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Fertilizer Stocks Sprouting

BY ALAN R. ELLIOTT
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Fertilizers are rarely the subject of deep intrigue. But when leading fertilizer stocks began climbing after scraping bottom in October, no one could say precisely why.

Since Oct. 21, **Potash Corp. of Saskatchewan** (POT) has soared 86%, **CF Industries** (CF) 98%

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and **Terra Nitrogen** (TNH) 109%.

Some analysts credit the recovery in oil prices — up 50% since December. Others say the move's a rebound — a recovery after investors overreacted during last year's sell-off. Still others point to a recent recovery in corn and soybean prices.

Just how uncertain is the market? A CIBC WorldMarkets analyst boosted Potash's price target to $140 from $120 on April 13. Four days earlier, a UBS analyst cut Potash's target price to $100 from $105.

Shares of **Mosaic** (MOS) shed a mere 4% April 7, when it announced its first-quarter EPS crashed 88% on a 36% drop in sales, the company's first slip in earnings since '06.

Analysts see a 51% earnings decline for Potash and a 79% drop for Agrium when they report over the next couple of weeks.

What makes the group's surge even more puzzling: the fertilizer business in the U.S. is in a condition of historical oversupply.

Blame high oil prices. Last summer, oil rocketed toward $150 a barrel, and leading analysts saw potential for $200 or higher. That, plus waves of new federal incentives for ethanol producers, pressed the ethanol industry into frenzied expansion.

Corn, the basic ingredient in the U.S. for ethanol, is a fertilizer-hungry crop. The future for both ethanol and corn looked bright. So fertilizer retailers stocked their warehouses with tons of nitrogen, phosphate and potash — just before the commodities bubble popped.

Now wholesale fertilizer prices have plummeted. Farmers have balked at retail prices nearing $900 a ton, six times what they paid four years ago. Distributors can't clear inventories, and the industry's sales channels are locked in a standoff.

"I've been in this business for a long time, 40 years," said Tip O'Neill, president of International Raw Materials, a fertilizer wholesaler based in Philadelphia. "I've never seen such resistance to prices."

1. Business:

There are three basic fertilizer categories: nitrogen, phosphorus and potassium. Phosphorus and potassium producers are mining operations, quarrying phosphate rock and potash. Nitrogen producers are refiners that turn natural gas into different forms of ammonia.

Potash is used worldwide, but the greatest quantities are produced in Canada and Russia.

Phosphate rock deposits are concentrated primarily in North America, North Africa and China. Nitrogen-ammonia refineries are easier to site, although expensive, costing about $1.5 billion to build. A new potash mine in Canada, by comparison, costs between $2.5 billion and $4.5 billion.

China produces most of its own nitrogen and phosphate. But it and Brazil are the world's two largest potash importers. India is the leading phosphate buyer. The U.S., India and Southeast Asia import the most nitrogen.

Corporate names may be misleading. Potash Corp., for example, is fairly evenly diversified beyond its namesake product. It saw 43% of its '08 sales from potash, 30% from phosphate and 27% from nitrogen. Terra Nitrogen, on the other hand, reels in nearly all its revenue from nitrogen-based products.

Industry watchers do not see the same oversupply issues internationally as they do in the U.S. But China's potash supply is an area of some debate.

"The Chinese say they have a lot," said Oliver Hatfield, director of the London-based Integer Research. "But it is hard to know whether they are saying that because of the (contract) negotiations (with potash producers)."

Name Of The Game: Place production facilities strategically. Keep operating costs lean and production tightly matched to demand and inventory levels.

2. Market

Farmers are fertilizers' chief customers. And for the time being in the U.S., farmers are not buying.

Fertilizer demand hinges on how many acres are planted each year, and for what kind of crop. Corn is the most fertilizer-intensive of the major seeds, followed by soybeans and wheat. The Department of Agriculture's March crop intentions report showed this year's corn acres down and soy up vs. '08. That suggests softer fertilizer demand, although only in comparison to last year's record levels.

