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Short Thesis

Why Lendlease is >50% overvalued

LLC currently trades near all-time highs, despite the **last 18-months being the worst financial results in the last decade**, with future results (contrary to popular belief) likely to disappoint as LLC has sold its high cash-generating assets. We believe this is driven by a **fundamental misunderstanding of its business** (debt and equity). We believe **markets are misled by favourable framing of results and commentary that we believe is misdirection**. We believe its accounting practices are questionable and it makes decisions based on achieving management KPIs and managing the share price. We believe this is demonstrated by three key facts: i) LLC has had the same audit firm since 1958; ii) abandoning S&P's credit rating, when it appears S&P may have downgraded LLC to "junk" at some point over the last 18 months; and iii) conducting a $500m buyback when it does not have the balance sheet capacity to do so.

We will compare **LLC's accounting practices with its peers to demonstrate inconsistency**, we will also demonstrate why **statutory earnings and period-end balance sheets are misleading** with respect to the now insolvent Carillion. The market analysing "statutory" earnings is causing a major mispricing of LLC's equity and an unrealistic view of LLC's debt position. There are very few assets remaining for LLC to sell and profits to engineer, which we will extensively analyse. The market is pricing **LLC's equity at ~$11b**, yet in the **last 8 years (post-GFC) LLC has produced free cash to equity of only $1.5b**. We present exhaustive analysis of the balance sheet to demonstrate excess cash will not be released and that in fact the balance sheet may need to be written down.

1. We believe there is **significant discretion in recognising profit** and **management are rewarded on the easier to manipulate metrics**. These include, but are not limited to: **management's own "*assessment of the market value*"** of hundreds of millions of dollars of Financial Assets, where fair value is "*calculated using inputs that are not based on observable market data*", triggering revaluations, **with the subsequent unrealised gains recognised as profit**;
    - $378m out of $721m 1H18 "EBITDA" was as a result of *discretion* including ~$309m "unrealised" profit.

2. **We believe LLC is significantly more geared than presented**. As we shall demonstrate, LLC is more highly-geared than it looks: interest coverage ratios are misleading because LLC counts *unrealised* profits in its ratios; its period-end cash balance is not reflective of operations; and it has significant off-balance sheet debt through its JV's, investments and PLLACes. Cash interest implies **LLC's average net debt balance is more like ~$3b**, rather than the $250m as at period end. In our view, LLC's credit metrics have weakened since FY15 and were especially weak in FY17 and 1H18. We therefore question whether its liquidity position implies that it is in a position to conduct a $500m share buyback.

3. We believe **Management KPI's are geared toward share price returns and statutory profits as opposed to operating and cash performance**; which may have resulted in *convenient* timing of asset sales and aggressive accounting. In our view, accounting consequences may have influenced operating and capital-allocation decisions; in particular, the decision of a $500m buyback, which may be relevant to management LTIs. In practical terms, for example, it was the sale of Retirement, regearing and loan back to LLC that provided most of the funding to enable the buy-back as opposed to operating cash flow, which was far less of a driver.
    - Further, from a capital allocation / valuation perspective; LLC is buying back its stock at >2x NTA. If the market believes LLC truly has a ~$50b development pipeline, generates ROIC of 16-19% across Development and Investments and is generating ROE of 12-18%, why buy back stock?
    - If you take the share buyback at face value, it suggests LLC is unable to deploy capital at higher returns than its cost of equity. If that is the case, why is the market paying ~$6b (~$10/share) for "goodwill" or an ability to generate returns if the buyback implies that goodwill does not exist?

4. **When LLC cannot generate operating earnings to meet the market's expectations it sells assets, reclassifies assets and writes up its balance sheet through unrealised profits**. We also attempt to demonstrate that **consistent messages on "earnings visibility" and "pipeline" may be considered, misdirection**. There are numerous examples that illustrate this, including but not limited to:

- the FY11 acquisition of Valemus at peak earnings, $42m profit recognised under acquisition accounting in FY12 and subsequent material downgrades in at least FY13 and FY18, yet goodwill is intact.
- the “agreement” to sell **King of Prussia on 24 May 2011 resulting in $102m out of $493m** FY11 profit, despite financial close (cash received) in FY12;
- the sale of its stake in JEM on 17 June 2013 at the **same time as announcing downgrades** to EMEA & Australia Construction;
- the sale of Bluewater in FY14 at the **same time as announcing poor performance across its business**, despite the CEO’s earlier claim that “***We don't expect it to be in FY14***”, yet it was sold 5 days prior to balance date on 25 June 2014 generating $485m out of $823m NPAT; and
- 1H18 result: the claim LLC’s minority shareholder (25%) has “**joint control**” of the disposed Retirement business and **unrealised revaluation** (~$102m) of the 75% it did not sell; the **potentially suspicious 83% upward revaluation of its US Military Assets** and the **35% increase in valuation of management’s assessment of market value** of APPF Commercial:
    - **at the same time as announcing a $164m profit decline in its Australian Construction business**.

5. **Asset sales should have turned into cash, yet LLC has generated only $93m free cash flow in 8 years**.
    - There has been an unprecedented property boom, globally, yet despite ~$1.25b debt/equity financing and material asset sales, the business has produced only $610m cash despite reporting $6.0b EBITDA.
    - When considering material asset sales of investments made *prior* to this time frame, cash flow is even worse (King of Prussia ~$500m in FY12, Greenwich/Jem/Aged Care ~$615m in FY13, Bluewater ~$1.3b in FY14, ~$400m PPP business in FY16).
    - Consistently LLC has reported substantial realised and unrealised gains for a period when its portfolio, overall, performed poorly, leading to billions of dollars of difference between cash flow and EBITDA. We believe this may be because it has sold its “winners” and kept its “losers” resulting in high P&L profit, low cash flow; and an unsustainably high dividend.

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6. **Catalysts for a material stock de-rating**:
    - Additional governance scrutiny from media, ATO, ASX, fund mangers following AMP / Macquarie scandals, Carillion collapse and issues born out of Blue Sky Alternative Investments.
    - Given financial assets have been marked-market; potential to “recycle” these assets for a material profit has largely diminished; especially given cap-rate movements / outlook. As such **it is now materially harder to sell assets to engineer an accounting profit when operating earnings disappoint**.
    - There are very few accounting profits available to engineer given the last ~8 years of aggressive accounting. As such, **a new CEO may take a knife to the balance sheet**. Further, a **new CEO will likely be forced to adopt more conservative discretionary / subjective accounting policies** either via accounting standards or better governance (such as a fresh audit firm or fresh board).

Valuation

Aggressive accounting and erroneous analyst interpretation of earnings leaves the stock trading at a ~**65% premium to book**. For a company that **uses mark-to-market accounting for the majority of its asset base, this is completely unjustified**. We believe the market is misdirected by statutory earnings, a high dividend yield and the positive framing of results and pipeline that distract from underlying performance.

Net assets are ~$6b vs a market cap of ~$11b; this makes little sense given its accounting policies, in our view. Cross-referencing to LLC’s peers, it also trades at a significant premium (>100%). Not only is such a premium unjustified, in this report, **we present an extensive body of evidence to support our investment thesis that LLC’s accounting discretion is an outlier to peers, resulting in operating earnings that are materially less than what the market is pricing in**. This in part is driven by **subjective management inputs, that we believe may be driven by management incentives** or the potential for the market to be focussing on statutory earnings as opposed to cash.

In our view, on a fundamental basis, **this stock should trade in the range of $8.60 to $11.01**; which is the range from net tangible assets to net assets because accounting policies largely imply book value = market value.

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LLC is significantly more geared than presented

As we shall demonstrate, LLC is more highly-geared than it looks, and we do not believe the company is in fact in a position to be buying back $500m of stock. This is driven by several reasons, including but not limited to:

- LLC counts unrealised profits in its coverage ratios;
- its period-end cash balance is not reflective of operations, i.e. 1H18 net debt of $250m compares to interest expense of ~$100m (annualised) and cash interest expense of ~$158m (annualised);
- operating cash flow (before interest, tax, dividends) only covered net cash interest expense by 2.9x in FY17; and
- significant off-balance sheet debt through its JV's, investments and PLLACes.

Unrealised profits in interest coverage ratios is misleading

For example, LLC reports 1H18 interest coverage of 12.5x; which (*prima facie*) implies the company may be conservatively geared. However, we believe this is misleading on two parts:

1. LLC includes unrealised profits (non-cash) as income, thereby inflating the earnings numerator
2. Cash interest is consistently and a materially higher than P&L interest

As we will later demonstrate, $309m of $670m EBIT was "unrealised" profit (Note 5, LLC Half Year report). Ratings agency S&P does not include unrealised profits or losses for purposes of calculating credit metrics; and in fact, uses "FFO", which we will also come to. We present our full calculation in the Appendix, however in summary, it is evident that LLC's credit metrics have weakened, not improved. Further, in FY17 and 1H18, by our estimation of S&P's methodology, LLC has negative FFO.

S&P Metrics	**FY15**	**FY16**	**FY17**	**1H18**
FFO (adjusted)	1,161	698	-1,101	-845
Debt	2,497	2,058	1,788	1,132
FFO / Debt	**47%**	**34%**	**-62%**	**-37%**
Adj FFO	1,359	884	-926	-762
Adj Interest	211	185	196	76
FFO Interest Coverage	**6.4**	**4.8**	**-4.7**	**-10.0**

So what did S&P say about LLC's credit metrics from FY17?

LLC no longer pays S&P for a credit rating.

Instead, at some point between FY15 and FY16, LLC obtained Fitch's services and from FY17 it no longer uses S&P for its credit rating services. This may be instructive.

LLC now uses Fitch to rate its credit

In our view, Fitch's approach to assessing the credit of LLC is misguided and or not reflective of LLC's operations or risk profile. To demonstrate, we reference Fitch's statement on 24 October 2017, a week after LLC announced the sale of its 25% interest in Retirement and **downgrade to construction**.

Fitch's press release was titled: "Lendlease's Earnings to Stay Strong Post Retirement Sale". **Fitch does not make one single reference to construction or risk to earnings / liquidity** despite LLC's announcement that: "*The composition of the FY18 result is expected to be impacted by underperformance in our Australian construction business which relates to a small number of engineering projects. As a result, the HY18 EBITDA contribution from the Australian construction business is expected to be lower than the prior corresponding period*".

LLC would **later reveal a loss in Australia construction of $66m vs a profit of $98m** in the pcp.

LLC would also later reveal **that 20% (~$1b) of its orderbook was underperforming**. From a credit risk / liquidity risk perspective, it should be noted that post the Valemus acquisition**, LLC has never achieved its target EBITDA margins in construction** (>5%) despite its larger competitor (CIM) consistently doing ~10% margins. This is **not the first time LLC has raised issues in its Engineering** business. Lendlease has **never done a tunnel job using a tunnel boring machine** (and neither has its JV partner Bouygues in Australia).

We question why Fitch does to mention the downgrade to construction or the potential systemic risk in the business and its potential impact to credit risk. Fitch's comment that "Lendlease's Earnings to Stay Strong Post Retirement Sale" is disingenuous, if not erroneous / misleading.

On 13 February 2018, Fitch affirmed LLC's BBB- rating and stable outlook based on its FY17 results. Fitch also reflected on the sale of Retirement (October 2017), so it appears the credit update also includes business activity from 1 July 2017 to 13 February 2018. Among the many erroneous statements made by Fitch, in our view, the most alarming is that it **again makes no reference to the construction cost blow-outs**. Not only does it make no reference to the "downgrade" to Australia Construction, Fitch says the construction backlog revenue of $21b at FY17 "supports its rating" and says that construction will support "underlying cash generation".

Fitch also makes the erroneous statement that "The company's recurring EBITDA is mainly attributable to its investment business". Fitch says: "investment management businesses generate **stable and predictable revenue**, which **underpins the company's credit profile** and **provides considerable headroom to the rating**. In FYE17, these businesses accounted for around **AUD390 million in EBITDA and are likely to represent around 30%-40% of EBITDA**".

- FY17 EBITDA was $1,386m and Investment Management was $495m; prima facie Fitch's statement is correct, but its job is to be critical and analyse LLC's financials. Upon doing this, this statement is far from reality.

Firstly, **operating cash flow for the group in FY17 was $146m**. It is **impossible for investment management's earnings to be "recurring"** at $495m if operating cash flow for the group is $146m. Not only are they not cash, they are **materially non-cash**. In fact, LLC even shows the split between recurring earnings and revaluations (which we depict and analyse later in the report), which is only **$116m of "operating earnings"** and $379m of "ownership interest" which is essentially realised profits on investments LLC has sold (therefore can't be recurring) and unrealised revaluations (which can't be recurring). This is also disclosed in Note 6 of the annual report.

Fitch's comparable companies bear little resemblance to LLC and demonstrates its lack of depth in companies it provides credit rating research to. Fitch uses Hong Kong based company Nan Fung International Holdings as a direct comparable. In our view, it is a **stretch to say the two companies are even comparable**; but note that Fitch rates the unlisted Nan Fung at BBB when S&P and Moody's rate it one rung lower at Baa3 / BBB-.

In our view, the misunderstanding of LLC's debt and equity is systemic, probably driven by the way the company frames its results and aggressive accounting policies it adopts.

Period-end cash balance is not reflective of operations

At 31 December 2017, LLC reported Payables of $4,719.6m and Receivables = $2,127.0m. This is the primary driver of its low net debt balance at reporting date of $250m. However, this is not reflective of its liquidity position given P&L net interest of ~$46m and cash net interest of $72m in 1H18. This implies **LLC's average net debt balance is more like ~$3b**.

- LLC average cost of debt in 1H18 was 4.8%. Net cash interest was $72m. For 6 months, 2.4% interest expense of $72m implies $3b of net debt (on average).

Debt-like instruments like PLLACes considered "creditors" not borrowings

Pre-Sold Lendlease Apartment Cash Flows (PLLACes), transfers Lendlease's rights to payments on the purchase prices of pre-sold apartments for a cash payment. We will later discuss PLLACes in detail, but at 31 December 2017, we estimate there are $525m worth relating to the Darling Square and Elephant & Castle developments. Our understanding is that financial institutions receive a coupon in exchange, therefore it appears a debt-like product, in our view. In other words, they operate like debt but are not considered debt for accounting purposes and are instead classified as "other creditors" in the balance sheet.

Significant off-balance sheet debt

Retirement geared-up and pushed off-balance sheet

As demonstrated by the Retirement, JV, LLC also carries significant debt off balance sheet.

There were two benefits of claiming its 25% equity partner had "joint control", one with respect to triggering a revaluation on the 75% it didn't sell (analysed later) and the other that $400m of JV debt is not consolidated to LLC (yet was a key driver in a ~$400m loan back to LLC, which was in turn the key driver of being able to fund a $500m share buyback).

That is, LLC counts the ~$400m cash from the loan in its net debt calculation but excludes its 75% share of the ~$400m debt in the Retirement JV.

Joint Venture Investment as at 31 December 2017	
Joint Venture investment value	**2.0**
Joint Venture debt	(0.4)
Net investment value (100%)	**1.6**
Net investment value (75%)	**1.2**

Source: LLC

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Developments in delivery also off-balance sheet

Most of **LLC's developments are financed off-balance sheet**.

Highlighted in red in the adjacent table are the developments in joint-venture, where they are equity accounted and therefore the debt of the developments not consolidated to LLC.

LLC's biggest on-balance sheet developments are financed by PLLACes and therefore not considered "debt" by accounting standards: Darling Square and Elephant & Castle.

LLC Joint Ventures at 31 December 2017

$m	FY17	1H18
-Retirement		1,229
- Circular Quay Tower	35	38
- Melbourne Quarter R1		10
- Melbourne metro		69
- Victoria Drive Wandworth	35	35
- Treviso	9	9
- 281 Fifth Ave	52	51
- Riverline	93	124
- 845 Madison	27	27
- Lendlease Towers LLC		26
- CDR JV Ltd (313@somerset)	76	79
- Paya Lebar	180	206
- Stratford City	90	91
-Hungate	7	7
- Intown SRL JV		19
- LRIP LP		2
- other	16	24
JV's	**617**	**2,046**

LLC still majority exposed to Australia

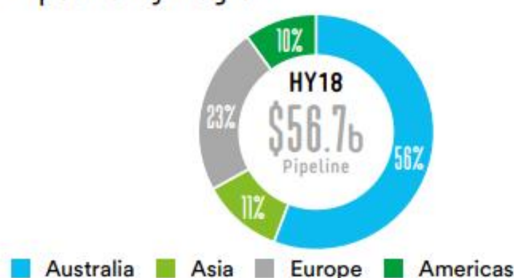
There may be a misinterpretation about LLC's exposure to offshore markets to offset what is now becoming a consensus view of house / apartment price declines in Australia. As shown in the adjacent chart, this is inaccurate.

That said, the main project below from LLC's FY17 annual report, the Tun Razak Exchange in Kuala Lumpur, which LLC touted at the time has an end development value of ~A$3b, remains shrouded in controversy with little, if any, capital invested (since it is not material enough to make the accounts).

As shown in the adjacent snapshot from LLC's FY17 annual report, the major developments listed are all "off-balance sheet".

This can be cross-reference in the accounts, as they are "equity accounted" joint-ventures.

Pipeline by Region



Source: LLC

$49.3 BILLION

of Development pipeline:

- Tun Razak Exchange Lifestyle Quarter, Kuala Lumpur
- Victoria Harbour, Melbourne
- Elephant & Castle, London
- Riverline, Chicago

Source: LLC

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Cross-reference to Carillion

Carillion (covered in detail later in the report) **at 31 December 2016, reported "net debt to EBITDA" of 0.8x** and "gearing" of just 9.5% (by LLC's definition (Net debt / tangible assets less cash)), yet **a year later the company was insolvent**, collapsing with only £29m left in cash and over £1.3b in debt.

Businesses need to be able to generate cash profits to pay interest and to amortise debt. Carillion is a classic example of how **managing its creditors and presenting an unrealistic / unrepresentative net debt at balance date and using non-cash profit its earnings numerator misrepresented its true liquidity position**.

It should be noted that Carillion was a consensus "buy" for most of its life on the LSE.

Investors should always pay attention to the difference, over time, to the ratio of EBITDA to operating cash flow. Contrast Carillion up until it was insolvent with LLC. Carillion had far better cash conversion (51% vs 30%).

Carillion (£m)	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	Total	cash conversion
EBITDA	150	176	167	222	169	219	230	183	**1,516**	
OCF	213	175	143	-12	-60	133	90	85	**767**	51%

LLC ($m)	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	Total	cash conversion
EBITDA	309	386	489	700	1,140	958	906	1,135	**6,022**	
OCF	168	-42	-46	81	822	-167	853	146	**1,815**	30%

Reconciling Carilion, it is clear that non-cash profits were driving its impressive profit results, but they were not cash-backed. In our view, **any argument for why operating cash flow is not a relevant measure of business performance (especially over time) is wrong and likely designed to mislead**.

Returns are misleading and calculated incorrectly

LLC claims Investments has a ROIC of 16.5%. If you are **to believe LLC generates ROIC of 16.5%, then it achieves returns greater than Blackstone, Brookfield, Carlyle Group and KKR by a significant margin**. We doubt this is the case. The return on capital or invested capital in a business attempts to measure the return earned on capital invested in an investment. The implication of ROIC is rooted in the concept of cash on cash return. It is usually defined as:

$$\text{Return on Capital (ROIC)} = \frac{\text{Operating Income}_t\ (1 - \text{tax rate})}{\text{Book Value of Invested Capital}_{t-1}}$$

The key here is "operating income" and that "cash" investments need to be measured against "cash" returns. LLC uses statutory net profit after tax, which is *not* "cash".

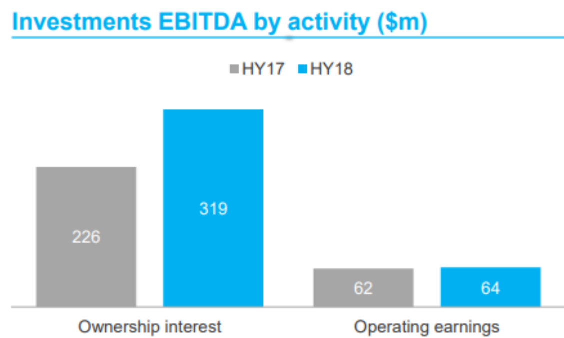
As disclosed by LLC in the adjacent chart, **operating earnings is only $64m**, the balance ($319m) being *unrealised revaluations*; which we will later analyse to be *questionable* revaluations.

