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28 December 2016 | Sector Update

Food & Beverages

***Maintain* NEUTRAL**

Shrinking margin amidst rising commodity prices

INVESTMENT HIGHLIGHTS

- **Mixed results recorded by F&B players**
- **Prices of commodities starting to normalise to FY14 level**
- **F&B players demonstrated shrinking margin**
- **Strategies are in placed to mitigate the rising commodity prices**
- **Maintain NEUTRAL on the sector**

Mixed results recorded by F&B players. From the latest earnings announcements, the F&B players under our coverage i.e. F&N and Nestle have registered mixed earnings results. F&N (NEUTRAL, TP: RM25.32) latest earnings result came lower than ours and consensus expectation as earnings had been dragged down by Malaysian F&B business segment due to lower revenue and high operating cost. Hence, we revised our TP downward to reflect the slowdown of F&B Malaysia business segment as well as rising commodity prices. With regards to Nestle (NEUTRAL, TP: RM82.82), latest earnings is in line with ours and consensus expectation. Therefore, we maintained our earnings forecast for Nestle as we believe it is fairly valued at this juncture. Another F&B player which is not under our coverage, Dutch Lady, has recorded earnings below consensus expectation as uptrend in skim milk powder prices has impacted earnings.

Table 1: F&B sector's earnings report card

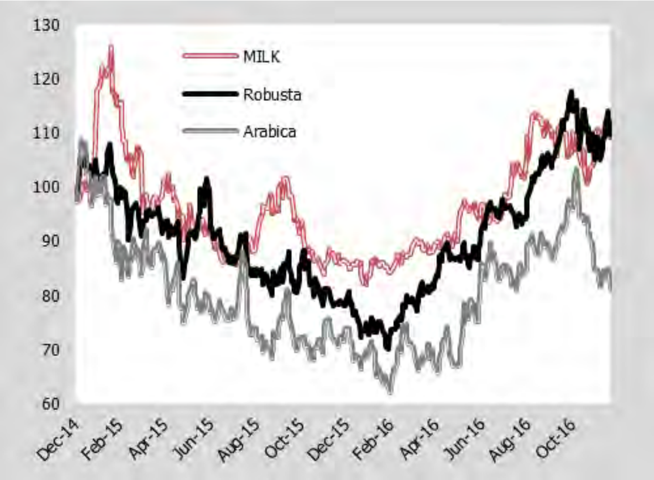
F&B Companies	Upgrade/ Downgrade	Previous Recommendation	New Recommendation	Previous TP	New TP
F&N	Maintained	NEUTRAL	NEUTRAL	RM28.35	RM25.32
Nestle	Maintained	NEUTRAL	NEUTRAL	RM82.82	RM82.82

Source: MIDFR

Prices of commodities starting to normalise to FY14 level. After experiencing more than a year of declining trend from the beginning of FY15, the price of agricultural commodities such as skim milk powder, coffee beans and raw sugar has surged since February this year, at prices even higher than FY14 price levels. Nevertheless, the price of cocoa has been dropping due to an increase in supply. In addition, the sector is further facing cost pressured by the depreciating ringgit as these commodities are traded in USD.

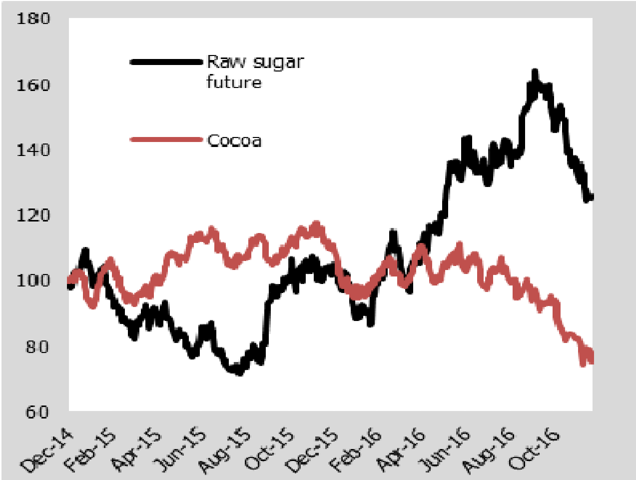
a) **Skim milk powder.** Whilst the price for skim milk powder hit the year-high of USD2,683 per mt on February 15 since then, it has been on a downward trend which lasted until February 16, thereafter, the commodity has risen by approximately +46% YTD. It is expected that the upward trend will remain as demand continues to be strong while production of milk is falling in the major exporting regions, particularly Europe and Australia, coupled with an unprecedented decline in New Zealand milk supply due to wetter spring (Sep-Dec 16) season there.

Chart 1: Normalised Milk, Robusta and Arabica coffee bean price trend (USD)



Source: Bloomberg

Chart 2: Normalised raw sugar and cocoa price trend (USD)



