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Fuel least popular

The Environmental Protection Agency makes war on it, people of any shade of green despise it, and the advent of cheap natural gas threatens to marginalize it. Coal—and a flourishing, $217 million market-cap coal miner—are the topics under discussion.

With the Nov. 14 news that the Tennessee Valley Authority will shutter eight coal-fired electricity-generating plants, the suspicion deepens that if anything could disprove the cheerful adage that all P.R. is good P.R., that something just might be coal. Even so, the official mineral of the state of Kentucky continues to generate 40% of America's electricity. Clean-burning natural gas accounts for just 27%.

Nor is coal likely to relinquish its lead in what is sometimes optimistically referred to as the "foreseeable" future. It will, by 2040, continue to claim as much as 35% of the electricity-generation market, compared to 30% for natural gas, projects the U.S. Energy Information Administration. That is, coal won't soon be going the way of the dinosaurs, from whence it came.

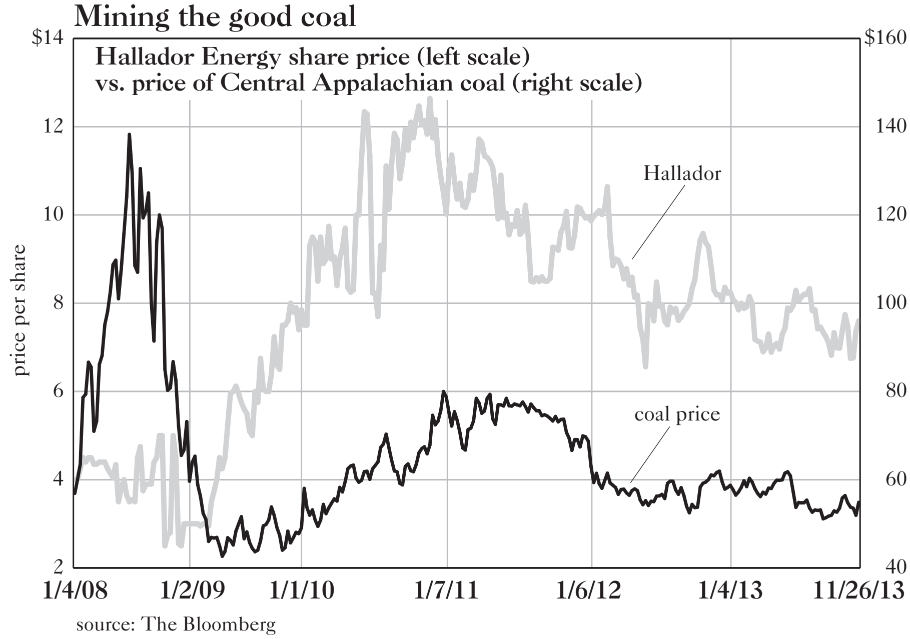
For connoisseurs of contrary opinion, Hallador Energy Co. (HNRG on the Nasdaq) ticks not one box, but two. Not only does it mine coal, but also its coal is the high-sulfur type that's linked to acid rain. To the question: "Why on earth would any utility choose to burn it—or be allowed to burn it?" There is this answer: Federal regulations long ago required utilities, at heavy expense, to neutralize those pollutants. "Counter-intuitively," Lucas Pipes, analyst with Brean Capital, advises colleague Evan Lorenz, "the increasing environmental standards have forced utilities over the tipping point to where it makes sense for them to burn higher-sulfur coal after they have installed higher-emission-standard technology."

So it is that high-sulfur coal is enjoying a renaissance. It's found in abundance in the so-called Illinois Basin, which encompasses the Land of Lincoln and parts of Indiana and Kentucky. Reserves in this locale are relatively accessible and extraction costs are relatively low—on the order of $30 a ton, about half the cost of the low-sulfur coal buried in the immense Central Appalachian Basin, a region stretching as far north as the Canadian border and as far south as Alabama.

Coal is in a steep bear market; the price of central Appalachian coal traded on the Nymex has declined to $54.93 per ton, down from $143.25 on July 1, 2008. But even at $44.50 a ton, the average price for all regions in 2013, mines like Hallador's operate in the black. Not so their Central Appalachian counterparts. Since 2005, according to Pipes, annual production in the Illinois Basin has expanded to 135 million from 93 million tons, while that in the central Appalachian zone has contracted to 75 million tons from 216 million tons.

