PT Adaro Energy Tbk

(ADRO.JK / ADRO IJ)

COMPANY UPDATE

Focusing on efficiency

- **Forecast changes.** We revise our earnings estimates by 7-18% for 2013-15 following 6M13 results primarily due to lower average selling price, partially offset by better-than-expected cost. The share price has increased strongly on the back of signs of an economy recovery in China, but the coal price remains low. We retain our NEUTRAL rating on the stock, and raise target price to Rp1,100 (from Rp900) based on P/E target of 10x for 2014.

- **Focus on efficiency.** Adaro has proved itself to have a good cost control over the operation, which is necessary for the low coal price environment. Its mining cash cost has declined by 8% YoY, primarily due to the lower strip ratio. The operation of conveyor belt for overburden removal, the mine mouth power plant and expansion of the river port should help improve efficiency.

- **Expect weak 3Q13.** Although there is positive sentiment on China’s recovery, the coal price remains low. We expect weak 3Q13 results, which could lead to further downgrades. Adaro plans to continue to increase its output by 5% p.a.; however, that depends on the market condition and the company’s ability to retain a low strip ratio to keep the cost low.

- **Maintain NEUTRAL.** Our target price of Rp1,100 is based on a P/E target of 10x for 2014. The key risk is coal price movement. Our sensitivity analysis shows that a 10% decrease in coal price would reduce our valuation by 50% and our earnings estimates by 50-58% for 2013-14. A 10% decline in sales volume would reduce our valuation by 17% and our earnings estimates by 16-18% for 2013-14. We retain our NEUTRAL rating on the stock.

Financial and valuation metrics

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<th>Year</th>
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<th>12/13E</th>
<th>12/14E</th>
<th>12/15E</th>
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<td>3,408.6</td>
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<td>0.01</td>
<td>0.01</td>
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<td>8.5</td>
<td>5.5</td>
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<td>Dividend yield (%)</td>
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<td>P/B (x)</td>
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<td>1.0</td>
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<td>0.8</td>
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<tr>
<td>ROE (%)</td>
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<td>9.4</td>
<td>11.4</td>
<td>15.6</td>
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<tr>
<td>Net debt/equity (%)</td>
<td>65.0</td>
<td>54.9</td>
<td>39.4</td>
<td>20.9</td>
</tr>
</tbody>
</table>

Source: Company data, Thomson Reuters, Credit Suisse estimates

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Focus charts

Figure 1: P/E band—leaving the bottom

Source: Bloomberg, company data, Credit Suisse estimates

Figure 2: Share price rises, but coal price remains low

Source: Company data, Credit Suisse estimates

Figure 3: Cost efficiency to preserve margin

Source: Company data, Credit Suisse estimates

Figure 4: Discount gets smaller to benchmark price

Source: Company data, Credit Suisse estimates

Figure 5: Adaro continues to grow volume

Source: Company data, Credit Suisse estimates

Figure 6: Market destinations—more volume to India

Source: Company data
Focusing on efficiency

Reducing cost to preserve margin

The pre-stripping work Adaro did in 3Q last year has had a positive impact on its cash cost this year—it has fallen by 8-9% YoY in 6M13, better than our expectation. This was primarily due to a lower strip ratio. Efficiency programmes were applied to the whole value chain, including adding large size barges to reduce transportation cost. The completion of the conveyer system for overburden removal, the operation of the mine mouth power plant and expansion of the Kelanis river port should improve costs in the future. Operating in low-strip-ratio areas cannot be sustained for the long term; however, other efficiency efforts will likely offset the increase in the strip ratio in the future.

Continues to grow output

Adaro has a track record of continuously growing its coal output. The company is targeting 5% p.a. in coal output although that also depends on the market condition. Demand for low-grade coal has been very strong, primarily from India. The company's sales volume to India has been growing, currently accounting for 23% of the total, up from only 10% in 2011. Due to strong demand, the discount of low-grade coal price (4,000-5,000kcal/kg for Adaro) compared to the Newcastle benchmark price (6,322kcal/kg) is declining. The company claims to have sold 80% of its volume this year. ADRO targets to sell 65% of sales volume at a fixed price this year.

