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For the contrary

The utility component of the S&P 500 is up by 12.3% in the year to date (the third-best performing index segment). Over the same span, the energy component of the S&P is down by 15.6% (the worst-performing index segment). Maybe it's time for a reversal of fortune.

In expectation of—at least—a reversal in energy, we direct your attention to a pair of coal stocks. The first, Hallador Energy Co. (HNRG on the Nasdaq), is a familiar name to constant readers. The second, Contura Energy, Inc. (CNTE, over the counter), now makes its *Grant's* debut. Each is cheap and marginalized. We're bullish on both.

Hallador, you'll recall (see, for example, the issue dated Jan. 15, 2016), is an Indiana company. Its coal and its customers are almost entirely situated within the Hoosier state. In the past 12 months, the company produced and sold 6.3 million tons of coal. With stronger demand and better prices, it could have produced and sold 10.9 million tons. The stockholders are paying $6 million a year to keep one of the three Hallador assets, the Carlisle mine, in a state of "hot idle." One may compare that non-revenue-producing outlay with the $31.9 million in operating income that Hallador generated in the 12 months through June 30.

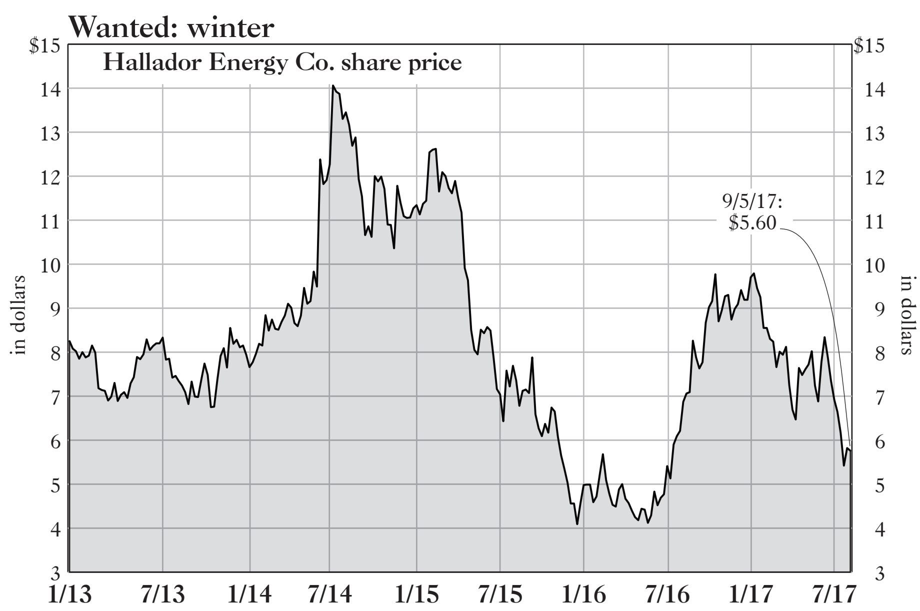
If you just awaked from a multidecade coma into which you had fallen at the time of passage of the Clean Air Act of 1963, you'd be surprised to learn that Hallador is even in business (there would be other surprises, too). The legislation made it illegal to burn the high-sulfur, cheap-to-extract coal that Hallador mines. The advent of technology, to allow for the "scrubbing" of sulfurous fumes in the chimneys of coal-burning utility plants, gave this kind of fuel a new lease on life. A surge in production in mines like Hallador's came at the expense of a drop in production at higher-cost mines like Contura's.

Contura came into the world through the 2015 bankruptcy of Alpha Natural Resources Holdings, Inc., a one-time East Coast coal-mining titan. (None of these companies has "coal" in its name, though you can guess at the truth by their rock-bottom valuations.) Cheap gas prices, coupled with the growth in low-cost, high-sulfur coal production, pushed Alpha to the wall.

Contura is a creation of Alpha's first-lien noteholders. They incorporated it with the intention of buying certain Alpha assets out of bankruptcy. Would the court approve of their plan? On July 7, 2016, the court gave the noteholders the green light.