"Within the coal industry," Lorenz points out, "there are lots of losers—and one or two winners. Conspicuous among the former are the companies that leveraged to expand at the top of the 2007-08 energy cycle. Arch Coal,

Mining the good coal



source: The Bloomberg

Peabody Energy Corp. and Consol Energy are among these encumbered unfortunates. James River Coal Co., which had a market cap of $704 million at year-end 2010, is quoted today at $54 million. Patriot Coal Corp., which had a market cap of $1.8 billion at year-end 2010, filed for bankruptcy protection in July 2012."

A very different proposition is Hallador, a lightly leveraged, low-cost, pure play on the Illinois Basin. Wholly owned Sunrise Coal is Hallador's principal business unit; it's responsible for all but $4.2 million of the company's $25.2 million in trailing 12-month operating income. Savoy Energy LP, a private oil and gas exploration company in Michigan, and Sunrise Energy LLC, a private oil and gas exploration company in Indiana—Hallador owns 45% of the first and 50% of the second—round out the corporate stable. As of Sept. 30, the parent's balance sheet showed $11.4 million of debt against $13.7 million of cash.

Hallador, via Sunrise, extracts coal at a cost of less than $30 a ton, the lowest cost of any public miner (only closely held Foresight Energy LLC, controlled by the farsighted Chris Cline, posts a lower cost per ton). The great bulk of the company's coal comes from the Carlisle mine, situated near the Indiana town of the same name. The Carlisle is a high-sulfur, underground deposit from which "continuous" mining machinery can surface as many as six tons of coal per minute. Carlisle has a capacity of 3.3 million tons a year and identified reserves of 43.5 million tons.

While Hallador's Ace-in-the-Hole mine, 42 miles northeast of Carlisle, a low-sulfur surface project, chips in a half-million tons in annual productive capacity and 3.1 million tons of reserves, and while management is developing a pair of much larger deposits on the Indiana-Illinois border (the so-called Bulldog and Russellville Mines), the fact is that, for now, Hallador is a one-mine company, with all the risks that concentration entails. For instance, in the first three quarters of this year, the cost of production at Carlisle jumped to $28.37 a ton from $26.53 in the 12 months of 2012. It was the discovery of a pocket of high gas (the same heat and pressure that transforms organic material into coal also produces highly flammable methane) that caused the bump up in cost; mining operations had to be moved to less productive parts of the mine while ventilation shafts were sunk to address the gas problem. The result: Cash flow in the 12 months to Sept. 30 declined to $27.8 million from $37 million in calendar 2012.

Hallador Energy Co.
(in millions of dollars, except per-share data)

	12 mo. 9/30/2013	2012	2011	2010	2009	2008	2007
Coal sales	$136.2	$138.0	$129.0	$117.4	$70.3	$27.2	$0.0
Other revenue	3.4	2.3	(0.8)	0.5	0.4	0.5	0.0
Coal operating expenses	118.6	105.8	99.3	90.7	78.3	51.2	28.4
Coal operating income	21.0	34.6	28.9	27.3	(7.6)	(23.4)	(28.4)
Equity income (Savory)	3.5	2.0	5.5	1.0	(1.7)	(2.3)	0.0
Equity income (Sunrise Energy)	0.6	0.2	0.9	0.0	0.0	0.0	0.0
Total operating income	25.2	36.8	35.3	28.3	(9.3)	(25.7)	(28.4)
Interest expense	1.5	1.1	1.3	1.9	2.0	4.0	4.1
Profit before tax	31.1	34.5	56.7	36.6	36.0	13.6	(2.8)
Net income	23.5	23.8	35.8	22.4	20.2	8.9	(2.4)
Diluted shares (in millions)	28.8	28.8	28.7	28.6	24.4	19.3	13.3
EPS	$0.82	$0.83	$1.25	$0.78	$0.83	$0.46	($0.18)
Cash	$13.7	$21.9	$37.5	$10.3	$15.2	$21.0	$7.0
Debt	11.4	11.4	17.5	27.5	37.5	40.0	35.4
Net debt	(2.3)	(10.5)	(20.0)	17.2	22.3	19.0	28.4
Oper. income/int. expense	17.1	33.5	27.4	14.7	(4.5)	(6.4)	(6.9)
Cash flow	27.8	37.0	60.1	45.5	45.2	18.8	(1.5)
Capital expenditures	(40.5)	(26.2)	(33.0)	(35.6)	(43.5)	(21.9)	(17.2)
Free cash flow	(12.7)	10.8	27.1	9.9	1.7	(3.1)	(18.8)

