



Bad News From Potash Corp./Saskatchewan: Is it Time to Sell?

Description

Few could argue that **Potash Corp./Saskatchewan** (TSX:POT)(NYSE:POT) occupies a highly privileged position in the global potash/fertilizer market. Currently, Potash Corp. is the world's largest fertilizer company and possesses a 20% share of global potash capacity. In addition, an impressive 50% of new global potash supply will be coming from Potash Corp.'s projects over the next several years.

The problem? Potash Corp. is fundamentally a commodity company, and with limited pricing power, its fortunes are in the hands of the volatile global potash market. With a reduction in global shipments expected in 2015, coupled with expected pricing weakness, Potash Corp. will be operating in a challenging market.

To make matters worse, Potash Corp. was recently informed about tax changes from the Saskatchewan government that will affect earnings. Is the case for Potash Corp. now bearish? Let's take a look at the risks.

Tax changes could reduce 2015 earnings by \$100 million

In announcing their 2015-16 provincial budget, the Saskatchewan government announced several changes to potash taxation, which Potash Corp. estimates could reduce their 2015 pre-tax earnings by \$75-100 million.

What were the changes? Essentially, the tax rules surrounding the company's deductions to their expansion and maintenance spending were changed. In the previous system, the company could deduct 120% of this spending in the year the spending occurred; in the new arrangement, expansion spending can only be deducted at a rate of 60%, and maintenance spending at a rate of 20%.

Assuming the full \$100 million impact to earnings, this would represent about 3.7% of Potash Corp.'s 2014 pre-tax earnings. This represents about 3.5% of Potash Corp.'s 2015 pre-tax earnings, as per the low end of their guidance. With Potash Corp. predicting 2015 earnings per share of \$1.90-2.20, this means Potash Corp. could see earnings lower than the lower end of their guidance.

Potash Corp. is also facing more competitive markets and weaker pricing

In addition to the negative tax changes, Potash Corp. may be facing slightly weaker than expected pricing for its Chinese contracts. Investors have been eagerly awaiting the results of ongoing pricing negotiations with China, with results initially expected in late-February. Recently Belaruskali (a major Belarusian potash producer) became the first to sign a contract for the first half of 2015, and negotiated prices came in at \$315 per ton.

This is weaker than many were expecting, with some expecting a 5-10% price increase from 2014's price of \$305 due to recent supply disruptions from the shutdown of Uralkali's Solikamsk-2 potash mine. This, however, proved incorrect, as high Chinese potash inventories and reduced Chinese demand lead to lower prices.

These lower prices will likely serve as a model for the prices Potash Corp. will attain from their negotiations, and lower prices should serve as a headwind for Potash Corp.

In addition to this, Potash Corp. will be facing a highly competitive marketplace in 2015. In 2013, when Russian Uralkali and Belarusian Belaruskali broke up their joint marketing cartel, potash prices plummeted as both producers began producing at maximum capacity, rather than coordinating production, leading to a "volume-over-price" strategy as both companies fight for market share.

These competitiveness will continue, especially as Belaruskali attempts to gain global market share. The company is producing at near full capacity, as they attempt to gain market share in China—the source of most future potash demand growth—as well as the U.S., where the company recently began selling for the first time.

Should you sell Potash Corp.?

Tax changes, weaker global pricing, and a highly competitive global marketplace are challenging conditions for Potash Corp. Investors should anticipate Potash Corp. earnings to come in at the lower end of their guidance unless excess demand appears.

Despite this, for investors with a fairly long-term view, as well as income-oriented investors, Potash Corp. is still a hold. Potash Corp. has a solid 3.95% yield that is sustainable, and long-term prospects for the fertilizer industry are very good, as population increases and emerging economies see a growing demand for food.

With low-cost production, and growing spare capacity to respond to demand increases, Potash Corp. is a solid long-term hold. Investors looking for short-term profits, however, should look elsewhere.

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amancini

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