



Americas: Energy: Coal

Greater confidence in met forecasts, BTU after China/Australia trip

Strong China demand outlook increases confidence in met coal forecasts: \$225/MT in 1H11, above mid-cycle through 2012

We met with the Ministry of Housing and coal, metals, auto, and real estate companies in China. We came away confident benchmark met coal prices will remain above mid-cycle through 2012, as we expect import demand growth largely from emerging markets will leave spare capacity at US/ Australia mines limited. China is targeting a 65% urbanization rate by 2030 from 47% today, implying infrastructure for over 200 mn people needs to be built. We expect 8%/7% Chinese steel production growth in 2011/2012 to be driven by aggressive government spending on the development of Tier 2/Tier 3 cities at the outset of its 12th Five Year Plan. Affirmation that the government's focus on mine safety continues to constrain domestic coal supply growth and that more domestic coal is being pulled West to developing inland regions gives us greater confidence Chinese seaborne net imports of met coal will grow 15 MM MT (50%) from 2010 to 2012. Contractionary government policy in response to inflation pressures or liquidity challenges remain key risks.

BTU favorite stock: Asia exposure, EPS growth visibility, discipline

Buy-rated BTU is still our favorite coal stock after its November 10-12 Australia analyst meeting. It is the best secular growth story among coal stocks on its combination of (1) unique direct exposure to growth in Asia demand via organic Australian projects (which remain on track) and pending JVs in China/India (which are slow to conclude but management remains confident will close), (2) visible EPS growth through 2015 with above average returns and further upside from JVs (not in our numbers), and (3) discipline – organic growth reduces the urgency of M&A. Management is reprioritizing exploration over M&A to extend BTU's asset life. We raise our six-month, multiples-based target price to \$64 from \$60 as we assume approximately \$5/MT higher 2011/2012 Newcastle thermal prices on greater confidence in China import demand. Key risks include 4Q Australian volume shortfall (we assume just below the midpoint of guidance) and cost pressures (tight labor market and weak US\$).

Neutral on stocks-already reflect met view, to be rangebound

We expect upside from positive 1H11 met coal/steel datapts (largely discounted already) and M&A (potential MEE sale, BTU JVs, CNX divestitures) to be offset by continued pressure on Eastern thermal pricing/demand (low gas prices /weak US activity) and potential continued challenges meeting volume/cost guidance (theme for many 3Q10).

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RATINGS AND TARGET PRICES

Company	Rating	Target price	Return potential	2-yr roll fwd EV/EBITDA
Alpha Nat Res	Neutral	\$48	1%	4.5
Arch Coal	Neutral	\$31	9%	5.0
Consol Energy	Buy	\$44	8%	5.7
Massey Energy	Neutral	\$41	-13%	5.4
Patriot Coal	Sell	\$14	-4%	3.6
Peabody Energy	Buy	\$64	11%	6.2
Walter Energy	Neutral	\$67	2%	5.4
Average			2%	5.1

* Walter's historical average EV/EBITDA is calculated from January 2009

** All target prices are 6-month, based on cash flow multiples and asset-value analysis

** Total return includes dividend yield

Key risks include price volatility, costs, govt pronouncements and geological events

Source: Goldman Sachs Research.

China demand outlook increases confidence in met coal forecasts

We recently attended the Goldman Sachs China Investment Frontier Conference in Beijing and Social Housing/Commodities field trip in Beijing and Shanghai, China. Over the five days we heard from or met with the Ministry of Housing and Urban/Rural Development and leading Chinese coal, steel, aluminum, auto, cement, and property development companies. **We came away more confident in the following themes.**

