



# A Brief Reprieve for Coal

While the resurgence of coal prices in 2016 may have provided a temporary relief for struggling operators, it's likely we haven't seen the last restructuring if regional government policies hold and prices maintain their current trajectory.

It was not that long ago that the coal industry in Asia Pacific experienced one of the worst commodity routs of recent times. As the Chinese economy slowed, the highs of 2011 for both thermal and coking coal plummeted leaving producers facing a harsh new reality. Debt-laden coal companies across Asia Pacific buckled under the pressure of sustained low prices with many major producers forced to restructure to survive. Berau Coal, Bumi Resources, Mongolian Mining, Hidili, E-Commodities Holdings (f.k.a Winsway Enterprises Holdings) and Cockatoo Coal were just some of the numerous names affected.

In early 2016, thermal coal and coking coal were trading at around USD\$50 and USD\$80 per metric tonne respectively, a far cry away from the glory days of the mining boom. At its peak in 2011, coal commanded upwards of USD\$100 for thermal and USD\$300 for coking coal.

For some producers, spot prices for coal dipped below their respective cost curves forcing them to often trade at losses (given significant take-or-pay obligations relating to associated infrastructure) and look to significantly reduce operating costs, defer capital expenditure and/or mothball or shut down mines. This environment only exacerbated matters for companies that had expanded too quickly on the back of easy credit and subsequently found themselves saddled with substantial debt burdens. At best, producers were looking to survive.

However, a combination of supply side reforms in China, increased demand from China's steel industry and production disruptions in Australia, drove a spectacular comeback for coal prices in 2016. By year end (2016), coal was one of the best performing commodities with spot prices up 186 percent for thermal coal<sup>1</sup> and 292 percent for coking coal<sup>2</sup> from the start of the year (refer to Figure 1). Comparatively, the S&P WCI Asia TR Index, which reflects a basket of commodities in Asia Pacific, was only up 22.77 percent in 2016 (albeit after three straight years of double-digit declines).

While the appreciation of coal prices in the second half of 2016 may have helped to alleviate some of the pressures on coal operators in the region, the outlook for the industry will likely be heavily influenced by the future direction coal dependent economies, including China, India and Japan, choose to pursue.

