MOI GLOBAL

Yara: Outlook Brightening for World's Largest Fertilizer Producer

Stuart Mitchell of S. W. Mitchell Capital presented his in-depth investment thesis on Yara International (Norway: YAR) at European Investing Summit 2018.

Thesis Summary:

Yara International is the world's largest fertilizer producer (ammonia, nitrates, and NPKs). The company is also developing a higher value-added crop nutrition business.

Recent history has been challenging for Yara. Following the 2011-2014 farming boom, grain prices fell sharply, stressing the industry. At the same time, Yara and other fertilizer producers had to cope with the extra capacity built up in the "good times". In particular, western manufacturers faced a flood of cheap urea exports coming out of China.

The outlook, however, is beginning to look more positive again. Chinese exports have fallen by ~60% since the start of 2018. Chinese manufacturers face more stringent environmental rules (75% of production is coal-based) and were heavily loss-making in 2016 ($2 billion). At the same time, Yara's competitive position has improved relatively due to lower gas feedstock prices.

More difficult market conditions prompted Yara to cut costs aggressively. Management plans to reduce the cost base by $500 million, or ~50% of 2016 EBIT. The team also hopes to add a further $600 million to sales by expanding premium products, most notably in Brazil, and by increasing ammonia production.

Trading at 1.2x book value, the shares appears enticingly valued for a company that has generated 15% ROCE over the cycle in the past.

The following transcript has been edited for space and clarity.

My presentation focuses on Norwegian fertilizer producer Yara, on which we've done a great deal of work, and we think there's a significant upside. Yara is not such a well-known company, so let me start with a brief introduction. This is the leading manufacturer of fertilizers, with an evenly spread global production – the US, North America, Asia, Africa, and Brazil. The current gas price, the glut of capacity, and limited export opportunity in the US place it at some disadvantage to producers who are purely in the US and benefit from the low gas price. If you look at Yara's productivity charts and compare the quality of its assets, you will see it generally comes out in the very top decile for all its plants compared to other producers worldwide. It is number one in nitrates and NPK. This great specialist business came out of the Norsk Hydro Group, focusing purely on the manufacture of fertilizers. We have a number one player globally, fabulous quality, and the most efficient production capacity. The slight disadvantage of being a global player as opposed to a US-based one is, in our opinion, a shorter-term thing.

Among Yara's strengths is its fully integrated business model, and there are numerous advantages and efficiencies coming from that. It has also built up a significant industrial business – it has managed to combine the byproducts of producing fertilizer to make extra products for non-fertilizer industrial clients. The top product is AdBlue, which is used to

reduce NOx emissions in diesel engines. People sometimes forget there is an advantage to being the largest producer because it means you can source raw material more cheaply than anybody else and can maximize capacity at a particular time in the cycle in a certain region, thus produce more cheaply. At the moment, Yara has been trying to push as much through the US as it can. Yara's global price is a bit cheaper than the price of gas worldwide – it is a significant advantage to be able to buy gas at $5 compared to $5.5 in Europe. The US gas price is far lower than everywhere else, but that will normalize over time.

Another interesting thing about this company is that it's got a great record, maybe better than can be expected from a cyclical company. Yara has achieved this because it is more efficient than anybody else at producing fertilizer. It's a cyclical record, but it's stronger on a long-term basis. The ROIC generated over time has been surprisingly good for a business like this – we have annual numbers such as 10%, 23%, 29%, and 25%. During the industry downturn in 2016, ROIC fell quite sharply to 8% and then 4%. CROGI (cash return on gross investments) has been 13.5% on average, which is an exceptionally and surprisingly high number for a business like this, but in 2017, we had a trough, with CROGI dropping to 6.5%.

What was our chance to buy this company? This is a cyclical industry, and the share price has been really depressed on the back of a combination of new capacity coming on and unusually weak demand, which normally follows a period of poor harvest and reduced cash flows, so the farmers are less able to spend money on fertilizer. In 2017, there was a significant amount of excess capacity in urea, which is the basic ammonia feedstock for fertilizers. At the same time, it was a period of unusually weak demand, so we hit a perfect storm. Urea prices came down to $200 a tonne compared to $600 a tonne at the peak. We've seen a sharp fall in prices during this period of excess capacity and weakish demand. It's quite interesting if you consider things like new build parity. If you were to build new capacity today, you'd have to do urea price at $320 a tonne just to cover your cost of capital. Any new capacity is a highly complex process – it can take four to five years to build a new plant. The amount of new capacity coming on should be significantly below demand, and then we'd also expect demand to be a bit higher as it balances out from the weaker periods we've had over the past few years.

