Company Research Report
17 September 2018
Armstrong Kamphoni
Kamphonia@cedarcapital.mw
+265 1 832 307

Equity research | Company Report

MALAWI

Sugar Production & Marketing

Bloomberg	Illovo.MW
Reuters	ILL.MV

Market Data	15-Sep-18
Closing Price	MK240.00
52 Week High	MK240.00
Change (%)	
52 Week Low	MK200.00
Change (%)	

Liquidity	
Market Cap (b)	MK172
Market Cap (m)	USD235
Shares (m)	713.4
Free Float (%)	16.00

Valuation Ratios	
P/E (x)	27.18
P/B (x)	3.35
EV/EBITDA (x)	10.41
DPS Yield (%)	0.00

Investment Opinion — Speculative BUY

It is difficult to make a call on Illovo Sugar Malawi (ISM). In one respect, the company is a potential *turnaround stock*, particularly after the company has indicated that by February 2018, the debt to the holding company had been reduced to around ZAR75 million from ZAR345 million. The company had further promised that by August 2018, the debt would be fully repaid.

Once ISM has been relieved of the interest burden and exchange losses, any upside in revenues and margins would filter undiluted to the bottom line.

On the other hand, the company's valuations are steep, with a P/E of 27x and EV/EBIDTA of 10.41x (twice the normal range). It appears that the share price has been sticky and has not responded to the weak earnings. Should the turnaround be borne in practice, we would expect the share price to remain stable whilst earnings grow into the valuation.

As well, ISM has not paid a dividend since FY15, so should cashflows improve with the repayment of the debt, investors would expect the company to resume dividend payouts. This could give impetus to those investors who invest looking for dividend inflows.

We rate ISM as a **Speculative, BUY** because while the company is not cheap on current fundamentals, it is a potential turnaround opportunity as the company corrects its operational inefficiencies and improve earnings through lower debt levels.

However, as we show in section (d) Illovo has not delivered in terms of capital appreciation when compared with the rest of the market. Using 2013 as a base, Illovo has returned 2% when the market has returned 227%. Given the devaluation of the Kwacha in the last five years, there has been a serious erosion in value.

Company Overview

Established in 1965 as Sugar Corporation of Malawi (SUCOMA), the company changed its name in 1994 to Illovo Sugar Malawi (ISM). The company is 76% owned by Associated British Foods (Illovo Group), Old Mutual Life Assurance has 8% and the balance is with the Malawian public.

The Illovo Group is the largest producer of sugar in Africa, with a total of 16 agricultural and manufacturing operations in six countries: South Africa, Malawi, Mozambique, Swaziland, Tanzania, and Zambia.

In Malawi, ISM runs two sugar estates;(a) Dwangwa in the mid-central region at Nkhotakota and (b) Nchalo situated in the south of the country at Chikhwawa. Illovo Sugar Malawi (ISM) has the capacity to mill 2.4 million tonnes of sugar cane – 80% from its own estates, 20% from out-growers – to produce over 300 000 tonnes of sugar annually. Both milling operations produce a by-product called molasses, which is sold as a fermentation raw material to both the Ethanol Company Limited and Presscane Limited.

Sugar cane growing is dependent on irrigation with Dwangwa Estates using waters from Dwangwa and Rupashe Rivers, supplemented by water from Lake Malawi, whilst Nchalo Estates sources water from the Shire River.

Both factories produce raw and refined sugar with the Nchalo factory also manufacturing value-added speciality sugars. More than half of the sugar produced is sold into the local direct consumption market (households) through a network of depots and into the local industrial and artisanal markets. Around 30% of sugar is sold into the European Union (EU) and the United States of America (USA) while the remaining 20% is sold into the regional markets.

ISM's estates are held under long-term leases acquired mainly in the 1960s and 1970s by the predecessor entity; Lonhro Sugar Corporation.

Operational and Financial Review

a) 6 months to 28 February 2018

The background to the financial results for the period between 1 September 2017 and 28 February 2018 include the following factors;

- Erratic weather conditions, starting with very wet conditions in November and December 2017 followed by a rather very dry January 2018.
- Lake Malawi waters rose 30cm, but not enough to allow for optimal power generation and irrigation by the estates and out-growers.
- There were intermittent power supplies to the estates.
- Both estates and out-growers were affected by very high levels of yellow aphid and red spider mite infestations, and army worm at Dwangwa, which resulted in costly chemical control requirements which negatively affected overall crop yields and the income statement.
- Continued illegal importation of sugar posed challenges in the domestic consumption market.

