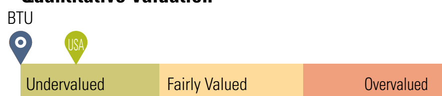
Peabody Energy Corp BTU (XNYS)

Morningstar Rating	Last Price	Fair Value Estimate	Price/Fair Value	Dividend Yield %	Market Cap (Bil)	Industry	Stewardship
★★★★★ 10 Sep 2015	1.78 USD 10 Sep 2015	4.00 USD	0.45	8.71 10 Sep 2015	0.50 10 Sep 2015	Coal	Standard

Morningstar Pillars	Analyst	Quantitative
Economic Moat	None	None
Valuation	★★★★★	Undervalued
Uncertainty	Very High	Extreme
Financial Health	—	Weak

Source: Morningstar Equity Research

Quantitative Valuation



	Current	5-Yr Avg	Sector	Country
Price/Quant Fair Value	0.60	0.80	0.76	0.83
Price/Earnings	—	16.6	15.3	19.8
Forward P/E	-33.9	—	11.1	14.7
Price/Cash Flow	2.7	7.8	7.0	11.7
Price/Free Cash Flow	—	18.6	13.3	18.1
Dividend Yield %	8.71	1.78	2.39	2.35

Source: Morningstar

Bulls Say

- Peabody's high-margin Australian operations have the potential to be a catalyst for significant growth, increasing the company's exposure to China and India.
- Peabody's Powder River Basin mines should continue to generate significant return, as the demand for its cleaner coal should remain strong as climate concerns grow.
- Peabody's low-cost Powder River Basin and Illinois Basin coal should be able to steal market share away from its high-cost Appalachian competitors.

Bears Say

- Coal could undergo a secular decline with the proliferation of renewable energy technologies and increased usage of other fuels.
- An increased focus on carbon emissions by regulators would hurt all coal demand, including PRB coal.
- The company acquired Macarthur at the peak of metallurgical prices, leaving it highly leveraged.

Arch Coal and Peabody Shares Rally on Increased Optimism for Arch Coal's Debt Exchange

Kristoffer Inton, Analyst, 28 July 2015

Investment Thesis

Peabody Energy mines coal in the Powder River Basin and the Illinois Basin in the United States and in the Queensland and New South Wales provinces in Australia, with smaller operations in the Southwest U.S. and Colorado. Through M&A, Peabody shifted to higher-growth, lower-cost coal regions--PRB, ILB, and Australia--and exited the high-cost Appalachian basin. Peabody is at risk for a secular decline in U.S. coal demand and uncertainty of metallurgical coal demand in Asia Pacific.

With around 75% of Peabody's domestic sales coming from the low-cost PRB and ILB, we like the firm's domestic portfolio. The PRB is one of the lowest-cost coal mining regions in the world, as its geology allows for easier mining methods. While customers' shipping costs are high, PRB remains the economical option thanks to abundance, low sulfur, and ultralow production costs. Despite high sulfur, we also like Peabody's ILB assets. Responding to government regulations, many coal plants installed scrubbers, reviving ILB's domestic demand. We believe lower-cost PRB and ILB coal is primed to steal share from Appalachia--a tailwind for Peabody. Domestic coal faces stiff competition from natural gas owing to near-term low but rebounding prices and longer-term increasingly strict environmental regulations. However, we think natural gas prices will increase over the long run, given that marginal shale gas operators are unable to generate acceptable economic returns at current prices, which should help stabilize U.S. thermal coal demand.

Australia generated significantly higher profit per ton than in its U.S. operations during peak seaborne prices. Peak seaborne prices enticed miners such as Peabody to invest in production capacity expansion, ultimately resulting in oversupply that weakened prices in the following years. Despite the rationalization of unprofitable high-cost seaborne supply, we expect that slowing steel production and increasing usage of domestic and nearby Mongolian supply in China will mute the recovery of met coal prices. As such, we expect Peabody's profitability to remain weakened and unlikely to return to levels seen during peak seaborne prices.

Kristoffer Inton, Analyst, 19 August 2015

Analyst Note

On Wednesday morning, Arch Coal and Peabody Energy shares rallied 40% and 15%, respectively, as of the writing of this note. Last month, Arch Coal announced a complicated set of debt-for-debt exchanges intended to improve its financial situation and help stave off bankruptcy.

As part of the transaction, some junior debtholders would receive more senior ranking debt. However, a group of senior lenders opposed the exchange, claiming that the exchange would give preferential treatment over existing senior debtholders. The exchange was recently extended yet again to Aug. 28, as Arch continues to work to get the transaction through. It was reported this morning that Arch is negotiating with the opposing loan holders, potentially offering better terms and a comparable yield to the new loan to get their approval. The market seems to have rallied around this news, as the uncertainty of the exchange is reduced if the senior lenders agree to the compromise.

While the news was specific to Arch Coal, Peabody shares also rallied. Although not in as dire financial straits as Arch, Peabody investors are clearly watching the debt-for-debt exchange as a potential solution to their own company's high leverage.

We are maintaining our fair value estimates of $3.50 per share for Arch and $4 per share for Peabody as we await the final outcome of the debt restructuring. Our fair value estimate for Arch continues to represent only option value for our bull-case scenario; we still believe the company has no equity value under our base case. We maintain our no-moat ratings for both companies.

Economic Moat

Kristoffer Inton, Analyst, 28 July 2015

We do not believe Peabody Energy has an economic moat. Despite its sizable position in the low-cost Powder River Basin, the company has significant weighting to more mediocre assets in Australia and the Uinta and Illinois basins in the U.S., more than offsetting any competitive advantage it has in the PRB.

