What Agrium's Quarterly Numbers Didn't Tell You

Description

A muted third quarter from **Agrium** (TSX:AGU, NYSE:AGU) wasn't surprising. Peer **PotashCorp** (TSX:POT, NYSE:POT) had already sounded the warning bell some days back when it delivered a weak set of numbers and lowered its full-year earnings guidance.

Interestingly, the market seems to have ignored Agrium's tepid performance and outlook, as reflected in the stock's firm prices. Investors are perhaps encouraged by the company's strong retail business performance and recent dividend increase, but everything may not be as good as it seems. Here's why.

Beneath the surface
Despite its third-quarter sales improving one percentage point, Agrium's net profit dropped 41% year over year. You may think rising costs are eating into Agrium's bottom line, but that's not the case.

Yet again, weakness in Agrium's wholesale, or fertilizer business, offset higher demand for its retail crop input and seeds. While retail sales jumped an impressive 15% year over year, the company's wholesale sales fell 24% on weak nutrient prices. As a result, a 17% jump in Agrium's retail gross profit couldn't save its overall gross margin from falling to 22% from 26% a year ago. For investors, there's more to this observation than meets the eye.

What you should know
Retail happens to be Agrium's largest business in terms of revenues — it generated $11.5 billion revenue last year. Comparatively, the company's wholesale business contributed only $5.5 billion to its top line. So ideally, Agrium should perform well if the retail markets are strong, but the third quarter proved otherwise. Simply put, a volatile fertilizer market can stem Agrium's growth even if the demand for its crop input and crop protection products rise. Given the persistent softness in fertilizer prices, that's not good news for Agrium and its investors.

Oddly enough, Agrium's management doesn't seem too excited about the retail business either. During the earnings call, when an analyst wanted to know what are the chances that the company's retail operating earnings will exceed that of the wholesale business in 2014, here's what Agrium's CEO, Michael M. Wilson had to say: "Well, I hope we don't have that situation because Wholesale is very strong." That clearly shows how important Agrium considers its fertilizer business to be, and substantiates the fact that the company can't really grow on a strong retail business alone.

What that means
As I mentioned earlier, uncertainties continue to prevail in the fertilizer market. PotashCorp projects its potash gross profit to fall at least 15% for the full year, and nitrogen and phosphate combined gross profits to drop at least 10%. Since Agrium deals in all three nutrients, its guidance reflects the weakness as well — At the higher end of projections, Agrium expects its full-year earnings to be around $7.75 per share – that's a 19% drop over 2012 earnings.

Dividends are good, but…
In such situations, investors may take heart to Agrium's plans to return greater cash to its shareholders. Agrium recently announced its fourth dividend hike in two years, with a 50% increase in its annual dividend. That takes Agrium's annualized dividend yield to 3.5% at its current share price. But with a dividend yield of 4.3%, PotashCorp still remains a better bet for income investors.

More importantly, Agrium is currently free cash flow negative while PotashCorp generated nearly $1.5 billion in FCF over the past twelve months. At 8 times FCF, PotashCorp shares are cheaper than Agrium which trade at 10 times FCF. PotashCorp also scores higher for better dividends and deep moat in the fertilizer business.

Foolish takeaway
All said, having a resilient retail business is certainly a huge advantage for Agrium. Once nutrient prices bounce back, Agrium should do as well as PotashCorp, if not better. Investors may have to deal with considerable volatility in the near term, but Agrium stock continues to look promising over the longer term.

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