Smart Company Analysis

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The Company: Pioneer Foods Group Ltd

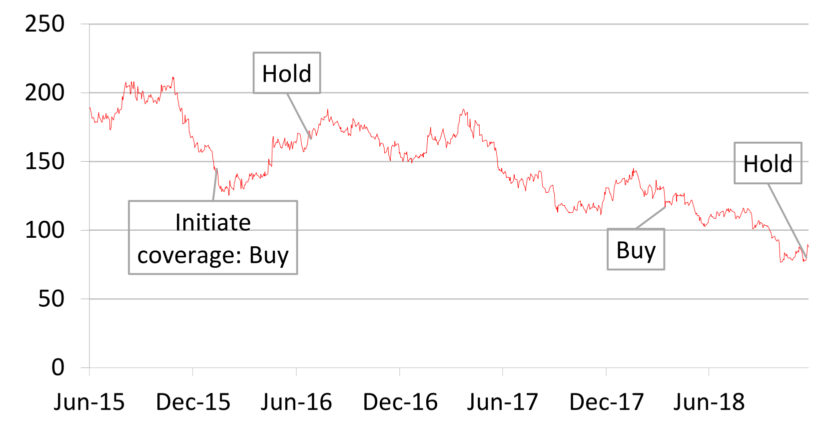
Rising raw material costs and muted consumer spending threaten profitability

Our call

Hold

Intellidex estimate of fair value:	*R94.46*
Spot price:	*R89.70*
Potential move:	*5.0%*

Pioneer's share price graph and Intellidex's previous calls



Background

Pioneer Foods' core business is the production and distribution of food, beverages and grocery products through two operating divisions: essential foods and groceries. It also has an international unit that sells products from both divisions. It has joint ventures with Bowman Ingredients and Bokomo Botswana and Namibia

Sensitivity analysis

Terminal growth		2%	4%	6%
Wacc	8.9%	11,999	14,307	19,331
	10.9%	9,475	10,611	12,588
	11.9%	8,598	9,446	10,825
	13.9%	7,177	7,666	8,387
	14.9%	6,633	7,016	7,561

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

Food producers had a turbulent ride from early 2015 until the end of last year because of the drought and declining sales volumes. However, the sector has turned the corner with most players reporting solid numbers.

Pioneer Foods reported 3% growth in revenue, 25% growth in net cash profit from operating activities and a 25% leap in adjusted headline earnings per share. What impressed us most is that all its divisions grew sales volumes. Most of its key brands – Sasko, Weet-Bix, Spekko, Liqui Fruit and Safari – gained market share. The group's operating margin improved significantly but is still below pre-drought levels.

Sadly, we do not see Pioneer replicating this in its next financial year. Its ability to grow volumes and margins will most likely be dampened by the frail consumer environment and soft commodity prices that have already started climbing, having fallen during the reporting period.

South African consumers are experiencing a severe wallet squeeze due to rising costs, including spiralling petrol and electricity prices, rising costs of debt, the implementation of the sugar tax and the VAT increase to 15%. These have taken their toll: September retail sales were flat year on year. Our main worry is that economists are predicting further increases in consumer inflation over the next year which will be detrimental to all consumer-facing businesses.

Food producers such as Pioneer will struggle to recover input costs without sacrificing volumes. Competition will also be intense as players battle for share of a slow-growth market.

On top of muted consumer spending, Pioneer is facing rising input costs. Prices for the group's key soft commodities increased sharply over the past few months. Maize, for instance, rose 25% during the year to end-September. And there are other potential headwinds: meteorologists indicate that there is a more than 50% chance of another drought-inducing El Niño event occurring in the coming season; policy uncertainty on land will continue to depress markets and any rand weakness will push up the prices of soft commodities.

Given these factors we have decided to downgrade Pioneer to a hold. We do not think the group will be able to meet our previous medium-term operating profit margin targets. We have also applied more conservative assumptions for the discounting and continuous growth rates which significantly reduced our fair value estimate from R144.05/share to R94.46/share.