As the largest of four major miners in the PRB, Peabody

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enjoys cash extraction costs under $10 per ton, excluding cash royalty payments. Historically, PRB coal has made up for its lower heat value than other major U.S. basins with its lower sulfur content, leading to its significant growth over the last few decades. With the proliferation of domestic natural gas production in the U.S., coal now faces a significant substitute for baseload power generation. However, we think PRB coal enjoys some cushion against natural gas that other U.S. basins do not. PRB customers are heavily based in the midwestern U.S. Whereas Eastern utilities' proximity to low-cost natural gas production like the Marcellus Shale allows them to enjoy prices even below the Henry Hub benchmark, Midwest utilities face a much higher delivered natural gas price. This geographic cushion keeps PRB competitive, even as natural gas prices tested the $2.50-$3.00 per mcf range in 2015. At our energy team’s midcycle gas price forecast of $4 per mcf, PRB coal retains a solid economic advantage to natural gas. PRB constitutes roughly 40% of Peabody’s total revenue.

Although the Illinois Basin, or ILB, mines do not operate with the extremely low extraction costs that PRB mines do, we still favorably view them as strong parts of the company’s portfolio. ILB enjoys some geographic advantage over PRB, as its closer proximity to utilities in the Midwest and East Coast and access to more shipping options create comparatively lower shipping costs for customers. In addition, ILB’s high heat content allows it to be used as a substitute for Central Appalachian, or CAPP, coal, which continues to face steep cost inflation. In fact, this has led to the rapid growth of ILB coal in recent years, as the basin steals share from its fellow bituminous coal basin. However, as potential CAPP to ILB basin switchers are located much closer to low-cost gas production, we think ILB faces a larger threat from natural gas than PRB does. Therefore, we do not think the basin enjoys a competitive advantage. ILB constitutes roughly 20% of Peabody’s total revenue.

We continue to think that Peabody’s Australian operations enjoy no competitive advantage. Although results have been muted as seaborne prices have fallen, Peabody’s Australian operations previously generated up to 40% of precorporate adjusted EBITDA. Although Australian coal generates significant revenue on a per-unit basis because of higher prices for its thermal coal and the inclusion of high-priced metallurgical coal, the segment also faces significantly higher extraction costs than both PRB and ILB, generating the lowest margin per ton. While Peabody's Australian coal operations have benefited in recent years from stratospheric met coal prices, the segment now faces challenging headwinds as prices have come crashing down as Asia-Pacific steel demand growth has slowed, and coal supply in the Pacific has increased rapidly thanks to expansion projects in Australia, Indonesia, and Columbia, among other countries along the Pacific Rim. Australia constitutes roughly 40% of Peabody’s total revenue.

Historically, coal has been a subject of environmental regulatory scrutiny. Two of the most impactful regulations for coal demand are the New Source Performance Standards and the Mercury and Air Toxics Standards. The Environmental Protection Agency proposed NSPS to set new carbon dioxide emissions standards for new coal-fired and natural-gas-fired power plants. If enacted, it would limit new coal-fired units to 1,000 pounds of carbon dioxide per megawatt-hour, effectively banning construction of new units without the use of carbon capture and storage technology, which remains uneconomical at this time. Ultimately, although NSPS’ impact on current coal demand would be minimal, it makes any expansion of coal-burning capacity virtually impossible. This limits growth opportunities for coal to increased utilization of current capacity and cross-basin market share stealing.

Separately in 2012, the EPA finalized the Mercury and Air Toxics Standards rule, which installs limits called maximum achievable control technology (MACT) standards on hazardous air emissions including mercury, particulate matter, sulfur dioxide acid gases, and other certain metals for both new and existing coal-fired power plants. The EPA set the standards based on the reductions of the best-performing comparable source for new sources and based on the top 12% best-controlled sources for existing sources. In June 2015, the U.S. Supreme Court ruled that the EPA failed to appropriately consider compliance costs when it interpreted the Clean Air Act to implement MATS. As initial implementation had been planned for 2015, we think the ruling will do little to undo the regulation’s impact. MATS is estimated to adversely affect nearly 60-70 GW of coal-fired capacity, but would likely be limited to older, less efficient plants in the eastern U.S. In general, any regulation including MATS could have a negative impact on coal demand given the additional compliance requirements. However, as eastern U.S. plants

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(the predominant customers of Appalachian coal) would be the most likely affected, demand for Appalachian coal is the most likely to suffer.

We currently do not include the EPA's proposed Clean Power Plan or other carbon regulations in our fair value estimates or moat considerations. In CPP, the EPA is targeting the reduction of carbon dioxide emissions, with coal being one of the, if not the primary, energy source adversely affected. Whether states push a switch away from coal to lower-carbon-emitting fuels like natural gas, or to renewables, coal is likely to face a diminished outlook should the regulation pass. Uncertainty concerning the magnitude, timing, and method of achieving reductions remain at the federal, state, and utility levels, making the impact of CPP difficult to capture. In addition, we think that the Supreme Court ruling on MATS signals a difficult road for the carbon regulation.

Valuation

Kristoffer Inton, Analyst, 28 July 2015

Our fair value estimate is $4 per share. For Peabody's U.S. operations, we believe near-term coal prices will remain relatively weak, driving the company to manage production in the Illinois and Uinta basins. However, we expect domestic coal prices to slowly improve through our forecast period, as coal burn increases and natural gas prices rise. We assume the company will expand production as it sees prices improve, growing from 191 million tons in 2014 to 197 million tons by 2019. We also anticipate operating costs per ton to slowly increase, as production ramps up through increased utilization of existing capacity and increased stripping ratio, particularly at the bowl-shaped Powder River Basin.

For the Australian operations, we believe the company's realized prices will increase over time. We anticipate the oversupply that has hurt seaborne markets will eventually dissipate, as higher-cost mines continue to be rationalized. However, we do not expect prices to return to peak levels seen in 2011. We believe production will remain relatively flat at roughly 38 million tons, as past capital investments and conversion to owner-operated sites ramp up and offset curtailed higher cost production. Finally, we anticipate operating costs per ton to steadily increase.

Our valuation assumes a cost of equity of 13.5% and an implied terminal enterprise value/EBITDA multiple of approximately 6 times.

