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Black as coal

Uncast in the big-screen epic of the plunge in oil and gas prices are the unassuming miners of Hallador Energy Co. (HNRG on the Nasdaq). A micro-cap Indiana coal producer, Hallador is profitable, unloved, obscure, cheap and—not the least of what commends it in this fraught moment in credit—on good terms with its lenders.

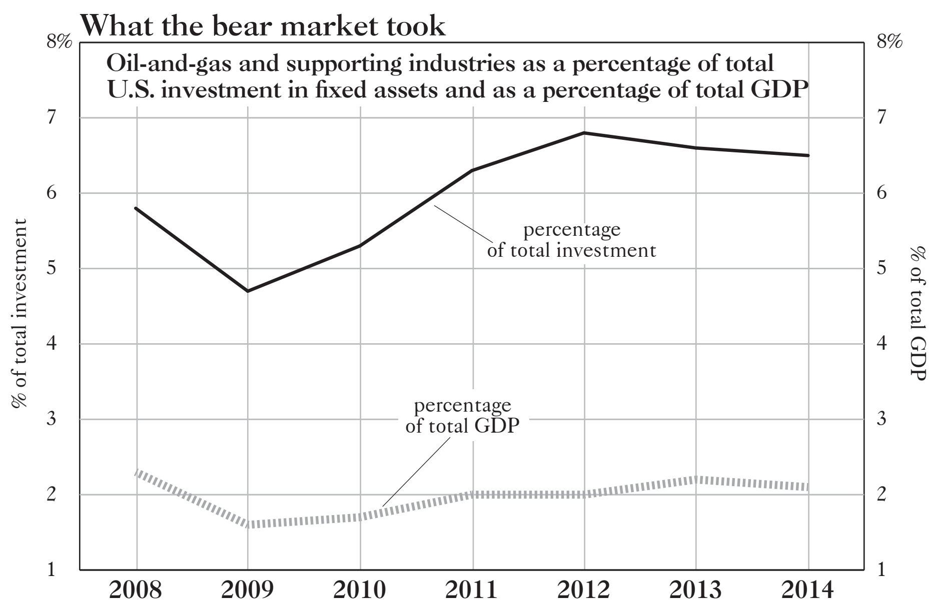
Now under way is a survey of the smoking ruins of what is still politely known as the energy business. The story comes in two parts: credit writ large and coal writ small. Shaky bulls will be tempted to pass over the first part in favor of the upbeat analysis in the second. They should resist the urge. Nothing is better calculated to restore the profitability of a fallen industry than to cut off its access to capital and credit. Even now, Mr. Market is setting up for the next bull market in fossil fuels.

At the spring 2015 *Grant's* Conference, James H.M. Sprayregen, bankruptcy specialist in the Chicago law firm of Kirkland & Ellis, presciently speculated on the coming troubles in oil and gas. For the moment, they resembled a "slowly moving blob," he said. Speculative-grade exploration and development companies were, indeed, deep in debt; out of a grand total of $1.4 trillion in outstanding speculative-grade corporate bonds, E&P companies had issued $210 billion's worth. Then, again, immediate maturities were small, and many an energy producer had hedged its 2015 output. Optimists by nature, the oil and gas men told themselves that, with a little luck and patience, they could outwait the bear market. Everyone knew that the then-prevailing levels of $53.98 a barrel and $2.68 an mcf were unsustainable. Besides, what did China have to do with anything?

Now that hedges are falling off and debt maturities are looming nearer (and the relevance of the People's Republic to the worldwide energy balance is becoming clearer), the blob has grown and picked up speed. It helps to recall, Sprayregen reminds colleague Evan Lorenz, that shale production requires continuous infusions of capital. Absent new investment, which is to say new borrowing, rates of production can decline precipitously.

