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1st March 2018

AA plc

Market capitalisation: £483m

Issuer	Isin	Tranche	Rating	Coupon	Min piece	Final maturity	Expected Maturity	Indicative price*	YTW	Spread
AA Bond Co Ltd	XS0996575378	A	BBB-	4.249%	£100k / £1k	31/07/2043	31/07/2020	103	2.95%	221bps
AA Bond Co Ltd	XS1529687870	A	BBB-	2.875%	£100k / £1k	31/07/2043	31/01/2022	98	3.43%	255bps
AA Bond Co Ltd	XS1645315620	A	BBB-	2.750%	£100k / £1k	31/07/2043	31/05/2023	95.5	3.68%	257bps
AA Bond Co Ltd	XS0949169923	A	BBB-	6.269%	£100k / £1k	31/07/2043	31/07/2025	110.5	4.58%	332bps
AA Bond Co Ltd	XS1211308231	B	B+	5.500%	£100k / £1k	31/07/2043	31/07/2022	91.5	7.80%	686bps

AA provides automobile insurance and breakdown cover. Its heritage dates back to 1905 when the company was founded by a group of motoring enthusiasts. Today there are more than 3m members. In 2004 the group was acquired by private equity groups CVC and Permira. The group IPO'd in 2014, subsequently selling AA Ireland in 2016.

In late September 2017 AA plc appointed Simon Breakwell as its CEO. He has led a "rigorous, bottom up review of the business" which led to a mid-February strategy update in which the group signalled a change in direction as well as a profit warning, and substantial cut in the dividend. The equity fell from 120p to around 75p, while the subordinate B tranche bonds dropped circa ten points. Following a well-received bondholder call yesterday, prices have ticked up from the early week lows.

With regard to strategy, management plans to invest in its motor insurance business to drive growth, and on breakdown / rescue there will be an increased focus on providing Telematics; the group's Car Genie product plugs into the dashboard of vehicles, collecting data on the health of the battery as well as engine diagnostics. This product is available for £29 per year for AA members; although we suspect the greater opportunity lies in B2B customers managing fleets of cars. We also think that greater roll out / implementation of telematic products can cuts costs within breakdown division as well as enabling the group to improve pricing of its motor insurance division. The product was only launched in the summer of last year, and so it's still a little too early to assess how well it is likely to be received in the coming years.

AA's performance

AA's FY 2018 prelims are likely to published at the end of March. In the first six months of the current financial year to 30th June 2017, the group revenues totalled £471m - a 1% increase on HY 2016. EBITDA also rose 1% to £193m, a margin of 41%. Breakdown cover has faced a number of challenges, including the increased Insurance Premium Tax, redress for customers with duplicate cover, as well as the introduction of renewal price transparency in April. However the membership proposition has demonstrated its resilience with new members up 12%; the net position is only marginally lower than FY 2017 with 3.325m members versus 3.335m members posted 6 months previously.

Revenue £M	H1 2017	H1 2016
Roadside Assistance	370	370
Insurance Services	66	64
Insurance Underwriting	3	1
Driving Services	32	32
Total	**471**	**467**

EBITDA £M	H1 2017	H1 2016
Roadside Assistance	174	179
Insurance Services	38	35
Insurance Underwriting	-	-1
Driving Services	9	9
Total	**221**	**222**

During the first six months of the year Insurance services division benefited from an 8% growth in the motor book to 616,000 policies. Home insurance fell 5%, but the group expects performance to improve in H2 following a number of strategic changes that were previously implemented to the motor book, which led to improved performance.

Through a tie-up with bank of Ireland the group offers deposits and loans, and at the half year had a balance sheet size of circa £250m, which is match funded by deposits. The in-house underwriter is only in its second year of operations, but has apparently made good progress versus its targets to grow motor and home policies. Driving Services revenue was flat, although instructors increased 6%.

Funding

Owing to a ten year period of ownership by Permira and CVC, AA is highly geared, although a refinancing in early July last year reduced the size of senior term facility using accumulated cash balances, as well as cutting interest costs. At the time Martin Clarke, CFO, commented that

"Since the IPO in June 2014 we will have reduced the annual cash interest cost on our borrowings by almost £90m from £206m to £118m by FY20. We have also reduced our total gross borrowings from £3.4bn at IPO to today's level of just under £2.8bn. The weighted average cost of that debt has fallen from 6.1% to 4.3% by FY20".

