CHICKEN PRODUCERS: "RAISING THEIR HACKLE FEATHERS"

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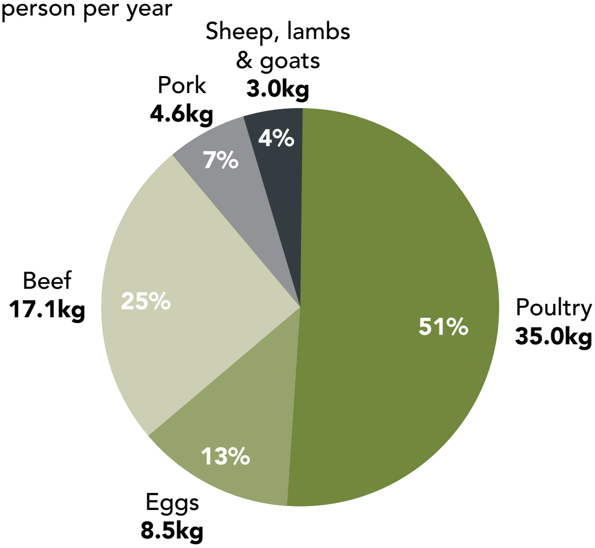
The poultry industry has had its fair share of media limelight in the past few years owing to a multitude of topical issues which threaten the sustainability of the local poultry industry. The public's interest in the fortunes of the poultry industry is not without cause by virtue of the poultry industry (mainly chicken and eggs) having grown to being just less than two thirds of all animal protein consumed by South African (SA) citizens. The growth in chicken has far outstripped other forms of proteins, in line with trends pervasive in other global markets. To put the popularity of chicken in context, chicken alone constitutes about 13% of consumers' shopping baskets at food retailers in SA.