Risk

Kristoffer Inton, Analyst, 28 July 2015

Peabody faces numerous risks outside its control. First and foremost, a fall in coal prices would have a significant impact on the company. Furthermore, coal's demand may be affected by a multitude of outside factors, including but not limited to prices in substitute fuels such as natural gas, environmental regulations, global and domestic economic performance, and weather. Margins can be negatively affected by an increase in key inputs, including fuel and labor. The company relies heavily on third parties to transport coal through rail and barge. Any issues that affect the ability of these companies to provide timely service can threaten Peabody's ability to deliver on its contracts and can raise costs. In particular, the Powder River Basin is serviced by only two rail companies, increasing the risk for transportation issues or price increases. Difficult geology at any of its mines may increase operating costs or require further capital investment. The company also faces risks created by previous mergers and acquisitions, including execution risk related to its large expansion investments in Australia.

Management

Kristoffer Inton, Analyst, 01 July 2015

Glenn Kellow became CEO in May. He previously served as president and COO of the company and is keeping the president role. Before joining Peabody in 2013, Kellow worked in a variety of executive positions across numerous countries and commodities for nearly three decades at BHP Billiton.

Gregg Boyce became executive chairman in May. He had served as Peabody's president and CEO since 2006 and chairman since 2007. His prior experience includes leadership roles at Rio Tinto and its subsidiaries Kennecott Energy and Kennecott Minerals, as well as education as a mining engineer. Boyce is also chairman of the Coal Industry Advisory Board of the International Energy Agency and formerly served as chairman of the National Mining Association.

We believe management has had its good times (the Patriot Coal spin-off) and its bad times (the acquisition of Macarthur Coal) as stewards of capital for shareholders. We like the spin-off of Patriot Coal in 2007, which allowed the company to focus on higher-potential PRB, ILB, and

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Australian mines and freed it from significant liabilities and a difficult operating environment from prior Appalachia operations, although management is not winning any fans with Patriot's ongoing bankruptcy and related lawsuits. We also like management's commitment to returning capital to shareholders by maintaining its dividend and intermittently buying back shares. However, we did not like the timing of the Macarthur Coal acquisition in 2011, a time of peak met coal prices, resulting in a more than $900 million impairment in 2012. Furthermore, the timing misstep echoes in the significant leverage used to finance the transaction that remains with the company today. We believe the pluses and minuses of management's past decisions balance out to give the company a Standard Stewardship Rating.

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Analyst Notes Archive

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Kristoffer Inton, Analyst, 19 August 2015

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As part of the transaction, some junior debtholders would receive more senior ranking debt. However, a group of senior lenders opposed the exchange, claiming that the exchange would give preferential treatment over existing senior debtholders. The exchange was recently extended yet again to Aug. 28, as Arch continues to work to get the transaction through. It was reported this morning that Arch is negotiating with the opposing loan holders, potentially offering better terms and a comparable yield to the new loan to get their approval. The market seems to have rallied around this news, as the uncertainty of the exchange is reduced if the senior lenders agree to the compromise.

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We are maintaining our fair value estimates of $3.50 per share for Arch and $4 per share for Peabody as we await the final outcome of the debt restructuring. Our fair value estimate for Arch continues to represent only option value for our bull-case scenario; we still believe the company has no equity value under our base case. We maintain our no-moat ratings for both companies.

EPA's Final Carbon Rules Positive for Clean Generation and Transmission, Negative for Coal

Charles Fishman, Analyst, 03 August 2015

The Environmental Protection Agency's final Clean Power Plan announced on Aug. 3 offers what we consider a mix of moderate positive and negative changes for utilities from the draft proposal issued in June 2014.

We are reaffirming our fair value estimates, moats, and moat trend ratings for all utilities, but we do not include explicit impacts from the CPP in our forecasts or fair value estimates. We think the rules will face stiff legal and political opposition and could change significantly. If the rules do take effect as written, beneficiaries should be low-carbon power producers such as Exelon, NextEra Energy, and Calpine; and electric transmission developers like wide moat ITC Holdings.

For coal miners and railroads, we are reaffirming our fair value estimates and moat ratings. Coal volumes are already facing near-term weakness from MATS-related plant closures. We forecast coal demand to stabilize as natural gas prices rise and the surviving coal fleet remains economical. CPP could force another wave of closures that would add additional pressure on coal, but the magnitude, timing, and legality remain uncertain. Furthermore, state-specific goals will impact the various coal basins differently. With lawsuits likely and some states vowing noncompliance, we do not think CPP in its current form will survive to full implementation.

The final rule extends the start of the compliance period to 2022 from 2020 but boosts the emissions reduction target to 32% from 2005 levels versus 30% in the draft. We still think the timeline is the biggest challenge given the planning and construction requirements to meet the target. Southern Company and SCANA should benefit from changes that give their home states more credit for their new nuclear projects.

We don't think the rules are strict enough to save Exelon's three Illinois nuclear plants we think are more likely than not to retire. We recently cut our Exelon fair value estimate to $35 per share from $37.

Peabody's Costs Fall While Coal Markets Remain Weak in 2Q; Maintaining $4 Fair Value Estimate

Kristoffer Inton, Analyst, 28 July 2015

On July 28, Peabody reported second-quarter results, generating $87 million in adjusted EBITDA. This marks a significant decline from $213 million in the same period last year.

The fall in EBITDA was certainly not a surprise, given the massive decline in seaborne prices and continued weakness in the domestic market. On the plus side, costs also declined, although much of the improvement can be

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attributed to factors outside management's control. U.S. production costs fell 4% year over year, largely due to a mix shift toward lower-cost Powder River Basin coal. Australian production costs fell 28%, largely due to lower oil prices and the appreciation of the U.S. dollar relative to the Australian dollar.

We've updated our model to reflect detail on Powder River Basin operations and Australian thermal and metallurgical operations. Our long-term forecast remains intact, and we are maintaining our fair value estimate of $4 per share. Our no-moat rating is unchanged.

