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Crookes Brothers Ltd

Promising medium-term prospects as key projects come online

Background

Crookes Brothers produces agricultural products including sugar cane, bananas and deciduous fruit. It has operations in SA, Swaziland and Zambia. A new farming operation is also under development in Mozambique to produce macadamia nuts, annual crops and bananas.

Our Thoughts

Crookes posted some very good numbers for the year to end-February, with strong performances from its main sugar operations as well as its banana produce. Profit margins expanded nicely, which saw attributable earnings end 33% higher.

However, investors have not been eager to stock up on the counter – its share price has been moving sideways since the release of the results. We think some were discouraged by management's cautious outlook for FY18. Management says it expects banana and cane prices to come under pressure as production and supply on the market recovers. Any decline on the selling prices for these two key products will certainly hurt the bottom line. The group is also planning large-scale replanting of drought-damaged fields in Mpumalanga. Farms in Mpumalanga account for close to half of Crookes' planted area, so the replanting may curtail sugar production volumes, which will also hurt earnings.

The ongoing drought in the Western Cape, where Crookes' deciduous fruit operations are based, is also a major concern. When water availability is under pressure, young trees' growth is limited and mature trees carry less fruit. Fruit quality is also compromised, making it difficult to turn profits. If weather conditions do not improve this winter, the deciduous fruit operations are likely to end FY18 in a loss-making position. This is happening at a time when the continued strengthening of the rand against the basket of currencies of Crookes' export destinations is also putting pressure on the performance of the division.

Largely because of these factors we see the group's earnings coming under pressure during FY18. We therefore change our call from buy to hold. However, we still think the counter is a buy for long-term investors.

Approximately R400m of assets reflected on its balance sheet are in the development phase. The group owns about 1,800 hectares of agricultural land on the KwaZulu-Natal south coast that is earmarked for conversion into residential and commercial sites. Of that, 1,400ha – containing 350 developable hectares – have already been approved for rezoning, and the first project for the development of a lifestyle village is planned for this financial year.

There is also the macadamias project in Mozambique that is not yet contributing meaningfully to profits, but is expected to do so soon. The group made a sizeable investment for the development of 1,500ha of land in northern Mozambique for macadamia nuts and other annual cash crops. Management reported an excellent first harvest from this project but more value will come through in due course.

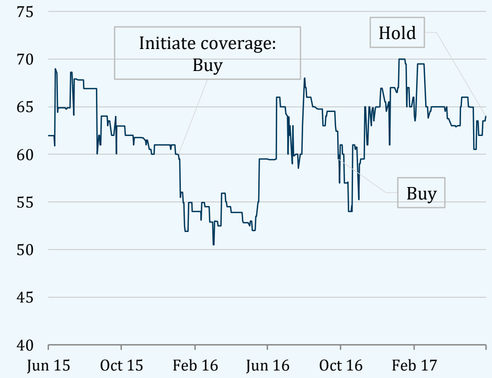
Adverse weather conditions are masking the substantial value about to be unlocked from the deciduous fruits assets. About four years ago, Crookes acquired High Noon deciduous orchards under its accelerated expansion and diversification programme. The purchase increased hectarage in the highly profitable deciduous fruits division to more than 650ha. Close to half of these orchards were replanted and are now approaching maturity. This is likely to see a rapid increase in fruit volumes if weather conditions improve, which will also bump up earnings.

Equity Research

HOLD

12-month target price	R55.86
Spot share price	R61.00
12-month implied return	-8.4%

Crookes share price



Source: I-Net BFA

Key statistics

Market cap: R976.92m

Price:earnings ratio: 15.09

Forward PE ratio (FY18): 8

Dividend yield: 2.58%

Forward dividend yield: 2.7%

Risk: High

12-month high: R70.00

12-month low: R54.00

Ave monthly volume: 35 180

Financial year-end: 31 March

Latest event

Final results

Date announced: 31 May 2017

Share details

Company: Crookes Brothers Ltd

JSE Code: CKS

Sector: Food producers

The impact of these projects on Crookes's financials will be significant. Crookes is predominantly a sugar company, but this will change: once the above initiatives come into full effect, we expect non-sugar operations to start dominating the group's financials.