FIGURE 1: SA PER CAPITA CONSUMPTION OF ANIMAL PROTEIN

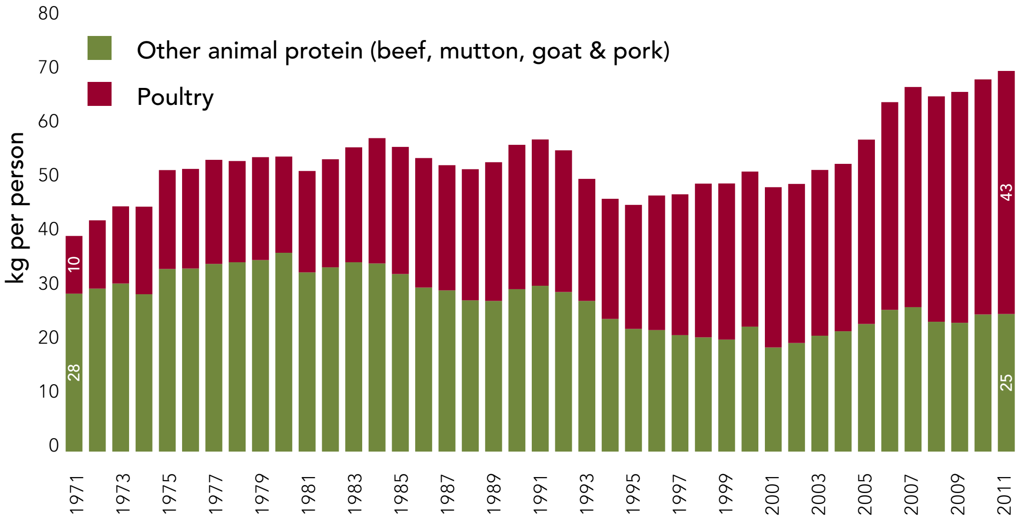
Kg's consumed per person per year



Source: Department of Agriculture, Forestry & Fisheries & Afena Capital

FIGURE 2: SA PER CAPITA CONSUMPTION OF ANIMAL PROTEIN

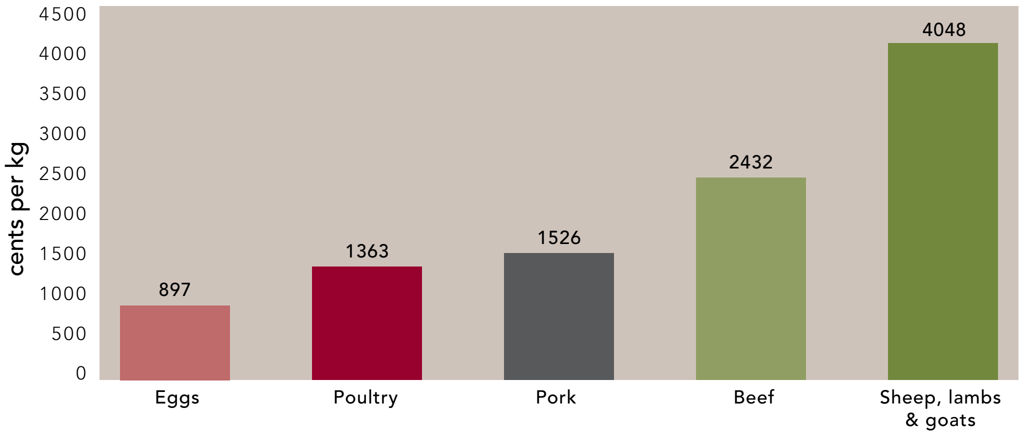
(Kg's consumed per person per year)



Source: Department of Agriculture, Forestry & Fisheries & Afena Capital

The public's vested interest in chicken also has economic and social roots, given that the poultry industry employs over 60 000 people (10% of all workers in the agriculture sector) and chicken also tends to be the entry level source of protein for the lower end consumer given that it is the cheapest form of meat protein.

FIGURE 3: SA PRICES OF ANIMAL PROTEIN IN 2011

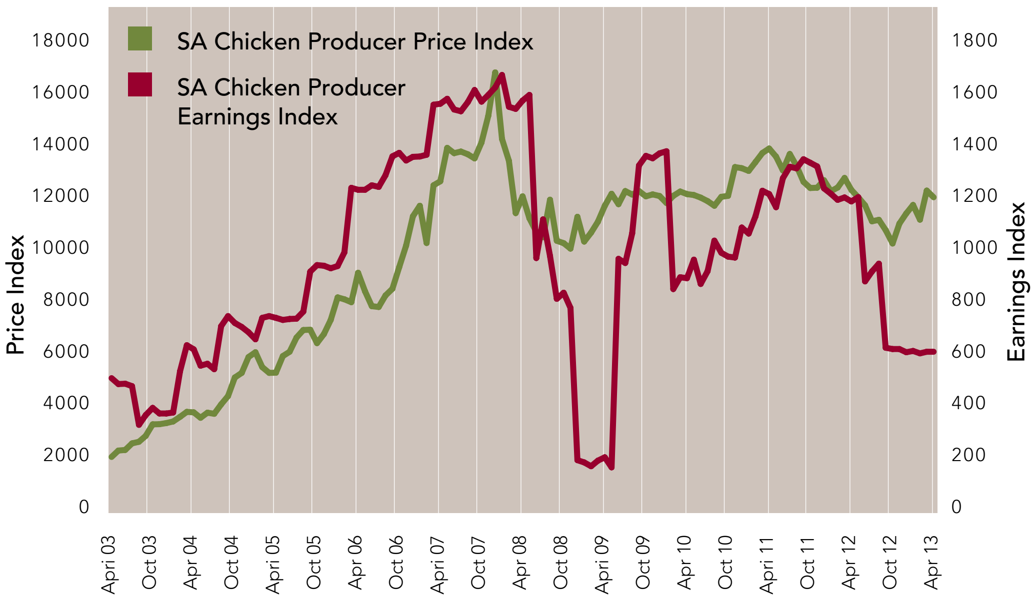


Source: Department of Agriculture, Forestry & Fisheries and Afena Capital

The threats to the industry with the most material significance, from a consumer and investor perspective, have been concerns raised over the competition created by an influx of cheap imported chicken, high grain prices putting pressure on local chicken producers and the impact of brine injection in chicken sold to consumers.

Investment markets, with respect to the listed chicken producers, have behaved in a way that is consistent with the combined effect of the concerns raised in the public arena. Since the peak in 2007, profits have reflected the manifestation of the existing threats whilst prices have discounted some of the pessimism of anticipated threats as well.

