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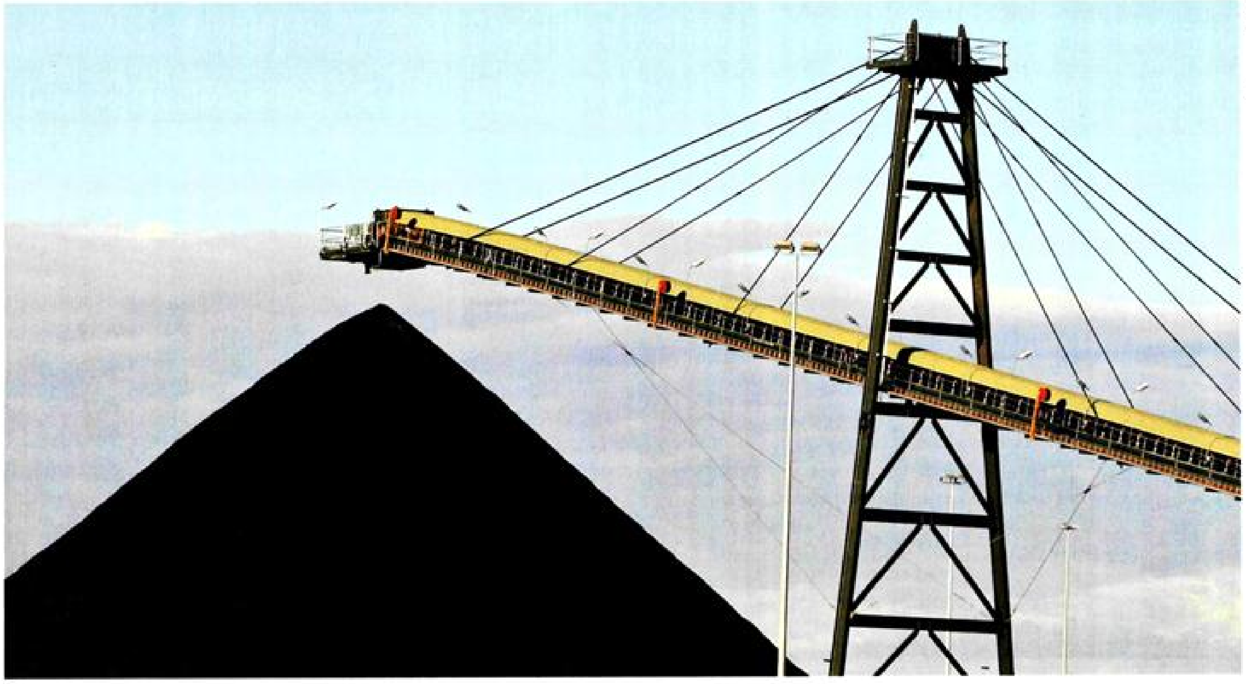
INVESTORS COLD ON COAL

SA's 'black gold' has lost its sheen with the operating environment even threatening to drive investments to neighbouring Mozambique and Botswana. Sharda Naidoo assesses the investment prospects.



Picture: 123rf

WITH FORWARD EARNINGS multiples of around seven, you would think investors would be rushing to plough into coal majors. But SA's "black gold"appears to have lost its investment sheen for now, degrading from "brilliant" to "okay" on the market's screen.

Share prices of coal stocks have been falling in the past few months (see graph page 31) as foreign investors, gobsmacked by the global market convulsions, dump this "risky" asset.

"Black gold is not as sexy, well, for now at least," says Keith Mclachlan of Thebe Stockbrokers. "The blue chips in energy have come off in a big way because of contagion in developed markets, despite growing demand from Asia."

