

Issuer Profile: Lendlease Group (“LLC”)

Neutral (4)

Ticker:

LLCAU

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Recommendation

- LLC posted better 2H results due to the strong performance from the development segment. Excluding the Engineering & Services (“E&S”) business which LLC had already made AUD500mn provision, reported operating EBITDA is down 9% y/y to AUD1.49bn, which is a significant improvement from the 34% y/y fall in 1H.
- We think the sale of the E&S business would be a material credit positive, which should reduce volatility of earnings while freeing up capital from the balance sheet. We think the revised EBITDA mix is better with just 10-20% target weighting coming from Construction, with the rest from Development (40-50%) and Investments (35-45%).
- Credit metrics have also improved with net gearing falling h/h to 22.5% (1HFY2019: 37.4%), bolstered by strong apartment settlements in 2H. The sale of stakes in Lendlease International Towers Sydney Trust and potential listing of a REIT are also credit positive.
- We may look to upgrade LLC’s Issuer Profile rating upon the completion of sale of the E&S business and listing of the REIT.
- We like LLCAU 3.9% ‘27s, which is offering wider spreads than peers which we rate at Neutral (3) Issuer Profiles including CAPLSP ‘27s, CAPLSP ‘29s and CITSP ‘26s.

Relative Value:

Bond	Maturity / Call date	Net gearing	Ask YTW	Spread
LLCAU 3.9% 2027	27/04/2027	22.5%	3.46%	187bps
CAPLSP 3.08% 2027	19/10/2027	73.2%	2.99%	139bps
CITSP 3.48% 2026	15/06/2026	44.5%	2.94%	138bps
CAPLSP 3.15% 2029	29/08/2029	73.2%	3.02%	136bps
FPLSP 4.15% 2027	23/02/2027	73.6%	3.69%	211bps

*Indicative prices as at 5 September 2019 Source: Bloomberg
Net gearing based on latest available quarter*

Background

- Founded in 1958, Lendlease Group (“LLC”) today is a leading Australian property company listed on the Australian Securities Exchange (“ASX”) with a market cap of AUD9.45bn.
- LLC structures its businesses along (1) Development, (2) Construction and (3) Investments.
- Australia is LLC’s core market though LLC has been diversifying into Europe, Asia and America.
- There is no controlling shareholder.

Key Considerations

- **Better 2H performance from development mitigated most of the declines in 1H:** LLC reported FY2019 results for the year ended 30 Jun. Reported operating EBITDA, excluding Engineering & Services (“E&S”), declined 9% y/y to AUD1.49bn. This is a significant improvement from the [34% y/y fall reported in 1HFY2019](#). Development segment is the outperformer with reported EBITDA rising 18% y/y to AUD793mn due to strong residential for sale apartment settlements, PLQ Office and US residential investment. While the communities sub-segment in Australia was impacted by subdued market conditions, strong residential for sale apartments (e.g. Darling Square) kept EBITDA contribution from Australia development stable y/y at AUD556mn.
- **Potential sale of E&S business; further provisions are unlikely:** The E&S business reported a loss of AUD461mn, mainly due to previously announced AUD500mn pre-tax provision from the underperforming projects. According to management, the amount of provision is appropriate. We think that it is unlikely for the projects that resulted in provisions to

further underperform as they are either completed (e.g. Gateway Upgrade North) or completing (e.g. Kingsford Smith Drive, North Connex M1/M2 Tunnel). LLC also confirmed that the sales process is underway for the E&S business. If the sale were to be completed, we think this would likely be a significant credit positive as it removes the uncertainty/earnings volatility of the business while lightening the balance sheet as we estimate that the E&S business takes up AUD2.09bn in total assets. Meanwhile, the E&S business backlog remains somewhat significant at AUD3.8bn, which relates mostly to Melbourne Metro Tunnel Project (<20% completed) and West Connex 3A M4-M5 Link Tunnels (<20% completed).

