Pressure On Margins Of Coal Mining Companies Due To Decreasing Coal Price But Offset By Rising Domestic Demand

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PEFINDO views that the rising domestic demand should mitigate the impact of world's lower demand to the Indonesia's coal producers. Domestic demand will be derived mainly from the operation of several delayed power plant projects as well as the Government's plan related with the fast track program of 10,000 MW phase two, of which, 30.7% is a coal-based power plant. The Government's decision to ban the export of mineral ore starting 2014 under the Ministry of Energy and Mineral Resources regulation No.7/2012 has also resulted higher demand of coal for its coal-fired power plant for the smelting process. Based on data from the Ministry of Energy and Mineral Resources, domestic coal demand is expected to reach approximately 85 million tons in 2013 and around 200 million by 2025. Moreover, we also view Indonesia as the country with the lowest cost of production of coal in the world with its open-pit mining as an advantage during falling coal prices and rising production cost. As a comparison, up to September 2012 (9M2012), the production cost of PT Bukit Asam Tbk (PTBA) is approximately around USD47.8 per ton, lower than China's Yanzhou Coal Mining Co. Ltd at around USD53.7 per ton.

The Decreasing Global Coal Price Puts Pressure On Margins Of Coal Mining Companies

Despite the strong domestic demand, overall demand is expected to remain sluggish in the short term, in line with the global economy outlook, especially from the United States and Europe, and also the economic slowdown from both China and India as the world's largest coal consumer. The United States has become one of the major coal exporters, especially since it has discovered cheap shale gas and uses it to run the power plant. This has resulted in an excess stock of coal in the United States, and therefore the majority of coal producers in the country are focusing on export markets. In our opinion, the oversupply and lack of demand are two major factors that drove the coal price to fall in 2012. Based on data from *Bloomberg*, the price of Bituminous coal (high rank coal of 6,600kcal/kg) at the beginning of 2012 was still in the range of USD118 per ton, now, the price has declined 23.4% to USD91.1 per ton (January 25, 2013) and it even has reached as low as USD78.1 per ton (October 19, 2012), the lowest in over two years. Higher demand in Europe during winter has pushed the coal price to around USD90 by the end of 2012 till the beginning of 2013, however, it will not last long since the winter season will soon be over. We view that the possibility for the price to rebound back at its peak at around USD100 per ton will remain difficult in the near to medium term, given the emergence of new coal exporting countries, such as the United States and Mongolia, and also considering China's excess supply of coal given the higher production in the country.

Majority of the coal mining producers in Indonesia in the third quarter of 2012 (3Q2012) experienced a decreased gross profit margin due to higher production cost and lower average selling price. From eleven coal mining companies that we analyzed, we noted that the increase of average production cost was higher than the average sales itself. The average production cost increased by 21.9% year on year (y-y) in 3Q2012, while average sales only increased by 2.7% y-y. The increase of production cost was mainly due to higher stripping ratio and the increase in coal transportation.

Table 1. Gross Profit Margin of coal mining companies in third quarter 2012

Company	Gross Profit Margin		Changes
	3Q2012	3Q2011	
Adaro Energy	31.3%	34.9%	-3.6%
Atlas Resources	8.5%	24.2%	-15.7%
Berau Coal	31.9%	41.3%	-9.4%
Bumi Resources	27.1%	38.4%	-11.3%
Bayan Resource	18.5%	30.3%	-11.8%
Indo Tambangraya Megah	32.7%	36.8%	-4.1%
Tambang Barubara Bukit Asam	44.9%	51.3%	-6.4%
Harum Energy	32.3%	41.4%	-9.1%
Toba Bara Sejahtera	16.4%	42.6%	-26.2%
Borneo Lumbung Energi	41.5%	58.5%	-16.9%
Resource Alam Indonesia	33.1%	41.1%	-8.0%
Average	**28.9%**	**40.1%**	**-11.1**

Source: Financial Statement September 30, 2012, processed by PEFINDO

We view that the company's ability to manage its cost in the context of weakening global coal price will be a key to the company's credit quality going forward. However, we also believe that the ability of companies to reduce or cut its cost substantially is limited as stripping ratio, labor costs, and royalties are likely to keep rising in the medium term, and are mostly beyond companies' control. In our opinion, the current situation faced by the coal industry will impact more on the small-sized coal mining companies or new large-sized coal mining companies in the industry due to the below-economic-scale production. This can be seen from the company's gross profit margin of a new coal mine which tends to be thin such as PT Atlas Resources Tbk (ARII; $_{id}$A /Stable) and PT Toba Bara Sejahtera Tbk (TOBA) at 8.5% and 16.4%, respectively in 9M2012.

We view that volume growth could mitigate such pressures on margins, but it will also require large capital spending. Our assessment of the management teams' risk appetite and approach to capital investments if such challenging operating conditions persist will therefore also be critical to the current credit profiles of these companies.

High Absorption Of Domestic Market Obligation (DMO) Could Mitigate Volatility Of Global Coal Price In Domestic Market

In our opinion, the low selling price of coal will have more impact on exports rather than domestic consumption. However, demand for coal for domestic needs highly depends on the coal-fired power plant projects, which are being undertaken by *PT Perusahaan Listrik Negara* (PPLN; $_{id}$AA+/Stable). Under the Ministry of Finance Decree No. 909K/30/DJB/2012, the Government has reduced its DMO target in 2012 from 82.1 million tons to 67.3 million tons, representing 20.5% of the total national production of 328.5 million tons. The lower target is due to less absorption of domestic coal requirement to date since there are delayed in operations for some of PPLN's power plant project. As a result, it is necessary to revise the DMO target to avoid further losses experienced by the coal mining companies. Up to October 2012, the actual absorption was only 6.3% of the planned total national coal production. PPLN is the largest coal absorber at 55.3% followed by independent power producers (23.7%), cement industry (12.5%), textile (2.9%), and fertilizers (1.9%). Under the Ministry of Finance Decree No. 2934K/30/MEM/2012, the Government has set a DMO of 74.3 million tons in 2013, which represents 20.3% of the nation's total coal production with PPLN still being the largest absorber at 66.3% or 49.3 million tons, increased by 32.6% compared to 2012.

Table 2. Realized and planned DMO (2011 – 2013)

In million tons	2011	2012E	2013E
Coal Production	326.7	328.5	366.0
Planned DMO	60.2	67.3	74.3
Realized DMO	65.5	20.8*	-
[%] DMO	**18.4%**	**20.5%**	**20.3%**

Source: Ministry of Energy and Mineral Resources, Director General of Minerals and Coal
** Up to October 2012 E: Estimated*

We estimate that the domestic demand for coal will continue to increase following the operation of several delayed power plant projects under PPLN's fast track program phase one as well as the Government's plan related with the fast track program of 10,000 MW phase two, of which, 30.7% is a coal-based power plant. Based on data from PPLN, around 58% of fuel mix for power generation will come from coal by 2019. We view that this could be a positive signal for the coal mining producers, particularly the ones that already have established domestic market, such as PT Adaro Energy Tbk (ADRO) and PT Bukit Asam Tbk (PTBA). However, the development of the coal-fired power plant usually takes long period of time to complete and operate, and therefore significant improvement in the cash flows may not be realized in the near term.