At this time of excess capacity and challenged demand, Yara's profits have come under a lot of pressure. Sales fell from NOK 111 billion in 2013 to NOK 94 billion in 2017, and EBIT and net income more than halved. In 2017, we even had cash outflows, and ROIC dropped to 4%. This created the wonderful opportunity to buy this nice company which generates, over the cycle, impressive returns on capital because of the various advantages it has, such as technological superiority, spread, size, and the resulting ability to purchase products more cheaply than anybody else. It has also worked hard to develop interesting mixes of trace products and more complex fertilizers than the competition.

Urea demand remains far below trend while supply growth slows. Back in the glory days of 2006, utilization rates were near 92%, and that's when urea prices were right up in the $600 levels. In 2016, at the bottom of the cycle, utilization was 79%. We expect the rate to pick up sharply over the next few years.

Another interesting piece of work we did was look at the age of ammonia capacity. A lot of it is extremely old now and very unprofitable. Yara is one of those groups that have constantly innovated and upgraded capacity so that in everything it does, it is in the top decile of its productivity curve. There's a lot of highly inefficient capacity, and with prices as low as they are now, this capacity will either be closed down or replaced. If it's replaced, urea prices have to be much higher to cover the cost of that capital investment.

The first thing Yara did was to try and cut costs, as any good company would do. You have to assume the fertilizer price isn't going to increase although we think there's a good chance it will do. Then you try and bring your profit back up just by cutting cost. Yara put in place an aggressive profit improvement program, the idea being to increase EBITDA by $500 million per annum by 2020. The company is already quite far ahead of this. The program aims for 10% greater production efficiency, 25% lower fixed costs, and 35% lower variable costs. Slightly more controversial is 35% from higher volumes, but the company is also adding capacity as this whole process goes through.

With the extra capacity added in the past few years, assuming urea and fertilizer prices stay where they are today, it should add $1.1 billion to 2020 profits. That's almost the same level as the profit Yara made back in 2017 of $1.4 billion. Our guess is that without cyclical upturn, the shares would be trading at 5x EBITDA, which is quite an attractive valuation with no increase in urea price, just work it is doing on the cost side. It's interesting that the shares are still trading at a big discount to competitors. When I say competitors, it's mostly those producing fertilizers in the US. They have the advantage provided by the glut of natural gas, but this should even out over the cycle, as it normally does. You get new capacity coming on Europe. At the same time, we're going to get the ports and the ships so that glut of capacity can be exported out to the US, and this competitive advantage will even out over the next few years, in our opinion.

What makes things all the more interesting is that we believe Yara can go a lot further. It's a very traditional European company, extremely asset-rich and conservatively run. It has got a number of gems that are difficult for the market to appreciate, and Yara can do a number of things which would surprise existing shareholders and could help drive the share price up quite significantly. The first thing is the industrials business, the one that uses the byproducts of fertilizer production to make various industrial products. In talks with people from the industry, we have found that these will be highly attractive, specialty chemicals to some chemical groups. Looking at the kind of prices these assets fetch in M&A, we think the business could be worth 25% of the current market cap. Yet, at the moment, it only makes 12% of group EBITDA. We believe it's something which could surprise a number of investors. If it were to announce the sale of this business somewhere around this price, it could drive the share price significantly higher. However, it's also complicated because these are products manufactured in existing Yara complexes so there would have to be some supply agreement. Despite the complexity, this is normal within the industry, and some other companies have done it.

We've also studied extensively the improvement program and believe the company can go quite a lot further than it has said. It's an aggressive program, but looking at the costs similar companies have been able to take out in difficult times and how much Yara has exceeded the program so far, we think it could save up a further $500 million. Our hope is that it will come up with a raised guidance for the savings from the improvement program. The management has already indicated it can do $700 million to $800 million, but our view is it could go way higher.