Overseas, data rolling out of China over the past couple of months suggests that heavyweight economy is shifting back into gear. That should also drive agricultural output and increased potash demand, Hatfield says.

3. Climate

The fertilizer business has traditionally been straightforward. The current climate, however, is anything but simple.

Pummeled stock valuations sparked consolidation on multiple fronts across the industry. In January, CF Industries launched a bid to take over Terra Nitrogen. A month later, Agrium bid for CF, but required that CF drop its effort to nab Terra. Both Terra and CF have refused the offers, and the takeover attempts and rhetoric have grown increasingly hostile.

Farmers have watched the Agrium-CF duel with increasing unease. Mosaic,

Potash and Agrium represent most of the potash production in North America. Mosaic and Potash are also big phosphate producers, versus Agrium's smaller share. The CF deal would change that, ratcheting up the industry's pricing power.

"That's the issue that's of interest here, because you'd have the big three in potash also having a hammerhold on phosphates," O'Neill said.

Regulators are looking closer than usual at the potential deal, conducting extensive interviews, O'Neill said.

"More interviewing than we've seen," he said, "And a lot of people are picking up the phone and calling on their own."

4. Technology

Fertilizer moved beyond the steer-and-shovel stage in the early 20th century. Fertilizer manufacturing jumped after WWII. The industry advanced to more effective fertilizer products and more efficient manufacturing processes through work done in the 1970s by engineers at the Tennessee Valley Authority.

But public funds to the TVA waned in the early 1990s, suspending the bulk of the industry's research and technology, leaving the industry largely dependent on existing products and processes. That worries some industry watchers calling for more public funding of fertilizer research. Advocates see promise in nanotechnology and plant genetics to develop "smart" fertilizers that deliver just the right amount of nutrients to a particular crop — without wasting energy on nutrients that plants won't use.

But for now, research and development lines on all the major fertilizer makers' budgets read "n/a," while agricultural operators such as **Monsanto** (MON) and **Syngenta** (SYT) invest nearly 10% of their annual revenue back into research.

5. Outlook

A cold, wet spring and vast flooding across the Northern Midwest have prevented farmers from getting their pre-planting field work done on schedule. The USDA expects the flooding to cut the spring wheat crop by a million acres.

"It's still early," said Rick Tolman, director of the National Corn Growers Association. "For the main part of the corn belt, we are still looking pretty good."

Futures markets have figured in healthy supplies across the board. Corn prices received in March by farmers were down 16% vs. the prior year, soybeans 20% and wheat 44%.

But a weak corn crop in Argentina and rebounding demand in China have boosted pressure for exports and led prices higher over the past several months. Corn climbed from $3 to $4 a bushel and soybeans bumped up from $8 to $10 since December.

Supplies could tighten significantly before the end of the year, especially on the global market, said Shawn Hackett, president of Hackett Financial Advisors .

"Everyone keeps telling us how bad it is and looks in the rear view mirror and tells us we're in a depression," Hackett said. "But everything that I see from a commodities perspective says that demand is growing."

Upside: The fertilizer outlook for the 2010 crop year is looking increasingly strong.

If global economies shift into gear and corn supplies tighten this year, prices will rise and farmers will inevitably plant more corn next year.

In addition, farm acreage will face a nutrient deficit. Record harvests in '07 and '08 pulled significant amounts of nutrients from the soil, according to Harry Vroomen, vice president of economic services with the Fertilizer Institute. This year's standoff between farmers and suppliers drained soils even further. As a result, forecasts call for applications to recover this fall and in 2010.

"You can kind of do that in the short run," Vroomen said. "But at a certain point, you have to put those nutrients back or they are going to cut into yields."

Risks: Despite the industry's current state of oversupply, future risks appear minimal.

Regulators could block or foil efforts at consolidation. But increase of supply, particularly in potash and phosphate, would require years to develop.

On the nitrogen side, Hatfield says natural gas prices will probably rise.

Fundamentals support a range between $6 and $7 per million BTU, Hatfield says, vs. current levels below $4. That increase would cut deep into nitrogen producers' margins.

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