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Sale of Construction Business

MACMAHON
Macmahon Holdings Limited
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Open Briefing interview with Chairman Ken Scott-Mackenzie
and CEO Ross Carroll

In this Open Briefing®, Ken and Ross discuss:

- Benefits to shareholders of the sale of construction projects to Leighton
- Strengths and positioning of Mining Business
- Growth opportunities post Construction exit

Record of interview:

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Macmahon Holdings Limited (ASX: MAH) will hold a shareholder meeting on 26 February to vote on the proposed sale of the majority of its construction projects to Leighton Holdings Limited (ASX: LEI), which forms part of Macmahon's strategy to exit its Construction Business and focus on mining services. How will shareholders benefit from this new strategy?

Chairman Ken Scott-Mackenzie
We decided to sell the Construction Business to focus on our Mining operations as the platform to develop a broad range of services for the mining industry. In most cases, our mining contracts are based on long-term relationships, allowing time to work through issues, and providing a strong alignment between the interests of the mining company and the contractor. This generally leads to a more acceptable risk profile compared with the short-term, adversarial nature of many construction contracts.

As a nationally based construction company with the associated overhead structure, we needed to significantly grow the business, take on more projects to spread overheads and risk, and provide continuity of employment for key staff. Until recently there were market opportunities, particularly in the resources sector, to support a strategy of growth. However increased competition, in particular from new market entrants, together with a shrinking market, provided limited opportunities to profitably grow the business. Macmahon's Board considered these dynamics would lead to more competitive pricing and contractual terms and conditions, and therefore higher risk.

Furthermore, the significant losses in our Construction Business in recent years, was another major factor behind our decision to exit the business. These losses lead to an unacceptable variation in our earnings year on year and therefore impacted our share price. The Company must deliver stable earnings to win back market confidence, and build shareholder value, which we strongly believe can be done through our new strategy.

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The Independent Expert who assessed the transaction with Leighton has concluded that the transaction is *not* fair to the (non-Leighton) shareholders of Macmahon, as the sale price of $29.6 million is below the Expert's estimated fair value of the assets of $31.3 million to $35.0 million. However, the Expert considers the transaction reasonable, particularly given the

potential costs of closing down the Construction Business. How was the sale price calculated and why are you recommending a transaction at lower than fair value?

Chairman Ken Scott-Mackenzie
The sale price was determined by a robust arm's length negotiation which considered: the projects being sold, the assets being used by those projects, the tender positions being sold and the Urban Superway project liability cap.

I think it is important to note that the Independent Expert concluded the potential advantages outweigh the potential disadvantages to shareholders as a whole, and that shareholders are likely to be better off if the proposed transaction proceeds.

The Independent Directors recommend a vote in favour of transaction and consider it to be in the best interests of shareholders for a range of reasons. The transaction has highly certain terms and limited conditions, ensuring greater certainty for shareholders. Leighton is also well known and highly regarded within the Australian construction market and has the financial strength and ability to complete the transaction. These factors will ensure the smooth transition of construction projects when the transaction is confirmed. The successful transfer of the majority of our construction projects will also remove approximately $8.7 million of pre-tax employee liabilities from the balance sheet and will ensure significant closure costs associated with the potential wind down of Construction can be avoided.

The Independent Directors consider the $1.4 million difference between the sale price and the Independent Expert's fair value to not be material, particularly in the context of Macmahon's ongoing strategy and the certainty the proposed transaction provides, including the Urban Superway project, which I would also like to touch on.

In our view there is real value to Macmahon shareholders in having secured a cap on the Company's exposure to losses on the Urban Superway project. We hold this view because – even though Macmahon's currently forecast share of the project loss is less than the cap of $25 million pre-tax – the project still has around a year to run. As such, given it is a large and complex project, we believe there remains considerable uncertainty for Macmahon over what the final loss may actually be. We see real value for shareholders in having secured a cap on our exposure to losses on this project – even though the Independent Expert did not ascribe any value to it.

