

# Crown Subordinated Notes (CWNHA)

## Special Report

Recommendation: **Subscribe**

We recommend investors with a high risk appetite Subscribe. A high stake bet!

### Overview

Crown (CWN) will raise at least \$525m via an ASX-listed security issue, Crown Subordinated Notes (CWNHA). CWNHA are long-dated, unsecured, subordinated debt securities, which rank above CWN ordinary shares and below other CWN debt. The notes mature in 60 years unless the issuer exercises an option to redeem at the first call date in September 2018, on any subsequent interest payment date or following a trigger event (see key terms). The notes pay quarterly interest based on the 90-day BBSW rate plus a 5.00% p.a margin. If the notes are not redeemed on the September 2038 step-up date the margin steps up once by 1.00% p.a. Interest payments are cumulative and deferrable at CWN's option and subject to mandatory deferral conditions. Being interest payments they are not franked.

### Summary and recommendation

We recommend investors subscribe, but only if they have a high risk appetite, and we suggest a small portfolio allocation. Morningstar assesses CWNHA as being high risk so potential investors need to weigh up an investment in CWNHA versus CWN equity. We also remind investors to seek independent professional advice before making an investment decision.

CWNHA is a pure debt security with no conversion into equity, offering an attractive margin of 5.00% that is also above our fair margin estimate of 4.85%. The note is similar to some of the long dated subordinated debt issues of recent times such as AQHHA and ORGHA issued by APA Group and Origin Energy. CWNHA has a higher risk profile than these two notes given its conditions and the underlying business so pays a higher margin. AQHHA and ORGHA pay margins of 4.00% and 4.50% respectively. Higher return equates to higher risk! The subscription of \$100m of this note issue by CWN's major shareholder, Consolidated Press

Holdings, gives us some confidence in the issue but it does not impact our assessment of the security's risk.

CWN is using proceeds to repay some bank debt, extend its debt maturity profile and qualify for treatment as 50% equity by some rating agencies. From a risk perspective we would prefer the issue of a higher ranking security such as the Tatts Bond (TTSHA) with mandatory interest payments, a shorter term and a step-up in the margin at the first call date, but this would mean a lower margin being offered. Given the treatment of 50% of this issue as equity by some rating agencies, some of our preferred terms may not have been able to be adopted.

Potential investors need to appreciate CWNHA is a long dated, unsecured, subordinated investment, which ranks just above ordinary equity and is therefore riskier than a bank deposit. Investors should also be aware CWNHA is a floating rate note which reprices quarterly, so interest rate changes will affect interest payments.

CWN operates the Melbourne and Perth casinos. Its investments in North America, United Kingdom and Macau bring some diversification but carry their own uncertainty. We believe CWN has a narrow economic moat as it holds a 40 year casino licence in Victoria and a licence in Western Australia extending to 2060.

Morningstar has assigned CWN a high uncertainty rating. While the business holds the licences to operate casinos in Perth and Melbourne, the business is capital intensive, has expansion risk, carries a sizable amount of debt, is subject to regulatory risk and earnings are exposed to consumer discretionary spend.

We do not think CWN's revenues are as stable as Tatts Group which has a high mix of relatively stable lotteries revenues. For CWN, main gaming floor revenues, including various table and electronic games such as poker machines, represent around half of total revenue and are the most stable of its revenue streams. VIP includes table and electronic games played by high-end clients in exclusive gaming areas, and contributes around a quarter of revenues. Non-gaming operations such as retail and hotel contribute almost a quarter of revenues.



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CWN's operating cashflows from its Australian operation are robust but are more susceptible to changes in consumer discretionary spend, in particular the VIP and non-gaming parts of the business, than Tatts Group. While having casino licences provides some protection as CWN has a monopoly in table gaming in Melbourne and Perth, it does not make it immune from competition from alternative forms of gambling and entertainment.