Performance Review

RESULTS IN BRIEF	FY17	Change (%)	FY16
Turnover (R'm)	664	22%	543
Operating profit (R'm)	125	73%	72
Operating margin (%)	18.8%	42%	13.3%
Attributable earnings (R'm)	65	33%	49
Heps (cents)	424.1	16%	366.0

- The group's three divisions reported solid growth in revenue. The sugar and banana operations grew 21% and 27% respectively, benefiting from higher selling prices.
- Revenue from deciduous operations rose 21% despite a substantial decline in prices driven by rand strength, among other factors.
- Operating profit increased 73% despite a R10m operating loss recorded in the deciduous fruit segment. This saw the operating margin expanding to 18.8%.
- Much of that growth, however, was eaten by a massive increase in profits attributable to noncontrolling interests of R31.3m (2016: R1.1m). As of 1 April 2016, Crookes converted its rights to the balance of a lease over a major portion of the 2,500ha Komati Estate to a 20-year partnering arrangement with the Mawewe community.
- Headline earnings climbed 16% to 424.1c/share (FY16: 366c/share).
- Cash generated from operations grew 5% to R102m (2016: R97m).

Sensitivity analysis

	Terminal growth	2%	4%	6.0%
Wacc	9.2%	8 051	10 828	17 074
	11.2%	5 476	6 809	9 167
	12.2%	4 609	5 586	7 195
	14.2%	3 332	3 890	4 721
	15.2%	2 862	3 297	3 920

This reflects the sensitivity of our forecasts to assumptions of the terminal growth rate and the weighted average cost of capital (Wacc). The highlighted cell shows our target price in cents.

Valuation

In addition to the normal variables that affect businesses in SA such as exchange rate fluctuations, price volatility and labour disruptions, the agricultural industry is further affected by the vagaries of mother nature. Droughts, floods and diseases can occur with little warning. These exogenous factors increase the forecast risk for Crookes, but its crop and geographical diversification helps to smooth its earnings curve.

We value the stock using a discounted cash-flow model assuming a terminal growth rate of 3.5% and a discounting factor of 12.35%. We used a discounting factor that is slightly higher than average to compensate for the high volatility in the group's earnings. Noteworthy is the group's planned capital expenditure of R226m for FY18, which is going to be one of the highest in recent years. This will reduce free cash flow in FY18 but will bolster earnings and boost cash flows in the medium to long term. The group may also have to increase its borrowings, which will affect profits. Taking these and other assumptions into account, we arrive at a fundamental price of R55.86/share and a one-year forward price:earnings ratio of 7.8. We issue a hold opinion for its shares.

The next 12 months may be challenging as the group recovers from the effects of the drought

Bull Factors

- Diverse range of crops that are well-spread geographically mitigate climatic, regulatory and geopolitical risks
- Increased focus on non-sugar operations likely to enhance earnings and improve diversity

Bear Factors

- Earnings vulnerable to exogenous factors such as weather and volatile exchange rates
- Drought conditions in the Western Cape to materially affect profits

Financial forecasts summary	2017A	2018E	2019E	2020E
Operating profit (R'm)	125.2	125.0	180.0	196.3
Net operating profit after tax (R'm)	100.2	103.9	145.3	158.2
Working capital changes (R'm)	-51.5	-56.0	-62.4	66.6
Capital expenditures	-159.0	-226.0	-120.6	-102.4
Unlevered free cashflows (R'm)	-93.1	-156.7	-10.3	169.3
Headline earnings per share (cents)	27.1	786.8	1042.2	1015.5
PER (times)	225.1	7.8	5.9	6.0

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A buy recommendation is made where the target price is 10% above the current price, a sell when it is 10% below the current price, and a hold recommendation when it is within 10% of the current price. The risk measure is a subjective determination guided by the beta of the share price. We also examine the financial and operating leverage of the business.

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