Peabody shares rallied roughly 15% after the earnings release, with shares reaching roughly $1.25 by midafternoon. Even so, share prices still sit roughly 70% below our fair value estimate. Over the last year, Peabody's stock has traded down sharply, with the decline accelerating in recent months as market sentiment soured on the coal industry. However, we continue to think the market has been overly negative on Peabody. Near-term coal market weakness is a given, so the question becomes, "can a coal company survive into better markets?"

Admittedly, Peabody does not boast the balance sheet strength that some peers do. However, although other coal miners have declared or are nearing bankruptcy, we think Peabody can weather the storm. At the end of the quarter, it had available liquidity of $2.1 billion, with its nearest-term debt maturity not coming until 2018.

Although Peabody's share price will likely remain depressed in the near term, we think the company has enough liquidity to endure.

Lowering Peabody's Fair Value Estimate to $4 From $6 and Downgrading Moat to None From Narrow

Kristoffer Inton, Analyst, 16 July 2015

We are lowering our fair value estimate for Peabody Energy to $4 from $6 and downgrading our economic moat rating to none from narrow, in conjunction with decreasing our long-term seaborne metallurgical ore price forecast to $110 per metric ton from $118. Despite its sizable position in the low-cost Powder River Basin, the company has significant weighting to more mediocre assets in Australia and the Uinta and Illinois basins in the U.S., more than offsetting any competitive advantage it has in the PRB.

With the exception of its PRB assets, Peabody's remaining coal portfolio exhibits middling production costs. In addition, with the inflated price and significant debt incurred to acquire its Australian assets at the peak of global coal prices, we don't expect Peabody to generate returns in excess of cost of capital under our updated seaborne forecast.

Although Peabody's balance sheet is weighed down by a meaningful amount of debt, we still think the company has the financial flexibility to navigate today's challenging coal markets. With no significant near-term maturities, federal coal lease expenditures ending in the next couple of years, and the potential for asset sales, we think Peabody has the wherewithal to wait for better prices. As U.S. natural gas prices approach our long-term forecast of $4 per mcf, we expect domestic coal to regain competitiveness.

Peabody Under Review

Kristoffer Inton, Analyst, 10 July 2015

We're placing our fair value estimate of Peabody Energy under review while we update our valuation assumptions.

Lowering Price Forecasts for Iron Ore and Met Coal on Cost Cuts and Lower Chinese Steel Demand

David Wang, Analyst, 10 July 2015

We are lowering our U.S. dollar-denominated price forecasts for iron ore and metallurgical coal based on greater-than-expected cost-cutting by miners and a steeper-than-expected decline in Chinese steel demand. Chinese iron ore production has also been more resilient than we had expected. Our long-term iron ore price forecast falls to $55 per metric ton from $64 per metric ton, while met coal falls to $110 per metric ton from $118 per metric ton. This change affects a broad swath of our mining coverage universe, and we are updating our fair value estimates accordingly.

Falling costs beget falling prices, since they lower the marginal cost of production. Since we last cut our price forecast for iron ore and metallurgical coal in March 2015, costs have fallen across the board: miners have experienced additional currency depreciation, as well as further deflation of costs denominated in local currencies. The Brazilian real has fallen another 10%, and the Australian dollar has fallen another 5%, though the Canadian dollar has remained relatively stable. This drives

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down local production costs in U.S. dollar terms. Furthermore, we see evidence of additional deflation as miners trim excess costs and renegotiate contracts with suppliers. In total, we estimate producers have slashed another 5%-8% from costs relative to our previous forecast.

The drop in Chinese steel consumption has been steeper than we had expected. After growing for more than a decade, apparent finished steel consumption in China fell 4% in 2014 and is tracking to fall at least 5% this year based on year-to-date figures. An even steeper decline in Chinese steel consumption implies lower demand for iron ore and met coal. As such, we expect the market clearing prices to be lower on the cost curves than it otherwise would be.

Wyoming Renews Peabody's Self-Bonding Ability, but Risk Still Real if Coal Market Remains Weak

Kristoffer Inton, Analyst, 08 July 2015

The Wyoming Department of Environmental Quality has confirmed that Peabody Energy still qualifies to self-bond its reclamation obligations at its three mines in the state, the company announced on July 8. Despite recent media speculation, Peabody will not be forced to find another form of assurance for these reclamation liabilities. Since we hadn't incorporated any additional costs from replacement surety bonds into our forecast, the announcement has no impact on our valuation model. Therefore, we are maintaining our fair value estimate of $6 per share and our narrow moat rating for Peabody. Additionally, we reiterate our very high uncertainty rating.

As of March 31, Peabody carried almost $1.4 billion of self-bonding for its reclamation obligations, of which $800 million is attributable to its Wyoming operations. Although Peabody's self-bonding ability is safe for now, we think that risk remains over the medium term. If coal markets continue to struggle and Peabody's financial health remains under stress, we wouldn't be surprised to see questions on self-bonding qualification resurface next year.

Peabody Expects to Miss 2Q Guidance; Lowering Fair Value Estimate to $6

Kristoffer Inton, Analyst, 01 July 2015

On Tuesday after the close, Peabody Energy announced it would miss its second-quarter adjusted EBITDA and adjusted earnings per share guidance due to weather-related shipment issues in the Powder River Basin and lower seaborne coal pricing. After updating our model for these near-term issues, we are lowering our fair value estimate to $6 per share from $6.50. We maintain our narrow moat rating.

This week has been tumultuous for Peabody's shares, to say the least. After the shares jumped Monday after the U.S. Supreme Court's decision to overturn the Mercury and Air Toxics Standards, they gave up those gains Tuesday as the market largely realized that MATS has already had an irreversible impact, as discussed in our June 29 note. With the announcement that it would miss its second-quarter EBITDA and EPS guidance, Peabody's shares had fallen 25% by late this morning. However, we think the market is overreacting to last night's news.

