PotashCorp

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# Goldman Sachs Basic Materials Conference

Adam Samuelson - Goldman Sachs Group Inc., Research Division

So in the interest of staying on time, I think we'll begin our next session. I'm Adam Samuelson, the agribusiness analyst here at Goldman Sachs. We're very happy today to have PotashCorp. Here to present from PotashCorp, we have their CEO, Jochen Tilk; and Denita Stann, who heads their Investor Relations and Public Relations effort is also here with us. I think, Jochen, maybe you want to just start with just some brief opening comments, and then we'll jump right into questions. There's microphones in the room. So we'll open it up to audience questions a little bit later on as well. But Jochen, we're happy to have you. Maybe just any opening thoughts and then I'll start off with some questions.

Jochen E. Tilk - Chief Executive Officer, President and Director

Thanks, Adam. Good to be here. Thanks, everyone, for joining us this morning. What I thought I'll do, I'll provide a few general comments on a couple of topics that are of most interest, and then I'll turn it back to you, Adam, and happy to take any questions that you and people in the audience have. Most of you are familiar with PotashCorp of Saskatchewan and we're the largest integrated fertilizer producer in the world. We produce all 3 nutrients and so a variety of industrial products. Historically, over the last 5 years, our gross margin split's been 60% from, 2/3 from potash and then the rest of it from nitrogen and phosphate.

So most people look at us as a potash producer, and given that we have the biggest or largest operating capacity in potash, people are very interested on our view in the potash market. So it won't surprise you that a big portion of the comments I make are related to potash but I don't want to make light of that we're significant nitrogen and phosphate producer as well.

On the potash side, the first question perhaps that I'll throw out there and answer myself is what's the market right now? What do you see happening over the next 6 months? We've made some comments a few weeks ago at our call, and we communicated some cautions, but supported optimism that we see the markets in a more positive light and we ought to translate that. We think that things have bottomed out, if that's the right term in terms of sentiment, in terms of potash prices. And let me explain that. We had a very tough 2015. I'll give you very few data points, one being the U.S. market had been a premium market for potash. It opened up at $410 Midwest prices and then ended up almost $200 below that 12 months later and the premium had all but disappeared, a significant amount of imports had come in. There were some structural matters that happened, and of course, people will question. Farmer economics is always a big driver. And so when we started 2016 at that level, we had a very cautious outlook. In fact, at the beginning of the year, we reduced our dividend. We cut our dividend from $1.20 to $1 per share as a response to that. We conveyed that caution around the globe. We said that Brazil was difficult. We saw that there was price erosion, lot of -- highly competitive environment. Brazil is a true spot market. And we also anticipated that the contract negotiations in China may prolong evidenced by the inventory in China. People were quoting those numbers and said "a lot of inventory in China, this could go on for a long time."

So we gave a cautious outlook as have pretty much everyone who has a view of the market. We look at it today and reflect on it, and we are much more encouraged in the direction things are going. First one, on U.S. market, domestic market, 3 important points. Because the premium has disappeared, the market is a less attractive one. We've seen less imports coming into the U.S., I think that's a natural thing. There are other markets that are more attractive. That's a plus. We can't predict that, but I think just by the difference in a price environment, you will see less imports into the U.S. as in previous years, certainly last year.

The second is that certain volume has flushed through the system. And as always the case, volumes build up towards season, the season kicks in and then there is high demand, farmers in U.S., distributors in U.S. don't take price risk. The inventory usually stays with the producers, and certainly, now our case. So there's been a lack of engagement, and then, we kick our supply chain in. Now 75% of the corn plus is planted in U.S. So a lot of it is done. But we flushed our inventory out, and we're now looking forward to the summer fill and the fall season.

And the third one, probably somewhat more surprising, farmers' economics in U.S. are good, they're certainly better than they were last year and they're better than they were a year before. If you look at the affordability of fertilizer versus the farmer's economics, they're quite attractive. You know that corn has come back to $4 and soybeans are $11. Lot of acreage planted, 93 million acres in the U.S. So it's -- they're good basics and that all is attractive. So we see that engagement. We know that, that farmers are applying product, and we know that as the summer fill comes, a lot of product will move.

