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Aurizon Holdings Limited

10 August 2022

Sector: Infrastructure
Sub-sector: Rail
Country: Australia
Ownership: Public

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Issuer Outline

Aurizon Holdings Limited (Aurizon, AZJ), is Australia's largest rail freight operator, transporting Australian commodities and connecting miners, primary producers, and industry with international and domestic markets. The company owns and operates one of the world's largest coal rail networks, linking approximately 50 mines with three major ports in Queensland. It operates under three segments: Network, Coal and Bulk.

The company was listed on the ASX in 2010 (prior to listing, AZJ was wholly-owned by the State of Queensland), with a market capitalisation of AUD7.2bn as at 10 August 2022. For regulatory purposes, the Group is required to operate its rail network business on a segregated basis under the Aurizon Network name (AUN - below rail), with the freight business operating under the Aurizon Operations entity (AUO - above rail). Aurizon Finance Pty Ltd (Aurizon Finance) is the financing vehicle for AUO.

AUN controls, operates, and manages a largely dedicated and purpose built heavy haul rail infrastructure known as the Central Queensland Coal Network (CQCN), under 99 year lease arrangements with the State of Queensland which commenced in July 2010. The CQCN is the largest coal export rail network in Australia. AUN operate on the CQCN regulated rail infrastructure under a stable and well-established regulatory regime. The economic regulation of CQCN is undertaken by the Queensland Competition Authority (QCA), and the current agreement will be in place until 2027.

AUO is the above rail, coal, and bulk segment of AZJ, and is Australia's largest rail freight operator, transporting over 250 million tonnes of commodities annually. The One Rail acquisition will be reported under AUO's Bulk segment.

Key Financials (AUDm)

LTM (30 Jun)	2022
Revenue	3,075.3
EBITDA	1,467.6
Net Interest Expense	(133.2)
Total Assets	9,675.5
Cash	172.1
Net Debt	3,273.7
Net Debt / EBITDA	2.2x
EBITDA / Net Interest Exp.	11.0x

Source: Company, FIIG Securities

Summary Bond Details

ISIN	Issue Amount	Ranking	Coupon	Coupon Frequency	First Call[1]	Maturity Date
AU3CB0244838[2]	AUD 425m	Senior Unsecured	4.00%	Semi-Annual	21 Mar 2024	21 Jun 2024
AU3CB0278380[3]	AUD 500m	Senior Unsecured	3.00%	Semi-Annual	09 Dec 2027	09 Mar 2028
AU3CB0274173[2]	AUD 500m	Senior Unsecured	2.90%	Semi-Annual	02 Jun 2030	02 Sep 2030

[1]Excludes potential terms that would allow the issuer to redeem prior to the maturity date through a make-whole call.
[2] Issued by Aurizon Network.
[3] Issued by Aurizon Finance.

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Strengths

- Strong competitive position: Aurizon's below-rail operations on the CQCN are the sole links for most of Queensland's coal mines to the major coal export terminals on its eastern coast. This monopolistic position and the supportive 'shadow' regulatory framework governing its revenue underpin the Company's solid market position and low business risk, with monopolistic characteristics.

  Although subject to more competition, Aurizon Operations operates in a largely duopolistic market in the coal and heavy bulk segment, with a dominant market position and market share in Queensland, reflecting its legacy position in that market and solid position in the New South Wales coal-haulage market.

- Transparent and well-established regulatory framework: Given its monopolistic position, AUN is subject to regulatory control for its operations (including how tariffs are set) administered by the Queensland Competition Authority (QCA). The QCA regulatory framework is transparent and well established, giving visibility into future regulatory revenue resets. It provides AUN with a window, if necessary, to implement countermeasures to protect the Company's financial profile. Although regulated resets had occurred every four years historically, the most recent agreement reached with customers spans a much longer period (to 2027), providing more long-term certainty, while the more frequent reset of the weighted average cost of capital (next in 2023) will ensure a closer tracking to actual debt costs.

- Predictable cashflows over regulatory period: AUN's access revenue is regulated and as such, supports the predictability of its cashflows. The access charges that AUN is permitted to levy are set under a revenue cap mechanism, which removes volume risk exposure due to coal haulage volume fluctuations. In addition, a substantial number of AUOs' contracts operate as a take-or-pay long-term structure, meaning that the company benefits from high visibility of its future cash flows. Contracts for both Aurizon's bulk and coal segments are more than 50% fixed revenue and the majority (56%) of Aurizon's coal contracts are locked in for 7 years or longer, further supporting visibility of cash flows.

