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INCOME BUILDER

HIGHLIGHTS:

- The coal industry is essentially bankrupt. Contributing factors include the low cost of natural gas; power plant emissions regulations; the strong dollar and most recently, the warm winter season. (p.1)
- 2016 will likely mark the bottom of the cycle for the industry. Production has been running 30% behind last year, but demand will pick up in the second half, assuming normal weather conditions. (p.1)
- Some coal bonds are attractive. Though speculative, they offer good upside potential longer-term and a possible hedge against a severe downside economic scenario (p.1)
- Walter Energy (WLTGQ): Right now, it looks like the unsecured bonds will get wiped out. (p.2)
- Alpha Natural Resources (ANRZQ): Estimated recoveries are 1%-3.5% for the bonds which are currently trading around 1%. (p.2)
- Arch Coal (ACIIQ) has filed for bankruptcy. Unsecured creditors have rejected Arch's offer of stock and warrants. (p.3).
- Peabody Energy (BTUUQ): Its still early days for this bankruptcy case (p.3)
- Cloud Peak Energy (CLD). One of the few to avoid Ch. 11 so far. CLD will have a tough first half, but if it meets its 2016 guidance, its stock and bonds will recover much of what they have lost. (p.4)
- ACTION THIS ISSUE: Holding existing positions (p.4)

THE COAL INDUSTRY RESTRUCTURES

BY STEPHEN P. PERCOCO

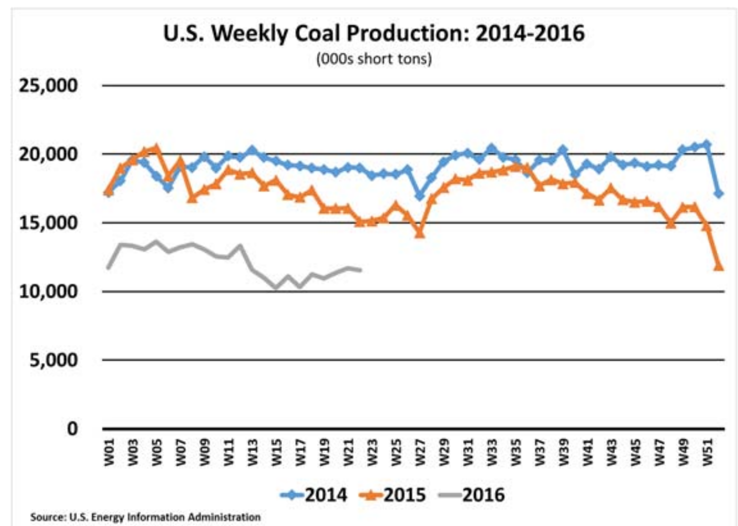
It is rare for an entire industry to go belly up, but that is what has almost happened in coal. Over the past year, nearly all of the major producers—including Walter Energy, Alpha Natural Resources, Arch Coal and Peabody Energy—have filed for bankruptcy.

While the bunching of Ch. 11 petitions makes the industry's downfall seem sudden, in fact it has been playing out over the past five years. Since the post-financial crisis peak in 2011, revenues and profits for most coal miners have been falling steadily. The decline accelerated when oil and natural gas prices began their steeper slide about two years ago.

Supporters of the coal industry point their fingers at the Obama administration for stricter rules on power plant emissions that have caused power producers to shutter about 15% of their coal-fired capacity. However, the bulk of the decline in coal demand has been caused by low natural gas prices, which have made it much cheaper to run gas-fired power plants.

The strong dollar has also been a big factor in the steep drop in coal exports. And to top it all off, the very mild winter across most of the U.S. left utilities with large stockpiles of coal.

All of these factors have driven coal production down this year to its lowest level since the 1970s. According to the Energy Information Administration (EIA), industry production has been running 30% below prior year levels for most of the 2016 first half.



Most of the decline is due to an inventory adjustment. Assuming normal summer weather, demand for coal should rebound in the second half of the year. Year-over-year production declines have been moderating in recent weeks.

The EIA previously anticipated that coal use will begin to recover to 2020. 2015 and 2016 were the big years for coal-fired plant closings, due to the deadline for complying with the EPA's Mercury and Air Toxics Standards. If the EPA's Clean Power Plan stands up to court challenges and a change in presidential administrations, coal demand will probably take another big dive after 2020, when the CPP is scheduled to go into effect. Otherwise, the EIA projects that coal demand will rise slowly to 2030, primarily as a result of an expected rise in the price of natural gas.