We look at Brazil, we had good engagements there. Brazil is a huge producer of soybeans, very attractive market. Political stability is welcome, but is not the biggest reason there. Farmer economics are a much bigger driver. They export in U.S. dollars. 70% of Brazilian crop is exported. So we see good engagement.

And of course, the last data point for optimism is the famous, infamous China contract, and every year, we engage in that process. We are 1 of 3 parties negotiating with the buying committee. We have not -- we're generally not the party leading, and we're generally not the party settling. So we anticipate one of our competitors to do so. The fact that it's prolonged is based on inventory in China, which provides stamina for negotiations, but at the same time, it's also a reflection that producers are more careful. I mean, they don't want to settle right away. I can't predict the timing. I can't predict the outcome. You read, perhaps, what bid ask prices are, and you can kind of extrapolate -- interpolate, I guess, what the number might be. But in any case, we're optimistic because it will happen in the weeks to come, that's a given. And it will happen at a price that we think is not inconsistent with what you see in Brazil right now, which would not be a bad outcome. So if that is so, a lot of volume engagement will take place. And then, if you combine those 3 points I made in U.S., in Brazil and in China that we see a lot of engagement in the second half, a lot of material that has to move to those countries and in places, and we're certainly ready and positioned for that. And we see opportunity for perhaps not just price stability, but the opportunity that prices will strengthen at that point, there is piece evidence. Domestic competitors have announced a price increase of $20 very recently from $225 to $245 potash Midwest. That's a sign that it's a consistent anticipation of a strengthening market.

When I translate that very briefly into how does it translate to your capital allocation? We reduced the dividend beginning of the year to $1. We think very highly, and for us it's very important that our dividend policy, capital allocation policy provides stability and sustainability, we spend an incredible amount of time reviewing that in light of what we think the markets will do. And when we had a cautious outlook, we certainly reflected on a payout ratio that's over 100%. We looked at how much money we have to borrow if markets would take a certain direction either up or down. And if markets were to be as they are today, no improvement, and that includes nitrogen and phosphate. So I'd say a relatively conservative outlook and not consistent with our current optimism but more cautious. Then our borrowing would be about $400 million to $500 million to support the dividend. We have some means to offset that. We've reduced our capital by about $100 million. That's already reflected in that. We have some other means that I don't want to get into right now, but we think that's doable. We also know that if prices improved by $20, as an example, then our borrowing would be reduced by $200 million. So it would be $200 million to $300 million, and we think that's very doable. And then looking at 2017, we think that in that market environment and the fact that we don't have the first quarter of the higher dividend payout -- as a reminder, our first quarter was still on $1.20, we think that overall, we would be at 100 percent or even less payout ratio -- percent payout ratio, which we think is sustainable.

So if the current market or an even better market evolves, then our decision to sustain the dollar dividend and that going forward, sustaining it going forward, it was definitely the right one. Of course, we do have to qualify it in a way that our #1 objective is to protect our balance sheet. And we regard our balance sheet as being one of the most important elements in the health of our company, in the future of our company. And we look at credit rating, we look at cash flow, we look at our sustaining capital, and maintaining our asset base. And if things were to change in the potash market, which is not what we anticipate at all at this point, then we'll have to look at it, reflect on it. But at our current expectations on markets, that's what we decided to do.