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Given the potential conflict of interest in agreeing to a transaction with your major shareholder, why did you decide to deal with Leighton in this matter?

Chairman Ken Scott-Mackenzie
At the time we decided to exit Construction, the Company was dealing with underperforming projects, including Hope Downs 4, that had led to a significant profit downgrade. We needed to close out these projects without any further losses, and critical to this was the need to stabilise the Construction Business unit and retain key people. To have gone through a public sale process under those circumstances would have been very high risk, with the potential for key staff to walk away given the business's uncertain future, exposing Macmahon to further project losses.

In light of this, pursuing a transaction with Leighton in the first instance could be done without destabilising the business and exposing Macmahon to those significant risks. By the time the transaction was made public, the majority of key staff would have a degree of certainty regarding continuity of employment. In addition, the negotiations could be expedited because Leighton understood our Construction Business well, given 38 per cent of the work was in joint ventures with Leighton Group companies.

It was also apparent that completion of any transaction with Leighton came with a high degree of certainty, because there would not be a problem with the assignment of joint ventures and the approval of clients was assured given Leighton's financial strength and its breadth of experience and resources in Australia.

Adding to our thinking at the time was our recognition that a successful equity raising was better assured if there was a transaction in place to sell the Construction Business.

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Why did the Board reject the proposals from Sembawang Engineers and Constructors, given Part A was for $38 million and Part B was based on identical terms to the Leighton proposal plus an additional $5 million?

Chairman Ken Scott-Mackenzie

The proposals from Sembawang contained little detail. They were highly conditional and only indicative. Sembawang was unable to adequately explain the basis of its indicative proposals, instead suggesting that due diligence was necessary for it to explain its own determinations. It would make very little commercial sense for Macmahon to walk away from the certainty of the transaction with Leighton and risk being sued for breach of contract in the hope that we might be able to do a better deal with Sembawang.

The actions of Sembawang, in terms of releasing inconsistent statements, commenting on individuals, releasing confidential correspondence, attempting to intimidate the Macmahon Board, threatening legal action and attempting to impose a completely unreasonable deadline, did little to encourage a leap in faith. Also, the completion of any transaction with Sembawang would be most uncertain given it would require the assignment of joint venture agreements and the approval of clients for the novation of contracts, particularly given it has no presence or experience in Australian construction projects.

Furthermore, correspondence from Sembawang indicated that the Singaporean company would act as a guarantor for the company's Australian entity, which was the proponent, but no financial information was provided to evaluate the substance of this guarantee.

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Post completion of the proposed transaction, Macmahon will retain a small number of construction projects, most near completion, plus a contingent, capped liability exposure to losses on the Superway project. What was the basis for retaining some construction projects, what is the time line for their completion, and when will Macmahon be able to present a clean set of "Mining Business only" numbers?

CEO Ross Carroll

The majority of the projects we are retaining are nearing completion. Solomon Rail Spur has just been completed, while Hope Downs 4, Gladstone LNG and the ULAN Alliance will demobilise before the end of April 2013. We believed it would be more efficient for us to complete the projects ourselves, particularly given any buyer would have required warranties. We will retain two projects that run for longer, the Trangie Irrigation Project in New South Wales and the XRL 822 Rail Tunnel Project in Hong Kong. Trangie is a very small project which we expect to complete in December 2014. XRL 822 is a joint venture with Leighton Asia, but we are actually doing underground mining for the JV – even though it is on a civil infrastructure project – so we decided it was best to keep the project as our underground mining people are involved.

Any one-off items associated with loss-making projects or the sale of the construction projects will be recognised in FY2013, so essentially you will see clean accounts from FY2014 onwards. There may be some very minor impacts from Construction next year. All the Construction issues will be dealt with in FY2013 and the Mining Business will dominate our results from FY2014.

