JCAP

Global
Short Ideas

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Coverage Initiation

Cimic (CIM ASX)
Financial Engineer

Nan Yiyi, with Melvin Glapion

Core business in decline
Cimic plays fast and loose with its accounting and seems to be squirreling away losses in affiliates. The core business is in secular decline, and Cimic is tricking out the financial statements. But that will not last for long.

Our checks raise questions
Our checks on projects scheduled for delivery at the end of 2016, 2017, and 2018 indicate delays and manipulation of contract values.

Bottom line inflation
A comparison of Cimic's statements with those of parent company Hochtieff AG (HOT ETR) indicates that Cimic may be inflating its bottom line by at least 20%.

Beware accounting tricks
Cimic's accounting tricks include aggressive revenue recognition, overvaluing assets for sale to improve the cash flow statement just before key reporting dates, improperly deducting impairment expenses, and aggressively using short-term debt while reducing provisioning. We believe the risks are significantly underestimated and likely to result losses in the near future.

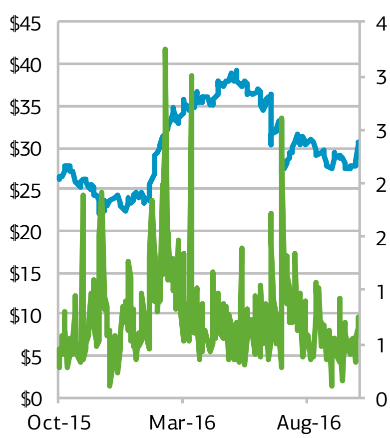
Cash problems ahead
We expect Cimic to run into cash problems in the next two quarters.

Valuation
We arrived our price target of AUD 20.68, 25.73% lower than Cimic's current price, based on our DCF model using a 7.8% WACC and 1.5% terminal growth rate.

Cimic (CIM ASX)

Price	AUD 30.47
Rating	**SELL**
Price Target	**AUD 20.68**
Difference	32%
Avg. Volume	12.2 mln
P/E	19.46x

Cimic (CIM ASX) last share price in AUD (blue) and volume (green, in mln shares)



Source: Bloomberg

Responsible for this report:
Anne Stevenson-Yang anne@jcapitalresearch.com +852 2534 7405

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Nan Yiyi yiyi@jcapitalresearch.com **Anne Stevenson-Yang** anne@jcapitalresearch.com +852 2534 7405

The Basics

Cimic used to rely on crony deals. Now, it's accounting manipuation.

It tells you something about Cimic that it had to change its name, from Leighton Holdings, to shake the cloud of corruption scandals. This Australian construction engineering service provider relied in the fat years on crony deals and now is leaning into accounting manipulation to disguise the deterioration in the core business that is underway.

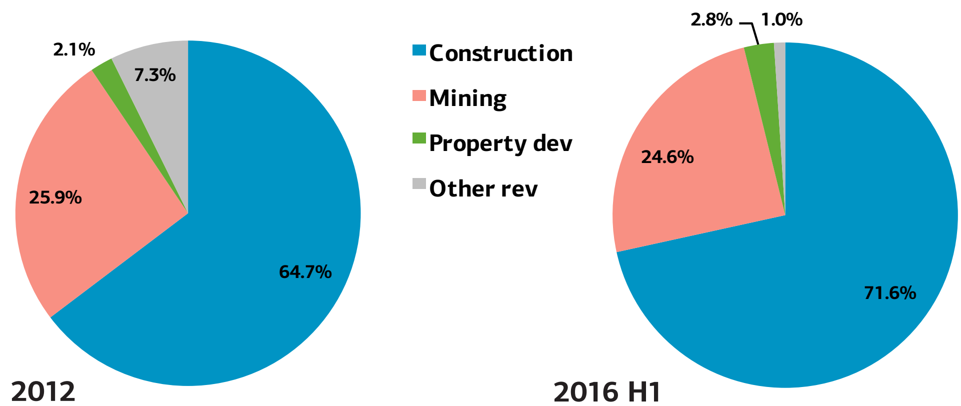
Cimic builds civil and mining infrastructure, operates coal mines, and builds commercial property. Some 71% of revenue derives from construction, of which 70% is in Australia and New Zealand. Back in the Leighton Holdings days, it was listed as LEI ASX. The renaming was not only cosmetic: there was a takeover and restructuring following AUD 1 bln in write downs that Leighton had been obliged to take on Brisbane's Airport Link Tunnel and Victoria's desalination plant in early 2011. The company had underestimated the complexity of the projects. As a result, Leighton became vulnerable to takeover and was acquired by German construction company Hochtief AG. The ultimate owner of both Cimic and HOT is a Madrid-listed company called ACS Actividades de Construccion y Servicios SA (ACS BME), which has a market capitalization of EUR 8 bln and trades at 18X earnings.

Cimic spent a lot of money to build its expertise in the mining industry but, since 2013, facing weak demand, the company has been trying to move more into infrastructure construction. Over the past five years, CIM's business has been more concentrated in construction, which is embedding higher risk given the fiercer competition in bids. In 2012, less than 65% of revenue came from construction, compared with more than 71% in H1 2016. The shift from mining to construction was a consequence of weakening demand in mining. Since 2014, were hit by a 18% decline in mining revenue growth, the company has undertaken a restructuring process focusing on cash and margin management after they.

The group is also more focused geographically on Australia and New Zealand than it was previously. For 2017-2018, 70% of the company's construction and mining projects are in these two countries, while at the end of H1 2016, 66% of the work in hand was coming from Australia/the Pacific.

The less diversified pipeline could place the company in jeopardy given construction spending cuts and more intense competition in bidding. According to data provided in Australia's budget, infrastructure spending is set to peak in 2016-2017.

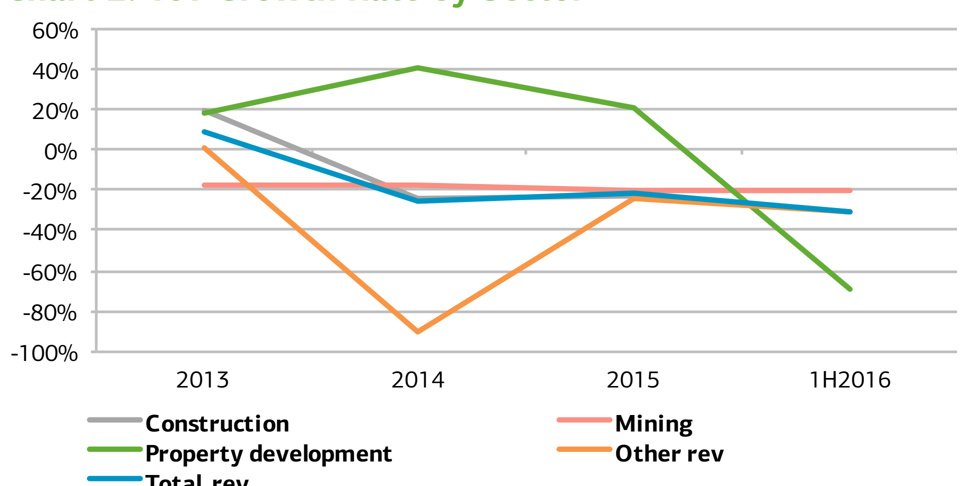
Chart 1. Cimic Revenue Breakdown



Source: Company data

CIM reported AUD 4.9 bln in revenue for the first half of 2016, down from AUD 7.2 bln in same period of 2015. Revenue freefell by 31% YoY, and 71% of the decline was due to a contraction in the construction business, which was down by AUD 1.6 bln YoY in the half. We expect the downward trend to continue in the near term.

