Three reasons to own Downer Group

August 2019 – James Miller, Portfolio Manager

Downer Group is an Australian listed company that designs, builds and sustains major infrastructure assets and urban facilities. The company's core business activities are backed by long-term contracts (some lasting more than 20 years) typically with Government clients.

To put the scale of this business into perspective, it employs more people than the Commonwealth Bank, BHP or even Telstra.

There are three reasons why we believe Downer is a compelling investment opportunity.

1. A high-quality business

When you think of engineering it may conjure up visions of large fixed-price projects and cost blow-outs. In recent times, engineering firms have been doing it tough. RCR Tomlinson went bust, Lendlease lost hundreds of millions of dollars building infrastructure and many other large-scale projects have been disasters.

Downer doesn't do the mega, one-off, fixed-price projects. They specialise in low-risk, urbanisation projects. Think roads, rail, schools, stadiums, hospitals and power. It's highly recurring and they have $43 billion of work in hand, spanning up to 30 years.

In our view, these twin tailwinds will drive Downer's continued growth:

- Population growth and urbanisation: Creating increased demand for urban infrastructure services.
- Demand to outsource: Particularly from government, to companies like Downer who have the expertise to plan, build and service urban infrastructure projects often at a cheaper price and higher quality.

2. An un-demanding valuation

In the 2019 financial year, Downer is set to deliver strong earnings growth. The future years are likely to grow steadily in the high single-digit range, driven by continuing contract wins as well as operational improvements.

Downer's current share price puts it on a price to earnings (P/E) multiple below the market average, despite the robust growth outlook that is higher than the market. This, in itself, a compelling investment proposition.

In addition, Downer delivers a dividend yield above 4%, backed by high quality earnings and cash conversion of around 90% over the past 7-years.

Why is Downer undervalued in our view? One of the problems is that it has no peer listed in Australia. You need to travel to the UK to find companies who do similar things such as long-term facilities management. Companies like Compass and Serco are both trading on 20x P/E ratios. Downer trades on a P/E ratio of around 15x today.

3. Key catalysts for Downer's valuation to re-rate

So how does the company trade at a higher multiple to generate capital growth for investors?

We believe there are two key catalysts on the horizon.

Downer is rumoured to be selling their mining services division. It makes up around 13% of earnings but consumes almost 50% of Downer's capital expenditure to generate those earnings. In our view, a sale of this business over the medium-term would move the company into a more capital light business model which is looked upon favourably by investors.

Secondly, the company currently loses money on the Royal Adelaide Hospital contract. It's a long-term contract with limited downside (less than 2% of Downer's market capitalisation). While not overly material, any positive outcome of a renegotiation of that contract in the medium-term would be better than the current situation and looked upon favourably by shareholders.

Conclusion: A high quality business with an un-demanding valuation

In our view, Downer is a compelling investment opportunity because of the quality of the business and exposure to urban services. In addition, the valuation for the business today is un-demanding with strong growth, good cashflow and some potential catalysts for a re-rate. For us, Downer ticks all the boxes.