Caltex Subordinated Notes (CTXHA): Looks attractive but could be more refined.

Special Report

Recommendation: We recommend investors with an above-average risk appetite Subscribe.

Overview

Caltex Australia (CTX) will raise at least $525m via an ASX-listed security issue, Caltex Subordinated Notes (CTXHA). This is above the initial offer size of $300m. CTXHA are subordinated, unsecured debt securities, which rank above CTX ordinary shares and below other CTX debt. The notes mature in 25 years unless CTX exercises an option to redeem early at the five year mark, on any subsequent interest payment date or following a trigger event (see key terms). The notes pay quarterly interest based on the 90-day BBSW rate plus a margin of 4.50% p.a. If the notes are not redeemed on the first call date the margin steps up once by 0.25% p.a. Based on the 90-day BBSW rate as at 1 August 2012 this would equate to an interest rate of 8.05% p.a. Interest payments are cumulative and deferrable but there are no mandatory deferral conditions. Being interest payments they are not franked.

Summary and recommendation

We recommend investors with an above-average risk appetite Subscribe. We would advocate a small portfolio exposure. CTXHA is similar to the subordinated note issues (ORGHA and AGKHA) by Origin Energy and AGL Energy but we think it is riskier as the earnings of the business are more volatile. The 4.50% margin looks attractive and is above our fair margin of 4.25% and rightfully above the margins being paid by ORGHA (4.00%) and AGKHA (3.80%). These two securities were trading at margins of 3.84% and 3.72% as at 1 August 2012.

We like the fact that CTXHA is a pure debt issue, there will be a step-up in the margin if the notes are not redeemed in five years and there is no conversion into equity or mandatory deferral of interest payments. That said, from a risk perspective we would prefer the issue of a higher ranking security with mandatory interest payments and possibly a shorter term or higher step-up margin, but this would have seen a lower margin being offered. CTX is probably not in a position to issue such a security as it would unlikely have classified for treatment as 50% equity by ratings agencies. This note issue is being used by CTX to support its credit profile with the rating agency it uses. CTX will be using the proceeds from the note issue to pay down some debt with the balance to support its growth plans and restructure of the supply chain.

Potential investors need to understand CTXHA is an unsecured, subordinated investment, which ranks just above ordinary equity and is therefore riskier than a bank deposit. Potential investors should be aware CTXHA is a floating rate note which reprices quarterly, so interest rate changes will affect interest payments. In a declining interest-rate environment, interest payments are likely to fall. The opposite is the case in a rising interest-rate environment.

CTX is Australia’s largest refiner and marketer of petroleum products with operations in all states and territories. It currently owns and operates two refineries at Kurnell (Sydney) and Lytton (Brisbane) with a combined capacity of over 35 million litres per day. Fully integrated operations include refining, terminals, pipelines, distribution and marketing. CTX operates its own fleet of road tankers, complemented by long-term contracts with transport companies for the carriage of refined products from terminals to service stations, distribution depots and commercial end users in the mining, industrial, aviation and transport sectors. The national service station network exceeds 2,000 sites including 350 jointly branded Caltex Woolworths. In late July 2012, CTX announced the outcome of its refinery review. As expected, the Kurnell refinery will close late 2014 and will be converted into a major import terminal. Lytton refinery will continue to operate. Refining has been loss making. The restructuring comes at a cost -- a $430m provision to cover redundancy, closure and remediation of the site. CTX will invest a further $250m converting the site into an import terminal together with expanding its capacity. This should
improve CTX’s risk profile as it will reduce potential earnings volatility, capital spending demands and asset concentration risk associated with refining. However this process, which will take a number of years, is costly and comes with risks including project delays, cost blowouts, unplanned shutdowns and operational impacts such as supply disruptions. In short, CTX’s risk remains high until it successfully delivers on its restructure plans.

On our estimates we expect CTX’s debt metrics to remain sound assuming a smooth and successful transition of Kurnell from a refinery into a storage facility. But this transition period is important for CTX. CTX maintains it will do what is required to maintain its credit profile including raising additional capital (which would most likely be equity), managing discretionary capital expenditure, adjusting the dividend payout or selling assets. There are also material debt maturities due during 2014 to 2016. This coincides with expected delivery of its restructure plan, so the successful delivery is important. Potential investors in CTXHA need to be comfortable with this level of risk.

