

CCRED POLICY BRIEF

Industrial Development Research Programme (IDRP): Food sector¹

July 2017

Introduction

The food processing sector in South Africa has grown more rapidly with a real value-add of 34% more in 2014 than in 2004, and compared to 15% in the manufacturing sector as a whole. The sector is also the largest manufacturing employer in the South Africa, accounting for 13.6% of total manufacturing employment. Given the potential of the sector to drive employment and growth, this policy brief identifies the main trends in terms of investment and performance of the firms listed under the food producers sector on the Johannesburg Stock Exchange (JSE). The assessment considers the period 2010 to 2015. A key question is understanding these investments and the orientation of the largest food producers as it relates to industrial development in South Africa.

The firms considered are: AH-Vest, Astral Foods, AVI, Clover, Crookes Brothers, Oceana Group, Pioneer Foods, Quantum Foods, RCL Foods, Rhodes Food, Sovereign Foods, Tiger Brands and Tongaat Hulett. These firms are involved in various levels of the agricultural value chain from farming, poultry production and fishing to production of processed foods.

Ownership structure

The ownership structure of most of the firms in the food sector is largely comprised of nominee companies of the large banks including Standard Bank which has a stake in 10 of the firms, FNB with ownership in 8

and Nedcor with significant shares in 5 of the 13 firms considered. The Government Employees Pension Fund (GEPF) and Public Investment Corporation (PIC) have the largest shareholding in two of the largest companies in the sector; Pioneer Foods through GEPF (10.9%) and Tiger Brands through PIC (11.3%). It is important to note however that the PIC and GEPF have shareholding across a very broad set of firms in the economy and will generally not seek to exercise control and be involved in the strategic direction of the investee firms except on certain cross-cutting issues such as compliance with BBBEE requirements.

Structure of the sector

The sector is highly concentrated with the different companies holding significant market share in a number of segments in the food sector. For instance, RCL Foods and Astral have a combined 46% market share in the broiler meat production market (poultry); Rhodes Food group has a 66.3% market share in canned meats; Tiger Brands has 48.6% market share of the retail value in the sugar confectionery market etc.

The sector also has high barriers to entry that include: high capital requirements, high levels of coordination through the value chain, and vertical integration. Entrants face difficulty in accessing customers and there is a history of strategic behaviour by incumbents through

¹ This policy brief draws from an underlying working paper forming part of the Industrial Development Research Programme (IDRP) funded by the DTI. See Nhundu et al. (2017), 'Growth and Strategies of large and lead firms - Food Sector', CCRED Working Paper No. 10/2017.

anticompetitive conduct e.g. bread cartel involving Pioneer Foods and Tiger Brands, amongst others. *An important means of entry and expansion into the sector has been through acquisitions to access new and niche markets.*

Key performance metrics

Assets

Tongaat Hulett, Tiger Brands, Pioneer Foods and RCL Foods are the largest companies in the food processing sector in terms of total assets accounting for 25%, 21%, 14% and 12%, respectively. Tongaat Hulett's assets consist of a very large portfolio of estate property and growth is underpinned by further acquisitions of Xinavane sugar mill in Mozambique, and various downstream investments. RCL Foods exhibited the highest assets growth largely through major acquisitions that include those of Foodcorp, Senn Logistics (largest logistics firm in Botswana) and TSB Sugar (top 3 sugar producer in South Africa). Overall total assets in the food processing sector doubled between 2010 and 2015 with a CAGR of 15%.

Retention rates

One of the key determinants of investment is the portion of the profits that a firm retains within the company after paying dividends (retention rate). High retention rates (above 50%) are indicative of firms in a growth phase, or firms with growth capacity and potential to make further investment in new projects and expansion. Low retention generally shows firms that prioritise paying out dividends to shareholders. In this regard, the food producers sector exhibited mixed results with only 6 of the large established entities retaining significant proportions of profits presumably with a view to reinvest.

Capital expenditure and investments

Replacement capital expenditure more than doubled from R1.6 billion (2010) to R3.7 billion in 2015 reflecting strategies to adopt the latest technology in order to lower production costs and improve efficiency and effectiveness. Furthermore, since 2010, investment in mergers and acquisitions (M&A), although vastly different from year to year, has been increasing on average while expansion capital investment has been decreasing. *This suggests that firms are now more inclined to expand operations through acquiring other existing businesses rather than expanding their own existing capacity.* Overall, replacement capital, expansion capital and M&A constituted 38%, 24% and 38% of expenditure, respectively. Major M&A transactions in the period include RCL Foods' acquisition of Foodcorp (2014), Tiger Brands' acquisition of Dangote flour mills, Oceana's 2015 acquisition of US-based Daybrook.

Profitability

The largest companies in the sector in terms of share of total revenue, as with total assets, are Tiger Brands (54%), Pioneer (18%), RCL Foods (12%) and Tongaat Hulett (12%). Over the period under review total revenue in the sector grew by 70% (CAGR 12%) driven by RCL Foods (CAGR 28%), Tongaat Hulett (13%), Oceana (13%) and Tiger Brands (10%).

