Australian
National
University

ANU Student Managed Fund

Rebalancing report:
Downer EDI Limited

Creation date: 15/02/2024 | Version date: 16/04/2024 (FINAL)

Contents

Notes:

All dollar amounts in this report are Australian dollars.

Glossary

AAE – Active Australian equities

ANU – The Australian National University

COGS - Cost of goods sold

DOW – Downer EDI Limited

EBIT – Earnings before interest and tax

EBITA – Earnings before interest, tax and amortization

ETF – Exchange traded fund

GDP – Gross domestic product

IAC – Investment Advisory Committee

IOZ – iShares Core S&P/ASX 200 ETF

MoS – Margin of safety

NAIRU – Non-accelerating inflationary rate of unemployment

ROIC – Return on invested capital

SG&A - Selling, general and administrative costs

SMF – ANU Student Managed Fund

WACC – Weighted average cost of capital

Portfolio recommendation

The Student Managed Fund (SMF) recommends rebalancing Downer EDI Limited (DOW) from a weighting exceeding 13% back to the 10% target weighting after a review conducted by the Active Australian Equities (AAE) team.

Investment thesis

On February 14th, the AAE team identified that DOW was near to the +/- 3% target weighting tolerance. The team subsequently conducted a review of Downer and concluded that should the stock exceed a 13% weighting within the AAE portfolio, it should be rebalanced back to its 10% target. The fund convenor was notified of the decision and rebalancing then occurred on February 15th at an average price of $5.074.

The choice to rebalance lends itself to the lack of justification allowing the stock to remain above the target weight.

Downer's share price rose sharply on 14 February 2024 on the back of positive reception of the half yearly report for the period ending 31 December 2023. We believe that some of the guidance provided by the board was overly optimistic. Despite this price spike, our research suggests a less optimistic outlook, dampening our longer-term assessment of company value.

The company fundamentals are changing due to sweeping changes implemented by the new board. The board have continued to sell sections of the business and downsize their workforce. Although appealing in the short term, we believe that this approach to improving profitability is unsustainable and there must be a point where the board devise a clear value enhancing strategy going forward. Given this, in addition to the decision to rebalance back to the target weight, AAE is also currently conducting a periodic revaluation of DOW, after which a decision will be made on whether DOW should remain in the AAE portfolio following Fund scrutiny during the semester.

To summarise, the reasons for the decision to rebalance our holding in DOW are:

1. We believe that the market response to the half-yearly results is not indicative of DOW's longer term potential, suggesting that guidance presented in that report is too optimistic, with the market pricing this guidance to a greater extent than we feel reasonable.
2. The over-reaction presented an opportunity to capitalise whilst the company are overvalued based on our modelling and sitting at a 52-week high. The fund stood to realise a capital gain by selling stock to re-establish the target weight.
3. Against the original investment thesis at the time of acquisition, the company provides a negative margin of safety, largely due to its failure to deliver franked dividends as expected. As such, there was no glaring reason to retain a portfolio weighting outside of the target range.

AUSTRALIA
ASX code: DOW

Downer
Relationships creating success

Price at time of rebalancing	$5.074
Valuation	$4.71
- Inc. Franking Credits	$4.71
Margin of safety (MoS)	-7.73%
- Inc. franking credits	-7.73%
Dividend yield (2023F)	2.69%
GICS	Commercial & Professional Services
52-Week Range	A$2.97 -A$5.21

Recommendation
Rebalance to target weight of 10%.

Key assumptions

Required return on equity	7.18%
WACC	5.88%

3-year share price history

Original investment thesis

AAE's decision to invest in DOW in 2022 was based on:

- The reliability of the company's cash flows especially given the degree of involvement with Government and diversification across both the Australian and New Zealand markets.
- Industry tailwinds including the shift towards contracting and a favourable political landscape.
- The competitive advantage the company possessed, which was mainly due to their large scale in what is typically a boutique market.

Downer EDI ultimately attracted a 10% weighting within the AAE portfolio, with trades occurring at an average price of $5.48 per share. After the fund invested in Downer EDI it underperformed relative to the market, dropping to as low as $2.97 per share. As outlined in the previous rebalancing report in 2023, there were two main reasons why Downer underperformed:

- Public disclosure of accounting irregularities relating to over-stated revenue in the AusNet project.
- Missed earnings guidance due to its inability to pass on increasing costs and the loss of several contracts.

In Semester one of 2023, the AAE team elected to rebalance when the portfolio weighting dropped below 7%, back up to the 10% target weighting. These shares were purchased at an average price of $3.32, giving the fund an average purchase price of $4.70.

Downer has performed well in the year since the previous rebalancing occurred. The price rose strongly in the mid-part of the 2023 calendar year with the announcement of the sale of the Australian Transport Projects and signing of two contracts: road maintenance for Hamilton City Council and a train manufacturing contract for the Queensland Government.