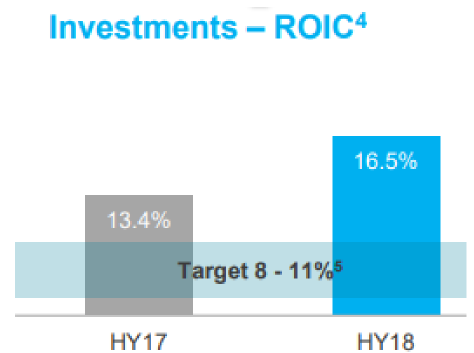
Claiming unrealised revaluations in a ROIC calculation is misleading.

As below, a more accurate representation of LLC's **Investment Management ROIC is ~2.7%**.

$m	Total	Operating earnings	Ownership interests
EBITDA	383	64	319
tax	-125	-21	-104
NPAT	259	43	215
Average capital invested	3,150	3,150	3,150
ROIC*	**16.4%**	**2.7%**	**13.7%**

Note: We have used arithmetic mean as opposed to averaged weighted mean, which is why we calculate ROIC at 16.4% vs the company at 16.5%.

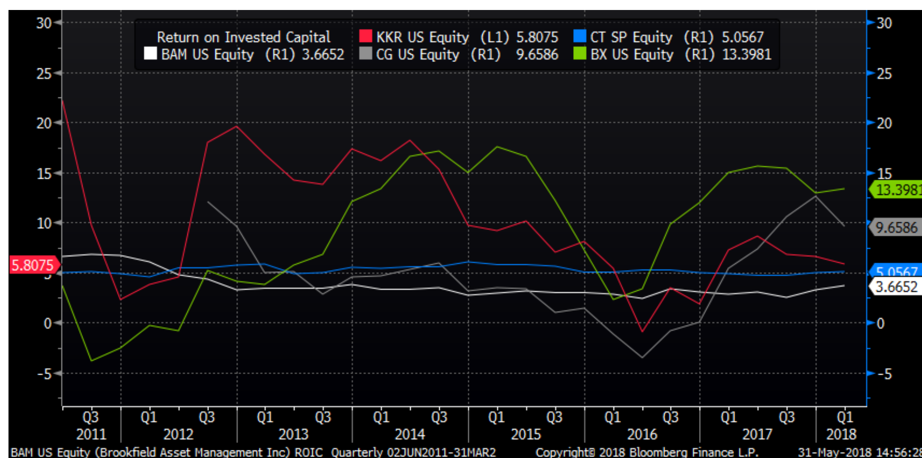




Source: LLC 1H18 result

If investors are pricing LLC off the fact that 30-40% of its earnings are driven by Investment Management that generates returns of 16.5%, they are misguided.

Given a significant portion of LLC's development pipeline is in JV or fund-through and not on-balance sheet, its returns will be materially less that what it claims in present development ROIC is.



Governance Red Flags

Other than myriad framing, presentation and potentially aggressive accounting we shall discuss, there are several other governance issues that may carry a red flag:

1. LLC has had the same audit firm (KPMG) since 1958. In 2013, the Board commenced a tender process for the role of external auditor for the Group. According to the company: "*A thorough process was undertaken, including the appointment of former ASIC Chairman Alan Cameron, AO as Probity Officer to oversee its robustness and independence*".
   - It was announced that KPMG would continue as auditor. LLC said, "*in considering retaining KPMG as the existing auditor, an appropriate balance was required between ensuring audit independence and maximising audit quality. The Group is a large listed company,* ***operating in a complex environment with complex business structures and operating models. KPMG has invested significant time and effort to understand the Group's operations and the cumulative knowledge of Lend Lease obtained by KPMG over many years cannot be underestimated***".
     - Any company being too "complex" for any other auditor is difficult to digest. After all, KPMG was Carillion's auditor every year since it was founded in 1999 and signed off on its 2016 accounts on 31 March 2017, just months before the construction company issued its first profit warning in July and announced a £845m write-down in the value of its contracts. Six months later the company was insolvent, collapsing with only £29m left in cash and over £1.3b in debt.

   We believe the recent findings from MPs in a final report from a joint-inquiry into Carillion's collapse is instructive when contemplating whether there is indeed a "red flag" here. Specifically:

   > "**There is a danger of a crisis of confidence in the audit profession. KPMG's audits of Carillion were not isolated failures, but symptomatic of a market which works for the Big Four firms but fails the wider economy. There are conflicts of interest at every turn**… explicitly include consideration of both breaking up the Big Four into more audit firms, and detaching audit arms from those providing other professional services".

This is what KPMG said in the FY17 annual report on "*Construction Revenue (A$12,646.5m) and Profit/Loss Recognition*":

The key audit matter: The Group performs various building, engineering and services construction contract works (projects) for a wide range of customers. The Group contracts in a variety of ways. Each project has a different risk profile based on its individual contractual and delivery characteristics.

We focused on construction revenue and profit recognition as a key audit matter due to the judgment required by us in assessing the range of factors that impact the Group's estimate of costs and revenue, and the potential impact on profit.

Estimating total costs to complete during project life is complex and requires judgment. Typical cost estimates include labour, subcontractors, equipment, materials, and project overheads. Changes to these cost estimates could give rise to variances in the amount of revenue and profit/loss recognised. Judgment is also involved by us in assessing the amount of revenue to be recognised specifically in relation to contractual variations and claims revenue, which has not been formally agreed with the customer at the reporting date.

How the matter was addressed in our audit: Our procedures included:

- Evaluation and testing of management's review and approval of revenue and cost forecasting;
- Selection of a sample of contracts for testing using:
    - Data Analytic routines based on a number of quantitative and qualitative factors, related to size and risk of projects; and The Group's project reporting tool.
- For the sample selected, we:
    - conducted visits to a selection of project sites to understand project schedule, forecast revenue/cost and risks and opportunities and worked with **KPMG engineering specialists** where required;
    - read relevant contract terms and conditions to evaluate the inclusion of individual characteristics and project risks in the Group's estimates;
    - tested forecast costs for labour, subcontractors, equipment, materials, and project overheads by comparing to actual incurred spend and committed future contracts;
    - tested the variations and claims included within revenue against the criteria for recognition in the accounting standards via assessment of:
        - correspondence between the Group and the customer; and
        - the Group's legal and external experts' reports received on contentious matters.

Juxtaposing what KPMG said and what happened

i. **~51 days later**, LLC announced (what was later revealed to be) an Australian Construction loss of $66.1m, ~$164m lower than the pcp ($97.9m).
ii. Further, LLC later revealed that 20% of its Engineering backlog was "underperforming".
iii. A loss of $66.1m is also inclusive of the profit that 80% of LLC's backlog that is making money.
iv. This implies the reversal of previously booked margin and recognition of expected losses **is likely more than $150m**.

The company was pressed on this on the conference call and refused to provide detail (which is inconsistent with comparable construction companies) again illustrating the reluctance to discuss specific projects and specific business lines, which appear self-serving and only selectively applied.

So, if the loss is due to multiple projects**, why didn't KPMG, as an "expert", with its "*KPMG engineering specialists*", given it has "*invested significant time and effort to understand the Group's operations*" identify these problem projects?** After all, according to LLC the "*cumulative knowledge of Lend Lease obtained by KPMG over many years cannot be underestimated*".

2. Two internal CFO appointments after last "external" CFO was appointed in 2009.
3. Same Chairman since 2003.
4. Same CEO since 2009.
5. July 2016 change to reporting structure: transitioning from four reporting segments: Development; Infrastructure Development; Construction; and Investment Management, to three reporting segments: Development; Construction; and Investments.
    - This made analysis significantly more difficult.

LLC happy to discuss the positives, but rarely the negatives

The reluctance to discuss specific projects and specific business lines are self-serving and only selectively applied. When it suits the company, it discloses details of asset sales, transactions, one-off costs / expenses and when it wants to hide negative details, it insists it doesn't not talk about specific projects or business lines. We also provide exhaustive evidence that consistent messages on "earnings visibility" and "pipeline" are misdirection.

There are many examples, but most recently:

Announcement 17 October 2017 - Lendlease Retirement Living transaction and market update

The announcement was released After Market at 5.20pm. **There was no analyst call**.

LLC announced the sale of 25% of its Retirement Living business. "*The overall impact of the transaction including transaction costs will be a net loss after tax of approximately A$35 million*" (LLC).

- This statement, considering the following analysis, appears incomplete, because the sale and classification to an equity accounted investment resulted in LLC revaluing the 75% stake it did not sell, resulting in "earnings" of ~$102m; which is not identified in the above statement and calculation.
- The key driver of LLC being able to "revalue" the 75%, was that according to LLC: The acquirer, the ~$550b Dutch pension fund, APG, obtained "*joint control over the major decisions of the entity*". This results in LLC's 75% investment recognised as an Equity Accounted Investment on the balance sheet and a profit of ~$102m.
    - A similar thing happened in FY17 when, with respect to the three International Towers Sydney at Barangaroo South, where LLC concluded, that as a result of reaching the operational phase, the investments were reclassified from Equity Accounted Investments to Other Financial Assets and measured at fair value through profit and loss.
- It is reasonable to assume LLC might have known it would reclassify the business to equity accounted investments, because the driver of "*write down the value of certain Deferred Tax Assets associated with the Retirement Living business*" is the Retirement business moving out of the Lendlease tax consolidated group to equity accounted investments.
- AASB 10 deals with loss of control. LLC has followed the guidelines; however, we would argue that its definition of "control" is questionable.

In our view, **this illustrates the significant *discretion* LLC has in recognising profit**.

Had the market understood this, there likely would have been many questions on the composition of the result, because as LLC claimed: "*underperformance to be offset by outperformance in other parts of our business. This reflects the benefits of the Group's internationally diverse portfolio across its Development, Construction and Investments segments which provides business model resilience*".

Is it simply a coincidence the unquantified construction loss is announced the same day as the company sold a 25% interest in its retirement business?

This is consistent with, but not limited to:

- The sale of its stake in JEM on 17 June 2013 at the same time as announcing downgrades to EMEA & Australia Construction; and
- The sale of its stake in Bluewater, sold 5 days prior to balance date on 25 June 2014, implying a material downgrade to analyst earnings forecasts.

Market update

"Following the strong FY17 result, the Group has made solid progress in the year to date across its business."

"The composition of the FY18 result is expected to be impacted by underperformance in our Australian construction business which relates to a small number of engineering projects. As a result, the **HY18 EBITDA contribution from the Australian construction business is expected to be lower than the prior corresponding period**. We expect this underperformance to be **offset by outperformance in other parts of our business**. This **reflects the benefits of the Group's internationally diverse portfolio** across its Development, Construction and Investments segments which provides business model resilience."

- This statement, as analysed below, appears disingenuous; if not misleading.

Reconciling October 2017 commentary with the actual results

1. "HY18 EBITDA contribution from the **Australian construction business is expected to be lower than the prior corresponding period**".
    - "lower" – the Australian Construction result was ~$164m lower (-$66.1m) than the pcp ($97.9m).
    - LLC essentially wiped out almost a year's worth of Australian Construction profit in this announcement (FY17 EBITDA was $201m).
    - Not calling out the magnitude (at the time) is disingenuous, if not misleading and inconsistent with peers. CIMIC for example, provided details on numerous occasions of its losses on Airport Link and Vic Desal; its cost to complete assumptions and an earnings bridge, disclosing among other things, the $259m profit from selling Leighton India to Welspun, which in part offset the construction losses.

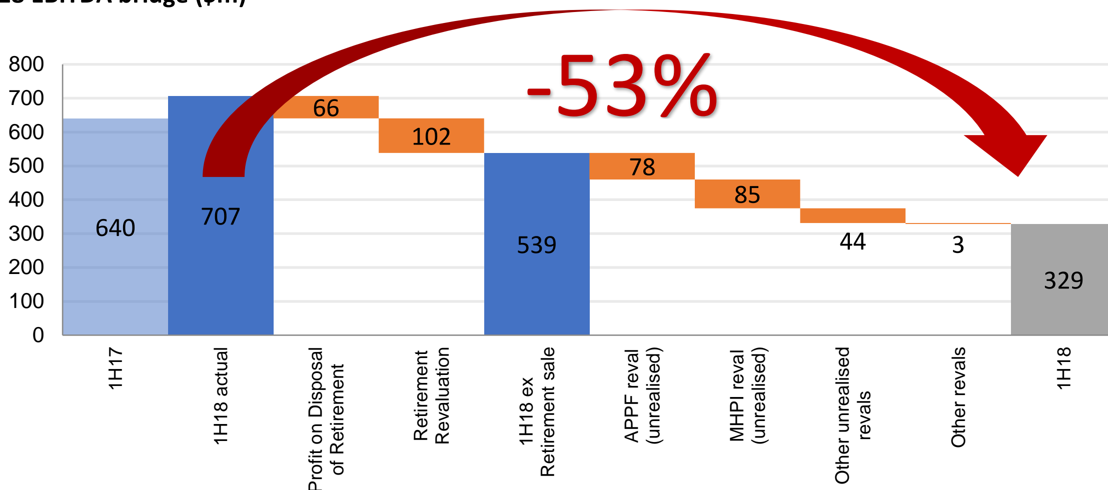
2. "We expect this **underperformance to be offset by outperformance in other parts of our business**".
    - "offset by outperformance in other parts of our business" – prima facie, this is correct, but upon further analysis it appears misleading. The "outperformance" as we analyse, is driven significantly by self-assessed revaluations, that have no cash impact.

3. This **reflects the benefits of the Group's internationally diverse portfolio across its Development, Construction and Investments segments which provides business model resilience**".
    - Qualifying the statement about outperformance by saying it reflects a "diverse portfolio" and provides "business model resilience" is disingenuous, if not misleading as operating EBITDA is materially lower than what we believe is implied.

Operating EBITDA was ~53% lower than reported EBITDA

Without revaluations and the sale of Retirement, **EBITDA would have been ~$329m, 49% lower than the pcp and ~53% lower than presented**. $329m EBITDA compares to $340m operating cash flow. Of course, LLC abandoned "operating EBITDA" a few years ago when it was not in its best interests because of favourable non-cash one-offs and earnings.

1H18 EBITDA bridge ($m)

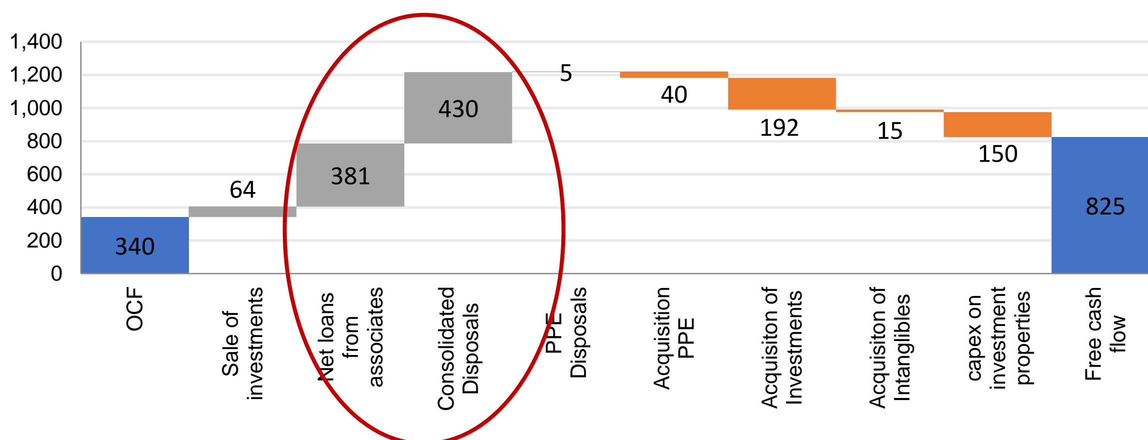


According to the 1H18 results presentation:

CFO said: "*Lendlease delivered a robust financial result with solid profit growth, strong cash generation, and a resilient balance sheet…This result, building on already solid foundations, has provided the capacity to undertake capital management, with the Board approving an on-market buyback of up to $500 million*."

This statement appears incongruous with the actual result where **free cash flow is driven by the sale of Retirement and what appears to be a regearing and then loan back to LLC**. This also raises the question of the extent of off-balance sheet debt the company has in its JV's and investments.

LLC 1H18 cash flow bridge ($m)



Consider what the CFO said on 28 August 2017, when answering questions about the poor cash flow generated in FY17:

- CFO: "…the Apartments business, we had c.2,500 completions and that had an attached revenue of c.$1.8 billion, 65% of that was settled at 30 June and post balance date, we had another $640 million circa to collect and to date, the outstanding amount is $220 million".
  - Analyst: "Just to be clear, there's about another $450 million of operating cash flow you've essentially collected to the end of August".
- CFO: "Yes, that's right".

If one takes the CFO at face value, it indicates the **business generated negative $110m in cash flow vs earnings of $721m in 1H18** i.e. the $450m received in July/August 2017 was for earnings recognised in FY17.

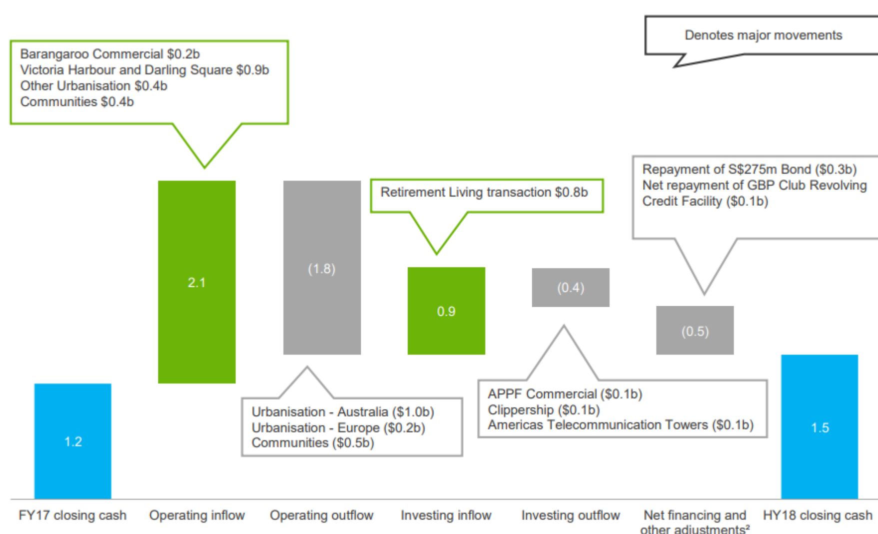
A detractor from 1H18 OCF was the outflow of a $400m PLLACes transaction. We discuss PLLACes and the potential for the market to be misguided by the potential cash generation / working capital release later in the report.

So where is all the cash? 1H18 earnings are being driven from both realised and unrealised revaluation and profits from asset sales. Cash was generated through asset sales and regearing, not earnings. How can the company claim, "*strong cash generation*" providing "*the capacity to undertake capital management*"?

In our view, this illustrates the company's reluctance to discuss the specifics via a conference call is self-serving and only selectively applied

Consider the way LLC presents its discussion on cash flow, which we believe is disingenuous, if not misleading, consistently. LLC does not provide an accurate cash flow bridge of its business to make sense of its operating performance. Instead it limits relevant parts and lists as a footnote: "*Represents an indicative analysis of operating cash inflows and outflows. Operating cash inflows and outflows relating to Construction have been included as a net position*".

Where is the depiction of its "recurring" earnings base for investment management, which the company claims were $383m in 1H18? Or the $450m of operating cash flow re apartment settlements the CFO flagged? Or a depiction of the $400m PLLACes outflow? Or the ~$380m loan from "associates and joint ventures" relating to Retirement.

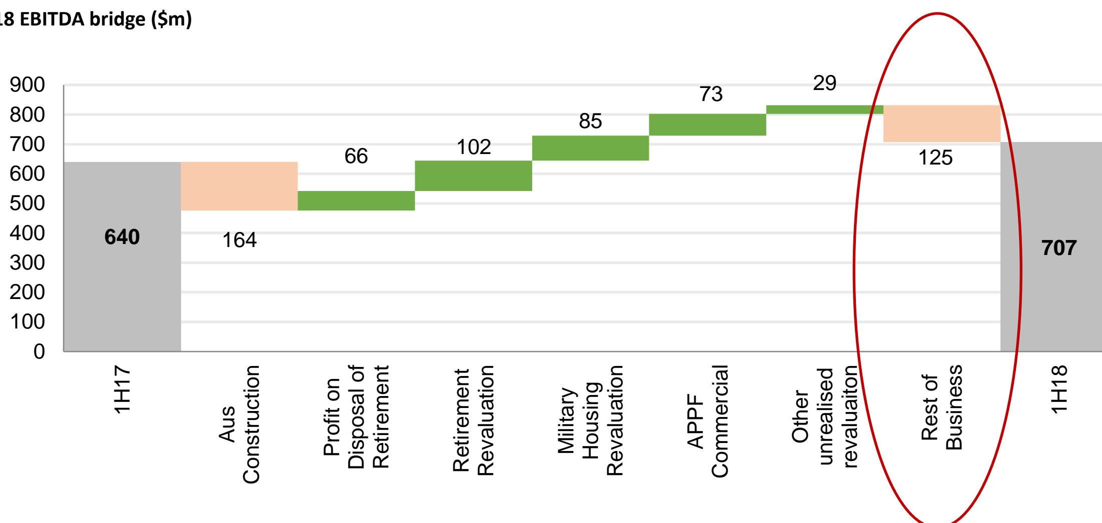


Source: LLC 1H18 result presentation

Cash Flows from Investing Activities	
Sale/redemption of investments	63.9
Acquisition of investments	(191.5)
Acquisition of/capital expenditure on investment properties	(149.5)
Net loans from associates and joint ventures	381.3
Disposal of consolidated entities (net of cash disposed and transaction costs)	430.4
Disposal of property, plant and equipment	4.8
Acquisition of property, plant and equipment	(39.7)
Acquisition of intangible assets	(14.9)
Net cash provided by investing activities	**484.8**

Further, when you juxtapose the *actual* result on 21 February 2018 with the comments made on 17 October 2017, and the movements YoY of the business (below); October commentary is incomplete and / or disingenuous. As is the 1H18 result commentary (analysed below) because without the sale and subsequent reclassification of Retirement and material revaluation of APPF Commercial and Military Housing, **the business went backwards** as opposed to what is claimed by the company as a "robust financial result" with "solid profit growth", providing "the capacity to undertake capital management".

