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All the news on ASX-listed agriculture and veterinary companies

Dr Boreham's Crucible: Bega Cheese

By TIM BOREHAM

ASX code: BGA

Share price: $5.80; **Shares on issue:** 302,337,115; **Market cap:** $1,753,555,267

Chief executive: Paul van Heerwaarden

Board: Barry Irvin (executive chair), Richard Cross, Patria Mann, Raelene Murphy, Terry O'Brien, Peter Margin

Financials (year to June 2020): revenue $1492.2 million (up 5.15%), reported net profit after tax $21.3m (up 80%), dividend 5.0 cents (down 9%), cash $22.9m, net debt $235.6m (down 11%)

Major shareholders: Ethical Partners Funds Management 7.74%, Perpetual Funds Management 7.6%, Fidelity 5.4%, Vinva Investment Management 4.1%, Dimensional Funds Advisors 3.5%, Spheria Asset Management 3.3%.

As with Patsy and Edina, it's all about 'names sweetie darling' around the corridors of the rapidly expanding milk processor's HQ in the southern New South Wales town of Bega.

In this case the names aren't LaCroix or Chanel, but powerhouse grocery brands that hold number one or number two positions in the market.

Bega has just finalized the $534 million purchase of Lion Dairy & Drinks from Japanese owner Kirin, after the Federal Government blocked Chinese group Mengniu Dairy's proposed purchase last year.

The deal bolsters Bega's annual revenue to more than $3 billion, delivering Lion brands including Dairy Farmers, Pura, Dare, Big M, Yoplait and Farmers Union.

It also elevates Bega from the country's third biggest to second biggest milk processor, ahead of Kiwi giant Fonterra but behind Canada's Saputo, which owns Murray Goulburn. Lion also delivers Australia's biggest cold chain distribution network, consisting of 136 facilities.

In 2017, Bega shelled out $460 million for the local grocery business of Mondelez, which US giant Kraft Heinz had sold to Mondelez in 2012. Most notably, the deal delivered the Vegemite brand, which despite its Aussie street cred had been owned by Kraft since the 1920s. So, all in all, a classic case of buying back the farm - literally.

The Lion purchase will double Bega's milk intake from dairy cockies to 1.75 billion litres a year.

Bega now goes by the subtitle of The Great Australian Food Company. Given the rapid shift to brands - notably non-dairy ones - we won't be surprised if the company sheds its outdated main moniker of Bega Cheese in the near future.

In the meantime, though, the company faces an ongoing legal stoush on the peanut butter front (see below).

A dairy impressive heritage

As visitors to the Bega Cheese Heritage Centre would know, the Bega Valley has a dairying heritage dating back to the mid-1800s. The company itself was founded as the Bega Co-operative Creamery Company in 1899, before demutualizing and listing on the ASX in August 2011.

Along the way, the company acquired 70 percent of Tatura Milk Industries in 2007 and the remainder in 2011. In 2009, the company picked up Kraft's cheese making facility at Strathmerton in Victoria and in 2014 commissioned a nutritional canning and blending plant in Derrimut in Melbourne's inner west, which was sold to Mead Johnson in 2017.

In 2018, the company paid $250 million to buy the Koroit plant (milk, butter and nutritional powders) from fellow processor Saputo. Koroit, in Western Victoria, also does a line in lactoferrin, a valuable milk by product.

In a move that would have done Sir Joh proud, in late 2017, Bega shelled out $12 million for the Kingaroy, Queensland based Peanut Company of Australia.

In its first big stab at expansion, in mid-2013, the company bid $350 million for the Warrnambool Cheese and Butter Factory, but missed out to Canada's Saputo in a tussle that also involved Murray Goulburn as a bidder and Kirin taking a strategic stake in Warrnambool.

Bega adviser David Williams says that the company made about $100 million on the "failed" bid when Saputo pushed the price up for Warrnambool, Bega and Murray Goulburn in a bidding war, which reset the value of dairy assets in Australia.

Since listing, Bega has been run by Barry Irvin. A notable board inclusion is Peter Margin, who ran the Lion businesses when they were known as National Foods.

Currently, Bega operates eight manufacturing sites in Queensland, New South Wales and Victoria. It buys 850 million litres of milk annually from 420 farmers and produces 300,000 tonnes of bulk and branded product.

In 2019, Bega closed its cheddar and mozzarella plant at Coburg North in Melbourne's northern suburbs, having acquired the site in 2009.

The company's titular product, Bega cheese, is actually licenced to Fonterra and produced under a white labelling arrangement.

In the 2018-'19 year Bega sourced 40 percent of its revenue from dairy consumer packaged goods, 35 percent from dairy and other ingredients (including bulk export lines) and 16 percent from spreads and 'other' grocery such as dips and sauces.

