Downer EDI Limited
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15 December 2022

The Manager, Listing
Australian Securities Exchange
ASX Market Announcements
Level 14, Exchange Centre
20 Bridge Street
Sydney NSW 2000

Dear Sir/Madam

Fitch Rating Update

Fitch Ratings have today affirmed their issuer rating of 'BBB' for Downer EDI Limited (ASX: DOW). The outlook on the rating has been revised to negative.

We attach a copy of the Fitch Ratings Report.

Yours sincerely
Downer EDI Limited

Robert Regan
Company Secretary

Authorised for release by Downer's Board of Directors.

FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Outlook on Downer's IDR to Negative on Governance Issues

Wed 14 Dec, 2022 - 5:01 pm ET

Fitch Ratings - Sydney/Singapore - 14 Dec 2022: Fitch Ratings has revised the Outlook on Australia-based Downer EDI Limited's Long-Term Issuer Default Rating to Negative, from Stable. Downer's IDR and senior unsecured ratings of 'BBB' have been affirmed. The affirmation also applies to all senior unsecured debt issued or guaranteed by Downer, including debt issued by subsidiary, Downer Group Finance Pty Limited.

The Negative Outlook reflects the weaknesses in Downer's governance structure after it identified accounting irregularities. It estimates that these led to an overstatement of pre-tax earnings of AUD30 million-40 million from the financial year ended-June 2020 (FY20) to November 2022. Downer will conduct an in-depth review into the financial impact and the control deficiencies that led to the irregularities. At this early stage of the review, the company believes the event is an isolated incident. The restatement of profit does not affect Downer's financial profile, but the Negative Outlook captures the risk that further issues could be identified by the review.

Downer also downgraded its earnings guidance for FY23, following a continuation of weather and labour disruption over 5M22. We believe these pressures moderated over the year and that the company will increasingly realise the benefits of cost pass-through measures, with its margin returning to above 5% in FY24.

KEY RATING DRIVERS

ESG - Governance Structure: The disclosure of accounting irregularities, resulting in an overstatement of reported profit from FY20 to November 2022, highlights deficiencies in Downer's control and governance structure. The company believes the irregularities were isolated to one contract, which was managed in a bespoke system due to its nature. However, the circumstances that caused the irregularities to occur and remain in force for several years are subject to an independent review. There is no cash impact from the irregularities.

The Negative Outlook reflects the risk that further issues could be identified while the review remains underway. Fitch will not only consider the financial impact of any further irregularities, but more importantly, that Downer's systems and processes are robust and that the control deficiency is not indicative of widespread weaknesses.

Weather and Labour Challenges: Difficult weather conditions, staff shortages and supply-chain issues in 5MFY23 led Downer to downgrade its profit guidance for FY23. This follows similar challenges that saw its EBITDA margin deteriorate to below 5% in FYE22, where flooding on Australia's east coast disrupted operations and high levels of absenteeism increased costs, as overtime, sub-contractor and temporary labour usage rose to replace staff at short notice.

We expect these issues to moderate as Downer implements more permanent measures, leading to an EBITDA margin recovery to above 5% from FY24. However, challenges are likely to remain during FY23, as the business continues to adjust to higher levels of absenteeism, particularly during any outbreaks of Covid-19.

Inflation-Linked Contracts to Restore Margin: Downer's ability to manage cost escalation is enhanced by its limited exposure to fixed-priced contracts; 96% of service work-in-hand, which makes up 91% of all work-in-hand, included some form of contracted price escalation mechanism at FYE22. Furthermore, 56% of service work-in-hand revenue resets are linked to the CPI and another 25% have a blended mechanism based on a combination of CPI, labour and material rates. We expect Downer to increasingly benefit from these provisions amid the high inflation, supporting margin stability over the longer term.

Resilient Core Urban-Service Business: We expect Downer to continue to benefit from government prioritisation of infrastructure development, which will remain the source of major opportunities in the medium term. Downer is the largest diversified-service group in Australia and New Zealand for transport, utility and facility-management services. Its strong revenue visibility is supported by work-in-hand of AUD36.1 billion at FYE22, with around 90% of customers being governments or government-related entities, most on long-term contracts.

Divestments Fund Capital Initiatives: Downer still has around AUD200 million in announced share buybacks available - based on current market prices - under a plan announced in April 2021. Fitch expects further share buybacks under the programme, alongside any bolt-on M&A, to be financed through asset sales and have a limited impact on Downer's financial profile as it had significant headroom in its leverage metric at FYE22. Downer announced that it is currently performing a strategic review of its Australian transport projects business.