Valuation
We assign CTXHA a fair margin of 4.25% comprising a 3.75% credit spread, an illiquidity cost of 0.25% and 0.25% for other features such as limited holder call rights and deferrable interest payments. We rate it as being riskier than Origin Energy and AGL Energy as the earnings of the business are more volatile. Assuming the restructuring is successful we would expect these notes to be redeemed at the first call date, particularly given their treatment as 50% equity by the rating agency will likely lapse after that date.

Key dates
► Margin announced: 3 August 2012.
► Offer opens: 8 August 2012.
► Closing date for shareholder and general offer: 28 August 2012.
► Closing date for broker firm offer: 4 September 2012.
► Issue date: 5 September 2012.
► Commencement of trading: 6 September 2012.
► First interest payment date: 15 December 2012.
► First Call Date: 15 September 2017.
► Maturity date: 15 September 2037.

Key terms
► ASX code is expected to be CTXHA.
► Face value: $100 per security.
► Minimum subscription amount: $5000 (50 units).
► Amount to be raised: $525m, with the ability to raise more or less.
► Interest rate: 90-day BBSW + margin.
► Margin: 4.50% p.a.
► Interest payments: Interest payments are deferrable at CTX’s option but there are no mandatory deferral conditions.Deferred interest payments are cumulative and compounding. If CTX does not make an interest payment in full within 20 business days after the relevant payment date, then subject to conditions, a number of restrictions are imposed upon CTX until all outstanding payments are made in full. The restrictions are:
  ▶ CTX cannot declare or pay any distributions on any equal or junior ranking obligations or shares issued by CTX. Essentially a dividend stopper comes into effect so CTX won’t be able to pay dividend on its ordinary shares.
  ▶ CTX cannot redeem, reduce, cancel, purchase or buy-back any equal or junior ranking obligations or shares issued.
  ▶ If any deferred interest payments remains outstanding five years after deferral of the then longest outstanding deferred interest payment then CTX must pay all outstanding deferred interest payments.
  ▶ Interest payments are payable quarterly in arrears, on the 15th of March, June, September and December.
► Term: 25 years.
► Early redemption: CTX has the right to redeem early:
  ▶ On the first call date of 15 September 2017;
  ▶ on any subsequent interest payment date after the first call date; or
  ▶ following specific trigger events: capital, tax, clean-up or change of control event.
* A capital event will occur if CTXHA are no longer treated as the same or higher category equity credit from the Rating Agency as initially attributed. CTX expects CTXHA will be initially be treated as 50% equity and 50% debt by the rating agency for its assessment of CTX’s credit profile until the first call date.
* A tax event will occur if any interest payment would not be deductible for tax purposes as a result of a change in law or if CTX is required to pay an additional amount above the prevailing tax rate.
* A clean-up event will occur if 80% or more of the face value of CTXHA are no longer on issue.
A change of control event will occur if any person or associate (other than Chevron which already has a 50% stake in CTX) has a greater than 50% interest in CTX’s voting shares.

- Ranking in wind-up:
  - Ahead of CTX ordinary shares and junior ranking obligations (if any).
  - Equally with other equal ranking obligations (if any); and
  - Behind all other creditors and other classes of securities.

- Redemption amount: $100 face value plus accrued interest.

- There is no conversion into CTX ordinary shares.

- Step-up margin: If the CTXHA are not redeemed on the first call date the margin steps up once by 0.25% p.a.

- Holder call rights: Holders can request the notes be redeemed early following a change of control event.

We have only presented a summary of material terms. Investors should examine the prospectus in detail.

