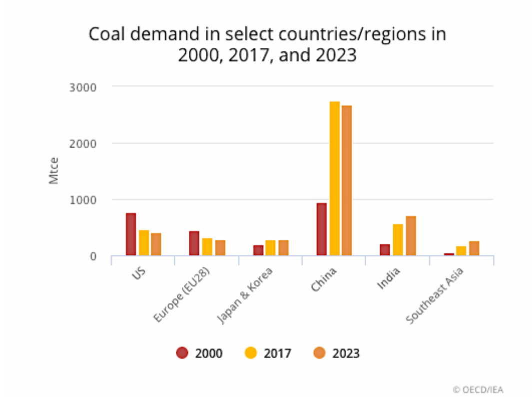
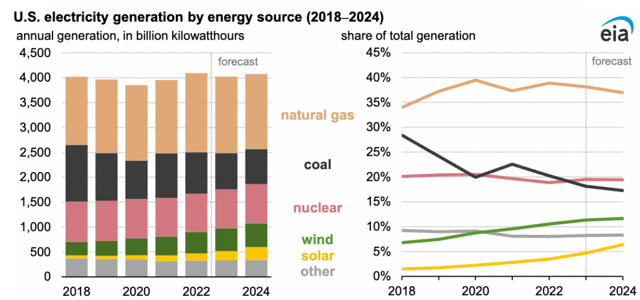
Overview

Energy is the cheapest sector in the S&P 500 relative to earnings, even lower than financials. Amongst the energy names, there's one sector that remains supremely cheap - coal. $BTU is a contrarian and emerging markets investment.

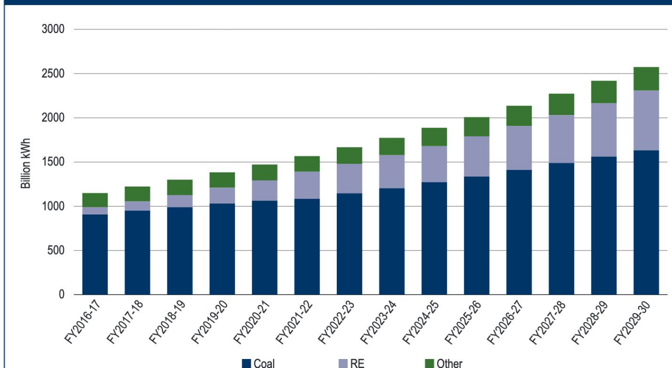


Isn't coal going away? Yes it is, particularly in the US, and potentially in the long run throughout the world. To be fair to coal though, the US still consumes a whole lot, enough to be 20% of total electricity production for the worlds largest economy, and while the US isn't growing its consumption, the rest of the world is in a very unique way, with total coal consumption re-accelerating and hitting record consumption in 2022 for the first time since 2013. Coal could be powering your EV right now. But ultimately, coal is an emerging markets story, and when we get to the financials of $BTU later in this writing, the investment may make more sense.



Coal hit record high consumption in 2022, the previous record wasn't 2019 or 2021, it was 2013. This leads us to believe that while coal prices have pulled back from their record highs in mid-2022 (as has $BTU stock), they will remain elevated above their 5 year average ex-2022 levels. This is a quote from the most recent $BTU earnings call on the demand picture: "India too has shown signs of improving economic activity (in Q1 + few weeks in April), resulting in increased power demand and elevated coal imports, despite an increase in domestic production. Overall demand for seaborn coal remains robust, and supply remains constrained across the globe. However we acknowledge that lower natural gas prices and higher coal inventories in Europe are short term headwinds." Coal prices fell a lot in early 2023 but have stabilized since, still well above normal levels, and underlying demand remains strong. In February, China lifted its ban on Australian coal imports (BTU has mines in the US and Australia), which had been in place since October 2020 to help support their domestic production while covid was taking an impact. In both China and India, coal accounts for over half of total electricity production.

Figure 11: Projected end-use electricity generation in India, by technology



Details of assumptions for the 2030 projection are given in the appendix. The calculation of aggregate electricity demand in 2030 comes from a study by Sahli Ali[30] at Brookings India.

No one wants to invest in coal. It's what Santa gives to naughty children. But capitalism exists, and because we've gone so far to moralize the issue and divest from these critical natural resources which keep the lights on in your local hospital and charge your EV, the companies have had no choice but to prioritize their shareholders and engage in capital return programs.