We think the warning does not warrant such a massive share price decline. First, we think the PRB volume announcement is a near-term impact that should be largely mitigated during the full year. Peabody expects that increased deliveries during the third and fourth quarters will be able to absorb the shortfall. We think this is very possible; the 5.0 million-5.5 million ton reduction represents just 3% of last year's production in Peabody's Western segment.

Second, the company announced that lower seaborne pricing would weigh on its Australian metallurgical coal. However, we fail to understand why the market wouldn't be pricing this in already, as the benchmark spot price is widely available to the market, and it has been no secret that seaborne coal prices remain weak.

Supreme Court Overturns MATS; No Impact to Coal or Utilities FVE, but CPP Looks Less Certain

Kristoffer Inton, Analyst, 29 June 2015

On Monday, the Supreme Court ruled 5-4 on Michigan v. EPA, throwing out the environmental regulator's Mercury and Air Toxics Standards. MATS was intended to regulate mercury and other hazardous air pollutants from power plants, and most significantly had an impact on heavy-emitting coal plants. Finalized in 2012, utilities have already largely implemented the EPA rule, installing scrubbers on surviving plants and shutting down other plants where economics made implementation cost prohibitive. In addition, with low-cost natural gas continuing to drive the construction of new natural gas generation, we think the ruling is too far past to necessarily

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Peabody Energy Corp BTU (XNYS)

Morningstar Rating	Last Price	Fair Value Estimate	Price/Fair Value	Dividend Yield %	Market Cap (Bil)	Industry	Stewardship
★★★★★	1.78 USD	4.00 USD	0.45	8.71	0.50	Coal	Standard
10 Sep 2015	10 Sep 2015			10 Sep 2015	10 Sep 2015		

undo the impact of MATS. However, we do think the ruling signals a difficult road for the EPA's proposed Clean Power Plan, which intends to drive carbon emission reduction, with coal generation being a prime target. The court ruled the EPA failed to appropriately consider compliance costs when it interpreted the Clean Air Act to implement MATS.

With MATS largely and permanently implemented, we maintain our fair values and moat ratings across our coal coverage. Although we think the Supreme Court ruling will force the EPA to more carefully push future regulation and will make the industry more fervent in its claims of EPA overreach, we caution investors that regulatory risk still remains a key risk to coal stocks.

We also are reaffirming our fair value estimates and moat ratings for all utilities. We don't expect this to have a material impact on power producers' investment plans or near-term cash flow. If this ruling sets a precedent that invalidates the CPP, it would reduce the potential upside for nuclear and renewable energy producers such as Exelon and NextEra Energy. We don't include carbon regulations in any of our fair value estimates.

Updated Valuations Assumptions for Peabody Energy Lead to Lower FVE of $6.50 per Share

Kristoffer Inton, Analyst, 11 June 2015

As natural gas prices remain in the $2.50-$3 per mmBTU range and weigh on coal's near-term cost competitiveness, we've revisited several of our valuation assumptions for Peabody Energy. We've increased our cost of equity assumption for Peabody Energy to 13.5% from 11%, reflecting very high systematic risk intensified by high financial leverage. We've also increased our cost of debt assumption to 10% from 8%. Together, these changes have increased our cost of capital assumption to roughly 9%.

Subsequently, we are lowering our exit multiple assumption to 6 times EV/EBITDA from 6.5 times. As a result of our valuation assumption changes, we are lowering Peabody's fair value estimate to $6.50 per share from $9 per share. We maintain our narrow moat rating.

Lowering Peabody's FVE to $9 on Challenging Market, but Current Price Assumes Permanent Weakness

Kristoffer Inton, Analyst, 23 April 2015

On April 23, Peabody reported first-quarter results, generating $166 million in adjusted EBITDA, a 6% decrease from $177 million in the prior-year quarter. However, results were marred by more than $100 million of unfavorable commodity and foreign currency charges, overshadowing Peabody's progress on costs. Operating costs per ton were down meaningfully in all segments over the prior-year quarter, as the company focused on factors under its control. However, both the domestic and seaborne coal markets continue to show significant weakness, weighing on coal prices and hurting Peabody's near-term outlook. The company lowered its production and price outlook for its U.S. operations, partially offset by a lower cost outlook. As a result of more near-term weakness, we've lowered our fair value estimate to $9 per share from $10 per share. We maintain our narrow moat rating.

With the stock currently trading below $5 per share, we think the market is assuming current market weaknesses reflect a new normal. However, for the seaborne market, we think supply will be further rationalized, supporting price increases from recent seaborne benchmark metallurgical contracts of $110 per metric ton toward our long-term price forecast of $118 per metric ton. Domestic coal operations continue to be challenged by very low natural gas prices of roughly around $2.50 per mcf, nearing the edge of PRB's cost competitiveness of $2.50-$2.75 per mcf and past ILB's competitiveness in the $3-$4 per mcf range. However, we think that as natural gas prices improve to our energy team's forecast of $4 per mcf, domestic coal will regain its cost competitiveness.

During the earnings call, management stated an interest in exploring an MLP structure. We are skeptical this will lead to anything. The volatility of coal prices would mean instability and unpredictability of yield, hurting the MLP's attractiveness to potential investors.

Cutting Our Price Forecasts for Copper, Coal and Iron Ore

Daniel Rohr, Analyst, 15 March 2015

Cheaper oil, weaker producer country currencies, and industry-specific deflation point to lower mining costs in 2015 and beyond. But with lower costs come lower prices. We've reduced our U.S. dollar-denominated forecasts for copper, coal, and iron ore accordingly. Cost mix and currency exposure differences mean larger cuts to our price forecasts for coal and iron ore than copper. Freight is a larger share of total costs for these bulk commodities,

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so the recent cut to Morningstar's long-term oil price (from $100 per barrel Brent to $75) generates more cost relief. Similarly, we estimate higher local content, mainly labor and services, for coal and iron ore compared with copper. Local currency weakness therefore drives relatively lower U.S. dollar costs for labor and services. We estimate the impact of a stronger U.S. dollar for each commodity based on the depreciation of key producing country currencies.