CWN's financial leverage measures are not an immediate concern, but have worsened due to funding needs for its large capital expenditure programs. The business will continue to have high capital expenditure demands. More than \$2bn has been invested between FY07 and FY12. Between FY13 and FY15 CWN expects to spend almost \$1.1bn on Burswood and Crown Melbourne. While the operating cashflows are robust, the demands on them by the business are high. We expect CWN to be able to meet its current capex demands from operating cashflow. However, these do not incorporate any additional expansion plans such as a potential development of a hotel and VIP gaming establishment at Barangaroo, Sydney.

### Valuation

We assess CWNHA as being high risk and assign CWNHA a fair margin of 4.85% comprising a 4.35% credit spread, an illiquidity cost of 0.25% and 0.25% for other features such as no holder call rights and deferrable interest payments.

### Key dates

- ▶ Margin announced: 20 August 2012.
- ▶ Offer opens: 21 August 2012.
- ▶ Closing date for CWN shareholder and general offer: 5 September 2012.
- ▶ Closing date for broker firm offer: 13 September 2012.
- ▶ Issue date: 14 September 2012.
- ▶ Commencement of trading: 17 September 2012.
- ▶ First interest payment date: 14 December 2012.
- ▶ First Call Date: 14 September 2018.
- ▶ Step-up Date: 14 September 2038
- ▶ Maturity date: 14 September 2072.

### Key terms

- ▶ ASX code is expected to be CWNHA.
- ▶ Face value: \$100 per security.
- ▶ Minimum subscription amount: \$5000 (50 units).
- ▶ Amount to be raised: At least \$525m. The major shareholder (48%), Consolidated Press Holdings, will take up \$100m of CWNHA offer.
- ▶ Interest rate: 90-day BBSW + margin.
- ▶ Margin: 5.00% p.a.

- ▶ Interest payments: Interest payments are deferrable at CWN's option and subject to mandatory deferral conditions.
- ▶ A Mandatory Deferral Event occurs if CWN's:
  - ▶ Leverage Ratio (Relevant Gross Debt (divided by two)/Normalised EBITDA) is above 5.0 times for two consecutive testing dates; or
  - ▶ Interest Cover Ratio (Normalised EBITDA/Normalised Net Interest Paid) is below 2.5 times on any testing date; and
  - ▶ CWN has a solicited rating from a rating agency.
  - ▶ The testing occurs every six months as at 30 June and 31 December.
- ▶ Deferred interest payments are cumulative and compounding. CWN intends to pay, but is not obliged to pay, any deferred interest payments within five years of the deferral of the oldest outstanding amount.
  - ▶ Optionally Deferred Interest Payments can be paid at any time unless a Mandatory Deferral Event exists.
  - ▶ Mandatory deferred interest payments can only be paid: if a Mandatory Deferral Event no longer exists; five years have elapsed since payment was due; or the step-up date has occurred; and provided CWN has not paid distributions on or redeemed, reduced, cancelled, purchased or bought back on any equal or junior ranking obligations.
- ▶ If CWN optionally defers an interest payment then, subject to conditions, a number of capital and dividend restrictions are imposed upon it until all optionally deferred interest payments are made in full. The restrictions are:
  - ▶ CWN cannot declare or pay any distributions on any equal ranking obligations, junior ranking obligations or ordinary shares issued by CWN. Essentially a dividend stopper comes into effect so CWN won't be able to pay dividend on its ordinary shares.
  - ▶ CWN cannot redeem, reduce, cancel, purchase or buy-back on any equal ranking obligations, junior ranking obligations or ordinary shares issued by CWN.
- ▶ Interest payments are payable quarterly in arrears, on the 14th of March, June, September and December.
- ▶ Term: 60 years.
- ▶ Early redemption: CWN has the right to redeem early:
  - ▶ On the first call date of 14 September 2018;
  - ▶ on any subsequent interest payment date after the first call date; or

