



PERITUS

ASSET MANAGEMENT, LLC

Market Commentary

Independent Credit Research – Leverage Finance – June 2010

RATINGS VERSUS REALITY

AAA or D?

As I was reviewing and updating James River Coal's credit profile, I recognized that it was a very *easy indictment of ratings agencies and provides a better understanding of why high yield remains a tremendous asset class and why good credit people use the ratings game to pick off both **lazy** investors who rely on ratings for investment decisions and many institutions that are forced to rely on ratings because of useless and outdated **legislation***. The James River 9 3/8% senior notes that Peritus owns were rated "Ca" by Moody's for the last several years. They were "upgraded" to "Caa1" on May 27th 2010. Here are the definitions for the ratings categories:

Caa – credits that are in poor standing and subject to very high credit risk

Ca – credits that are highly speculative and are likely in or very near default

According to ratings agencies these bonds were effectively in default. Our belief is that credit is either AAA or D (paying and expected to continue to pay or not paying and in default). So to us this company was in effect AAA, while one of the major rating agencies was telling us that these bonds "are likely in, or very near default." So who is right? Let's start with a very brief overview of the business and the numbers.

Business/Financial Overview¹

James River Coal reported good numbers for the first quarter. Earnings before interest, taxes depreciation and amortization ("EBITDA") were \$46 million in Q1 which suggests that \$180 million in EBITDA is rational for the year, but let's be more conservative and call it \$150 million. How about for the next year? Their contracted tonnage and pricing is filling up for 2011 at average prices similar to this year, so 2011 EBITDA will likely be similar. Coal is generally sold into two markets: metallurgical coal for steel production and thermal or steam coal for electricity generation. There has been an abundance of thermal coal in 2010 but inventories are expected to normalize later this year as production has been curtailed. Metallurgical coal has been very strong throughout 2010. We like the contracted nature of the revenues and cash flows which allow us to generate reasonably precise expectations for the future.

Now a brief review of the numbers helps show why we like the credit profile. The company has a very large cash balance of over \$150 million. In fact their cash balance is more than the senior bonds we own, seeming to provide a margin of safety on many fronts. Additionally, given our

¹ The following is an example of the investment analysis performed by Peritus. Any projection or expectation given is based on Peritus' current beliefs and assumptions and is subject to change. Actual results may differ materially. Financial data gathered from company filings with the SEC as well as information provided on conference calls.

EBITDA forecast, we expect the company to generate almost \$60 million in simple free cash flow (EBITDA – interest expense – capital expenditures) so the cash balances are likely to continue to grow.

Capitalization		Rate:	Q1	Q2	Q3	Q4	
Revolver	\$0	6.75%	\$0	\$0	\$0	\$0	L+275 due 2/12
Senior Notes	\$150,000	9.375%	\$3,516	\$3,516	\$3,516	\$3,516	due Jun 2012
Conv Notes	\$129,650	4.75%	\$1,540	\$1,540	\$1,540	\$1,540	
Other	\$0	0.00%	\$0	\$0	\$0	\$0	
Total Debt	\$279,650	Interest	\$5,055	\$5,055	\$5,055	\$5,055	\$20,221
		Cap Ex	\$17,500	\$17,500	\$17,500	\$17,500	\$70,000
Stock Price	\$15.50	Amortz.	\$0	\$0	\$0	\$0	
# of Shares	27,543,278	Uses	\$22,555	\$22,555	\$22,555	\$22,555	
Market Capitalization	\$426,921	EBITDA	\$37,500	\$37,500	\$37,500	\$37,500	EBITDA \$150,000
Total Debt	\$279,650	FCF	\$14,945	\$14,945	\$14,945	\$14,945	EBITDA/Int 7.4
Projected Leverage	1.9						
Enterprise Value	\$706,571	Amtz.	2010	\$0			Liquidity: Availability \$36,200
EV/EBITDA	4.7		2011	\$0			Cash \$153,129
MAD	\$126,521		2012	\$150,000			Total \$189,329
MAD Leverage	0.8		2013	\$0			

So in summary, we have the following:

- Good basic business supplying an essential product to utilities and steel producers
- A balance sheet that has huge a cash balance equivalent to about 60% of total debt
- Net debt (debt minus cash) of \$127 million or approximately 0.8x EBITDA
- Free cash flow potential generation of \$60 million annually based on what we believe to be a conservative EBITDA run rate of \$150 million.

That's great, but investing is all about the future. The ratings agencies do claim that their ratings consider the future of the company rather than looking just at the past. Apparently, that is why the bonds were "upgraded" to "poor standing and are subject to very high credit risk." Not only do we believe this rating to be positively absurd, the company's future looks solid based on their bookings for 2011 and our own forecasts. But one needs to look for additional clues. In this case we find the company's comments from their last earnings call interesting to say the least.²

FINAL TRANSCRIPT

Apr. 30. 2010 / 3:00PM, JRCC - Q1 2010 James River Coal Company Earnings Conference Call

maintain that position. I want to keep a balance sheet, I think I said this to one of the ratings agencies, I want to keep a balance sheet that is stronger than dog's breath. Because we've lived with no money. We've lived with -- as Mike [Willem] used to say,

We're keeping an open contract book. We obviously have strong cash flow for the next several years. We are not in any rush to go out and price coal into a market that is clearly strengthening, so we're leaving it where it is. We are very well positioned for sustained profitability and I will talk about that in a few moments.

We remain very skeptical of rosy forecasts of any kind. However, in the current litigious environment managements are cutting back on offering guidance and comments of any kind regarding the future. When they do offer them, they would have been scrubbed by counsel and have a rationale for their statements. So in this case, management echoes our own feelings.

² "JRCC – Q1 2010 James River Coal Company Earnings Conference Call." Thomson StreetEventsSM. April 30, 2010, p. 15, 3.

Summary and Conclusion

There continues to remain a massive disconnect among investors about the corporate bond market, the ratings process and risk. It has been my experience over the past 26 years that the models used by the rating agencies favor size and longevity and are in no way forward looking. This fact and the arbitrary restrictions placed on many institutional investors provide the perfect recipe to generate alpha (excess risk adjusted returns) through an active credit process.

Investors should understand what the ratings agencies themselves say about their ratings. Among their various disclosures, the ratings agencies caution that their ratings are opinions and are not to be relied upon alone to make an investment decision, do not forecast future market price movements, and are not recommendations to buy, sell, or hold a security. So if the company who rates bonds tells you that they are effectively useless as an investment tool, why use them? Answer: we don't.

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