Maybe 1/3 and final area is the long-term prospect. So I talked about 2016, how we see it evolving and I talked about capital allocation, but just looking beyond that and we get asked this question a lot and so I'll volunteer and say , "Well, you have the highest operating capacity, one of the lowest cost producers." Our anticipated cash costs after the final Rocanville run will be approximately at current exchange rates to the Canadian dollars. Our cost base in potash is Canadian approximately $70 U.S., all for cash cost. And that makes us a very competitive producer and people say, "Well, that would give you the opportunity perhaps to go for market share." Our approach to market is to balance supply and demand, and you have to be very clear when you choose that route. We think it's a better business model, it's one that provides better margins. It provides better returns on our assets. It's one that's sustainable in that market that we are in, not just for historic experience, but just looking forward. And the biggest driver in making that decision and looking to market is really how we see supply and demand evolving in the next few years. And just give you a very brief set of numbers. We look at current operating capacity at approximately 65 million tonnes per year. So that's what we -- and we can go through mine by mine and what's in, what's out. And that includes our operating capacity but not 100% of it. So we think that 65 million is what some of our competitors can produce at maximum capacity because they will produce full-out and it assumes the capacity that our biggest competitors, so the Russians and the Belarusians have, 65 million. And it's been tested, certainly in 2014, and it's been tested in a couple of other locations. We think that consumption is today, we know about approximately 60 million tonnes. Our guidance's been 58 million tonnes, 59 million tonnes, 60 million tonnes, 61 million tonnes. We saw 63 million tonnes in 2014, we saw 59 million tonnes in 2015, but 60 million tonnes is probably a good number. And we see that growing by approximately 2%, maybe 2.5%. So by 2020, it would be approximately give or take 70 million tonnes. Now there will be incremental capacity, we know that. There will be further capacity coming on. There's a project by K+S, Legacy, and there's a European Russian producer, EuroChem. And we incorporate that and some other gives or take. There will also be capacity coming off, about 7 million tonnes of mine closures and depletions. So we balance that out. And we think that in 2020, we are in a situation where the margin between operating capacity and consumption is about 5 million tonnes, 78 to 75. And that 5 million tonnes really supports, in our view, that matching supply and demand and not producing what the market doesn't need in simplified terms is, by far, the right approach, and that's what we do. We've tested a bit in the beginning of the year. We pulled out 0.5 million tonnes at the international market, I should say, when I say, we -- in this case, it was Canpotex, 300,000 of that was in Brazil. We think that worked well. There was good response in the market. So that's our strategic approach to market, and that will be the approach going forward. And it's based on that supply and demand balance as we see it, which we think is relatively tight. And keep one thing in mind, in the last 10 years, a lot of money had been spent for expansions. Clearly, there was a sense if not euphoria or certainly, enthusiasm 7 to 8 years ago when those decisions were made. They were all made more than 5 years ago, more than half a decade ago. They're now coming to completion. There's really very little left. But give or take maybe, I don't know, $50 billion may have been spent in incremental expansions, brownfields and greenfields. In the next decade, so the same period going forward I would doubt very much that much would be invested in growth. I think everyone will draw from their expansion so that the incremental investments or the new investment in capacity will be very little for a number of reasons. So that in the next 10 years, we will certainly see a very different environment in terms of building new capacity than we have in the past. So I'll pause there. Those were my 3 areas: current markets, our capital allocation policy and how we look into the future, toward the future and in terms of supply and demand and our approach to markets.

Adam Samuelson - Goldman Sachs Group Inc., Research Division

All right, that's very helpful, Jochen. Maybe going back to the current market discussion a little bit and obviously, the time of year with no resolution, China is top of mind. And I know you talked about coming -- something happening fairly soon. But I want to move more philosophically, what's the value at this point of this annual or semiannual Chinese contract structure? I think if you look back at 2015, this inclusion that you withdraw was a lot of that optional tonnage in the second half of the year, it wasn't consumed. It just went right into inventories. They were incented to take it because of the way the contract structures work and ended up impacting the first half of 2016 in a pretty negative way. As you look at Canpotex, sitting at Canpotex -- the Canpotex level, how do you maybe try to change that incentive to make it a more constructive ongoing market engagement in China? Or what -- how do you think about changing that import channel?

