IMPACT OF THE GLOBAL FINANCIAL CRISIS ON AUSTRALIAN
CONSTRUCTION COMPANIES: A CASE STUDY

Ram Karthikeyan THANGARAJ*, Toong Khuan CHAN**
*(Cronin & Pain, Australia)
**(Faculty of Architecture Building and Planning, University of Melbourne, Australia)

ABSTRACT

This paper reports on the in depth financial analysis of four Australian firms that were significantly affected during the period of global financial crisis (GFC) within the building and construction supply chain from 2005 to 2010. These four firms were chosen from a study that involved analysis of 43 publicly listed and large private companies within the sector to understand the sectoral impact due to GFC. Financial ratios and Altman Z Score were used for the purpose of the analysis. All the four firms reported negative earnings for the financial years 2008 to 2010. They all grew rapidly during the boom years either organically or through acquisitions in overseas market. These firms either went into receivership or buyouts, or liquidated a large portion of their assets to pay off their short or long term liabilities. Low cost of debt, coupled with easy availability of finance, was the trigger behind these firms’ rapid expansion. Fall in revenues, decrease in asset valuation and rising interest expenses arising out of the financial crisis were the reasons behind these firms being unable to sustain their pre-GFC growth. Guidelines for effective financial management of firms to withstand future financial crises were developed.

Keywords: Financial Ratios, Construction, Global Financial Crisis, Australia, Financial Distress.

1.0 INTRODUCTION

Well over a decade of mismanagement of risk, low interest rates and lack of financial regulation have been cited to be the factors that led to the cause of GFC in the US. The collapse of Lehman Brothers in September 2008 started a series of panic selling and caused much distress to many other financial institutions and markets across the world. Five years after this crisis, much of
the western world is slowly on the path to recovery, but many European countries are still struggling to manage their respective economies.

As the Australian share market was very much in line with the global economies, the S&P ASX200 index fell from a peak of 6800 in late 2007 to 3100 in early 2009. Australian banks fared much better, as their exposure to collateralized debt obligations (CDOs) was relatively small in comparison with other countries. The housing market was also in a strong position. In 2007, non-conforming loans in Australia accounted for about 1% of total loans, in comparison with 13% in the US (Debelle, 2008). The Australian Federal government mitigated the effects of the economic slowdown with a quick reduction in interest rates and AU$42 billion stimulus package.

1.1 Objectives and Scope

These developments provided the motivation to develop a broader understanding of the effects of this recent financial crisis on the construction supply chain thorough a case study of four Australian companies. An analysis focused on characterizing the impact of the GFC on the financial performance of companies within four sectors of the industry: building material suppliers, building contractors, property developers and Australian Real Estate Investment Trusts (A-REITs) have been published previously (Thangaraj and Chan, 2012). This paper examines the business strategy leading up to the GFC, the financial position of these four companies during this period, and reports on the final outcome of their positions. The key points examined are the severity of the impact by means of ratio analysis, changes in cost structure and financial distress. The findings will inform investors, managers and construction professionals in devising strategies for prudent financial management and for weathering future financial crises.

2.0 METHODOLOGY

The financial investigation involved an analysis of 43 companies selected based on the criteria that included the availability of data and their representation within the four sub-sectors of property development, material suppliers, building construction and A-REITS. The financial performance of all selected companies was calculated over the 2006-10 period, both years inclusive. Despite its many drawbacks, the most precise information on these companies can only be determined by relying on audited financial statements (Langford et al. 1993). Four companies were selected based on news reports of their financial distress or removal from the stock market: Centro Properties Group, Valad Property Group, Raptis Group Limited and CEC Group Limited. Centro and Valad were both stapled securities indicating exposure to both the investment trusts and the property development companies while Raptis was a pure property development company. CEC represented the building construction sub-sector. There were no material supplier firms that were found to be in distress during this period.

3.0 PERFORMANCE ANALYSIS OF COMPANIES

In terms of revenue, property developers and A-REITs exhibited significant decline in revenues in 2008 and 2009, and in the case of developers, continuing into 2010. The building material sector exhibited a marginal contraction of 2.8% in 2009 followed by a further reduction of nearly 7% in 2010. On the contrary, revenues for building contractors continued to increase, albeit by only 1.6% in 2009 and 0.8% in 2010 despite the slump in building starts in late 2008. The nature of the building construction business is that builders are not immediately affected by a downturn due to continuing construction projects awarded a couple of years earlier. The launch of a number of stimulus packages; bringing forward spending on large-scale infrastructure and additional spending...
on new school buildings in late 2008 and early 2009 by the Australian government mitigated the effects of the GFC on the local construction market.

