

LEND LEASE STRATEGY DAY

HELD ON
WEDNESDAY 13 MAY, 2009

AT THE OBSERVATORY HOTEL, SYDNEY

MARK MENHINNITT
PPP – LEND LEASE’S GROWTH PLATFORM

MR MARK MENHINNITT: Welcome back everybody. My name is Mark Menhinnitt and I’m here today to talk about the Public Private Partnership part of the business and a bit of a view on where we see that going and some of the issues within the market.

In terms of the agenda today, what I would like to cover is a bit of PPP 101. What is the model and the rationale? So why does it exist and what is it? The fit with Lend Lease’s strategies so how do we extract value from that market? A bit of an observation on some of the issues in the market and the opportunity or impact for Lend Lease and where we are currently situated in markets around the world in this space? Where we have solid positions, where we have emerging positions and a little bit about what we’re going to do going forward and where we see the potential value?

And then the PPP business does inherently provide a fantastic long-term franchise. You own and operate these assets over the long haul and now that we’ve been doing that for some time, it is worth just reflecting on – we’ve picked a case study here with Actus that shows what the value of that franchise really is and how those assets perform.

So this is sort of the PPP 101 session and just a very simple description because sometimes there is confusion in the market, particularly at this point in time when we talk about stimulus PPPs, et cetera. Some stimulus is just direct capital spend by government and others, depending on which part of the world you’re in, manifest themselves as public private partnerships.

So just defining what the PPP model is and I’ll just read it: PPPs are partnerships between the public sector and the private for the purposes of designing, planning, financing, constructing, operating projects which would be regarded traditionally as falling within the remit of the public sector. The essential elements are the need for capital investment and on-going asset-management services. So it clearly plays very well to Lend Lease’s business model as Tony outlined before.

So in terms of what the value chain looks like and where we play in that, it's quite important to sort of define that because I'll come back to this a little later in defining where we sit in each of our markets around the world.

There is the origination role and each one of these elements for the value chain is where we extract or where the market opportunities to extract returns. The origination capability which is about building consortiums bidding, the transaction structuring of the deal and long term relationship management with government and key stakeholders like financiers and equity purchasers.

There is the development and project management piece which is very much about the product development so creating the asset and designing it.

Obviously construction is about delivering the asset and then the long term asset management/funds management function - these are long term concessions typically anywhere from 25 years to 50 years.

And then obviously the operations, maintenance and lifecycle management because you actually are responsible for the operation and the maintenance over that concession period.

It is worth just talking about that because it does set up where I'm going to talk to a little later as to where we're positioned and where we see our growth opportunities.

In terms of how we look at the market, there are two quite distinct broad sectors and then sub-sectors within those and quite often it has historically been merged into these two because of the type of asset and also the risk profile attached to those PPPs.

Now there is the economic infrastructure market which is typically roads, bridges, transport, ports and that type of thing. Historically had a lot of patronage risk associated with that. So that means if you build a toll road, as the sponsor of the deal you take the risk on whether one car goes through the tunnel or 100,000 cars go through the tunnel. Very, very different risk profile in that segment.

Then there is the social infrastructure sector which is where Lend Lease has historically participated and that is again defined typically by no patronage risk. That is, you get paid an availability payment.

So you provide the asset, a hospital for example, and the government will pay you for that hospital being available to take people that need to go to hospital. So if one person visits the hospital, it doesn't matter, you still get paid.

The only risk associated with it is having the availability so there are abatement regimes in place if there is non-availability. But fundamentally, the funding stream for that asset is guarantee by the full faith and credit of the

government that you have entered into the agreement with.

That is again where Lend Lease plays. So we don't look to historically participate in the space where there is patronage risk. Our focus is very much on the availability payment model.

I think it is important because there has been a lot of news around failed PPPs and they are typically in toll roads, tunnels, areas where there are high levels of patronage risk.

So why is it attractive to government? Why is this model – because PPPs isn't a sector per se; it's a procurement model or a relationship model that operates within particular segments of the market.

So why is government attracted to this? I think fundamentally across the world, you've seen a move – and it hasn't been just recently in the last few years, it has been over the last decade or so and Australia was really probably one of the first movers in this space – that governments realised that they were better at funding infrastructure (economic or social) than they are at providing it themselves and being the service provider.

So smart governments have said okay, we are required to provide the asset but do we need to actually undertake the design of it, the ownership of it, the building of it, et cetera?

