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Clipped wings: A look at South Africa's poultry industry

ARTICLE SUMMARY

Poultry profits are booming, but given the cyclical nature of the industry it's not sustainable.

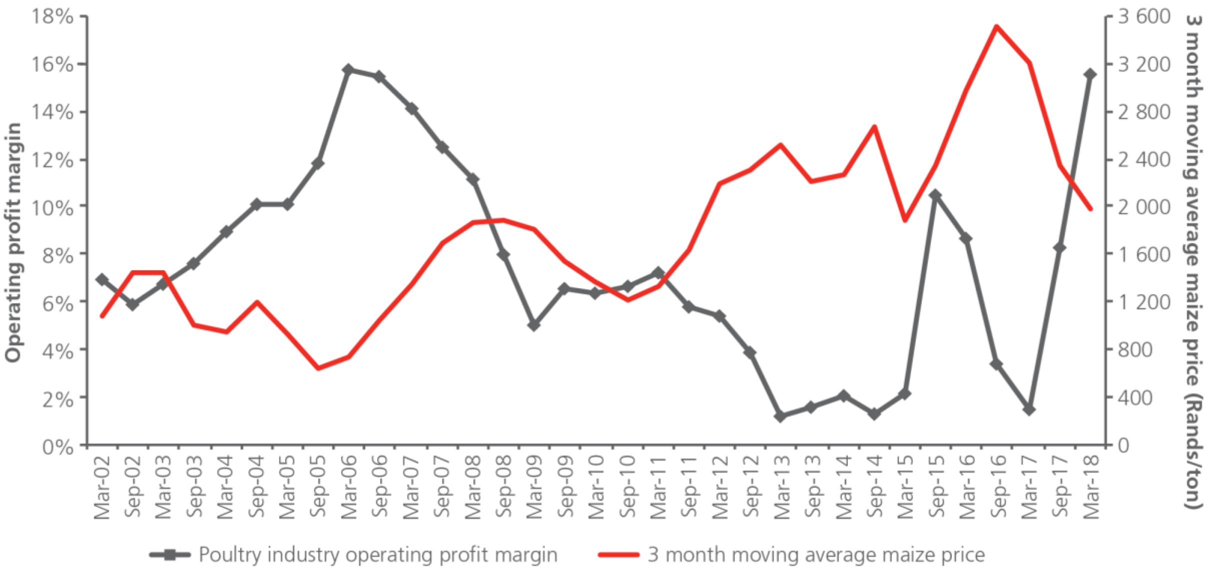
The market has fallen in love with the poultry industry in 2018: profits have been booming and share prices rallying. But not too long ago, the industry was out of favour and in a dire state. Based on past trends, we believe that poultry companies' current record-high operating profit margins will likely revert to historical long-run averages. Investors may not realise it, but this industry is highly cyclical. The majority of its costs are driven by the price of feed which can fluctuate considerably, depending on the demand and supply dynamics of the primary ingredient, maize. The selling price of chicken is a function of local supply and demand, as well as the price of substitute products such as imported chicken and other protein sources.

The country's four major poultry producers have had to learn to cope with sharp swings in feed prices over the years, generally conserving cash in anticipation of tough times to come. These companies comprise Astral Foods and RCL Foods, both listed on the JSE, as well as Sovereign Food Investments and Country Bird Holdings, both of which have been de-listed from the stock exchange. Few examples are better for highlighting this market cyclicality than what has happened to the industry in the past three years.

From extreme low to record-high returns

Graph 1 illustrates how the industry is currently experiencing 12-year-high operating profit margins (shown by the red line); however, just over a year and a half ago, companies saw a sharp decline in these margins. This was due to a coincidence of several negative factors, the primary one being the recent inland drought. South Africa suffered two successive years of low maize production as low rainfall and dry weather conditions damaged the 2015 crop and discouraged farmers from planting maize during the 2016 season. The resulting shortage of local maize forced South Africa to import from abroad. The higher price of the imported grain also put upward pressure on the local maize price as it rose towards import parity pricing levels. Chicken feed costs rose to exorbitant levels, taking company production costs with them.

Graph 1: The poultry industry operating profit margin is cyclical



Source: Bloomberg, company annual reports and company data

At the same time, the companies weren't able to push through price increases to consumers to recover these high maize costs due to a prevailing oversupply of chicken: both local overproduction and increased imports limited poultry producers' pricing power. The ramp-up in poultry production and the resultant oversupply were the culmination of industry-wide capacity-enhancing investment that occurred during the preceding years. Weak import tariff protection facilitated the continued proliferation of imported chicken into South Africa, compounding the local oversupplied situation.

The confluence of all of the above negative factors resulted in the poultry industry experiencing all-time low operating profit margins from late 2016 onwards (as the graph highlights). Something had to be done to stem the decline in profits. The easiest and first line of defence for the poultry industry was to reduce supply of chicken to the market.