FIGURE 4: SA CHICKEN PRODUCERS



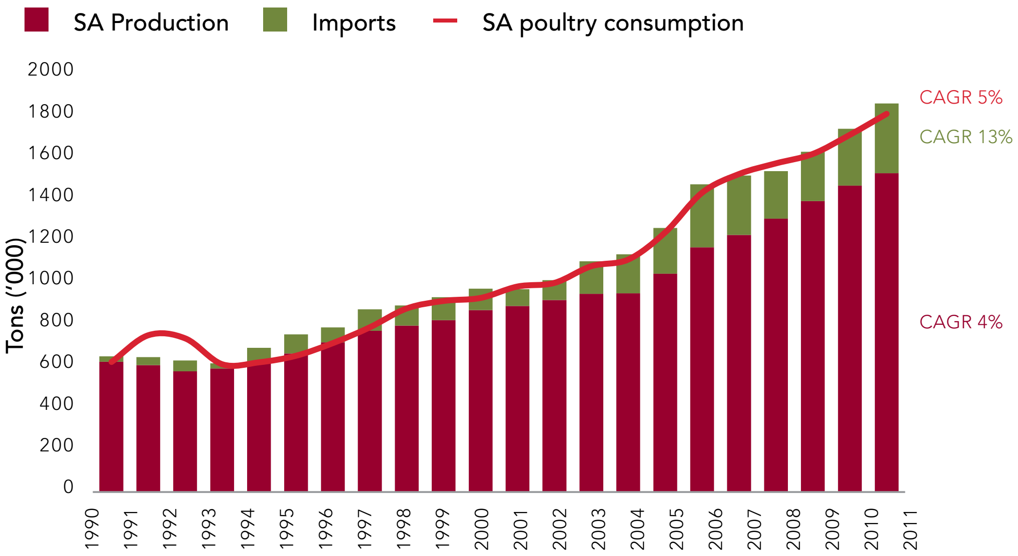
Source: Bloomberg & Afena Capital

For the purposes of this article we limit our scope to addressing imports, which in our view, are the concern which poses the most significant threat to the long term sustainability of the chicken industry at present

The plague of imports

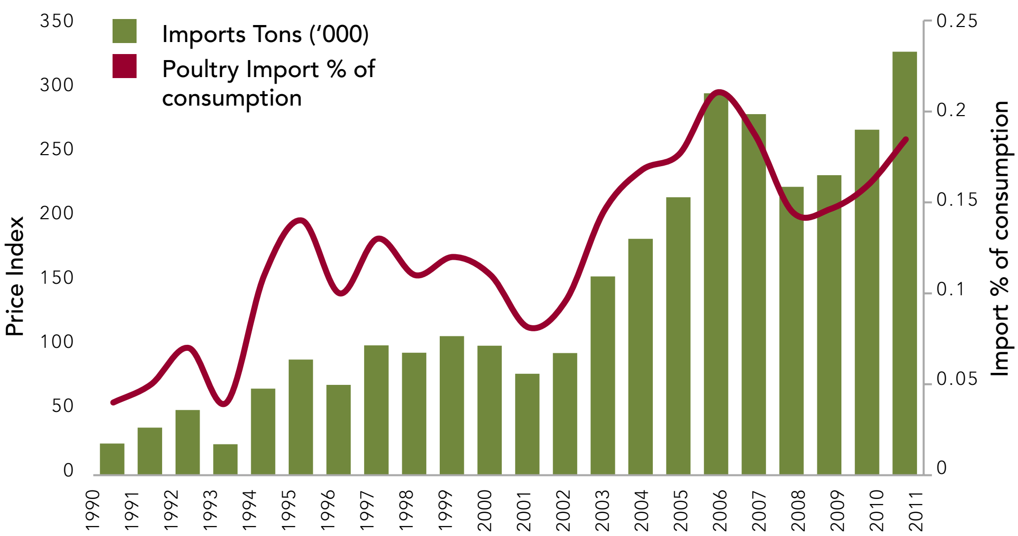
In the last two decades, imports have become an increasingly important source of chicken supply to the consumer. This consistent growth, well ahead of local chicken producers' production, has led to imports rising to almost 20% of SA chicken consumption. At 20% of consumption, the level of import dependence is now higher than that of all the other meat categories in SA.

