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ANALYST'S CORNER

Potash Market Showing Signs of Recovery

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RIN: Last year was pretty tough for commodities, and it seems that for potash, it was even tougher given the dissolution of Belarusian Potash Company (BPC). To start things off, can you give us a little bit of an overview about what happened in the potash market in 2013 and how it impacted the companies working in the space?

KM: True, 2013 was not an easy year for the potash sector, especially in the wake of that BPC break up. That was a shocker for the entire industry. It affected potash prices and had a very strong influence on the majors. Subsequently, it had a lot of influence on the juniors, because if prices remain low, it becomes difficult to visualize juniors posting healthy project economics based on the lower potash prices.

As an overview of what happened, at the end of July, Uralkali announced that they were quitting BPC, a partnership that was the main trading house for Uralkali and Belaruskali. Together, these two companies within the BPC framework controlled between 40 and 45 percent of global potash exports, so they had a major influence on potash pricing going into China, India and Brazil.

Once BPC stopped operating, Uralkali started selling individually, and they announced to the market that they expect prices to go down towards $300 per metric ton over the next six to 12 months. That was a very negative event. Across the entire sector, if we look at all the majors, like PotashCorp (TSX:POT), Agrium (NYSE:AGU), Mosaic (NYSE:MOS), Compass (NYSE:CMP), Intrepid (NYSE:IPI), ICL (TLV:ICL) and K+S, they dropped 19.5 percent on that day alone.

The market has been recovering since then.

We view this development as an opportunity for the sector and have told investors to start looking to the potash sector, because we are not expecting Uralkali to stay outside of the partnership for too long.

RIN: Was there anything else that happened in the potash market that investors should know about?

KM: Another negative thing that happened during that time was that a Chinese group took a 12.5-percent position in Uralkali. That was the first time that an end user in the $20-billion industry had taken a position in one of the producers. This was not positive. Most of the sector feels like that might influence prices on the negative side going forward, but it's hard to say how much of an influence that will have.

BHP, of course, pretty much gave an indication that they will only slowly develop their project in Saskatchewan. They gave no indication that they are in a rush to develop it. They will keep slowly developing it, but nothing that will move the project into production any time soon.

As for Uralkali, now that it has new management in place, the indications are that discussions have already begun to reform a potential partnership with Belaruskali. It has been confirmed that a meeting between the new management and BPC took place at the end of January of this year, so things are moving in that direction.

As well in January, Uralkali and China signed an agreement for 700,000 metric tons of potash at $305 per tonne, which is much lower than what we saw in 2013. It is a new low for the potash price, if you look at the last five years, but with the new management potentially reforming BPC, or a similar type of structure, we expect that they will have, again, enough market control to try and push for higher pricing.

RIN: How is this price indicative of the market? What can investors look forward to in 2014?

KM: Well the agreement did come at a very low price relative to what we have seen in the last two years. We think the major producers will keep hurting over the next 12 months with prices being so low. But the main thing to look at is the volume sold, because we expect the buyers will start returning to larger volumes.

RIN: Could we consider rebound buying as the catalyst in market this year?

KM: Correct. If we don't see a rebound in buying, even at those low prices, that will be negative to the industry. The main thing this year is to see end users, especially India and China, buying again.

RIN: How does the demand look for potash?

KM: In 2012, global potash demand was at around 51 million metric tons. That improved to around 53 million metric tons in 2013. We would like to see in 2014 demand reach 55 million metric tons or more. That would be an indication that end users are ready to apply potash at normal levels again. We saw evidence in the last few years of potash under-application by end users due to high prices, and that was one of the main causes of this slowdown in potash buying. If you start seeing that it's back to the 55 million metric tons level, then that indicates that the end users are adjusting their buying habits.

RIN: Okay. To switch gears and look at companies, the major players in the market seem to set the bar for sector performance. How do junior potash companies measure up against these major players, and how do investors gauge them?

KM: Potash projects are extremely capital intensive, and therefore are very hard to fund for a junior company. The juniors are not really measured in comparison to the major producers, but more on their chances of being developed, or being taken out by a major.

As a result, we see the juniors more divided into two camps. One is the end user side; the other is the major's side. Most of the juniors in the sector today tend to play on the end user side. They're trying to partner up with nations who are major potash buyers, such as China and India, in hopes that major offtake agreements with established buyers of potash will help them develop the project by themselves.

A few good examples of this type of company are Encanto Potash (TSXV:EPO), Western Potash (TSX:WPX) and Karnalyte Resources (TSX:KRN). From these three, Encanto has the most ambitious target where the company is working on securing an offtake agreement with an Indian consortium led by Rashtriya Chemicals and Fertilizers Ltd. for 2 million metric tons per year. This could be a major game changer, to have a junior with such a major offtake and could open many doors in terms of financing for the company.

On the other hand, we've got the companies that are on the major's side, and who are in this game to work with established potash producers, with the potential of being fully taken out down the road.