In 2022, the AAE team pitched DOW to IAC with an MoS of 8.00% without franking credits and 50.59% with franking credits. Further, the rebalancing in 2023 pitched DOW with a MoS of 14.16% without franking credits, and 53.31% with franking credits. However, Downer has failed to deliver any franking benefit since 2019.

DOW is a labour-intensive business, with contractor costs making up 41.0% of total costs whilst internal employees contribute 30.3% of total costs in FY23. Previously, DOW relied on contractors to keep labour costs low, as outlined in the original investment thesis. This became a problem however when the shift towards contractors lead to higher labour costs for DOW as contractor costs rose 11% in FY23. In addition to this, internal labour costs increased 1.6% despite a decreased headcount.

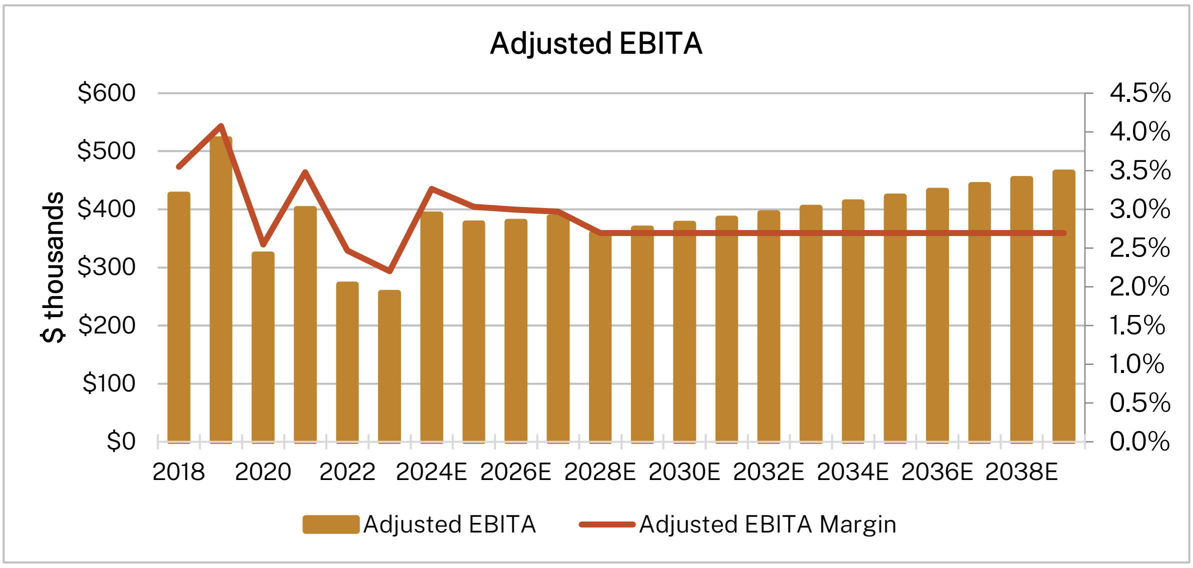
The original investment thesis spoke of a favourable political landscape. In hindsight, this has been only partially correct. Since the purchase of DOW, Australia's Government has changed. The Labor party are traditionally more agreeable towards workers than the Liberal-National Coalition. This, along with high inflation has driven wage increases across the economy, putting upward pressure on DOW's costs with both subcontractor and internal labour costs increasing. On the other hand,, the Labor government has allocated a lot of resources into accelerating Australia's clean energy transition. Downer has been able to benefit from this shift with renewable energy providing the only substantial growth in the business in the most recent half-year. The utilities segment was the only portion of the business to benefit from this policy and contributed just 20.4% of the group revenue.

An increase in infrastructure spending which was assumed in the initial thesis was dampened by the contractionary policy stances adopted by both the Labor Government and the Reserve Bank of Australia (RBA). The level of both public and private expenditure fell which then put downward pressure on Downer's revenue.

Overselling and Underdelivering

Downer operates in low margin markets, making the company valuation very sensitive to changes in these margins. Following the acquisition of Spotless, margins were eroded and continued to trend downward until the board were replaced in an attempt to repair DOWs damaged reputation following an Independent Commission Against Corruption (ICAC) inquiry. The new board has provided margin guidance which would see the company improve its EBITA margin by 100 basis points per year, representing a significant improvement considering the current EBITA margin of only 2.5% - a 40% improvement year-on-year. The team believes that such an improvement is unlikely without fundamentally altering the company's operations.
In the first half year after providing this guidance, DOW sold off multiple low margin businesses in an attempt to raise the group margin, but they remain unlikely to succeed in meeting guidance. Selling off unprofitable business units is one of the easier ways to cut costs but is hard to continue to do indefinitely. Downer's business segment sales have already led to decreased group revenue. Without substantial cost reductions, it will decrease the company's free cash flows and destroy value.