An encumbered E&P company confronts a knotty business problem. Should it invest, only to lose $10 or $20 or $30 per barrel (and the equivalent per mcf of natural gas)? Or should it stop investing, at the immediate risk of incurring a markdown in asset values over and above the loss that the bear market continues to inflict?

In keeping with the symmetry of finance, to impair the value of an asset is to nick the value of its corresponding liability. As energy prices fall, losses creep up the capital structure. Bankruptcy means the destruction of equity value, of course. What has taken some getting used to in this washout is that bondholders, too, have been put at risk. As to the term loans or revolving lines of credit—senior-most claims that banks extend—they remain a safe haven so far, though even the bankers are starting to sweat. (See the Nov. 27 issue of *Grant's* for an analysis of banks with outsize energy exposures.)



source: Bureau of Economic Analysis

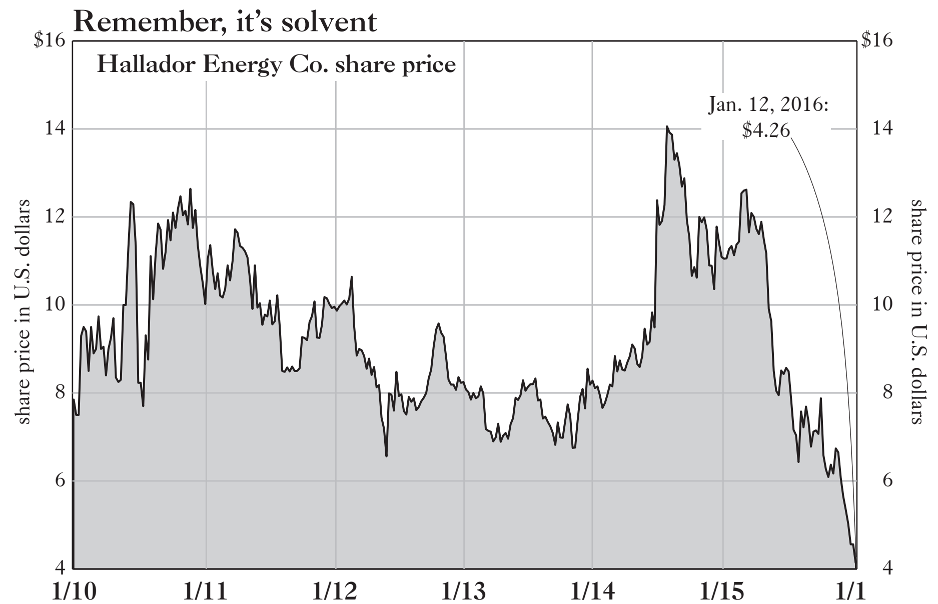
Says Sprayregen: "We've started a number of negotiations where we thought the value ended in the unsecured bonds and during the negotiation, the value kind of ended in the second liens, which are right above the unsecured bonds and below the revolver. In some of them, before the negotiation is over, the value ends in the revolver."

"I'll give you a poster child," Sprayregen goes on. "We just filed a bankruptcy case for a company called Magnum Hunter Resources. In that case, the entire amount of the debt is being converted into equity, and there is also a debtor-in-possession loan that as part of the deal is being converted into equity. That's what I call a problem above the EBITDA line, so you can't even finance your bankruptcy without turning that into equity. That's not everybody, but that is very much a sign of the times."

In the palmy days of ZIRP and QE, credit to the E&P industry was, if not exactly free, then at least freely available. For all intents and purposes nowadays, no debt financing is available to E&P borrowers on any terms; the capital markets are shut to them. For the stricken companies, hardly anything could be more immediately bearish. For the price of oil and gas, hardly anything could be more ultimately bullish.

Every spring and fall comes a reappraisal—"redetermination" is the term of art—of the value of the oil and gas collateral that secures the loans that finance the production of American energy. Bank lending officers guess the course of future energy prices. They apply those guesses to the value of petroleum reserves—proved, developed and producing—of their E&P borrowers. The lower the collateral values, the lower the estimated future cash flows that those reserves may generate, and the lower the size of the credit facilities that the bankers may be prepared to extend.

