



The Agriculture Sector*

Sector Analysis - Agriculture

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Antitrust Enforcers Looking at the Agricultural Sector: Will this Possibly Affect the Expected Consolidation within the Fertilizer Industry?

I. Introduction

On Saturday buried on the bottom of page 3 of the Wall Street Journal we find an article entitled: *Antitrust Enforcers Begin Visiting Farm Belt*. The article indicated that: “The Obama administration will take an extensive look at concentration in U.S. agriculture as part of its increased emphasis on antitrust enforcement, a Justice Department official said Friday.” Philip J. Weiser, a Deputy Assistant Attorney General at a farmer gathering in St. Louis on Friday August 7, 2009 stated: “Those federal antitrust regulators are “committed to examining the level of competition in several agribusiness sectors, such as the marketing of genetically modified seed, dairy processing and meatpacking.” If this is their intent an investigation into the fertilizer industry cannot be far behind.

On September 11, 2008 Mosaic was listed in an antitrust law suit against Potash producers. It was filed in Federal Court by Minn-Chem Inc. a Minnesota company arguing that price collusion existed in the industry. On January 14, 2009 after the Mosaic analyst meeting we argued that it is unlikely that this case will go anywhere, but there is: “The risk that lawyers and or the anti-trust division of the Justice Department under the Obama Administration will take an interest in this case” or issue. Since then there has been a second case filed against Mosaic and the other potash fertilizer producers by Dykes Feed & Fertilizer, Inc. on July 7, 2009. In addition several other firms have joined the Minn-Chem class actions.

In their annual filing for the year ending May, 31, 2009 Mosaic reported that:” On June 15, 2009, we and the other defendants filed motions to dismiss the complaints in the Potash Antitrust Cases. We believe that the allegations in the Potash Antitrust Cases are without merit and intend to defend vigorously against them. At this stage of the proceedings, we cannot predict the outcome of this litigation or determine whether it will have a material effect on our results of operations, liquidity or capital resources (May 31, 2006 The Mosaic Company 10K pp. 90).

We still do not believe that the Justice Department will bring serious anti-trust action in this area. However, where it is most likely to have an impact is in the area of consolidation where this industry is already highly concentrated with few dominant participants. In addition there are systems set up for price leadership and full cooperation amongst parties with respect to international distribution which will make it more difficult for the Justice Department or the courts to get a handle around.

Our aim here is not to do a full legal analysis of the events but to highlight this as an additional risk factor, and a risk factor to future consolidation within the industry. We expect that if the Justice Department takes any action in this industry it will be with respect to their power to limit additional consolidation. What makes this more interesting is that Mosaic and the other fertilizer companies are trading with a consolidation premium.

II. Central Issues for Mosaic Going Forward

Last January after Mosaic's analyst meeting we wrote the following:

“In New York on Tuesday January 13, 2006 The Mosaic Company held an Institutional Investor & Analyst Meeting, which was relatively benign in that there was very little new information presented. The company fielded numerous questions with about half the questions related to a single issue: **the company's ability to continue to maintain the current price of Potash and Phosphates in this weakened international environment.** Management was adamant in its public statements that they would be able to maintain these prices. Privately they were more deferential and acknowledged the existence of the class action law suit again all the major Potash companies, filed by Minn-Chem, Inc., a wholesaler of farm supplies in Sanborn Minnesota.

The Central Issues were:

1. Given that there has been a nearly 400% increase in the price of Potash and DAP/ Phosphates over the past three years is this price level sustainable.
2. Is the Minn-Chem Inc. law suit credible and is there likely to be any antitrust action in this industry.
3. Wholesale prices are dropping resulting from large inventory imbalances.

The Mosaic Response:

1. The Mosaic Company will maintain prices at the current levels while recognizing that at these prices demand may be lower than in past periods.
2. The law suit (not discussed publicly) is deemed not consequential, since there was no mention of it in the latest 10Q, issued after the law suit was filed.
3. The **inventory** imbalances will adjust” (SISR, *Mosaic Analyst Meeting: Ability to Maintain Existing Prices and Antitrust Law Suit Key Highlights* January 14, 2009, p.1).

