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US coal producers hit by weak coal demand and low natural gas price

by Victor Liu

The US coal producers have been struggling for a few years and have performed even worse over the last year. In fact, most of the main players in this industry are already in financial distress. Alpha Natural Resources witnessed a drop in stock price by more than 80% and has announced plans to negotiate its August debt payment; Arch Coal has been talking about a bond exchange in order to reduce its debt burden; and Patriot Coal, which was also a major player in the industry, filed for chapter 11 bankruptcy protection this May. The US coal industry has taken a battering mainly due to two factors: the Chinese economic slowdown and the plunge in the natural gas price.

As the world's largest coal importer, China accounts for more than 49% of global coal consumption. Mistakenly expecting the demand by China for more coal for power plants and steel-making, big US producers had raised lots of debt in the past few years to buy coal capacity to feed the demand. However, China's energy consumption has grown at its slowest pace last year since 1990, as it planned to switch its economic focus from the heavy manufacturing industry to the service industry. The slowdown in demand for coal used in heavy industry has cut back on the amount of coal imported and the resultant coal supply glut has weighed on the coal price. The left part of Figure 1 shows the slump in the coal price, which has hurt the profitability of the coal producers.

The other reason for the worsening US coal industry lies in the sliding natural gas price. The great American shale gas revolution since 2008 has made the natural gas production increase significantly and, in turn, pushed the price of natural gas down to a historically low price range, as shown in the right part of Figure 1. The price further declined along with the oil slump from the second half of 2014. The long-lasting low price of natural gas has motivated many US power-plant operators to switch from coal to natural gas, as natural gas emits 45% less carbon dioxide than coal and delivers higher thermal efficiency. According to the US Energy Information Administration (EIA), coal accounted for 48% of US electricity generation by fuel and natural gas accounted for 21% in 2008, whereas in 2014, coal accounted for 39% and natural gas accounted for 27%, respectively. The trend of decreasing coal usage has hit the business development for US coal miners, and they are likely to suffer more if the Clean Power Plan, President Obama's plan to reduce carbon emissions by 30% below the 2005 level by 2030, is successfully implemented later in 2015.

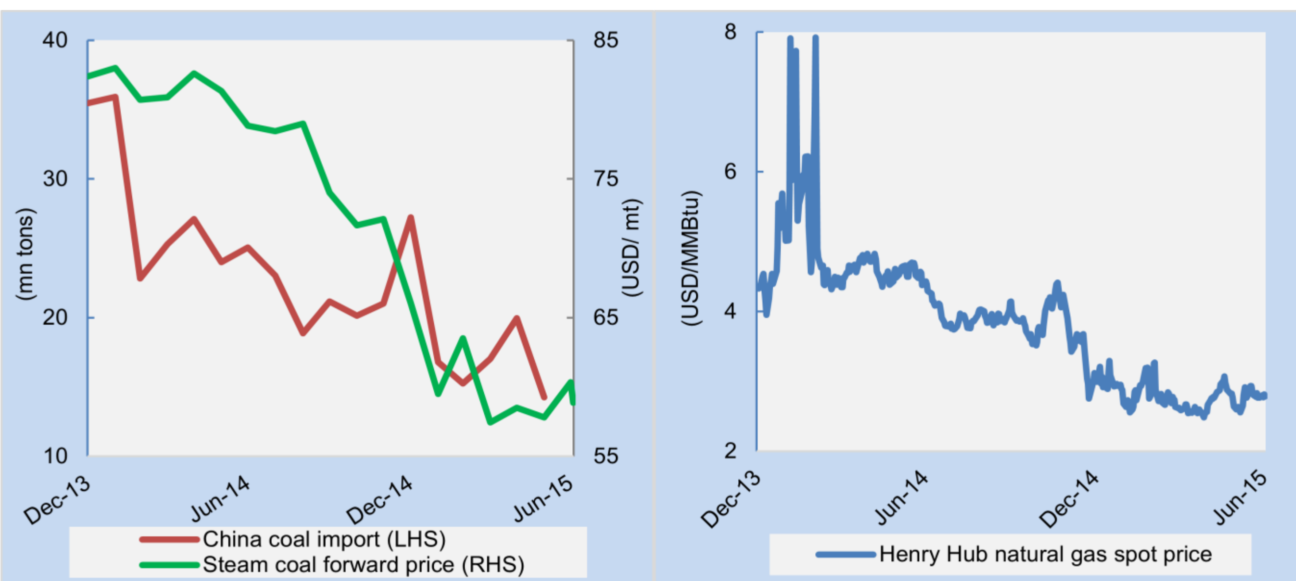

Figure 1: China coal import, first year generic CIF ARA steam coal forward price and Henry Hub natural gas spot price. *Source: Bloomberg*

The RMI aggregate 1-year Probability of Default (PD), a simple median of 12 US coal miners, reflects those firms' financial challenges. As Figure 2 shows, the RMI aggregate 1-year PD increased to 181bps on Jul 3, 2015 from 2bps on Jun 30, 2014, while the US coal stock market index dropped by 66% during the same period.

