LONG IDEA
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Coal in Green Clothing

This metallurgical coal producer is poised to take advantage of rising demand amid restricted supply in the premium coal market. The compelling mix of strong fundamentals and an attractive valuation position this company as a promising option for intelligent capital allocators. Warrior Met Coal Inc (HCC: $35/share) is this week's Long Idea.

HCC presents quality risk/reward given the company's:

- position as a supplier of high-quality metallurgical coal amid rising demand
- strong revenue growth and improving profitability
- consistent cash flow generation
- attractive valuation

Thermal vs Met Coal: Important Difference

As the ESG movement gains momentum, the broad-stroke dismissal of coal risks oversight of a crucial product - metallurgical ("met") or coking coal, which Warrior Met Coal supplies. Thermal coal, primarily used for electricity generation, is, indeed, in structural decline with the transition towards renewable energy sources. However, it's crucial to distinguish it from metallurgical coal, a critical component in steel production.

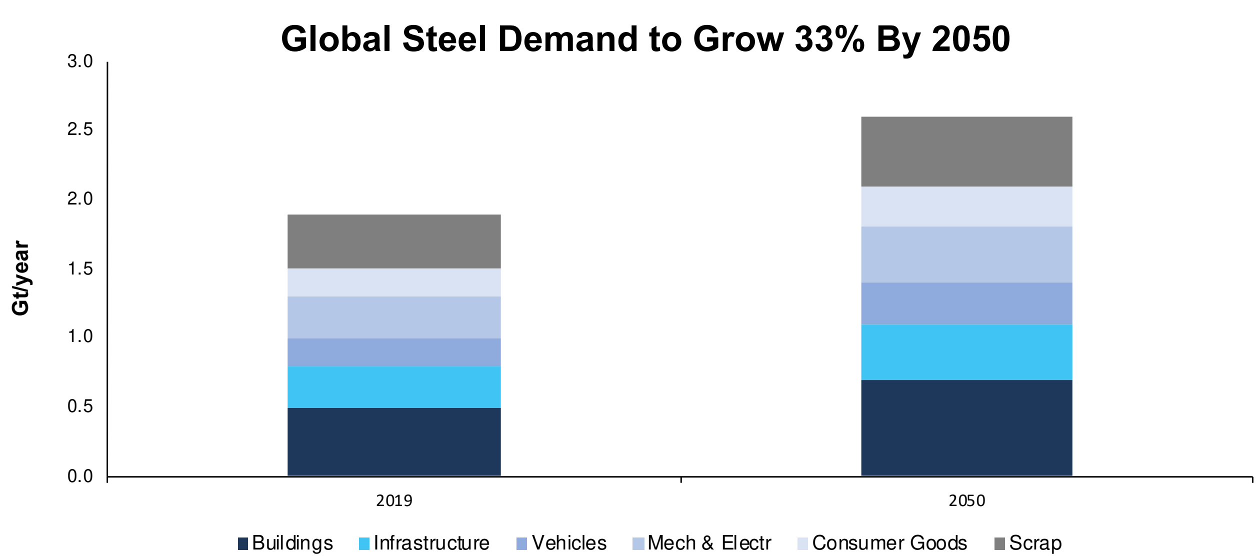
ESG Needs Steel and Steel Need Met Coal

Steel is the backbone of most renewable energy infrastructure, and, according to the World Coal Association, 70% of all steel production currently relies on met coal. Considering that the United Nations recommends the world must double (add another 8,000 GW to) its renewable energy capacity by 2030, we expect demand for steel and met coal to soar. As the International Energy Agency (IEA) notes, "steel needs energy and the energy system needs steel."

Furthermore, the International Renewable Energy Agency reports that solar power is set to expand significantly, potentially reaching up to 8,519 GW by 2050, almost nine times the installed capacity in 2020. Again, this expansion would be steel-intensive as the solar power industry requires steel for solar panels and infrastructure support.

Figure 1 shows how the IEA expects demand for steel to grow significantly over the next 25+ years.

