Lendlease Group

Building shareholder value from great property DNA

April 2022

TANARRA
LONG TERM VALUE

IMPORTANT

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A high-quality company with best-in-class urban regeneration capabilities

Best-in-class urban regeneration capabilities

Lendlease's urban regeneration capabilities are globally best-in-class, and integrated across development, construction and capital solutions. Examples include Barangaroo South in Sydney and Elephant & Castle in London

Lendlease is a leader in many of the gateway cities sought-after by institutional real estate investors, including London, Milan, New York, Chicago, San Francisco Bay Area, Singapore, Kuala Lumpur, Sydney and Melbourne

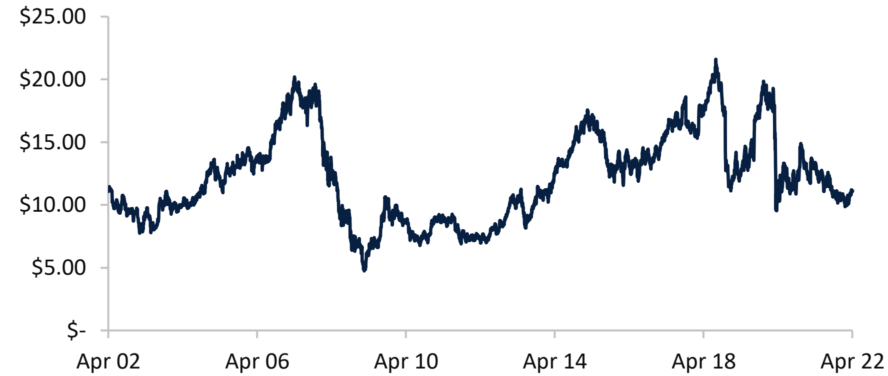
Lendlease has strong relationships with many institutional investors, pension funds and sovereign wealth funds, including Abu Dhabi Investment Authority, APG, Aware Super, CPPIB, GIC, Mitsubishi Estate, Ping An Real Estate and PSP

For these reasons we regard Lendlease as a fundamentally high-quality global company with real competitive advantages

However, these capabilities have not been reflected in shareholder returns

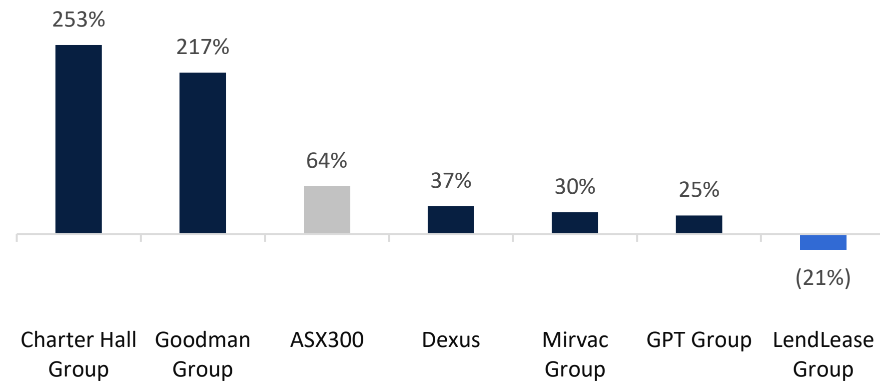
- Lendlease's total shareholder return over the past five years has been very weak at -21%, lagging the S&P/ASX 300 by 85%.[1] In our opinion, this underperformance reflects a sustained period of earnings weakness and project impairments, due predominantly to three factors:
  - Losses in the engineering construction business. This business has subsequently been sold (other than a few legacy projects which Lendlease is building out) and the remaining building construction business is materially lower in risk
  - COVID-related losses and delays, which we believe should largely unwind by FY24
  - Changes in the accounting treatment of development profits, which now conservatively back-weight profits to the end of project life, creating a gap in development earnings
- We believe Lendlease hit an earnings trough in 1H22, and should now be on a strong growth trajectory out to FY24, assuming no more material project issues in the development and construction businesses. This inflection is driven by the unwinding of the above factors, and progress toward management's strategic targets of:
  - >$8bn p.a. in development production by FY24, with a 10-13% ROIC
  - $70bn funds under management (FUM) by FY26
- In our view, this earnings recovery has not yet been reflected in Lendlease's share price

Lendlease share price over 20 years



Source: Bloomberg.

