How a HK market sleuth blew the lid on CIMIC

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CIMIC could be withholding more secrets, warns the analyst who cracked the reverse factoring controversy at Australia's largest construction group.

The company first came across Nigel Stevenson's radar courtesy of a tip-off from a company insider in 2016.

Nigel Stevenson first started looking into CIMIC after a tip-off from a company insider.

The market sleuth, who cut his teeth in investment banking in London before time on the buy-side with Veritas Asset Management, is an analyst at the Hong Kong-based boutique GMT Research.

After running the rule over CIMIC's books at the time, Stevenson decided that with critiques from Morgan Stanley and other brokers, there was enough coverage of Australia's largest construction group.

But that changed when CIMIC's 2018 annual report dropped. "I took a look at the full-year results last year, and a number of things raised alarm bells," he says.

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Among the red flags was a sudden increase in contract assets and disclosures relating to CIMIC's high-value dispute with Chevron [https://www.afr.com/companies/infrastructure/cimics-chevron-debt-dispute-continues-as-interim-profits-rise-20170718-gxd9dj], he recalls.

One of three analysts at GMT, which sells its analytics and research to a client base of about 60 institutional fund managers and hedge funds, Stevenson then spent 1½ months looking deeply into CIMIC. One thing stood out.

"The more you dig, you see references to the fact that they'd been factoring – supply chain finance and reverse factoring."

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Factoring is traditionally used to unlock cash by effectively selling amounts owed to a company by its customers to a financier.

The financier receives the right to the future payment from the customer, while the business immediately receives what would have otherwise been paid later by its customer, less the financier's cut.

By contrast, reverse factoring is where a business uses the financier to pay amounts it owes to suppliers [https://www.afr.com/companies/infrastructure/accounting-body-to-delve-into-tiger-trap-20190925-p52uti].

The suppliers are paid by the financier and the business then pays the financier back. The practice provides what can be described as a debt-like product, but which is generally treated as a trade payable rather than debt. Its growing use has been raised as a concern by some regulators and in capital markets [https://www.afr.com/companies/infrastructure/reverse-factoring-proliferates-in-cimic-20191007-p52y8u].

In CIMIC's 2018 annual report, released at the start of last year, the company did not detail the extent of supply chain finance beyond acknowledging that it had been used.

In its 2019 report [https://www.afr.com/companies/infrastructure/cimic-replaces-ceo-after-1b-net-loss-discloses-reverse-factoring-20200204-p53xil], however, the company came clean on its use. CIMIC reported net operating cash flow before factoring of $1.243 billion and $1.25 billion after factoring, up by just $7 million.

Along with the disclosures for 2019, the company also restated the numbers for the prior year, revealing the extent of its use.

In 2018, operating cash flow jumped from $508 million to $1.903 billion after factoring, up by $1.395 billion.

'Grossly misleading'

Stevenson says the company's failure to fully disclose the impact of factoring 2018's results was a key issue, because CIMIC claimed to have strong cash flow and cash-back profits.

"And that was grossly misleading, because in 2018 pretty much all their cash flow came from factoring of receivables, so selling receivables and pulling cash in."

He says they were later forced to disclose the extent that supply chain finance had been used in 2018.

Stevenson's first report on CIMIC following the 2018 results hit headlines in May last year [https://www.afr.com/companies/infrastructure/cimic-market-value-drops-by-1-6b-on-alleged-accounting-shenanigans-20190507-p51krh]. Raising warnings of overstated profits and cash flow, the analysis triggered a $1.6 billion sell-off in the company's shares and a 7 per cent fall in one day.

Stevenson also flagged the risks associated with CIMIC's Middle East operations at the time. While it was known that the segment was a significant risk, when the company finally announced the $1.8 billion [https://www.afr.com/companies/infrastructure/cimic-takes-1-8b-write-off-on-middle-eastern-venture-20200123-p53tz4] write-down at the end of last month the ultimate hit to shareholders was worse than many expected.

Days after the write-down was announced, Stevenson doubled down on his concerns about CIMIC's lack of transparency around its use of factoring.

"Unfortunately, there may be more skeletons in the closet: CIMIC has still not come clean on the level of reverse factoring, which may (once again) be hiding weak underlying cash flow," he wrote in research on January 31. The following week CIMIC released its annual report, which included the supply chain disclosures.

What's all the fuss about?

Stevenson says the risks posed by reverse factoring were evident in the collapse of the then second-largest construction company in the UK, Carillion, in January 2018.

"One of the issues there was that they run up basically a half a billion pounds reverse factoring facility." He said its use had been masked in the company's payables.

"They'd disclose the fact that they [used supply chain finance], but hadn't disclosed the amount or exactly where those figures showed up in the balance sheet.

"One of the issues there was the fact that when it was clear that they were having certain financial difficulties, the bank started shutting down these facilities or restricting them, which only made the matter worse."

Carillion did not collapse because of reverse factoring. The employer of 43,000 people called in the administrators after issues that included contract pricing and profit recognition.

But reverse factoring did support a company already in trouble in a way that may not have been clear on examination of its accounts.

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"This whole thing that it's not really a form of debt, yes that's true up to a point if it's used as just part of the working capital. But if you then push it to the point where you rely on it for funding, it then effectively becomes a form of debt."

CIMIC's disclosures relating to its use of supply chain finance are a step in the right direction, but Stevenson says there are other questions that remain unanswered by the company.

"The catalysts [that could cause a financial stress event] potentially is if there are any issues with some of their contracts."

Stevenson says contracting in the large project construction industry is not within his expertise, but said there are examples of possible issues.

"If for instance there are large losses on certain contracts that haven't been disclosed, or they've been slow disclosing or certainly there is a sort of issue on a particular contract where they make a large loss on it, these are some of the potential catalysts."

Industry impediments

The problem is common in the industry, Stevenson says, due to the complexities of the agreements and revenue recognition.

"Management has a lot of discretion on some of these long-term construction contracts on how exactly they recognise revenue or profits."

The problem is, he says, that "everything looks fine, until perhaps some later date several years down the road it all kind of blows up and you realise there's a big kind of problem there".

"So it's the aggressiveness on profit recognition and potential problems on contracts, potential problems in the Middle East, which have obviously come to light, or finally sort of fully come to light."

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