

Drought & fertilizer stocks

Fertilizer demand likely to accelerate

In a worst case scenario, China may lose about 15mt or 13% of its wheat crop in 2009 as a result of the severe drought in the North. While this may have little impact on the domestic wheat price and import/export, fertilizer demand may pick up substantially. Key beneficiaries, in our view, include China Bluechem (CBLUF, HK\$4.26 C-1-7, Buy) and Sinofert (SNFRF, HK\$3.98, C-1-7, Buy).

Once every 30 years drought has hit China

Nevertheless, judging from the government's comment, the severity seems less than that in 2000 when China lost around 13% of its wheat production.

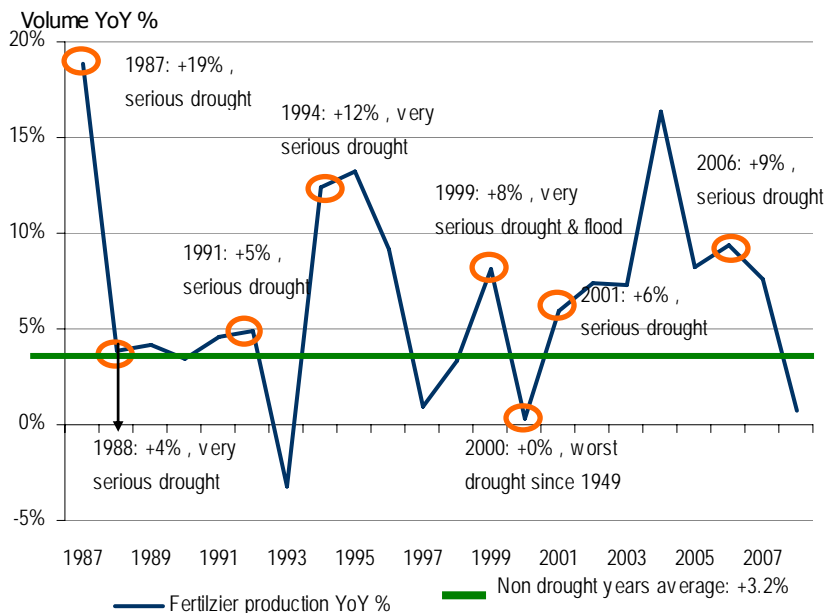
Little impact on wheat price/trade

Due to ample reserves and government's reluctance to import, we believe that the drop in output will unlikely impact China's wheat price and imports much.

Fertilizer the big winner

Since 1987, fertilizer demand in China grew on average 7.9% in drought years, more than double the 3.2% average in non-drought years. As a result, we believe that the chance of a significant pick up in fertilizer demand is high.

Chart 1: YoY growth of fertilizer production in China



Source: CEIC, BAS-ML research

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Worst case probably a loss of 15mt or 13%

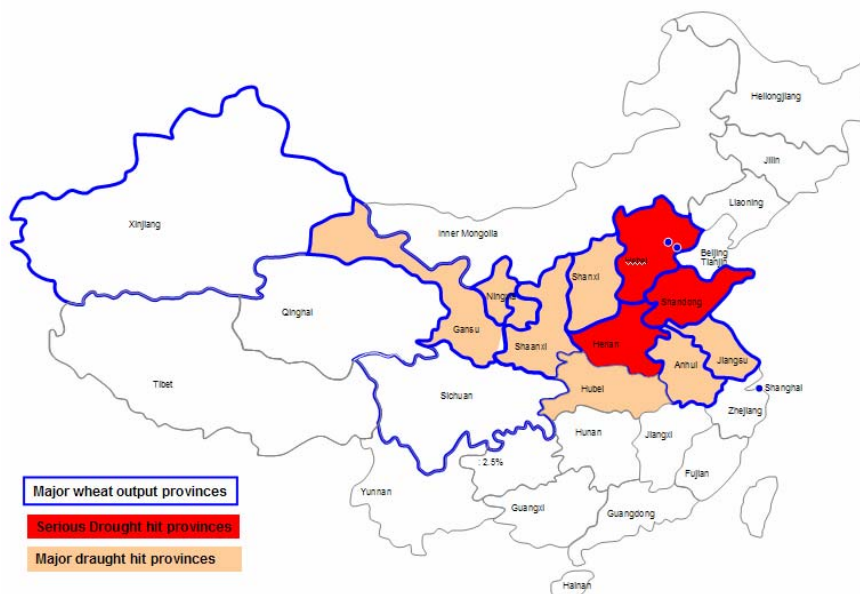
In recent months, a drought that normally only occurs once every 30 years has hit all the major wheat producing regions in China, with the top three output provinces suffering particularly hard blows (Table 1, Chart 2).