SA has one of the richest coal deposits in the world and about 40-50 years of supplies at current rates of extraction. In 2009, this energy-producing commodity, according to the Chamber of Mines, became SA's largest mining activity, raking R65bn in revenue compared with gold's R49bn. SA's coal reserves now rank as the world's fourth-largest with 30,4bn tonnes, and SA is the seventh-biggest producer at at 250,6-million tonnes per annum (Mt/year). However, government-induced uncertainty, inadequate rail and ports infrastructure and a fluctuating rand have scared off investors and left operators disinclined to put more money at risk.

"SA is being left behind in coal development and investment," says McCloskey Group founder Gerard McCloskey. "Coal needs a czar in SA."

Some of the SA's largest coal producers such as **BHP Billiton Export Coal, Anglo Coal** and **Rio Tinto** recently erected for-sale boards on some of their undeveloped low-grade thermal coal prospects. They prefer to focus on higher-margin export coal and move away from low-margin Eskom contracts for thermal coal.

South African coal has been in high demand from Asia as it is central to infrastructure and economic development. China has become a net importer of coal, and India now accounts for fully one third of all shipments purchased through

COAL MINERS

Notes:
- SA Coal has been excluded due to limited share trading liquidity
- Hwange has been excluded due to limited share trading liquidity & high political risk in Zimbabwe, though it has performed pretty well on a rebased share price basis

Source: I-Net Bridge

Richards Bay Coal Terminal (RBCT). The low-grade steaming coal is being gobbled up by India's rapid expansion of its coal-fired energy infrastructure and demand is expected to last for at least another decade. "That is why Eskom (the biggest buyer of lower-grade thermal coal) has expressed concern about South African coal companies exporting lower quality thermal coal to India," says Momentum Asset Management's Sholto Dolamo. "Security of supply becomes an issue for Eskom if it is competing with India."

Eskom and the government are now talking of export bans on coal to ensure the power utility has sufficient material for its plants. Coal production, according to the soon-to-be-released SA Coal Road Map, will need to increase by 3,5% a year to meet Eskom's energy needs. The map also entails ramping up export capacity to 91Mt/year. That, however, will require a further R100bn in capex investment by coal majors in SA.

Mining is a long-term investment with many risks, so investors need to hunt for higher returns. "But for that to happen Eskom would have to incentivise coal companies on prices," says Dolamo. "The reality now is even if these coal exporters wanted to export higher quantities, they can't because of infrastructure constraints."

Export capacity is tightly limited because coal producers are so dependent on Transnet for moving bulk coal, mostly from mines in Mpumalanga and Limpopo to RBCT and other ports. RBCT has capacity to move 91Mt/year, but only about 63Mt/year is shipped out.

"South Africa's infrastructure is collapsing," McCloskey told investors and government officials at a recent mining conference. "The country is forgoing an opportunity to have India and China underwrite its coal mine and logistics capital."

Transnet has indicated that it is engaged in expansion activities, but public-private partnerships between the parastatal and miners may be necessary to ensure that capacity is increased to the desired levels.

McCloskey adds: "It would be galling if the [investment] action in southern Africa is not in South Africa, but rather in Mozambique and Botswana".

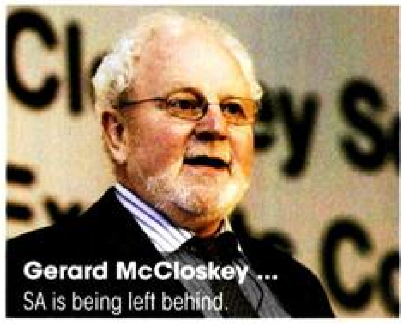
Mozambique is enjoying a coal mining renaissance, with global miners such as Rio Tinto and **Vale** investing in rail and port infrastructure there rather than in SA to export their products. The governments of Botswana and Mozambique are also in advanced talks about developing a southern African super-rail network to challenge Transnet's monopoly and enable SA's coal producers to divert their exports through Maputo.

> "Black gold is not as sexy, well, for now at least. The blue chips in energy have come off in a big way"

Eskom is the biggest buyer of lower-grade thermal coal. The problem is the power utility pays substantially lower than the $103/t companies fetch through RBCT. Eskom's prices vary from contract to contract, with some companies being paid less than what it costs them to dig the coal from the ground.