Culling excess supply

In an attempt to reduce supply and regain pricing power, the major poultry producers embarked on rightsizing initiatives. Astral temporarily cut production and RCL permanently lowered its own during 2017. The drought itself brought about a contraction in poultry production as it led to the demise of small- to medium-sized debt-laden poultry producers who couldn't afford to continue rearing their chickens. Sovereign became the target of a hostile and opportunistically low takeover bid from Country Bird that was ultimately unsuccessful (read about Prudential's active role in defeating the bid in our previous edition). Those poultry producers that had strong enough balance sheets to withstand the rising cost of feed production ultimately survived.

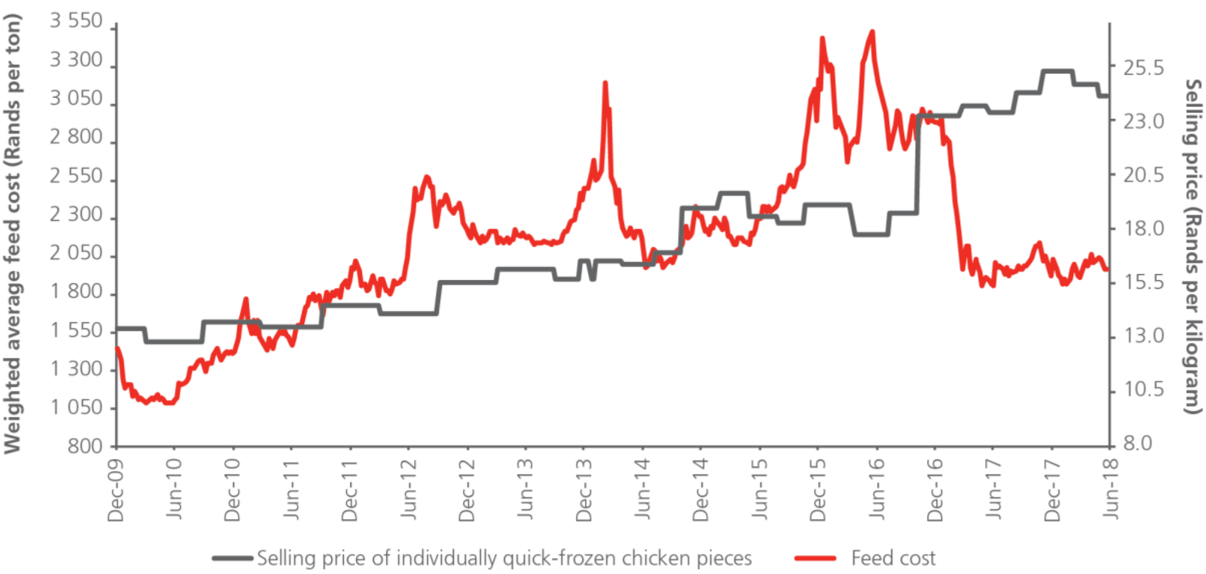
The rains return, the cycle turns

The rains eventually returned and maize farmers managed to produce an unexpected record-breaking maize crop in 2017, thanks to greater acreage planted and superb growing conditions in mineral-rich soil that was replenished during the dry spell. With the extra supply, South Africa returned to being a net exporter of maize, and local maize prices fell toward export parity pricing levels. The profit recovery only began in earnest during the latter half of 2017 as major poultry companies were still using expensive maize (old-season) that was procured during the previous year, despite cheap maize (new-season) being available for use earlier on in the year. This was the start of an improved business cycle for poultry producers, as the fall in feed costs coincided with a better balanced market for poultry due to cut-backs in supply by the major producers, as well as improved demand for poultry from consumers. These three factors resulted in a marked improvement in operating profit margins.

Record-high margins not sustainable

At Prudential, we question the sustainability of current poultry margins, as high selling prices and low feed costs (as illustrated in Graph 2) cannot be maintained into perpetuity. The established poultry producers have indicated their intention to expand capacity and ramp up production to take advantage of the current favourable conditions, possibly leading to an oversupply in the market if demand doesn't materialise as expected. This would put downward pressure on selling prices and company profit margins. Equally, competition from smaller new entrants, enticed by peak profits, is also on the rise.

Graph 2: Rising selling price coincides with falling feed cost



Source: Bloomberg and company data

At the same time, there are indications of higher maize prices to come. At the time of writing, South African maize futures prices for 2019 are trading above current spot prices – this reflects expectations that the new maize crop will be smaller than that of 2017. The weaker rand against the US dollar will also result in higher import prices, pushing local maize prices higher. The aforementioned trends will all likely limit producers' pricing power in the future and lead to an under-recovery of rising feed and non-feed costs. Consequently, the current exceptionally favourable conditions of high selling prices, low costs and high operating margins are set to turn negative again, moving through the cycle and resulting in lower company profits going forward.

In light of our view that the current tailwinds for the poultry industry will likely transform into headwinds, Prudential clients have limited exposure to the sector (apart from a small indirect shareholding in RCL Foods), having previously had exposure to the now-de-listed Sovereign and to Astral.

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