Table 1: Comparison to other issues by Industrials

<table>
<thead>
<tr>
<th>Name</th>
<th>ORGAHA</th>
<th>TAHHB</th>
<th>AGKHA</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type</strong></td>
<td>Unsecured Subordinated Notes</td>
<td>Unsecured Subordinated Notes</td>
<td>Unsecured Subordinated Notes</td>
</tr>
<tr>
<td><strong>Issuer</strong></td>
<td>Caltex Australia (CTX)</td>
<td>Origin Energy (ORG)</td>
<td>Tabcorp (TAH)</td>
</tr>
<tr>
<td><strong>Issue Date</strong></td>
<td>5-Sep-2012</td>
<td>24-Dec-2011</td>
<td>22-Mar-2012</td>
</tr>
<tr>
<td><strong>Margin above Base Rate</strong></td>
<td>4.50% p.a.</td>
<td>4.00% p.a.</td>
<td>4.00% p.a.</td>
</tr>
<tr>
<td><strong>Base Rate</strong></td>
<td>90-Day BBSW</td>
<td>90-Day BBSW</td>
<td>90-Day BBSW</td>
</tr>
<tr>
<td><strong>First Call Date</strong></td>
<td>15-Sep-2017</td>
<td>22-Dec-2016</td>
<td>22-Mar-2017</td>
</tr>
<tr>
<td><strong>Maturity Date</strong></td>
<td>15-Sep-2037</td>
<td>22-Dec-2071</td>
<td>22-Mar-2037</td>
</tr>
<tr>
<td><strong>Step-Up</strong></td>
<td>Once off 0.25% p.a. in year 5.</td>
<td>Once off 1.00% p.a. in year 25.</td>
<td>Once off 0.25% p.a. in year 5.</td>
</tr>
<tr>
<td><strong>Interest Payments</strong></td>
<td>Unfranked, floating rate quarterly cash payments in arrears.</td>
<td>Unfranked, floating rate quarterly cash payments in arrears.</td>
<td>Unfranked, floating rate quarterly cash payments in arrears.</td>
</tr>
<tr>
<td><strong>Interest Deferral</strong></td>
<td>Optional deferral subject to a dividend stopper. Cumulative but can be deferred up to 5 years.</td>
<td>Optional deferral subject to a dividend stopper. Mandatory deferral on breach of interest coverage or leverage ratio. Cumulative but can be deferred up to 5 years.</td>
<td>Mandatory deferral on breach of interest coverage or leverage ratio. Cumulative but can be deferred up to 5 years.</td>
</tr>
<tr>
<td>Conversion into ordinary shares</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td><strong>Risk</strong></td>
<td>Medium</td>
<td>Medium</td>
<td>Medium</td>
</tr>
</tbody>
</table>

Source: Morningstar/Issuer prospectus

**Risks specific to CTXHA include**

CTX may default on the payment of interest or face value.

CTXHA holders are unsecured, subordinated creditors and rank just above CTX ordinary shareholder so in a wind-up scenario could lose all their investment.

Interest payments may be deferred for up to five years. This could make the price of these securities more volatile than those not subject to interest payment deferral.

CTXHA are long dated securities and could remain on issue well beyond the first call date at the five year mark.

Holders have limited call rights.

CTX may redeem the notes early following a trigger event.

Once listed, the price of CTXHA may fluctuate and may therefore trade below face value.
These are floating rates notes which will reprice quarterly, so interest rate changes will affect interest payments and may affect the price of the security.

There is a risk that liquidity of the notes will be low, which will impact the bid/ask spread.

About the issuer

Business overview

CTX is listed on the ASX with a market capitalisation around $3.8b as at 1 August 2012. It is a transport fuel supplier, convenience retailer and an integrated oil refining and marketing company. It operates two major refineries at Kurnell in Sydney and Lytton in Brisbane. The company also operates with a myriad of subsidiaries; Caltex Australia Custodians, Caltex Australia Petroleum, Caltex Fuel Services, Petroleum Services, Hunter Pipe Line Company, B&S Distributors and Jet Fuels Petroleum Distributors.

Relationship with Chevron

US listed global energy giant Chevron owns a 50% stake in the CTX. Chevron is one of the world’s largest energy companies. As at 27 July 2012 it had a market capitalisation of US$215bn. Caltex operates independently of Chevron. Chevron has three directors on the CTX Board, which comprises a total of 8 directors including the CEO. There is interchange between the two companies in terms of technical and research capabilities and purchase and sales. CTX licences its brand from Chevron.