A March report by Clarksons Platou Securities analysts Jeremy Sussman and Lee McMillan furnishes a good overview of the Contura situation. They write:

In our view, by and large Contura ended up with the better of the assets. Specifically, Contura got around 4 million tons per annum of high-quality, cost-competitive met coal production from the Nicholas, McClure, and Toms Creek mine complexes in West Virginia/Virginia, around 8 million tons per annum of high-quality, low-cost Northern Appalachian production from the Cumberland mine, around 30 million tons per annum of lower-quality, but low-cost Powder River Basin production from the Eagle Butte and Belle Ayr mines and the company's 65% interest in the Dominion



Terminal Associates coal-export terminal in Newport News, Virginia.

Contura entered into an agreement with Alpha, whereby Contura would market Alpha's export tonnage, and receive a margin on that coal, generally in line with industry standards. With that said, Contura was required to provide specified credit support to the reorganized Alpha in the aggregate amount of $35 million per year, and make contributions of up to $100 million over the next 10 years into certain restricted cash accounts to help fund ongoing reclamation support for a reorganized Alpha.

While American coal production goes steadily down, coal stocks are all over the place. According to the U.S. Energy Information Administration, coal consumption in the 50 states has traced a decline to 748 million tons in the 12 months ended May 2017, from 1,128 million tons in calendar 2007. Hallador's common stock has been though several bull and bear markets in just the past few years. The share price soared to $10.02 on Nov. 9, 2016, from $4.09 on Jan. 15, on which date *Grant's* had identified it as a pick to click. The price today is $5.60.

Wasn't Donald Trump supposed to fix this problem? "Well," observes colleague Evan Lorenz, "he didn't fix the weather. It was unpleasantly warm (from a coal miner's perspective) in January and February. After years of inexpensive and ample gas supplies and several disappointing winters, utilities hang back from signing new supply contracts. As of June 30, Hallador had contracted only 2.9 million tons of coal for 2018, down from the 4.6 million it had contracted 12 months earlier to sell in 2017. The decline in signed tons has been a key reason for the stock's sell-off this year."

The question, observes Lucas Pipes, analyst at FBR Capital Markets (he is bullish on both Hallador and Contura), is whether these deeply ingrained buying habits will continue to serve the utilities' best interests. He observes that everyone is betting on low gas prices, even as American exports of natural gas are poised to accelerate.

Perhaps CONSOL Energy, Inc., a Canonsburg (Pa.) producer of coal and natural gas, can help us peer into the future. CONSOL, Lorenz notes, "has a history of timing investments poorly with respect to the energy markets"—a promising description of a potential contrary indicator. "On March 15, 2010," he continues, "when natural gas commanded $4.40 per mmBtu, CONSOL announced the purchase of Dominion Energy, Inc.'s Marcellus shale assets. Gas trades at $2.97 per mmBtu today, after having dropped to as low as $1.64 on March 3, 2016. On Feb. 29, 2016, CONSOL announced it would sell its big Buchanan Mine, a metallurgical coal mine in Virginia. At the time, benchmark coking coal from Australia sold for $77.40 per metric ton. Today, benchmark coking coal goes for $210. And on July 11 came CONSOL's announcement that it will spin off its thermal coal operation as a separately traded company."

The coal market can turn on a dime. A surprise spike in export volumes in 2008–09 led to a doubling of prices, to $60 per ton from $30. The weak dollar exchange rate may prove the catalyst for another such burst of overseas buying. In the first half of 2017, the United States exported 44.1 million tons, 55% more than it did a year earlier.

There was a hint—a tease—of such a scenario at the start of 2017. "It was cold in December," Hallador CEO Brent K. Bilsland fondly recollects. "Gas prices were high. We had utilities sitting in our office asking us, 'When can you get your Carlisle open and back up?' They were nervous. They saw this thing starting to turn and realized that the market doesn't have the depth that it once did. So when it turns, it is going to be more severe. It is going to be a higher [price] jump, quicker."

"Guess what happened?" Bilsland continues. "January and February turned out to be 75 degrees [Fahrenheit] in Indiana. That relieved the pressure. They backed off. They kept their buying interest short. What we see in terms of the environment that we're in, is that coal inventories at the customer level are normal. They were high, and now they are normal. Gas inventories at the storage level were high, now they are normal. The export market, I believe, is in the money. Part of the weakening U.S. dollar. Part of that is just tightness in Asia."