- ▶ following specific trigger events: accounting, change of control, tax or capital event.
- ▶ An accounting event will occur if as a result of a change in accounting principal and standard, the application of Mandatory Deferred Interest payments will no longer satisfy the criteria required by the rating agency to receive the same equity credit as initially attributed.
- ▶ A change of control event occurs if any person (other than Consolidated Press Holdings, James Packer or related interest) acquires more than a 50% of the voting shares in CWN. If CWNHA are not redeemed following a change of control event the margin steps up by 5.00% p.a.
- ▶ A tax event occurs if any interest payment would not be deductible for tax purposes as a result of a change in law.
- ▶ A capital event will occur if CWNHA are no longer eligible for the same or higher category equity credit from a rating agency as was initially attributed to the notes, as a result of a change in the rating agency's assessment criteria. Equity credit means that part of the amount raised will be treated as equity by rating agencies for their assessment of CWN's credit profile. CWN expects that CWNHA be treated as 50% equity for quantitative purposes from the rating agency it uses.
- ▶ Ranking in wind-up:
  - ▶ Ahead of CWN ordinary shares and any ranking obligations (if any).
  - ▶ Equally with other equal ranking obligations (if any); and

**Table 1: Comparison to other issues by Industrials**

	<b>CWNHA</b>	<b>AQHHA</b>	<b>CTXHA</b>	<b>TAHHA</b>	<b>ORGHA</b>
<b>Name</b>	Crown Subordinated Notes	APA Group Subordinated Notes	Caltex Subordinated Notes	Tabcorp Subordinated Notes	Origin Energy Subordinated Notes
<b>Type</b>	Unsecured Subordinated Note	Unsecured Subordinated Note	Unsecured Subordinated Note	Unsecured Subordinated Note	Unsecured Subordinated Note
<b>Issuer</b>	Crown (CWN)	APT Pipelines Ltd (APTPL), the borrowing entity of APA Group (APA)	Caltex Australia (CTX)	Tabcorp Holdings (TAH)	Origin Energy (ORG)
<b>Issue Size</b>	At least \$525m	At least \$475m	At least \$525m	\$250m	\$900m
<b>Issue Date</b>	14-Sep-2012	18-Sep-2012	5-Sep-2012	23-Mar-2012	24-Dec-2011
<b>Margin above Base Rate</b>	5.00% p.a.	4.50% p.a.	4.50% p.a.	4.00% p.a.	4.00% p.a.
<b>Base Rate</b>	90-Day BBSW	90-Day BBSW	90-Day BBSW	90-Day BBSW	90-Day BBSW
<b>First Call Date</b>	14-Sep-2018	31-Mar-2018	15-Sep-2017	22-Mar-2017	22-Dec-2016
<b>Maturity Date</b>	14-Sep-2072	30-Sep-2072	15-Sep-2037	22-Mar-2037	22-Dec-2071
<b>Step-Up</b>	Once off 1.00% p.a. in year 26 (14-Sep-2038)	Once off 1.00% p.a. in year 25.5 (31-Mar-2038)	Once off 0.25% p.a. in year 5 (15-Sep-2017)	Once off 0.25% p.a. in year 5. (22-Mar-2017)	Once off 1.00% p.a. in year 25. (20-Dec-2036)
<b>Interest/Dividend Payments</b>	Unfranked, floating rate quarterly cash payments in arrears.	Unfranked, floating rate quarterly cash payments in arrears.	Unfranked, floating rate quarterly cash payments in arrears.	Unfranked, floating rate quarterly cash payments in arrears.	Unfranked, floating rate quarterly cash payments in arrears.
<b>Interest Deferral</b>	Optional deferral subject to a dividend stopper. Cumulative.	Optional deferral subject to a dividend stopper. Cumulative but can be deferred up to 5 years.	Optional deferral subject to a dividend stopper. Mandatory deferral on breach of interest coverage or leverage ratio. Cumulative but can be deferred up to 5 years.	Mandatory deferral on breach of interest coverage or leverage ratio. Cumulative but can be deferred up to 5 years.	Optional deferral subject to a dividend stopper. Mandatory deferral on breach of interest coverage or leverage ratio. Cumulative but can be deferred up to 5 years.
<b>Mandatory deferral on breach of interest coverage or leverage ratio.</b>	Optional deferral subject to a dividend stopper. Cumulative.	Optional deferral subject to a dividend stopper. Cumulative but can be deferred up to 5 years.	Mandatory deferral on breach of interest coverage or leverage ratio. Cumulative but can be deferred up to 5 years.	Optional deferral subject to a dividend stopper. Mandatory deferral on breach of interest coverage or leverage ratio. Cumulative but can be deferred up to 5 years.	No
<b>Conversion into ordinary shares</b>	No	No	No	No	No
<b>Ranking</b>	Above CWN ordinary equity.	Above APA stapled securities.	Above CTX ordinary equity.	Above TAH ordinary equity.	Above ORG ordinary equity.
<b>Risk</b>	High	Medium	Medium	Medium	Medium

