



Why Agrium Inc. Shareholders Could Lose From the Potash Corporation of Saskatchewan Corp. Merger

Description

As soon as the news of a historic merger between **Agrium Inc.** (TSX:AGU)(NYSE:AGU) and **Potash Corporation of Saskatchewan Corp.** (TSX:POT)(NYSE:POT)—the number one and two global fertilizer names by market cap—surfaced, both analysts and investors alike began speculating on which group of shareholders stands to gain most from a transaction.

Analysts at **Bank of Nova Scotia** found the answer fairly straightforward; in a note released after the rumours were confirmed, they stated that they clear trade would be to “short POT and buy AGU.” Without any details, the reasons for why seem fairly clear.

A merged entity would give Potash Corp. considerable exposure to Agrium’s network of retail stores (the largest agricultural retailer globally and a source of counter-cyclical cash flow), and analysts estimate that a merged entity would obtain about 30% of EBITDA from retail, giving Potash Corp. much needed diversification.

In addition, the retail network could be a powerful source of demand for Potash Corp.’s potash tonnes (Agrium retail currently sources about half of its potash from its wholesale operations and the other half from **Mosaic**). Potash Corp. could take over Mosaic’s role in a merged company.

On top of this, Potash Corp. would gain control over Agrium’s 2.8 million tonne Vanscoy potash mine, which gives Potash Corp. more options to optimize costs across its production network as well as more power to influence potash prices.

What Agrium stands to lose

For these reasons, many commentators have suspected that Potash Corp. is pursuing Agrium in this merger attempt, and the benefits to Potash Corp. are clear (especially after a historic potash downturn that resulted in Potash Corp. shares that are down 37% over the past two years).

The issue is that Agrium has actually fared extremely well during this downturn. Over the same two-year period Agrium shares are up 25%. While Potash Corp. has slashed its dividend by 75% (in the

last year alone), Agrium has been steadily hiking its dividend (at an impressive 18% CAGR since 2013).

Not only has Agrium grown its dividend during this period, it has also bought back \$1.05 billion worth of stock, grown its free cash flow at a 41% CAGR, and is potentially looking at a 10% free cash flow yield over the next few years even under reasonable assumptions for crop and crop nutrient markets.

With this in mind, Agrium seems to be doing just fine on its own. A merger with Potash Corp. would serve to dramatically amplify Agrium's exposure to volatile nitrogen, potash, and phosphate prices (increasing earning exposure from an expected 20%, 11%, and 6% in 2017 to 29%, 26%, and 14%, respectively, according to **TD Bank**). Its retail exposure would decline from 51% of earnings to 31% of earnings in a merged business.

It would put mean Agrium's future earnings would be more dependent on a recovery in commodity prices than on the future growth of its retail segment, which has been the central focus of the company over the past several years, and is a business that Agrium can grow even in weak markets through tuck-in acquisitions, the sale of higher-margin products, cost reductions, and modest organic growth.

Agrium's outperformance is largely due to its integrated and retail-focused strategy, which has provided steady growth and dividend payments, and a merger could jeopardize it.

What are the benefits?

The fact Agrium confirmed that it is in talks means its board must see some benefit in a merger. If Potash Corp. were acquiring Agrium, it would likely need to pay a huge premium (Potash Corp. is trading at a much higher multiple and a "merger of equals" would mean Potash Corp. would have to pay up).

If Agrium is acquiring Potash Corp., however, according to analysts at Bank of Nova Scotia, Agrium would likely need to pay no premium at all. This would give Agrium the chance to acquire additional potash exposure at the bottom of the cycle, which means more upside for shares when potash prices recover.

CATEGORY

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