Final port of coal? The Brookfield Dalrymple IPO

Ulf Erlandsson (*). Not investment advice. Important disclosures at the end.

There has been accelerated efforts by Canadian asset manager Brookfield to IPO one of the world's biggest thermal coal terminals,[1] Dalrymple Bay, in the next few weeks. Early indications ("IPT") was for a post IPO dividend yield of around 5.5-6%,[2] but as time has progressed this has been lifted to 7% (=the price of the IPO has been lowered) and the total stake that Brookfield is selling has been reduced so that they will retain 49%.[3] In this context it should be noted that Industry Queensland is reporting an intention of Brookfield to increase coal capacity of Dalrymple from 85 million tonnes of coal per annum (MTpa) to 100MTpa.[4]

Given such aggressive expansion plans in a sector that many believe is struggling, it may be less of a surprise that institutional investors appear to not have been playing ball so far. We think that even with an indicated 7% *2021* distribution yield, we would have some question marks around the following factors in the transaction, that now appears on track to be marketed to retail investors:

- Dividend yield offered vs other alternatives
- Future funding costs and bridge loan facilities
- Diversification: high beta to the Australian economy
- Coal business model credibility
- Governance: QIC and Brookfield joint majority
- Technical: post-IPO stabilization

The remainder of this article elaborates on the above bullets. The AFII is not party to the transaction process itself but looks forward to potentially having these factors further explained in the IPO prospectus and any marketing material associated with it.

We iterate our earlier view that a first step to make the Dalrymple Bay IPO aligned with what we deem to be responsible investment guidelines/coal exclusions would be to shut the thermal coal part of it.[5] We opine that it would be good economics through a reduced funding cost channel as well as positive climate impact.

[1] Although Dalrymple runs a 80/20% met/thermal coal mix, the total throughput x 20% still makes Dalrymple a top global thermal player.
[2] "Dalrymple Infrastructure worth $3b plus: IPO sponsor brokers", and "Brookfield offers 6pc yield to early Dalrymple backers", AFR Street Talk, 19/27 Oct 2020.
[3] "Dalrymple Bay IPO launches at $2.57 a security, 7pc yield", Ibid, 12 Nov 2020.
[4] "Dalrymple Bay coal port IPO to raise $656m", Industry Queensland, 12 Nov 2020.
[5] "Dalrymple of Queensland and the Mighty Greenwash", Anthropocene Fixed Income Institute, 29 September 2020.

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Dividend yield and funding costs

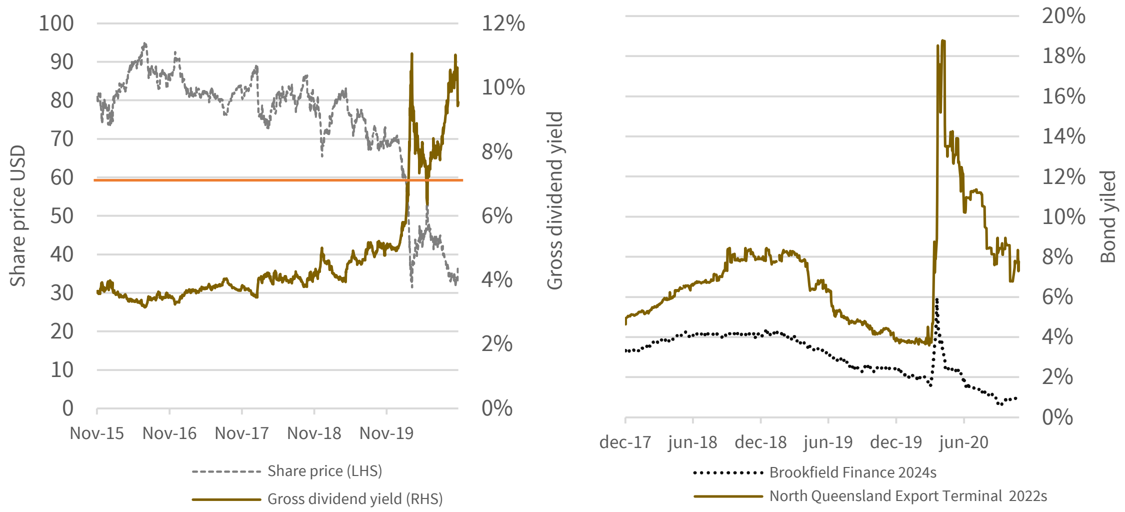
Dividend yield: As a comparison to the now indicated 7% yield, a company like ExxonMobil (ticker XOM) trades at ~10% dividend yield, has a higher credit rating (Aa1/AA, Moody's/S&P) and arguably a more credible climate transition plan than Dalrymple – e.g. XOM is not 100% dependent on coal. Historical XOM equity price and dividend yield are shown in the left-hand panel of Figure 1. The AFII believes that also the XOM dividend yield should be viewed as "unstable" and in no way guaranteed – indeed rather unlikely - to crystallize over the medium to long term.