GDP growth is forecast to remain weak, and inflation above the target band at least in the near future. This will make it increasingly difficult for Downer to meet this optimistic guidance. As such, the team have modelled the EBITA margin as below, falling short of board expectations.



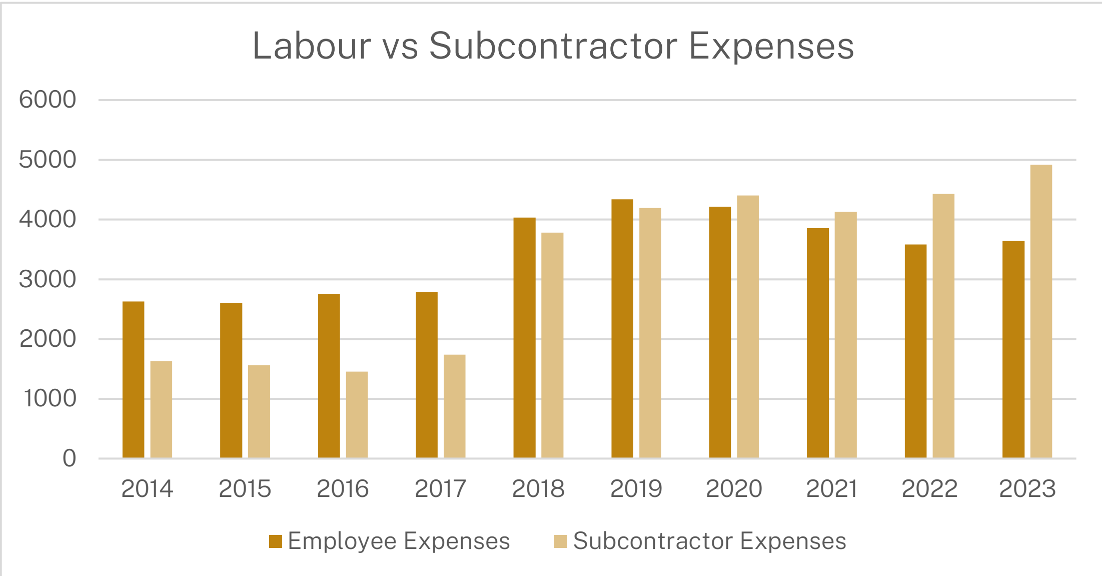
"A Low-Quality Business"

The company was described as being of poor quality by members of IAC during the initial investment pitch, and upon reflecting on the company's performance since acquisition, in addition to our future expectations, we are not presently as positive about the company's prospects relative to previous valuations. The expectation of franking credits in earlier valuations made it appear like a case of a marginal company, but nevertheless a solid investment for the SMF. With the failure to deliver any of the expected franking credits, Downer is not only a marginal company, but an investment which is unlikely to aid the Fund in achieving its objectives. Further, DOW has shown that it lacks the ability to pass on cost increase to its customers, and therefore during economic downturns or high inflation environments, we expect downward pressure on its margins. Anticipated economic volatility in the short to medium term is reflected in the AAE team's forecasts.

Further to this, weather events are costly to Downer. The increasing incidence of extreme weather events due to climate change, will significantly impact Downer. This was made clear when in the first half of 2023, lost shifts were 40% above average because of weather events.

Increased working from home provisions and a struggling commercial real estate sector pose additional tangible threats to Downer. As COVID allowed companies to function without requiring staff to attend the office, we have since observed a sustained conversation around continued working from home.

Contractor costs also rose sharply as a percentage of total expenses as contractors increased their fees. Downer's lack of pricing power limited the company's ability to pass on these cost increases to its customers. The recent period of high inflation has led to wage growth, and as a labour-intensive business this increased Downer's costs and squeezed margins.



Downer's dividend yield is less than that of the IOZ and with no indication that this will improve moving forward. The Fund does not currently view DOW as a more attractive investment than the ASX 200 ETF.

Downer made a loss of $385.7m in the twelve months to June 30, 2023. This was preceded by a $155.7m loss in the year ending June 30, 2020. Consistent financial losses are negative signs for a business, and generally represent the destruction of value within a company. Even though FY20 presented some unique challenges, their failure to adapt to those challenges is a point of concern. The Fund places a high degree of value on avoiding losses – Downer have shown that they are a company lacking resilience when economic conditions are unfavourable. Whilst the past cannot predict the future, Downer is by its very nature a cyclical stock and may not assist the fund in preserving value during bear markets.

The company's liquidity is also an area of concern. They maintain a current ratio of only 1.1, leaving the company especially vulnerable to unexpected liquidity shocks when the company faces unfavourable conditions – this may include times of unexpectedly low government spending or periods of rapidly increasing inflation. As a company which is susceptible to changes in material prices and labour costs, this is a concern.