Figure 1: Global Steel Demand, 2019 – 2050



Sources: IEA and New Constructs

The importance of met coal in the transition to renewable energy is a paradigm that the market seems to overlook. Companies like Warrior Met Coal, that produce high-quality metallurgical coal used for steelmaking, are integral facilitators of the energy transition, a fact which is obscured by the negative sentiment attached to the broader 'coal' market.

Increased Capacity to Meet Demand

The increase in steel demand doesn't translate into a boom for all coal. Not all coal grades make the cut.

As one of the leading producers of high-quality, low-volatility met coal, Warrior Met Coal is uniquely positioned to capitalize on the uptick in steel demand.

The ongoing development of the Warrior Met's Blue Creek mine, one of the few remaining premium met coal reserves in the U.S., is a significant catalyst for the company's future growth. Blue Creek is set to elevate the company's total production capacity by 60% annually with its estimated yield of 4.3 million short tons per year by 2025. The project has a net present value (NPV) of $1 billion (more than half of the company's market cap) and is expected to pay for itself in two years, with an after-tax internal rate of return (IRR) of 30%.

Blue Creek mine is primarily a longwall operation, which is renowned for high productivity, safety, and lower costs as compared to other mining methods. The mine also harbors a long lifespan, with enough estimated coal reserves to sustain mining activities for approximately 50 years.

Decreasing Supply Strengthens Competitive Position

McKinsey reveals that the exploration and development of new coal mines have significantly decelerated globally. As long as ESG-driven divestment in coal mining continues, the supply of high-grade metallurgical coal could tighten, which would only strengthen Warrior Met's competitive position and future cash flow growth.

Furthermore, the coal trade has always been a complex chessboard of geopolitics and market forces, but recent shifts in international relations and industry dynamics have created a unique opportunity for US-based producers like Warrior Met Coal.

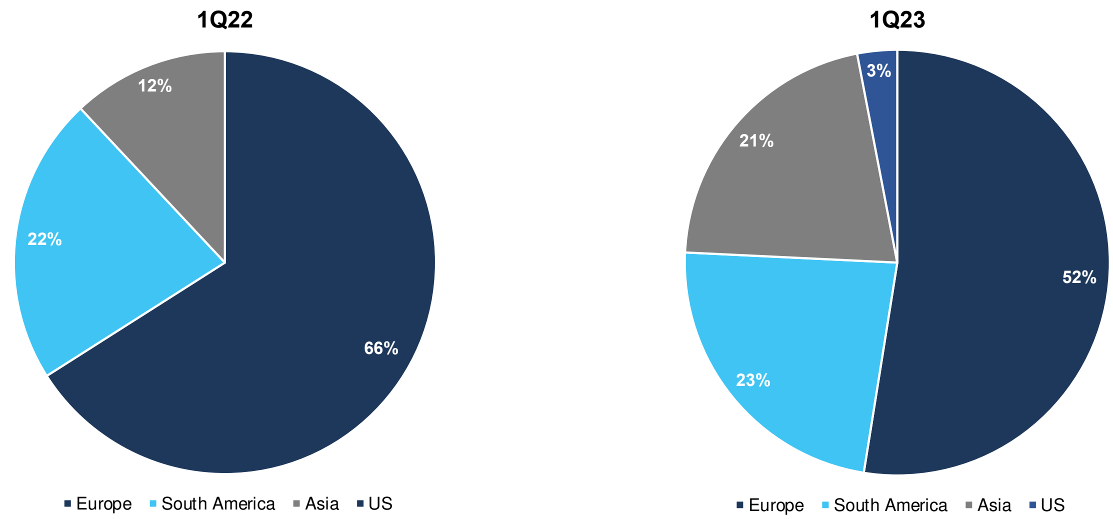
China, the world's largest consumer of high-quality metallurgical coal, has seen its relationship with Australia, the leading exporter, become strained. This rift has caused China to seek alternative sources, providing an opportunity for U.S. coal to fill the void. Though the unofficial ban to Australian imports was lifted by China in January 2023, S&P Global expects Australian coal purchases to remain limited in 2023.