DERIVATION SUMMARY

We rate Downer using the business-service navigator framework. Downer's strong domestic market position and long-term recurring revenue contracts support the rating. However, the company's international diversification remains limited, with revenue largely generated in Australia and New Zealand. This constrains the rating to the 'BBB' category. The Negative Outlook relates to governance issues that remain under review.

Downer's leverage and interest coverage are comparable with that of Australian peer, Lendlease Corporation Limited (BBB-/Stable). Lendlease benefits from greater geographical diversification, but Downer's lower exposure to cyclical cash flow and higher share of recurring maintenance-style projects result in a one-notch rating differential.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- Revenue growth of 1.0% in FY23, accelerating to 2.0%-3.0% from FY24, taking into account sold businesses.

- EBITDA margin, adjusted for lease expenses, improving to 4.5% in FY23 and around 5.5% thereafter, as labour challenges are addressed.

- Capex of around 2.5% of revenue a year.

- Dividend payout ratio of between 60%-70% of consolidated underlying net profit after tax before acquired intangible amortisation.

- Returns to shareholders by way of share buybacks of AUD200 million, spread over FY23 to FY26.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Fitch could revise the Outlook to Stable if, upon the completion of the review into the accounting irregularities, it is determined that the incident was isolated and that there are no widespread issues with the controls or governance.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Fitch may downgrade the IDR if, upon completion of Downer's internal review into the accounting irregularities; further losses are identified that see EBITDA net leverage rise above 2.2x for a sustained period (FY22: 1.4x); or if more systemic issues are found within the control structure that suggest governance is weaker than currently incorporated in the rating.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Strong Liquidity: Downer had AUD739 million in cash and AUD1.2 billion in undrawn committed facilities at FYE22. Its weighted-average debt duration was 3.9 years (FYE21: 3.8 years). Downer's next bond maturity is in FY26. Downer has also protected itself from current interest-rate rises by recent refinancing activity and hedging, while also benefitting from its existing fixed-rate debt. These actions have led to its guidance that interest expense, excluding lease interest, may increase by around AUD5 million in FY23.

Downer has demonstrated access to a wide range of funding sources, including syndicated loans as well as local and international capital-market debt and equity.

ISSUER PROFILE

Downer is a leading provider of services in Australia, with operations across transport, utility services and facility management.

SUMMARY OF FINANCIAL ADJUSTMENTS

Under Fitch's hybrid methodology, we have applied 100% equity credit to Downer's redeemable optionally adjustable distributing securities (ROADs) preference shares. This reflects their subordination, as they are only senior to equity, and permanent status as part of Downer's capital structure.

In accordance with our methodology, we have included all coupons on the ROADs as interest in both the profit and loss and cash flow statements. This has resulted in Fitch's calculated net profit after tax being lower than Downer's reported figure by the amount of the ROADs coupon.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Fitch has assessed Downer's exposure to ESG outside of the standard Business Services defaults, due to the group's exposure to a more diverse range of end-businesses than business-services peers.

Downer has an ESG Relevance score of '5' for Governance Structure due to the identification of accounting irregularities that led to an overstatement of profit since FY20, which remain subject to review. This has a negative impact on the credit profile and is highly relevant to the rating, resulting in a change to the Outlook to Negative, from Stable.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3 - ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on our ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY / DEBT ⬍	RATING ⬍	PRIOR ⬍

Downer EDI Limited	LT IDR	BBB Rating Outlook Negative	Affirmed	BBB Rating Outlook Stable
senior unsecured	LT	BBB	Affirmed	BBB
Downer Group Finance Pty Limited				
senior unsecured	LT	BBB	Affirmed	BBB

VIEW ADDITIONAL RATING DETAILS

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PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

APPLICABLE CRITERIA

Corporate Hybrids Treatment and Notching Criteria (pub. 13 Nov 2020)

Country-Specific Treatment of Recovery Ratings Criteria (pub. 06 Jan 2021)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

Sector Navigators: Addendum to the Corporate Rating Criteria (pub. 29 Oct 2022)

Corporate Rating Criteria (pub. 29 Oct 2022) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Downer EDI Limited	EU Endorsed, UK Endorsed
Downer Group Finance Pty Limited	EU Endorsed, UK Endorsed

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Corporate Finance   Industrials and Transportation   Asia-Pacific   Australia