Chart 2. YoY Growth Rate by Sector



Source: Company data

Deteriorating Business

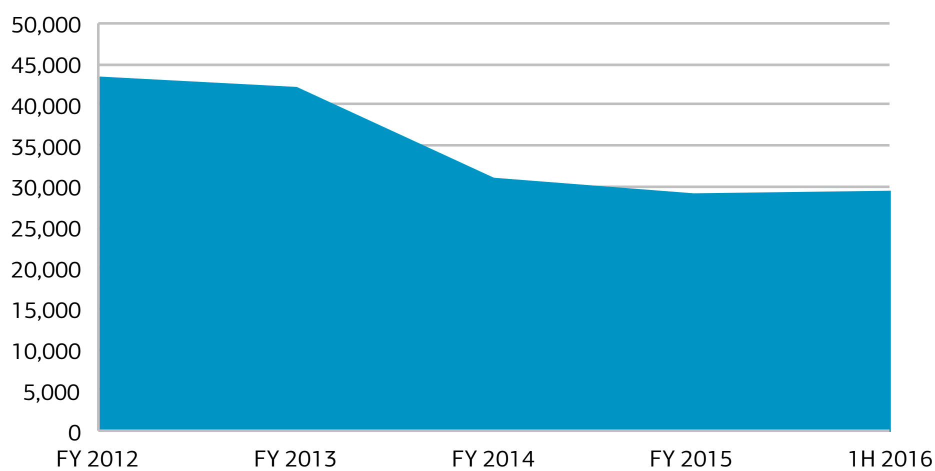
Project Crunch

We went through eight of Cimic's major projects that are planned for completion in 2016-2018 and found that three are delayed from between one month and a year and two projects reported lower revenue than had been advertised. A USD 1.7 bln contract in Qatar is shared with another company, but Cimic reports the total contract amount as their own. These are illustrations of general slowing of projects, which may reveal stretched cash flow. The last quarter of this year is critical for the company, given delays in H1 (See Appendix: Current Projects).

Gloomy on Work-in-Hand

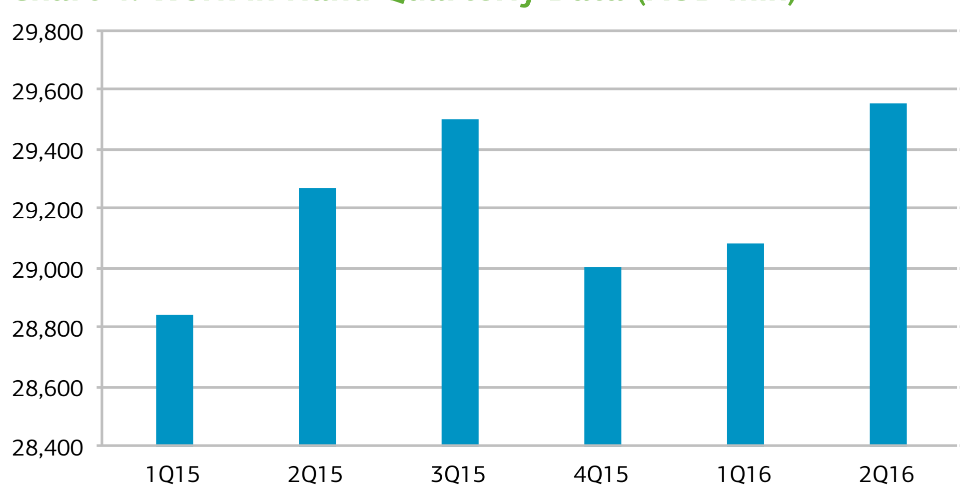
Work in hand (WIH) seems to have stabilized in H1 2016, but the stability is only apparent. WIH declined from 2012, bottomed in 2015, and reversed to positive growth in Q1 2016, stabilizing, with 1% YoY growth, in H1 2016. In terms of sectors, construction WIH was up 5.8% on Q4 2015 and up 2.6%

Chart 3. Work in Hand Annual Data



Source: Company data

Chart 4. Work in Hand Quarterly Data (AUD mln)

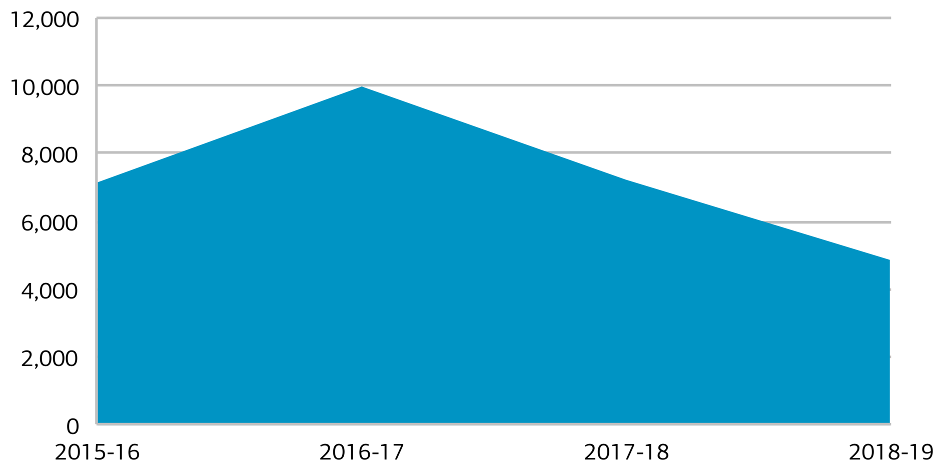


Source: Company data

on Q1 2016 while WIH in mining processing rose 4.4% in Q4 2015 and 4.7% on Q1 2016.

But the recovery is unlikely to be sustained, given that Cimic's main market, Australia, is reducing expenditure on infrastructure.

