7 April 2022

Basic Materials | Mining

Adaro Energy (ADRO IJ)

Trading Buy (Maintained)

Determined To Seek More Value; TRADING BUY

Target Price (Return):	IDR3,600 (20.0%)
Price (Market Cap):	IDR3,000 (USD6,688m)
ESG score:	2.80 (out of 4)
Avg Daily Turnover (IDR/USD)	375,614m/26.2m

- **TRADING BUY, new IDR3,600 TP from IDR3,400, 20% upside, c.8% FY22F yield.** We adjust FY22-23F earnings estimates by +6% and -2% due to coal price volatility, and expect prices to remain at high levels – at least throughout this year (FY22F Newcastle average: USD220.00/tonne) – before normalising. Adaro Energy's participation in a USD728m investment into an aluminium smelter should create additional value in the long term. ESG factors still pose the biggest long-term downside. However, we remain optimistic on ADRO's prospects, given its diversified business.
- **ADRO was among parties that signed a LoI for a USD728m investment** in an aluminium smelter (c.500,000-tonne target capacity; to start operations by 2025-2026). The total investment amount has not been determined – we think it could be over USD1bn, given the higher commodity prices and additional infrastructure (ie electricity, maintenance equipment), which will result in higher costs (our base cost estimate is c.USD1,950/tonne to meet its capacity targets). The decision is in line with the President's directive to ban bauxite ore exports (main material for aluminium production; Figure 10) from this year, to cut Indonesia's import dependencies (c.750,000 tonnes of aluminium imported pa to cater to c.1m tonnes of domestic demand).
- **We think the project remains feasible,** thanks to the positive outlook for aluminium (low inventory situation, in contrast with higher demand should sustain prices at above c.USD2,800/tonne in the medium term; Figure 6) providing decent returns in the future (breakeven period for similar projects typically averaged at about four years, potential IRR at 15-20%). Based on our back-of-the-envelope calculation, the potential could be equal to c.10% of ADRO's 5-year EBITDA average, using operational parameters from regional aluminium companies and the project's planned funding structure (ADRO will take a c.65% portion). No details have been disclosed by management so far. We have not factored in the additional earnings into our current projections.
- **We believe strong coal prices** (from higher demand for thermal and high-CV coal; Figure 5) will continue to be the main driver for ADRO's share price performance, in addition to management's buyback initiative (up to c.USD280m as of 21 Jun 2022). However, this could catch up faster than its fundamentals, in our view – and act as a downside due to the unpredictable nature of commodity prices. Our new 12-month TP of IDR3,600 is derived from a 7.9x P/E target to FY22F-23F EPS (ADRO currently trades at 6.2x), which represents a c.20% upside. A 4% ESG discount has been applied to the valuation, based on our proprietary methodology. ADRO's strong operational cash flow should maintain its robust cash position (FY21 net cash: USD425m, FY20 net debt: USD182m) and partially ease the risks of an upcoming expansion cost, in our view.

Forecasts and Valuation	Dec-20	Dec-21	Dec-22F	Dec-23F	Dec-24F
Total turnover (USDm)	2,535	3,993	5,275	4,173	3,965
Recurring net profit (USDm)	147	933	1,170	885	788
Recurring net profit growth (%)	(63.6)	535.3	25.3	(24.3)	(11.0)
Recurring P/E (x)	45.52	7.16	5.72	7.55	8.48
P/B (x)	1.8	1.6	1.4	1.3	1.2
P/CF (x)	10.66	5.44	3.36	4.30	4.60
Dividend Yield (%)	3.7	2.2	8.4	10.5	7.9
EV/EBITDA (x)	7.24	3.68	1.74	2.07	1.86
Return on average equity (%)	3.9	23.8	25.8	17.6	15.0
Net debt to equity (%)	8.8	net cash	net cash	net cash	net cash

