



*Sugar is one of the world's oldest documented commodities, and at one time, it was so valuable that people locked it up in a sugar safe!*

### Agriculture

Reuters Ticker	ILV.MV
Target Price	MWK366
<b>Market Data</b>	<b>25-Jan-22</b>
Closing Price	MWK300
52 Week High	MWK300
52 Week Low	MWK80
Market Cap (bln)	MWK214
Market Cap (mln)	US\$216
P/E	10.46x
P/B	2.43x
DPS Yield	6.00%



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## MALAWI

### *Rights economics and moat ...*

Illovo's fortunes, as an integrated agriculture entity, are greatly affected by yields from the farm, efficiencies at the sugarcane milling plant, and the price of sugar in the market. The company's sugarcane estates score highly, with yields per hectare of 98 to 100 tonnes in recent times, against a world average of 70-80 tonnes and sucrose content of 14.10% which is very competitive. Total production from the company's estates has grown by 30% from the low point of 230 000 tonnes in 2018 to 279 000 tonnes in 2021.

Illovo is also an acknowledged low-cost producer, thanks to irrigation facilities, good climatic conditions, and high cane yields. This low-cost status will allow Illovo to remain competitive in the export markets even during soft commodity price periods. As well, the company is Malawi's biggest of the two sugar producers and thus, can control its margins without comprising demand. At the same time, the demand for sugar is generally inelastic.

### *Management can control the sales mix ...*

The proportion of sugar sold into the domestic market against that sold into the export markets affects revenue growth rates. In the domestic market, sales in 2021 grew 17% while exports were more or less flat. Local sales have a higher impact on the P&L and hence as local volumes grow, profits grow at a faster pace.

We expect export prices to improve in 2022 amid a global shortage of sugar driven by supply chain disruptions and the food-versus-fuel debate playing out in Brazil, which is the world's biggest exporter. Sugar prices on the world markets rose by 33% to close at US\$0.415/kg in 2021.

Management has the leeway to control the volume that is sold into the regional, US, and EU markets after the domestic market has been satiated. This allows the company to manage margins, whilst matching forex requirements with exports receipts.

### *More tailwinds than headwinds...*

Growth in the total production which is up 38% since 2019 coupled with higher export prices driven by a global shortage of sugar and improving export logistics should drive revenue growth going forward. Increases in plant efficiencies should improve margins and profitability. However, after the remarkable earnings growth in FY21, PAT growth in FY22 will certainly be slower, given the high base.

We estimate that Illovo will grow EPS by 28% to MWK36.67. This means that Illovo is currently trading at a historic P/E of 10.46x and forward P/E of 8.18x, which is cheap. We have a target price of MWK366.66. **BUY.**



## Business Description

Illovo Sugar Malawi (Illovo) has its roots in the formalisation of sugarcane cultivation in 1960, through a partnership of Lonhro International Corporation, the government of Malawi, and the Commonwealth Development Corporation (CDC). The partnership created the company; Sugar Corporation of Malawi (SUCOMA). The first sugarcane estate was established in 1968 in the Shire Valley at Nchalo Estate (20 925ha). Dwangwa Sugar Corporation (DWASCO) - 13 300ha estate - was then established in 1978. The two estates have a combined 34 225ha area under sugarcane cultivation.

In 1998, the Malawian government initiated a privatisation program under which both sugarcane estates were taken over by the South African-based Illovo Sugar Group, under the banner of Illovo Sugar Malawi. The ultimate holding company, though, is Associated British Foods plc.

Illovo is a vertically integrated company that grows sugarcane, mills the sugarcane, extracts, refines, and distributes sugar. The company harvests around 2 million tonnes of sugarcane from its two estates which together with approximately 280 000 tonnes produced by smallholder farmers (out-growers), enables the production of about 260 000 tonnes of sugar. The Dwangwa factory produces both refined white and brown sugar while the Nchalo factory produces brown and value-added specialty sugars. Molasses, a by-product, is sold as a fermentation raw material to Ethanol Company and Presscane Limited.

Sugar is distributed to customer outlets through five distribution centres, using a hub and spoke model.