Furthermore, the ongoing conflict between Russia and Ukraine has triggered global sanctions against Russia, which subsequently reduced its met coal supply. These two geopolitical shifts create a window for Warrior Met Coal to step in and bolster its exports.

India, a country experiencing a dramatic surge in coal imports and steel production, is also becoming a significant player. Its long-standing friendship with the US presents another advantageous trade opportunity for Warrior Met Coal. The company's sales show a clear trend towards an increased share of exports heading to Asia, which reflects the growing demand in the region. See Figure 2.

Lastly, if US-China relations deteriorate further, American companies may look to fill coal needs domestically, and we expect that Warrior Met Coal would be happy to oblige.

Figure 2: Warrior Met Coal's Revenue By Geography: 1Q22 – 1Q23



Sources: New Constructs, LLC and company filings

Fiscal Policy and Political Tailwinds

There are several fiscal measures in place which will boost near-term demand for steel and, by association, met coal. The Infrastructure Investment & Jobs Act passed in late 2021, for example, includes $110 billion earmarked for roads and bridges, $55 billion for water infrastructure, $66 billion for rail, and $25 billion for airports – all of which require steel and met coal. Steel producers are already taking note: Charlotte, North Carolina-based steelmaker Nucor Corp., in its latest investor presentation, estimated the Infrastructure Act is poised to bolster steel demand by 3 to 5 million tons per year.

The phenomenon of reshoring – repatriation of manufacturing operations from overseas – is further fueling steel demand. The impetus provided by the CHIPS and Science Act, which allocated roughly $55 billion to encourage essential manufacturing reshoring, is anticipated to prompt 27 projects by 2029. Nucor highlights that these advanced manufacturing facilities, including 10 semiconductor plants, will be heavily reliant on steel.

"Green economy" investments, funded by the Inflation Reduction Act's $370 billion tax incentives, are also driving demand for steel. The Biden administration's ambitious target of 30 gigawatts of US offshore wind capacity by 2030 could potentially translate into a demand for about 7.5 million tons of steel, which provides an attractive growth opportunity for steel producers and met coal miners alike.

Carbon Catch Widens the Moat

Technological innovations in Carbon Capture, Utilization, and Storage (CCUS) could significantly strengthen the met coal industry and Warrior Met Coal. CCUS technology seeks to capture carbon dioxide emissions from sources like power plants and industrial processes to prevent them from entering the atmosphere. Once captured, the carbon dioxide can either be utilized for industrial purposes or stored underground.

According to IEA estimates, to achieve global net-zero emissions by 2050, nearly 15% of cumulative emission reductions will have to come from CCUS applications in sectors where emissions are notoriously hard to abate, including steelmaking. Thus, advancements in CCUS can directly benefit Warrior Met Coal by ensuring the continuous demand for met coal.

McKinsey highlights how the Inflation Reduction Act offers generous tax credits for carbon capture, which makes CCUS technology economically viable for ammonia, ethanol, and natural gas facilities. The report states that if the cost of CCUS was reduced to around $85 per ton of CO_2, it could potentially result in the capture of up to 4.2 gigatons of CO_2/year by 2050, which would effectively safeguard the relevance of companies like Warrior Met Coal in a net-zero world.

Green Steel Still A Mirage

The green revolution in steelmaking, while a noble goal, faces a steep uphill climb before becoming a widespread reality. As per the World Coal Association, the majority of steel production currently relies on the blast furnace-basic oxygen furnace (BF-BOF) route, which uses coke made from metallurgical coal. This process accounts for 70% of global steel production.

Given the sheer scale of existing BF-BOF facilities, it's not hard to see why. For instance, in China—the world's top steel producer—the average age of the fleet is just 11 to 13 years. Meanwhile, India, the key growth vector, boasts a fleet with an average age of around 18 years. Given the long useful life of these facilities, both countries' infrastructures represent a significant sunk cost, which naturally slows down the transition to alternative steelmaking technologies.

