Watpac

March 2018

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Disclosure

Entities managed by Sandon Capital own securities in Watpac Ltd.

Sandon Capital is not retained by, and has no relationship with Watpac Ltd.

Company Description

- Watpac (WTP) operates in two main segments:
  1. The Construction business operates nationally with a broad client base spanning the commercial, education, health & science, residential, defence and sports sectors
  2. The Civil & Mining business is headquartered in Perth, WA and has active contracting projects in the mining and civil sectors
- WTP reports two operating segments:
  - Construction – 35% FY17 EBITDA
  - Civil & Mining – 65% FY17 EBITDA
- WTP has a market capitalisation of ~$141m[1]
- The Balance Sheet is strong with net cash of $248m[2]

1. Based on a closing share price of $0.77 on 28 February 2018
2. As at 31 December 2017, per the company's FY18 Interim Financial Report

Our Investment Thesis

- Funds managed by Sandon Capital have been shareholders of WTP for over 12 months and today own 5.4m shares (~3% of total shares outstanding)
- We believe the true value of WTP is not reflected in the current market price of WTP shares
- WTP's capital heavy Civil & Mining business is incongruous with its capital light Construction business
- Despite a recovering end market, we believe the poor earnings performance and declining order book in the Civil & Mining business has resulted in it being significantly undervalued by the equity market
- WTP should investigate merging the Civil & Mining business with another mining contractor

Our Investment Thesis

- A scrip based deal would allow WTP shareholders to retain exposure to the mining services upcycle. It would also provide the benefit of a more capable and focused management team
- WTP's Balance Sheet is inefficient. Adjusting for working capital and bank guarantees, we estimate the unencumbered cash position to be in excess of $35m
- Previously, WTP has used a buyback to return capital to shareholders, however implementation has been sporadic and consequently there has been very little value accretion. We believe WTP's significant surplus cash should be returned to the rightful owners, the shareholders
- Given the current share price of WTP relative to its net tangible asset backing, WTP shareholders would be better served by WTP buying back WTP shares rather than pursuing inorganic growth opportunities

Our Investment Thesis – Sum-of-the-Parts Valuation

- The sum of WTP's individual components are worth significantly more than the value currently ascribed by the market
- To value Contracting, we estimate the business will generate EBIT of $29.3m in FY19. From FY11 – FY16, the business generated ***average*** EBIT of $32.5m, hence we believe our valuation is very conservative

	Basis	Multiple Range		Value	
Contracting	FY19 EBIT	5.0	7.0	146.6	205.2
Mining & Civil	Book Value	0.8	1.0	56.3	75.0
Property	Book Value	1.0	1.0	13.2	13.2
Corporate/Other	FY19 EBIT	5.0	7.0	(87.4)	(122.4)
Enterprise Value				128.6	171.0
add: net cash				248.2	248.2
less: working capital				(162.6)	(162.6)
less: provisions & other liabilities				(28.4)	(28.4)
Equity Value				**185.8**	**228.2**
per share				**$1.01**	**$1.24**

Source: Sandon Capital analysis

Mining & Civil

Mining & Civil Overview

- WTP entered the mining & civil services industry when it acquired JMS Group for $20m in August 2008
- WTP commenced reporting segment earnings for the Mining & Civil business in FY11. Since then, the segment has generated ***total*** EBIT of $73.2m, whilst outlaying $295.4m in capital expenditure
- Much of the capital equipment that has been purchased is now sitting idle or underutilised as WTP continues to lose customers, despite the significant upswing experienced by the mining sector over the past 12-24 months
- From 30 June 2015 to 31 December 2017, WTP's order book has fallen by 90%. Other comparable mining services contractors have seen growth in their order books in that time

Mining & Civil Underperformance Relative to Peers

- The poor performance of WTP's order book is demonstrated in the table below

$m	30-Jun-15 order book	30-Jun-17 order book	change
WTP	219	48	-78%
MLD	1,223	1,516	24%
MAH	1,150	1,200	4%
NWH	663	857	29%