### Shareholder Structure

SUCOMA Holdings Limited	542 084 186	75.98%
Old Mutual Life Assurance Company (Malawi) Limited	74 753 151	10.48%
Ramesh Haridas Savjani	14 821 735	2.08%
First Merchant Bank Limited	12 915 541	1.81%
Magetsi Pension Fund	8 838 257	1.24%
	<u>653 412 870</u>	



## Swot Analysis

<u>Strengths &amp; Opportunities</u>	<u>Weaknesses &amp; Threats</u>
<p>Strong management team.</p> <p>Good balance sheet liquidity position.</p> <p>First mover advantage and local market dominance.</p> <p>Good credit history in the local financial market.</p> <p>Strong roots in local markets and first-hand knowledge of local culture.</p> <p>low-cost producer</p> <p>Expansion of production capacity.</p> <p>Relative inelasticity of product demand.</p> <p>Strong brands even at the regional level.</p>	<p>Unpredictable weather and rainfall patterns affect sugarcane output.</p> <p>Exchange rate risk (remains a significant risk due to the cyclical nature of the economy).</p> <p>Reduction in purchasing power of the citizenry due to rising unemployment and low disposable incomes. To counter this threat, Illovo has introduced smaller pack sizes of 220gram and 500gram packs to cater to local customers who are financially unable to purchase larger bags.</p> <p>The sugar industry is vulnerable to political interest interventions.</p> <p>Inadequate physical infrastructure in the country results in rising logistics costs.</p> <p>An insect infestation may cause a rise in costs due to the need to import pesticides.</p> <p>New entrants are likely to disrupt the market for sugar as well as contracted out-growers.</p>

## Industry Review

### What is sugar?

Sugar which is used as a sweetener in food and beverages, is a crystalline substance acquired from various plants, such as sugarcane and sugar beets. In Sub-Saharan Africa, sugar is mostly derived from sugarcane.

Sugarcane is a perennial crop that is very sensitive to climate, soil type, irrigation, and harvest periods. The sugarcane stalk consists of approximately 14%, 68%, 15%,



and 3% of fibre, water, soluble sugar, and non-sugars respectively. The crushing/harvesting season normally starts in April of each year.

There are many variants of sugar;

- **Raw sugar** is not exactly 'raw', as sugarcane would have been processed to extract the sugar. Thus, raw sugar is any sugar that has been through this first cycle of crystallisation, at a sugar mill. Raw sugar is not fit for direct human consumption so is most commonly bought in bulk by food processors for use in food production and by other companies which are strictly sugar refineries.
- **Brown sugar** is refined sugar with molasses added back in. Brown sugar is refined and then turned back into a product containing molasses fit for human consumption.
- **Refined/White** is sugar that has been through two stages of crystallisation, first at a mill and then at a refinery. This gives it its signature white, crystalline appearance. White sugar is fit for human consumption and is also used in the food and beverage industries. It can also be bought over the counter in portable form for consumption and use by households.

#### The elasticity of demand for sugar...

Sugar is a product that consumers use, almost daily, in the preparation of many food items. In this role, sugar has weak alternatives or substitutes. As such sugar can be treated as a basic necessity, and all necessary goods are normal goods. Households with stable incomes tend to consume more sugar as they have more meals. Furthermore, the proportion of income spent on sugar is relatively small. Thus, the demand for sugar is inelastic.

#### Features of the sugar industry...

- *Production* - Up to August 2016, Illovo had been the only producer and distributor of sugar in Malawi, before it was joined by Salima Sugar Company (Salima) with operations located in the Chikwawa Greenbelt Site. Salima is 60% owned by AUM Sugar Company and 40% by the Malawi government. The two companies produce on average 300 000 tonnes of sugar annually, with Salima accounting for less than 20% of total production.
- *Capital hungry business* - sugar production is a long-term business, due to the capital-intensive nature of the investment and the period over which sugar is grown. A sugar mill capable of producing 150 000 tonnes of sugar per annum costs approximately US\$80mln to build, before taking into account support facilities such as housing, etc. By the same token, the cost of bringing one hectare of virgin land into cane production is estimated at US\$3 500 per hectare. Consequently, to start a sugarcane estate to produce



the 150,000 tonnes of sugar, the total capital cost could amount to US\$150mln for the whole infrastructure.