- 1. Strong medium-term outlook for China's demand for steel and met coal.** We encountered little pushback from industrial companies to the GS Global ECS Research team's 10% China GDP growth rate forecast for 2011, with most expecting double-digit growth for their own businesses in 2011. We believe the government will aggressively spend on the development of Tier 2/Tier 3 cities at the outset of its 12th Five Year Plan next year, as it aims to reach a 65% urbanization rate by 2030 from 47% today (implying infrastructure for over 200 million people needs to be built). Virtually none of the companies expected the negative impacts of recent energy conservation efforts to persist beyond the conclusion of the 11th Five Year Plan in December. Real estate developers believed the government's tightening measures (restrictions on the number of homes one can own and the availability of financing) will cap pricing upside in Tier 1 cities but not dampen underlying demand, noting vacancy rates remain low in Tier 2/Tier 3 cities.
- 2. Benchmark met coal prices will average \$225/MT in 1H 2011,** up from \$209/MT in 4Q 2010 on improved global steel production in key emerging economies led by China. We see potential upside to pricing if Australian exports disappoints due to bad weather (mines and railroads in Queensland are still recovering from heavy rains) or Chinese demand positively surprises after energy conservation efforts are relaxed. However, we are not raising estimates for now because most companies we met with are seeing \$215-\$220/MT benchmark pricing and benchmark settlements have not typically been far from the prevailing spot rates;
- 3. Met coal prices will remain above mid-cycle through at least 2012** as strong seaborne import demand growth (led by China) will keep spare capacity at US and Australian mines limited, with Australian utilization rates remaining near or above 90% through 2013. Affirmation the government's focus on mine safety continues to constrain domestic coal supply growth and more domestic coal is being pulled West to developing inland regions gives us greater confidence Chinese seaborne net imports of met coal will grow from 30 MM MT in 2010 to 45 MM MT in 2012. We do ultimately expect prices to normalize to \$160/MT, as significant capacity in Australia and Mozambique (as well as other geographies we did not cover on this trip) appears on track to come on line from 2013-2015 and most companies appear to be assuming \$150/MT benchmark pricing long term when evaluating the feasibility of new projects.

We have raised our Newcastle thermal coal forecasts to \$105/\$100/\$95 per MT from \$99/\$96/\$80 per MT in 2011-2013. Our forecasts are now consistent with those of our counterparts at Goldman Sachs & Partners Australia (Malcolm Southwood, Neil Goodwill, and Paul Gray) and reflect higher Indian and Chinese imports and potential weather-related disruptions confirmed on our trip.

Contractionary changes to government policy in response to inflation pressures or funding/liquidity issues are the key risks that concerned almost every company and market participant we spoke with (ironically, the government's will to spend was also the biggest source of confidence in demand for many of the same individuals). We note GS China economists and portfolio strategists expect the government to respond quickly and decisively to inflation through measures including rate hikes and higher bank reserve requirements through 2Q 2011. As highlighted by Helen Zhu in her November 12, 2010,

report "Inflation and imminent tightening, how to position?", policy conditions, despite tightening, are nowhere near unfavorable enough to put growth at meaningful risk or to increase systemic risks. Also, most we met with, including the representative from the Ministry of Housing and Urban/Rural Development, saw limited downside risk to spending on Tier 2/Tier 3 city development and social housing due to their high level of priority in the government 12th Five Year Plan and the government's still-reasonable level of total debt relative to GDP.

Exhibit 1: We expect met coal prices to remain above mid-cycle through at least 2012 and have raised our 2011-2013 Newcastle thermal coal prices largely on confidence in strong Chinese import demand
US and global thermal and met coal price forecasts

