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Caltex Subordinated Notes (CTXHA)

Fixed Interest

Issue overview

Issuer	Caltex
Issue ASX code	CTXHA
Face value	$100
Estimated offer size	$300m
Bookbuild margin range	4.50-4.75%
Franking	0%
Interest payments	Quarterly
Minimum application	$5,000
Call date	15 Sep 2017
Step-up date	15 Sep 2017
Step-up margin (year 5)	0.25%
Maturity	15 Sep 2037

Timeline

Lodgement of prospectus	31 July 2012
Bookbuild margin	8 Aug 2012
Announcement of margin	9 Aug 2012
Offer opens	9 Aug 2012
Offer closes:	
Shareholder & General	28 Aug 2012
Broker Firm	4 Sep 2012
Issue date	5 Sep 2012
ASX listing (deferred settlement)	6 Sep 2012

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

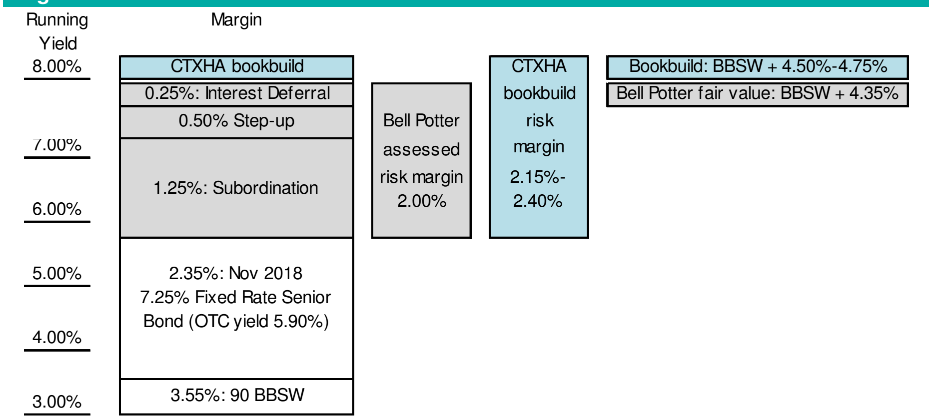
Premium fuel delivers a premium yield of over 8%

The new $300m issue of unsecured, subordinated, cumulative notes by Caltex (CTXHA) represents the sixth issue of a subordinated debt security with equity credit features since October 2011. The bookbuild margin range of 4.50-4.75% above 90 BBSW (currently 3.55%) represents the highest margin offered on any new ASX listed debt or hybrid issue, boosting the initial floating yield to over 8%.

This margin in part reflects the volatility of CTX's earnings, particularly associated with its Refining division, as well as the risks associated with the closure of its loss making Kurnell refinery in Sydney by late 2014. Including demolition, site remediation and redundancies, closure is expected to cost ~$430m, plus an extra $250m of capex for conversion of Kurnell into a major import terminal. Successful implementation of the strategy in shifting the business focus from refining to retail via its network of ~2,000 service station should provide a meaningful reduction in CTX's risk profile.

On balance the additional risk appears adequately compensated by the margin range. We assess a fair value margin on CTXHA of 4.35%, reflecting a premium of ~2.00% on the Nov 2018 Caltex debt security trading in the wholesale over-the-counter market.

Figure 1: Bell Potter fair value assessment



SOURCE: COMPANY DATA, BELL POTTER

Key features

- **Initial floating yield of at least 8.05%:** Based on current 90 BBSW of 3.55% and bookbuild margin range of 4.50-4.75%.
- **Quarterly unfranked interest**: First interest payment date 15 December 2012.
- **Interest protected:** While the issue terms allow for deferral of CTXHA interest payments at CTX's discretion for up to 5 yrs on a cumulative & compounding basis, the dividend stopper requiring non payment of ordinary dividends offers protection.
- **Redemption likely in 5 years:** Although CTXHA has a 25 year maturity, in the absence of a material deterioration in CTX's credit profile, we expect redemption at year 5. While loss of equity credit at year 5 is a significant penalty for most issuers to ensure redemption, CTX will also consider factors such as its financial position, operational performance, funding requirements and access to capital markets.
- **Risks:** Refer page 7 of this report.

