More earnings upside for Malayan Flour Mills

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Decision-critical analysis

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We met with Malayan Flour Mills' management team last week to discuss the progress of the company's expansion plan and industry outlook. We feel positive on the overall development and are confident with the profit recovery this year. We made some minor adjustments to our forecast and maintain our "buy" call.

Stable revenue growth from Vietnam and Indonesia

Revenue from the flour and grains trading segment totalled RM1.73 billion in FY2018, an increase of 5.5% from RM1.64 billion in FY2017, driven by higher consumption in Vietnam and Indonesia. Demand was underpinned by growing populations, particularly the middle-income classes. The stable revenue growth translated into higher operating profit of RM65.9 million in FY2018 than the RM63.6 million seen in FY2017.

However, operating margin decreased slightly to 3.81% in FY2018 (FY2017: 3.88%) due to higher wheat costs, which eroded profitability. Wheat price averaged US$497.8/BU in FY2018 compared with US$439.4/BU in FY2017 (+13.3% year on year). Currently, two of MFlour's Vietnam flour mills — Mekong Flour Mills Ltd and Vimaflour Ltd — are running at more than 90% utilisation rate. Its 30%-owned Indonesian associate — PT Bungasari Flour Mills — also reached maximum capacity.

However, the Malaysian mills, based in Lumut in Perak and Pasir Gudang in Johor, are still suffering from excess capacity due to intense competition among local players with the utilisation rate averaging 50% currently. We maintain our revenue forecast of RM1.85 billion for this segment, supported by additional capacity of 500MT/month in Indonesia. All the necessary equipment is being installed and can be expected to start operating by 3Q2019.

Margins supported by lower wheat costs and price adjustments

Recall that MFlour's Indonesian operation recorded a net loss of RM6.9 million in FY2018 compared with RM7.7 million in FY2017 due predominantly to the price war waged by Indonesian millers and the sharp depreciation of the rupiah against the greenback. PT Bogasari Flour Mills, the largest flour miller in Indonesia, did not increase its selling prices in order to protect its market share despite the sharp rise in wheat costs. Positively, we expect Bungasari to return to profitability this year, considering the improved foreign exchange rate and less intense competition, which have, in turn, given the company some room for price adjustments.

We also expect MFlour to maintain its operating margin at around 6% as management recently increased pricing in Vietnam, as well as lower wheat prices of around US$466/BU at the time of writing. We believe our forecast is reasonable, given the slight strengthening of the ringgit. Purchases of wheat (80% of production costs) are done in US dollars. Management also highlighted that the Malaysian operation will be more selective and focus on profitable customers, which should preserve its margins going forward.

Construction of processing plants well on track

Revenue for the poultry integration segment dropped to RM692.9 million in FY2018, down 9% from RM761.4 million in FY2017. The business slipped into the red, reporting an operating loss of RM929,000, primarily due to depressed live bird prices and the unexpected Inclusion Body Hepatitis, which resulted in a higher mortality rate among the chicken, low feed conversion rate and a downward fair value adjustment for biological assets amounting to RM8.4 million in FY2018.

MFlour's expansion programme is divided into three phases. The first, which included the construction of a rendering plant and a wastewater treatment plant, is completed and commenced operations at end-2018. Under Phase 2, the company is building its primary processing plant, which, upon completion, should increase its production capacity from 80,000 birds to 240,000 birds slaughtered per day. The construction was 83% completed as at Oct 31, 2018, and the plant is expected to commence operations by 3Q2019. The last phase, which is the reconstruction of a further processing plant, is ongoing and is expected to be completed by end-2020.

MFlour currently produces 70 million birds per year. However, we understand from management that it is being constrained by limited bird slaughtering capacity. As a result, the company sells 50% of its broilers to the live bird market, which is controlled by wholesalers and where prices are more volatile. This explains, in part, the reason behind the volatile quarterly operating margin for its poultry integration segment.

Higher capacity and meat consumption to drive growth for poultry integration

Moving forward, management indicated that it could quickly ramp up capacity to 120,000 birds per day once the construction is completed in 3Q2019. Currently, Malaysians consume 53kg of chicken meat per year, equivalent to 25 broilers, and this is expected to grow further. We think MFlour can easily utilise its additional capacity in two to three years, given stronger meat consumption and higher demand from fast-food chains such as McDonald's, KFC and Kenny Roaster. Capacity constraints limited MFlour's ability to sell to export markets — most of its products are currently sold in the domestic market. Management has expressed intention to penetrate overseas markets such as Singapore and the Middle East by leveraging the gold standard of Malaysia as a halal hub.

All in, we are projecting revenue of RM944 million and RM1.28 billion for FY2019 and FY2020, which translates into a CAGR of 35.6% due to the low-base effect in FY2018. We also believe the new primary processing plant will improve its operating margin for the coming years, conservatively estimating it at 4.5% and 5% for FY2019 to FY2020. This is because the company can sell more further processed products such as meatloaf, frankfurter, breaded fried chicken and nuggets (produced in the further processing plant), all of which command higher margins compared with selling to the live bird market. MFlour can mitigate rising costs by tweaking the feed composition, should any one of the commodities — wheat, flour, corn and soyabean — experience a surge in price. Live bird price has recovered to above RM5 per bird from the lows of RM3.90 per bird in 3Q2018.

Expecting more earnings upside; maintain 'buy'

To recap, MFlour successfully raised RM275 million recently via the issuance of RCULS, bonus shares and free warrants to partly fund its expansion programme. That increased its outstanding shares to 951.6 million as at March 6, 2019. We see limited earnings dilution in the near term as the RCULS' conversion period is five years, starting from Jan 24, 2019. The company has set aside RM200 million for capital expenditure for the next two years, mainly for the reconstruction of the further processing plant, the construction of an aqua feed milling plant and jetty extension. We believe the expansion will result in higher potential cost savings in the longer term.

After its dismal performance in 2018, we believe MFlour is poised for a strong recovery, underpinned by better chicken prices and volume as well as softer commodity costs. The stock is trading at an attractive forward PER of 10.4 times after the recent price rally. Assuming full conversion of the RCULS and warrants, the fully diluted PER stands at 12 times FY2019 estimated earnings. Looking ahead, earnings should continue to grow at a healthy clip, supported by a ramp-up in bird slaughtering capacity as well as productivity and efficiency gains with the new plants. E

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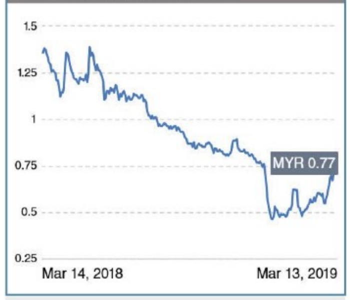
MALAYAN FLOUR MILLS BHD



Valuation score*	2.00
Fundamental score**	0.40
TTM P/E (x)	41.37
TTM PEG (x)	(0.56)
P/NAV (x)	0.90
TTM Dividend yield (%)	5.41
Market capitalisation (mil)	735.40
Shares outstanding (ex-treasury) mil	961.31
Beta	0.84
12-month price range	0.46-1.39

*Valuation score - Composite measure of historical return & valuation
**Fundamental score - Composite measure of balance sheet strength & profitability
Note: A score of 3.0 is the best to have and 0.0 is the worst to have