

## **Bright Spots in the Fertilizer Market: Robert Winslow**

By The Energy Report, on January 15, 2013

Global population growth and escalating food demand underpins long-term upside for potash, phosphate and nitrogen producers, but fertilizer oligopolies may have jumped the gun last year with aggressive rates that priced farmers out of the market. As farmers expand acreage rather than boost yields in now-tired fields, grain prices have backed off recent highs. That's why Robert Winslow, agriculture research analyst and director at National Bank Financial, is picking his stocks with care. In this interview with The Energy Report, he shares where he sees strengths and weaknesses in the industry and names some interesting contrarian plays.

**The Energy Report:** Your last interview took place in April of 2011. What have been the major developments on the agricultural front impacting the fertilizer markets since then?

**Robert Winslow:** Increased weather volatility, like last summer's drought in the U.S., which led to modern-era highs in corn, wheat and soybean prices, have had a significant impact on the market. Although grain prices have softened of late, I believe you're likely to see somewhat higher-than-usual grain prices through at least the first half of 2013, given the persistent dryness in the U.S. Corn Belt and wheat-growing regions. Grain prices drive farmer sentiment and buying, and therefore the price and the demand for fertilizer.

We've seen some disconnects when it comes to potash, such as in India: Because the rupee was devalued about 20% through 2012, Indian farmers can't afford to pay the prices that the potash companies would charge, and this resulted in subdued demand. Chinese demand has been somewhat subdued as well. Globally, we've had this really interesting dichotomy with high grain prices buoying larger demand in places like North America and even Brazil, but softening demand in yet other parts of the world with country-specific issues. In total, we haven't seen the demand strength in potash that you might have otherwise expected with this high grain-price environment.

Some would say it's partly because grain prices are not sustainable at these high levels. We are actually of that view. Like any commodity, when the price gets too high, two very simple things play out: demand destruction and supply response. You've seen demand destruction over the last 3–6 months. For example, high-cost ethanol plants have been shuttering production. High-cost producers of cattle, pigs and chickens have been culling their herds because they can't afford the feed costs unless meat prices rise in conjunction, which they have not.

Then there's supply response. Farmers are expanding acreage by moving into marginal land. You may not get robust yield on that land, but you can still increase production, which we're seeing play out now. Brazil is expected to increase soybean acreage by 8–10% this year. With these dynamics playing out, the grain prices are beginning to come down. We expect that by the second half of 2013 you should start to see lower fertilizer demand reflected in pricing, even in the U.S. and Brazil. That is why we maintain a fairly cautious view on the fertilizer sector at this stage.

**TER:** How might continuing climate change and severe weather affect grain prices and fertilizer demand?

**RW:** Nobody really knows the answer. I don't pretend to, but I will say that the stocks-to-use ratio for grains right now, globally, is about 68–69 days of supply. It's relatively tight compared to the last 30 years or so, and it doesn't take much to tip over and get a real spike—or falloff—in grain prices. When you do get these supply shocks through floods or droughts, the relatively tight supply situation can move prices quite dramatically, which we saw just this past year.

Many investors don't believe such price spikes are sustainable and they aren't going to pay for them. We're probably at least two years away from where we have a bit more of a buffer in the stocks-use ratio to get us away from this tightness

that is causing more volatility in the grain price. In the meantime, we can expect continued volatility in both grains and fertilizer equities.

**TER:** How have the various segments of the fertilizer industry performed in the last year and a half?

**RW:** Potash has been the commodity with the most interest. We've been a bit of an outlier in the investment community, with a rather bearish view on both the commodity itself and on some of the senior potash producer equities. We are of the view that the potash oligopolies (and we all know who they are) have been rather aggressive with their pricing. In a perfect world, you might be able to raise your prices every year, but we don't live in a perfect world. Places like India just couldn't afford the higher prices, so they bought less. The oligopolies and agronomists are right in saying that parts of the world, like India and China, need more potash in the soil, but ultimately, demand is price dependent.