Valuation & Capital Returns

Peabody Energy ($BTU) trades at just over 2x earnings, trailing earnings. While their earnings can be volatile and hard to predict in the short run due to the nature of commodities markets, Wallstreet expects Q2 earnings to be higher than Q1 despite a fall in the price of coal. BTU's US mines produced 31% more EBITDA (they used EBITDA on the call) in Q1 vs Q4 despite the challenging market conditions. They continue to benefit from the rolloff of lower priced contracts that were used as hedges prior to the massive spike in prices and re-acceleration of coal demand. BTU is sold out on coal for the remainder of the year. For BTU specifically, Q2 is expected to produce more cash than Q1 in part because Q1 will be their lowest production quarter of the year since they pulled forward maintenance projects allowing them to increase production and transportation for the remainder of the year. Nonetheless, they made $268.5m in net income which is their lowest in the recent 4 quarters, in part reflecting a recent fall in coal prices and lower production. That's slightly less than 3x earnings.

$BTU has approved authorization to purchase over 33% of its current market cap at the time of this writing, and intends to return 65% of free cash flow to shareholders from here on out. They have negative net debt: $1.3b in Cash, $2.3b in Current Assets, $30m in Short Term and Current Portion Long Term Debt, $622M in Current Liabilities, and $332m in Long Term Debt. Comparing their most recent balance sheet with their current market cap, BTU trades roughly *10% below book value* (assets - liabilities). This is the best balance sheet in the industry.

Assets - Liabilities = Book Value
$5.6b - $2.3b = $3.3b
Market Cap = $2.95b

Street '23 Expected Earnings = $1b

Cash Flow Evaluation

For BTU it's not just a solid balance sheet. It's solid cash flow and earnings, 65% of which is going to be returned to shareholders after April's capital return program announcement (and retroactively to the start of 2023). After all, the world is transitioning to renewable energy, why invest back into the business? $BTU is now a shareholder cash generating machine (which is ultimately what every stock is supposed to be, but few are priced to be especially in the current environment) at the lowest rung of pricing in the stock market. Don't feel bad, Warren Buffet is aggressively buying OXY, and that's just one level above.

However, no stock is without risks. A stock like BTU has inherent volatility due to the nature of inconsistent commodities markets. However, due to the fundamentals underlying the coal market, it's reasonable to assume that coal prices will remain elevated above their long run averages as coal consumption returns to new records not seen since 2023, and is projected to continue growing. The economic signs point to this. China has recently lifted its ban on Australian coal for the first time since 2020. India, despite increasing domestic production, is also increasing coal imports. India's coal consumption is expected to continue to grow for many years to come. While it's nearly impossible to predict what the exact coal prices will be in the years ahead, these signs, in addition with the re-acceleration in coal consumption, indicate that consumption will remain strong, supporting elevated longer run prices above historical prices.

Even if coal prices were to return to normal price levels, which I view as unlikely but possible, BTU can remain profitable. BTU's Newcastle/Thermal coal break even price is $50-55 per ton. We haven't seen a price that low since the lows of covid, before China banned Australian coal imports, which they have undone recently. BTU expects its coking coal break even price to *decline* to $135-$145 per ton. Pre-pandemic prices were comfortably above these levels, although have dipped below for short periods of time in the past, posing potential risks and volatility to the stock. I must reiterate though, at those times, coal consumption's record was seen in 2013. The future is uncertain, but given the re-acceleration in coal consumption to new record highs not seen since 2013, the lifting of Australian coal imports by China, and the growth in Indian coal imports despite an increase in domestic consumption, it appears the economic forces point to continued strength in coal demand and BTU's healthy profitability for many years to come.

Conclusion

According to their last earnings conference call, BTU's new capital return plan is to begin by prioritizing share buybacks and then as the share outstanding decreases, eventually increase both fixed and variable dividends to a dividend to buyback ratio of something like 50/50. This will shrink the amount of shares that dividends will be paid out on, and then maximize the cash flow remaining shareholders can receive. This is the ideal plan for patient shareholders who want cash flow and a return on investment. Cash flow has some volatility in it, but after a fall in coal prices, $BTU was able to produce over $268m in Q1 They're expected to produce more than that in Q2. 65% of that free cash flow is going to be returned to shareholders from here on out. Coal demand and BTU's profitability looks to remain strong for years to come and Coal is the cheapest area of the stock market, with $BTU being the best stock in that space. $PBR paid out over 50% in dividends last year. This kind of thing that isn't seen anywhere else in the stock market can happen when ESG things get involved.

While it is true the world is transitioning to renewable energy, when we look under the hood, we can see that both coal *consumption* and coal *prices* hit a *record high* in 2022. That was not after a previous record hit in 2021 or even 2019. It was a record last hit in 2013, and is a trend that is expected to continue.