There are a number of reasons why governments have moved to this model and you're seeing more and more – despite obviously the issues and the funding of deals which I'll cover a little later, there is still a high level of attraction to this model and it is because the government can define its total cost of ownership from day one.

So in a PPP model, government doesn't pay you a capital component or whatever; they pay you an availability income stream. So when you bid one of these things, you are fundamentally saying, we need to get paid X per annum over the 30 year concession.

So the government knows what it is going to cost them in their forward budgeting for that asset over the long haul and they can budget accordingly. It achieves value because of - the value that comes out of the private sector is because there is now an ability to integrate the capital costs with the operating costs.

Historically, governments build great big hospitals and then they turn the lights on and go ooh, that cost a bit more than we thought and then there is a budget hole. So what they are able to do is get the merge of all that, the integration of the capital and all the operating expenses into one annual payment. So it achieves far greater governance and transparency and brings an enormous amount of discipline into government because they have to

define what they want upfront.

When they bid these things, it's not we want this and then the scope grows as the project goes on so there is an enormous amount of discipline gets applied to capital expenditure by government.

As is a great history of now if you look back in the UK and here in Australia, a number of reports have been done by UK Treasury and various consultants here in Australia that have defined on-time performance of PPPs versus the traditional method of government agencies and it is quite clear that there is a lot of value that comes from this to government.

I think the last point here about in the end there has to be a value for money evidence to the government and that is done through a public sector comparator. So in Australia, for example, when you bid a PPP they look at all the elements of that; the annualised payment, the risk transfer and there are certain adjustments made to that to make sure that it's an apples for apples between the public sector doing it and private sector doing it and the decisions made.

Historically again, there have always been a value for money outcome for the government. So the governments are very attracted to the model despite the issues of financing at the moment. Long-term this is a model that governments want to pursue and it's a model that plays very well to Lend Lease's capabilities.

So in terms of some of the market issues, the PPP model is not immune from the global financial crisis. Clearly the model has a financing component to it. The Government is looking for the private sector to bring finance into these deals.

So clearly, not unlike other assets, there are funding shortfalls that need to be dealt with but clearly governments are now taking steps to deal with that. Essentially and particularly in the social infrastructure space, the income stream that supports the PPP is a governmental income stream.

So the government has got a choice: do we go out and raise state bonds or allocate money from consolidated revenue to fund the building of a hospital or do we take a position to either guarantee the debt on the project itself if it's a PPP, come in as a co-lender, et cetera? There are different avenues available to government to leverage their position as the sole source of income for these deals.

So they want to take steps to make sure that this model is still available to them and that is emerging. I will talk a bit more about that in a minute.

There are a couple of issues in the market now. There are new capital adequacy requirements now being put in place, particularly for regulated

banks. That is potentially limiting some of the capital available – equity to these deals. But what it has done is provide Lend Lease with a tremendous opportunity step into that space.

So whenever you find a market disruption occurring opportunities emerge from that and in this particular case, that's an opportunity for us to move into the origination space, particularly here in Australia.

The debt capital markets have essentially either closed or have retracted for a number of reasons, primarily because a lot of the purchasers of bonds that backed a lot of the PPP deals relied on credit enhancement. So the Ambacs and the MBIA's, et cetera would come in as a credit insurer to enhance or increase the credit rating of a particular deal and as we've seen in the marketplace, a lot of those credit insurers have exited the market.

So for the time being, the bond markets or the debt capital markets are essentially closed or very limited so the principal source of funding for deals is now banks and that brings some challenges with it in terms of the tenor of the debt and so forth and we will talk more about that in a minute.

But fundamentally over time, when the bond markets come back and we do see them coming back within the next couple of years - PPP bonds are very sought after by a lot of life companies and pension funds because of the governmental profile of the bond payments coming out of government income streams and the term of those matching a lot of life company liabilities. There is a great match-up so there is inherently a lot of demand for these bonds. We're just going through a process at the moment of redesigning if you like what that market is going to look like.

As I said before, there is limited capacity in the market and it has been written in Australia that PPPs above \$500 million – you know you really struggle to get a syndication of banks that in aggregate can lend into a deal above \$500 million. Smaller deals – there is capacity there, you \$200-300 million PPPs. But once you get into the \$1-2 billion sort of range, it dries up.