	Hard coking coal			Thermal coal						
	Asia (FOB port, \$/MT)	USA (FOB port, \$/ST)	USA (FOB mine, \$/ST)	CAPP \$/ST	NAPP \$/ST	PRB 8800 \$/ST	Interior \$/ST	West Bit \$/ST	Newcastle	
									new, \$/MT	old, \$/MT
3Q 2010	\$225	\$204	\$164	\$65.32	\$65.92	\$14.45	\$43.05	\$40.00	\$94.02	\$94.02
4Q 2010E	\$209	\$190	\$150	\$70.00	\$65.00	\$13.00	\$50.00	\$45.00	\$98.08	\$96.98
CY 2010E	\$191	\$170	\$135	\$62.58	\$62.60	\$12.69	\$44.08	\$41.25	\$96.51	\$96.23
1Q 2011E	\$225	\$204	\$164	\$70	\$65	\$13	\$55	\$45	\$105	\$97
2Q 2011E	\$225	\$204	\$164	\$70	\$65	\$13	\$55	\$45	\$105	\$100
3Q 2011E	\$200	\$181	\$146	\$70	\$65	\$13	\$55	\$45	\$105	\$100
4Q 2011E	\$200	\$181	\$146	\$70	\$65	\$13	\$55	\$45	\$105	\$100
CY 2011E	\$212	\$193	\$155	\$70	\$65	\$13	\$55	\$45	\$105	\$99
1Q 2012E	\$200	\$182	\$152	\$70	\$65	\$13	\$55	\$45	\$100	\$100
2Q 2012E	\$200	\$182	\$152	\$70	\$65	\$13	\$55	\$45	\$100	\$95
3Q 2012E	\$190	\$173	\$148	\$70	\$65	\$13	\$55	\$45	\$100	\$95
4Q 2012E	\$180	\$164	\$139	\$70	\$65	\$13	\$55	\$45	\$100	\$95
CY 2012E	\$193	\$175	\$148	\$70	\$65	\$13	\$55	\$45	\$100	\$96
CY 2013E	\$160	\$145	\$120	\$70	\$65	\$13	\$55	\$45	\$95	\$80
CY 2014E	\$160	\$145	\$120	\$70	\$65	\$13	\$55	\$45	\$80	\$80
CY 2015N	\$160	\$145	\$120	\$70	\$65	\$13	\$55	\$45	\$80	\$80

Source: Goldman Sachs Research estimates.

Exhibit 2: Strong growth in China met coal imports complements growth in India and South America along with a slow recovery of demand in Korea, Europe and the United States...

Global seaborne met coal supply-demand, million MT unless otherwise noted

	2004	2005	2006	2007	2008	2009	2010E	2011E	2012E
Seaborne imports									
China (net)	(0)	(0)	(2)	1	(0)	30	30	38	45
Japan	56	55	52	54	54	45	51	50	49
Korea	15	12	12	16	19	15	20	23	24
India	0	21	22	24	25	25	30	34	39
Europe	51	51	54	59	61	41	51	57	58
South America	11	11	12	14	16	12	16	18	21
Other	42	50	40	42	43	31	35	41	44
Total	174	200	192	211	217	199	233	261	280
Seaborne exports									
Australia	117	125	124	137	134	134	151	168	182
USA	20	21	20	26	35	31	42	44	44
Canada	22	25	23	25	25	21	25	29	31
Other	16	29	24	23	23	13	15	20	23
Total	174	200	192	211	217	199	233	261	280
Asia hard coking coal benchmark (\$/MT)	\$58	\$125	\$116	\$98	\$300	\$129	\$191	\$213	\$193

Source: McCloskeys, EIA, Goldman Sachs Research estimates.

Exhibit 3: ...to leave Australia (largest global supplier) and US (marginal global supplier) spare capacity limited

Estimated metallurgical coal production and spare capacity, million MT

	2010		2011		2012		2013	
	Capacity	Production	Capacity	Production	Capacity	Production	Capacity	Production
Australia								
Covered	125	119	130	128	138	137	151	141
Uncovered	28	24	33	32	45	40	46	36
Total exports	152	143	163	160	182	177	197	177
USA								
Covered	47	44	55	51	57	50	57	49
Uncovered	17	17	19	15	20	16	20	16
Total production	65	62	75	66	76	66	77	65
Sold in North America		22		24		24		23
Seaborne exports		40		42		42		42
Australian mine utilization rate		94%		98%		97%		90%
US mine utilization rate		96%		88%		86%		85%

Source: McCloskeys, Goldman Sachs Research estimates.

Many industrial companies we met with were not seeing concerning levels of slowdown in their businesses, still expecting double-digit growth in 2011 and preferring that growth come down to more sustainable rates. They generally felt better about demand now than they did three months ago despite concerns over tightening measures. Key drivers of positive sentiment included the following.