- *Labour intensity* - on a typical sugarcane estate one hectare of sugarcane land will, on average, employ three people. These people will be responsible for fertilising, weeding, and cutting the cane.
- *Markets* - the domestic market, comprising households and industry absorbs roughly 60% of the sugar produced. The balance is exported to the USA, EU, and regional markets. Industrial consumers dominate the market. The industrial users get the sugar in 50Kg and 1 000kg bags.
- *Price arbitrage* - sugar prices in the region differ from country to country. Traders occasionally take advantage of these pricing differences and illegally export from or import sugar into Malawi depending on the arbitrage opportunities.
- *Productivity* - Malawian sugarcane has an average sucrose content of at least 14% which is higher than most other African producers.
- *Efficiencies* - the country's sugar industry is one of the most efficient in the world, producing sugar at the factory cost of USD0.03/kg. It remains highly competitive even after taking into account its landlocked nature and its state of infrastructure, which adds almost USD0.02/kg to get the sugar to the nearest port in Mozambique for export. The world market price for raw sugar is around US\$0.40/kg.
- *World sugar market and prices* - many analysts expect the shortage of sugar on the world markets to continue, following frosts -induced reduction of production in Brazil and the preference for using sugarcane in fuel rather than food. Inventories have also been falling in Europe. In view of lower output and falling EU stock levels, the sugar market forecast was bullish for the 2021/2022 season. Consultancy group Fitch Ratings expects sugar prices in 2021 and 2022 to reach the highest level since 2016/2017. Raw sugar prices are projected to end 2021 at US\$0.40/kg, while white sugar prices are seen ending the year at US\$520/tonne.



## Financial Review

### Revenues

The main drivers of revenue growth are (a) the amount of sugar produced and sold; (b) the prices at which the sugar is sold; (c) the sales mix between domestic sales and exports and (d) the exchange rate movements.

	2017	2018	2019	2020	2021
<b>Sugar volumes</b>	<b>244 674</b>	<b>227 021</b>	<b>215 141</b>	<b>272 788</b>	<b>297 010</b>
Local volumes	137 606	170 792	137 716	147 242	172 578
Export volumes	107 068	56 229	77 425	125 546	124 432
<b>(MWK blns)</b>					
Local Revenues		116 314	99 476	98 165	115 300
Export Revenues		25 446	30 200	48 788	47 959
<b>Total Revenues</b>		<b>141 760</b>	<b>129 676</b>	<b>146 953</b>	<b>163 259</b>

Total sugarcane crushed rose 9% to 2.4 million tonnes, with out-growers delivering 22% of the sugarcane. However, the sucrose content at 14.10% was lower than the 14.29% enjoyed in FY20, and also the yield per hectare had declined marginally to 98 tonnes from 100 tonnes.

Illovo produced a total of 279 278 tonnes of sugar in FY21, up 17% on the prior year, and sold 297 010 tonnes, which was an annual increase of 9%. As such, revenues rose 11% to MWK163.3bln driven by a 17% surge in domestic sales to 173 578 tonnes, while exports at 124 432 tonnes were flat. The second factor impacting positively on revenues was the strategic pricing initiative by management in the face of lower illegal sugar imports as the MWK depreciated. Exports were



constrained by Kenyan import bans, logistical challenges of accessing the Rwandan and South African markets as well as COVID-19 induced restrictive border controls. Access to the EU and US markets was also negatively impacted by the scarcity of containers and general disruptions in the world's shipping industry, which saw volumes declining by 56% and 37% to 2 278 tonnes and 8 840 tonnes respectively.

### Cost drivers

Major costs for the company include the cost of farming as it pertains to labour, and chemicals such as pesticides and fertilizers. At the sugar mill, the major cost is electricity which is approximately 25% of total costs. As a business, the exchange rate impacts significantly on costs as the majority of non-labour input costs (pesticides, spares, and expatriate consultants) are foreign currency denominated, with about 80% being in ZAR and the balance being US\$.

In FY21, the Cost of Goods Sold (COGS) grew at a slower pace of 7% to MWK96.7bln, attributed to increases in the prices of fertilizer, electricity, and cost of transportation. Payments to sugarcane growers rose by 58% to MWK18.5bln, on the back of sugarcane deliveries being 23% higher. Sugarcane growing and manufacturing costs declined 16% to MWK78.8bln.