Jochen E. Tilk - Chief Executive Officer, President and Director

Thanks, Adam, for that question. We think about that a lot, and I'll take that. You look at a contract negotiation, which is meant for 2016, a country consumes approximately 15 million tonnes of potash, 25% of the world potash consumption of 50 or 60 today, and it domestically produces half of that 7 million to 8 million and then it imports the other half. And then the negotiations are still ongoing midyear, and so everything is kind of retrospect and it really makes you wonder where's the logic there? And if the hypothesis is you get a better price on a contract negotiation then you do on spot, then I would beg to differ. I think on average, it's all the same. If you were to look at long term, the spot probably gives you more volatility, but on average, probably a similar price. And you see Brazil and the United States working very well, extremely well on spot. And so it makes you wonder if there is actually a benefit for either party, where the true disadvantages, in my opinion, for both countries and producers is on logistics. I don't see any benefit to sit there and have ships paying demurrage, producers waiting, and then the magic date comes and then everything moves. There's a lot of NPK producers in China that depend on product to make their compound blends. And it's a seasonal business. I mean, the true dynamic, and you see that in the U.S. and Brazil, it’s weather, it's planting. Those are the drivers of our business and the contract negotiations an artifact. So I agree that I don't think it's beneficial to either party, but I'm most respectful to China, I'm very respectful to the buying committee and their logic. The inventory buying is a bit of an artifact to prolong negotiations, you're absolutely right. There's an optionality in most contracts. It goes into inventory, and it’s bought at the price of the previous year. And then the following year, negotiations are defined by the amount of inventory because that is the stamina that the party has. And so you build up more inventory, and at the end of the year, it looks better and then you prolong negotiations the following year. And that is a true artifact and I'd be surprised if China or the Chinese buying committee isn't reflecting that. So that really makes sense because you never know if you get a better deal the year before or if you get a better deal the following year. It's really -- it's a bit of a speculation. It's not really for us to change that. We're one party, we supply approximately 2.5 million tonnes into China, so that's Canpotex. And we will communicate that. We're incredibly supportive, we'll put our product in there. We have a great supply chain so we can do deal with logistics. But we would certainly communicate and say, is this really the best way for either producers and the country or are there better ways of doing that. And if that helps China to reflect on the sensibility of the negotiations, so be it, if it doesn't. So -- but I take your point. We would prefer a better way and I think everyone would, but we're also respectful of the fact that it's not us -- up to us to change that.

Adam Samuelson - Goldman Sachs Group Inc., Research Division

Okay, great. And then maybe I'll one more in the market environment and make sure the audience has sometime. You talked about the North American market, the premium going away, I think it's interesting, you look globally today. Europe has very significant premiums to the rest of the world, would seem to offer the highest potential netback to Canpotex today, at least by my math. And I am wondering as you think about marketing opportunities, why you haven't seen Canpotex, or frankly, others even being more aggressive in trying to maybe break into that European market a little bit more just to come out and do business why aren't you trying to make money there?

Jochen E. Tilk - Chief Executive Officer, President and Director

Yes, good point and a question that we got often, why aren't you shipping to Europe and to premium market? I think, I mean, the first answer is that it can be short-lived and a relatively small tonnage can negatively impact that market. And you would argue that a premium market, particularly at a time when cost of shipping is extremely low, I mean the cost of shipping across the globe has never been lower than it is today, a premium in any domestic market is artificial. Europe is unique in a number of reasons. I mean it's more fragmented, it's still many countries. It has a more complex structure of tariffs and these kind of things, which always play a role. It also has specialty products. People are very careful about choosing the type of products they apply, they're more selective. So it's not a broad bulk market. So you have to be thoughtful on all of these points: the unique countries, the unique products, the unique jurisdictions. But the most important one to me is economics 101 that if you were to be mindful – or successful in doing that and logistics can be overcome, then that premium market would not be there for very long. And United States is case in point, that's the example. You look at U.S. and the premium market lasted all but 12 months. And I don't think that's a good outcome either because what will happen is potash is, in its way, it's a 0 sum proposition. The tonnes that are produced will show up somewhere. And if they cannot be sold in Europe, they'll go perhaps to Brazil and go perhaps to other parts in the world. So when we look at any market, we look at it globally. We don't look at just any specific market because we know that the tonnes will not disappear, they will just be rerouted. And so to answer your question, I think the premium would erode very quickly, and therefore, you have to be mindful to -- it would only move tonnes to different parts in the world and that would have an impact. So at this point, that's not a real attraction to us.

Adam Samuelson - Goldman Sachs Group Inc., Research Division

Okay and maybe just to make sure we have time anybody in the audience who has questions, we've got mics here. All right, I'll keep going. So maybe switching gears and something you didn't talk about in your opening comments about was nitrogen market. And I'd love, the pricing there has been equally, if not more, even weaker than it has been in the potash based of late. You've got a large position in Trinidad. Maybe talk about where you actually see cost support in the nitrogen market today and talk about how the current ammonia price environment maybe impacts some of the reinvestment economics in Trinidad on the gas side and if you have concerns there about gas availability over the medium term?