Source: Company data, RHB

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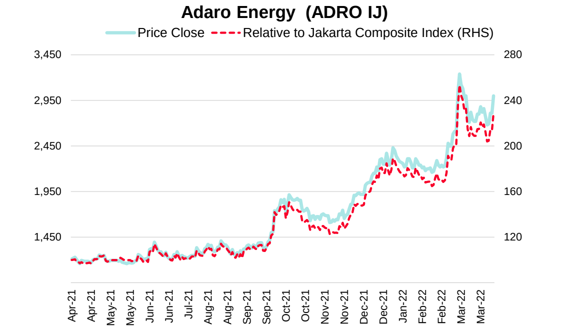
Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	33.3	(1.3)	33.9	63.9	153.2
Relative	24.7	(4.5)	26.6	50.2	133.5
52-wk Price low/high (IDR)					1,160 – 3,240



Source: Bloomberg

Overall ESG Score: 2.80 (out of 4)

E: GOOD

Among ADRO's efforts to minimise the impact of mining activities to the environment is its preservation initiatives at the Bakut Island conservation area (15.58ha), in collaboration with South Kalimantan Agency for Conservation of Natural Resources or BKSDA. It received a Gold Proper Award from the Ministry of Environment & Forestry in 2020 – an award it has consecutively won since 2018.

S: GOOD

ADRO realised a social development investment of USD7.3m to carry out its CSR programme – this was an increase from USD4.1m in 2019. It also received the 2020 Charity & Community Impact Award from Coaltrans Asia.

G: GOOD

Its MSCI rating has been upgraded to BB from B, due to significant improvements in its corporate governance practices – notably with an increase in board size with the appointment of another independent commissioner. In addition, ADRO's good corporate governance implementation is also based on ASEAN Corporate Governance Scorecard parameters.

Financial Exhibits

Asia
Indonesia
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Trading Buy

Valuation basis

P/E target derived from mean line 5-year P/E band (at 7.8x) to forward rolling FY22-23F EPS

Key drivers

i. Increase in coal sales volumes;
ii. Increase in coal prices;
iii. A drop in oil prices.

Key risks

i. Weaker ASPs due to slower GDP growth if the economic recovery takes longer than expected;
ii. Slower demand growth leading to a further glut in global supply;
iii. Unexpected bad weather halting production..

Company Profile

Adaro Energy is a coal-mining company. The company and its subsidiaries currently deal in coal mining & trade, coal infrastructure & logistics, and mining contractor services.

Financial summary (USD)	Dec-20	Dec-21	Dec-22F	Dec-23F	Dec-24F
Recurring EPS	0.00	0.03	0.04	0.03	0.02
DPS	0.01	0.00	0.02	0.02	0.02
BVPS	0.12	0.13	0.15	0.16	0.17
Return on average equity (%)	3.9	23.8	25.8	17.6	15.0

Valuation metrics	Dec-20	Dec-21	Dec-22F	Dec-23F	Dec-24F
Recurring P/E (x)	45.52	7.16	5.72	7.55	8.48
P/B (x)	1.8	1.6	1.4	1.3	1.2
FCF Yield (%)	7.0	20.7	21.7	20.8	19.3
Dividend Yield (%)	3.7	2.2	8.4	10.5	7.9
EV/EBITDA (x)	7.24	3.68	1.74	2.07	1.86
EV/EBIT (x)	16.12	3.68	2.46	2.80	2.64

Income statement (USDm)	Dec-20	Dec-21	Dec-22F	Dec-23F	Dec-24F
Total turnover	2,535	3,993	5,275	4,173	3,965
Gross profit	577	1,770	2,231	1,703	1,555
EBITDA	916	1,584	2,806	2,058	1,911
Depreciation and amortisation	(504)	1	(828)	(541)	(562)
Operating profit	411	1,585	1,979	1,517	1,349
Net interest	(54)	(49)	(46)	(56)	(36)
Pre-tax profit	222	1,486	1,906	1,455	1,310
Taxation	(64)	(458)	(610)	(472)	(428)
Reported net profit	147	933	1,170	885	788
Recurring net profit	147	933	1,170	885	788

