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No lump of coal

Evan Lorenz writes:

Widows, orphans, environmentalists and mega-cap institutional investors, please turn the page: *Grant's* is bullish on little Hallador Energy Co. (HNRG on the Nasdaq), coal miner turned coal-fired power producer. It's our AI play.

Since the start of 2023, shares of the power producers NRG Energy, Inc. and Vistra Corp. have returned 175% and 319%, respectively, far outpacing the 42% gain in the S&P 500. As Mr. Market does not need to be reminded, the nation's fast-proliferating data centers have a ravening demand for electricity. That HNRG is down by 39% over the same period underscores both the risk and the opportunity in the analysis to follow.

Hallador continues to mine coal (*Grant's*, Nov. 29, 2013). What's different is the coal-fired power plant near Merom, Ind., pop. 208, which it acquired in 2022. This facility, Hallador's one and only generating station, has proven itself a critical cog in the Midwestern power grid. Even so, HNRG changes hands at a lower multiple than the stocks of even the despised pure-play coal miners; the Hallador market cap registers just shy of $226 million.

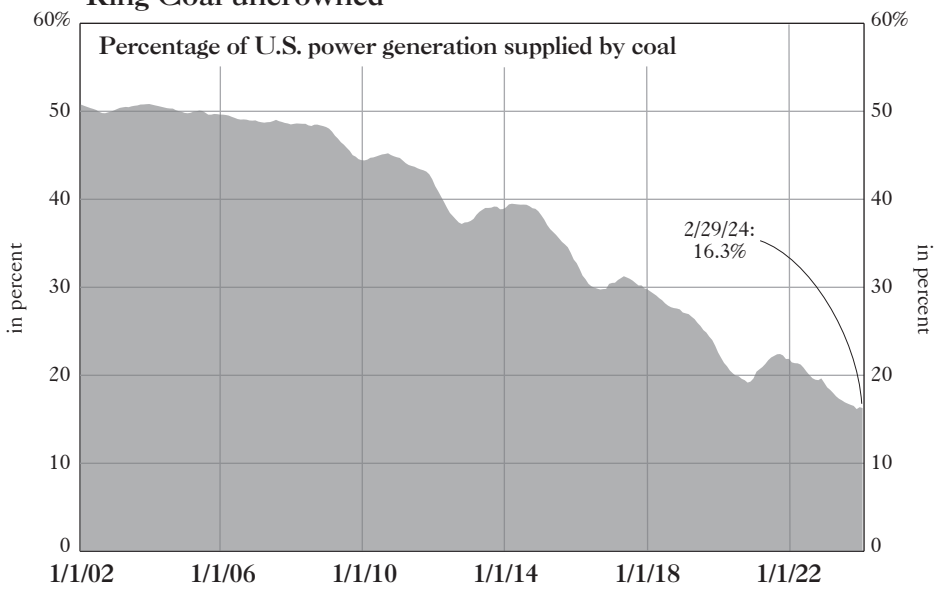
"Electrical demand basically hasn't grown for decades," a knowledgeable friend points out—in the 10 years through 2022, generation expanded at an anemic 0.4% per year. "Now it's projected to grow in the low-to-mid-single digits, which is just really onerous on the grid."

During that low-growth era, utilities prioritized greening over growing. In that spirit, the Midcontinent Independent System Operator, Inc. (MISO), which oversees electrical transmission in 15 states and the Canadian province of Manitoba, recently boasted that it had achieved a 30% drop in carbon emissions since 2005 across the market it serves.

"Intermittency" is the familiar Achilles' heel of green generation. "You cannot turn on a solar panel," Brent Bilsland, Hallador's CEO, reminds me. "They go home every night. You cannot turn on a windmill." Coal-powered plants—"base load" assets, as they're known—are as dependable as they are controversial. Hostage to extreme temperatures and "wind droughts" (about one per year, on average, with some dead calms spanning four days), the Midwest would seem to be tailor-made for the fuel that nobody seems to want but many undoubtedly need.