Furthermore, many of the emerging alternative technologies simply aren't cost-competitive or technologically ready yet. Processes like hydrogen ironmaking may hold future promise but will not be widely adopted for at least a couple of decades, especially in the developing world. To top it off, the world's premier premium low-volatility (PLV) coal basin – Queensland, Australia – is facing regulatory challenges that will limit long-term capital investment. This dynamic may contribute to an enduring scarcity premium for high-quality coals.

While green steelmaking is a worthy aspiration, it will likely take a considerable amount of time before the green revolution in steelmaking affects Warrior Met.

Strike Over, Growth Begins

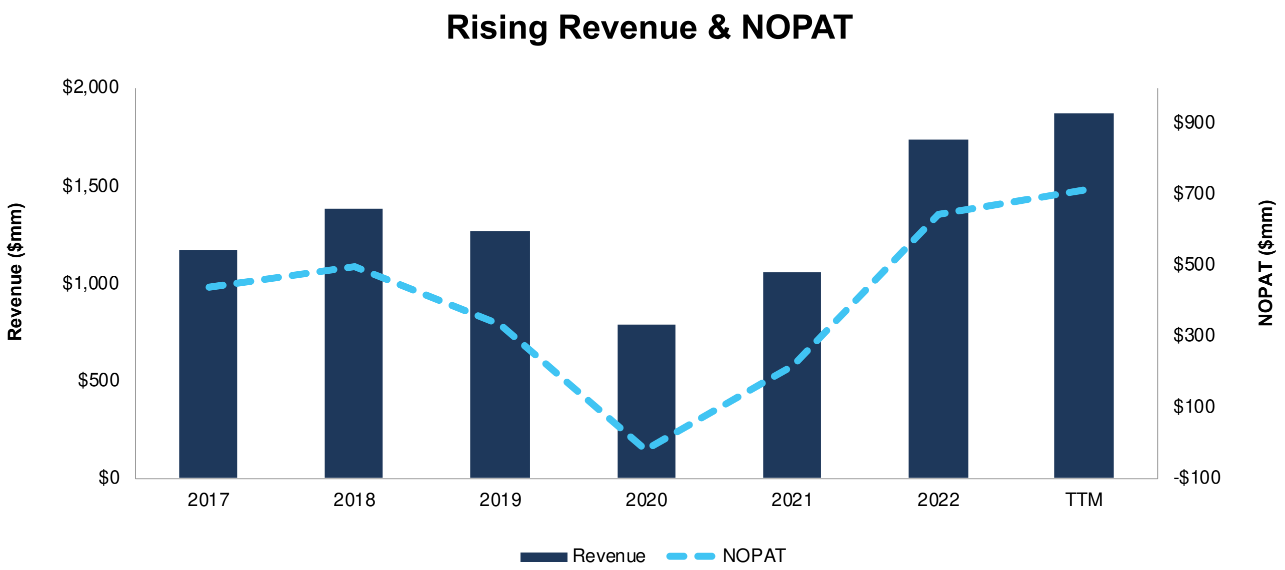
After two years, the labor strike involving members of the United Mine Workers of America ended in February 2023, when union members returned to work without reaching an agreement. Warrior Met Coal is well-positioned for a future of predictable growth and smoother operations.

Notably, the company's revenue and NOPAT rose during the strike, which puts the company in a strong negotiating position with the labor union and sets the table for steady growth in the future.

Earnings Are Heating Up

Warrior Met Coal had an impressive 1Q23, with revenue up 35% year-over-year (YoY) and NOPAT up 11% YoY. Free cash flow (FCF) was positive for the eighth consecutive quarter in 1Q23 and up 13% YoY. Longer-term, the company has grown revenue and NOPAT by 9% and 10% compounded annually, respectively, since 2017. The company's NOPAT margin improved from 26% in 2019 to 38% in the trailing twelve months (TTM), while invested capital turns rose from 1.4 to 1.7 over the same time. Rising NOPAT margins and invested capital turns drive the company's return on invested capital (ROIC) from 37% in 2019 to 65% in the TTM. See Figure 3.