FIGURE 5: SA POULTRY DEMAND AND SUPPLY



Source: Department of Agriculture, Forestry & Fisheries and Afena Capital

FIGURE 6: POULTRY IMPORT DEPENDENCY

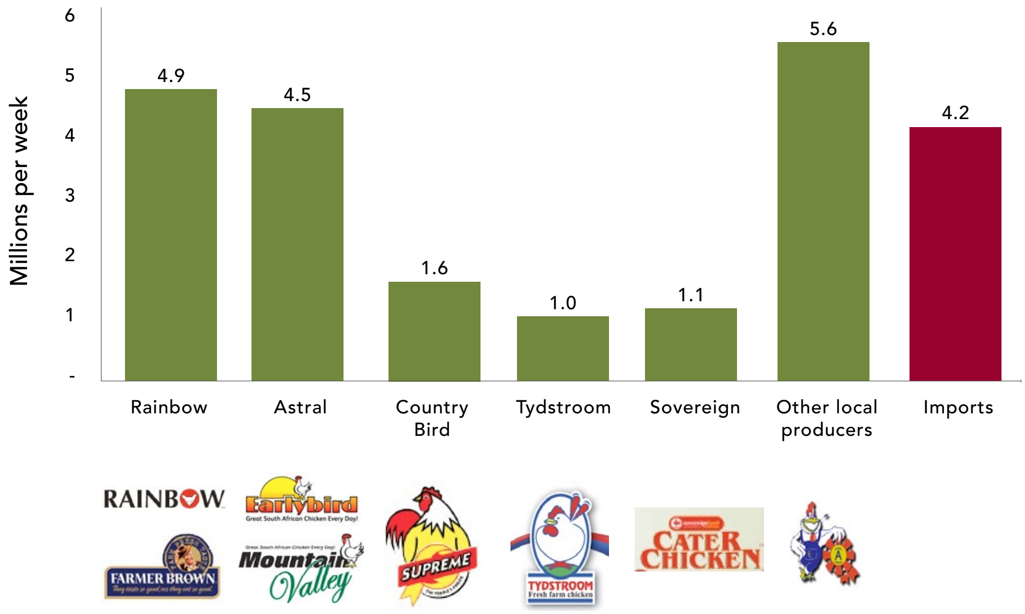


Source: Department of Agriculture, Forestry & Fisheries and Afena Capital

The emergence of imports as a significant source of supply means that they are now the third largest source of chicken in SA. This has firmly entrenched imports as a viable competitor to the local producers.

FIGURE 7: AVERAGE BROILER PRODUCTION PER WEEK

March 2012



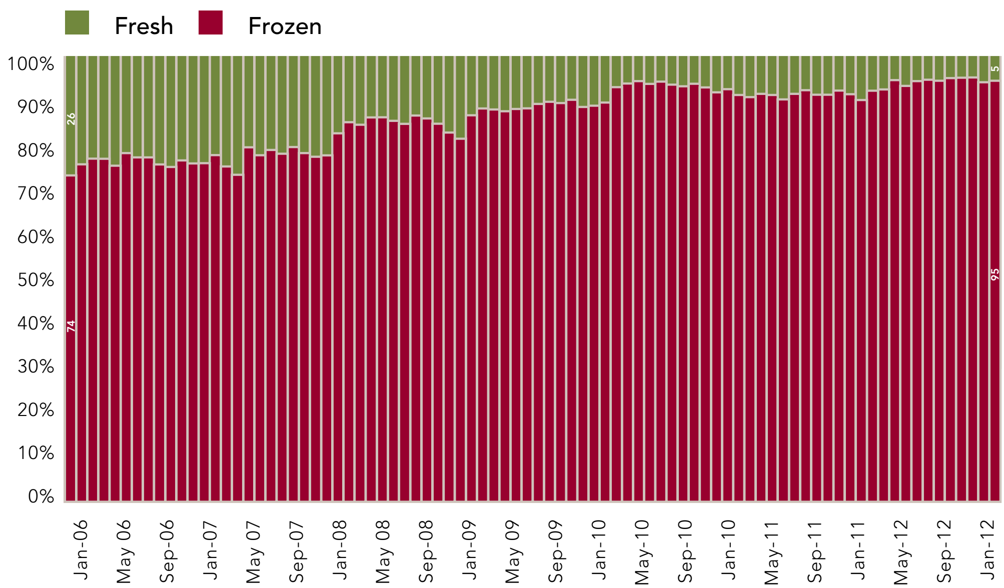
Source: Astral, SAPA & Afena Capital

This development has shifted the consumption patterns of SA consumers and the pricing dynamics of the local market in a meaningful way, to the detriment of local chicken producers.

