BondAdviser

Research Report

Report Created on 16 August 2016

Issuer Name

Aurizon Network Pty Limited

Security Name

Aurizon 5.75% 2020

Security Recommendation

Hold

Security Risk

Upper Medium

Issuer Outlook

Improving	Stable	**Deteriorating**

Key Characteristics

Product Type	Corporate Bonds	**Last Price**	$108.62
Issue Size	$525,000,000.00	**Accrued**	$1.67
Par Value	$100.00	**Capital Price**	$106.95
Fixed/Floating	Fixed	**Running Yield**	5.380%
Payment Frequency	Semi Annual	**Yield to Maturity**	3.940%
Current Distribution	5.750%	**Trading Margin**	2.110%
Issue Margin / Coupon	5.750%	**Optional Call Date**	
Franking Credits Incl.	No	**Legal Final Maturity**	28 October 2020
ASX Listed	No (ISIN: AU3CB0215119)	**Next Ex-Date**	21 October 2016
Convertible	No	**Next Payment Date**	28 October 2016
GICS Sector	Transportation	**Next Cash Distribution**	2.88

Summary

On the 28th of October 2013 Aurizon Networks Pty Limited (under terms and conditions set out in the information memorandum dated the 4th of October 2013) issued fixed rate notes (ISIN: AU3CB0215119) under its medium term note programme raising $525 million. These securities are sold to wholesale investors only (no prospectus being issued) and are not listed on the Australian Securities Exchange.

These securities are structured as direct, senior unsecured notes and interest payments are non-discretionary, fixed rate and paid on a semi-annual basis in arrears. The coupon on this security was set at 5.75% p.a. and is paid on the 28th of April and October each year up to the maturity date. There is no optional call date but holders have the option to force redemption of the notes if the notes are downgraded by any rating agency below investment grade. Legal final maturity of the notes is the 28th of October 2020.

This security is subject to multiple financial covenants including a negative pledge and cross-default condition.

Figure 1: Capital Structure[1]

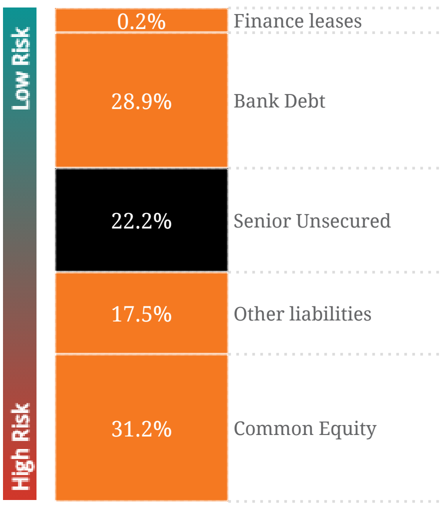
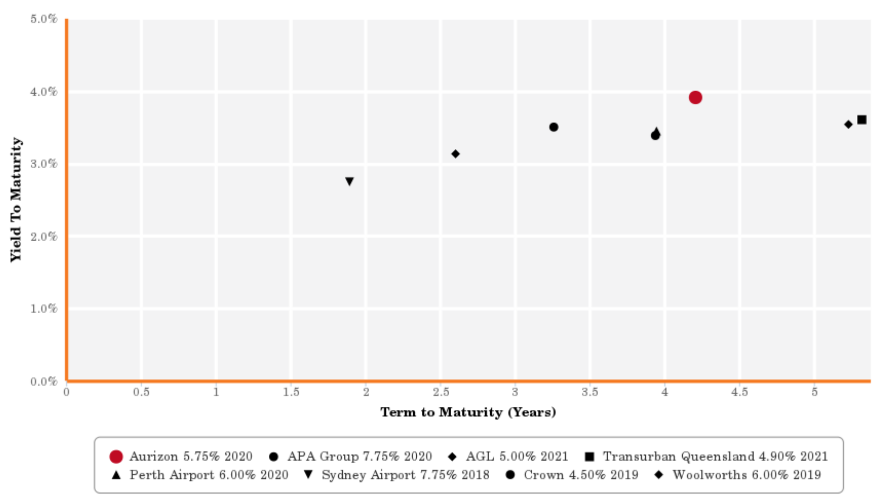


Figure 2: Relative Value[2]



Security Recommendation - Hold *as at 15 August 2016*

BondAdviser currently recommends the Aurizon 5.75% 2020 as a **Hold**.

