Competition, barriers to entry and inclusive growth: Agro-processing

Poultry, Dairy, and Milling of Maize and Wheat

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12 March 2016

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We should be particularly concerned about barriers to entry in agro-processing

1. Significant economy-wide impact; labour absorptive sector with strong backward and forward linkages, and export opportunities into the region
2. Highly concentrated; still dominated by the same firms as under state-sanctioned monopoly; low levels of dynamism and transformation
3. Incumbents vertically integrated and have significant scale (in a sector where scale economies matter)
4. Extensive anti-competitive conduct uncovered in the recent past (prosecuted with varying degrees of success)

Poultry

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Poultry

- Poultry sector characterised by high levels of vertical integration, economies of scale (esp. at breeding and abattoir level)
- One of the key determinants of competitiveness is the access to key inputs – feed and breed
  - Breeds highly concentrated both nationally and globally; RSA: Ross (Astral), Cobb (RCL) and Arbor Acres (CBH)
  - Tying of feed by other means?
- Recent re-entry by Afgri (2006) and new entry by GFC (2010); otherwise all new “entry” by contract growers
- AFGRI/Daybreak
  - Vertically integrated: feed, abattoirs, grower farms, some retail
  - Suffered massive losses for 2 years and, in 2014, divested to AFPO Consortium (Matome Maponya Investments, 54% and PIC, 36%)
- GFC
  - Objective: to diversify their business, adding ‘value’ to grain; vertically integrated into feed
  - IDC finance: loan and equity (including the Agro Processing Competitiveness Scheme from Pioneer settlement)
  - Only recorded its first profit in 2014/15

Key insights

1 **Entry is not sufficient: scale and multi-level entry matters:** contract growers do not have scale or vertical linkages to be true rivals; - reliance on vertically integrated incumbents leaves scope for strategic behaviour; development funding must take a value chain approach

2 **Soft funding and long-term support is required to create true rivals:** even vertically integrated entrants made losses for 4 years; takes time to develop capabilities and routes to market.

Entry is possible, but requires capabilities, finance and access to inputs and consumers markets

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Milling

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There have been a number of new entrants into milling since 2010

New entrants

Premier: entry into new market (EC)

Lethabo: new maize miller; entrepreneur

AFGRI & OVK: additional value add

New entrants on the horizon

Bakhresa, Tanzanian firm, to start in 2015, in Durban for KZN and export market. IFC-supported

Existing grain handler (MGK) expanding into wheat milling, and into pasta and biscuits, Northern Cape

FABCOS

Foundation for African Business and Consumer Services

But there have also been exits

Wheat Micro Mills, launched by the DTI in 2013; reasons for exit possibly include no route-to-market, operational inefficiency, failure to establish brand

Poor business management? Business in distress, to be purchased by VKB and Louis Dreyfus

Lethabo Milling's experience emphasizes the importance of access to markets & finance

- Produces *Lethabo*-branded super maize meal, samp, maize rice and white grits
- Main competitors: Ace (Tiger), Iwisa (Pioneer)
- Took 4 year to obtain funding
- Entered through Massmart support (SDF from Walmart merger)
  - Offtake agreement and DOB contract provided surety for commercial loan[1]
  - Massmart provided additional support including, e.g. training program, waiving listing fees, fast-track payments, and assisting with his pricing model
- Total capital of **R9.8mn** required to refurbish plant and purchase inputs[1]
- Cash-flow and working capital management challenging

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[1] Comprised of 1.6mn grant by Massmart and R8.2mn loan from ABSA

Key insights

1 **Again; soft loans and long-term support required:** bankability of Lethabo Milling questioned due to concentrated market and strong brands – *exact reasons* that entry is important

a Innovative competition settlements could provide funding: innovative settlements aimed at disrupting markets or supporting new entry have been effective; also delivers direct benefit to consumers

2 **Many entrants underestimate the difficulty of accessing formal retail:** burdensome (national) listing requirements, marketing allowances, and distribution/swell allowances a major BTE