Some of the older contracts, for example, are under water. Take **Optimum Coal**, which has been bought out by global diversified commodities trader **Glencore** and is likely to be delisted soon. It has a 20-year contract that was negotiated several years ago and is now selling at a loss to the power stations (because the company's costs have escalated), while competitors such as **Exxaro**, which have newer contracts, are profitable. Exxaro is the primary supplier of coal to Eskom with a 40-year contract. The prices the companies negotiate with Eskom over long-term contracts are crucial in informing their future profits and capex.

Despite the risks and foreigners off-loading coal stocks, some fund managers believe there is a compelling argument for the long-term investment prospects of coal. "Yes, there are global jitters and risks, and the likes of Anglo American and BHP Billiton are being sold down," says Dolamo. "But coal miners are profitable and are trading at low PE ratios, creating buying opportunities."



Gerard McCloskey ... SA is being left behind.

So, where do the opportunities lie in this bearish market? All the large companies, including the shareholders of RBCT, are solid. Investors should seek companies with larger exposure to the export market that can deliver superior returns and dividend yields over the long term.

Of the coal majors, fund managers like diversified miners such as Anglo (see table page 32), which is trading on a forward PE of 7,6, BHP (7,4) and Exxaro (7,9). "Provided commodity prices continue at current levels, these companies should be

Pure Coal Plays	Current Price	Market Cap (Rm)	PE	Forward PE	Dividend Yield
Exxaro	R180,78	64 838	10,1	7,9	3,3%
Optimum	R35, 01	8 815	17,4	8,6	0,9%
Sentula	195c	1 144	12,1	not available	0,0%
Keaton	245c	420	23,8	not available	0,0%
Hwange	345c	350	115,0	not available	0,0%
Coal of Africa	635c	3 886	-2,2	-5,0	0,0%
Wescoal	72c	120	-2,8	not available	0,0%
SACMH	27c	122	-30,7	not available	0,0%

Other coal miners	Current price	Market cap (Rm)	PE	Forward PE	Dividend yield	
Anglo American	R311,98	418 969	8,5	7,6	1,5%	Diversified miner, Coal contributed 15% to FY2010 group operating profit
BHP Billiton	R248,50	530 842	8,2	7,4	2,8%	Diversified miner, Coal contributed 12% to FY2011 group operating profit

Source: I-Net Bridge

cash flush. If the rand remains around R8,20/ dollar or weakens, they should generate a lot more cash, especially as they expand," says Dolamo.

Glencore, because of its shareholding in Optimum Coal, which has 8Mt/year of export capacity through RBCT, and **Xstrata**, which is growing export volumes with **African Rainbow Minerals** locally, can be tapped into through the London Stock Exchange.

"Exposure to the export market is where investors can get attractive margins of up to 30%. If you want exposure to a commodity that will increase in price over time, then the diversified energy globals and coal majors in SA are cheap now and could pay off handsomely over the next five years," says Dolamo.

Coal of Africa, listed in SA, the UK and Australia, could also be a good bet as it is the only significant local producer of coking coal. "If you want to spice up your portfolio, I would consider Coal of Africa. Its mines are still under development, but once they are in full production mode it will fly. But you have to be mindful of the many environmental concerns," adds Dolama. Investors can also get exposure in coking coal through BHP and Anglo, which is growing production of this high-grade coal in Australia.

The darling of the coal producers in SA is diversified miner Exxaro, which also has base metals, mineral sands and industrial minerals assets. Exxaro, in which Anglo American has a 10% stake, is the second-biggest coal producer in SA, with its coal business offering operating margins of 28%. "It has become the best coal asset in SA," says Mclachlan. "It has big reserves in Limpopo and Waterberg. It is a proactive company; it's been investing and improving its operations with expansions on the horizon." It has also increased its exports, with coal contributing 60% of group revenue and nearly all of its net operating profit in the first six months of 2011.

