Can Potash Corp./Saskatchewan Inc.'s Dividend Be Sustained?

Description

Potash Corp./Saskatchewan Inc. (TSX: POT)(NYSE: POT)) delivered a reasonable performance for the third quarter of the 2014 financial year, but higher mining and income taxes detracted from the final outcome. For income investors, the main question is whether Potash Corp. can maintain its dividend despite the volatile pricing and volume nature of their key products. The salient points are discussed below.

The third quarter financial performance was subdued by higher taxes

Potash Corp.announced earnings per share of $0.38 for the third quarter, 7.3% lower than the comparable quarter last year and also weaker than the market consensus forecasts. Net income for the quarter was down by 11% and by a whopping 27% for the first nine months of the year compared to 2013.

Despite the somewhat dismal appearance of the net profit line, gross quarterly profit actually increased compared to last year, buoyed by an 8% increase in revenue and solid increases in potash and fertilizer volumes. However, higher mining and income taxes as well as a sharp decline in dividend income from associated companies took a heavy toll, resulting in the decline in the quarterly net profit.

… and cash flow continued to deteriorate

The operating cash flow declined by 7% in the quarter and by a rather concerning 26% for the nine months compared to the same period one year ago. The considerably lower capital expenditure requirement supported free cash flow (that is, operating cash flow minus capital expenditures), which declined by only 13% for the first nine months of the year.

Management predicts a sound final quarter

The company expect earnings per share of between $1.75-$1.85 for the full year, which will represent a decline of 11% (on the midpoint) compared to 2013. The performance in last quarter of 2014 should compare favorably to a very poor final quarter of 2013.

… but further declines in product prices and volumes will challenge this resolve

Potash Corp. currently pays a quarterly dividend of $0.35 per share, with a total cost of around $1.15 billion per year. The dividend increased sharply over the past few years as a step up in fertilizer prices since 2008 supported the company's profitability. In addition, Potash Corp. has been actively repurchasing shares, amounting to $1.1 billion so far in 2014.

The free cash flow estimate for 2014 indicates an amount of $1.4 billion, leaving a shortfall of around $800 million given the amounts spent on share repurchases and dividend payments. This will have to be financed from cash resources or borrowings, which could easily be absorbed by a very sound balance sheet.

Looking forward to 2015, the company indicated that the multiyear $8 billion capital expenditure program would conclude and that ongoing maintenance expenditures would amount to $600 million-$800 million per year. Assuming that dividend payments would take priority over share repurchases and that the business profit will be similar next year, the dividend would be readily covered by the free cash flow, possibly leaving some room for growth.

However, the main risks for investors are declines in fertilizer prices and/or volumes from 2013-2014 levels. Given the current record grain crops in Canada and the U.S., it is not inconceivable that fertilizer prices and perhaps even volumes could decline over the medium term. The company's profitability is highly sensitive to product prices — a broad fertilizer product price decline of 10% will, for example, reduce free cash flow to the level of the current dividend.

In conclusion

The current dividend is not at risk in the immediate future but is subject to volatile potash and fertilizer prices and volumes. Investors dependent on income from Potash Corp. should be aware that the dividend stream is subject to considerable risk.

CATEGORY

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Date
2025/07/02
Date Created
2014/10/24
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