Cash flow (USDm)	Dec-20	Dec-21	Dec-22F	Dec-23F	Dec-24F
Change in working capital	(67)	(89)	(274)	128	40
Cash flow from operations	627	1,229	1,991	1,554	1,454
Capex	(157)	157	(540)	(163)	(162)
Cash flow from investing activities	(47)	(98)	(571)	(136)	(154)
Dividends paid	(250)	(147)	(560)	(702)	(531)
Cash flow from financing activities	(639)	(317)	(662)	(786)	(609)
Cash at beginning of period	1,576	1,174	1,814	2,627	3,141
Net change in cash	(59)	815	759	632	691
Ending balance cash	1,174	1,814	2,627	3,141	3,722

Balance sheet (USDm)	Dec-20	Dec-21	Dec-22F	Dec-23F	Dec-24F
Total cash and equivalents	1,174	1,814	2,627	3,141	3,722
Tangible fixed assets	1,539	1,312	1,318	1,167	1,003
Total investments	629	973	973	973	973
Total assets	6,229	7,366	8,325	8,214	8,337
Short-term debt	643	271	271	271	271
Total long-term debt	865	1,337	1,323	1,309	1,296
Total liabilities	2,430	3,129	3,383	3,189	3,148
Total equity	3,799	4,238	4,942	5,025	5,188
Total liabilities & equity	6,229	7,366	8,325	8,214	8,337

Key metrics	Dec-20	Dec-21	Dec-22F	Dec-23F	Dec-24F
Revenue growth (%)	(26.7)	57.5	32.1	(20.9)	(5.0)
Recurrent EPS growth (%)	(63.6)	535.3	25.3	(24.3)	(11.0)
Gross margin (%)	22.8	44.3	42.3	40.8	39.2
Operating EBITDA margin (%)	36.1	39.7	53.2	49.3	48.2
Net profit margin (%)	5.8	23.4	22.2	21.2	19.9
Dividend payout ratio (%)	170.2	15.7	47.9	79.3	67.4
Capex/sales (%)	6.2	(3.9)	10.2	3.9	4.1
Interest cover (x)	4.60	19.02	25.70	17.05	19.55

