

DIAMOND HILL

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Coal: A Vital Resource in a Changing World

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Modern life depends on electricity: it powers our homes, businesses and industries. As the world's most abundant source of electricity, coal plays a crucial role in meeting global energy demands. Despite narratives surrounding a transition to cleaner energy sources, coal continues to play a vital role in powering many industries, and in some segments (such as steelmaking), it will be hard to displace. The combination of this continued demand with notable supply constraints presents a compelling investment opportunity within the energy sector.

Two Types of Coal

Coal, a versatile resource, is classified into two main types based on its properties and uses. The first is thermal coal, primarily used in power generation. It is further categorized into low, mid and high calorific value (CV) coal, with higher CV coal indicating greater energy content. The second type is metallurgical coal, also known as "met coal" or "coking coal." This type is a key component in steelmaking, as it is used to create coke in blast furnaces, which in turn is used to heat iron ore and produce steel.

Coal Demand

Global thermal coal demand is driven primarily by the need for electricity generation. Developed economies like the US and Europe are attempting to transition away from coal-generated power due to environmental concerns. While the decline in coal power production is notable, it is less than some have predicted. Additionally, coal power generation remains a low-cost source of electricity in a world that has experienced persistent inflation over the past three years, particularly in emerging economies such as India and China. These countries depend heavily on coal-fired power plants to fuel economic growth and industrialization. Though thermal coal is often viewed unfavorably, its resilience in the global energy market makes it a surprisingly durable asset despite the widespread perception of a rapid decline.

The future for coal varies by type. Unlike thermal coal, met coal presents a more stable long-term demand outlook. Global demand for met coal is projected to stay steady and potentially increase for the foreseeable future, primarily driven by the need for steel in India and Southeast Asia. This growth in India and SE Asia should offset weaker longer-term demand from China, the world's largest consumer of met coal. That said, China remains the largest steel producer globally by a wide margin, so a major downturn in China could negatively impact met coal demand across Asia.



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Coal Supply

Despite its importance, coal faces supply constraints, particularly in the Western world, where permitting new coal mines has become quite challenging, and royalties on coal producers have increased (Australia being the primary example of the latter point). Securing financing for new coal mining projects is becoming increasingly challenging due to the global push towards decarbonization and investor pressure to divest from fossil fuels. Also, the availability of skilled labor and logistical bottlenecks in transporting coal from mines to ports further exacerbate supply constraints.

Coal Company Profitability & Attractiveness

The imbalance between the consistent demand for coal and the constraint on its supply creates a more supportive environment for coal prices over the long term than many market participants expect. The current energy landscape, characterized by geopolitical tensions and a renewed focus on energy security, has highlighted coal's continued importance in the global energy mix. While coal prices, much like any commodity, fluctuate in the short term, the essential nature of coal and its supportive pricing environment over the long term create potential future profitability for coal producers. Additionally, the popular perception of coal as an environmentally unfriendly commodity with rapidly declining demand has weighed on stock prices in the industry, creating attractive opportunities for value-oriented investors.

Coal remains an essential resource, particularly in emerging economies. The demand for specific types of coal, like high-CV thermal coal and met coal, persists due to their critical role in power generation and steelmaking. The constraints on coal supply, stemming from fewer permits, higher royalties, financing challenges and logistical bottlenecks, have created a demand-supply imbalance over the medium term. This imbalance underpins a potentially lucrative opportunity for investors seeking to capitalize on sustained demand and favorable pricing dynamics within the global coal market.

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