Nat Resources & Energy
Chemicals
Equity – Israel

Israel Chemicals

Downgrade to Neutral (V); K+S cuts potash price; could be first crack in industry discipline

- **K+S reduces European spot potash prices from USD750/tn to USD610/tn, undermining our view on industry discipline**
- **We now model 2H09 contract at USD580/tn and spot at USD660/tn, down from USD770/tn and USD715/tn previously**
- **We lower our target price from ILS56 to ILS44, and downgrade our rating from Overweight (V) to Neutral (V)**

Neutral (V)

Target price (ILS)	**44.00**
Share price (ILS)	**38.06**
Potential total return (%)	**15.6**

Performance	1M	3M	12M
Absolute (%)	-5.3	21.6	-52.5
Relative^ (%)	-6.4	-4.5	-36.3

Index^	TA-100 INDEX
RIC	ICL.TA
Bloomberg	ICL IT
Market cap (USDm)	12,165
Market cap (ILSm)	48,145
Enterprise value (USDm)	13033
Free float (%)	38

Note: (V) = volatile (please see disclosure appendix)

K+S (SDF GR, Overweight (V), EUR60) yesterday announced that it is lowering spot potash prices in Europe from c USD750/tn to c USD610/tn (EUR555 to EUR435), as well as cutting up to 2m more tonnes of production during 2H09. We view this move to be negative on two fronts. In the near term, falling spot prices in Europe may spread into other geographies, as well as depress the outcome of the Chinese contract price talks. More importantly, K+S has traditionally been a price taker within the highly-concentrated potash industry structure, up until now led by Uralkali (BPC) and Potash Corp (Canpotex). This unexpected move by K+S may indicate the first break in industry and pricing cohesiveness and undercuts our outlook for potash pricing power.

We had been expecting a China contract price and global spot price in the USD750/tn range during 2009, based on steadfast price discipline among manufacturers. Production cuts would keep supply close to demand, and even as purchase volumes plummeted, tight markets would allow producers to stave off demands for price discounts, especially in contract talks with China and India.

Up until now, it seemed as if this would be the case, as producers absorbed volume drops of up to 70% while waiting for a contract outcome equal to or higher than 2008's price. K+S' move undermines our view of the unity of purpose amongst producers, and the industry's ability to maximise prices. **We now think contract prices may end up between USD600-550/tn, and spot prices may range from USD750-600/tn**. Weighting the scenario of probabilities, we now forecast ICL's 2H09 contract revenues atUSD565/tn; spot of USD655/tn, and an average FY09 received price of USD620/tn. These fall from USD770/tn, USD715/tn, and USD720/tn respectively. These reductions drive our drop in target price from ILS56 to ILS44 and rating from Overweight (V) to Neutral (V).

We now wait to see what impact, if any, K+S' announcement has on the timing and price **outcome of the China negotiations**. We also look for signs that the USD610/tn price is spreading to other geographies, **or other signals of deteriorating discipline**.

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Financials & valuation

Financial statements

Year to	12/2008a	12/2009e	12/2010e	12/2011e
Profit & loss summary (USDm)				
Revenue	6,904	4,316	5,817	6,197
EBITDA	2,565	1,284	2,430	2,473
Depreciation & amortisation	-230	-191	-206	-212
Operating profit/EBIT	2,335	1,093	2,224	2,261
Net interest	-122	-61	-57	-40
PBT	2,227	1,033	2,169	2,222
HSBC PBT	2,227	1,033	2,169	2,222
Taxation	-233	-228	-412	-477
Net profit	2,004	811	1,757	1,744
HSBC net profit	2,004	811	1,757	1,744
Cash flow summary (USDm)				
Cash flow from operations	1,884	1,027	1,998	2,201
Capex	-320	-343	-268	-233
Cash flow from investment	-511	-343	-268	-233
Dividends	-966	-405	-878	-1,047
Change in net debt	-137	-284	-852	-921
FCF equity	1,587	707	1,633	1,943
Balance sheet summary (USDm)				
Intangible fixed assets	0	0	0	0
Tangible fixed assets	1,907	2,060	2,122	2,143
Current assets	3,803	3,767	4,711	5,550
Cash & others	340	529	1,381	2,302
Total assets	5,738	5,854	6,860	7,720
Operating liabilities	1,670	1,471	1,599	1,761
Gross debt	1,446	1,350	1,350	1,350
Net debt	1,105	821	-31	-952
Shareholders funds	2,443	2,848	3,727	4,424
Invested capital	3,700	3,827	3,853	3,630