1H18 EBITDA bridge ($m)



Just a coincidence there was no analyst call at the October 2017 "downgrade"?

In 2017, LLC had multiple *non-result* presentations/ webcasts to the market:

1. 28 April 2017: "Engineering and Services Market Update"
2. 19 June 2017: "International Operations Market Briefing"
3. 19 September 2017: "Americas Market Briefing"

So why not have a webcast / call for this announcement?

Market reaction

- Stock closed at $18.60 on 17 October 2017 after increasing from $16.50 at the FY17 result on 28 August 2017
  - Stock closed at $16.65 after the market digested the announcement.
- The stock reaction of down ~10% needs to be taken in context of several bullish presentations (including a broker presentation in Hong Kong) by the company after the FY17 result and the positive outlook contained in that result. The share price essentially gave up those gains.
  - Post the announcement, Macquarie, for example, said: "*We currently forecast a $17m improvement in construction EBITDA in 1H18 to **$113.5m** but the update on construction gives cause for concern*".
    - Construction EBITDA was a **LOSS of $66.1m** vs Macquarie's forecast of $113.5m.
- Had the company conducted an analyst call, it appears reasonable to conclude that Macquarie would not have come to that conclusion (given the Macquarie analyst's line of questioning at the 1H18 result).
- Given 1H17 group EBITDA was $640m, it is **doubtful one would expect the rest of the business to grow ~41% to offset the Australia Construction result**, but as above, the statement on the earnings impact from selling Retirement appears incomplete and the company made no mention it was essentially self-assessing the value of two assets that resulted in material non-cash and unrealised profits.

If LLC reported FFO there would be little confusion

…although the share price would likely be materially lower

Funds From Operations (FFO) is Industry Practice

It is **industry practice** to discuss **Funds From Operations (FFO) and Adjusted FFO and not statutory profit**, as there is industry acknowledgement that **statutory profit does not reflect operating or cash performance** or allow a meaningful comparison between property companies. FFO is also the practice of ratings agency S&P.

Statutory earnings mask operating and cash performance

As demonstrated, statutory earnings can mask operating performance when a company chooses to self-assess the value of its investment portfolio and substitutes realised losses for unrealised profits.

LLC's peers tackle this issue by talking about "operating performance" or FFO: i.e. This is determined by adjusting statutory net profit after tax under Australian Accounting Standards for certain items which are non-cash, unrealised or capital in nature.

We discuss this is detail in section named: How do peers present earnings?

1H18 Result

If one analyses the "presentation" – it looks like a good result…. **BUT the majority of 1H18 profit is included in "other income"** as it is driven the profit from selling 25% of Retirement, the unrealised revaluation of the 75% it didn't sell and other unrealised revaluations, not operating earnings:

	Note	6 months December 2017 A$m
Revenue	4	8,691.2
Cost of sales		(7,778.0)
Gross profit		**913.2**
Share of profit of equity accounted investments	8	7.0
Other income	5	378.0
Other expenses		(628.0)
Results from operating activities		**670.2**
Finance revenue	7	6.1
Finance costs	7	(52.1)
Net finance costs		**(46.0)**
Profit before Tax		**624.2**
Income tax expense	9	(198.5)
Profit after Tax		**425.7**

Source: LLC

If one analyses the 4D, you see that "other income", which we have proven above appears to be the line entry for non-cash / unrealised profits or revaluation.

Other Income of $378m is predominantly driven by unrealised revaluation gains

	6 months December 2017 A$m
Net gain on sale/transfer of investments	
Consolidated entities[1]	66.4
Other assets and liabilities	2.7
Total net gain on sale/transfer of investments	**69.1**
Net gain on fair value measurement	
Investment properties	13.8
Fair value through profit or loss assets[2]	187.2
Total net gain on fair value measurement	**201.0**
Other[3]	**107.9**
Total other income	**378.0**

Source: LLC

We have attempted to reconcile the $378.0m in the following analysis.

Breakdown of 1H18 other income: ($m)

Net gain on sale/transfer of investments	**69.1**		
Consolidated entities		66.4	
Profit on disposal of LRIP LP			87.3
Loss on disposal - Retirement Living Trust			-20.9
Other assets and liabilities		2.7	**66.4**
		69.1	
Total net gain on fair value measurement	**201.0**		
Fair value through profit or loss assets		187.2	
Australian Prime Property Fund – Industrial			1.4
Australian Prime Property Fund – Commercial			73.3
Australian Prime Property Fund – Retail			3.6
Military Housing Projects Initiative			85.1
Lendlease Asian Retail Investment Fund			0.8
Parkway Parade Partnership Limited			0.5
Other			22.5
Investment properties		13.8	**187.2**
		201.0	
Other	**107.9**		
Revaluation gain - Lendlease Retirement Living Trust		101.9	
Other		6.0	
		107.9	
Total other income	**378.0**		

Total Other Income of $378m out of the statutory profit number of $425.7 does not appear operating and is mostly unrealised.

Estimated FFO

	FY15	FY16	FY17	1H18
Operating Cash Flow	-376	827	-98	191
Decrease in Receivables	-1,854	846	36	-70
Decrease in Inventory	-634	57	-229	775
Increase in Payables	1,002	-707	1,250	366
FFO (pre-adjusted)	1,110	632	-1,155	-880
plus pension expense	16	16	16	16
FFO (adjusted)	1,161	698	-1,101	-845

Bloomberg Financial Statement Analysis

Ticker: LLC AU Equity | Periodicity: Semi-Annuals | Currency: AUD | Note: Years shown on the report are Fiscal Years | Company: LendLease Group

Filing: Most Recent

Reconciliation

	Original:2016 S1	Original:2016 S2	Original:2017 S1	Original:2017 S2	Original:2018 S1
For the period ending	2015-12-31	2016-6-30	2016-12-31	2017-6-30	2017-12-31
EBITDA Reconciliation					
EBIT, GAAP	359.90	463.40	554.10	483.00	664.10
+ Revenue Adjustments	0.00	0.00	0.00	0.00	0.00
+ Cost of Revenue Adjustments	0.00	0.00	0.00	0.00	0.00
+ Other Op Inc Adjustments	-80.80	-168.50	-128.70	-68.60	-256.30
+ SG&A Adjustments	0.00	0.00	0.00	0.00	0.00
+ R&D Expense Adjustments	0.00	0.00	0.00	0.00	0.00
+ D&A Adjustments	0.00	0.00	0.00	0.00	0.00
+ Prov for Doubtful Acct Adj	0.00	0.00	0.00	0.00	0.00
+ Other Op Exp Adjustments	2.80	-0.50	-28.10	0.90	0.70
EBIT, Adjusted	281.90	294.40	397.30	415.30	408.50
+ Depreciation & Amortization	40.80	41.90	47.80	50.40	50.40
EBITDA, Adjusted	322.70	336.30	445.10	465.70	458.90
EBIT Reconciliation					
EBIT, GAAP	359.90	463.40	554.10	483.00	664.10
+ Disposal of Assets	-2.60	-18.90	2.40	2.50	-2.50
+ Asset Write-Down	-21.10	11.40	-45.30	-62.40	-187.90
+ Sale of Business		-163.30	-78.60	-15.90	-66.40
+ Sale of Investments	-57.10	4.50		-23.20	
+ Unrealized Investments	2.80	-2.70	-18.60	14.60	1.20
EBIT, Adjusted	281.90	294.40	397.30	415.30	408.50

Bloomberg also provides a reconciliation of GAAP to non-GAAP earnings.

Non-cash or extraordinary income expenses may be the key driver for why LLC’s GAAP tax expense post-GFC (FY10-1H18) is only $1.2b compared to earnings of $6.4b, or a tax rate of only 19%.

More importantly, cash tax paid over that period is a meagre **$607m**.

US Military Housing revaluation illustrates discretion and selective disclosure

As shown in the table above, there were material revaluations of LLC's available for sale assets (now recognised at fair value) including revaluing US Military Housing from **$102.8m to $187.9m** (without providing any details of variables used).

- On the conference call, LLC said "*strong market comparables in the US market for similar assets led to that valuation growth… the valuers have used a DCF, discount rate, of 8.5 per cent which we think is a fair discount rate for that high quality portfolio*".

According to LLC: "*The equity investment in US Military Housing was revalued in the period. The initial development periods across each of the projects have recently completed. Subsequently, the portfolio was independently valued, leading to strong gains in underlying investment values reflecting the high quality of the portfolio and recent market transactions*".

- If you analyse LLC's US Military portfolio, the majority of its equity is invested across five projects: Hickam, Air Combat Command Group II, Tri-Group, Camp Lejeune Phases 1 and 2, Island Palm Communities. As at 31 December 2016, invested & committed equity totalled US$87m. As at 30 June 2017, equity = A$102.8m.

Given the majority of LLC's equity was invested > 10 years ago and the aforementioned projects have been operational for 5-10+ years, **what has happened in between 30 June 2017 and 31 December 2017 to result in a revaluation from $102.8m to $187.9m?**

- ➢ The only event that we can think of that occurred during this period was in **December 2017 when Congress rewrote the U.S. Tax Code**.
- ➢ As the projects span from October 2001 to October 2010, **why do the "initial development periods" occur during the same six-month period?**

Questionable asset classification and valuation methodology

It should be noted the valuation method for Level 3 fair value assets is defined as: "*calculated using inputs that are not based on observable market data*". In this case, it appears that LLC used an "independent" valuer to conduct the valuation. It separately disclosed on the earnings call that an input was used for what it believes to be a "strong market comparable" for "similar assets". In our view, as we shall demonstrate, there is reasonable subjectivity here and in fact LLC's valuation approach and disclosure are materially different to its peers.

MHPI

The military housing privatization initiative (MHPI) was established by the United States Congress in 1996. The MHPI are authorised to enter into agreements with private developers selected in a competitive process to own, maintain and operate family housing via a fifty-year lease. The MHPI used a qualification-based procurement process to select a private sector partner to share the investment, risk, and reward for improving quality and quantity of military housing. The five leading developers are: Balfour Beatty, Corvias, Lendlease, Lincoln Military Housing, and Hunt Companies. A full list of projects contained within a report to congress in March 2018 can be found here.

Taking Island Palm Communities (IPC) as an example, the term of the ground lease is 50 years with a 25-year extension option. As such**, IPC has a leasehold interest in the land and a fee interest in the housing projects/ improvements**. Both the land and the improvements will revert to the Government at the end of the lease term.

These projects are highly-geared, albeit non-recourse, but relevant to the argument of off-balance sheet financing. For example, IPC raised debt via bonds of US$1.6b with equity from LLC of US$8m issued to finance the demolition, construction, and renovation of housing units for military families.

Balfour Beatty

There is limited disclosure in LLC's accounts about MHPI. As such, we have analysed Balfour Beatty. LLC's agreements with the DoD may be different, however given these projects all fall under the one government directive, it may be fair to assume similarities.

Portfolio valuation December 2017
Value by sector

Sector	2017 (2016) No. projects		2017 £m	2016 £m
Roads	13	(13)	**290**	366
Healthcare	4	(4)	**136**	140
Student accommodation	4	(4)	**64**	63
OFTOs	3	(3)	**51**	46
Waste & biomass	4	(4)	**57**	57
Other	5	(5)	**38**	35
UK total	33	(33)	**636**	707
US military housing	21	(21)	**497**	438
Healthcare & other PPP	3	(3)	**28**	9
Student accommodation	7	(6)	**49**	38
Residential housing	7	(6)	**34**	28
North America total	38	(36)	**608**	513
Total[5]	71	(69)	**1,244**	1,220

US Military Housing ~80% of North America. As per the accounts: "Operational performance movements resulted in a £33 million increase in the value of the portfolio (2016: £61 million), consisting mainly **of an increase of £106 million due to the change in Federal corporate income tax rates enacted in the US** and a £56 million reduction due to the rise in the value of sterling".

Source: Balfour Beatty

Balfour Beatty also saw a net gain from the reduction in US tax rate. Unlike LLC, it clearly attributes its portfolio revaluation to this. Unlike LLC, Balfour Beatty does not use mark-to-market accounting and take this gain through its earnings because the value of US military housing is **recognised at initial equity investment plus the value of its accrued preferred return**.

According to Balfour Beatty, which has 21 military housing projects valued at £497m, the first phase of the project, known as the **initial development period**, covers the period of initial construction or renovation of military housing on a base, **typically lasting three to eight years**. Balfour Beatty's range of financial close across its portfolio was November 2003 to June 2014.

- If LLC has a similar "initial development period", it would suggest individual projects would have reached this period many years ago.

According to Balfour Beatty, the projects will typically receive, to the extent that adequate funds are available, an annual minimum preferred rate of return. On most existing projects, this annual minimum preferred rate of return ranges from 9% to 12% of Balfour Beatty Communities' initial equity contribution to the project.

- This is consistent with other developers / operators of military housing including GMH Communities Trust and Forest City. Forest City sold its operations to Hunt in early 2016 for US$209m. In 2015 Forest City said its Military Housing business net operating income was US$25.9m; implying a yield of 12%.

In addition, Balfour Beatty says (2017 Annual Report) "on most of the existing projects, the total amount that Balfour Beatty Communities is entitled to receive (inclusive of the preferred return) is **generally capped at an annual modified rate of return, or cash-on-cash return, on its initial equity contribution to the project. Historically, these caps have ranged between approximately 9% to 18%** depending on the particular project and the type of return (annual modified rates of return or cash-on-cash). However, in some of the more recent projects, there are either no annual caps or lower projected annual rates of return".

- As such, in our view, LLC's discount rate of 8.5% appears aggressive. Aggressive on an absolute basis and a relative basis. It may also be considered an aggressive valuation methodology and would be considered even more aggressive should LLC's minority equity positions be similar to its peers in that they are 50-year leases with capped upside.
- In addition, if the change in US tax code was a material driver of the valuation increase from $102.8m to $187.9m, LLC's comments are disingenuous, if not misleading.

Why does it appear LLC uses a different valuation methodology than others?
If you take the valuation methodology at face value (noting there is no mention from LLC about the potential impact on valuation of the US tax cuts), it is reasonable to assume there is no reason to materially adjust cash flow forecasts at 30 June 2018 and there is no reason to adjust the risk premium (arguably could go up); because this was done at 31 December 2017. The only variable therefore that should change is the US 10-year (or similar). The US 10-year was ~2.40% at 31 December 2017 and is currently yielding ~2.95%.

As such, shouldn't LLC revalue its Military Housing portfolio down at 30 June 2018?

APPF Commercial revaluation further illustrates discretion

The timing of equity raisings, buying and selling assets and moving assets from said company's balance sheet to a fund controlled by it may be considered a potential conflict of interest. This potential conflict of interest may be amplified should that company also own a stake in the fund itself.

LLC is the manager of APPF Commercial and as of 31 December 2017 it held a 7.7% stake. This potential conflict of interest was raised in 2013, when according to media reports, LLC faced ~40% redemptions. The media article said, "*some investors in the unlisted APPF Commercial fund also made separate, direct investments in the Barangaroo project*".

Australia Co-investments	Lendlease Interest (%)	Market Value[1] June 2017 ($m)	Market Value[1] December 2017 ($m)
Australian Prime Property Fund Retail	1.7	73.2	77.0
Lendlease International Towers Sydney Trust	15.0	411.5	446.5
Australian Prime Property Fund Commercial	7.7	211.6	285.0

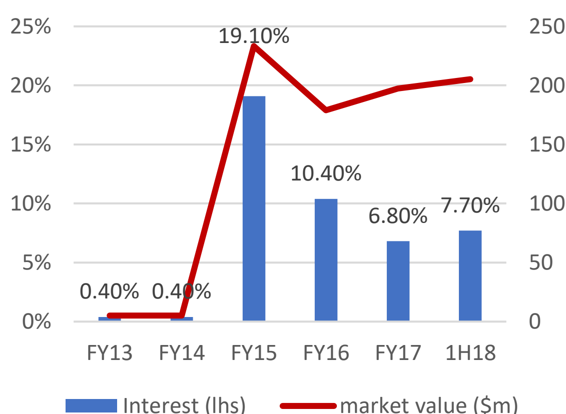
Australia FUM	Fund Type	Asset Class	Market Value[1] June 2017 ($b)	Market Value[1] December 2017 ($b)
Australian Prime Property Fund Retail	Core	Retail	5.2	5.4
Lendlease International Towers Sydney Trust	Core	Commercial	3.5	3.8
Australian Prime Property Fund Commercial	Core	Commercial	3.8	4.5

Source: LLC

LLC's ownership on APPF Commercial has increased from 6.8% at 30 June 2017 to 7.7% at 31 December 2017; potentially magnifying a revaluation.

That is, the difference between ~$285m and ~$212m ($73.3m) appears to form part of the $187.2m "other income" as described above. It appears, therefore, that LLC has invested additional equity into APPF Commercial, resulting in a higher equity amount and a higher ownership amount as the increase in the value of APPF Commercial is ~19% and LLC's share of the valuation increase is ~35%.

$m	FY17	1H18	Δ %	Δ $
assets	3,800	4,500	18%	700
gearing	12.50%	14.70%	2.20%	
co-investment	212	285	35%	73
%	6.80%	7.70%	0.90%	
APPF equity	3,112	3,701	19%	590
cap rate	5.60%	5.30%	-0.30%	
# of assets	19	21		2
Debt	475	662	39%	187
Assets	3,800	4,500	18%	700
Equity	3,325	3,839	15%	514
gearing	12.5%	14.7%	2.2%	



The other question is why APPF Commercial is classified as a Level 3 financial asset?

Not only is APPF Commercial's value "*calculated using inputs that are not based on observable market data*", (as below) so are the managed funds. In our view, they should be considered Level 2 as there is "*observable market data other than unadjusted quoted prices for an identical asset or liability*". There is also an argument of Level 1 given the fund likely reports NAV.

A Level 2 classified asset is determined using valuation techniques which **maximise the use of observable market data and rely as little as possible on entity-specific estimates**.

$187m 1H18 profit was derived from revaluing Level 3 assets

The fact that there is no disclosure on the methodology is instructive and another example of how self-serving and selective LLC is with its disclosure.

In our view, there are many arguments to suggest most of these Level 3 investments should be measured at net assets value, not at fair value.

1H18 - Non-Current Assets Measured at Fair Value ($m)		December 2017	June 2017
Fair Value Through Profit or Loss – Designated at Initial Recognition			
Lendlease International Towers Sydney Trust	Level 3	446.6	411.5
Lendlease One International Towers Sydney Trust	Level 3	230.2	202.7
Australian Prime Property Fund – Industrial[2]	Level 3	72.3	70.9
Australian Prime Property Fund – Commercial[2]	Level 3	284.9	211.6
Australian Prime Property Fund – Retail[2]	Level 3	77.0	73.4
Lendlease Public Infrastructure Investment Company	Level 3	41.0	40.7
Military Housing Projects Initiative[2]	Level 3	187.9	102.8
Lendlease Asian Retail Investment Fund[2]	Level 3	25.7	24.9
Parkway Parade Partnership Limited[2]	Level 3	37.7	37.2
Other investments[2]	Level 3	9.4	19.6
	Level 1	18.1	
		1,430.8	**1,195.3**
Other	N/A		**8.0**
Total non current		**1,430.8**	**1,203.3**
Total other financial assets		**1,433.2**	**1,236.3**

Source: LLC

The sale of Bluewater is another example of convenient timing of asset sales

We believe Management KPI's are geared toward share price returns and statutory profits as opposed to operating and cash performance; which has potentially resulted in the convenient timing of assets sales.