Given a view of poor growth prospects – commented further below - for Dalrymple, and the clear risk to funding (see below), the slated 7% numbers seem low in comparison average debt costs of around 4.5%, as we understand has been indicated in the IPO process.

Future funding costs/Bridge loan: Comparable venture Adani Abbot Point (ADAABB), recently renamed to North Queensland Export Terminal, has a similar business model (with 60/40% met/thermal), and funding at 7.5%,[6] if accessible at all. We see the funding costs for the North Queensland Export Terminal (#10 in the world[7] vs Dalrymple #3), with a not too different met vs thermal coal mix and operated by Adani Ports and Economic Zone (ADSEZ, rated BBB-), to be 6-8% above those of Brookfield Finance (BAMACN, rated BBB).

Another more direct comparison is the DBCT BIP AUD Frn 12/22 (ISIN AU3FN0001368) which appears to have been trading with an average discount margin (~spread) of around 250bp, cf. ADAABB's spread of ca. 730bp, indicating downside if support for DBCT deteriorates. Summing these together, we believe the currently indicated 4.5% cost of debt should be stress-tested for potentially significantly higher levels.[8]

Figure 1. Left: ExxonMobil stock price and gross dividend yield, Dalrymple IPO 2021 yield highlighted; Right: bond yields of Brookfield bonds and North Queensland Export terminal bonds. Source: Bloomberg.



[6] Currently, the two-year maturity ADAABB 4.45 12/22 (USQ0102FAD70) bond trades at a discount price of 94, with a yield to maturity of 7.6%. The equivalent credit spread (z-spread) on the bond is 735bp, which, if translated comes out at a number of approximately 23% implied cumulative default probability.

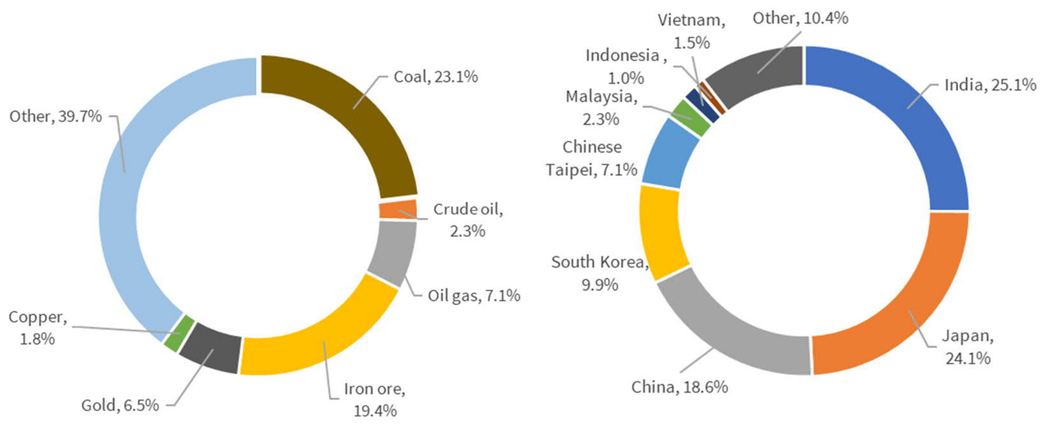
[7] 2018 numbers, see "Dalrymple of Queensland and the Mighty Greenwash", Anthropocene Fixed Income Institute, 29 September 2020.

[8] We note a what appears to be a bridge-loan of $550mn issued in USD in September, but with no fund proceeds until December. We seek details on the pricing of that and who the investors are.

Diversification, business model viability, governance

Diversification: The basics of diversification theory indicates that investors that have high dependence on the local Queensland/Australian economy's coal exposure, e.g. by owning real-estate, paying local taxes, or other exposures to economic growth in the region, should require a significant risk premium/price discount due to the IPO'd shares' correlation with other parts of their individual income statement and balance sheet. We highlight the export dependencies of Australia in Figure 2, where it should also be noted the commitments in many of the Australia export recipient to lower coal exposure (see "Why 2020 is turning out to be a pviotal year for fossil fuel exits", IEEFA, 30 Oct 2020, for an overview), right panel of Figure 2.

Figure 2. Australia (2018) export mix. Source: OEC.



Coal business model credibility: How well do we expect coal to do in the future? We are confused by Brookfield Infrastructure CEO's belief in "*DBCT is a great asset. We would love to hold it forever […]*"[9] vis-à-vis Brookfield Vice Chair Mark Carney's repeated statements around the demise of coal: "*Up to 80% of coal assets will be stranded, [and] up to half of developed oil reserves.*"[10] Indeed, as highlighted in Figure 3, coal exports from Dalrymple have been falling and are back to 2012 levels. Naturally this has to be discounted by the Covid-19 impact, but it is clear that the trajectory has a negative bias.

Over time there are clear fundamental risks to the met coal business (80% of Dalrymple capacity) through carbon-free steel production, cf. "How Hydrogen Could Solve Steel's Climate Test and Hobble Coal", Bloomberg News, 29 Aug 2019. There is significant investment going into the space, cf. "*The [German] government is ready to offer grants equivalent to about 30% to 40% of the 10bn EUR transition to fossil-free steel under a hydrogen-development program.*"[11] Thermal coal (20%) is already widely believed to be in a death spiral.