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Your reasons for exiting the Construction Business included its lack of scale, high overhead costs and difficulty in attracting and retaining key management necessary to deliver projects profitably. To what extent is your Mining Business any better positioned in these areas?

CEO Ross Carroll
Firstly, in Mining, Macmahon has an overhead structure that can be easily built on: we have a head office which contains most of the support functions and smaller branches in each of the regions where we choose to operate. This is in contrast to Construction, where we had high overheads given we had to maintain a presence in each state.

Our Mining Business has also demonstrated consistent growth in recent years, with strong margins and an increasingly diverse customer base. Within the business, we are working across a broad range of commodities and geographic regions for a number of blue-chip customers and we are confident we can continue to increase its scale given recent project wins such as the 10-year, $900 million Tropicana gold project and the $1.8 billion Christmas Creek iron ore project. In FY2012 we had Mining turnover of about $850 million and conceivably in FY2014 we will have turnover of $1.4 billion to $1.5 billion. We are growing the scale of the business but doing it in a way that ensures we maintain our margins.

One of the strengths of the business is its quality order book and its very good relationships with customers. We have the ability to offer a full suite of mining services, which ensures that we have the expertise to develop long-term and mutually beneficial relationships with our clients. I believe the breadth of our services is unmatched by any of our competitors.

Another strength of the business is that the projects are longer term. When you have got big, blue-chip projects that run for five or 10 years, it is much easier to attract and retain people. We also find that mining projects do not have the high risk profile of construction projects. And because the majority of our mining projects are low cost mines with blue-chip miners, they are less likely to close when commodity prices come under pressure. That was demonstrated last year, when commodity prices fell we did not see any drop-off in our work.

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Macmahon's current Mining Business is heavily reliant on surface mining, with some exposure to underground and international mining work. Under the new strategy, you are planning to expand the business in engineering and in other "low capital intensity" areas. What expertise do you have in these areas, what is your competitive positioning, and what are the opportunities?

CEO Ross Carroll
After we exit Construction, our energy and focus will be on growing the Mining Business. We see a range of opportunities to continue to grow the business and deliver better margins. We have got good, long-term relationships with our customers and we are already providing a broad range of services. We have got a lot of leverage to increase our service offering through both our existing relationships and our existing skill base.

We think there is an opportunity to continue to expand our international operations. We are already operating in Mongolia, where we are working on the Tavan Tolgoi project. That is going to be one of the world's largest coal mines and it has really only just started. We also have limestone quarrying operations in Nigeria and we want to broaden our activities in the African region, geographically and into other commodities such as gold. We see Africa as highly prospective for our Underground Business.

We have an Engineering Business that has been quite successful. That business came out of our Underground Business and we will be looking to expand it into surface mining work. We also have a fixed plant group that does a small amount of plant construction and maintenance for our mining customers. There are a lot of opportunities to grow that business. We have two large workshop facilities – one here in Perth and the other in the

Bowen Basin in Queensland, plus two smaller ones in Lonsdale and Orange, and there is capacity to put more business through them.

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Macmahon generated operating cash flow of $86.8 million in FY2012, down from $92.4 million in the previous year. After capex of $186.4 million, up from $82.2 million, free cash flow was negative $99.6 million, versus positive $10.2 million. How will the cash generation capability and capex needs of the business change with the change in focus to Mining?

Chairman Ken Scott-Mackenzie
The EBITDA margin of the Mining Business ranges from 15 to 20 per cent, which allows for comfortable reinvestment in replacement and growth capital. In periods of rapid growth, the Company's capex and working capital facilities will provide additional flexibility to pursue growth projects. However, as we have said, in order to balance our capital requirements, part of our strategy is to develop less capital intensive services for our clients such as maintenance and engineering.

