FINANCIAL REVIEW smartinvestor

SE inside views

HD **Temptation for adventurous palates**

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WC 928 words
PD 12 December 2014
SN Financial Review Smart Investor
SC FRSINV
ED First
PG 22
LA English
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FOOD

The free trade deal with China beefs up the potential for local food and beverage producers, and should provide the shrewd with opportunities to get stuck in, writes Michael Smith.

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Food is big business and the appetite for stocks exposed to the changing eating habits of the growing Asian middle classes offers great investment opportunities.

Australia's free trade agreement with China means local dairy, beef and wine exporters will be better placed to compete with major exporting rivals in New Zealand and Europe. Foreign buyers are also circling food and beverage producers, which means there is potential upside if your investment becomes a takeover play.

The problem for investors is there are few listed large caps and returns from the remaining players in the market are not always impressive. There have been more failures than success stories in the sector, despite the potential for Australian food exporters, and investors should tread warily.

Unlisted firms dominate the industry but dairy, cattle and grain are represented by companies such as Australian Agricultural Co, Goodman Fielder, Bega Cheese, Select Harvests and GrainCorp.

The November trade deal means Chinese tariffs on Australian products will fall, although it will take years to flow through. Citi analysts say there will be tariff reductions on dairy from 20 per cent and beef from 25 per cent, which could create future opportunities for shrewd investors.

"Although the agricultural industry in Australia is made up largely of unlisted operators, one consequence could be more local companies publicly listing over time," Citi analyst Gino Rossi says.

China is also important for Australian premium wine and accounts for 12 per cent of exports by value. This could stimulate volumes and lift margins for Treasury Wine Estates. Soon after the free-trade agreement was announced, China's New Hope signed a deal with ASX-listed Freedom Foods to invest up to $500 million in Australian dairy farms and processing plants.

Bega Cheese, which has signed a $100 million deal with a Chinese firm to supply long-life milk, says it is also exploring more partnerships.

A three-way takeover battle for Warrnambool Cheese & Butter in January 2014 highlighted the potential upside in locally listed agriculture stocks when foreign buyers come knocking. Canadian dairy giant Saputo eventually won that bid after the competition watchdog knocked back Murray Goulburn's bid. Dairy executives expect more consolidation in the industry.

Murray Goulburn, which is Australia's biggest dairy exporter, plans to raise up to $500 million when it lists a unit trust on the Australian Securities Exchange next year, which will offer investors another option to put their money into the dairy industry. In mid-November, shares in Bega were trading 11 per cent higher than October's lows of about $4.79. Analysts have six holds, one buy and one sell on the stock.

Foreign interest in other commodities such as beef and grain is strong. Brazilian food giant JBS acquired private ham, bacon and smallgoods producer Primo Smallgoods in November for $1.45 billion. This was double the company's enterprise value in 2011.

Some investors say beef producer Australian Agricultural Co (AACo) could be the next takeover target, although it is an intensive land play which has not paid a dividend for the past five years. While it posted a heavy loss in 2013, a change in strategy as it secures cattle supply agreements for its Darwin abattoir has improved prospects. AACo's shares, which now trade above their net asset value, have risen 25 per cent so far this year.

Rural land and water company PrimeAg delisted from the ASX in 2013 because it failed to trade above its asset value and generate adequate capital returns.

Pastoral group Elders is also recovering from years of serious problems which forced it to sell off assets to pay down debt. Bell Potter analyst Jonathan Snape says tailwinds in the cattle and real estate markets mean Elders should be in a substantially improved operating position this year, particularly now it has paid down debt.

It is dangerous to lump all agricultural stocks together as they each face unique challenges, although takeover activity is a common theme. GrainCorp's stock has not yet recovered from the blow of the federal government's rejection of a $3.4 billion takeover offer from US giant Archer Daniels Midland (ADM) in late 2013.

Treasury Wine Estates is focusing on its turnaround plan after knocking back takeover bids from private equity giants KKR and TPG Capital. Bread producer Goodman Fielder is the target of a $1.3 billion takeover offer from Singapore's Wilmar International and Hong Kong's First Pacific but regulatory hurdles are delaying the deal's conclusion.

Almond producer Select Harvests owns vast tracts of orchards in South Australia, NSW and Victoria. Its share price has risen more than 24 per cent over the past six months due to a spike in almond prices.

Agriculture stocks are also notoriously unpredictable as they are often held hostage to seasonal factors such as rain and drought. They can also be capital intensive and fail to produce the cash flows forecast. Part of the problem is attracting the funding needed to keep the businesses growing.

Still, with ANZ and Port Jackson Partners predicting Australia's agricultural exports will grow at least 125 per cent by 2050, the companies that get it right should offer plenty of upside for the more adventurous investor.

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AN Document FRSINV0020141211eacc0000o

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