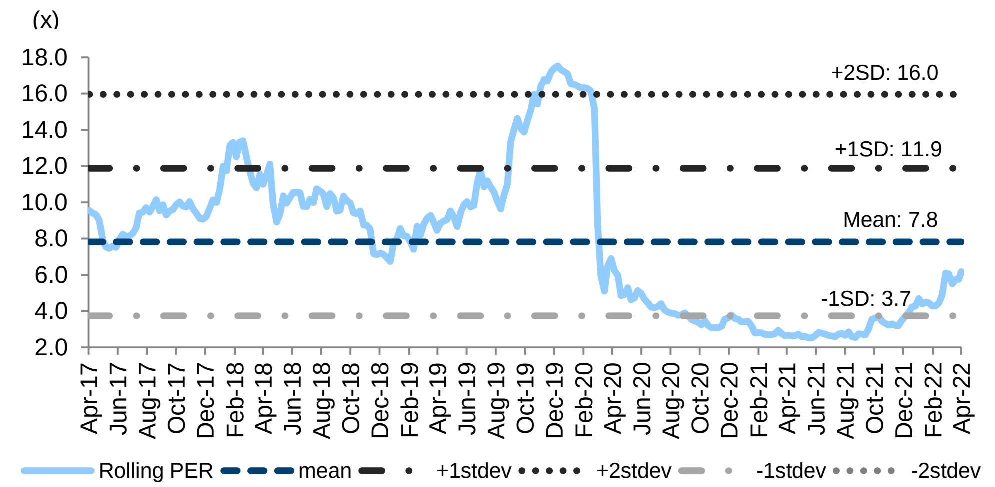
Source: Company data, RHB

Figure 1: RHB vs Street's estimates

	RHB (new)			RHB (old)			Change			Street			RHB vs Street		
(USDm)	**2022F**	**2023F**	**2024F**	**2022F**	**2023F**	**2024F**	**2022F**	**2023F**	**2024F**	**2022F**	**2023F**	**2024F**	**2022F**	**2023F**	**2024F**
Revenue	5,275	4,173	3,965	4,913	4,224	3,895	7.4%	-1.2%	1.8%	5,063	4,299	3,888	4.2%	-2.9%	2.0%
Gross profit	2,231	1,703	1,555	2,039	1,722	1,539	9.4%	-1.1%	1.0%	2,249	1,729	1,372	-0.8%	-1.5%	13.3%
Operating profit	1,979	1,517	1,349	1,844	1,544	1,334	7.3%	-1.8%	1.1%	1,920	1,313	1,054	3.0%	15.5%	28.0%
Pre-tax profit	1,906	1,455	1,310	1,790	1,480	1,291	6.5%	-1.6%	1.4%	1,941	1,351	1,097	-1.8%	7.7%	19.4%
Net profit	1,170	885	788	1,100	906	778	6.4%	-2.3%	1.4%	1,209	855	691	-3.2%	3.5%	14.0%
Margin															
Gross	42.3%	40.8%	39.2%	41.5%	40.8%	39.5%				44.4%	40.2%	35.3%			
EBIT	37.5%	36.4%	34.0%	37.5%	36.6%	34.3%				37.9%	30.5%	27.1%			
Pre-tax	36.1%	34.9%	33.0%	36.4%	35.0%	33.2%				38.3%	31.4%	28.2%			
NPM	22.2%	21.2%	19.9%	22.4%	21.5%	20.0%				23.9%	19.9%	17.8%			
Key assumptions															
Vol. production (m tonnes)	58.0	60.5	63.2	58.0	59.5	61.1	0.0%	1.7%	3.5%						
ASP (USD/tonne)	88.8	65.1	58.9	82.5	67.1	59.8	7.6%	-2.9%	-1.5%						
Cash cost (USD/tonne)*	32.1	22.7	21.0	30.6	24.6	22.1	4.7%	-7.8%	-5.0%						

*Note: *Ex-royalty costs*
Source: Company data, RHB

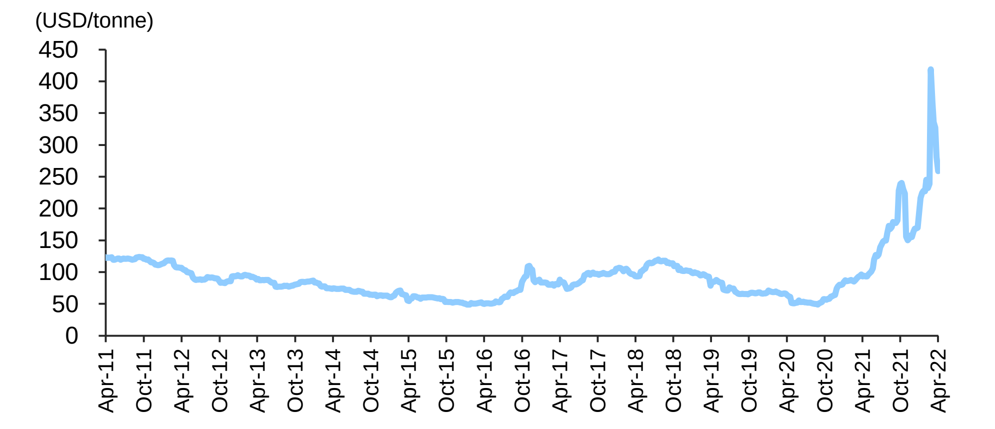
Figure 2: ADRO's 5-year average P/E band



Source: Bloomberg, RHB

- ADRO remains attractive – it is still trading at around the -0.5SD line based on the 5-year forward-rolling P/E band, providing a c.22% upside gap to the FY22F P/E target of 7.9x
- The unexpected turn of events since early this year (Indonesia's temporary coal ban in January and the Russia-Ukraine war) has given support once again for coal prices to soar above its highest historical price point (Newcastle: c.USD440.00/tonne; +159% YTD).

