

AVI: deserving of a premium rating

The first intuition article I wrote about was about AVI. In that edition, specific focus was paid to the quality of the management team. AVI has moved 47% YTD. It is worth revisiting the business to review the value drivers and the underlying moving parts that help drive its competitive advantage. These factors highlight why a premium pricing on the share is justified and suggest that more value can still be accrued.



**Lebogang
Malatji**

It's been over 18 months since we last covered AVI in Intuition. What was of particular concern back then was the impact of the macro-specific factors that had weighed on valuations. We highlighted the negative interaction between supply and demand side shocks. On the supply side, the most significant was the rise in commodity prices, particularly coffee and crude oil.

These had an exaggerated impact on inflation and ultimately pricing. However, some of these pricing shocks are not yet out of the system, and now for different reasons. AVI is still contending with elevated prices for some of their critical inputs, even though oil prices have stabilised. Prices for soft commodities are driven largely by events in producer nations. We pointed to the forecasted drought conditions in Brazil, which have now materialised. This, of course, is not an unusual occurrence. Floods and droughts are common. However, Patrícia Pinho, deputy

COFFEE AND OIL PRICES



Despite the stabilization of crude oil prices, prices for other critical inputs have increased, underpinned by extreme weather conditions in producer nations.

SPEED READ

- The current drought is now the worst on record affecting about 58% of Brazil. This in turn is impacting on soft commodity prices.
- Their fishing operations are experiencing some of the toughest conditions for twenty years. I & J's profitability over the past few reporting periods has declined steadily from a peak of R417 million to R197 million this past year.
- It appears the tide is turning more favourable. The combination of the two-pot system and interest rate cuts should see a boost to disposable income. The absence of loadshedding is also boosting margins.
- AVI is synonymous with quality. The company has grown its earnings and dividend by 6% and 7% per annum respectively over the past five years in this country. Despite the tough past 12 months, AVI has rewarded its shareholders with a special dividend, the third in 6 years.

science director at the Amazon Environmental Research Institute, said in an interview that the issue now is the increased range of the two extremes. The current drought is now the worst on record, affecting about 58% of Brazil. Consequently, coffee prices are up 38% this year, along with other key ingredients like butter (+53%), potatoes (+37%), and tea (+57%). Recently, forecasts of rains across Brazil have helped ease the prices somewhat, but a meaningful change is needed before AVI can reap any benefits.

Within the South African context, weather predictions indicate that we are entering La Nina conditions, which are characterized by above-normal rainfall. This will help local production, which should ease food inflation further. Lastly, the running theme within South Africa recently has been load-shedding and the impact thereof on operations.

The team at Eskom has made tremendous progress, which helped ease the pressure on margins given reduced use of expensive generators.

There are two critical issues I want to highlight in this edition – challenges at I & J and the increased competition. I&J, a segment within AVI that catches, processes and sells premium value-added seafood locally and internationally, has been under severe strain. The current fishing performance is the worst in over 20 years. I&J’s profitability over the last few reporting periods has been deteriorating, from a peak of R417 million to R197 million in the most recent financial year. There are two issues:

1. Poor catch rates that are well below historical levels.
2. The Abalone resource within South Africa is declining due to poaching and ecological changes, compounded by the Department of Forestry & Fisheries pointing to the quota allocated for commercial farming as excessive. This implies further reductions in the Total Allowable Catch for Abalone in the future.

Recently in the Western Cape, police seized abalone worth R10 million from a single bust. To put that into context, it equates to about 26% of AVI’s profits from abalone over the last year. A report by the Global Initiative against Transnational Organised Crime highlighted that about R1 billion worth of abalone is poached in SA each year. This is miniscule compared to the absolute levels of poached abalone that has flooded world markets, adding further strain to growth for legitimate operators. Port problems due to Transnet’s woes only



Abalone is a hugely popular seafood among Asian consumers with demand in China especially high.

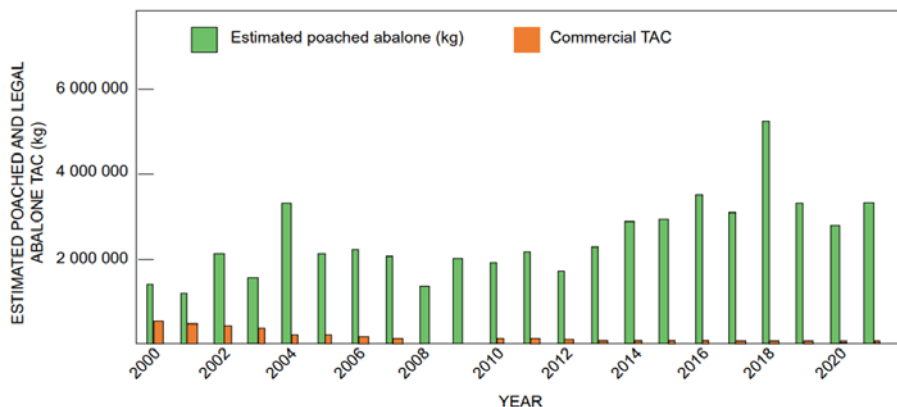
compounded the challenges. Fortunately, AVI has a well-regarded management team who don’t just sit on their hands. They have expanded their fleet to ensure they can take advantage of their full hake quota, and the outlook for Asian demand is improving – a large market for AVI’s exports.