Operating expenses declined by 9% to MWK31.4bln, as salaries and wages rose by 7.5% - in line with inflation - to MWK28.6bln. Distribution expenses declined 16% to MWK14.7bln following the optimisation of the route to market strategies.

### Margins

Margins expanded significantly in 2021 with gross margins improving by 235bps to 41% while EBITDA margins rose to 21% from 15%. This was as a result of revenues growing in double digits while COGS grew at a slower pace and operating expenses declined. Operating margins nearly doubled to 16% from 9% in FY20. Net income margins rose from 2% to 13% in FY21.

### Profitability

Gross profits rose 18% to MWK66.5bln, while EBITDA galloped 60% to MWK35.1bln attributed to the strong margin performance. At the operating level, profits doubled to MWK26bln.

After accounting for biological assets fair value adjustments of MWK6bln, finance costs of MWK2.8bln (down 29%), and a hefty 474% rise in the tax bill to MWK8.9bln, the PAT rose 7.5x to MWK20.5bln. The tax bill increased as a direct consequence of the rise in profitability. The tax rate remained at 30% of PBT.

### Cash Flows

On the back of the solid growth in operating profits, net cash flow generated from operations increased to MWK32.7bln from MWK23.6bln. Free cash flow generation was good at MWK25.75bln compared with MWK18.9bln in FY20.





### Dividend

The strong cash flow generation enabled Illovo to re-instate the dividend payout ratio to above 50%, paying out MWK18.00 per share for the year.

### Cash resources and Gearing

Another consequence of the strong growth in profits and improved free cash flow generation was the reduction of the net debt to MWK9.9bln from MWK19.9bln, as the company paid off MWK15bln worth of short-term borrowings. Cash balances closed the period at MWK3.9bln which covered the bank overdraft of MWK3.5bln. The overdraft facilities attract interest rates of between 11%pa and 15%pa. Two-thirds of the cash balance was held as US\$ and amounted to roughly US\$3.2mln.

### Working Capital

The inventories base of MWK44.2bln, comprised of sugar stocks valued at MWK35.2bln, which essentially represented 2.5 months' future revenues. The debtor's book rose by single-digit to MWK18.7bln, largely reflecting the growth in revenues. Illovo closed the year with inventory days of 140 days and debtors' day of 38 days.

Payables were largely unchanged at MWK27.6bln, with just under MWK1.7bln is denominated in ZAR and US\$.

The capex to revenues ratio has averaged 5% in the last three years.

### Fixed assets

The fixed asset base was valued at MWK65.1bln with the majority being "growing sugarcane" worth MWK26.1bln and plant and machinery of MWK26.8bln.

### Financial Ratios

	Aug-21	Aug-20	Aug-19	Aug-18
GP Margin	41%	38%	44%	44%
EBIDTA Margin	21%	15%	20%	25%
PAT Margin	13%	2%	8%	12%
Debtors Days	38,65	43,59	52,52	23,31
Inventories Days	171,87	206,28	244,59	97,26
Payable days	16,47	12,43	7,92	3,44
Pay-out Ratio	63%	13%	0%	0%
Expense Ratio	19%	23%	23%	19%
Taxation Rate	30%	36%	31%	32%
ROE	26%	4%	15%	27%
Debt/Equity	4%	23%	43%	36%





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## CONCLUSION & RECOMMENDATION

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For FY22 we are forecasting PAT and net sales of MWK25.1bln (22% year-on-year) and MWK189.5bln (16% year-on-year) respectively. We expect total volume sales to increase by 9% to 320 500 tonnes and exports to benefit from the MWK depreciation.

Illovo is trading on a 1-year rolling forward P/E of 8.18x, inexpensive versus its average of 10x (calculated after normalizing for FY20). Our current TP is at MWK366.66 implying an upside of 22%. **BUY**



