Why Agrium Inc. Still Has Plenty of Upside Remaining

Description

It's been a wonderful time to be an **Agrium Inc.** (TSX:AGU)(NYSE:AGU) shareholder as of late. After trading flat for the majority of 2014, Agrium shares shot up on the news that activist investors ValueAct capital revealed a 5.7% stake in the company. This was a solid confirmation to investors of Agrium's inherent value.

Then, in November, Uralkali—a major Russian potash producer responsible for 20% of global production—had to close down its Solikamsk-2 mine due to flooding. The result? 2.3 million tons of lost potash production, part of which will likely be assumed by Agrium.

Finally, in January, Agrium raised it is payout ratio to 40-50% of free cash flow, indicating Agrium's impressive free cash flow growth potential as a result of Agrium completing its major production expansions. The result? Agrium shares have skyrocketed 54% since November.

Now, the debate is on as to whether Agrium is overvalued. Personally, I think its growth is just getting started.

Why Agrium is still undervalued

Recently, Agrium released its full-year 2014 and Q4 2014 results. The company reported a full-year earnings per share of $4.97, which represented a massive drop from the $7.20 per share in 2013. With a current share price of $143, Agrium seems far from undervalued, trading at a price-to-earnings (P/E) ratio of 28.

The key to Agrium's value lies in its earnings-growth prospects. Agrium announced its 2015 earnings guidance, with earnings per share for 2015 expected to come in between $7.00 and $8.50. If you assume Agrium will achieve the low end of earnings guidance (at $7.00 per share) for 2015, this will give Agrium a very low forward P/E ratio of 20, which would be in line with the peer average of 19.06.

Even better, if Agrium achieves the high end of its guidance (at $8.50 per share), Agrium would trade an extremely low multiple of 16.9, which is significantly below the peer average. This implies that Agrium's currently high P/E ratio is justified, since it accurately reflects Agrium's impressive growth profile. In both these cases, Agrium shares would need to rise significantly to be valued comparable to the group average.

In fact, assuming Agrium will trade equal to its peer group with a P/E ratio of 19.06 in 2015, this would give Agrium a share price of $133 if it hits the low end of its guidance, and $161 if it hits the high end of its guidance.

However, one can make the argument that Agrium should trade at a higher multiple than its peer group. After all, its closest competitor, **Potash Corp./Saskatchewan** trades at a forward P/E of 23. This would give Agrium a share price of $161 if it hits the low end of its guidance, and an impressive $195 if it hits the high end of its guidance.

Agrium deserves the same multiple as Potash Corp.

Agrium typically trades at a lower multiple then Potash Corp. (although this is changing, as Agrium becomes more properly valued). There are several reasons why this gap is likely to close further.

First, Agrium has a stable, constantly growing retail business. CEO of ValueAct Capital Jeffrey Ubben describes it as a “stable jewel,” and it allows Agrium to offset weak earnings from wholesale when fertilizer prices are low, and enhance these earnings when prices are high. At the same time, retail stability supports Agrium’s dividend, and allows the company to have one of the highest potash operating rates in the industry, since the company can move its product into the retail segment.

Second, Agrium is becoming the same quality of dividend payer as Potash Corp. After increasing its dividend by 27 times since 2011, Agrium plans to boost its payout ratio to nearly 50% of free cash flow from 25%. Since free cash flow for Agrium is expected to grow to $1.3 billion in 2017 (from $746 million in 2014), Agrium can expect its dividend to nearly double.

With better growth than Potash Corp., a strong dividend, and a retail advantage, there is no good reason for Agrium to be trading at a cheaper multiple.

CATEGORY

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amancini