Fitch Downgrades PJSC Uralkali to 'BB-'/Stable on Completion of Share Buyback Tender

Fitch Ratings-London-05 October 2015: Fitch Ratings has downgraded PJSC Uralkali's Long-term Issuer Default Ratings (IDR) to 'BB-' from 'BB+'. The Outlook is Stable. This follows a last-minute increase in the amount of the second share buyback programme in 2015, leading to higher leverage while also underlining increased unpredictability around shareholder actions. The foreign currency senior unsecured rating on Uralkali Finance Limited's notes has been downgraded to 'BB-' from BB+.

The downgrade reflects Uralkali's weakened financial metrics and aggressive shareholder actions culminating in the departure of a key shareholder, Chengdong Investment Corporation (CIC). Following the completed USD2.06bn share buyback, we now forecast Uralkali's funds from operations (FFO) adjusted net leverage at 3.7x in 2015, an increase from the 3.2x we had expected following the initial buyback announcement. Leverage continues to remain considerably above our previous downgrade trigger of 2.5x to 2018, even when assuming no future shareholder returns. This places Uralkali's credit profile at 'BB-', after a two-notch discount for weak corporate governance.

A strong operational profile and robust cost position affords Uralkali a large degree of flexibility over the pace of de-leveraging which can lead to positive rating action once leverage returns to levels compatible with its ratings. However, this is contingent on clarity on the company's future capital structure and financial policy.

KEY RATING DRIVERS

Share Buybacks Increase Leverage

The recently completed USD2.06bn share buyback follows a USD1.1bn share buyback completed in June 2015, and has been funded by new bank debt (a repo transaction from VTB bank for USD800m) and available cash. The earlier buyback resulted in Uralkali's free float shrinking to 23% from 28%, and the recent buyback reduces this further to around 14%. This raises the possibility of a delisting of Uralkali's global depository receipts (GDRs) from the London Stock Exchange, leaving Moscow-based MICEX as the only stock exchange where Uralkali's equity can be traded, if this is not de-listed as well.

The share buybacks are accompanied by increased uncertainty on future dividend outflows and future buybacks as the company continues to adopt an unpredictable financial policy, which is leading to a less diversified shareholder structure. This comes at a time of lower production following the Solikamsk mine accident - which has led to accelerated capex - and weaker-than-expected potash price recovery, meaning FFO adjusted net leverage will increase to 3.7x in 2015.

Lower Production, Moderate Capex

The flood accident at Uralkali's Solikamsk-2 potash mine in 4Q14 resulted in output reduction to around 11mt in 2015 from 12.1mt in 2014. Production is not expected to return to 2014 levels until 2018 when new potash fields come on line. Uralkali has therefore accelerated expansion capex over the medium-term to restore production volumes and global market share over the next few years. Uralkali's decrease in earnings from lower production is, however, offset by rouble depreciation, which is contributing to lower rouble-based production costs versus US dollar-denominated revenues.

Pricing Broadly Flat

The break-up of the BPC potash cartel resulted in intensifying competition on prices since late 2013 as Uralkali fought to regain lost market shares. This was a stark departure from the supply-discipline that had characterised the market and underpinned the resilience of potash prices through the cycle. Spot potash prices remain at levels of around USD300/t, reflecting the fundamental rebasing of potash prices at a lower level. Fitch forecasts a prudent USD5/t increase in potash prices per year in 2016-2017. However, we believe that low potash prices will continue, given significant excessive capacity in the market as well as potential capacity coming on in Canada and a low grain price environment in the short term.

Leverage Drives Downgrade

Under our base case, Uralkali's vertical integration and competitive cost base should support EBITDA margins of 55%-60% through the cycle. We forecast FFO adjusted net leverage will increase to 3.7x in 2015 following its two share buybacks. We expect it to remain above our previous downgrade trigger of 2.5x until 2018, due to higher capex as well as lower prices and production and also due to the potential for further creditor negative events to weaken the balance sheet.

Corporate Governance

Fitch extended the corporate governance discount to Uralkali to two notches from one notch, following the July 2015 USD1.1bn share buyback and the commencement of a discretionary dividend policy. The shareholder structure is becoming more concentrated that Fitch no longer sees a balance of interests across all stakeholders, with the buyback favouring certain large shareholders at the expense of creditors.

Country and Industry Risks

Rating constraints include Uralkali's full exposure to the potash demand cycle. In Fitch's view, combined with the high contribution of emerging markets to revenues (64% in 2014, excluding Russia), this implies higher earnings volatility than for more diversified peers. Although these markets present strong growth potential, they also tend to exhibit more erratic demand patterns than mature agricultural regions.

Operational risks are also higher in potash mining than other fertilisers as water-soluble salt deposits are susceptible to flooding. Finally, the ratings are constrained by the higher-than-average legal, business and regulatory risks associated with Russia (BBB-/Negative/F3).

KEY ASSUMPTIONS

Fitch's key assumptions within the rating case for Uralkali include

-- USD300/t potash export price in 2015 with prudent USD5/t annual growth in 2016-2017

-- Output gradually recovering to 12mt by 2018 from 11mt in 2015

-- USD/RUB at 60 in 2015, rising to 55 thereafter

-- Modest capex acceleration to USD0.7bn-USD0.8bn in 2016-2018 from USD0.4bn in 2015

-- Shareholder distributions of USD0.5bn annually from 2016

RATING SENSITIVITIES

Negative: Future developments that could lead to negative rating action include:

--A further lower rebasing of potash prices, material disruptions and decrease in production or a continued aggressive financial policy resulting in FFO adjusted net leverage above 4x over the next two years.

--Further aggressive shareholder actions that become detrimental to the operation and financial profile of Uralkali leading to a larger corporate governance discount.

Positive: Future developments that could lead to positive rating action include:

--Re-establishment of financial policies and clarity of the shareholder structure, coupled with an improvement in potash pricing and higher production, resulting in FFO adjusted net leverage sustainably below 2.5x.

LIQUIDITY

Uralkali's liquidity is adequate with USD2.5bn of available cash at end-2014, USD1.1bn free cash flow generation forecast over 2015 and USD800m raised under the VTB repo structure, against USD0.7bn short-term financial obligations and USD3.16bn of share buybacks. Liquidity for 2016 should also remain adequate assuming continued access to Russian loan markets and strong free cash flows, unless significant shareholder distributions are made. Uralkali continues to have access to capital markets, as demonstrated by signing a recent four-year pre-export financing loan of USD655m.

In accordance with Fitch's policies the issuer appealed and provided additional information to Fitch that resulted in a rating action that is different than the original rating committee outcome.

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria
Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage (pub. 17 Aug 2015)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
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