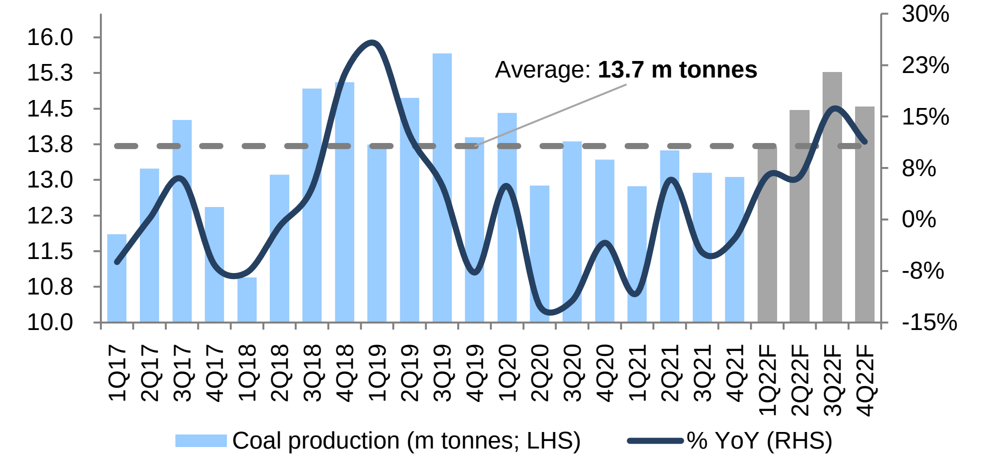
Figure 3: Newcastle price trend



Source: Bloomberg, RHB

- Coal prices ascended to their highest historical price point. We believe the average price throughout this year will remain high (FY22F Newcastle average price: USD220.00/tonne vs FY21's USD136.00/tonne)

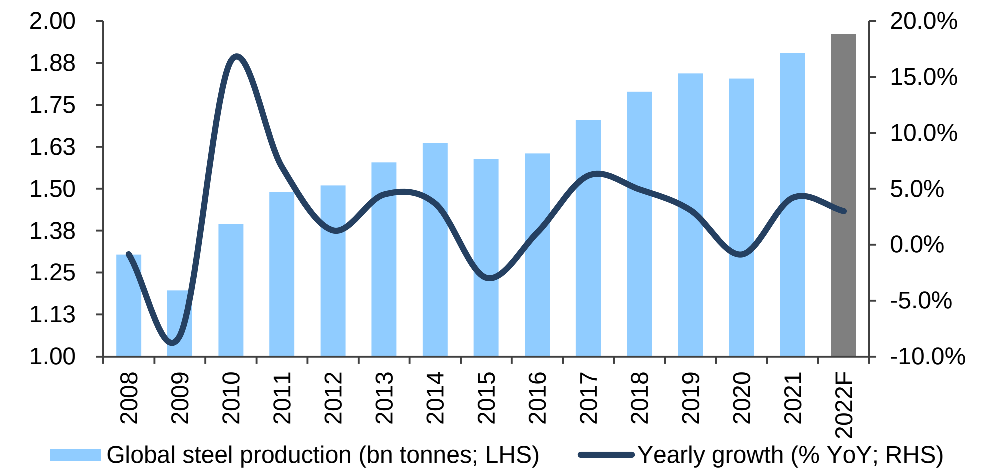
Figure 4: ADRO coal production trend and quarterly estimates



Source: Bloomberg, RHB

- Coal production is relatively low during the early part of the year due to seasonal factors, before picking up once drier weather sets in (usually in April-September)
- Management is optimistic of production growth at 58-60m tonnes this year (FY21: 53m tonnes)