We should also note that with rising geopolitical tensions, cf. Chinese import bans on Australian products,[12] core Australian export products with fairly high degree of substation potential, such as coal, could be at clear risks. The recently signed RCEP could alleviate some of those concerns, but it remains a very relevant topic.

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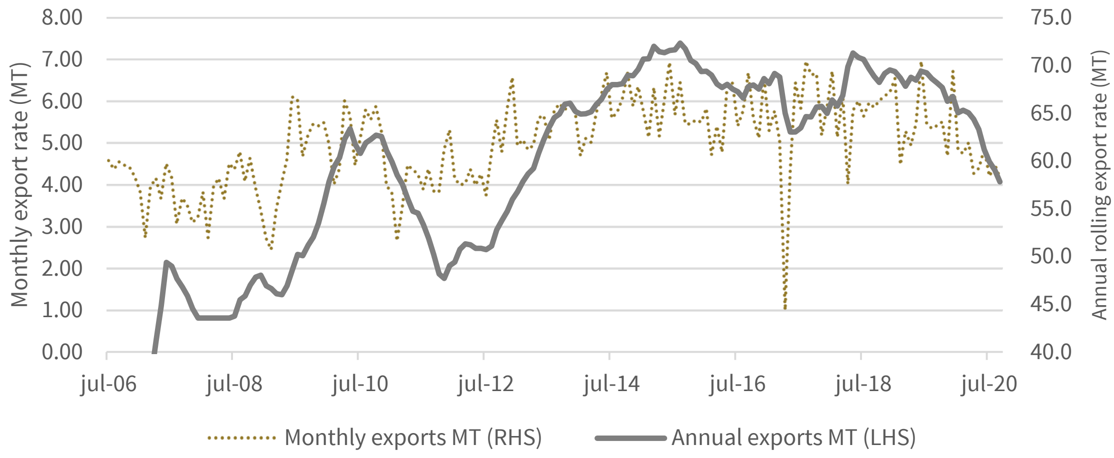
[9] "Brookfield Infrastructure Partners LLP Q2 2020 Conference Call & Webcast", 5 Aug 2020.
[10] "Firms must justify investment in fossil fuels, warns Mark Carney", The Guardian, 30 Dec 2019. This was prior to Carney joining Brookfield. On Carney's joining Brookfield, see "Carney to lead asset managers climate change strategy", Central Banking, 27 Aug 2020.
[11] "Thyssenkrupp in Talks for at Least 5 Billion Euros in Steel Aid", Bloomberg News, 9 Nov 2020.
[12] "Australian exporters scramble as more China trade bans grow", The Guardian, 5 Nov 2020.

Figure 3. Dalrymple Bay coal exports. Source: Bloomberg.



Governance: With the IPO cut-back, Brookfield will retain a 49% and QIC taking a 10%/$130mn stake. Other investors should be aware of their minority (lack of) control and the potential for collusion between the majority shareholders. As has been reported in Australian media:[13]

" *[…] owner Brookfield has gone back to the future in appointing a new independent chairman for the proposed Dalrymple Bay Infrastructure. The listed Darlymple Bay Infrastructure is to be overseen by David Hamill, a former Queensland treasurer and transport minister.*"

As a general note on corporate governance, we believe there should be a risk premium attached to corporate structures where there has been fluidity of key personnel across large stakeholders' organizations.

Syndication and execution risks: We believe in there could be a reduced bank willingness to support ('stabilize') the IPO given its coal exposure, which could put a market technical negative on post-transaction price dynamics and volatility. Banks are not keen to be associated with large coal transactions and we note the absence of domestic banks in the IPO process. Instead it is being lead by Bank of America Merrill Lynch, Credit Suisse and Citigroup. All three banks have various statements on their coal financing, we refer to "Summary of Credit Suisse' Sector Policies and Guidelines" as an example:

"*Any transaction involving the following sensitive activities must be referred to Sustainability Risk and may subsequently require escalation to the Reputational Risk Review Process:*

- ***Coal mining:*** *In the event of transactions involving thermal and/or metallurgical coal mining activities, including associated infrastructure development, particular scrutiny will be placed on strategy and actions to manage climate change risks, water contamination, habitat depletion, and worker health and safety."*

To be clear, this might not operate as an exclusion policy, but should be seen as an indication of the potential wariness among financial counterparties to take risk around not only coal mines, but also associated infrastructure. In this context, we also note a movement – indeed driven by prominent Brookfield employees - arguing to reduce banker compensation when their revenue is based on engaging in fossil transactions.[14] It is almost ironic.

[13] "Dalrymple Bay locks in debt, gears up for equity", AFR Street Talk, 30 Sep 2020.
[14] "Mark Carney says banks should link executive pays to Paris goals", The Guardian, 13 Oct, 2020.

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