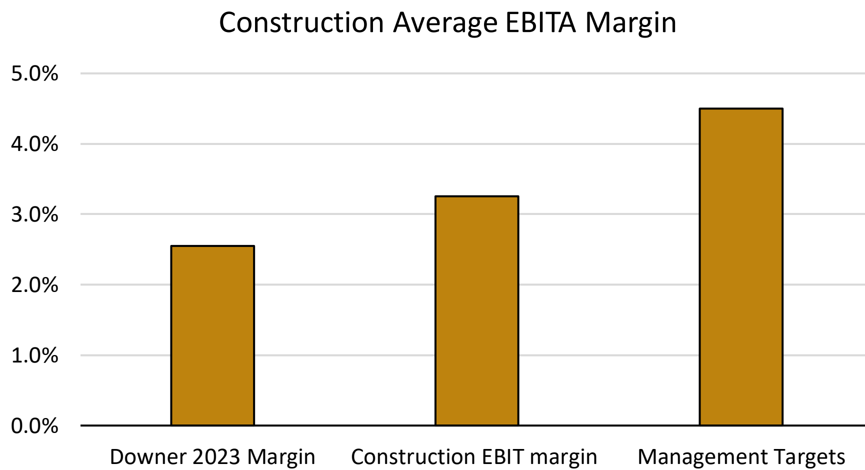
Franking Rate	Target Price (Inc. FC)
10%	$4.32
20%	$4.46
30%	$4.60
40%	$4.73
50%	$4.87
60%	$5.01
70%	$5.15
80%	$5.29
90%	$5.42
100%	$5.56

Appendix F: EBITA Margins



Appendix G: Comparable EBITA margins





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