ANU Student Managed Fund

Investment recommendation

Inghams Group Limited

ASX code: ING

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Creation date: 01/04/2023 | Version date: 10/04/2023 (FINAL)

Contents

Notes:

All dollar amounts in this report are Australian dollars.

Glossary

AAE – Active Australian equities

AASB – Australian Accounting Standards Board

ANU – The Australian National University

ASX – Australian Securities Exchange

DAFF – Department of Agriculture, Fisheries and Forestry

EBITA – Earnings before interest, tax and amortisation

EBITDA – Earnings before interest, tax, depreciation and amortisation

FC – Franking credits

FCF – Free cash flow

FY – Financial year

IC – Invested capital

ING – Inghams Group Limited

IOZ – iShares Core S&P/ASX 200 ETF

MoS – Margin of safety

NOPLAT – Net operating profit less adjusted taxes

P/E – Price-to-earnings ratio

ROIC – Return on invested capital

RBA – Reserve Bank of Australia

SMF – ANU Student Managed Fund

WACC – Weighted average cost of capital

Portfolio recommendation

We recommend that the Student Managed Fund (SMF) **sell** its entire active position in Inghams Group Limited (ING) within the Active Australian equities (AAE) portfolio, and invest the proceeds in the iShares Core S&P/ASX200 ETF (IOZ).

This recommendation is subject to the price remaining above $2.77 and expires once the ING 2022-2023 financial results are released (expected 18 August 2023).

Investment thesis

The key reason for our sell recommendation is that ING offers an unattractive trade-off between maximising the expected value of funds invested and the risk of a sustained loss of value. In short, we see more downside risk than upside potential.

The SMF's original investment thesis was based on ING's dominant market position in a concentrated industry, the expectation that temporary cost pressures would subside, investments in efficiency, and growth expectations for poultry consumption in Australia. Since the initial investment on 3 May 2019, the SMF's investment in ING has delivered a holding period return of -21.32% as a consequence of these assumptions not being fulfilled. ING's performance reflects:

- Persistent cost pressures stemming from drought conditions, supply chain challenges, elevated input prices (particularly wheat and soy) and labour shortages; and
- The inability for ING to pass through these costs to customers.

Consequently, we have refreshed our view and hence valuation to recognise the combination of exposure to external cost pressures and the company's limited pricing power. Another important aspect is the implication of operating leases for ING's valuation following the Australian Accounting Standards Board (AASB) accounting policy change (AASB 16) requiring operating leases to be reflected on the balance sheet. This revealed a different picture of the company's leverage and cash flows to that on which the original investment case was based.

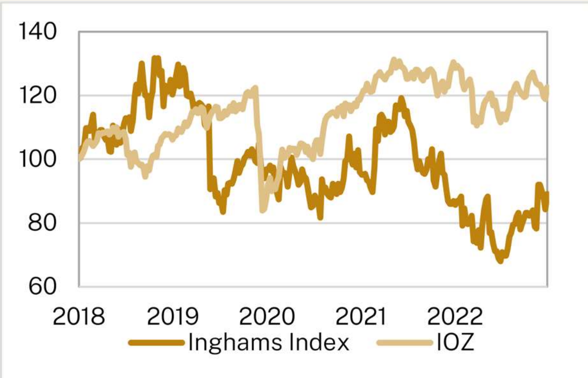
The key risk to selling the SMF's position would be if we have underestimated ING's long-term ability to generate operating earnings, due to either cost pressures proving transitory in nature or because ING management delivers a sustainable uplift in product pricing across the business. Another possibility is that easing cost pressures for the near-term lead to a bounce in earnings and the share price, providing a better exit point. Nevertheless, we conclude that the risks of retaining ING are more significant than the risk of unwinding the position at this current time.