Aurizon's results reflect the current state of global coal markets. While haulage volumes have begun to stabilise (after a precarious start to 2016), management have outlined they expect volumes to remain flat over the medium term. This has forced the group to abandon their proposed share buy-back scheme, impair assets and focus on cost management to salvage any potential improvement in profitability. Although we take some comfort in the Network's regulated revenue structure (which should continue its stable revenue growth) its credit rating remains capped by the parent. This means the credit profile of the Network is tied to that of the group. Given our outlook, we believe negative credit risk migration (or the deterioration of the credit profile) is likely over the coming periods.

Our valuation assumptions for this security are based on the security being redeemed (in full) at maturity (28 October 2020) and all interest payments being made in a timely manner. As Aurizon has a unique business model, we utilise comparably rated securities to determine fair value based on our fundamental view. Our analysis suggests the deterioration in credit profile is already priced into the security (at least partially) and we believe the margin offered is fair. For this reason, we maintain our recommendation at **Hold** but remain cautious of the challenging long term outlook the group and the network face moving forward (i.e. low global growth, viability of coal as an energy source).

The primary risk to our thesis is a sharp deterioration in earnings driven by either a demand or supply shock to the Queensland coal market. However, reduced capital expenditure, strong customer credit profiling, limited contracting risk and increased fixed pricing are all key strategies that will offer some protection from counterparty risk should a material deterioration in the Queensland coal market occur.

Positive / Negative Risk Factors

What factors would change the Recommendation UP

- The Network's monopoly position prevents the premise of competition and therefore, lessens the risk of earnings over time;
- Take-or-pay contracts reduce the risk that Aurizon Network's revenues will fall short of expectations. A take-or-pay contract protects Aurizon Network in the event of technical factors or demand conditions affecting a user's shipments of coal. Within the period of the contract this protection will apply up to the point that the user defaults. Even in the event of default, a re-organised business would need to resume operations applying the same take-or-pay contracts. The proportion of take-or-pay contracts has risen considerably over the last decade, and the percentage of the contract to be paid in the event of relinquishment has increased to 50%;
- Aurizon Network's earnings risk is buffered by the regulatory framework in which it operates. This means it's similar to regulated energy networks and water businesses. Not like Class 1 rail and airports whose revenues are highly sensitive to the economic cycle. While Aurizon Network's infrastructure transports coal to the ports, the regulatory mechanisms offer protection from volatile coal prices (which impacts heavily on the coal mining companies);
- If counterparty risk occurs whereby certain mines become non-operational, the Maximum Access Revenue (MAR) specified by the regulator will be shared among the remaining access users to make up the shortfall. This will protect the Network against any short-term slowdown in Queensland mining;
- Reduced capital expenditure, cost reduction, limited contracting risk and increased fixed pricing over the medium term are all key initiatives set by the group to offset poor expected trading conditions for 2017;
- Higher Maximum Access Revenue (MAR) cap drafted and approved for UT5 (the next regulatory agreement) for the regulatory period starting mid-2017;
- Higher than expected coal volumes triggering the turnaround in the Queensland economy;
- Diversification away from commodity haulage into other goods. This will reduce the Network's dependence on the Queensland's coal market. We note that this would require substantial funding.

What factors would change the Recommendation DOWN

- The Network's credit rating is tied to group. This means that cost of funding of the low-risk 'Below Rail' business will ultimately depend on the creditworthiness of its high-risk 'Above Rail' counterpart. If a downgrade of the parent was imminent, bondholders would be risk of capital losses through mark to market adjustments;
- Aurizon Network's performance is tied to regulation. Any adverse change in the undertaking and subsequent access agreements, could cause a sharp deterioration in earnings and substantially increase liquidity pressure;
- Higher-than-expected capital expenditure requirements for the Network will erode future free cash flow;
- The Network is ultimately exposed to Queensland's competitiveness relative to other global seaborne miners and long-term viability of coal. Although regulatory mechanisms should protect the network from short term market fluctuations, it is unlikely these mechanisms will shield the Network from a large-scale deterioration in the Queensland mining sector;
- 100% dividend payout ratio continues to put pressure on the group's cashflow;
- Continuing slow-down of the Chinese economy leading to prolonged poor export demand and low commodity prices;

- Unexpected changes to climate change policies by the Australian Government could have a negative impact on the Queensland coal industry;
- Further asset impairments due to decreased contract value;
- Wholesale energy prices remain elevated which would offset cost saving initiatives;
- Further shareholder friendly activity such as special dividends or a renewed share buyback;
- Management have outlined their disagreement over the weighted average cost of capital (WACC) proposed for UT5 with the QCA. This may disrupt revenue trajectory for the Network by increasing the uncertainty of MAR.