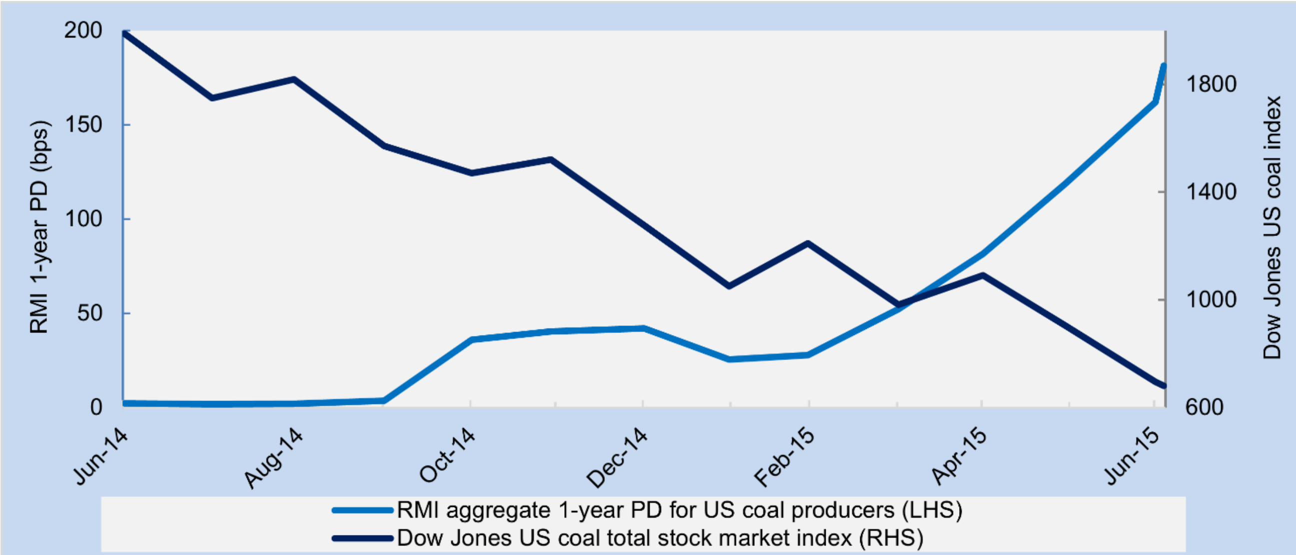

Figure 2: RMI 1-year aggregate PD for 12 US coal producers vs. Dow Jones US coal total stock market index. *Source: Risk Management Institute, Bloomberg*

From a firm-specific perspective, it is also noteworthy that the RMI 1-year PD for Peabody Energy, the industry leader in the US coal sector, surged to 1,320bps on Jul 3, 2015 from 13bps on Jun 30, 2014, in tandem with an 88% drop in its market cap of USD 4bn. The financial figures in Table 1 shed some light on the financial difficulties faced by Peabody. In the first quarter of 2015, Peabody saw a year-on-year decline in its revenue and profitability and a sharp increase in its leverage ratio. The company has recently announced its plan for job-cutting and sale of assets to improve its liquidity and credit profile.

	Q1 2014	Q1 2015
Revenue (USD mn)	1,627	1,538
Net income margin	-3%	-11%
Total debt / total equity	149%	255%

Table 1: Financial data for Peabody Energy Corp. *Source: Bloomberg*

The China economic slowdown and the lower price of natural gas have both caused the US coal producers to suffer from financial distress. The outlook for these firms remains uncertain in an environment of volatile crude oil and natural gas prices as well as uneven global economic growth.

