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Coal market consolidation unlikely to fix supply glut; prices expected to remain depressed – Conference Coverage

Proprietary

Story:

The US coal market is unlikely to see transformational mergers in the near term that would shake up the industry, help operators cut costs and alleviate some of the supply glut that weighs on the market, said participants at a coal conference organized by the Turnaround Management Association yesterday in New York.

While some players might look to pick up assets opportunistically during 363 sales, the low price of metallurgical coal and the highly leveraged balance sheets of coal miners are expected to deter mergers in the space, said Fred Vescio, director at Houlihan Lokey, speaking at yesterday's event held at the offices of law firm Davis Polk.

Also dampening consolidation in the space is the lack of operational overlay that would help companies take capacity out of the market, noted Vescio. For example, **Alpha Natural Resources** has reserves concentrated in the Powder River Basin while peer **Arch Coal** is mining more coal in the Central Appalachia (CAPP) region.

The industry might see more one-off purchases of specific mining complexes and reserves that fit into the buyer's portfolio, Vescio continued. Recent examples include the sale of three **James River Coal** mining complexes to **Blackhawk Mining** during bankruptcy this summer, and **JW Resources** acquisition of the Straight Creek and Red Bird thermal coal mining operations from **Xinergy** for USD 47.2m in 2013.

Structural changes are pressuring the thermal and metallurgical coal markets, including increased Chinese coal supply, regulatory issues and the "coal to gas switch" power switch in the US – and are also impacting valuations, noted Vescio.

Historically, investors used a 6x-8x EBITDA multiple to value coal producers. But in the current environment it's hard to identify the "representative mid-cycle EBITDA" to apply, noted Mark Buschmann, senior managing director at Blackstone.

Panelists agreed that a USD 160-USD 180 per tonne met coal price would most likely represent a sustainable level over the long term that would incentivize miners to deploy capital. However, that range is "a quantum leap from where we are today," continued Buschmann. Met coal recently traded at USD 114/tonne on the spot market.

While it's hard to predict where prices will be in the next year, all the panelists expressed pessimism about the prospects of a recovery even over the next several years. And if expectations are that the recovery won't take place until 2017 or 2018, that could also act as a deterrent for some investors to dip their toes in the coal market, added Kenneth A. Hiltz, managing director at AlixPartners.

"It's a highly volatile space and it's hard to predict," said Hiltz. When Patriot Coal restructured in 2013, many investors were focused on the low price of thermal coal, and viewed the met coal market as a savior to bail out coal companies, he added. However, in the meantime the macro picture shifted dramatically as the met coal market also took a hit and benchmark prices fell to roughly USD 120 from USD 300 in 2011, amid lower Chinese imports, a weaker Australian dollar and slow response from producers to cut output.

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Issuer	Alpha Natural Resources, Inc.
Issuer	Walter Energy, Inc.

Arch Coal Inc is in Distressed Debt

Alpha Natural Resources, Inc. is in Distressed Debt

Walter Energy, Inc. is in Distressed Debt

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"Companies don't have a real motivation to restructure until you see prices hitting a bottom," continued Hiltz. Some companies might defer closing mines in order to avoid high fixed costs of asset retirement obligations (ARO), a claim that cannot be rejected in Chapter 11, he noted.

The slew of liabilities associated with operating mines could also make it harder for some coal companies to obtain a debtor-in-possession loan during bankruptcy, said Jeff Robinson, managing director at Sankaty Advisors.

"What assets do I get to underwrite? **Walter Energy** has two operating mines it's not like you have a portfolio [of assets to choose from]," he continued, noting that in this case the operational advantages are limited.

"We are in a cycle of a longer downturn [...] and some of the companies are in complete denial and don't believe there is an overcapacity," said Spiro Youakim, managing director at Lazard. "The people in this room are the motivators of a change," concluded Youakim, looking at the crowd of investors including hedge fund managers and bankers that filled the room.

by Madalina Iacob and Andrew Ragsly

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