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TRADER EXTRA

A Bargain in the Coal Bin

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By Vito J. Racanelli May 26, 2018

The stock of companies exiting bankruptcy isn't exactly popular with the average investor. Previous shareholders, after all, are typically wiped out in Chapter 11. And when these companies return to the equity market, they mightn't be widely followed, as Wall Street sometimes gives them less attention than they might otherwise receive.

For Peter Andersen, a money manager who focuses on debt to get insight into equities, companies out of bankruptcy come with significantly cleaned-up balance sheets, and their newly issued equity represents potentially contrarian investment opportunities, thanks to investor apathy.

What's important, he says, is to look for businesses that failed because they groaned under too much debt and not from intrinsic competitive problems, such as poorly made products, for example. The latter isn't easily repaired. This investment theme has led Andersen, who founded and runs money manager Andersen Capital Management, to Arch Coal (ARCH).

The coal producer exited bankruptcy in October 2016 and effectively has no debt, with the bankruptcy clearing about $5 billion in liabilities from its balance sheet. Previous to the Chapter 11 filing, Arch had made debt-fueled acquisitions. Then coal prices fell, and bankruptcy followed. Those debt payments did it in, and "Arch got ahead of its skis," Andersen notes.

Arch shares closed Friday at $81.61 down from around $101, a 52-week high, in March. Late last month the stock fell when it announced first-quarter earnings per share that were below expectations.

Andersen says the miss in one quarter's profits doesn't detract from earnings improvements seen since the bankruptcy or from Arch's attractive longer-term macro fundamentals. It produces both metallurgical coal—high-quality coking coal used in steel-making—as well as thermal coal used by utilities for electricity generation.

Andersen expects Arch to benefit from its balance sheet—one of the strongest in the industry—and its status as a low-cost coal producer, with mines in Appalachia, Wyoming, and Colorado.

While some investors shy away from coal, given its declining importance in domestic power generation, continued global growth, particularly in China and emerging markets, remains a support to coal use in general and prices. The World Steel Association, meanwhile, expects tonnage production to grow a robust 6% this year.

Energy prices go up and down over the years, but prices for the various grades of coal in general are higher since early 2016. For example, coking coal—this year expected to account for more than half of Arch Coal's earnings before interest, taxes, depreciation, and amortization—is about $180 per metric ton, compared with below $100 more than two years ago.

Arch shares trade at a relatively low multiple, about eight times analyst expectations of $10.16 in earnings per share this year. The stock offers a 2% dividend yield, and the company's much improved capital structure since the bankruptcy has allowed it to buy back $341 million in stock. Shares outstanding have dropped by almost 20% since the stock was relisted in October 2016, to 20.6 million shares.

Future coal demand looks to be favorable for Arch, Andersen says. From here, the money manager sees 25% upside over the next couple of years as foreign demand for U.S. coking coal, in particular, is generally expected to grow about 3% annually over the next eight years or so.

Arch has one more advantage it didn't have in 2016: The Trump administration is decidedly friendlier to the industry than the previous one. Higher coal prices are good for Arch, but low interest expenses mean Arch can weather volatility, and it makes for a better outlook. After the recent drop, Arch shares deserve a look.

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