The coal sector is worth your time and attention for several reasons: First, prices of the stocks and bonds issued by the large coal miners are extraordinarily depressed. Risk remains high, but there is significant upside potential in many of these securities at current levels.

Second, while downside risk is still high—even after falling 99.9%, you can still lose that last 0.1%—an investment in coal can serve as a hedge in a severe downside economic scenario characterized by a collapse in the dollar and rising interest rates and commodity prices. As with put options, you might think of an investment in coal bonds as a form of portfolio insurance.

Third, a review of the current state of publicly-traded coal securities provides an opportunity to see how bankrupt unsecured claims and interests are faring in the current market environment. It ain't pretty.

Although bankruptcies and roll-ups, mostly of smaller coal firms, have been ongoing over the past two decades, the recent spate of large coal company bankruptcies began with Walter Energy, which filed for Ch.11 in July 2015. That was quickly followed by Alpha Natural Resources (August 2015) and then by Arch Coal (January 2016) and Peabody Energy (April 2016).

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Walter Energy (WLTGQ): The recent outcome of the Walter Energy case raises a warning flag for investors in bankrupt coal stocks and unsecured bonds. Walter's bank lenders petitioned the court to purchase the core operations of the company in a Section 363 sale, after a stalking horse auction whereby other potential buyers were invited to top the lenders' bid. (General Motors also utilized a Section 363 sale to sidestep prepetition liabilities and make a quick exit from bankruptcy.) Thus, Walter Energy's lenders were able to "credit bid" for the core assets – i.e. acquire the core operating assets in exchange for their claims. Walter's non-core assets were also sold to a third party.

The senior lenders were able to convince the judge that this Section 363 sale offered the best way to avoid a deterioration in the value of the company's operations, preserve the greatest number of jobs and relieve the debtor of liabilities, including certain reclamation obligations; but unsecured creditors were left holding the bag. The case is not completely settled yet and I don't know what, if anything, is left in the estate after the asset sales; but chances are that there is probably very little value left, given that Walter Energy's 9.875% Senior Notes due 2020 traded on June 2 at 0.035 or $0.35 per $1,000.00 face value.

Alpha Natural Resources (ANRZQ). Alpha is the nation's third largest coal producer and the leading producer of metallurgical coal, with a large reserve base in Appalachia. It also has a meaningful presence in the Powder River Basin in Wyoming.

The company's annual EBITDA peaked at just over $950 million in 2012, but then plunged to only $76 million in 2013 and then to a negative $91 million in 2015. Meanwhile its total debt outstanding increased from $3.4 billion in 2012 to $4.3 billion in 2015. Unable to generate cash to service that debt load, the company filed for bankruptcy in August.

Alpha's bankruptcy plan is similar in some ways to Walter Energy's. The company has proposed to transfer six of its largest and most profitable mining complexes, with a total of 15 active mines, to a newly-formed company (Newco), in a Section 363 sale. By doing so, Alpha and its senior secured creditors, hope to create a profitable company that will be mostly unburdened by certain legacy costs. Newco should therefore be a good candidate to return to the public markets.

Alpha's remaining assets—27 mining complexes with 29 active mines and perhaps 15 or more inactive mines—as well as its legacy (and non-cancellable) liabilities will stay the debtor. That "Reorganized ANR" may come public again, but it might also remain unlisted. Conceivably, Reorganized ANR could sell off its assets piecemeal over time, probably to smaller investor groups, or it may even attract a bid from a private equity firm

Alpha's common stock, which now trades on the "pink sheets," has traded most recently at $0.01, down from a post-financial crisis peak of $68.05 in January 2011.

Its unsecured bonds have been similarly decimated. They have recently been trading around 1% of par or for $10 per $1,000 of face value.

The public markets have therefore been ascribing little, if any, value to Alpha's publicly-traded securities.

The proposed bankruptcy plan confirms that view for Alpha's equity investors, but ultimately recoveries for bondholders are still somewhat up in the air. Under the plan, equity holders would get wiped out. Barring a sudden and dramatic turnaround in Alpha's business by June 27, the court deadline for voting on the plan, equity investors will get zero.

Bondholders, on the other hand, are being offered, among other things, 5% of the equity of Newco, warrants for 7.5% of Newco (at an exercise price that ensures that secured creditors get all of their money back firts) and all of the equity of Reorganized ANR (subject to several important caveats).