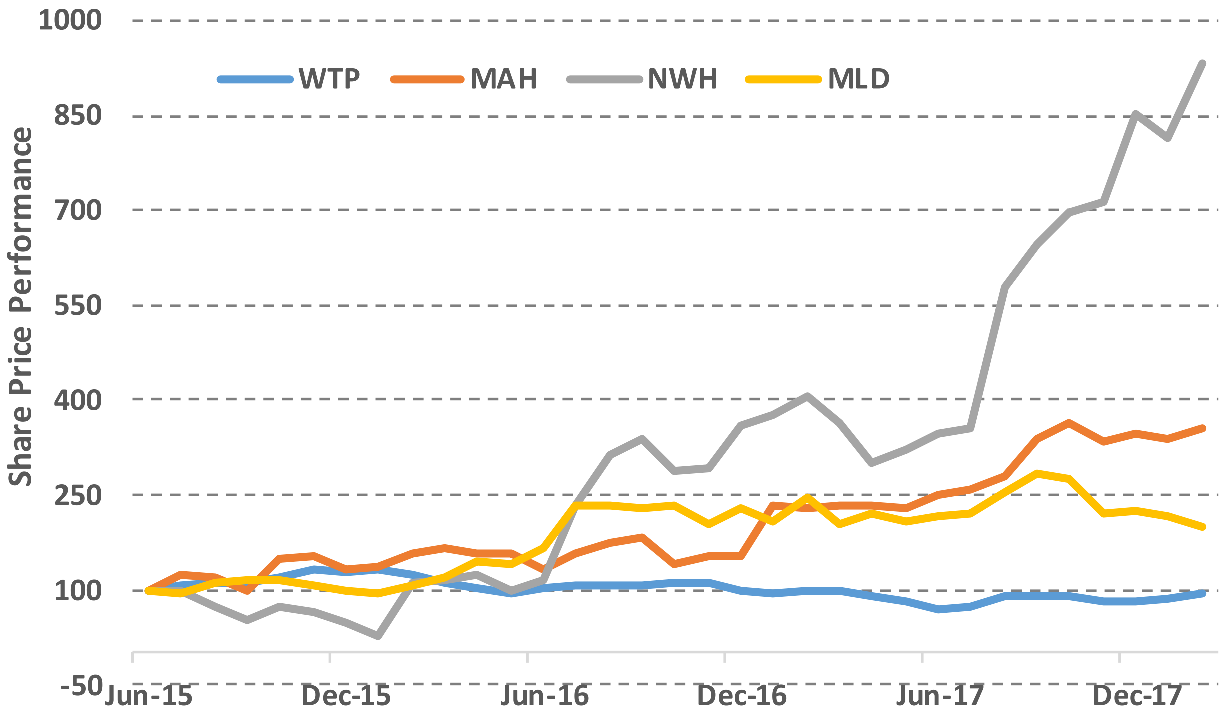
- We have used 30 June 2017 order books rather than 31 December 2017 as both MAH & NWH have made acquisitions since that date that have inflated their order book

- Following completed work and the loss of the Mt Magnet contract, WTP's order book deteriorated further to $22m at 31 December 2017

Source: Watpac (WTP), MACA (MLD), MacMahon Holdings (MAH), NRW Holdings (NWH), Sandon Capital analysis

Mining & Civil Underperformance Relative to Peers

- The poor performance of WTP's Mining & Civil business has also been reflected in the significant underperformance of the WTP share price relative to other mining contractor peers



Source: Bloomberg, Sandon Capital analysis, Base = 100 at 30 June 2015, Bloomberg has not consented to the use of its data in this presentation

Mining & Civil Equipment Significantly Undervalued

- Whilst WTP's Mining & Civil business has materially underperformed competitors, we believe the realisable value of its equipment is significantly above that implied by the current market price of WTP shares
- The write-down in Civil & Mining equipment value in FY17 arose from the reduced forward order book and the subsequent reduction in expected future cash flows. We do not believe the write-down was a result of the diminution in the value of the equipment itself
- Given the sharp uptick the mining services industry has seen over the past 12-24 months, we believe the equipment is worth significantly more to a third party than the value currently implied in the WTP share price
- WTP should investigate merging the Civil & Mining business with another mining contractor