Issuer Outlook - Deteriorating *as at 15 August 2016*

Aurizon Network Pty Ltd is a wholly owned subsidiary of Aurizon Operations Limited and the ultimate parent company is Aurizon Holdings Limited. It controls, manages and operates Australia's largest export coal rail network - the Central Queensland Coal Network. The Network has a 99-year lease arrangement with the State of Queensland and contributes more than 50% of the consolidated group EBIT. The rail infrastructure is regulated by the Queensland Competition Authority. Aurizon Network Pty Ltd is defined as the parent's "Below Rail" operations and enjoys a monopoly position within the Queensland rail system.

Regulation

In November 2010, the Central Queensland Coal Network was privatised by the Queensland State Government and became Aurizon Network. In accordance with the Queensland Competition Authority (QCA), the Network must allow third-party train operators to use its network.

In August 2014, Aurizon Network submitted a draft access undertaking (DAU) for QCA approval labelled UT4. The final decision on UT4 was released in April 2016. This outlines the maximum total rail access charges the Network can charge third-parties ($3.925 billion) for the 2014-2017 period. Aurizon targeted up to $4.78 billion. Aurizon Network must submit a new DAU to the QCA by September 2016 for the next regulatory period commencing in July 2017. This will be known as UT5.

Aurizon Network's regulated revenue is protected through a series of contractual and regulatory mechanisms that are included in the Access Undertaking and subsequent Access Agreements (with third party users). These mechanisms are triggered when revenue shortfalls occur (i.e. realised tonnage railed is less than regulatory approved forecasts). The primary mechanism is known as take-or-pay (ToP) whereby the Network can recover lack of revenue from the access holder. Additionally, if significant counterparty risk occurs whereby certain mines become non-operational, the Maximum Assess Revenue (MAR) will be shared among the remaining access users. The shortfall is recovered by adjustments to tariffs with a 2-year lag. On the other hand, the unregulated business (known as 'Above Rail') is not protected by these mechanisms and therefore earnings are subject to greater risk.

Earnings

Aurizon Holdings comprises the Network ('Below Rail') and its rail haulage ('Above Rail') business. The majority of Network's access revenue (~70%) is derived from access agreements with the parent company's 'Above Rail' contracts and as a result, the Network's performance is reliant on the rest of the consolidated group.

In line with guidance, the Above Rail business posted poor results for the 2016 financial year. Revenue decreased by 10% to $3.1 billion while underlying EBITDA declined 14% to $733 million. This was driven a reduction in haulage volumes across all commodities reflecting the challenging macroeconomic environment. However, Aurizon was able to deliver $123 million of transformation benefits which resulted in an 8% decrease in operating costs. The group is expecting to achieve $630 million in cost reductions over a five-year period ($380 million remaining) and if successful, this would improve the resilience of the unprotected Above Rail business throughout the commodity cycle.

Coal haulage continues to be the primary contributor to Above Rail earnings (60% of income). In Queensland (where in Network is situated), volumes were down 3% in the first half of 2016 following the ramp-up of BHP Billiton Mitsubishi Alliance (BMA) rail before stabilising in the second half. Overall, Above Rail revenue per Net Tonne Kilometres (NTK) was down 3%. While these results illustrate increasing competitiveness, 62% of coal haulage counterparties are investment grade with a weighted average contract length of 10.5 years which offers some relieve from a credit perspective. In addition, 96% of contracts are expected to be new form (fixed rather than volume-based) by 2018.

The group's Below Rail operations (Aurizon Network) follows revenue trajectory in line with approved levels given by the QCA. Due to regulatory protection mechanisms, income shortfalls can be recovered through adjustments to tariffs and as a result, profitability remains relatively stable year on year. Revenue increased by 6% to $1.2 billion and underlying EBITDA rose 9% to $764 million. Surprisingly, these results were driven by record volumes not consistent with the Above Rail business and overall NTK was up 2% from longer average haul lengths.

Our analysis suggests that six mining companies (investment grade) currently account for ~80% of 'Below Rail' contract volumes and this arguably demonstrates an element of customer concentration risk. These companies are most likely the lowest cost producers in the industry and as a result they are less likely to default on contractual obligations than smaller competitors. That being said, it is difficult decipher how these contracts are structured and who with (the parent mining company, the Australian subsidiary or the individual mine itself). For this reason, we are confident that regulatory mechanism will continue to shield the Network from the commodity cycle but are remain cautious of the lack transparency on contract structures.

