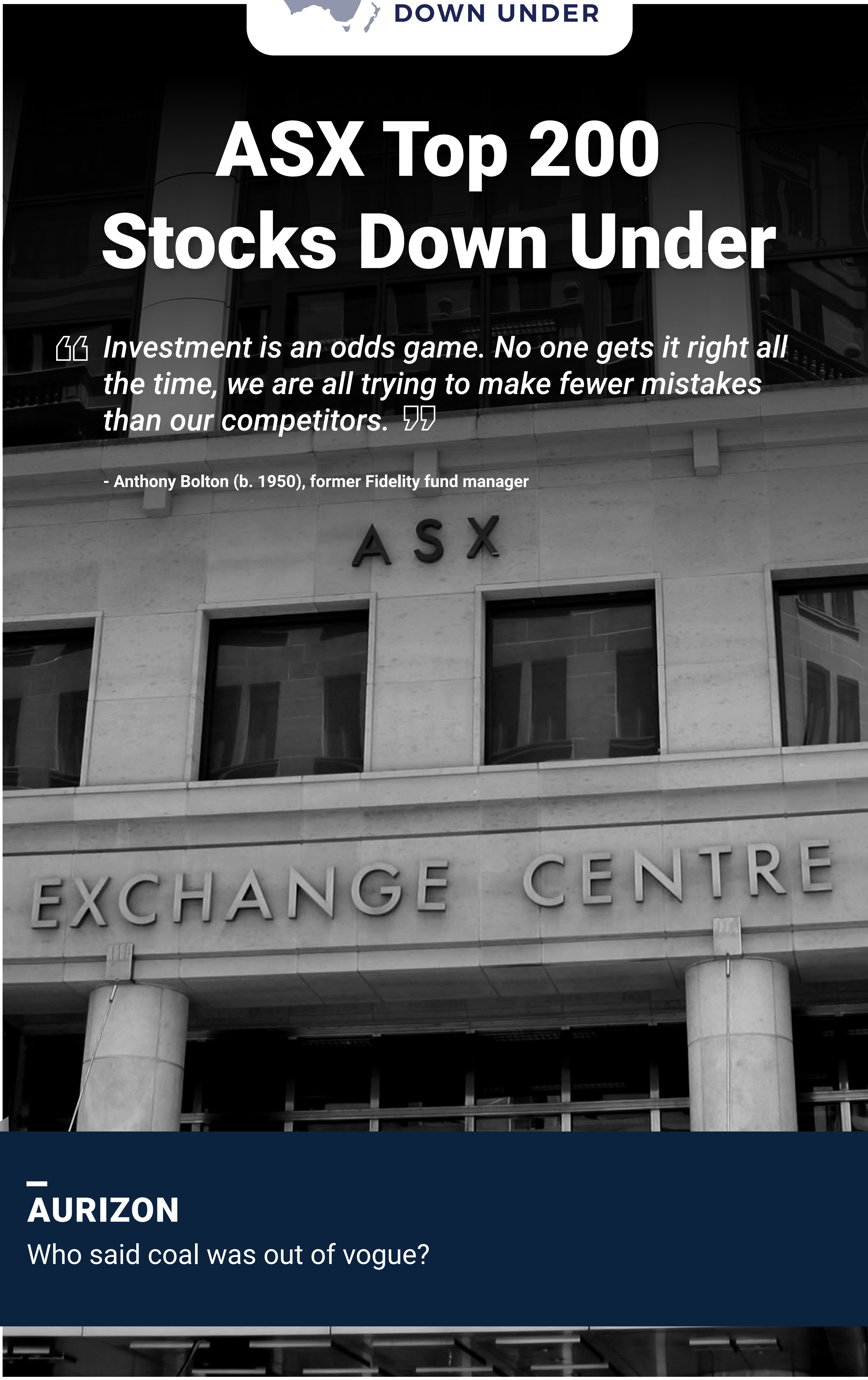
STOCKS DOWN UNDER

22 AUG 2022

ASX Top 200 Stocks Down Under

> *Investment is an odds game. No one gets it right all the time, we are all trying to make fewer mistakes than our competitors.*

- Anthony Bolton (b. 1950), former Fidelity fund manager



AURIZON

Who said coal was out of vogue?