In any case, MISO reports that, over the past 10-plus years, surplus reserve margins—i.e., generating capacity that can be deployed at a moment's notice—have been "exhausted" through load growth and the retirement of such plants as the one at Merom. Since 2022, the power overseer says, it's been running near the "level of minimum reserve margin requirements," i.e., the amount of excess generation over peak load: "While MISO has implemented several reforms to help avert near-term risk, more work is urgently needed to mitigate reliability concerns in the coming years. In fact, the region only averted a

King Coal uncrowned



source: The Bloomberg

capacity shortfall in 2023 because some planned generation retirements were postponed and some additional capacity was made available to MISO."

By 2028, MISO will suffer a 4.7 gigawatt (GW) shortage, according to projections by the North American Electric Reliability Corp., plans to add 12-plus GW of new generation, the equivalent of a dozen nuclear power plants, notwithstanding. The reason, says MISO, is "because the new resources that are being built have significantly lower accreditation values than the older resources"—in other words, they are less reliable. Anyway, the grid overseer notes, a backlog of uncompleted capacity additions is running at an average of 650 days behind schedule on account of regulatory hurdles and supply-chain problems.

You'd think that electric utilities would be thrilled at the pickup in demand, but AEP Ohio, the Buckeye state operating unit of the American Electric Power Co., Inc., for one, can attest that it's possible to have too much of a good thing. The utility stopped servicing new data centers and crypto miners in March. It says it's in receipt of more than 30 GW of new power requests.

What it now needs, AEP insists, is a special tariff structure to cover the costs to connect new customers: 10-year contracts with minimum power-purchase guarantees and hefty "exit" fees on any who wish to terminate service early.

Approval of this request by the Public Utilities Commission of Ohio would substantially raise the fixed costs of data centers—the likes of Alphabet, Inc. and Amazon.com, Inc. had better hope their AI bets play out. As for the rest of us, surging demand for generation in the context of the relatively fixed supply of generation hardly seems calculated to produce lower power bills.

The problems that power-hungry AI presents go well beyond the grid. In 2020, Microsoft Corp. pledged that, by 2030, it would remove more carbon than it emits. Yet the company acknowledged last week that emissions are 30% higher than they were four years ago, even as plans to build still more data centers move forward. It happens that increasingly dirty Microsoft is the biggest holding of the iShares ESG Aware MSCI USA ETF, which manages $12.8 billion.

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Our 2013 article on Hallador made a bullish case but began with some cautionary facts. Thus, the company operated a single mine in Indiana that produced the kind of high-sulfur coal that causes acid rain. And the proportion of American power supplied by coal-fired plants had shrunk to 39% from 51% over the preceding decade.

But new, federally mandated scrubbers were rendering Hallador's coal suitable for burning at most generating stations. Besides, Hallador was the lowest-cost producer among publicly traded coal miners. This combination of facts, we reasoned, would allow the company to prosper even as coal slipped slowly away.

All was well as the share price nearly doubled in the next eight months, to $14 and change, but we bargained without the American shale revolution. The resulting collapse in gas prices similarly deflated coal prices, and Hallador, by September 2020, was trading at $0.62 a share.

In 2013, the U.S. Energy Information Administration made bold to predict that coal would deliver 35% of power generation by 2040, but neither did the EIA foresee the gas glut. In the 12 months ended February, coal accounted for just 16.3% of America's power mix versus 43.4% for natural gas and 21.4% for renewables.

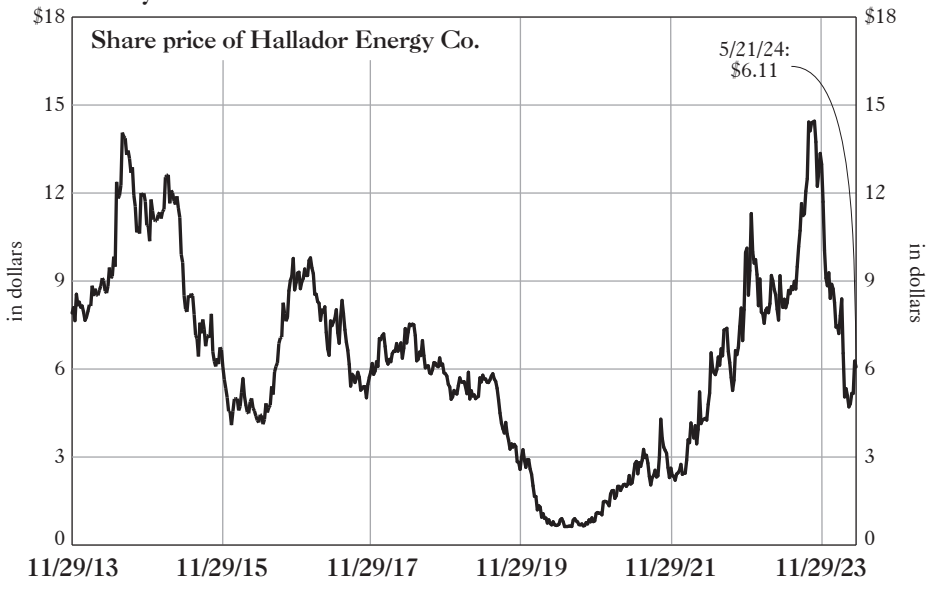
Hallador, profitable in 7 of the past 10 years (2019–21 were the loss-making exceptions), survived the devastation in coal by virtue of its low costs, a position enhanced by the company's 2014 purchase of a mine from utility Vectren Corp.