AUSTRALIA

ASX code: ING

Price (at 08/04/2023)	$2.89
Valuation	$2.64
- inc. franking credits	$2.97
Margin of safety (MoS)	-8.65%
- inc. franking credits	2.77%
Dividend yield (2022A)	2.20%
GICS	Food, Beverage and Tobacco
52-week range	$2.31 – 3.30
Recommendation	Sell
Key assumptions	
Required return on equity	7.48%
WACC	5.84%
Carbon intensity	
ING	83.50
ASX200	236.08

Five-year share price history



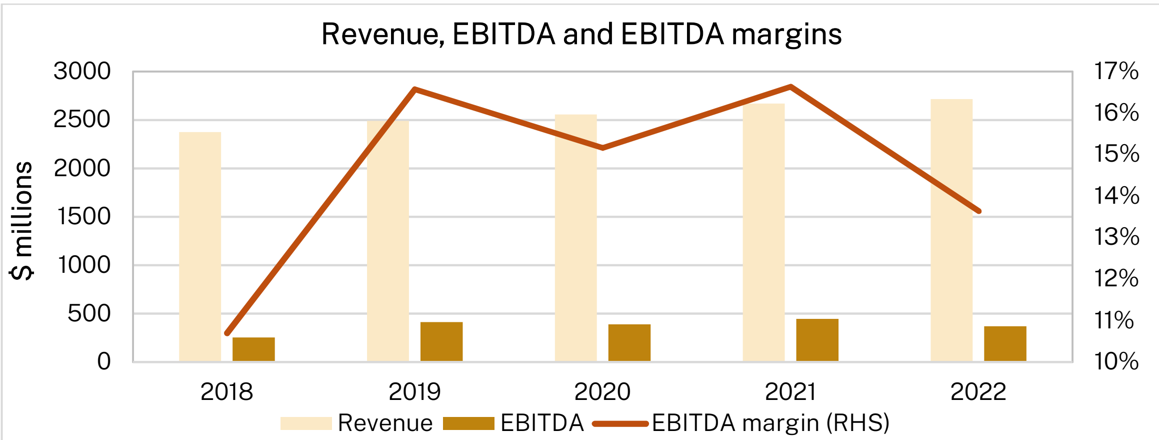
Investment case

Alignment with SMF objectives

The investment objective of the SMF is to maximise the trade-off between the long-term expected value of funds invested with the risk of a sustained reduction in the real value of those funds. Since the time of investment, ING has achieved a negative holding period return of -21.32%, largely driven by sustained cost pressures and management's inability to pass these costs on. Unfortunately, we consider that this decline represents a permanent loss of value as the market revised down its expectations about profitability and cash flows. Looking forward, avoiding further declines depends on the capacity for ING to deliver long-term sustainable cash flows that at least match, if not exceed, what is now priced into the market. This requires a well-developed and executed strategy to produce stable revenue, manage margins and a reinvestment plan to sustain and grow the business. However, ING is confronted by a number of risks.

First is the risk that future revenue growth might be challenged relative to history. The original investment thesis addressed the growth in poultry consumption based on chicken being a healthier and cheaper alternative to other meats. Data from the Department of Agriculture, Fisheries and Forestry (DAFF) indicates that from 1992 to 2023, chicken consumption as a percentage of total meat consumption has grown from 25% to 48%, with research from IBISWorld indicating that poultry consumption is approaching a point of relative saturation in per capita terms. Hence, if poultry consumption is approaching its per capita maximum, future revenue growth will be constrained relative to the past. Between 1998 and 2018, poultry volumes grew at a compound annual growth rate (CAGR) of 8.3% while meat consumption grew at 0.9%. Despite this risk, our ING revenue forecast projects an average growth rate across the entire forecast period of 3.80%, which is 0.90% higher than forecast at the original investment stage. Subsequently, the scope for waning revenue growth presents a source of potential downside to our valuation.

Second is the exposure of ING's cost of goods sold (COGS) to external factors coupled with an inability to pass these costs on. In retrospect, this risk was not fully understood by the AAE team at the time of investment, in part due to limited historical data available following ING's listing in 2016. The chart below illustrates that, while revenue has experienced stable growth over time, margin management has been poor in response to emerging cost pressures. The elements that contribute to these cost challenges are discussed further below, including why these factors have resulted in a revised risk assessment for ING.

