Brazil's agricultural evolution and its impact on South Africa - By Aslam Dalvi, Kagiso Asset Management Equity Analyst

Mentioning Brazil conjures up different ideas and emotions for people. For some, perhaps the first thing that jumps to mind is the world renowned Rio Carnival. For others, it may be the world famous "Cristo Redentor", which overlooks the beautiful city of Rio.

Typical of an analyst, what defines Brazil for me is the story of the country's political transition, its recent economic success and the important role of agriculture in its economy.

Brazil enjoys significant agricultural advantages relative to South Africa. We believe this has allowed downstream industries such as the Brazilian poultry producers to emerge among the lowest cost producers in the world. Given these cost and competitive advantages, we view poultry imports from Brazil as a key threat to the local poultry industry.

Brazil

Brazil, South Africa's largest trading partner in Latin America, is known for its remarkable economic turn-around over the last ten years as well as its socio-economic policy model. It is one of the fastest growing emerging economies in the world with large and expanding agricultural, mining, manufacturing and services sectors.

On the face of it, the importance of agriculture is not clear as it accounts for around 10% of Brazilian GDP. A closer look, however, shows that "agribusiness" (which includes all related agricultural industries) accounts for roughly 30% of GDP and roughly 40% of exports. The high contribution from agriculture is not surprising as Brazil enjoys significant structural advantages when it comes to farming.

Counting blessings

Brazil has abundant agricultural land. According to the UN's Food and Agriculture Organisation, Brazil has roughly 600 million hectares of arable land available, of which 12% is currently in use. Land available for future agricultural development is about 450 million hectares - more than the US (second place) and Russia (third place) combined. Brazil also has a favourable climate with temperatures and rainfall levels ideal for growing crops.

In addition, the country has vast water resources, with approximately 12% of the world's fresh water. It has access to one of the world's largest underground water basins, the Guarani Aquifer, which the country shares with its neighbours Argentina, Uruguay and Paraguay. This water resource is a self-replenishing water mass, providing almost limitless access to fresh water and crop irrigation.

Another significant advantage is that Brazil's electrical power grid is largely based on hydro-electricity, which meets about 80% of the country's demand needs. While supply of electricity is subject to some unique risks, such as the droughts experienced in 2001/2002, Brazil's hydro-electricity grid results in a relative cost advantage to other countries.

These competitive advantages have ensured that Brazil has grown its agricultural sector dramatically in the last few years. For example, grain production has almost doubled over the last decade with corn production up from 80 million tons in 2000 to approximately 150 million tons currently.

What is even more striking is that Brazil enjoys these competitive advantages despite significant infrastructure challenges in the form of inadequate roads, ports, airports and other transportation modes. With the Brazilian government's commitment to address these challenges, it is clear to us that Brazil's cost competitiveness will continue to improve and allow the country to further entrench its agricultural superiority.

Comparison with South Africa

In contrast with Brazil's 600 million hectares, South Africa has 15 million hectares of arable land. Of this, only 22% is considered "top grade" arable land, putting the country at a clear disadvantage in terms of access to high quality farm land.

Another key disadvantage relative to Brazil is access to water with rainfall unevenly distributed across the country. About 65% of the country does not receive sufficient rainfall for rain fed crop production. As a result, South African farmers rely increasingly on more costly irrigation systems.

Energy costs in South Africa also remain a concern, with South African electricity tariffs expected to rise in excess of 20% over the next few years, putting further pressure on farmers and downstream industries.

A comparison of soil quality and climate between the two countries also shows Brazil with a clear advantage.

In addition to the above, South Africa has unique challenges. Land redistribution in particular is a major concern given the poor rate of farming success once productive land is handed over. Recent research highlights that the success rate remains below 10%, raising concerns around the current framework of land redistribution.

The challenge facing South African farmers can be seen by looking at key statistics in the agricultural sector. The number of farms, as measured by the Department of Agriculture, has declined by about 31% over the last two decades and total hectares planted for corn has declined by about 40% since 1970. This has resulted in South African agriculture, as a percent of GDP, declining from 9% in 1960 to about 2% currently.

