Summarised Investment Case – Pioneer Foods Group Ltd

<u>Company overview</u>

Pioneer Foods ("PFG") is one of the largest South African producers and distributors of branded food and beverage products. Although the Group operates mainly across South Africa, supplying wholesale, retail and informal trade customers, PFG has been growing its' international business. Currently, PFG exports to more than 60 countries, representing 21% of operating profit.

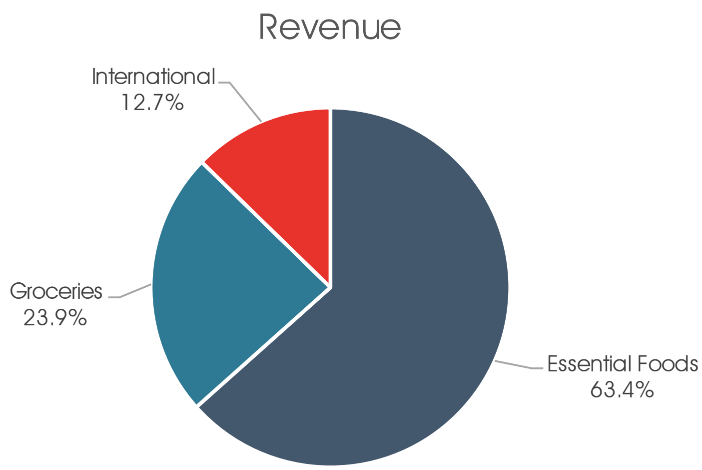
The International Division comprises Heinz Foods SA (49.9%), Bowman Ingredients South Africa (50%), Bokomo Namibia (50%), Bokomo Botswana (50%), Food Concepts Pioneer Limited Nigeria (50.1%), Alpen Food Company SA (50%), Amigear Ventures Botswana (49%). These equity-accounted, joint venture investments based in South Africa, Nigeria, Botswana and Namibia do not form part of PFI's segmental results, but are managed by the International division.

Pioneer Foods was established in 1997 and listed on the JSE in 2008. It has three main divisions:

1) **Essential Foods:**
   Essential Foods manufactures wheat and maize products, pasta; it packs rice, beans and other dried vegetables and has large bakery operations.

2) **Groceries:**
   Groceries produces breakfast cereals, rusks, cake mixes, baking aids, dried fruit products, nuts, sweet and savoury spreads, processed salads, long-life fruit juices, fruit concentrate mixtures and dairy fruit blends.

3) **International:**
   International is primarily structured around an export business model which is managed across two channels, namely Africa and Rest of the World. This division also incorporates the Group's fruit operations and the wholly owned Bokomo Foods UK business.



Recent developments

PFG's share price has dropped over 36% from its high of R186 in March 2017. There has been a series of extraordinary events that have affected the company over the 2016/2017 period, with the drought and subsequent maize pricing being the most significant impact on company earnings. The company also had to contend with unfavourable currency headwinds, lower demand in African markets, a small raisin crop, and well-respected CEO Phil Roux announcing his retirement in September 2017. All of this has weighed heavily on PFG's share price.

Essential Foods:
Essential Foods, which usually accounts for approximately 57% of operating profit, is the most exposed to maize prices and operating earnings were down 49% for the six months to March 2017 (compared to 2016 interims).

Groceries:
Performance of the groceries division for the first half was disappointing. Cost push inflation into the summer season, coupled to a cooler inland, impacted volumes and margins significantly.

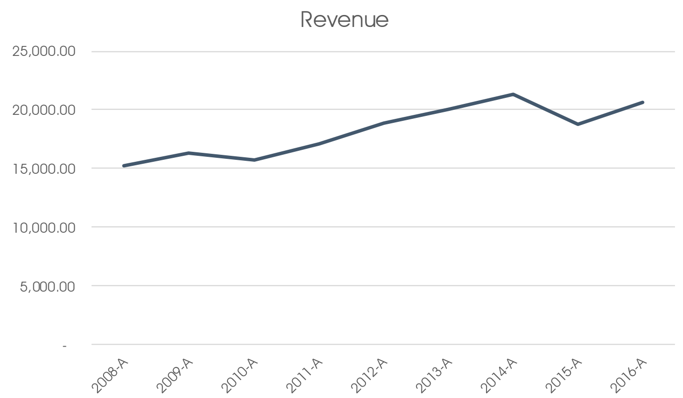
International:
Profit contraction was the most severe in this division consequent to lower beverage export volumes and margin pressures. Currency devaluation in key markets placed pressure on the Ceres value proposition. Raisins historically contributed materially to profitability of International. Profitability in the first half was eroded due to a smaller crop and a relative stronger currency.

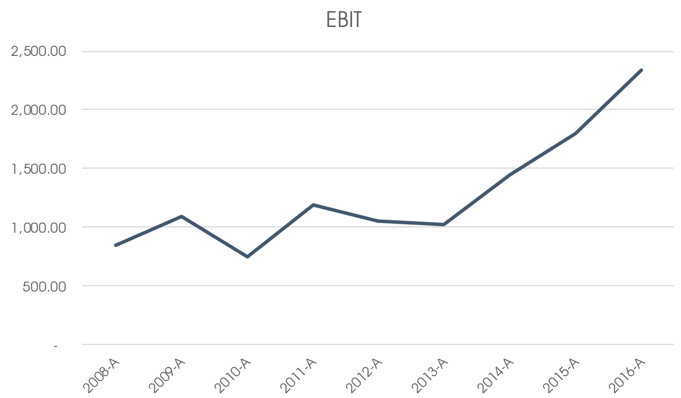
Following the first half results, PFG also announced, on the 8th August, that revenue for the 10 months to 31 July 2017 was down 4%.