CEO Ross Carroll
In the past there has been a view that our Construction Business generated the free cash flow to finance growth in our Mining Business. But it is worth pointing out that in recent periods we have been able to grow our Mining Business while the Construction Business was not performing. Our Mining Business is very focused on return on capital. Looking at the Christmas Creek project for example, it will turn over $400 million a year and we have put in $30 million worth of new capital. The last significant capex we foresee on our current projects is for the second and third fleets at Tropicana. After that the business will be in a very strong cash generating position.

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In the current year ending June 2013, Macmahon expects group NPAT of nil to $25 million, based on pre-tax profit of $85 million to $100 million in Mining and a pre-tax loss of $65 million to $90 million in Construction. What are the key risks to this guidance, and to what extent are the FY2013 earnings of the Mining Business indicative of the expected earnings of the business going forward?

CEO Ross Carroll
We need to finish the Hope Downs 4 project and there is always some potential, which we have highlighted, for further losses on that project. Our initial guidance also did not include the impact of the sale of the Construction Business, which will not be fully known until we have finalised the 31 December numbers for the projects Leighton is acquiring. There always remains the possibility that unforeseen circumstances, such as unanticipated weather events, will impact our operations. And although we do not expect it, there is small potential for delays in the ramp-up at Tropicana or Christmas Creek. Finally, the Mongolian project is dependent on us getting both short-term and long-term funding, and that could be impacted by sovereign risk issues. However, at this point, excluding sale and closure impacts, we expect to be within our guidance range.

Our margins have been quite consistent in the Mining Business, excluding FY2010 when we were impacted by the GFC, and we anticipate future margins to be broadly consistent with the historical results. As I mentioned earlier, we are looking to grow our revenue on the back of major projects including Tropicana, Christmas Creek and Tavan Tolgoi and through increasing our scope of work in our lower capital intensive businesses and in Africa. We believe we can do that and at least maintain our historical margins, if not improve them.

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Following its recent $80 million capital raising, Macmahon expected to have pro-forma net debt of $19.5 million, with gearing of 4.9 per cent. The transaction with Leighton is expected to bring in net cash of $4.3 million, after employee entitlements and other adjustments and assuming the worst-case capped loss from the Superway contract. You will also retain

about $45 million of plant and equipment previously used by the Construction Business that you will either use in the Mining Business or sell. To what extent will Macmahon be adequately funded to execute its Mining strategy in the short to medium term, including projects such as Christmas Creek?

Chairman Ken Scott-Mackenzie
The recent capital raising has strengthened the balance sheet, increased liquidity and reduced gearing. Proceeds from the raising will be used to fund the start-up of Christmas Creek, ensure financial flexibility, and fund the growth of our core Mining Business and general working capital requirements. Christmas Creek does not require significant injections of capital beyond the start-up capital, as equipment for the project will primarily be supplied by the client. Tropicana will be funded out of the Company's undrawn capex facilities.

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Under your new strategy, the Company will be completely reliant on the mining sector. Given the inherent cyclicality of the sector, does this strategy provide a long-term solution for sustainable earnings?

CEO Ross Carroll
Our Mining Business has had a strong and profitable history and its future is underpinned by a significant order book of $3.6 billion, including the $1.8 billion contract for Christmas Creek, so we have a very good foundation to work from. The business has a diversified blue-chip client base and our contracted projects give us a broad commodity exposure and geographical footprint. As part of that, we focus on trying to win work at low cost mines, which are less likely to close when commodity prices come under pressure.

Our operations consist of surface, underground and international mining projects and we expect to continue to grow by leveraging our blue-chip client relationships, as well as our strong pipeline of new opportunities, including further expansion overseas.

Chairman Ken Scott-Mackenzie
In wrapping up, I would also like to point out that we strongly believe our Mining strategy will deliver far greater earnings certainty year on year at significantly less risk than our Construction Business.

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Thank you Ken and Ross.

For more information about Macmahon Holdings, visit www.macmahon.com.au or call CFO Theresa Mlikota on +61 407 470 859.

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