3.1 Centro Properties Group

Centro Properties Group is a public listed trust that is involved in all aspects of retail ranging from investments, management, development of retail properties and also syndicated fund management. First established in 1985, the firm was restructured as a stapled security consisting of one unit of Centro Properties Trust stapled to one share in Centro Properties Limited prior to listing. The resulting entity was listed in the market in 1997. It grew aggressively from 2000, with operations in the US commencing in 2003 through the Centro Watt joint venture. Centro owned 810 shopping centres of which 682 were in the US. In April 2007, it completed a US$5 billion acquisition of New Plan Excel Realty Trust in the US. In May 2007, it acquired Gallileo Funds Managements Limited and purchased the remaining 50% it didn’t already own in Centro Watt. Centro also purchased the Warnbro Fair Shopping Centre in Western Australia in July 2007. By October 2007, Centro Retail Trust was merged with Centro Shopping America Trust.


However, in December 2007, Centro’s share price collapsed drastically (Figure 1.1) after it announced its inability in refinancing debt obligations of AU$3.9 billion. Investigation by ASIC revealed that Centro had classified AU$1.1 billion of debt as non-current in its 2007 Annual report, when they were in fact current liabilities (Klan & Condon, Centro failed to disclose AU$1bn of debt, 2007). In July 2008, it announced the sale of 29 shopping malls in the US, but failed to close the US$872 million deal by October (Hoy, 2008). In July 2011, it sold 588 US shopping centres to Blackstone Group Limited, US for AU$9.4 billion.

After a series of profitable years, the company has reported only losses from 2008 onwards. The initial investor confidence and subsequent loss is reflected by the 74% increase in market capitalization from 2005 to 2007 and a decline of 98% from 2007 to 2010. Net profit margin in 2006 was extraordinary at 74%. Two years later, in 2008, the firm was to incur a loss of AU$2.76 for every dollar of sales! This was due to huge rise in expenses such as impairment of goodwill, impairment of investments in joint ventures, and property revaluation totalling AU$1.078 billion and financing costs adding another AU$411.185 million. This decrease in profitability has also affected the firm’s Return on Average Asset (ROAA) from 11% and 7% in 2006 and 2007 to -14% and -18% in 2008 and 2009, indicate the firm losing its efficiency in utilizing its assets for revenue generation.
Similarly, the Return on Average Equity (ROAE) of -58% and -241% in 2008 and 2009 marks the drastic fall in operating efficiency in generating return to shareholders. The current ratio of 2010 is 97% less than its 2005 value. This indicates that the firm’s current liabilities have increased by 97% for 2010 in comparison with 2005. The reason is a high expansion cost and drop in the value of assets as a result of GFC. Moreover Centro was holding majority of its assets in the US, which was the epicenter of the GFC. The working capital turnover turning into negative since 2007 indicates that the firm was lacking in funds for operations. The increase in debt to equity ratio from 0.85 to 4.79 from 2005 to 2008 indicates the firm has been aggressively financings its growth with debt. Subsequent year values are in negative signifying cost of debt has significantly increased relative to its earnings. The P/E ratio of 2005 stood at 22.83, indicative of investor’s willingness to pay $22.83 for $1 of its earnings. Whereas a negative value from 2008, is a consequential of negative earnings. The low price of the shares indicates that investors foresee an inferior earning potential for the firm.

Centro recorded 34% higher profit in 2006 in comparison with the industry average but subsequently fell in line with the sector average. However, from 2008 the performance fell drastically indicating that expenses were very high in comparison. After a number of executives were found guilty for failing to disclose billions of dollars of short-term debt, the company was in the process of being wound up at the end of 2011.

3.2 Valad Property Group

Valad Property Group, incorporated in January 1995 was listed in the ASX in 2002 as a stapled security. Throughout its history it has expanded through acquisitions rather than organic growth. In mid-2004, it acquired ICA Property Group specializing in non-residential property development and fund management. Again from 2005 to 2007, it made a string of acquisitions ranging from retail centres, office blocks, resorts, spa and residential properties. In 2006, it raised AU$200 million for Valad Core Plus, an open ended wholesale investment fund. Despite the property market downturn in 2008, Valad managed to raise about AU$3 billion of equity and debt for its fund management business.

