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HD **Rocky road response**

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TRANSPORT

Despite a challenging year, rail transport companies have tightened their belts and it's paying off, writes Michael Smith.

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There are buying opportunities locked away in the nation's transport companies.

While the end of the mining boom, weak commodity prices and a lacklustre global economy have made life difficult for rail freight firms such as Aurizon and Asciano, it is not all bad news.

A period of aggressive cost-cutting and radical restructuring under new management or owners mean value is now being unlocked in the firms tasked with transporting commodities and other products around the country and offshore.

But the make-up of the listed transport sector looks radically different from it was a decade ago. A former market darling, logistics outfit Toll Holdings, has fallen from grace after years of acquisitions. QR National was taken out of the Queensland government's hands and floated in 2010, while Asciano brought in new management to get costs under control, and it is now looking at selling its ports business.

Meanwhile the new kid on the block, McAleese, had a disastrous ASX debut when a fatal oil tanker crash saw the company's Cootes division losing key contracts.

Aurizon (formerly QR National) and Asciano, with market capitalisations of $10 billion and $6.3 billion respectively, dominate the listed transport sector and look like solid buys despite some tough market conditions. Both are at the tail end of sweeping restructures. The focus has been very much on costs rather than growth but there are signs that headwinds are abating and the hard work is about to pay off.

Neither company is without risks though, and some analysts are dubious about Asciano's and Aurizon's bullish growth forecasts given the tough economic conditions. Both are asset rich, though with the potential for higher shareholder returns if they offload stakes in port or rail businesses.Confident despite difficult year

It was not an easy year for rail group Aurizon, which reported a 43 per cent fall in annual earnings for 2013-14 to $253 million. Although underlying earnings before interest and tax (EBIT) rose 13 per cent on the previous year to $851 million due to stronger coal and iron ore haulage volumes, Aurizon did not take as much cost out of its business in the second half as forecast. Chief executive Lance Hockridge remains confident the company is a growth story because weak commodity prices do not necessarily have an impact on volumes.

Hockridge has said in the past he would like to the double the size of the group every five years. He has met that target to date, overseeing the company's transformation from an inefficient government entity into a modern and more nimble operation.

But a repeat performance looks unlikely. Uncertainty surrounds many of the big mining projects the rail freight group is looking at, while the threat of potential industrial action and bad weather in Queensland are also risks.

Analysts have started asking if the dividend payout ratio is sustainable. Aurizon is forecasting cost cuts of up to $300 million over two years from a target of $230 million. Since privatisation, Hockridge has got the efficiency ratio down from 91 per cent to 77.7 per cent, and aims to get this down to 75 per cent by the end of the current financial year.

While a lot of the low hanging fruit has gone, Aurizon wants to use assets more effectively by improving the productivity of train crews, payloads and roster changes. Hockridge has proved he is good at stripping out inefficiencies so should be able to meet his new targets.

There are mixed views on Aurizon's prospects, with 11 buy recommendations on the stock compared with seven holds and one sell. The stock is trading at around $4.70, well above its 2010 IPO price of $2.55. The shares hit a high of $5.27 on April 29 and have recovered from a low of $4.49 in September last year.Volume growth opportunity

Importantly, Aurizon expects coal volumes of between 210 million and 220 million tonnes this year compared with 210.4 million last year, suggesting plenty of prospective growth.

Deutsche Bank analyst Cameron McDonald, who has a buy rating on the stock, says there is material upside potential and notes that the increased cost out guidance underpins growth of 14 to 20 per cent earnings before interest and tax in 2015.

There are risks, though. Aurizon is also looking to build new rail networks in Western Australia's Pilbara region and Queensland's Galilee Basin. It needs to pay for these and one option is the possible sale of a 49 per cent stake in its Queensland tracks business, which could fetch up to $2 billion.

Asciano is also looking at potential divestments, with the partial sale of its Patrick ports business up for grabs at the right price. Patrick, which operates container terminals in Sydney, Perth, Melbourne and Brisbane, is being eyed by Chinese conglomerate China Merchants. A partial sale could net up to $2.5 billion.

Asciano shares hit their highest level in October after the rail freight group beat forecasts with a 5 per cent rise in pre-tax earnings, increased its final dividend by 36 per cent and forecast stronger earnings growth this year.

Analysts have 10 buys, six holds and one sell on the stock, which hit a high of $6.612 in August compared with a low of $5.13 in April. Healthy dividend likelyHigher coal haulage volumes have underpinned the result while port container lifts also increased. With business and volumes improving at a time when costs have fallen and capital spending in decline, the company is expected to have a solid year.

The result marked a turnaround for CEO John Mullen who has been through a tough couple of years. Asciano has been a cost-cutting story for some time but now the focus is on what it does with Patrick. Mullen is tipping about 10 per cent underlying earnings growth a year for the next two years and a healthy final dividend should keep investors happy. A lot of this is to do with cuts and restructuring rather than the external environment which remains challenging but is showing signs of bottoming.

"With dividends increasing and returns improving, we believe Asciano will continue to re-rate irrespective of any corporate activity around the ports business," Citi analyst Anthony Moulder says.

Global logistics firmToll Holdings is also going through a restructure as it cuts its business divisions to six from five. It has warned operating conditions remain difficult and wants to cut an additional $50 million in costs. Broker views, however, remain more divided, with analysts placing seven holds, three buys and six sells on the stock which is trading at around $5.81 compared with $6.02 in late August.

CO qrntnl : Aurizon Holdings Limited | tolhld : Toll Holdings Ltd | dorval : Aurizon Mines Ltd | hclamn : Hecla Mining Co

IN i211 : Metal Ore Mining | i71 : Railroads | i77002 : Freight Transportation Arrangement | ibasicm : Basic Materials/Resources | icargo : Freight/Cargo Transport | igoldm : Gold Ore Mining | imet : Mining/Quarrying | irailtr : Road/Rail Transport | irfrght : Railroad Freight | itsp : Transportation/Shipping

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