Cashflow

On a consolidated basis, Aurizon recorded negative free cash flow of -$3 million as the company maintained its target 100% dividend payout ratio. Due to poor operational cash generation (weaker volumes), this was financed by a $343 increase in debt and reduced capital expenditure. This suggests that management view the reduction in volumes as a short-term fluctuation in the market but if adverse conditions persist, this payout ratio will become unsustainable. As a result, we believe that the group will be forced to cut dividends to maintain their credit rating. Aurizon has already announced the discontinuation for its proposed share buyback program partially for this reason ($301 million spent in 2016) and we view management's shareholder friendly nature as a major concern for debt investors moving forward. While the $650 million cost transformation program is offering some support to cashflow at this point in the commodity cycle, we believe further measures will be required if the coal market remains subdued.

As the Network's rating is capped by the parent, its cost of borrowing is ultimately tied to actions of the group. As this is where most of the group's debt lies, we expect that the group's credit rating will continue to be a key priority to management to ensure future funds. For this reason, we believe the group will be forced to focus on its balance sheet over the medium term to prevent a downgrade and the implementation of key savings measures mentioned and cessation of the share buyback reflects this.

Capital Management

Due to the low risk nature its 'Below Rail' business, the majority of the consolidated group's debt is held in the Network (90%). All material growth projects were completed in December 2015 and as a result the Network's net debt position is expected to remain flat at $2.9 billion while all sustaining capital expenditure requirements are funded through operating cashflows. Although this seems conservative, the consolidated group saw a 21% increase in net debt over 2016 to $3.4 billion. The additional funds were primarily used to fund the share buyback program and resulted in group gearing increasing from 30.2% to 37.4%. Given the bleak coal market outlook, it is possible that gearing will rise over 40% if the dividend payout ratio is maintained or cost saving initiatives are not met.

Given the stress the buyback put on the group's credit profile (and possibly the group's credit rating), we hope management will take a more cautious approach before chasing shareholder returns at the expense of the balance sheet.

Near the end of 2015, the Network was able to extend its $490 million bank facility maturity from 2017 to 2022. Following this (May 2016), Aurizon refinanced its $1.2 billion debt obligation maturing in 2019 via a new Euro bond. As a result, the group's closest debt repayment is scheduled for 2019 which will give the group some financial flexibility if trading conditions worsen.

Outlook

Although coal volumes have stabilised, Queensland coal is still facing a challenging price environment and weaker export demand. This is evident in $528 million in group asset impairments incurred over 2016. While the company views the reduction in coal volumes as a singular re-basing of volumes, it can be argued that it is a more permanent structural issue concerning the viability of coal relative to other energy sources and long term demand in a low growth global economy.

Assuming volumes remain steady, Aurizon have given 2017 group guidance of revenue between $3.35 - $3.55 billion and underlying EBIT of $900 – $950 million which is a slight improvement on 2016. Due to anticipated higher energy and depreciation costs, the Network is expected to produce a flat result. Given the group's failed investments and projects and poorly timed share buyback, we now have less confidence in management and believe these forecasts are optimistic.

Next Event: Aurizon Holdings Annual General Meeting 2016 to be held on the 18th of October 2016.

Figure 3: Credit Curve (Comparable Securities)[2]

