Warrior Met Coal Inc [NYSE:HCC] Initiate at BUY at 7.5% | PT: \$105.96

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CIMG Investment Research

A Hot Commodity Trading at a Steel

Warrior Met Coal Inc (NYSE: HCC) is a pure-play producer and exporter of metallurgical coal headquartered in Brookwood, AL. Metallurgical coal, or hard coking coal, is a critical component of steel production by metal manufacturers in Europe, South America, and Asia. HCC has two active mines in the Brookwood area, Mine No. 4 and Mine No. 7, that operate highly efficient longwall mining operations. Mine No. 7 features two longwalls and produces premium, Low Vol, steelmaking coal that results in price realizations near or above the S&P Global Platts Index. Mine No. 4 features a single longwall and produces High Vol A quality coal that typically trades at a more significant discount to the price of coal from Mine No. 7. To reduce costs, both mines are vertically integrated and feature their own preparation plant facilities and access points to rail lines. In addition to the two preexisting mines, HCC is also developing Blue Creek, a third longwall mine that sits on one of the few remaining untapped High Vol A steelmaking coal reserves in the U.S. Management estimates that continuous miner unit production will begin in Q3 2024, with longwall production expected to start in Q2 2026. Together, the coal from all mines is exported to a diversified customer base of blast furnace steel producers, primarily located in Europe, South America, and Asia. HCC has a shipping time and distance advantage serving customers throughout the Atlantic Basin compared to competitors in Australia and Canada, and its proximity to the primary export terminal in Mobile, AL, underpins a significant cost advantage over other domestic steelmaking coal producers.

Investment Thesis

High realized prices and operational efficiency result in industry-leading margins, and a clean balance sheet drives robust free cash flow generation. Warrior's "variablized" cost structure in labor, royalties, and logistics contracts varies in response to changes in spot prices, protecting through-the-cycle profitability. Royalties are calculated as a percentage of the realized price, and continuous miner unit usage can be adjusted in response to prices. This structure dramatically lowers the cash cost of sales if realized prices fall while effectively capping costs in higher-price environments, allowing HCC to generate meaningful operating cash flow. This cost structure allows Mine No. 4 and Mine No. 7 to produce significant output while remaining two of North America's lowest-cost steelmaking coal mines. Additionally, the mined coal is competitive in quality with the premium hard coking coal produced in Australia that is used to set industry pricing benchmarks, allowing Warrior to capture the highest price realization of any U.S. coal producer selling into the export market.

Downcycle investments into Blue Creek will yield massive returns amid a global steel shortage. In Q1 2022, Warrior announced the relaunch of the Blue Creek project. The Blue Creek mine sits on one of North America's largest untouched metallurgical coal reserves, with an estimated combined resource and reserve base of 119.3 million short tons. Furthermore, the mine will be vertically integrated, with its own built-belt conveyor system, which will lower operating costs and improve port transportation speeds. Relative to Mines No. 4 and No. 7, Blue Creek will provide an additional 50 years of operating life and increase yearly production capacity by 60% once the first longwall is completed in the second half of 2026. This added capacity will help Warrior maintain their status as the number one exporter of met coal in the United States (Top-10 globally). This excess supply will not go unused, with global demand for steel continuing to outpace supply. As developing Asian and African countries resume covid-paused infrastructure spending, Warrior's distance advantage allows them to supply the necessary materials to steelmaking plants abroad most effectively.

Industrials and Energy

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Figure 1: HCC 2 Year Stock Chart



