Moving Down the Food Chain
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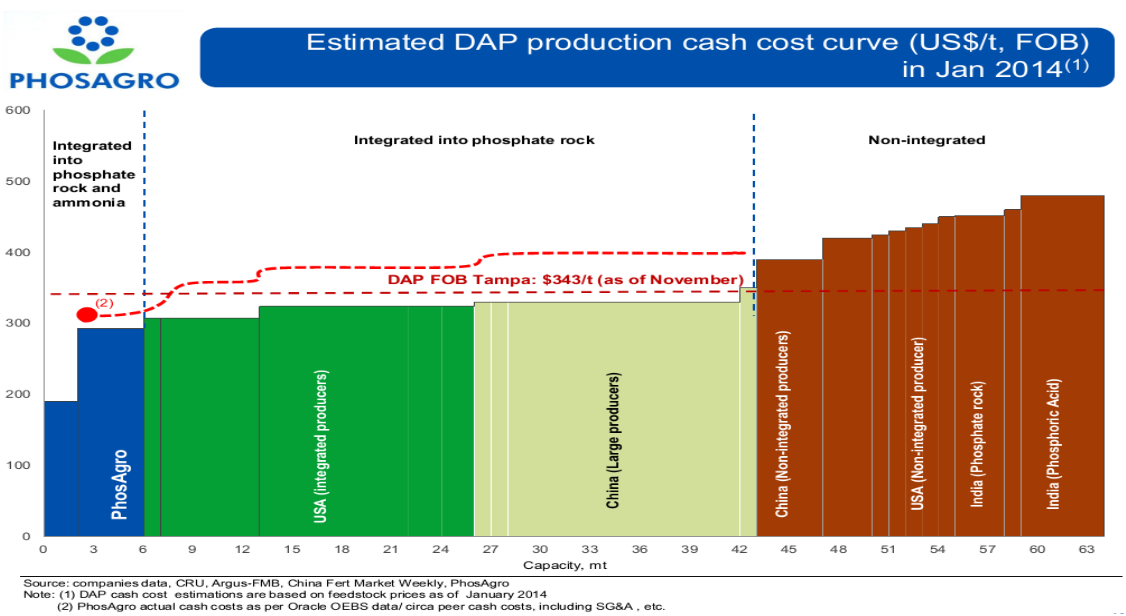
As I am sure we all remember from when we were kids, it was explained to us that a chain, no matter how strong it was, was only as strong as its weakest link. As I look at the backdrop, it seems to me that the weakest link in the food chain is phosphate and, in particular, phosphate rock.

Roughly 85% of the world's rock that gets produced every year is within vertically integrated fertilizer companies. The big companies like it that way. They like taking THEIR [phosphate] rock, shipping it to THEIR phos-acid facilities, where they mix it with THEIR sulfuric acid to make THEIR phosphoric acid. Then, they mix it with THEIR ammonia and make THEIR phosphate fertilizer (MAP & DAP). In the case of some companies, like Agrium, they even sell the MAP & DAP through THEIR retail distribution. This is why they are called "vertically integrated" fertilizer companies.

The problem is that 15% of the required rock to make the MAP & DAP is not integrated and those who require it are reliant on others to get it. That situation creates what I would call the "not as vertically integrated as they should be" fertilizer companies and they pay a price for that. First, as I have discussed many times, there is the security of supply price. We are all aware of where this "extra 15%" phosphate comes from and it sure wouldn't be my first choice (or 10th!!) to base my operations on. Second, there is a very real monetary cost to not being totally self-reliant. One need only look at Agrium's recent financials to see what happens; with their Ontario mine now closed, they rely on Morocco for roughly 40% of their rock requirements. Their gross margins on phosphate fertilizer out of their Alberta facility (now fed by imported rock) have gone from something to nothing....they actually lost $16/ton.

Agrium's situation is not unique. There are many "not as vertically integrated as they should be" companies out there that are becoming "not as PROFITABLE as they should be" companies. Below is a slide out of a recent PhosAgro presentation that speaks for itself; if you are not integrated you don't make money (you probably lose it).