Chart 5. Australia Infrastructure Budget

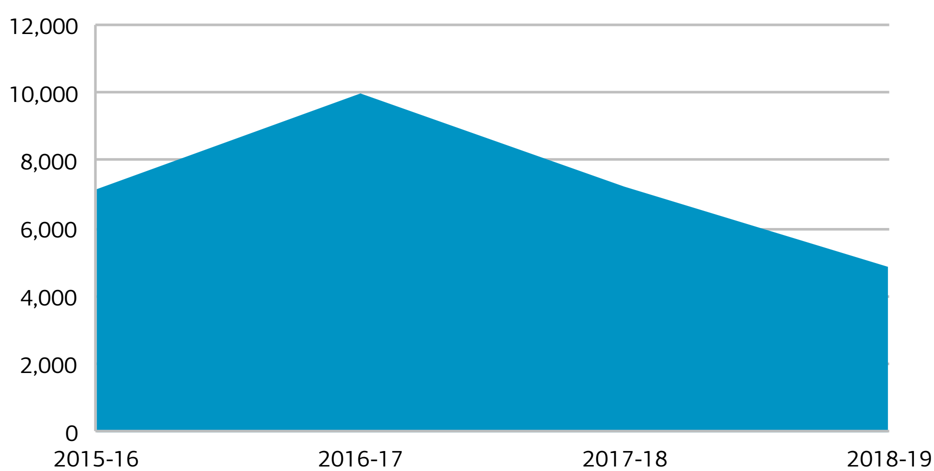


Source: Australian Parliament

No Progress on Legacy Receivables

Cimic is trying to claim AUD 1.86 bln in capital and AUD 500 mln in interest costs from a consortium with Italian engineering company Saipem responsible for the 2.1-kilometer Gorgon jetty and marine structure in western Australia. The AUD 1.86 receivables constituted 46% of the total

Chart 6. Provisions as % of Accounts Receivable



Source: Company data. Note: The Lendlease financial year ends June 30.

receivables by H1 2016 and had been sitting on Cimic's balance sheet for years without adjustment. This is unreasonable, as the longer receivables are left unpaid, the less likely they are to be fully recovered.

Suspicious Accounts

Hiding Losses in Subsidiaries

We think that Cimic is using Habtoor Leighton Group (HLG) as a vehicle to hide losses. Cimic claims on its website that it owns 45% of HLG and accounts for it using the equity method. But we believe that Cimic has controlling power over HLG and should consolidate the company.

HLG, which specializes in rail, oil, and gas infrastructure, was founded in 2007 and is an important partner to Cimic in the Middle East and North Africa. Al Habtoor Group chairman Khalaf Ahmad al-Habtoor and Al Habtoor Engineering Enterprises co-founder and Habtoor Leighton Group Chairman Riad Sadik owned 27.5% each when the joint venture was formed and may still; Cimic does not comment on the joint venture's structure. In late May, Al Habtoor Group publicly distanced itself from the joint venture, saying it had "no relationship" with the company and played "no role in the day-to-day operations." Meanwhile, Cimic has been raising its equity share in HLG without making any further disclosure. These facts indicate that Cimic has the largest shareholding in the company and exercises significant control over HLG. Furthermore, HLG CEO Jose Antonio Lopez-Monis was the Director of the International Department of the ACS Group, Cimic's ultimate the parent. All this indicates that HLG should be consolidated. By using the equity method instead, HLG's can potentially be a receptacle for losses.

HLG was profitable until Cimic took over.

HLG was a profitable company until Cimic took over, according to the government-owned newspaper al-Emarat al-Youm. But the year after Cimic took over, HLG reported losses of AUD 14.3 mln on AUD 1.1 bln revenue.

The Cimic website shows that, for H1 2016, HLG recorded revenue of AUD 628.8 mln, or 13% of Cimic group revenue and yet it employs 20,000 people, nearly half of Cimic's total of 42,000 people. This implies that HLG is only half efficient in terms of revenue per person as Cimic while Cimic is half as efficient as Lendlease, Cimic's closet peer. We believe the better explanation is that Cimic has pushed costs off to HLG.

In August, CEO Lopez-Monis was arrested after on accusations filed in the United Arab Emirates. He was released 10 days later without no further disclosure from the company, but there quickly followed a binding contract for Al Habtoor Holding LLC to transfer its shares to Riad Al Sadik, with no change in Cimic shareholding. We believe that the detention related to a bribery scandal in 2010 and 2011, when Leighton used Unaoil to pay tens of millions of dollars to the Iraqi government to get a USD 1.3 bln in oil-field contracts. New evidence of emails between the management of Unaoil and the former chief operating officer of Leighton group revived a long-going investigation by the Australian Federal Police. The amount of the bribery payments was said to be as high as USD 75 mln.

Inadequate Provisions

Despite ever-increasing risk in this industry, Cimic has been reducing provisions and impairment. In 2015, provisions contracted by 69% compared YoY. We believe this underestimates the impairments that should be recorded from Cimic's exposure to the troubled HLG and Gorgon projects.

Table 1. Provisions and Impairment

AUD mln	2012	2013	2014	2015
Impairment of goodwill	0	0	0	2.7
Impairment of investments in infrastructure toll road companies	63	18.5	0	0
Impairment of investments accounted for using the equity method	35	15	0	0
Property development and property joint ventures write-downs	0	81.2	5.3	8.2
Impairment of property, plant and equipment	0	10	0	0
Net amounts set aside to provisions	476.6	564.00	542.3	168.4

Source: Company data

Evidence that Cimic is under-provisioning comes from a few delayed projects, where clients are seeking compensation for the late delivery and associated losses.

Wynn Macau Ltd. said on January 27 this year that Cimic, the contractor for its second casino in Macau, could be liable for as much as USD 200 million in damages if the Wynn Palace project experiences further delays. The project then experienced additional delays of three months. The casino opened in August, five months behind schedule. For the first half of 2016, the total amount of provisions disclosed by Cimic was AUD 335 mln, which would be insufficient if there are other projects like this. We feel that Cimic is not diligent enough in reviewing its projects and recognizing issues on its balance sheet accordingly.

West Connex is a case where Cimic did not adjust for the foreseeable losses and tried to hide losses of AUD 27 mln at the end of last year, according to an internal budget obtained by the media. Cimic originally projected that it could earn AUD 26 mln profit.

A company insider suggested that the loss of AUD 50 mln for the JV would widen to AUD 100 mln. A second internal budget entitled "overall project outlook" provides three scenarios and corresponding outcomes, ranging from a loss of AUD 1.98 mln to AUD 12.18 mln. But the official budget released to public indicates that costs are under control.

In the case of Royal Adelaide Hospital, costs blew out and the project was delayed for at least nine months. Because the project is run under a public-private partnership model, the delay cost the government AUD 1 mln per day in fees to the consortium, and the government is seeking compensation from Cimic.

We believe that hiding losses in projects and not providing provisions for assets are the two methods Cimic uses to improve its balance sheet. Cimic constantly has lower provisions for receivables than its closest competitor, Lendlease. From FY 2012 through FY 2016, with the exception of FY 2015, Lendlease had higher provision ratios for accounts receivable. As of June 30, 2016, Leadlease's provision ratio was 4% higher than Cimic's.

Phantom Cash

We suspect that the company may be using its capital expenditure budget to hide flows of cash. We examined Cimic's capex spend and PPE balances over the course of the last several years and found that the fact that it doesn't have as much cash as the income statement would suggest. Cimic is spending on PPE and yet the total PPE assets are declining by more than can be accounted for by sales of assets or the modest amount of impairments to PPE. So where is the capex going?

