Rating Methodology for Coal Mining Companies*

Overview

Indonesia is the largest thermal coal exporter and the second largest coal exporter in the world. According to the Ministry of Energy and Mineral Resources (ESDM), the country is one of the fastest growing coal producers and consumers globally. In year 2013, Indonesia was the fourth largest producer of coal behind China, USA and Australia with a total production of 237.4 million tons (Source: British Petroleum's Statistical Review of World Energy, June 2014). Most of Indonesian coal is used for power generation. Some of the major players within the Indonesian coal mining space include PT Adaro Energy Tbk, PT Berau Coal Tbk, PT Bukit Asam Tbk, PT Bumi Resources Tbk, PT Indo Tambangraya Megah Tbk, and PT Kideco Jaya Agung.

The Coal business in Indonesia could be undermined by the overlap between the regulations laid down by ESDM and the Ministry of Forestry and between those stipulated by the central and local governments. Besides, the lengthy process of obtaining mining licenses and expansion permits could also impact coal mining operations adversely. As such, the coal industry in Indonesia requires greater clarity, certainty and consistency in regulations so as to be able to develop further and realize its potential.

Regulations apart, Indonesian coal mining industry is exposed to volatility in coal prices, which is largely a function of global demand–supply dynamics. Further, the industry has to contend with the risk arising from the limited infrastructure available to transport coal from the site to the seaport for export, or to stations of loading for supplies in the domestic market. Compliance with environment standards is another issue confronting the country's coal sector.

Analytical Framework

As in the case of other manufacturing companies, for coal companies too, the rating methodology employed by ICRA Indonesia involves an assessment of the business risks, financial risks, and management quality of the entity being rated. This note highlights the factors that are specifically evaluated while assessing the credit quality of a coal company. For analytical convenience, these factors may be grouped under the following heads:

- Industry Risk
- Issuer's Competitive Position
    - Operating Efficiency
    - Pricing Flexibility
    - Customer Diversification and Counterparty Risk
    - Reserve Replacement
    - Environmental Compliance
- Parent-Subsidiary Structure
- Financial Position
- Management Quality

Industry Risk

One of the key factors influencing the development of the coal industry in Indonesia is the regulatory framework. ICRA Indonesia believes that the current regulatory framework is somewhat lacking in consistency, marked by overlaps between certain regulatory measures. Besides, law enforcement is also considered weak.

According to the BP Review mentioned above, Indonesia has proven coal reserves of over 28.0 billion tons, or 3.1% of the world's total coal reserves. While ICRA Indonesia sees some business opportunities to export coal, governmental support through an improved regulatory framework is required.

Since 2009, the government has introduced various changes in the mining regulations including a ban on mineral-ore exports, introduced in January 2014 . The coal is not included in the same yet although there were plans to increase the royalties payable by a class of miners called IUP (Izin Usaha Pertambangan) that hold business license and are private entities. For the time being, however, the increase in royalty has been postponed on account of sub-optimal levels of coal prices that are already adversely impacting the sector. In short, the sector is being closely monitored and to a certain extent controlled by the government. Further there are directives on the quantity of production, to be reserved for domestic consumption. Thus it is necessary to evaluate constantly, the impact of changing regulations on the performance of coal mining companies.

With the gradual liberalisation of the Indonesian economy and increase in environmental awareness, changes in the regulatory environment are likely, and these can significantly impact the fundamentals of the existing coal companies. Already, the recent regulatory changes signal a movement towards market competition on the one hand and compliance with more stringent environmental norms on the other. ICRA Indonesia evaluates the likely impact of these changes on the competitive position of the issuer.

Issuer's Competitive Position

Operating Efficiency

In the coal sector, which like most other commodity sectors is faced with price volatility, the single most important factor that determines an issuer's competitive position is its cost structure. The cost structure, in turn, is dependent on several factors, the chief among which are discussed here.

