

ASX Coals: coal price changes

Higher costs balance material coal price increases

- **We prefer thermal coal** — We have increased our price forecasts for thermal coal by between 13% and 45% over our new 10-year forecast and lift coking coal by an average of 15% over a similar period. Our LT thermal and coking forecasts have risen 17% to US\$105/t and US\$200/t, respectively.
- **Strong A\$ is hurting short term** — In addition to increases coal prices, Citi has lifted currency assumptions for the A\$/US\$, which offsets near and medium-term earnings to a degree. A\$ strength peaks in 2012 at 1.06 and our long-term forecast of 0.80 applies from 2017.
- **Costs are also on the rise** — In our recent note, *ASX Coals: rising cash costs*, we examined the trend in cash costs for ASX-listed coals and concluded ~15% CAGR in costs over the past 6 years. Given the pace of cost increases in the industry is driven by strong demand for coal, we believe it is logical to increase costs also as markets are forecast to remain tight over the next decade. Consequently, we increase cost inflation to 5-10% over the period, believing costs will continue to grow, albeit at a slower pace.
- **Carbon tax impact** — We now include the impact of the proposed carbon tax in our models, assuming A\$26/t of CO₂e. For our companies, this equates to between A\$1.50 and A\$2.50/t additional cost above and beyond inflationary pressures with C&A the most exposed. We estimate this is equivalent to a reduction in NPV of up to 4%.
- **Preferred names** — In order of preference, our preferred coal names are Whitehaven, Resource Generation and New Hope. Whitehaven has a growing profile in thermal coal and in our opinion is still a strong M&A candidate. Resource Generation is heavily discounted versus peers and offers exposure to a large, long-life asset. New Hope features strong management who has shown itself adept at cost and margin control.

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Ticker	Rating		Target Price		Current Year Earnings Estimates		Next Year Earnings Estimates	
	Old	New	Old	New	Old	New	Old	New
CNA.AX	2M	1M	A\$125.00	A\$130.00	A\$8.32	A\$7.66	A\$8.68	A\$8.70
COK.AX	1H	1H	A\$0.65	A\$0.70	A\$-0.01	A\$-0.01	A\$0.01	A\$0.01
MCC.AX	3M	3M	A\$11.00	A\$10.50	A¢67.2	A¢66.9	A¢83.1	A¢83.1
NHC.AX	2M	1M	A\$5.60	A\$6.00	A\$0.19	A\$0.18	A\$0.33	A\$0.34
RES.AX	1S	1S	A\$1.40	A\$1.50	A\$-0.02	A\$-0.02	A\$-0.02	A\$-0.02
WEC.AX	1H	1H	A\$4.10	A\$4.30	A\$-0.09	A\$-0.09	A\$0.00	A\$-0.04
WHC.AX	1M	1M	A\$7.00	A\$7.00	A¢17.8	A¢17.8	A¢42.0	A¢36.1

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Coal price changes

The demand for coal from the energy and steel sectors appears to be unrelenting and is likely to keep coal prices elevated for the foreseeable future. With large parts of the industry handicapped by infrastructure constraints, it's being left up to too few producers to meet the strong demand from developing economies. This will leave the coal market exposed to sudden price spikes and a new premium on supply as disruptions become common place.

Despite the modest outlook for advanced economies, we think that the strong EM growth should keep global growth buoyant, at 3-4% this year and 2012, and even higher thereafter – well above the long-run norm of just below 3% YoY.

We have increased our price forecasts for thermal coal by between 13-45% over our new 10 year forecast (Figure 1). Thermal coal's share of the electricity generating capacity is rising, not only Japan and Germany (after the nuclear crisis in March) but also in developing economies. China and India are becoming significant importers as domestic production in both countries lags behind demand.

As developing economies (outside of China) boost steel consumption over the next decade, demand for premium hard coking coal will remain strong. With new sources of supply scarce, we believe HCC prices have permanently jumped up to a new level. Therefore we have increased our forecasts of prices in 2014-2018 by an average of 15% (Figure 1).