Peanut butter wars

The purchase of the Kraft Australian grocery business has plunged Bega into two messy and expensive legal battles, one of which has been resolved in its favor.

When the assets were transferred from Mondelez to Bega, previous Kraft-Mondelez sloppy paperwork created a dispute about whether Bega was entitled to the so-called 'trade dress' - the distinctive yellow-lidded containers for its peanut butter.

Bega simply replaced Kraft with its name on the jars. But with its eyes on re-launching its own brand in the $100 million a year peanut butter market, Kraft took Bega to court.

In April last year, the full Federal Court ruled in Bega's favor and then the High Court refused to hear Kraft's appeal application. The gist of the decision was that in buying Kraft's local business Bega was also acquiring the rights to the design of the jars - for both smooth and crunchy peanut butter, to be precise.

The trouble is, Bega's use of its own name on a wider suite of products incensed Fonterra, which launched a legal action claiming this breached its exclusive branding agreement with Bega penned back in 2001.

In part, Fonterra contends that plonking the Bega name on products such as peanut butter "damages the existing reputation of the Bega trademarks for representing natural cheese sourced from Australia".

The Victorian Supreme Court finished hearing the case in July last year and a judgment is pending.

In a counter claim filed in March 2019, Bega alleges that Fonterra breached the agreement by under-investing in the Bega brand, relative to Fonterra's other brand such as Mainland. In August last year, the company disclosed total costs of $41.2 million over two years, pertaining to the Heinz and Fonterra jousts and acquisitions.

The Bega-Fonterra contract runs to 2026 and pencil in that as the divorce date: this couple might be sharing the same hayshed, but there's no love lost.

Finances and performance

The $534 million Lion acquisition - or $668 million after expenses - was mainly funded by a $401 million capital raising and $267 million of debt. The retail stanza raised $115 million, with only 40 percent of holders participating (or 50 percent after applications into an over-subscription facility). But not to worry, the offer was underwritten.

Priced at $4.60, a nine percent discount, the institutional placement and rights offer raised $286 million.

The acquisition has elevated Bega's debt to $518 million, or 3.3-times underlying earnings. Management is targeting a ratio of more like two times earnings, which is expected to be achieved by divesting non-core assets, including property.

Management expects $36 million of cost benefits from the purchase, which will result in the company's earnings per share growing in the double digits up to June 2022.

Bega's own earnings have been constrained by a drought-induced tight milk supply. But the Kraft lines have been doing well, in line with buoyant grocery conditions generally.

Lion has struggled, but generated $56 million of underlying earnings before interest, tax depreciation and amortization (Ebitda) from $1.6 billion of revenue in the 12 months to September 2020. Excluding the acquisition, Bega said it would satisfy market expectations of Ebitda of $124 million for the year to June 2021, 20 percent higher than previously.

Over the last 12 months Bega shares have traded between $3.86 (January 6, 2020) and $5.82 (now). Historically the price has ranged between $1.49 (July 2012) and $7.71 (December 2017). Bega has a 15 percent shareholder cap, which expires this August.

So, who Better Buy Bega? We'll just have to wait and see …

Dr Boreham's diagnosis:

As with the company-making Kraft acquisition, the Lion purchase can't be downplayed in terms of moving Bega from its reliance on raw milk pricing and availability.

Even on Lion's subdued numbers last year, its revenue and earnings were 107 percent and 54 percent of Bega's (respectively).

During the drought, all processors faced the problem of tight supply which meant they had to pay more at the farm gate for the cow juice, thus crimping margins.

The wet 2020 on the eastern seaboard has ameliorated this issue. Still, in the long term the company is assuming that non-coastal dairying regions (notably the Goulburn Valley) will become unviable because of climate change.

In any event, branded goods mean fatter margins, don't they sweetie darling?

Broker EL&C Baillieu estimates the Lion portfolio will increase Bega's branded revenue to 80 percent of the total, from 64 percent, currently.

Bega also faces the normal risk of paying for an acquisition - or, in its case, acquisitions. Lion's earnings have been going backwards, so the company needs to tap the expected cost benefits from lowering non-manufacturing overheads.

From what we can see, Bega's purchase price was in line with other comparable transactions. The headline number is also less than the $600 million offered by China's Mengniu Dairy, before the suitor was kyboshed by the Federal Government, effectively handing Bega a $66 million discount.

And given Kirin bought the old National Foods business for $2.8 billion in 2007, it can't be accused of overpaying, especially given that Kirin National Foods bought Dairy Farmers for $910 million the following year.

Disclosure: Dr Boreham is not a qualified agronomist and does not possess a doctorate of any sort. He enjoys his Vegemite for breakfast lunch and tea … ok, breakfast only.