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Investor briefing

Adani Ports and Special Economic Zone (NSE/BSE: ADANI PORTS)

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Adani Ports and Special Economic Zone has expanded into thermal coal haulage, creating a subsidiary that will haul coal for the Carmichael coal project in Australia. This creates reputational and financial risks for investors.

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Summary

This briefing is provided to inform existing and potential investors in Adani Ports and Special Economic Zone (Adani Ports) of the company's establishment of Bowen Rail Company, which will transport coal for the controversial Carmichael coal project in Australia.

This move into coal haulage exposes investors to substantial financial and reputational risks. Adani Ports already exposes investors to the risks of Adani's coal supply chain operations. Continuing to invest in Adani Ports now means investors are contributing funding to what is possibly the world's most controversial and contested coal project (as recently outlined by the Anthropocene Fixed Income Institute).

Institutional investors pursuing Paris alignment in their portfolio or avoiding new thermal coal projects are urged to rule out and/or reconsider any holdings in Adani Ports or provision of financial services to Adani Ports and communicate their concerns to the company, given the following risks:

- **Reputational risks**
    - The Adani Carmichael coal project is arguably the most controversial coal mining project in the world. It has faced ten years of sustained local and global opposition due to its significant cultural, ecological and climate impacts, including:
        - The destruction of Wangan and Jagalingou sacred sites such as the Doongmabulla Springs and the continued resistance to the project by Traditional Owners who have repeatedly refused to consent to the mine on their land.
        - The project's role in opening up the unmined Galilee coal basin will facilitate the release of up to 705 million tonnes of carbon dioxide pollution from the basin each year, which is 1.3 times Australia's total annual emissions. This undoes global efforts to reduce greenhouse gas emissions in line with the Paris climate goals.
        - On the doorstep of the Great Barrier Reef World Heritage area, Adani's coal project will increase carbon emissions that fuel coral bleaching and will drastically increase the number of coal ships traveling through the already dying reef.
        - While huge areas of Australia are in serious drought, the Carmichael mine has been granted free and unlimited access to groundwater resources and it is estimated it will drain at least 270 billion litres over the life of the mine.
    - Adani Ports' "low risk" ESG rating is threatened by its expansion into coal haulage for Adani's Carmichael mine due to both governance issues around risk disclosure and environmental issues associated with facilitating the opening up of a massive untapped thermal coal basin.
    - Every company associated with the Carmichael coal project faces major community opposition, with over 80 international banks, insurers and contractors having publicly ruled out any support for the project.

- **Transitional climate change risks**
    - Adani Ports already operates the world's largest coal import terminal. Its move into coal haulage services for the Carmichael coal project increases the company's exposure to thermal coal at a time when institutions are reducing such exposure in line with the Paris climate goals.

Background

- Adani Ports and Special Economic Zone has set up a subsidiary, *Bowen Rail Company*, which will haul the coal for the under-construction Carmichael coal mine in Queensland, Australia. Adani Ports has made no major public announcement about this substantial investment and expansion into thermal coal haulage, and it appears major investors and financial advisers were also not informed.

- The Carmichael coal project is highly controversial. A massive international campaign has been working to stop the Carmichael mine and rail line from being built due to the project's devastating climate and other impacts. The project has been delayed by at least seven years and it has constantly faced abandonment by contractors, insurers and lenders due to its controversial nature.
- The Carmichael project is at risk of becoming a stranded asset. Adani intends to have it produce low-quality thermal coal for 60 years, despite renewable energy already being cheaper than coal for electricity generation in India (Carmichael's only known market), and the goals of the Paris Agreement requiring coal-burning electricity generation to be phased out globally by 2040.
- Adani's Carmichael coal project will clear the way for the development of an entirely new thermal coal mining region and thereby facilitate the release of 20-30 gigatonnes of CO_2 emissions, or approximately 5-10% of the remaining global carbon budget to keep warming below the 1.5C Paris target.

1. Adani Ports has quietly expanded into coal haulage for the Carmichael coal project in Australia

In August 2020, the Bowen Rail Company was publicly launched after being incorporated in December 2019. Adani Ports and Special Economic Zone's latest annual report outlines its whole ownership of Bowen Rail Company via holding companies in Singapore. The directors of the company are all senior Adani staff. Despite this, the media release and website published for the company launch didn't mention any links to Adani Ports. According to a report by ABC news in Australia, the biographies of key Bowen Rail Company staff published on its website omitted their previous work for Adani. Bowen Rail Company will transport coal to Adani's Abbot Point coal port, the port via which Carmichael coal will be exported to India. Adani Ports has no experience of running a coal haulage company in Australia, nor does any company within the Adani group.