Issuer thesis

CTX is Australia’s largest refiner and marketer of petroleum products with operations in all states and territories. It currently owns and operates two refineries at Kurnell (Sydney) and Lytton (Brisbane) with a combined capacity of over 35 million litres per day. Fully integrated operations include refining, terminals, pipelines, distribution and marketing. It operates its own fleet of road tankers complemented by long term contracts with transport companies for the cartage of refined products from terminals to service stations, distribution depots and commercial end users in the mining, industrial, aviation and transport sectors. The national service station network exceeds 2,000 sites including 350 jointly branded Caltex Woolworths.

CTX has a strong competitive position and comparative advantage operating two strategically located refineries on the east coast where over 80% of the country’s fuel is sold. CTX is market leader, providing 35% of all transport fuels sold. This production capability is backed by Australia’s largest distribution network serviced by an extensive company-owned logistics operation. Despite the physical moat there are too many factors influencing profitability that are outside management control including oil prices, currency and offshore refiner margins. We therefore assign no moat rating to CTX.

The refining industry is gradually being rationalised resulting in a fundamental shift in the demand-supply equation for transport fuels. CTX is well placed to benefit from rationalisation as it owns and operates the largest share of refining capacity. Management has dramatically overhauled the balance sheet while operating efficiency, refinery utilisation and margins have improved. The business is now on a more stable foundation. The expansion of refining capacity in the Asian region and dependence on imported light sweet crudes has added to the volatility to refiner margins.

We perceive business risk as High due mainly to factors outside of management control. Risks include global crude oil price volatility and the US$/A$ exchange rate although the introduction of hedging from 1 July 2010 has dampened earnings volatility. Sourcing of light sweet crudes can require premiums being paid to secure supply affecting the refiner margin. A contraction in economic activity could result in lower demand for transport fuels although in a capacity deficient industry reduced imports would probably allow refineries to operate at higher utilisation rates. A higher A$ encourages imports of refined products. CTX is suitable for investors with above average risk tolerance - trading stock, not investment grade. In February 2012 the two refineries were written down by $1.5bn and a review of the refinery operations as to their long term viability.

In late July 2012, CTX announced the outcome of its refinery review. As expected the Kurnell refinery will close late 2014 and will be converted into a major import terminal. Refining has been loss making. It’s a scale/efficiency story. CTX just can’t compete with the larger, more modern and efficient refineries in Asia. Kurnell’s geographical location is ideal to facilitate seaborne cargoes and efficient distribution. Kurnell has been responsible for the overwhelming majority of refining losses in recent years. Availability and reliability has not been consistent hurting production and utilisation rates.

Lytton refinery will continue to operate. Superior hardware and recently increased diesel capacity
together with ‘potential targeted incremental investments’ should eradicate refining losses. There is no guarantee Lytton is a long term proposition. The agreement with 50% shareholder Chevron should ensure reliability and continuity of supply. This certainty of supply was integral to the decision to close Kurnell.

The restructuring comes at a cost – $430m in a provision to cover redundancy, closure and remediation of the site. This amount does not represent the actual cash expenditure in relation to this process as it excludes future cash expenditure already reflected as a liability on it’s books such as employee liabilities which will need to be paid out. CTX will invest a further $250m converting the site into an import terminal together with expanding its capacity.

In the near term the current dividend payout ratio of 40–60% of NPAT on a replacement cost of sales (RCOP) basis will be reduced to 20–40%. It will revert to 40-60% after the closure of Kurnell in late 2014. Cash outflows associated with the closure and conversion will be offset to some degree by cash inflows from the closure due to tax benefits – lower tax paid – and the release of working capital – inventories in particular.

Longer-term benefits include the elimination of refining losses at Kurnell, significantly reduced maintenance capex at Kurnell and reduced earnings volatility given reduced exposure to refiner margins. Earnings visibility should also improve. The Marketing operations will leverage off the superior distribution network including the transport fleet, pipelines and storage facilities which should underpin a continuation of strong earnings growth.

