31 October 2017 | Sector Update

Food & Beverages

***Maintain* NEUTRAL**

Rising cost of paper-based packaging material

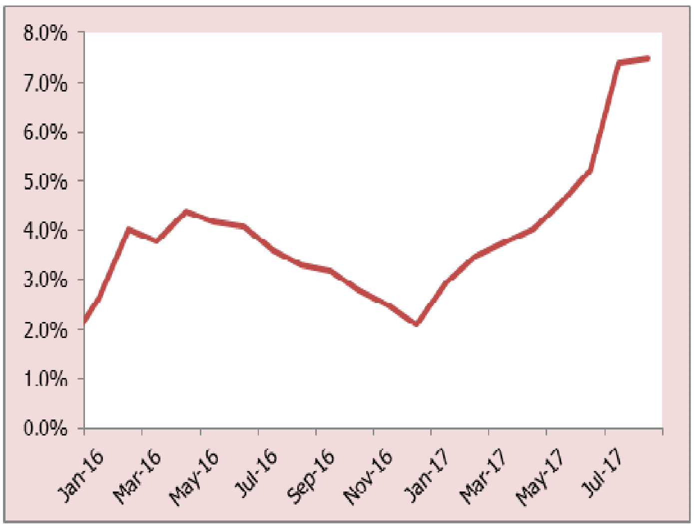
INVESTMENT HIGHLIGHTS

- **Rising international wood pulp and paper prices**
- **Local paper and paper products prices are also on the rise**
- **Small to mid-sized F&B players are most impacted by the rising paper price**
- **Additional pressure for F&B players to increase product prices**
- **Expect F&B players to increase their product prices to the local market next year**
- **Maintain NEUTRAL on Consumer sector and F&B sub-sector**

Rising international wood pulp and paper prices. Wood pulp prices are on the rise hitting historical high level, affecting manufacturers that use these goods as input materials. To date, the international hardwood pulp price has rallied from US$200 per tonne to US$690 per tonne mainly due to supply disruption as pulp mills in Indonesia and Brazil experienced lower production due to environmental concerns as well as maintenance shutdown. As wood pulp is the major input for paper, rising wood pulp prices are expected to flow through to the price of paper. This threatens the profit margins of paper-based packaging suppliers and as a result of cost-pass through, the end consumers mainly F&B manufacturers will also be affected.

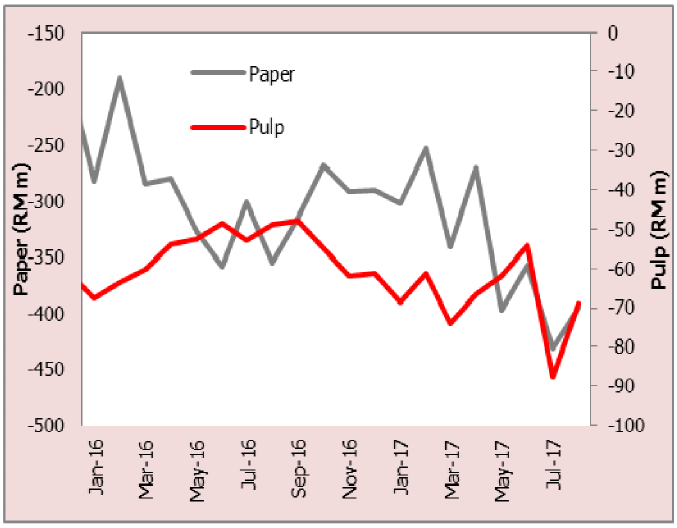
Locally, paper and paper products prices are also on the rise. Locally, paper and paper products prices have been on an increasing trend which is in line with the global trend. From Figure 1, paper and paper products prices are on an upward trajectory since December 2016. The price growth was +2.1%yoy then before it peaked to+7.5%yoy in August 2017. This upward trajectory may continue in the upcoming months as Malaysia is a net importer of pulp and paper. From our analysis, there is an increasing demand of pulp and paper locally and this coupled with relatively weaker Ringgit contribute to the widening gap between import and export of these goods. From Figure 2, the gap between the import and export trade of paper and pulp has widened to RM395.1m and RM68.9m respectively.

Figure 1: Paper & Paper Products prices year-on-year growth (%)



Source: Department of Statistic Malaysia

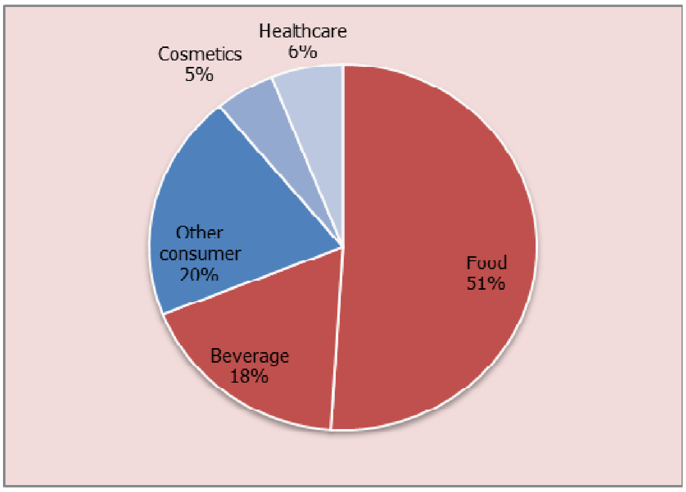
Figure 2: Paper & Pulp export-import deficit (RM m)