We have raised our **LT thermal coal price to \$105/t** based on rampant (and permanent) cost inflation. Our new **LT HCC price of \$200/t** reflects our views that the industry's high margins (~50%) are here to stay as a lack of new supply creates a high barrier to entry. For semi-soft coking and PCI coal, we have increased our **LT prices to US\$150/t and US\$160/t**, respectively (Figure 1). In addition, we have rebased our LT time frame so that our new price forecasts apply 10 years forward rather than 5 years as previously forecast.

We refer readers to Citi's major coal report, *Bulk Commodities: No more tough times for the Coal Miner's Daughter*, dated 4 July 2011 for a full analysis of global coal markets.

Figure 1. Coal price forecasts

	2009	2010	2011e	2012e	2013e	2014e	2015e	2016e	2017e	2018e	2019e	2020e	LT
Hard Coking	172.3	190.5	293.8	275.0	247.5	240.0	230.0	215.0	235.0	250.0	245.0	242.5	200.0
Semi soft	116.3	139.3	220.8	194.8	165.0	160.0	148.4	143.3	156.7	166.7	163.3	161.7	150.0
Thermal	83.8	91.0	122.0	139.0	148.0	152.3	145.5	139.3	141.8	150.5	149.3	140.5	160.0
LV-PCI	128.8	144.3	228.1	197.5	167.7	162.6	150.9	182.7	187.3	192.0	196.8	201.7	105.0
A\$/US	0.74	0.88	0.99	1.06	1.00	0.93	0.90	0.84	0.80	0.80	0.80	0.80	0.80

Source: Citi Investment Research and Analysis

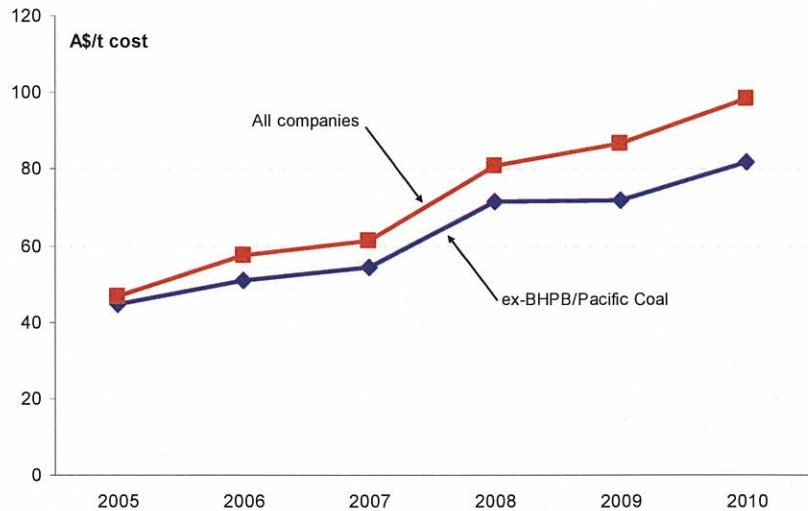
Material changes to ASX coals

Given Citi's new coal price deck and revised LT timetable, we have made material changes to our coal company earnings forecasts and valuations. In particular, the period previously assigned to the LT i.e. from 2016 onward, has a slower fade to LT prices beginning 2021, which has a strong positive impact on NPV estimates.

Our revised earnings and valuations are a result of competing effects:

- **Positives:** prices across all years & extension of the LT to 2021
- **Negatives:** stronger A\$/US\$ up to 1.09 & higher costs

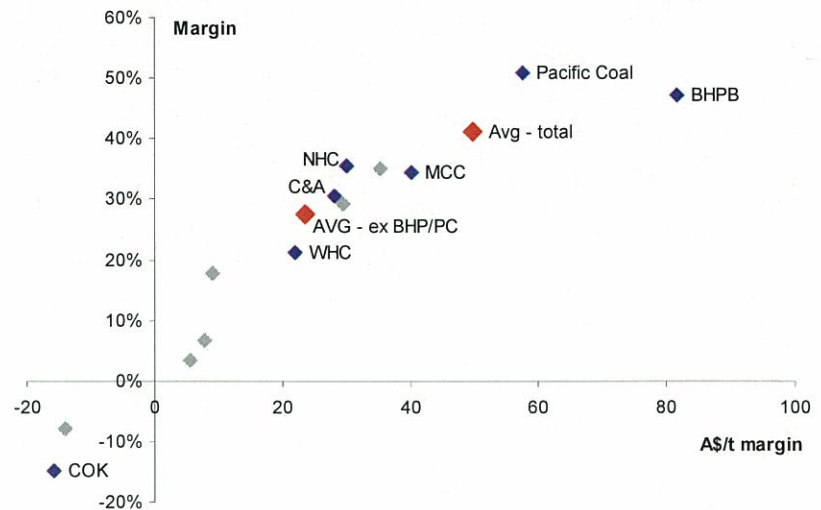
Figure 2. Average ASX coal company cash costs