Jochen E. Tilk - Chief Executive Officer, President and Director

Yes, for sure. Just to give you a few data points and refresh your minds, we were a significant ammonia producer. We produce approximately 2.2 million tonnes of ammonia in Trinidad and Tobago. We have 3 ammonia plants, and we also have a urea plant. We produce ammonia and other products at 3 sites in the United States, about the same amount and so a total of about approximately 5 million tonnes. There is a significant cost differential now in between U.S. ammonia and any offshore ammonia because of the import costs in ammonia and nitrogen is gas. 85% is natural gas, and gas in the United States is the most competitive today and so domestic production is very competitive. Trinidad gas costs are higher. They used to be more attractive on a world scale. So to Adam's question, what's your philosophy, what's your approach there? I mean, for us, the way we look at it is, we are in the global ammonia trade, merchant ammonia out of Trinidad. We have -- we ship not insignificant amount to the U.S. but we also have other customers in Chile and around the world. As we see the trade pattern evolving with domestic, U.S. domestic ammonia and nitrogen products being more competitive and the incremental capacity coming on in U.S. that we will ship ammonia to different parts of the world. Certainly, different jurisdictions, whether it's South America, the Caribbean or even India where offshore ammonia and non-U.S. produced ammonia is more competitive. There's also possibility for us to increase our urea production in Trinidad and Tobago, meaning we use more of our ammonia to make other product solids that we can then ship to fertilizer markets. So when we look at Trinidad ammonia going forward, we certainly have to look at other markets other than the U.S., and we have to look at the possibility of maybe increasing production of others to service those markets. Now in the U.S., I think given the competitiveness of the natural gas in U.S. and given incremental plants coming online that U.S. will eventually become more self-sufficient. So the imports in U.S. will reduce. And the way you define your position in U.S. as a nitrogen producer is having the most competitive assets you can possibly have. That means the highest gas efficiency, the best product variety, good logistics and that's what we have. I mean, we've got 3 phenomenal plants with Lima, Geismar, and Augusta and logistically, when you look at the map, the areas we serve is extremely well-placed. We've got very competitive operating costs, and we make essentially products that go all the way across – liquids and solids – the nitrogen space. And so they're well positioned. We have some expansion opportunity if we feel that makes sense at some of our plants. We have just expanded Lima and added about 350,000 tonnes of ammonia and nitrogen production there. So Trinidad and Tobago, looking at offshore markets, looking at changing over the next 5 years and then, domestically sustaining our product variety and competitive position. And any potential expansion there would be somewhere at our plants, we have that competitive position.

Adam Samuelson - Goldman Sachs Group Inc., Research Division

Great and we're running short on time. I want to make sure anybody in the audience here if there's a question from the group?

Unknown Analyst

There's been some consolidation on the nitrogen side. There's few, kind of, smaller players left. Would that be an area that you would look to add capacity potentially?

Jochen E. Tilk - Chief Executive Officer, President and Director

Yes, when there is that opportunity, we tend to look at it. As you said, they're smaller players, often single plants which are non-core and we look at that and then we apply those criteria, we say, "Well, where are they located, how do they fit into our sales strategy? What products they make? And are they competitive? And then what would be the return on that investment?" And it does become more one of capital allocation. So the answer is if there are competitive plants, if the return on capital would up appropriately, and we would always compare that to an expansion in one of our own plants. And if I take Geismar as an example and we said, "What's the cost of putting an ammonia loop in there? What's the rate of return on that investment? And then compare it to an acquisition. And if it works out, we will give it some thought. If it isn't. It's hard to find plants that are more competitive or it's hard to find plants that are more competitive than an internal expansion -- a brownfield expansion. So that would be the challenge in that.

Adam Samuelson - Goldman Sachs Group Inc., Research Division

Great, and I think we're just about out of time, unfortunately. So I think maybe we're going to leave it there. Jochen, I want to thank you very much for attending today.

Jochen E. Tilk - Chief Executive Officer, President and Director

Adam, thank you very much for the opportunity, and thanks for joining us today.