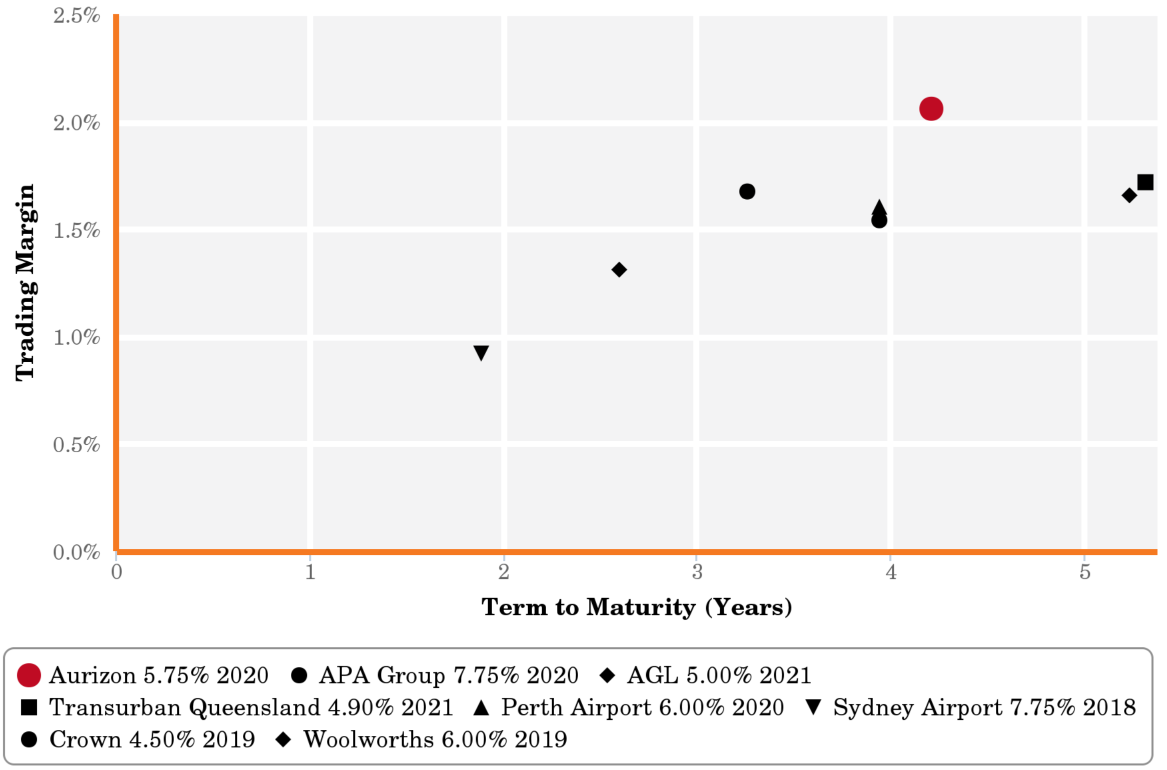
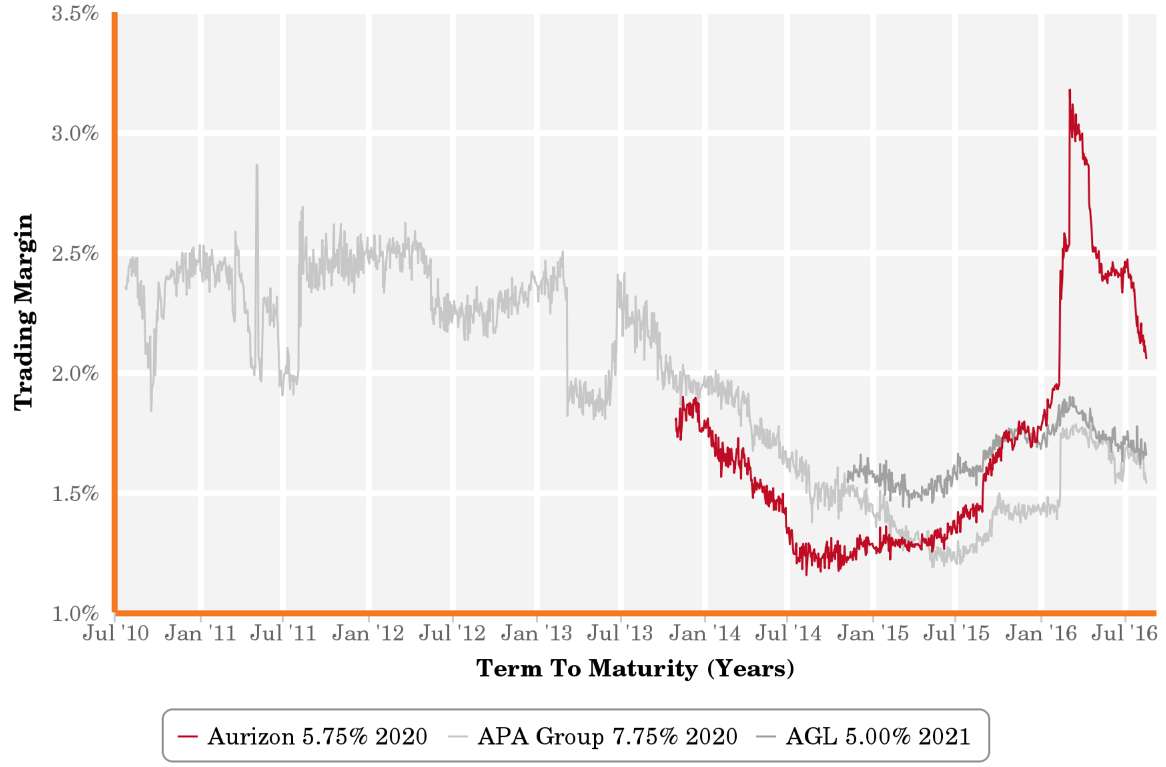