So as I mentioned before, the government is taking steps to deal with that, not just here in Australia but around the world. In the UK, they have set-up a governmental bank to lend into these deals basically as a co-lender on the same terms as private debt capital and ultimately they may exit that position over time.

So they are focused on providing the necessary grease to make the PPPs continue. The same thing has happened in Canada. Niagara Health have stepped in with a capital infusion.

So they still want the PPP model but the governments are going to step up and start to fund some of this. Queensland schools are another example where they have put in place a supported debt model. It has a few fleas on it

but fundamentally you see government stepping into the lending space.

There are a lot of issues to work out with that but the direction is that governments will continue to drive this model and in the short term take a different position.

I mentioned before about the patronage risk. There has been a lot of press around failed toll roads and tunnels and that type of thing. Just last week I think it was reported that governments now, particularly in Australia, are looking to undertake critical road projects, bridge projects, as availability payment models.

So Peninsula Link in Victoria, Northern Link in Brisbane are projects that may well go down the path where the government takes the patronage risk. Still wants to do the PPP but will take that usage risk and from our point of view, we will only look at projects that have an availability model.

What has happened too I think with contraction of some of the investment banks out of this space that traditionally saw these opportunities as a capital structuring opportunity as opposed to a whole of life property and asset management play.

Some of those organisations have contracted or exited the market so again that's a tremendous opportunity for us to strengthen our positions where we are now but also enter segments where we are not currently represented. I will talk a bit more about that later.

I think I have covered this previously but ultimately PPP deals are awarded on your ability to prove that you are able to add value over and above what the government can do. So they are not a hard dollar drag race on construction cost although that is a key value driver in the equation. The player that has the ability to integrate the origination side, the financing structure, the transaction structure, the design, the construction, the operation and maintenance regime, they will be the winners at the end of the day. So you have got to have end-to-end skills and the ability to integrate across that value chain. So it plays very well to Lend Lease's strengths.

The other thing about the PPP market or model is that there are quite high barriers to entry. I think the comment was made before that there are a lot of competitors in this space. There are competitors in the space in particular elements of that value chain but competitors that have an ability to actually integrate across all those elements and do it well are actually quite limited.

I think the success we had in Actus in the US was very much around that. We had a very tight integrated value proposition that positioned us very well. So I actually think the competitive space, albeit there are a lot of players there, there are very few players that actually bring all this together well.

Ultimately, I think we are quite strongly positioned as I mentioned and we have tremendous credentials in this space. In the property space in Rod Leaver's business, some of the best performing property funds around and I think our credentials as an investment manager or long term partner are quite good.

There are a few slides here. I'm not going to go through all the ticks and crosses and things like that. It is there for your consumption late at night when you've got nothing else to do. But what it does try to explain here is our view of the market.

I've got four slides here covering the UK, the US, Canada and Australia. I'll give you our view of the social infrastructure markets, where we see those markets as having scale, of being large. We're only really focused on scale markets because you need to have a scale market to be successful because you've got to be able to continuously improve.

As I said, there is quite a significant barrier to entry and whether we see those markets as growing, inactive, slow or whatever. Then where we are currently positioned across that value chain I mentioned before of origination, development, et cetera. So where we are currently positioned and where we see our desire or aspiration to grow into a scale position.

So that is what is sort of laid out on these four slides. As I said, I won't go through each of them but I will cover each region just in terms of where our focus is.

In the United Kingdom, despite some of the challenges that they face in a lot of the residential sectors, there is a huge commitment to upgrade health, education, public housing, things like that and we are very well positioned. We have a strong position with the Catalyst Lend Lease business in health and now, as education emerges as a market, we're developing a strong position there.

I will talk about education just briefly. It is a significant market; it is in the order of £12-15 billion in terms of what is going to come through over the next number of years. So it is a very large market, it's a growing and we're well positioned.

The reason why education is a high level of focus for us is that when you win an education deal in the UK you form what is called an LEP (a Local Education Partnership) with the government. That partnership then has the ability to roll all its education assets through it but also is able to then essentially morph into a local infrastructure partnership.

So public housing upgrades, et cetera can also be run through that partnership. The ability to create very solid long-term franchise value through a focus in the education sector is where our focus is.

So the accommodation market there and as I mentioned the public housing, you know the council flats if you like, is a very strong – it's a large market and it is going to emerge over time. Our focus is to grow a scale position across the value chain as that emerges.

