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MSM benefits from cheaper raw sugar in spot market

Producer's long-term obligation to purchase from suppliers being reduced

by **ADRIAN LIM**

SUGAR producer MSM Malaysia Holdings Bhd, which is controlled by the Felda group, is benefiting from the current down-trend in free-market raw sugar price, which has given a boost to its earnings.

The company's long-term obligation to purchase raw sugar from its suppliers is gradually being reduced to 40% in FY13 from 60% in FY12.

Thus, the company is able to source for cheaper raw sugar from the spot market.

At the same time, the government is likely to address the subsidy rationalisation plan in the upcoming budget to trim the country's fiscal deficit which was reportedly rising.

Higher sugar prices could be back on the agenda this time around as the government had reduced the subsidy for sugar by 20 sen per kg in the last budget.

The price of sugar, a controlled item, had gone up five times in recent years – by 20 sen per kg on Jan 1, 2010; 25 sen on July 18, 2010; 20 sen on Dec 4, 2010; 20 sen on May 10, 2011, and 20 sen on Sept 29, 2012, bringing the retail price to RM2.50 per kg currently.

Responding to the move by the government to reduce sugar subsidy, MSM Malaysia said it had passed the higher cost to customers by increasing its retail sugar price proportionately.

Therefore, MSM Malaysia is expected to benefit from lower raw sugar prices and the potential subsidy rationalisation plan by the government.

MIDF Research analyst Kelly Tan says: "While MSM is contractually required to purchase 60% of its FY12 raw sugar requirements for retail sale through various long-term contracts, the group's obligation was reduced to 40% beginning FY13 to be carried through into FY14, in accordance with the terms of the long-term contracts.

"This could make a big impact as retail sales make up the bulk of MSM's sales volumes and revenue," she tells ***FocusM***.

She adds that the International Sugar Organisation has forecast that global supplies of sugar will outstrip demand.

She says the international body has projected an excess of 3.5 million metric tonnes (MT) in 2013/2014, adding that the situation is likely to persist until next year.

Meanwhile, RHB Research analyst Chan Jit Hoong says: "The recent frost in Brazil has driven up raw sugar prices in the past month amid worries of a reduction in sugarcane yields.

"However, the loss quantum turned out to be minimal, which sent sugar prices down again. In addition, the weak Brazilian reais against the US dollar encourages Brazilian sugar producers to increase their exports and this may further soften sugar prices."

After the company's briefing on Aug 23, Tan notes that MSM Malaysia has put in some strategies to address the concern over its operational costs.

She says the company is tapping into the low raw sugar price as such a situation will not last forever.

"While total approved capital expenditure budgeted for FY13 was around RM76.2 mil, only RM28.1 mil has been utilised in H1FY13.

"Therefore, the company has room to further use up to RM48.1 mil in 2HFY13. Major areas of application will include capacity increments, machinery additions, upgrades and replacements.

"We view the expansions favourably as economies of scale will be the likely result, thus bolstering MSM Malaysia's competitiveness," Tan notes.

According to *Bloomberg* data, raw sugar prices have fallen from a high of 35 US cents per pound in January 2011 to a low of 16 US cents in July 2013 on high inventories.

Tan says: "The cost savings [from this low price] are expected to have a huge impact given that free-market sugar traded at 34% discount to MSM Malaysia's long-term contract cost in H1FY13."

She adds that these cost savings are expected to translate into higher revenue as MSM Malaysia is able to increase the price competitiveness of its products.

Besides that, she notes MSM Malaysia has inked several long-term contracts with a few suppliers, diversifying its risk of price fluctuation associated with the cost of raw materials.

Obviously, Tan adds, the move has benefited MSM Malaysia from being overly dependent on a single supplier in the event of a shortage of raw sugar supplies.

Q2 results overview

MSM Malaysia posted a 75% jump in second-quarter FY13 net profit to RM92.58 mil from a year earlier on lower costs. Revenue increased 10.7% to RM604.61 mil due to higher export sales.

An analyst with Affin Investment Research says the near-term outlook for MSM Malaysia's earnings still remains cautious.

The analyst says the sales volume during the Hari Raya festive celebration was flat. Besides that, there are uncertainties over the government's subsidy rationalisation plan on sugar in Budget 2014.

Hence, the analyst observes that the move by MSM Malaysia in raising the sugar price last year has resulted in lower demand of 6.7% year-on-year.

Reviewing its Q2 results, the analyst notes that MSM Malaysia's growth in volume sales was mainly driven by higher exports to multinationals in Australia, South Korea and Singapore.

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Coupled with higher demand from local food and beverage businesses, the analyst says the company expects sales volume to improve in the second half compared with the first six months because of some issues which the local multinationals encountered earlier.

The issues include higher labour costs on off-loading the sugar from cargo, higher processing costs and additional processing cost.

While this analyst maintains its downward bias recommendation on MSM Malaysia, Chan and Tan are slightly bullish on the prospects of the company.

Outlook for H2

Chan says: "We increase our FY13 core earnings forecast by 6.5% to RM250.5 mil after revising up our sales volume assumption to 965,542 tonnes.

"We are also lowering our raw sugar market price plus freight cost assumption to 20 US cents per pound from 23 US cents.

"In addition, we are changing our mix of raw sugar utilised at market price to long-term contract price assumption to 50:50 from 40:60."

Chan adds that about 50-60% of the company's FY12 to FY14 raw sugar purchases have been locked in at 26 US cents, about 56% above the current market price.

For the second half (H2), Chan says the mix will normalise given its long-term commitments for its requirements earlier and believes that MSM's H2 pre-tax profit margin will return to the 12-13% level against 18% in Q2FY13.

In the meantime, MSM Malaysia aims to ride on the strength of its major shareholder Felda Global Ventures Holdings Bhd (FGV) to grow in the area of consumer goods, particularly in Southeast Asia, as the company will be launching more products to tap these markets.

According to its annual report, MSM Malaysia wants to further make inroads in emerging countries, and it will be looking into ways to selectively make strategic acquisitions or significant investments in areas where there are opportunities for growth.

The company will continue to partner international sugar traders across the region to further expand into South Korea and China, directly and indirectly.

The company notes that its recently enhanced warehouse operations in Sungai Buloh, Selangor, together with the addition of two new silos and a new automatic storage and retrieval system will contribute to the group's profitability through increased storage capacity and better efficiency.

Felda Global Ventures Sugar Sdn Bhd is the major shareholder of MSM Malaysia with a 40.03% stake, followed by Koperasi Permodalan Felda Malaysia Bhd (20%), FGV (10.97%) and the Employees Provident Fund (6.03%). FocusM

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BLOOMBERG

Higher sugar prices could be back on the agenda in the upcoming budget

The price of sugar has been increased five times since Jan 1, 2010