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Zenith Energy Ltd

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Security
AUD40m 7.55% Oct 2025

ISIN
AUD3CB0255271

Currency
AUD

Type
Secured subordinated

Issuer Outline

Zenith Energy, heardquartered in Perth, specialises in the provision of remote power generation solutions to the resources and energy sectors. Zenith's customers are typically located in remote areas not connected to the electricity grid, requiring the installation and operation of stand-alone power generation. The majority of Zenith's operations are located in Western Australia and Queensland, with some limited operations in Papua New Guinea. Customers include the US blue chip oil & gas producer Chevron.

Zenith generates its revenue from three distinct segments:

- Build, Own, Operate (BOO): Under the BOO segment, the company will enter into a long-term contract with a customer for the provision of electricity at a given site.
- Manage, Operate, Maintain (MOM): Under the MOM segment, the company will operate electricity generation assets that are owned by the customer under a medium to long-term contract
- Engineering, Procure, Construct (EPC): Under the EPC segment, the company will design and construct power generation solutions for clients but will not be involved in the operations.

Key Financials (AUDm)

LTM (30 Jun)	2019
Revenue	55.2
EBITDA	20.7
Interest Expense	3.9
Capex	86.7
Cash	7.3
Debt	80.0
Net Debt/EBITDA	3.5x

Source: FIIG Securities, Company reports

Key Terms			
Coupon Type	Fixed	Minimum Amount	AUD10,000
Rate	7.55%	Denomination	AUD1,000
Frequency	Quarterly	Issuer Credit Rating	NR
Domicile	Australia	Issue Credit Rating	NR
Amount Issued/Outstanding	AUD40m/AUD40m	AU Withholding Tax Exempt	Yes
Key Dates			
Issue Date	10 August 2018	Maturity Date	10 August 2025
Next Call Dates	10 August 2022 @103.00	10 November 2022 @103.00	10 February 2023 @103.00

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Strengths

- **Long-term cash flows:** About 90% of revenue are generated from long-term contracts under either the BOO or MOM models. Given the fixed term nature of the contracts, this provides a relatively high level of certainty about likely earnings in the near term and acts as a floor over the medium term. Assuming no new contracts are added to the current portfolio and no extension, revenue will peak in FY20 at about AUD63.3m but would still remain above AUD50m for the life of the notes. In practice, it is likely that the company will renew a material proportion of its BOO contracts which provides a good degree of comfort that revenue are likely to be broadly stable (and more likely will increase) over the life of the notes.
- **Solid contractual structure:** Power purchase agreements are structured to ensure a great degree of predictability for Zenith. In particular, tariffs under the PPA's incorporate a capacity charge that the company will receive irrespective of the amount of power generated. This ensures that the company will be able to recover its fixed costs in all circumstances, even if a mine is placed on care and maintenance. In addition, should a customer elect to terminate its contractual relationship early, Zenith will receive a compensation payment sufficient to cover the notional debt relating to that contract.
- **Essentiality of power for mining operations:** Power is essential for mining operations, especially as mines are generally located well away from electricity transmission networks, and the cost of connection would be exorbitant. As a result, power costs can be seen as some of the highest priority payments a mine would make, even in a stress scenario since continued revenue (from extraction and processing) would be predicated on continued availability of power. This critical nature is recognised by mining companies and their financiers, which require Zenith to enter into tripartite agreements. Under these agreements, upon a default of a customer, Zenith would agree not to terminate its contract provided the financiers undertake to pay Zenith's invoices.
- **Incumbent advantage:** While the remote power sector is relatively competitive, it is also characterised by a very strong incumbent advantage. Once a company has installed its generation capacity on a client's site, a significant part of the equipment will start depreciating and would have a book value well below the replacement value of new equipment. Upon a contract renewal, the incumbent will have the ability to bid a lower price as it will have the benefit of equipment already on site (and prices tend to be a direct function of required investment, which would be lower for the incumbent). In addition to the financial advantage, an incumbent would have had the benefit of demonstrating its ability to efficiently run its operations, an important factor given the criticality of power for mining operations.
- **No exposure to fuel price:** Fuel cost generally represents a high proportion of the overall cost of producing power and will experience variability, usually in line with oil price. Saying that, under its contracts, provision of fuel (gas, diesel) rests with the client who has an obligation to ensure that sufficient quantity is available for use by Zenith. In addition, the client will be responsible for the cost of the fuel. As such, Zenith is not exposed to fuel cost variation, thereby ensuring that its costs of providing power are likely to remain stable over the life of a contract.
- **Significant site redundancy:** A typical site operated by Zenith will have multiple generators linked to switching equipment, with power then being distributed across the entire site. The generator redundancy ensures that any breakdown of one generator will not stop electricity production for the entire site. This redundancy also enables Zenith to undertake preventative maintenance on one generator while it continues to produce power. While other systems (such as switching gear) may not have the same level of redundancy as the generators, this reflects the lower probability of failure.
- **Experienced management team:** Zenith's senior management, including its executive chairman, has extensive experience in the remote energy business through, among others, their prior involvement in StateWest, a company which was operating in the same segment as Zenith. The experience and expertise span the entire offering, from design and construction to operations.
- **Supportive covenant package:** The subordinated notes have the benefit of a comprehensive covenant package designed to ensure that additional debt will primarily be used for investments in new projects which should result in a lift in earnings but also ensure that a portion of that new investment will be cash funded. Further, the Priority Financial Indebtedness Ratio will limit the amount of debt that will have priority over cash proceeds in the event of a default, an important consideration given the junior position of the subordinated notes.

