

## Wescoal promises growth – Intellidex

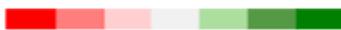
Stock has good value for investors who can stomach a bit of volatility, research house says.

*Intellidex | 9 July 2015*



**Recommendation: SPEC BUY**

**Analyst conviction meter**



Weak Neutral Strong

**Risk level**



High Medium Low

There seems to be no relief in sight for low international coal prices and investors are losing patience: they sent the coal mining index (J150) 50% down since the beginning of the year.

It's worth noting though that while bigger miners with export grade coal reserves will continue to feel the pinch from the deterioration in international coal prices, smaller players with lower exposure to the export market are not directly affected. Most junior miners including Wescoal produce lower-grade coal which is sold to Eskom at production cost plus a rate of return. Though the selling price is typically lower than export prices, the costs of supplying Eskom are lower and it is a substantial and reliable market.

Wescoal is in a growth phase and seems to have a lot to offer in the medium to long term. As the group is set to surpass the 2-million tonne production mark by the end of the financial year, the only down point to its investment case seems to be the lack of long-term supply contracts. Its shares are trading at a lowly price:earnings ratio of 10, which looks like a bargain considering the growth it promises.



Wescoal share price spent the better part of last year moving sideways. The group was hit by boardroom ructions, a failed hostile takeover bid and non-renewal of critical Eskom long-term supply contracts because of its BEE ownership ranking. Its shares lost 6% since the release of subdued annual results on June 26. Revenue for the year to end-March was 46% higher at R1.67 billion (2014: R1.14 billion), largely due to the first-time inclusion of MacPhail, which was acquired towards the end of last year. The improvement in profitability from both of its divisions helped grow headline earnings 1.3% to 15.4c (2014: 15.2c).

Given Eskom's insatiable demand for coal, Wescoal's long-term prospects are largely dependent on how fast and profitably it can ramp up production. The company received a major boost in the past financial year from the awarding of a water use licence for the much-awaited Elandspruit colliery, which puts it a step closer to operationalising the mine. Once fully operational, the mine is expected to produce about 2.4 million tonnes per year. This will more than double the current production but will also result in significant margin expansions from the increased contribution of higher-margin mining operations.

While this is obviously an exciting development, our biggest concern is the delay in securing long-term supply contracts with Eskom due to the group's lack of appropriate black shareholding. Wescoal has 31% black ownership, which falls short of Eskom's 50% plus 1 shareholder requirement. With 80% of its current reserves being Eskom-grade, the current scenario where the company is selling on short-term supply contracts is worrisome. This is likely to have significant knock-on effects on revenues and unit costs. It might also hinder the group's ability to raise long-term funding.

Nonetheless, even after adjusting earnings estimates for these possible knock-on effects, our discounted cash-flow model shows that the stock still has good value for investors who can stomach a bit of volatility.

However, given the uncertainty on when and how the company will address its BEE ownership, we issue a speculative buy for its shares. Management has promised to address the issue and has been given until the end of 2016 to meet the BEE requirements. We are confident though that it will meet this requirement before the deadline.

Wescoal [JSE : WSL]	2015A	2016E	2017E	2018E
Revenue (R'm)	1,674.4	1,808.3	2,079.6	2,391.5
EBITDA (R'm)	100.4	101.8	98.4	115.9
PBT (R'm)	37.1	38.2	43.9	52.7
Attributable income (R'm)	29.0	30.0	34.5	41.5
Headline earnings per share (cents)	15.40	16.15	18.58	22.29
PER (times)	9.7	9.3	8.1	6.7

### Bull factors

- Increased demand for coal by Eskom to stabilise local price received
- Fulfilment of regulatory requirements positions the group to operationalise Elandspruit
- Integration of MacPhail provides synergy opportunities that could enhance margins

### Bear factors

- Increased competitor activity and logistics oversupply in trading division likely to put pressure on already slim margins
- Over-reliance on Eskom and threat posed by the enforcement of BEE requirements for Eskom suppliers

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