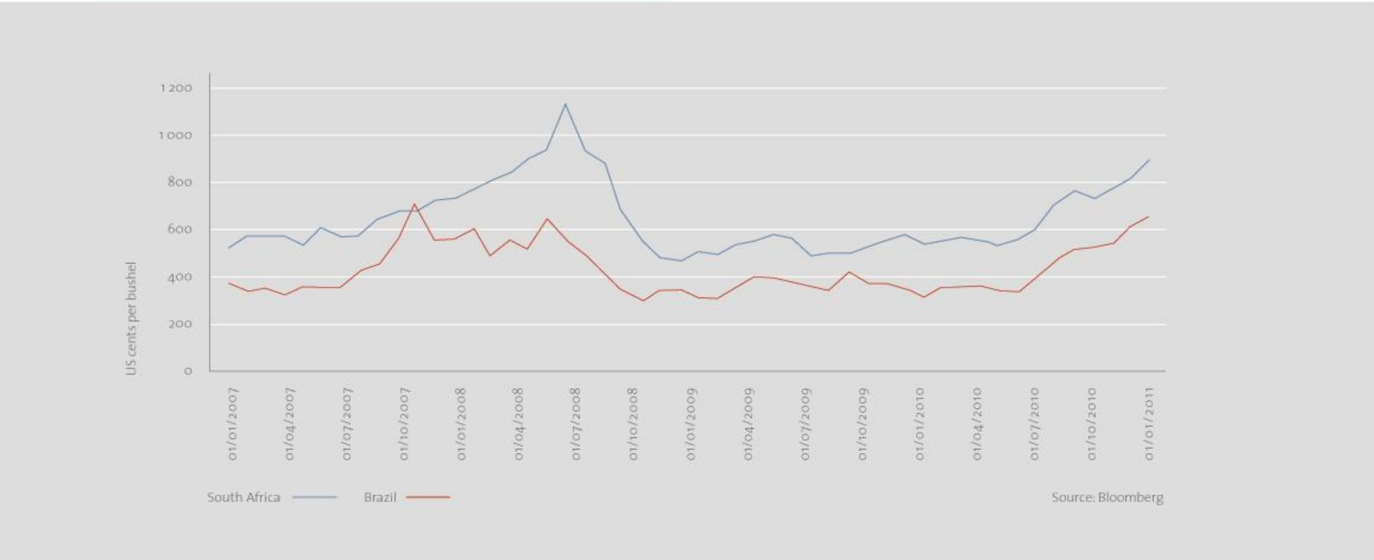
The story of poultry in Brazil and South Africa

The agricultural advantages enjoyed by Brazil have allowed the country to grow agricultural crops, such as corn and soy, at prices lower than other countries, including South Africa.

Adjusting for the impact of currency, research shows that Brazilian corn prices are generally 25% to 35% cheaper than South African import parity prices (see graph below). The South African import parity price reflects the world price of corn, adjusted for the cost of transport, insurance and storage, and is generally a good proxy for what producers pay in normal, non-surplus years.

This huge input cost advantage has put Brazilian poultry producers in a globally competitive position, as corn and soy account for about 55% of the cost of raising a bird.

Brazilian corn prices versus South African corn prices



Brazil also has significant scale advantages, with the country producing in excess of 11 million tons of poultry per year. With the ability to spread their fixed cost base across such significant volume, the country is arguably one of the lowest unit cost producers of poultry in the world.