Ratio, growth and per share analysis

Year to	12/2008a	12/2009e	12/2010e	12/2011e
Y-o-y % change				
Revenue	68.4	-37.5	34.8	6.5
EBITDA	181.8	-50.0	89.3	1.7
Operating profit	226.8	-53.2	103.5	1.6
PBT	245.2	-53.6	109.8	2.5
HSBC EPS	273.8	-59.6	116.7	-0.7
Ratios (%)				
Revenue/IC (x)	2.0	1.1	1.5	1.7
ROIC	61.1	22.6	46.9	47.4
ROE	94.6	30.6	53.4	42.8
ROA	38.5	13.9	27.6	23.9
EBITDA margin	37.2	29.7	41.8	39.9
Operating profit margin	33.8	25.3	38.2	36.5
EBITDA/net interest (x)	21.0	21.2	42.7	62.0
Net debt/equity	44.0	28.1	-0.8	-21.2
Net debt/EBITDA (x)	0.4	0.6	0.0	-0.4
CF from operations/net debt	170.5	125.1		
Per share data (USD)				
EPS reported (fully diluted)	1.56	0.63	1.37	1.36
HSBC EPS (fully diluted)	1.56	0.63	1.37	1.36
DPS	1.17	0.32	0.68	0.81
Book value	1.91	2.22	2.91	3.46

Key forecast drivers

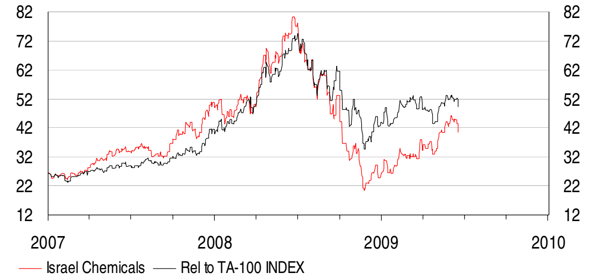
Year to	12/2008a	12/2009e	12/2010e	12/2011e
Avg. Potash price (USD/tn)	542	623	636	642
Potash produced (m tn)	5.0	4.5	5.4	5.8
Potash capacity utilisation %	90.3	78.5	89.8	91.6
Gross margin %	50.0	41.9	55.5	51.0
EBITDA margin %	37.2	29.7	41.8	39.9
Net margin %	29.0	18.8	30.2	28.1

Valuation data

Year to	12/2008a	12/2009e	12/2010e	12/2011e
EV/sales	1.9	3.0	2.1	1.8
EV/EBITDA	5.2	10.2	5.0	4.6
EV/IC	3.6	3.4	3.2	3.1
PE*	6.2	15.3	7.0	7.1
P/Book value	5.0	4.3	3.3	2.8
FCF yield (%)	13.0	5.8	13.4	15.9
Dividend yield (%)	12.2	3.3	7.1	8.5

Note: * = Based on HSBC EPS (fully diluted)

