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Eurasia | Agricultural Chemicals

Uralkali Group (URKA LI)

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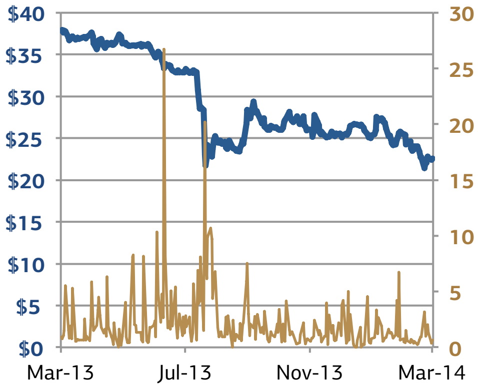
Uralkali Group (URKA LI) one-year share price in USD (blue) and volume (gold, in mln shares)



Source: Bloomberg, March 12, 2014

Uralkali Group (URKA LI)

Price	USD 22.60
Rating	**BUY**
Price Target	**USD 32.02/GDR**
Difference	**41.7%**
Market Cap	USD 13.23 bln
Simple Moving Avg.	0.95 mln
P/E	11.09x

Source: Bloomberg, March 12, 2014

Ukraine on the parade

+ Ukraine conflict won't hinder URKA's operations

While Uralkali and other Russian stocks have tumbled since Russia began military interventions in Ukraine, we believe that URKA is unlikely to be affected by sanctions, as agricultural chemicals will likely be exempted in the case of severe and wide-reaching sanctions. European countries remain wary of harsh sanctions, as they are reliant on Russia for natural gas. The main concern will be higher interest rates and an inability of Russian companies to secure foreign loans, both of which could be a downside catalyst.

+ Exports to China trend towards all-time highs

Uralkali has historically more than doubled volumes during contract periods in China by selling on the spot market. Contract volumes ranged from a quarter million to nearly a million tons for the URKA allotment under BPC. Based on their five-year track record, January exports and 2013 Q4 production, we see URKA exporting 1.5 MMT to China in 2014 H1, using our conservative estimate.

+ Belarusian bluster

Belarusian president Alexander Lukashenko and Belaruskali management have all stated innumerable times that BPC will be re-formed in the near future. We believe that Belarus has received all of the accommodations from Russia that they are likely to get—a change in management. After the BPC break-up, Belaruskali was left with such limited transport infrastructure that it is unable to deliver more than half of its annual production, ensuring that the rumors of a reunion won't stop any time soon.

+ Reiterate BUY; PT USD 32.02/GDR

We reiterate our price target of USD 32.02/GDR based on our DCF valuation with a WACC of 11% and growth rate of 3%.

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Taking a Ukraine-check

Uralkali (URKA LI) has seen a price depreciation of 12% since early February, up from a 17% drop a week ago, corresponding to the ongoing conflict in Ukraine. While the same fate has affected Russian companies listed overseas and in Moscow, in the case of URKA we believe the market has overestimated the real threat to its business operations.

The main concern is whether Russian companies will be affected by sanctions imposed on Russia in response to military action in Ukraine. So far, these look to be limited to freezing accounts of Russian nationals overseas—which disproportionately affects the Russian elite/oligarchs—and also flows of hard currency into Russia. This is mostly attributable to the fact that continental Europe is dependent on Russia for much of its energy, particularly natural gas, and Germany in particular is hesitant to impose any sanctions that might result in energy insecurity. This in turn makes it unlikely that any sanctions will be imposed on the Russian economy as a whole, and instead will target particular institutions.

It is very unlikely that sanctions to Russia will include agricultural chemicals.

In this scenario of cobbling together sanctions, we believe that it is very unlikely that agricultural chemicals will be included, and therefore URKA is likely to emerge unscathed from an operations perspective. URKA accounts for 20% of global potash production and 25% of the export market. If URKA were banned from selling potash in many or all markets, this would lead to a severe supply constriction, which would adversely impact global food production. In other words: the sanction would have the effect of hurting food producer nations, and the income Russian gains from agricultural chemicals is relatively small in comparison to the harm such a sanction would wreak globally.

Ignore the Canadians

Potash Corp. (POT US) has been quietly suggesting that sanctions against Russia are a near-term catalyst for a price rebound. Given the massive depreciation in stock price following the BPC break-up, it is unsurprising that POT and the other Canadian producers would be peddling this idea. POT saw a 5% increase on this speculation last week. We do not believe that there is any credibility to this line of thinking.

Agricultural products and chemicals have a long history of being

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excluded from sanctions for humanitarian and global food supply reasons. Even in recent cases where severe sanctions have been imposed, for example, in Syria, products and commodities relating to agriculture are explicitly excluded from the purview of the sanctions.[1]

Key risks

While we remain positive on the prospect that URKA will rebound this year, there are several new risk factors to take into account. The blanket risk is that all Russian stocks will be adversely affected by the situation in Ukraine regardless of how it impacts their business, either directly or indirectly.

URKA's exports to China and South East Asia are unlikely to be affected by the potential sanctions.

The most direct risk to URKA would be that sanctions could stop URKA's ability to export to certain markets, with North American and European markets being the most likely to be closed due to sanctions. We believe it is unlikely that China or South East Asia would choose to abide by sanctions. Distributors in China say they have heard nothing about the possibility of Chinese Customs heading off shipments, and all four distributors we talked to believe that to be an unlikely outcome.

Increasing instability could lead to interest rate hikes, which would significantly impact all Russian corporations. While URKA has less debt on its books than other Russian companies and banks, all Russian stocks would likely be affected by such a change.

Also, many international banks are signaling that they will delay issuing loans to Russian companies for the present.[2] This could potentially impact URKA, which is seeking a USD 500 mln loan for refinancing. This could leave firms unable to secure financing, or left with unsecured loans as their only option in the near- to medium-term.