- **The continued industrialization/urbanization of Tier 2 and Tier 3 cities.** China wants to achieve a 65% urbanization rate by 2030 versus 47% in China, 87% in Europe and 76% in the US at present, implying over 200 million people of China's 1.3 billion

people need to move to cities. The belief is urbanization brings better jobs, healthcare, education, etc. for the overall population and stimulates economic growth.

- **Continued interest in real estate by wealthy individuals** because of the limited number of alternative investment opportunities (restrictions on the equity market, ability to shift capital internationally).
- **The government's increasingly intense focus on affordable housing for low income people (ie "social housing") as a key part of its 12th Five Year Plan**

Some specific commentary of note from various companies/entities included:

- **All of the property developers we met with felt good about current activity and the outlook, with many saying tightening measures are more likely to cap pricing upside in Tier 1 cities (the government's ultimate goal, along with ensuring housing for lower income citizens) than to derail underlying demand.** They noted that, although vacancy rates appear high in Tier 1 cities (some estimated 20%-25% or higher), they are low in Tier 2 and Tier 3 cities. Recent tightening measures have included rules that limit the number of homes people can own and the availability of financing the acquisition for additional homes beyond one's first.
- **One property company felt fears about additional rules restricting property development would likely incentivize acceleration of longer-term projects over the next few years (indicating upside for near term demand). Another indicated small companies were more likely to slow land acquisitions (the largest component of development costs) than construction if they felt strain on their balance sheets,** thus changes to land supply rules would take one year to one and a half years to have a meaningful impact on the housing market. In a separate meeting, a representative of the Housing ministry indicated the government is privately evaluating new property tax and land acquisition rules but said the country is not ready to uniformly implement them so they will likely be trialed in big cities.
- **China State Construction Corp said it has not slowed down construction despite tightening measures as it is too logistically challenging to start and stop big projects.**
- **The auto and auto parts companies on a conference panel all expected double-digit growth next year,** supported by a refresh cycle in Tier 1 cities (growing wealth and a government push for more energy efficient cars) and first car purchases in Tier 2 and 3 cities (Baoshan Iron & Steel cited similar themes)
- **Baoshan Iron & Steel has strong end-market demand expectations,** expecting 15% FAI growth and 10% growth for both housing and autos sectors in 2011 (all down from 2010 but still strong).
- **The need to build out the rail infrastructure (urbanization + increasing transport of commodities) remains a key source of demand** in the near term as well as potential source of upside to the prices of the commodities transported on them (including coal) should the timing of infrastructure expansions fall short of expectations.

Additional takeaways from meeting with large coal and steel companies include the following.

- **China is expected to remain a net importer of thermal and met coal for the foreseeable future.** The rail network limitations (there are only two railroads) and distance from producing regions to many steel plants and utilities makes imports more economic. There will also be a pull on domestic coal towards Western regions as urbanization leads to increased demand.

- **The Chinese government's focus on mine safety continues, putting upside risk on import demand and pricing**, with 1,600 mine closures completed to date, ahead of the stated target of 1,500 and the government increasing the costs of poor safety records by raising compensation paid to people and families who are hurt in accidents.
- **The proposed changes to Chinese resource tax rates (3%-5% of sales price versus Rmb 3-8 per MT previously) is not expected to be negative for imports if passed.** The company emphasized China's tax scheme has been and will likely remain favorable to imports and discourage exports.
- **Baosteel says it and most of its peers are currently running near capacity.**
- **More inefficient steel and iron ore capacity is expected to be shut down next year, but overall capacity and production is expected to be up.**

Social housing appears poised to remain a key new driver Chinese demand for materials over the next few years, likely representing "baseload" demand with more limited downside even in a worst case scenario for the economy. We estimate social housing will account for 6% of steel demand next year-assuming 25% of steel demand is from housing and 24% of next year's residential housing GFA will be for social housing (we refer readers to "Social housing, Part 2 – Even larger ambitions, even more support," published by Helen Zhu on November 10, for additional details). Neither investors nor the government were focused on social housing as recently as last year, but this changed when the spike in property prices led to a number of uprisings/protests. The local media pays close to attention to issues of housing/wealth inequity, thus making management of negative housing headlines remains a key focus of the government.