The number of employees was reduced from 52,000 in 2020 to 32,000 in 2023. The board has indicated that they will continue to reduce the size of their labour force, particularly those in highly paid roles. Rates of labour productivity remain sluggish, and the labour market remains tight. Whilst there is no single value of the NAIRU which is universally accepted, there is a general consensus that this should be at around 4.5%. Despite contractionary monetary and fiscal policy, unemployment still sits at 3.7% seasonally adjusted as at February 2024 according to Australian Bureau of Statistics (ABS).

Downer maintains a heavy reliance on government contracts. This exposes Downer to uncertainties relating to government policy, in the form of decreased government spending, or a preference towards small local contractors, or in-house completion of projects.

Levels of long-term debt are not insignificant. The ratio of tangible assets to liabilities is 1.03:1 as of the half year to December 2023. The longer high interest rates persist however, the harder it will be for Downer to service their debt. The company's interest cover ratio as of the half year to December 2023 is 2.93x. This is adequate, however it is lower than that of many of Downer's comparables and all other stocks within the SMF portfolio. Given Downer are highly exposed to inflation, a higher interest cover ratio would be preferrable. Inflation is seemingly persistent and there are suggestions that tax cuts may come to fruition next financial year resulting in persistent high inflation.

The Upside

Despite the downsides, DOW does present the possibility of margin recovery. Rather than signing a large quantity of lower margin contracts, Downer has recently signed three major contracts with high margins: construction and manufacturing for QLD Rail announced on June 30, 2023; building and maintenance roads in Hamilton, New Zealand, announced on July 3, 2023; and finally, the redevelopment of a Defence facility in South Australia announced September 14, 2023. The market reacted positively to these announcements on the whole.

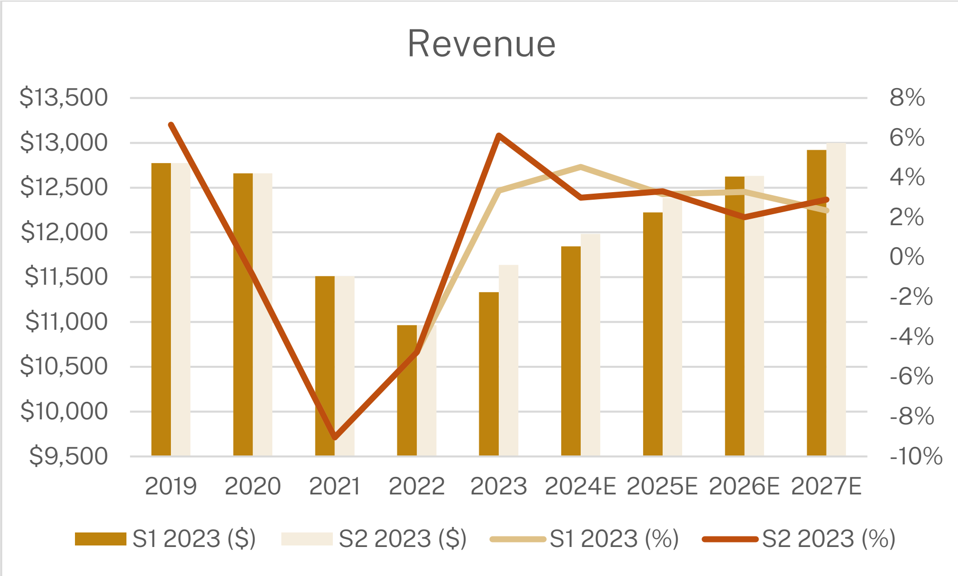
Many of Downer's contracts now include inflation links, granting DOW the ability to pass on at least a portion of cost increases throughout a project. These contracts do present a potential problem however, with clients likely to prefer fixed price contracts to inflation-linked contracts of similar price, particularly during periods of high inflation.

Weaknesses in the Chinese economy may lead to lower steel prices, lowering input costs for Downer. Prices of minerals used in renewable energy production have decreased significantly over the past few years as supply has increased to meet demand. This will likely lead to lower costs in the renewable energy segment of the business, likely improving margins.