Where exactly is Cimic's capex going?

There is also a discrepancy in Cimic's accounts between calculated and reported capex. From 2012 to 2015, reported capex declined by 76%, from AUD 1.12 bln in 2012 to AUD 266 mln in 2015. This should improve the company's cash position. But we find that Cimic uses all sorts of dubious accounting to plump up the cash.

Table 2. Cimic Capex

(AUD mln)	2012	2013	2014	2015	H1 2016
Capex reported	1,123.0	815.0	439.0	266.0	91.0

(AUD mln)	2012	2013	2014	2015	H1 2016
Payments for PPE	1,224.8	964.5	705.1	266.3	90.7
Sale of PPE	102.1	149.8	81.8	156.2	30.0
Net capex calculated	1,122.7	814.7	623.3	110.1	60.7
Change in PPE increase	-448.2	-319.2	-126.1	-313.7	-321.1

Source: Company data

Who Set the Prices?

The company sold its wholly owned subsidiary of John Holland to CCCC International Holding Ltd right before the balance sheet date on December 12, 2014 at an implied enterprise value of AUD 1.15 bln, at a 31X trailing P/E. That is extremely high for this industry. Thiess Services & Leighton were both much more profitable than John Holland and yet were valued at a huge discount to Holland, at only 7x earnings.

Five days later, Cimic sold a very profitable business unit, Service, to a fund which is a JV of Cimic and Apollo Global Management. Service's contribution to Cimic revenue from January 1 to December 17, 2014 had been AUD 2,238.1 mln and contribution to net profit was AUD 153.4 mln after tax, implying a 6% net margin, much higher than the group average. This profitable business sold for only AUD 860 mln, yielding an implied enterprise value of AUD 1.075 bln, with a 7X P/E ratio.

The counterparty in the John Holland deal was CCCC's wholly owned subsidiary, CCCC International Holding Ltd., an affiliate of the Construction Banks of China. The pricey deal is in tune with China's capital outflow trend. Chinese entities often offer very high nominal prices for assets in order to move capital, and it is not unusual for the recipient to allow a portion of the payment to flow back into the hands of the buyer once the money is safely overseas.

Thiess Service & Leighton was sold to a JV between Cimic and Apollo. Again, it would not have been hard to set an artificial price, in this case to cover up inflated cash from aggressive recognition of revenue.

Table 3. Deal Summary

(AUD mln)	Revenue to Cimic	Profit to Cimic	Consideration	Enterprise value	PE(X)
John Holland	3,195.5	36.5	723.9	1,150.0	31.51
Thiess Services & Leighton	2,238.1	153.4	860.6	1,075.0	7.01

Source: Company filings

The Holland deal was reported by Cimic on December 12, 2014, but John Holland reported that the equity was transferred on April 20, 2015. That means that the deal should have been recorded in Q2 2015 rather than in 2014. As a consequence of straddling the two periods, Cimic recorded an AUD 402 mln cash outflow in 2014, as the cash consideration had not been received by the reporting date and the cash disposal was recorded when the assets were transferred to the buyer. In 2015, Cimic could record a AUD 724 mln cash inflow from the deal.

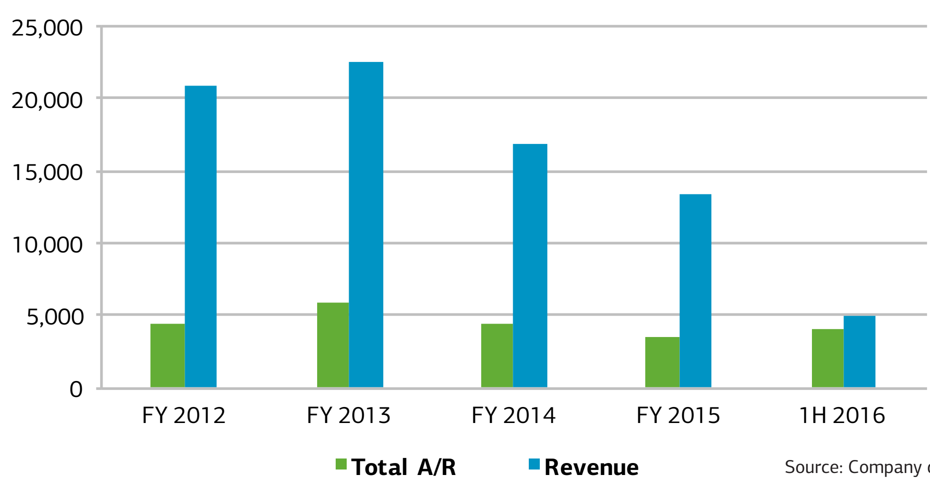
Takeover Bids for Subcontractors at a 46% Premium

Cimic took the market by surprise when it announced on October 9, 2016 that it would take over its subcontractor UGL at a 46% premium to the last closing price. Cimic paid AUD 525 mln, or 32% of its cash on the balance sheet as of the end of H1 2016.

We think the actual price could have been lower, with the announced price conveniently removing phantom cash from Cimic's balance sheet. Furthermore, the real target may have been UGL's liabilities. UGL holds an uncapped liability for its contract at Ichthys, a liquid natural gas project in northern Australia. So far, a AUD 375 mln provision has been taken, suggesting further downside risk to UGL earnings and cash flow. Given this liability and the fact that Ichthys is a subcontractor to Cimic, Ichthys did not have much negotiating room. The undefined liability could provide Cimic with the discretion to decide how much to write down in the future.

The hostile takeover was very rare in Australia. The takeover was announced as final and unconditional.

Chart 7. Revenue vs Accounts Receivable



Source: Company data

Aggressive Revenue Recognition

Over the past four years, Cimic's revenue has declined by 36%, from AUD 21 bln in 2012 to AUD 13 bln in 2015. Yet total accounts receivable dropped only by 20% over the same period of time. The inconsistency suggests that the company may be billing and recognizing revenue much too early.

Data for H1 2016 show receivables ramping up again compared to H1 2015. Days Sales Outstanding in H1 2015 were 76; in 2016, they are up to 147--a 96% increase. (See chart 7 at the bottom of page 11.)

Inconsistency with Parent Company Financials

It is very difficult for us to reconcile Cimic's disclosures with those of its 71.48% parent. Cimic contributes around 70% of Hochtief's Asia-Pacific Division revenue, but profit before tax is an 80% share and Cimic is 100% of net profit. Yet Cimic's contribution to HOT's net cash position is much lower. This leads us to suspect that Cimic is inflating revenue and profit by at least 20%.