“A report by the Global Initiative against Transnational Organised Crime highlighted that about R1 billion worth of abalone is poached in SA each year.”

In the recent earnings call, management highlighted that within the footwear and apparel segment, one of its popular items that had a selling price of R700 per unit when AVI acquired the business more than a decade ago now sells for R2,800, a 300% increase,

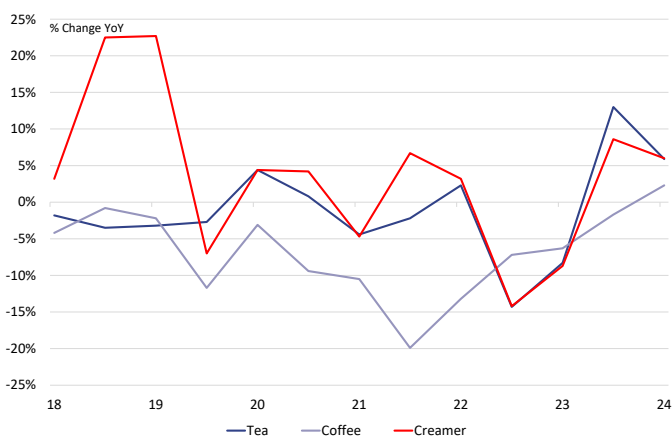
pointing to significant inflationary pressure. Higher pricing in response to inflation has been a driver of revenues over the past few semesters, although this is offset by volume declines. While all producers are contending with inflation, the largest impact has been the increased competition in the marketplace. Aggressive discounting and lower-priced options by competitors in an inflationary environment have added pressure within some of AVI’s key categories. Despite this, AVI has been able to defend market share due in large part to its value brands across all its units, highlighting the importance of a diversified portfolio across price points. In the Footwear and Apparel segment, volumes are still under pressure despite discounting to manage inventories. This is a sign of continued consumer pressure. Fortunately, Entyce Beverages has been the standout, despite price increases averaging 14.8%. Volumes increased, in part due to base effects, but also due to the launch of value brands.

ABALONE: POACHING VS LEGITIMATE CATCH



Although poaching has declined from the highs reached in 2018, it is an inhibiting factor for commercial fishing.

VOLUME GROWTH IN KEY CATEGORIES



Volumes have recovered as consumers shifted to lower priced brands. One example is Rooibos, where volumes have grown strongly following the launch of a cheaper, value brand last quarter.

Nonetheless, there are early signs of improvement. The recently initiated two-pot system should see easing pressures on consumers with more disposable income, which could potentially help drive volumes. As of the latest date, News24 reported that gross withdrawals have reached about R21 billion. Secondly, interest rates have already started to fall, and should fall by another 1% over the next 9 – 12 months. Lastly, stimulus across Asia is stoking demand for seafood – a key export market for AVI.

Despite what by all accounts was a tough year, AVI continues to deliver the goods. Earnings grew 24%, with a commensurate increase in the dividend. Furthermore, thanks to their superb financial management and strong balance sheet, AVI has rewarded its shareholders with a special dividend as well – the third in the past 6 years. AVI’s inclusion in portfolios is not merely because management is dedicated to shareholder returns through dividends and special dividends. AVI has always traded at a premium to its peers, a recognition by the market of the significant quality of its operations, results, and management relative to peers. Over the past five “lost” years in South Africa – from 2019 to 2024, AVI has grown its earnings and dividend by 6% and 7% per annum respectively – a commendable performance and well ahead of the broader sector, who have all seen earnings contract. This is further supported by a peer-leading return on equity of 42% and operating margins at 21%, contrasted to the sector median of 9.6%. A great quote by William A. Foster captures this: “Quality is never an accident; it is always the result of high intention, sincere effort, intelligent direction and skillful execution.” Management has been able to navigate an incredibly difficult period of pricing-led growth through effective hedging strategies. Now, as supply-side issues are resolved through accelerated reform under the GNU and demand-side pressures ease, we expect that AVI will benefit from both volume growth and expanded margins. That is an attractive combination.



Coffee prices have spiked over the last year, along with many other soft commodities putting margins under pressure at firms like AVI.



By the end of November, it will have been six months since our election ushered in the GNU. This presentation will focus on the outlook for 2025, and delve specifically into whether the SA story is still intact.



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Topic: Outlook for 2025. Is that SA Story Intact?

Natal Midlands

Date: 05 December 2024

Venue: Christ Church Howick, 23 Mare Street, Howick

Morning Time: 10am for 10.30am

Evening Time: 5.30pm for 6pm

Johannesburg

Date: 04 December 2024

Venue: Rosebank Union Church, Cnr Winne Mandela Drive and St Andrews Road, Hurlingham

Time: 7am for 7.30am

Cape Town

Date: 2 December 2024

Venue: SSISA Conference Centre, Boundary Road, Newlands, Classroom 1, 3rd Floor

Time: 7.30am

Venue: ABRU Motor Studio, Lourensford Wine Estate, Somerset West

Time: 5.30pm for 6pm



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