Should You Sell Agrium Inc. Before Earnings?

Description

Investors in **Agrium Inc.** (TSX:AGU)(NYSE:AGU) must be nervous before the fertilizer company's second-quarter earnings release on Augusut 3. After all, rival **Potash Corporation of Saskatchewan Inc.'s** (TSX:POT)(NYSE:POT) Q2 numbers were nothing short of a disaster; Potash Corp.'s Q2 earnings slumped almost 70% year over year, it downgraded its full-year guidance, and it even slashed its dividend yet again.

So should Agrium investors sell the stock now in anticipation of weak quarterly results?

Agrium's profits could tumble

The average analyst estimates for Agrium's Q2 earnings stand at US$4.08 per share, which translates into a drop of roughly 17% year over year.

Interestingly, analysts project Agrium's Q2 revenue to decline only about 5% year over year as the company derives a major portion of revenue from its retail business of seeds and crop-protection products, the demand for which isn't as volatile as that of fertilizers. Comparatively, Potash Corp. is a pure-fertilizer play, and hence it suffered an almost 39% drop on its top line in its last quarter.

That said, I wouldn't be surprised if Agrium misses profit estimates given that its margins depend largely on fertilizers. Consider this: in Q2 Potash Corp. realized almost 44% and 27% lower prices for potash and nitrogen, respectively, which sent its gross profits tumbling. As Agrium's wholesale, or fertilizer, business revolves around the two nutrients, its margins and net profit could take a big hit in Q2.

Why Agrium could lower its earnings guidance

I'm also not ruling out the possibility of another outlook downgrade when Agrium reports its Q2 numbers. Investors may recall that Agrium had lowered its earnings guidance for 2016 to US$5.25-6.25 per share from US$5.50-7.00 per share during the first quarter. Unfortunately, Potash Corp. projects a "weaker price environment" through the rest of the year, which is a concern for Agrium.

Remember, Agrium will have earned 11% lower profits than 2015 if it hits the upper end of its current guidance range this year. In other words, if the company lowers its outlook again, it'll mean greater than 11% drop in full-year earnings, which is worrisome.

Could Agrium cut its dividend?

Unfortunately, the answer to that question appears to be yes. While Agrium is free cash flow positive, it is doling out much higher dividends than FCF, which could turn out to be a major problem during these challenging times. With Agrium's profits expected to decline this year, its FCF could also come under pressure, making its dividend unsustainable.

Agrium's handsome dividend yield of 3.9%, which has kept investors hooked to the stock despite the company's weak performance, could be at risk.

Should you sell Agrium stock now?

There's no denying that Agrium faces several challenges currently. However, it may not suffer as much as Potash Corp. if fertilizer markets were to weaken further, thanks to a more diversified portfolio.

Ironically, Potash Corp. is trading at a substantial premium of 19 times trailing earnings to Agrium's 13 times P/E, despite the latter appearing to be a stronger company. In other words, much of the pessimism may have already been factored in Agrium stock. So even if the company's numbers disappoint and the stock reacts adversely, investors needn't panic and sell off because Agrium looks well poised to emerge as a winner when the business cycle turns.

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