SANDON CAPITAL

Watpac

Vote <u>AGAINST</u> the Scheme Resolution

May 2018

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Disclosure

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Vote AGAINST the Scheme Resolution

- On 7 June 2018, Watpac Ltd (WTP) shareholders have an opportunity to vote AGAINST a Scheme that Sandon Capital believes manifestly undervalues WTP and is unfair to shareholders
- We believe that the WTP Board and management have presided over poor operating and financial performance for a number of years, and the resulting weak share price has left the company vulnerable
- In our opinion, the proportional Scheme offer from BESIX is extremely opportunistic and coincides with some of the worst financial performance in WTP's history. WTP has delivered statutory losses in 3 of the past 5 years and is guiding to another loss in FY18
- BESIX are taking advantage of this poor performance and weak share price, seeking to gain control of WTP for a bargain price

Vote AGAINST the Scheme Resolution

- By accepting the proportional offer, shareholders will deliver BESIX a disproportionate share of the benefits arising from any future improvement in the operations of the company
- The Scheme Booklet states that *"BESIX intends to seek to bring long-term value to WTP with a return to recurring profitability in the shortest timeframe possible"* [1]
- In our opinion, there is no need to cede control to BESIX for this to occur
- If the current Board and management cannot return to WTP to profitability quickly, then a new Board and management team focused on operational excellence and disciplined capital management should also be able to bring long-term value to WTP, to the benefit of all shareholders

1. Page 50, Watpac Ltd Scheme Booklet

Vote AGAINST the Scheme Resolution

- We do not agree with a number of the assumptions used in the Independent Expert's Report (IER)
- Specifically, the independent expert has used bottom of the cycle margin and earnings estimates to value WTP's Construction business
- Applying mid-cycle margin assumptions for WTP's Construction business would increase the IER's valuation range to $1.06-1.36 per share
- We also believe the IE has used extremely conservative assumptions to value WTP's Mining & Civil business and also to value the amount of excess capital that is available to WTP
- We doubt the benefits BESIX claims it will bring to WTP will benefit minority shareholders. For over 5 years, BESIX has had at least one representative on the Board and for the past 3 ½ years has had two representatives

Vote AGAINST the Scheme Resolution

- BESIX has also entered into JV arrangements with WTP, however to date WTP and BESIX have not carried out any work together
- To us, it appears that BESIX has bought little, if any, benefits to WTP whilst it has held a significant stake with commensurate Board representation. We question what benefits BESIX will bring in future
- We believe BESIX, rather than minority shareholders, will be the greatest beneficiary of BESIX gaining control of WTP
- We wholeheartedly agree with one of the key reasons provided by directors to vote against the Scheme, specifically:

  "…you may be concerned that BESIX, as a majority shareholder, has the ability to exercise effective control over Watpac in a manner that may be perceived to be disadvantageous to minority shareholders" [1]

1. Page 116, Watpac Ltd Scheme Booklet

Vote AGAINST the Scheme Resolution

- In our opinion, a significantly better outcome for shareholders other than BESIX is for the Scheme to be voted down, followed by changes at Board and management level in order to drive significant improvement in governance and operational performance
- Sandon Capital has voted AGAINST the Scheme Resolution and encourages other shareholders to do the same

Independent Expert Assumptions & WTP Valuation

- We do not agree with a number of the assumptions in the IER. In our opinion, these assumptions minimise the value of WTP
- Specifically, we believe the Independent Expert (IE) has used bottom of the cycle margin assumptions to value the Construction business, which has had a significant negative impact on the IE's valuation for WTP
- According to the IE, in WTP's Construction business *"average construction margins (before unallocated overhead costs) over the FY13 to 1HY18 period were around 2.5% of revenue"* [1]
- We note that WTP has had a number of operating issues in its Construction business in the last 2-3 years which have had a meaningful negative impact on margins
- In the following pages, we show how an "Adjusted Margin", which eliminates one-off impacts to the Construction division, would increase the IE valuation range by $0.24-0.36 per share

1. Page 116, Watpac Ltd Scheme Booklet

Impact of an Adjusted Margin

- In FY16, *"EBITA margins were negatively impacted by aggregate losses of $22.1m recognised on two significant projects"* [1]
- In FY17, Watpac management stated that *"subcontracting price rises considerably exceeding those typically experienced over the long term adversely impacted EBITA by some $20m"* [2]
- Whilst the IE acknowledges these impacts on the business in its commentary, it has not adjusted earnings and margins for these one off items when calculating the long term value of WTP
- If we adjust earnings for the one off issues, we calculate that the underlying EBITA margin generated by WTP's Construction business is 0.75% - 1.0% higher than that utilised by the IE when calculating its value for WTP

1. Page 115, Watpac Ltd Scheme Booklet
2. ibid

Impact of an Adjusted Margin

- The table below highlights the reported margin and Adjusted Margin for WTP's Construction business