Figure 3: Warrior Met Coal's Revenue and NOPAT: 2017 – TTM



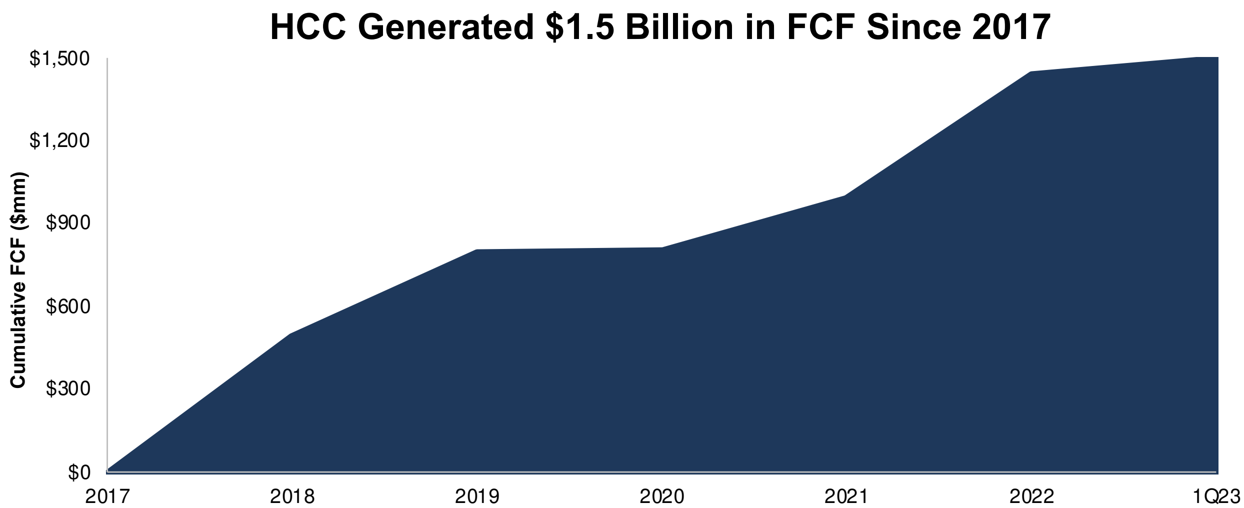
Sources: New Constructs, LLC and company filings

Strong and Rising Free Cash Flows

Warrior Met Coal's large and rising free cash flow (FCF) show's company's ability to fund new projects and return capital to shareholders.

Per Figure 4, Warrior Met Coal has generated a cumulative $1.5 billion in FCF since 2017, which represents 101% of its enterprise value.

Figure 4: Warrior Met Coal's Free Cash Flow, 2017 – TTM



Sources: New Constructs, LLC and company filings

Superior Profitability

In addition to being one of the only pure-play metallurgical coal companies in the U.S., Warrior Met Coal has the highest profitability compared to its publicly-traded peers. The company's ROIC of 38% is the best among its competitors, which include Arch Resources (ARCH), and BHP Group (BHP), among other large materials companies. See Figure 5.

Figure 5: Warrior Met Coal's Profitability Vs. Peers: TTM

Ticker	Company Name	NOPAT Margin	IC Turns	ROIC
HCC	**Warrior Met Coal Inc.**	**38%**	**1.7**	**65%**
ARCH	Arch Resources Inc.	29%	2.1	59%
BTU	Peabody Energy Corp	31%	1.1	34%
CEIX	Consol Energy	28%	1.1	30%
BHP	BHP Group, Ltd.	34%	0.7	22%
RIO	Rio Tinto, PLC	25%	0.4	11%

Sources: New Constructs, LLC and company filings

Shares Have 100%+ Upside at Current Price

At its current price of $35/share, Warrior Met Coal has a price-to-economic book value (PEBV) ratio of 0.2, which means the market expects profits to permanently fall 80% from current levels. Below, we use our reverse discounted cash flow (DCF) model to further quantify how low the expectations baked into Warrior Met Coal's stock price are. We also present the upside potential in the stock even if the company grows NOPAT below historical growth rates.