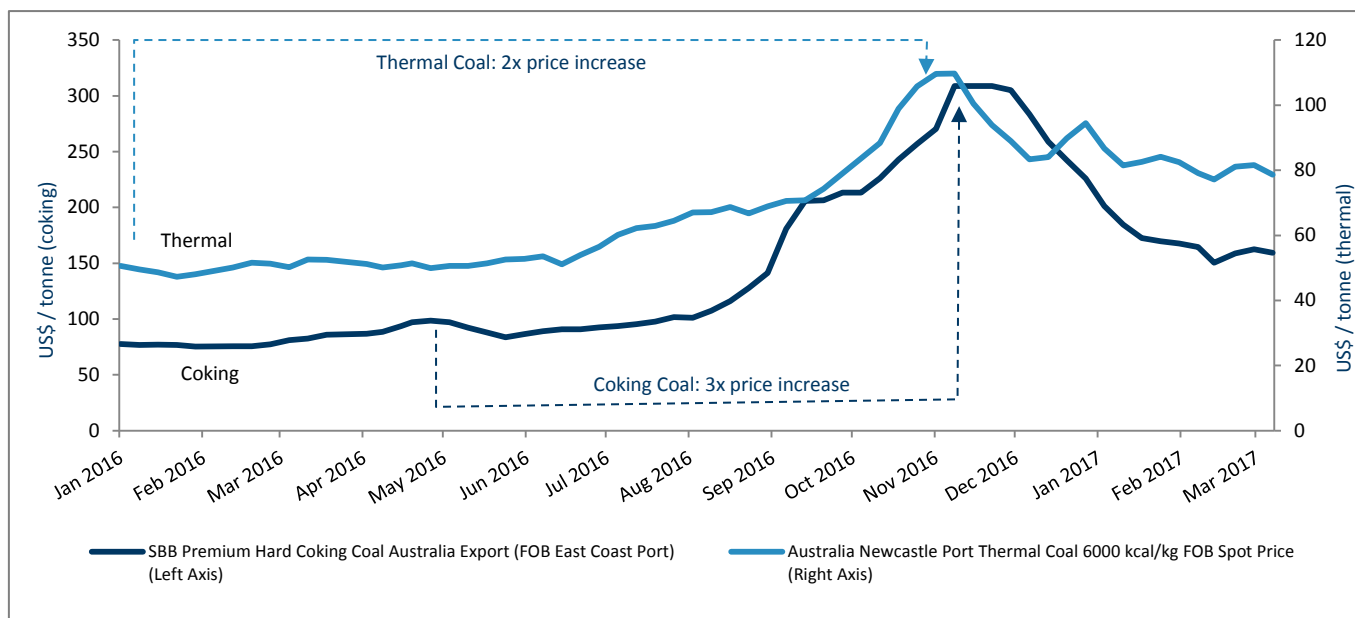
## A Raft of Coal Restructurings

As the price of coal dipped to unprecedented lows, operators that had funded rapid expansion from cheap funding (China development banks alone have provided c.USD\$30 billion in financing for coal projects worldwide in recent years), found themselves with significant debt obligations and upcoming maturities that they could not afford to service in the recent price climate. As such, the appointment of legal, financial and specialist

<sup>1</sup> Australia Newcastle Port Thermal Coal 6000 kcal/kg FOB

<sup>2</sup> SBB Premium Hard Coking Coal Australia Export (FOB East Coast Port)

Figure 1: Historical coal prices



Source: Bloomberg

restructuring advisors became increasingly common among the struggling operators across Indonesia, China and Australia.

Bumi Resources and Berau Coal, two of the major thermal coal producers in Indonesia, were forced to restructure their balance sheets and resolve in excess of USD\$3 billion of maturing debt obligations by undertaking debt for equity swaps and applying term outs to remaining debt balances (with creditor approval still to be finalised).

In China, hard coking coal producer E-Commodities Holdings (f.k.a. Winsway Enterprises Holdings) restructured outstanding debt with a mix of cash, equity and contingent value rights (“CVR”) implemented via schemes of arrangement in Hong Kong and the British Virgin Islands as debt was reduced from c.USD\$500 million to c.USD\$170 million.

Two Australian producers, Baralaba Coal (f.k.a Cockatoo Coal) and Bandanna Energy were both at the mercy of their creditors with their operations placed in the hands of voluntary administrators and/or receivers. While Baralaba emerged from a successful restructure implemented by way of a deed of company arrangement, Bandanna was not as fortunate, being placed in liquidation, its assets sold and the company eventually delisted from the ASX.

Despite having successfully negotiated favourable lending terms and take-or-pay contracts with coal producers, local media reported that senior lenders to infrastructure asset Wiggins Island Coal Export Terminal in Australia (WICET) became jittery over the company’s ability to service and ultimately repay c.USD\$3 billion in debt used to fund construction in late 2011. To this day, talks between lenders and the company are continuing.

## A Welcome Spark for Coal

Not surprisingly when China, the world’s largest producer and consumer of coal, decided to tackle domestic overcapacity and production inefficiency in the coal sector, it had ramifications for the entire regional industry.

Domestic measures included mandated mine closures and the implementation of restrictions on the number of days many coal mines were allowed to operate (decreasing from 330 to 276 days). Consequently, the short term supply constraint shifted the domestic focus to the seaborne market to satisfy demand.

Magnifying Chinese supply side measures were production disruptions in Australia including weather-induced outages, industrial action and other production issues. Finally, also fueling the uptick in prices was an increase in demand from China’s steel industry as producers looked to restock inventories and growth in construction continued.

These factors culminated in coking coal spot prices reaching USD\$311 per metric tonne in November 2016<sup>3</sup> — nearly three times the price of April 2016 (see Figure 1). Thermal coal behaved similarly, increasing two-fold from the beginning of the year reaching USD\$110 per metric tonne around the same time (see Figure 1).