What is social housing? Social housing is property that is heavily subsidized by the government for rent or purchase by citizens with lower income levels, with the extent of subsidization depending on a person's financial status. It has come into focus due to high housing prices and unrest by poorer segments of the population in response (spiking property prices made it near impossible for many to find housing despite being fully employed).

Three areas of focus for social housing: (1) Big urban areas with very high pricing for housing; (2) very poor western provinces; (3) Eastern cities with populations of four million people or more. In Western provinces the government is more focused on "low cost rentals," while it has greater focus on "public rental" (less subsidized than low rental) in the Eastern provinces which are wealthier.

Social housing is estimated to account for only a mid-single-digit percentage of the overall housing market at present but is expected to account for a significant percentage of units developed over the next five years. For example, between one third and one half of land supply in Beijing is allocated for social housing this year and next. The Housing ministry representative we met with expected social housing to represent approximately 5 million units out of 10 million units nationally per year over the next few years. GS strategist Helen Zhu expects the government to raise the target to seven million per year, with social housing accounting for 24% of the residential property GFA in 2011.

Most local participants do not see much risk of the program being reduced. Most people we spoke with (property developers, policy advisors, cement companies) saw limited downside risk to spending on social housing even if Chinese and global GDP are softer than expected, as it remains a central component of the central government's Five Year Plan. The Housing Ministry representative felt in a worst-case scenario the government would include funding as part of another stimulus package.

The program is still in the early phases of implementation, leading some to take a "wait and see" approach. One company believes it will take 1-2 years for social housing programs to be fully up and running. Another is taking a "wait-and-see" approach to see if

key issues can be worked out before factoring social housing into its longer-term estimates of demand.

Key risks/issues appear to be the following.

1. **The ability of the central government to fund.** GS strategist Helen Zhu flags the current funding shortfall at more than Rmb 700 billion but is not concerned, as she expects the federal government to reallocate resources.
2. **Local governments do not implement.** Misalignment of central and state government interests could potentially hurt the actual number of projects that are completed. Forcing states to allocate land to social housing would eliminate much of the revenue from the sale of high priced land to developers that many states currently depend on for their budgets.
3. **The need for better margins for developers to embrace.** Property developers all cited the need for a more sustainable business model (i.e., better margins) to believe the government's long term targets for social housing development are achievable. Most say government-guaranteed gross margins on projects are high-single digits with net margins as low as 3%-5%. Ways to improve returns on projects included circumventing the need to acquire land from the government (as BBMG did by converting industrial land they already previously developed), adding commercial businesses to development projects and getting better financing terms from local banks.

Peabody is still our favorite coal stock following Australia meetings

After visiting industrial companies in China and coal companies in Australia and attending Peabody's Australia analyst meetings/tour, BTU remains our favorite coal stock, as it is unique amongst covered companies in its combination of the following.

1. **Asia exposure.** Peabody has direct exposure to growth in Asian demand for met and thermal coal via organic Australian projects (which remain on track) and pending JVs in China/India (which are slow to conclude but management remains confident will eventually close).
2. **Visible earnings growth and reinvestment opportunities, superior returns and EPS upside.** Visible EPS growth (2010-2015 CAGR of 12%) with above average returns (2011-2015 average CROCI of 13%), over \$5.3 billion in free cash flow over the next five years, and further upside from pending JVs (not in our/consensus estimates).
3. **Discipline: Organic growth and pending JVs reduces urgency of M&A.** We previously highlighted expectations Peabody would maintain discipline in allocating capital in our note "Reiterate Buy following mgmt trip on Asia growth, capital discipline" published August 22, 2010. Since then Peabody has remained patient due to less attractive valuation for potential targets, significant organic growth projects already under way, and pending joint ventures in Asia. While in Australia, management indicated it is reprioritizing exploration in Mongolia, China, Indonesia, and Mozambique over M&A to extend asset life due to valuation (though it continues to evaluate opportunities).

We also see less downside to Peabody's earnings than to earnings of Appalachian peers facing rising cost and permitting pressures. And valuation remains attractive, with BTU still trading approximately 0.5X below its historical one-year and two-year rolling forward EV/EBITDA historical averages.

