

South African sugar producers strongly positioned for growth post EU sugar market reforms by Kagiso Asset Management Equity Analyst Rubin Renecke

Following major structural shifts in the global sugar industry in the form of European Union (EU) sugar market reforms, local sugar producers Illovo Sugar and Tongaat Hulett are robustly placed for growth.

In both cases, credit needs to be given to the management of both companies for having had the vision to position themselves optimally for the EU reforms by anticipating excess demand that would be required by the EU and therefore by setting up the necessary infrastructure to meet this demand.

Both Illovo and Tongaat have actively increased production over the last few years and are set to continue to do so in order to benefit from the EU reforms.

Both groups are also examples of companies that have strong earnings and growth potential from current levels and yet trade at reasonable multiples to the rest of the market.

EU reforms

The EU reforms, the final phase of which kicked in last year and will run for the next five years, aim to reform the EU market following “dumping” by the EU of excess supply of sugar onto the world market some years ago. This “dumping” and its negative effect on the global sugar price was one of the catalysts for structural reforms to the sugar protocol in the EU, partly enforced by the World Trade Organisation. The reforms have reduced EU sugar supply by about 5 million to 6 million tons with the shortfall required to be picked up as a block by African Caribbean and Pacific Group of States (ACP) and Least Developed Countries (LDC) countries.

The positive aspect of the reforms for ACP and LDC countries is that countries that are able to expand sugar production will benefit disproportionately to other countries that don't have the capacity to expand.

Illovo Sugar and Tongaat

Countries that both Illovo and Tongaat operate in include South Africa, Mozambique, and Swaziland, while Illovo has further operations in Zambia, Tanzania, Malawi and Mali (Mali, which will start producing in about three years time) and Tongaat has additional operations in Zimbabwe (currently not operating at full potential).

Illovo Sugar

Of the two companies, Illovo is by far the better positioned to benefit from EU reforms because most of the countries it operates in form part of the ACP and LDC group. The bulk of its expansion has been because of the anticipated EU reforms: A few years ago, Illovo started expanding into Zambia and Malawi by buying farms and investing in irrigation equipment and plantings in anticipation of the EU reforms. Further expansions into Tanzania and Mozambique followed, which also aim to take advantage of the EU reforms.

Illovo management recognised that increased volumes meant a decrease in the unit cost of production as well as guaranteed export prices – all big positives. In addition, UK listed food producer ABF owns about 51% of Illovo and has by far the dominant market share in the UK. ABF owns British Sugar, which has a joint venture with Illovo, thereby allowing the local sugar producer access to market premiums on refined sugar.

In the medium-term, Illovo's production is set to expand from a current 1.8 million tons to about 2.6 million tons with most of the sugar produced going to protected markets, i.e. markets that impose tariffs on imported sugar below a specified reference price.

Tongaat

Tongaat, to a lesser extent, has similar sort of positive prospects. The company has invested substantial amounts of capital in its sugar operations in countries like Mozambique and Swaziland and these investments have been timed to coincide with a significant liberalisation of the EU sugar market to the benefit of countries like Swaziland and Mozambique.

In addition, Tongaat has substantial sugar and agricultural investments in Zimbabwe. These investments are not reflected in the company's market valuation but have significant earnings growth potential that will be unlocked as economic and political stability returns to Zimbabwe.

When production in Zimbabwe reaches 600 000 tons (production last year was only about 290 000 tons), Zimbabwe will be the lowest sugar producer on the African continent, lower than any current Illovo country. The current problem in Zimbabwe is political instability as well as under spending on infrastructure.

In addition, Tongaat's extensive sugar, starch and property businesses in South Africa provide a strong valuation underpin to the current market valuation of the company. Tongaat produces about 800 000 tons of sugar in South Africa, which is expected to be stable to slightly rising in future. It also operates in Swaziland, where it has spent substantial capex and where production should be increasing significantly from about 60 000 tons to 100 000 tons of sugar.

Production in Mozambique is also expected to more than double to about 300 000 tons in the next few years from current levels.

Tongaat's other key interests include massive land developments in KwaZulu Natal, where management is in the process of partly developing and selling off land, as well as a starch business which manufactures starch and glucose for livestock feeds.

Countries that Tongaat is invested in (Mozambique, Swaziland, Zimbabwe) will therefore benefit positively from the EU reforms and similar to Illovo, provide strong earnings growth over the next few years.



Enquiries:

Vera von Lieres, Communication Strategist

Tel +27 21 673 6316, Cell 082 958 4276

Email vvonlieres@kagisoam.com