Source: Morningstar/Issuer prospectus

**Figure 1: CWN Businesses**

<b>Crown Melbourne</b> Melbourne, Australia - 100% Owned	<b>Melco Crown</b> Macau, Special Administrative Region of the People's Republic of China - 33.6% Interest
<b>Burswood</b> Perth, Australia - 100% Owned	<b>Betfair Australasia</b> Australia - 50.0% Interest
<b>Aspinall's Club</b> London, UK - 100% Owned	<b>Aspers Group</b> United Kingdom - 50.0% Interest
	<b>Cannery Casino Resorts</b> United States - 24.5% Interest
	<b>Echo Entertainment Group</b> Australia - 10.0% Interest

Source: CWN

- ▶ Behind all unsubordinated creditors (including all debt currently on issue) and all other creditors preferred by law.
- ▶ Redemption amount: \$100 face value plus accrued and deferred interest except following a capital trigger event, holders will receive \$101 plus accrued and deferred interest.
- ▶ There is no conversion into CWN ordinary shares.
- ▶ Step-up margin: If the CWNHA are not redeemed on the step-up date the margin steps up once by 1.00% p.a.
- ▶ Holder call rights: Holders cannot request the notes be redeemed unless there is an Event of Default occurs and is subsisting. This does not include deferral of interest.

We have only presented a summary of material terms. Investors should examine the prospectus in detail.

#### **Risks specific to CWNHA include**

The issuer may default on the payment of interest or face value.

CWNHA holders are unsecured, subordinated creditors and rank just above CWN ordinary shareholders so in a wind-up scenario could lose all their investment.

There is no restriction on the issuer issuing more senior or equal ranking securities, which may reduce the ability of CWNHA holders to recover their investment in a wind-up scenario.

Interest payments may be deferred at the option of the issuer or due to mandatory deferral conditions. This could make the price of these securities more volatile than those not subject to interest payment deferral.

CWNHA have a 60-year term and could remain on

issue well beyond the first call date in September 2018.

Holders have limited call rights for early redemption.

The issuer may redeem the notes early following a trigger event.

Once listed, the price of CWNHA may fluctuate and may therefore trade below face value.

These are floating rates notes which will reprice quarterly, so interest rate changes will affect interest payments and may affect the price of the security.

There is a risk that liquidity of the notes will be low, which will impact the bid/ask spread.

#### **About the issuer**

##### **Business overview**

CWN is listed on the ASX with a market capitalisation around \$6.2b. CWN is a casino operator and owns the Melbourne (Crown) and Perth (Burswood) casinos, a casino in London (Aspinall's Club) as well as having various other gaming investments and joint ventures in Australia, the UK, USA and Macau. The company has a major shareholder, Consolidated Press Holdings, which has a 48% stake.

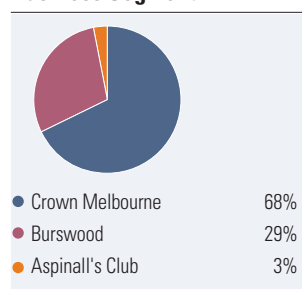
##### **Issuer thesis**

CWN operates Australia's popular Melbourne and Perth casinos. The two Australian casinos contribute to 70% of CWN's valuation. Investments in North America and Macau bring some diversification but carry their own uncertainty. Competitive advantages primarily stem from local casino monopolies plus gaming management expertise. The Melbourne casino licence is exclusive until 2033 and Burswood's casino licence runs until at least 2060. Both casinos are well-managed and generate reliable cash flows, helped by substantial reinvestment. As such, we assign a narrow economic moat to CWN.