As the coal market sank into terminal decline, the Hallador front office looked for a different business model. In 2018, it invested in a project in Colorado to produce sand for the fracking industry. Little came of it.

The next opportunity involved the aforementioned environmentally marginalized coal-fired power plant in southwest Indiana. Hallador decided to buy it—this was in the fall of 2022—and one might well have wondered why. The plant, built in 1982 and boasting 1.08 GW of capacity, was slated to close in 2023. It was a good thing it didn't. Except for the reprieve of the Merom property, the threatened 2023 Midwest power shortage actually would have come to pass (recall MISO's description of that close call).

Hallador paid no cash for its new asset but agreed to assume decommissioning and environmental-remediation expenses when the plant is closed for good as well as to sell electricity to the prior owner, Hoosier Energy, at concessionary prices (specifically, at a rate of $34 per megawatt hour for three-and-a-half years, less than the mid-$50 rate that Hallador has been contracting with other cus-

Not yet Nvidia



source: The Bloomberg

tomers; the prices exclude payments that Merom receives for providing capacity to the grid).

While Hoosier had planned on shutting Merom last year, the plant can continue to operate until 2039, according to Hallador. This will require approximately $45 million in spending to comply with the EPA's latest effluent-limitation guidelines and, down the line, may require Merom to burn both gas and coal. "What I'm talking about is simply running a gas line into the plant and putting gas nozzles in the boiler," Bilsland tells me. "It's not a new plant. It's the same heat rate.

"As far as the turbine and generators go," the Hallador CEO continues, "these get rebuilt. Turbines get rebuilt every five years, generators every 10. So it kills me when people say, 'Wow, it's a 40-year-old plant.' That's when it was built, but it constantly gets rebuilt, and there are improvements and new capital expenditures."

Beyond 2039, Hallador will still own a 1.08 GW interconnection to the MISO network. "This is essentially the on/off ramp to the grid," is how Bilsland puts it. "If we were building an interstate, and I said you could own the land all around this intersection's on- and off-ramps, I think that would be something you would want to own. I'm confident that power will still be put on and taken off of the grid at the Merom node 100 years from now. The generation form will change. In fact, it may change two more times in 100 years, but there will still be a whole lot of power being put on or taken off the grid at that location."

Rebuilding this kind of grid infrastructure is neither easy nor cheap. AEP Ohio, in making its case to lock in data-center customers to long-term, minimum-volume tariffs, argued that "[b]uilding electrical infrastructure required to serve this kind of load is not an immediate solution and can take years for planning, regulatory approvals, material acquisition, and construction. For instance, 120 miles of 765 kV line would take approximately 7–10 years to build and could cost hundreds of millions of dollars."

Certainly, coal-fired power plants are not everyone's cup of tea. Iron Mountain, Inc.'s data centers, for example, source 100% of their power from renewables (*Grant's*, May 10). But other consumers decline to subordinate baseline dependability to renewability. Bilsland tells me that one prospective customer recently discussed locking up one gigawatt of power, essentially all of Merom's capacity.

Hallador says it's looking forward to receiving responses later this month to the requests for proposals it sent to data-center and industrial power users (just in case more than one customer will finally be required to make a go of things). "We've had a fair amount of interest," Bilsland says. "We'll see if interest translates into a deal. You never really know. We're confident that people want the volume."