Over the same period, the SA chicken market has seen a move from buyers purchasing whole chicken carcasses, which tended to be fresh, to a market where consumers have a preference for packages of individually quick frozen chicken pieces (termed IQF in poultry circles). Since imported meat tends to be transported in its frozen form, given that for example meat imported from Brazil is in transit for about six weeks before being offloaded at docks in SA, this effectively opened up a market for importers to supply frozen individual chicken pieces to the SA market.

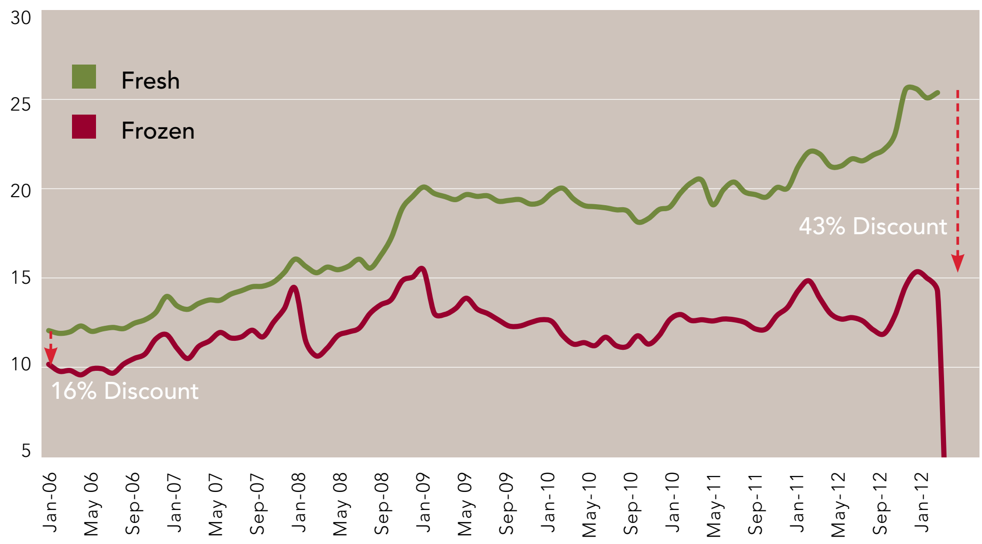
The increased consumption of frozen chicken has had other adverse implications for local chicken producers besides just allowing a new entrant to supply chicken to the SA consumer. Frozen chicken is sold at a material discount relative to fresh chicken, with this discount widening from 16% in 2006 to about a 43% currently.

