

THE STRAIGHT TALKING

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HAS THE MONEY DRIED UP?

South Africa is currently recovering from one of the worst droughts in its history, with 2016 having received the lowest rainfall since record keeping commenced in 1904. This, along with other company specific factors, has resulted in high levels of volatility in the diversified food producer counters. In this note we discuss the impact of the drought on soft commodity prices, consider the timeline to recovery and finally evaluate whether the quality food producer stocks are still attractive investments at current levels.

Much has been written about El Nino, which develops from warmer than normal sea surface temperatures in the Equatorial Pacific near South America, causing a shift in atmospheric circulation (disrupting trade winds) and wreaking havoc on normal temperature and rainfall patterns. El Nino affects different regions in different ways, but leads to significantly reduced rainfall in Southern Africa.

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This past El Nino was one of the strongest on record, leading to a drought that has ravaged virtually all crops over the past 18 months. This has curtailed production from maize to sugar and along with a weaker Rand, has seen food inflation almost trebling from 4% in mid-2015 to almost 12% today. This figure would have been even higher, as the dry weather forced farmers to cull cattle herds, artificially lowering the price of meat as supply flooded the market. Meat comprises 30% of the CPI food basket, and we expect herd rebuilding to be a solitary headwind to a much lower 2017 food inflation outlook.

The drought has considerably reduced maize production over the previous two seasons. South Africa, which produces 12-13m tons of maize in a good year, produced only 9.9m tons in 2015 and 7.5m tons in 2016 of the summer crop, shifting our country from a net exporter to a large net importer and having a dramatic effect on prices. The price of white maize, a staple food for many South Africans relying on 'mielie pap' as a source of energy, doubled from around R2600 per ton in early 2015 to above R5000 in the same period of 2016, making it tough for poor South Africans to afford their favoured carbohydrate. Yellow maize, which forms the base of many animal feeds, also doubled, leading to significant knock-on price increases in proteins such as chicken.

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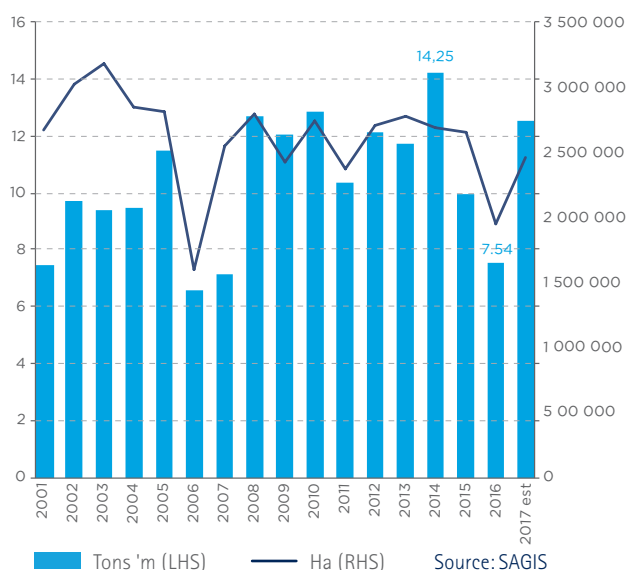
The peculiarities of the global white maize market conspired to make this variety even harder to come by locally. Firstly, a "true" international price for this varietal is hard to determine, with the South African Futures Exchange being the only white maize futures market in the world. The US, by far the global leader in maize production (around 380m tons pa), is primarily focused on the yellow varietal, and the government of Mexico, the world's largest consumer of white maize (used in tortillas), intervenes to set prices, thus negating the desirability or need for an exchange. Secondly, South Africa had been unable to import maize from the US due to differences in legislation relating to genetic modification. Therefore, we were forced to import from Mexico, itself a large net importer with murky pricing dynamics.

Of the listed food producers, Pioneer Foods has the largest direct exposure to maize meal, through their market leading White Star brand. This adds an element of cyclicity to their earnings, and we estimate that White Star's contribution to group operating profit could range from low single digits in a drought-hit period (such as 2016, and possibly into 2017), to around 20% in a good year. Pioneer took the decision to continue buying expensive maize as the price rose to secure volumes, a decision they felt was necessary as the market leader and which resulted in them gaining further market share. In their most recent annual results, maize volumes declined by 5% on the back of price inflation of almost 40%!