Source: Citi Investment Research and Analysis

On the issue of costs, we have increased our expectations for all companies. In our recent note, *ASX Coals: rising cash costs*, we analyzed the cost structure of ASX-listed producers over the period 2005-2010 and concluded that on average, cash costs had risen ~15% p.a. (Figure 2).

Figure 3. Average cash margins, 2005-10



Source: Citi Investment Research and Analysis

This is largely a function of the strong global demand for commodities that has led to, amongst other things, higher input costs (e.g. tyres, explosives, fuel), power, labour and infrastructure costs. Other factors include structural changes to the industry, such as higher strip ratios, that are not reversible. Nevertheless, EBITDA margins have been healthy to say the least with an average of ~30% (Figure 3).

Given our continued bullish outlook for bulk commodities, we believe it is reasonable to assume that cost pressures will continue to be an important factor for the coal industry. While we do not envisage continued growth at 15% p.a. we believe ~5% p.a. is more reasonable than previous inflation assumptions of 2.5%.

Carbon tax impact included now in our models

With details of the proposed carbon tax to be released on 10 July 2011, we include an additional cost for Australian mines of up to A\$2.50/t. We assume a flat levy of A\$26/t of CO₂e and apply this rate to data published by producing companies. Of the independents, C&A has the most intensive emissions profile with almost 2.5Mt of CO₂e over 25Mt sales (10% basis) in 2010. An A\$26/t carbon price equates to ~A\$2.50/t for the company.

The carbon tax represents another impost on the Australian coal industry, which appears to be the country's highest taxed mining sector. Aside from corporate tax, coal royalties of up to 10% apply and additional costs are looming with the proposed MRRT and carbon tax. In Figure 4, we show the estimated NPV impact of the new carbon tax on applicable coal companies under our coverage. **The effect on valuation is 2-4%.**

Figure 4. Effect of carbon tax on ASX coal company NPV

Company	NPV impact		
	A\$m	A\$/sh	%
C&A	444	5.13	4%
COK	27	0.03	4%
MCC	92	0.31	3%
NHC	81	0.10	2%
WHC	81	0.16	3%

Source: Citi Investment Research and Analysis

Earnings Changes

Earnings changes for ASX coals under our coverage are shown in Figure 5. The uplift in earnings is lower than might be expected over the next 18 months as there has been a large increase in currency forecasts and cost inflation. However, by 2013E, higher coal prices begin to win out over costs and earnings grow.

Figure 5. Earnings revisions

EPS (A¢/sh)	2011E			2012E			2013E		
	Old	New	%chg	Old	New	%chg	Old	New	%chg
CNA.AU	832.0	766.0	-8%	868.2	870.0	3%	863.3	1099.0	27%
COK.AU	-0.6	-0.7	-23%	1.2	0.9	-24%	0.8	0.9	7%
MCC.AU	67.2	66.9	0%	83.1	83.1	0%	83.9	75.5	-10%
NHC.AU	19.0	17.8	-5%	32.9	34.2	4%	43.0	50.9	18%
RES.AU	-2.5	-1.6	34%	-2.4	-2.3	6%	-6.2	-8.0	-30%
WEC.AU	-8.8	-8.9	-1%	-0.1	-4.3	n.m.	11.4	9.5	-17%
WHC.AU	17.8	17.8	0%	42.0	36.1	-14%	48.9	48.7	-0%

Source: Citi Investment Research and Analysis

Valuation Changes

NPV changes as a result of new coal prices are shown in Figure 6.