For coal, our long-term forecast for thermal prices falls 11%, from $75 to $67 (free-on-board Newcastle, 6,7000 kcal/kg) in real terms. Our long-term forecast for benchmark hard coking coal also falls 11%, from $133 to $118. In both cases, while we expect the eventual roll-off of take-or-pay infrastructure contracts to tighten supply, weakening Chinese coal demand is likely to circumscribe any upside.

For iron ore, we now expect benchmark prices (62% iron content, delivered China basis) to average $60 for most of this decade, down 14% from $70 (both figures in real 2015 terms). We expect prices to nudge up slightly to $64 by 2020. We maintain our view that Chinese steel demand has peaked, preventing any meaningful price recovery for iron ore.

For copper, our long-term price forecast falls a more modest 8%, from $2.67 per pound to $2.46. Because oil comprises a lower share of the total cost of producing copper, lower labor and services costs account for a larger share of the reduction to our copper price forecast.

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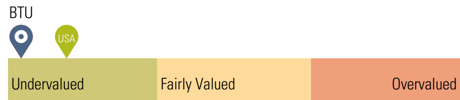
Peabody Energy Corp BTU

Last Close	Quantitative Fair Value Estimate	Market Cap (Mil)	Sector	Industry	Country of Domicile
1.78	2.95	559.3	Basic Materials	Coal	United States

Peabody Energy Corp is involved in mining. It mines, prepares, and sells thermal coal to electric utilities and metallurgical coal to industrial customers.

Quantitative Scores

		Scores All	Rel Sector	Rel Country
Quantitative Moat	None	1	2	1
Valuation	Undervalued	99	92	100
Quantitative Uncertainty	Extreme	13	17	25
Financial Health	Weak	6	3	6



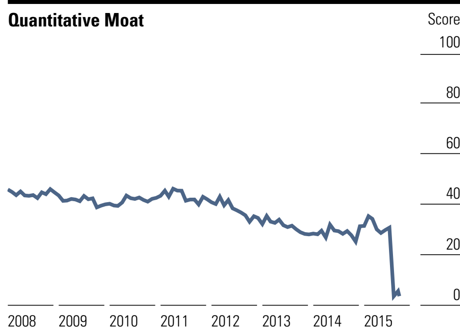
Valuation

	Current	5-Yr Avg	Sector Median	Country Median
Price/Quant Fair Value	0.60	0.80	0.76	0.83
Price/Earnings	—	16.6	15.3	19.8
Forward P/E	-33.9	—	11.1	14.7
Price/Cash Flow	2.7	7.8	7.0	11.7
Price/Free Cash Flow	—	18.6	13.3	18.1
Dividend Yield %	8.71	1.78	2.39	2.35
Price/Book	0.3	1.9	0.9	2.3
Price/Sales	0.1	1.2	0.8	1.8

Profitability

	Current	5-Yr Avg	Sector Median	Country Median
Return on Equity %	-67.3	-1.9	8.9	11.9
Return on Assets %	-14.8	0.2	4.3	4.8
Revenue/Employee (K)	757.2	905.2	609.1	304.1

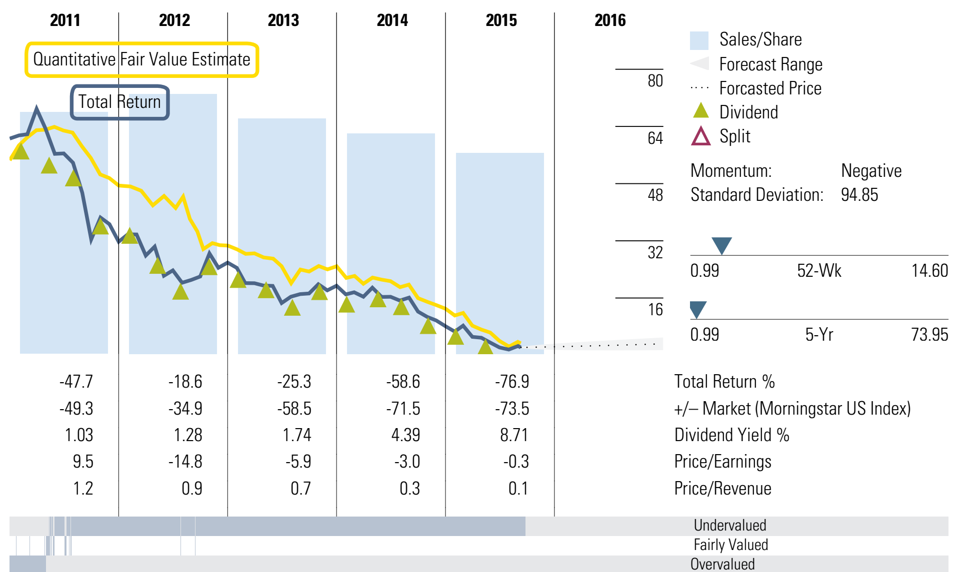
Quantitative Moat



Financial Health

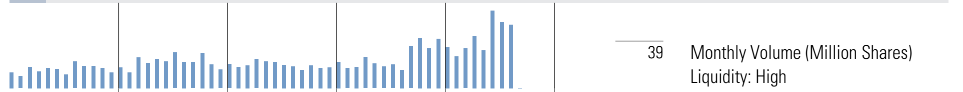
	Current	5-Yr Avg	Sector Median	Country Median
Distance to Default	0.1	0.5	0.5	0.6
Solvency Score	917.5	—	537.5	564.4
Assets/Equity	4.8	3.4	1.4	1.7
Long-Term Debt/Equity	2.2	1.4	0.2	0.3