The maize cycle should, however, turn attractively this year as rainfall normalises, with the area planted during the last three months of 2016 up by over 25% compared to the previous year. Although the first official maize crop estimate is only anticipated in February, most market observers expect a bumper crop this season, which has already lead to significant price declines on futures contracts. Although we expect some initial pain to earnings in the first half of 2017, Pioneer's earnings should benefit significantly over the next twelve months or so, as their market share gains position them well in an environment of increasing maize availability and falling costs. Tiger Brands and the Brait-owned Premier Foods also have maize meal exposure with their Ace and Iwisa brands, although it is a far less material contributor to earnings. The headwind of high input costs in 2016 for all these players will become a tailwind in the latter half of 2017 and possibly beyond.

Local legislation has also added to the food sector's recent woes, specifically in the case of wheat. South Africa has long been a net importer of wheat, consuming in excess of 3m tons per annum but producing under 2m tons, a figure that has been in steady decline since peaking in the late 1980's, when the area planted to wheat was four times what it is today. Globally wheat prices have been in consistent decline, driven by a 20% plus increase in production over the past decade as China, India, Russia and the EU saw a surge in production. Why then, have SA prices been on the rise?

Chart 1: SA maize: Area planted and production



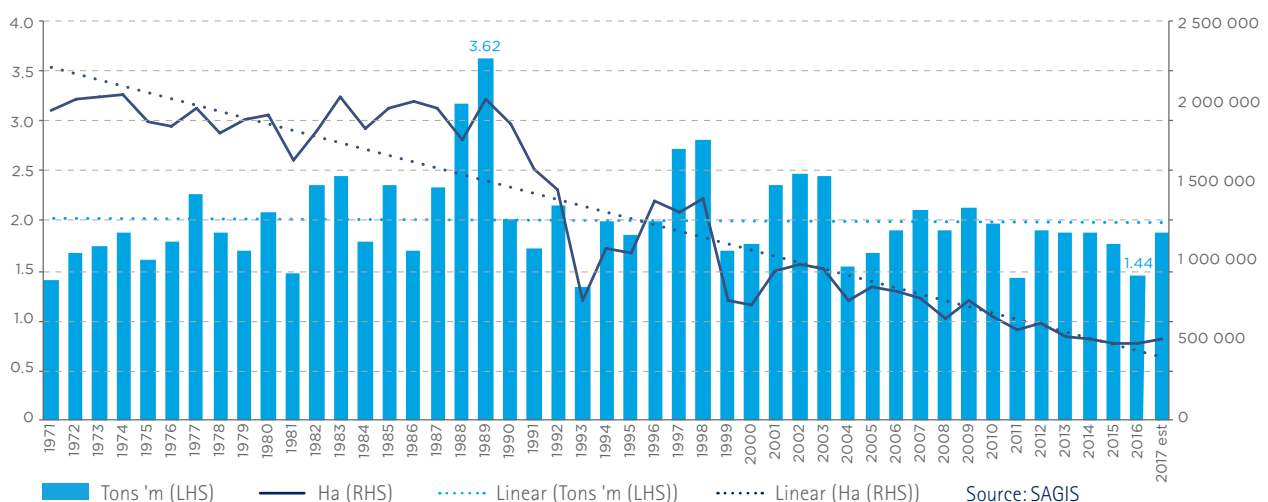
To protect local farmers and jobs, South Africa invokes a wheat tariff on imports coming into the country. The tariff is enforced when international prices, in US dollars, fall below a certain threshold, or reference price. The major problem with the tariff is that it has not encouraged local production, as the local area planted to wheat has continued to contract, shedding jobs along the way. Secondly, Rand weakness has sharply increased the dollar-based tariff in local currency terms. Finally, we have not been able to benefit at all from the steady down trend in international wheat prices.

Although some form of tariff is justifiable, the current formula and Rand weakness has resulted in a tenfold increase in the tariff from R157 per ton in 2014 to over R1591, now comprising around a third of the cost of wheat. In South Africa wheat is used predominantly for human consumption, with the majority going into bread. In May 2016, SAFEX wheat prices peaked at over R5200 per ton, a level at which wheat costs alone contributed almost 30% of the price of a loaf of white bread! There may well be good news around the corner though, as the current tariff structure is under review by the International Trade Administration Commission of South Africa (ITAC).