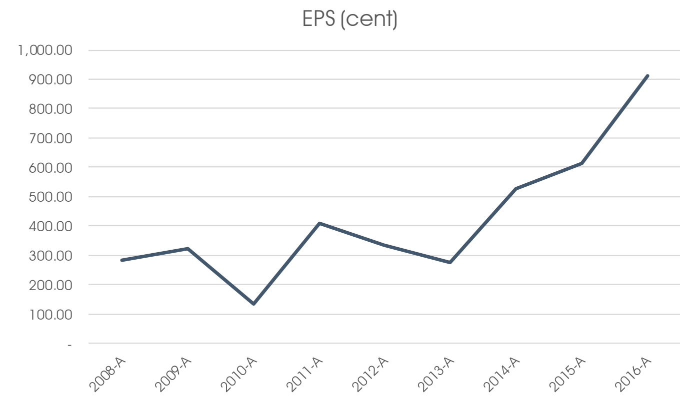
Financial position and outlook

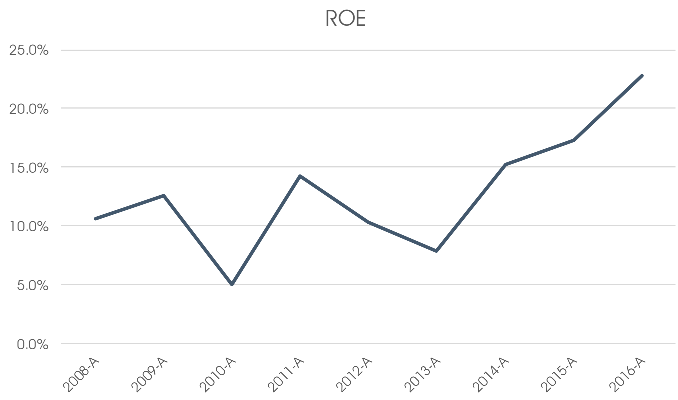
PFG operates in a highly competitive and cyclical industry. The confluence of all the above mentioned exogenous events has been detrimental to PFG this year.

However, looking over a longer time period, both forward looking and historically, we believe PFG to be a steady, defensive natured, and decent performer (financially). The below charts illustrate PFG's performance from 2008, over an eight-year historical period, bearing in mind the Global Financial Crisis of 2008.









From the graphs above, the solid performance post the 2008 crisis is apparent. This was achieved through improvement in efficiencies which resulted in increased operating profit and earnings (EBIT, EPS and ROE). This is highlighted, more so, considering revenue was growing at a more subdued rate.

Another indicator of the decent historical performance is the lower growth rate in their operating assets, which shows that improved earnings were achieved without significant costs or spending needed on the balance sheet.

The growth in their operating earnings has outperformed the growth in their operating assets. This has resulted in PFG generating improved free cash flows over the period.

	FY2011:	**FY2016**	**% growth**
Revenue	16,853	20,600	22.2%
EBITDA	1,492	2,562	71.7%
Invested Capital	7,439	8,971	20.6%
Free cash flow	(200)	523	361.0%

	FY2011:	**FY2016**	**5 year ave.**
EBIT margin	7.1%	11.4%	7.6%
EBITDA margin	8.9%	12.4%	9.2%
ROE	13.3%	21.5%	14.0%
ROIC	14.1%	23.8%	14.4%

As mentioned above, PFG has encountered a slew of negative headwinds, and full year 2017 results are expected to be poor (compared to FY2016). As stated in their half year results, PFG believes that its performance will improve in the second half of 2017: "notwithstanding a constrained trading environment in South Africa. An increased raisin supply, lower maize input costs from June, lower beverage input costs and Aeroton bakery and Weet-Bix capacity should help to improve profitability".

The strong Rand (impacting exports), potential longer lag time on maize prices, decreased volumes, revenue decline, and resultant market share losses, are all contributors to PFG's relatively poor 2017 results. A positive from the first half results was PFG's good cost controls, with only a 3% rise in non-production operating costs, well below inflation.

Valuation

Our valuation has taken into consideration PFG's history, their current disappointing results, and fair forecasts of future performance and financial stability. We have looked at a combination of Price-to-earnings, EV-to-EBITDA, Dividend yield, Price-to-book, Free cash flow DCF scenarios, and ROIC, WACC, and NAV metrics; all amounting to a calculated fair value of circa R148.

We believe the share price has been overly punished, due to exogenous factors mostly outside of management's control, and in our opinion not enough credit has been given to the improved historical controls and efficiencies of recent years. PFG is a brand leader and staple among South African households. The company will experience a bad year, but looking through the current results, and the unlikeliness of the same onslaught repeating in the near future, we believe PFG is currently undervalued and worth materially more than the current share price reflects.