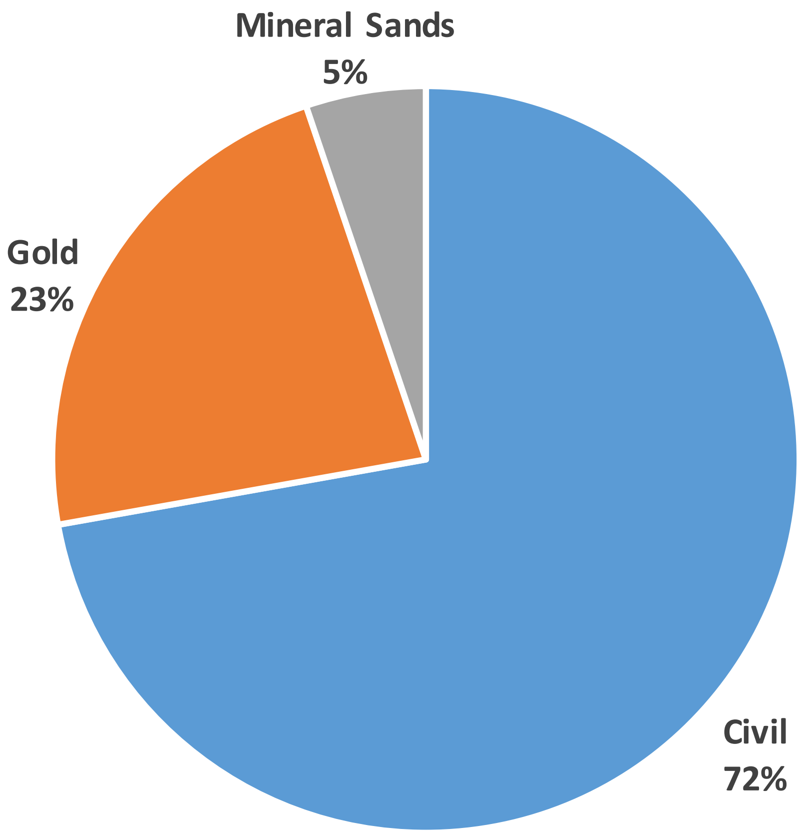
Mining & Civil Should be Merged with a Competitor

- A scrip based deal would allow WTP shareholders to retain exposure to the mining services upcycle. It would also provide the benefit of a more capable and focused management team
- The table below lists the main competitors for the Mining & Civil business. All are priced at a significant premium to their underlying net tangible assets (NTA). As such, we believe our value estimate of $56-75m for Mining & Civil is conservative

Company	31-Dec-17 NTA	Share Price[1]	Premium / (Discount)
WTP	$0.974	$0.770	-20.9%
MAH	$0.174	$0.235	35.3%
MLD	$1.206	$1.505	24.7%
NWH	$0.560	$1.725	208.2%

1. As at 28 February 2018
Source: MACA (MLD), MacMahon Holdings (MAH), NRW Holdings (NWH), Bloomberg, Sandon Capital analysis

Mining & Civil Overview – Work in Hand by Sector



Source: Watpac, Sandon Capital analysis

Construction

Construction Overview

- WTP's Contracting segment has been the mainstay of the company for almost 30 years. Today, the division constructs buildings in the sports, health & science, defence, education, residential, commercial, retail and industrial sectors
- In contrast to the Mining & Civil business, the Construction business has generated ***total*** EBIT of $218.5m since FY11, and outlaid only $3.0m in capital expenditure
- At 30 June 2017, the Construction business had total assets of $144.3m, which we understand is largely made up of receivables
- Whilst segment liabilities are not reported, we believe a large portion of the payables on WTP's Balance Sheet relate to payments to be made to sub-contractors of the Construction segment