The latest refinancing has also meant that the next "expected" debt maturity is now three years away in 2020, which will allow time for the group to accumulate profits with a view to further deleveraging. The group's outstanding borrowings are as follows:-

	Expected maturity date	Interest rate	Principal £m	Issue costs £m	Amortised issue costs £m	**Total as at 31 July 2017 £m**	Total as at 31 July 2016 £m	Total as at 31 January 2017 £m
Senior Term Facility	31 July 2021	5.71%	250	(4)	3	**249**	453	347
Class A1 notes	31 July 2018	-	-	-	-	**-**	474	175
Class A2 notes	31 July 2025	6.27%	500	(1)	-	**499**	499	499
Class A3 notes	31 July 2020	4.25%	500	(3)	2	**499**	498	499
Class A4 notes	31 July 2019	-	-	-	-	**-**	249	55
Class A5 notes	31 January 2022	2.88%	700	(37)	4	**667**	-	664
Class A6 notes	31 July 2023	2.75%	250	(4)	-	**246**	-	-
Class B2 notes	31 July 2022	5.50%	570	(16)	8	**562**	722	560
		4.52%	**2,770**	**(65)**	**17**	**2,722**	2,895	2,799

Comment

AA's recent weakness (both equity and bonds) was triggered by a 21ST February strategy update in which the group issued a profit warning – EBITDA is now expected to be in the £335m to £345m range – analysts had forecast the figure would be around £390m in the current financial year. It has also cut the dividend to 2p year, reducing dividend costs from circa £57m to £12m.

Most of the dividend saving is to be ploughed back into the business; IT transformation costs are expected to be £35m spread across two years, with a further £55m of maintenance capex spread over three years, and £19m in "growth capex" to boost roadside capabilities and its data offering to customers. As a consequence, free cash flow is expected to be £20m this year, rising to £80m and then £100m in the following two years.

While from an equity perspective the group's profit warning is undoubtedly disappointing, from a creditor's point of view the cut in the dividend provides some comfort – and if the strategy is correct can lead to growth in the business. AA has said that from next year it is expecting compound annual growth rates (revenue) of 3-5% for the group, and 5-8% for EBITDA. It's tempting to say they should apply all the excess cash in the business to debt reduction, but in reality the group needs a plausible growth story rather than just a wind-down policy to keep investors on side.

At the time of the bond holder call yesterday, Simon Breakwell *(a fantastic name for a roadside recovery CEO!)* said that group has £80m of unrestricted cash at plc level. All the bonds are issued by AAbond Co which is a whole business securitisation (with all the A notes and the term facility benefiting from a prior claim to the B notes).

There is no maintenance leverage covenant in the deals (i.e. that would trigger an event of default), however, for as long as the seniors' net leverage ratio exceeds 5.5x EBITDA, the group is prevented from paying dividends.

The group is however required to maintain a debt service coverage ratio (DCSR). If the A notes breach a 1.35x cover ratio, it constitutes a trigger event which would prevent any coupon on the B notes. If 1.1x cover is breached, it would constitute an event of default of the A notes, which would mean the repayment of all amounts outstanding could be accelerated at the behest of the creditors. The B notes must only maintain a 1x cover ratio, but in the event of a default on payment of principal or interest, it appears B creditors may be able to force a sale of the securitisation away from AA plc. So ordinary shareholders may be keen to remain compliant…

At the last bond holder report at 31st July 2017, the group published free cash flow of £325m, and a Tranche A debt service charge of £104m. In other words, free cash flow would have to more than half before the group would be unable to meet its 1.35x DSCR, which would prevent coupons on the B notes.

Conclusion

The cut in the dividend is largely funding the investment that the group believes it needs to apply to its business operations, meaning that anticipated free cash flows over the next two to three years can be applied to further deleveraging. Although there is no current intention to do so, other options include a rights issue (likely unpalatable with the stock at 75p), or a sale of the insurance arm. Although management's view is that there are significant cross-selling opportunities, with only 10% of its membership base purchasing the group's insurance products.

It is also worth noting that even if the group's credit profile did materially weaken, all the class A and B notes have final maturities in 2043, with the earlier dates only amounting to "expected" redemption points. This may seem less appealing to creditors, as there is some extension risk. But it puts the business on a sounder footing as it works through its strategy plans in the years ahead.

We think the B notes offer the most compelling entry point into the capital structure. Although a trigger of the DSCR could trigger a pause in coupons, there is currently plenty of headroom. And after a significant price fall from 102 to 88 (the notes are currently around 91.5 offered) we think there is scope for further price recovery when the dust settles around the new strategy. The full year prelims, expected towards the end of March, may also help to settle investor nerves. A safer play would be the 6.269% A notes, which benefit from a coupon step-up in 2025 if the deal is not redeemed, as well as the additional collateral cover of the B notes.

Please call the desk if you have any enquiries.

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