

AVI: coffee with cream

“The secret to running a successful company is to recognize and understand the simple ground rules - quality in and quality out.” This quote was made by AVI management in their 2008 annual report. How apt that is. Furthermore, it applies to both the company’s products and its management team, a team that have delivered the goods year after year. It is tough times at present for local manufacturing businesses, but AVI is proof that investing behind a highly competent management team can protect you from the worst of the economic cycle.

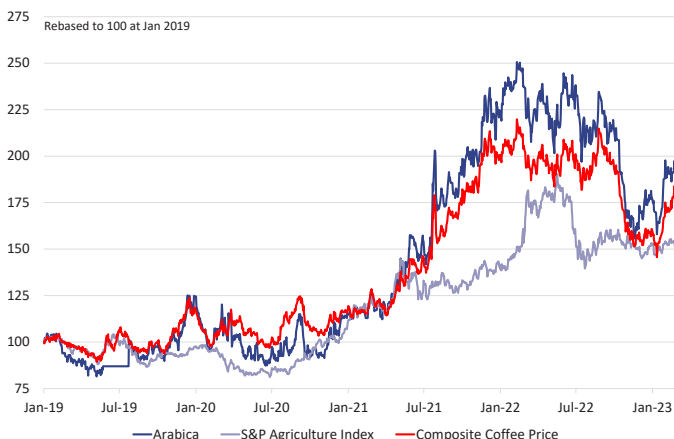


**Lebogang
Malatji**

In all economies, the impact of macro events on the primary agricultural sector is exaggerated, and the severity thereof is compounded due to tight margins. Covid, global supply chain issues, the Russia-Ukraine conflict, elevated commodity prices, a weakening currency, climate and now electricity shortages have all conspired to drive commodity prices significantly higher. Furthermore,

on average crude oil prices have risen by 140% over the past 3 years. South Africa is a net exporter of primary agricultural products - so you might think that we should be shielded from global trends. Unfortunately, that is not the case. Crucial inputs into production such as seed and fertilizers are imported. Furthermore, for AVI, some of its

COFFEE PRICES VS S&P AGRICULTURAL INDEX



Unfortunately for those who need their caffeine fix each morning, coffee prices remain elevated relative to history and unfavourable weather patterns suggest this may continue for the foreseeable future.

SPEED READ

- Tea and coffee comprise over 30% of revenues. But Robusta bean and Chicory prices have increased by 141% and Arabica coffee beans by 164%.
- According to the South African Weather Service, SA is currently still experiencing a “La Nina” weather system. This is typically associated with above average rainfall. It is expected to normalize by May. Unfortunately, by the end of this year, forecasters are predicting the return of “El Nino”, which is often associated with drought conditions in SA.
- AVI is not immune from loadshedding. Its generator installations across the Group ran for a total of 2,612 hours in 2022, more than double the 1,230 hours in 2021. This is expensive and impacts margins.

key products – such as coffee and tea – are also largely imported. So local food manufacturers are still at the mercy of global trends.

An example of this is Arabica coffee beans which increased over 150% from the low point in 2020 to the peak at the end of 2022. They have retraced since, but still remain elevated and substantially higher than pre-Covid levels even though broader agricultural prices (as measured by the S&P Agricultural Index) have softened on the back of lower grain prices. Unfortunately, this has made our much-loved early morning coffee rather more expensive than it used to be. Recent updates suggest that Brazilian farmers are hoarding supplies and further driving Arabica and Robusta prices higher. With expected droughts in

Brazil forecasted and excessive rainfall in Indonesia, it is hard to see prices declining any time soon. This is not great news for AVI, as price pressure in coffee will remain. That implies either hiking prices, which would have a negative impact on volumes, or keeping prices low, which would negatively impact margins. An unenviable catch-22 situation. Fortunately, they actively hedge their exposure and lock in low prices when they can. It's a key cog in their strategy.



ENSO, the organization responsible for monitoring the EL Nino weather pattern has recently confirmed that La Nina remains firmly in place. But this is expected to change before the end of the year.

The other major issue affecting local farmers and hence food producers is the weather. Readers will not be surprised to note that SA is currently experiencing weather associated with the “La Nina” phenomenon, which generally brings higher than average rainfall. One need look no further than the magnificent Howick Falls to validate just how much rain we have had since November. Intuitively, rains should be good for farmers and food prices – but the devil is in the detail. Too much rain leads to flooding, waterlogged fields, poor harvests and failed crops, all of which are being experienced across SA in various degrees. Forecasters predict that La Nina will change to El Nino by the end of the year – a weather system associated with drier than average conditions. It is quite possible that we experience mild drought conditions next year. This highlights just how unpredictable and cyclical weather patterns have become and they are impacting prices on the shelves.

The third factor affecting food manufacturers is the recently launched investigation by the Competition Commission



Raw coffee beans after harvesting. Coffee prices remain high across the world due to high demand and weather pattern that have been unfavourable to production.

into the prices of fresh produce. What the Commission’s Concentration Study showed was the increased number of large commercial farms which in turn hinders the ability of smaller farmers to achieve economies of scale and be competitive. What can be read into this is that there is a higher probability of increased regulation in the sector. That may be positive for the consumer but is a negative for producers.

