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Christmas came early

"If you look at all the other players, all the goliaths of the industry," Hallador Energy Co. CEO Brent Bilsland was musing the other day, "they are all struggling to stay afloat because they put way too much debt on and bought assets at the peak of the market. Now what's interesting is there are few buyers at the bottom of the market. For the lower-cost producers with healthy balance sheets, it is like Christmas every day."

Hallador (HNRG on the Nasdaq), one of those lower-cost, well-financed producers, is the topic. When it featured in these pages on Nov. 29, 2013, Hallador was, essentially, a one-mine company. Thanks to a timely acquisition last summer, it is today essentially a three-mine company. Curiously enough, the share price is lower today than it was before the 2014 accession.

As to size, Hallador is absolutely small in market cap—just $304 million on the hoof—but also relatively large in market cap. Arch Coal Inc., one of the industry's shrunken giants, is today worth only slightly more than our up-and-comer. Heavily encumbered and unprofitable is Arch; lightly leveraged and profitable is Hallador. Twenty-three analysts cover Arch; three follow Hallador, on which we remain bullish.

The high-sulfur coal that Hallador produces is the kind to which the Environmental Protection Agency, of all the federal bureaucracies, has given a leg up. Costly scrubbers—installed by regulatory edict to cleanse the exhaust of coal-fired utility plants—make high–sulfur coal not only environmentally acceptable but also commercially preferable.

It is preferable, especially, in the state of Indiana, and Hallador is a Hoosier enterprise. It mines its coal near Carlisle, Ind., in the southwest corner of the state; 85% of that coal is sold in Indiana, the remainder being consigned to Florida by rail. The nice thing about Indiana, apart from the friendly people and the intellectual and cultural mecca called Indiana University, is that natural gas presents no serious price competition to coal. So it is that since the third week of June, crude oil prices have been sawed in half while the price of Hallador's coal is lower by just 3% to 4%. Not that the spot price has much significance. For 2015, Hallador has locked in purchase agreements for 100% of its output with investment-grade customers at $43.32 a ton, up from $43.04 in 2014.

Certainly, the collapse in crude is no unalloyed negative for the coal miners. Surging domestic oil production outstripped the installed pipeline capacity; the overflow moved by rail. The throttling back of domestic oil production promises fewer transportation bottlenecks. As it is, coal inventories at American power plants stand at a nine-year low, according to the U.S. Energy Information Agency. "Utilities want to burn coal," colleague Evan Lorenz points out. "They've had trouble getting it."

The biggest coal producers are having trouble just staying solvent. Not only Arch but also Peabody Energy Corp. (BTU on the Big Board), the No. 1 coal miner by tons sold, borrowed heavily to finance acquisitions

Bigger and cheaper

source: The Bloomberg

its owners now wish they never made. Net of cash, Peabody's debt is no less than 18.6 times greater than its trailing 12-month earnings before interest, taxes, depreciation and amortization. At least Peabody shows positive cash flow; over the past 12 months, Arch's EBITDA weighed in at minus $85.8 million.

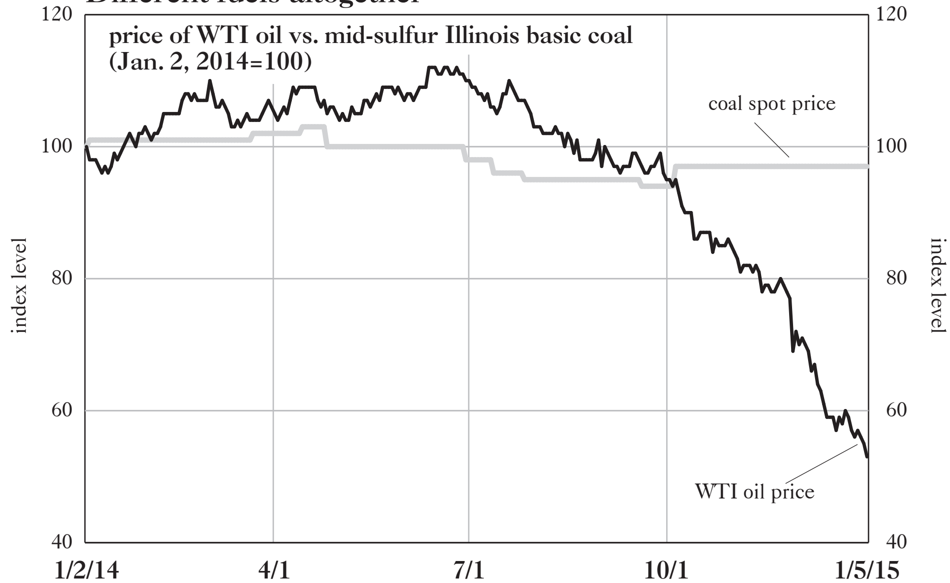
Until not many months ago, the Carlisle mine was effectively the revenue sum and substance of Hallador Energy. Carlisle is a 3.3 million ton per annum underground asset situated in the Sullivan County, Ind., town of the same name. There were, and are, other properties in the corporate portfolio—a much smaller coal mine, some oil and gas and methane interests—but Carlisle was dominant. Its importance came painfully to light last year as Hallador got waylaid on a subpar Carlisle coal seam. The experience serves as a salutary reminder that geology holds the upper hand. "The thing about mining is, it is not a factory floor," says CEO Bilsland, adding, "Don't get me wrong. We were a little surprised that it has lasted as long as it has lasted."

There were man-made problems on the rails, too, with the consequence that Carlisle persistently produced at less than full capacity. On a Sept. 4 conference call, management related that the mine was operational on only two Saturdays all year. Taking one thing with another, the cost to extract a ton of coal jumped to $30.25 per ton in the first half of 2014 from $28.22 per ton in the first half of 2013.