Maintain NEUTRAL, raise TP to Rp1,100

Following its 6M13 results, we have adjusted our earnings estimates accordingly with slightly lower selling price and sales volume, which partially offsets the lower mining cost. These have reduced our earnings estimates for 2013-15 by 7-18%. We raise our target price for Adaro, despite the revisions in our earnings forecasts, to Rp1,100 (from Rp900), which is now based on P/E target of 10x for 2014, with the coal price movement as the key risk.

We have run our sensitivity analysis on coal price assumptions. If the coal price remains at the current US$76/t until FY14E, PTBA's ASP will go down by 12% in FY13E and 16% in FY14E, reducing our net income estimates by 68% in FY13E and 82% in FY14E. Net-net, our target price for PTBA will decline to Rp200/share, down 82% from Rp1,100/share.

The share price has reacted strongly due to the positive movement in the Chinese economy. However, coal prices remain low and we are concerned with the oversupply situation, despite strong demand. The depreciation of AUD, IDR and INR could keep the coal price low. We expect earnings to disappoint in 3Q13, which could lead to another downgrade. Therefore, we retain our NEUTRAL rating on the stock.
Reducing cost to preserve margin

The efforts made to implement cost reduction initiatives—such as improving road conditions, reducing average coal hauling cycle time and requiring contractors to reduce fuel usage by 2% p.a.—have shown positive results. Adaro was able to cut its cash mining cost (including royalty) to US$40.6/t in 6M13, down 8% YoY. This was primarily due to a lower strip ratio, which was down to 5.7x in 6M13, from around a 7x level last year. Some pre-stripping work was done in 3Q12, causing the strip ratio to increase to 9x. The company had to expense the cost in 2012. As the pre-stripping has been done, it would ease future cost. Adaro is targeting a strip ratio of 5.5x for this year.

Figure 7: Declining strip ratio

Source: Company data

Figure 8: Preserving margin by reducing cost

Source: Company data, Credit Suisse estimates

The company is looking to improve efficiency in all value chains—from the mining contractors, barging and transhipment. Its mining contractors are Pama, a subsidiary of United Tractors (UNTR), which has been working for the company since the beginning of the operation; Sapta Indra Sejati (SIS), Adaro’s subsidiary; Buma, the subsidiary of Delta Dunia (DOID), and two other smaller contractors.

Figure 9: Mining contractors

Source: Company data

Figure 10: EBITDA/tonne

Source: Company data, Credit Suisse estimates
Sapta Indra Sejati (SIS), Adaro’s mining contracting subsidiary, also works for Berau (BRAU); Mustika Indah Permai (MIP), Adaro's subsidiary in South Sumatra; and Borneo Indobara, a member of the Sinar Mas group. Their work for Adaro accounts for over 60% of the total volume. The capacity is 33mt of coal output with just over 1,600 units of heavy equipment. The target is to get 178m bcm of overburden and 29 mn tonnes of coal getting volume, suggesting a utilisation rate target of 85%. The company reduced its capex to US$40 mn this year from US$120 mn last year.

The overburden out of pit crushing and conveying system (OPCC) has been completed and is in operation. The system will consist of two 7,000 tonnes per hour (tph) crushing stations, and one 12,000 tph crushing station with a 7.7 km conveyer system. Part of the conveyer includes a 2.4 km transportable conveyer along with a mobile stacking and spreading conveyer.

The mine mouth power plant with a capacity of 2x30MW has also been completed to supply the operation of OPCC. The operation is run by a fully owned subsidiary, PT Makmur Sejahtera Wisesa (MSW). The guarantee power output is 52.5MW, of which around 1.5MW excess will be sold to the national grid through PLN, the state-owned power company.