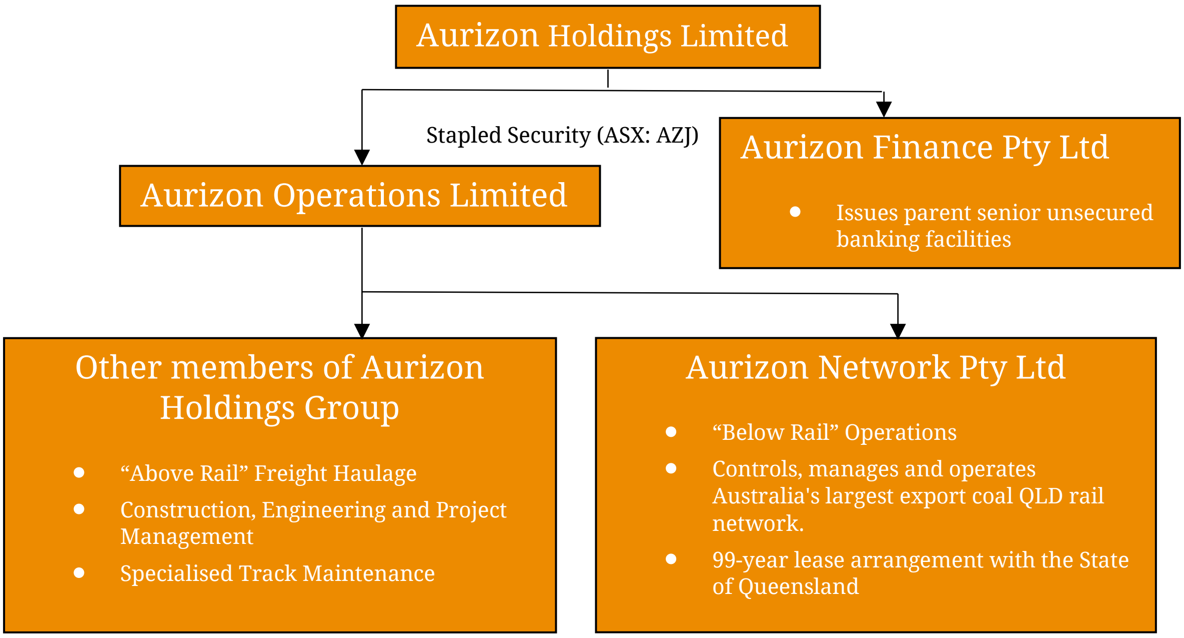
Figure 4: Historical Trading Margins of Comparable Securities



[1] The balance sheet structure diagram represents a measure of liabilities and captial in order of seniority of the overall cash balance sheet.
[2] Pricing as at close of business 15 August 2016

