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APA Group Subordinated Notes (AQHHA)

Fixed Interest

Issue overview

Issuer	APA Group
Issue ASX code	AQHHA
Face value	$100
Estimated offer size	$350m
Bookbuild margin range	4.50-4.70%
Franking	0%
Interest payments	Quarterly
Minimum application	$5,000
Call date	31 Mar 2018
Step-up date	31 Mar 2038
Step-up margin (year 25)	1.00%
Maturity	30 Sep 2072

Timeline

Lodgement of prospectus	9 Aug 2012
Bookbuild margin	16 Aug 2012
Announcement of margin	17 Aug 2012
Offer opens	17 Aug 2012
Offer closes:	
Shareholder & General	10 Sep 2012
Broker Firm	17 Sep 2012
Issue date	18 Sep 2012
ASX listing (deferred settlement)	19 Sep 2012

Additional Disclosure: Bell Potter Securities Limited is acting as Co-manager to the APA Group Subordinated Notes issue and will receive fees for this service.

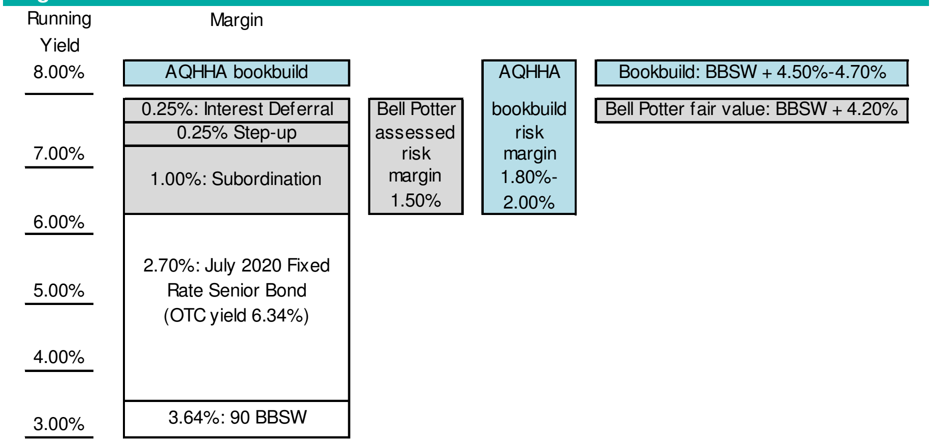
The defensive pipeline delivering over 8% yield

The new $350m issue of unsecured, subordinated, cumulative notes by APA (AQHHA) represents the 7th issue of a subordinated debt security with equity credit features since Oct 2011. Noting the success of the Caltex Subordinated Notes (CTXHA) issue last week which was upscaled from $300m to $525m with the margin set at 4.50% (bookbuild range 4.50-4.75%), we assess a lower issuer risk profile for APA than CTX.

As a utility company backed by long term contracts with price escalation, APA generates a highly predictable earnings stream from delivering around 50% of Australia's natural gas through its network of 12,800km of gas transmission pipelines spanning every mainland state and territory. This has enabled APA to increase ordinary distributions every year since 2005.

Our fair value margin assessment on AQHHA of 4.20% highlights the attractiveness of the 4.50-4.70% bookbuild range. This provides a yield premium of ~1.8% to the July 2020 APA senior debt security trading in the wholesale over-the-counter (OTC) market. We also note the duration to the Mar 2018 AQHHA call date is 28 months shorter than APA's OTC security, which equates to reducing our risk margin assessment by 0.25%.

Figure 1: Bell Potter fair value assessment



SOURCE: IRESS, YIELDBROKER, COMPANY DATA, BELL POTTER

Key features

- **Initial floating yield of 8.14%:** Based on current 90 BBSW of 3.64% and bookbuild margin range of 4.50-4.70%.
- **Quarterly unfranked interest**: First interest payment date 31 December 2012.
- **Interest protected:** While the issue terms allow for deferral of AQHHA interest payments at APA's discretion on a cumulative & compounding basis, the dividend stopper requiring non payment of ordinary dividends offers protection.
- **Margin increases 3%** if AQHHA is not redeemed under a change of control event.
- **Redemption highly likely at March 2018 call date:** Although AQHHA has a 60 year maturity, we expect redemption at the March 2018 call date. AQHHA will become an expensive debt facility once equity credit disappears in March 2018.
- **Risks:** Refer page 5 of this report.