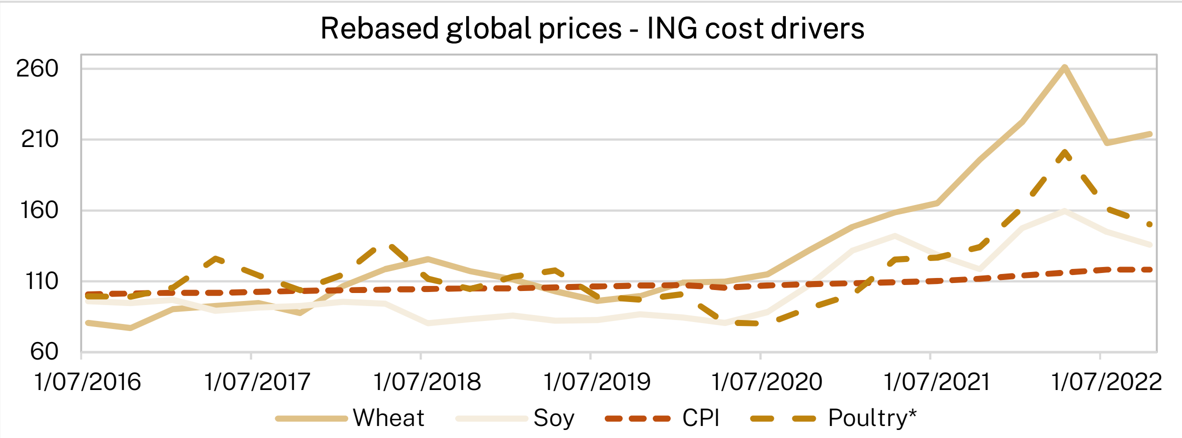


Another important aspect of the original investment thesis included capital investment programs to enhance operational efficiency. Here there have been a number of developments impacting our view of the company and the risks it faces. The first relates to operating leases, noting that leases dominate ING's balance sheet and comprise the bulk of fixed assets. At 31 December 2022, lease liabilities stood at $1.342 billion versus net debt of $294 million, while right-of-use assets were 2.65-times the size of property, plant and equipment. This gives rise to significant uncertainty around the level of investment needed to sustain the business. Second is the possibility that ING has been underinvesting. Since the first half of 2020, the value of leases has declined moderately while capital expenditure has fallen from $40.5 million to $23.5 million per half. This appears to reflect underinvestment rather asset efficiency, given that capital expenditure sits at 53% of pre-AASB 16 depreciation in 1H23 and is well below the management's stated target range of 75-90%. Underinvestment in capital management programs could constrain the capacity of ING to achieve operational efficiency and establish genuine growth prospects for the business. Our forecasts assume that invested capital (IC) recovers as a percentage of revenues to around 1.40x, consistent with the historical average. There is a risk that a period of higher capital spending is needed, which presents another potential risk to free cash flows and hence our valuation.

Susceptibility to external cost drivers

The exposure of ING's earnings to external cost pressures seems inherently structural, as evidenced by the inability of the company to pass through cost increases into prices to protect margins in recent years. Over the last five years, management has indicated that a number of causes have resulted in volatile earnings performance, including drought conditions in Australia in 2018-19, COVID-19 disruptions from 2019-20, labour shortages and elevated commodity prices. Whatever the reason, margins and earnings end up taking the hit every time.

Feed costs are a significant and volatile component of total expenses, and have been impacted by the weather, growing conditions and international events, including Russia's invasion of Ukraine. Importantly, these factors are fundamentally outside the control of ING. The chart below plots rebased changes in the price level of key feed inputs for ING (wheat and soy) alongside the global poultry price and the Australian consumer price index (CPI). We note that despite these external cost pressures having significant influence on the global poultry price, Australian poultry prices have only grown at an average of 1.6% over the last five years, with ING's revenue growth suppressed at 2.3% over the same period.