The Kelanis River terminal capacity is to be increased to 70 mn t from 55 mn t, by installing an additional three-stage crushing facility to increase loading capacity to 10,500 tph, upgrading the barge loading system to increase capacity to 14,000 tph, and the electrical power capacity to 25MW, and the facility to improve the quality control of the coal. On the barging side, it has added two large barges to reduce transportation cost.
Continues to grow coal output

As the company has been able to improve cost, volume growth has continued. 6M13 results showed an 8% YoY increase in production volume and a 6% YoY increase in sales volume to 24.9 mn t and 25 mn t, respectively. Adaro is targeting coal output of 50-53 mn t this year. It intends to grow its volume by 5% p.a.; however, that depends on coal price and the company’s ability to maintain its low cost structure. The low strip ratio cannot be sustained in the long term. Costs will eventually have to increase.

Figure 11: Production profile


Tutupan Wara/Paringin MIP

Source: Company data, Credit Suisse estimates

Adaro has been working in the Tutupan area since the beginning of the operation. The next growth areas are Wara and Paringin, which have low grade coal. The company sells around 20% of its coal output to the domestic market, primarily to PLN, the state-owned power company. Sales volume to India has been growing gradually, now accounting for 23% of total sales, up from 15% in 2012 and 10% in 2011, as more volume comes from the Wara and Paringin areas.

Figure 12: Sales volume


Export Domestic

Source: Company data, Credit Suisse estimates

Figure 13: Market destinations

Strong volume growth to India

Source: Company data
Adaro sells coal with CV between 4,000kcal/kg and 5,000kcal/kg. In the past, when coal prices were low, the company contracted out its volume in the beginning of the year. When the coal price was high, it took the opportunity to generate more margin by keeping around 30% of its volume to be sold at the spot price. For this year, Adaro has contracted 80% of its volume at fixed price and index linked. The target is to have 65% at fixed price and the remainder is index linked. The 6M13 realised price was US$59/t, lower than our expectations. The company claims that demand for low-grade coal has been very strong, from India and China, and the discount to its ASP has become less compared to before.

The development in other areas has been slow, considering market conditions. In Mustika Indah Permai (MIP), a coal mining area in Lahat district, South Sumatra, the company has done pre-stripping and built up the main infrastructure. Adaro owns a 75% stake of MIP through PT Alam Tri Abadi. The coal from MIP would be transported by trucks through the road that Adaro has built. The affiliate company, PT Servo Meda Sejahtera (35% owned by Adaro), has built a dedicated 229 km hauling road for coal transportation in the Lahat area to the Kertapati port in Palembang, South Sumatra. However, due to the current market condition, it is not economical to produce coal from MIP.

Another area in South Sumatra is Bukit Enim Energi (BEE), which is currently at the exploration stage. Adaro owns a 61% stake through ATA; remaining shareholders include PT Pamapersada Nusantara (under UNTR.JK) with a 20% stake.

PT Bhakti Energi Persada (BEP) has low-grade coal concessions in South Kalimantan. Adaro, however, has full control of the management, operations and funding of BEP from 28 May 2012, the date of signing. Currently, the company is in the process of getting permits from the government, acquiring land, completing engineering and geological studies, and getting social and community support.

Adaro is in the process of drilling to complete JORC reserve studies, land acquisition and building a hauling road, which will connect Balangan to the existing hauling road at Paringin. The company expects to complete its JORC reserve study by late 2013 and start production in early 2014.

The JV with Electric Power Development (J Power) and Itochu Corporation under PT Bhimasena Power Indonesia to build 2x1,000MW power plants in Central Java has been delayed primarily due to challenges related to land acquisitions.
Maintain NEUTRAL, raise TP to Rp1,100

Adaro's share price has reacted positively on the China PMI number providing a sign of recovery. However, the coal price remains low at US$76/t. We believe the coal price has bottomed, but remain concerned about the oversupply situation. With the depreciation of AUD and IDR, as well as INR, the coal price could stay low. The positive sentiment on coal stocks comes from the improvement in the Chinese economy. 3Q13 earnings will likely be poor on lower coal prices, which could lead to further earnings downgrades.