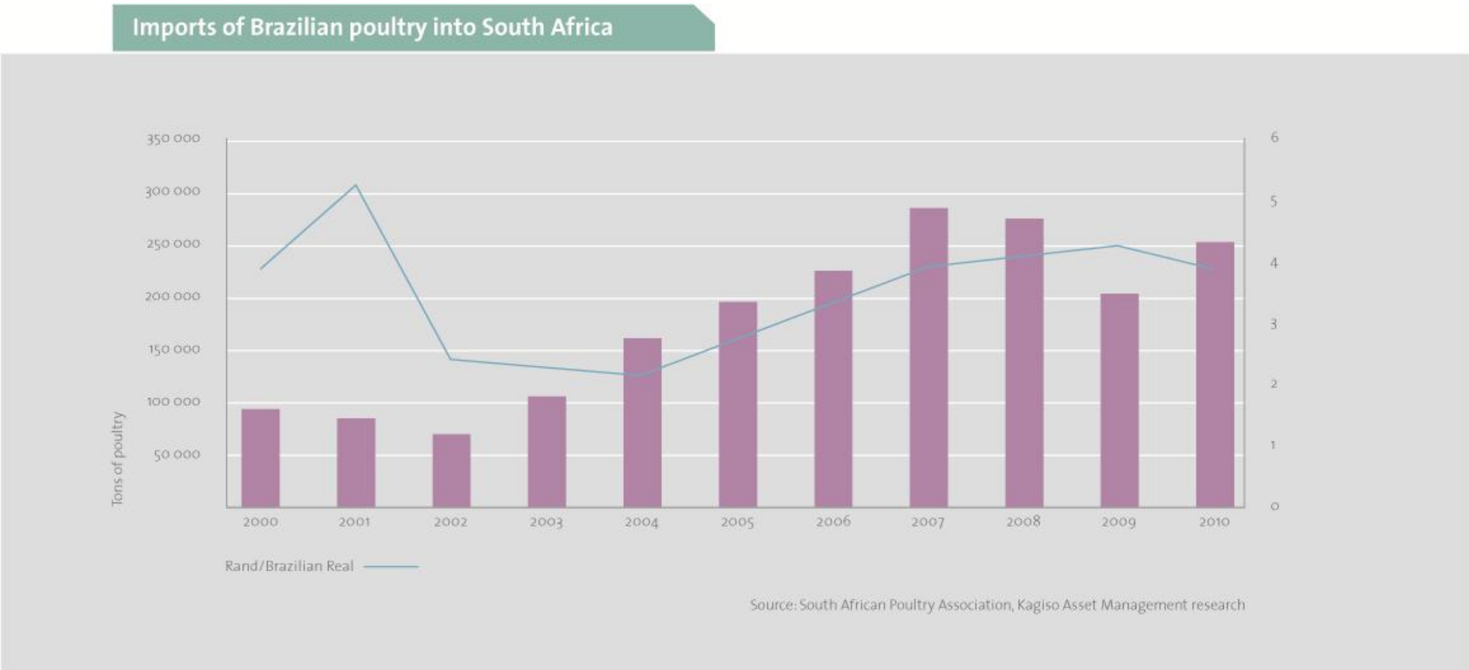
With access to cheap input costs and significant scale advantages, poultry producers in Brazil have flourished over the last decade. According to statistics from the Brazilian Poultry Association, the volume of poultry exports has tripled in the last decade.

Brazil is currently the third largest producer of poultry in the world and the largest exporter globally, with Brazilian exports accounting for a massive 40% of global poultry trade.

In contrast to Brazil, South African producers don't enjoy the same input cost advantages and the outlook for key operational costs, such as labour and electricity, is also worse. In terms of scale, South Africa is also at a significant disadvantage with local producers producing roughly 1.3 million tons of poultry per year.

Imports into South Africa and the rise of competitors

According to the South African Poultry Association, approximately 15% of all poultry demand is met through imports. Of this, roughly 71% of all imports are from Brazil - highlighting the key role that Brazil plays in our local poultry industry. Poultry imports have grown steadily over the last decade, growing from about 95 000 tons in 2000 to approximately 251 000 tons currently (see graph below).



While the recent rand strength, which makes imports cheaper and more attractive, partly explains the sharp rise in imports in 2010, an underlying trend is clear. We believe this trend of growing imports will likely continue, in turn putting pressure on local producers, who - structurally - cannot compete with Brazilian imports.

Our concern with local poultry producers is the emergence of a "super" competitor in the local market that has, and will continue to have, a structural cost advantage over local producers. It is clear to us that, in the absence of direct import restrictions or tariffs, South African producers will continue to lose market share.

June 2011

Enquiries:
Vera von Lieres
Tel +27 21 673 6316, Cell 082 958 4276
Email vvonlieres@kagisoam.com