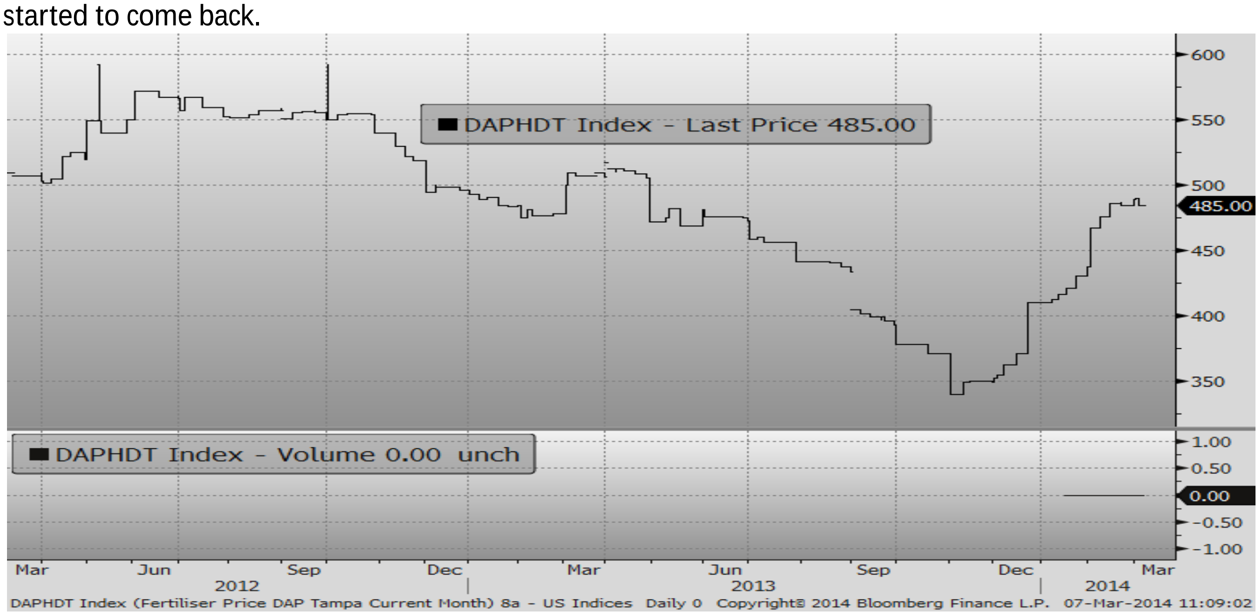
So those that are in need of rock will probably need to figure out how to get it. By get it, I mean secure it. And by secure it I mean own it. The problem is, a lot of that rock can't be owned because it is not independent, it belongs to large entities that have excess. OCP (the Moroccan Crown Corp.) has a lot of that excess rock, PhosAgro the large Russian integrated producer has excess rock and, others do as well, but there are very few independent deposits up for grabs and even fewer if geopolitical issues are taken into account.

The Winds of Change

Phosphate

There has been a noticeable change over the last several weeks on various fronts. Starting with the fertilizer complex in general, prices have rebounded nicely after an 18 month slide. The sell-off was particularly severe on all fertilizer components after the potash cartel that Uralkali was part of disbanded. At the time, it seemed bizarre that phosphate and nitrogen should get hit hard as it was an event that only directly affected potash but the market always shoots [sells] first and asks questions later.

As you can see, over the last few months finished phosphate products like DAP (chart below) have started to come back.



Source: Bloomberg

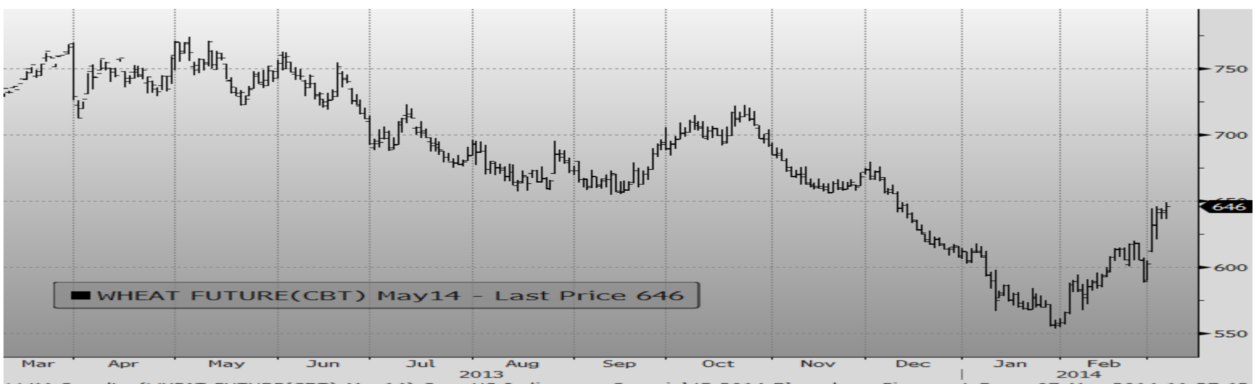
Supply has also started to shrink:

"U.S. wholesale phosphate (DAP/MAP) inventories fell a second month in January, dropping 22% yoy, according to TFI data. Inventories declined the most in 15 months, as production fell 17% yoy and exports rose 15% yoy. DAP/MAP inventories fell sequentially for a second consecutive month, falling 15%."