Figure 6. NPV changes

	Old	New	%chg
CNA.AU	120.00	128.87	7%
COK.AU	0.66	0.72	9%
MCC.AU	10.86	10.48	-3%
NHC.AU	5.81	6.02	4%
RES.AU	1.93	2.04	6%
WEC.AU	8.55	8.69	2%
WHC.AU	5.28	6.35	20%

Source: Citi Investment Research and Analysis

Recommendation Changes

Higher coal prices lead us to upgrade two companies whose main exposure is to thermal coal:

- **C&A:** upgrade to Buy from Hold and A\$130 target
- **New Hope:** upgrade to Buy from Hold and A\$6.00 target

Both companies are significantly off their highs and, while there may be some short-term weakness around results, both offer good long-term thermal coal exposure and growth. Our current preference is New Hope over C&A, which we think has better newsflow in the short term.

Order of preference

While our recommendations are heavily skewed to Buy, we have distinct preferences amongst ASX coals under our coverage. In order, they are:

- **WHC (1M):** the pick of the larger miners. Growth in thermal coal and still a strong candidate for M&A in our view.
- **RES (1S)** trades at a large discount to the sector but the best of the emerging coal companies. RES has a project of scale and a team that can deliver it.
- **NHC (1M):** quality management operates well in an environment of high cost pressures
- **C&A (1M):** we see a weak Q and 1H versus consensus, so downgrades may be coming. Long-term growth and tier 1 assets are attractive at the current price.
- **COK (1H)** has struggled of late as funding concerns grow. Shares have been marked down to below replacement value of assets that include 1.5Bt coal resource and 3.5Mtpa port access.
- **WEC (1H)** is range bound at current low share price until management proves the technology works. We believe progress is being made but the market is understandably cautious.
- **MCC (3M):** our only Sell for the coals. Cost pressures are particularly high in our view as Middlemount ramps-up and Coppabella/Moorvale look to be past their prime.

Coal prices and currency: New Hope's earnings are sensitive to the price of thermal coal and differences versus our coal price assumptions are a risk to our earnings forecast.

Should the risks above be more positive or negative than we have anticipated, the stock could trade above/below our target price.

Resource Generation

Company description

RES is a 'concept coal' company with assets in the Waterberg region of South Africa. The main development is the Boikarebelo project. It has 3Bt of coal resources and 745Mt of reserves. RES initially plans an open pit producing c6Mtpa of washed coal with a 50:50 split between domestic and export .

Investment strategy

We rate RES shares as Buy/Speculative. RES is very high risk but potentially a highly rewarding prospect. The company has a huge resource position in the mainly untapped Waterbank coal region of South Africa. Its resource base, build out of domestic South African power capacity and demand for coal from emerging markets such as India is likely to see RES evolve into a 6mtpa coal producer.

Valuation

Our target price of \$1.50/share is set as a 75% risk weighting to our NPV of \$2.04 per share. Our NPV is based on DCF analysis using a 14.5% discount rate and a US\$105/t long term thermal coal price. We believe a 75% risk weighting to our NPV is appropriate given the early stage of the project as well as the infrastructure barriers that need to be overcome.

Risks

We rate RES as a Speculative risk given the non producing nature of its assets. Key risks to achieving our target price are as follows:

Commodity price: Coal prices have become more volatile over the past 5 years as the historically bulk traded market has moved to a more terminal market approach. At the same time China has been swinging from importers to exporters to importers of coal which has had a significant effect on the supply-demand balance of the seaborne market. Given the big coal resources that China has, there is always the risk that it could increase domestic production and turn again to a net exporter of coal, having a negative influence on the coal price.

Rail: RES's coal assets are located in the Waterberg region of South Africa. The region is not as well serviced by infrastructure as the coal fields of the Witbank are.

Political Risk: South Africa has had a revolution in its minerals industry in the past decade with the implementation of Black Economic Empowerment.

If the impact on the company from any of these factors proves to be greater than we anticipate, the stock will likely have difficulty achieving our target price. However, should they be less than anticipated, the stock could trade above our target price.