The above reads like a litany of woe, and investors might interpret that as a signal to get as far away from this sector of the market as possible. But that is not necessarily the case. “In a chronically leaking boat, energy devoted to changing vessels is more productive than energy devoted to patching leaks.” The quote is ascribed to Warren Buffet and essentially points to the need for an effective tactical response given a challenge. One of our core investment themes is “Pockets of Excellence” and AVI management exemplifies this. They have been hugely effective in steering the ship in an extremely volatile environment.

“In a chronically leaking boat, energy devoted to changing vessels is more productive than energy devoted to patching leaks.”~ Warren Buffet

The chart below illustrates my point. It shows the trend in earnings growth over the past 13 years for three of our major food producers – AVI, Tiger

Brands and RCL Foods. (The period for RCL is slightly shorter as it was only listed in its current form in 2013.) The chart speaks for itself. We all know that the past ten years have been tough. The economy has barely grown, GDP per capita has shrunk, which means that on average, we are all getting poorer, and costs, including imported items, continue to rise. Not an ideal set of circumstances. Yet over that period, AVI has grown its earnings twofold, and

reasonably consistently too – a dip in 2019 and then again in 2020 due to Covid. Its peers have not fared as well. Tiger Brands’ earnings are only just positive, and RCL is erratic due to the highly cyclical nature of the chicken industry

SA FOOD SECTOR: EARNINGS GROWTH



AVI has delivered superior and more consistent profit growth than its peers, thanks in part to the quality of its management team.

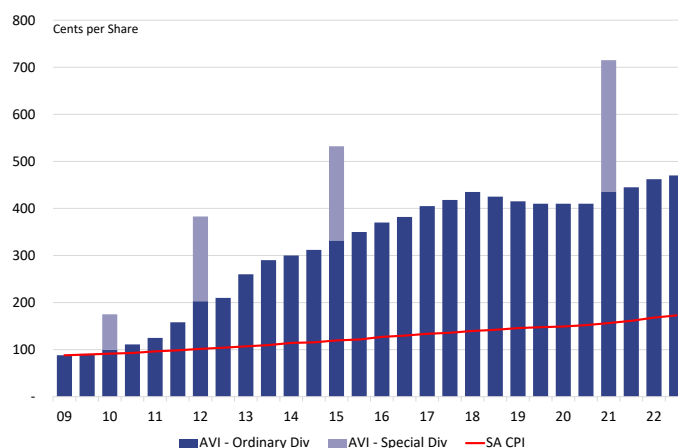
Such a pattern is not a coincidence. It is thanks to a superb management team that have been able to successfully understand the market and position their company accordingly. AVI does not have cyclical operations (except fishing), their brands are well respected and popular, and their operational excellence allows a tight control of costs to protect margins. In this regard, there was a shred of good news in the Budget. The impact of loadshedding is widely felt and within AVI, generator installations across the Group ran for a total of 2,612 hours in 2022, more than double the 1,230 hours in 2021. National Treasury has alleviated some of the pressure faced by food producers. They have extended the diesel fuel rebate to manufacturers of foodstuffs for a period of 2 years. This has two benefits. Firstly, it will help to contain costs, which will protect margins. Secondly, it should slow price increases, thereby helping to contain inflation and in turn signal a peak in interest rates.

“The economy may be tough, but superior management delivers growth”

The major benefit of disciplined cost control and margin management, again a function of an extremely capable management team, is the Company’s ability to generate cash. The Group generates more than sufficient cash to invest in capacity expansion as evidenced by the planned expenditure in creamer capacity, extra biscuit line capacity, snack-line replacements, I&J fishing vessel upgrades and new retail stores. This is not a company sitting on its hands. But in addition to all this

expansion, the Group still has cash to spare. Clients will know that dividends are at the heart of our philosophy, more specifically “a heavy emphasis on increasing dividend yields over time”. Dividends are well covered by earnings, and excess cash is returned to shareholders frequently through both ordinary and special dividends. In a volatile market where at times capital appreciation is hard to come by, stable cash flow in your pocket is hugely reassuring. Management has delivered consistent growth in the ordinary dividend well ahead of inflation before special dividends are even considered. Our politicians would have done better to have invested their cash into AVI rather than

DIVIDEND GROWTH RELATIVE TO INFLATION



Using 2009 as a starting point, AVI’s ordinary dividend has grown from 88c per share to the current 462c per share. If the dividend had grown by inflation, it would be equivalent to just 173c per share today. Income growth has been far superior to inflation, implying real growth in income and living standards. The light blue bars show special dividends declared over the years – very much the cherry on top.

hiding it under pieces of household furniture. Whilst there is always scope for caution, AVI exemplifies the reason for investing in shares, and especially those with superior management. We discussed this at length in our December Insight presentation when we focused on Microsoft and Afrimat. AVI fits firmly into the same category. The economy may be tough, but superior management deliver growth seemingly against the odds. They are ideally poised to reward shareholders handsomely if economic growth does accelerate in the years ahead. In the meantime, the company delivers inflation-beating income growth, allowing shareholders to live off dividends whilst waiting for conditions to turn. The management team has been hugely effective in steering the ship in an extremely volatile environment. We have every confidence that they will continue to do so.



Topic: **The Mechanics of Markets**

Natal Midlands

Date:	Thursday, 16th of March
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg

Date:	Tuesday, 14th of March
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am



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