This is a complex plan that is difficult to evaluate. The Disclosure Statement estimates recovery values—for example, it says that the above package for bondholders represents a recovery of "approximately 1% to 3.5%" of their claims—but it offers no detail on how it reached that conclusion.

The Disclosure Statement also notes that the various components of the distributions to creditors are inherently difficult to value. Yet, it does not provide necessary details about the terms of certain securities being offered to creditors or key assumptions in the projected financial statements for Newco and Reorganized ANR to allow the creditors to make a reasonably informed assessment of the value of the consideration being offered to them. Given the difficulty of valuing the consideration, it is important that creditors have sufficient information to form their own assessments of the bankruptcy plan's proposed recoveries, if they choose to do so.

For example, the financial projections for both companies are rudimentary. They do not provide details on certain key assumptions such as future estimates of tons sold and average sales prices. Nor do they provide a current estimate of Alpha's coal reserves and how those reserves will be split between Newco and Reorganized ANR.

Even so, the committee of unsecured creditors probably did obtain sufficient details to evaluate, with the aid of their financial advisors, the bankruptcy plan and the consideration being offered. (The committee has endorsed the bankruptcy plan.)

Actual holders of unsecured claims can probably get access to certain key exhibits of the bankruptcy plan (detailing the terms of the proposed new securities of Newco and Reorganized ANR), that were omitted in the documents filed with the court, by calling Alpha's bankruptcy counsel or financial advisors.

Yet, even if I accept the disclosure statement at face value, I believe that bankruptcy plan does not structure recoveries in a way that is fair to Alpha's unsecured creditors. For example, the Newco warrants may give the unsecureds an additional 7.5% stake, but the strike price on the warrants will be set to ensure that secured creditors get all of their money back with interest before the warrants have any intrinsic value. That is all well and good; but why then are the warrants for only a 7.5% stake?

In theory, when the secured creditors are paid in full, the unsecured creditors are entitled to all of the remaining value, up to the face amount of their claims. Why shouldn't the unsecured creditors get warrants for 99% of Newco under those terms? By giving the unsecureds only a 7.5% stake, the secured lenders could conceivably recover more than their claims and accrued interest, which is more than they are entitled to under the law.

There are a couple of reasons for this: The secured creditors want their securities to have additional upside potential so it will be easier for them to cash out. A 99% warrant stake would also be a significant overhang on Newco common stock.

Even so, there is room somewhere between 7.5% and 99% for Alpha to give bondholders who rode the bonds down from par a greater chance at a more meaningful recovery.

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Despite my reservations about the Bankruptcy Plan, if I accapt the Disclosure Statement's estimated recovery of approximately 1% to 3.5%, then the bonds should have significant upside potential from current levels of around 1%.

Arch Coal (ACIIQ). Arch Coal is the second largest U.S. coal producer with significant operations across the major coal producing regions, including the Powder River Basin and Appalachia. The company filed for bankruptcy in January 2016.

The Income Builder has maintained a modest 10 bond position in Arch for some time. Those 7% Notes due 2019 last traded at 1.77% of par value or $17.70 per $1,000 face amount. The bonds have tripled in price in just the past two weeks.

Arch has not yet chosen to follow the lead of Walter Energy and Alpha Natural to place its most valuable assets in a Newco, but it has taken steps to keep its options open.

Prior to the bankruptcy filing, Arch entered into a Restructuring Support Agreement (RSA) with its first lien secured creditors. The RSA outlined the terms by which the lenders would agree to proceed with a restructuring of Arch's capitalization through the bankruptcy process. Without such an agreement, the lenders might have pressed the court to foreclose on their collateral to avoid a further diminution of its value.

The RSA calls for equity investors to be wiped out; the senior lenders would receive $115 million in cash, $327 million in new debt, nearly all of the equity of the recapitalized company and control of six (out of seven) seats on Arch's Board of Directors. Second lien and unsecured creditors would receive a small amount of common stock and some warrants. A $200 million accounts receivable securitization facility would be reinstated.

Early on in the bankruptcy, there was a court fight over a proposed debtor-in-possession (DIP) lending facility. Unsecured creditors argued that it was costly and the company did not need the money. It would also, through a cash maintenance covenant, reduce the amount of cash-on-hand that the company could use to finance its business. Ultimately, the company (and the first-lien secured creditors) prevailed.

Arch filed its first bankruptcy plan and accompanying disclosure statement in early May. Those documents did not contain specific terms for the consideration being offered to second lien and unsecured creditors because the company has not yet reached an agreement with them. The disclosure statement also did not include projected financial statements, which are the basis for estimating the recoveries for each class of creditors under the plan.

