

Ag & Vet Weekly



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All the news on ASX-listed agriculture and veterinary companies

Dr Boreham's Crucible: Costa Group

By TIM BOREHAM

ASX code: CGC

Share price: \$2.96; **Shares on issue:** 400,830,387; **Market cap:** \$1,186.5 million

Chief executive officer: Harry Debney*

Board: Neil Chatfield (chairman), Mr Debney, Peter Margin, Janette Kendall, Dr Jane Wilson, Tim Goldsmith

* At the May AGM Mr Debney flagged his intention to retire within the next nine months.

Financials (calendar 2019):** revenue \$1030.8 million (down 6%), earnings before interest tax depreciation and amortization \$151.3 million (up 27%), adjusted net profit \$28.5 million*** (down 50%), reported net loss \$35.4 million (previously \$45 million profit), net debt \$178.8 million (down 27%), full year dividend 5.5 cents per share, fully franked

Major identifiable holders**:** Perpetual Asset Management 12.99%, Lazard Asset Management 5.6%, Schroder Asset Management 5.5%, AMP Capital Investors 5.09%

** Given the company changed from a June to December full-year balance date, the 2018 comparison is based on proforma numbers.

*** Before the accounting rules for biological assets (SGARA) and the new rule requiring lease liabilities to be recognized on balance sheet

**** ECP Asset Management held 5.29% as of balance date but ceased to be a substantial shareholder in March 2020

Investors know June as the “confession season” given the propensity of companies to drop bad news when the magnitude of an earnings decline becomes apparent ahead of the June 30 balance date.

This year, relieved Costa shareholders avoided hearing about a profit downgrade, which must be (silent) music to their ears - given the horticultural giant's performance in recent years.

Last year, nothing went right for Costa, which is the country's biggest fresh food supplier, operating across 50 sites here, as well as facilities in Morocco and China.

The company is the biggest supplier of berries, mushrooms, citrus and glasshouse tomatoes and is also big in avocados. The local coverage includes 4,500 planted hectares and 30 hectares of glasshouse operations.

In the last couple of years, crops were tempered by a lack of rain, while a single fruit fly was found at its Renmark citrus facility.

Furthermore, its Moroccan blueberry crop was delayed and some of its local produce succumbed to raspberry crumble, which sounds rather tasty but is not desirable at all.

And did we mention bushfire damage to its blueberry farm in Tumbarumba?

Now, the spring has returned to management's steps in the wake of the coronavirus crisis. Rain is tumbling again and commodity prices are robust.

The company also operates in an essential service and the government even obliged by extending the visa period for itinerant workers, the lifeblood of the company.

Challenges remain for what CEO Harry Debney dubs the "finest horticultural and agronomic thinkers and practitioners in Australia, but also the world".

One big issue is to find the right replacement for the hands-on Mr Debney, who is packing his bags after a decade at the helm.

Another is navigating a change to the ownership structure of its landlord, the listed property trust Vitalharvest.

Costa's rich history

Costa Group's lineage dates back to a Geelong fruit and veg shop called Covent Garden, founded by the Costa family in 1880.

Fast forward a few years and by the 1960s the company was a key supplier to those emerging outlets called supermarkets and in the 1980s it became a key exporter.

The company expanded in earnest from 2011, buying Adelaide Mushrooms in 2013, establishing a Moroccan blueberry joint venture (African Blue) and forming the Driscoll's blueberry joint-venture to tackle the Chinese market.

Along the way, it expanded its local operations across the country, hedging its exposure to weather conditions.

The company also exited the leafy vegetable category and also decided that spuds were a dud. And it has reduced its presence in the banana and table grape sectors.

The company is synonymous with current patriarch Frank Aloysius Costa, who has run the joint since 1959, but retired from the board last July.

Arguably, he is even better known for his beloved Geelong Football Club, of which he was president during the club's drought-breaking premierships in 2007 and 2009.

Costa Group listed on the ASX on July 24, 2015, in a sell-down that saw 244.7 million shares listed at \$2.25 apiece.

The Costa family retained 32.8 million shares - around 10 percent - as did strategic buddies Paine + Partners (a US private equity firm).

The listing raised eyebrows by not including the underlying property which was retained by the family in a complex arrangement, before being hived off as Vitalharvest Freehold Trust in June 2018.

The property assets were acquired by Costa's 2007 takeover of banana purveyor Chiquita Brands, which was renamed Costa Exchange.

Breeding the master race ... in fruit

There's more to growing stuff than sticking a seed in the ground and praying for rain.

A "breeding program" for blueberries involves sub-tropical and tropical species

"The [intellectual property] we continue to develop includes the leading premium Arana blueberry gives us the advantage of superior product genetics and positions us as the world's leading blueberry company," chairman Neil Chatfield told the AGM.