It is likely Adani was forced into the more expensive option of self-haulage due to established coal haulers refusing to do business with it. The community campaign against the Carmichael project has resulted in Adani having difficulty in securing contractors for construction and operation. Eighty-four companies are now listed as refusing to undertake any work related to Carmichael, including Genesee and Wyoming, one of only three established coal haulers operating in Australia. Haulage company Aurizon, which controls the rail network Adani must access to transport coal, confirmed to the ABC it was not aware of any tender process for haulage contracts for

Carmichael, despite Adani's claims that first coal will be shipped in 2021. The lack of a tender process leaves Bowen Rail Company as the only candidate for coal haulage.

Adani Ports has probably already shifted funds to Bowen Rail Company for capital expenditure programs; the company claims its first four locomotives are due to arrive in 2021. The Institute for Energy Economics and Financial Analysis estimates that self-hauling coal will increase costs for Adani by $200 million for the first 10mtpa phase of the Carmichael project, rising to $500 million for the 27mtpa phase. The most likely source of this additional capital is Adani Ports.

Adani's Australian assets have long been underpinned by what experts have labelled an opaque web of companies and trusts, posing a significant risk to investors. The Adani family has the ability to shift cash and assets throughout its conglomerate structure and has often done so. A loan or equity injection into one Adani Group company could be used to finance another.

However, the fact that a wholly owned Adani Ports subsidiary will be undertaking the transportation of Carmichael mine coal provides an obvious and direct pathway for finance to be shifted from Adani Ports to the Carmichael project. From Market Forces' enquiries it is clear that many major Adani Ports bondholders and bankers were not informed about Adani Ports' move into coal haulage and the Carmichael project. Investors must now re-examine the risk profile of Adani Ports and Special Economic Zone. This is discussed further below.

2. Adani Ports' involvement in the Carmichael coal project increases risk of reputational damage to its investors and bankers

As mentioned above, over 80 companies, including 47 finance companies and 24 insurers have publicly pledged to stay away from Abbot Point coal port (recently rebranded as North Queensland Export Terminal) and the Carmichael mine and rail line, due in part to significant public opposition to a new thermal coal mine being constructed during a climate crisis. Blackrock has weighed in on investing in Adani's coal project, criticising Siemens for failing to fully consider the "breadth of risks" associated with the Carmichael mine and rail. Blackrock advised that Siemens needed to improve its risk assessments around environmental, social and governance issues.

Burning the coal from Adani's Carmichael mine will release on average 77 million tonnes of CO_2 each year. As the first coal mine in the untapped Galilee Basin, the Carmichael project will facilitate the mining of thermal coal which will produce around 24 gigatonnes of CO_2 emissions, or approximately 6% of the remaining global carbon budget to keep warming below the 1.5C Paris target. The Queensland Resources Council has admitted that the Carmichael project is the “ice-breaker” which will enable at least six more massive thermal coal mines to go ahead with lower infrastructure and approvals costs. If all Galilee coal mine proposals go ahead, their coal would generate yearly emissions equivalent to 1.3 times Australia’s entire annual carbon emissions.

For investors utilising ESG ratings, the “low” ESG risk ranking set for Adani Ports has been questioned by market analysts due to governance and environmental issues. Adani Ports’ lack of transparency and disclosure around the purpose of Bowen Rail Company erodes its governance values. Environmental criteria are also undermined by the fact that Adani Ports operates the largest coal import terminal in the world, last financial year deriving 32% of volumes from coal (down from 47% in FY15). The Carmichael coal project has a first phase of 10 million tonnes per annum (mtpa) production, increasing to 27mtpa and has approval for up to 60mtpa. Adani Ports will be exposed to this thermal coal via both Bowen Rail Company and the ports it owns. Adani Ports’ now direct role in opening up an untapped thermal coal basin through the Bowen Rail Company means that its “low risk” ESG rating should be immediately reviewed.

3. Adani Ports’ exposure to the Carmichael coal project exposes investors to major new financial risks

Investors in the Carmichael project, which Adani Ports investors can now count themselves among, face two major sources of financial risk:

1. The Carmichael mine, rail line and Abbot Point coal port are at significant risk of becoming stranded assets as thermal coal use is phased out, as outlined below, and;
2. The Carmichael project is finding it increasingly difficult to find appropriate insurance coverage, as outlined in section four.

In November 2018 Adani was forced to declare that the Carmichael coal mine and rail line would be “self funded” after dozens of banks refused to support this remote and low quality thermal coal export venture, particularly given the 400km distance to the coast and lack of any existing commercial infrastructure needed for the project. This year, Adani’s Abbot Point coal port (which will export Carmichael coal) has faced ratings downgrades triggered by a failed bond issue, an exodus of creditors and an expensive penalty of $107 million in the Queensland Supreme Court. Faced with shrinking appetite from investors, Abbot Point coal port recently officially rebranded as the North Queensland Export Terminal. In another direct link with the Carmichael project, Adani Ports holds equity in the aforementioned Abbot Point coal port.