So our objective if you like – our high level objective in the UK is to grow market share, so get our footprint down, similar to where Actus was a few years ago. Target the larger unitary local government authorities and develop partnerships where we can then deliver a lot of that social infrastructure.

One of the key elements, and Rod will pick up a little bit on it later, is the establishment of a PPP fund where we can actually start to – as we develop the assets, find partners that want to own those assets long term.

As I mentioned before, they are very attractive to certain investors. We are not a natural long-term owner of project equity in these PPP deals. Our focus is taking the equity position, structuring it, getting the project going and then finding a long term owner and obviously taking returns through that process.

So we've got some things to do with Catalyst in the UK, some provisions to the business model. Get the velocity of capital up and really leverage our lead position in that market as developer. So I see some good opportunities there.

In the US, Tony mentioned before, in the social infrastructure space of health, education and the like it is a very small and slow moving market. The US is essentially a privatised health market anyway. There is very little social health in the US. There is some with Veterans Administration, a little bit with some state institutions but by and large, health is a privately operated sector.

Similar with education – education is a very fragmented market in the US run by local countries, unified school districts and the like. So in terms of putting a lot of effort into health, education and justice, they are not scale markets for us.

I think a lot of people talk about stimulus spend in the US and where things are going. In the PPP space, it is actually a relatively small and immature market.

On the slide here I've got in the construction thing we're inactive. Through Bovis we are very active in this space. We are very active in the construction of health care facilities, hospitals, education programs and the like. But in terms of PPPs, that particular element, as I said, is relatively small.

Accommodation obviously through DoD and utilities as well through DoD (Department of Defence) are big markets for us. There is still a good burn on the Actus Housing Program. We've still got barracks pilots that are running through now so it is not going to happen in a blast like family housing

happened but barracks will happen over time.

And I think a great opportunity in utilities. Tony mentioned before the sustainability credentials that we have. We are exploring opportunities now with the military to develop renewable energy where we actually become a renewable energy provider on military installations. So it is early days but quite promising and there is a huge focus by the Obama Administration on using the military to seed a lot of the green initiatives.

So Canada is not a market that I think we've touched on before. It is a relatively new market; it's about four years young. It is a very large market. Canada has very similar characteristics to Australia in terms of its population of 33 million focused in a number of particular provinces.

They have a big social infrastructure program that is owned by government but they are looking to move into the private sector across health, education and justice. So from our point of view, our strategy there is really about market entry.

We are about to move into our first bid on a schools program there; we are in partnership with someone. So we see some good opportunities emerging. It is, as I said, a large market. It is growing and there is a good sustainable pipeline of opportunities there.

In terms of the model, it is very similar to the UK and Australian model so there is no barriers in terms of the structure of the deals, the risk profile and the like. So very comfortable with Canada but at the moment focusing on the market entry strategy.

In Australia, interestingly although it's our home market, we are really not represented in the origination space and there are a number of reasons for that. I think historically we have looked at the infrastructure market or the PPP market in Australia as we'd only enter it if we were in a fully integrated program.

When you look at the scale of the market just in health care or the like, it probably didn't have the scale that made it interesting to us. But with the shifts in the market and the opportunity to enter the origination space and take lead positions, we are really looking at Australia and we are actually quite excited about some of the opportunities that are there.

We are currently working on the first few PPPs in that origination space. Bovis Lend Lease is very well positioned in the development, project management, construction space in Australia so call me biased but I think we're probably one of the – or the lead player particularly in the design of construction in major tertiary hospitals in this country.

So very strong presence there but a need to expand in the origination space

and start to extract far better returns. So we see good opportunities in health because they are large markets and there are growth opportunities there.

I mentioned before and just to conclude, is that the PPP model if you like provides a tremendous franchise opportunity for Lend Lease. These are not one-off projects that you go and bid it, win it, close it, deliver it and then move on. There is a long-term value stream that we sit on.

So we look at recurrent earning streams and building a base of solid earning streams. The PPP market model for us is quite exciting and what we have got here is a little bit of a view of what that looks like on a project that we closed about four years ago at Fort Drum in Upstate New York. Probably one of the coldest places you've ever been if you want to visit there in January, but an installation that has now been running for about four years.

So in terms of just the operating performance - to pick up the paper just once a week and read about the residential crisis in the US et cetera - so there is always a question of well what's the sustainability of the military housing market in the US amidst all this crisis?