Caltex Subordinated Notes

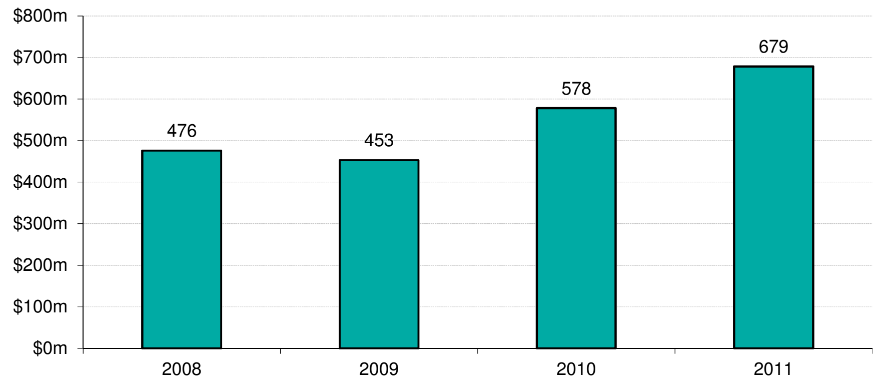
Caltex overview

With operations in Australia dating back more than 70 years, Caltex is Australia's largest supplier of petroleum products and convenience retailer, supplying around one in every three litres of petrol, diesel and jet fuel consumed in Australia. Caltex is currently ranked the 70th largest ASX listed company with a market cap of $3.8bn. Caltex also has a supply agreement with US oil giant Chevron (market cap US$216bn) who is a 50% shareholder of Caltex.

Caltex has two key divisions: Marketing and its Refining & Supply division.

- Marketing: Promotes and sells Caltex fuels, lubricants, specialty products and convenience store goods through a national network of around 2,000 Caltex, Caltex Woolworths and Ampol branded service stations, as well as a network of resellers and direct sales channels to corporate customers.

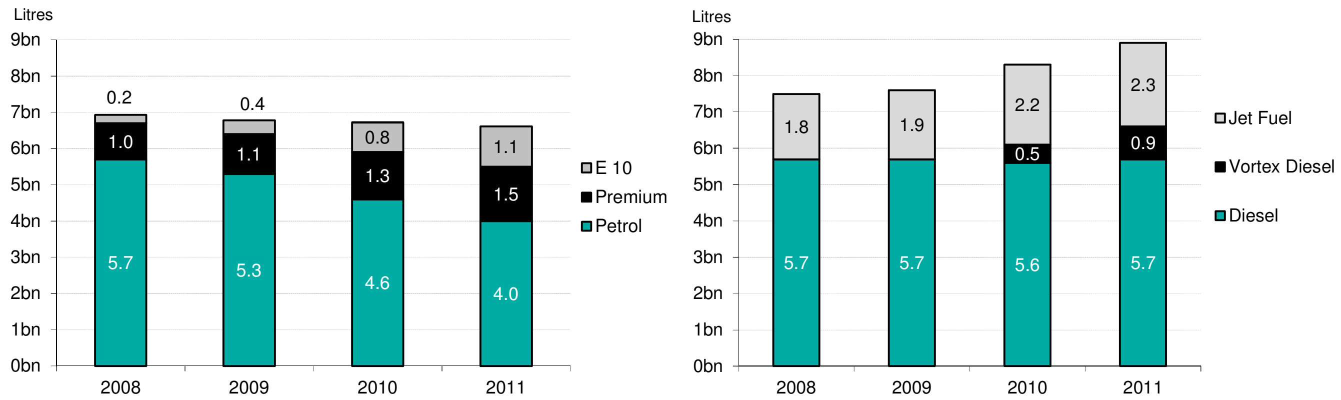
Figure 2: Marketing division EBIT



SOURCE: COMPANY DATA, BELL POTTER

The earnings profile of this division has defensive attributes similar to that of the non-discretionary retailers. Divisional EBIT for 2011 increased 17.5% to $679m, driven by organic growth in higher margin premium fuel sales and better convenience store earnings. Since 2008, the division has delivered a compound annual growth rate in EBIT of 13.5%.