Table 1: Major wheat producing area hit by the drought

Producing region	Acreage (mn Mus)	Winter wheat (mn Mus)	Spring wheat (mn Mus)	07 output ('000 tons)	% of total %	Hit by the drought	08 output ('000 tons)
Henan	78	76	2	29,802	27.3%	Y	
Shandong	53	53	-	19,956	18.3%	Y	
Hebei	36	36	-	11,937	10.9%	Y	
Anhui	35	35	-	11,113	10.2%	Y	
Jiangsu	31	26	5	9,738	8.9%	Y	
Sichuan	20	17	3	4,517	4.1%		
Shaanxi	17	17	-	3,591	3.3%	Y	
Hubei	16	16	-	3,532	3.2%	Y	
Xinjiang	9	7	3	3,413	3.1%	Y	
Gansu	15	9	6	2,374	2.2%	Y	
Others	46	36	10	9,325	8.5%		
Total	356	328	28	109,298	100.0%		112,500

Source: China News, Xinhua, NBS, BAS-ML research

Chart 2: Wheat producing area in North China has been hit hard



Source: Xinhua, BAS-ML research

According to Xinhua's latest report on Feb 12, so far the drought has affected about a third (118mn Mus) of China's wheat producing acreage, out of which, 35mn Mus (approximately 10%) seriously. Chinese farmers grow two crops of wheat each year: the winter crop and the spring crop. The winter crop (Aug-May growth season) is far more important than the spring one and is suffering from the drought. March-April rainfall is critical. If the drought drags on until then, it may mean disaster for both crops.

Coming up with an estimate of how much wheat production this year will be lost is a difficult task, partly because the season is not yet over and partly because of a lack of information. Nevertheless, we take comfort in the fact that China's wheat output never dropped by more than 13% YoY unless the government was distracted by political turmoil (Table 2).

Table 2: No drought caused >13% of wheat output loss (1949-2008)

Year	Description	Affected area	Output YoY%	
			Wheat	Rice
1959	Very serious drought	North & South China	-2%	-14%
1960	Extreme drought	North & South China	0%	-14%
1972	Very serious drought	Central China	10%	-2%
1987	Serious drought	North & South China	-3%	1%
1988	Very serious drought	Central China	-3%	-3%
1991	Serious drought	South China	-2%	-3%
1994	Very serious drought	North China	-7%	-1%
1999	Very serious drought & very serious flood	North China	4%	0%
2000	Worst drought since 1949	North & South China	-13%	-5%
2001	Serious drought	North & South China	-6%	-5%
2006	Serious drought	Central China	11%	1%
2008-2009	An event for every 30 years	North China	??	NA