- Completion of One Rail acquisition to diversify earnings: In mid-2022, AZJ announced it had completed the acquisition of One Rail Australia (ORA) for AUD2.35bn. ORA comprises bulk rail haulage and general freight in South Australia and the Northern Territory, the Tarcoola-to-Darwin below rail line, and coal haulage business in New South Wales and Queensland. The latter will be divested for competition reasons, but until then, will be held and operated separately to AZJ. The acquisition will enable AZJ to grow its earnings away from the coal segment and improve its market share in the haulage of other key commodities such as grain and rare earth metals. The initial focus for AZJ will be the integration of One Rail's operations, which is expected to immediately lift earnings in FY23. The Tarcoola-to-Darwin line should also benefit from a growing number of mining projects in both states, especially for commodities showing currently strong demand (copper, phosphate, rare earths).

- Adequate liquidity: As at 30 June 2022, the Company had available cash of AUD172m and undrawn facilities of approximately AUD1.45bn, which together with operating cash flow in excess of AUD1.3bn is expected to be sufficient to cover the Company's operating cash needs over the next 12 months. Further, Aurizon has a good track record of proactively refinancing its maturing debt (including undrawn bank lines). Aurizon's next significant maturity is in June 2023, when an AUD750m bank facility (with only AUD255m currently drawn) is due for repayment.

- Notes benefit from a guarantee and negative pledge: The notes also benefit from a Negative Pledge, so long as the notes remain outstanding, the Issuer and the Company undertake that it will not, and the Company will ensure that each member of the Guarantor Group shall not create or permit the creation of a security interest other than a Permitted Security Interest, which are deemed materially less beneficial to the interest of noteholders.

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Risks

- Integration legislation and regulatory risks: AUN is exposed to these risks due to the highly regulated nature of infrastructure assets with monopoly characteristics in Australia, limiting the Company's financial flexibility as regulated charges do not necessarily reflect actual or projected opex, capex, or costs of capital. As such, if regulated charges are lower than Aurizon's costs, this may affect the Company's financial performance. However, these risks are partly mitigated by QCA's well established and transparent regulatory framework, together with the most recent agreement for the current regulatory period which was reached directly between Aurizon and its customers, pointing to the QCA's willingness to take a light handed approach and intervene only when the parties cannot reach an agreement.
- Dependence on the coal sector: Aurizon has a significant dependence on the coal sector. Continued weakness in coal market fundamentals are the main potential source of future credit pressure, notwithstanding the Company's take-or-pay contracts. In large, this scenario would impair the capacity of coal producers to pay access charges, particularly any increases resulting from socialisation due to counterparty failure. However we note that Aurizon are making a concerted effort to diversify away from coal. It recently acquired the CBH Grain contract in Western Australia, and its bulk segment benefited from favourable growing conditions resulting in record grain export volumes. The acquisition of One Rail Australia will increase this trend.
- Geopolitical tensions between Australia and China: China's ban on Australian coal continues to be of concern, however the Company is somewhat shielded from the expected lower coal volumes as any surplus (overs) or deficit (unders) in revenues will be recouped with a two-year lag, given the regulated nature of the business. Additionally, Aurizon's customers successfully replaced around 95% of the 74 million tonnes of coal that was exported to China in the prior year. This is supported by strong steel production in other nations, particularly in India, which saw record annual crude steel production in 2021.
- ESG pressure: In addition to its largely single sector exposure, Aurizon's coal exposure also introduces risks from an ESG perspective, with a growing number of investors reducing or entirely eliminating any exposure to companies that are operating within the broader coal segment. This is partly mitigated by the fact that Aurizon's coal exposure is weighted towards metallurgical (rather than thermal) coal. In addition, given its position in the logistics chain (rather than a direct producer), we believe ESG concerns will likely translate into marginally higher cost of debt rather than availability of funding. In the near term, we believe that this ESG exposure will impact Aurizon in terms of debt costs rather than materially restrict its access to capital.
- Higher than expected capex: Aurizon's business requires significant capital investment, and as such, there is a risk of higher than expected capex spending and associated execution risks.
- Debt structure: The notes issued by Aurizon Network and Aurizon Finance have a limited recourse to their specific borrowing group (AUN and AUO respectively), with no cross guarantees between the two business segments or a guarantee from AZJ. Despite this legal construct, both segments are core components of the group and we believe that the group will support either of its segments (by redirecting earnings from other parts of the group) in a time of stress. As such, we look at the credit quality of each segregated entity as equivalent to the credit quality of the consolidated group.

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