For now, the power-purchase agreement with Hoosier is an earnings and revenue depressant. Hallador has presold 1.6 million MWh of energy for the last nine months of 2024 at $44.39 per MWh and 1.9 MWh for next year at a rate of $47.76 (prices include payments for capacity). When that agreement expires in 2026, Merom's contract price will jump to $68.96 per MWh.

On the first-quarter earnings call, Bilsland presented an outline for what Merom might earn after the Hoosier agreement ends. Hallador is targeting electrical sales of 6 million MWh per year, which works out to a 63% utilization of the Merom plant and compares with sales of 4.2 million MWh last year. At that level of utilization, costs per MWh work out to approximately $40, so selling electricity at around $60 per MWh would result in operating income of $120 million per year.

Costs have been running higher than normal at the company's coal-mining unit. Some of this overrun is due to Hallador trimming production to a target of 4.5 million tons a year from 6.6 million last year. On the first-quarter call, management said that costs had declined to the mid-$30s per ton by March from $44.94 last year. Hallador has already secured buyers for 2.8 million tons of coal in 2026 at an average price of $51.80. Assuming sales of 4 million tons in 2026, a cost of $40 per ton and an average price of $50 per ton would produce $40 million in operating income.

Subtracting $11 million for corporate expenses, Hallador has a shot at generating $149 million in operating profit in 2026, which would value the company at 2.1 times enterprise value to that year's operating income. For comparison, coal miners Alliance Resource Partners, L.P. and Consol Energy, Inc. change hands at an average of 6.3 times this year's estimated operating income while power producers Vistra and NRG trade at 16.5 times this year's operating-income guesstimate.

There are risks to the bull case, of course. "The power markets are starting to bake in much more attractive fundamentals," Lucas Pipes, who rates Hallador a hold for B. Riley Securities, Inc., tells me. "Nothing is ever done until it is done. You need to lock it in, and you need to execute." In other words, show me.

"As coal-fired generation is a shrinking industry, there are diseconomies of scale," Pipes continues. "I heard an anecdote over a year ago from another operator of a coal-fired plant out west. He said, concerning a specific part, 'There are only two individuals across

Hallador Energy Co. at a glance
all figures in $ mns except per share data

	TTM*	2023	2022	2021	2020
sales	$283.3	$361.9	$289.4	$247.7	$244.2
operating income	38.5	65.0	30.4	-6.0	3.1
net income	21.0	44.8	18.1	-3.8	-6.2
earnings per share	0.59	1.25	0.55	-0.12	-0.20
diluted shares	34.8	36.8	33.6	30.6	-30.4
cash	1.6	2.8	3.0	2.5	8.0
debt	89.8	106.9	101.7	107.8	-136.1
total assets	585.4	589.8	630.6	354.0	384.1

*12 months ended March 31, 2024.

source: company reports

the country who can fix it.... If they don't feel like it, this plant isn't running until they decide to show up.'"

There is also the risk, observes paid-up-subscriber John Niforatos, of Hallador's single generating station closing down or needing maintenance or having "to go offline for some reason." Niforatos, accepting that risk, says he holds a position in Hallador.

As of March 31, unrated Hallador's balance sheet showed a net debt balance of $88.1 million, a sum equal to 1.6 times trailing Ebitda. In the 12 months ended March, operating income covered interest expense by 2.8 times.

Hallador is somewhat of a Wall Street orphan. Exactly one analyst covers the stock, the aforementioned Pipes. Short interest sums to 4.3% of the float, although holders of a $10 million Hallador convertible note might be hedging their equity exposure through short sales rather than expressing outright bearishness. Over the past 12 months, insiders have purchased 46,100 shares at a net cost of $240,265. In aggregate, the C-suite owns 32.3% of shares outstanding; Bilsland personally owns 3.9%.

To highlight the news that, starting last quarter, Hallador began to derive more revenue from power generation than from mining, management is doing a kind of inside-baseball rebranding; it's in the process of changing the corporate Standard Industrial Classification code to 4911 (electrical services) from 1220 (bituminous coal and lignite mining).

"It's exciting," Bilsland tells me. "We spent the past 19 years in a contracting market. Now we're entering a market that is expanding because, for the first time in 25 years, demand for electricity is growing in everything, from electric vehicles to AI to the onshoring of industry."

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