Source: Department of Statistic Malaysia

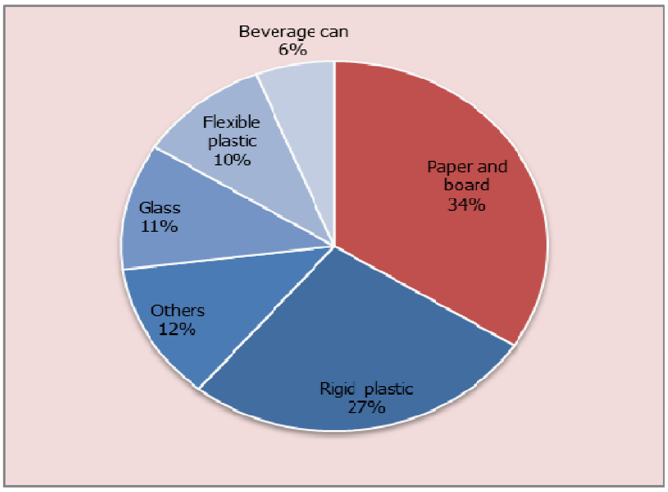
F&B players are most impacted by the rising paper price. The F&B industry represents the biggest market for global packaging with 69% of the total market size (Figure 3). While in the packaging market, paper and board (including paper bags and cartons) is the largest consumer packaging category with approximately 34% share of the total packaging market (Figure 4) as food products are usually packaged and shipped with paper-based materials. On the other hand, PET and HDPE polymers prices (input goods for plastic bottles) remain stable as crude oil prices are forecasted to average USD55 per barrel in FY18. Nevertheless, rising paper price is a concern to F&B players as this will contribute to a higher cost for packaging. Our channel check with industry player confirms that as of this year, there were already two rounds of price increases by packaging supplier for packaging material of about +2% to +3% increases each time. Hence, it is also expected that packaging material supplier will further increase their product selling prices going forward.

Figure 3: Global packaging – by market



Source: Ernst & Young

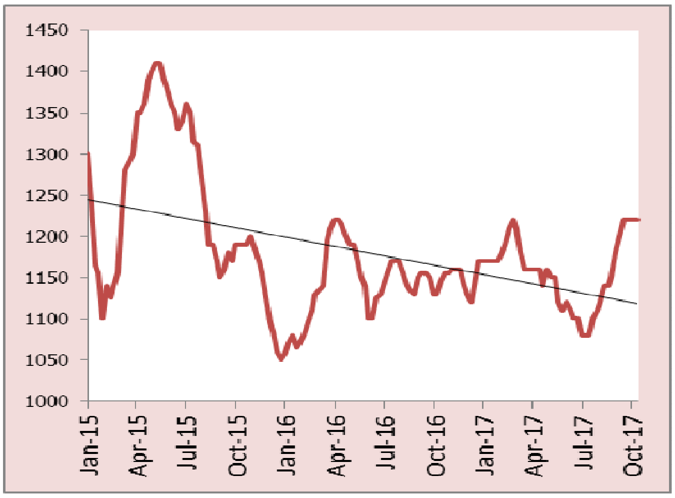
Figure 4: Global packaging – by type



Source: Ernst & Young

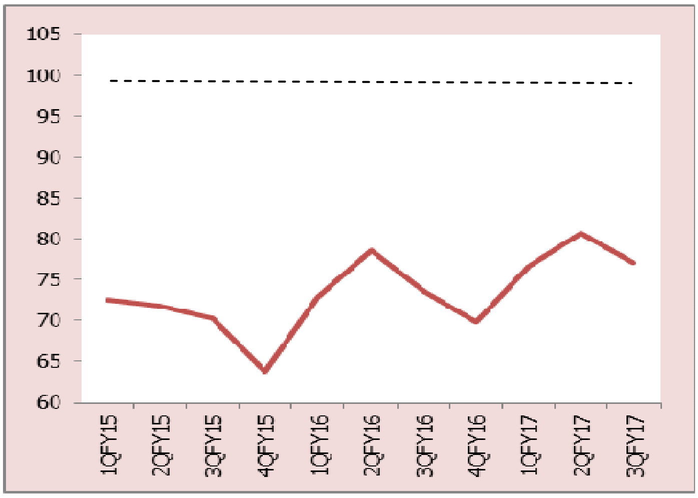
Spritzer less affected by the rise in paper-based packaging material prices. We reiterate our **BUY** recommendation for **Spritzer (TP: RM2.83)** partly due to the stabilising PET prices as it uses plastic-based packaging for its products. Also, Spritzer has also revised upwards the selling prices for some of its products by approximately 5%. We are positive on the price adjustment as it will enhance average selling prices as well as profit margins. We believe that sales volume should remain stable due to minimal increase in prices. Spritzer was also a sponsor of the SEA Games and the promotional activities should have driven volume and sales higher. We expect brighter prospects for Spritzer going forward due to stabilising PET prices, stronger sales from Malaysia and lower operating expenses in China.