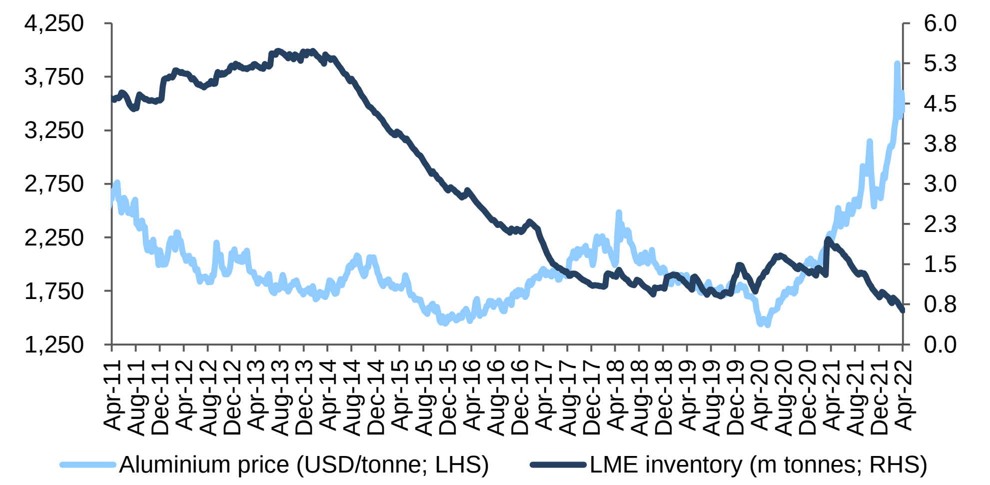
Figure 5: Global steel production trend



Source: Bloomberg, RHB

- Coking coal is an essential input for production of iron and steel. The largest single-use of coal in the steel industry is as a fuel for the blast furnace and production of metallurgical coke for reduction of iron ore or for injection with the hot blast.
- Global steel output is projected to reach its record high again this year, thanks to normalisation in manufacturing and global construction activity.

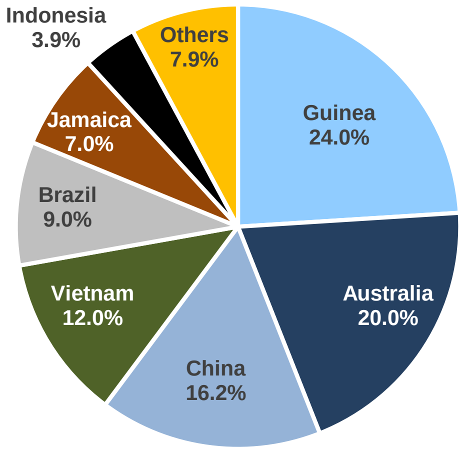
Figure 6: Aluminium prices vs inventory trend



Source: Bloomberg, RHB

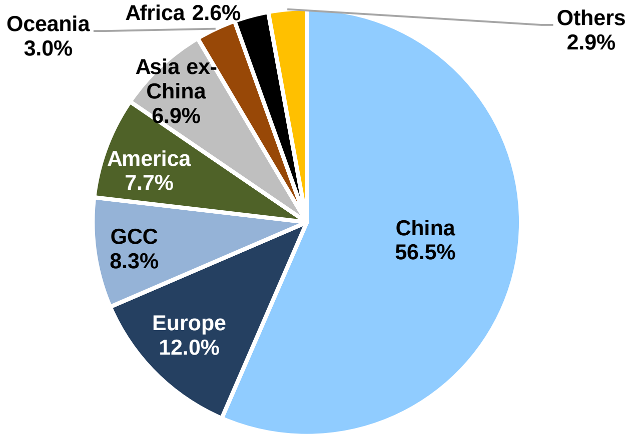
- Supply constraints have become a major theme across commodity sectors, given the rapid recovery of demand post pandemic, which has not been met with a fair increase in output
- Further uncertainties were triggered by new geopolitical tensions, exacerbating low inventory levels – this remains the main catalyst for upward trend in commodity prices in the medium term, including for aluminum.

Figure 7: Bauxite reserves by country (c.32bn tonnes in total)



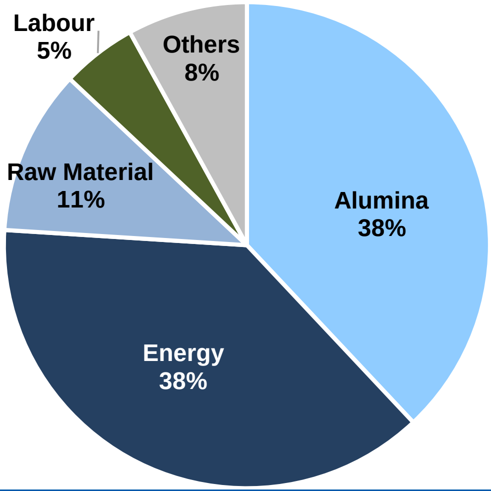
Source: Bloomberg, RHB

Figure 8: Global share of aluminium production by region (c.70m tonnes per year)



