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Eurasia | Agricultural Chemicals

Uralkali (URKA LI)

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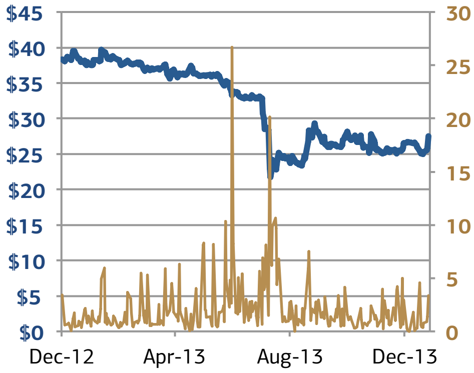
Uralkali Group (URKA LI) one-year share price in USD (blue, left scale) and volume (gold, in mln shares)



Source: Bloomberg January 16, 2014

Uralkali Group (URKA LI)

Price	USD 27.50
Rating	**BUY**
Price Target	**USD 32.02/GDR**
Difference	**16%**
Market Cap	USD 15.76 bln
Simple Moving Avg.	1.0 mln
P/E	13.6x
Free Float	46%

Source: Bloomberg January 16, 2014

Exceeding expectations

+ 2013 production at 10 MMT, meets our forecast

Uralkali announced 2013 Q4 production volumes earlier this week, reporting 2.8 MMT in production, a 61% increase over 2012 Q4, and 10 MMT for 2013, a 10% increase over 2012. This slightly overperfomed our expectations upon which we based our revenue projections for 2013, and demonstrates Uralkali's ability to easily ramp up production to over 11 MMTPA very quickly.

+ China price at blenders holding at USD 340/t

In our latest checks with four blenders in eastern China, we found that imported potash was selling at USD 340/t and domestic potash was selling at USD 350/t. These prices include transportation and logistics to blender (averaging USD 30/t from port for imported potash), and taxes and fees to local governments (about USD 10/t), but are pre-VAT.

+ Chinese producers break even USD 300-310/t

In our recent checks in Qinghai Province, location of China's potash production, we found that the total average cost of production is around USD 280/ton due to high tax rates, fixed costs and operational costs. Transport to blenders typically costs USD 30 from inventory facilities. Domestic production is one third of supply, and Chinese government policy will favor domestic production over imports. We believe this will likely provide price support for potash in the short term.

+ Reiterate BUY; PT USD 32.02/GDR

We reiterate our price target of USD 34.29 based on our DCF valuation with a WACC of 11% and growth rate of 3%.

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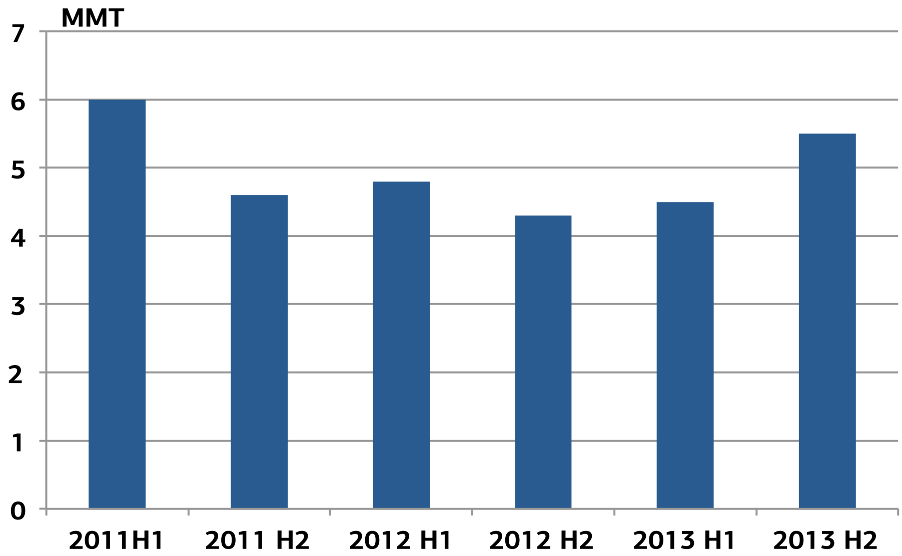
Output growth exceeds price decline

URKA posted its best production numbers since 2011, growing 22% HoH.