In 2007, it gained a foothold in Europe through an investment in Crownstone European Properties Limited. It entered the US through a joint venture with Kemco, a US based REIT. Increasing credit crunch, interest expenses and liabilities leading up to the GFC derailed the firm’s growth eventually hurting its profitability. Loss of investor confidence started at the beginning of 2008. In April 2011, Valad announced an AU$806 million takeover bid, including AU$500 million of its liabilities by Blackstone Real Estate Partners, US a subsidiary of Blackstone Private Equity, US (Carter, 2011). The deal was closed in mid-2011, and Valad was subsequently delisted from the ASX on 30 August 2011.

At its peak in 2007, Valad stood with a staggering market capitalization of AU$25 billion. Compared to its 2005 market value this was a 153% growth. Most of its growth was heavily funded by debt. Financial crisis factors such as increased cost of debt, reduced revenue and fall in property valuation eventually lead to the downfall of the company. These factors will be evidenced with ratios in the section below. The year on year growth in profitability has played an important role in increasing its market capitalization. Profits had increased by 130% and 160% for the year 2007 and 2006. Whereas after the crisis, Net profit margin was at its lowest in 2009 financial year at -365%. Similar trend is visible in its ROAE value, as the increase from 2005 to 2006 was 87%. The value reported for 2009 is -116%. The profitability ratios indicate high growth followed by even higher fall in profitability.

Current ratio values have remained above 1.0, especially the 2008 value of 2.27 indicates that they had $2.27 worth of assets to cover every $1 of liability. This indicates that the firm was well
positioned in short term to cover for its liabilities. The low asset turnover values help in identifying the firm’s strategy of high profit margins. Their debt ratio stands to support the firm as well positioned to cover for its long term liabilities. The value has remained below 1.0 from 2005 to 2010. Throughout the six year analysis period, the operating cash flow ratio reported a negative value of -2.81 only for 2007. The cash flow statement for that year identified operating earnings to be AU$117 million against an expense of AU$321 million. Two possible scenarios are (i) the firm was spending much more in its operations than its earnings, or (ii) the firm had realised profits, but the real cash was yet to come. The reason behind the failure of the firm is well captured when analyzing revenue and interest coverage ratio in unison. The reported revenue for year 2010 and 2009 were significantly lower at 25% and 54% of the 2008 earnings. And the interest coverage values for 2008 to 2010 are all negative. Based on both these values it can be identified that the company failure was due to loss in revenue and rising interest expenses.

3.3 Raptis Group Limited

Raptis Group, a property developed based in the Gold Coast was listed in the stock market in 1986. The group has but dozens of towers across the Gold Coast including the Raptis Plaza shopping centre and the iconic Chevron Renaissance high rise apartments. In 1993, the firm was placed under administration due to a debt of AU$70 million (Klan, 2009) but with subsequent recovery of the property market in Queensland the group was successfully turned around.

Since 2003, the firm’s market capitalization has increased drastically triggered by the booming property market in the Gold Coast. The reprise seems to have been short lived. This growth was heavily funded by debt. In late 2008, Capital Finance Australia placed Limdaning, a subsidiary, under receivership for failing to pay its subcontractors (Smart Company, 2008). The group ceased trading in the exchange in early 2009. The last annual report filing was for 2008 financial year.

The company’s profitability grew by 80% and 36% annually between 2005 and 2007. From 2003 to 2007, revenue has also been on steady rise except for a minor dip of 8% in 2006. It has maintained an average ROAE of 40% for the years 2003 to 2007 possibly through a high leveraged position. ROAA fluctuated between 2 to 4% for the analysis period of 2003 to 2007.

The firm has increased its dependence on debt substantially in the years leading up to the GFC. This is evident from the Net Gearing value. During its last year of operation in 2008, its gearing value was at its peak of 69.69. Highly leveraged firms are considered to be very risky especially during a downturn as the firm has to service its debt irrespective of any fall in sales. Current ratios pre 2006 financial year place the firm in a financially healthy position. As the 2005 value of 1.65 can be interpreted as the firm having $1.65 worth of assets for every $1 of its liability. But the values of 2006 and thereafter signify that the firms liabilities was higher than its assets. The rise in liability is further well documented through the leverage ratio. A value of below 1 is a most preferable situation. The debt ratio from 2004 to 2008 has remained below 1, only by a very low margin. The debt to equity ratio concretizes the fact that debt funded growth was one of the major reason for the firm to be facing receivership. The 0.92 value of debt to equity is a clear sign of a financial trouble. For the year 2008 its total liability was about AU$900 million of which interest bearing liability alone was close to 75%.