Price relative



Source: HSBC

Note: price at close of 18 Jun 2009

Lower price scenarios based on weaker industry discipline

While the notional damage to our perception of producer discipline causes us to discard our "higher than last year" price thesis, the practical implications of K+S' announcement do not indicate a total meltdown for potash netbacks in the period to come. This is because we believe K+S' low presence outside the European market may prevent the spread of the new rate if other manufacturers stick to their current strategy. We roughly estimate that the German firm will cut 2.0m tonnes of production, making between 2.0-2.6m tonnes of potash in FY09. This represents 4.5%-6.0% of the global market in the current year. K+S sells primarily to Europe, with only 30% of volumes exported to Latam and Asia in a good year. Given poor demand in 2009, we think K+S exports could be significantly less than this. Other producers are trying their best to deal with lower demand by shuttering capacity. The test will be to keep production down and maintain consistent spot prices elsewhere; if exports from Europe are limited, the affect of K+S's announcement could effectively be ringfenced to continental European markets only.

Potash industry shuttering, in '000 tonnes

Supply in FY2008	Production cuts in 1H09							Supply 2009 YTD
	K+S	Uralkali	Silvinit	Mosaic	PotashCorp	Agrium	Belaruskali	
52,000	2,000	800	750	1,000	4,700	550	1,875	40,325
								-22.5%

Source: HSBC estimates, company reports, Fertilizer Week

Scenario A: The K+S USD600 spot price becomes prevalent in the rest of world from USD750 currently. China demands a discount of USD100 to spot, and the BPC, sensing deteriorating cohesiveness amongst other suppliers agrees to a CFR equivalent (FOB + shipping) price of USD500/tn for 2009. This would fall from a CFR equivalent of USD650/tn (USD590/tn FOB + USD60/tn shipping) in 2008. We estimate a 25% probability of this occurring.

Scenario B: Shipping rate differentials and only a small degree of exports from Europe mean that the K+S USD600 spot price moderately impacts the rest of world. Brazil spot fall to falls to USD700/tn. China sees that discipline is not that damaged, and agrees to pay USD575/tn CFR equivalent, which is a more modest discount from last year's price. We estimate a 45% probability of this occurring.

Scenario C: No exports from Europe mean the K+S announcement has no repercussions for world spot prices. Other potash makers continue to cut production, maintaining unity on offshore prices. Brazil spot is unchanged at USD750/tn. China sees that discipline is largely intact, and agrees to pay USD600/tn CFR equivalent, a slight discount from last year's price. We estimate a 25% probability of this occurring.

Spot and contract potash price scenarios, USD/tn

Probability	Brazil & Other spot	European spot	China Contract	ICL avg 3Q09 received	ICL avg 4Q09 received	ICL avg FY09 received	ICL avg FY10 received	ICL Target price (ILS)
Scenario A: 25%	650	600	500	555	555	587	597	39.5
Scenario B: 45%	700	600	575	605	611	628	641	44.7
Scenario C: 30%	750	600	600	626	636	646	659	46.9
Weighted average result	700	600	565	599	605	623	635	44.0
Previous estimate	750	750	750	739	739	720	747	59.0

Source: HSBC estimates

Agriculture fundamentals still intact

We still believe that agricultural trends remain healthy for investors. Poor weather, the financial crisis, and lower use of nutrients have led to a drop in yields and production during the 2008/09 season, while demand remains strong. This is applicable to both corn and especially soybeans. The latter is particularly relevant as the new 2009/10 season will kick off in September in Brazil, where soybeans are dominant. We think Latam soy farmers are in good shape exiting 2008/09. We calculate that as group, soy farmers made just as much or even more revenue in the current year than in 2007/08, due mainly to timing of forward sales and a favourable USD/BRL exchange rate. In addition, the Brazilian government is announcing a USD45bn aid package to farmers for 2009/10. Nutrient destocking has completed, and Potash Corp's CEO, Bill Doyle, predicted that the country will restart imports of 4m tonnes of potash between July and October 2009. While the move by K+S may cause us to question the structure of the potash industry and its ability to maximise prices, we do not doubt the underlying demand growth story of more intensive use of fertilisers in agriculture over the years to come.