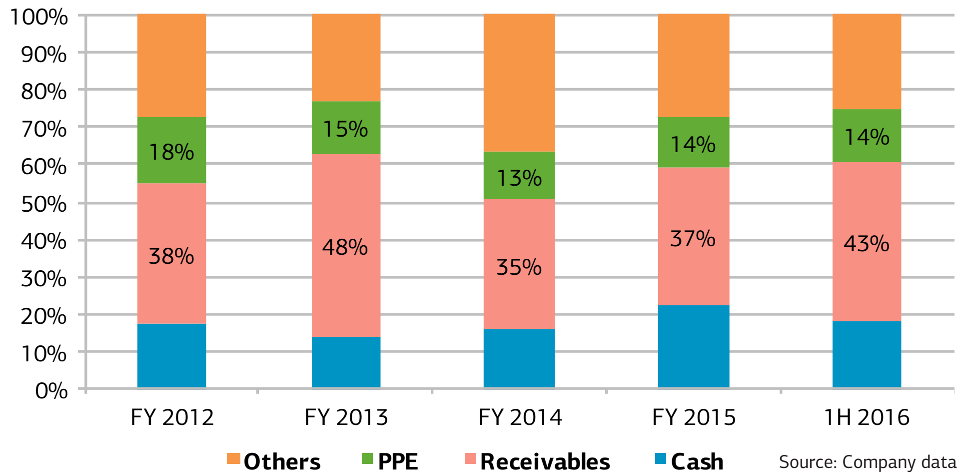
Table 4. Comparison with Parent Company

(AUD mln)	HOCHTIEF Asia Pacific Division			Should be included in HOT, according to Cimic report			Cimic contribution		
	1H2016	1H2015	FY 2015	1H2016	1H2015	FY 2015	1H2016	1H2015	FY 2015
Profit before tax	300.2	311.9	633.4	245.7	254.5	514.5	82%	82%	81%
PBT margin	9.2%	6.3%	7.0%	7.1%	5.0%	5.5%			
Net profit	138.8	128.0	258.5	171.2	180.7	360.1	123%	141%	139%
Net cash/ net debt	584.7	435.4	1,092.5	374.2	248.6	778.1	64%	57%	71%
Divisional sales	4,920.5	7,128.4	13,352.4	3,467.8	5,047.7	9,359.5	70%	71%	70%

Source: Company data

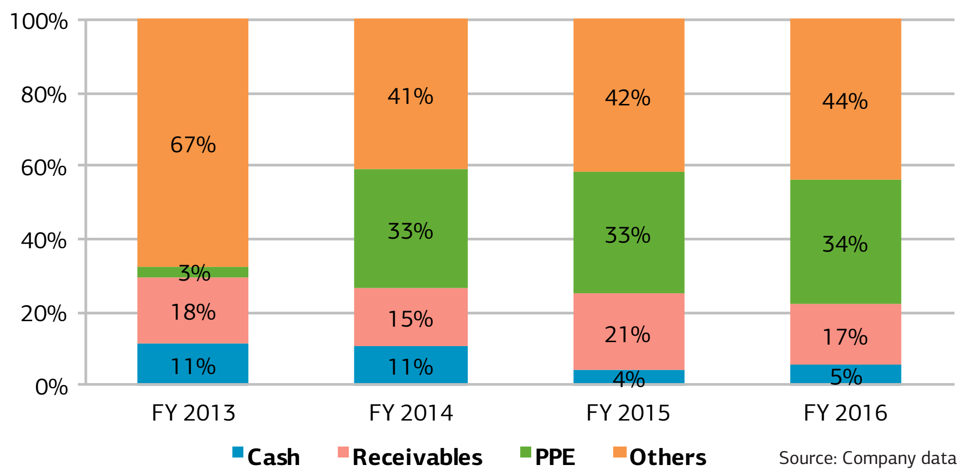
Cimic's balance sheet doesn't look like that of a company in a capital-intensive industry, where the majority of assets should be long-term and fixed. Instead, 43% of total assets are accounts receivable, and PPE accounted for only 14% of the total as at the end of June. Lendlease, Cimic's closest peer, has only 17% assets in receivables and 34% in PPE. This suggests that the company converts its revenue to cash much less efficiently than its peers do and supports our view that Cimic is very aggressive about revenue recognition.

Chart 8. Cimic Asset Breakdown



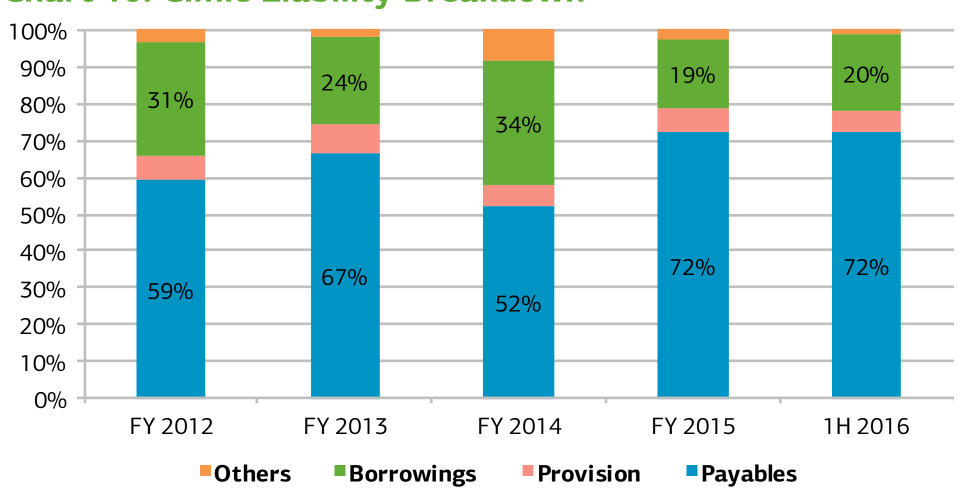
Source: Company data

Chart 9. Lendlease Asset Breakdown



Source: Company data

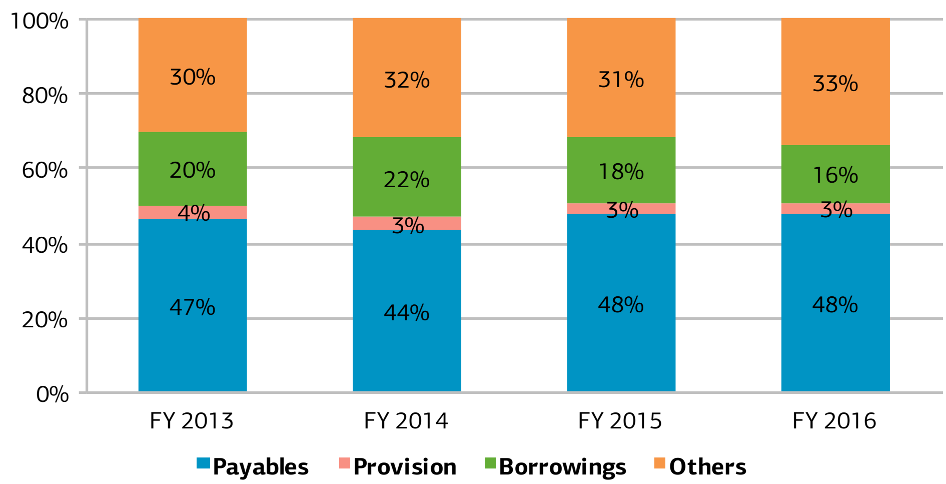
Chart 10. Cimic Liability Breakdown



Source: Company data

On the liability side, 72% of the liabilities at the end of H1 2016 were payables, up from 59% in 2012, while borrowings declined from 31% to 20% over the same period. Lendlease had only 48% in payables and 16% in borrowings, with quite stable liability. If Cimic is dolling up cash-flow statements, this is how--increasing payables. This could hurt the company in the long run.