DCF Scenario 1: to Justify the Current Stock Price

We assume Warrior Met Coal's:

- NOPAT margin falls to 8% (from 38% in the TTM), and

- revenue falls 4% compounded annually from 2023 – 2032 (compared to 9% compound annual growth since 2017).

In this scenario, Warrior Met Coal's NOPAT would fall 18% compounded annually through 2032 and the stock would be worth $35/share today – equal to the current price. For reference, Warrior Met Coal has grown NOPAT by 10% compounded annually since 2017.

DCF Scenario 2: Shares Have 100%+ Upside Even Assuming Drop in Profits

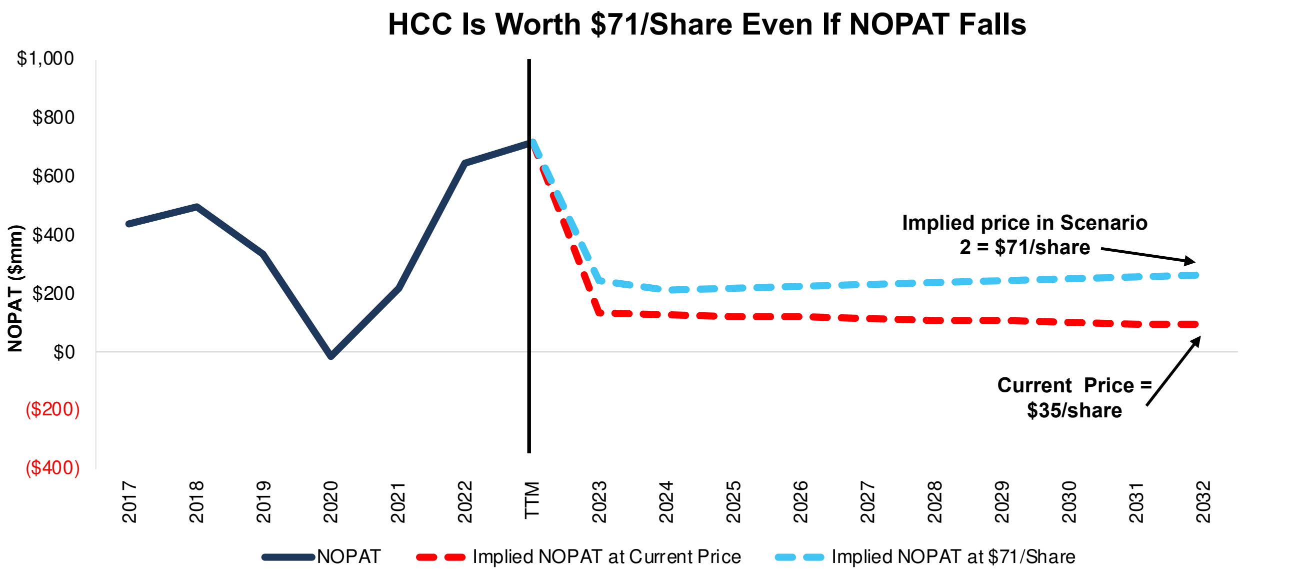
If we assume Warrior Met Coal's:

- NOPAT margin falls to 15% (still below its 5-year average of 23%) from 2023 to 2032,
- revenue grows at consensus estimates in 2023 (-7%) and 2024 (-14%), and
- revenue grows 3% compounded annually from 2025 to 2032 (versus 13% compounded annually since 2019), then

HCC would be worth at least $71/share today – a 100%+ upside to the current price. In this scenario, Warrior Met Coal's NOPAT falls 9% compounded annually over the next decade and in 2032 is just over one-third its 2022 NOPAT.

Should Warrior Met Coal grow profits more in line with historical levels, the stock has even more upside. Figure 6 compares Warrior Met Coal's historical NOPAT to the NOPAT implied in each of the above DCF scenarios.