Credit News

Indonesian government appeals against Bakrie Telecom debt restructuring

Jul 3. Indonesia's communications ministry has appealed to the country's Supreme Court against PT Bakrie Telecom Tbk's debt restructuring on Jul 3. The company said that 94.5% of its creditors had approved its proposal, however some of its bondholders said they were excluded from the process. According to the lawyer representing investors, the restructuring plan would be considered void and the company would be placed into bankruptcy and liquidated if the Supreme Court overturns the Jakarta court decision. Besides, Bakrie Telecom owes license and frequency rights fees to the government. However, the government was not informed during the restructuring process. (Straits Times)

Regulators warn banks on loans to oil, gas producers

Jul 2. US regulators are currently raising an alert on banks' unhealthy exposure to oil-and-gas producers. The Federal Reserve claims that banks are issuing a large number of loans to these companies, which are of questionable credit quality. This move further worsens the challenges faced by the oil and gas companies, as they are already struggling with high debt loads, along with lower prices for their production of oil and natural gas. Regulations have forced banks to be strict with their credit loans to these companies, despite the banks' attempts to be lenient with troubled energy companies, in order to avoid triggering their default and bankruptcy filing. (WSJ)

RBI, government in discussions for recapitalization of banks

Jul 2. India's central bank is in talks with the government over recapitalization of public sector banks (PSBs). Reserve Bank Governor Raghurum Rajan said that the central bank is considering handing out more capital to clean the balance sheet of PSBs and relieve their financial stress. The central bank also promised to work with PSBs to ensure early recognition and intervention of asset quality problems. With regard to the transmission of policy rate by banks, due to the competition from the money market, the banks' ability to retain profits has been hindered. (PTI)

Tough outlook for China's mid-tier banks after rate cuts

Jul 1. Chinese mid-sized banks are in a hurry to attract funds from depositors as the central bank had announced on Jun 28 that it was reducing its 1-year deposit and lending rate to 2% and 4.85%, respectively. In addition, competition from trust and wealth management companies in attracting funds are likely to affect the banks' net interest income. As competition for funds heats up, smaller banks have been shifting towards more risky activities by lending more to micro enterprises and agricultural businesses. (Business Times)

Puerto Rico power company avoids default with USD 415mn bond payment

Jul 1. Puerto Rico's power authority (Prepa) avoided default on Jun 1 by making a USD 415mn bond payment partly financed by insurers that backed the bonds, but creditors cautioned they would take legal action if restructuring negotiations with the utility over its USD 9bn debt deteriorate further. According to a statement of bondholders, the restructuring agreement must be completed by Sep 1. The restructuring talks are seen as a gauge of whether the US commonwealth can fix other broken public entities as it tries to climb out of a USD 73bn debt hole. (Guardian)

Macedonian central bank sees no new steps to protect banks from Greek impact (TODAY)

Tighter credit oversight of S-REITS is credit positive (Moody's)

China's central bank to provide liquidity to help stabilize stock market (WSJ)

Regulatory updates

BIS proposes to revise the current CVA framework

Jul 1. The Basel Committee on Banking Supervision is proposing to revise the current CVA framework. The new framework accounts for the exposure component of CVA risk along with its associated hedges in the capital charge. This provides a better alignment of the economic risk and capital charge for CVA, as well as reduces incentive for banks to leave some of their risk unhedged. Second, the new framework attempts to harmonize the practices used by institutions with industry practices for accounting purposes. Thirdly, the new CVA framework revision aims to make the computation approach more consistent with the revised market risk framework. This leads to a more coherent framework for CVA, through improving the alignment of regulatory treatment of CVA with banks' risk management practices. (BIS)

New ECB approach to bank risks may lead to higher capital rules

Jun 30. The European Central Bank's new approach to capital thresholds may lead to stricter requirements for some Italian lenders. The ECB is drawing up capital requirements tailored to individual banks, an exercise known as the Supervisory Review and Evaluation Process (SREP). Some banks may see a need to recapitalize once the ECB completes the process by October this year. Italian banks have been struggling with EUR 192bnb of non-performing loans, most of which went bad during the last three years. (Bloomberg)

US Comptroller's Office sees increasing credit risk in banking sector

Jun 30. The semi-annual report, released by the Office of the Comptroller of the Currency (OCC), warns emerging risk in the US banking sector. In face of increasing competition, many banks were compelled to ease lending and underwriting policies, especially for auto, business and commercial real-estate loans. The report said that the office would continue monitoring other incipient credit risks in the sector, including potential losses banks could face from the oil and gas industry, which is paring production in response to falling prices. Despite the mostly unfavorable observations, the agency also reported some positive news: banks had fewer unresolved regulatory issues, and measures of bad loans are approaching low levels seen before the recession. (WSJ)

EU watchdog imposes its first fine on rating agency DBRS (Reuters)

EU bank resolution agencies get more discretion from EBA (Bloomberg)

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