Source: CEIC, China Ministry of Water Resources, BAS-ML research

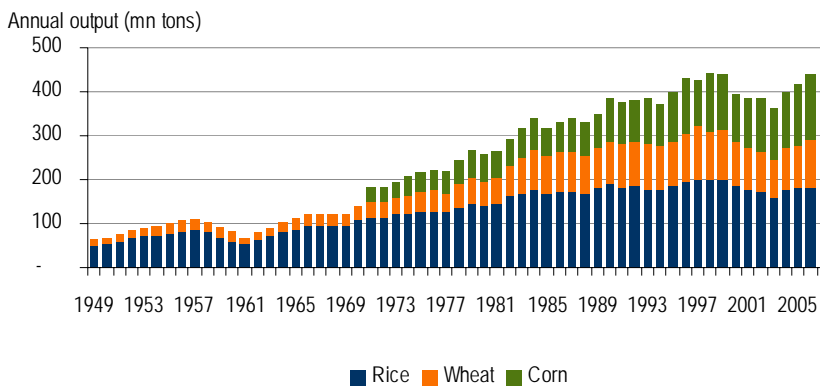
Even “the worst drought since 1949” (by China Ministry of Water Resources) in 2000 only reduced China’s wheat output by 13% (rice was -5% YoY). China Meteorological Administration has categorized the latest drought as “an event every 30 years”, indicating that it’s less severe than the one we experienced in 2000. Chinese government’s intensified effort is another assurance. The central government has granted a special fund of Rmb400mn, and several provincial governments have vowed to match or put in more. The central government also ordered affected provinces to treat drought fighting as their first priority, and “to irrigate land at any cost”, according to Xinhua on Feb 9.

A 13% output loss will translate into about 15mt of wheat, based on a total output of 113mt in 2008.

Impact on food safety

Wheat accounts for about a quarter of China’s grain output in 2007 (Chart 3) and is mostly consumed by humans (about 1% was used in animal feed in 2006).

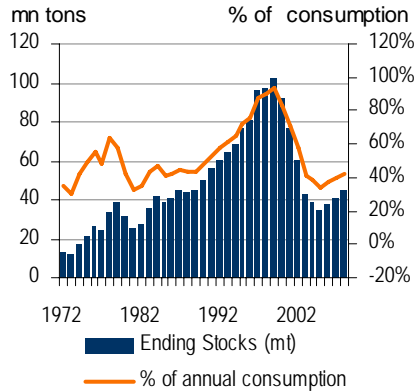
Chart 3: Wheat: 24% of 2007’s total grain output



Source: CEIC, BAS-ML research

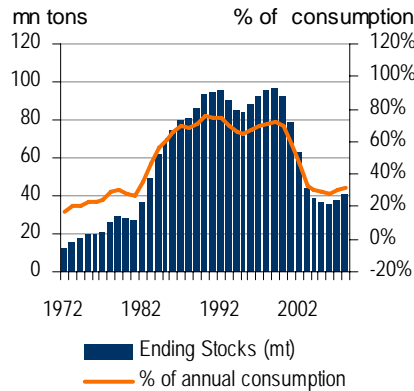
Among grains, wheat has the highest inventory level relative to consumption (Chart 4-6).

Chart 4: China's wheat inventory: 42% of 2008's annual consumption



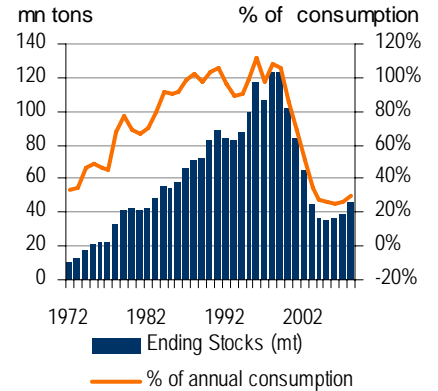
Source: USDA, BAS-ML research

Chart 5: China's rice inventory: 32% at 2008's annual consumption



Source: USDA, BAS-ML research

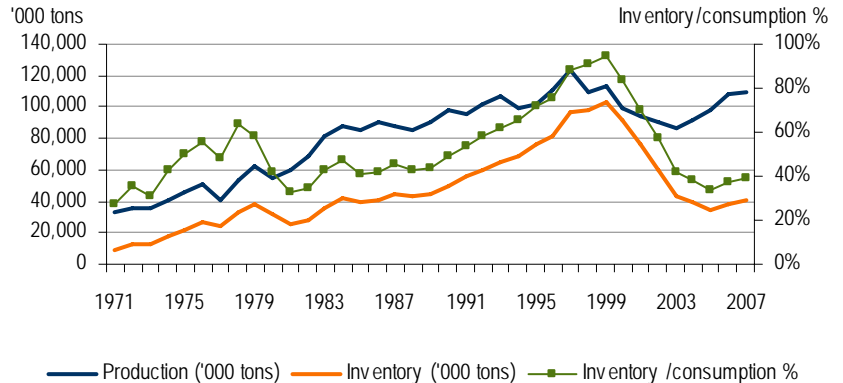
Chart 6: China's corn inventory: 29% at 2008's annual consumption