On the thermal coal front, Dolamo says the bigger companies could cash in provided there is no further underdelivery from rail at RBCT. "Things look quite positive from an annualised run rate. The bigger guys are also a lot more defensive and they protect you if things fall out of bed in the global economy. Their prices already factor in a slower Europe."

While some juniors such as **Wescoal** and **Keaton Energy**, which recently bought Leo Mining with RBCT allocations, might look cheap and ripe for the picking, Mclachlan believes it will be counter-intuitive to buy the small caps when you can buy a major such as Exarro on a better forward PE.

Mining consultant Xavier Repost agrees: "They're still good in terms of value, but I wouldn't consider them good buys now. If something happens to our coal prices, they wouldn't survive."

THE INVESTMENT CASE

Exxaro

The diversified miner has a strong pipeline of projects in SA, Namibia, China and Australia where exploration activities at a coking coal resource look promising.

Locally, it intends becoming the country's top coal producer by 2018. It has already pumped a large amount of capital to ensure it can meet its agreement to supply coal to Eskom's new Medupi power station for the next 40 years. It has set aside R9,5bn in capital expenditure to expand the Grootgeluk mine and build two new coal beneficiation plants on site.

These coal reserves in the Waterberg basin could produce good margins, especially if Eskom's plans for future developments in the area – as well as those to develop sites for independent power producers – take off.

The group has also formed a joint venture with **Sasol** to build a new coal mine in the area to supply Sasol's planned Mafutha coal-to-liquids project. Its fortunes will depend largely on how coal prices play out.

Exxaro is also developing its own energy portfolio, potentially to be housed in a separate company. It is looking at the feasibility of building power-generation capacity and is investigating co-generation and renewable energy projects. Its first project, expected in early 2012, will be the construction of a small plant at its Namakwa Sands operation. It has also submitted a proposal for its own 600MW coal-fired power station in the Waterberg.

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Anglo Coal

Anglo Coal is the world's sixth-largest private sector coal producer and exporter, with operations in SA, Australia, South America and Canada. In SA, it owns and operates eight sites. It has a 50% interest in the Mafube colliery, while four operations are in the Witbank coalfield and supply about 22Mt/year of thermal coal to the export and local markets. In addition, the New Vaal, New Denmark and Kriel mines supply 35Mt/year of thermal coal to Eskom. Its Isibonelo operation produces 5Mt/year for Sasol Synthetic Fuels under a 20-year supply contract.

Anglo Coal routes nearly all its export coal through RBCT, in which it holds a 27% interest. For the year to June 30 2011, export thermal coal production increased by 5% in SA.

There are other big revenue spinners on the horizon. It is doing feasibility studies on a thermal coal mine, New Largo, in Mpumalanga. It is also ramping up production to about 3Mt/year for export from Zibulo. In Australia, it is developing a number of coking coal projects. The plan is to double coking coal production by 2020, from about 15Mt/year now.

BHP Billiton

It is growing both thermal and coking in Australia, so South African investors will still get exposure to the profits. It will also be almost doubling coking coal production from around 30Mt/year now to about just under 70Mt/year by 2020. There are also major expansions on the go in South America, Mexico, and New South Wales.

BHP Billiton Energy Coal South Africa, 100%-owned by BHP, produces energy coal for the local and export markets from three main operations: Khutala Colliery, Klipspruit Colliery and Middelburg Mine Services, located in the coalfields of Mpumalanga. For the year ending June 2011, operating profit increased 62% to $32bn, with coal recording strong results.

Coal of Africa

This producer of coking coal has been plagued by controversy over environmental concerns at the Vele Colliery in SA, which is close to a Unesco World Heritage Site. But it now plans to raise about $100m in a placing to bring the Vele project into production and complete the acquisition of Rio Tinto's Chapudi Coal project.

It expects to produce its first coking coal from Vele in the first quarter of 2012, ramping up to an initial target of 1Mt/ year. IM