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Pacific National Finance Pty Ltd

8 July 2022

Sector: Infrastructure
Sub-sector: Transportation
Country: Australia
Ownership: Private

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Issuer Outline

Pacific National Finance Limited is the wholly owned financing subsidiary of Pacific National Holdings Company Pty Ltd (PNH) (formerly Asciano Limited). Pacific National Finance acts as the borrower for PNH.

PNH is Australia's largest national rail freight operator, operating primarily under three main segments: containerised freight, metallurgical coal, and thermal coal. PNH is the largest provider of containerised rail freight services in Australia, which generates more than a third of total revenue, and operates in an effective duopoly in coal haulage.

PNH is owned by a consortium of investors, comprising affiliates of Global Infrastructure Partners (GIP; 27% ownership), Canada Pension Plan Investment Board (CPP; 33%), China Investment Corporation (CIC; 16%), GIC Private Limited (GIC; 12%) and British Columbia Investment Management Corporation (BCI; 12%). Together they manage over USD1.9tr in investments.

Key Financials (AUDm)

LTM (30 Jun)	2021
Revenue	2,294.0
EBITDA	819.0
Interest Expense	173.0
Total Assets	4,921.0
Total Debt	3,013.0
Cash	78.0
Net Debt/EBITDA	3.7x
EBITDA/Interest Expense	4.7x

Source: S&P Capital IQ, Company, FIIG estimates

Summary Bond Details

ISIN	Issue Amount	Ranking	Coupon	Coupon Frequency	First Call[1]	Maturity Date
AU3CB0229680	AUD 350m	Senior Unsecured	5.25%	Semi-Annual	N/A	19 May 2025
AU3FN0035770	AUD 100m	Senior Unsecured	3M BBSW + 2.60%	Quarterly	N/A	12 May 2027
AU3CB0244325	AUD 250m	Senior Unsecured	5.40%	Semi-Annual	N/A	12 May 2027
AU3CB0266906	AUD 450m	Senior Unsecured	3.70%	Semi-Annual	24 Jun 2029	24 Sep 2029
AU3CB0282812	AUD 400m	Senior Unsecured	3.80%	Semi-Annual	8 June 2031	8 Sep 2031

[1]*Excludes potential terms that would allow the issuer to redeem prior to the maturity date through a make-whole call.*

Pacific National Finance Pty Ltd

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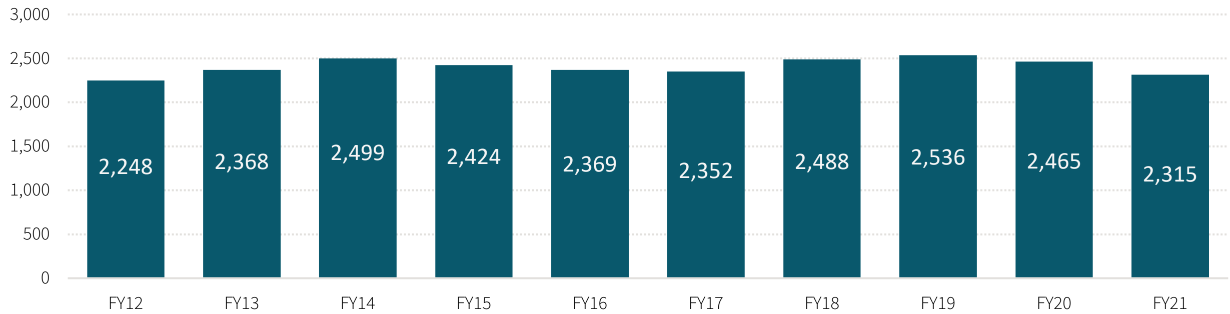
Strengths