Source: USDA, BAS-ML research

According to the US Department of Agriculture (USDA), China held 45mt of wheat inventory as at the end of 2008, representing about 42% of China's 2008 consumption (Chart 7). A 15mt output loss will lower China's inventory level to about 28% of 2008 consumption, still well above FAO's recommended grain safety level (inventory at 18% of consumption).

Chart 7: China wheat inventory: stable recently at 38-40% of annual consumption



Source: USDA, BAS-ML research

Impact on price/rural income

As grain prices are tightly controlled in China through a minimum purchasing price (MPP) mechanism, to compensate a 13% drop in volume, the government needs to raise the wheat price by approximately 15%. Given that the government just increased its wheat MPP by 15% in Oct 08, it's difficult to see that it will raise it again so soon. More likely we believe that some form of direct subsidies to farmers will be paid to maintain their income. A 15mt loss in output represents a one-off economic loss of Rmb26bn at Rmb1,740/ton, or about 0.4% of the government's 2008 fiscal income, so well within the government's capabilities.

If MPP of wheat is raised substantially again contrary to our current expectations, it may have some minor cost impact on wheat users such as Tingyi (TCYMF, 322 HK, HK\$8.48, C-3-7, Underperform) and Synear (SYNRF, SG\$0.235, not rated) according to our consumer analyst Denise Chai.

Table 3: China: 2% of 2008 world's wheat trade

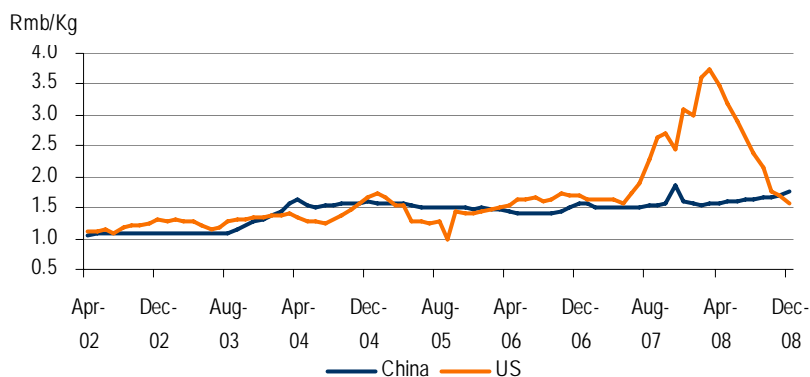
Country	Export volume ('000 tons)	% of 2008 world total	Ranking
United States	27,216	22%	1
Canada	19,000	15%	2
EU-27	19,000	15%	3
Russian	15,000	12%	4
Australia	13,000	10%	5
Ukraine	9,000	7%	6
Kazakhstan	5,200	4%	7
Argentina	4,300	3%	8
Pakistan	2,400	2%	9
China	2,000	2%	10
Subtotal	80,216	65%	

Source: USDA, BAS-ML research

Impact on wheat import & export

We don't expect any major pick up in wheat imports as a result of the drought. Even with a 13% output loss, China should not be in a great hurry to restock given the healthy inventory situation. If China imports any significant quantity, it would add pressure on the domestic wheat price, thus farmers' income. Given that raising farmers' income is a key initiative for the government, partly to help domestic consumption, it's quite likely that the government will refrain from large scale importing of wheat even though the current market price in the international market is attractive (Chart 8).

Chart 8: China wheat wholesale price: now above global price



Source: MOA, Bloomberg, BAS-ML research

Some cut to exports is possible. But this shouldn't create any major issue in the international wheat market as China has been a minor player (Table 3).

Impact on fertilizer

Wheat accounts for about a fifth of China fertilizer demand, according to Wheat Analysis. The drought may help fertilizer demand in China by our assessment.