In response to these challenges, the company in addition to increased pesticides application had to invest in additional standby power facilities.

Armstrong Kamphoni
Kamphonia@cedarcapital.mw
+265 1 832 307

In the half year, revenues were up 35% to MK66 billion on the back of increased exports, at a time when illegal importation of sugar continued. However, Illovo responded by introducing new and affordable pack sizes, which energised volumes.

The aforementioned increase in costs related to pest infestation and operating expenses which grew in line with inflation, saw operating profits growing at a diluted pace of 12% to MK14.2 billion.

Finance costs were adversely impacted by foreign exchange losses on the ZAR345 million holding company loan as the Rand appreciated significantly against the Kwacha. The resultant outflow was MK4.4 billion, up 152% on the corresponding period.

At the end of the period, PAT at MK7.0 billion, is down 10% of the first half of last year.

	H1 2017	H2 2017	H1 2018
Total Revenues	**49 099**	**74 936**	**66 210**
Operating Profit	**12 696**	**6 006**	**14 173**
Net Financing Costs	(1 732)	(6 114)	(4 372)
PBT	**10 964**	**(108)**	**9 801**
	(3 229)	(610)	(2 844)
Net Profit/loss	**7 735**	**(718)**	**6 957**

Source – Company Annual Reports & Cedar Capital Research

Looking at the last's year full, it shows that H2 was strong revenue wise, but weak bottom line wise. In fact, the company recorded a loss in H2, primarily on lower operating margins and higher financing costs.

b) 5 years to 31 March 2017

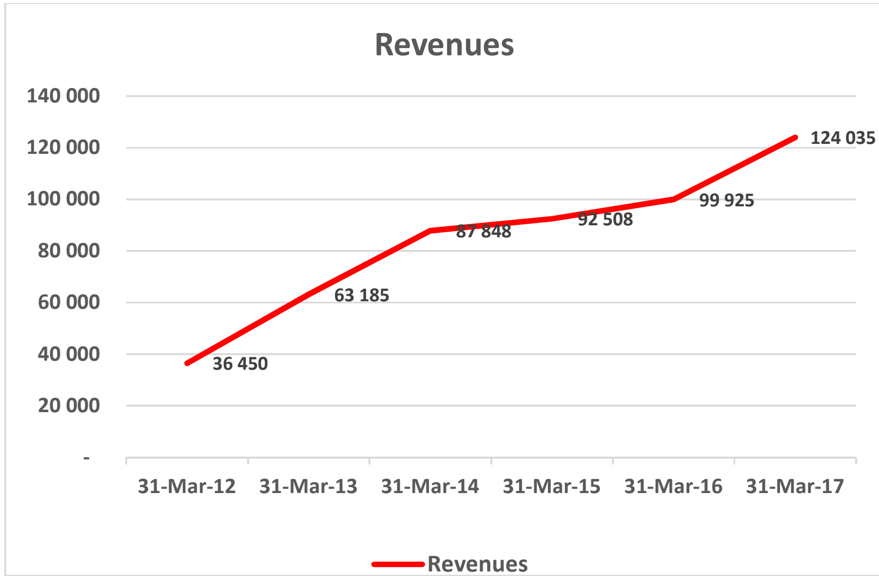
The five-year picture is not pretty. It shows company that has been in steady decline both in production/sales volumes and in earnings. Production peaked at nearly 300 000 tonnes in 2013 and has been consistently declining to reach 240 000 in FY17, showing a 20% decline from the peak.

	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17
Production (tonnes)	283 487	299 494	289 013	282 962	269 389	239 951
Sugar sales (tonnes)	283 487	293 938	290 505	273 244	255 468	244 671
Variance	-	5 556	(1 492)	9 718	13 921	(4 720)

Source- Company Annual Reports & Cedar Capital Research

Revenues have, however, been increasing, growing by an average 30%, driven mostly by increased export prices, increases in the local price of sugar and to a greater extent the depreciation of the local currency. Turnover in FY17 was MK124 billion.