Figure 16: P/E band

![Figure 16](image)

Source: Bloomberg, company data, Credit Suisse estimates

Figure 17: P/E increases even though coal remains weak

![Figure 17](image)

Source: Bloomberg, company data, Credit Suisse estimates

We revise our earnings forecasts for Adaro due to lower-than-expected selling price and sales volume, lower overburden removal for the mining contracting business, partially offset by better-than-expected mining cost. These have changed our earnings estimates for 2013-15 by 7-18%. We believe costs will improve in 2014, although we remain concerned whether the low strip ratio could be maintained in 2015.

Figure 18: Forecast changes

<table>
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<tr>
<th>US$ mn</th>
<th>New FY13E</th>
<th>FY14E</th>
<th>FY15E</th>
<th>Old FY13E</th>
<th>FY14E</th>
<th>FY15E</th>
<th>Change (%) FY13E</th>
<th>FY14E</th>
<th>FY15E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales volume (mn t)</td>
<td>52</td>
<td>54</td>
<td>57</td>
<td>53</td>
<td>55</td>
<td>58</td>
<td>(2)</td>
<td>(2)</td>
<td>(2)</td>
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<tr>
<td>Production (mn t)</td>
<td>50</td>
<td>52</td>
<td>55</td>
<td>50</td>
<td>52</td>
<td>55</td>
<td>-</td>
<td>-</td>
<td>-</td>
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<td>ASP (US$/t)</td>
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<td>61</td>
<td>67</td>
<td>61</td>
<td>62</td>
<td>68</td>
<td>(3)</td>
<td>(2)</td>
<td>(2)</td>
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<td>Sales</td>
<td>3,159</td>
<td>3,409</td>
<td>3,902</td>
<td>3,363</td>
<td>3,590</td>
<td>4,100</td>
<td>(6)</td>
<td>(5)</td>
<td>(5)</td>
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<td>EBITDA</td>
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<td>951</td>
<td>1,240</td>
<td>942</td>
<td>1,004</td>
<td>1,302</td>
<td>(12)</td>
<td>(5)</td>
<td>(5)</td>
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<tr>
<td>Net profit</td>
<td>247</td>
<td>319</td>
<td>488</td>
<td>302</td>
<td>345</td>
<td>523</td>
<td>(18)</td>
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<td>EPS (US$)</td>
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<td>0.02</td>
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<td>0.02</td>
<td>(18)</td>
<td>(7)</td>
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</table>

Source: Credit Suisse estimates

Despite the decline in our earnings estimates, we raise our target price for Adaro to Rp1,100, from Rp900. Our target price is now based on P/E target of 10x for 2014. The key risk in our valuation is the declining coal price. We assume a benchmark price of US$91/t for 2014, compared to US$76/t currently. We retain our NEUTRAL rating on the stock.

We have run our sensitivity analysis on coal price assumption. If coal price remains at the current level of US$76/t until FY14E, PTBA's ASP will go down by 12% in FY13E and 16% in FY14E, reducing our net income estimates by 68% in FY13E and 82% in FY14E. Net-net, our target price for PTBA will decline to Rp200/share, down 82% from Rp1,100/share.
Figure 19: Sensitivity analysis if coal price remains US$76/t

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<th>Change (%)</th>
<th>Base</th>
<th>If coal price stays US$76/t</th>
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<tr>
<td></td>
<td>ASP</td>
<td>Net income</td>
</tr>
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<td>FY13E</td>
<td>FY14E</td>
<td>FY13E</td>
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<td>Adaro (US$mn)</td>
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<tr>
<td>FY13E</td>
<td>(12)</td>
<td>(16)</td>
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<td>FY14E</td>
<td>(68)</td>
<td>(82)</td>
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<tr>
<td>FY13E</td>
<td>59</td>
<td>61</td>
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<tr>
<td>FY14E</td>
<td>52</td>
<td>51</td>
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Source: Credit Suisse estimates