In the avocado sphere, Costa is tinkering with high density, trellised and protective cropping - as well as a pre-smashed variety to ease the workload of inner-city cafes.

Okay, part of that paragraph was an attempt at humor. As for the rest, it's all about increasing crop yield and quality and reducing water consumption.

As for the citrus business, the company is introducing robotic carton consolidation and palletizing at its Renmark packing facility. Its so-called Spectrum technology uses infra-red beams to grade the quality of the fruit.

"This is crucial for markets such as the US, Japan, Korea and China where the appearance and taste of the fruit is a key differentiator for consumer preference and being able to obtain premium pricing," Mr Chatfield said.

Costa is also on the renewables wagon, building a 5,000-panel solar farm at its Monarto mushroom facility.

So insofar as the fungi are left in the dark, they don't have to be.

Tenancy capers

In a surprise development, last month Vitalharvest (not Costa) told the ASX that the expansionary Perth property funds manager Primewest acquired the management rights to Vitalharvest from Gofarm for \$10 million.

Primewest is a listed property manager co-founded and chaired by the John Bond, the son of the late Perth entrepreneur and goal-bird Alan Bond.

The fund also acquired an 11.8 percent Vitalharvest stake for \$19.2 million, with dibs on a further 6.2 percent.

Gofarm is chaired by Frank Costa's brother Robert, with Costa Asset Management owning half of the management entity. Costa Asset Management represents the family offices of Robert and the family of brother Anthony, who died in 2017.

Last year, Gofarm served a notice of dispute on Costa Group, in relation to the information required to ascertain its share of Costa Group's profits under the variable rent component of the deal.

The dispute was eventually resolved.

To be renamed the Primewest Agri-chain Fund, Vitalharvest has \$275 million of assets, all leased to Costa Group.

The leases expire in 2026, but are renewable for a further 10 years at Costa's option.

As Primewest notes, the rents are also subject to an uncapped market-based rent review, which we understand would be favorable to the landlord (Vitalharvest).

If the parties can't reach agreement does Costa pluck up its trees and greenhouses and go elsewhere?

Finances and performance

The proliferation of woes sent Costa's bottom line to a reported \$35.4 million in calendar 2019 on just over \$1 billion of revenue, compared with a \$45 million profit previously.

Overlooking some accounting flummery, net profit halved to \$28.5 million.

Just to complicate things, the company last year changed to a December-end balance date.

Wisely, Costa plans to cease the practice of guidance using actual numbers – citing the “industry’s inherent forecasting challenges”.

Broker, Citi, plugs in earnings before interest tax depreciation and amortization (Ebitda) of \$146 million for calendar 2020, 49 percent higher than previously.

The firm notes that in an “unusual operating environment”, domestic mushroom, berry and avo prices are all higher, while citrus prices are “encouraging” for the second half.

Avocado lovers will know that the fruit is in season, but despite their abundance, prices are up around 50 percent while mushie prices are up 40 percent.

Costa’s “prudent and disciplined” approach to capital allocation involves targeting a minimum return on capital of 20 percent on new investments over a three to five-year time span.

The company also targets a long-term average of one to two times net debt to Ebitda.

The company has cash of \$36 million and net debt of \$178.9 million.

Since listing, Costa shares have peaked at \$7.74 (June 2018) and traded as low as \$1.88 (August 2015).

As could be expected, the stock has performed relatively well during the corona-crisis, falling from \$3.16 in late February to a March 23 low of \$2.50, returning to \$2.96 as we went to press.

Dr Boreham’s diagnosis:

In its listed life, Costa has proved an underwhelming - but far from disastrous - investor experience.

With some operational issues ironed-out the company looks in better shape, but with agri-business one can never forget the exogenous factors such as precipitation or lack thereof.

In Mr Debney’s words: “In agriculture we can never fully eliminate risk, only mitigate it.”

He adds management is focused on addressing climate change risks, improving water security and reducing waste from the growing and post-harvest stages.

Insofar as the company is not hostage to the weather gods and soft commodity prices, investors are keenly awaiting who will replace Mr Debney as grower-in-chief.

Disclosure: Dr Boreham is not an agronomist and does not possess a relevant - or irrelevant - doctorate of any sort. He loves avocados but would never pay more than \$20 for the smashed variety with eggs - even in an inner-city café with milk crates as chairs and Vegemite jars as glasses.

Ag & Vet Weekly can be contacted at: PO Box 5000, Carlton, Victoria, Australia, 3053
email: editor@agvetweekly.com; www.agvetweekly.com; twitter: @AgVetWeekly