

EUREKA *report*



Downer's bargain bonds

By Elizabeth Moran
January 31, 2011

PORTFOLIO POINT: The market reaction to last week's bad news on costs shows once again the strength of bonds compared with equities.

Downer EDI came out of a trading halt last week after it announced more delays for the Waratah Train project and provisions for a \$250 million loss.

As it stands, this is the second year in a row in which the company has had to lower earnings expectations as a result of provisions relating to a single contract.

The reaction from the equity market was swift as shares in Downer EDI (DOW) fell 25% on opening, although they clawed back some ground to close on Friday at \$3.80.



The equity market's savage response to the news once again underscores the relative differences between equities and bonds. It is true to say that the profit warning indicates profit growth will be much lower than forecast. But as a bond holder, profit is a secondary consideration to the company's ability to continue to trade and survive.

Downer has a strong balance sheet and a sound order book, with more than \$20 billion of work in hand. Yes, profits are poor but bond holders, sitting higher in the capital structure, will be protected by lower-ranked equity holders and can still expect full repayment of debt at maturity.

Downer's significant order book, liquidity reserves and its diversification – geographically and in its business segments – provides sufficient comfort that the company will survive and thus be able to repay the bonds in full at maturity at current rates of between 8.5–9%

The bad news regarding Downer last week provides an opportunity to prospective bond investors. Our analysis is that even though the story is much more an equity tale, some bond holders will over-react and sell, possibly causing spreads to widen and creating an opportunity for nimble investors.

Overview

The Downer EDI Group is one of Australia's largest engineering services firms with revenue of more than \$6 billion and market capitalisation of about \$1.3 billion.

It is relatively well diversified, geographically and by sector. With a focus on larger infrastructure type projects, Downer concentrates on four sectors:

Mining, providing contract mining services including blasting, excavation, processing, haulage and restoration.

Works, providing construction and maintenance of roads and highways, providing construction and maintenance of below rail infrastructure and overhead electrification, and infrastructure maintenance services to utilities.

Rail, design, manufacture, refurbishment and maintenance of above rail rolling stock.

Engineering services, providing engineering and consultancy services with a focus on infrastructure and heavy industry.

Key points on the profit warning

- Downer, under Australian accounting standards, complies with construction contract accounting. Under these rules, once a loss is established for a particular contract the total loss must be written off immediately. So the Reliance Rail contract, which should have made profits over several years, now must account for all anticipated losses in the current year.
- While another year of write-downs (they provisioned a similar amount last year) doesn't reflect positively on management, this is predominantly an equity story as the provisions related to future earnings – which will no longer be earned – from the Reliance Rail project. The provision is of a similar size to the 2010 provision, which effectively wiped out all of last year's profits.
- Downer updated unaudited accounts and noted underlying performance for the six months to December 31 remains solid at \$132 million (EBIT). Roughly, doubling that, \$264 million for the full-year profit estimate means it's not hard to imagine that the announced pre-tax provision of up to \$250 million will wipe out most of this year's profits, similar to last year. This isn't a good look, but underlying performance remains relatively solid. Provisions are for future earnings, not current cash.
- Operating cash flow for the six month period was \$124 million and Downer maintains high levels of liquidity with \$830 million in cash and undrawn facilities. This \$124 million operating cash flow included \$62 million outflow relating to Reliance; that is, the \$124 million cash flows includes the Reliance commitment for the current period.
- Downer confirmed it remains in compliance with its funding covenants. A move to negative watch on the rating by Fitch is a little irrelevant as the bonds were already priced as if a downgrade had occurred. However, the "shot across the bow" by the rating agency may result in an equity raising, a big plus for bond investors (and a negative for equity investors).
- The Reliance Rail project remains ring-fenced from Downer EDI. Downer has work-in-hand (order book) of about \$20 billion, with the bonds maturing in late 2013. The order book should be more than sufficient to ensure maturities are met.
- Current market capitalisation is still over \$1 billion, providing a significant cushion for bond holders.

Downer has been impacted by the floods because some of the mines to which it provides contract services have been flooded, reducing throughput and profitability. However, we expect it will gain additional business to repair damaged infrastructure, somewhat offsetting near-term losses. (For more information, see **A step ahead of the coal trains**, by my colleague Gavin Madson.)

Portfolio analysis

I don't have enough cash in my portfolio to buy the Downer bonds. Further, reviewing the list of investments in my portfolio, none stand out as underperforming or not achieving the return, diversification, liquidity or inflation-linked protection that I intended on purchase.

It is not economical to buy or sell bonds in small parcels and returns are meant to be derived over the medium term. But, if I had Downer shares in my equity portfolio or if I had just received an unexpected inheritance then adding a parcel of these bonds would certainly be worth considering.



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