Figure 3: Caltex fuel sales



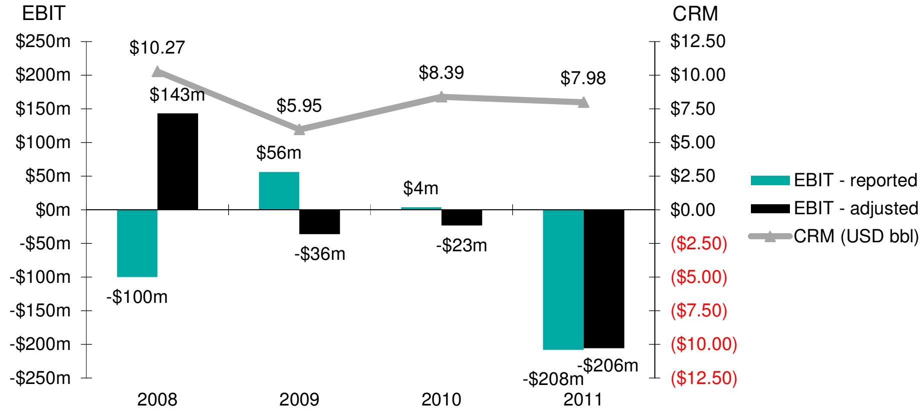
SOURCE: COMPANY DATA, BELL POTTER

Caltex Subordinated Notes

Caltex overview (continued)

- Refining & Supply: This division sources the supply of crude oil and refined products on the international market, to supply its refineries and ultimately supply the distribution network of its Marketing division through its infrastructure of pipelines, terminals, depots and transportation fleet.

Figure 4: Refining & Supply division EBIT

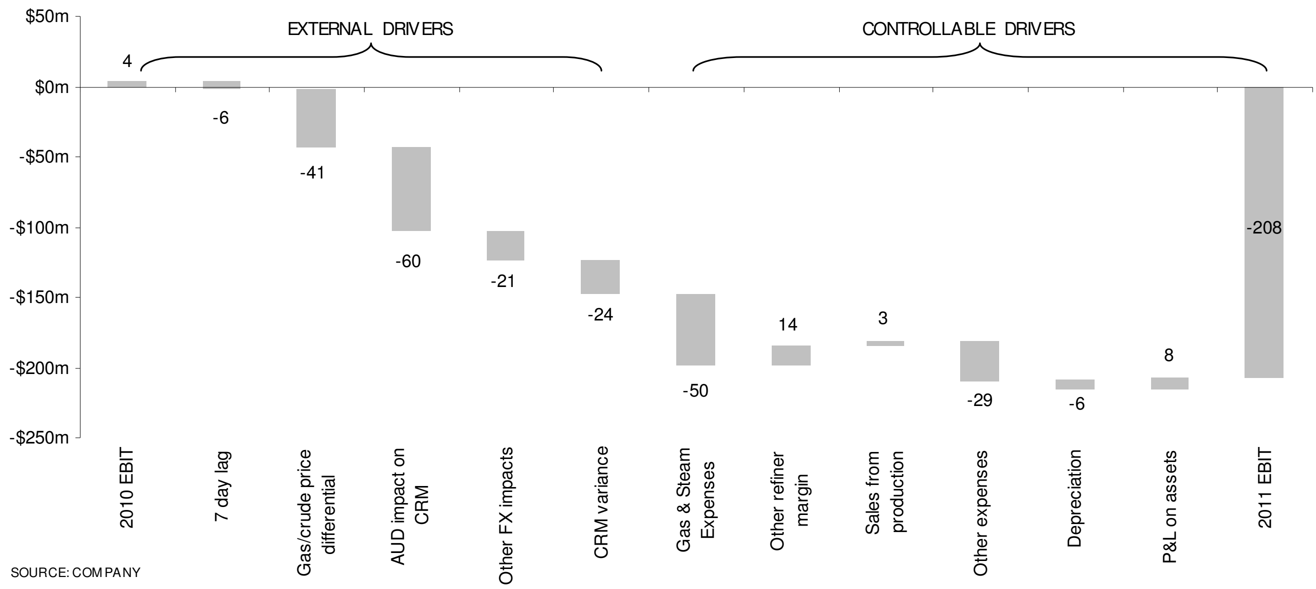


NOTE: EBIT ADJUSTED EXCLUDES FX IMPACT ON PAYABLES

SOURCE: COMPANY DATA, BELL POTTER

The earnings of this division have historically been volatile and difficult to forecast. While its 2011 revenue of $15.4bn equated to 53% of group revenue, EBIT moved from a $4m gain in 2010 to a $208m loss in 2011 (refer Figure 5). One major factor producing the earnings volatility is the Caltex Refiner Margin (CRM), which represents the difference between the cost of importing a standard Caltex basket of refined products to Eastern Australia and the cost of importing unrefined crude oil required to make that product basket. Other factors include the FX impact on the CRM and accounts payable, refinery outages for maintenance, time lags of up to a month for passing through oil price increases for wholesale and commercial customers and the price differential between gas and crude oil prices.