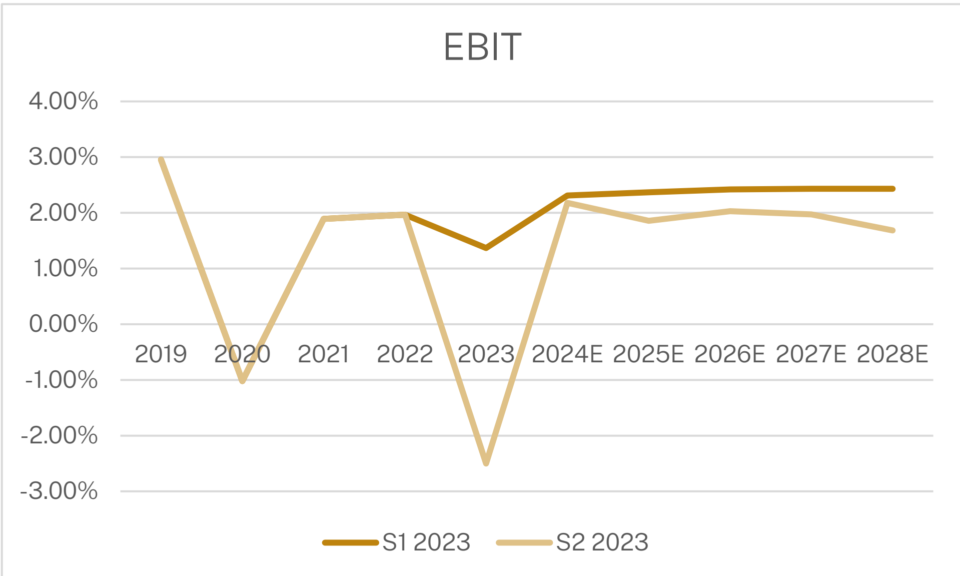
Overall, we see a path for improvement, but we believe that this scenario has already been priced by the market. Our base case valuation of $4.71 sits below the current market price - $5.074 at the time of rebalancing.

Updated valuation

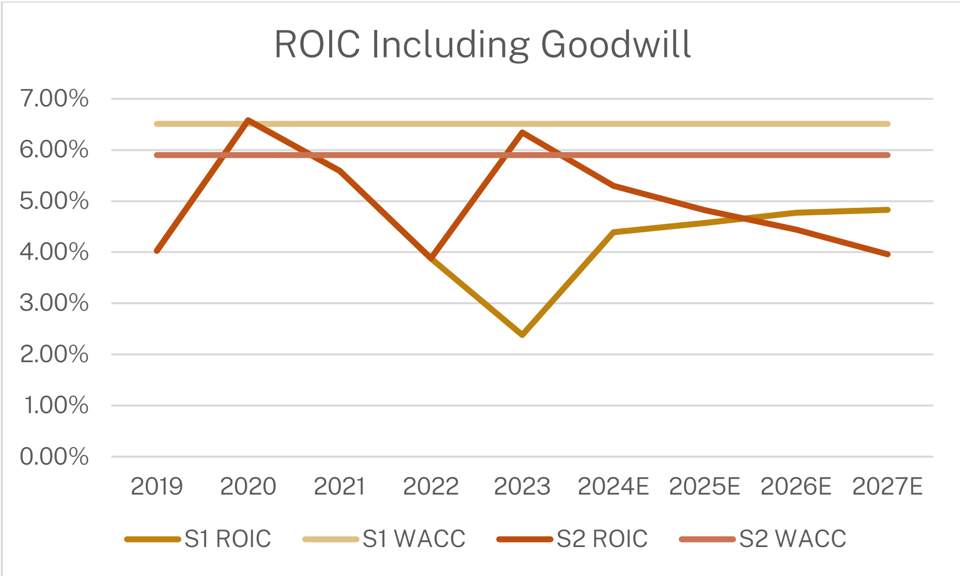
The most recent revaluation of Downer was conducted using the new, more streamlined industrial model developed by AAE. The forecasts were updated to account for the team's latest expectations of the company's operation.



Revenue exceeded forecasts on the back of better-than-expected performance in FY23. This was an encouraging sign for Downer. With reference to their expected future performance, estimated revenue growth rates were adjusted down, factoring in small adjustments due to macroeconomic conditions and changes in strategy, namely the board's decision to sell less profitable segments of the company.



The shift to the new model in Semester 2 2023 takes the focus away from EBIT margins and places it on EBITA margins. For comparative purposes, the EBIT margins have been calculated and plotted above. The company quite dramatically underperformed on the margin front during FY23. The new model accounts for some margin recovery, though not to the extent that guidance would suggest. EBIT margins ultimately settle slightly below historic forecasts based on expected lasting effects from inflation and anticipated low GDP growth in the near future.



Even with significant margin improvement forecast relative to the previous revaluation, the model now results in a negative margin of safety. This valuation utilised the SMF equity return target from semester two of last calendar year; this is lower than the current target. The WACC used in semester two of 2023 was lower than that used during the semester one revaluation, based on a lower target equity return for the fund, and a higher debt to equity ratio. Even given the low WACC, ROIC including goodwill remains below WACC and as such the company continues to destroy rather than create value.