Armstrong Kamphoni
Kamphonia@cedarcapital.mw
+265 1 832 307



Source – Company Annual Reports and Cedar Capital Research

At gross profit level, growth rates have been inconsistent, increase by 14% in FY14, declining by 2% and 8% in FY15 and FY16 respectively, before rebounding by 24% in FY17. In the last financial year, gross profits of MK55 billion were realised, as margins fell from 57% in FY14 to around 45% in FY16.

The picture has been much grimmer at operating profit level, with margins declining from 33% in FY14 to a low of 13% in FY16, before recovering 211 bps to 15% in FY17. The result was consecutive declines of 12%, 18%, 45% in FY14, FY15, and FY16 respectively in operating profits. Margin recovery in FY17 spurred a 24% growth in operating profits to MK19 billion.

The bane for the group has been the increasing interest burden, which is owed to the holding company. The debt started with a balance of MK4.2 billion in FY15, before ballooning to MK38.5 billion in FY16. By the end of FY17, the balance was MK24.3 billion. The debit in the P&L for the interest costs has severely constrained bottom line growth.

ISM has endured a steady decline in PAT, from the peak of MK21 billion to a low of MK1.8 billion in FY16. The performance in FY16 was also impacted by changes in accounting standards, meaning that the 292% rise in PAT to MK7 billion achieved in FY17, arose out of the restatement downwards of FY16 earnings from MK5.5 billion to MK1.8 billion.

Because of the poor showing on the income statement, returns have been weak, with ROE regressing from a high of 64% in FY13 before ebbing at 6.11% in FY16. FY17 is a respectable 19%, again showing the impact of accounting policy changes.

Kamphonia@cedarcapital.mw
+265 1 832 307

Margins & Returns	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17
Gross Profit Margin (%)	47,01	68,88	56,59	52,65	44,97	44,25
Op Profit Margin (%)	33,02	51,40	32,57	25,33	12,96	15,08
Interest Cover (x)	31,34	13,15	18,17	6,04	1,28	2,40
PBT Margin (%)	31,96	47,49	30,78	21,13	2,85	8,80
ROA (%)	19,61	32,77	24,21	18,21	1,81	6,93
ROE (%)	**39,16**	**63,62**	**45,87**	**52,77**	**6,11**	**19,33**

Source – Company Annual Reports & Cedar Capital Research

At first glance, FY17 seems to be showing a recovery, but that view is distorted by the changes in accounting policies which led to the restatement of FY16 numbers. However, the table shown in (b) shows that H2, was weaker on account of both low operating profits and high interest charges.

Risk factors and share price returns

- *Lack of consistency in production, revenues & earnings growth rates* – Illovo Sugar Malawi being an agriculture producer operates in an industry which is capricious, and performance depends on amongst other things; (a) acts of God, either positive or negative in terms of rainfall conditions; (b) commodity prices of sugar on the international market and (c) third party electricity suppliers affecting irrigation of fields and running of the mills. So, every agriculture season is different from the last, and in some cases expectations of continuous earnings improvements on the part of Illovo may be misplaced.

- *The past as an indication of the future* – As noted earlier, the second half of FY17 saw a loss of MK718 million being recorded, against a profit of MK7.7 billion in first half. The revenue picture is also a contrast, with H2 FY17 being 1.5x higher than H1. As such we are unable to use any pattern to discern how FY18 and FY19 will turn out to be.

- *The counter has severely underperformed the market* – As the chart below shows, Illovo (brown line) has for an extended period seriously underperformed the Malawi All Share (Purple line). We have looked at the returns for the period starting 2013 on a rebased basis

Company Research Report
17 September 2018
Armstrong Kamphoni
Kamphonia@cedarcapital.mw
+265 1 832 307

Source – Thompson Reuters Eikon

In the last 5 years, the price has remained range bound between a low of MK160 and a peak of MK294. The share price has done hardly anything this year. It is up only 2% at a time when the market is up 227%.

Cedar Capital Limited
4th Floor, Livingstone Towers
Sir Glyn Jones Road
P O Box 3340
Blantyre, Malawi
+265 1 831 995
Feedback: nzimar@cedarcapital.mw