Figure 5: Refining & Supply EBIT movement in year ending December 2011 versus December 2010



SOURCE: COMPANY

Caltex Subordinated Notes

Caltex Supply Chain Restructure

As Caltex's Australian refineries are relatively small and lack the larger scale of the more efficient modern refineries with which it competes against in the Asian region, Caltex announced on 26 July 2012 it would close Sydney's Kurnell Refinery in the second half of 2014 and turn it into an import terminal. Caltex has undertaken a long term supply agreement with its 50% shareholder Chevron to ensure a reliable and efficient supply of imported product.

While this strategy appears sensible to stem the losses from Kurnell and reduce the group's earnings volatility, there will be considerable costs required to implement this strategy. Caltex intends to raise provisions of $430m to cover site remediation ($260m), site demolition ($80m) and staff redundancies ($90m). In addition, Caltex will spend an additional $250m in capex to convert Kurnell into an import terminal.

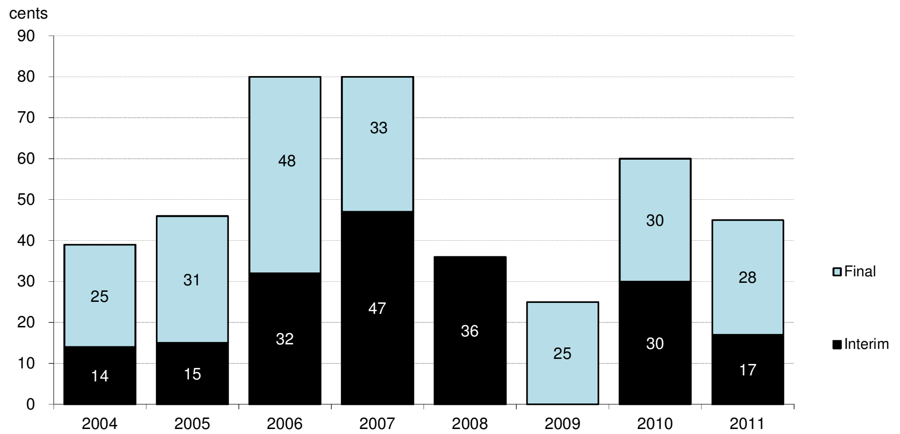
Although it is likely these costs will weaken the financial metrics of Caltex, the CTXHA issue will provide some form of balance sheet support during the transition period for Kurnell. CTXHA is also important in allowing continued investment in growing Caltex's supply chain and marketing operations.

Focus to maintain net debt at $750m

Noting Caltex in its 1H12 profit outlook on 28 June 2012 stated it expects net debt to be around $750m at 30 June 2012, and expects to keep net debt around this level. One response has been to lower the dividend payout ratio from 40-60% to 20-40% for the next five dividends between 1H12 and 1H14.

While a reduction in dividend payout is positive for Caltex's financial metrics, the volatile nature of Caltex's dividend highlights less protection from the CTXHA dividend stopper than issuers such as Woolworths or Origin who would face a material decline in their ordinary shares given they both have outstanding records at maintaining and growing ordinary dividends. We also note Caltex missed two ordinary dividend payments in March 2009 and September 2009.

Figure 6: Caltex ordinary dividends



SOURCE: COMPANY DATA, BELL POTTER

Caltex Subordinated Notes

Figure 7: ASX listed subordinated debt securities with equity credit features

	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	$300m	$650m	$1,000m	$250m	$900m	$700m
ASX Listing	6 September 2012	5 April 2012	29 March 2012	23 March 2012	23 December 2011	25 November 2011
Margin: 90 BBSW +	4.50-4.75%	3.80%	3.25%	4.00%	4.00%	3.25%
Maturity	25 years	27 years	25 years	25 years	60 years	25 years
First call date	Year 5	Year 7	Year 5	Year 5	Year 5	Year 5
Step-up date	Year 5	Year 7	n/a	Year 5	Year 25	Year 5
Step-up margin	0.25%	0.25%	0.00%	0.25%	1.00%	1.00%
Optional interest deferral	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	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 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 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	At least 50% first 5 years, then 0%	100% first 7 years, then 0%	At least 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 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

Caltex Subordinated Notes

Comparison with Origin Energy Notes (ORGHA)

In terms of benchmarking CTXHA with an existing issue, ORGHA provides the closest comparable. Both Caltex and Origin Energy have the same investment grade credit rating as well as a relatively defensive retail division. Both companies face financing and project execution risks over the next three years relating to the Kurnell refinery for Caltex and the Australia Pacific LNG (APLNG) project for Origin.