We read in the *Oil & Gas Journal* that the fall 2015 redetermination season was not so rugged; instead of the expected 15% contraction in borrowing authority, the banks imposed a shrinkage of just 2%. "Recent fall redeterminations . . . have been surprisingly gentle, leading to stable producer liquidity," an analyst at Jefferies & Co. was quoted as saying. Bearing in mind both the violence of the subsequent price decline, and of the mindset of



the post-Dodd-Frank bank regulatory apparatus, we are prepared to believe that the spring reckonings will be tougher.

With respect to the nearby oil price, one can imagine a number of different scenarios:

– a higher price, brought about by war or cyber war in the Middle East, including (let us just speculate) an electromagnetic-pulse attack that disables the Saudi oil fields;

– a lower price, caused by a drop in oil demand, provoked by an unscripted American recession;

– a dull, stationary price, the coming to fruition of the "lower for longer" scenario.

In 2014, oil and gas production contributed 2.1% of U.S. economic production but 6.5% of U.S. fixed-asset investment. Just how severe is the pullback in energy-related investment is yet undocumented, though one may guess. Thus, in November, measured year-over-year, the price of hot-rolled steel fell by 43%, even as the imports that compete with domestic production dropped by 36%. The Federal Reserve Bank of Dallas reported a decline in its manufacturing outlook index for December to negative 20.1 from minus 4.9 in November. Quoth a survey respondent: "The price of oil is really impacting our customer base and, in turn, purchases of our product. It is getting ugly."

"Ugly" does no justice to the state of the coal-mining business. Alpha Natural Resources, Patriot Coal, Walter Energy, Inc. and Arch Coal, Inc. are already in bankruptcy. Peabody Energy Corp., which contributes almost a quarter of the nation's coal output, would seem to be edging toward the courthouse doors; its 10% second lien bonds, issued in March at 97.57, change hands today at 18. "It is a perfect tsunami that is hitting the industry at a time when it has extremely high leverage," Brent K. Bilsland, CEO of the aforementioned Hallador Energy, advises Lorenz. "It had high leverage and it became extremely high leverage."

Up until the collapse in oil and gas prices, you wouldn't mention Hallador in the same breath as the mighty Peabody. In terms of millions of tons of coal produced per annum—8.3 vs. 227—there is simply no comparison. It is a measure of Bilsland's tsunami that Hallador's stock-market capitalization, $123.8 million, tops Peabody's, $83 million. Debt explains the paradox; net of cash, Peabody owes $6 billion.

Hallador, one of the *Grant's* value stocks which seems to become ever more value-laden (see, for instance, the issue of *Grant's* dated June 12, 2015), owns three coal mines in Indiana. Two of these properties, Oaktown 1 and Oaktown 2, were acquired from Vectren Corp. in 2014; a $350 million bank loan financed the transaction. Bilsland tells Lorenz that $100 million of those borrowings have been repaid since the acquisition date. Pre-Vectren, Hallador had no net debt, and Bilsland sounds as if the company were pointing to a return to that happy condition. "Our board hates debt," he says. "Hates it."

The coal that Hallador mines is the high-sulfur kind from the Illinois Basin. Bilsland insists it's the very best kind. "The U.S. coal supply in general will shrink," he says, "but the Illinois Basin will grow. The economics are better. The reason they are better is when the Clean Air Act came in, everyone moved away from high-sulfur coal. For 30 years, assets that were economic in the Illinois Basin were not mined. Now that all [utility] plants are basically scrubbed to reduce emissions, it has kind of flipped it. You have these reserves—we are mining seven-foot coal competing with Central Appalachia that is mining 3½-foot coal. What do you think is going to be lower cost?"