Revised DOW valuation

Target Price	4.71
Price when rebalanced	5.074
Margin of Safety (MoS)	-7.73%
WACC	5.88%

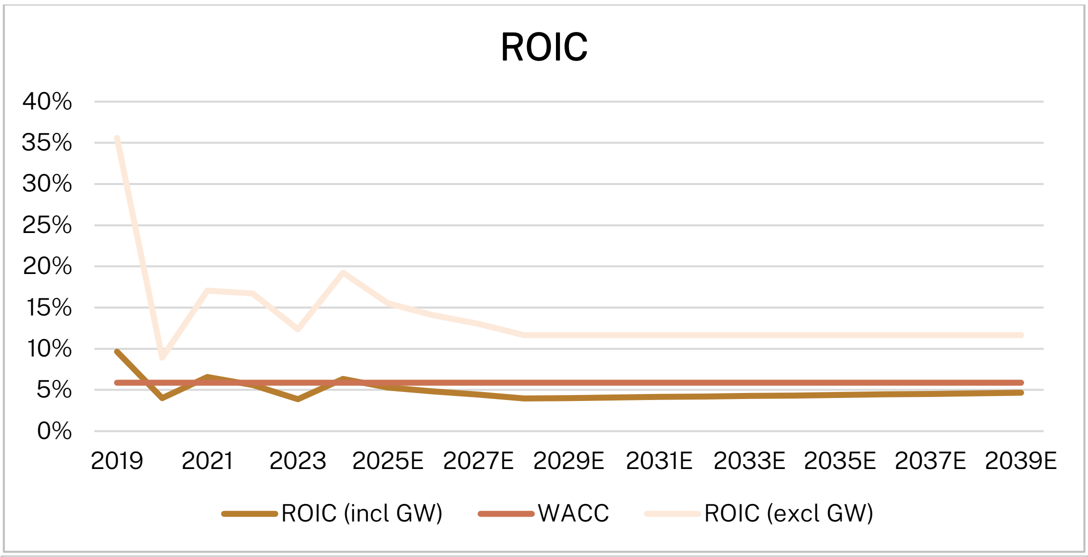
Portfolio considerations

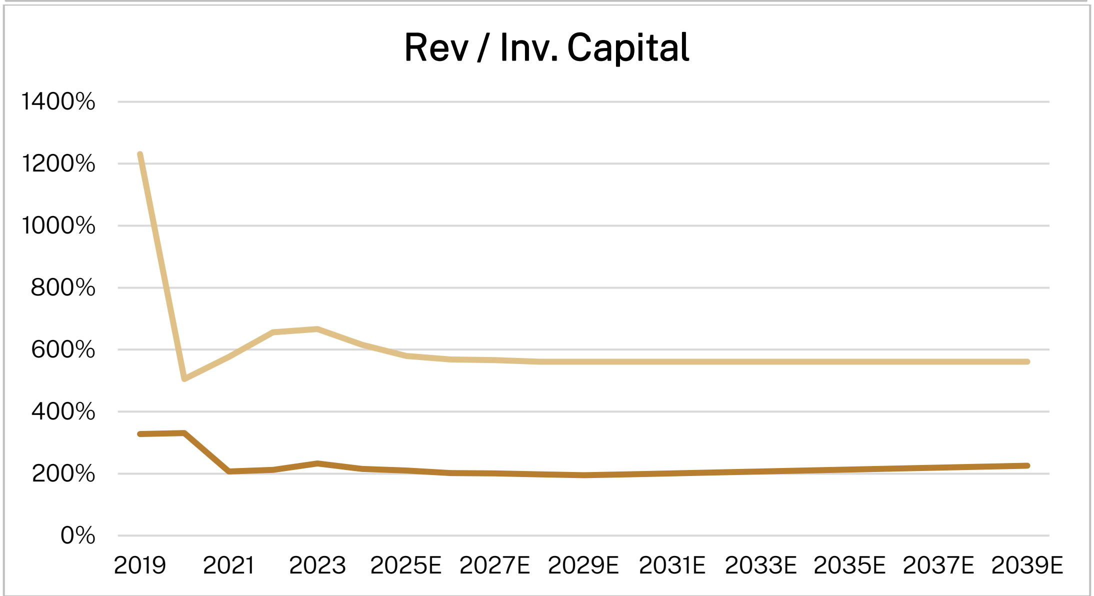
The SMF portfolio benefits from not being overexposed to DOW. The target weights exist to prevent unacceptable levels of firm-specific risk. DOW has a lower dividend yield than the benchmark and fails to provide the fund with any benefit from franking credits. There is no apparent reason to allow Downer EDI to exceed its target weighting, hence, it was rebalanced according to the SMF policies.