In that January 14, 2009 report we concluded that:

“The expectations of SISR are no different than they were prior to attending the meetings:

- A. We were one of the first on the street to argue that in a down turn they will attempt to keep prices levels constant and sacrifice output. In fact in our October report we correctly projected output levels which were well below the companies projections at the time.
- B. Currently we are on record for believing that the price will decline by 20 to 30% percent in the next 3 to 6 months, but not much more. Given that prices are up 400%, this would not be a major decline in price in our view.
- C. Given that these were our expectations prior to the meetings we are hard pressed to believe that there is anything really different than what we believed last week.
- D. We are maintaining our price target of \$60 a share by end of summer 2009.
- E. The law suit will go nowhere because the legal system is not currently able to deal with the nature of international issues that are involved in this case. The courts have not been able to touch the international oil companies and they will not be able to touch the international fertilizer companies. The attorneys for Mosaic, Potash and Agrium may have been underpaid in that the international structure that was created will be hard to break up by the U.S. courts. The legal system has not evolved enough to handle cases involving globalization of trade, and at this point, with so many other issues on its plate, this will not be the first that the Justice Department will take on” (SISR, *ibid* January 14, 2009, p. 4).

III. Ability to Maintain Elevated Price

On April 8, 2009 we modified our outlook after Mosaic reported and it had become clear that the degree of price destruction was even worse than our estimates, which had been much worse than the company had guided. On April 3, 2009 we wrote that:

We are removing Mosaic from our recommended list on the basis of their current earnings and expected earnings going forward. We are recommending a sell on the stock with a projected price target of \$30 in the intermediate future, or lower.

After the close today Mosaic reported their Q309 earnings with net earnings of \$58.8M or \$0.13 on sales of 1375.5. This compared to Q308 with net income of \$520.80 or \$1.17 on sales of 2147.2.

Our greatest concern was that the sales of phosphates tonnage was down 50% year over year and their sales of potash tonnage were down 63%. Of greater concern was that their average selling prices of phosphates were down y/y from \$487 per ton to \$413 per ton or 15%. That would not trouble us as much if their Q209 price was not \$1083 or a 61.9% decline q/q, from last quarter. Potash was better, but perhaps a disaster ready to happen in that their average price for potash actually increased from Q209 to the current quarter, from \$529 to \$565 or a 7% increase.

In essence we are finding a 67% drop in per unit sales of both potash and phosphates but more startling a 62% decline in price in phosphates, their main product in one quarter. Even worse despite the fact that their net sales were down 35.9% their COGS were down only 15.0%. Then

we have forward quarters where they will have very difficult price comparisons since there was nearly a 200% price increase last year (SISR, Mosaic Disappointment Could Get Worse: Removing MOS from our Recommended List: On the Basis of Expected Future Earnings p.1).

On July 22, 2009 the most recent quarter, Mosaic reported full year results with the following quarterly breakdowns:

Q409 Revenues were \$1,594M in contrast to \$3,467M in Q408
 Q409 Net Income before Taxes were (187.4) M in contrast to a profit of 1,183M in Q408
 Q409 Earnings per share were \$0.33 in contrast to \$1.93 per share in Q4 2008.

One may simply ask if they had a \$187.4 million loss how they could have earned \$0.33 cents per share. A closer look at their income statement would reveal that they took a \$330M credit for Provision for Income Taxes in Q409. Otherwise they would have had a loss of about \$0.40 instead of a \$0.33 profit. The media noted that they beat estimates by \$0.22 and since then the stock has been up about 10 to 15%. We have given up attempting to understand this area largely because legal but innovative accounting that always appears to arrive when these companies are in trouble.

Based on every data point that we know of that can be drivers for fertilizer growth beginning with farm income, to company sales, to product pricing, to crop prices we are hard pressed to see how these fertilizer companies can maintain their stock price. There is one possible exception and that has been possible consolidation in this space, which has been holding up the price of these companies.