source: company reports

Another thing for the would-be investor to consider is the inescapably capital-intensive nature of the mining business. Capital expenditures, which totaled $40.5 million over the last 12 months, up from $26.2 million in 2012, have been inflated by $9 million for the purchase of Ace-in-the-Hole, $4 million for land around Carlisle and Bulldog and costs to permit the two new mines. To bring either into production at Carlisle's three-million-ton-per-annum rate would require an additional $150 million. Management estimates that maintenance capital expenditures will run between $3.50 and $4 per ton of capacity, or approximately $12-$13 million for the Carlisle mine.

"We don't operate on a factory floor where it is the same every day," Brent K. Bilsland, president of Sunrise Coal, reminds Lorenz. "Mining is about following the geology. From time to time, we have all four of our mining units in great conditions, and from time to time, we have three out of four in bad conditions."

There's no confusing Hallador with Exxon in the stock-market liquidity department; management, the board and affiliates own two-thirds of the 28.6 million HNRG shares outstanding. One-half of this chunk of inside holdings is persistently shrinking. Yorktown Energy Partners LLC, owner of 9.7 million shares, or 34% of the outstanding, has been distributing blocks of 750,000 shares to its limited partners every quarter or so. Many of the recipients turn right around and sell their Hallador in the open market.

Yorktown tells Lorenz that its exit from Hallador is no reflection on the company or its management. The fact is, rather, that the investment funds holding Hallador shares are nearing the end of their respective lives. "We wouldn't distribute a stock we thought either had issues or we thought was highly overvalued," Yorktown partner, Peter Leidel, says. "We want to distribute stocks we think people can hold and do well with. We think the stock ought to be higher than it is, but coal is out of favor."

Perhaps this overhead supply weighs on the share price. Certainly, the coal bear market does the stock price no good. In any case, the shares trade at 10.2 times trailing net income and yield 2.1%; they're quoted at a multiple of enterprise value to EBITDA of five times.

Whether you consider Hallador cheap at the price will depend, in part, on your view of natural gas. On this score, it's notable that gas prices weighed in at an average of $2.73 per million Btus in 2012 but have averaged $3.58 per million Btus so far in 2013 and are tipped to rally to $3.81 in 2014 (so, at least, tips the gas futures market). It's not inconceivable that coal, in relation to gas, is as cheap as it's going to get for a while. "When the ratio of natural gas prices to coal prices is approximately 1.5 or lower [per million Btu], a typical gas-fired combined-cycle plant has lower generating costs than a typical coal-fired plant," the EIA noted in its Annual Energy Outlook 2013. Coal, according to the agency, is expected to command $2.20 and $2.29 per million Btu in 2013 and 2014, making the black mineral cheaper to burn than natural gas.

"Hallador gets credit for what it is," Lorenz observes—"that is, a low-cost producer in a geologically fertile region. But it gets little, if any, credit for its two oil and gas development businesses, or for what its coal-mining operations might become. What management hopes to become is much bigger—and could be. To bring either Bulldog or Russellville into production would take nine months and the previously cited $150 million. 'Either one of those projects doubles our company,' Bilsland tells me. 'We are trying to get into a position where five years from now, we can bring three or four more new projects and triple the size of our company. That's our goal.' The financing would appear to be available: Hallador has in place a revolving credit facility of $165 million, of which $153.6 million remains untapped. Hallador's covenants limit the company's borrowings to 2.75 times EBITDA. Management takes a dim view on diluting ownership via an equity raise and would prefer to fund growth via cash flow and its credit facility, even if that means it takes longer to ramp up a new mine."

"What I like about this management team is that they are rational deployers of capital," Mat Klody, managing partner of the Chicago-based hedge fund, MCN Capital Management, and a Hallador shareholder, tells Lorenz. "They didn't do a lot of stupid things at the peak of the cycle and now they are seeing a lot of potential M&A opportunities pop up. They've been cautious to date about deploying capital, in particular with the great organic opportunities in place. They are definitely opportunistic."

"Opportunistic"—in capitalist circles, it's the highest praise.

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