Figure 5: HDPE polymers prices (USD/tonne)



Source: Bloomberg

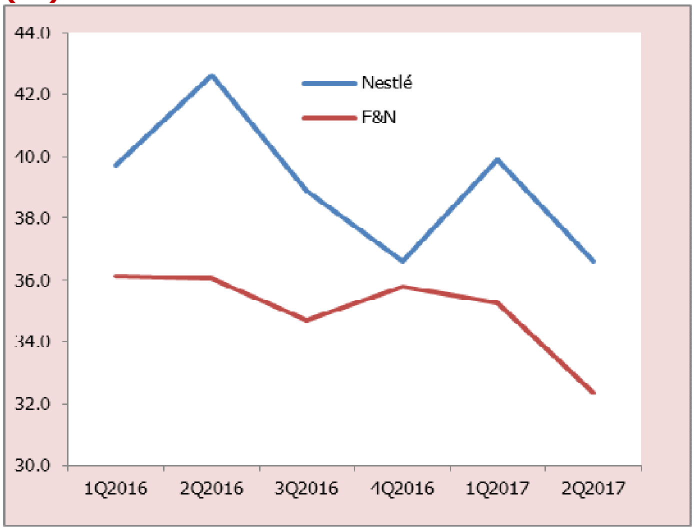
Figure 6: MIER consumer sentiment index



Source: MIER

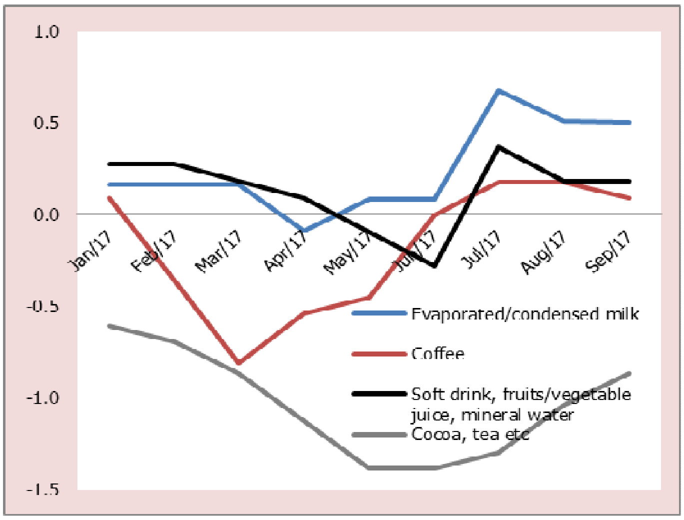
Additional pressure for F&B payers to increase product prices. Despite the rising raw material prices as well as packaging cost, most F&B companies have only increased product prices on a selective basis. While we estimate that packaging cost constitutes less than <10% of cost of sales, the ever increasing input costs will put pressure on F&B players to further increase prices. The GP margin for F&B players such as Nestle and F&N are on a downward trend with the latest recorded margin in the 2Q17 at 36.6% and 32.3% from the peaked of 42.6% and 36.1% respectively (Figure 7). We note from Figure 8 however, that on average product prices only increase marginally about +0.5%yoy starting from June 17. From this observation, we conclude that while F&B players need to increase product prices, the rising input costs were mostly absorbed for now as it is necessary to maintain market share in the current environment.

Figure 7: Quarterly GP margin for Nestlé and F&N (%)



Source: Bloomberg

Figure 8: Selected F&B products prices year-on-year growth (%)



Source: Department of Statistic Malaysia

Nevertheless, retail prices of F&B products continue to increase in FY18. F&B players under our coverage recorded a decline in GP margin last quarter due to the inability to pass the rising costs to end consumers. Moreover, the consumer sentiment index at 3Q17 was reported at 77.1, a decline of -3.6ppts from 2Q17 and hence, making it harder for F&B players to fully pass rising costs to consumers. Nevertheless, we expect that F&B players will continue to raise product prices next year albeit selectively in order to protect their profit margins. In addition, bigger F&B players have more headroom to generate savings via operating efficiency efforts to mitigate rising costs. Hence, we maintain **NEUTRAL** on **Nestlé (TP: RM82.76), F&N (TP: RM25.47), QL Resources (TP: RM4.13), MSM (TP: RM3.31)** and **Oldtown (TP: RM3.10)**.

Maintain NEUTRAL on the sector. Due to the rising input costs such as paper-based packaging material, we expect small to mid-sized F&B players to be impacted due to a weaker bargaining power and their limited ability to switch suppliers. In comparison to bigger players like Nestlé and F&N, these companies have other means in mitigating rising input costs such as focusing on operating efficiency efforts to gain extra savings. That said, we expect that F&B players will be pressured to raise their retail prices in order to maintain margins. Overall, we are maintaining our **NEUTRAL** call on the F&B sector.

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MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS

STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >10% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >10% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -10% and +10% over the next 12 months.
SELL	Total return is expected to be <10% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >10% 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.