Deliveries so far undisrupted

Uralkali is on track to post its highest export volumes to China in the first half of this year. Historically, URKA has exported more than double its contracted allotment to China due to its additional sales on the Chinese spot market, which were sanctioned under the BPC charter.

URKA's contract allotment is the highest on record, which

[1] http://www.stewartlaw.com/Article/ViewArticle/975

[2] http://www.reuters.com/article/2014/03/03/ukraine-crisis-loans-idUSL6N0M02SB20140303

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combined with its usual rate of exports (we assumed a base case of 1.1 spot tons to over 1 contract ton), would produce an export volume of nearly 1.5 MMT in the first six months of the year. URKA is already on track to deliver that quantity: exports in January amounted to almost a quarter million tons.

Table 1. Contract and actual sales of potash by URKA in China ('000 tons)

Contract period	Contract tons	Uralkali's allotment	Real exports	Monthly avg.	Exports: Contract
Jan-Dec '10	1,400	*840*	2,213	184	1.6 : 1
Jan-Jun '11	720	*432*	894	149	1.1 : 1
Jul-Dec '11	700	*420*	1,220	203	1.9 : 1
Apr-Jun '12	500	*275*	576	192	1.1 : 1
Jan-Jun '13	1,000	*550*	1,160	193	1.1 : 1
Jan-Jun '14	700	700	*1,470*	***245***	

Source: J Capital, China Customs, Bloomberg, CNAMPGC

Note: figures in italics are J Cap estimates. URKA's allotment prior to July 2013 was subject to agreement within the BPC charter. After July 2013, contracts were made between URKA and Chinese importers directly.

In the worst case scenario from URKA—sanctions are imposed by the West that inhibit their ability to deliver to Western markets—delivering an annualized rate of (base case) 3 MMT to China this year is particularly important. We had estimated that exports to those regions would total just under 1.5 MMT in 2014, down slightly from 2013. This would account for 10-13% of URKA's total sales volume this year. Even in this scenario, it is possible that only about 1.0 MMT would be blocked, and that some Eastern European markets (including parts of Ukraine as well as the Balkans) would continue to have Russian potash.

A drop in exports to Western markets due to sanctions could be replaced by growth in Asian markets.

However, this tonnage could be replaced by impressive growth in other markets. We believe Asian markets are more likely to ignore sanctions, and South East and East Asian markets have already signed purchase agreements for 2014. Malaysia and Indonesia look ready to consume an extra 1 MMT on top of 2013 import levels, and China is on track to import an additional 0.5 MMT this year compared to 2013 in our base-case projection. On an export tonnage basis, even with the threat of sanctions, URKA looks to maintain sales tonnage even with the loss of the Western markets.

Belaruskali blues

Belarus has now probably reaped the total benefit that it will see from Uralkali and Russia in the aftermath of the BPC dissolution

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last July. Belaruskali succeeded to dethroning former Uralkali CEO Vladislav Baumgertner, who spent nearly four months in a Minsk jail after he broke off the JV. Baumgertner was a Suleiman Kerimov man, who in turn is in the Russian Prime Minister's, Dimitry Medvedev, camp, which is slightly more moderate than President Vladimir Putin's.

The two new owners replacing Kerimov, Mikhail Prokhorov and Dimitry Mazepin, were supposedly going to be more Belarus-friendly, and they both are firmly under the thumb of Putin. Prokhorov is a colorful figure in Russia—infamous for a 2007 arrest for prostitution in France—who's long tenured status as a minor, Putin-government sanctioned opposition leader suggests that he is closely connected with Putin in order to have survived and thrived so long. Mazepin, the head of Russian fertilizer giant Uralchem, has the dual benefit of having experience in the sector and being from Minsk originally: this was probably the concession given to the Belarusians, who had actually been lobbying for a direct ownership stake in Uralkali.

URKA has no plans of rejoining Belaruskali, which has been suffering since BPC broke off.

Earlier this week, Putin acolyte Sergei Chemezov and new member of the Uralkali board stated explicitly that rejoining Belaruskali would not be a top management priority.[3] This is the strongest statement from a Putin-faction member; previous statements were all from those closely associated with PM Medvedev. What this tells us is that Putin put some effort into satisfying the Belarusians, but only the bare minimum, and that effort is now over.

With Ukraine a distraction for the present, and potash a small segment of the Russian economy, Putin will likely not act further. The blustering from Belaruskali and from Belarusian President Alexander Lukashenko is unlikely to stop anytime soon because the dissolution of BPC is hitting them harder than analysts originally calculated.

Where have all the trains and trucks gone?

Belaruskali accounts for a significant portion of Belarus' export revenue, and, more importantly, its revenues have been providing 20% of the funds needed to pay back an IMF loan of USD 3.5 bln. At the same time Belaruskali has been hamstrung in its ability to deliver potash internationally. While no one has verified counts of potash inventory in Belarus, we estimate Belaruskali's total

[3] http://itar-tass.com/ekonomika/1035904

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inventories at 4.5-5.5 MMT at the end of February 2014 based on production and sales, up from about 1.5 MMT in mid-2013.

BPC's dissolution seriously affected Belaruskali's transportation and logistics infrastructure.

The dissolution of BPC wreaked more havoc on Belaruskali than just the collapse in pricing facing all potash producers. BPC was a JV established to share logistics and transportation infrastructure between Uralkali and Belaruskali. What was obfuscated over the several years of this venture was that the entire infrastructure belonged to URKA. When URKA left the JV, Belaruskali was left with a reduced inability to move product from mine to port. We estimate that Belarus can only move between 25-45% of its yearly production with its current logistics network.

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Simplified Financials

Table 2. 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 3. 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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