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Good times for coal

Whitehaven Coal brought back memories of the good old days when it published its annual financial results last week.

John Robertson* | 23 Aug 2017 | 19:10 | Opinion

Investors are unlikely to readily help new coal mines into production, helping the cause of existing miners

Growing output, rising prices, falling debt, a capital return and rising dividends were the discussion points in the presentation hosted by Whitehaven Coal chief executive Paul Flynn.

The company's 17.7 million tonnes of coal production was 12% higher in the year ended June 2017, after more than doubling over the prior three years.

Average realised prices increased 49% to A$104 (US$82) per tonne driven by an 85% rise in the US dollar market price for metallurgical coal and a 52% gain in thermal coal prices through the course of the year.

Operational cash flows of $655 million increased 143%. The cash surge funded $21 million in sustaining capital and a further $71 million in capacity expanding projects.

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Lowered capital needs followed completion of the company's most recent expansion project at Maules Creek, which accounted for 42% of sales volumes after commencing production in 2014/2015.

Debt was lowered by $539 million. A modest 9% gearing ratio at the end of the accounting period edged below the 10-15% target range.

The company said it wishes to distribute an additional $205 million to shareholders in November implying a yield of 6%. Depending on a favourable opinion from Australian tax officials, the foreshadowed distribution will comprise a capital return and an unfranked dividend.

> ***"Having to depend on organic cash flows for growth may be no bad thing. Rather than trying to persuade investors to re-embrace the merits of coal, Whitehaven may be better off simply keeping quiet"***

The best may still lie ahead with scope for Whitehaven to raise saleable coal production by more than 5Mt over the coming five years.

A targeted 50:50 split between metallurgical and thermal coals from its Maules Creek site, up from 25:75, will add value.

Strengthening coal prices in the past three months suggest a flow-through of favourable market conditions into the new financial year.

The improved operational and financial performance of the company has come with a $0.8 billion lift in market value to $3.4 billion since the beginning of June.

Despite this recent 30% revaluation and consistent with the rest of the sector, the company's share price remains within the range in which it has traded throughout 2017.

By far the largest part of the company's market re-rating occurred during 2016 when rising coal prices helped boost the share price by 740%. At the same time, the small resources share-price index, of which Whitehaven is a constituent, was only 80% higher.

Overall, since the low point in sector prices in early 2016, Whitehaven has added 820%. The largest ASX-listed stocks have made a 72% gain. The mid-cap stocks in the sector have put on 76%. Exploration stocks have lagged the field. The PortfolioDirect explorers share-price index is up only 18%.

Timing has distinguished Whitehaven from the trailing pack of companies in the sector.

Whitehaven has just passed the 10th anniversary of its ASX listing. It had been sufficiently well advanced on its expansion path as global commodity markets slumped to have struggled but, having survived, it is now beginning to thrive. There are parallels here with Fortescue Metals Group.

Whitehaven's outstanding share price performance now prompts questions about its valuation.

While the company's performance harks back to better times, one ingredient is missing. The broader macro support for the sector which typified 2005-2007, for example, is absent.

Sector momentum, against the background of a currently directionless market, is making a negligible contribution.

Intrinsic value and, in particular, how well the company can use its $3 billion capital base will set the barriers to future investment returns.

On this point, in an otherwise high quality investor presentation, Whitehaven is studiously silent.

Return on capital is only one measure of performance but it is the mother's milk of investment markets. It is the most important ingredient in long-term investment success.

With a greatly lowered debt component in the company's funding mix, a cash flow return in the vicinity of 14-16% should be the hurdle against which to judge whether the company is a competitive investment.

The 2016/17 cash flow return sat just below 15%.

The company has proved and probable marketable reserves of 862Mt on which to base production longevity and to support its market value.

The company's stated production intentions and prevailing coal prices would validate a value target of around $4.4 billion or 30% higher than the current market price.

The valuation is, as one would expect, highly sensitive to the coal price outcome; drop the price by $10/t and there is no longer any market discount.

A Whitehaven investment goes against the recent trend among larger institutional investors to eschew holdings in coal producing companies.

The reluctance of some of the largest investors to support coal investments is a double-edged sword for Whitehaven.

Funding and growth opportunities will be limited as long as larger investors are sidelined.

At the same time, hostility to coal related investments builds scarcity value. Fewer investible opportunities reduce the chances of downward market pressures on both equity and end-product prices.

The company has been a forthright advocate of coal-related investments pointing to generally rising Asian demand and scope for cleaner coals, such as those in its own portfolio, to take up a larger share of the market.

The company has also argued strongly that low emission technologies can contain electricity costs, while potentially lowering the quantities of carbon emitted by older power generators.

However soundly based these arguments may be, opposition from leftward-leaning institutions with an eye on stakeholder opinion will remain tough to overcome.

Having to depend on organic cash flows for growth may be no bad thing. Rather than trying to persuade investors to re-embrace the merits of coal, Whitehaven may be better off simply keeping quiet.

The fewer new mines, the better Whitehaven's returns are likely to be and the wealthier its politically incorrect shareholders will become.

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