Price Versus Quantitative Fair Value



2011	2012	2013	2014	2015	2016	
-47.7	-18.6	-25.3	-58.6	-76.9		Total Return %
-49.3	-34.9	-58.5	-71.5	-73.5		+/– Market (Morningstar US Index)
1.03	1.28	1.74	4.39	8.71		Dividend Yield %
9.5	-14.8	-5.9	-3.0	-0.3		Price/Earnings
1.2	0.9	0.7	0.3	0.1		Price/Revenue

Undervalued
Fairly Valued
Overvalued



2010	2011	2012	2013	2014	TTM	**Financials** (Fiscal Year in Mil)
6,860	7,974	8,078	7,014	6,792	6,285	Revenue
14.1	16.2	1.3	-13.2	-3.2	-7.5	% Change
1,326	1,593	173	-325	-135	-1,144	Operating Income
56.9	20.2	-89.2	-288.3	—	—	% Change
774	958	-586	-525	-787	-1,887	Net Income
1,087	1,633	1,515	722	337	200	Operating Cash Flow
-557	-847	-1,158	-726	-488	-470	Capital Spending
530	786	357	-4	-151	-270	Free Cash Flow
7.7	9.9	4.4	0.0	-2.2	-4.3	% Sales
2.85	3.52	-2.19	-1.97	-2.94	-7.00	EPS
71.7	23.5	-162.2	—	—	—	% Change
1.96	1.70	1.33	1.02	-0.36	-1.00	Free Cash Flow/Share
0.29	0.34	0.34	0.34	0.34	0.17	Dividends/Share
17.25	19.51	18.26	16.66	13.23	5.94	Book Value/Share
271,100	268,600	270,100	271,700	278,254	278,254	Shares Outstanding (K)
						Profitability
18.4	18.9	-11.3	-11.9	-23.8	-67.3	Return on Equity %
7.3	6.8	-3.6	-3.5	-5.8	-14.8	Return on Assets %
11.3	12.0	-7.3	-7.5	-11.6	-30.0	Net Margin %
0.64	0.57	0.50	0.47	0.50	0.49	Asset Turnover
2.4	3.1	3.2	3.6	4.8	7.2	Financial Leverage
29.4	30.4	26.6	18.2	15.8	14.5	Gross Margin %
19.3	20.0	2.1	-4.6	-2.0	-18.2	Operating Margin %
2,707	6,556	6,205	5,971	5,966	6,285	Long-Term Debt
4,661	5,485	4,905	3,909	2,725	1,654	Total Equity
0.9	0.8	0.7	0.6	0.6	0.6	Fixed Asset Turns

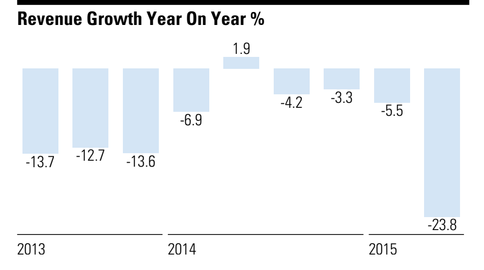
Growth Per Share

	1-Year	3-Year	5-Year	10-Year
Revenue %	-3.2	-4.9	2.5	6.5
Operating Income %	—	—	—	—
Earnings %	—	—	—	—
Dividends %	0.0	0.0	6.3	10.0
Book Value %	-30.7	-20.9	-6.4	4.2
Stock Total Return %	-87.1	-52.4	-41.2	-18.5

Quarterly Revenue & EPS

Revenue (Mil)	Mar	Jun	Sep	Dec	Total
2015	1,537.9	1,339.3	—	—	—
2014	1,626.8	1,758.0	1,722.9	1,684.5	6,792.2
2013	1,748.0	1,725.3	1,797.6	1,742.8	7,013.7
2012	2,038.6	1,998.2	2,058.8	2,016.9	8,077.5
Earnings Per Share					
2015	-0.65	-3.84	—	—	—
2014	-0.18	-0.27	-0.56	-1.92	-2.94
2013	-0.09	0.33	-0.10	-2.12	-1.97
2012	0.63	0.75	0.16	-3.77	-2.19

Revenue Growth Year On Year %



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Morningstar Equity Research Methodology

Fundamental Analysis

At Morningstar, we believe buying shares of superior businesses at a discount and allowing them to compound over time is the surest way to create wealth in the stock market. The long-term fundamentals of businesses, such as cash flow, competition, economic cycles, and stewardship, are our primary focus. Occasionally, this approach causes our recommendations to appear out of step with the market, but willingness to be contrarian is an important source of outperformance and a benefit of Morningstar's independence. Our analysts conduct primary research to inform our views on each firm's moat, fair value and uncertainty.

Economic Moat

The economic moat concept is a cornerstone of Morningstar's investment philosophy and is used to distinguish high-quality companies with sustainable competitive advantages. An economic moat is a structural feature that allows a firm to sustain excess returns over a long period of time. Without a moat, a company's profits are more susceptible to competition. Companies with narrow moats are likely to achieve normalized excess returns beyond 10 years while wide-moat companies are likely to sustain excess returns beyond 20 years. The longer a firm generates economic profits, the higher its intrinsic value. We believe lower-quality no-moat companies will see their returns gravitate toward the firm's cost of capital more quickly than companies with moats will. We have identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale.