Chart 11. Lendlease Liability Breakdown



Source: Company data

Factoring Business

We find it is hard to reconcile the changes in accounts receivable on the balance sheet with the cash flow statement. The differences between the two have grown more volatile since 2014, when the company started its factoring business.

In the 2014 and 2015 annual earnings calls, management was reluctant to share details on the factoring business and said only that AUD 400 mln in receivables had been sold. If this is the case, the amount sold in 2015 should have been around AUD 1.1 bln rather than "the same level as 2014." The higher number would have supported better operating cash flows. If the company was selling off some of its highest credit receivables, then what remained on its books would have been of lower credit quality. Yet, Cimic continues to reduce its provisioning for bad debts. The company could also use factoring to get rid of non-performing receivables. That may be a reason for reducing provisions.

In 2014, Cimic established a leasing company, FleetCo, to manage equipment and increase its efficiency. Management has refused to provide color on how the business is doing. It is very common in heavy machine and construction industry companies to establish leasing companies to transfer capex off balance sheet and improve margins. We suspect Cimic is doing the same thing here.

Table 5. Accounts Receivable: Cash Flow vs Balance Sheet

AUD mln	FY 2012	FY 2013	FY 2014	FY 2015
Growth current A/R	1,299	1,291	-1,625	-767
Growth of non-current A/R	-102	127	120	-34
Total increase in A/R	1,197	1,418	-1,505	-800
Increase in A/R (CF statement)	677	828	-534	-1090
Differences	520	590	-972	290

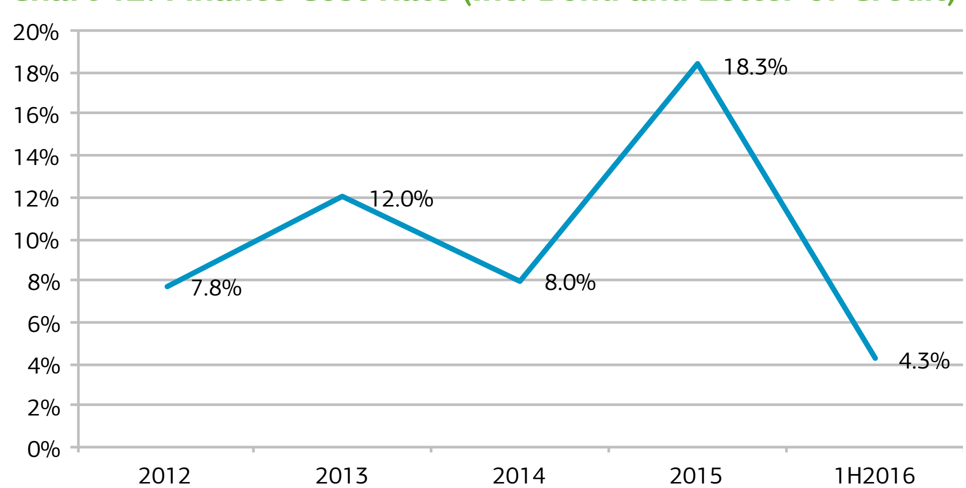
Source: Company data

From Long-Term to Short-Term Financing

Financing costs have been very volatile over the past five years, ranging from 7.8% in 2012 to a high point of 18.3% in 2015. The spike in 2015 was mainly due to a repayment of AUD 3 bln in debt, according to the cash flow statement. At the same time, the company borrowed another AUD 800 mln.

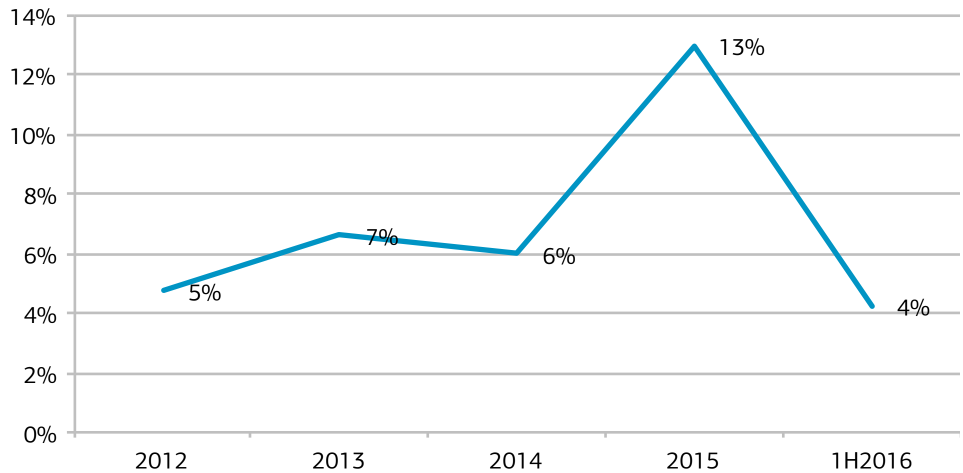
It is not unusual to see volatilities in financial costs in construction companies, yet it seems that only 2015 saw a spike in the interest rate. The

Chart 12. Finance Cost Rate (Inc. Bond and Letter of Credit)



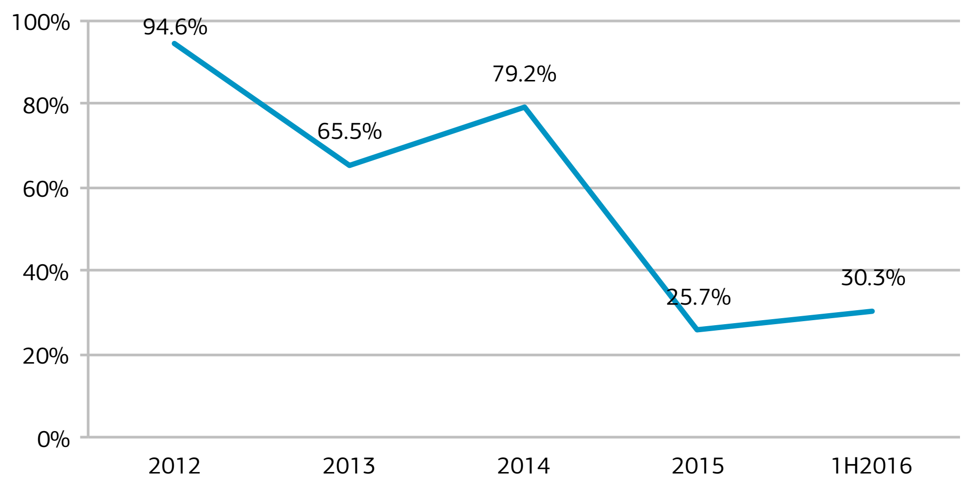
Source: Company data

Chart 13. Finance Cost Rate (Only Interest Cost)



Source: Company data.