The price of wheat on the futures exchange has already declined materially as the Rand has strengthened and traders have begun to speculate as to the outcome of the ITAC tariff review. This should benefit all of the major bread and wheat milling players. The three large producers, namely Tiger Brands, Pioneer and Premier Foods each produce over 500m loaves of bread per annum under the Albany, Sasko and Blue Ribbon brands and sell wheat flour and related products under the Golden Cloud, Sasko and Snowflake brands respectively. Although there may be political pressure to lower bread prices in response to any tariff adjustment, we anticipate this to be done in a measured basis and still expect to see significant relief given the input cost moves. Tiger Brands has significant earnings exposure to these categories, with milling and baking comprising nearly 40% of group operating profit. We estimate that bakeries and wheat flour contribute almost 30% to Pioneer's profitability.

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Chart 2: SA Wheat: Long term area planted and production





As a result of this cost-push inflation in an extremely tough consumer environment, we have been given the opportunity to add quality food producer stocks to our portfolios such as Tiger Brands and Pioneer (through Zeder) in the recent past at attractive valuations.

Tiger Brands has an unrivalled diversified portfolio of leading South African brands with pricing power such as Albany, Tastic, KOO, All Gold, Jungle and Black Cat. These strong brands should contribute to consistent group earnings growth ahead of inflation if managed correctly. The group is also much cleaner following their much-publicised Dangote Flour Mills disposal (in Nigeria) just over a year ago. Most importantly though, is the appointment of new leadership in the form of FMCG veteran and ex-Mondelez executive Lawrence MacDougall, who is currently finalising his full strategic review. Tiger Brands has suffered from poor decision-taking in recent years, as evidenced by the failed Nigerian venture and other blunders in Africa. Back at home, it was also clear that the company has perhaps taken their eye off the ball in the management of their local brands – pricing was erratic, especially for a market leader, there was a lack of innovation, pack size options were insufficient, core brands were not leveraged into adjacent categories and there was insufficient investment behind brands. Fixing these problems could result in a material revenue boost, and this, along with easy wins in the cost base, should enhance earnings going forward. The company has negligible debt and is looking for acquisitions. On a forward PE of 16.5x, the stock is by no means cheap, but we remain holders due to the significant optionality available to the group, as well as the expected earnings tailwinds to come from softening soft commodity prices.

A lot of work has already been done by Phil Roux and his team at Pioneer Foods, with operating margins and returns on equity almost doubling over a four-year period. We expect to see further cost reduction opportunities as well as further innovation as the group continues to grow its portfolio of brands and reduce reliance on the more commodity related parts of the business. Interestingly, it is the more commodity related exposure that will boost earnings in the near term as the maize cycle turns. We consider Pioneer attractively priced at 15x forward earnings, also considering that the group is almost in a net cash position, and is on the hunt for a sizeable acquisition. We are confident that Pioneer's top class management team can add further value for shareholders.

We have invested into Pioneer via Zeder, an actively managed investment holding company with a primary focus on agribusinesses. In addition to Pioneer, which contributes around two thirds of the NAV, Zeder owns attractive agriculture investments including Capespan, Zaad Holdings and Kaap Agri. All of these companies have been negatively affected by the drought in one way or another, and we expect their outlook to materially improve as normal rainfall patterns resume. Zeder's cash flows had historically been hamstrung by onerous management and performance fees paid to its anchor shareholder, PSG. A significant milestone was reached last year whereby the existing fee agreement was terminated and internalised via the issue of a further 14% of share capital to PSG on fair terms. This will free up cash going forward, which CEO Norman Celliers can use to grow the attractive asset base further. Importantly, PSG remains involved through Board and Exco representation.

It is clear to us that the drought has resulted in significant earnings headwinds to the listed food producers, and we expect these to reverse into tailwinds over the coming years as earnings normalise. This has been an extremely tough period for consumers and food producers, who were unable to pass on the full extent of this input cost inflation. 2016 was, in general, a particularly difficult year for South Africans; a year in which we argue that growth has bottomed and inflation has peaked. Going forward consumer confidence should slowly start to repair itself, and quality food producer counters such as Tiger Brands and Zeder/Pioneer should benefit handsomely.

2016 was, in general, an extremely difficult year for South Africans; a year in which we argue that growth has bottomed and inflation has peaked