On 22 October 2013, CEO said:

- "*We do intend to sell Bluewater at some time in the next two years. **We don't expect it to be in FY14** but it will be, as I said, some time in the next two years*".

The sale of Bluewater was announced **25 June 2014** (5 days before the end of FY14) and **implied a significant downgrade to analyst earnings expectations for the rest of the business**.

Bluewater was held as Inventory; as such there was a significant profit taken through the P&L, the balance sheet adjustment was a decline in inventory and the cash came through a working capital release in operating cash flow.

- That contributed ~**$1.263b to operating cash flow** and ~**$485m to NPAT** from the profit on sale and $46.4m in operating profit.

Had Bluewater not have been sold:

- Operating cash flow would have been **negative ~$441** vs **~$338m**
- Profit after tax would have been ~**$338m vs ~$823m** reported

Is it purely a coincidence that in the absence of selling Bluewater, NPAT would have <u>decreased</u> by 38% and operating cash flow would have been <u>negative</u> $441m?

From examination of management KPIs in the Annual Report it appears there may have been other motivating factors behind selling Bluewater 5 days before the end of the financial year after saying it was not going to happen.

PERFORMANCE ASSESSMENT	RESULT
The targets included a significant stretch. Overall the CEO outperformed against all financial metrics: ▪ NPAT of A$822.9 million was significantly above budget and 50% higher than 2013; ▪ Revenue growth was above target despite a challenging market; ▪ EBITDA of A$1,192.8 million was well above target and 61% higher than 2013. EBITDA of 8.5% represents a 3.0% increase on 2013 and was above target; ▪ Return on Equity (ROE) of 18.2% outperformed our 15% target; ▪ Cash flow from operating and investing activities outperformed against targets, despite the net investment into the production of the development pipeline; and ▪ The CEO has delivered outstanding securityholder returns with security price growth of 57% for the year.	Outstanding performance

Firstly, NPAT, Revenue, EBITDA, ROE all use the same "numerator" therefore beating on one implies a beat on all.

To say NPAT was "significantly above budget" and "50% higher than 2013" when **ex-Bluewater NPAT would have 39% lower** is disingenuous.

Even more obtuse is the fact the Board can claim "*cash flow from operating and investing activities outperformed against targets, despite the net investment into the production of the development pipeline*". What targets are the Board using when Bluewater accounted for $1.3b of cash in FY14 and operating and free cash flow would have bene negative **had Bluewater not have been sold**.

This is detailed in Note 29 of the Annual Report "Notes to the Statement of Cash Flows" and the Board's comments, in particular the justification: "*despite the net investment into the production of the development pipeline*" **appears incongruous with the audited financial results**.

rfm

As is the overall result being deemed an "outstanding performance"

Contrast with Stockland KPIs and Scorecard

Management are not rewarded for NPAT growth. As such, the CEO does not talk about the 35% growth in FY17 NPAT driven by a $264m property revaluation.

	FY13	FY14	FY15	FY16	FY17
Underlying Profit[1] ($M)	495	555	608	660	**696**
FFO[2] ($M)	472	573	657	740	**802**
Statutory profit ($M)	105	527	903	889	**1,195**
Security price as at 30 June[3] ($)	3.48	3.88	4.10	4.71	**4.38**
Distributions/Dividends per security (cents)	24.0	24.0	24.0	24.5	**25.5**
Underlying EPS (cents)	22.4	24.0	25.9	27.8	**29.0**
FFO per security (cents)	21.3	24.8	28.0	31.1	**33.4**
Statutory EPS (cents)	4.7	22.8	38.5	37.4	**49.8**
Stockland TSR – 1 year (%)	17.5	20.5	12.3	16.4	**7.1**
A-REIT 200 TSR (excluding SGP) – 1 year (%)	24.8	11.3	24.2	21.1	**(6.7)**

Corporate Balanced Scorecard

KPI	Commentary	Overall Rating
Business and Financial Performance (75%)		
Group performance • Funds from Operations per security (FFOps) guidance of 6% to 7%; and • Return on Equity[1] (ROE) of 10%.	• FFOps growth was 7.4% to 33.4 cps. • ROE was 11.4%.	Above Target
Business Performance • Operating Business performance in line with plan;	Business unit profitability was up on FY16: • Commercial Property FFO of $608 million was up on FY16 and in line with plan. • Residential Operating Profit of $270 million was well up on FY16 and above plan. • Retirement Living profit of $63 million was up on FY16 and in line plan.	Above or On Target

One company that could benefit from reporting statutory earnings and not calling out realised and unrealised gains is Berkshire Hathaway. Of course, it chooses not to…

Examining the Berkshire annual report, **FY17 NPAT was ~$44.9b. up 87% on FY16**. This was driven by the one-off tax benefit and investment gains. The **operating result was poor**, driven by reinsurance, down ~15% YoY.

Berkshire was also a major beneficiary of profits courtesy of the US tax cuts, here is what Buffett said about that:

> "The format of that opening paragraph has been standard for 30 years. But 2017 was far from standard: **A large portion of our gain did not come from anything we accomplished at Berkshire**. The $65 billion gain is nonetheless real – rest assured of that. But only $36 billion came from Berkshire's operations. The remaining $29 billion was delivered to us in December when Congress rewrote the U.S. Tax Code".

Not only does Berkshire not take that liberty and specifically call these non-operating items out, but here's what Buffett says about realised and unrealised gains:

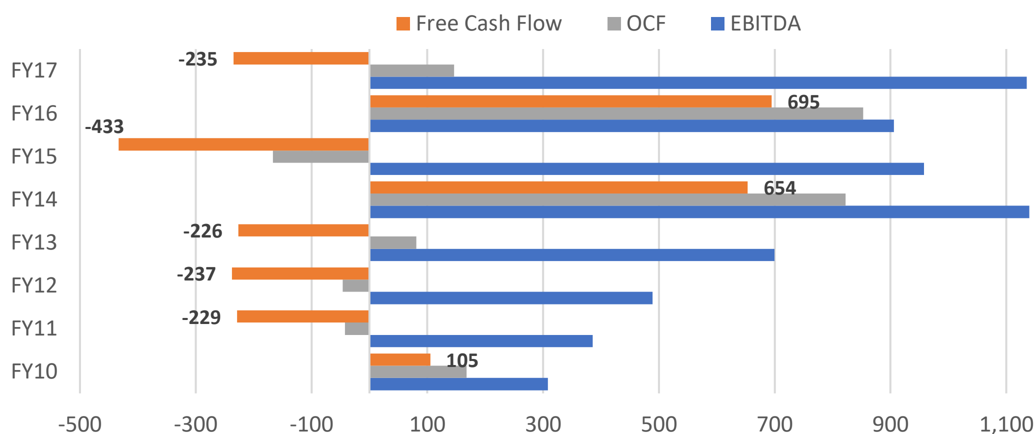
> "**I must first tell you about a new accounting rule** – a generally accepted accounting principle (GAAP) – that in future quarterly and annual reports **will severely distort Berkshire's net income figures and very often mislead commentators and investors**. The new rule says that the net change in unrealized investment gains and losses in stocks we hold must be included in all net income figures we report to you. That requirement will produce some truly wild and capricious swings in our GAAP bottom-line. Berkshire owns $170 billion of marketable stocks (not including our shares of Kraft Heinz), and the value of these holdings can easily swing by $10 billion or more within a quarterly reporting period. Including gyrations of that magnitude **in reported net income will swamp the truly important numbers that describe our operating performance. For analytical purposes, Berkshire's "bottom-line" will be useless**. The new rule **compounds the communication problems we have long had in dealing with the realized gains (or losses) that accounting rules compel us to include in our net income**. In past quarterly and annual press releases, **we have regularly warned you not to pay attention to these realized gains**, because they – just like our unrealized gains – fluctuate randomly. That's largely because **we sell securities when that seems the intelligent thing to do, not because we are trying to influence earnings in any way**. As a result, we sometimes have reported substantial realized gains for a period when our portfolio, overall, performed poorly (or the converse).

Asset sales should have turned into cash, yet LLC has generated only $93m FCF in 8 years

In 8 years:

- Total EBITDA = $6.0b
- Cash flow from operations = $1.8b
- Free cash flow = $93m; Free cash flow to firm = $836m; Free cash flow to equity = $1,511m

LLC ($m)



When considering material asset sales (King of Prussia ~$500m in FY12, Greenwich/Jem/Aged Care ~$615m in FY13, Bluewater ~$1.3b in FY14) of investments made *prior* to this time frame, cash flow is even worse. As such**, it is disingenuous, if not misleading, to now consider the total of (operating + investing cash flow) as a relevant metric**.

Consistently LLC has reported substantial realised gains for a period when its portfolio, overall, performed poorly, leading to billions of dollars of difference between cash flow and EBITDA. We believe this is because it has sold its "winners" and kept "losers" resulting in high P&L profit, low cash flow; and an unsustainably high dividend.

One reason for the cash mismatch is that Investment income is mostly revaluation

One reason for the **signifcant cash mismatch is that investment income is mostly revalution, not earnings**. These gains indeed may be real, albeit mostly unrealised. They are reflected in book value, but they are not operating earnings. And in our view, the exhaustive analysis we have performed indicates the presentation of the reuslts may be disingenous, potentially resulting in the equity market being misled, and consequently overvaluing the stock.

LLC even points this out in its FY17 slide presentation , clearly stating that 77% of earnings are revaluaitons of profits from disposals and only 23% of investment earnings are operating earnings. That said, in LLC's commentary it appears to frame the result in such a way it is reasonable for the reader to infer it is in fact higher income driving the result.

In FY17, as detailed above, with respect to the three International Towers Sydney at Barangaroo South, LLC concluded, that as a result of reaching the operational phase, the investments were reclassified from Equity Accounted Investments to Other Financial Assets and measured at fair value through profit and loss. That was the key driver of FY17 investments; not "*Higher investment income, including co-investments in the three office towers at Barangaroo South, Sydney*".

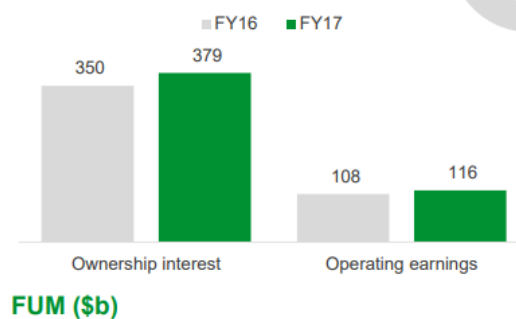
Investments

Performance highlights[1]

- ROIC of 11.7%, above target range, driven by solid performance in Australia
- Ownership earnings derived from investments increased by 8% to $379.2 million
  - Solid growth in the Retirement Living business
    - Average unit resale prices increased 11%
    - Two additional villages acquired
    - Exploring the potential introduction of capital partners
  - Higher investment income, including co-investments in the three office towers at Barangaroo South, Sydney

36% of operating EBITDA

Investments EBITDA by activity ($m)



FUM ($b)

Source: LLC

Consistent messages on "earnings visibility" and "pipeline" are misdirection

We will go on to demonstrate that LLC's business has performed poorly, over whatever timeframe is required.

In our view, positive media comments and result framing coincides with poor results. There are many examples, but we have included some to consider before we analyse results and cash flow. For example, when describing the 1H14 result in February 2014 the CEO said on outlook:

- "Forward sales in our residential development business and embedded returns in our pipeline of opportunities clearly underpin our earnings visibility over the next three years".
  - Yet as just discussed, less than four months later the company has to sell its stake in Bluewater to avoid NPAT being 39% lower than the pcp.

This did not stop the CEO from claiming a year later that "*The positive residential housing market has supported growth in our pre sold revenue, which now totals $3.6 billion and has further increased our earnings visibility over the next three years*".

- Yet in FY15 operating cash flow was the worst post-GFC.

In November 2016 at its AGM the CEO said "*We are well placed heading into FY17 given our financial strength and earnings visibility, despite mixed market conditions*".

- Yet as analysed in the report, it was revaluation and asset sales that drive the result as operating cash flow was only $146m, which is not working capital related, as we shall demonstrate.

At the FY17 result, LLC said: "*Well positioned for future success: Earnings visibility from extensive pipeline across our business segments*" and then handed down the 1H18 result, as analysed. The company even repeated "*strong earnings visibility for the coming years*" at the 1H18 result.

The company has said this for years and has not handed down a strong result since. Or perhaps it is a strong result in context to statutory earnings or management KPIs, which Buffett considers to "*mislead commentators and investors*" and swamps the "*truly important numbers that describe our operating performance*". It is **irrelevant that LLC is in the business of trading assets, so is Berkshire, just in a much larger scale**.

These strong results and earnings visibility courtesy of a global pipeline can only be viewed, given the facts, as misdirection.

Cash flow analysis

There has been an unprecedented property boom, globally, yet despite ~$1.25b debt/equity financing and material asset sales, the business has produced only ~$610m cash.

1. Only 2 years in the last 8 has EBITDA > Operating Cash Flow (before interest & taxes).
2. **Total cash conversion in 8 years = ~25%**. Net working capital is a contributor of poor cash flow; but the main driver is non-cash profit (~$2.5b).
3. **When considering material asset sales** (King of Prussia ~$500m in FY12, Greenwich/Jem/Aged Care ~$615m in FY13, Bluewater ~$1.3b in FY14) of investments made prior to this time frame**, cash flow is even worse**.
4. **Dividends appear unsustainable** as they are not driven by operating cash flow, rather asset sales and is why despite the massive profits and asset sales **LLC has not significantly de-geared through this period**.
5. It is therefore difficult to reconcile the consistent messages from the Board about the strength of the results and the actual numbers when the majority of profits are non-cash:
    a. "*The Group delivered **a solid performance** for the financial year ended 30 June 2017, with Profit after Tax of $758.6 million, up from $698.2 million in the previous financial year… **I am extremely pleased with the progress the Group has made in delivering on its strategy in recent years***". Chairman, 2017 Annual Report.
6. As detailed below, amounts received from disposal of assets and investments = ~$3.5b and net capex and investments = ~$3.7b. Total investing cash flow from FY10-17 = ~$1.2b (outflow), driven by the FY11 acquisition of Valemus.

As can be seen in the table:

- Non-cash adjustments total $2,480m out of $4,787m or 33% of statutory profit
- Cash from operating activities = $1,815m
- Cash from investing activities = -$1,205m
- The business has generated $610m cash flow (operating less investing)
- $1,248m cash raised from financing

LLC cash flow ($m)	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	Total
Net Income	346	493	501	549	823	619	698	759	4,787
Depreciation & Amortization	40	52	77	87	88	80	83	98	605
Deferred Income Taxes	46	109	-92	98	80	201	275	75	792
Other Non-Cash Adj	-173	-399	-170	-173	-220	-190	-538	-618	-2,480
(Inc) Dec in Inventories	-366	-87	-249	-53	-115	-754	-574	-802	-3,000
Inc (Dec) in Other	275	-211	-114	-428	167	-121	908	635	1,112
Cash from Operating Activities	**168**	**-42**	**-46**	**81**	**822**	**-167**	**853**	**146**	**1,815**
Disp in Fixed & Intang	3	18	597	16	45	12	17	13	720
Acq of Fixed Prod Assets	-63	-187	-191	-307	-169	-267	-158	-381	-1,723
Acq of Intangible Assets	-72	-8	-18	-37	-76	-67	-46	-24	-348
Dec in LT Investment	374	398	329	398	148	0	0	0	1,646
Inc in LT Investment	-256	-264	-212	-275	-606	0	0	0	-1,612
Cash from Divestitures	0	10	0	214	31	-6	383	548	1,180
Cash for Acq of Subs	-172	-638	0	0	-8	7	0	0	-810
Other Investing Activities	-65	-17	1	146	21	-63	-194	-87	-258
Cash from Investing Activities	**-250**	**-687**	**505**	**154**	**-615**	**-383**	**1**	**70**	**-1,205**

+ Dividends Paid	-126	-127	-155	-217	-210	-374	-293	-338	-1,841
+ Cash From (Repayment) Debt	-11	391	-378	547	280	-57	-298	224	699
+ Cash (Repurchase) of Equity	789	0	0	0	0	0	0	107	896
+ Other Financing Activities	0	-48	-33	-39	-181	-34	-29	16	-347
+ Net Cash From Disc Ops	0	0	0	0	0	0	0	0	0
Cash from Financing Activities	**653**	**216**	**-566**	**291**	**-110**	**-465**	**-620**	**9**	**-594**
Effect of Foreign Exchange Rates	-56	-77	18	31	9	50	25	16	17
Net Changes in Cash	**515**	**-590**	**-88**	**557**	**106**	**-966**	**258**	**241**	**34**

$m	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	Total
Cash Paid for Taxes	82.1	23.1	138.1	-34.7	126.2	122.0	-11.5	144.8	**590**
Cash Paid for Interest	80.1	113.4	124.7	116.3	149.6	151.2	134.8	120.4	**991**

- Also note cash tax in those 8 years totals $590m, which is ~30% of cash flow from operations.
- Claims that investors should sum operating and investing cash flow is also likely misdirection. Note investing cash flow in 8 years only totals an outflow of ~$1.2b. Summing operating cash flow with investing cash flow over the last 8 years totals $2.2b vs EBITDA of $6.0b.

There are no working capital gains to be had

There appears to be a market belief that LLC is due a large working capital release, which may justify the poor cash flow and may justify why LLC trades at a significant premium to book (because inventory is undervalued).

As we shall demonstrate, this is not the case. In fact, it is almost implied that it will not happen given LLC's disclosure. After reporting operating cash flow of negative $46m in FY12 and $95m in FY13 vs EBITDA of $810m (FY12) and $744m (FY13) or cash conversion of 3% in those two years; LLC produced the below slide in the October 2013 investor day:

Segment	Overview	FY14	FY15	FY16	Total
Communities	Net cash proceeds Assuming 2,500 annual lot sales	Cash Positive	Cash Positive	Cash Positive	Cash Positive
Apartments	Net cash proceeds 11 towers currently in delivery	Investing	Investing	Cash Positive	Cash Positive
Barangaroo	Net cash proceeds Development Office towers 2 & 3 only and $500 million Co-investment by Lend Lease	Investing	Investing	Cash Positive	Cash Positive
Infrastructure	Net cash invested Secured Australian PPP projects	Investing	Investing	Investing	Investing
Total		Investing	Investing	Cash Positive	Cash Positive

This implies that by FY16 the business is "cash positive" and cash positive overall from FY14-16.

So how did that turn out?

Cash conversion:
FY14: 72%
FY15: -17%
FY16: 94%

Total: 50%

This slide implies there is a working capital release in FY16 that will offset negative working capital in FY14 and FY15. FY16 was indeed the best cash flow result the company has had. Nonetheless, cash conversion was still <100% and as the above calculation shows, cash conversion over those three years was 50%.

At the FY14 result, LLC provided a forecast for FY17, again showing the business would be cash flow positive:

	Overview	FY14	FY15	FY16	FY17
Communities	**Net cash proceeds** Assuming 2,500 annual lot settlements	Cash Positive	Cash Positive	Cash Positive	Cash Positive
Apartments	**Net cash proceeds** 19 apartment buildings currently in delivery	Investing	Investing	Cash Positive	Cash Positive
Commercial	**Net cash proceeds** Barangaroo office towers – development and investment; commercial tower at RNA; commercial tower at TIQ	Investing	Investing	Cash Positive	Cash Positive
Infrastructure Development	**Net cash invested** Secured Australian PPP projects	Investing	Investing	Investing	Cash Positive
Other	**Net cash proceeds** Sale of Bluewater Shopping Centre	Cash Positive			
Total		Cash Positive	Investing	Cash Positive	Cash Positive

FY17 EBITDA was $1.14b

FY17 operating cash flow was $146m

FY17 free cash flow was negative $235m

At the FY15 result, not only was FY17's forecast reiterated but FY18 was also represented to be a "cash positive" year.

	Overview	FY15	FY16	FY17	FY18
Communities	**Net cash proceeds** Assuming >2,000 annual lot settlements	Cash Positive	Cash Positive	Cash Positive	Cash Positive
Apartments	**Net cash proceeds** 25 major apartment buildings currently in delivery or conversion	Investing	Investing	Cash Positive	Cash Positive
Commercial	**Net cash proceeds** Barangaroo office towers – development and investment; commercial tower at Brisbane Showgrounds; commercial towers at TIQ	Investing	Cash Positive	Cash Positive	Cash Positive
Infrastructure Development	**Net cash invested** Secured Australian PPP projects	Investing	Cash Positive	Cash Positive	Cash Positive
Total		Investing	Cash Positive	Cash Positive	Cash Positive

As discussed, 1H18 EBITDA was $707m vs operating cash flow of $340m

Yet as presented all divisions were supposed be cash flow positive

At the 1H16 result (17 February 2016), LLC reaffirmed FY17 and FY18 "cash positive" projections and introduced an FY19 forecast.