In 2012, global potash demand looked to be in the neighborhood of 50 million tonnes (50 Mmt), which is below the levels we saw back in 2004. Thus, the commodity usage has been basically flat to down over the last 7–8 years—not a compelling investment theme. But the potash price more than tripled over that period. This aggressive pricing has since come back to bite the oligopolies. I expect a demand recovery in 2013 because India has been under-applying fertilizer, and it will need to make up for that at some point. I doubt India would purchase its full allocation, which would be 6–7 Mmt, unless it can buy potash near or below \$400/Mmt. And if it does buy the 6-7 Mmt, then there's a good chance India might buy less again in 2014, with Indian farmers trying to mine the soil. Of course, if the rupee comes back with vigor, India would have more buying power.

On the supply side, there's tremendous brownfield supply expected over the next three to four years. Most of it is coming from the oligopolies themselves. It looks like the global supply will be growing about 4% per year, on average, over the next four years. So if your demand is flat and supply is up 4% per year, it doesn't bode well for potash prices. That doesn't include the greenfield supply that could come on from BHP Billiton Ltd. (BHP:NYSE; BHPLF:OTCPK), K+S Potash Canada (SDFG:FSE) or any of the juniors that are working to build mines. So the supply/demand dynamics are not, in our view, compelling for potash over the next two years, particularly if we get less volatile global weather patterns and grain prices trend down.

**TER:** How do the prospects look in the other fertilizer segments?

**RW:** Phosphate is looking rather interesting here. Not unlike potash, there's a bit of an oligopoly situation, with Morocco controlling half or so of the global phosphate rock market. It appears that Moroccans really want to move more into the higher-margin business. Instead of just selling rock to the world, they figure they can make monoammonium phosphate and diammonium phosphate, which are finished fertilizer products. This will make it rather challenging for the non-integrated phosphate producers and/or companies that still rely on imported rock. U.S. phosphate producers like The Mosaic Co. (MOS:NYSE) and Agrium Inc. (AGU:NYSE; AGU:TSX), for example, rely or expect to rely to some extent on Moroccan rock.

On the other hand, that should provide some interesting opportunities for the greenfield phosphate companies, certainly in North America, that are developing phosphate deposits. There are a couple of companies in particular that you might want to keep an eye on. One is d'Arianne Resources Inc. (DAN:TSX.V; DRRSF:OTCBB; JE9N:FSE) and the other is Stonegate Agricom Ltd. (ST:TSX, SNRCF:OTCPK). Both are working on projects here in North America. The next few years could be interesting for them.

**TER:** Then how about the nitrogen products?

**RW:** Unlike potash and phosphate, nitrogen isn't reliant on ore bodies. It's produced all over the world, so you don't get the sort of concentration you get in potash and phosphate. If you're investing in that sector, you have to be a little careful, because we believe that nitrogen producers in North America, in particular, are near peak margins due to the low price of natural gas, which is a big input component. In our view, you shouldn't generally buy equities that are about to post peak earnings and peak margins, especially when the market already expects those peak results.

Two companies in particular, Agrium Inc. (AGU:NYSE; AGU:TSX) and CF Industries Holdings Inc. (CF:NYSE), have share prices near their all-time highs, and the market's already valuing some pretty robust results for them. We would be very cautious, and, in fact, we have an Underperform rating on Agrium. That stock's trading a little over \$102 today, and we have an \$87.50 target on it.

**TER:** How are current commodity and financial market conditions affecting plans for junior mining companies in the project development stage?

**RW:** It's a challenging time. Finance risk is the key challenge for a lot of these junior companies, whether it's potash or phosphate. That means that if you have an ore body or an asset, it needs to have some competitive advantages, for example by being a low-cost operation either at the mine level or through low distribution costs. We look at projects like Allana Potash Corp. (AAA:TSX; ALLRF:OTCQX) in Ethiopia, for example, which looks to be well positioned as a low-cost operation at the mine gate and could be one of the lowest-cost delivered potash suppliers into India, which has no domestic potash. Companies are better off when they have these types of strategic advantages, but at the end of the day, the finance risk is still an overwhelming one today.