- **Not overly worried over weaker results from Construction (excluding E&S):** Reported EBITDA for the segment fell 29% y/y to AUD211mn, mainly due to lower margins of 2.2% (FY2018: 3.1%). The decline is mainly from Australia (reported EBITDA: -35% y/y to AUD126mn) with EBITDA margin in Australia falling y/y to 3.1% (FY2018: 5.2%). That said, the margins is within LLC's expectations (2-3%) for the segment and we think there should be less variability given that the segment no longer includes E&S.
- **Lower revaluation gains from Investments though operating earnings are stronger:** Reported EBITDA for the segment fell 27% y/y to AUD489mn, mainly due to the decline in revaluations with co-investment revaluations falling to AUD103mn (FY2018: AUD182mn). Meanwhile, operating earnings rose 8.3% y/y to AUD144mn. We should expect recurring earnings from the segment to increase with Funds Under Management ("FUM") growing to AUD35.2bn (FY2018: AUD30.1bn) and another AUD3.3bn of secured FUM from LLC's development pipeline. LLC also increased its Assets Under Management ("AUM") of retail and office to AUD15.4bn (FY2018: AUD12.7bn) and holds US Military Housing (AUM: AUD13.3bn).
- **Monetising assets:** According to Bloomberg, LLC is planning to raise SGD750mn from a REIT listing in Singapore. According to the Business Times, the properties that may be included in the REITs are one property each in Singapore and Milan. We think that having a REIT listing is beneficial because a REIT would allow LLC better flexibility to inject and monetise its own assets in the future, even if LLC does not have a major stake in the properties that will be included in the REIT. Separately, Bloomberg reported that GIC is buying 25.1%-stake in Lendlease International Towers Sydney Trust (stake estimated at ~AUD1.1bn), of which 11.1%-stake (worth ~AUD480mn) is likely to be sold by LLC.
- **Solid development pipeline to provide earnings visibility:** Total development pipeline is approaching AUD100bn post results (end Jun 2019: AUD76.1bn). The most significant addition is the AUD20bn San Francisco Bay Area project (secured post-FY2019), which will be jointly undertaken with Google to deliver mixed-use neighbourhoods with 15,000 residential units. The pipeline may grow further given LLC's preferred status for two projects in London (AUD14.5bn) and Birmingham (AUD2.7bn). Aside from solid earnings visibility from development (covering FY2019's development revenue by 30x), part of the pipeline is expected to join LLC's FUM. As a result, LLC expects its FUM to double from AUD35.2bn as of end 30 June 2019.
- **Healthy credit metrics:** Net gearing fell h/h to 22.5% (1HFY2019: 37.4%) on the back of an estimated ~AUD884.2mn cashflow from operating activities in 2HFY2019, bolstered by apartment settlements (FY2019: AUD1.4bn) in the 2nd half. Net gearing in the longer term may stabilise around low 20% to mid 40%, based on LLC's guidance of targeting net debt/net tangible assets (less cash) at 10%-20%. Meanwhile, liquidity remains ample at AUD3.9bn with AUD1.29bn in cash and AUD2.8bn in bank facilities. We calculate that EBITDA/Interest and net debt to EBITDA are strong at 7.5x and 1.3x respectively. These are expected to improve significantly when the E&S business which delivered negative SGD461mn in FY2019 is sold.

Explanation of Issuer Profile Rating / Issuer Profile Score

Positive (“Pos”) – The issuer’s credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral (“N”) – The issuer’s credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

Negative (“Neg”) – The issuer’s credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings into a 7 point Issuer Profile Score scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Please note that Bond Recommendations are dependent on a bond’s price, underlying risk free rates and an implied credit spread that reflects the strength of the issuer’s credit profile. Bond Recommendations may not be relied upon if one or more of these factors change.

Explanation of Bond Recommendation

Overweight (“OW”) – The performance of the issuer’s specific bond is expected to outperform the issuer’s other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Neutral (“N”) – The performance of the issuer’s specific bond is expected to perform in line with the issuer’s other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Underweight (“UW”) – The performance of the issuer’s specific bond is expected to underperform the issuer’s other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

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