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HD **Wood gets rough ride at WorleyParsons**

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WorleyParsons is used to having a pretty easy ride from investors. The $4.3 **billion company** that was morphed by founder John Grill from a small Australian consultancy group into a global engineering brand has traditionally been so highly valued that its stock has traded at premiums of up to 30 per cent against its peers.

Presiding over an expanding business, Grill did such a good job most of the time that investors did not question the **company**'s sometimes opaque disclosure and lack of detailed profits guidance.

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But new chief executive Andrew Wood, who replaced Grill just over a year ago, is having a much rougher ride.

Wood issued his first profit warning just seven months after becoming CEO, telling investors in May that fiscal 2013 net profit after tax would be between $320 **million** and $340 **million** – not more than $345.6 **million** as expected. Six months later, Wood cut fiscal 2014 guidance from "increased earnings" on 2013's reported net profit of $322 **million** to a new range of between $260 **million** to $300 **million**.

Investors were stunned by the second warning on November 20; it came just six weeks after WorleyParsons had reaffirmed its previous guidance at its annual meeting. The **company**'s shares, which slumped 26 per cent after the second warning – wiping $1.3 **billion** off its market value – have not recovered to previous levels, and are trading at their lowest price for five years.

Wood blamed the most recent cut in guidance on "slow starts" to the **company**'s engineering and project management contracts around the world, arguing expected recoveries following the resources slump in some arms of its business, such as its minerals and metals division, had not eventuated.

The group's Canadian business, which generates almost a third of group revenues, is also facing challenges as **oil** sands projects encounter tougher competition from low-cost shale-**oil** production.

Canadian **oil** sand producers have had difficulties transporting **oil** to export markets due to lack of pipeline and trucking capacity, forcing them to buy rail carriages so they can use rail networks.

Investors who have held on to their stock after the profit warnings say the engineering group has historically been good at adapting its business to changing circumstances, and that they believe the share price will recover when capital spending by **oil** and gas producers – WorleyParsons's most lucrative clients – picks up.

Even after its share price plunge, WorleyParsons is trading at an 8.3 per cent premium to its peer base – which includes international engineering and construction groups such as KBR, Halliburton, Fluor and Foster Wheeler – on a price/earnings ratio of 14.3 times, says research from Moelis.Seeking to assuage investor concerns

Wood has sought to assuage investor concerns over the suddenness of the most recent profit warning – which led to the filing of one class action lawsuit from Melbourne City Investments and spurred Maurice Blackburn to investigate potential legal action – by telling investors WorleyParsons will re-examine its budget and forecasting process and be more transparent in disclosing information that could influence future profits.

The Melbourne City lawsuit, filed by former Minter Ellison partner Mark Elliot, alleges that WorleyParsons's internal reporting systems should have alerted the **company** before November 20 that its 2014 income would be lower than forecast, and that it did not immediately disclose information affecting its earnings forecast.

But some investors are abstaining from the stock, worried by the extent of WorleyParsons's project slowdowns, with Wood confirming in November that they were not limited to core markets in Australia and Canada, but extended globally (the group operates in more than 40 countries) and that he was uncertain how long they would last.

Some market observers have also questioned whether WorleyParsons is facing structural changes to its operational model that require more radical changes to its business at a time of increasing consolidation in the engineering sector that could make the **company** vulnerable to a potential takeover.

WorleyParsons's group profit margins were lower in fiscal 2013, with margins on earnings before interest and taxation (EBIT) on aggregated revenue falling to 6.9 per cent from 7.2 per cent, and well down on the 9.7 per cent reached in 2009.

WorleyParsons makes most of its profits from its hydrocarbons division, which provides a range of services – from evaluation studies to engineering design and construction management – for new and existing **oil** and gas projects around the world.

The division generated a solid performance in fiscal 2013, increasing EBIT by 6 per cent to $634 **million** and keeping margins steady at 11.9 per cent while its minerals, metals and chemicals division generated only a marginal increase in EBIT to $136 **million**.

Oil and gas explorers and producers have traditionally hired engineering, production, construction and management companies (EPCM) like WorleyParsons to do initial engineering work and hire and manage construction companies to build the project.Hiring constructions companies directly

But exploration and production companies are increasingly hiring construction companies directly to build projects, which in turn subcontract engineering work out to companies like WorleyParsons, according to analysts at research group CLSA.

WorleyParsons acknowledges that some clients will switch from EPCM companies to general construction groups on some contracts, but argues that its customers – which include multinational **oil** and gas producers like Shell and BP – are highly sophisticated and will pay for customised services.

It believes that while **oil** and gas producers may favour construction groups that work on lower-margin lump-sum contracts for "repeatable" work like building liquefied natural gas plants; for more risky and complex projects they will prefer EPCM companies that work on more flexible contracts.

Wood has no plans to take WorleyParsons down the path of lump-sum contracts, and intends to try to lift the group's performance in its existing markets, even as its customers are under pressure to become more efficient and cut costs, forcing delays to projects – not just in the metals and **mining** sector, but also in hydrocarbons.

He sees opportunities in further developing the **company**'s "Improve" division, which upgrades assets on existing projects, as well as following its customers into new regions, such as eastern Africa and the Arctic Circle.

WorleyParsons is also expanding its advisory business to try to develop new business markets, and last year set up a "New Ventures" group led by David Steele, a member of the contractor's executive committee, and struck an alliance with accounting group Deloitte Australia.

In addition, it is looking for new ways to cut costs. Wood told analysts last year that the **company**, which employs about 39,800 people globally, had become "overhead" heavy and needed to get rid of more jobs.

WorleyParsons has been trying to reduce salary costs by designing and developing more of its resources projects outside its Australian headquarters, with India, **China**, Malaysia and the US increasingly used as venues for "engineering centres".

Still, Wood may be forced to reshape WorleyParsons's business even faster if he is to keep up with competitors such as the UK's AMEC, which last week announced a provisional $US3.2 **billion** takeover of fellow engineering and construction group Foster Wheeler. AMEC has pitched the **purchase**, which would create a group with a market capitalisation of about $US9 **billion**, as a transformational deal that will dramatically improve its position in the **oil** and gas chain by creating a vertically integrated business allowing it to provide services throughout the **oil** and gas supply chain.

The deal has led analysts to speculate on what role WorleyParsons, which has been an active acquirer in the past, may play in further consolidation.

Analysts at Morgans note WorleyParsons is now the largest engineering **firm** globally without a dedicated construction arm.

But Credit Suisse has speculated that WorleyParsons is unlikely to make a large **acquisition** until it has addressed its operational issues, and that it could instead become a target for a competitor wanting to boost its own professional services business.

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