Unfortunately for producers however, the November peaks did not last for long. In response to the spike in prices, the Chinese government relaxed its earlier implemented production caps on domestic coal production. And as Australian production issues abated, coal prices retreated to close out 2016.

<sup>3</sup> The Australia Government: Office of the Chief Economist – Resources and Energy Quarterly

## The Year Ahead

With prices continuing on their downward trajectory in the first quarter of 2017, many analysts believe that the surge in the second half of 2016 may have only been temporary relief for producers.

Both thermal and coking coal prices are down roughly 30 percent and 50 percent respectively on peak prices in 2016, highlighting significant price volatility whilst underscoring the difficulty facing those tasked with development and operational planning in what is a capital intensive industry.



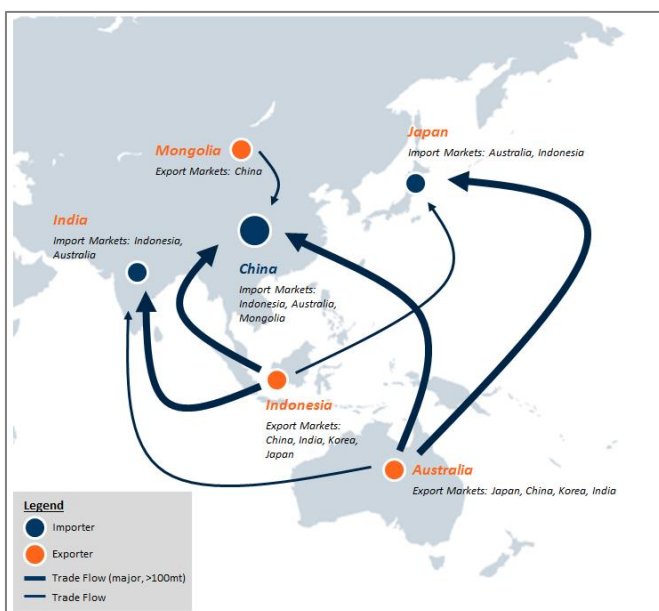
The November highs did not last for long... coal prices retreated to close out 2016.



The fortunes of coal producers in Asia Pacific, particularly those in Australia and Indonesia, are tied to the economic activity in and policy decisions of China, India, and Japan. The prospects for coal and the direction of trade flows will be determined by the success of domestic reforms relating to coal producers being implemented in the two most influential economies when it comes to regional supply and demand, specifically China and India.

In China, the government hopes to streamline the industry by pursuing: consolidation in the sector (driven by the restructuring of SOE's); capacity rationalisation; and reducing inefficiencies. Meanwhile in India, coal production is being ramped up to meet ambitious energy self-sufficiency goals.

**Figure 2: Trading flows of the major coal-dependent economies in Asia Pacific**



Source: FTI Analysis

## China's Long Term Direction

Despite relaxing some of its supply side reform policies towards the end of 2016, China remains focused on streamlining the domestic coal industry and pushing the renewable energy agenda.

According to the National Development and Reform Commission ("NDRC"), there are plans to cut at least 800 million tonnes of 'outdated' and inefficient coal capacity, which will be partially offset by adding 500 million tonnes of 'advanced' capacity. A recently announced directive from the NDRC to cancel the building of more than 100 coal-fired plants eliminating more than 120 gigawatts of future coal-fired capacity is evidence of the intent to follow through on their intentions. Despite these cuts, the NDRC has targeted output of 3.9 billion tonnes by 2020<sup>4</sup>, up from output of 3.75 billion tonnes in 2015.

As the world's biggest emitter of greenhouse gasses, China's vision of cutting carbon emissions and reducing its carbon footprint is no easy task. With coal accounting for around 75 percent<sup>5</sup> of China's total electricity production (in 2012), reducing coal's dominance as the primary source of energy will no doubt face major political scrutiny, however the government appears to remain focused on investing in renewable energy sources (such as solar and wind), aiming to spend at least USD\$360 billion on renewable power sources through 2020<sup>6</sup>.