	Overview	FY16	FY17	FY18	FY19
Communities	**Net cash proceeds** Assuming >2,000 annual lot settlements	Cash Positive	Cash Positive	Cash Positive	Cash Positive
Apartments	**Net cash proceeds** 17 major apartment buildings[2] currently in delivery or conversion	Investing	Cash Positive	Cash Positive	Cash Positive
Commercial	**Net cash proceeds** 5 major commercial buildings (incl. development and investment positions) currently in delivery or conversion	Cash Positive	Cash Positive	Cash Positive	Cash Positive
Infrastructure Development	**Net cash invested** Secured Australian PPP projects	Cash Positive	Cash Positive	Cash Positive	Cash Positive
Total		Cash Positive	Cash Positive	Cash Positive	Cash Positive

lendlease [1] All cash flow based on current portfolio / investments
[2] In 1H16 nine apartment buildings completed and one apartment building commenced delivery

Prima facie, this slide is particularly bullish. In isolation, it would be reasonable to expect that cash conversion is expected to be >100% from FY16-19 and that LLC would be the beneficiary of a significant working capital unwind and may have surplus capital in which to either return to shareholders or deploy toward its claimed ~$50b development pipeline.

Yet as we demonstrate below, this was far from the case in FY16, FY17 and 1H18. Remembering the above slide was presented on 17 February 2016 (and was the last time the company would put the slide in its earnings presentation). FY16 was a relatively strong year, but cash conversion still was not >100%, but more importantly FY17 had just $146m operating cash flow, implying cash conversion of just 13%, despite LLC's previously claiming that all business segments and the business as a whole would be "cash positive".

What is the company's definition of "cash positive"? As a cross-check, **FY17 free cash flow to equity was only $2m**; or by LLC's (irrelevant in our view) **operating and investing cash flow was negative $27m**.

$m	FY14	FY15	FY16	FY17	1H18
OCF	822	-167	853	146	340
EBITDA	1,140	958	906	1,135	715
cash conversion	72%	-17%	94%	13%	48%
Free Cash Flow	654	-433	695	-235	151
Free Cash Flow to Equity	979	-478	413	2	-207

Not a surprise that at the next result, LLC no longer provided that slide

Despite that slide appearing in every result and investor day presentation from 2013 to February 2016, at the next result (August 2016), the **slide was no longer in the presentation**. Instead, the company would announce it would "re-segment" its divisions from FY17.

It is convenient that **FY17 was supposed to be cash positive** in all businesses and in its business as a whole, but then handed down **operating cash flow of only $146m**; only to then exclude the slide from presentations and also re-segment earnings to make comparison more difficult.

In our view, this a further example of how LLC's disclosure is self-serving and only selectively applied

Working capital position

Receivables	**FY14**	**FY15**	**FY16**	**FY17**
Trade receivables	1,247	1,122	1,163	1,241
Retentions	204	335	307	326
Current receivables	**1,451**	**1,457**	**1,470**	**1,567**

Creditors	**FY14**	**FY15**	**FY16**	**FY17**
Trade creditors	2,594	2,775	2,965	3,414
Construction revenue – amounts due to customers	601	743	575	702
Retentions and deferred payments (current)	381	710	561	571
Current creditors	**3,575**	**4,229**	**4,101**	**4,687**

Inventory	**FY14**	**FY15**	**FY16**	**FY17**
Development properties	581	1,115	1,020	1,163
Construction work in progress	756	858	894	976
Other	9	7	9	13
Total current	**1,346**	**1,980**	**1,923**	**2,152**

PLLACes

A contributing factor for apartment settlements not flowing through to a working capital release is that many of these cash flows have already been pre-sold (PLLACes). PLLACes transactions involve selling the presold apartment cash flows for a specific development project to a third party for cash consideration. Our understanding this is made to banks who receive a slightly better interest rate than on debt. LLC takes the first 10% of settlement risk. This is essentially debt.

PLLACes	FY15	FY16	FY17
Concavo	185		
Darling Square	365	365	365
Toorak park		335	335
Elephant & Castle			225
Total	**550**	**700**	**925**
Δ PLLACes	550	150	225

PLLACes are disclosed in the annual report under “Other”

Financial Disclosure	June 2017 A$m	June 2016 A$m
Current		
Trade creditors	3,413.9	2,964.6
Construction revenue – amounts due to customers	702.1	575.1
Insurance claim reserve	21.3	18.8
Related parties		4.8
Retentions and deferred payments	571.2	561.4
Other[1]	870.3	204.1
Total current	**5,578.8**	**4,328.8**
Non Current		
Insurance claim reserve	10.0	9.4
Retentions and deferred payments	783.4	775.9
Other[1]	978.7	1,124.1
Total non current	**1,772.1**	**1,909.4**
Total trade and other payables	**7,350.9**	**6,238.2**

1. Includes unearned income liabilities from PLLACes transactions. PLLACes transactions involve selling the presold apartment cash flows for a specific development project to a third party for cash consideration.

Source: LLC

It is important to note that these developments are essentially 100% debt funded; but the “debt” is not shown on LLC’s balance sheet because the PLAACes are considered a Creditor. This also implies there is zero cash flow upside from settlements; only downside in the event that apartments are not settled.

As below, it is correct to say that inventory is increasing and there is likely future margin imbedded in that inventory. That said, you need to analyse the balance sheet overall and see that creditors are outpacing inventory, mostly driven by trade creditors and “other creditors”.

Working Capital	FY14	FY15	FY16	FY17
Trade receivables	1,247	1,122	1,163	1,241
Retentions	204	335	307	326
Current receivables	**1,451**	**1,457**	**1,470**	**1,567**
Trade creditors	2,594	2,775	2,965	3,414
Construction revenue – amounts due to customers	601	743	575	702
Retentions and deferred payments (current)	381	710	561	571
Current creditors	**3,575**	**4,229**	**4,101**	**4,687**

Creditor growth is outpacing inventories

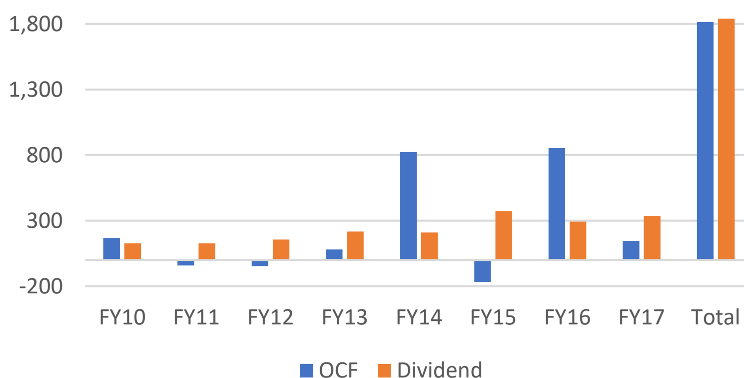
Inventories	FY14	FY15	FY16	FY17
Current				
Development properties	581	1,115	1,020	1,163
Construction work in progress	756	858	894	976
Other	9	7	9	13
Non current Development properties	1,786	2,124	2,975	2,975
Total inventories	**3,132**	**4,104**	**4,898**	**5,127**
Δ		*973*	*794*	*229*
Trade creditors	2,594	2,775	2,965	3,414
Construction revenue – amounts due to customers	601	743	575	702
Insurance claim reserve	17	18	19	21
Related parties	127	254	5	0
Retentions and deferred payments (current)	381	710	561	571
Other	316	536	204	870
Total current creditors	**4,034**	**5,036**	**4,329**	**5,579**
Insurance claim reserve	16	15	9	10
Retentions and deferred payments	329	756	776	783
Other	378	815	1,124	979
Total creditors	**4,756**	**6,622**	**6,238**	**7,351**
Δ		*1,866*	*-384*	*1,113*

Why the dividend is likely unsustainable

As above, **dividends** appear unsustainable as they **are not driven by operating cash flow**, rather asset sales.

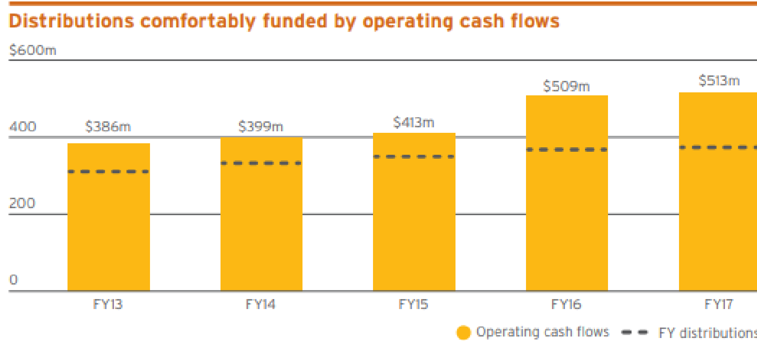
This is especially evident in FY17 where the result was driven by non-cash profits i.e. revaluations and profit from asset sales and not operating / cash earnings

- There also appears to be a common misconception that LLC has invested more in its pipeline than it has effectively sold. This does not appear accurate (which is discussed in detail in the prior section on working capital).
- As per the above cash flow reconciliation, FY10-17 investing cash flow is an outflow of $1.2b, which is approximately equal to the ~$1.3b inflow from Bluewater, which was carried as inventory and therefore recorded in operating cash flow. In any case the production capital was invested long before this timeframe.



From FY10 (below), OCF is approximately equal to dividends, but as detailed above OCF is inflated by ~$1.3b of Bluewater cash. Adjusting for this, OCF = ~$600m vs dividends/ distributions of $1.8b.
That is, in the absence of selling assets, LLC cannot pay its dividend out of cash from the business.
A key driver of this is that it sets is distribution policy as a % of NPAT and not FFO.

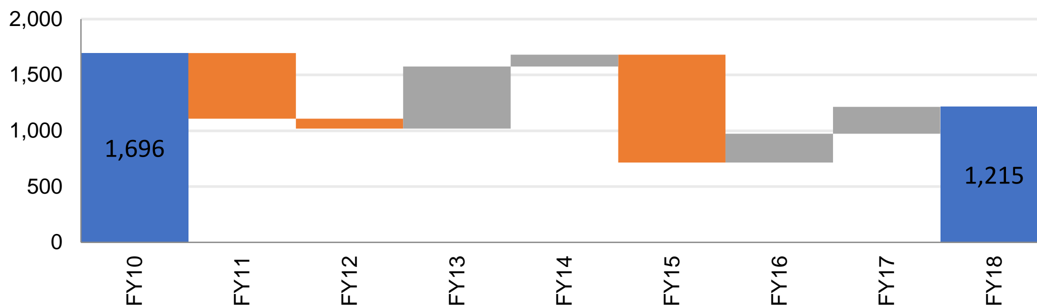
Compare this to Mirvac, for example, where distributions are covered by operating cash flow.



Source: MGR

This is why despite $6b of EBITDA LLC has not significantly de-geared through this period

Net change in cash ($m)



Selling "winners" and keeping "losers" is the reason P&L profit is high and cash flow is low

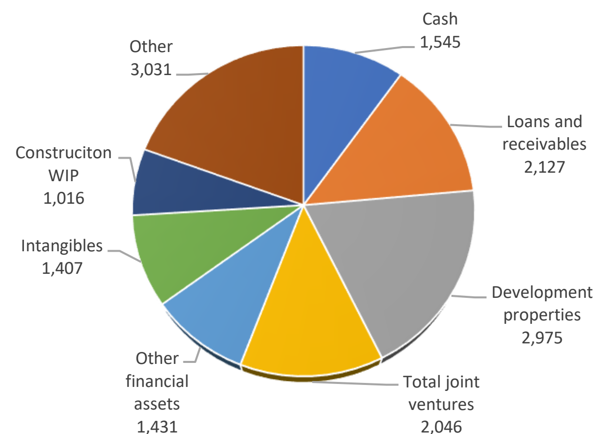
LLC has disposed of $3.3b of consolidated assets since FY13, primarily these consist of Aged Care, Bluewater, PPP, Retirement. Our hypothesis is that is has sold its high cash generating businesses and retained its low cash generating businesses and that is why its cash flow is poor vs statutory profits.

Balance sheet marked up, stock trading 77% premium, paying for value that is not there

At 1H18 LLC had $15.6b assets. The major items are summarised in the adjacent chart.

In our view, given accounting methodology, most of LLC's asset base is marked to market:

- Other Financial Assets of $1,431m and Total joint ventures of $2,046m were revalued at the 1H18 result.
- Development properties $2,975m likely has embedded margin.
- There may be risk to construction WIP and receivables.



LLC Balance sheet at 31 December 217 ($m)

Balance sheet breakdown ($m)

	1H18	Item	Comment
Current Assets	1,545	Cash and cash equivalents	
	2,127	Loans and receivables	
	686	Development properties	
	1,016	Construction work in progress	WIP is a risk
	12	Other	
	2	Other financial assets	
	105	Other assets	
	724	Loans and receivables	
Cost	2,975	Development properties	Only balance sheet item that has upside
Equity Accounted	222	Total associates	
	2,046	Total joint ventures	marked to market at 31 December 2017
Cost	74	Retail property	
	105	Telecommunication towers	
	379	Assets under construction	
Measured at Fair Value	26	Lendlease Asian Retail Investment Fund	marked to market at 31 December 2017
	38	Parkway Parade Partnership Limited	
	188	MHPI	
	447	Lendlease International Towers Sydney Trust	
	230	Lendlease One International Towers Sydney Trust	
	72	Australian Prime Property Fund – Industrial	
	285	Australian Prime Property Fund – Commercial	
	77	Australian Prime Property Fund – Retail	
	41	Lendlease Public Infrastructure Investment Company	
	28	Other Unlisted Investments	
	149	Deferred tax assets	cash flow / market prices unlikely support value
	425	Property, plant and equipment	
	1,407	Intangible assets	
	81	Defined benefit plan asset	
	67	Other assets	
Total Assets	**15,578**		

Valemus

The acquisition of Valemus in FY11 is endemic of what we believe to be a business model of capitalising expenses and taking profits (but rarely losses) through its P&L. The result of this being high profits and low cash flow. It may also be evidence of aggressive accounting and selective disclosure. It is also representative of one of the more questionable accounting practices of recording the difference between net assets and amount paid as “goodwill” (not specific to LLC).

Mostly a building business (which LLC already had in Bovis), Valemus was acquired for ~$1b. **Had Valemus not been acquired, FY12 EBITDA ($810m) would have been ~26% lower ($598m) and ~27% lower than FY11**. Reason being, that LLC sold a cash-generating asset in King of Prussia (added $102m out of $493m FY11 profit), which needed to be replaced, as well as the income King of Prussia generated.

In what we believe is endemic across the business: the practice of framing information that appears to mislead investors, the slide presentation of the acquisition appears to justify this view, in our opinion. The claim that its gearing post-acquisition would be ~5.8% using Valemus’ cash balance some 2.5 months prior to the announcement of the acquisition and three months before LLC would complete the transaction / be entitled to profits is not accurate.

Valemus had a significant negative working capital balance. That is, payables far exceeded receivables (common for that type of business). As such, LLC would have to fund that difference (likely in the range $200-300m).

In addition to the acquisition price, a further $95m was contracted to be paid and not included in that calculation.

Impact of the transaction	▪ The transaction is expected to provide ~15% EPS accretion on a full year basis in the first full financial year ending 30 June 2012 ▪ Lend Lease's gearing post the acquisition is expected to be approximately 5.8%, taking account of significant Valemus cash balances of $539m as at 30 September 2010 ▪ Lend Lease expects that its current investment grade credit rating with S&P and Moody's (BBB-/Baa3 with a stable outlook) will be maintained following the acquisition ▪ Lend Lease retains its capacity to deliver on its existing development pipeline ▪ Lend Lease will be receiving a full indemnity with regard to the Westpoint litigation

1.A further payment of A$80m plus A$5m per month from 1 October 2010 to completion will be made in lieu of 2010 profits not distributed. Lend Lease will be entitled to all profits from 1 January 2010 onwards

SOURCE: LLC

Acquiring a construction business was a good way to fill a hole in earnings, because it would not yet be known those earnings were not "real". **Less than two weeks after LLC handed down its FY12 result it revealed to the market there were issues with Abigroup's accounts; namely a problem project not brought to account**. In typical fashion, rather than disclose this "downgrade" LLC simply advised the market it was not "material" to the group.

- **FY12 operating cash flow was negative $46m vs EBITDA of $810m**

This is another example that LLC's disclosures are self-serving and selectively applied

Also, in the FY12 result, contributing to the poor cash performance was that LLC used its discretion (without calling it out) to recognise a $42m profit in FY12, recognised under acquisition accounting (writing up goodwill).

On the Australian construction business LLC said:

- "*Infrastructure business result above expectation*"
- "*Strong performance from infrastructure business with FY12 earnings accretion exceeding expectations*"

FY12 write-up of Australian Construction Goodwill

Construction	
Carrying amount at beginning of financial year	1,056.3
Acquisition of consolidated entity	
Fair value adjustment on finalisation of goodwill on acquisition	42.0
Effect of foreign exchange rate/other movements	14.0
Carrying amount at end of financial year	**1,112.3**

Source: LLC

Yet, as above, less than two weeks after LLC handed down its FY12 result, **after revising the value of goodwill up, it downgrades earnings which leads to its CEO and CFO leaving the company**. The new CEO, LLC would later blame for the next material downgrade (according to Macquarie).

In addition, the $42m "accounting" profit is larger in quantum than the costs LLC selectively chose to disclose:

- Settlement of NY investigation = $21m
- Inventory impairment = $39.5m
- FX impact = $8.5m

Australian Construction

LLC downgrades earnings again

Construction illustrates this point and how discretion with accounting can lead to higher profits without the corresponding cash contribution. This is illustrated by many periods of poor performance and Construction goodwill remaining unimpaired. That is: marking up its winners, but not its losers.

According to the LLC accounts, total construction EBITDA FY10-17 is $2.4b vs Group EBITDA of $6.0b.

Group Operating cash flow less cash interest and cash tax (cash flow from operations) over that period is $1.8b.

Construction EBITDA should cash backed. If LLC construction EBITDA is cash backed, its contribution to cash flow from operations should be in the vicinity of EBITDA of $2.4b. As above, **group cash flow from operations is only $1.8b**. Something appears obtuse.

- As a point of comparison, CIMIC, at FY17 reported cash flow from operations of $1.5b, an EBITDA conversion rate of 101%; 110% in FY16; and 139% in FY15.

Rather than tell the market the full story about why its businesses are underperforming, the company refuses to provide details, or it blames previous management

Quoting from Macquarie's research piece dated 17 October 2017: "***LLC indicated all problematic projects were legacy projects that had been mispriced by the prior construction management team***".

- As above, LLC held a webcast / call with the market on 28 April 2017, presented by the new CEO Engineering & Services.

At no point did the Engineering CEO allude or make reference to *any* issue with the bidding of projects. In fact, a portion of that presentation was devoted to the risk management the company had in place. "*You know, risk management is really important and it really goes across the whole project lifecycle and that includes way before we even start bidding the project…*"

Nonetheless, if there were any issues with the bidding process of previous management, wouldn't it have been captured by the:

- Monthly reviews
- Quarterly Business Review Process: management meetings to review/manage business financial and operational performance
- Limits of Authority: framework of limits to restrict and monitor the ability of employees to expose Lendlease to risk
- Investment Committee: detailed review of resources, budget, risks and capital strategy at regional and Board level
- Centre of Excellence: provides knowledge sharing, governance and operational excellence and expertise at all stages
- Capabilities: assessment of experience, expertise, technical proficiency, capacity of people involved at each stage to guarantee execution excellence

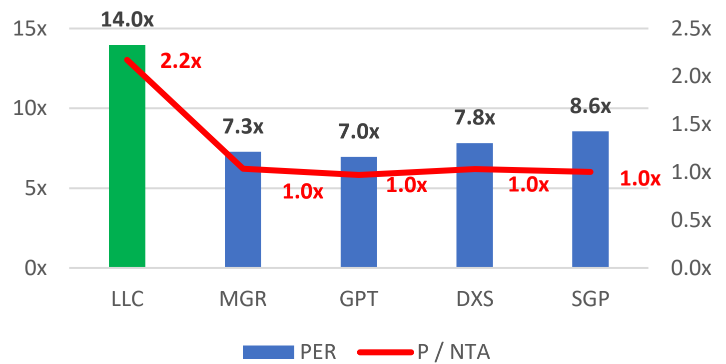
It should be noted that **all these things were in place when these problem projects were bid**. Not only that, **LLC has the same CEO, CFO** (current CFO was an employee, albeit a different person) **and the same Chairman**. Further, the timing of the disclosed project issues on the same day as announcing the retirement sale. If, as LLC states, conducts "monthly reviews", "quarterly business reviews" etc, it is convenient timing to unveil a downgrade to its Australian Construction business, which was later revealed to be a ~$164m lower profit than the pcp and revealed that **multiple projects** were underperforming; or **20% (~$1b) of its orderbook**. For multiple projects of $1b value to be underperforming, given the above focus on risk, to arise at the same time needs further analysis.