Source: BondAdviser

Legal Structure



Source: BondAdviser, Company Reports

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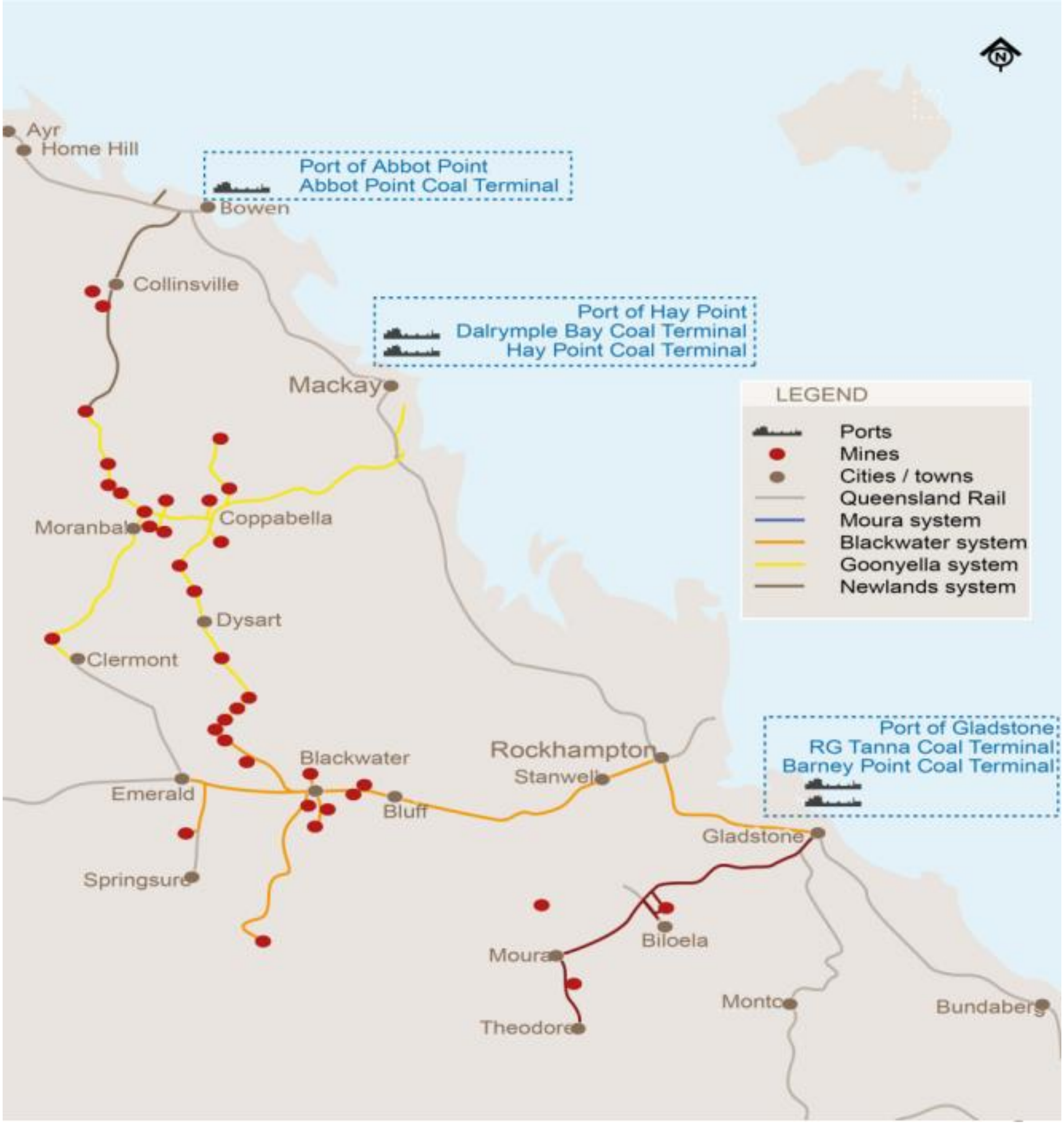
Central Queensland Coal Network



Source: Company Reports

Aurizon Network Pty Limited: Financial Summary

Aurizon Network Pty Limited: Financial Summary | **Recommendation Summary** | **Hold**

16 August 2016

Profit and Loss	2016	2015	2014	2013
Note: Group Results				
Revenue ($m)	3,458.0	3,780.0	3,822.3	3,736.3
Operating Expenses ($m)	-2,026.0	-2,291.0	-2,435.2	-2,485.6
EBITDA ($m)	1,432.0	1,489.0	1,387.1	1,250.7
Depreciation & Amortisation ($m)	-561.0	-518.5	-499.2	-496.3
Underlying EBIT ($m)	871.0	970.5	887.9	754.4
Net Interest ($m)	-150.0	-135.0	-112.1	-103.3
Underlying Pre-Tax Profit ($m)	721.0	835.5	775.8	651.1
Taxation ($m)	-121.0	-231.0	-216.0	-164.1
Net Profit ($m)	600.0	604.5	559.8	487.0

Credit Metrics	2016	2015	2014	2013
Note: Group Results				
Revenue Growth (%)	-8.5	-1.1	2.3	5.7
EBITDA Growth (%)	-3.8	7.3	10.9	19.3
Net Leverage (x)	2.40	1.90	1.90	1.90
Interest Cover (x)	9.50	11.00	12.40	12.10
Gearing (%)	37.4	30.2	28.4	26.7
Dividend Payout Ratio (%)	100.0	84.5	63.0	55.7

Divisional Revenue	2016	2015	2014	2013
Note: Group Results				
Commercial/Marketing ($m)	2,931.0	3,151.0	3,270.6	3,300.9
Operations ($m)	215.0	332.0	337.6	343.7
Network ($m)	1,179.0	1,108.0	1,012.1	979.5
Corporate/Inter-Segment ($m)	-867.0	-811.0	-798.0	-887.8
Total ($m)	3,458.0	3,780.0	3,822.3	3,736.3