FIGURE 8: MARKET SHARE OF FRESH AND FROZEN CHICKEN



Source: SAPA & Afena Capital

FIGURE 9: AVERAGE PRODUCER PRICES FOR CHICKEN



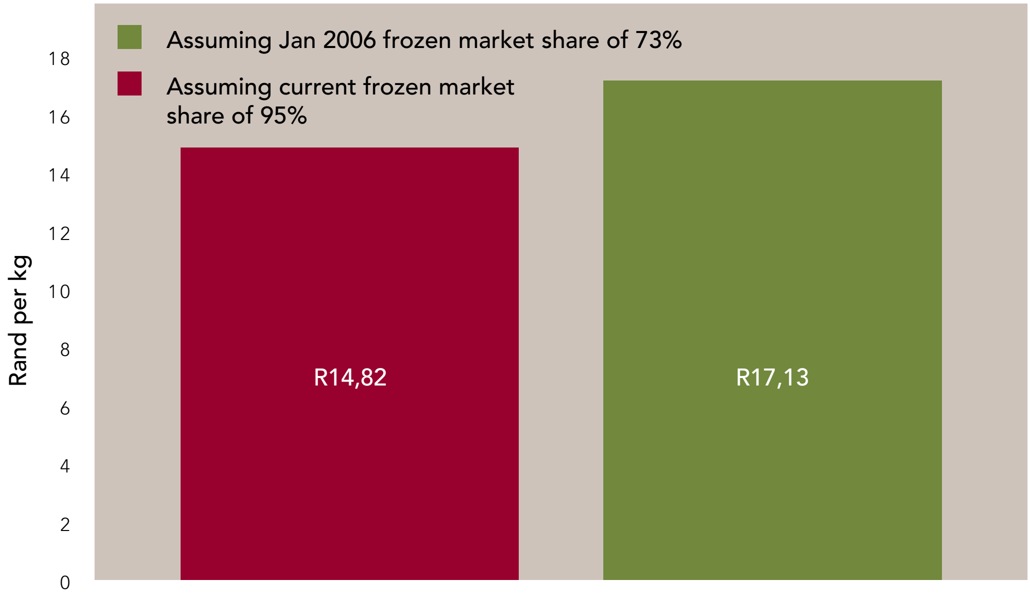
Source: SAPA & Afena Capital

The widening of the discount is indicative of the fact that fresh chicken prices have risen at 11% per annum over the last six years, whereas frozen chicken has only managed to increase at a rate of 5% per annum. The lower rate of growth in prices in frozen chicken reflects the local chicken producers' lack of pricing power given that they are competing directly with cheaper frozen imports whereas in the fresh segment of the market, the local chicken producers are only competing amongst each other.

The overall impact on the local chicken producers' profitability is negative due to a fairly interesting nuance. Given that the local chicken producer is now selling more of the lower priced frozen chicken, the average price he fetches for selling his entire pen of chickens is now lower than it would have been had he sold more of the higher price fresh chicken. The nuance that must borne in mind is that for this same local chicken producer the costs of nurturing a chicken before slaughter at 35 days does not change regardless of whether the chicken will be sold as fresh or frozen after slaughter. So in effect the local producers' profit per chicken will fall given that he will fetch a lower average price for his chickens whilst the costs of producing those chickens remains the same. Given the current proportion of frozen chicken sold (to total chicken sold), local chicken producers are earning about R14.82 per kilogram which is 13% lower than what they would have earned had the proportion of frozen chicken been only 73%, as was the case in January 2006.

FIGURE 10: WEIGHTED AVERAGE PRODUCER PRICE FOR CHICKEN

Weighted between frozen and fresh prices by market share



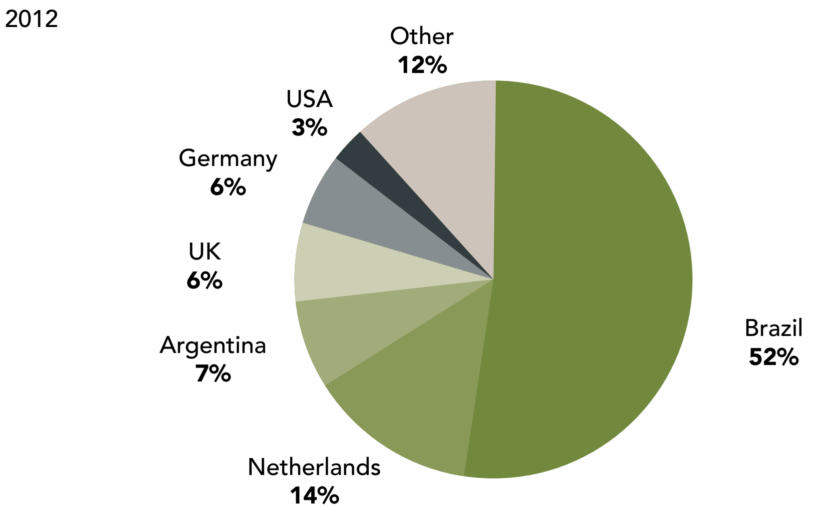
Source: Astral, SAPA & Afena Capital

Chicken Murder

As a lay man, this entire scenario still begs the question as to why the local chicken producers have allowed the imports to escalate to a level that threatens their own survival. The simple answer is that it is not really in their hands because the economics are against our local chicken producers.

The majority of the chicken which is docked off on SA shores originates from Brazil, the third largest producer after the US and China. Brazil has transformed itself from not producing any commercial chicken in 1960 to being the third largest producer in the world, employing over 3.6 million people, all in just over 50 years. Brazil is now a net exporter of chicken to the tune of over 3.3 million tons which is almost twice the amount of chicken that South African consumers buy per year. Although Brazil is only the third largest producer of chicken in the world, it is the largest in terms of global trade, making up about 40% of all trade between countries. It should be no surprise then to SA's local producers or consumers that Brazil supplies 52% of our imported chicken.