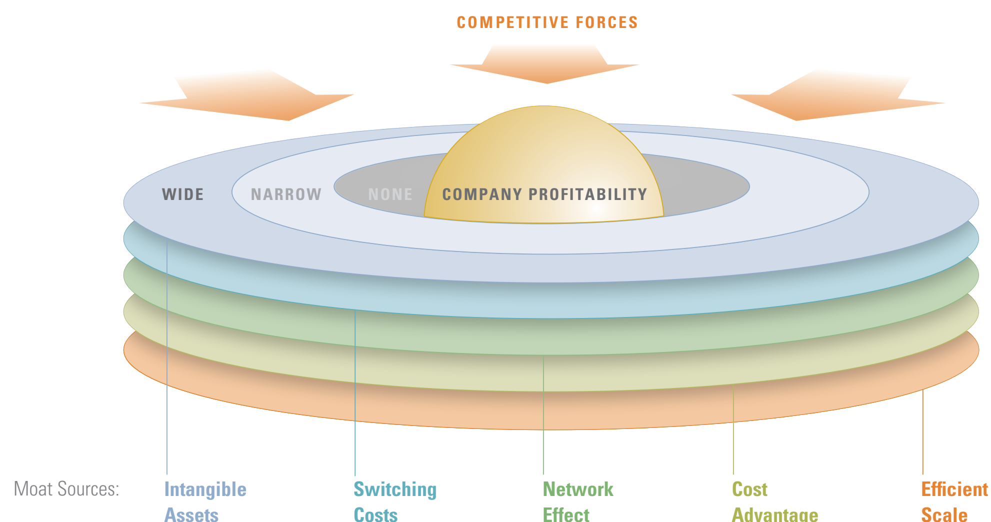
Fair Value Estimate

Our analyst-driven fair value estimate is based primarily on Morningstar's proprietary three-stage discounted cash flow model. We also use a variety of supplementary fundamental methods to triangulate a company's worth, such as sum-of-the-parts, multiples, and yields, among others. We're looking well beyond next quarter to determine the cash-generating ability of a company's assets because we believe the market price of a security will migrate toward the firm's intrinsic value over time. Economic moats are not only an important sorting mechanism for quality in our framework, but the designation also directly contributes to our estimate of a company's intrinsic value through sustained excess returns on invested capital.

Uncertainty Rating

The Morningstar Uncertainty Rating demonstrates our assessment of a firm's cash flow predictability, or valuation risk. From this rating, we determine appropriate margins of safety: The higher the uncertainty, the wider the margin of safety around our fair value estimate before our recommendations are triggered. Our uncertainty ratings are low, medium, high, very high, and extreme. With each uncertainty rating is a corresponding set of price/fair value ratios that drive our recommendations: Lower price/fair value ratios (<1.0) lead to positive recommendations, while higher price/fair value

Economic Moat



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ratios (>1.0) lead to negative recommendations. In very rare cases, the fair value estimate for a firm is so unpredictable that a margin of safety cannot be properly estimated. For these firms, we use a rating of extreme. Very high and extreme uncertainty companies tend to have higher risk and volatility.

Quantitatively Driven Valuations

To complement our analysts' work, we produce Quantitative Ratings for a much larger universe of companies. These ratings are generated by statistical models that are meant to divine the relationships between Morningstar's analyst-driven ratings and key financial data points. Consequently, our quantitative ratings are directly analogous to our analyst-driven ratings.

Quantitative Fair Value Estimate (QFVE): The QFVE is analogous to Morningstar's fair value estimate for stocks. It represents the per-share value of the equity of a company. The QFVE is displayed in the same currency as the company's last close price.

Valuation: The valuation is based on the ratio of a company's quantitative fair value estimate to its last close price.

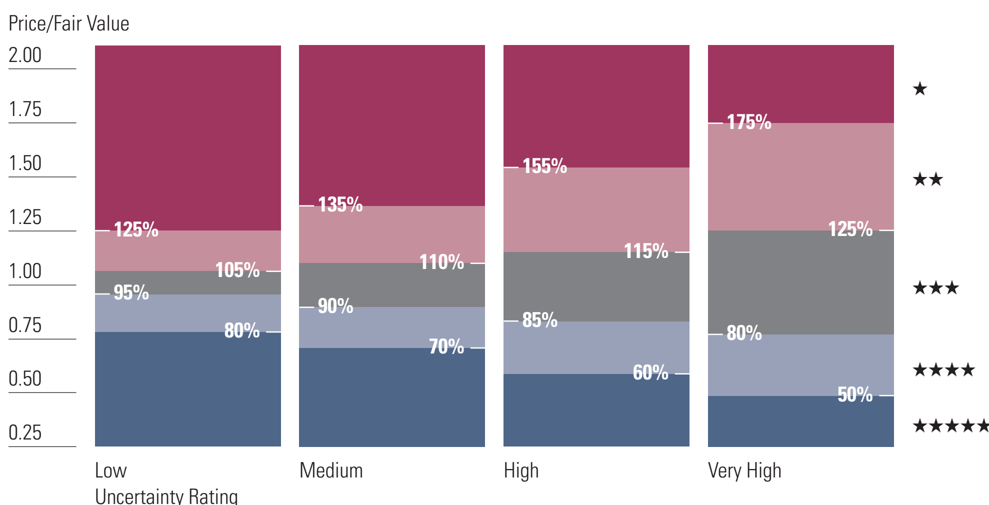
Quantitative Uncertainty: This rating describes our level of uncertainty about the accuracy of our quantitative fair value estimate. In this way it is analogous to Morningstar's fair value uncertainty ratings.

Quantitative Economic Moat: The quantitative moat rating is analogous to Morningstar's analyst-driven economic moat rating in that both are meant to describe the strength of a firm's competitive position.

Understanding Differences Between Analyst and Quantitative Valuations

If our analyst-driven ratings did not sometimes differ from our quantitative ratings, there would be little value in producing both. Differences occur because our quantitative ratings are essentially a highly sophisticated analysis of the analyst-driven ratings of comparable companies. If a company is unique and has few comparable companies, the quantitative model will have more trouble assigning correct ratings, while an analyst will have an easier time recognizing the true characteristics of the company. On the other hand, the quantitative models incorporate new data efficiently and consistently. Empirically, we find quantitative ratings and analyst-driven ratings to be equally powerful predictors of future performance. When the analyst-driven rating and the quantitative rating agree, we find the ratings to be much more predictive than when they differ. In this way, they provide an excellent second opinion for each other. When the ratings differ, it may be wise to follow the analyst's rating for a truly unique company with its own special situation, and follow the quantitative rating when a company has several reasonable comparable companies and relevant information is flowing at a rapid pace.

Uncertainty Rating



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