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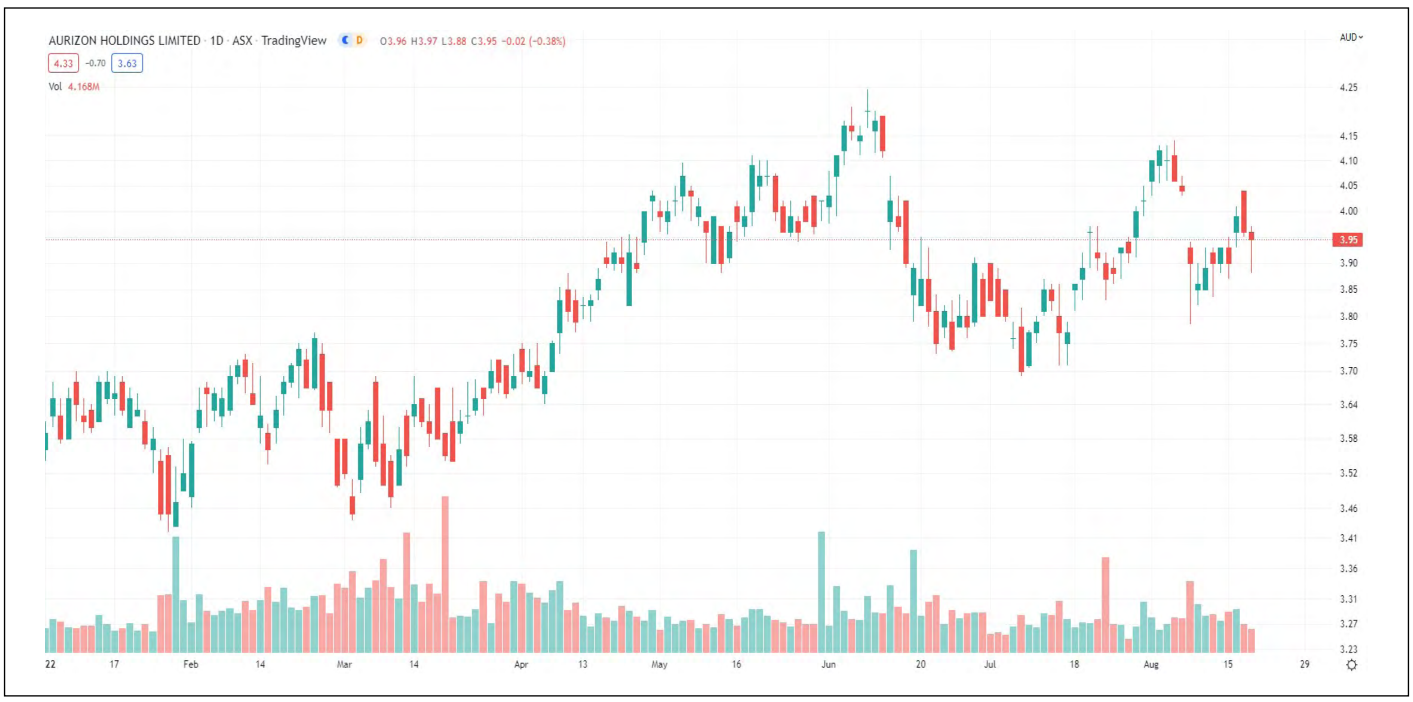
Stocks Down Under rating: ★★★★

ASX: AZJ
Market cap: A$7.3BN

52-week range: A$3.30 / A$4.24
Share price: A$3.94

Just why has Aurizon gained 10% this year while the ASX 200 has lost 6%? You could argue that it has benefited from higher coal prices. But remember, Aurizon isn't a coal company, it's a rail freight operator with significant exposure to coal. The pivot to value stocks has played well into the hands of infrastructure operators like Aurizon. And even though coal will eventually be phased out, it will be more gradual and Aurizon is pivoting well ahead of time.

Share price chart



Source: Tradingview

Benefiting from coal

Infrastructure assets typically are monopolies or semi-monopolies and are utilised extensively over very long horizons. And this is true with the Central Queensland Coal Network, which Aurizon operates and manages. This is a 2,670km collection of railways across four corridors that collect coal from over 50 mines in Queensland's Bowen Basin. The railways, which Aurizon calls its 'Network' business take the coal to export ports and to domestic users. Until 2004, this was operated under several Queensland Rail Divisions, but Aurizon was founded to bring it under one banner. The company was privatised and listed in 2010.