Analysts Jason Miner & Philippe Tardieu - Bloomberg
Feb 24, 2014

Grains

We have also witnessed a significant increase in the price of grains which should continue to have a positive effect on fertilizer prices. As grain prices continue to move, farmers want to produce more and the best way to improve crop yields is fertilizer. The more farmers make, the more they are willing to spend. Issues such as the Brazilian drought and tensions in the Ukraine have also played a part recently in pushing grain prices higher with corn [briefly] touching $5/bushel. *(Charts are as of close Mar. 6, 2014)*

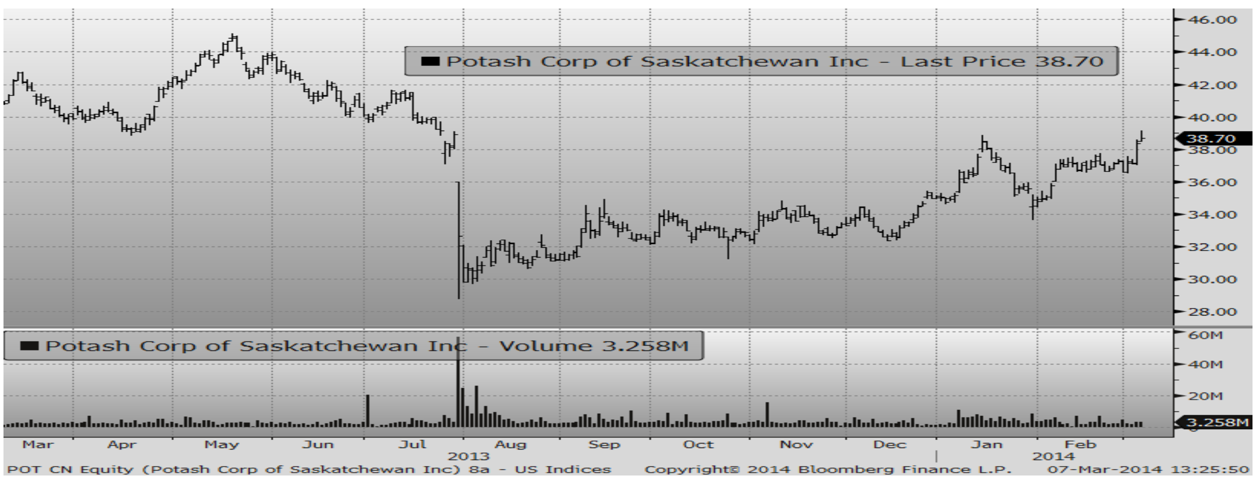


Source: Bloomberg

Grains are not alone either. Other agricultural commodities, coffee, sugar, cocoa, cotton have all been very strong as well; coffee is at 2 year highs.

Equities

Needless to say, with this backdrop, the share price of many of these "not as integrated as they should be" fertilizer companies have been acting very well (as the charts below will show [as of Mar. 6, 2014]).



Source: Bloomberg

Commodity equities are a funny beast; they don't trade based on where the commodity is today, they trade where investors think the commodity will be in the future. Case in point, last December I tried to explain why I thought gold stocks acted so miserably. It's not that gold was $1,200/oz., it was that looking into the future, most market participants thought gold would be a lot lower. With that, there was no reason for investors to buy and what they actually did was sell. Gold is up about 10% from December but the gold stocks are up considerably more, why? Because, looking into the future, many investors now believe the future looks better, not worse and so they are paying for the future appreciation; not selling ahead of the future depreciation.

I think the same argument can be made for the fertilizer stocks. Up until a little while ago, fertilizer prices had been declining for 18 months. Grain prices had been in a steady downtrend and commodity stocks had been a bad place to be. The present situation was bad and the future looked worse. But much like the gold stocks, things have changed and the future looks better. After 18 months of steady declines, fertilizer prices are up so people are paying up for the stocks.