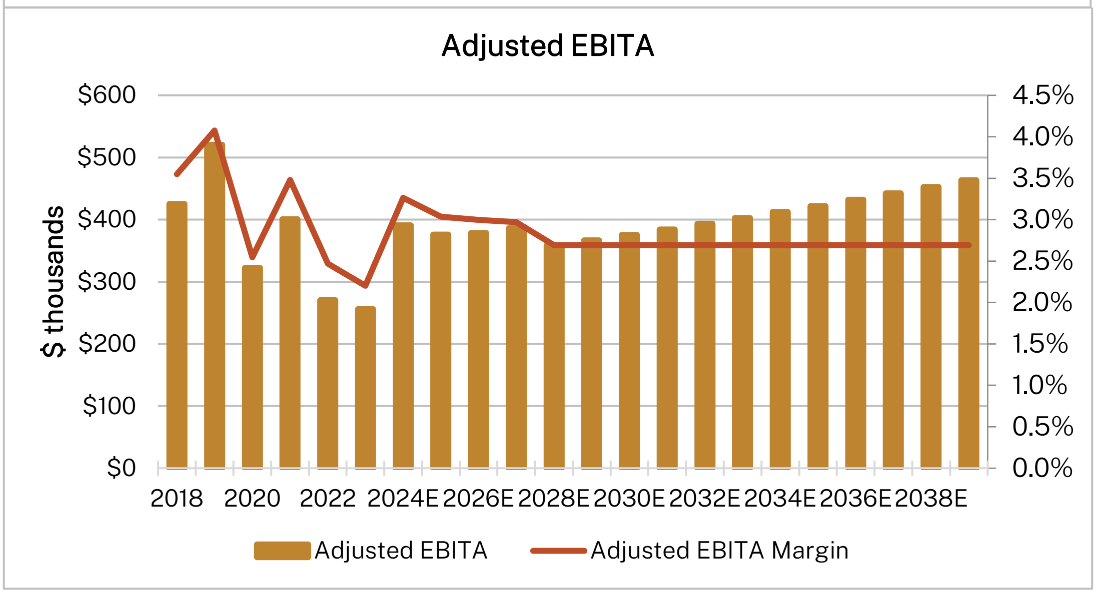
Conclusion and recommendation

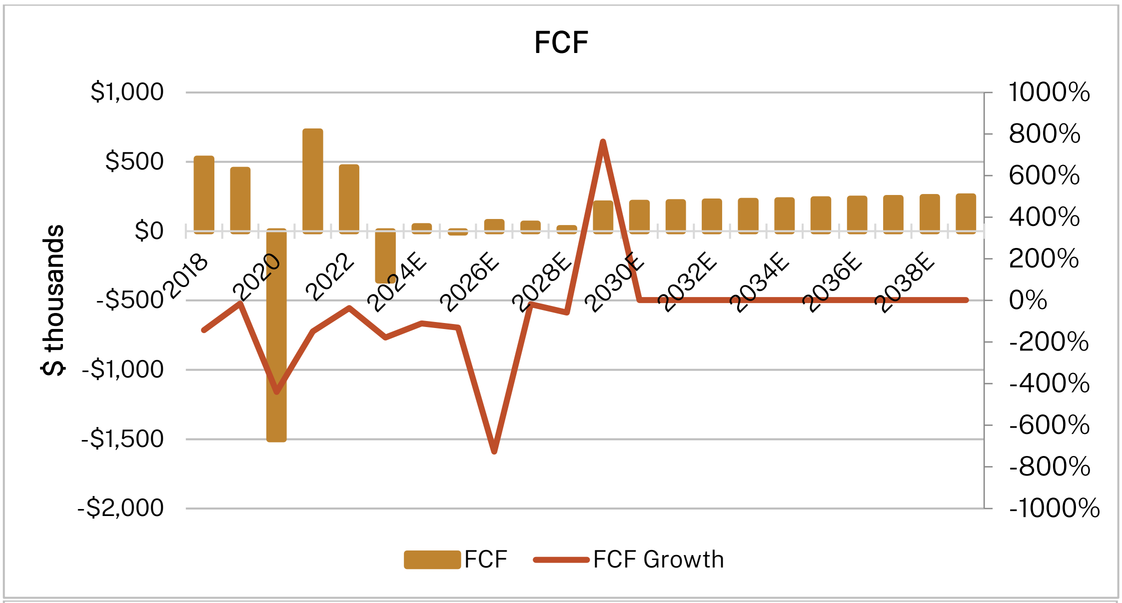
The AAE team asserts that there is no significant upside to be gained by allowing Downer EDI to differ from the target weight it was assigned. As such, we recommend that the fund rebalance back to the target weighting of 10%. A decision surrounding DOWs long-term future in the fund will be made early in the semester following a comprehensive revaluation.