Figure 20: P/B band—trading slightly above the low range

Source: Bloomberg, company data, Credit Suisse estimates

Figure 21: P/B goes up faster than coal price

Source: Bloomberg, company data, Credit Suisse estimates
Credit Suisse

Companies Mentioned (Price as of 20-Sep-2013)
Berjaya Coal Energy Tbk (BRAU.JK, Rp187)
Delta Dunia Makmur (DOID.JK, Rp95)
PT Adaro Energy Tbk (ADRO.JK, Rp960, NEUTRAL[V], TP Rp1,100)
United Tractors (UNTR.JK, Rp17,300)

Disclosure Appendix

Important Global Disclosures

I, Ami Tantri, certify that (1) the views expressed in this report accurately reflect my personal views about all of the subject companies and securities and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

3-Year Price and Rating History for PT Adaro Energy Tbk (ADRO.JK)

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<th>Date</th>
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<td>07-Feb-12</td>
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* Asterisk signifies initiation or assumption of coverage.

The analyst(s) responsible for preparing this research report received Compensation that is based upon various factors including Credit Suisse's total revenues, a portion of which are generated by Credit Suisse's investment banking activities.

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Underperform (U) : The stock’s total return is expected to underperform the relevant benchmark* over the next 12 months.

*Relevant benchmark by region: As of 10th December 2012, Japanese ratings are based on a stock’s total return relative to the analyst’s coverage universe which consists of all companies covered by the analyst within the relevant sector, with Outperforms representing the most attractive, Neutrals the less attractive, and Underperforms the least attractive investment opportunities. As of 2nd October 2012, U.S. and Canadian as well as European ratings are based on a stock’s total return relative to the analyst’s coverage universe which consists of all companies covered by the analyst within the relevant sector, with Outperforms representing the most attractive, Neutrals the less attractive, and Underperforms the least attractive investment opportunities. For Latin American and non-Japan Asia stocks, ratings are based on a stock’s total return relative to the average total return of the relevant country or regional benchmark; Australia, New Zealand are, and prior to 2nd October 2012 U.S. and Canadian ratings were based on (1) a stock’s absolute total return potential to its current share price and (2) the relative attractiveness of a stock’s total return potential within an analyst’s coverage universe. For Australian and New Zealand stocks, 12-month rolling yield is incorporated in the absolute total return calculation and a 15% and a 7.5% threshold replace the 10-15% level in the Outperform and Underperform stock rating definitions, respectively. The 15% and 7.5% thresholds replace the +10-15% and -10-15% levels in the Neutral stock rating definition, respectively. Prior to 10th December 2012, Japanese ratings were based on a stock’s total return relative to the average total return of the relevant country or regional benchmark.

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Market Weight : The analyst’s expectation for the sector’s fundamentals and/or valuation is neutral over the next 12 months.

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An analyst’s coverage sector consists of all companies covered by the analyst within the relevant sector. An analyst may cover multiple sectors.

Credit Suisse’s distribution of stock ratings (and banking clients) is:

<table>
<thead>
<tr>
<th>Rating</th>
<th>Versus universe (%)</th>
<th>Of which banking clients (%)</th>
</tr>
</thead>
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<td>Outperform/Buy*</td>
<td>42%</td>
<td>(55% banking clients)</td>
</tr>
<tr>
<td>Neutral/Hold*</td>
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<td>(48% banking clients)</td>
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<td>Underperform/Sell*</td>
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<tr>
<td>Restricted</td>
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* For purposes of the NYSE and NASD ratings distribution disclosure requirements, our stock ratings of Outperform, Neutral, and Underperform most closely correspond to Buy, Hold, and Sell, respectively; however, the meanings are not the same, as our stock ratings are determined on a relative basis. (Please refer to definitions above.) An investor’s decision to buy or sell a security should be based on investment objectives, current holdings, and other individual factors.

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Price Target: (12 months) for PT Adaro Energy Tbk (ADRO.JK)

**Method:** Our target price of Rp1,100 for PT Adaro (ADRO.JK) is based on a 2014E P/E (price/earnings) multiple of 10x.

**Risk:** Risks to our Rp1,100 target price for PT Adaro Energy Tbk are lower-than-expected volume and price, and possible higher costs considering the size of company’s mining area.

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