- Strong market position supported by relatively high barriers to entry: PNH's credit profile benefits from its strong market position as the largest carrier of interstate rail freight and largest intermodal rail operator with a national footprint in Australia. PNH is effectively an infrastructure-style business; it dominates the East-West corridor, accounting for approximately three-quarters of containerised freight volume and will be one of the main beneficiaries of Australia's Inland Rail project (freight rail line directly connecting Melbourne and Brisbane). PNH is also one of two major coal haulage companies in Australia, operating in an effective duopoly throughout New South Wales and Queensland. Barriers to entry in rail haulage are relatively high, owing to the capital, concessionary, contracting, or physical constraints that underpin the rail haulage industry (source: S&P Global Ratings), which generally has two or (sometimes) three main players within PNH's local market.
- Significant proportion of take-or-pay contracts for coal, providing a degree of cash-flow and revenue stability: PNH's revenue benefits from the structure of its contracts, particularly for its metallurgical coal and thermal coal segments. They typically average ten years upon inception (average weighted life to maturity is currently six years) and are performance-based (with the majority take-or-pay). The latter is important as it means movements in price have little immediate impact on revenues, until contract renewal. Further, contracts signed under its intermodal business are generally around five to seven years, but vary in length and contract terms, and may contain volume commitments (but is less exposed to externalities, such as commodity prices). PNH generally enjoys long standing relationships with its major customers, a function of its duopoly and near-monopoly over particular haulage networks, which partly mitigates the risk of non-renewal of contracts. PNH is also able to pass on a substantial amount of its largest operating costs. PNH's revenues have therefore exhibited a high degree of stability over the last decade, despite frequently volatile commodity prices (see Figure 1 below).

Figure 1: PNH Revenue (AUDm)



Source: Company

- Ultimate customer-base provides high degree of diversity: Although revenue by immediate customer is reasonably diversified (top 10 customers, who are among the largest miners in the world and leading Australian industrial companies, account for half of PNH's revenue), the end-customer for PNH's services, which includes domestic and international markets, provides a high degree of revenue diversity.
- Staggered debt maturity provides visibility over liquidity needs: Liquidity is solid for PNH, which includes AUD700m available under its various revolving bank facilities (as at December 2021), and benefits from a staggered maturity profile for both its revolving facilities (which typically have a relatively high proportion undrawn) and its term debt. The Company's next meaningful debt maturity is April 2023, when its USD250m bonds are due for repayment. Capex requirements, although high, are also reasonably predictable. PNH's liquidity also benefits from the long-term strategic focus of its investors (explored further below), who have shown a willingness to forgo distributions in order to preserve PNH's credit strength; PNH has opted not to declare any dividends to its owners since the onset of the COVID-19 pandemic.
- Strong shareholder group with long-term investment mandate provides a relatively high degree of certainty: While private ownership is typically associated with lower levels of financial flexibility relative to publicly listed companies, it is

arguable PNH's current ownership contingent, which includes global infrastructure managers (GIP), sovereign wealth funds (CIC and GIC), and large pension funds (CPP, BCI), provide a relatively high degree of certainty and commonality around matters including strategic direction, investment needs, and distributions. While the ability of the shareholders to provide support to PNH, if required, depends on their respective ability and willingness to do so, we note that management remains committed to maintaining an investment grade profile, which is likely to be supported by its various owners.