In mid-May, certain unsecured creditors filed an adversary proceeding with the bankruptcy court for equitable subordination. If successful, this would strip the first-lien lenders of their collateral and perhaps subordinate their claims to all other unsecured creditors. The plaintiffs are charging that the first-lien creditors were responsible for blocking a proposed exchange offer last fall which would have allowed them to swap their unsecured bonds for a smaller amount of secured bonds. Now, instead of getting a potential recovery of say 30 or 40 cents on the dollar through their first-lien loans, those bondholders that supported the debt exchange are now being offered a "measly" few pennies for their unsecured bonds.

The adversary proceeding highlights one aspect of the disagreement between the company and first-lien lenders on one side and the unsecured creditors on the other. It will provide some leverage for unsecured creditors to cut a better deal. As a result, they could very well end up with a recovery in excess of the 2%-3% that the company probably proposed. That is perhaps why the unsecured bonds have tripled in price recently.

Yet, the unsecured bonds still have downside risk. First of all, it is not clear whether all unsecured bondholders will benefit from these negotiations. The adversarial proceeding focuses on the 7.25% Senior Notes due 10/1/2020, which have a negative pledge covenant (prohibiting the company from issuing secured debt unless the 2020s are similarly secured). This was the key debt issue in the proposed exchange offer and it is possible that the judge could rule that only this debt issue is entitled to a reduced first-lien claim or sweetened equity package.

GSO Capital Partners, a significant holder of the 7.25s, voted in favor of the debt exchange last year. It is the lead plaintiff in the Adversary Proceeding and also the only bondholder on the unsecured creditors committee. It is unclear whether GSO efforts to get a better deal for itself and the other plaintiffs will benefit all unsecured creditors.

Besides the uncertainty of these negotiations, year-over-year industry production volumes, as noted earlier, have been running 30% behind last year for much of 2016. Comparisons have improved in recent weeks, though. Production was down "only" 23.4% in the week ended May 28, 2016 .

With the approaching summer cooling season and perhaps some rebuilding of stockpiles for the upcoming winter season, demand for coal should pick up, so year-over-year production comparisons will become much less unfavorable. By the end of 2016, production will probably be running ahead of last year.

But prices are still falling. Three of the five major coal producing regions reported declines in average spot prices for the week ended May 17, led by the Powder River Basin, where the average price fell 5.9% to just $8.80 per ton.

I think that it is a reasonable bet that prices will stop falling soon; but it is pretty clear that second quarter results for the entire industry will be awful. If the companies end up burning through a fair amount of cash, unsecured creditors may have a tougher time improving their recoveries.

Furthermore, demand for coal is still vulnerable to a downturn in the economy. If that downturn is accompanied by falling commodity prices, it may be difficult for these companies to lift themselves out of chapter 11. In that case, unsecured creditors may have to settle for even less (which would be nothing).

Despite that risk, I think that Arch's unsecured bonds have good upside potential, once this severe industry inventory adjustment is complete. The unsecured bonds are currently trading around 1.75%-2.0% of par value. The upside potential could be more than twice that. Given the recent adversary proceeding, the 2020s are probably the best bet. However, I am going to hold my existing position in Arch Coal bonds at this time, because I have made a commitment to refocus this newsletter on income-producing securities.

A previous, more detailed analysis of Arch Coal is available on my website at http://www.larkresearch.com/2016/05/18/arch-coal-goes-bust/.

Also on the website is an analysis of the coal industry which makes the case that 2016 will likely mark the bottom for prices and production. Here's that link: http://www.larkresearch.com/2016/05/24/coal-goes-bust/.

Peabody Energy (BTU): Peabody, the largest U.S. coal company also with operations in Australia, filed for bankruptcy on April 13, 2016. The case is still in its early stages. As with Arch, there has been some jostling between unsecured and secured creditors over the terms of the DIP facility. In this case, several unsecured bondholders (i.e. an ad hoc group) stood up to challenge what they saw as the broad waivers of statutory and legal protections of unsecured creditors sought

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by the first-lien lenders. They also objected to giving the DIP lenders at this time the right to credit bid their loans. In recent weeks, Peabody has filed an adversarial proceeding against Citibank over the definition (and therefore the scope) of assets secured under the bank agreement.