APA Group Subordinated Notes

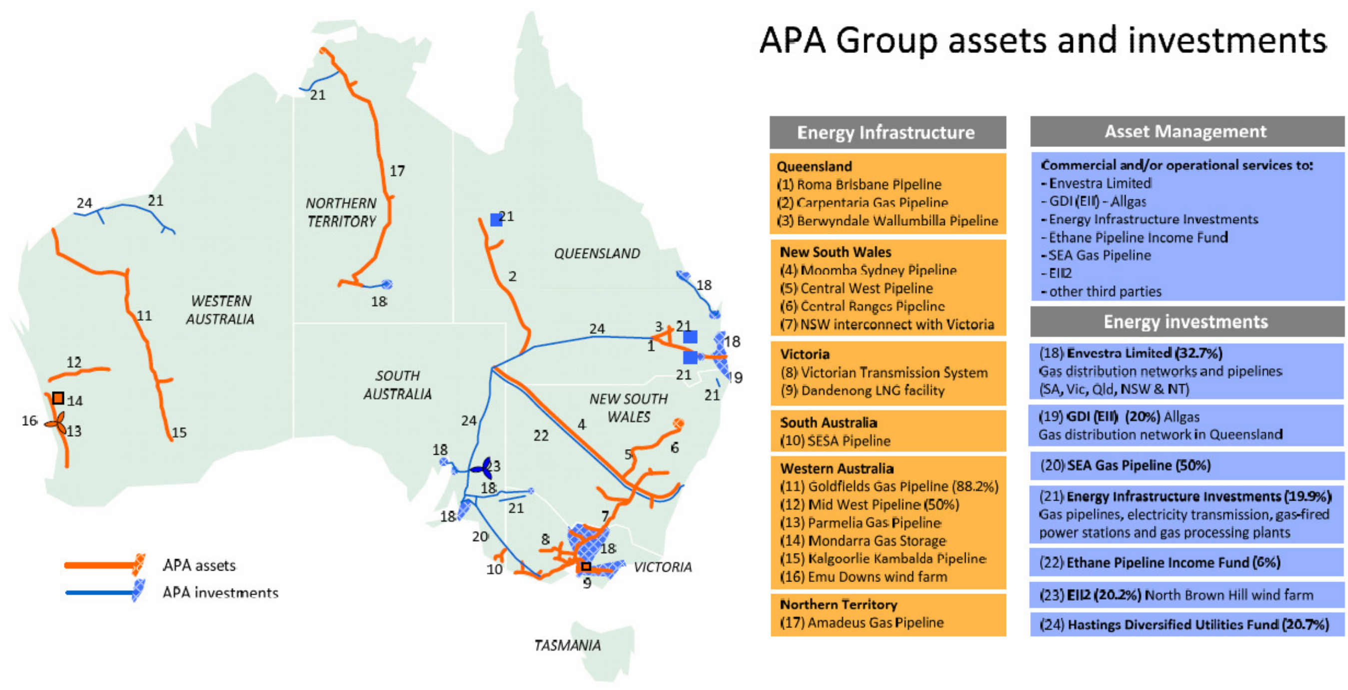
APA overview

APA is Australia's largest natural gas infrastructure business and is currently ranked the 64th largest ASX listed company with a market cap of $3.1bn.

APA has three key business segments:

- Energy Infrastructure (FY11 EBITDA up 4% to $424m): Australia's largest gas transmission infrastructure owner with a network of 12 high pressure gas transmission pipelines. This network spans over 10,000km in each mainland state and territory, connecting Australia's major gas fields with major markets. APA also has gas storage facilities at Mondarra (WA) and Dandenong (Vic), and an 80MW wind farm at Emu Downs, 200km north of Perth.
- Energy Investments (FY11 EBITDA up 20% to $39m): Includes interests in ~2,500km of gas transmission pipelines. Investments include:
  - ⇒ Gas distribution networks: Envestra (33%), GDI (20%)
  - ⇒ Gas pipelines: SEA Gas Pipeline (50%), Ethane Pipeline Income Fund (6%), Hastings Diversified Utilities Fund (20.7%)
  - ⇒ Energy infrastructure: Energy Infrastructure Investments (20%), EII2 (20%)
  - ⇒ Power stations: Diamantina (50%)
- Asset Management (FY11 EBITDA up 42% to $27m): APA provides commercial, operating services and/or asset maintenance services to the majority of its energy investments.