Risks

- Revenues are highly exposed to ESG factors: PNH still maintains a large footprint in coal haulage rail services that contributes ~40% of operating revenues, of which 57% is metallurgical and 43% thermal. Environmental factors have triggered a structural transition away from coal (particularly thermal), and while thermal coal is expected to remain an important component of the energy mix in Asia in the short-to-medium-term (given the region's reliance on coal-fired electricity generation and Australia's high-quality coal), the transition could pose a challenge to revenues if the timeframe is shorter than many are forecasting. There is also a dearth of a commercially viable alternative for the use of metallurgical coal as a key input in steel production, although this too is subject to new advances in green steel production. For as long as Australia is exporting coal, PNH, which has a duopoly in coal haulage, will be one of the main conduits. Coal contracts are performance based and incorporate a large take-or-pay component, so movements in price have little-to-no impact on revenues until contract renewal, which have on average six years to run. PNH is no-doubt aware of the long-term transition away from coal, and is well-placed to absorb the change. This includes increasing revenues from containerised freight (currently 38% of revenues), itself a positive response to environmental factors (road to rail). Containerised freight is forecasted to become a higher proportion of earnings over time (coal is forecasted to decline to ~30% of PNH revenues by 2025-2030).
- Exposure to volume variation: PNH's non-coal and containerised freight operations are exposed to the general state of economic conditions, both domestically and globally. A weak market environment could result in lower than expected demand for its services, which could affect demand for grain and freight forwarding services. Australia is one of the largest grain exporters in the world and is exposed to global market conditions, annual production, global demand, and global pricing in this segment.
- Debt-funded capital expenditure (capex) results in high financial leverage: PNH operates in a capital-intensive sector, extending to the maintenance and replacement of its existing fleet, as well as to support volume expansion through the completion of the company's new freight terminals. The latter is likely to contribute to a high level of debt-funded expenditure (PNH capex is typically debt-funded).

  While the current headroom above rating triggers for leverage suggests the increased leverage is unlikely to result in a lower rating (S&P Global Ratings), there is a risk of higher than expected capex (and as such, leverage). We note that PNH has developed a sound track-record of maintaining its non-growth capex in line with the cyclical nature of its overhaul program (including limiting growth-related capex to priority projects during periods of economic uncertainty), while at the same time, extracting cost savings through operational efficiencies (including asset utilisation), which is set to continue.
- Modest revenue diversity by business segment: 40% of PNH's revenue is derived from coal (of which 57% metallurgical and 43% thermal), with domestic containerised freight making up much of the residual (38%). In time, the concentration by business segment is set to increase, with containerised freight forecasted to become the predominant revenue earner for PNH. While this would normally be viewed as a negative development, an increase in revenue from containerised freight would increasingly position PNH as an infrastructure-style business (movement of goods around Australia), whose output would be reflective of broader economic activity.

Pacific National Finance Pty Ltd

Summary Financials

The financial summary below represents the consolidated operations of Pacific National Holdings Pty Ltd (AUDm, FYE 30 June).

Income Statement	FY17	FY18	FY19	FY20	FY21
Revenue	2,289	2,458	2,487	2,436	2,294
Total operating expenses	(1,561)	(1,651)	(1,608)	(1,666)	(1,475)
EBITDA	771	850	882	771	819
Interest expense	(221)	(227)	(209)	(218)	(173)
Depreciation & amortisation	(286)	(284)	(327)	(340)	(361)
Net income	1,107*	211	235	152	199
Balance Sheet	FY17	FY18	FY19	FY20	FY21
Cash	112	172	68	871	78
Goodwill	874	874	874	874	919
Net property, plant, and equipment	3,046	2,971	3,203	3,119	3,253
Total assets	5,220	4,912	5,128	5,812	4,921
Total debt	3,303	2,910	3,083	4,112	3,013
Total equity	1,274	1,316	1,034	685	872
Cash Flow Statement	FY17	FY18	FY19	FY20	FY21
Funds from operations	595	666	686	570	631
Cash interest paid	(220)	(196)	(196)	(202)	(187)
Capex	(178)	(168)	(284)	(246)	(278)
Credit Metrics	FY17	FY18	FY19	FY20	FY21
Net Debt/EBITDA	3.9x	3.2x	3.3x	4.0x	3.7x
EBITDA/Interest Expense	3.5x	3.7x	4.2x	3.6x	4.7x
Funds From Operations/Debt	19.7%	24.2%	23.8%	18.7%	20.6%

*Source: S&P Capital IQ, Company, FIIG estimates. *Includes proceeds from sale of discontinued operations.*

Pacific National Finance Pty Ltd

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