However, we still find Pioneer attractive for long-term investors. With a leaner business structure thanks to cost-cutting initiatives and investments in production efficiencies over the past few years, Pioneer is positioned to beat the market average should conditions improve. Its lowly geared balance sheet also gives it flexibility to pursue acquisitions.

Analysis of results

Pioneer's FY18 results were satisfactory with revenue growing 3% as improved sales volumes more than offset weak price realisations caused by price deflation in soft commodities.

The groceries division was the star performer. It reported 17% growth at the top line on 15% growth in volumes. Sales volumes for the important cereals and long-life fruit juice products increased 22% and 28% respectively. Divisional operating profit grew in line with the top line.

The international division reported 12% growth in the top line as new route-to-market strategies were bedded down. Fruit exports benefited from improved local fruit availability, strong global demand and high dollar prices. The division's operating profit soared 136%, translating into an operating margin of 8.2% (FY17:5.6%).

Essential foods, the group's largest division, also delivered a solid performance despite facing serious headwinds towards the end of the second half. Sales volumes increased 2% but price deflation in most key categories resulted in a 5% decline in revenue. The operating margin printed at 7.7% (FY17: 6.4%). Joint ventures had a mixed performance. Bowman Ingredients (SA) performed well while Bokomo Botswana and Bokomo Namibia delivered below-par performances.

The group operating profit margin expanded from 5.6% to 8.2%. Adjusted headline earnings before costs related to a black economic empowerment share-based scheme increased 25% to 553c/share (FY17:442c/share). The board maintained the dividend at 365c/share.

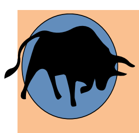
Macroeconomic analysis

Inflationary pressures remain a real risk. The Reserve Bank, which recently hiked the repo rate by 25 basis points, is expecting inflation to rise gradually to a peak of 5.6% in the third quarter of next year. With such an upward facing inflation curve, consumption growth is likely to be muted.

However, Pioneer should be cushioned somewhat by the defensive nature of its product portfolio and internal initiatives aimed at strengthening the brand and increasing the visibility and availability of its products. Its wheat value chain, led by bakeries, should benefit from the refined route-to-market capability, enhanced production efficiencies and improved product quality.

The groceries and international divisions should also be able to deliver decent performances with a turnaround at Heinz Foods SA, an anticipated higher vine fruit crop and expectations of a more beneficial exchange rate for exports. Management reports that the joint ventures' performance improved materially in the fourth quarter of FY18.

Maize operations are likely to come under pressure. While demand for maize meal products is likely to remain strong given ample local raw material supply, down-trading within the category is likely to continue. Pioneer, whose White Star brand is commands a significant price premium over competitors, will most likely suffer.



Bull Factors

- Diversified business mix supported by well-recognised brands
- Focus on resetting the cost base and improving productivity should drive further margin expansion
- Defensive nature of Pioneer's business to sustain earnings
- Improving operational efficiencies

Bear Factors

- Highly competitive operating space makes volume growth extremely difficult to achieve
- Weak consumer spending due to rising cost of living
- Rising costs of raw materials

Key statistics

Share details – Share Code: Pioneer Foods
Sector: **Food and beverages producers**

Market cap: **20.52bn**	12-month high: **R146.44**
Net debt:equity ratio**: 5%**	12-month low: **R73.00**
Price:earnings ratio: **16.39**	Ave monthly volume: **11.4-million**
Forward PE ratio (FY19): 14.4	Financial year-end: **30 Sep 2018**
Dividend yield: **4.09%**	Latest event**: Final results**
Forward dividend yield: **5%**	Date announced: **19 Nov 2018**
Risk: **Medium**	

RESULTS IN BRIEF	FY18	Change (%)	FY17
Turnover (R'm)	20,152	3%	19,575
Operating profit (R'm)	1,646	50%	1,099
Operating margin (%)	8.2%	45%	5.6%
Attributable earnings (R'm)	1,073	48%	726
Heps (cents)	545.0	33%	410.1
