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## Tassal – something smells fishy

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It has been hard to find high quality businesses trading at attractive valuations in recent times. With share prices growing faster than earnings in recent years, valuations have started to become stretched across the board.

At times like this, one option for investors is to lift their heads above the immediate detail and scan the distant horizon; to try to spot large structural changes early and position accordingly for the long term. This is not easy to do, but potentially very profitable. For example, investors who anticipated the strength and duration of the mining boom could have enjoyed many years of rising tides.

### **Food bowl oversold**

One potential area of opportunity is agriculture. It has been said that Australia should aspire to be the “food bowl of Asia”, and there are some obvious reasons why this might be argued. In particular, the emergence of a very large middle class in Asia with increasingly Western tastes, combined with Australia’s long-standing agricultural credentials and clean environment.

For an investor wanting to explore this road, however, the going starts to get tricky quite early in the journey. In contrast with the resources sector, where many of the world’s premier listed mining businesses operate out of Australia, the ASX contains relatively little by way of large, world-class agricultural businesses.

While there are no doubt many good unlisted agriculture businesses in Australia that could also be considered, the sector is highly fragmented, and there are few enterprises with the scale to match even a mid-tier listed resources company.

### **The Tassal tale**

One of the few listed Australian agriculture investments, Atlantic Salmon producer Tassal (ASX:TGR), may provide a case in point. Tassal shares have more than tripled from around \$1.20 in 2014 to almost \$4.00 currently, and on the face of it, TGR represents a live example of the “food bowl” theme bearing fruit for investors. However, a look at the underlying dynamics identifies some issues.

### **Tassal (TGR)**



**Source:** Yahoo! 7 Finance, 24th of July 2014

Tassal's recent run comes on the back of a significant capital investment program. Between 2008 and 2012, it invested around \$200 million in developing its production and infrastructure capabilities, with the aim of bringing its operations to world's best practice. While profitability has improved somewhat, Tassal's return on equity has been consistently below 15% in recent years and is forecast to remain there for the foreseeable future. At this rate, investors do not have a strong incentive to put capital into the business.

Perhaps a more surprising development is Tassal's export sales. In 2012, Tassal generated a small, but meaningful, percentage of its revenues from exports. Since then, exports have shrunk to near zero. At its first half results, the company commented on this: "Tassal's previous reliance on volatile export markets has been successfully eliminated." It seems that competing overseas was much less rewarding for Tassal than selling domestically.

As a purely domestic supplier, Tassal may well have the ability to generate improving profits. However, like many domestic food producers, it must deal with very powerful supermarket chains, which may constrain potential returns, and clearly the "food bowl of Asia" theme does not apply. At this stage, it appears the strong run in Tassal's share price may not have a strong fundamental underpinning.

At the risk of generalising, it seems to us that investors need to be careful in navigating the agriculture investment theme. Where large capital investments are required in what are essentially commodities businesses with limited value add, we may find more examples of modest returns, and relatively few glowing success stories. Certainly Australia should not ignore the growth opportunities afforded by agriculture, but, in the long run, if we want a balanced, thriving economy, we may need to look beyond digging things out of the ground (or water) and shipping them to Asia.

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