Note: GCC stands for Gulf Cooperation Council
Note 2: America includes North and South region
Source: Bloomberg, RHB

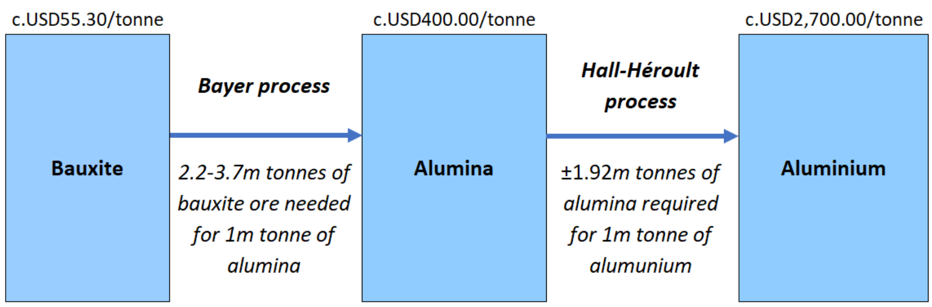
Figure 9: Aluminium smelter cost structure (per tonne)



Source: Bloomberg, RHB

- Aside from alumina requirements, energy utilisation took the second-biggest chunk of total cost in aluminum production – most aluminum smelters around the globe still rely on fossil fuel (mostly coal) as an energy source.
- However, studies reveal that adoption of renewable energy will potentially reduce overall production costs by 5% (source: BloombergNEF).

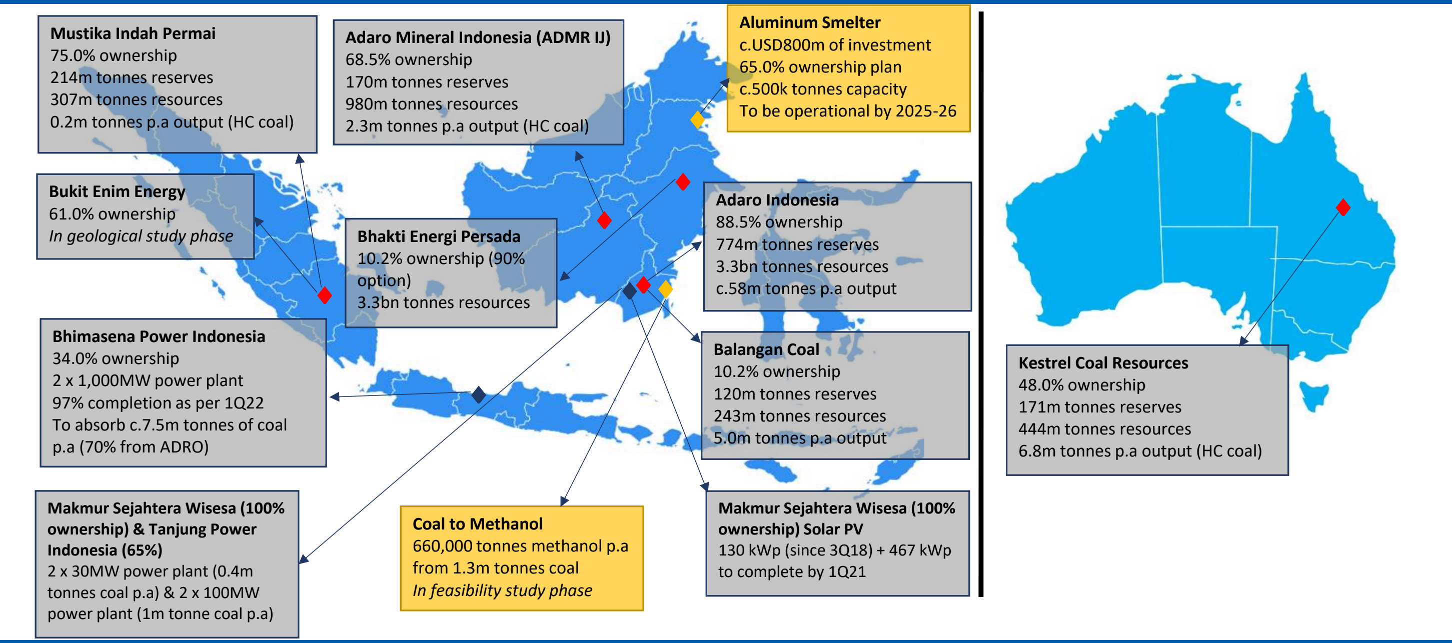
Figure 10: Material processing for aluminium production