Essentially the key factor for the 0.50% margin differential relates to issuer reputation and defensiveness of earnings. This is highlighted by their respective track record of ordinary dividends - Origin is yet to cut its dividend, reflecting its historically defensive earnings profile. Caltex did not pay a dividend in March 2009 or September 2009. As such, the market cap impact suspending ordinary dividends is significantly greater for Origin than Caltex. This puts greater strength behind the dividend stopper on ORGHA.

While we view redemption of CTXHA at the year 5 call date as highly likely, Caltex has flagged this may not occur if there is a material deterioration in its credit profile.

Caltex states it "intends to retain CTXHA in its capital structure in circumstances where Caltex's credit profile is materially worse than as at the date of this Prospectus, unless it elects to replace CTXHA with a new issue of hybrid or other securities which are ascribed at least an equal equity credit".

Figure 8: Comparison with Origin Energy Notes

	Caltex Subordinated Notes (CTXHA)	Origin Energy Notes (ORGHA)
Issue size	$300m	$900m
Margin: 90 BBSW +	4.50-4.75%	4.00%
Maturity	25 years	60 years
First call date	Year 5	Year 5
Step-up date	Year 5	Year 25
Step-up margin	0.25%	1.00%
Optional interest deferral	Yes, subject to dividend stopper. CTX did not pay ordinary dividends in Mar 2009 and Sep 2009	Yes, subject to dividend stopper. ORG has an outstanding ordinary dividend track record
Mandatory interest deferral	No	Yes, if Origin's Leverage Ratio is above 4.0 times, or Interest Cover Ratio is below 3.5 times
Interest deferral	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
Key issuer risks	Earnings volatility from refining and costs associated with closure of the Kurnell refinery and capex required to convert into an import terminal	Development, environmental, financing and project executions risks on the APLNG project
Likelihood of year 5 redemption	High. If there is a material deterioration in CTX's credit profile, CTX has flagged it may not redeem the security at yr 5. Considerations include its financial position, operational performance, funding requirements & access to capital markets	Very high.
Issuer market cap	$3.8bn, 70th largest ASX listed company	$12.7bn, 15th largest ASX listed
Interest Cover (EBIT)	6.5x	4.7x
Assessed equity credit	At least 50% first 5 years, then 0%	100% first 5 years, then 0%
Ranking	Subordinated, ranks above ordinary equity	Subordinated, ranks equal with Euro Capital Securities, above ordinary equity

SOURCE: COMPANY DATA, BELL POTTER

Caltex 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 CTXHA satisfies the requirements of one of the ratings agencies to allow at least 50% classification as equity in calculation of its financial ratios, therefore providing ratings support to Caltex.

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

Figure 9: CTXHA ranking - pro forma as at 31 December 2011

	Ranking	Existing Instruments	Amount
Higher Ranking	Debt / bonds	Banks loans, facilities Other unsubordinated notes and bonds	$619m
	Subordinated debt / hybrids	CTXHA	$300m
Lower Ranking	Equity	Ordinary shares	$2,218m

SOURCE: COMPANY DATA, BELL POTTER

Investment risks

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

Risks associated with Caltex:

- Caltex Refiner Margin (CRM): this is the key metric which drives the profitability of the refining business.
- Commodity price risk.
- Competitive risk: the transport fuels industry is facing structural changes as local refineries close and are converted to import terminals. This may result in new competitors or increased competition.
- Operational risk: the nature of the business carries inherent risks and hazards that may include pipeline and storage facility damage or ruptures, explosions and fires, mechanical incidents including the transportation of fuel.
- Kurnell closure and the conversion to an import terminal is complex and costly subject to regulator and environmental risks.

Key Risks associated with CTXHA:

- CTXHA are subordinated obligations of Caltex, 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 Caltex. However, the interest payments, if deferred, will cumulate for up to 5 years.
- Deferral of interest payments is likely to have an adverse effect on the market price of the CTXHA.
- Duration: Failure of Caltex to redeem at year 5 increases the prospect the security will not be redeemed until year 25, 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 5 years. If credit margins widen beyond the initial range or the company has credit issues, CTXHA may trade at a discount.

Fixed Income

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