Uralkali reported 10 MMT in total production for 2013 this week, matching our target of 9.9 MMT. The 2013 Q4 production figures of 2.8 MMT demonstrated that URKA has the ability to ramp up production significantly in a short time frame, and boosted production to their highest levels in over two years. Given the 2013 Q4 production levels, we believe 2014 production is likely to be in the 12.3-13.4 MMT range.

Chart 1. Uralkali production volumes



Source: Company filings, Bloomberg

Typically, Q4 is the lowest production quarter of the year, with production volumes on average 13% lower than Q1 and 33% lower than Q2 or Q3. Uralkali posted a 41% QoQ decline in 2011 Q4 and a 35% decline QoQ in 2012 Q4, production grew in 2013 Q4 by 4% QoQ. 2013 Q4 production was 35% higher than URKA's average Q4 production.

In our projections for 2013, which we used to estimate revenue and arrive at our price target, we saw URKA increasing production to 9.9 MMT for the year, slightly below the actual production volume of 10 MMT. If URKA were to maintain their 2013 Q4 level of production in 2014, it would boost its volumes to 11.2 MMT.

However, over the past several years, the prior year's Q4 production has been lower than any quarter the following year. Estimating based on past production patterns, this puts URKA's

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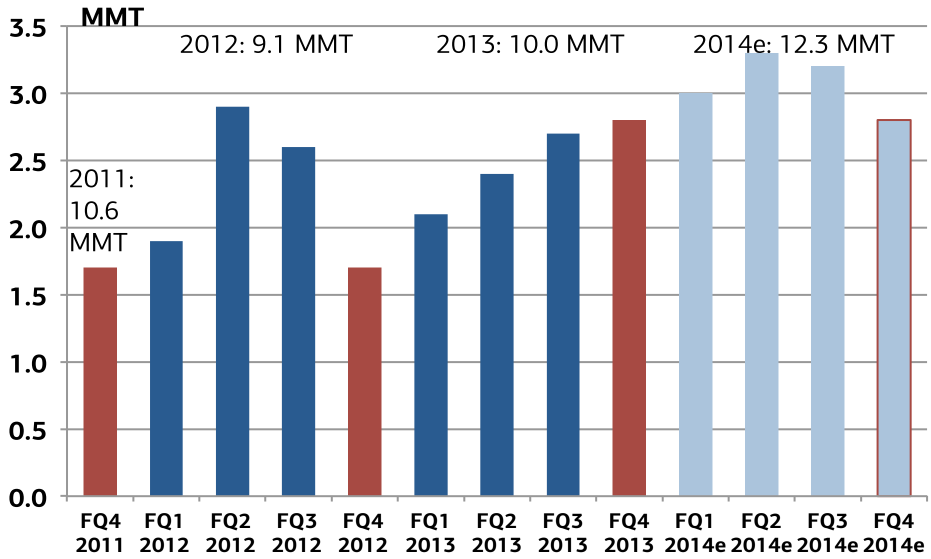
likely 2014 production at 12.3 MMT, but potentially as high as 13.4 MMT.

Chart 2. Q4 production and 2014 estimates



Source: Company filings, J Capital estimates

URKA's cost per ton decreases as production grows, keeping their margins above 30% at USD 300/t.

What makes this particularly good news for URKA is that we believe that as their production increases, their costs decrease. Instead of re-opening closed facilities, URKA is increasing production at already operational mines. We estimate that if production increases to 12 MMT in 2014, the cost per ton will decrease by 12% compared to production of 9-10 MMT. If URKA manages to produce 13-14 MMT, the cost per ton will decrease by 16%. This translates to maintaining a margin of at least 30% even at USD 300-USD 325/t in 2014.

So far this has come as positive to URKA's bottom line. Net profit has increased alongside volumes to more than compensate for declining margins.

Table 1. URKA production and margins in Q4

	Production (MMT)	Sales (MMT)	Margin	Profit (mln USD)
2012 Q4	1.7	1.8	45%	USD 290
2013 Q4	2.8	2.9	36%	USD 360

Source: Company filings, J Capital estimates (sales, margin and profit for 2013)

Note: URKA does not break out quarterly numbers, so we extrapolated based on company data for 2012.