	FY13	FY14	FY15	FY16	FY17	1H18	Ave.
Revenue	1,045.6	856.6	929.3	1,048.7	952.5	524.7	
EBITA	24.3	25.8	35.0	27.5	13.4	9.2	
Margin	2.3%	3.0%	3.8%	2.6%	1.4%	1.9%	2.5%
Adjusted EBITA	24.3	25.8	35.0	49.6	33.4	19.2	
Adjusted Margin[1]	**2.3%**	**3.0%**	**3.8%**	**4.7%**	**3.5%**	**3.7%**	**3.5%**

- In the Scheme Booklet, the IE uses a long term margin assumption of 2.5-2.75% to value WTP's Construction business, well below the average adjusted margin of 3.5% achieved since FY13

1. Adjusted Margin is adjusted for aggregate losses of $22.1m recognised on two significant projects in FY16, subcontracting price rises adversely impacted EBITA by ~$20m in FY17, and ~$10m in 1H18

Source: Watpac financial reports, Scheme booklet, Sandon Capital analysis

Impact of an Adjusted Margin

- Watpac commenced separate reporting for its Construction business in FY11. We note that the IER has ignored the strong margins from the Construction business in FY11 (5.5%) and FY12 (3.8%)
- This is evidence that WTP has had a long track record of achieving margins significantly above those used by the IE to calculate its long term value of WTP’s Construction business
- We believe the Adjusted Margin of 3.5% is more representative of the long term margin potential of WTP’s Construction business
- Increasing the IE’s margin assumption for the Construction division to 3.5% adds $0.24-0.36 per share to the IE’s valuation range
- The “Adjusted” valuation range of $1.06-1.36 per share is well above the current underwhelming offer from BESIX

Impact of an Adjusted Margin

- Our analysis of higher margins is supported by a comment in the Scheme Booklet that appears to be sourced directly from WTP management:

  "Watpac management consider that higher construction margins can be achieved in the future due to, inter-alia, more selective tendering" [1]

- We believe that once adjustments are made to better reflect long term margins in WTP's Construction business, the opportunistic nature of BESIX's proportional Scheme offer becomes even more evident
- Sandon Capital has voted AGAINST the Scheme resolution. We encourage other shareholders to do the same

1. Page 116, Watpac Ltd Scheme Booklet

We Have Doubts Over the Benefits That BESIX Brings

- BESIX claims that once it controls WTP, there will be significant benefits for WTP shareholders
- BESIX first bought a 15.6% stake in WTP in April 2013 and was granted a Board seat soon after. BESIX progressively increased its holding in WTP and was granted a second Board seat in October 2014
- For over 5 years, BESIX has had at least one representative on the Board and for the past 3 ½ years has had two representatives
- Over that time we have seen the operating performance of WTP's Construction business deteriorate and the order book in the WTP's Mining & Civil business all but evaporate
- It is not apparent to us that BESIX has added any value to WTP in the past. This is why we are sceptical of any benefits BESIX may bring in the future

Source: Watpac ASX announcements

We Have Doubts Over the Benefits That BESIX Brings

- BESIX claims that it is *"seeking to optimise Watpac's financial arrangements with the support and strength of BESIX's balance sheet"* [1]
- Over the next 6-12 months, we expect WTP to sell the balance of its property assets and sell parts or all of the Mining business. If these assets are sold for cash at the valuations ascribed by the IE, the proceeds will be >$60m
- As a result of the sale of surplus property assets and the announcement of the strategic review for the Mining business, WTP has already started to optimise it's financial arrangements and therefore we believe has no need for the support and strength of BESIX's balance sheet
- Clearly, there are already steps being taken to improve the value of WTP. If the Scheme proceeds, BESIX will be the greatest beneficiary of these changes

1. Page 48, Watpac Ltd Scheme Booklet

We Have Doubts Over the Benefits That BESIX Brings

- BESIX claims that it wants to enable *"diversification of the combined entity towards other contracting disciplines and sectors in Australia"* [1]
- BESIX have only ever completed two construction projects in Australia
  1. Design & Construction of the tug facilities at Port Hedland, W.A.
  2. Two quays and a breakwater at Chevron's Wheatstone project at Onslow, W.A.
- Whilst BESIX has significant offshore construction experience, it has very little experience in Australian construction markets, in particular in WTP's areas of expertise on the east coast
- We question, what, if any benefits, an offshore entity with minimal experience in this market may bring to a well established domestic operator

1. Page 48, Watpac Ltd Scheme Booklet

We Have Doubts Over the Benefits That BESIX Brings

- BESIX claims that *"providing Watpac access to BESIX's international client base as well as network of key suppliers, subcontractors and consultants"* [1] will be of benefit to WTP
- BESIX itself acknowledges in the Scheme Booklet that gaining control of WTP will allow *"BESIX to establish a significant footprint in Australia to grow and geographically diversify its existing business"* [1]
- In our opinion, BESIX will gain significantly more from controlling WTP than any benefits flowing to WTP minority shareholders