FIGURE 11: ORIGIN OF CHICKEN IMPORTS INTO SA



Source: SAPA & Afena Capital

The main reason for their dominance of global trade emanates from Brazil, along with the US, being the lowest cost producers of chicken in the world. Brazil can produce a live bird at slaughter for between US$1.05 to $1.18 (the table below says $1.19) per bird. Brazil's position at the lower end of the global chicken cost curve means that they can export chicken profitably to countries like SA who are positioned higher up on the cost curve. SA local chicken producers can only produce a live bird at slaughter which is 18% more expensive at US$1.28 to $1.38 per bird mainly due to Brazil having access to cheaper feed, specifically maize, which is the main cost of nurturing a chicken. In terms of chicken farming though our local chicken producers fare very favourably with both Brazil and the US.

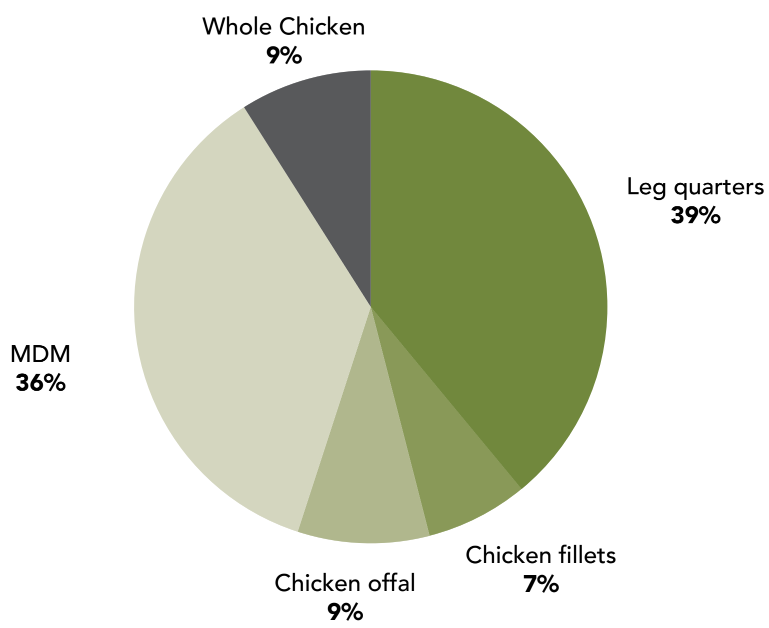
	Cost of live bird (2012 YTD)		
Production cost	Brazil	South Africa	USA
Cost of live bird ($ per kg)	1.05 – 1.19	1.28 – 1.38	1.01

Source: Astral, SAPA & Afena Capital

Crying Foul

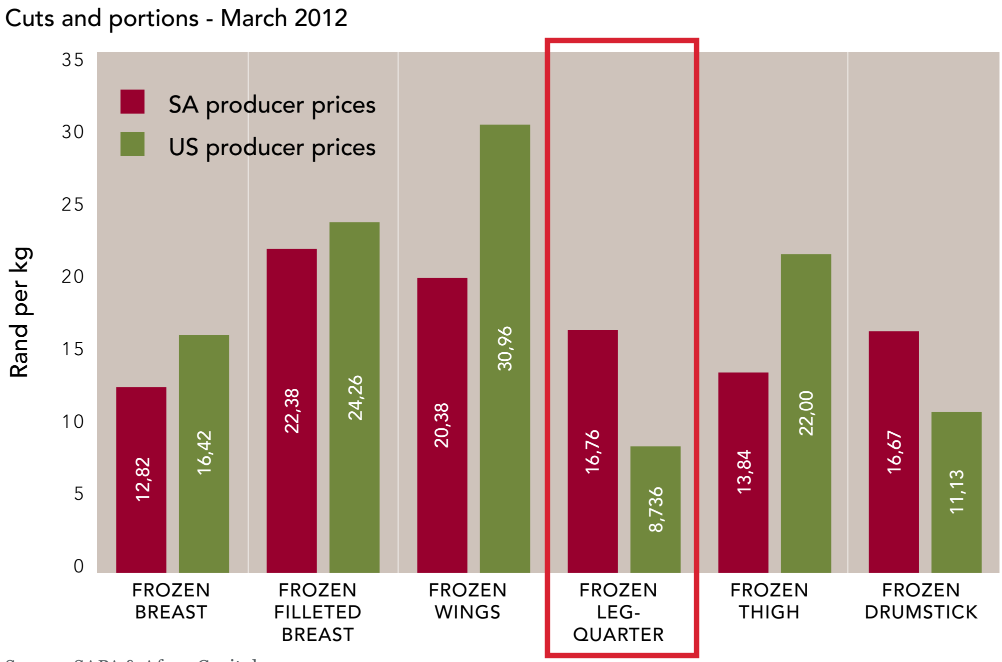
The real perversity in the imports from Brazil lies in the leg-quarters being the dominant chicken piece that they export to SA. Brazil exports mainly to Asia (65% of their exports) which has a preference for white chicken meat (breasts & wings) relative to the brown chicken meat (leg quarters). The preference in SA is the quite the opposite to that of these Asian markets, with SA having a high affinity for brown chicken meat. Incidentally, the US has a similar preference to that of these Asian markets and hence it is possible to draw inferences using the US as a reference point for pricing dynamics in a market with a preference for white chicken meat. Given the high demand for brown chicken meat in SA and the low demand for brown chicken meat in the US, SA prices for leg-quarters are twice those earned in the US for the same cuts.

