

## The Company: Astral Foods Ltd

### Incoming minimum wage and rising feed costs threaten margins

#### Our call

**Hold**

Intellidex estimate of fair value: **R171.55**  
 Spot price: **R179.28**  
 Potential move: **-4.3%**

#### Astral's share price graph and Intellidex's previous calls



#### Background

Astral is a poultry and animal feeds producer. Its key activities entail manufacturing animal feeds, broiler genetics, the production and sale of day-old chicks and hatching eggs, integrated breeder and broiler production operations, abattoirs, and the sale and distribution of various poultry brands. The animal feeds operation is housed under the feed division and the rest under the poultry segment.

#### Sensitivity analysis

Terminal growth	1%	3%	5%
10,2%	21 330	24 124	29 067
12,2%	17 418	18 945	21 322
13,2%	15 979	17 155	18 906
15,2%	13 626	14 343	15 340
16,2%	12 697	13 270	14 047

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.

#### Investment thesis

The operating environment in the poultry industry during FY18 was near perfect. Broiler price inflation raced ahead of overall food price inflation for the bulk of the year, despite a continued inflow of imports and a depressed consumer environment. The costs of raw materials softened (on average) and there was no major disease outbreak. This was something of a perfect storm for poultry producers.

Astral delivered strong on-farm performances: increased production volumes, a solid feed conversion rate and low mortality rates. A better feed conversion rate means less feed was used to achieve the targeted broiler slaughter weights.

While we do not expect a replication of FY18, we see operating conditions in the chicken industry enabling

Astral to deliver solid earnings during FY19. Local maize prices have trended upwards over the past few months. However, analysts are not expecting maize prices to reach anywhere near 2016 levels when prices hit around R4,500/tonne. We also expect poultry pricing itself to come under pressure given the deteriorating consumer environment and rising chicken imports.

However, it is two other factors that we think will inflict the most pain on Astral's margins. The first is the recently promulgated National Minimum Wage Bill. The second is the July Constitutional Court ruling confirming the deeming provision (that an employee who earns R205,000 a year or less and is contracted through a labour broker becomes a permanent employee of the hiring firm after three months of employment).

It is difficult to estimate the exact quantum of the financial impact of these legislative changes on Astral because we do not have all the details we need. However, our worst-case scenario, which is what we have input into our valuation model, projects above-average growth in employment costs of 15% a year over the next three years.

Astral employs an average of 4,500 contract employees every year. A sizeable portion of those are contracted through labour brokers. A recent investigative report by City Press found that 580 employees at Astral's Oifantsfontein processing plant were employed through labour brokers with 80% being regarded as "permanent casuals". Such employees may now be deemed to be permanent Astral employees, which will require their salaries to be

equalised with those of other employees. They will also be entitled to benefits.

The minimum wage will require employers in the agriculture sector to pay their employees a minimum of R18/hour starting from 1 May 2019 and R20/hour from 1 May in 2021. City Press alleges that some of Astral's employees earn about R12.33/hour. Should that be the case, wages for such employees will have to be hiked by 46% to meet the minimum wage requirement.

After considering these issues and the group's plan to expand production capacity, we value Astral at R171.55/share, which falls in our hold region. We used a discounting rate of 13.17% and a continuous growth of 3%.

#### Analysis of results

An increase in external revenue of 4.5% and considerably lower raw material costs were the main drivers of Astral's profitability.

The growth in external revenue was supported by higher poultry selling prices as well as slightly higher volumes across all divisions.

Operating profit climbed 78.7% to a record level of R1.9bn (FY17: R1.09 billion), resulting in an operating profit margin of 15.0% (2017: 8.7%). Selling price inflation contributed R519m while the decline in feed costs contributed R465m to operating profit.

The improvement in profitability stemmed largely from an increase in the poultry division's operating profit from R638m to R1.5bn. The feed division posted an increase of 16.7% in operating profit to R457m. African operations contributed operating profit of R32m. Headline earnings were up 93.9%. The board rewarded shareholders with a dividend of R10.50/share, bringing the total dividend to R20.50/share, up from R10.50/share in the previous year.

Working capital was strained. The number of working capital days deteriorated significantly to 34 (FY17: 24 days), caused in large part by a strong accumulation of inventory and a longer debtors payments period. Management blamed this on a build up of finished poultry goods stock, higher biological assets on hand to support higher weekly slaughter volumes, and payments from trade receivables that were only received after month-end.

The balance sheet remained in good health with negative gearing. This provides impetus for Astral's planned R1.1bn expansion programme.

#### Macroeconomic analysis

Astral's major input is maize, with other weather-dependent inputs such as soya and sunflower. However, management has been looking at ways to re-engineer its feeding programme to de-emphasise the role of maize in its cost structure. It has had some success but maize remains important.

Prices of maize and other soft

commodities are influenced by several factors, but the major drivers are local supply/demand dynamics, the rand's value and global prices. A recent projection by the government's Crop Estimates Committee, sets the overall crop output for 2018 at 12.9-million tonnes. While that is substantially lower than the 16.8-million tonnes harvested in 2017, it is good enough to support lower prices in the short term.

However, higher maize prices could be triggered by policy uncertainty on land, a weakening rand and the weather: meteorologists are indicating that there is a more than 50% chance of another drought-inducing El Niño event occurring in the coming season.

We see limited opportunities for increasing poultry prices, which are on an already elevated level set during FY18. South African consumers are experiencing a severe wallet squeeze due to rising costs. That and the prospect of higher imports of chicken from Brazil and the US compromise poultry players' ability to hike prices.



#### Bull Factors

- Potential margin support from a planned expansion of poultry production capacity
- Chicken remains an affordable source of protein



#### Bear Factors

- Rising prices of soft commodities undermine operating margins
- Influx of imports from markets with relatively better pricing power
- Introduction of minimum wage and ConCourt ruling on permanent employees
- Weak consumer spending due to rising living costs

#### Key statistics

Share details – Share Code: Astral Foods  
 Sector: Food and beverages producers

Market cap: **7.5bn**  
 Net debt:equity ratio: **0%**  
 Price:earnings ratio: **4.7**  
 Forward PE ratio (FY19): **6.5**  
 Dividend yield: **11.75%**  
 Forward dividend yield: **8%**  
 Risk: **High**

12-month high: **R335.19**  
 12-month low: **R168.96**  
 Ave monthly volume: **2.85-million**  
 Financial year-end: **30 Sep 2018**  
 Latest event: **Final results**  
 Date announced: **19 November 2018**

RESULTS IN BRIEF	FY18	Change (%)	FY17
Turnover (R'm)	12 979	5%	12 417
Operating profit (R'm)	1 942	79%	1 087
Operating margin (%)	15,0%	71%	8,8%
Attributable earnings (R'm)	1 420	85%	767
Heps (cents)	3712,0	94%	1914,0

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