We raise estimates and our six-month, multiples-based target price to \$64 from \$60 (11% return), as we now assume higher 2011-2013 Newcastle thermal coal prices. Peabody trades at 6.2X, two-year rolling forward EV/EBITDA versus its 6.8X historical average, 5.7X for Consol, 5.0X for Arch, and 4.5X for Alpha. We believe the premium to peers is deserved due to its superior growth outlook and risk profile. Key risks include 4Q Australian volumes (Peabody and others are still dealing with challenges from heavy rainfall, but we already assume slightly below the midpoint of 2010 volume guidance) and cost pressures from tight labor markets and FX (though BTU has 75% of its 2011 Australian dollar needs hedged at US\$0.80).

Additional details from the November 10-12 analyst meeting/tour follow.

- **Asia organic growth plans remain on track**, with updates in line with what we have been assuming and no significant changes from recent presentations.
- **The conclusion of terms for pending deals in China and India remain slow going but management remains confident they will still get done.**
- **Management said Peabody is currently reprioritizing exploration over M&A as a way to extend the life of the company...** There is a team established in Mongolia to conduct a large amount of exploration. Peabody is also exploring in China and Indonesia and has applied for licenses in Mozambique (it will know whether it received them soon). In our conversation with Riversdale Mining's CFO (independent Australian mining company with three development projects in Mozambique), Peabody was included on the list of large international coal companies it would find attractive to bring in as a partner on its East Tete project in the next 1-2 years.
- **...But it does continue to patiently evaluate M&A opportunities as they arise.** Management indicated Peabody continues to evaluate opportunities in Australia and all other key growth markets it has identified (i.e., Asia and Africa). There is reportedly a range of opportunities including producing and undeveloped resource assets available. Management indicated it did not have a strong preference for one type of asset over the other, though noted undeveloped assets do tend to have better valuations.
- **While management repeatedly insisted Peabody is "faring better than most," it still has seen some negative impact from the heavy rains in Queensland and New South Wales.** We are currently assuming just below the midpoint of the 27-29 MM tons 2010 Australia volumes guidance (which implies roughly flat qoq volumes of 7.6 MM tons in 4Q vs 7.5 MM tons in 3Q). When it rains too hard, operations can be forced to stop temporarily, particularly if the pits fill with water which must be pumped. But if a company has inventories on the ground (which Peabody has highlighted it does), a producer would lose less time from disruptions because it can continue processing coal. Peabody, however, would not be able to get around the issue of reduced railcar speeds (which reduces maximum system capacity) due to the land under the rails becoming soft (which can cause the track to cave or buckle when trains run at high speeds).
- **The labor market in Australia is tight, though mine managers are not seeing rising input cost pressures for now. The market for mining equipment in Australia is also tight, with management indicating it expects to wait 6-12 months for new equipment.** Management and mine employees alike characterized the entire Australian mining industry as an "employees market." Management said it could often take over six months to identify suitable employees, making it challenging to staff mine expansions. Competition for met coal miners in Queensland/Bowen Basin is reportedly the highest due to its remote location, tougher conditions and competition with gold mines in northern and western Australia. Though it is not yet clear they are seeing wage pressures for now, this is a theme we will continue to watch.

- The NCIG terminal is operational and continues to slowly ramp up to the Stage 1 30 MM MT nameplate capacity over the next 12 months as it deals with water contamination.** NCIG is a terminal adjacent to PWCS (where Peabody also has approximately 7 MM tons of capacity) in Newcastle, from which it ships mostly thermal coal. Peabody has a 17.7% stake in the shares and overall capacity of NCIG. The terminal is currently operating at a 1.5 MM MT/month run rate, below its 2.5 MM MT/month nameplate rate as it operators work to clean up contamination that occurred when there were steel works at the terminal. As a result of the contamination, only 120 meters of the 180 meter wide waterway are able to be used. Once the cleanup is completed, it can use the full waterway and headline capacity can be achieved. Terminal management officially hopes to have that process done by September 2011, with a goal of beating that timeline. Stage 2 of the terminal has already been approved by shareholders, will raise capacity to 53 MM MT and is currently expected to be completed in 2013. A third stage (to increase capacity to 66 MM MT) has not been approved by shareholders yet, though the terminal is fully cleared for development up to the 66 MM MT total by regulators.

