SISR Strategic International Securities Research Inc.
An Independent Research Firm

Economics & Stocks

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Silvinit Shipping Potash Despite Sinkhole: But Prices Increase 20%

Summary:

We are changing our rating on the Agricultural Chemical Sector particularly fertilizers to a Market Outperform from Market perform based on a 20% price increase for potash resulting from a sinkhole in Russia. Silvinit a miner supplying 10% of the world's Potash had reported on October 25th that it was in danger of needing to suspend all shipments of potash for several months, following the appearance of a sinkhole close to the only rail line available to them. Currently, they claim that they are still shipping and the sinkhole has slowed its progress, and will in all likelihood not impede shipments. A new rail line is being build and it is expected that by the time the sinkhole reaches the tracks, that a new loop will have already been built.

On October 8, 2007 we wrote that: "we are calling for a major top in the entire Agricultural Sector due to the decline in the price of Ethanol and transportation bottlenecks." (SISR, Farm Economic Boom Nearing Top). The thesis was that with ethanol bottlenecks there would be a slowdown in the expansion of corn acreage, which in turn would remove the pricing pressure for fertilizers, and agricultural equipment, and seeds. We are raising our rating on the fertilizer companies based on the events of October 25, 2007, relating to the sinkhole in Russia.

Once this problem was announced Potash and Urakali, the two largest potash producers, immediately stopped shipping Potash fertilizer, in order to access the impact on the market. Potash and Urakali resumed shipments yesterday November 7th with an announcement that they have raised prices. Potash announced that they were raising prices for U.S. customers by $50 per short an increase of approximately 20%. Urakali also announced that for their Asian clients they were raising prices by $40 per short ton. Potash had already increasing prices on October 1, 2007 by 20$ or about 7%.

On October 8th we had downgraded the sector from a market outperform to a market perform, based on the expectation that pricing would be stable in the 5 to 7 % range going forward. For the past three years much of the revenue and earnings growth for these companies had resulted from the fact that they have had an exceptional period of pricing power. The volume of product that the North American producers have shipped has increased only nominally but with a 50% increase in phosphates prices in the last 12 months and an 80 % price increase for potash in the last three years these companies' financials have grown commensurately. We had believed that it would be unlikely that given their current valuations and a slower growth rate of revenues and earnings for both Mosaic and Potash, resulting from stable pricing, that their stock price would continue to perform at such an accelerated rate of close to a 400% price appreciation. We as a consequence lower their rating to a market perform. However, with this unexpected event of the sinkhole and the consequent ability of these companies to raise the price of Potash, we are reversing our rating back to an outperform, assuming that the price increase in potash is sustainable, which we believe is likely.

Key points:

I. We are Increasing our Rating to Outperform for both Potash and Mosaic from Market Perform

We are changing our rating on both Potash and Mosaic from a market perform to a market outperform based on the likelihood that they will be able to sustain the price increase of nearly 30% on Potash going forward. Uralkali announced a similar price increase to $400 per metric ton from $360, including cost and freight to Asian markets. Additionally, with these increases in the price of potash, Potash and Mosaic will have additional bargaining power when they negotiate with China for that counties annual set price on Potash. Both Potash and Mosaic have been able to benefit from price increase in their primary products of Phosphates and Potash over the past few years, and it has been price and not increased tonnage shipped that has lead to their lofty revenue and earnings growth rates, and a nearly 400% price increase in the value of their stocks, over the past few year.

II. Farm equipment held at Market Perform

We are maintaining our market perform on farm equipment based on the facts that: farm income is likely to decline with higher prices to the farmer for fertilizer; and the likelihood that the ethanol bottlenecks will hold back last year's surge in the planting of corn. Corn prices while coming back have receded considerably throughout the year, and it is uncertain if these current high prices for corn and soybeans will be sustainable enough to bring on an increase in acreage, as it did last year. Record earnings for farmers is highly correlated to farm equipment purchases, however, we do not see the corn and beans sustaining the highs of last year.

III. We are keeping our Underperform on the Ethanol Producers

We are maintain an under perform for the ethanol sector. Corn and soybean prices again are currently elevated creating high input cost for their products. Additionally the price has been fluctuating quite extensively creating greater risks in the futures market for hedge their costs due to the volatility in the markets. Last year many of the company hedged at $4.00 only to have the price of corn fall to the low $3 range. Additionally, bottlenecks still exist in getting ethanol to the market. These factors all leading us to believe that it is an unlikely event that the Ethanol producers will actually benefit from the ethanol boom in the near future. The bearers to entry appear to be low for these producers and the ability to get product to the coasts appears stalled for the intermediate future. This of course says nothing of the likely resistance by the oil companies to use Ethanol. The companies in this sector, thus still appear to be an underweight in contrast with the rest of the market.

IV. Rails likely the Biggest Gainer remain an Outperform

The rail companies as do the fertilizer companies appear to be the real winners here. Ethanol at this level of production is a relatively new phenomenon. Ethanol is being produced in increased volumes and the only way to get it to the refineries is by rail. Special cars are being built and other provisions are being made for this transport. Once the bottlenecks are worked out we expect an increase in rail costs, which will be a major beneficiary to these rail carriers. We thus are continuing to maintain an outperform for this sector.

Certification:

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2 – Overweight – The stock is expected to outperform the equal weighted expected total return of the sector coverage. Our investment horizon is 12 – 18 months except as specified by the reporting analyst.

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5 – Rating Suspended – The rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when SISR Inc. is acting in an advisory capacity in a merger or strategic transaction involving the company.

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Price Chart:

A price chart, with changes of ratings and price targets in prior periods, is included above, for all securities covered in this report.

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