See Appendix for LLC's slides on risk management

LLC and comps / market earnings are Apples and Oranges

Most analysts appear to believe LLC is cheap on a relative PE basis. However, this is erroneous.

- Measuring on a **like-for like** basis, **LLC is materially more expensive** on PER than its peers.
    - The average PER of its peers is 7.4x.
    - If LLC traded at the peer average its share price would be **$9.94** vs current share price of $18.19. ~**45% downside**



- Cross reference Price / NTA:
    - Peers trade ~1x
    - If LLC traded at the peer average its share price would be **$8.69** vs current share price of $18.19. **~52% downside**

There is a simple explanation for this… Framing

Stockland, Mirvac and GPT all present FFO or cash earnings; "operating profit". **Operating profit** is the relevant number.

If that is used in the denominator, SGP = 14.2x; MGR = 17.0x and GPT = 15.6x. But one can't take those multiples and apply it to LLC earnings, because Operating Profits of **SGP, MGR and GPT exclude** items such as: Commercial Property revaluations and Mark-to-market gains/losses on financial instruments; which are **included by LLC**.

rfm

How do peers present earnings?

FFO

Reconciling Cash from operating activities (CFOA) and net income to show non-cash profit and working capital movements shows Cash from operating activities is a better measure of FFO than Net Income.

As such, in the absence of a detailed reconciliation from statutory net profit to FFO (as detailed by LLC's peers as per the PCA), it appears reasonable to use CFOA as a proxy for FFO.

- LLC has averaged **$227m CFOA vs $598m statutory NPAT**
- FFO likely lands within this range but should demonstrate using statutory NPAT as the dominator in comparing metrics like PER and ROE is misleading.

If LLC moved to industry practice and reported on FFO, with a similar reconciliation as peers / industry practice, the market would likely have a different view of the value of LLC's equity

LLC is the only one of its peers that does not adjust its earnings to represent "underlying and recurring" earnings from its operations or present "FFO".

This "framing" or "presentation" or asymmetrical treatment has widened the gap between LLC's market value and intrinsic value.

$ million	FY16	FY17	Change
Development	500.2	552.4	10%
Construction	288.1	338.3	17%
Investments	457.7	495.3	8%
Operating EBITDA	**1,246.0**	**1,386.0**	**11%**
Corporate costs	(191.1)	(184.2)	4%
Group EBITDA	**1,054.9**	**1,201.8**	**14%**
Depreciation and amortisation	(82.7)	(98.2)	(19%)
EBIT	**972.2**	**1,103.6**	**14%**
Net finance costs	(109.4)	(96.6)	(12%)
PBT	**862.8**	**1,007.0**	**17%**
Income tax expense	(164.7)	(248.3)	(51%)
External non-controlling interests	0.1	(0.1)	-
NPAT	**698.2**	**758.6**	**9%**

rfm

Contrast the current "framing" or presentation of LLC results with its historical presentation when it wanted to split out the "negatives":

Results Summary

	Revenue		EBITDA		Profit/(Loss) After Tax[1,2]	
	June 2009 A$m	June 2008 A$m	June 2009 A$m	June 2008 A$m	June 2009 A$m	June 2008 A$m
Retail	125.8	130.7	86.0	79.4	60.3	66.1
Communities	586.4	969.5	70.0	124.0	88.3	100.3
Public Private Partnerships	1,507.0	962.7	66.7	46.0	74.4	59.0
Investment Management	69.1	127.3	35.3	151.2	28.9	137.3
Project Management and Construction	12,422.0	12,426.8	251.6	201.7	168.9	150.0
Total operating businesses	**14,710.3**	**14,617.0**	**509.6**	**602.3**	**420.8**	**512.7**
Group Services	23.4	7.6	(80.6)	(86.2)	(67.8)	(59.0)
Group Treasury	51.3	53.3	(17.2)	1.0	(41.4)	(14.8)
Group Amortisation					(4.1)	(3.0)
Total corporate	**74.7**	**60.9**	**(97.8)**	**(85.2)**	**(113.3)**	**(76.8)**
Total operating	**14,785.0**	**14,677.9**	**411.8**	**517.1**	**307.5**	**435.9**
Inventory carrying value adjustments			(226.1)	(121.5)	(188.3)	(121.5)
Goodwill impairments			(252.9)		(252.9)	
Other carrying value adjustments			(233.0)		(204.7)	
Property investment revaluations[3]			(325.7)	(69.2)	(263.0)	(60.2)
Savings implementation costs			(120.8)		(83.9)	
Net gain on Bovis UK pension scheme curtailment			44.3		31.7	
Total statutory	**14,785.0**	**14,677.9**	**(702.4)**	**326.4**	**(653.6)**	**254.2**

Source: LLC

Brookfield is precedence of reporting FFO and segment FFO

There is also precedence for non-property companies to use FFO. One is the recently spun-off Brookfield Business Partners (BBU), which is a portfolio of assets including 100% of Multiplex and minority interests in a range of other business (commercial and residential real estate; fuel distribution; Industrials: including manufacturing, metals & mining and water supply; and oil & gas). Multiplex is one of LLC's biggest construction competitors in Australia and London.

BBU has excellent disclosure in its Annual Report and earnings presentations. BBU uses "Company Funds From Operations (Company FFO)" and describes it as:

- "a key measure of our financial performance and we use Company FFO to assess operating results and our business performance. Company FFO is a non-IFRS measure which does not have any standard meaning prescribed by IFRS and therefore may not be comparable to similar measures presented by other companies.
- Company FFO is calculated as net income excluding the impact of depreciation and amortization, deferred income taxes, breakage and transaction costs, non-cash gains or losses and other items".

Statements of Operating Results

US$ MILLIONS, unaudited	Three Months Ended December 31, 2017	Three Months Ended December 31, 2016	Year Ended December 31, 2017	Year Ended December 31, 2016
Company EBITDA by segment				
Business Services	$ 35	$ 20	$ 83	$ 69
Construction Services	4	35	20	104
Industrial Operations	36	(1)	87	11
Energy	46	17	91	72
Corporate and Other	(13)	(8)	(41)	(16)
Company EBITDA	$ 108	$ 63	$ 240	$ 240
Company FFO by segment				
Business Services	$ 22	$ 19	$ 66	$ 54
Construction Services	—	31	26	94
Industrial Operations	23	(2)	132	6
Energy	26	16	52	63
Corporate and Other	(3)	(9)	(24)	(17)
Company FFO	$ 68	$ 55	$ 252	$ 200

Statements of Financial Position

US$ MILLIONS, unaudited	As at Dec 31, 2017	As at Dec 31, 2016
Net debt by segment		
Business Services	$ 327	$ 132
Construction Services	(234)	(162)
Industrial Operations	361	164
Energy	151	188
Corporate and Other	(392)	(573)
Net debt	$ 213	$ (251)
Equity attributable to unitholders by segment		
Business Services	$ 448	$ 357
Construction Services	959	877
Industrial Operations	661	372
Energy	660	344
Corporate and Other	310	551
Equity attributable to unitholders	$ 3,038	$ 2,501

Reconciliation of Proportionate Operating Results to Consolidated Operating Results

For the THREE MONTHS ended DECEMBER 31, 2017 US$ MILLIONS, unaudited	Attributable to unitholders: Business Services	Construction Services	Industrial Operations	Energy	Corporate and Other	Total	Attributable to Non-controlling Interest	As per IFRS Financials
Revenues	$ 1,213	$ 1,272	$ 146	$ 36	$ 2	$ 2,669	$ 5,710	$ 8,379
Direct operating costs	(1,159)	(1,254)	(102)	(21)	—	(2,536)	(5,498)	(8,034)
General and administrative expenses	(23)	(14)	(8)	(3)	(15)	(63)	(44)	(107)
Equity accounted Company EBITDA[1]	4	—	—	34	—	38	6	44
Company EBITDA	$ 35	$ 4	$ 36	$ 46	$ (13)	$ 108	$ —	$ —
Realized disposition gain (loss), net[2]	—	—	—	—	—	—	—	—
Interest expense	(6)	—	(11)	(3)	(1)	(21)	(46)	(67)
Equity accounted current taxes and interest[1]	—	—	—	(12)	—	(12)	(1)	(13)
Current income taxes	(7)	(4)	(2)	(5)	11	(7)	(4)	(11)
Company FFO	$ 22	$ —	$ 23	$ 26	$ (3)	$ 68	$ —	$ —
Depreciation and amortization expense						(37)	(72)	(109)
Impairment expense, net						(9)	—	(9)
Realized disposition gain (loss) recorded in prior periods[2]						—	—	—
Other income (expense), net						(57)	(15)	(72)
Deferred income taxes						10	6	16
Non-cash items attributable to equity accounted investments[1]						(20) $	(3)	(23)
Net income						$ (45)	$ 39	$ (6)

Source: BBU

Skanska is LLC's closet global comparable

Skanska's operations cover construction and development of commercial property, residential and public private partnership (PPP) projects in the Nordic region, Europe and USA. It competes directly with LLC in London and the US.

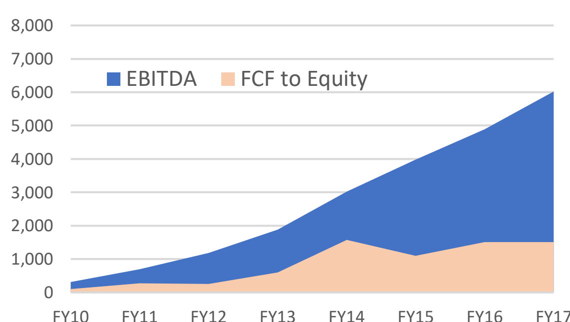
> Market cap- LLC: A$10.5b vs Skanska A$10.8b
>
> Free Cash Flow to Equity (8 years)- LLC: A$1.5b vs Skanska: A$4.7b

It is also worth noting how detailed Skanska's disclosure is in its Annual Report and Quarterly, which we take snapshots in the Appendix.

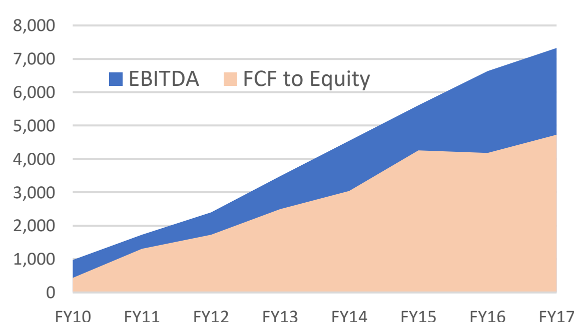
The **market is valuing LLC at a similar market cap to Skanska (~A$11b), which appears completely unjustified** given the comparison of cash flow generation and returns to equity.

We believe this is as the result of the Australian market capitalising marked-to-market earnings of earnings that its peers do not report. As below, the cash flow returns to equity are materially different, with **Skanska generating Free Cash Flow to Equity of A$4.7b vs LLC of A$1.5b** over the same 8-year period. Likely for this reason, Skanska trades ~2.5x book and also generates ~20% ROE.

LLC A$'000: EBITDA vs FCF to Equity



Skanska A$'000: EBITDA vs FCF to Equity



As analysed, in 8 years LLC has reported EBITDA of $6.0b and cash flow from operations of $1.8b. Compare this to Skanska, which has reported A$7.3b and cash flow from operations of $4.4b.

Accounting methods / discretion are materially different

Firstly, Skanska has impaired Construction goodwill materially over time. Secondly, Skanska does not "fair value" account its investments and financial assets. This is one contributing factor to it trading at a multiple of book value.

For example, "Investments in joint ventures and associated companies" is mostly Skanska's investments in PPP's (Note 20B). Consolidated carrying amounts represent Skanska's share of the equity including results achieved, Group adjustments and deductions for dividends provided.

Skanska non-current Assets (SEK m)

SEK M	Note	Dec 31, 2017
ASSETS		
Non-current assets		
Property, plant and equipment	17, 40	6,874
Goodwill	18	4,554
Other intangible assets	19	962
Investments in joint ventures and associated companies	20	3,314
Financial non-current assets	21	2,276
Deferred tax assets	16	1,757
Total non-current assets		**19,737**

Unrealised development gain in Infrastructure Development

SEK bn	Dec 31, 2017	Dec 31, 2016
Present value of cash flow from projects	3.8	5.2
Present value of remaining investments	–0.8	–0.9
Present value of projects	**3.0**	**4.3**
Carrying amount before cash flow hedging	–2.5	–2.9
Unrealized development gain	**0.5**	**1.4**
Cash flow hedges	0.6	0.6
Effect on unrealized equity [1]	**1.1**	**2.0**

1 Tax effects not included.

Contrast this to LLC's "fair value" accounting treatment of its US Military Assets. Putting aside the debate about what are profits, cash-profits, recurring / non-recurring; companies that are not using "fair value" or mark-to-market accounting should justifiably trade at a premium to book because the market value of realisable value exceeds book value. This argument cannot be had for LLC, as demonstrated.

As in the example of US Military Assets and Balfour Beatty above, Balfour Beatty does not classify its PPP assets at fair value and is why the carrying value of all PPP assets at 31 December 2017 was £163m vs directors valuation of £1,240m. Like Skanska, this is a driver to why Balfour Beatty trades ~2x book. We have included similar disclosure from LLC in the appendix showing assets accounted at fair value.

LLC in not an Industrial

LLC should not be compared to an Industrial with respect to Price/Earnings. The litmus test here is cash flow. Industrial companies, over time, should have cash conversion = 100%. As below, Skanska's cash conversion = 117% over the below period.

Construction

SEK M	2017	2016	2015	2014	2013
Revenue	150,050	138,001	140,648	128,663	118,976
Operating income[1]	1,205	3,546	3,874	4,508	3,880
Operating margin %	0.8	2.6	2.8	3.5	3.3
Free working capital, SEK bn	21.8	22.5	20.5	18.1	18.5
Operating cash flow	2,136	4,562	6,803	2,979	3,470

Source: Skanska FY17 Annual Report

As such, comparing LLC to a multiple of the ASX 200 is chalk and cheese. By and large, ASX 200 companies or industrials / financials strip many of the earnings LLC includes: profits from asset sales, revaluations and unrealised profit and losses from management self-assessment of illiquid assets.

Statutory earnings, in most parts, are useless with respect to analysing companies. Further, the earnings denominator used in "market" calculations is not on statutory earnings, but earnings as complied by Bloomberg (or another data provider) where analysts strip out many of the positive earnings contributors LLC reports.

Capitalising non-cash profits results in LLC trading at a completely unjustifiable level.

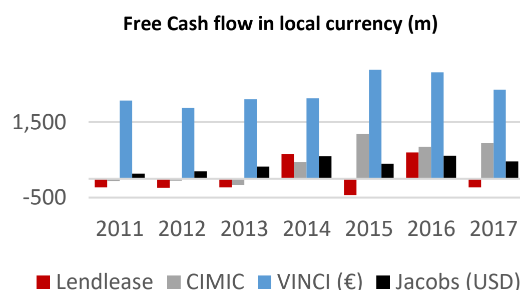
We picked 3 global industrials to demonstrate the difference: CIMIC (CIM AU), VINCI (DG FP) and Jacobs (JEC US) and display Free Cash Flow in local currency. CIMIC is LLC's closest local comparable given it performs construction, property development and owns / develops PPP assets. Jacobs is a global consulting company across Aerospace & Technology; Buildings & Infrastructure; Industrial; and Petroleum & Chemicals. VINCI is a construction company as well as developing and owning assets.

- **LLC has generated Negative $13m free cash flow in 7 years**

7-year Free Cash Flow Total vs Market Cap (m)

	Total	Mkt Cap
Lendlease (AUD)	-13	10,594
CIMIC (AUD)	3,140	14,838
VINCI (€)	16,239	49,925
Jacobs (USD)	2,711	8,179

Free Cash flow in local currency (m)



CIMIC was savaged by the market when it began to report poor cash flow, driven by injecting money into HLG, providing security over loans, PPP equity losses, major project losses and a massive receivables build. It has still generated ~$3b more cash than LLC.

- Incidentally, CIMIC faces a $500m write down when it adopts AASB 9 and $900m write-down when it adopts AASB 15.

We have reconciled LLC's non-cash profits from P&L to cash flow statement in the Appendix.

Summary

1. We believe there is significant discretion in recognising profit and management are rewarded on the easier to manipulate metrics.

    - We have illustrated how $289m out of $721m 1H18 “EBITDA” was as a result of discretion and does not reflect the performance of the business or what management is control of.
    - We have further illustrated this behaviour is systemic over the years and is not consistent with peers. We have provided exhaustive analysis and comparison of LLC’s revaluation of its US Military Assets and the difference between the way LLC recognises profits and value of assets on the balance sheet, while its peers do not (Balfour Beatty, Skanska).

2. We believe Management KPI’s are geared toward share price returns and statutory profits as opposed to operating and cash performance; which has resulted in *convenient* timing of asset sales and aggressive accounting.

    - Bluewater is case and point where, despite telling the market it would not sell its stake in the asset in FY14, management sold Bluewater five days prior to the end of the financial year. In doing so it received as “outstanding result” on its financial KPI’s, despite the fact the investment and development and subsequent value creation of Bluewater occurred many years before and without the sale, NPAT would have decreased by 39%.

3. When LLC cannot generate operating earnings to meet the market’s expectations it sells assets, reclassifies assets and writes up its balance sheet through unrealised profits.

    - We believe we have illustrated that LLC’s results are framed such that analysts and the market are misled and deceived to thinking that LLC is handing down extraordinary results. In our view, the sale of its stake in JEM on 17 June 2013 at the same time as announcing downgrades to EMEA & Australia Construction; and the announcement in October 2017 that was later revealed to be a downgrade in the vicinity of $150m.
    - We believe LLC’s announcements to the market are disingenuous, if not misleading and that its disclosure is selective and self-serving. We believe this warrants a material share price discount.

4. Asset sales should have turned into cash, yet LLC has generated only $93m free cash flow in 8 years.

    - We have performed extensive analysis on LLC’s balance sheet and cash flow and compared the company to local and global firms. In our view, there is little doubt that our suspicions are correct, and the stock is materially overvalued.

5. Valuation – we have demonstrated why some companies should trade at premiums to book value given accounting techniques and why LLC specifically should not. LLC has the traits of a company that, arguably, should trade at a discount to book value, as opposed to the completely unjustifiable premium it presently trades. The key reason is the use of “fair value” or mark-to-market accounting. We have provided extensive analysis of comparables to demonstrate this and even found a comparable company that is the owner of the same asset to demonstrate our thesis.

6. In our view, this stock should trade at a discount or at best at book value. This implies a share price of ~$11.00 vs ~$18.00.

Appendix

Carillion

On 16 May 2018, there was a 100+ page report issued by the House of Commons on Carillion, including describing Carillon as "*a story of recklessness, hubris and greed*", with directors paying out dividends based on profits that were supported by exploiting its suppliers and even describing Carillion's board as "*both responsible and culpable for the company's failure*."

According to the report: Carillion's collapse was sudden and from a publicly-stated position of strength. The company's 2016 accounts, published on 1 March 2017, presented a rosy picture. On the back of those results, it paid a record dividend of £79 million—£55 million of which was paid on 10 June 2017. It also awarded large performance bonuses to senior executives. On 10 July 2017, just four months after the accounts were published, the company announced a reduction of £845 million in the value of its contracts in a profit warning. This was increased to £1,045 million in September 2017, the company's previous seven years' profits combined. Carillion went into liquidation in January 2018 with liabilities of nearly £7 billion and just £29 million in cash.

It should be noted that Carillion was a consensus "buy" for most of its life on the LSE.

In our view, investors should always pay attention to the difference, over time, of EBITDA to operating cash flow. In our view, the reason is that it will pick up non-cash profit (realised / unrealised).

Below we reproduce Carillion and Lendlease to show this:

CLLN (£m)	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	Total
EBITDA	150	176	167	222	169	219	230	183	**1,516**
OCF	213	175	143	-12	-60	133	90	85	**767**

rfm

LLC ($m)	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	Total
EBITDA	309	386	489	700	1,140	958	906	1,135	**6,022**
OCF	168	-42	-46	81	822	-167	853	146	**1,815**

Reconciling Carilion, it is clear that non-cash profits were driving its impressive profit results, but they were not cash-backed. In our view, **any argument for why operating cash flow is not a relevant measure of business performance (especially over time) is wrong and likely designed to mislead**.

It should not come as a surprise that non-cash profits significantly increased in the years before insolvency. Non-cash profits could not be more relevant.

