Downner
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10 March 2023

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 remains 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 Affirms Downer at 'BBB'; Maintains Negative Outlook on Margin Challenges, Governance Risk

Thu 09 Mar, 2023 - 5:29 PM ET

Fitch Ratings - Sydney - 09 Mar 2023: Fitch Ratings has affirmed Australia-based Downer EDI Limited's Long-Term Issuer Default Rating (IDR) at 'BBB'. The Outlook is Negative. At the same time, Downer's senior unsecured rating of 'BBB' has also been affirmed. The affirmation 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 ongoing margin pressure, with the EBITDA margin falling to 3.3% in the first half of the financial year ending June 2023 (1HFY23) amid labour and weather-related issues. We expect these issues to persist for the remainder of FY23, alongside further expected project losses. This has led to the company downgrading its earnings guidance for the second time in FY23. The EBITDA margin should improve in FY24, but near-term risks remain.

We originally revised the Outlook to Negative in December 2022 due to governance-related risks after Downer identified and announced accounting irregularities. The company has now concluded its investigation and has confirmed that this was an isolated incident. However, Downer is now also included in an anti-corruption investigation. The

Outlook captures risk around the company's controls, although there is limited information on the allegations to assess any risks. We have also lowered our assessment of Management and Corporate Governance in the navigator in light of this.

KEY RATING DRIVERS

Ongoing Weather and Labour Challenges: Difficult weather conditions, staff shortages, supply-chain issues and losses on an underperforming contract continued to challenge Downer's margin in 1HFY23. This follows similar challenges that saw its EBITDA margin deteriorate to below 5% in FY22. We expect the margin to remain challenged for the remainder of FY23, with the company downgrading its earning guidance for the second time in the financial year to reflect further expected losses on underperforming projects, weather impacts and an expected slowdown in government minor capital works.

Downer's new CEO has announced a strategic reset to address the challenges and restore profitability - with around AUD100 million in EBITDA benefit targeted by FY25. We also expect the margin to improve in FY24 as the company addresses the ongoing labour shortages and benefits from a recovery in volumes following the weather-related issues. However, the Negative Outlook reflects the risks around delivering this turnaround in the near term, with challenges expected to persist for the remainder of FY23 and as the strategic reset is actioned.

Inflation-Linked Contracts to Restore Margin: Downer's ability to manage cost escalation is enhanced by its limited exposure to fixed-price 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, Downer has been able to renew its labour Enterprise Bargaining Agreements well within CPI escalators to date. We expect Downer to increasingly benefit from these provisions and actions amid Australia's high inflation, supporting margin stability over the longer term.

ESG - Governance Structure: Downer completed its independent review of the accounting irregularities disclosed in late 2022. The review confirmed that the irregularities were an isolated incident and there were no widespread control or governance weaknesses or further losses to be recognised. The company has implemented additional procedures to bolster its controls around large projects and has announced that it has documented and agreed a reset with the customer to return the project to profitability.

However, the Negative Outlook captures the risk that further governance issues could be identified during an inquiry by the New South Wales Independent Commission Against

Corruption (ICAC). ICAC has announced that it will investigate certain employees of Downer EDI Works Pty Ltd as part of a larger investigation for allegedly obtaining benefits for themselves in a dishonest manner. No further information has been provided by ICAC and Downer has publicly affirmed its commitment to complying with the law. The inquiry will commence in late March 2023.

Resilient Core Urban-Services Business: We expect Downer to continue to benefit from government prioritisation of infrastructure development, which will remain a source of major opportunities in the medium term. Downer is the largest diversified-services group in Australia and New Zealand for transport, utility and facility-management services. Its strong revenue visibility is supported by work-in-hand of AUD38.8 billion at 1HFY23, with around 90% of customers being governments or government-related entities, most on long-term contracts (FYE22: AUD36.1 billion).

Commitment to Balance-Sheet Strength: Downer's net debt rose to AUD937 million at 1HFY23, from AUD620 million at FYE22, as cash conversion fell to 8.5% (1HFY22: 92.4%) mainly due to timing of payments and receipt collections. The company will use the collections and proceeds from the sale of the Australian transport projects business to reduce debt. Fitch had expected the proceeds to fund shareholder returns. We expect any future share buybacks under Downer's plan, announced in April 2021, to be financed through asset sales and have limited impact on Downer's financial profile.

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 ongoing margin challenges due to labour shortages and weather-related events, together with ESG risks associated with management controls.

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 2% in FY23, before falling by around 9% in FY24 and then rising by 1%-2% in FY25 and FY26, taking into account sold businesses.

- EBITDA margin, adjusted for leases expenses, remaining below 4% in FY23 then improving to 5% and above, as labour and weather-related challenges are addressed and the strategic reset is implemented.

- 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.

- Potential 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 Downer is on track to return its EBITDA margin to above 5% for a sustained period by FY24. This would also require no findings of widespread issues with controls and governance.

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

- EBITDA margin not improving to above 5% on a sustained basis by FYE24 (F22: 4%).

- Net debt/EBITDA rising to above 2.2x for a sustained period (last 12 months to 1HFY23: 2.1x).

- Any findings in current or future inquiries indicating more systemic issues within Downer's 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 AUD450 million in cash and AUD1,185 million in undrawn committed facilities at 1HFY23, with a weighted-average debt duration of 3.4 years (FYE22: 3.9 years). The 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 existing fixed-rate debt. This 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, and 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 facilities 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

Downer has an ESG Relevance Score of '4' for Governance Structure, which has a negative impact on the credit profile, and is relevant to the rating in conjunction with other factors.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means 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 Fitch's 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 Negative
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

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APPLICABLE CRITERIA

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

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)

Country-Specific Treatment of Recovery Ratings Criteria (pub. 04 Mar 2023)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

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