"Despite the debacle in energy prices and the displacement of coal by natural gas," Lorenz relates, "Hallador remains profitable and expects to continue to be profitable in 2016 (though at a substantially lower level than in 2015). Owing to the increased volumes from the Oaktown mines, Hallador's sales and EPS jumped by 126% and 277%, measured year-over-year, in the 12 months till Sept. 30. In the third quarter, the company sold 1.8 million tons of coal at an average price of $45.41 per ton and a $31.82-per-ton cost of extraction. Compare this to the third quarter of 2014, when sales weighed in at 1.5 million tons at an average price of $43.18 per ton and a $35.06-per-ton cost of extraction."

Nothing so dazzling appears to be on tap this year; high coal inventories and low natural-gas prices dim the outlook. If all goes according to plan, Hallador will sell 6.5 million tons vs. 8.3 million tons in the 12 months ended Sept. 30—5.5 million have already been contracted at an average price of $43.55. Extraction costs may dip a little as management shifts operations to the Oaktown twins. Based on expected volumes and costs, Bilsland projects that the company will generate $40 million of free cash flow in 2016; he says that the money is earmarked for debt reduction. The anticipated 6.5 million tons, Bilsland reminds Lorenz, are "only 55% of our company's capacity. If we can generate that kind of cash flow running at 55% of capacity, we think that as this market recovers from the tsunami that hit in 2015 we are a pretty good value play."

"As the market recovers" is an expression of optimism that well suits the leader of a company who derives more than half of his compensation in vested shares (he owns 3.6% of the shares outstanding). For the rest of us, we must acknowledge the risk that the market does not recover—that the dollar and the temperatures stay elevated and that the price of gas remains depressed.

The Vectren acquisition has bought Hallador operating flexibility at the cost of some balance-sheet anxiety. By the lights of an over-encumbered industry, the company's debt metrics are hardly onerous; in the third quarter, borrowings, net of cash, weighed in at 2.4 times trailing EBITDA, while operating income covered interest expense by a factor of 2.9:1. "One bank in our [loan] syndicate," Bilsland tells Lorenz, "told us that they are involved in 15 coal loans. Of the 15 coal loans they are involved in, ours and one other were the only ones that have not asked for a waiver. I think that their [the banks'] coal positions aren't great and they've taken a lot of heat over that. We've performed and done everything we said we would do." Pretty clearly, it behooves Hallador to continue to perform; neither the bankers nor the regulators who hang at their elbows are likely to meet a downside surprise with much empathy.

Lucas Pipes, analyst at FBR Capital Markets & Co., calls Hallador "one of the best options" on the price of natural gas; at $3.50 or $4.00 an mcf, he says, the company and its shareholders would be golden. "And if you say that the sustainable gas price is maybe not $3.50 or $4.00, but if it is in the low-$3 range," Pipes proceeds, "then a low-cost Illinois Basin producer such as Hallador should be able to make a healthy living."

"The cure for low prices is—ultimately—low prices," Lorenz notes. "As hedges roll off and capital markets dry up, E&P companies will begin to curtail gas and oil production. As the coal industry continues to struggle with over-supply, high-cost mines will be shuttered. Bilsland contends that, when (not if) the switch again takes place, coal prices will lurch higher. In 2008–09, an unexpected, 20-million-ton boost in exports caused prices to double, to $60 a ton from $30, in just six months. Next time, the lurch could be more dramatic on account of the demoralized state of the industry. Spending on mining machinery is at rock bottom. 'In the coal mines,' Bilsland tells me, 'they have gone two, three, four, five years with only doing bare bones—minimal maintenance—on this equipment.'"

Hallador changes hands at 4.4 times trailing net income, at 7 times the consensus earnings estimate for 2016; at the current sub-$5-per-share price, the indicated dividend yield is 3.8%. Our level of conviction in this matter? We are undogmatically bullish. In contrast, we observe that many are dogmatically bearish—no fewer than 1.6 million shares of this thinly traded stock are sold short.

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