Peabody's outstanding unsecured bonds are currently trading around 14 cents on the dollar. That's a much higher level than any of the preceding bankruptcies. Unlike the other coal bankruptcies, their is no RSA between the company and first-lien lenders. In addition, investors in the unsecured bonds include well-known and experienced distressed investors, such as Elliott Management and Aurelius Capital Management, which are participating actively in the bankruptcy. This suggests perhaps that Peabody's unsecured bonds have a better chance at a more meaningful recovery than those of the other major coal producers.

Its still early days in Peabody's bankruptcy case. The debtor has yet to file its bankruptcy plan and disclosure statement with the court. Until that happens, we won't know what recoveries the company is offering to the various classes of creditors.

The progression of coal bankruptcies has been noteworthy. They began with one of the smaller publicly-traded coal companies, Walter Energy, then progressed from the number 3 producer (Alpha) to number 2 (Arch) and then to number 1 (Peabody). Unsecured creditors have fared most poorly at the smaller companies, but may have a better chance at recovery with the larger ones. The later bankruptcies will likely be resolved after industrywide production bottoms out. Those companies that resolve their cases later will probably be facing a better performance outlook, which should also lead to better recoveries for the unsecured creditors.

As long as the U.S. economy is able to avoid an economic downturn that is accompanied by falling commodity prices, the outlook for the coal industry and for investors in coal companies should brighten in the second half of 2016.

Cloud Peak Energy (CLD): Cloud Peak, which operates exclusively in the Powder River Basin, has been one of the few major coal producers to avoid bankruptcy so far. Although it too has seen its profitability plunge over the past few years, it has, up until the 2016 first quarter, been able to maintain positive interest coverage on its outstanding debt (i.e. generate more EBITDA than interest expense). This is due in part to lower leverage: Its debt as a percent of total capitalization was 36.6% at the end of the first quarter, among the lowest in its peer group. More importantly, Cloud Peak has not drawn down any of its bank credit facility to date. Thus, its outstanding unsecured senior notes have not faced the prospect of being crushed by bank lenders.

Its two outstanding bond issues are still receiving interest payments. They trade at distressed prices, but at much higher levels than those of the bankrupt coal producers. Cloud Peak's 8.5% Senior Notes due 12/15/19 last traded at 45 to yield 38%, while the 6.375% Senior Notes due 3/15/24 last traded at 36 to yield just under 26%.

Although the bonds have rebounded from their mid-February lows, Cloud Peak faces another tough quarter, which is likely to result in negative interest coverage. At the end of March, the company had $79 million in cash, which is probably enough to cover the loss; but it may decide to draw down part of its bank facility anyway to maintain an adequate cash cushion. At the end of March, Cloud Peak had $478 million in borrowing capacity under its bank and receivables securitization facilities; but borrowing availability under the bank facility can be cut reduced or cut off as profitability declines and if the company violates covenants. It is highly likely that Cloud Peak's borrowing availability will be cut in half before the end of the year as a result of its declining profitability.

If the company is able to deliver on its 2016 guidance, it will be able to continue paying interest on the senior notes and maintain access to its bank facility. However, with a tough second quarter, my analysis suggests the company is in danger of violating its EBITDA coverage covenant in the third quarter, even assuming a fairly significant improvement in third quarter results. I also believe that it is going to be tough for Cloud Peak to meet its full year guidance with a second consecutive quarter of EBITDA near zero. The current distressed prices of CLD's Senior Notes echo those concerns.

Ultimately, I think that Cloud Peak has a great franchise that will prove its value over time. It has held up better than nearly all of its peers so far, but this latest leg down in coal demand has put every company's creditors and investors at risk.

I would like to double down on my position in Cloud Peak's 6.375% Senior Notes. However, I have decided to wait until after second quarter results are reported at the end of July before deciding to jump back in.

Portfolio Changes

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BONDS Issuer	Type	CUSIP	Action	No. of Bonds	Recent Price	Coupon	Yield	Maturity	Call Date/ Price	Ratings
Arch Coal	Senior Notes	039380AE0	Hold	10	1.77	7.000%	N/A	15-Jun-19	N/A	WR/D/WD
Cloud Peak Energy	Senior Notes	18911XAA5	Hold	10	35.45	6.375%	26.2%	15-Mar-24	3/15/19 103.19	Caa1/B+/NR

Lark Research, Inc.
839 Dewitt Street
Linden, New Jersey 07036
(908) 448-2246
incomebuilder@larkresearch.com

www.larkresearch.com

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