*Global poultry prices are only used and may not provide a reliable illustration of domestic price changes.

Grain prices are volatile and thus cost pressures may ultimately prove short-term in nature. With grain prices now showing signs of declining, earnings can be expected to recover as costs stabilise. Nevertheless, our valuation is based on expectations for long-term future cash flows, and a recovery in earnings is captured in our model. More importantly, recent underperformance demonstrates that cost fluctuations can impact the underlying performance of ING over extended periods of time, and remain a source of risk. The table below highlights the sensitivity to costs by estimating the shift in the MoS from changes in COGS over the stage one forecast period (2022-23 to 2026-27), assuming there is no adjustment in product prices.

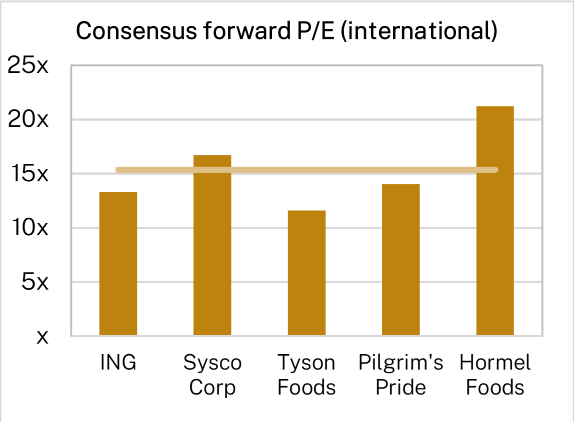
+2% COGS	+1% COGS	Base Case	-1% COGS	-2% COGS
$2.13 (-26.3%)	$2.39 (-17.3%)	$2.64 (-8.7%)	$2.88 (-0.3%)	$3.12 (+8.0%)

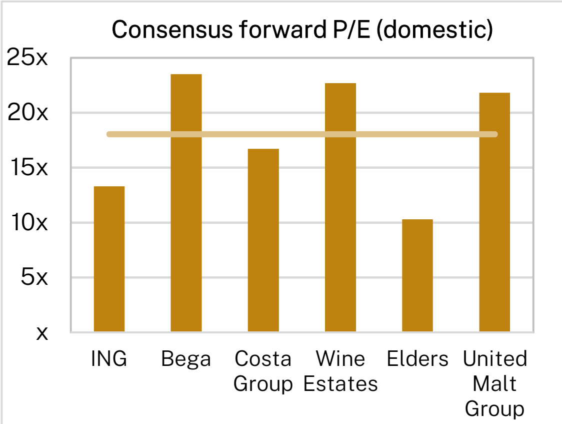
There are also emerging pressures on the horizon that may contribute to continued pressure on costs and hence margins. These include the ongoing global supply constraints caused by wheat bottlenecks from the Russia-Ukraine conflict, Bureau of Meteorology predictions for drier conditions following three consecutive La Nina events, higher than average inflation and potential for higher labour costs due to future wage increases, as forecasted by the Reserve Bank of Australia (RBA).

Market pricing in earnings recovery

We have explored the extent to which the expected earnings recovery has been priced in by the market by examining price-to-earnings (P/E) ratios and imputed pricing assumptions using our model. ING's trailing P/E is currently sitting at 77.3x, whilst the consensus forward P/E for the next twelve months is 13.3x, implying a forecast earnings recovery of approximately 5.8x.