Taken together, the Carmichael mine, rail and associated coal port have been increasingly shunned by global investors, reflecting the rapid escalation of global financial institutions enacting thermal coal exclusion policies more aligned with a Paris Agreement outcome which requires a terminal decline in the seaborne thermal coal market.

In India, Adani is the biggest generator of coal-based power in the private sector and the biggest importer of thermal coal for power plants, leaving the group highly exposed to energy market shifts. Adani intends to sell all Carmichael coal to the power stations it owns under its financially distressed Adani Power corporate entity, including the massive 4.6GW Mundra plant in Gujarat, the Udupi coal plant in Karnataka and the controversial and contested still under construction plant at Godda. There is no other known buyer for Carmichael coal, with Adani committed to a “pit to plug” vertical integration model.

Energy trends do not bode well for coal-fired power in India. Solar and wind have been the cheapest sources of bulk power generation in India for the past three years. Since 2014, the mid-case levelised cost of energy has dropped by 80% and 66% for solar and wind respectively. Domestic renewable energy prices are about 20-30% below the cost of India’s existing domestic coal-fired power generation costs, and half the cost of new plants powered by imported coal.

Despite this, Adani’s coal venture relies upon a market for Carmichael coal for decades. Therefore Adani Ports’ investors have recently become directly exposed to the financial risk of starting a huge new thermal coal chain in the midst of a significant restructuring in India’s electricity market, where rapid reduction in renewable energy prices is impacting the viability of coal-burning plants. The Carmichael mine, rail line and Abbot Point coal port have been labelled as future stranded assets, and Adani Ports creditors are now exposed to that risk through its direct ownership of the Bowen Rail Company providing coal haulage for Carmichael.

Adani’s Mundra coal-fired power plant has faced significant losses and has failed to cover capital costs due to the higher-than-expected cost of imported coal, compounded by the ongoing currency depreciation (given Mundra is reliant on a US$ denominated commodity). These high costs mean that Adani Power is losing money for every unit of electricity generated at Mundra, leading to the company periodically discontinuing its contracted output for the state of Gujarat. This has forced the state of Gujarat to purchase power on the market in order to meet demand, which will likely lead to higher electricity bills for consumers.

Having seen a 63% decline in its share price over the last decade since IPO, Adani Power now has an equity market capitalisation of just US$1.9bn, which is dwarfed by an enormous net debt of US$8.0bn as at March 2020. Its auditors qualified their audit opinion on the grounds of Adani having a material weakness in financial controls and excessive financial leverage. Coal power station utilisation rates across India have now fallen below 55% and are forecast to remain at these decade lows for coming years, far below the level needed for ‘baseload’ configured generators like Mundra to recover operational costs. In its latest quarterly results, Adani Power reported another net loss of US$94m for the three months ending June 2020 after a US$302m net loss in FY2020, building on a run of huge losses since FY2012.

With Adani’s imported coal plants in India already facing an uncertain future, and the cost of wind and solar power continuing to fall every year going forward, Adani Ports’ role in opening up a new thermal coal project and new thermal coal rail haulage business is a major financial and ESG risk to its investors. This risk is exacerbated as global investors are increasingly looking to align with net zero emissions by 2050 targets or earlier for developed markets.

4. Carmichael’s insurance problems further exacerbate the financial risk faced by Adani Ports investors.

Market Forces has recorded twenty-four major insurance companies that are publicly refusing to insure the Carmichael project specifically or via a general policy refusing underwriting to new thermal coal mines and related infrastructure.

These include many of the biggest insurance companies in the world such as:

- Allianz
- Argo Ltd
- Axa
- Axis Capital
- Canopius
- CNA Hardy
- Generali
- Hannover Re
- HDI Global
- Liberty Mutual
- Mapfre
- Munich Re
- QBE
- SCOR
- Swiss Re
- Zurich

With previous insurers Liberty Mutual, Axa and HDI Global refusing to renew coverage, Adani’s current underwriting is coming from the Lloyd’s market. Public pressure has already convinced at least one of its existing insurers, Aspen, to refuse to renew coverage and remaining Lloyd’s syndicates are facing escalating public campaigns.

As more insurers rule out coverage, it is increasingly likely that in the near future Carmichael will be unable to obtain the insurance it needs for completing construction or ongoing operation. Under this scenario, investors exposed to Carmichael, including those exposed to Adani Ports, will face increasing financial risk.

Conclusion

Adani Ports' role as the coal hauler for the greenfield Carmichael thermal coal project in Australia generates serious reputational and financial risks for any investor and financier associated with the company. We encourage all investors in Adani Ports and Special Economic Zone to refuse to support the Carmichael coal project and thereby reconsider existing investments in Adani Ports and rule out any future investments.