Exhibit 4: Updated BTU EPS and EBITDA estimates

	EPS			EBITDA (\$ millions)		
	new	old	% chg	new	old	% chg
Q3 2010	0.99	0.99	0%	567	567	0%
Q4 2010	0.94	0.93	0%	537	536	0%
FY 2010	3.12	3.12	0%	1,888	1,887	0%
FY 2011	4.75	4.61	3%	2,460	2,406	2%
FY 2012	5.30	5.17	3%	2,595	2,547	2%
FY 2013	4.88	4.39	11%	2,482	2,293	8%
FY 2014	5.14	5.13	0%	2,587	2,587	0%
FY 2015	5.55	5.55	0%	2,760	2,760	0%

Source: Goldman Sachs Research estimates.

Maintain Neutral coverage view, stocks to remain rangebound

With 3Q earnings complete and coal stocks having significantly outperformed the market (stocks under coverage excluding MEE are +14%/+7%/+6% versus the S&P 500 over the last three months/1 month/1 week), we maintain our Neutral coverage view due to limited average upside (2%) for the group and an expectation stocks will remain rangebound near term. Potential positive factors include the following.

- Sequentially higher 1Q 2011 met coal benchmark pricing and improving 1H 2011 steel datapoints.** We believe these improvements have been largely anticipated, were responsible for most of the recent rally (along with increased investor appetite for risk in the broader market), and are now mostly discounted in the stocks (we are generally only 2%-5% above consensus for 2011 EBITDA estimates despite a \$212/MT forecast for 2011 benchmark met coal prices and volumes generally near the high end of company expectations).
- M&A activity: Although we do not expect a widespread wave of M&A to take place across the sector...** Conversations with the managements of both covered and uncovered coal companies leads us to believe valuation of many potential targets

(particularly internationally) remain too high to be attractive. US companies are facing strong competition from Chinese, Indian, Japanese, and Korean strategic buyers for both global met coal and international thermal coal assets. We separately believe only the subset of companies under coverage which derive the majority of their profits from met coal are likely to be of interest to strategic buyers, though they still remain less attractive to international buyers (the most likely acquirers in our view) due to lower quality, longer distances and more challenges with supply security relative to Australian and Canadian companies. Our conversations also lead us to believe some Chinese companies are concerned about a lack of familiarity with US companies, while Japanese and Korean companies largely prefer equity stakes in undeveloped resources to be developed longer term over corporate deals for companies with large producing asset bases (such as all the companies we cover).

...We do see specific situations amongst companies under coverage which could lead to outperformance. As highlighted in our report "M&A potential offsets operational challenges/uncertainty; Neutral," published October 28, the board of Massey affirmed it is evaluating strategic alternatives that could conclude with an eventual sale of the company or specific assets. Peabody management also confirmed it should announce terms of pending joint ventures in China and India soon (providing a potential source of earnings upside, as credit is not reflected in our/ consensus estimates). And proceeds from Consol's expected divestiture of non-core met coal assets could positively surprise (we refer readers to our report "EPS miss, catalysts delayed, but risk/reward remains positive; Buy," published October 31, for additional details). For Consol, we see \$2-\$3/share of upside from the potential sale.

Potential offsetting negative factors include the following.

1. **Continued pressure on Eastern thermal pricing/demand from low gas prices and weak US economic activity.**
2. **Companies' ability to hit volume guidance and maintain control over costs, which was a negative theme for many in 3Q 2010; we continue to watch closely.**
3. **Continued announcements of coal plant retirements, which is admittedly a longer-term issue that could still potentially dampen sentiment and reduce target multiples.**

We maintain Buy ratings on Peabody Energy (as discussed above) and on Consol Energy due to its attractive high-margin businesses and improved risk/reward. We believe further downside to Buy-side estimates and sentiment from low gas prices is limited and the shares reflect little credit for expected asset sales and West Virginia resource potential.