Figure 2: APA Group assets and investments



SOURCE: COMPANY DATA

APA Group Subordinated Notes

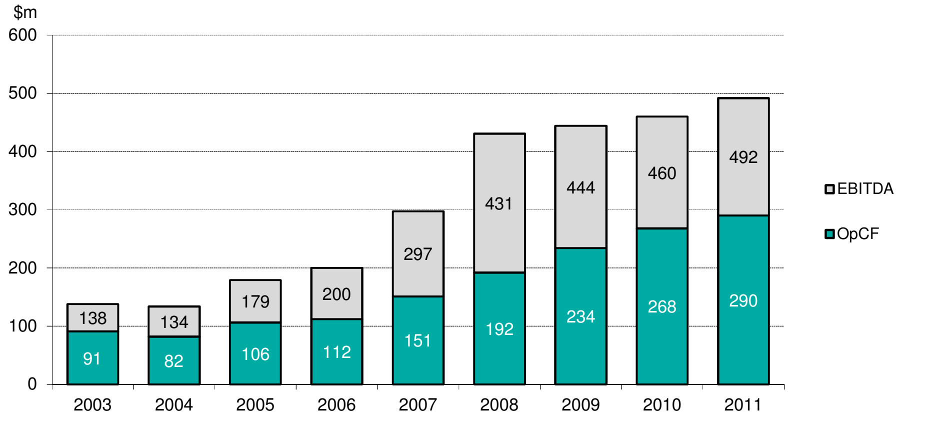
Highly predictable revenue and cash flows

APA's highly predictable revenue and cash flow are a function of the group's mix of regulated revenues and long term negotiated contract from transmission of a product where there is relatively inelastic demand.

Approximately 45% of group revenue is generated from assets subject to full regulation. This is associated pipelines and networks which have a natural monopoly, resulting in a regulator determining price and other terms of access for standard services to ensure the operator receives a reasonable return on investment.

The remaining 55% of group revenue is generated from assets subject to light regulation, where the regulator will arbitrate if negotiations between APA and the customer cannot agree on contractual terms and pricing. Revenue from these assets is generally structured under medium to long term contractual service arrangements, which includes provision for price escalation.

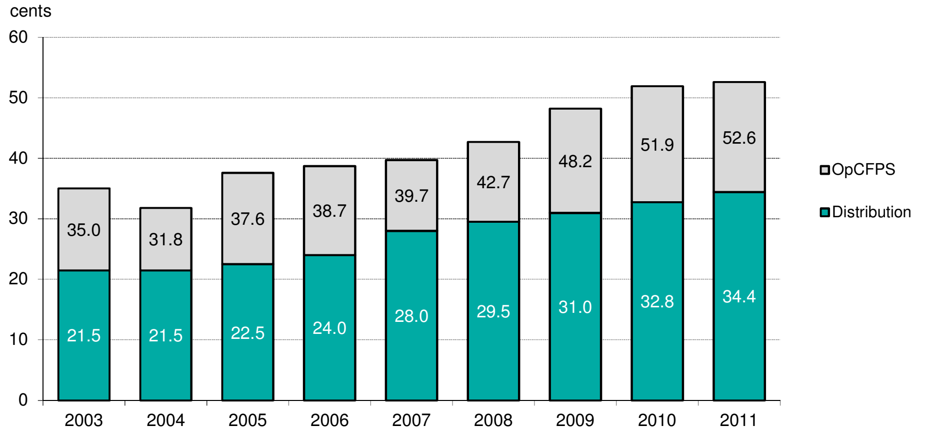
Figure 3: EBITDA and Operating Cash Flow - Year Ending June



SOURCE: COMPANY DATA, BELL POTTER

This revenue model combined with solid interest cover of 2.5x, moderate gearing (net debt / equity) for an infrastructure company (utility) of 148%, and operating cash flow covering distributions ~1.5x underpins APA's outstanding track record of continuously growing distributions each year since FY05. This highlights the strength of the dividend stopper in the unlikely event that APA defers AQHHA interest payments.

