How China Is About to Send Potash Corporation of Saskatchewan Inc. Shares Rallying

Description

After a weak 2015, **Potash Corporation of Saskatchewan Inc.** (TSX:POT)(NYSE:POT) started the first half of 2016 on an even weaker note—realized potash prices in Q2 2016 were a mere $154 per tonne, down from the 2015 realized price of $264 per tonne and a far cry from 2012 prices of $424 per tonne.

Not only were prices weak, but so were sales volumes, and this weakness can largely be attributed to extremely delayed contracts with China and India. For the first half of 2016 offshore volumes were down 33% from last year, while North American volumes actually rose.

Since potash is not traded on any public exchanges and the potash market is dominated by a relatively small set of large producers, large contracts are a key part of how potash is sold globally. China is the world's largest consumer of potash (using about 20% of global demand), and it needs to import about half of that from seaborne sources.

As a result, the contracts set with China typically set an important benchmark price for the year and often establish the floor price, since China receives the lowest prices as it is the largest importer. Most years, Canpotex (the potash marketing consortium Potash Corp. belongs to) settles the contract in January (on very rare occasions as late as July), but this year August has already rolled around and no firm contract has been settled.

While Potash Corp. is in negotiations with China right now and details are being finalized, the late settlement is a major sign of market weakness. China is not taking significant potash deliveries and this is due to large potash inventories and a weak market.

Many feared that no contracts would be set in 2016, which would mean prices would be negotiated on the spot market. The spot market is far more competitive, which could ultimately mean even more downside for potash prices.

The finalization of the China contract will lead to a much better second half

Not only has no contract with China reduced potash deliveries to China, but it has also resulted in generally lower engagement. Since China contracts are key benchmarks, many consumption regions were holding out and waiting for the China contract to settle so they had a benchmark to use.

Fortunately, it now seems that that not only will Potash Corp. get a China contract for the remainder of the year, but it will also be at a reasonable price. Most importantly, this could set up a big demand recovery in the second half of 2016 and into 2017.

Firstly, BPC (the Belarusian potash firm and one of the largest in the world) just settled a Chinese contract at a price that was better than expected ($219 per tonne). This eliminated many fears that a contract price below $200 per tonne would be established (some rumours said China was bidding at $180 per tonne).

BPC's contract likely set a floor for the market for the year, and while it may be down 30% from last year, Potash Corp. and Canpotex should come out with a similar price contract shortly. This means there is a stable outlook for potash prices for the remainder of the year, and that potash volumes will finally be moving into China.

Most importantly, the delayed contract should set the market up for a big demand rebound. Potash Corp. notes that years where China settles the contract late usually results in the next year having a big rebound in demand. Previous late settlements led to between a 5% and 15% demand boost the following year.

The lack of an early contract settlement early means that inventories will have been drawn down (probably on a global level), and the result is that due to lower inventories China and others will likely see a spike in demand in order to restock inventories.

This will be good news for Potash Corp. shares.

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