

## HD Infrastructure: Rocking the foundations

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A brutal restructuring of Leighton's global construction empire could change the way it bids for projects.

Australia's multi-**billion** dollar construction industry is in a state of flux following a takeover offer for 74% of Leighton Holdings by German building **company** Hochtief. Leighton employs 55,000 staff worldwide and has Adollars 42 **billion** worth of projects underway in more than 20 countries including Australia, New Zealand, **Hong Kong**, Singapore, India and the Middle East. The **company** has a reputation for bidding aggressively for contracts, using its cosy banking relationships and its global reach to grow revenues by 13% a year since 2005.

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Hochtief first became a shareholder in Leighton in 1981 and for a long time was happy to sit back and watch the profits roll in. More recently it started to talk about boosting its share in the Australian **company** and playing a more active role in decisions. Those plans were accelerated in 2011 when Hochtief itself was bought by Spanish construction **group** ACS, a **company** crippled by the global financial crisis and desperate to diversify its earnings away from Europe.

ACS, short for Actividades de Construcción y Servicios, says Leighton can be run more efficiently and, according to sources, the Spanish **group** is ready to undertake a brutal restructuring that could include asset sales, business mergers and the culling of some brands. In March it signalled the scale of its intentions by sacking the **company's** chief executive Hamish Tyrwhitt and chief financial officer Peter Gregg, and replaced them with two Spaniards, Marcelino Fernandez Verdes as CEO and Javier Loizaga as CFO.

Under review will be the way Leighton bids for projects and how much it spends on winning new business. Much of Leighton's success over the years has been due to its cutthroat bidding tactics, which has included instructing its subsidiaries, such as Thiess and John Holland, to bid against each other for the same projects. Now there's a chance these subsidiaries will be **sold** or at least folded into Leighton to create a centralised entity - possibly with different divisions focused on construction and **mining** services.

'ACS runs its bidding **group** on a tight budget,' said one project financier in Sydney who is familiar with the European **firm**. 'If it plans to make Leighton more profitable then I expect it will start by running a razor through the bid teams, and this could have a big impact on the competitive environment.'

Guy Robinson, an equities analyst at Citi in Sydney, says large bids cost up to Adollars 30 **million** to prepare. 'On a major project this can represent about 1% of project value,' he said. 'My guess is that ACS will be focused on cash and cash flow, and this might stop it from bidding on overly risky projects.'

Under King's reign

To some degree, Hochtief had already started to institute a more conservative approach to tendering at Leighton, having ousted former chief executive Wal King after 23 years at the helm. It was under King's reign that subsidiaries were encouraged to bid against each other and while this guaranteed higher volumes for the **group**, it didn't always work out. In 2010, two such projects went spectacularly wrong - the Victorian desalination plant and Brisbane's Airport Link. Leighton took a pre-tax write-down of Adollars 1.26 **billion** on the projects and King was asked to resign.

'The bids for these projects were formulated behind Chinese walls that didn't really exist,' the project financier said. 'Each party was meant to be operating independently, unaware of the other's pricing and technical solutions, but instead it led to a dilution in resources and rock-bottom prices. It was a disaster.'

When Hochtief installed Tyrwhitt as CEO in August 2011 he introduced a single-bid model, saying the plan was to build a higher quality order book at the expense of volumes. Subsidiaries were told they could work together in a consortium but were only permitted to submit one bid per project. The probability of winning was instantly reduced, Citi's Robinson said. 'Instead of being two out of three on a shortlist, they became one out of three.'

This may help to explain why work-in-hand has fallen from Adollars 46.2 billion in June 2011 to Adollars 42.2 billion in December last year.

#### Ratings concerns

Craig Parker, a senior director in Standard & Poor's corporate ratings team in Melbourne, says the fact that ACS 'now has the opportunity to influence which projects Leighton bids for' is a cause for unease. Following Hochtief's takeover offer, S&P and fellow rating agency Moody's warned that it might downgrade Leighton. A one-notch drop from its current BBB-/Baa2 status would bring Leighton into line with local competitor Lend Lease, while a two-notch drop would place it below investment grade.

The agencies are worried about ACS's aggressive debt strategy and how this might affect Leighton's future business and financial profile. 'ACS's use of debt and its appetite for large sums of debt are at the core of our concerns,' Parker said. 'After the financial crisis ACS ran a debt-to-Ebitda ratio of 7-to-8 times, which is extremely high for a construction company and far above Leighton's peak of 2.2 times in 2011.'

(ACS has been working to reduce its debt burden and in February this year reported that net debt for the group stood at EUR4.2 billion, down from circa EUR9 billion during the crisis. Much of the decrease has been achieved by severe cost-cuts and non-core asset disposals.)

A drop in Leighton's credit rating to sub-investment grade would have an impact on the price at which it can issue debt. 'Leighton's cost of capital would certainly rise, though it is difficult to say by how much,' said Maurice O'Connell, a senior analyst at Moody's in Sydney.

'(The company) might also find itself shut out of deals where the project sponsor insists on dealing with a counterparty that has investment-grade status. Unless of course it can appease the sponsor by issuing a performance bond, and in this case, the impact of a downgrade could be quite muted.'

There is also the issue of outstanding under-claims, O'Connell said, referring to work that has been completed and not yet billed. 'Leighton has seen a material increase in receivables of Adollars 1.3 billion year-on-year to a total of around Adollars 5.1 billion today. This is a very large amount.'