Disciplined financial policy enforcement and expiring NOLs set the scene for future share buybacks when the cycle reverses. The ownership rights of Warrior Met Coal's two mines used to belong to Walter Energy, a Birmingham-headquartered subsidiary of KKR portfolio company Walter Industries. However, Walter Energy filed for Chapter 11 bankruptcy protection in 2016, and Warrior Met Coal, LCC., was created as an independent entity. After a certificate of conversion was filed in Delaware, newly named Warrior Met Coal, Inc. went public on April 19, 2017. As a result of the bankruptcy reorganization process, HCC inherited \$2.5 billion in net operating loss carryforwards (NOLs) from Walter Energy, Inc., that the company has been able to use to mitigate a significant portion of its income tax expense every guarter that they have been a publicly traded company. However, accepting this obligation severely limited HCC's options to return capital to shareholders. If the company were to buy back shares, it would increase its earnings per share, accelerating the utilization of NOLs by offsetting profits with reduced outstanding shares. In a commendable act of discipline, management continued to execute their dividend policy as their market capitalization was cut by nearly 70% in the pandemic, allowing them to utilize the entire face value of their NOLs (~\$2 billion over seven years). In the last year alone, HCC saved \$600 million in tax expenses from the NOLs, allowing them to fully fund their annual Blue Creek Capex with unpaid tax money. A \$0.05 guarterly dividend was established shortly after the IPO and has since risen to \$0.08, but the company frequently issues a sizable special dividend closer to \$1.00-\$2.00 per share. Unfortunately, HCC can't avoid the IRS forever and is set to run out of NOLs next quarter. Once free of the dividend burden, management has cited a willingness to incorporate buybacks into their shareholder capital allocation plan, especially when coal prices begin to fall. Considering their significant cash position, in an ultra-bear case scenario, when spot prices fall back to pandemic levels, causing a severe drop in share price, management has indicated its willingness to repurchase up to 30% of its market capitalization. Overall, Warrior's management has remained disciplined in returning significant amounts of excess cash to shareholders, a trend that will only continue as NOL expiration unlocks new levers for management to pull.

Valuation

To model HCC, we used a 30-year DCF with a 12% discount rate and no terminal value because metallurgical coal is a finite resource. We estimate a full peak-to-peak spot price cycle length to be around 15 years. Thus, we projected 30 years to include approximately two complete pricing cycles.

Company Overview

Warrior Met Coal Inc (NYSE: HCC) is a pure-play metallurgical coal producer and exporter headquartered in Brookwood, AL. They generate revenue from two segments: Coal sales, which account for roughly 98% of total revenues, and Other revenues, which include the sale of natural gas extracted as a byproduct from the coal mines, royalties from leased properties, the Blue Creek mine development, and changes in fair value of natural gas swap contracts. Warrior operates two active coal mines in Brookwood, AL, and exports their coal to end markets in Europe, South America, and Asia through the McDuffie Terminal at the Port of Mobile in Mobile, AL. The coal that Warrior produces contains very low sulfur, has strong coking properties, and is of comparable quality to coal referred to as "premium HCC" produced in Australia that serves as the benchmark for the S&P Global Platts PLV (Premium Low Vol) index, the flagship benchmark assessment of metallurgical coal spot prices. These similarities in quality allow HCC to realize prices near or above index spot prices. Over the last twelve months, the company's geographic customer mix was 48% in Europe, 29% in Asia, 21% in South America, and 2% in the United States. Noteworthy customers over that period were E-Commodities Holdings Private Limited, Salzgitter Flachstahl GMBH, and Exiros BV Sucursal Uruguay, who accounted for 14.9%, 12.4%, and 11.8% of total revenue respectively. Additionally, since February 2017, HCC has made arrangements with XCoal Energy & Resources to serve as XCoal's strategic partner for exports of low-volatility hard-coking coal. As a result of the arrangement, XCoal takes title to and markets coal that Warrior would have historically sold on the spot market in an amount of the greater of (i) 10% of HCC's total production during the period or (ii) 250,000 metric tons. All of Warrior's customers produce steel through the Blast Furnace-Basic Oxygen Furnace (BF-BOF) production method, which is the cheaper of the two methods of steelmaking.

Industry Overview

Metallurgical coal, also referred to as "met coal," "coking coal," or "coke," is a naturally occurring sedimentary rock that serves as an irreplaceable ingredient in BF-BOF steelmaking. Blast Furnace-Basic Oxygen Furnace, or BF-BOF steelmaking, is one of the two modern methods of steel production. In BF-BOF steelmaking, a combination of iron ore and limestone is heated in a blast furnace powered by coking coal to form iron. This iron is converted into scrap steel in a basic oxygen furnace, cast, and rolled into finished steel products. The other steelmaking method is through electric arc furnaces or EAF. This process takes existing scrap steel and recycles it into newly finished steel products through an electric arc furnace. This method is viewed as the most sustainable method of steel production. Still, it is very costly, eliminating it as a viable option for developing countries looking to obtain large quantities of steel, especially when energy is expensive. The United States is the only country in the world that has adopted EAF steelmaking as its primary source of steel (70% of steel production in 2023). High-quality steel is required to produce the key green technologies at the core of global decarbonization initiatives, including electric vehicles, wind turbines, and solar panels.