The difference in Raptis Group’s profitability and the developer sector is very huge. This could arise from Raptis expenses being higher than the other firms operating in the sub sector. High expense can be a resultant of soaring interest cost as identified above in the horizontal analysis. It is established fact that downturn in an economy impacts revenue, which in turn lowers profitability. Hence, Raptis maintaining lower profitability even during a booming economy has affected them to the extent of failing on its payments to subcontractors during the crisis.
The highly leveraged nature of Raptis is evident from the difference in its debt ratio against the sectors average. It can be summed up that debt funded growth has affected the firm significantly during the crisis period.

3.4 CEC Group Limited

Established in 1977, CEC Group has evolved from a small civil construction company into a vertically integrated public firm by 2008. Since its listing in 2004, the company has significantly branched into construction and property development markets especially in and around North Queensland. Its three main core business units were property development, construction and materials. CEC Constructions, CEC Bitumen and Asphalt Services, CEC Property, CEC Remote Solutions, Rapid Build, CEC Townsville and CEC Mt Isa were its subsidiary companies. These firms undertook a multitude of works such as civil engineering contracts, property development, services for mining and quarry operations, project management for its own group companies in remote locations and modular building systems.

Coupled with the property development boom in Queensland and high positive sentiment in the market, the firm had a steady rise in its share price pre-GFC. In 2008, the consolidated revenue was AU$209 million. The aftermath of financial crisis such as credit crunch, fall in revenues, rising interest expenses all together crippled the firm. The group announced a loss of AU$70 million, total debts of AU$135 million and assets worth AU$93.5 million in December 2010. Following this announcement, lenders demanded payments of its debt of about AU$63.5 million in May 2011. Defaulting on the payment eventually placed the firm under receivership. The firm was removed from the official list in the market with effect from the close of trading on Monday 29 August 2011.

During the 2007 market peak, the firm boosted a market capitalization of AU$141 million. But after a series of loss reporting financial year, rising interest expenses and falling revenues had decreased its market capitalization to a mere AU$4.7 million. The firm’s gross profitability has been on a downscale from since 2005, sliding from 24% to -3% by 2010. This indicates that the firm was losing money in its core operations and reason like fall in asset valuation have only added fuel in driving the firm towards its present financial tragedy. In comparison with its ROAA, the ROAE values are very high. This indicates that the firm was highly leveraged and will be expected to be hit due to increased cost of debt during a downturn.

The current ratio of the firm has above 1.0 throughout the period of study indicating that the firm was in a good position to cover for its short term liabilities. But the low quick ratio indicates that the firm is highly depended on its inventory turnover to pay for its short term liabilities. Such a model is faced with trouble during a downturn as there is a fall in revenue due to reduced spending. This is evident as the revenue dropped by 50% from 2008 to 2010 financial reporting. Very high revenue to equity of above 3.0, especially from 2008 to 2010 indicates that the firm equity was very low and was funded largely by debt. This is further established by its high value of 4 for the debt to equity ratio for 2009 and 2010. The firms high P/E ratio pre GFC period, indicates the generally high investor confidence during those period. Since 2008 due to loss in profits, the P/E ratio has turned negative. Interest coverage ratio clearly captures the firm’s inability to meet its interest expenses, as the values after 2008 are all negative.

4.0 CONCLUSIONS

These four case studies have identified a number of factors that have led companies in the building and construction industry to failure during the recent global financial crisis. The findings confirm that property development companies utilized a larger proportion of debt to fund their purchases of real estate. Financial ratio analyses have indicated that the industry was highly
susceptible to the effects of the GFC, especially those companies that are over-geared. All three property development (and two with stapled real estate investment trusts) firms expanded their operations at a very rapid pace, benefitting substantially from the availability of easy financing and increasing property valuations in the years leading up to the GFC. The low cost of debt, coupled with easy availability of finance led to a debt fuelled growth of many property development companies. A fall in revenues accompanied by a decrease in asset valuation and rising interest expenses arising out of the financial crisis were the reasons behind these firms eventual failures.

The situation with the building construction company is less dire. Most building construction companies that were solely involved with construction work were only marginally affected by the GFC. Companies that were distressed were those that were again highly leveraged. CEC failed due to rising interest expense coupled with a drop in revenues leading to its inability to repay its loans.

REFERENCES