There is one development stage fertilizer company that we're most intrigued by, and that's MBAC Fertilizer Corp. (MBC:TSX; MBCFFOTCQX), because its finance risk is now largely behind it—it is about to move into production in the next few months or so. It has a phase one phosphate project in Brazil called Itafos, right in the Cerrado, which is the breadbasket of Brazil. It also has another phosphate asset to the north of the Cerrado. This company has a logistic advantage because half of the phosphate fertilizer manufactured in Brazil uses imported rock from Africa. We are extremely interested in this stock and it has our Top Pick rating in the sector. We have a \$5.25 target on the stock with an Outperform rating. Frankly, the company is a potential acquisition target because there are parties that appear to be aiming to consolidate the phosphate fertilizer sector in Brazil. We believe MBAC Fertilizer is one to own for 2013.

**TER:** It's nice to see some blue sky on the horizon.

RW: I'm not a complete bear on the sector. There are some bright spots in my coverage list.

**TER:** Do you expect any other interesting M&A activity in this industry due to current market conditions?

RW: I don't see much particularly different about 2013 versus 2012 as far as the macro call goes. There's been expectation for some time that the Indians and/or Chinese would come in and buy up more of the junior fertilizer companies to help secure supply, particularly in the potash sector. That just hasn't happened yet. One thing that's different about 2013 is that there should be a number of bankable feasibility studies completed this year, which will help derisk a number of the early-stage projects. It looks like Allana Potash is expecting its bankable feasibility any day now and d'Arianne Resources is expecting a bankable feasibility mid-year. Elemental Minerals Ltd. (ELM:TSX; ELM:ASX; EMINF:OTCPK) has a bankable study expected in the second half of 2013 on its potash project in the Republic of the Congo. Even IC Potash Corp. (ICP:TSX; ICPTF:OTCQX), which is a company looking to develop a sulfate of potash fertilizer project in the U.S., expects a bankable study in mid- to late 2013 as well.

There are number of bankable feasibility studies coming, which will help derisk these projects and could spur some investment by the likes of the Indians, the Chinese and even the Brazilians as they look to secure fertilizer, but time will tell. Because finance risk is quite significant for these companies, they ultimately need strategic partnerships and/or offtake agreements to help mitigate that risk. So as these studies come out in the next 6–12 months, which could change the equation for many of them. We'll have to wait and see how that plays out.

**TER:** You talked about MBAC, which you like. What's the situation with PotashCorp. (POT:TSX; POT:NYSE)?

**RW:** We're bearish on that one. I believe we have the only Sell rating for that stock on Bay Street and Wall Street. So if you like contrarian views, that's us. The potash commodity supply/demand situation is not particularly compelling. In terms of valuation, we look at that company as having mid-cycle earnings around \$3.05 a share in our 2014 estimate. A typical multiple on mid-cycle earnings tells us this stock is overvalued at \$41–42. The Street and most analysts seem to love it. They believe it's worth \$50+. Considering the cyclical downside potential for grain, we're not of that view. We had a sell on it for most of 2012 and it's been the right call. We'll have to see how 2013 plays out.

**TER:** What do you see ahead for fertilizer producers and how can investors position themselves in this industry, if they like the future prospects?

**RW:** It's as simple as this: The correlation between grain prices and agricultural equities, particularly the fertilizers, is quite high. Grain prices have retreated of late but still appear to have more downside risk than upside and we would argue over the next year or so, barring unforeseen supply shocks, the trend for grain prices is for further downside. If you're of that view, then the bias for the agricultural equities would be down as well. So we're pretty cautious here. We'd be inclined to sell into strength, if these agricultural equities rally, and focus more on the supply/demand fundamentals for grains. With that view, we have only a select few buys and we're more cautious with a number of sells in our universe.

**TER:** And there's a little bit of news on the horizon for mid-year with some of the smaller companies if they can get their act together.

**RW:** That's correct, on the bankable feasibility studies coming out.

**TER:** We greatly appreciate your time and input today, Robert.

**RW:** Thank you very much.

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