We maintain our Sell rating on Patriot Coal due to its less attractive upside, asset mix, and near-term catalysts versus peers. Beyond the roll-off of underwater contracts through 2012, we see limited opportunities for management to further narrow its gap in returns versus peers absent M&A.

We remain Neutral rated on the following companies.

- **Massey Energy**, as we believe upside risk from potential M&A offsets our view that the fundamental value for the shares is below current levels;
- **Arch Coal**, pending greater confidence PRB 8800 prices can rise meaningfully from the current \$13.65/ton average price for 2011 delivery (our forecast remains \$13/ton);
- **Alpha Natural Resources**, due to better company-specific catalysts and reinvestment opportunities amongst Buy-rated stocks and because the potential that ANR could do an acquisition with poor terms remains a potential overhang for the shares.

- **Walter Energy**, due to less attractive upside versus Buy-rated peers, which could improve with the emergence of an opportunity to materially grow production medium term, much higher met coal prices or M&A interest.

Exhibit 5: We see 2% average return potential for coal stocks

Ratings, target prices and valuation metrics for coal stocks

Company	Rating	Target price	Return potential	2-yr roll fwd EV/EBITDA	Hist avg EV/EBITDA	Target EV/EBITDA	1-yr roll fwd EV/EBITDA	Hist avg EV/EBITDA	Target EV/EBITDA
Alpha Nat Resources	Neutral	\$49	1%	4.5	4.3	4.6	5.3	5.0	5.3
Arch Coal	Neutral	\$31	9%	5.0	6.1	5.3	5.5	7.2	5.8
Consol Energy	Buy	\$44	6%	5.7	5.9	5.9	6.9	6.7	7.1
Massey Energy	Neutral	\$41	-13%	5.4	5.2	4.8	6.2	6.1	5.5
Patriot Coal	Sell	\$14	-4%	3.6	5.1	3.4	5.9	7.0	5.7
Peabody Energy	Buy	\$64	11%	6.2	6.8	6.9	7.1	7.7	7.8
Walter Energy	Neutral	\$97	2%	5.4	4.6	5.5	5.5	6.4	5.6
Average			2%	5.1	5.4	5.2	6.1	6.6	6.1

* Walter's historical average EV/EBITDA is calculated from January 2009

*All target prices are 6-month, based on cash flow multiples and asset-value analysis

* Total return includes dividend yield

Key risks include price volatility, costs, gov't pronouncements and geological events

Source: Company data, Goldman Sachs Research estimates

Reg AC

We, Andre Benjamin and Brian Singer, CFA, hereby certify that all of the views expressed in this report accurately reflect our personal views about the subject company or companies and its or their securities. We also certify that no part of our compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

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The precise calculation of each metric may vary depending on the fiscal year, industry and region but the standard approach is as follows:

Growth is a composite of next year's estimate over current year's estimate, e.g. EPS, EBITDA, Revenue. **Return** is a year one prospective aggregate of various return on capital measures, e.g. CROCI, ROACE, and ROE. **Multiple** is a composite of one-year forward valuation ratios, e.g. P/E, dividend yield, EV/FCF, EV/EBITDA, EV/DACF, Price/Book. **Volatility** is measured as trailing twelve-month volatility adjusted for dividends.

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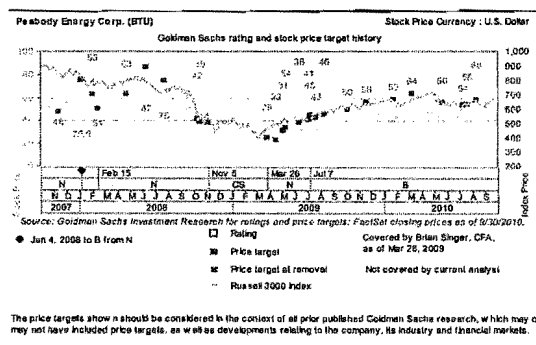
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Price target and rating history chart(s)



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