### Issuer risk
Potential risks involve the volatility in the global crude oil price and the US$/A$ exchange rate, light-heavy crude spreads and regional refiner margins. A contraction in economic activity could result in lower demand for transport fuels although in a capacity-deficient industry reduced imports would probably allow refineries to operate at higher utilisation rates subject to mechanical availability. A persistent high A$ would encourage imports of refined product. A rising crude price could affect demand for transport fuels. The closure of Kurnell by late 2014 will see CTX move to become primarily an importer and marketer and distributor of transport fuels in the future. This should improve the CTX’s risk profile as it will reduce potential earnings volatility and asset concentration risk associated with refining. However this process, which will take a number of years, is costly and comes with risks including project delays, cost blowouts, unplanned shutdowns and operational impacts such as supply disruptions. In short, CTX’s risk remains unchanged until it successfully delivers on its restructure plans.

### Management
CTX is capably led by Julian Segal. Mr Segal has a strong depth of commercial and management experience and since coming on board in mid 2009 has
successfully steered to company in the right direction. There were major challenges facing CTX and the company is now on a more solid foundation.

Earnings and cashflow

CTX reports earnings in two ways, statutory and replacement cost of sales operating profit (RCOP). Under statutory/historical cost accounting CTX records unrealised gains or losses on its inventory of crude oil depending changes in the USD price of crude oil and the AUD/USD exchange rate. RCOP removes the impact of this from profit. RCOP is commonly used in the global refining industry and by the rating agency CTX uses and its bank covenants.

CTX has guided for 1H12 RCOP NPAT for the six months to 30 June 2012 between $185m–$205m versus $113m in 1H11. Statutory NPAT is expected to be between $150m–$170m compared to $270m in 1H11. The stronger RCOP result has largely been attributed to improved transport fuel margins along with increased refinery volumes. In the marketing business CTX is seeing strong sales of commercial diesel, retail premium and jet fuel. Refining benefitted from higher margin, though this was partially offset by higher freight coats as CTX accessed more West African crude. The Kurnell refinery is old and requires a diet of the light sweet variety of crude (i.e. oil with less sulphur content) to operate.

CTX’s earnings and operating cashflows are volatile, primarily due to its refining business. The move to reduce exposure to refining should reduce this earnings volatility. There are also significant capital expenditure demands on the business.

Balance sheet

Over the period 2012 to 2016 CTX does not expect net cash inflows/outflows to have a significant impact on its net debt balances. However the timing of cash flows will not coincide and it assumes things go according to plan. This note issue is being used by CTX to support its credit profile with the rating agency it uses. CTX expects CTXHA will be initially be treated as 50% equity and 50% debt by the rating agency for its assessment of CTX’s credit profile.

CTX will be using the proceeds from the note issue to pay down some debt and the balance for general corporate purposes to support its growth plans and restructure.

As at 31 December 2011 CTX had $619m in debt and $2m in cash. The company expects net debt to be around $750m as at 30 June 2012. As at 30 June 2012 CTX had $1.7bn in committed facilities, not including these notes.

CTX’s debt metrics look sound. On a proforma basis as at 31 December 2011 adjusted for the closure of Kurnell and the proceeds from this issue the debt metrics are:

- Interest Cover (RCOP EBIT/Net Int): 6.5x
- Net Debt/(Net Debt + Equity): 27%
- Net Debt/Equity: 38%
- Leverage (Net Debt/RCOP EBITDA): 1.0x

On our estimates we expect interest cover to be lower, around 5.5x and leverage to increase to around 1.3x by FY14 assuming a smooth and successful transition of Kurnell from a refinery into a storage facility. Both are still sound but the transition period is important for CTX. As we mentioned earlier there are risks with the project such as project delays, cost blowouts and impact upon the existing operations. CTX maintains it will do what is required to maintain its credit profile including raising additional capital (which would most likely be equity), managing discretionary capital expenditure, adjusting the dividend payout or selling assets. There are also material debt maturities due during 2014 to 2016. This coincides with expected delivery of its restructure plan, so the successful delivery is important.