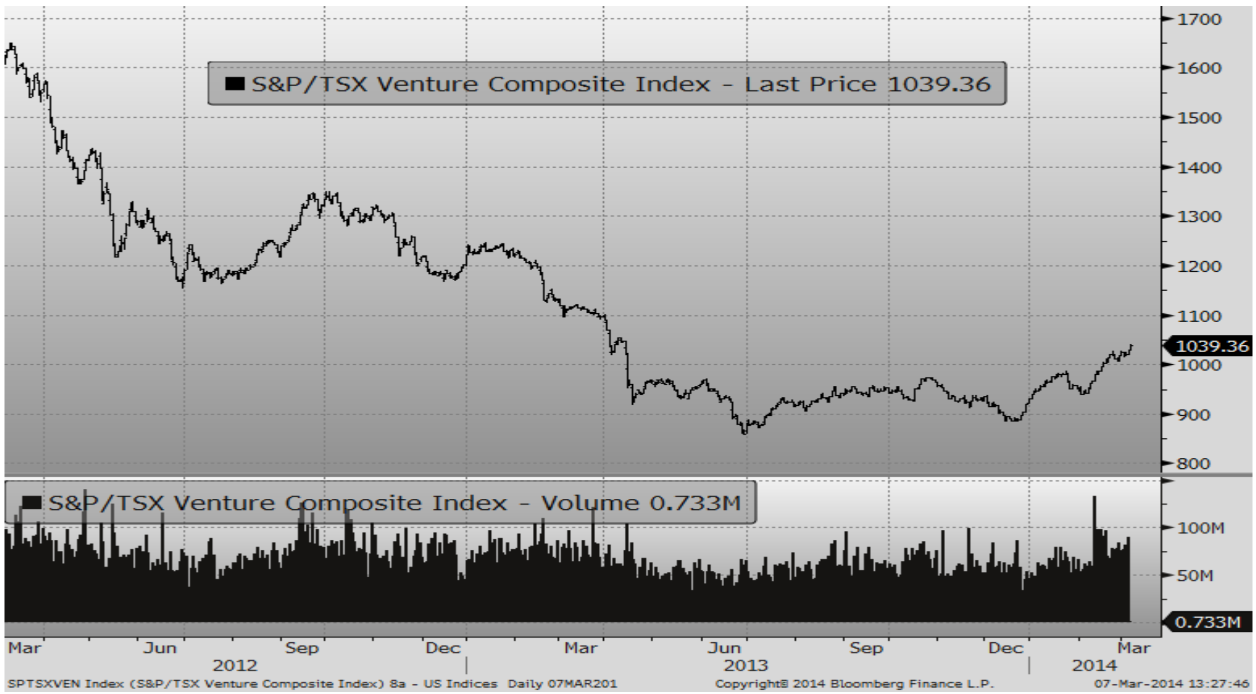
I also believe that the fertilizer stocks are being helped by the generalists. It's the one commodity that everyone understands….we all eat. After seeing almost every sector but the commodity sector run last year, investors are looking for an opportunity. Agriculture is an easier decision to make because gold is "too bizarre to understand" and industrial commodities need a better economy and who knows where that stands. Agriculture, and therefore fertilizer, has future prospects that investors feel good about.

One last thing, if you had your eye on an asset, would you rush to buy it if you believed that time was on your side? With each passing month as the conditions worsened, you would wait hoping that there would be a misstep that you could take advantage of. Perhaps you might even be concerned for your own prospects. But, if the mood changed and you were more confident in the future prospects of your business and, you no longer believed that bad things might befall that asset you covet, you might give it a more serious look.

Small Cap

The world I live in is the small cap commodity sector….ouch! If big cap commodity has been ugly, just imagine the small caps. These guys have little to no revenue, rely on the good graces of investors to finance and need to negotiate the treacherous waters of investor sentiment to have any chance of success. Most investors look at the big caps for a sign. Investors typically buy the big caps and then move down the food chain to the smaller names. Even those that specialize in the small cap world take their cue from the big caps; they see what is working and mimic it in a small cap name.

The small cap resource sector has started to act a whole lot better as witnessed by the TSX-Venture exchange. Investors are starting to look for opportunities amongst the wreckage of the last 3 years. We will see if this is a true reversal but things are looking a lot better and investor appetite is stronger.



Source: Bloomberg

For the last 3 years, we [Windermere] have been invested in Arianne Phosphate. There have been a lot of good reasons to own it (and we own a considerable amount) but those reasons have been company specific. The prospect to grow the asset, the high quality of the phosphate it produces, the location of the asset and the high quality team associated with it have culminated in a very positive feasibility study released the end of last year. Arianne's Lac a Paul deposit alone is worth roughly $2 billion and yet its stock currently trades at $100M market cap. What Arianne never had going for it was a good macro environment. Right now, fertilizer prices act better, grain prices act better, fertilizer stocks act better and junior resource stocks act better. Arguably, this is the best macro environment that Arianne has ever faced so, to use another agricultural saying: when the sun is shining….

Lastly, and above all else, this is my opinion. As I always say, we (and I personally) own a lot of stock and I am biased, but I/we would not own so much if I/we didn't believe.