Note: Price figure indicates one-year historical average
Source: Bloomberg, Alcoa, RHB

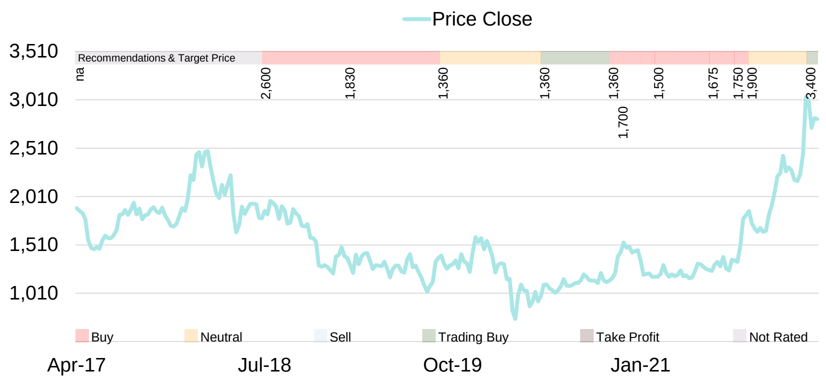
- The enhanced value from processing bauxite into aluminum is very lucrative.
- However, factors such as funding, professional skills required, and ecological impact remain the biggest challenges for the industry, especially in Indonesia – Inalum (Holding of Mining Industries) is the only company currently operating aluminum smelters in the country, with c.240,000 tonnes of capacity pa.

Figure 11: Some of ADRO's major assets



Source: Company, RHB

Recommendation Chart

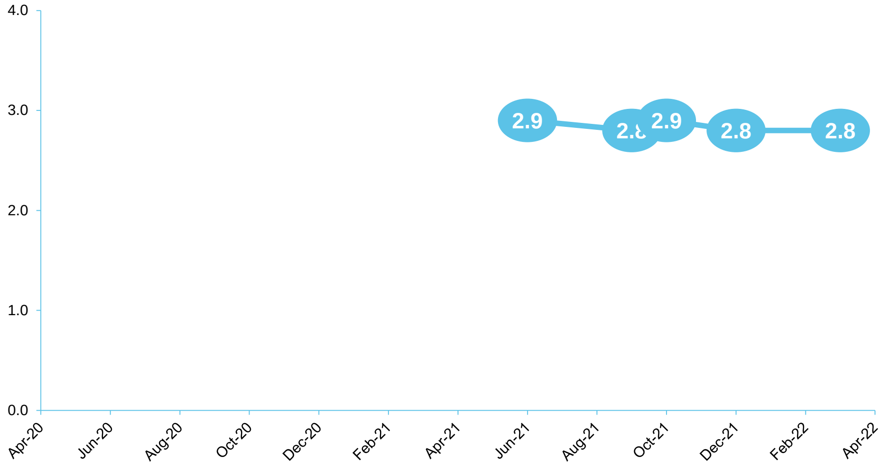


Source: RHB, Bloomberg

Date	Recommendation	Target Price	Price
2022-03-04	Trading Buy	3,400	3,040
2021-10-11	Neutral	1,900	1,915
2021-09-07	Buy	1,750	1,345
2021-07-07	Buy	1,675	1,250
2021-02-22	Buy	1,500	1,210
2020-11-27	Buy	1,700	1,390
2020-11-04	Buy	1,360	1,110
2020-05-19	Trading Buy	1,360	1,005
2019-11-22	Neutral	1,360	1,320

Source: RHB, Bloomberg

ESG Rating History



Source: RHB

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Neutral:	Share price may fall within the range of +/- 10% over the next 12 months
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