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Price check

Our checks with blenders and traders in Southeast China indicate the current price paid by blenders before VAT is USD 340/ton. This infers that import prices at port are around USD 300-310/ton.

Chinese producers costs are USD 285/ton and they are getting slightly better prices of around USD 350/ton at blenders. Should prices fall below USD 310, and in the absence of tax relief or government subsidy, they will become unprofitable.

We visited Qinghai Province earlier this week, which is where most of the 3 MMTPA of Chinese domestic potash production is produced. We spoke with a number of traders who confirmed that Chinese potash cannot be profitable below a price at blender of USD 290-300/t given the current high cost nature of domestic production. Chinese producers on average have total costs of approximately USD 285/t. This means with prices at USD 350, the domestic producers are able to maintain good profitability (though with net profit below 15%, their margins don't compare to most importers).

"The Salt Lake Community," a compound largely comprised of potash traders offices in Xining, Qinghai. Photo by J Capital, 13 January 2014.

The traders pointed to the high fixed costs and high running costs as the basis for this, as well as unreasonably high taxes—much like Belarus, Qinghai depends on taxes on the potash industry for a significant portion of its tax revenue, which we estimate could

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contribute be as much as 9-13% of total provincial tax revenue. Transportation costs are also hefty: lack of sufficient rail infrastructure leads to triple the cost per ton to transport to eastern China compared to importers.

Looking ahead in 2014

A positive side of the price decline in China is that blenders are slightly more optimistic about demand. One blender in Guangdong told us: "We'd usually expect 2% growth. But I think this year more farmers will buy NPK fertilizer instead of just NP because it will be a bit cheaper than last year. That might give us 4-5% growth in our business."

For potash companies, lower inventory levels overall YoY for fertilizer has spurred greater buying, with higher levels of port inventory than a year ago. This is a typical restocking period for MOP, the potash input for fertilizer; so higher inventories suggest blenders are predicting better spring demand.

Table 2. China potash and fertilizer inventory

MMT	MOP at Chinese ports	Potash fertilizer	All fertilizers
Dec-12/Jan-13	1	3.3	26
Dec-13/Jan-14	1.3	2.3	21
YoY	30%	-30%	-19%

Source: Bloomberg, J Capital, interviews

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Simplified Financials

Table 3. Balance Sheet

USD Mln	2008	2009	2010	2011	2012
Total Non-Current Assets	1,242	1,576	1,617	10,686	11,333
Property Plant & Equipment - Net	1,042	1,405	1,547	3,170	3,385
Other Intangible Assets	5	5	5	5,592	5,855
Goodwill	12	12	12	1,830	1,940
Receivables	N/A	N/A	N/A	N/A	N/A
Total Current Assets	878	509	837	1,981	2,958
Total Share Capital	26	20	20	38	36
Total Shareholders Equity Excluding Minority	1,177	1,455	1,863	8,047	8,756
Total Liabilities and Shareholders Equity	2,120	2,085	2,455	12,667	14,291
Total Noncurrent Liabilities	364	301	333	3,885	4,037
Total Current Liabilities	578	329	258	723	1,490
Total Liabilities	942	630	591	4,608	5,526

Source: Company filings

Table 4. Income Statement

USD Mln	2008	2009	2010	2011	2012
Revenue	2,534	1,069	1,699	3,496	3,950
Costs of Good Sold	380	281	390	888	991
Operating Income	1,567	417	674	1,691	1,852
Distribution Expenses	397	192	422	631	771
General and Administrative Expenses	129	121	163	220	231
Taxes Other Than Income	16	16	21	29	39
Income Before Income Taxes	1,192	355	651	1,337	1,936
Income Tax Expense (benefit)	306	68	102	152	340
Net Income	885	287	548	1,184	1,601
Reference Items					
Total Cash Common Dividends	343	0	1	0	450
Dividends Per Share	0	0	16	12	15
Export Sales	2,349	923	1,547	3,082	3,300
Depreciation Expense	101	102	120	243	290
Other Financial Losses	11	30	15	326	53

Source: Company filings

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