The Australian gaming market is mature but delivers robust cash flows. Australian casinos are more reliant on the local mass market and not on international VIP business. However, CWN's Australian properties are attractive enough to be must-visit places for either VIP or local Victorian and Western Australian players. CWN continues to reinvest in both gaming and non-gaming facilities. Around AUD 1.8 bn was invested from fiscal year 2007 to fiscal year 2011 and another AUD 1.1 bn is expected over the next three years.

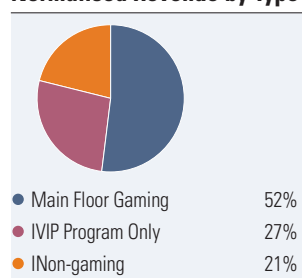
CWN's joint venture in Macau remains a growth opportunity. Investment is a relatively modest net AUD 1 bn equity investment via its 33.4% interest in

**Figure 2: CWN: FY12  
Normalised Revenue by  
Business Segment**



Source: CWN

**Figure 3: CWN: FY12  
Normalised Revenue by Type**



Source: CWN

Melco-CWN (MPEL). Macau gaming revenue grew strongly in 2011 but was weaker in 2012 as economic growth slowed in the region. The VIP market was hit the hardest but mass-market gaming revenue continues to grow through rising disposable income.

A risk is the bias toward acquisitions despite abysmal investments. Offshore investments outside Macau have been largely written down. The VIP segment is the focus for future purchases as evidenced by the purchase of Aspinall's Club in London. The price tag of GBP 36m (AUD 55m) is relatively small in the context of casino assets. Participation in the construction of a premier hotel in Barangaroo Sydney is likely to see a VIP-only gaming operation at the hotel if this goes ahead.

Regulatory requirements in gaming are extensive, acting both as a constraint and a major barrier to entry. Obtaining a casino licence and site approval is a lengthy process given the social and community impact. Growth initiatives such as expansion and renovation are subject to regulatory approval.

CWN remains a leveraged play on global confidence and consumer discretionary spend. It offers solid returns from its core local business, but has still to prove it can grow effectively elsewhere. Macau, which broke even in 2011, gives moderate medium-term upside for earnings. The key short-term driver is its Macau operation; MPEL became profitable in fiscal 2011 and we expect earnings growth to continue.

### Economic Moat

We believe CWN has a narrow economic moat. CWN currently holds a 40 year casino licence in Victoria and a licence in Western Australia extending to 2060. The Victorian licence was acquired for \$200m and expires in November 2033. While both licences are not exclusive and the respective state governments could issue further licences, we believe a second casino in each state is unlikely to have a significant economic impact on CWN's assets. Its assets are situated in the capital cities of both states and it is unlikely more casinos will be approved in those cities at close proximity. Considering the large upfront capital needed to open a new casino complex, we believe the mature gaming market in Australia is unattractive for offshore casino operators, compared to higher growth and return emerging markets such as Asia. We believe that Melco-CWN (MPEL) has a narrow moat and that business contributes 30% to our valuation of CWN. MPEL is only one of six casino operators in China. Further gaming licences are unlikely to be issued by the government. Gaming is illegal in mainland China

and restricted to the territory. In our view, this is not going to change in the near term.

### Business Risk

Morningstar has assigned CWN a high uncertainty rating. While the business holds licences to operate casinos in Perth and Melbourne, the business is capital intensive, has expansion risk, carries a sizable amount of debt, is subject to regulatory risk and its earnings are exposed to consumer discretionary spend.

Regulatory risk is heightened with independent MPs' push for gambling limits on poker machines. In our view, there remains a long road ahead for the initiative to be drafted and pass through parliament, but it does provide short-term headwind. If the legislation is passed through, capex is needed to reconfigure poker machines and we also expect gaming machine volume and revenue to fall.