IV. Impact of Anti-trust Action on Possible Consolidation in the Industry:

Over the past 4 months there has been some consolidation within this industry. CF Industries (CF) is attempting to purchase Terra Industries (TRA) with Agrium Inc. (AGU) in a bid to purchase CF Industries. In early July there were rumors that Vale (VALE) would be making a hostile takeover move for Mosaic, at around \$60 per share. This rumor was later denied. In February there were rumors that Cargill which owns approximately 64% of Mosaic was considering purchasing the remaining 36% of Mosaic for between \$58 and \$60 per share. These rumors and other possible consolidation in the industry may be the likely reason for the elevated price of Mosaic despite what on the surface should be fairly negative earning.

In January we wrote that:

“The Minn-Chem Inc. Law Suit

- A. At this juncture the suit does not appear to be credible in that it is centered on pricing in the U.S. and under the current structure there is sufficient competition in the United States to completely dismiss the law suit. There is no collusion in the U.S. markets.
- B. The risk is that lawyers and or the anti-trust division of the Justice Department under the Obama Administration will take an interest in this case.
- C. The risk is that the courts and the Justice Department will recognize that there is a degree of limitation of competition outside the U.S., which may put pressure on the U.S. markets, causing higher prices in the U.S. markets.

- D. We believe that this argument will not fly because there has always been ample supply to the U.S. markets and they are selling at market price, not at a fixed price like they do in China.
- E. Our view and the view of several other analysts at the meeting, was that this is not a credible issue. It will only be in the event that the Justice Department get's interested, which we currently we do not expect.
- F. The Mosaic Company understand that they pushing the envelope, but they have limited control of the other participants like Potash Corp, Uralkali, Belaruskali, and Belarusian Potash Company, and it would be difficult for anyone of these companies to break this pattern because of their integrated involvements in the international markets.
- G. Also, they are all working at near capacity except for Potash Corp which has excess supply.
- H. Finally, it would be difficult for the American courts to argue that Potash needs to produce additional product, such a request appears to be beyond the jurisdiction of the courts" (SISR ibid p. 3).

Today we still feel that given the way that the fertilizer companies structured their business with partnership in international companies doing the international sales, even if there were price collusion, it will be difficult for the Justice Department and or the U.S. Federal Courts to get a handle around these issues, especially without international cooperation. In this instance Canada which has been very protective of it fertilizer industry may not be as cooperative as would be necessary for major action to be taken. Similarly, Russia and Belarus historically have not been very open to these kinds of international agreements.

However, when it comes to the ability of the Justice Department to limit consolidation in this industry this is where they may be able to exert their influence, and here is where we believe the greatest risk is to Mosaic and the other Fertilizer companies from this antitrust discussion.

V. Summary

We have argued since April 2009 that we thought that the price of Mosaic (MOS) and Potash (POT) were higher than we thought they should be. This is based on their future prospects given the price of fertilizers, corn and wheat crops, and farm incomes. We even argued that the infamous belief in the long run bull agricultural cycle is based on limited real facts. It is true that in China, Brazil and India there will be an upgrade in food consumption to products requiring more fertilizers, but China has been very good at being self sufficient and has actually gone from being a net importer of phosphates to a net exporter, Mosaics largest fertilizer component. The agricultural cycle being associated to the commodity cycle occurred when the equity markets started to show limited appreciation, is based on a very thin facts and more on the growth of commodity speculation that occurred during the 2006 to 2008 period, than on any assumptions regarding population growth and food demand.

What is more interesting is the fact that the degree of speculation that led to major world food inflation is now being addressed by the CFTC as we have reported with respect to our work on energy. We will go one step further and argue that the anti-trust division is also looking into these same issues of speculation in the prices of agricultural crops. That is why the law suits against the Potash producers is so important, because it creates attention for the Justice Department of possible other reasons for the high price of fertilizers, that helped to destabilize word food prices in 2008.

We expect that little will come out of the Justice Department regarding antitrust action, except with respect to some limitation of the consolidation in the industry. This we believe is the greatest risk, and if this is why these companies have elevated stock prices at this juncture, we are simply attempting to raise some cautionary flags, that consolidation may be more limited than some expect in this industry.

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