While China's agenda may be considered by some as a step in the right direction, it faces the challenging task of balancing long-term environmental targets with energy price volatility, a key theme to look for in 2017.

Furthermore, recent announcements by the NDRC which suggest a move to more selective reform measures for the industry may not be the news reformists want to hear. Energy prices are clearly still a concern for the Chinese central government.

## India's Focus on Energy Self-reliance

Against a backdrop of structural changes in China, many producers in both Australia and Indonesia are turning to India and its growing economy to fill the export gap.

Despite its abundant coal resources, India has traditionally been a major importer of coal from Indonesia and Australia for power generation purposes—imports account for around 20 percent of domestic demand. This may be set to change with India's recently published National Electricity Plan indicating that the government will significantly lower dependence on thermal coal imports over the next 3-5 years as part of a bid to become energy self-sufficient.

India's intention to eventually shift from a net importer to exporter of coal is a lofty one, requiring the country to restructure its inefficient coal mining sector and invest significantly in technology and transport infrastructure. This vision also hinges on

<sup>4</sup> <https://www.ft.com/content/3d9d0c78-ce7b-11e6-864f-20dcb35cede2>

<sup>5</sup> International Energy Outlook 2016  
<https://www.eia.gov/outlooks/ieo/electricity.cfm>

<sup>6</sup> China to plow \$361 billion into renewable fuel by 2020 (Thomson Reuters - <http://www.reuters.com/article/us-china-energy-renewables-idUSKBN14P06P>)

India's ability to meet domestic coal production capacity targets and ambitious goals for renewable energy generation.

Both Indonesian and Australian coal producers (which collectively made up around 85 percent of India's coal imports in 2015) are poised to suffer if this strategy eventuates and may have to look to other emerging markets in South East Asia to fill the potential export gap.

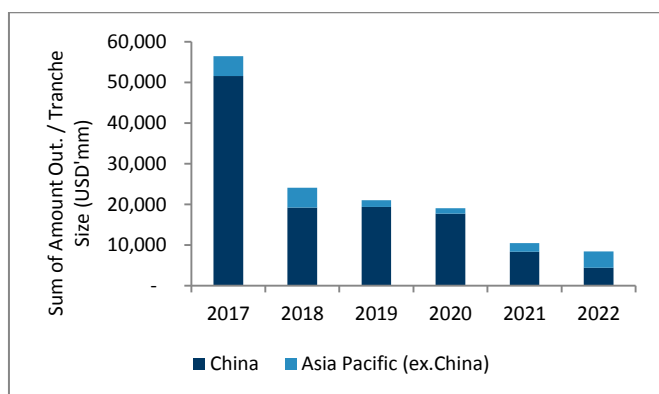
## Maturing Debt

In recent years, the increase in debt sourced by Asia Pacific coal producers has been to fund acquisitions as much as to drive organic growth. E-Commodities Holdings (f.k.a Winsway Coking Coal Holdings) saddled up on debt for its acquisition of the Grande Cache Coal mine in Canada before divesting the assets at a loss in 2015. Conversely, China Shenhua Energy has continued to develop coal-associated infrastructure assets including railways and ports. And now, the maturities of similar organic and external growth fueled debt obligations are coming into focus.

According to data obtained from Bloomberg, in excess of USD\$55 billion worth of loans and bonds issued by companies engaged in coal operations will mature in 2017 (unless otherwise extended),<sup>7</sup> of which a significant proportion of outstanding loans are linked to Chinese operators.<sup>8</sup>

While bond issuers across the region are likely to face redemption pressures over the next few years, it appears the Chinese government is playing a central role in easing pressures on its largest coal miners by extending maturity dates on debt and launching programmes pushing banks to swap debt for equity in corporates.