Source: Bloomberg

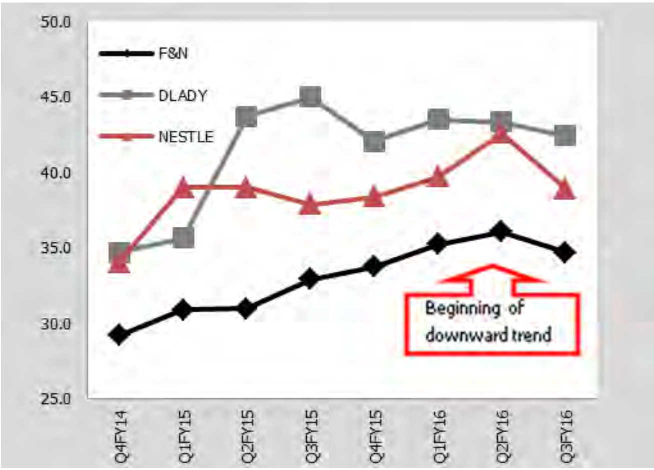
b) **Robusta and Arabica coffee beans.** The price of Robusta beans has appreciated to a USD 2,100 per mt level in November 16, up +36% from USD1, 528 per mt beginning of FY16. The Robusta beans, the lower quality of the two coffee bean types and generally used in instant coffees and coffee flavored products, has been hit by supply concerns, with insufficient stocks in Brazil and poor crop yields from major producers in Brazil and Vietnam. There are also major concerns over the yields in Brazil for 2017/18 seasons, after drought had impacted the Robusta growing regions. Meanwhile, the more premium Arabica coffee experienced a rise of +28% YTD on November 16 but has been on a decline ever since as the supply outlook for Arabica has improved. As the price spread between the two types of beans narrowing, some might regard the more premium Arabica beans as substitute to the scarce Robusta beans which might spur a rally on the price of the former. Currently, the price spread between Arabica and Robusta beans has dropped to USD597 per mt from the average at USD 1,000 level in the past two years. Going forward, we expect that coffee beans prices will remain volatile in the short and medium term.

c) **Raw sugar.** International raw sugar price was trading approximately USD 0.14 per pound in January 15, and peaked at USD0.24 per pound (+70%) in October 16. The price has now gradually decreased to USD0.18 per pound in December 16. The earlier run-ups in price was due to the deficit in supply as El Nino phenomenon resulted in droughts in parts of south and south-east Asia including major producers India and Thailand. Due to the raw sugar price uptrend, the wholesale prices of refined sugar sold to local F&B players was increased in November from RM1,800 per ton to RM2,500 per ton (+31.6%). Note that the local F&B players now can only source their sugar locally since the cessation of Approved Permit (AP), hence, this increase will further impact their margin. However, rains had returned in September and it is expected that production should rise in 2017/18, providing a breather to the raw sugar price trend moving forward.

d) **Cocoa.** Cocoa prices experienced a 25% drop from as high as USD2,910 per mt in early FY16 to approximately USD2,187/mt on December 16. Improved weather conditions have boosted supply and cocoa prices seem to have fallen to its three-year low. The drop in cocoa price has helped cushion the increase in other commodity prices for F&B players that use cocoa as one of their raw materials.

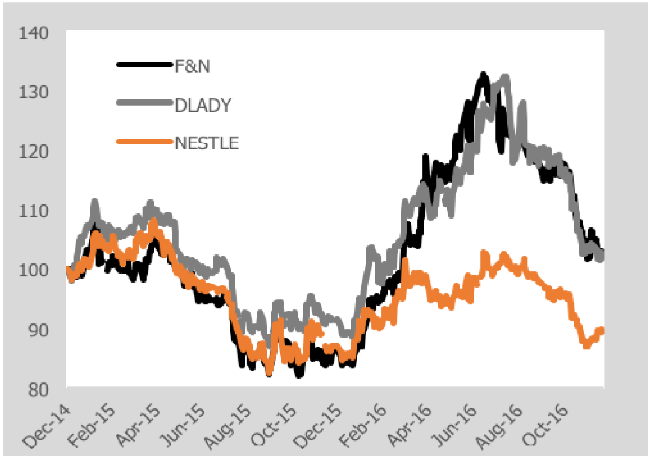
F&B players demonstrated shrinking margin. F&B players like F&N, Nestle and Dutch Lady has been benefiting from the subdued commodity prices for the past two years. GP margin for these players has been on an increasing trend for seven consecutive quarters from Q4FY14 to Q2FY16 as depicted in the Chart 3 before declining in Q3FY16. The reversal of the upward trends of GP margins from Q2FY16 corresponded well to the surge in commodities prices starting from February 16 (Chart 1). We presume that the commodity prices have between 3-4 months of lagging impact to the companies' cost of sales, on the back of their average inventory turnover of approximately 2-3 months. Therefore, we expect that margin compressions will continue for at least another two consecutive quarters. In line with the shrinking margin, share prices have started to fall from July 16 as depicted in Chart 4.

Chart 3: F&B players' GP margin trend



Source: Bloomberg

Chart 4: F&B players' share price trend



Source: Bloomberg

Strategies are in placed to mitigate the rising commodity prices. As F&B players are limited in their ability to pass on these costs to consumers by raising selling price due to weak consumer sentiment and stiff competition, strategies such as product innovation, improving cost efficiency and productivity are more appropriate. For instance, Nestle and F&N has been benefiting from its product innovation initiative with introduction of products which utilize less sugar, indirectly moderates the impact of higher refine sugar price. Also, they have always been emphasising on improving cost efficiency and productivity. Furthermore, Nestle, for instance has planned to launch a global procurement hub in Malaysia which amongst others, will assists in management of procurement for raw materials while F&N has been working on internal consolidation exercise as well as launching a new polyethylene terephthalate (PET) bottling manufacturing line to improve its operational efficiency and service levels.

Maintain NEUTRAL on the sector. Due to the normalisation of commodities prices, F&B players face challenges in controlling raw material costs in the short term on top of weakening Ringgit. We expect that the margin compression will continue for at least two consecutive quarters. Nevertheless, we are not overly concerned on the commodity prices uptrend on the long term as we believe that local F&B players have taken appropriate measures through product innovation and improvement of internal operating efficiency. Hence, we are maintaining our **NEUTRAL** call on the sector as we believe that measures taken by F&B players are appropriate to combat the rising costs.

Aaron Tan Wei Min |
Nabil Zainoodin
nabil.zainoodin@midf.com.my
03-2772 1663

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MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS	
STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >15% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >15% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -15% and +15% over the next 12 months.
SELL	Total return is expected to be <15% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >15% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.
SECTOR RECOMMENDATIONS	
POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.