Depth of coal reserves and coal quality: The depths at which the coal reserves are residing and the quality of coal have a significant impact on the cost structure of a coal company. For instance, certain regions may have coal seams closer to the surface and at a low gradient, whereas in the case of others, the coal seams may be residing at greater depth, with a steep gradient and also interspersed with geological faults. The extraction costs would be lower in case of the former. However, the cost disadvantage associated with extracting coal from seams located at greater depths may be offset by the superior quality of coal, which would fetch better realizations. ICRA Indonesia therefore analyses the relative costs and benefits associated with extraction.

Productivity parameters: While the depth of coal reserves and the ratio of open cast to underground mines are given for a company, at least in the medium term, the productivity of operations is dependent on several factors, including: (1) extent of mechanization; (2) nature of mining technology used; (3) extent of use of contract labour (a judicious use minimizes overheads); and (4) machinery utilization pattern (optimum use of machinery, especially heavy earthmoving equipment). ICRA Indonesia, therefore, evaluates the trends in key productivity parameters like output per man-shift (OMS), value of output per unit of labour employed, and system utilization. Since spares are a major cost item, a coal company's ability to optimize on its inventory of spare parts and procurement costs is also important. Mining practices (as discussed) can have a significant impact on the operating profitability of a coal company, the quality of reserves notwithstanding.

Labour costs and labour productivity: Labour costs comprise the most important cost component for coal mining companies. This is so because, typically, the companies have a large workface, the average age of workers is high, wages have to be raised periodically (or at least have been in the past), there is resistance to retraining and redeployment to new mines, and the mandatory social overheads are high. ICRA Indonesia therefore evaluates the trends in labour costs, periodicity of wage increases, and the ability of a coal company to pass on wage increases to consumers through increases in product prices. These apart, ICRA Indonesia evaluates the company's history of labour relations and the number of person-days lost because of labour unrest, strikes and such other disruptions.

Quality: Consistent quality in terms of coal grades, specification and weights, enables a company achieve higher average realizations, thereby improving its operating profitability. ICRA Indonesia analyses the initiatives taken by a coal company to ensure supply of consistent coal quality and minimize disputes through joint sampling/third-party sampling at loading and customer ends, electronic weighing, and such other measures.

Pricing flexibility

In a decontrolled regime, coal companies, theoretically, have the flexibility to raise price so as to offset the impact of any major cost increases. In reality, however, such flexibility may be limited, given the strategic importance of the key consuming sectors like power, the fact that matters pertaining to the coal industry are politically sensitive, and the need to maintain price competitiveness vis-à-vis alternative fuels. ICRA Indonesia therefore analyses the degree of pricing flexibility that a coal company has and the extent to which it can absorb cost increases without suffering a major deterioration in its debt-servicing ability.

Customer diversification and counterparty risk

ICRA Indonesia evaluates the diversity in a coal company's customer profile, the off-take pattern, and the credit quality of the company's key consumers. Given the high fixed cost nature of coal mining operations, a coal company is highly sensitive to volume sales. Thus, long-term contracts, which mitigate off-take risks and assure stability in off-take, are viewed favourably. ICRA Indonesia also evaluates the credit quality of a coal company's key consumers across sectors.

Reserve replacement

A coal company's reserve replacement strategy is an important factor influencing its long-term viability, and therefore, credit quality. To increase production levels, a company needs to explore new reserves besides replacing its current production volumes. Thus, ICRA Indonesia evaluates the coal company's record of exploration success and its ability to successfully commission new mines without any major time or cost overrun. The latter is all the more critical, given the time consuming and laborious processes involved in securing clearances, especially those related to the environment and rehabilitation/resettlement.

Environmental compliance

ICRA Indonesia reviews a coal company's record of compliance with environmental norms. Besides, it also checks for the company's track record in terms of compliance with safety standards.