The coal market is given to sudden changes in direction, as noted. It's not so clear that the consolidating Hoosier coal business is nimble enough to respond. Since 2014, the number of Indiana coal producers has fallen to four from seven. And there may soon be fewer, speculates Mathew Klody, founder and managing partner of MCN Capital Management. In 2010 and 2011, high-cost producers responsible for as much as 25% of the output in Indiana signed five- and six-year contracts at then-favorable prices. Now that the contracts are up for re-bidding, says Klody, these producers will struggle to make a go of it at today's unfavorable prices. Some may choose not to try.

If coal exports continue to rise and mines to shutter, utilities may one day have to scramble for coal. One might even envision a spike in coal prices, à la 2008–09. Hallador wouldn't mind: That $6 million per year expense to idle the Carlisle mine would disappear, and the now-dormant property would revert to profitable operation.

"Hallador is active in a single state, and three-quarters of the coal it mines remains in Indiana," Lorenz points out. "Contura is active in multiple basins, and three-quarters of the metallurgical coal it mines in West Virginia and Virginia is exported. Yet, both companies are united in one feature: valuation. Hallador trades at 5.4 times enterprise value (market cap plus net debt) to earnings before interest, taxes, depreciation and amortization (EBITDA) and sports a 15% free-cash-flow yield. Contura trades at 2.8 times EBITDA and a 41% free-cash-flow yield (EBITDA and free-cash-flow annualized from the first half of this year's results)."

Hallador is a straightforward play on thermal coal, which is burnt to generate electricity. Contura is a 49% play on metallurgical coal, which is burnt, alongside iron ore, to produce steel. As mentioned, the price of benchmark met coal in Australia has zoomed, to $210 from the mid-$70s in early 2016. The source of the rally is strong demand for steel and mine closures in China as well as a spring 2017 cyclone in Australia that closed some of that country's mines.

"A lot of people will value these assets on marginal costs of extraction," Ian McCulley, a managing director at Dialectic Capital Management and *Grant's* alumnus, tells Lorenz. "They [assume a price of] $125 on met coal. On those kinds of numbers Contura is probably between five and six times EBITDA but still generating pretty healthy free cash flow. The other interesting thing to think about is [that] the 10-year met coal price is $175. So, maybe it is not so outlandish to use a number like $150–160 for next year, which is where the futures market says it will be."

In any case, Contura appears to be cheap even if met coal falls to the marginal cost of extraction. And until that happens, the company is paying large dividends. As with many post-bankruptcy coal companies, Contura is focused on returning cash to shareholders (in this case, the former Alpha bondholders). In the first half of 2017, the company paid $9.00 per share in dividends vs. a current stock price of $61.75.

Both Contura and Hallador are microcaps. After this year's sell-off, Hallador's market cap foots to $166.7 million. While Contura is larger with a $679.6 million market capitalization, the stock is listed in the OTC market and trades $1.5 million per day. On July 31, Contura announced an IPO to list on the New York Stock Exchange. The company would not be selling shares; rather, existing holders planned on lightening positions. The company cancelled the IPO on Aug. 10 when indications of interest were priced below levels that Contura's shareholders would accept.

"I think in the near term the most likely course of action is trying to get uplisted," i.e., listed on an exchange without the sale of any shares, Alex Rotonen, Contura's vice president of investor relations, tells Lorenz. "Again, that has to be evaluated and fully vetted and made sure that we meet all of the criteria. But that is something that we're in the process of looking at. Being listed on the pink sheets is not anyone's aspiration as a company. So our goal is to get out of there to an exchange that allows a more varied pool of investors to buy shares. Uplisting seems to be the easiest way to get there sooner rather than later. It's too early to give you anything definitive. I don't want to jump the gun on what the board is going to decide, which, by the way, is meeting relatively soon."

Contura is the less leveraged of the pair. As of June 30, net debt amounted to $410.3 million, or 1.1 times annualized first half EBITDA. In the first six months of the year, operating income covered interest expense by 6.1 times. On June 30, Hallador's net debt amounted to $209.6 million, or three times trailing EBITDA. In the 12 months ending June 30, operating income covered interest expense by 2.6 times.

There is no insider activity to report in Contura's short life as a public company. In the past year, Hallador insiders have sold $906,683 worth of stock at prices $7 and higher vs. the aforementioned current share price of $5.60. It's a tough business.

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