### Management

CWN's acquisition track record is mixed. Apart from Macau, CWN's overseas expansion has been largely expensive and woeful. In FY09 CWN booked write-downs of around \$1.4bn, primarily from its foray into the US. Executive Chairman, James Packer, and current CEO and MD, Rowen Craigie, were largely responsible. Both sit on the investment committee, responsible for recent acquisitions and divestments. James Packer holds a 48% stake in CWN through his family company Consolidated Press Holdings (CPH), and is also co-chairman at MPEL along with Lawrence Ho. Ho is the son of one of the richest men in Asia, Stanley Ho, who previously held a monopoly over the Macau gaming market. Craigie had lengthy experience in the group. Craigie held senior positions in Crown Melbourne as COO and CEO prior to the de-merger of CWN from PBL Gaming. The board consists of 11 directors, 6 of whom are independent. On the positive, domestic operations are continuing well.

### Earnings

CWN's net profit for the year to June 2012 was solid and in line with expectations. Normalised NPAT increased 22% to \$415m. The normalised results are adjusted to remove the impact of variances from the theoretical win rate on VIP program play.

Softness in VIP revenue at Crown Melbourne in the second half was offset by stronger contribution from Burswood. VIP gaming at both venues benefited from favourable win rates. VIP win rates at Melbourne and Burswood were 1.5% and 1.84% respectively, compared to a theoretical win rate of 1.35%. As such, actual EBITDA for the group increased 25.8% to \$801.3m while normalised EBITDA grew at a slower

pace, lifting 8.6% to \$722m. Normalised margins dipped 100 bps to 28% on higher gaming taxes and costs at Melbourne. We expect costs to fall as refurbishments complete and operations at recently reopened gaming floors ramp up. Final dividend of 19cps takes total FY12 dividends to 37cps, in line with last year. Franking was slightly lower than expected at 50%.

We do not think CWN's revenues are as stable as

Tatts Group (TTS) which has a high mix of relatively stable lotteries revenues. For CWN main gaming floor revenues are the most stable of its revenue streams. Around half of CWN's normalised revenue come from main floor gaming, which includes various table and electronic games such as poker machines in the main gaming area. VIP includes table and electronic games played by high-end clients in exclusive gaming areas, contributed just above a quarter of normalised revenues. Non-gaming revenues contributed below a quarter of normalised revenues. It includes revenues generated from accommodation, food and beverage outlets and retail.

### Cashflow and Capital Expenditure

CWN's operating cashflows from its Australian are robust but are more susceptible to changes in consumer discretionary spend, in particular the VIP and non-gaming parts of the business, than Tatts. While having casino licences provides some protection as CWN has a monopoly in table gaming in Victoria and Perth, it does not make the company immune from competition from alternative forms of gambling and entertainment available to consumers.

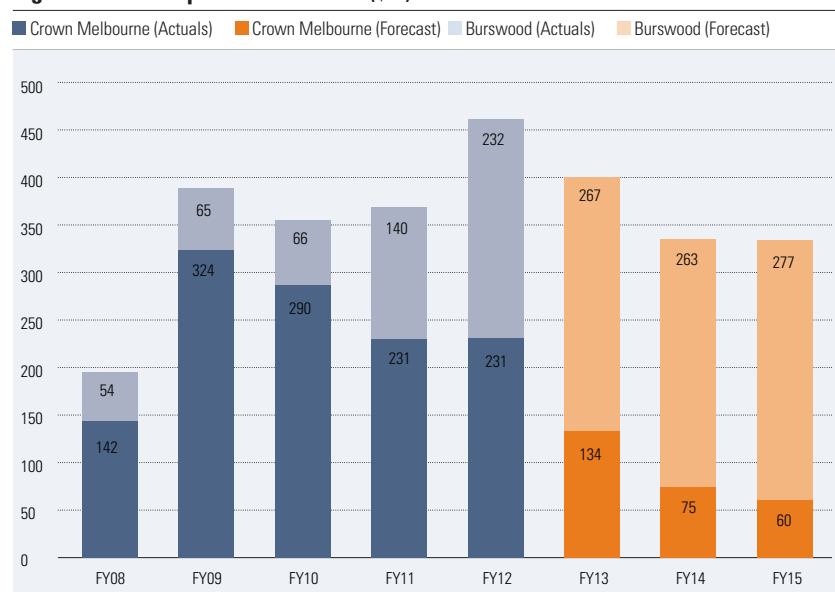
CWN has high capital expenditure demands and will continue to do so. More than \$2bn was invested between FY07 and FY12. Between FY13 and FY15 CWN expects to spend almost \$1.1bn on Burswood and Crown Melbourne. So while the operating cashflows are robust, the demands on them by the business are high.