Parent-Subsidiary Structure

ICRA Indonesia consolidates the financials of the operating (mining) company with that of the holding company on the basis of the extent of ownership. ICRA Indonesia believes that an entity's creditworthiness is determined not only by its own business and financial risk profile, but also by that of its family of operating companies since the extent of ownership largely determines the extent to which funds (cash/capital) can flow within the group. Apart from ownership, ICRA Indonesia also attempts to identify whether any member of the group can be insulated from the rest of the family because of legal, regulatory or geographic factors, the extent of strategic importance and therefore inter-dependence between members, and the limits, if any, to this extent of dependence (i.e. the extent of "arm's length").

Financial Position

While evaluating the financial position of a coal company, ICRA Indonesia places particular emphasis on the following factors:

- Proportion of labor costs in the overall cost structure
- Periodicity and quantum of wage increases in the past and expectations on the same
- Sensitivity of operating profitability to volume of sales
- Break-even volumes
- Trends in receivables and cash flow from operations
- Quantum and nature of capital expenditure and means of funding the same

Given that coal prices are likely to be more volatile in future, ICRA Indonesia draws up cash flow projections for a range of product prices to assess a company's debt servicing capacity even under periods of stress. Besides, ICRA Indonesia evaluates the sources of financial flexibility (for the company concerned) by way of access to institutional funding, flexibility in repayment (to the Government) terms, or availability of liquid investments. In case a company has large capital expenditures plans, the sources of funds for such expenditures and the expected benefits are also examined.

Management Quality

ICRA Indonesia assesses a coal company's management in terms of its depth, level of experience and record of proven success, growth philosophies, track record in managing under-performing assets, financial policies, and the degree to which the stated policies are consistent with the business strategies. ICRA Indonesia takes a favourable view of a coal producer's ability to cope with periodic wage increases, close down uneconomic mines and reduce or redeploy workforce. A specific aspect of management strategy that is evaluated is the company's plan towards adopting clean coal technology and ensuring that its mining operations are environment-friendly and socially sustainable.

Summary Rating Outlook

In ICRA Indonesia's view, the recent shifts in the regulatory environment impacting the coal sector point to a gradual movement towards market competition. The ability of a coal company to capitalize on the emerging market opportunities would however depend on its bargaining power with its dominant customers, particularly those in the power sector, since price increases are no longer a pass-through of input and other cost increases.

The share of coal in the global consumption of primary energy is likely to witness a decline in the long term, especially in developed countries. In developing countries, however, coal usage is expected to increase, with India and China accounting for nearly the entire incremental demand. Although coal is not a dominant source of primary energy in Indonesia with a share of over 20%, the coal consumption has nearly tripled during last decade and surpassed natural gas as the second most consumed fuel (US Energy Information Administration (EIA)). Its use is being encouraged also on account of the fact that it is relatively abundant in supply domestically as against oil which needs to be imported. Thus, increase in coal consumption is likely to sustain over the foreseeable future. This, along with the favourable domestic demand-supply situation anticipated on account of growing economy, is likely to keep the business risks for a coal company low. While ICRA Indonesia's rating outlook for the coal sector factors in the stability of off-take by power sector, credit quality issues remain a key concern.

ICRA Indonesia takes a favourable view of the initiative by domestic coal companies to enter into long-term bilateral agreements with clients since this is expected to act as a strong entry barrier and protect the commercial interests of coal companies. The favourable demand-supply situation in coal, as discussed, is of course contingent on the timely commissioning of various power projects, the timely development of captive coal mines by coal companies, augmentation of the existing evacuation network (railways primarily) to transport the additional volumes, as well as the development and adequate availability of "washing" facilities, particularly for high-ash coal. But here again, the coal industry's ability to contain the extent of environment/rehabilitation related problems (which have affected project progress in the past) would remain a key rating concern.

ICRA Indonesia expects to see the projected shifts in production from higher-cost underground mines to the more mechanized open-cast mines, employment of contract labour, rationalization of uneconomic mines, reduction in manpower, and increase in quality focus of coal companies in preparing the ground for the industry to improve its profitability levels. Significantly, a coal mining company's ability to cope with periodic wage increases in future will largely determine its profitability level.

* Adopted and modified from ICRA Limited's *Rating Methodology for Coal Mining Companies*