It's true that farmers won't apply fertilizer to dry fields where crops are doomed, but they normally apply more fertilizer to the remaining crop for better yield. March – May is the critical period for the winter crop, and fertilizer demand during this period usually accounts for half of wheat's total needs. In addition, China's practice for fighting drought is still the traditional way of flooding the whole field with water, instead of drip irrigation. This practice inevitably leads to too much water in the field. Unfortunately, all nitrogen, phosphate and potash fertilizers can easily be carried away by water, so the high water content will substantially lower fertilizer' effectiveness. This forces farmers to apply even more fertilizer. In fact, Mr. WEI Zhaoan, deputy head of MOA, urged farmers to do so at a State Council's news conference on Feb 12.

History data seems to support our view. In Table 4, we examine fertilizer production growth during drought years. We use production as a proxy for demand as sales/demand data is unavailable. The average growth during drought years since 1987 is 7.9% with the worst case at 0% and best at 19%.

Table 4: Fertilizer production on average +8% YoY during drought years.

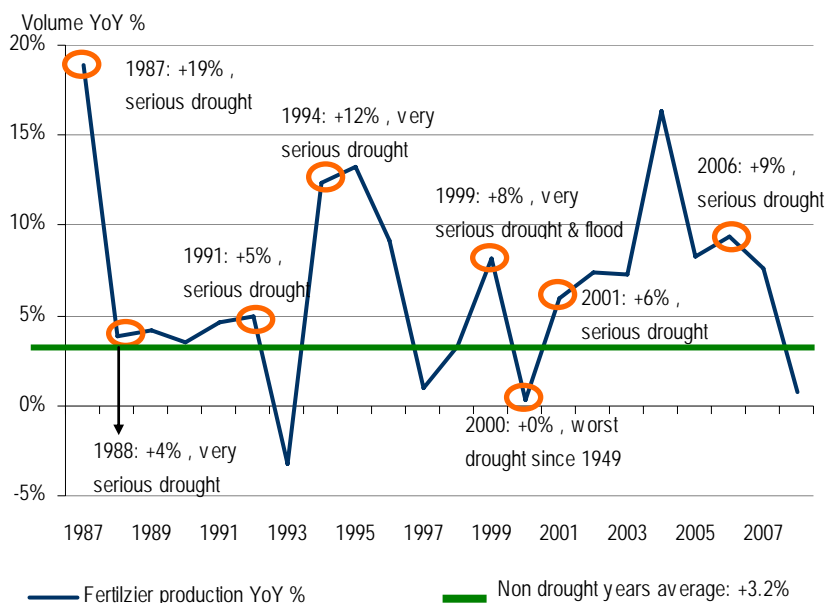
Year	Description	Affected area	Fertilizer demand YoY %
1987	Serious drought	North & South China	19%
1988	Very serious drought	Central China	4%
1991	Serious drought	South China	5%
1994	Very serious drought	North China	12%
1999	Very serious drought & very serious flood	North China	8%
2000	Worst drought since 1949	North & South China	0%
2001	Serious drought	North & South China	6%
2006	Serious drought	Central China	9%
2008-2009	An event for every 30 years	North China	??

Demand growth- best case: drought only	19%
Demand growth- worst case: drought only	0%
On average : drought only	8%

Source: CEIC, China Ministry of Water Resources, BAS-ML research

Average growth rate for non-drought years is 3.2% during the same period (Chart 9).

Chart 9: China history of fertilizers' demand (1987-2008)



Source: CEIC, BAS-ML research

On balance, we expect China Bluechem and Sinofert to be net beneficiaries of the drought. With any acceleration in demand, fertilizer prices are expected to rise. There is a risk that the government may place a price cap on fertilizers in drought stricken areas. But we remain doubtful about the effectiveness of such price control in China.

Based on BAS-ML estimates, for every 10% rise in urea price, China Bluechem's FY09 earnings will increase by approximately 20%; for every 10% rise in phosphate (DAP) price, a more modest 5% impact on earnings.

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