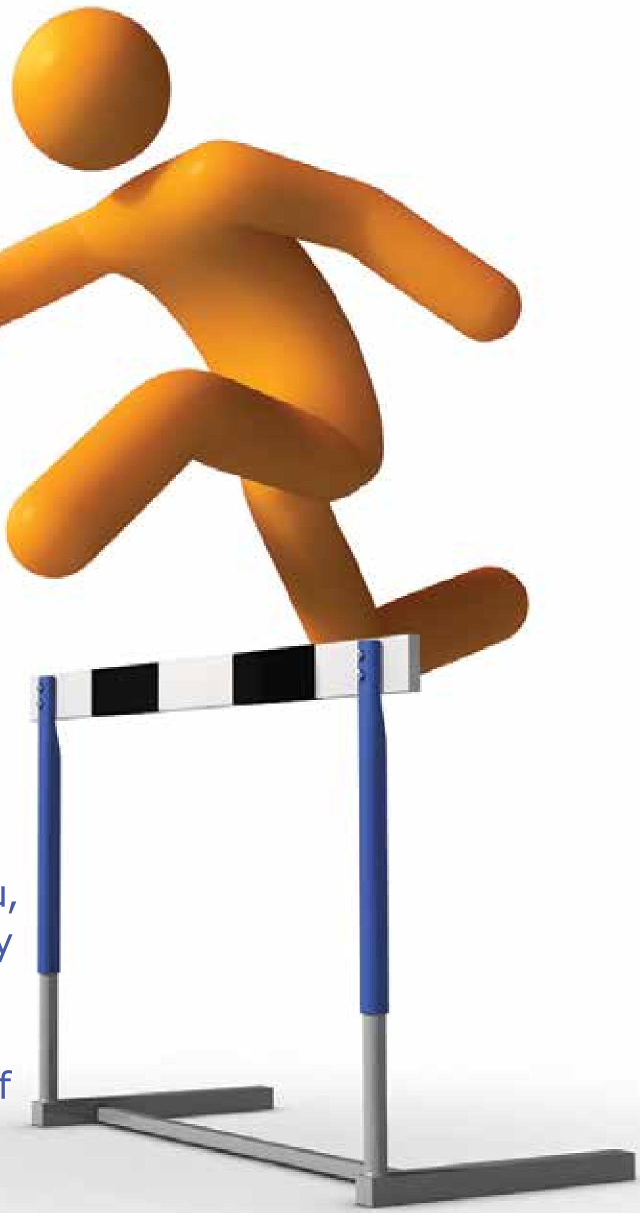

THE FINAL HURDLE

Andrew Church, Falcon Group, Singapore, and Dr Lars Shernikau, IchorCoal Group (parent company of HMS Bergbau AG), Germany, explore the facts and funding options available for the trading of Indonesian coal.

Indonesia is now the largest coal exporter in the world in terms of tonnage, having surpassed long-standing leaders, Australia. However, the outlook for the sector is not promising. Indeed, Indonesia's coal industry faces many challenges: not only is it plagued with falling coal prices, it is constantly under threat from new regulatory restrictions that will severely affect coal production practices.

Perhaps most troubling, however, is the way in which companies in the coal business that are able to overcome pricing and regulatory hurdles are faced with a squeeze on funding. As global banks retreat from an uncertain market, coal traders and miners across a large spectrum of the mining segment are left searching for the financing to fund their day-to-day working capital needs.

Yet there is cause to hope. The withdrawal of global banks has created opportunities for local banks and alternative financiers. Coal companies are discovering that these can tailor financing more to their needs.

Price drop

One major threat to the Indonesian coal industry is the continued drop in coal prices. As of early May 2013, the coal reference price (HBA) declined 3.4% to US$ 85.33/t from US$ 87.56/t in January 2013 and 25% from its high of around US$ 113/t in March 2013.

Part of the problem is oversupply. The drop in the price of coal freights has encouraged countries, such as the US and Colombia, to export coal to Asia. However, this has caused supply to outstrip demand – forcing global prices lower. API2 (European delivered prices), for example, cooled off by over 35% over the past 12 months, from over US$ 125/t to a recent low of approximately US$ 77/t by June 2013.

The Indonesian coal industry has also seen competition from South Africa for market share in coal exports to India, a key market for the country. Despite remaining India's largest supplier, many of the country's leading importers are starting to shift focus to South Africa's higher calorific value thermal coal. Even Australian coal, US coal and selected Russian cargos have been imported into India. Indeed, analysts suggest that India's market share in South African exports – stagnant at around 70 million t over the previous two years – increased from a little less than 30% in 2011 to about 40% in 2012.