CLLN (£m)	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	Total
Net Income	132	147	135	149	100	121	133	124	1,041
D&A	68	63	62	62	44	45	45	45	435
Non-Cash Items	-47	-37	-46	-58	-39	-42	-81	-89	-437
+ Stock-Based Comp	4	-4							0
+ Other Non-Cash Adj	-51	-33	-46	-58	-39	-42	-81	-89	-437
Chg in Non-Cash Work Cap	60	1	-9	-165	-166	9	-7	5	-272
+ (Inc) Dec in Inventories	4	-3	20	15	-1	-1	-14	-6	13
+ Inc (Dec) in Other	56	5	-28	-180	-164	10	7	11	-284
OCF	**213**	**175**	**143**	**-12**	**-60**	**133**	**90**	**85**	**767**

Carillion also had a progressive dividend policy for every year since inception in 1999, reflecting its P&L profits and not its cash flow.

Case study: European Construction

An example of why keeping losers results in poor cash flow

As below, Goodwill for European construction remains unchanged (but for FX adjustments) from FY11 at **~$236m** on average **~$11m annual EBITDA**. Any construction business trading on **22x EBITDA** would seem excessive, relative to other construction companies.

A$m	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Goodwill	216	220	222	244	265	241	231
EBITDA	27	32	-20	-25	23	6	32

The below table is from the accounts of business Lendlease Construction (Europe) Limited – which can be found here. There are always limitations to using these filings given holding company structures, related party transactions etc; but they normally provide a reasonably accurate picture operating performance.

The operating company's parent Lendlease Construction Holdings (Europe) Limited's also lodges accounts. Per the accounts, the holdings company has paid only **1 dividend from FY11-17** to its parent (Lendlease Europe Limited), **a £48m in-specie distribution in FY15** "out of distributable reserves following sale of Lend Lease Facilities Management Limited and not out of operating earnings or operating cash flow.

Analysing both accounts, one is able to distinguish non-operating one-offs like the Lancashire impairment.

£m	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Revenue	605.1	545.3	448.5	441.3	524.6	603.8	636.3
Gross profit	45.4	51.0	32.2	18.8	29.0	37.2	42.6
Operating profit	12.9	18.8	-10.8	9.1	3.1	-2.6	18.2
NPAT	12.3	17.0	-4.9	14.0	7.9	0.7	20.2
OCF	19.5	8.8	-67.4	4.0	29.3	-34.0	-8.4
Net assets	66.7	82.5	65.6	79.5	87.2	104.9	122.1
Dividends paid				-13.0			
Equity raised						50.0	
Cash	81.9	90.0	22.0	22.4	51.5	69.0	60.2

We note the following from the operating company:

- **OCF in 7 years totalled NEGATIVE £48m**; which is broadly equal to operating profit.
- Not only that, the business has paid only **1 dividend in FY14 (£13m)**.
- Amounts due from "related parties" = £265m at 30 June 2017 or 42% of revenue.
- Construction WIP sits at 8.3% of revenue.

The FY16 result, should put all uncertainty to rest. Given a **~£50m increase in receivables**, resulting in a **OCF outflow of ~£34m**; Lendlease Construction (Europe) Limited) **raised £50m equity** from Lendlease Construction (Europe) Holdings Limited.

In Lendlease Europe Holdings Limited Annual report, it said: "*No impairment arose as a result of the review of goodwill for the Construction CGU for the year ended 30 June 2016. Based on information available and market conditions at 30 June 2016, a reasonably foreseeable change in the assumptions made in this assessment would not result in impairment of Construction goodwill*".

This is exactly the same statement used in FY15, FY14, FY13, FY12 (but for the dates).

At the Investor Day on 15 October 2015, LLC said about Europe Construction:

"You'll recall that when market conditions got very tight after the financial crisis and margins were being compressed to 1% and 2% for risk work, we decided to stop building revenue in that market because we were going to get caught, and now what's happened with our contemporaries is effectively they locked in construction pricing two or three years ago and have been hit by inflation. A number of players in that market are in a lot of trouble".

- These appear strange comments from the CEO where less than a year later, it was *his* business that was doing a £50m equity raising after declaring an operating loss and a blow out in receivables.
- As can be seen in the table, operating profit in FY15 was breakeven. Which was followed up by a loss in FY16 and an equity raising.

£m	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Revenue	605.1	545.3	448.5	441.3	524.6	603.8	636.3
Gross profit	45.4	51.0	32.2	18.8	29.0	37.2	42.6
Operating profit	12.9	18.8	-10.8	9.1	3.1	-2.6	18.2
NPAT	12.3	17.0	-4.9	14.0	7.9	0.7	20.2

Management has been quizzed significantly over time about the performance of its construction business and most of the time it appears the market infers management's comments about poor profitability to be timing related re revenue recognition.

- There is no mention of £50m equity being injected into the European Construction Business in the FY16 Annual Report, FY16 earnings presentation or the FY16 analyst call.

As discussed and illustrated, there is a reluctance to discuss specific businesses, which appears self-serving and only selectively applied.

- There is no discussion on cash flow or anything really material to one's understanding of the business performance other than for the company to say:

- **Construction** profit after tax decreased by A$19.6million to a A$6.1 million loss after tax. The prior corresponding period included the contribution from the close out and settlement of the Global Renewables Project in Lancashire. Despite contributions from new projects secured and the quality of the backlog revenue that includes the integrated pipeline, market conditions remain challenging; and

How does one reconcile the comments made on 15 October 2015, the commentary above regarding the December-half 2015 result, the result itself and the equity raising in FY16?

In the FY15 Annual Report, LLC comments about Europe Construction included:

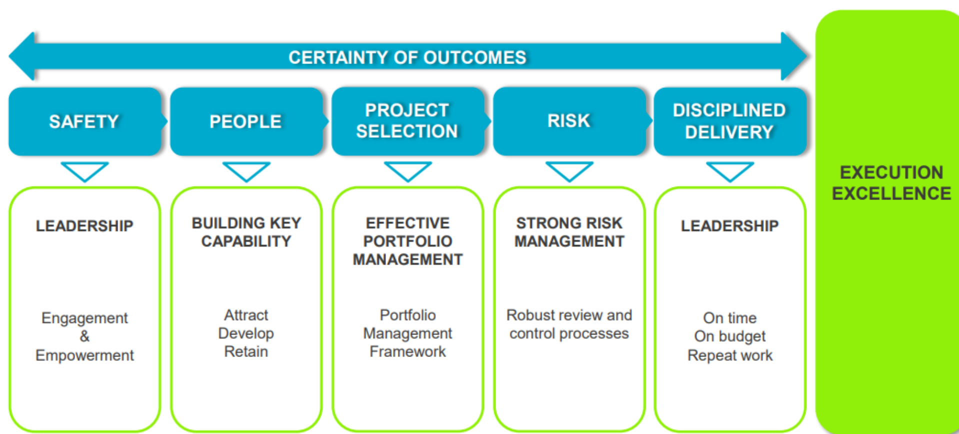
- "Construction Profit after Tax increased by A$42.5 million to A$18.5 million, **due to contributions from key new projects secured and the integrated pipeline**, in addition to the close out and settlement of the Global Renewables project in Lancashire during the year"
- "Gross Profit Margin increase **was driven by the growth in the pipeline of key external and integrated development projects**, in addition to the close out and settlement of the Global Renewables Project in Lancashire during the year".
  - EBITDA was A$23m (1.8% margin), which *prima facie* appears a reasonable result for its business mix and compared to the A$25.1m loss in FY14.
  - However, **this is not operational**, and from analysis of Lendlease Construction (Europe) Limited's accounts appears to have little to do with "*contributions from key new projects secured and the integrated pipeline*"

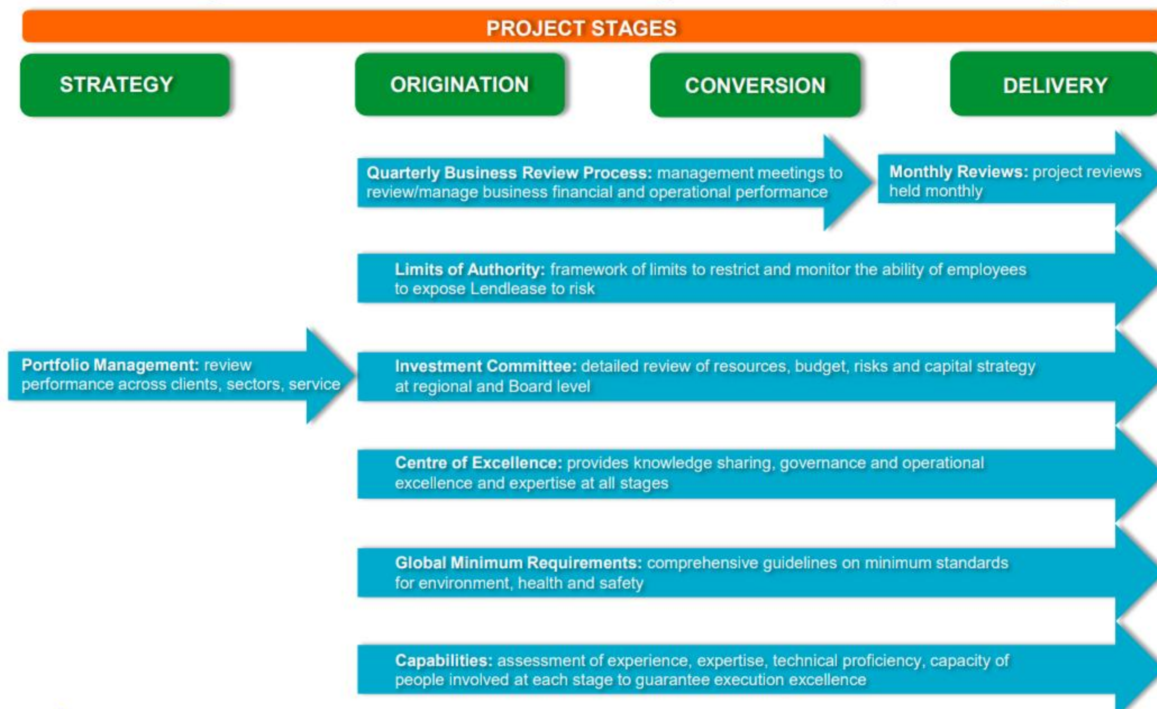
The FY15 result for Construction in Europe needs to be analysed in the context that in the prior period (FY14), LLC took a A$16m post-tax provision for the Global Renewables project in Lancashire.

- From examination of Lendlease Construction (Europe) Holding Limited's accounts it appears there was a £22m "impairment of investments" i.e. it sits outside of the operating business anyway.
- Conveniently there was no disclosure in the LLC accounts of what the "write-back" totalled, but if you assume it was in the same quantum, A$16m post tax = ~A$21m pre-tax vs the result of ~A$23.
    - ➢ Framing the commentary to suggest the key drivers of the result are "*growth in the pipeline of key external and integrated development projects*" appears to contradict the actual results from the "audited" accounts.

This is a further example of how selling "winners" and keeping "losers" results in high P&L profit and cash flow is low.

Australian Engineering "risk management"





Property companies all report FFO

Stockland's FY17 presentation of results and reconciliation to FFO

	FY17 $M	FY16 $M
Statutory Profit	1,195	889
Adjust for:		
Amortisation of lease incentives and lease fees	69	67
Straight-line rent	(6)	(8)
Non-recurring dividend revenue	(71)	–
Commercial Property revaluations (gain)[1]	(264)	(432)
Net change in fair value of Retirement Living investment properties[2]	(6)	24
Mark-to-market (gain)/loss on financial instruments	(118)	171
Net gain on other financial assets	(1)	(4)
Net loss on sale of other non-current assets	1	2
Other items	(3)	1
Tax expense (non cash)	6	30
Funds From Operations (FFO)	**802**	**740**
Maintenance capital expenditure[3]	(53)	(53)
Incentives and leasing costs for the accounting period[4]	(62)	(63)
Adjusted Funds From Operations (AFFO)	**687**	**624**

Stockland provide a full reconciliation between statutory NPAT and FFO (as per PCA guidelines).

There is no opaqueness and therefore no confusion by the market as to its value.

This is reflected by the stock trading around NTA on a consistent basis.

Likewise, Dexus- a full breakdown of what is cash and what is not cash so the market can clearly interpret "operating profit" or cash / FFO.

Reference	Item	30 June 2017 $m	30 June 2016 $m
Statutory AIFRS net profit after tax		1,264.2	1,259.8
Investment property and inventory	(Gains)/losses from sales of investment property	(70.7)	(15.0)
	Fair value gain on investment property	(704.7)	(814.4)
Financial instruments	Fair value (gain)/loss on the mark-to-market of derivatives	91.1	(70.5)
Incentives and rent straight-lining	Amortisation of cash and fit out incentives	49.9	44.7
	Amortisation of lease fees	12.1	8.5
	Amortisation of rent-free incentives	54.9	51.0
	Rent straight-lining	(16.8)	(11.3)
Tax	Non-FFO tax expense	8.0	13.1
Other unrealised or one-off items	Other unrealised or one-off items[1]	(70.3)	144.9
Funds From Operations (FFO)		**617.7**	**610.8**
Maintenance and leasing capex	Maintenance capital expenditure	(57.5)	(76.2)
	Cash incentives and leasing costs paid	(58.6)	(61.9)
	Rent free incentives	(61.9)	(58.8)
AFFO		**439.7**	**413.9**
Distribution		**451.7**	**421.1**
AFFO Payout ratio[2]		**100.2%**	**101.7%**

Contrast Dexus' "Reconciliation of profit to net cash flow from operating activities" with its calculation of FFO

As demonstrated below, adjustments are made for non-cash items such as "Net fair value gain of investment properties" or revaluations and "Net gain on sale of investment properties" or asset sales.

Dexus FY17 ($m)

Net profit/(loss) for the year	**1,264**	**1,264**	**Net profit for the year attributable to stapled security holders**
Capitalised interest	-10		
Depreciation and amortisation	8	5	Amortisation of intangible assets
Net fair value (gain)/loss of investment properties	-458	-705	Net fair value gain of investment properties
Net (gain)/loss on sale of investment properties	-23	4	Net fair value loss of derivatives and interest bearing liabilities
Share of net (profit)/loss of investments accounted for using the equity method	-470	-71	Net gain on sale of investment properties
Distributions from investments accounted for using the equity method	238	100	Incentive amortisation and rent straight-line
Net fair value (gain)/loss of derivatives	101	13	Coupon income, rental guarantees received and other
Net fair value (gain)/loss of interest rate swaps	-10	8	Non-FFO tax
Amortisation of deferred borrowing costs	4		
Net fair value gain/(loss) of interest bearing liabilities	-88	**618**	**Funds from Operations (FFO)**
Provision for doubtful debts	-1		
Change in operating assets and liabilities	102		
Net cash inflow/(outflow) from operating activities	**657**		

It therefore appears reasonable to examine LLC's reconciliation of NPAT to operating cash flow and add-back the identified likely non-cash profits to approximate FFO; which is materially lower than statutory NPAT; consistent with its peers.

LLC $m	**FY14**	**FY15**	**FY16**	**FY17**
Profit after Tax (including External Non Controlling Interests	**823**	**619**	**698**	**759**
Amortisation and depreciation	88	80	83	98
Net gain on sale of investments, plant and equipment	**-21**	**-101**	**-237**	**-120**
Write back of impairment of equity accounted investments	2	-4	-3	-4
Impairment of other financial assets	3	4	3	0
Impairment of property, plant and equipment	2	8	0	2
Net unrealised foreign exchange gain and currency hedging costs	**-9**	**75**	**-2**	**-19**
Net fair value gain on investments	**-18**	**-25**	**-12**	**-55**
Share of profit of equity accounted investments	-59	-20	-152	-78
Dividends/distributions from equity accounted investments	34	18	60	34
Fair value (gain)/loss on investment properties	**-50**	**12**	**2**	**-23**
Other	**-92**	**-109**	**-108**	**-253**
Net cash provided by operating activities before changes in assets and liabilities	**704**	**556**	**332**	**342**
LLC FFO approx.	**635**	**471**	**341**	**290**

12 MONTHS TO 31 DECEMBER ($ MILLION)	2017	2016	CHANGE
Funds From Operations (FFO)	**554.2**	**537.0**	↑ 3.2%
Valuation increases	717.7	611.6	
Treasury items marked to market	(2.9)	(23.0)	
Other items	0.1	27.1	
Net Profit After Tax (NPAT)	**1,269.1**	**1,152.7**	↑ 10.1%

"Funds from Operations (FFO) represents GPT's underlying and recurring earnings from its operations. This is determined by adjusting statutory net profit after tax under Australian Accounting Standards for certain items which are non-cash, unrealised or capital in nature. FFO has been determined in accordance with the guidelines issued by the Property Council of Australia"

	FY16	FY17
Operating profit after tax	**534**	**482**
Funds from operations	547	500
Adjusted funds from operations	487	438
Statutory profit after tax	**1,164**	**1,033**

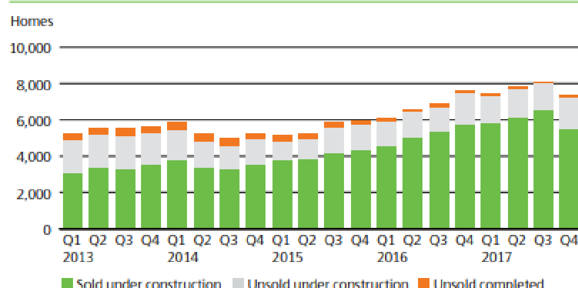
Skanska Development Disclosure

Residential Development

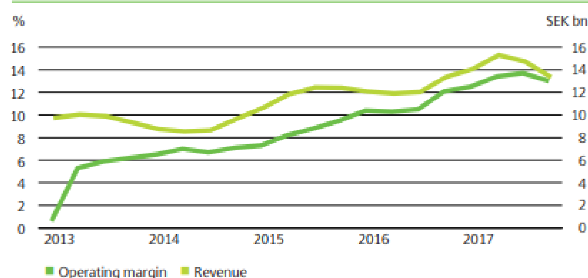
SEK M	2017	2016	2015	2014	2013
Revenue	13,237	13,264	12,298	9,558	9,234
Operating income	1,716	1,605	1,174	683	573
Operating margin, %	13.0	12.1	9.5	7.1	6.2
Investments	-11,093	-9,148	-6,675	-6,871	-6,961
Divestments	11,773	7,517	8,630	8,939	7,980
Operating cash flow from business operations [1]	1,229	-1,210	1,509	1,830	446
Capital employed, average, SEK bn	12.7	11.6	9.3	10.4	10.8
Return on capital employed, % [2]	15.4	17.1	14.4	7.1	7.4
Number of employees	482	434	389	396	419

1 Before taxes, financing activities and dividends.
2 A definition is provided in note 44.

Homes under construction and unsold completed



Revenue and operating margin, rolling 12 months

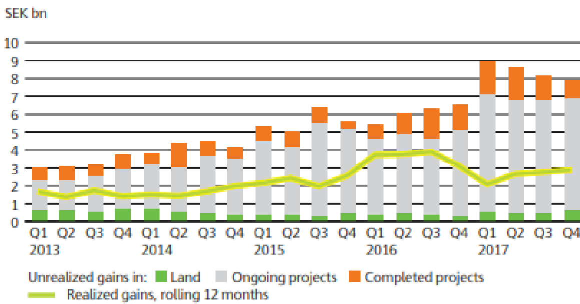


Commercial Property Development

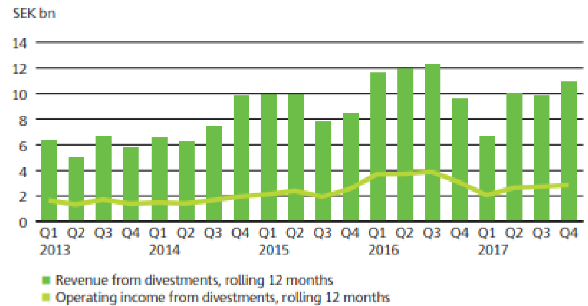
SEK M	2017	2016	2015	2014	2013
Revenue	11,440	10,226	9,034	10,228	6,206
Operating income	2,714	2,336	1,947	1,700	1,068
of which gain from divestments of properties [1]	2,879	3,111	2,564	1,989	1,415
Investments	-10,716	-8,364	-8,826	-6,885	-4,514
Divestments	9,341	9,043	9,914	8,237	6,954
Operating cash flow from business operations [2]	-3,119	-687	917	1,174	1,722
Capital employed, SEK bn	24.5	19.9	16.5	15.0	13.5
Return on capital employed, % [3]	15.5	14.8	15.6	11.4	10.7
Number of employees	389	364	344	304	279
1 Additional gain included in eliminations was	197	173	190	279	112

2 Before taxes, financial activities and dividends.
3 A definition is provided in note 44.

Unrealized and realized gains



Revenue and operating income from property divestments

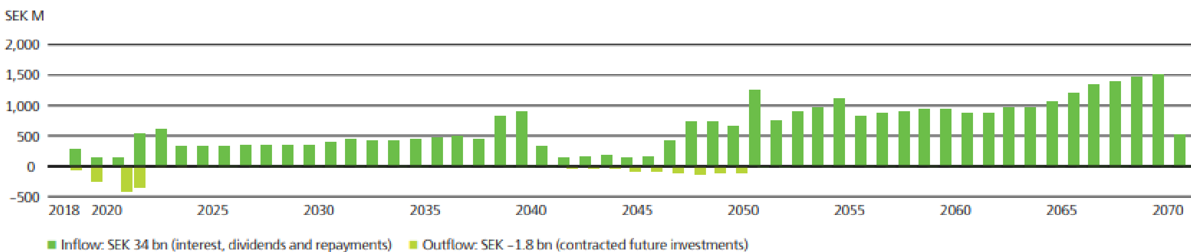


Infrastructure Development

SEK M	2017	2016	2015	2014	2013
Revenue	81	237	106	163	87
Operating income	925	1,818	863	463	401
Investments	-449	-1,336	-234	-328	-75
Divestments	1,950	3,102	1,114	419	242
Operating cash flow from business operations [1]	4,096	-1,045	1,258	-106	108
Capital employed, SEK bn	1.8	5.4	1.8	1.9	2.0
Return on capital employed, % [2]	3.6	41.1	12.7	16.9	17.5
Net present value, project portfolio, SEK bn	3.0	4.3	4.8	5.3	4.9
Employees	94	102	111	127	130

1 Before taxes, financial activities and dividends.
2 A definition is provided in note 44.

Estimated annual cashflow in Skanska Infrastructure Development's project portfolio December 31, 2017[1]



1 Cash flows have been translated into SEK at the exchange rates prevailing on December 31, 2017.

Reconciliation of non-cash P&L in the Income Statement as "other income"

All Revenue from IM, Construction, Development are included in gross profit.