Divisional EBIT	2016	2015	2014	2013
Note: Group Results				
Commercial/Marketing ($m)	2,878.0	3,079.0	3,171.0	3,178.9
Operations ($m)	-2,443.0	-2,527.0	-2,597.8	-2,735.8
Network ($m)	506.0	484.0	411.7	416.6
Corporate/Inter-Segment ($m)	-70.0	-65.5	-97.0	-105.3
Total EBIT ($m)	871.0	970.5	887.9	754.4

Balance Sheet	2016	2015	2014	2013
Note: Group Results				
Cash ($m)	69.0	171.0	318.0	107.6
Receivables ($m)	514.0	543.0	603.0	579.5
Other ($m)	261.0	220.0	415.0	245.8
Total Current Assets ($m)	844.0	934.0	1,336.0	932.9
Property, Plant & Equipment	9,719.0	9,900.0	9,441.0	9,473.4
Intangibles ($m)	190.0	127.0	64.0	11.4
Other ($m)	115.0	375.0	107.0	101.4
Total Assets ($m)	10,868.0	10,519.1	10,948.0	11,336.0
Payables ($m)	297.0	368.0	461.0	320.7
Other Current Liabilities ($m)	435.0	447.0	391.0	470.6
Current Borrowings ($m)	6.0	59.0	42.0	
Non-Current Borrowings ($m)	3,484.0	2,924.0	2,799.0	2,478.6
Other ($m)	932.0	1,002.0	882.0	753.6
Total Liabilties ($m)	5,154.0	4,830.0	4,575.0	4,023.5
Net Assets ($m)	5,714.0	6,506.0	6,373.0	6,495.6
Net Debt ($m)	3,421.0	2,812.0	2,523.0	2,371.0

Cashflow	2016	2015	2014	2013
Cash From Operations ($m)	1,347.0	1,496.0	1,306.0	1,049.0
Interest Received ($m)	2.0	9.0	9.0	2.0
Taxation ($m)	-131.0	11.0	-124.0	-31.0
Net Operating Cashflow ($m)	1,218.0	1,516.0	1,191.0	1,020.0
Capital Expenditure ($m)	-692.0	-1,013.0	-826.0	-930.0
Payments for Intangibles ($m)	-80.0	-70.0	-45.0	-14.0
Other ($m)	32.0	-78.0	7.0	53.0
Net Investing Cashflow ($m)	-740.0	-1,161.0	-864.0	-891.0
Change In Borrowings ($m)	450.0	107.0	345.0	1,305.0
Net Equity Issuance ($m)	-301.0	-69.0		-1,050.0
Dividends Paid ($m)	-529.0	-396.0	-117.0	-200.0
Interest Paid ($m)	-138.0	-128.0	-90.0	-114.0
Other ($m)	-62.0	-16.0	-26.0	-62.0
Net Financing Cashflow ($m)	-580.0	-502.0	-117.0	-121.0
Change in Cash ($m)	-102.0	-147.0	210.0	9.0
Free Cashflow ($m)	-3.0	107.0	19.0	-223.0

Source: Company data, BondAdviser estimates.

Research Methodology

Every research report prepared by BondAdviser includes a clear recommendation - **Buy**, **Hold** or **Sell** - on the security. This recommendation framework is designed to help investors navigate different investment opportunities by identifying the market price, yield, term to maturity, liquidity, volatility and risk.

The guide below may help you understand our research opinions. For further information on our research approach, you can refer to our RG79 statement by **clicking here**.

Research Opinions key

- **Buy** - Over the next 12 months, the analyst expects the security to outperform the current yield due to credit spread tightening or favourable movements in the underlying yield curve.
- **Hold** - Over the next 12 months, the analyst expects the security to provide stable returns broadly inline with the current yield but with little credit spread tightening.
- **Sell** - Over the next 12 months, the analyst expects the security to underperform the current yield due to credit spread widening or adverse movements in the underlying yield curve.
- **Suspended** - The recommendation has been suspended temporarily due to the disclosure of new information or market events that may have a significant impact on our recommendation. This also includes situations where we have been given non-public information and we need to temporarily suspend our coverage in order to comply with applicable regulations and/or internal policies.
- **Not Rated** - A security that has not been assigned a formal recommendation.

Analyst

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