The sector reported consistently poor profitability figures relative to the average of all firms listed on the JSE. On average the net profit margin of the food producers was 5% lower than the JSE benchmark. This could be explained by the poor performance of poultry firms (Astral, RCL Foods, Sovereign and Quantum Foods which together account for 24% of total revenue of firms in the sector), affected by imports, amongst other factors. Positive results were observed from firms with

greater diversity in terms of product categories which could be largely a result of the ability to mitigate losses and risk in one product category against profits in another.

Emerging trends

Three main trends could be observed from the firms' investment activity: the consolidation of the firms, their entrance into niche markets (diversification) and expansion internationally.

Consolidation and integration

Out of the 92 total investment transactions made by the 13 firms investigated (identified from company documents), 32 transactions (35%) were purchases of shares or an increase in existing shareholding in other companies to consolidate ownership and influence in existing investments. There was also the integration of internal divisions within the firms. Some of the reasons provided by firms for consolidation and integration are that the firms wanted to benefit from operational synergies, and take control and ownership of core divisions such as distribution and warehousing.

Niche market entrance

A number of the firms diversified their product offering and entered niche markets. Their primary means of entry into these markets was the acquisition of established companies. For instance, Clover acquired Nkunzi Milkway (Pty) Ltd, an Ayrshire milk supplier of niche dairy products to Woolworths. Entrants in the new market segments are likely to have lower cost efficiency, financial capability and scale initially and are likely to experience some difficulty in establishing their brands such that the firms are vulnerable to acquisitions by larger incumbent rivals. Additionally, high entry barriers also make it difficult for new firms

to enter and compete effectively in the sector.

Besides entering new markets through acquisitions, some food producers introduced new product lines (e.g. AH-Vest launching a low salt additive tomato sauce for health conscious customers) or engaged in joint venture and partnership deals (e.g. Future Life/Clover). The partnership deals have the potential to further increase the large firms' market share and raise barriers to entry in various food product lines.

International expansion

Of the 13 firms investigated, 10 expanded into other countries between 2010 and 2015/16. For the period under review, 56% of the total value of investments by firms in this sector were outside South Africa and the remaining 46% within the country. Of the 35 international investments that took place, 54% were in southern Africa, 34% in the rest of Africa and 11% outside Africa. The move towards international expansion appears to be largely due to the saturation and low demand in the local market.

Policy considerations

High concentration in the sector points to the needs for measures to encourage entry.

While there have been a number of policy interventions in the sector, they have not had the objective of encouraging new entry and competition in the sector. The conditions the competition authorities have placed on the merging parties in the sector, however, have done much to reduce anti-competitive behaviour and to encourage the entry of new participants by emphasising supplier development programmes targeted at supporting black entrants and their access to the final market. The conditions placed on the

Walmart/Massmart merger, for instance, resulted in the creation of a fund that benefited entrants such as Lethabo Milling. The Competition Act and authorities are therefore a useful tool to open up for black entrants. There might be scope for the DTI to cooperate in the formulation of conditions for problematic mergers in the food processing sector that would continue to not only create funding for industrialists but also support programmes.

It is also important for the competition authorities in South Africa to consider as a priority the long-term effects of mergers in South Africa to the extent that they result in increased concentration in the sector. This is especially important given high barriers to entry (reinforced by vertical integration) and a notable absence of new, black-owned rivals that are able to contest these markets not only in South Africa, but in the southern Africa region as well. Demand in the region for processed food products from South Africa has grown considerable, and constitutes as large proportion of manufacturing exports.

In this regard, collaboration with the DTI is important given extensive incentive and funding programmes currently in effect in the sector, which may not succeed if entrants cannot actually access markets and grow their businesses. Drawing from CCRED's extensive work on agro-processing value chains in South Africa and the region, there are also other possible interventions that can increase access to markets and integration of new suppliers into concentrated food value chains. These include addressing constraints to supplying regional markets such as poor transport networks, non-tariff barriers and border delays in transiting between South Africa and neighbouring countries. These constraints decrease the cost competitiveness of South African

producers in the region, particularly smaller firms that may be looking to start exporting.

A key constraint for new firms relates to funding for multi-level entry in various agro-processing and food production value chains. Firms face challenges in accessing government incentives or funding from the private sector. The extensive presence of nominee companies of the large banks in the ownership structure of food producers and public information from the banks suggests that they view the sector as a high growth sector. This may point to opportunities for partnerships with financial institutions to set up more easily accessible loans and funding for entrants into the sector. An arrangement could be made in which the government could provide guarantees to industrialist to ensure they have access to necessary funding to either start or grow their businesses. It is important to note however that there may be low incentives for financial investors, already earning good returns from interests held in the large incumbent food producers, to support new challenger firms as well.

Lastly, there are important dimensions at the sub-sector level which should be considered. For example, the poultry industry which contributes about 25% of total revenues in the sector has experienced increasing costs and competition from foreign imports. The solution has been to provide various forms of protection from cheap imports. However, there may be opportunities to increase the cost competitiveness of domestic producers relative to imports, through encouraging and developing capacity for regional sourcing of key inputs into production such as soya from Zambia. This includes projects to upgrade regional sources where there are quality issues with the products produced, and agreeing on appropriate standards.