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Pessimism to burn

When Norway's sovereign wealth fund, on orders from the Norwegian parliament, prepared to divest its coal holdings last week, it joined members of the Rockefeller family, the French insurer AXA and the Church of England in pledging to sell the shares of the companies that mine the world's least beloved fossil fuel.

Now unfolding is a bullish update on Hallador Energy Co. (HNRG on the Nasdaq), a cash flow-positive miner of that very sedimentary rock. Does the name sound familiar? It has featured in the issues of *Grant's* dated Nov. 29, 2013, and Jan. 9, 2015. Since our January installment, the price has fallen by 28%, to $7.93 a share.

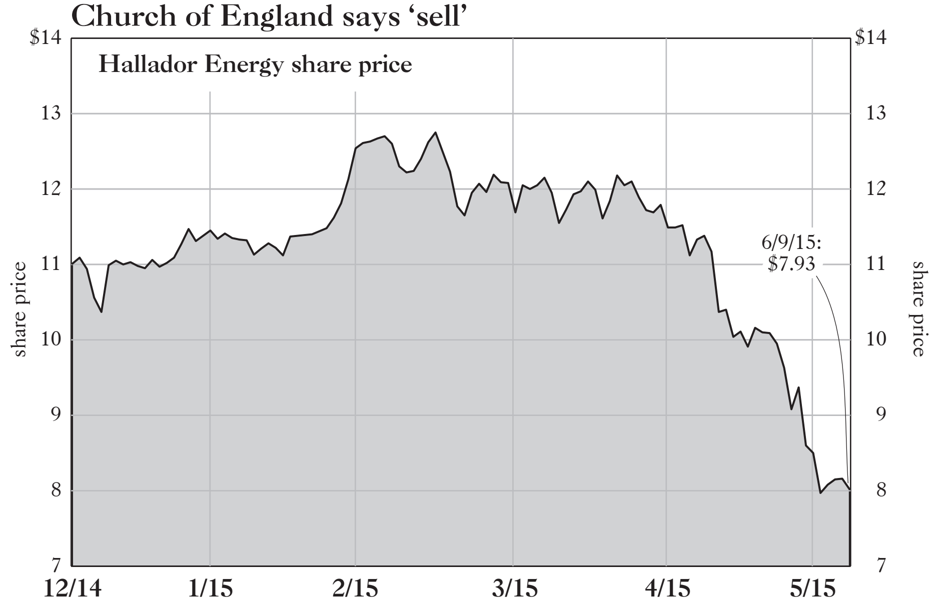
What's right with Hallador and what's wrong with coal are the companion points of focus here. From the producer's point of view, everything is wrong with coal. It is oversupplied. It competes with ultra-cheap natural gas. It wears an environmental "Kick Me" sign. As for the would-be divesters of coal stocks, they had better hurry up while there's still some quoted equity value left to divest. The unsecured public debt of Arch Coal Inc. and Alpha Natural Resources Inc. are quoted at prices to yield 73.1% and 88.9, respectfully. As for the aristocrat of the industry, Peabody Energy Corp., its senior unsecured debt, the 6 1/2s of 2020, fetches a mere 25.2%. Word has it that some big banks are refusing to lend against coal-mining collateral.

Hallador mines high-sulfur coal in and around Carlisle, Ind. It sells 85% of this output to Indiana utilities, which neutralize the sulfuric emissions with EPA-mandated scrubbers. Before its 2014 acquisition of Vectren Fuels, Halador was a one-mine company with the capacity to produce 3.8 million tons of coal a year. Now it's a three-mine company with the capacity to produce 10.2 million tons of coal a year. Hallador's coal assets lie within the low-cost Illinois Basin. It also owns some oil- and gas-producing properties in the Trenton-Black River Play in southern Michigan.

Hallador borrowed $350 million to effect the Vectren acquisition. Mindful of how leverage has sunk the major coal producers, management has hastened to pay down debt. Outstandings were reduced to $292 million by the end of March and will dwindle to $250 million by the end of December, the company projects. "Think about that," CEO Brent K. Bilsland invites colleague Evan Lorenz. "On a stock with 29 million shares, we will have paid down $3 per share in debt, but instead of our stock increasing by $3, it's gone down by almost that amount."