Chart 14. Borrowings to Equity

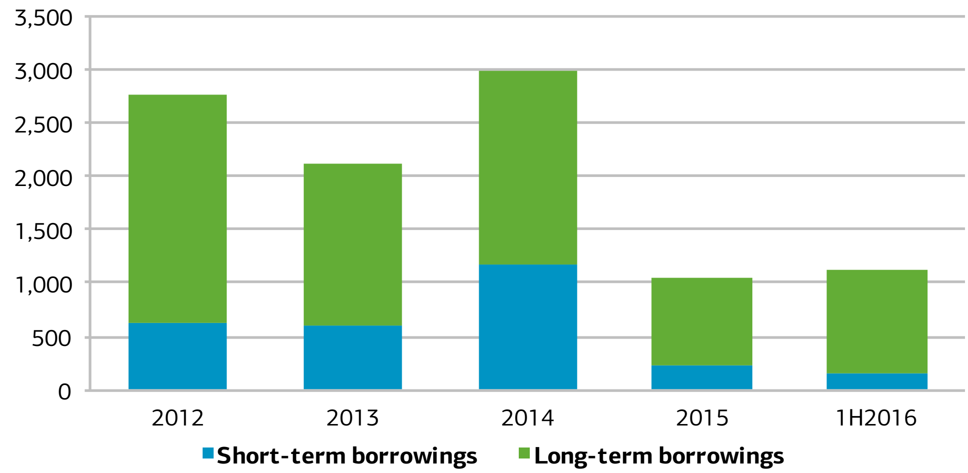


Source: Company data

management explanation provided no color on the interest cost surge in 2015, but in the 2014 earnings call, management suggested to analysts that the finance cost includes both fixed and variable expenses including the cost for bonds and letters of credit. But removing the cost of other financing instruments and leaving only interest cost also shows volatility.

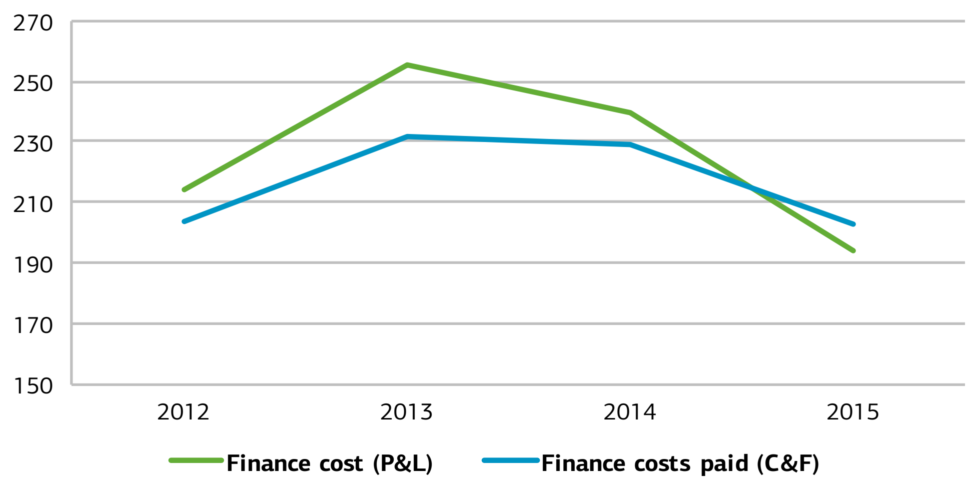
It is understandable that the company was trying to repay high-interest debt and borrow again at a lower rate. But the financing costs did not change much. In 2012, the finance cost was AUD 203.6 mln on AUD 2.8 bln borrowings, and in 2016, AUD 202.8 mln on almost one-third of the 2012 debt. The most likely explanation is that Cimic is borrowing heav-

Chart 15. Borrowings (AUD mln)



Source: Company data.

Chart 16. Finance Costs (AUD mln)



Source: Company data

ily short-term. If this is really the case, this implies that Cimic has a cash-management issue and lacks the working capital to fund its operating activities. The other possible explanation is that the company borrowed right before the financial reporting date to make the balance sheet pretty. This would in the short term lift the cash flow, but we would expect to see weak and less efficient cash management to show in the long run.

Employment Costs Higher Than Peers

Cimic looks over staffed compared with peers, but inconsistency in disclosure of the number of employees makes us suspect that Cimic might be hiding some expenses in the employee benefit categories.

Cimic appears to have overstated its personnel cost.

Personnel is the second-largest component of cost, following subcontractors, accounting for 25% of total expenses in 2015. Personnel cost is 47% higher than that of Lendlease. In the 2014 annual report, Cimic stated that it planned to reduce layers of management and hierarchy, yet there was no disclosure of the number of employees for that year. According to the Cimic website, at the end of Q1 2016, employees numbered 42,000 while at the end of June, Lendlease employed a little more than 12,000 full-time employees. Cimic may include part time employees and third party contractors in the number of employees, however the personnel cost is still too high compared with its peers, especially when Lendlease is still growing and requiring more personnel.

If Cimic is not hiding expenses or losses in its personnel cost, Lendlease is twice as efficient based on revenue per employee. Lendlease is three times as efficient in costs per employees.

A cross check against Cimic's parent company filings indicates that Cimic has overstated its personnel cost: Cimic constantly reports more employees than HOT's entire Asia Pacific Division. At the end of Q1 2016, HOT's Asia-Pacific division had 26,000 employees while Cimic has 42,000, according to the companies' reports.

Table 6. Cimic Data on Employees

	FY 2012	FY 2013	FY 2014	FY 2015	1Q2016
Employees	61,000	56,000	N.A.	43,400	42,000
Personnel costs	5,538	5,908	4,363	3,059	N.A.
Cost per ppl (AUD/ppl)	90,792	105,502	N.A.	70,493	N.A.
Rev per ppl (AUD/ppl)	340,466	401,811	N.A.	305,829	56,910

Source: Company data

Table 7. Lendlease Data on Employees

	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Number of equivalent full time employees	17,315	15,634	13,268	12,443	12,162
Personnel exp	2,250.30	2,355.50	2,349.40	2,259.10	2,079.20
Exp per employees (AUD/ppl)	129,962	150,665	177,073	181,556	170,959

	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Rev per employees (AUD/ppl)	807,109	893,828	1,053,143	1,068,762	1,240,627

Source: company data : Note: financial year ended June 30

Table 8. Cimic and Hochtief Employee Count

	FY 2012	FY 2013	FY 2014	FY 2015	Q1 2016
HOCHTIEF Asia Pacific Division	55,959	58,715	50,014	30,494	26,263
Employees reported by Cimic	61,000	56,000	N.A.	43,400	42,000