Appendix: Key financials









FCF
$1,000
$500
$0
-$500
-$1,000
-$1,500
-$2,000
$ thousands
1000%
800%
600%
400%
200%
0%
-200%
-400%
-600%
-800%
-1000%
2018
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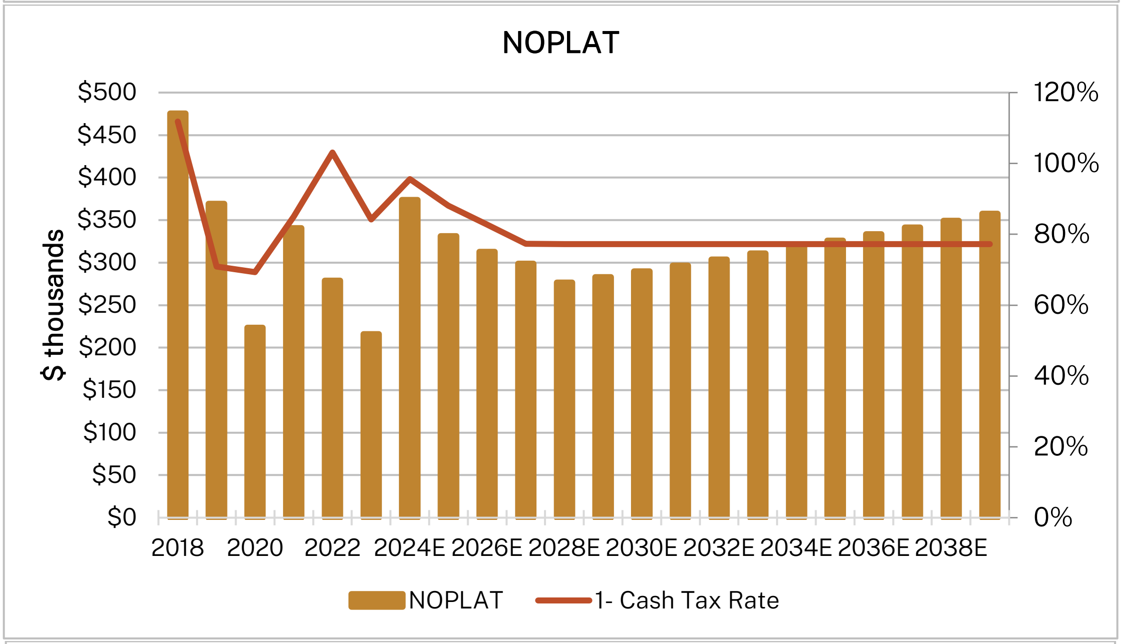
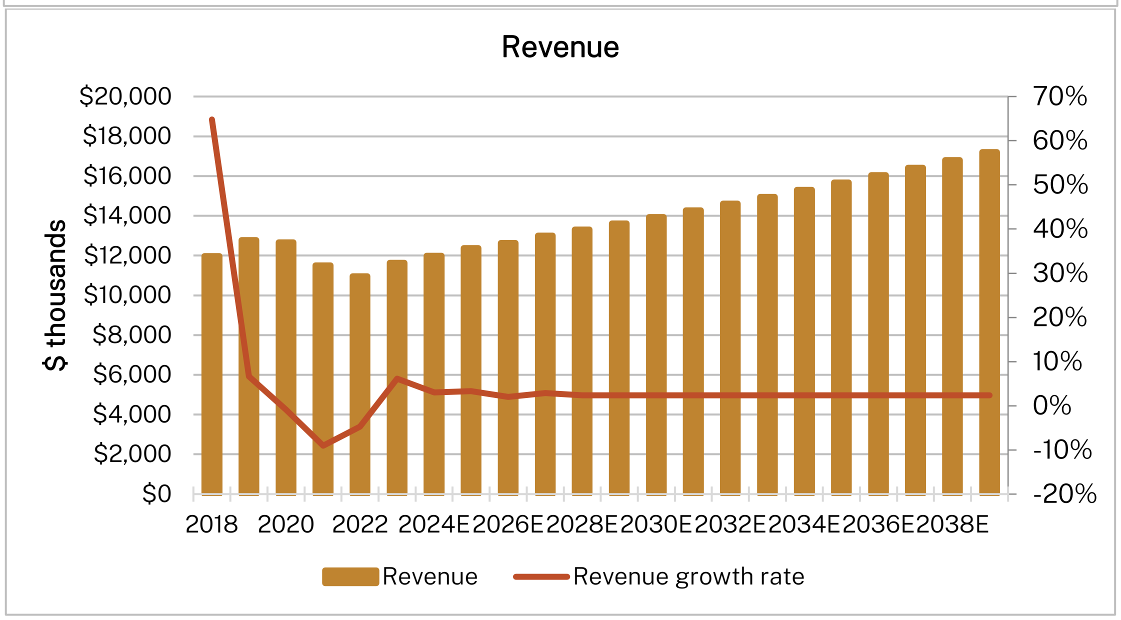
2038E
FCF
FCF Growth



NOPLAT
$500
$450
$400
$350
$300
$250
$200
$150
$100
$50
$0
$ thousands
120%
100%
80%
60%
40%
20%
0%
2018 2020 2022 2024E 2026E 2028E 2030E 2032E 2034E 2036E 2038E
NOPLAT
1- Cash Tax Rate



Revenue
$20,000
$18,000
$16,000
$14,000
$12,000
$10,000
$8,000
$6,000
$4,000
$2,000
$0
$ thousands
70%
60%
50%
40%
30%
20%
10%
0%
-10%
-20%
2018 2020 2022 2024E 2026E 2028E 2030E 2032E 2034E 2036E 2038E
Revenue
Revenue growth rate

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