You can hardly blame operating results. Thus, in the first quarter, Hallador posted year-over-year gains of 174% in revenue, 108% in earnings per share, and 177% in selling volumes. On 2.1 million tons of coal production, the company realized an average price of $45.23 per ton, up 6% from the year earlier. Costs per ton of output came in at $30.83, up by 4% from the year earlier. A bump up in costs at the legacy Carlisle mine is responsible for the increase in average costs. Bilsland, observing that mines present messier

Church of England says 'sell'



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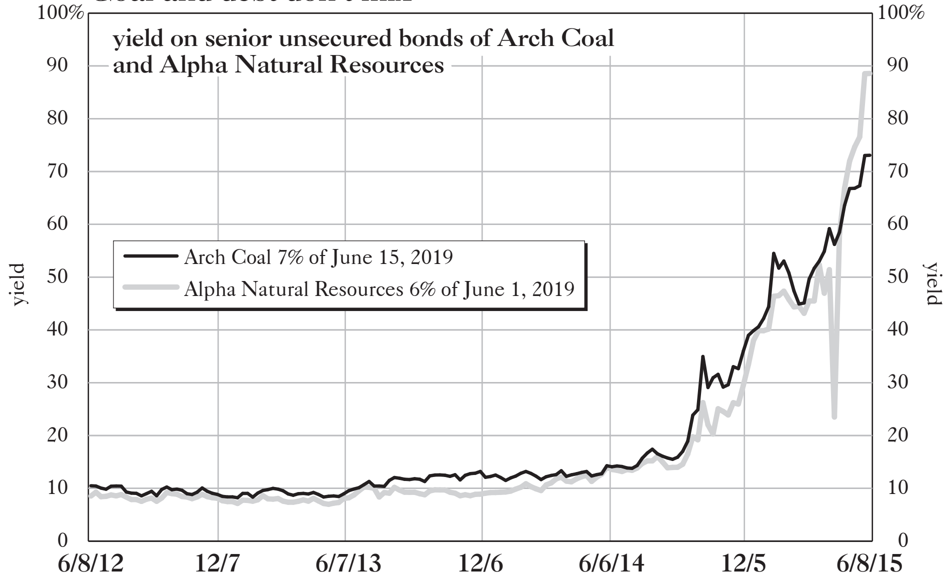
Coal and debt don't mix



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management problems than do factory floors, indicates that costs at Carlisle will probably return to $30 or so by the end of the year.

"While the coal industry's problems weigh heavily on Hallador's share price," Lorenz points out, "there is a positioning issue as well. Private-equity shop Yorktown Partners LLC owns 29% of Hallador's stock. Periodically, Yorktown distributes shares of Hallador to its limited partners, some of whom seem to follow the lead of the Church of England and drop them as if they were sinful. On May 26, Yorktown distributed 700,090 shares, leaving it with 8.55 million, or 29% of the shares outstanding. On an average day, 67,030 HNRG shares change hands; on the six days following the distribution, a daily average of 191,251 shares did. Hallador traded at $9.63 on May 22, the last trading day before the distribution. It closed at $8.08 on June 2."

Bilsland reminds Lorenz that the cure for low prices is, in fact, low prices. Prevailing low gas prices—ergo, low coal prices—will force compensatory action: layoffs, shutdowns, consolidations in the coal industry. "The other thing we think is interesting," Bilsland adds, "is once this higher cost production gets idled, you don't bring it back on until pricing is much higher. You will run something at a slight loss for a period of time, but you don't bring it back at a slight loss. You bring it online when you get to a comfortable margin."

Hallador is repurchasing no stock. The float is small enough as it is, Bilsland says. Lorenz asked if the CEO was buying some more for himself. "Seventy percent of my net worth is already tied up in our stock," Bilsland replied. "Two-thirds of my compensation is stock. It makes it harder for me to get excited about buying more stock. My interests are very aligned with the shareholder. Our board is 60% of the stock. We are very much attuned to creating value. We don't get overly focused on whether the price is up or the price is down, because we are long-term holders, and we are out to build a business. We know that eventually the market will value what we have."

Hallador is expected to earn $1.35 per share and $125 million in EBITDA (earnings before interest, taxes, depreciation and amortization) this year, valuing the company at 5.9 times estimated net income and 4.1 times enterprise value to EBITDA. As for 2016, whatever such distant projections might be worth, analysts have penciled in $0.99 a share in net income and $108 million in EBITDA. At today's share price, the business would be valued at eight times projected 2016 earnings and 4.7 times projected 2016 EV to EBITDA.

Bilsland continued: "I look around at other industries and I see these multiples that stocks trade at. I ask myself the question: 'Is my EBITDA different than theirs? Is my EBITDA any less valuable than theirs?' That is the part I struggle with. Coal has been out of favor before. Coal will come back into favor. It will probably be exports that get everyone excited again. We have a perfect storm going on right now: We have cheap gas, a strong dollar, which has killed exports so that all the coal that was going to exports is coming back to the domestic market. It is a game of musical chairs. We are fighting for the same seats. In the end, contracts will find their way to the low-cost production. We feel that we have a large share of low cost production."

Bilsland concluded his interview with a reflection on the public markets. "When you are private," he said, "everyone asks you how business is going. Sunrise was private. We merged into Hallador Petroleum, now Hallador Energy, of which I became the CEO. When that happened, the day we went public, everyone asked what your stock price is. It is the same business. To me, what it proves is that there are more traders out there than true investors."

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