BRIEFING NOTE

Struggling U.S. Coal Companies Face Debt Hurdles, Complications From Reclamation and Pension Obligations, Pressure from Hedge Funds

June 1, 2015

By Tom Sanzillo

As the U.S. coal industry continues its tail spin, the cumulative impacts of its many liabilities—reclamation costs, pension obligations and debt service—grow more complicated and burdensome.

One symptom of the malaise is the recent sharp upturn in layoffs, as coverage in the trade press—even the mainstream press—is punctuated more and more by job-loss news. Alpha Natural Resource’s more than 500 layoffs, mostly in West Virginia, were expected. What comes as more of a surprise is the more than 2,000 job cuts in Illinois, Ohio, West Virginia, and Virginia by Murray Energy and CONSOL Energy. Murray and CONSOL are companies that have a business strategy based on smaller markets, mines with lower production costs, and a solid base of stable power plants. This should be a recipe for job security for remaining mine workers, not a recipe for layoffs. Weak markets and low coal prices threaten even this attempt to breathe new value into oversized coal reserves, however. Mining companies are selling coal but with tighter margins and a worrisome outlook. Global markets continue to show weak pricing through 2021.

Stock prices reflect this outlook. Peabody Energy fell recently to a record low $3.35 per share range and Arch, which closed this past Friday at 50 cents a share, is facing delisting from the New York Stock Exchange for failing to maintain a $1 per share price for 30 days.
The Coal Industry’s Debt Problem

SNL reports recently that Imperial Capital, an important player in the corporate bond market, has downgraded its rating to “sell” from “buy” on Alpha debt. The company’s business model “is under attack from all sides,” writes Imperial, and its “runway’ may end in 12/31/16.”

Alpha is a microcosm of the debt problems engulfing many coal companies.

Imperial Capital, in its note on Alpha, sees fundamental erosion in corporate bond values in the coal sector. There are real questions here of liquidity and coal reserve valuations, (“Another Year Older and Deeper in Debt”). Imperial is saying now that Alpha's liquidity seems inadequate. The question: “Do bondholders really think it’s okay for this company (or any company, for that matter) to adopt a strategy of spending every last nickel of its cash just to keep the lights on when there is no new revenue in sight?” This slow-motion train wreck is now becoming unacceptable to bond investors, and Imperial, in so many words, is counseling bankruptcy as a way to preserve remaining bond value.

Credit insurance has become another point of weakness for coal companies. For Arch Coal, for instance, credit-default protection costs have increased by 300 percent over summertime 2014 prices. Company liquidity is stressed. Its bonds face imminent maturity. They must be either paid off or refinanced. After years of losses and falling revenue, it is difficult to see a path toward paying significant debt maturities in 2018, 2019 and 2020.

Arch is a good example, too of a problem endemic across the coal industry, where executives seem reluctant to drop old schemes in favor of more practical business management. Arch has signaled it will move forward with capital expenditures for the undeveloped Otter Creek coal mine in Montana. With coal at $60 per ton in the global market this mine project, once thought of as a source of coal exports to Asia, seems more destined now to slog through in a troubled domestic market where there are no price signals to support greenfield projects. Still, the company stands by its ambition even after showing losses and diminished liquidity for the past few years in a trend that will be carried through at least 2016—if not longer. How can Arch leverage new capital for a project that may start as early as 2017?

One has to wonder about the modeling being done on Otter Creek. Two points in particular come to mind:

- Such models often use presumed (and affordable) interest rates, but a company in such dire straits as Arch will never be able to secure a competitive interest rate.

- Because global seaborne thermal markets are in such deep and probably permanent decline, Otter Creek’s coal would have to go into the domestic market—an area of increasing competition. Indeed, Arch will be competing again itself, bringing on a small low-cost mine that will drive down Powder River Basin coal prices against its larger, more expensive mines in the region.

Fitch Ratings has commented recently on the rise of corporate credit defaults generally and noted that the contribution of the minerals and mining sector to that trend—mostly by coal producers—is pushing concerns to the level of outright default warnings. Rating agencies are tuned into not only
coal producers Walter Energy, Alpha, Arch and Peabody but the enormous impact of Energy Future Holdings’ $42 billion bankruptcy on the high-yield bond markets. Absent a broad turnaround in the prices of commodities, worldwide deterioration in minerals and mining is expected to continue with coal production making a substantial contribution to the negative outlook.

A Potential Reclamation-Bond Shock

Imperial identifies as a precipitating event for Alpha the recent announcement of reclamation bond reviews by West Virginia officials. Subsequent to Imperial’s release Alpha has also been found in noncompliance on its reclamation bonds in Wyoming. These events come against a backdrop of news that federal regulators are now investigating more broadly whether U.S. coal companies are truly in any position to make good on the “self-bonding” by which they promise to pay for cleanup costs.

Imperial notes that Alpha, for one, may need to be required to prove it has adequate resources to cover its reclamation obligations. A bankruptcy would be required for Alpha to get access to short-term dollars to continue operations and to debtor-in-possession loans that would allow the company to meet its reclamation responsibilities.

To those who wonder whether the reclamation bond issue carries much weight: In Alpha’s case the risks are cumulative and mounting.

Pension Obligations Are Also Looming

SNL has a recent report of note, too, on how coal companies are slipping in their obligations to meet their pension-fund obligations. Pension-plan funding levels (the percentage of liabilities funded by existing assets) have deteriorated as company pension investment strategies have moved from equity to debt (one hopes it’s not coal debt). This trend, at bottom, will mean a higher level of unfunded liabilities.

On the flip side, some of the companies have funding levels in the 80% range, which is decent, but coal-company pension funds like every other aspect of the industry, are under stress. And in this time of enormous energy-market transition this set of assets and liabilities contribute to the restless situation across the coal sector.

Hedge Funds Are Leaving the Sector

Finally, credit again to SNL for an article that documents the departure of hedge funds from coal stocks, though some are still hanging on.

The last go-round for hedge funds—those vast pools of mostly unregulated capital that are
considered the smart money by many investors—has been a kind of bottom-feeding exercise used to exploit tiny movements in coal equities that have become penny stocks. This investment strategy only underscores the diminished market power of the coal industry. Recall Peabody’s expulsion last year from the S&P 500 Index and Arch’s recent NYSE delisting warning for its failure to maintain a $1 share price.

Combined, exclusion for broad indexes and abandonment by hedge fund is a kind of inexorable, silent divestment by the markets in the coal space. Institutional funds that retain coal in their portfolios do so with a kind of perverse logic that places investment form over investment performance.

**Conclusion**

- What we see across the U.S. coal sector in recent weeks are telltale layoffs in areas of the industry we thought might weather the industry’s persistent shrinkage.
- There’s a growing recognition that the purported liquidity of U.S. coal companies is not enough to handle its mountain of debt and other liabilities in a time of low prices.
- While the sector is reasonably positioned on its pension obligation, the outlook on that point is deteriorating.
- A loss of hedge fund interest in coal stocks is exacerbated by mainstream skittishness.

**About the Author**

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The Institute for Energy Economics and Financial Analysis (IEEFA) conducts research and analyses on financial and economic issues related to energy and the environment. The Institute’s mission is to accelerate the transition to a diverse, sustainable and profitable energy economy and to reduce.