Based upon Morningstar current forecasts we expect CWN to be able to meet its current capex demands from operating cashflow. However, these do not incorporate any additional expansion plans such as a potential development of a hotel and VIP gaming establishment in Sydney.

### Balance Sheet

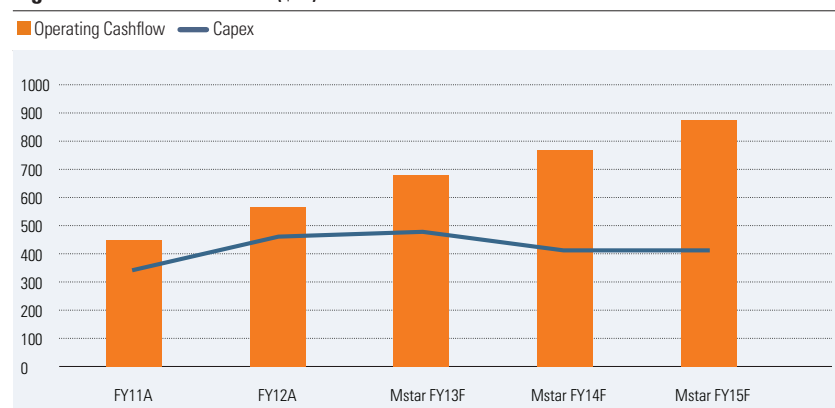
Financial leverage measures are not an immediate concern, but have worsened given funding needs for its large capital expenditure programs. As at 30 June 2012 CWN had drawn debt of \$1.65bn and \$512m in undrawn capacity. The cash balance stood at \$149m, though this included \$143m in cash allocated to working capital. The bulk of the debt is bank debt though the mix is changing following the \$300m medium term note issue in July and this subordinated note issue. The debt maturity is improving with CWN getting a \$300m five year medium term note issue away in July 2012. This subordinated note issue will be used to reduce bank debt due in FY14, further extend the debt maturity profile and increase undrawn