Forecasts

Lower expected potash prices are the main driver of our lower revenue and profits forecasts for Israel Chemicals. In addition, we raise our expected external sales volumes by c 7% from 2.5m to 2.7m, as we believe that lower prices will somewhat increase demand. Following 1Q09 results, we raise our estimate for 2Q09e gross margin, accounting for the fact that lower production volumes across the company reduce the absolute amount of COGS. Finally, we tweak upward our revenue estimates at ICL-IP and ICL-PP to smooth out declining sales over FY09.

ICL P&L: changes to HSBC forecasts 2009e-10e, in USDm except EPS

	New forecasts					Old forecasts				
	2Q09e	3Q09e	4Q09e	FY09e	FY10e	2Q09e	3Q09e	4Q09e	FY09e	FY10e
Revenues	900.2	1,254.3	1,263.3	4,316.2	5,817.0	863.7	1,458.7	1,307.3	4,528.2	6,288.0
Cost of Sales	540.9	693.8	742.0	2,506.1	2,806.8	634.2	693.8	742.0	2,599.4	2,911.3
Gross Profit	359.2	560.5	521.4	1,810.1	3,010.2	229.5	765.0	565.3	1,928.8	3,376.8
Operating Exp.	162.4	202.2	189.1	717.2	785.9	162.4	202.2	189.1	717.2	785.9
Operating Profit	196.9	358.3	332.2	1,093.0	2,224.3	67.1	562.7	376.2	1,211.7	2,590.9
Pre-Tax Income	169.1	330.5	304.5	1,032.3	2,167.4	39.4	535.0	348.4	1,151.0	2,533.3
Income Taxes	32.1	62.8	57.9	228.3	411.8	7.5	101.6	66.2	250.9	481.3
Net Income	137.1	267.9	246.8	810.6	1,756.7	32.1	433.5	282.4	906.7	2,053.0
EPS (diluted) ILS	0.11	0.21	0.20	0.63	1.37	0.03	0.34	0.22	0.72	1.50

Source: HSBC estimates

Valuation

We reduce out target price for ICL from ILS56 to ILS44 per share using a DCF analysis, with a 12.0% cost of capital (WACC) and a 3.0% terminal growth rate. Our WACC is based on a risk-free rate of 5.5%, equity risk premium of 4.5%, beta of 2.05 and pretax cost of debt of 5%. We increase our WACC from 11.0%, as we increase our beta from 1.75 to 2.05, to account for major risks surrounding the potash industry at the moment. Using the former WACC of 11.0% would result in a price target of ILS50.1 per share. (We use a forward-looking beta to capture increased industry risk. Historical two-year beta stands at 1.4.)

Our revised target price indicates a potential return of 15.6%. HSBC's ratings methodology assigns a Neutral (V) rating for volatile shares with a potential return within 10.0% above or below the 11.0% equity return hurdle rate set for shares traded in Israel. We thus reduce our rating from Overweight (V) to Neutral (V) on ICL shares.

ICL peer comparison

Name	RIC	EV/Revenue (x) 2009e	EV/Revenue (x) 2010e	EV/EBITDA (x) 2009e	EV/EBITDA (x) 2010e	PE (x) 2009e	PE (x) 2010e
Potash Corp.	POT	5.7	3.9	11.3	7.1	13.2	8.8
K+S	SDFG.DE	2.0	1.7	7.9	6.2	10.8	8.4
Agrium	AGU	0.9	0.9	6.7	4.9	10.4	6.7
Mosaic	MOS	2.1	2.2	7.3	6.1	11.0	8.7
Uralkali	URKA.RTS	3.8	2.9	5.7	4.2	7.6	5.3
Avg. comparables excl. Uralkali		2.7	2.2	8.3	6.1	11.4	8.2
Avg. comparables incl. Uralkali		2.9	2.3	7.8	5.7	10.6	7.6
Israel Chemicals at ILS38	ICL.TA	3.0	2.1	10.2	5.0	15.3	7.0
Israel Chemicals at ILS44		3.4	2.4	11.4	5.7	17.0	7.9