Source: Watpac, Sandon Capital analysis

Construction Risks Don't Appear to be Managed Properly

- We estimate that the capital (receivables) required to fund the Construction business is more than funded by sub-contractors (payables)
- The negative working capital position of the segment makes it an attractive business, provided the risks are managed properly
- Unfortunately, WTP has had a number of issues in the Construction segment over the past three years that have negatively impacted earnings and provided constant disappointments for shareholders
- In FY16, there were $22.1m in losses recognised on the ANSTO and 333 George Street construction projects. In his FY16 AGM address, the Managing Director commented that *"areas have been identified within the pre-contract processes on both projects that could have been substantially better executed"*

Construction Risks Don't Appear to be Managed Properly

- In FY17, two projects in South East Queensland *"substantially eroded"* profitability in the Construction segment. The impact on profitability arising from these projects has continued into FY18
- In its FY18 Interim Financial Report, WTP commented that *"several projects that were adversely impacted by … market conditions continued into the Reporting Period and will continue into the second half of the 30 June 2018 financial year"*
- We have no confidence that similar issues will not arise in the future

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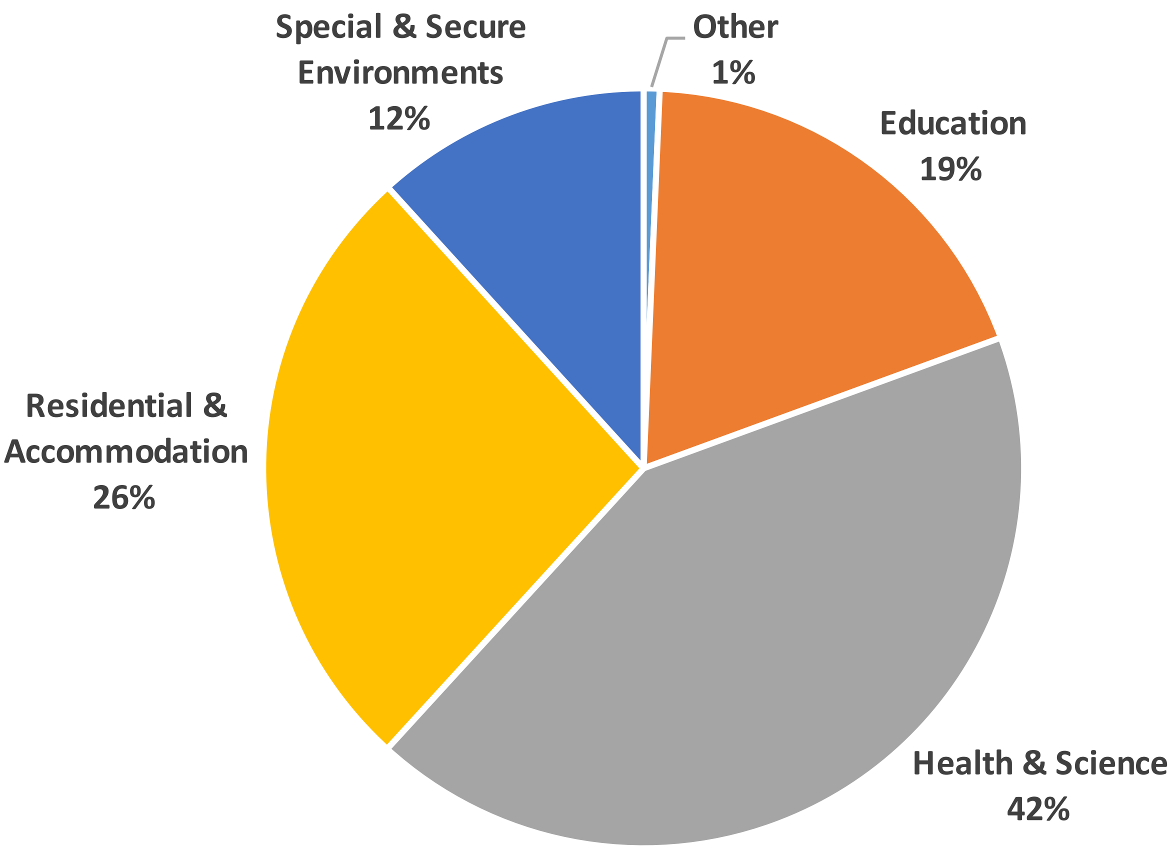
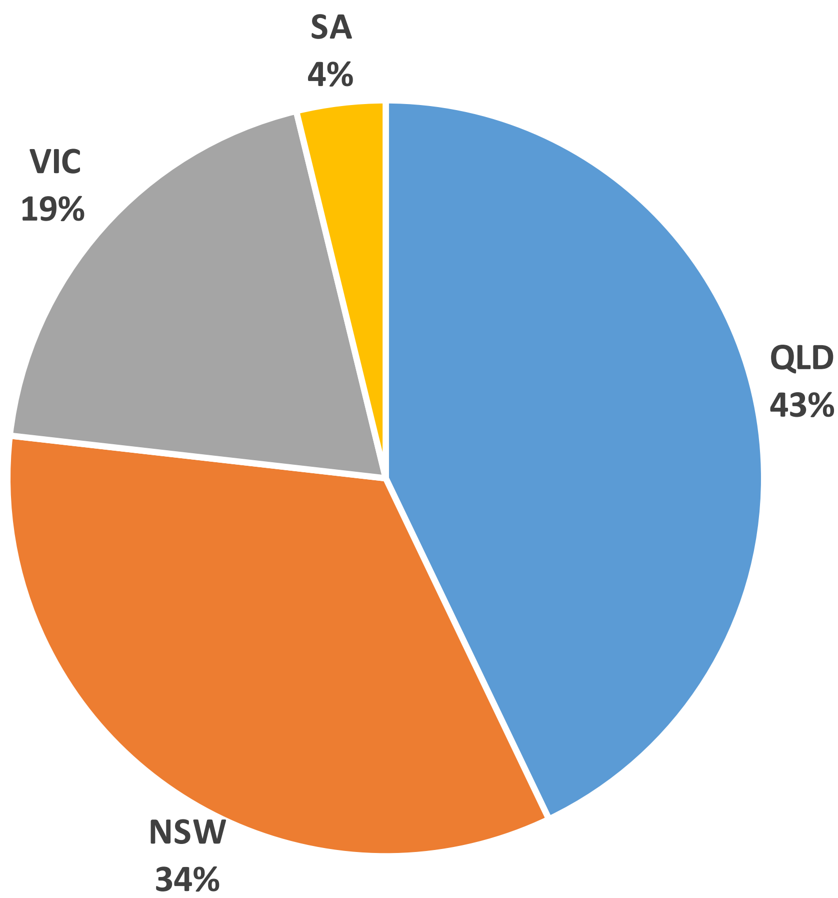
Construction – Work in Hand by Sector



Source: Watpac, Sandon Capital analysis
Residential & Accommodation includes hotel construction

Construction – Work in Hand by State



Source: Watpac, Sandon Capital analysis

Capital Allocation

Excess Capital Should be Returned to Shareholders

- At 31 December 2017, WTP had a net cash balance of $248m
- The Construction business is working capital intensive, hence not all of the cash on the Balance Sheet is available to distribute to shareholders
- After adjusting for net working capital and bank guarantees, we estimate that WTP has in excess of $35m of unencumbered cash available
- The company does not have franking credits, hence the most logical method of returning cash is via a share buyback
- WTP has an on market buyback program in place, however it is currently inactive. Since the buyback was announced on 23 August 2017, only 2.6m shares have been repurchased, and no shares have been repurchased since 18 October 2017