What has actually happened, and I think as Steve mentioned before, it is a very counter cyclical market that we play in here. If you look at the top graph there, it shows our actual NOI, that's net operating income, so that's the rent we receive, all our operating expenses, debt service, et cetera.

What is the net operating income that drops into the bottom line? You can see how we're now sitting about 15 per cent above what our budget is so the project is performing very well from an NOI point of view. Occupancy – again above pro forma.

So we haven't been affected and this is characteristic of a lot of our installations across the US so the assets are performing quite well.

I put this slide up for those of you that were able to visit Fort Campbell three years ago. You probably forgot this slide because you were off playing with guns and flying helicopters and stuff like that. But it's worth just reflecting on this slide that I put up three years ago because it does define - and it is not dissimilar, although the equity we put into Actus deals is a bit lower than what we do in Catalyst, et cetera – the fee streams that you earn out of that value chain are reasonably consistent. How we earn them and how we characterise them might be a bit different but they are still there.

So this slide showed for a typical deal of \$300 million and Fort Drum is about that. What we put in terms of cash equity, what our annual rent looks like and then some of the fees. These are well known in the marketplace; in fact, I think they only publish them on their website to make sure that we don't ramp them up over time.

So what this shows is over the 50 year period, how we earn our income and again it shows the long term value that we have. We take out a development fee when we close the deal for the structuring of it. We earn design and construction asset management fees, property management fees through the life of construction but then through the out-year period, once we've finished the initial development phase, we then have ongoing fee streams from the asset property management maintenance roles we have performed but also the ongoing construction and upgrading of the asset.

So that is the model; that is what I presented three years ago. So was I telling porky pies back then or has that actually come to fruition?

This is where we are sitting with Fort Drum today. The original project closed in May of '05, we were awarded the project late 2003 or early 2004. Original sources of development value is about \$313 million and we spent that on putting some new homes in and repositioning a lot of the existing ones.

Subsequent to that, we closed on a pilot project for barracks (Bachelor Office Quarters) nearly two years ago now and that is now coming to a completion and that will run and they will see how that operates before making a decision to then continue with more barracks.

Last year, we got a capital infusion. We had quite a deficit of housing in the market so we needed to put more housing in place. We raised additional funds in the market and combined with the government contribution, raised another \$175 million.

So graphically what that means is we started at about, as I said, just above \$300 million. We have had a couple of additions to that and extended the initial development period out to about June 2011 so now the project value is about \$520 million.

Through all of that, we obviously get to grow our fees because we have more houses that we manage, et cetera. We get development fees, we get design and construction fees and the like so everything is sort of hinged if you like off the scope.

Then just looking at the normal capital planning, every year when we do a budget and business plan, we do a capital plan for the balance of the 50 years and this is just looking at what is going to roll through as part of that capital planning process.

In about 10 years' time, the project will then go up to in excess of \$700 million and that is only the next 10 years. As I said, it is a 50 year franchise so the concession concludes in 2055 so it is something for the grandkids to look after but the Army actually has the option to extend for another 25 years on the back of that so these are potentially 75 year deals.

So Fort Drum is not dissimilar to – I could put one up for Fort Hood and you would see that. You would see it for Fort Campbell. We have had a lot of growth in the assets even though we hadn't even got to the end of the initial development period.

So I think in terms of understanding the PPP business, it is not just bidding and closing and winning and closing deals. It is about establishing the long term franchise that this model delivers.

So in summary, the model has been embraced by governments worldwide; some a little bit slower than others but it is something that is going to be an enduring feature of government procurements.

As I said before, the market will continue to move forward despite the current global financial crisis, the Great Recession, whatever you want to call it. The market is still moving forward, deals are being put into the marketplace.

We expect Adelaide Hospital, for example, will come to market in June and there is a deep pipeline of other deals out there.

It is a very strong fit. Lend Lease's platform and core capabilities that Tony went through before, map very well to this model. Take the lead position on the deals, maximise the operating returns and then create a long-term franchise.

There are opportunities in the markets that we look at – the United Kingdom, the US (predominantly through the Department of Defence), Canada and Australia. Some of those will be growing current positions and others leveraging that franchise and a couple of sectors really starting to move into the origination space.

From my point of view sitting here, I think we are quite well organised to secure lead positions in each of those markets.

So with that, I will ask Murray to come up and give us an overview of Bovis Lend Lease. Thanks.

END OF TRANSCRIPT