Allana Potash (TSX:AAA), who is developing the Danakhil deposit in Ethiopia, is a good example of a company in this category. They just recently signed a partnership with Israel Chemicals (ICL). Potash One is a good example from the past, where they got acquired by K+S, who are now building that mine. Companies in this group tend to have better valuations due to the history of previous juniors being taken over, while the companies on the end user side tend to have lower valuations because it's not clear how they will get financed and bring their projects into production with the help of an end user.

RIN: That's interesting. To look at the different types of potash, muriate of potash (MOP) is the standard type of potash that we hear about most often, and that's where it gets the standard price. Then, there's sulfate of potash (SOP), which actually gets a higher price in the marketplace. How is this price determined in comparison to the MOP?

KM: SOP is a relatively small market. It's roughly 6 million metric tons versus the 55 million metric tons of MOP. Today, SOP is primarily artificially produced by the Manheim process, which consumes MOP and sulfuric acids to produce SOP and the by-product hydrochloric acid (HCl). This accounts for over 70 percent of global production. Because it is strongly dependent on input cost, such as MOP, sulfuric acid and energy, the floor price for SOP is at a significant premium to MOP.

The remaining global production comes mainly from three brine deposits located in Chile, operated by SQM, in the United States operated by Compass Minerals and in China, operated by Loubopo.

RIN: We're seeing some juniors also looking in the United States at developing SOP projects, is that correct?

KM: Correct. There are three projects in the US that are looking to develop SOP production. One of them is EPM Mining Ventures (TSXV:EPK) who is exploring the Sevier Lake brine deposit in Utah, just to the south of the Compass Minerals Great Salt Lakes mine. From all the juniors in the sector, EPM has the lowest capital costs to start their operation. The other one is the Ochoa hard-rock deposit (polyhalite) in New Mexico operated by IC Potash (TSX:ICP). From all the SOP projects, IC Potash has the most advanced project and the company is currently in project financing stage. The third is the Blawn Mountain alunite ore project operated by Potash Ridge and that's located in Utah as well.

There's one more polyhalite project that's located in Great Britain, and that's being developed by Sirius Minerals.

RIN: You mentioned that EPM project is brine versus the IC potash, which is hard rock?

KM: Polyhalite, yes.

RIN: What's the difference?

KM: Well, first, the brine is located near surface within the upper part of the playa sediments like it is the case for EPM or is part of a standing water body like it is the case at the Great Salt Lake where Compass Minerals operates. In both cases it's low cost to get it. The second difference is that all the salts and minerals you are after are already dissolved in the brine. EPM definitely has an advantage in that they are going after technology that is already being used to produce SOP in three other brine deposits. Polyhalite is an underground operation so there are some extra costs and risks associated with that but that is offset through higher volume mining. Overall, the operation for IC Potash is expected to be fairly simple from mining standpoint. They will then have to bring the ore to surface where it will have to be processed to produce SOP.

RIN: It's underground, but is it soluble?

KM: Correct. That was always one of the main risks with polyhalite because it was never mined in the past for SOP. You have to crush and grind it; you have to go through the traditional beneficiation. Polyhalite then does have the extra requirement where you have to make it soluble in water by calcination, and from there you proceed in the regular method to crystallize SOP. IC Potash was able to demonstrate the entire process at the pilot plant stage and we expect EPM Mining to do the same during their upcoming Feasibility Study.

RIN: Who are the primary markets for SOP?

KM: SOP targets the high-value crops, and those tend to be fruits and vegetables. The reason it's targeting those crops is because they tend to be very sensitive to chloride. Chloride is the main component besides potassium of MOP, the traditional form of potash. Because many fruit and vegetable crops require potassium, but they do not tolerate chloride, or they cannot take large quantities of it, farmers are obliged to use SOP in order to grow those crops. A very good example would be your grapes, almonds, peaches and citrus fruits. They're very high-value crops because they take small area, but they produce a very high-value product, while the land-extensive crops take very large areas, and whatever they produce is sold at a much lower price. The money there is made on the high volumes.

RIN: Is the SOP, then, beneficial for companies like EPM and IC Potash. Just in the US, is that a good place for them to be in terms of a market?

KM: I think so. SOP does have a good market in the United States, and Compass Minerals already sells a lot locally. They don't have to export a lot, and that's mostly because the US has a very good fruits and vegetables industry. Citrus fruits such as oranges and tree nuts such as almonds are two very large industries in the US and some of the largest in the world, so it is definitely something that both companies evaluate in terms of selling locally before exporting.

RIN: Okay. Excluding the major players, are there any juniors in Canada and the US that you like?

KM: Yes, from the companies we mentioned earlier, we covered EPM Mining and IC Potash in the SOP sector, and then we covered Encanto Potash on the MOP side.

On IC Potash we have a speculative buy recommendation and a $1.40 target. Encanto Potash is a speculative buy with a $0.50 target. EPM Mining would be a speculative buy and a $1.30 target.

RIN: Excellent, thank you very much.

KM: Thank you.