The other thing which intrigued us is that Yara has a lot of really interesting assets sitting on its balance sheet at pretty much nothing, but we consider them quite valuable. It has got ports and terminals, for example, and those could be worth far more than the balance sheet suggests. There could be a possibility for sale and leaseback. We could be talking of value of $1.5 billion or $2 billion. That's something which could really surprise investors and help push the share price further.

Pulling all this together, we talked about the current level of EBITDA, we looked at the extra capacity and the improvement program and what that could bring in the EBITDA, and we looked at the extra cost-cutting. But then we considered the impact of urea prices back at $430, which is a recent peak and would justify new build of capacity, and we find the shares would be trading at something like 3.5x earnings. That looks difficult to achieve right now because we're at the bottom of the cycle and the cost-cutting program has to proceed, but our guess is the business of a company with proven quality can generate such returns over the long term. I think we have a tailwind now. With very little new capacity coming on in the fertilizer area and demand recovering nicely, there's a good chance we'll start to see the value of these assets and then sharply higher profits over the next few years. It seems to have a PER of 3.6x for what probably would be a midcycle urea price that is too cheap, and why not pay 7x, 8x, or 9x for an asset of this quality?

To sum up, Yara is a really good business that has had super quality over the cycle and generated great returns. We were presented with a good opportunity when it faced a perfect storm with all the new capacity coming on and unusually weak demand. The company put in place an aggressive restructuring program, but we think it can go a lot further. There are various hidden valuable assets which the market isn't fully aware of, and if they're externalized, it should drive the share price significantly further.

The following are excerpts of the Q&A session:

Q: Stuart, thank you so much for articulating your thesis here for our benefit. Could you comment a bit more on capital allocation and whether there's anything you might prioritize differently than the management is doing at this time?

A: One of the big challenges of capital allocation in a firm like this is that it takes an awfully long time to build a plant, not only planning but also the context. The region of the world where you're operating can change dramatically during the time you're building the plant. One of the obvious questions is why not build more plants in the US, where you have the benefit of lower gas prices. The trouble with that is there are ports and terminals being built to start exporting this glut of excess gas. I'm not totally clear on whether it makes sense to add more capacity in America at this stage of the cycle. There could be a case for it.

The other part is value-added products, and Yara is in the process of doing this. One area in which it is a global leader is digital farming. It's all about farmers being able to look at a field and see where they're wasting fertilizer. There are some parts of the field which need more fertilizer than others, and Yara sells this as a package to its farmers. It offers them value-added products, a tailored package of a mix of different fertilizer products that exactly fit the farmers' land. We think that's something it should continue to allocate more capital to.

Looking at the bigger question of asset management, selling the industrial business would make a lot of sense; Yara could either pay that cash out to investors or reinvest it back in productivity and make the core business even stronger. It could also reconsider owing its terminals. These assets are quite valuable to other groups, which can perhaps optimize and run them better as part of a portfolio of terminals across the world. I think there's a reasonable case for that as well. Overall, this is a very well-managed company, with a CEO and CFO among the most impressive ones I've met. Still, some of us think they could maybe go a bit further.

Q: What companies would you consider the closest comparables here?

A: It’s really difficult to compare. The best are the Americans, the ones generating the highest returns, and then you have a number of groups operating within larger chemical businesses out of the Middle East. But there’s nothing quite like Yara, which is a global player purely focused on fertilizer production. The others tend to be within larger industrial groups.

Q: What data points could someone track to either validate or challenge your thesis over time?

A: One thing you’ve got to keep on top of is the fertilizer price. It is just beginning to rise nicely now, and if we’re right about the tightening up of the market, it should move quite higher. Since natural gas is the feedstock, the second thing you’ve got to watch closely is the gas price in Europe. You need to keep a close eye on the competitive advantage American producers currently have and hope that the gap starts to narrow as more capacity comes onstream in Europe, port facilities are built in the US, and the products start to get exported. That’s a critical factor because it could be the extra trigger for this company to trade more in line with the American rivals that have this cheap feedstock.

From a super long-term value perspective, you’ve got to make sure you get all the latest analyses that look at the productivity of ammonia and fertilizer plants across the world. Its plants need to be in the top quartile ranking. This is taking out the effect of different gas prices in different parts of the world, looking at straight productivity, the amount of yield coming out of a plant, and the number of workers. For the long-term value case, the company has to stay in the top decile across its plants.