As Leighton tries to claw-back these receivables, it might be tempted to rethink its processes and tighten its contractual terms. 'This could make it slightly less competitive, but I suspect other players in the market will be focused on these performance measures too,' said O'Connell.

Whether the rating agencies move to downgrade Leighton will become clear in the next two months. Their analysis is hampered by the fact that neither publishes a formal rating on ACS or on Hochtief and are therefore relying on publicly available information to form an opinion. ACS hasn't been willing to answer the agencies' questions on just how it plans to influence future Leighton policy.

Leighton also declined an interview with FinanceAsia.

#### Gaps form in the market

Commentators say if Leighton decides to sell Thiess and John Holland, or consolidate them into the wider group, a gap could form in the market for mid-tier construction projects in Australia, those valued between Adollars 200 million and Adollars 500 million. 'With Thiess and John Holland out of the picture there would be fewer players providing price tension in these mid-tier deals,' said one equity analyst who did not want to be named. A number of firms already play in this space including Melbourne-based McConnell Dowell, Brisbane-based Seymour Whyte Constructions and New Zealand's Fulton Hogan.

On larger projects, Leighton will remain a front-runner. 'If I try to imagine how large projects will be bid in the future, my guess is there will be three companies that make the shortlist - typically this would be Leighton, Lend Lease and then a large international player who will joint venture with a small local contractor,' Robinson said.

The picture is less clear for Leighton's international **operations**, which now make up 19% of **group** profits and form the backbone of its diversification strategy. As of December, the **company** had Adollars 12.3 **billion** of overseas projects underway. In Asia current projects include a Adollars 2.8 **billion** contract to design and build a luxury **hotel** for Wynn Resorts in Macau, and a Adollars 656 **million** contract to construct a component of the Shatin to Central Rail Link development in **Hong Kong**.

'ACS will now have more say over which markets Leighton bids in and what projects it bids for,' said the project financier. 'There might be pressure to avoid international projects that ACS is bidding for, crimping Leighton's expansion strategy.'

However ACS chooses to play its cards, it will be careful not to derail a business that brings it significant value. 'Leighton contributes 90% of Hochtief's earnings and 40% of ACS's **group** earnings,' the **equity** analyst who declined to be named said. 'This makes it a prize asset.'

ACS will tread a delicate balance between reducing costs and minimising project blowouts, while also bringing in new business. The **company** has a number of soon-to-be completed projects that will need to be replaced, including three or four large LNG contracts worth Adollars 4 **billion** in annualised revenue.

As Robinson at Citi concludes: 'Leighton can't really afford to stay out of the bidding process if ACS wants to achieve its goal of improving margins.'

4 - Number of CEOs since 2011:

Wal King, David Stewart, Hamish Tyrwhitt, Marcelino Fernandez Verdes

Projects awarded to Leighton in 2013

Macau - Design and build of luxury Wynn Resort, Adollars 2.8 **billion**

**Hong Kong** - Construct part of the Shatin to Central Rail Link, Adollars 656 **million**

Singapore - Construction of Thomson Line project and Springleaf station, Adollars 329 **million** to

Gurgaon, India - Luxury **residential** development, Adollars 246m

Abu Dhabi - Expansion of the Abu Dhabi International Airport, AED600 **million**

Dubai - Construction of **residential** project featuring 2 x 75-storey towers, 1 x 52-storey tower, AED1.45 **billion**

Dubai - Next phase of the Jafza One-Jafza Convention Centre complex, AED275 **million**

Sydney - Tunnels and excavation for North West Rail Link, Adollars 1.5 **billion**

Brisbane - Moreton Bay Rail Link, Adollars 650 **million**

Perth - Airport and Freight Access Project, Adollars 600 **million**

Melbourne - New airline terminal and transport facility, Adollars 370 **million**

Dysart, Queensland - Expansion of the Lake Vermont **coal** mine, Adollars 550 **million**

Blackwater, Queensland - Extension of the Curragh **coal** mine, Adollars 570 **million**

Surat Basin, Queensland - Construction of gas compression facilities for QCLNG, Adollars 1.8 **billion**

Off Karratha, Western Australia - Further civil works on the Gorgon LNG Project, Adollars 1.2 **billion** (total Gorgon works now valued at Adollars 2.3 **billion**)

Tom Price, Western Australia - Mine contract for the Kings **iron ore** deposit at the Solomon Hub, Adollars 1.3 **billion**

Auckland - Auckland Causeway upgrade, NZdollars 220 **million**

Wellington - Preferred tenderer for Transmission Gully motorway, Adollars 900 **million**

WORK IN HAND (Adollars **billions**)

**Group** International **operations**

June 2010	41.5	-
June 2011	46.2	13.8
December 2011	44.6	15.9
December 2012	43.5	13.8
December 2013	42.2	12.3

Source: Leighton Holdings Total revenue (Adollars **billions**)

June 2010	18.6
June 2011	19.4
December 2011	12.2
December 2012	32.1
December 2013	24.4

Source: Leighton Holdings International Work-in-hand by Country (AUD **billion**, as at 31 December 2013) Total: dollars 12.28 Other: dollars 1.06 **Hong Kong**/Macau: dollars 4.06 Indonesia: dollars 3.64 Middle East: dollars 1.41 Mongolia: dollars 1.17 India: dollars 0.94 Source: Leighton Holdings

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