1. Page 48, Watpac Ltd Scheme Booklet
2. ibid

We Have Doubts Over the Benefits That BESIX Brings

- The Independent Expert Report discloses that *"Watpac and BESIX have…explored various opportunities across both construction and civil projects on a joint venture basis. To date, however, Watpac and BESIX have not carried out any work together"* [1]
- BESIX has had ample opportunity through its Board representation and JV arrangements to demonstrate the benefits it can bring to WTP and its shareholders
- To date, these benefits appear to be marginal at best, hence we are highly sceptical as to any benefits BESIX will bring in the future
- If BESIX want to use WTP as its vehicle to establish a significant Australian footprint and demonstrate the benefits it brings, it can do so by acquiring all of WTP at a price that is acceptable to shareholders

1. Page 48, Watpac Ltd Scheme Booklet

We Have Doubts Over the Benefits That BESIX Brings

- The proportional offer currently tabled is both opportunistic and underwhelming, as are the benefits that BESIX supposedly brings. In our opinion, there are significantly greater benefits for BESIX than for WTP shareholders from the current Scheme arrangement
- BESIX has the financial capacity to acquire all of WTP. Indeed, as at 31 March 2018, BESIX had a cash of €372m and access to €130m of undrawn committed credit facilities[1]
- If BESIX want control of WTP, they have the means at their disposal to pay WTP shareholders a fair and reasonable price for all of their shares
- We believe that price should be at least within the “Adjusted” valuation range of $1.06-1.36 per share

1. Page 49, Watpac Ltd Scheme Booklet

BESIX Interests Not Aligned with Australian Shareholders

- On page 50 of the Scheme Booklet, under BESIX's post-acquisition intentions, it is stated that *"Upon a return to profitability…BESIX's current intention would be to support the payment of dividends that are in line with or higher than historic distribution levels that followed previous profitable years for Watpac"*
- We believe this creates a clear misalignment with WTP's Australian domiciled shareholders given WTP's lack of franking credits
- As at 30 June 2017, WTP had a franking account balance of $41,000, thus WTP is unable to pay fully franked dividends until it re-commences paying tax. This is unlikely to occur until all tax losses & offsets have been fully utilised
- As a foreign entity, there is a risk that BESIX will seek to have WTP pay unfranked dividends

BESIX Interests Not Aligned with Australian Shareholders

- In the absence of franking credits, a more tax effective method of returning cash to Australian shareholders would be by way of an on market buyback, however this would effectively be a takeover by stealth, another unappealing option for minority shareholders
- Based on its public disclosures, we are of the opinion that if BESIX gains control of WTP, its motives may be significantly adverse to WTP's Australian minority shareholders

The Status Quo Cannot Prevail if the Scheme is Voted Down

- WTP has reported statutory losses in three of the past five years and will report another statutory loss in FY18. This comes at a time when conditions in the Australian construction industry have been strong
- In addition, for the past two years, WTP's listed mining contractor peers have been winning work, generating profits and increasing their order books
- In our opinion, poor operational performance has persisted at WTP for some time now. Indeed, in his FY16 AGM address, the Managing Director stated that *"areas have been identified within the pre-contract processes…that could have been substantially better executed"*
- We believe this highlights the potential opportunity that exists by simply improving WTP's operational capabilities

1. Page 50, Watpac Ltd Scheme Booklet

The Status Quo Cannot Prevail if the Scheme is Voted Down

- BESIX's intention for WTP to *"…return to recurring profitability in the shortest timeframe possible"* [1] is instructive in that BESIX also highlight the persistent underperformance that has occurred at WTP, as well as the potential upside if operational performance can be improved
- A return to recurring profitability in the shortest timeframe possible was certainly not embedded in the WTP share price prior to the announcement of the Scheme Implementation Agreement, nor is it reflected in the underwhelming consideration on offer from BESIX
- Whilst we may be sceptical of the benefits that BESIX can bring to Watpac, we are certainly not sceptical of their ability to identify an underperforming asset that can be readily improved
- In our opinion, there is significant upside for WTP's profitability and cash flow if operational performance can be turned around

1. Page 50, Watpac Ltd Scheme Booklet

The Status Quo Cannot Prevail if the Scheme is Voted Down

- Given the persistent poor performance over the past five years, we do not believe this can be achieved by the current Board and management. As such, change needs to occur
- The position of a number of independent directors becomes untenable if the Scheme fails
- Whilst Board and management refreshment does not need to occur immediately should the Scheme be voted down, we do expect to see a transition period no longer than 12 months where new directors are invited to join the Board to replace outgoing directors
- It will be the new Board's responsibility to determine if the current management team is the appropriate one to drive improved performance and long-term value at WTP

Conclusion

- In our opinion, the WTP Board has agreed to a Scheme of Arrangement that provides poor consideration and a poor outcome to WTP shareholders
- We believe the consideration of $0.92 per share manifestly undervalues WTP. Furthermore, WTP shareholders will be left holding a minority position in an illiquid company controlled by BESIX
- Sandon Capital has voted AGAINST the Scheme Resolution and encourages other shareholders to do the same
- Shareholders should note there is a risk that the WTP share price will fall if the Scheme is not implemented, however we believe this will only impact shareholders who have a short term focus
- Over the long term, we believe WTP's share price will rise above the opportunistic offer from BESIX if WTP can make operational improvements and return to consistent profitability

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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