Revenue / income that falls outside buying and selling goods / services is included in "Other income"; i.e.

- Net gains or losses on sale/transfer of investments
- Net gains or losses on fair value remeasurements

In most circumstances, these would be non-cash.

There was additional disclosure in the FY17 annual report as to what "other income" was, in the footnote. Notably: "As disclosed in Note 31 'Related Party Information', the Group transferred the Lendlease Retail LP investment to the Lend Lease UK Pension Scheme in June 2017, which resulted in the recognition of A$61.7 million of plan assets… **and A$23.2 million of revaluation gains released to the Income Statement**".

Income Statement

Year Ended 30 June 2017

	Note	June 2017 A$m	June 2016 A$m
Revenue	4	16,659.0	15,088.5
Cost of sales		(14,841.0)	(13,388.5)
Gross profit		**1,818.0**	**1,700.0**
Share of profit of equity accounted investments	5	77.9	151.6
Other income	6	247.2	256.9
Other expenses		(1,039.5)	(1,136.3)
Results from operating activities		**1,103.6**	**972.2**
Finance revenue	8	12.0	16.8
Finance costs	8	(108.6)	(126.2)
Net finance costs		**(96.6)**	**(109.4)**
Profit before Tax		**1,007.0**	**862.8**
Income tax expense	9	(248.3)	(164.7)
Profit after Tax		**758.7**	**698.1**

Financial Disclosure	June 2017 A$m	June 2016 A$m
Net gain on sale/transfer of investments		
Equity accounted investments		36.8
Other assets and liabilities	2.0	21.5
Consolidated entities[1]	94.5	163.3
Available for sale financial assets	23.2	15.8
Total net gain on sale/transfer of investments	**119.7**	**237.4**
Net gain on fair value measurement		
Investment Properties	22.5	
Fair value through profit or loss assets	55.1	11.9
Total net gain on fair value measurement	**77.6**	**11.9**
Other[1]	**49.9**	**7.6**
Total other income	**247.2**	**256.9**

1. Net gain on sale of consolidated entities includes a A$66.2 million gain on sale of the Circular Quay Tower entities in December 2016 and A$14.7 million gain on sale of Victoria Drive Wandsworth entities in June 2017. Other income includes the related revaluation gain on the retained Equity Accounted Investment in the entities (Lendlease Circular Quay Trust A$16.7 million and Victoria Drive Wandsworth A$16.6 million). The majority of cash was received for these transactions during the year ended 30 June 2017.

2. The Group transferred the Lendlease Retail LP investment to the Lend Lease UK Pension Scheme in June 2017, which resulted in the derecognition of the A$61.7 million investment and A$23.2 million of revaluation gains released to the Income Statement. Refer to Note 6 'Other Income' and Note 31 'Related Party Information'.

There is a more material number in FY16, without the disclosure. i.e. at least 37% of NPAT in FY16 was likely non-cash and one-off.

Disclosure in FY17 at least allowed the breakdown in the adjacent table

	FY17
Gain on sale - Circular Quay tower	66.2
Gain on sale - Victoria Drive Wandsworth	14.7
Transfer Lendlease Retail LP investment to the Lend Lease UK Pension Scheme	23.2
Other gain on sale	15.6
	119.7
Revaluation - Circular Quay Trust	16.7
Revaluation - Victoria Drive Wandsworth	16.6
Other revaluation	44.3
	77.6
Other	49.9
Total Other Income	**247.2**

This is evidenced in the cash flow statement

16. Notes to Statement of Cash Flows

	June 2017 A$m	June 2016 A$m
Reconciliation of Profit after Tax to Net Cash Provided by Operating Activities		
Profit after Tax (including External Non Controlling Interests)	758.7	698.1
Amortisation and depreciation	98.2	82.7
Net gain on sale of investments, plant and equipment	(119.7)	(237.4)
Write back of impairment of equity accounted investments	(4.0)	(3.3)
Impairment of other financial assets		3.4
Impairment of property, plant and equipment	1.5	
Net unrealised foreign exchange gain and currency hedging costs	(18.8)	(25.4)
Net fair value gain on investments	(55.1)	(11.9)
Share of profit of equity accounted investments	(77.9)	(151.6)
Dividends/distributions from equity accounted investments	33.9	59.9
Fair value (gain)/loss on investment properties	(22.5)	2.2
Other	(252.5)	(107.5)
Net cash provided by operating activities before changes in assets and liabilities	**341.8**	**309.2**

- We believe the mismatch between "EBITDA" and Operating cash flow is not working capital driven or a timing issue from the reconciliation of NPAT to OCF before changes in assets and liabilities.
- In FY16 and FY17 the difference between cash and non-cash was **$366m** and **$417m**.
- Some of this difference can be explained, but as displayed, the major drivers are:
  - Net gain on sale of investments, plant and equipment
  - Share of profit of equity accounted investments (will discuss separately).
  - Other

Again management were rewarded for the result and somehow for cash flow

Analysis of the FY17 profit composition and cash flow indicate a poor operating result, but that is not how the LLC board saw it:

June 2017 was A$1,750,000 (being the combined cash and deferred components of his STI), which equated to 100 per cent of the CEO's target STI award. Refer to the table Remuneration Awarded by the Board on page 101 to see the total remuneration awarded to the CEO for 2017.

PERFORMANCE ASSESSMENT

A summary of the result against each financial measure is below:

Profit after Tax	Ahead of Target	Actual Profit after Tax was $758.6 million, up 8.7 per cent on FY16 and ahead of target
EBITDA $	Ahead of Target	An increase of $146.9 million, up 13.9 per cent on FY16 and ahead of target
EBITDA Margin	On Target	7 per cent which was slightly ahead of target
Return on Equity	On Target	At 12.9 per cent the result was towards the upper end of the stated target range of 10 to 14 per cent
Cashflow	Ahead of Target	Strong management of settlement risks and cashflow
Overheads	Ahead of Target	Business efficiencies delivered that saw overheads lower than targeted

The Group continues to deliver results in line with its Portfolio Management Framework achieving or exceeding all financial measures outlined above, with strong Return on Invested Capital (ROIC) performance in the Development and Investments segment and an improving Construction EBITDA margin. These results, combined with a very strong balance sheet that provides future capacity (gearing at 5 per cent and cash and cash equivalents of $1.2 billion), support the Board's assessment of the Group's financial performance as strong.

It is clear the result is poor and driven by non-cash one-offs . At least $247.2m inclusing $78m in revaluations and another material amount that is unidentided ($49.9m).

LLC non-current assets

The majority of LLC's non-current assets are measured at "fair value", with a significant amount using management' own assessment.

Non Current Assets		
Loans and receivables		742.4
Inventories	11	3,171.3
Equity accounted investments	12	2,268.0
Investment properties	13a	557.4
Other financial assets	14	1,430.8
Deferred tax assets		148.9
Property, plant and equipment		424.7
Intangible assets		1,407.2
Defined benefit plan asset		80.8
Other assets		67.3
Total non current assets		**10,298.8**
Total assets		**15,792.0**

13. Investment Properties

	December 2017 A$m	June 2017 A$m
a. Investment Properties – Non Current		
Retirement living properties[1]		6,443.4
Retail properties	73.9	72.6
Telecommuniation towers	104.7	83.3
Assets under construction	378.8	368.1
Total investment properties	**557.4**	**6,967.4**
Reconciliations		
Reconciliations of the carrying amount for investment properties are as follows:		
Carrying amount at beginning of financial period	6,967.4	5,940.7
(Disposal)/acquisition of investment properties	(6,618.8)	218.1
Capital expenditure	135.8	300.2
Fair value gain recognised through the Income Statement	13.8	22.5
Increase attributable to capital gain	49.0	468.8
Foreign exchange rate/other movements	10.2	17.1
Carrying amount at end of financial period	**557.4**	**6,967.4**
b. Resident Liabilities[1]		
Gross resident liabilities		5,295.7
Deferred management fees receivable on owned sites		(722.7)
Total resident liabilities	**-**	**4,573.0**

1. During the period, the Group sold a 25% interest in its Retirement Living investment. As a result of this transaction, the investment properties, resident liabilities, and deferred revenue related to Retirement Living have been derecognised. The Group equity accounts its residual interest in the Lendlease Retirement Living Trust. Refer to Note 5 Other Income, Note 8 Share of Profit of Equity Accounted Investments, and Note 12 Equity Accounted Investments for more information.

Net investment properties are classified as Level 3 in the fair value hierarchy.

Net investment properties include net retirement living properties after deducting resident liabilities and related deferred revenue, A$nil million (June 2017: A$1,738.7 million), retail and telecommunication properties A$178.6 million (June 2017: A$155.9 million) and assets under construction A$378.8 million (June 2017: A$368.1 million).

14. Other Financial Assets

	Fair Value Level[1]	December 2017 A$m	June 2017 A$m
Current Measured at Fair Value			
Fair Value Through Profit or Loss – Designated at Initial Recognition			
Negotiable instruments	Level 1		31.4
Derivatives	Level 2	2.4	1.6
Total current		**2.4**	**33.0**
Non Current Measured at Fair Value			
Fair Value Through Profit or Loss – Designated at Initial Recognition			
Lendlease International Towers Sydney Trust	Level 3	446.6	411.5
Lendlease One International Towers Sydney Trust	Level 3	230.2	202.7
Australian Prime Property Fund – Industrial[2]	Level 3	72.3	70.9
Australian Prime Property Fund – Commercial[2]	Level 3	284.9	211.6
Australian Prime Property Fund – Retail[2]	Level 3	77.0	73.4
Lendlease Public Infrastructure Investment Company	Level 3	41.0	40.7
Military Housing Projects Initiative[2]	Level 3	187.9	102.8
Lendlease Asian Retail Investment Fund[2]	Level 3	25.7	24.9
Parkway Parade Partnership Limited[2]	Level 3	37.7	37.2
Other investments[2]	Level 3	9.4	19.6
	Level 1	18.1	
		1,430.8	**1,195.3**
Other	N/A		**8.0**
Total non current		**1,430.8**	**1,203.3**
Total other financial assets		**1,433.2**	**1,236.3**

1. Refer to Note 17 'Fair Value Measurement' for details on basis of determining fair value and valuation technique.
2. As a result of the first time adoption of AASB 9 *Financial Instruments* (refer to Impact of New and Revised Accounting Standards), these investments have been reclassified from Available for Sale to Fair Value Through Profit or Loss. June 2017 comparatives have been restated to include units in Australian Prime Property Fund - Industrial of A$4.2 million, Australian Prime Property Fund - Commercial of A$6.3 million, Australian Prime Property Fund - Retail of A$45.9 million, Lendlease Asian Retail Investment Fund of A$24.9 million, Parkway Parade Partnership Limited of A$37.2 million, Military Housing Projects Initiative of A$102.8 million and Other Investments of A$9.5 million. These investments were previously classified as Available for Sale Investments.

a. Fair Value Reconciliation[1]

The reconciliation of the carrying amount for Level 3 financial assets is set out as follows.

December 2017	Note	Unlisted Investments A$m
Carrying amount at beginning of financial period		1,195.3
Additions/(disposals)		56.3
Gains/(losses) recognised in Income Statement		170.8
Transfers		(10.1)
Other movements		0.4
Carrying amount at end of financial period		**1,412.7**
June 2017		
Carrying amount at beginning of financial year		619.4
Additions/(disposals)		37.3
Gains/(losses) recognised in Income Statement		48.1
Other movements		490.5
Carrying amount at end of financial year		**1,195.3**

1. Following the adoption of AASB 9 *Financial Instruments*, the assets previously classified as Available for Sale have been reclassified to unlisted investments. Comparative balances have also been reclassified.

The potential effect of using reasonably possible alternative assumtions for valuation inputs would not have a material impact on the group.

KPMG on Asset Valuation

The key audit matter:

The Group is required to assess the value of investment properties, available for sale investments, and fair value through profit or loss investments at each reporting date. **Valuations of assets are generally performed using internal valuation methodologies** (discounted cash flow or capitalised income approach) or **through the use of external valuation experts**. External valuations are obtained on a rotational basis by management each year, with the remaining investments being valued internally. The Group's investment properties are primarily comprised of retirement villages and the key assumptions used in determining their value are discount rates, changes in village residents, current units/homes market prices and growth rates.

Other financial assets are predominantly investments in entities which in turn own commercial and retail property. Accordingly the valuation assumptions are predominantly the capitalisation of earnings rates, discount rates, future rental income, capital expenditure projections and leasing incentives. The valuation of the properties held by these entities directly impacts the fair value of the Group's interests in these assets. The valuations of these assets is a key audit matter as they:

- are judgmental,
- contain assumptions with estimation uncertainty, which are inherently challenging to audit, and
- lead to additional audit effort often due to the high number of differing assumptions and models, across varying asset classes.

How the matter was addressed in our audit

Our procedures included:

- Assessment of the scope, competence and objectivity of external valuation experts engaged by management for assets valued by external valuation experts;
- Evaluating and testing management's review and approval of internal valuations based on the Group's policies for internally valued assets;
- Assessment of the valuation methodology for consistency with accounting standards and industry practice for that asset's class;
- Comparing, with market data published by commercial real estate agents and/or our knowledge of the nature of the asset and its historical performance, key assumptions such as:
  - discount rates
  - changes in village residents
  - units/homes current market prices
  - growth rates
  - capitalisation of earnings rates
  - future rental income
  - capital expenditure projections
  - leasing incentives

Estimate FFO (S&P)

S&P Metrics	FY15	FY16	FY17	1H18
Operating Cash Flow	-376	827	-98	191
Decrease in Receivables	-1,854	846	36	-70
Decrease in Inventory	-634	57	-229	775
Increase in Payables	1,002	-707	1,250	366
FFO (pre-adjusted)	1,110	632	-1,155	-880
plus pension expense	16	16	16	16
FFO (adjusted)	1,161	698	-1,101	-845
Gross Balance Sheet debt	2,450	2,151	2,152	1,793
Operating Leases	178	416	385	385
Total Debt	2,747	2,567	2,537	2,178
Cash	750	1,008	1,249	1,545
less WC	500	500	500	500
Surplus cash	250	508	749	1,045
Total debt less surplus cash	2,497	2,058	1,788	1,132
Debt	2,497	2,058	1,788	1,132
FFO / Debt	**47%**	**34%**	**-62%**	**-37%**
FFO Interest Coverage				
FFO	1,161	698	-1,101	-845
+ Cash Interest paid	188	204	153	72
+ lease interest	45	32	61	30
- lease adjustment to depreciation	-35	-51	-39	-19
Adj FFO	1,359	884	-926	-762
Interest expense	167	153	135	46
Lease Interest	45	32	61	30
Adj Interest	211	185	196	76
FFO Interest Coverage	**6.4**	**4.8**	**-4.7**	**-10.0**

The Property Council of Australia – FFO

The Property Council of Australia produced a White Paper (Version 2) in December 2017: Voluntary Best Practice Guidelines for disclosing FFO and AFFO: A guide to calculating Funds From Operations and Adjusted Funds From Operations.

- The background of the paper, according to the PCA is that **investors and analysts consistently request additional financial information from real estate organisations to help understand and compare the underlying financial performance of property entities**. Across the globe, there **are several alternative performance metrics** used by real estate organisations to provide additional financial information. For example: National Association of Real Estate Investment Trusts (NAREIT) FFO; European Public Real Estate Association (EPRA) Earnings Per Share; and Real Property Association of Canada FFO. No one performance metric has been adopted globally.
- One of the aims of the guidelines is to: "**drive better understanding of the performance of an entity and create a practical and meaningful bridge to the audited accounts**".
    - All of LLC's peers have adopted the guidelines.

The Property Council reviewed the NAREIT FFO definition in order to draft a suitable Australian FFO definition. In the NAREIT 2002 White Paper, FFO is defined as:

"FFO means net income (computed in accordance with generally accepted accounting principles), excluding gains (or losses) from sales of property, plus depreciation and amortisation, and after adjustments for unconsolidated partnerships and joint ventures."

- Property Council FFO is the organisation's **underlying and recurring earnings from its operations**.
    - In the Appendix, we have included the Guidelines set out adjustments to convert AIFRS net profit after tax to Property Council FFO.

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Property Council FFO Guidelines

Item	Definition	+ / - to net profit
Statutory AIFRS Net Profit after tax		
Investment Property and Inventory		
Gains from sales of investment property	The realised gain or loss is the difference between the sale price and the previous carrying value of investment property, net of transaction costs	-
Losses from sales of investment property		+
Fair value gain on investment property	The non-cash fair value adjustment between the current fair value of the investment property and the built up book value at the date of valuation	-
Fair value loss on investment property		+
Impairment charges on inventory	Assets classified as inventory are required to be carried at the lower of cost and net realisable value. This assessment should be undertaken on a project by project basis	-
Reversal of impairment charge on inventory		+
Depreciation on owner occupied property, plant & equipment (PP&E)	Property assets where the owner is a material tenant of the building must be classified as PP&E and held at cost and depreciated. This is the depreciation charge included in the statutory profit	+
Goodwill and Intangibles		
Impairment of goodwill or impairment and amortisation of intangibles	Impairment and amortisation charges recognised on goodwill and other intangibles	-
Reversal of impairment of goodwill or intangibles		+
Financial Instruments		
Fair value gain on the mark to market of derivatives	Non-cash movement of the unrealised fair value gain/loss on derivative positions held in the balance sheet	-
Fair value loss on the mark to market of derivatives		+
Fair value movement of equity component of convertible bonds	Fair value movement on the equity component within a convertible bond	+ / -
Incentives, straightlining and leasing costs		
Amortisation of fit out incentives	The non-cash amortisation (over the term of a lease) of the incentives provided to enter into a lease	+
Amortisation of cash incentives		+
Amortisation of project incentives		+
Amortisation of rent free incentives		+
Amortisation of leasing costs	The non-cash amortisation (over the term of a lease) of the leasing costs incurred to enter into a lease	+
Rent straightlining	The adjustment made to rental income to reflect leases with fixed rate increases over the term of the lease	+ / -
Tax		
Non-FFO tax benefits	This represents the tax expenses / benefits of non-FFO items	-
Non-FFO tax expenses		+
Other Unrealised or One Off Items		
Recycling of Foreign Currency Translation Reserve (FCTR)	The FCTR appears as a separate component of equity in the balance sheet. It represents the cumulative gains and losses on the retranslation of the entity's net investment in foreign operations. On disposal of the foreign operation, the cumulative amount of any exchange differences relating to that operation should be recognised in the income statement together with the gain or loss on disposal of the operation	+ / -
Other unrealised or one off items	To be adjusted in FFO at the discretion of the organisation with clear explanation. These are items which are not viewed by management as part of the underlying and recurring earnings A one off item is an item that did not occur in the prior period and highly unlikely to reoccur in the following accounting period	+ / -
Property Council Funds from Operations		

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