Milk it with these 3 dairy queens

by Roger Montgomery

Australia is only a small global dairy producer, manufacturing just 2% of global dairy production, however our relatively small population means that 34% of our milk production is exported, earning $3 billion and making Australia the third largest exporter. In 2001, the industry was deregulated and unsurprisingly a rationalisation (a euphemism for the financial hardship of thousands of people despite $1.73 billion being paid to farmers for restructuring) has occurred leaving a core of more efficient producers that are trying to compete against international competitors who, unsurprisingly, are heavily subsidised – thank our Liberal National Party's level-playing field ideology for that!

Last season was described by many as 'tough' for dairy farmers, with the impact of low international prices being compounded by a step-down in farm gate prices. More recently, modest growth in milk production, generally favourable seasonal conditions and contained input costs all pointed to the Australian Dairy industry entering a 'recovery phase', according to the latest Situation & Outlook report from Dairy Australia.

Longer-term, the growing global population, along with increasing per capita annual consumption should bode well for Australia's high-quality products. Moreover, while annual cheese consumption in Japan is between 2-4kg per capita, and close to two kilograms per person in Korea and Taiwan, it is currently less than 100 grams per person in China.

Investors in the sector should also be aware of Murray Goulburn's impact on the supply chain.

In early 2016 Murray Goulburn implemented a raw milk pricing mechanism that was designed to provide unitholders, along with farmers, exposure to increases in the realised profit per unit of milk solids. The structure however inadequately rewarded the unitholders for capital investments they made that were necessary to grow the company's branded product capacity. The milk price and NPAT formula largely rewarded farmers, through high raw milk prices, for the returns generated by capital investment made by the company and its unitholders.

While dairy farmers became accustomed to processors announcing a season-opening price along with a forecast closing price – with regular 'step ups' through the season, Murray Goulburn and Fonterra, upon realising the flaw in the model, cut the prices towards the end of the season, causing financial hardship and triggering legal action by the ACCC for alleged unconscionable conduct.

With the argument that there is money to be made in farming, but not by farmers, local operators have no choice but to become more efficient or leave. To that end, some operators claim that the sale or break-up of operator Murray Goulburn, is the catalyst required to encourage further consolidation.

Let's take a look at three companies in the sector.

Bega Cheese (ASX:BGA)

Run by CEO and farmer Barry Irwin, Bega represents a successful example of the transition from co-op to company.

Bega avoided the retrospective pricing debacle that entangled Murray Goulburn, and as a result has picked up valuable milk supply.

While dairy consumption growth in China has fallen from 19% per annum between 2000 to 2008, it has fallen to just 2% in the last five years and many experts believe the low rates of growth are likely to continue.

Despite slowing growth, China is a huge market and Cheese consumption is expected to grow at rates above sector aggregate numbers. Bega's long-term agreement to cut and process cheese for NZ dairy giant Fonterra offers an income stream with less volatility than traditional dairy farming.

BGA reported FY2017 profit of $30.3 million (up 3.8%) and revenue growth of 3% to $1.23 billion thanks to cream cheese and mozzarella, and a contract with Woolworths that saw volumes ramp-up faster than expected.

With an historical P/E of over 30 times for a business generating single digit returns on equity, the stock is not cheap.

a2Milk (ASX:A2M)

Agricultural companies will always find sustainable earnings growth challenging. Volatile commodity prices and reliable customer relationships in Asia are A2M's challenges. The latter is particularly important because success relies on scaling significantly or remaining a niche player.

The share price appreciation of A2 belies the fact that it is currently a relatively small player. One industry expert observed; "Companies do OK when they stick to their niche but when they have grand plans to get bigger they struggle. It's difficult from Australia."

While premium and imported brands of powdered milk formula continue to take market share, and online prices are rising, A2 must compete with global dairy giant Danone – a company whose products dominate the SKU's on China's bestseller lists – not to mention Nestle and Fonterra.

Sales to China are expected to make up approximately 55% of FY18 revenues and the company's 'a2 Platinum' brand is growing in popularity there. A2 is now ranked eighth in a measure of online share of SKUs. Having achieved China FDA registration, the company's future earnings have a lower level of risk.

The share price is factoring in the best of all possible outcomes for all aspects of the business.

Murray Goulburn Unit Trust (ASX:MGC)

At Murray Goulburn's annual general meeting the company announced it had entered a binding agreement for the sale of all of its operational assets and liabilities to Canadian dairy company Saputo for $1.31 billion.

In justifying the sale, the company pointed to high debt levels, upcoming refinancing and continued milk losses (see Bega note).

The $1.31 billion will be used to repay transaction costs and liabilities and remaining cash, which is expected to amount to $1.10-1.15/share will be distributed to shareholders and unitholders. The final amount payable however will be dependent on whether the current net tangible assets of $1.30 is reduced by further write-downs as a result of further declines in milk supply.

There is also the uncertainty surrounding any liability in relation to the ACCC proceedings (but no financial penalty sought), ASIC investigation and unit holder class action, for which of course indemnity insurances might be assumed and should be investigated.

MGC is expected to distribute $0.75/share initially and retain the remaining $200 million as a contingency against the conclusion of the above actions which will take several years to conclude. Investors who buy MGC today would be arbitraging the return of the remaining funds against time and against the risk of a reduced distribution.

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