The key to the bullish case is that costs are likely to drop, the disappointments of 2014 notwithstanding. On July 1, Hallador disclosed the acquisition of a trio of underground mines from Vectren Corp. for a consideration of $320 million. They are Oaktown 1 and Oaktown 2, situated 15 miles southeast of Carlisle, and Prosperity, another underground mine, situated 40 miles southeast of Carlisle. Hallador shut Prosperity as soon as the deal closed and moved its equipment north to the Oaktown properties. Because each of the Oaktown mines produces roughly what Carlisle does, the transaction has effectively tripled Hallador's annual production, to 9.7 million tons.

Happily, the Oaktown deposits happen to be adjacent to War Eagle, a reserve body that Hallador was developing before the Vectren purchase. Altogether, Oaktown, War Eagle and Carlisle form a 230 million-ton contiguous reserve position.

Different fuels altogether



source: The Bloomberg

The acquisition is a company maker, to listen to Bilsland. In fact, both parties, seller no less than buyer, seem to stand to gain by it. Under Vectren's management—a management whose first priority was producing and distributing power, not digging up coal—the mines were realizing $45.56 a ton at a cost of no less than $44.92 a ton. Sans Prosperity, and under Hallador management, that cost plunges to between $31 and $32 a ton. Because Vectren ran the mines under contract, Hallador has inherited no legacy employees and no union contracts. The Vectren coal business, Bilsland tells Lorenz, was, "a misunderstood asset that fit perfectly into our fold. We've run it for four months, and we are ecstatic with the purchase we've made."

Geologically, too, the acquisition is a winner, the reserves at the Oaktown complex being on average 5.9 feet thick vs. 4.9 feet at Carlisle. "When we looked at Oaktown, the epiphany before we bought it is this is a reserve that should have a lower cost than Carlisle because it is thicker," Bilsland says. "A lot more money was spent on cap-ex. We spent $100 million when we developed a three million-ton-per-year mine at Carlisle. Vectren spent $420 million and developed a six million-ton mine at Oaktown."

If only Bilsland were running the trains. "We can sell the coal," the CEO continues, "but if the railroad doesn't pick it up, it doesn't get sold. Between us and Vectren, we had something like 600,000 tons of that in 2014: sold but didn't get moved. That gets pushed into 2015. The question becomes, 'What will rail service be like?'

"The one thing that is different for us in 2015," Bilsland goes on, "is one-third of our product will move via truck." The fact that the Oaktown mines are adjacent to Carlisle gives management options to manage rail deliveries, too. "We've worked with the railroads and with our utilities to allow us, if the loop is blocked—meaning if I have two full trains sitting in Oaktown and a customer has scheduled a train to come into Oaktown but the loop is full—we now have the right to load at either Carlisle or Oaktown," Bilsland says.

If transportation is the great unknown, there's no such suspense concerning mining costs. Can they return to $30 a ton? "[E]mphatically yes," Bilsland pledges. If Mr. Market is reading this, he might make a note; the Street seems to have penciled in $32 a ton.

"If you look at the bottom line here," Mat Klody, managing partner at the Chicago-based hedge fund MCN Capital Management and a Hallador shareholder, tells Lorenz, "if they can do what they say they can do with costs next year, they are going to produce nine to 10 million tons, they are 100% hedged so there is no price risk for the next 12 months, and they think they can get costs below $30 a ton. If you do the math, they are going to do $2

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in free cash flow next year." At $10.56 per share, that would price Hallador at a free-cash-flow yield of 19%.

"More importantly," Lorenz proceeds, "management believes that the Oaktown complex should have lower operating costs than Carlisle. In 2012, Carlisle produced coal at $26.53 a ton. In 2013, its costs rose to $29.14 a ton, then followed the escalation of costs attendant on operations in that lower-grade seam late in 2013 into 2014. Each dollar below the projected $30 per ton in costs is worth $0.25 in EPS in 2015."

Debt has been the undoing of Big Coal, and Bilsland wants you to know how much he knows it. As recently as July, he points out, Hallador had no net debt. Pouncing on the Vectren opportunity, it borrowed $350 million. Bilsland says the company has earmarked incremental cash flow for debt reduction. By year-end 2014, $40 million to $50 million of the outstanding obligation was to have been repaid. By the looks of things, Hallador's net debt to 2015 EBITDA from coal operations alone will amount to 2.7 times, with operating income covering interest expenses on the order of 4.6 times. "We've got great assets, a lean, low-cost culture," Bilsland says. "If we don't get too cute and put too much leverage on the balance sheet, we are going to be here for a long time to come." And, he adds, "We think there will be some sweetheart deals on coal over the next two years, so we want to get our balance sheet as healthy as possible so if any of those opportunities present themselves, we can take advantage of it."

Hallador trades at 37 times' trailing 2014 net income and at 7.1 times the three-analyst consensus of 2015 earnings of $1.48 a share. "However," Lorenz points out, "if management really delivers on its projections, I think Hallador would earn $1.78 a share, which would put the forward valuation closer to six times. The shares yield 1.5%.

"There are coal MLPs out there: Consol is doing a coal MLP; Foresight Energy is another big Illinois Basin producer and they are a MLP," Klody adds. "The multiples are twice the multiple of Hallador. That is the other interesting aspect of the story. Foresight is trading at eight to nine times' enterprise value [equity cap plus debt minus cash] to EBITDA, Hallador at 4.5 times EV to EBITDA. I don't think coal assets should be MLPs but the reality is there is an arbitrage opportunity in the market and if Hallador is doing well, they will not continue to trade at half the multiple of a guy down the street. That guy down the street will be incented to buy Hallador—issue equity at eight to nine times—and buy the company at five times."

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