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Risks

- **Reliance on energy charges to service debt:** While the capacity charge is designed to broadly cover fixed costs, the charge alone is not sufficient to cover debt principal repayments. As such, Zenith relies on the energy charge in order to cover those payments. This means that each contract will have to produce a base level of power and the company is exposed to volume fluctuations.
- **Limited ability to lift contract revenue if costs are higher than expected:** The BOO & MOM contracts are structured with fixed capacity & energy tariffs. While the revenue will vary based on actual generation, the variability is designed to replicate the movement in variable costs (linked to generation level). Should the company's fixed costs increase faster than expected, there is no ability to adjust revenue upwards.
- **Construction risk:** Under the BOO model, Zenith undertakes to build and operate generation units from a pre-agreed date. This means that, until construction is complete, Zenith will not earn any revenue. In addition, in certain circumstances, the company may be liable for financial penalties if it is not in a position to deliver power by a pre-agreed date. Further, Zenith bears most of the risks related to construction, including the risk of cost overruns.
- **Exposure to mining sector:** All of Zenith's customers are in the volatile and cyclical mining sector and some customers could file for bankruptcy during a downturn. While Zenith cannot insulate itself entirely from that risk, the company's strategy has been to diversify its exposure to different commodities, recognising however a majority of its customers are mining gold. We don't believe that the large exposure to the gold sector is overly negative, since gold is generally viewed as not being as volatile as other commodities.
- **Contract termination:** Zenith's customers have the ability to terminate their contracts early, which would affect future earnings and leave the company, in the case of BOO contracts, with generation assets that would need to be redeployed. In the event of a customer electing to terminate a contract early on a no-fault basis, the customer will have the option to purchase Zenith's equipment at a pre-determined price. Alternatively, the customer will have to pay a pre-agreed termination payment. In either case, the amount to be paid is sized to ensure that Zenith can pay down the portion of its debt related to the project that is being terminated so that its financial ratios are not negatively affected by the termination. The same termination payment obligations would apply in the event Zenith terminates the contract due to a customer default.

  In the event the termination is due to a Zenith default, no termination payment would be payable but Zenith would have the right to recover its generation assets in order to redeploy them. A more likely scenario, given the criticality of power for mining operations, would be that the customer will seek to buy Zenith's assets under the buy-out option, which includes a pre-determined price.
- **Material damage to equipment:** Zenith's generation units could suffer material damage and become inoperable for lengthy periods of time which could affect earnings due to a loss of revenue as well as potential rectification costs. Unless the damage was such that it would result in a completely write-off of a unit, it is likely that the company would be able to repair the equipment and get back on line in a relatively short period of time. In a more extreme scenario of a write-off, insurance cover held by Zenith would ensure some cash recovery for the loss incurred.
- **Standstill Period:** Under the terms of the intercreditor agreement with the senior first ranking creditors, payment of interest and principal under the subordinated notes will be possible unless an event of default has occurred. Upon occurrence of an event of default, cash flows will only be available to cover operating costs and payment of interest and principal on the senior debt. Further, subordinated creditors will be unable to start enforcement for a period of up to 90 days.
- **Recovery on the notes subordinated to bank facility:** The subordinated notes only have a second ranking priority over the security granted by the company. This means that, in the event of a default, cash proceeds would first be used to pay down the bank debt, with the remaining proceeds available for the subordinated notes. Given this position, proceeds may not be sufficient to repay the subordinated notes entirely. It should be noted that the Priority Financial Indebtedness Ratio is designed to ensure that priority debt will remain below 2x Pro-forma EBITDA and the Debt to Asset Ratio will ensure total debt is never more than 70% of the book value of generation assets. It should also be noted that the subordinated notes

benefit from ongoing amortisation which will ensure that noteholders will gradually receive a return of their invested capital.

- Growth appetite: Zenith is a relatively young company, having been created in 2006 and, in that time, has grown to become an independent power producer with over 420MW of capacity (owned or under control). In the past twelve months, Zenith has added more than 100MW. The company continues to actively pursue new opportunities given the continued demand for efficient, off-the-grid power generation. This can potentially expose the company to two major risks:
    - Rapid expansion could stretch the company's resources or lead the company to bid more aggressively in order to maintain the rate of growth. In those scenarios, the company may accept unreasonable deadlines or underestimate the construction costs, resulting in potential losses.
    - Adding new investment to the company's portfolio would likely result in debt levels increasing over time and, in particular, the company could take on more debt that ranks ahead of the subordinated notes to fund that growth.

Other risks

- Call risk: A decision to call the bonds ahead of the maturity date depends on a number of factors, including the relative cost of entering new debt financing, the company's liquidity position, and the availability and attractiveness of new funding opportunities at the call date. In addition to the call dates listed above, Zenith has the following call options:
    - The Issuer may redeem some or all of the Notes on 10 May 2023 @103.00
    - The Issuer may redeem some or all of the Notes on 10 August 2023, 10 November 2023, 10 February 2024 and 10 May 2024 @ 102.00
    - The Issuer may redeem some or all of the Notes on 10 August 2024, 10 November 2024 and 10 February 2025 @ 101.00
    - The Issuer may redeem some or all of the Notes on 10 May 2025 and thereafter @ 100.0
- Duration risk: The Zenith AUD 7.55% secured subordinated bonds mature in 2025 and carry some duration. Investors are exposed to a degree of interest rate risk on the bond. For example, a 100bp increase in yields would result in about a 3.70% fall in the capital price of the bond, all other things being equal.
- Interest deferral/cancellation: n/a
- Non-viability trigger: n/a

Summary

The Zenith Energy 7.55% secured subordinated notes maturing 10 August 2025 offer investors high yield exposure to an Australian specialised power producer supported by long term agreements with customers in the mining industry.

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