**Figure 3: Maturity profile of Loans and Bonds issued by coal operators over the next five years**



Source: Bloomberg Fixed Income Screen (accessed February 2017)

According to the *Financial Times*, The Shanxi province in China (one of China's most coal-dependent provinces), extended the maturity of up to RMB400 billion in loans as a result of the country's depressed coal sector.<sup>9</sup> While this may provide some

<sup>7</sup> Based on country of incorporation, includes Australia, China, Hong Kong, India, Indonesia and Singapore. Caymans and BVI; excludes government bonds. Figure includes amounts outstanding and tranche size

<sup>8</sup> Excludes government debt and debt information not captured by Bloomberg

<sup>9</sup> <https://www.ft.com/content/8b244b36-5d39-11e6-a72a-bd4bf1198c63>

breathing room over the short-term, it is unlikely to be the long-term solution required.

## What Happens Next?

A sustained higher price environment (similar to the price in late 2016) would allow coal producers to reopen mines, continue feasibility studies and restart expansion projects that had been deferred due to cost cuts. Higher prices will also mean a windfall for economies such as Australia and Indonesia where these exports heavily impact on their terms of trade and fiscal balances.

However should coal prices continue to decline to levels seen in the first half of 2016 as they are currently trending, further industry consolidation can be expected as companies seek efficiencies and cost savings to remain competitive. Previously restructured companies that have been banking on a return to higher coal prices will face significant uncertainty, and their lenders may not be willing to roll over or extend new facilities.

At lower price levels, many producers will be forced to either diversify or exit the industry if they are unable to achieve sustainable cost cuts and increase productivity. But while there are greater opportunities for producers in Asia to achieve such cost cuts (given Asia lags the West on continuous improvement techniques and cost management methods), the political agendas of regional governments may impact these opportunities.

Many uncertainties lie ahead over the next few years as China and India continue to drive the outlook for coal in the Asia Pacific region. China will need to balance its long-term political agendas (including meeting ambitious pollution targets and maintaining employment stability in key regional areas reliant on mining) whilst not impacting economic growth India meanwhile will need to drive domestic production to meet ambitious targets of energy self-reliance.

At the same time, sustained social pressures may continue the push of the renewable energy agenda. With technological advances and the support of government subsidies, biomass, wind and solar energies are becoming increasingly competitive and threaten to surpass fossil fuels as a cheaper source of energy. Bloomberg data shows that per-unit costs are already equivalent or even lower than the costs of coal in some countries (some solar power contracts are being tendered at below USD\$0.03 a kilowatt-hour today<sup>10</sup>— half the average global cost of coal power).

Ultimately, the recent spike in 2016 may only be a temporary reprieve providing some breathing room for struggling producers, with the road back to sustainable profits in the longer-term challenging. It would likely require sustained higher prices before producers consider progressing major projects and assessing their pipeline opportunities particularly given the associated infrastructure spend. Even in such a scenario some higher cost producers may still be unable to recover from previous debt binges. Needless to say, in 2017 it is unlikely the industry will go quietly into the night.

<sup>10</sup> <https://www.bloomberg.com/news/articles/2017-01-03/for-cheapest-power-on-earth-look-skyward-as-coal-falls-to-solar>

## How We Can Help?

The coal industry is facing significant challenges on account of market, regulatory, political and technological factors. Yet with these challenges come opportunities. FTI Consulting's Global Mining Advisory Practice and Energy Power and Products Practice provides a wide array of advisory services that address the strategic, financial, reputational, regulatory and legal needs of mining, energy and utility clients.

FTI Consulting's professionals have been involved in the largest recent restructurings of coal operators in Asia Pacific (including Mongolian Mining Corporation, PT Bumi Resources and Peabody Energy<sup>11</sup>) and globally (including Arch Coal, Patriot Coal, Peabody Energy and Walter Energy). With decades of proven mining experience backed by an extensive global network, our team of professionals brings key disciplines and local specialists together to ensure the right people are available when you need them.

To find out more about our service offerings please visit [here](#) or contact one of our experienced professionals below.

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<sup>11</sup> Australian operations

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