Figure 6: Warrior Met Coal's Historical and Implied NOPAT: DCF Valuation Scenarios



Sources: New Constructs, LLC and company filings.

Sustainable Competitive Advantages Will Drive Shareholder Value Creation

Here's a summary of why we think the moat around Warrior Met Coal's business will enable it to continue to generate higher NOPAT than the current market valuation implies.

- unique position as a supplier of high-quality metallurgical coal
- increased capacity with the Blue Creek mine
- decreased supply due to many factors
- strong revenue and margin growth

What Noise Traders Miss with Warrior Met Coal

These days, fewer investors focus on finding quality capital allocators with shareholder-aligned corporate governance. Due to the proliferation of noise traders, the focus is on short-term technical trading trends while more reliable fundamental research is overlooked. Here's a quick summary of what noise traders are missing:

- metallurgical coal is entirely different from thermal coal and is in high demand

- the transition to renewable energy is dependent on steel and met coal
- strong public support for infrastructure spending supports the steel and coal industries
- advances in carbon capture technology will safeguard coal's place in the energy matrix.

Earnings Beats & ESG Turnaround Could Send Shares Higher

Warrior Met Coal has beaten earnings estimates in seven of the past 10 quarters and doing so again could send shares higher. Beyond earnings beats, overall market sentiment has been weighed down by ESG-driven divestment from the coal industry. Any easing of those concerns or broader recognition of the importance of met coal in the renewable energy transition could send shares higher as well.

Dividends Could Provide 3.3% Yield

Since 2017, Warrior Met Coal has paid $1.4 billion (73% of market cap) in cumulative dividends, both quarterly and special dividends. The company's current regular dividend, when annualized, provides a 0.8% yield. From 2018 – 2021, the company also repurchased $51 million (3% of market cap) worth of stock. In 2022, the company did not repurchase shares.

Warrior Met Coal announced a $0.88/share special dividend in February 2023. Should Warrior Met Coal issue similar special dividends, combined with the regular dividend, investors would be looking at a 3.3% total yield.

Executive Compensation Could Be Improved

Investors should favor companies with executive compensation plans that directly align executives' interests with shareholders' interests. Quality corporate governance holds executives accountable to shareholders by incentivizing them to allocate capital prudently.

In addition to base salary, Warrior Met Coal's executives receive long-term incentives that are split between time-based and performance-based restricted stock units (RSUs). These awards are tied to operational metrics such as 'longwall feet of advance' as well as cash costs, and total shareholder return. Instead of using metrics that are not directly related to shareholder value creation, Warrior Met Coal could improve its executive compensation by including ROIC as a performance metric.

Tying executive compensation to ROIC ensures that executives' interests are more aligned with shareholders' interests as there is a strong correlation between improving ROIC and increasing shareholder value.

Despite using subpar performance metrics in its executive pay, Warrior Met Coal's management has grown economic earnings, the true cash flows of the business, from $391 million in 2017 to $632 million in the TTM.

Insider Trading and Short Interest Trends

Over the past 12 months, insiders have purchased 374,714 shares and have sold 189,433 shares for a net effect of 185,281 shares bought. These sales represent less than 1% of shares outstanding.

There are currently 3.6 million shares sold short, which equates to 7% of shares outstanding and seven days to cover. The lack of significant short interest reveals not many are willing to take a stake against this highly profitable company.

Attractive Funds That Hold HCC

The following funds receive our Very Attractive rating and allocate significantly to HCC:

1. ETF Series Acquirers Fund (ZIG) – 3.3% allocation
2. Van Eck Steel ETF (SLX) – 2.0% allocation
3. Alpha Architect U.S. Quantitative Value ETF (QVAL) – 2.0% allocation

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Disclosure: David Trainer, Kyle Guske II, and Italo Mendonca receive no compensation to write about any specific stock, style, or theme.

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Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions, and biases.
2. Only our "novel database" enables investors to overcome these flaws and apply reliable fundamental data in their research.
3. Our proprietary measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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