**Figure 4: CWN Capex commitments (\$m)**



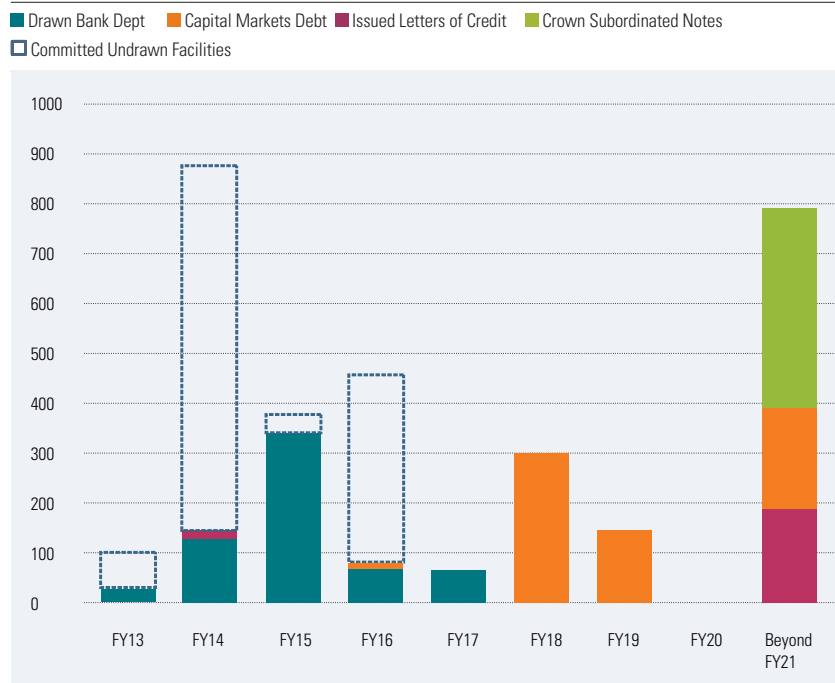
Source: CWN

**Figure 5: CWN: Cashflows (\$m)**



Source: CWN and Morningstar

**Figure 6: CWN: Pro-forma debt Maturity Profile as at 30 June 2012**



This above is post the \$300 MTN issue and Subordinated note issue (\$400m). Source: CWN

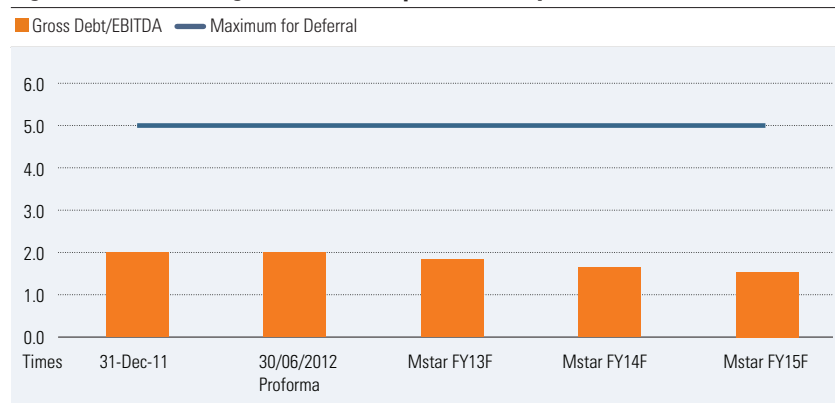
debt capacity.

The notes are subject to mandatory deferral conditions. There are leverage and interest coverage hurdles which are tested every six months.

- ▶ Leverage Ratio (Relevant Gross Debt (divided by two)/Normalised EBITDA) is above 5.0 times for to two consecutive testing dates; or
- ▶ Interest Cover Ratio (Normalised EBITDA/ Normalised Net Interest Paid) is below 2.5 times on any testing date.

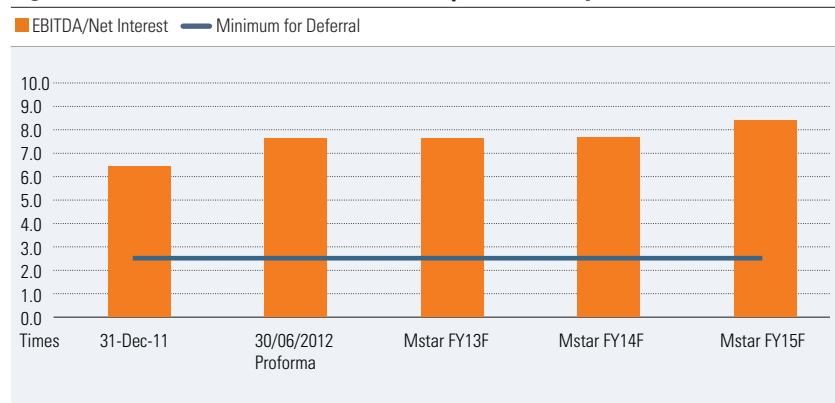
Based upon Morningstar current forecasts we expect CWN to be remain with the mandatory deferral hurdles. ■■

**Figure 7: CWN: Leverage calculated as per mandatory deferral event measure**



Source: CWN/Morningstar

**Figure 8: CWN: Interest Cover calculated as per mandatory deferral event measure**



Source: CWN/Morningstar