China's slowing growth has also significantly affected coal prices in Indonesia. The economic slowdown and a desire to increase domestic production reduced the ability of Chinese importers and power plants to buy expensive coal. Despite recent record low coal prices, many Chinese power plants are now losing money. Furthermore, Chinese authorities – in response to chronic pollution – are considering regulations that would clamp-down on lower-grade coal imports. Such plans, if implemented, would potentially affect between 50 to 70 million tpa of lower calorific value coal exported by Indonesia to China.

Natural wealth

A dwindling export market is not Indonesia's only concern. A significant challenge to the country's coal industry comes from the move to regulate Indonesian coal production by way of a coal export tax policy or even a coal export ban.

Indonesian officials intended to prohibit overseas sales of coal with a heating value of less than 5700 kCal/kg on an air-dried basis, with a decree due to be implemented in 2014. This would have forced export-oriented miners to upgrade the heating value of their coal.

While recent reports suggest that the Indonesian Government has scrapped plans to introduce such regulation in a bid to boost prices, the motivation remains. The government may have paused plans to implement a coal export ban, yet it still wants to preserve its natural wealth for future domestic use, even if it does not seem necessary.[1] Regulation on coal production will come in one form or another and, when it does, it will shake-up an Indonesian coal industry too accustomed to producing low-calorific value coal. Indeed, Indonesian officials have not abandoned all plans to regulate coal production and they are still pursuing plans to control the coal output by giving each producing region an annual mining quota.

Credit for coal

Many companies associated with the Indonesian coal business – whether they are traders, miners or exporters – are faced with a more immediate challenge: funding. Commodity banks are global players and, with so much uncertainty in the Indonesian markets due to coal pricing and the regulatory environment, credit teams have often been forced to question the stability of the country's coal industry.

Added to this is the implementation of Basel III regulation, which controls how much capital global banks must keep on their balance sheets (and therefore their ability to lend to corporates), and the pressure on global banks to favour domestic markets.

Subsequently, despite Indonesia being the largest exporter of thermal coal in the world, many medium-sized Indonesian coal traders, miners and exporters are struggling to access the financing they require to fund otherwise profitable trade flows and coal production.

Overcoming the final hurdle

Local banks are stepping up to fill the gap left by global banks, with banks in Singapore, Hong Kong and Malaysia setting their sights on further expansion across Asia. Indeed, coal traders and miners turning to local banks have found that they are sometimes more appropriate for their needs than global banks. Local banks can boast in-depth knowledge of Indonesia's political, cultural and regulatory environment. Many also have a historic domestic presence, which means they have a greater understanding of the inherent risks in the industry.

However, while the opportunity to fill the gap left by global banks has long been available, local banks have yet to take full advantage of it. This is perhaps partly due to the resources available to them, which are less advanced than global banks and mean local banks are less able to provide sophisticated funding solutions.

But there is another player in the financial landscape: the alternative financier. Alternative financiers have significantly increased efforts to fill the gap left by banks and have the resources and expertise to create sophisticated solutions. Alternative financiers have been building expertise and local knowledge, as well as structuring tailored solutions for corporates, for some time. Indeed, rather than following the model of one solution to suit all, alternative financiers prefer to create solutions to meet each client's specific requirements. As traders and miners linked to the Indonesian coal industry seek to diversify their funding options, alternative financiers add a new flavour through being flexible, innovative and able to act with speed.

Funding solutions come in many different forms. Yet the key to success within the new, more diversified, funding landscape lies in collaboration. Firstly, between the alternative financier and client. Of course, this has not gone unnoticed by some of the more entrepreneurial local banks, resulting in collaboration between banks and alternative financiers. This collaboration means that Indonesian coal traders are able to access solutions that combine the best capabilities that both institutions are able to provide. Ultimately, this leads to a more comprehensive funding solution aligned with the coal company's trade needs.

While obstacles, such as bank appetite and regulation, are posing a real challenge to companies linked to the Indonesian coal industry, funding options may not be such a concern. Given that the rise of local banks and alternative financiers has made the financial landscape more diverse, perhaps reduced global bank support to companies in the coal industry may not be such a bad thing after all. WC

Sources

1. See: SHERNIKAU, L. and GOECKUS, D., "Myths and realities", *World Coal* (June 2013), pp. 41 – 44.