Figure 4: Operating Cash Flow and Distribution Per Security - Year Ending June



SOURCE: COMPANY DATA, BELL POTTER

APA Group Subordinated Notes

Figure 5: ASX listed subordinated debt securities with equity credit features

	APA Group Subprdinated Notes (AQHHA)	Caltex Subordinated Notes (CTXHA)	AGL Energy Subordinated Notes (AGKHA)	Colonial Group Subordinated Notes (CNGHA)	Tabcorp Subordinated Notes (TAHHB)	Origin Energy Notes (ORGHA)	Woolworths Notes II (WOWHC)
Issue size	$350m	$525m	$650m	$1,000m	$250m	$900m	$700m
ASX Listing	19 September 2012	6 September 2012	5 April 2012	29 March 2012	23 March 2012	23 December 2011	25 November 2011
Margin: 90BBSW+	4.50-4.70%	4.50%	3.80%	3.25%	4.00%	4.00%	3.25%
Maturity	60 years	25 years	27 years	25 years	25 years	60 years	25 years
First call date	Year 5.5	Year 5	Year 7	Year 5	Year 5	Year 5	Year 5
Step-up date	Year 25	Year 5	Year 7	n/a	Year 5	Year 25	Year 5
Step-up margin	1.00%	0.25%	0.25%	0.00%	0.25%	1.00%	1.00%
Optional interest deferral	Yes, subject to dividend stopper	Yes, subject to dividend stopper	No	Yes, subject to dividend stopper	No	Yes, subject to dividend stopper	Yes, subject to dividend stopper
Mandatory interest deferral	No	No	Yes, if AGL's Leverage Ratio is above 4.0 times, or Interest Cover Ratio is below 3.0 times	No	Yes, if Tabcorp's Leverage Ratio is above 3.5 times, or Interest Cover Ratio is below 3.0 times	Yes, if Origin's Leverage Ratio is above 4.0 times, or Interest Cover Ratio is below 3.5 times	No
Interest deferral	Interest can be deferred on a cumulative and compounding basis	Interest can be deferred for up to 5 yrs on a cumulative and compounding basis	Interest can be deferred for up to 5 years on a cumulative and compounding basis	Interest can be deferred for up to 5 yrs on a cumulative and compounding basis	Interest can be deferred for up to 5 years on a cumulative and compounding basis	Interest can be deferred for up to 5 years on a cumulative and compounding basis	Interest can be deferred for up to 5 yrs on a cumulative and compounding basis
Assessed equity credit	50% first 5.5 years, then 0%	50% first 5 years, then 0%	100% first 7 years, then 0%	50% first 5 years, then 0%	100% first 5 years, then 0%	100% first 5 years, then 0%	50% first 5 years, then 0%
Ranking	Subordinated, ranks above ordinary equity	Subordinated, ranks above ordinary equity	Subordinated, ranks above ordinary equity	Subordinated, ranks above prefs & ordinary shares held by Commonwealth Bank	Subordinated, ranks above ordinary equity	Subordinated, ranks equal with Euro Capital Securities and above ordinary equity	Subordinated, ranks above ordinary equity

SOURCE: COMPANY DATA, BELL POTTER

APA Group Subordinated Notes

Equity credit for some, debt for others

In order to obtain Equity Credit, the security must have equity like features such as deferral of interest payments and the provision for the issuer to extend redemption to the maturity date. The structure of AQHHA satisfies the requirements of both S&P and Moody's to allow at least 50% classification as equity in calculation of its financial ratios, therefore providing ratings support to APA.

While the structure satisfies the ratings agencies equity requirements, others view this as debt. AQHHA will be classified as debt by the ATO, allowing tax deductions on interest payments. APA will also report this security as debt on its balance sheet.

Figure 6: AQHHA ranking - unaudited at 8 August 2012

	Ranking	Existing Instruments	Amount
Higher Ranking	Debt	Bank debt, US private placements, European Medium Term Notes, Australian Medium Term Notes	$2,990m
	Subordinated debt / hybrids	AQHHA	$350m
Lower Ranking	Equity	Ordinary shares	$1,610m

SOURCE: COMPANY DATA, BELL POTTER

Investment risks

Investment risks are essentially split between APA Business and Security Risks.

Risks associated with APA include:

- Regulatory risk: Adverse regulatory outcomes could impact APA's earnings and financial position.
- Bypass and competitive risk: Customers may bypass APA if a new gas transmission pipeline competes and services the same end market as APA.
- Operational risk: Loss of earnings and costly repairs as a result of such factors as equipment failures, rupture of pipelines and IT problems.
- Financing risk: The ability of APA to refinance debt may be impacted by a material decline in financial performance or a dislocation of credit markets.
- Contract renewal risk: APA may not be successful in renegotiating contracts up for renewal, or the contracts may be renewed on adverse terms on account of such risks as gas supply and customer demand.
- Construction and development risk: APA growth and maintenance capex is subject to design and construction risks, as well as cost blowouts and delays.

Key Risks associated with AQHHA include:

- AQHHA are subordinated obligations of APA, therefore, rank behind senior debt but ahead of shareholders in event of a wind-up.
- Interest payments may be deferred at the sole discretion of APA. However, the interest payments, if deferred, will cumulate and compound.
- Deferral of interest payments is likely to have an adverse effect on the market price of the AQHHA.
- Duration: Failure of APA to redeem in March 2018 increases the prospect the security will not be redeemed until year 60, creating downside risk to the security price. Holders have limited redemption rights before maturity.
- Interest rate margin. The margin is fixed for an initial period of up to 25 years. If credit margins widen beyond the initial range or the company has credit issues, AQHHA may trade at a discount. The security price could also come under pressure if new issues offer more attractive terms and margins.

Fixed Income

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