FIGURE 12: CHICKEN IMPORTS INTO SA BY PIECE 2012



Source: Astral, SAPA & Afena Capital

FIGURE 13: COMPARISON OF SA AND US CHICKEN PRICES



Source: SAPA & Afena Capital

Despite this perversity there can be no denying that there is sound economic rationale for Brazil favouring the delivery of brown chicken meat to SA at favourable prices, en route to exporting white chicken meat to larger markets in Asia.

The only legitimate avenue of defence for local chicken producers relates to lobbying the Department of Trade & Industry (The DTI) for tariff structures in SA that protect the local industry or at least put the local industry on an equal footing. The inefficiency in the tariff structure exists because the Brazilian imports of leg-quarters are subjected to fairly lax import duties. Currently, all leg-quarter imports are subject to a 220c/kg general duty which equates to about 13% of SA producer prices of leg-quarters. On the other hand, the only leg quarters subject to anti-dumping duties are those imported from the US but this is largely a legacy issue. The impact of these anti-dumping duties is quite apparent in that the US despite being the 2nd largest exporter of chicken in the world only features as the 6th largest exporter into SA.

The DTI has abandoned the re-instatement of anti-dumping duties imposed on Brazilian boneless cuts in 2012, which technically excluded leg-quarters which are the main problem, for what seems like maintenance of good diplomatic ties with its fellow BRICS counterpart. Current indications suggest that the DTI has encouraged local producers to apply for increases to the low general duties currently imposed in order to allow local chicken producers the opportunity to create a more equal footing relative to the cost-superior Brazilian imports.

There is quite recent precedent for the DTI allowing local industries to increase tariffs where the tariffs currently imposed are lower than the maximum tariff allowed by the WTO (World Trade Organisation). It would be reasonable to assume that the survival of the local chicken industry, which supports over 60 000 jobs directly, is of higher priority than the processed tomatoes, stainless steel sink and uncooked pasta industries which were the beneficiaries of higher tariffs in 2012.

Don't Count Your Chickens

There is no doubt that the industry is in distress with the latest results to December 2012 showing that the large, listed players are currently making losses. 1000 jobs have been lost already in the chicken industry and liquidations that are currently in progress are likely to result in a further 2000 to 3000 job losses.

The DTI has indicated that there is good chance that if the local chicken producers apply for higher general tariffs they are likely to be granted. If sanity prevails, we are likely to see the local chicken industry restoring the pricing power that has been absent from the industry for many years. The prospects for the industry would improve as our local chicken producers would be competing on a more equal footing with the imports that currently threaten their survival. Consumers on the other hand will most likely to see more expensive chicken in their shopping baskets, which is the price we will pay to keep the local chicken industry afloat. Until we see higher import tariffs on chicken imports granted by the DTI, we remain wary of the sustainability of the chicken industry in its current form.

“Excellence is to do a common thing in an uncommon way.”

~ Booker T. Washington ~