Perpetual Equity Investment Company Limited

Stock story: Bega Cheese

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Australian mid-cap stock Bega Cheese (ASX:BGA) has detracted from returns in recent times. However, we believe the quality of the company's assets, their experienced management team and a positive outlook for future profit growth are justification for continued conviction in the stock.

BGA is a household name and engages in the receiving, processing, manufacturing, cutting and packaging of traditional cheese products, as well as the manufacture of other high value dairy products. Bega trades as a mid-cap stock on the ASX and remains a key position in PIC's portfolio.

Recently, we have seen the outlook for BGA weaken, driven by concerns around weakening global commodity markets and heightened competition domestically for milk supply.

The drought is also having a significant impact on BGA and other dairy producers, driving up the cost of milk and resulting in milk processors like BGA competing for volume. In New South Wales volume has been poor and some milk processors have been forced to travel all the way down to Victoria to source milk, which in turn pushes up the price of the inventory.

BGA has a rich history in Australia, starting as a dairy cooperative at the turn of the 20th century. At the time, advances in refrigeration prompted the commercialisation of the milk industry and cooperatives were formed in response as a more efficient means of transporting, processing and marketing the milk of farmers.

In the ensuing decades, BGA undertook a number of organic and inorganic growth initiatives which saw the cooperative expand its operations and enter new markets including butter, milk powder and cheese.

In 2008, after more than 100 years as a cooperative, BGA changed its corporate structure to become a company before listing on the Australian Securities Exchange in 2011.

Today, BGA remains one of Australia's largest food companies with a stable of quality assets. Importantly, we believe that the company has a strong management team that, over time, have proven themselves proficient allocators of shareholder capital.

In our view, BGA's recent acquisition of the stable earning Vegemite brand has helped turn the company into a more robust business that is better able to weather the volatility of dairy product prices.

Despite some headwinds, we believe our investment thesis for this company remains valid and that BGA is poised to benefit from:

1. **Further rationalisation in the milk industry**

   Following the deregulation of the Australian dairy industry in 2001, the market has continued to rationalise and consolidate with less efficient operators either exiting the industry or being acquired. This trend continues to be a tailwind for the remaining large operators such as BGA who continue to grow and benefit from increased economies of scale.

2. **Increased supply of raw milk**

Over the years BGA has developed a reputation in the marketplace for treating its milk suppliers well. Doing so has provided BGA with a competitive advantage over its peers when it comes to attracting new raw milk supply. However, until recently, the company's processing capacity has been constrained, meaning it hasn't been able to properly leverage this edge. The company's acquisition of a large dairy processing facility in June last year changes this dynamic.

3. **Strategic growth opportunities**

Following the purchase of the Koroit facility from international dairy heavyweight Saputo, BGA recently conducted a capital raising and the $202.2 million raised has significantly strengthened the company's balance sheet. BGA is now better positioned to pursue strategic growth opportunities. In 2017, the company completed the acquisition of the Mondalez grocery business, which gave it the famous Australian Vegemite brand.

In short, BGA has demonstrated an ability to turn milk into profits over many years and we believe their extra milk supply will underpin future profit growth. We remain positive on the outlook. As at 30 June 2019, PIC held 1.42% of the portfolio in Bega Cheese.