3 **Incentive programs are onerous and poorly designed:** firms use consultants to navigate incentive programmes; wasteful (and easy to solve)

4 **Insider networks exclude entrants:** industry association offers the only accredited milling training programme; not readily available to new entrants

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Diary

Dairy farmers are expanding into processing

2 most recent entrants into UHT were both formed by dairy farmers

COEGA DAIRY

- Based in Coega IDZ
- Started production late 2011
- Produce Shoprite own-brands, Coega-dairy branded UHT and butter
- Recently entered into agreement with Famous Brands to supply their cheese

Dairy Day

- Based in KZN, formed by 26 dairy farmers in Midland
- Recently acquired Honeydew processing plant

1

In response to increasing milk supply and lower prices, farmers in EC and KZN establishing processing facilities to add more value

2

For Coega, key issues were:

- Greater certainty that farmers would have a buyer for their milk
- Obtaining fair prices
- Favourable payment terms, good cash flow

3

Sustainability depends on having some core business

- DOBs for Shoprite
- Cheese for Famous Brands

Incumbents are expanding through niche markets and new products

- Entered into high-margin yoghurt & custard in Jan (recorded 83% increase in profit this year)
- Purchased Nkunzi Milkyway (Woolworths supplier) in April
- Competitive dynamics & brand loyalty vary by product (brand less important in fresh milk than cheese & yoghurt)
- Private labels have grown; now preferred ‘brand’ in Europe
- UHT margins competed down (pressure from DOBs)
- Derives ~50% of revenue from distribution
  - Fleet & location of processing plants far from milk-producing regions historical legacy
  - Continues route planning a key competitive advantage
- Imported packaging and local plastic packaging a key cost driver; ~17% of total product cost
- Transport ~7-8% of total product cost

Key insights

1. **Questions of anticompetitive behaviour by milk processors post competition cases remain:** Price fixing case against Parmalat, Clover & Midlands Milk; Parmalat under investigation for inducement abuse (bonus scheme for continuous supply of raw milk)
2. **Dairy farmers integrating into processing,** but high costs and poor utilization means further entry into UHT unlikely
3. **Large incumbents are finding new customers** (forecourts, informal retail) to decrease reliance on supermarkets and **building alternative revenue streams** (e.g. Clover: logistics 50% of revenue)
4. **Concentrated input markets drive costs:** IPP in tetrapak and high price of polymers cited as major challenge, particularly with volatile exchange rate

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Key themes emerging from the sector study

- Entry about both overcoming intrinsic features (need for inputs, scale economies & finance etc.) and incumbent advantages
  - Funding requires a value chain approach; based on understanding of particular chains
- Significance of access to markets, and logistics cuts across studies: buyer power of retailers remains a challenge
- Smaller farmers need to be linked into processing (including through cooperatives, VKB arrangements)
- Policy decisions do not always seem consistent
  - Recent increase in wheat tariff by ~R900 to protect farmers
  - Soya tariff raises costs of poultry producers
  - SA will not produce sufficient wheat and soya given water → regional linkages
  - At the same time, entry by micro millers supported by DTI to decrease food prices

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Back-up slide on mergers

Four trends emerged from the merger review

Vertical integration into consumer goods and retail

- Former co-operatives and producers integrating into manufacture of consumer goods and expanding retail footprint (into fuel); dairy & milling[1]

Consolidation to increase throughput in existing facilities

- Mostly in poultry, but also in dairy and fishing
- Poultry producers purchasing contract growers
- Dairy firms expanding into dairy-based beverages and juice

Expansion into niche markets; often unaffected by imports

- Seen in large dairy mergers, but confirmed for other sectors during interviews (e.g. Clover acquisition of Nkunzi)

Increasing private equity, trader, and MNC involvement

- Increasing private equity interest across agro-processing; particularly in FMCG
- Acquisition of firms with existing African footprint, or acquisition of SA firm as base for expansion
- Increased involvement of commodity traders producer & processing level

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[1] Growth of current vertically integrated poultry producers occurred in the same way