5 year TSR vs. S&P/ASX 300 & key comps[1]



Source: Bloomberg.

1. *Five years from 11 April 2017 to 11 April 2022.*

Creating a "development to funds management" flywheel business model

1. The weight of global institutional capital looking to deploy into real estate significantly exceeds the available stock of prime real estate opportunities

2. We believe Lendlease would benefit from simplifying its structure and concentrating invested capital and management focus on two core and complementary businesses:
   1. Real estate development, especially large-scale urban regeneration
   2. Funds and asset management of prime real estate

3. These two businesses are mutually reinforcing, creating a flywheel effect:
   – The development business provides a product pipeline to grow FUM, with development profits funding the co-investments book
   – The funds management business generates a defensive earnings stream to grow the development book, provides ballast against the volatility of development earnings, and funds a sustainable dividend

Lendlease as a real estate developer-manager

A top-tier, capital-light building construction business that provides a competitive advantage in pricing and executing development projects

CONSTRUCTION

DEVELOPMENT

Defensive funds management earnings support a growing high-risk, high-return development business

Best-in-class asset creation capabilities provide a unique & valuable product pipeline to support external FUM growth

FUNDS MANAGEMENT

CO-INVESTMENTS

A book of ≤10% co-investments provides strong asset-backing, efficiently aligns Lendlease with its capital partners, and supports access to debt capital markets

Lendlease can enhance shareholder value through a range of measures

We agree with the strategy Lendlease presented at its 2021 Strategy Briefing and believe shareholder value can be further enhanced by:

- Exiting Australian retirement and communities, or reducing equity stakes to ≤10%
- Accelerating FUM growth by building capabilities to source external assets
- Fully embracing the global gateway cities strategy by building out and exiting exposures to cyclical Australian markets
- Better aligning executives with shareholders through an increased TSR component in the LTI plan, and aligning other employees through an ESS
- Expanding the cost-out program, in particular from group overheads
- Further enhancing the Board's expertise in property development and construction
- Extending leadership in green design and construction, especially in the use of cross-laminated timber and low-carbon concrete, and also in energy efficiency

Significantly asymmetric return profile

- In our view, there is a good probability that management can achieve its development and FUM targets, especially if it accelerates and intensifies its efforts on transitioning to a developer-manager flywheel model
- As a consequence, we believe Lendlease is capable of significantly outperforming the S&P/ASX 300 over the next few years, provided it can successfully manage the risks in its development and construction businesses
- If so, Lendlease presents as one of the most compelling risk-reward profiles in the S&P/ASX 300

- We believe the shareholder return profile of Lendlease should be materially skewed to the upside. In our view, there is:
  - Moderate share price downside to an $8.40 bear-case valuation or $7.80 NTA
  - Moderate upside on a return to a pre-COVID development and funds management trajectory
  - Substantial upside if management can partially or fully achieve its development and FUM growth targets

- Key risks to our investment thesis include:
  - Materials and labour cost inflation impacting construction margins and development returns
  - Development risk where Lendlease has acquired land upfront or sunk meaningful capital on pre-works
  - Property cycle risk as interest rates normalise, especially if the velocity of leasing and capital transactions substantially slows as a consequence
  - Other material adverse surprises on development and construction projects

Tanarra Capital's FY24 valuation scenarios for Lendlease Group[1]

Scenario	Bear case	Pre-COVID trajectory	Targets partially achieved	Targets fully achieved
Development production ($bn p.a.)	3.5	4.8	6.0	8.0
FUM ($bn)	40	45	50	55
Construction margin	1.5%	2.0%	2.5%	2.5%
Valuation	**$8.40**	**$14.20**	**$20.30**	**$25.20**
Upside	***-24%***	***+28%***	***+83%***	***+127%***

1. *Valuation upside from $11.10 closing price on 11 April 2022.*

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Date

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