Note: ICL priced at 18 Jun 09 and others at 17 Jun 09: Potash Corp (POT US, not rated, USD95.6); K+S (SDF GR, Neutral (V), EUR49.3, TP: EUR60.0]); Agrium (AGU US, not rated, USD42.8); Mosaic (MOS US, not rated, USD46.3); Uralkali, (URKA RU, not rated, USD3.5), Israel Chemicals (ICL IT, Neutral (V), ILS38.06, TP: ILS44).
Source: Company data, HSBC estimates for Israel Chemicals and K+S, Reuters for other companies

Risks

We raise our forward-looking beta for ICL from 1.75 to 2.05 to capture the increased riskiness of the potash industry.

- ***Short term: the outcome of the ongoing Chinese contract price*** is a main indicator for prices and thus ICL's revenues and profits in 2009. The possibility that Russian potash producers will agree to Chinese demands for lower prices in 2009 is amplified by K+S lowering spot prices in Europe. A stronger than expected price, resulting from these negotiations would be an upside risk.

- ***Long term: industry price and volume discipline.*** The potash industry has been able to maximise prices for its product in the past fours years by maintaining unity of purpose amongst producers, i.e. favouring price over volume. K+S's move could be first crack in industry discipline, auguring poorly for future price trends.

- The main company-specific risk in 2009 is cost trends. Lower volumes and prices reduce profits, but dramatic declines in costs dampen the shock of lower revenues to some extent and could lead to upside risk. If input price inflation again takes hold and ICL experiences both lower revenues and higher costs, profit and valuation contraction could be severe.

- The main upside risk is that agriculture fundamentals remain strong, and we still believe demand for fertilisers will grow over the coming years. This would be positive for ICL's revenue streams.

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For each stock we set a required rate of return calculated from the risk free rate for that stock's domestic, or as appropriate, regional market and the relevant equity risk premium established by our strategy team. The price target for a stock represents the value the analyst expects the stock to reach over our performance horizon. The performance horizon is 12 months. For a stock to be classified as Overweight, the implied return must exceed the required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock must be expected to underperform its required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands are classified as Neutral.

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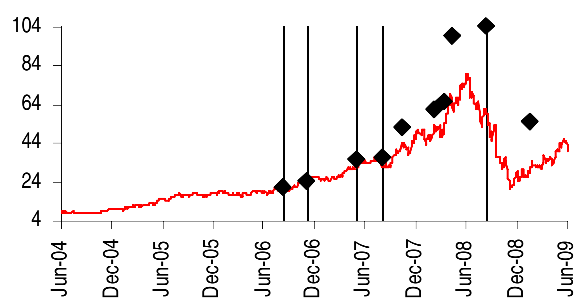
Overweight (Buy)	34%	(33% of these provided with Investment Banking Services)
Neutral (Hold)	39%	(31% of these provided with Investment Banking Services)
Underweight (Sell)	27%	(28% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities

Israel Chemicals (ICL.TA) Share Price performance ILS Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Overweight	Neutral	24 August 2006
Neutral	Underweight	20 November 2006
Underweight	Neutral	15 May 2007
Neutral	Overweight	21 August 2007
Overweight	Overweight (V)	26 August 2008
Target Price	**Value**	**Date**
Price 1	21.45	24 August 2006
Price 2	24.30	20 November 2006
Price 3	36.00	15 May 2007
Price 4	37.30	21 August 2007
Price 5	52.00	01 November 2007
Price 6	61.50	25 February 2008
Price 7	66.00	26 March 2008
Price 8	100.00	28 April 2008
Price 9	105.00	26 August 2008
Price 10	56.00	04 February 2009

Source: HSBC

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Company	Ticker	Recent price	Price Date	Disclosure
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Source: HSBC

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