Now Aurizon does have some exposure to other commodities, but coal is its main exposure. And for this reason, investors may not want to invest in this company– either because they don't think coal should still be used for energy or that it will be gradually phased out. Be the latter as it may, it is expected to happen over a longer-term horizon. And in the shorter term, prices have been boosted by Russia's invasion of Ukraine and ironically the refusal of banks to fund projects. Obviously, coal prices are volatile. But it still accounts for 35% of the world's electricity and is Australia's second largest source of export revenue. Aurizon's coal exports in FY21 totalled 202m tonnes, roughly half of Australia's export volume.

Still, Aurizon already has interests outside coal, including providing rail services to 30 grain receival and handling facilities in NSW not to mention copper, lithium, nickel, and iron ore zinc concentrates to the port of Newcastle. The company is hoping for a 20-25% market share of a $1.3bn profit pool for bulk haulage by 2030. Admittedly, it won't have a monopoly here, but if it just had a 20% share, it could generate $250-$300m in additional earnings and more than double current profits. It has made acquisitions to expand its business including a storage and handling facility at Townsville and Newcastle ConPorts. And it is looking to sell East Coast Rail, which hauls coal for Glencore in NSW and Queensland separately from its own coal haulage operations, hoping for bids next month.

Modest FY22 results, but long-term growth forecast

Aurizon, which uses 1 July - 30 June as its calendar year, reported FY22 results a fortnight ago. Granted, it saw little impact of high coal prices with underlying EBITDA declining 1% to $1.47bn and revenue only growing 2% to $3.1bn. Although its NPAT fell 2% on an underlying basis and 15% on a statutory basis, coming in at $525m and $513m respectively, free cashflow grew 13% to $665m. Dividends were consequently slashed by 26% to 21.4c per share, down from 28.8c.

But remember, the statutory results were impacted by one-off tax benefits in FY21 and transaction costs from the acquisition of One Rail Australia. Volumes of coal were lower, impacted by production cuts, flooding events and COVID-19 disruptions, but rising inflation, cost management and higher revenue yields mitigated the damage.

For FY23, the company is guiding to EBITDA of ~$1.47-1.55bn, including the contribution from the One Rail Bulk business and the impact of wet weather in July 2022. This EBITDA result would be neutral at worst, 5.4% growth at best. Consensus estimates for FY23 are $3.36bn in revenue and $1.51bn in EBITDA, which would mark 9% revenue growth and 3% EBITDA growth.

Aurizon's current share price implies valuation multiples of 7x EV/EBITDA and 14.5x P/E for FY23, which we think are slightly above average compared to the broader market, but arguably cheap for a monopoly. Consensus estimates continue to forecast growth for future years, by FY26 it is forecast to achieve $3.67bn in revenue and $1.75bn in EBITDA, which would both be 19% higher than FY22.

Can it last for the long term

There are some reasons you may not want to invest in this company, including commodity price risks, contract risk and price regulation. Yes, Aurizon's infrastructure is a monopoly, but its pricing is still regulated by the government and it has had public spats with regulators, particularly about the WAAC the Queensland Competition Authority uses. Still, with its monopoly position, it has far higher pricing power than it would have in a regular market place.

Of course, there's the ESG image problem of coal. As we noted above, some investors may just hate coal, while others just can't trust that coal will have its way. We think its arguable that banks withdrawing funding will mean there won't be too many coal aspirants coming to the ASX or obtaining funding. But good companies with free cash flow can be self-sustainable and we think this is the case with Aurizon. Even though many of the world's biggest companies anticipate an eventual end date to coal, they have committed to running existing developments to the end of their useful lives, which in some cases is 20-30 years away.

Aurizon may not necessarily be a company for a 20 to 30-year investment horizon, but don't discount it completely given it is hoping to increase the reliance on the bulk business, hoping to double earnings by CY2030. Furthermore, we think Aurizon is more reliable in the short-term with high inflation and even for the medium term (i.e. 3-5 years) in light of its projected earnings growth. So, it's four stars from us.

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