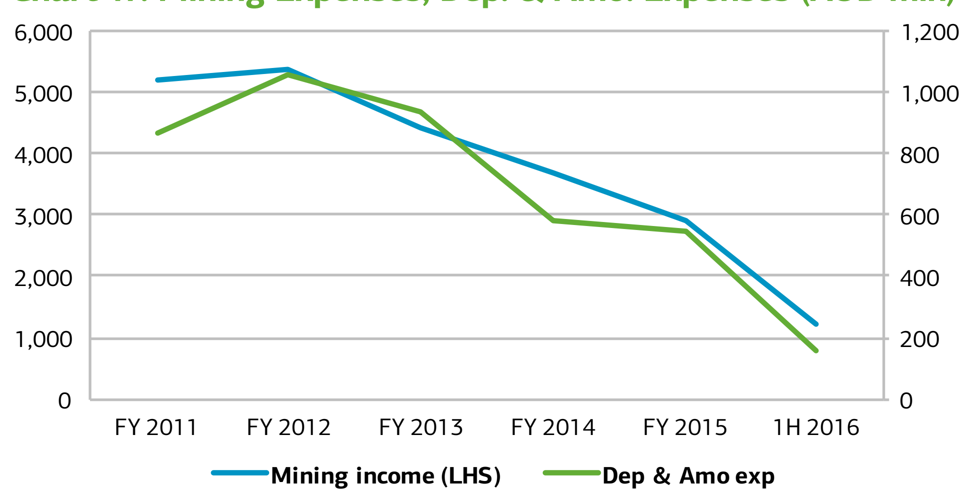
Source: company data

Highest Depreciation

According to Cimic's annual report, mining equipment is depreciated based on "cumulative hours worked." Depreciation should be positively correlated with the revenue from mining, and Cimic has reported stated that a reduction in depreciation expenses is mainly due to the contraction of mining revenue. During the downturn, depreciating equipment based on working hours would under-estimate the expenses.

Moreover, compared with peers, Cimic has the highest depreciation and amortization rate. Cimic revenue is almost at the same scale as Lendlease, twice DOW and nearly 10 times of the MMD Group. Therefore, it is hard to understand why Cimic does not enjoy any of the economies of scale. In

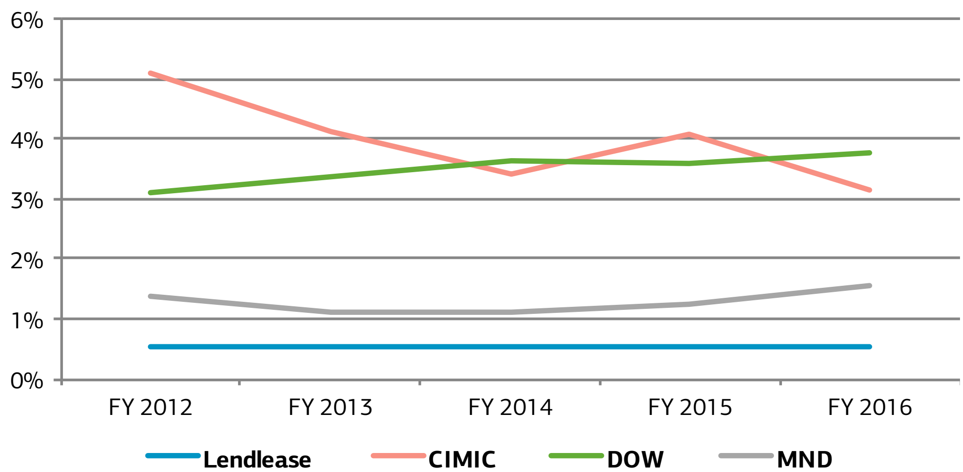
Chart 17. Mining Expenses, Dep. & Amo. Expenses (AUD mln)



Source: Company data

addition, as we reported in the section on capex spending, Cimic has dialed down the amount of capex spend considerably over the last several years. Yet its depreciation and amortization levels remain stubbornly high. We believe it is likely that Cimic is hiding other expenses in the depreciation and amortization component and improves margins through reductions in cost.

Chart 18. Dep. Ratio (Dep. and Amo. Expenses as % of Rev.)

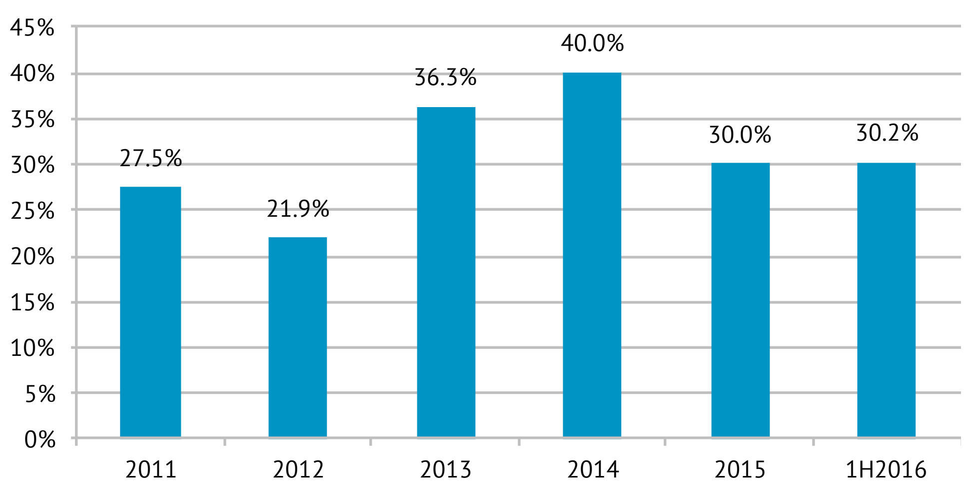


Source: Company data

Tax

The effective tax rate should be relatively stable unless there is a change in tax policy. But that is not what we have seen for Cimic in the past five years. The lowest effective tax rate was 21.9%, in 2010, and since then, the

Chart 19. Effective Tax Rate



Source: Company data

rate soared to 40% then slumped by 10% to 30% in 2015. Since non-operating gains are all recorded in the comprehensive section of the income statement as after-tax value therefore even with selling any assets in that year should not have such great impact on the effective tax rate. This just increases our concern on the credibility of Cimic's financials.

Valuation

We arrive at our price target of AUD 20.68 based on our DCF model, assuming a 7.8% WACC and 1.5% terminal growth rate. We forecast our 2016 numbers based on adjusted 2015 numbers to reflect the aggressive accounting for revenue, receivables and provisions.

Risks

- The stock is fairly illiquid and the short interest is high. A short squeeze should be expected.
- Recovery of impaired receivables
- Higher-than-expected infrastructure construction awards
- Share buy-backs

Nan Yiyi yiyi@jcapitalresearch.com **Anne Stevenson-Yang** anne@jcapitalresearch.com +852 2534 7405
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