### INCOME STATEMENT

	Aug-21	Aug-20	Aug-19	Aug-18
<i>Domestic Market</i>	115 300	98 165	99 476	116 314
<i>EU Market</i>	8 840	14 110	7 022	12 471
<i>USA</i>	2 778	6 386	6 059	5 195
<i>Regional Market</i>	36 341	28 292	17 119	7 780
<b>Turnover</b>	<b>163 259</b>	<b>146 953</b>	<b>129 676</b>	<b>141 760</b>
<i>Cost of Sales</i>	<i>(96 807)</i>	<i>(90 593)</i>	<i>(73 080)</i>	<i>(79 686)</i>
<b>Gross Profit</b>	<b>66 452</b>	<b>56 360</b>	<b>56 596</b>	<b>62 074</b>
Opex	(31 425)	(34 461)	(30 100)	(26 778)
Other Income	71	28	2	31
<b>EBITDA</b>	<b>35 098</b>	<b>21 927</b>	<b>26 498</b>	<b>35 327</b>
Depreciation	(9 120)	(8 962)	(5 292)	(4 057)
<b>Operating Income</b>	<b>25 978</b>	<b>12 965</b>	<b>21 206</b>	<b>31 270</b>
FV of growing cane	6 034	(4 800)	(1 157)	(1 042)
<i>Interest Expenses</i>	<i>(2 774)</i>	<i>(3 902)</i>	<i>(5 395)</i>	<i>(5 937)</i>
Finance income	100	22	28	36
<b>PBT</b>	<b>29 338</b>	<b>4 285</b>	<b>14 682</b>	<b>24 327</b>
Tax	(8 869)	(1 546)	(4 599)	(7 878)
<b>ATTRIBUTABLE</b>	<b>20 469</b>	<b>2 739</b>	<b>10 083</b>	<b>16 449</b>
<b>Headline PAT</b>	<b>20 469</b>	<b>2 739</b>	<b>10 083</b>	<b>16 449</b>

### BALANCE SHEET

Cash & near	3 922	318	722	249
Derivative assets	33		87	156
Debtors	18 681	15 891	19 212	18 104
Related party debtors	524	1 864	936	1 324
Bio Assets - growing cane	28 865	22 831	27 631	26 074
Inventories	44 248	46 919	55 477	42 468
<b>Current Assets</b>	<b>96 273</b>	<b>87 823</b>	<b>104 065</b>	<b>88 375</b>
PPE	58 190	55 498	56 144	50 481
Investments	604	494	463	
<b>Total Assets</b>	<b>164 525</b>	<b>146 373</b>	<b>160 672</b>	<b>138 856</b>
Trade payables	27 414	26 643	32 344	31 187
Related party payables	4 237	4 498	1 670	1 500
<b>Current Liabilities</b>	<b>46 925</b>	<b>53 370</b>	<b>67 734</b>	<b>54 829</b>
Borrowings	3 500	16 580	30 389	22 194
<b>Capital/NAV</b>	<b>88 171</b>	<b>71 874</b>	<b>71 298</b>	<b>60 939</b>
Capex	8 873	6 190	10 989	14 413



**METRICS**

Number of shares	713 444 391	713 444 391	713 444 391	713 444 391
EPS	28,69	3,84	14,13	23,06
Headline EPS	28,69	3,84	14,13	23,06
NAV	123,58	100,74	99,93	85,42
DPS	18,00	0,50	0,00	0,00
Share Price	300,00	82,32	210,00	200,00
<b>P/E (x)</b>	10,46	21,44	14,86	8,67
<b>P/B (x)</b>	2,43	0,82	2,10	2,34
<b>EV/EBITDA (x)</b>	6,10	2,68	5,65	4,04
<b>Net debt/Equity (%)</b>	<b>(0,48)</b>	<b>22,63</b>	<b>41,61</b>	<b>36,01</b>
<b>debt/Equity (%)</b>	<b>3,97</b>	<b>23,07</b>	<b>42,62</b>	<b>36,42</b>
GP Margin	41%	38%	44%	44%
EBIDTA Margin	21%	15%	20%	25%
PAT Margin	13%	2%	8%	12%
Yield on Cash	5%	4%	6%	
Cost of Debt	28%	17%	21%	27%
<b>Debtors/Revenues</b>	<b>12%</b>	<b>11%</b>	<b>14%</b>	<b>13%</b>
Days working capital	93,68	87,91	98,34	43,19
Debtors Days	38,65	43,59	52,52	23,31
Inventories Days	171,87	206,28	244,59	97,26
Payable days	16,47	12,43	7,92	3,44
Cash Conversion Cycle	194,05	237,45	289,19	117,13

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