Excess Capital Should be Returned to Shareholders

- Previous buybacks have been similarly underwhelming
- Following the buyback that was announced on 25 August 2015, only 4.1m shares were repurchased and the buyback was terminated on 3 May 2016
- The reason provided for the cessation of the buyback was so that the balance sheet could be preserved *"to explore future strategic options"*
- There was press speculation that WTP was looking to acquire Seymour Whyte, however were trumped by French company, Vinci[1]
- Given WTP's share price relative to its net tangible asset backing, we believe it makes eminently more sense, on a risk-adjusted basis, to aggressively buy back WTP's own shares than pursue inorganic growth opportunities

1. www.afr.com/business/frances-vinci-in-takeover-talks-with-seymour-whyte-20170315-guz5v3

Financials – Balance Sheet as at 31 December 2017

ASSETS	
Current assets	
Cash & equivalents	256.7
Receivables	107.3
Inventories	10.4
Assets held for sale	1.3
Total current assets	**375.6**
Non-current assets	
Receivables	0.0
Inventories	11.9
PP&E	84.0
Intangibles	17.7
Deferred tax	24.1
Total non-current assets	**137.7**
Total assets	**513.3**
LIABILITIES	
Current liabilities	
Payables	280.2
Short-term debt	6.3
Employee benefits	13.9
Provisions	0.0
Total current liabilities	**300.4**
Non-current liabilities	
Payables	10.2
Long-term debt	2.2
Employee benefits	3.4
Provisions	0.9
Total non-current liabilities	**16.7**
Total liabilities	**317.1**
Total Equity	**196.1**

Source: Watpac

Valuation

Share price[1]	0.770				
Shares on issue	183.4				
Market Capitalisation	141.2				
Net Debt / (Cash)[2]	(35.0)				
Enterprise Value	106.2				
NTA	0.97				
Multiples	**FY14**	**FY15**	**FY16**	**FY17**	**FY18E**
EV / Revenue	0.1x	0.1x	0.1x	0.1x	0.1x
EV / EBITDA	1.4x	1.5x	3.2x	4.5x	3.4x
EV / EBIT	3.0x	3.4x	9.0x	35.4x	9.8x
P / E	7.8x	8.1x	18.0x	130.2x	25.6x
FCF Yield	66.7%	31.3%	54.1%	-10.0%	7.7%
Dividend Yield					0.0%

1. Based on a closing share price of $0.77 on 28 February 2018
2. Adjusting for working capital and bank guarantees

Source: Sandon Capital analysis

Key Risks

- Construction activity, particularly on the eastern seaboard of Australia
- Risk management at Construction projects
- Underlying activity in Mining & Civil markets
- Risk management at Mining & Civil projects
- Balance Sheet Valuation of Mining & Civil equipment
- Value destructive acquisitions and poor capital allocation decisions
- Major shareholder with potentially differing objectives to minority shareholders
- Share price risks surrounding BESIX proposal (both if it proceeds or does not proceed)

Sandon Capital Investment Team

Gabriel Radzyminski – Portfolio Manager

Gabriel established Sandon Capital in 2008 after having devised and managed a number of successful investment funds for a leading high net worth wealth management firm. Sandon Capital has successfully invested its funds on behalf of wholesale clients, and advised shareholders, in a variety of listed companies, funds and trusts that have benefited from its activist investment strategy. Gabriel is currently Chairman of Sandon Capital Investments Limited, is an executive director of Mercantile Investment Company Ltd and a non-executive director of Future Generation Investment Company Ltd and Ask Funding Ltd.

Campbell Morgan – Analyst

Campbell joined Sandon in 2014 and has over 15 years of experience in both Australian and International financial markets. Prior to joining Sandon, Campbell managed a Global Materials portfolio for Millennium, a New York based hedge fund with >US$30bn under management. Prior to this he was a Senior Analyst for a Global Industrials portfolio at Citadel Investment Group, a US$25bn Chicago based hedge fund. Campbell started his career in Australia, working in the Investment Bank at ANZ and after that as an Equity Research Analyst for Merrill Lynch before moving overseas in 2007 to work in Funds Management.

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