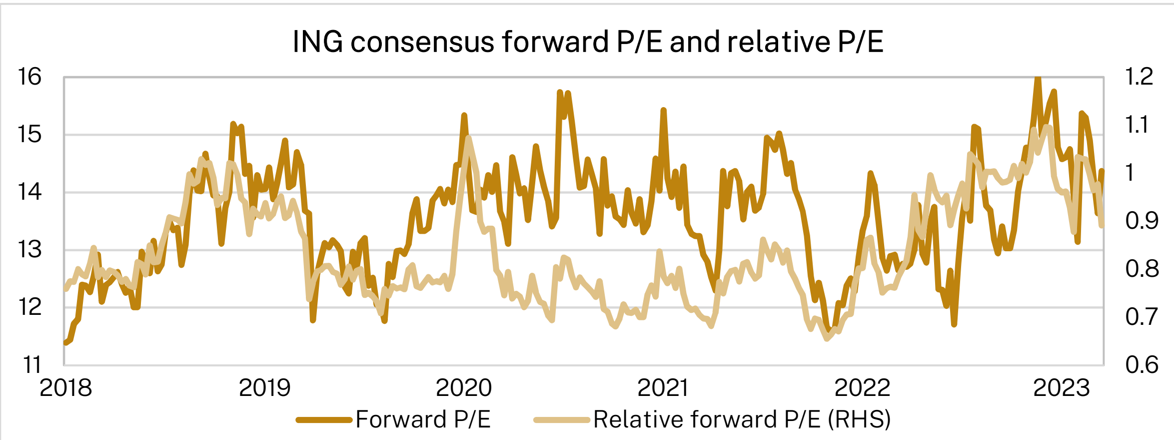
The charts below assess ING's relative pricing against comparable companies. Due to the absence of publicly traded poultry companies on the ASX, we have sought international comparisons primarily from US listings of other poultry businesses. We have also compared ING with ASX-listed food industry companies.



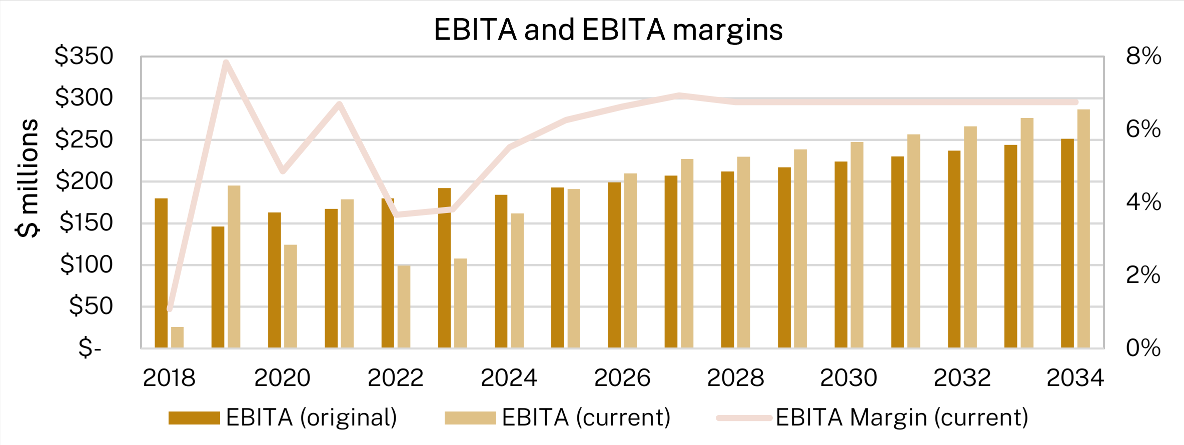


ING's consensus forward P/E ratio of 13.3x is lower than the 15.4x average for US poultry companies and the 18.1x average for ASX-listed food companies. While the above P/E analysis on its own suggests that ING offers value relative to comparative companies, it is essential to consider additional factors before drawing conclusions, especially as the valuation of both the international and domestic companies encompass a diverse range of influences and thus cannot be directly compared.

Another approach is to compare ING's P/E against its own history. The charts below plot ING's consensus forward P/E and relative forward P/E versus the market. The current forward P/E ratio of 13.3x is slightly below the 5-year average of 13.6x. This indicates that the market's expectation of the company's future earnings growth is largely in line with its historical performance. This suggests that the market believes the company will continue to grow at a similar rate to what it has experienced over the past five years. The relative forward P/E compared to the market is at 0.9x, which is slightly higher than historical average of 0.83x. This implies that the market may have increased expectations for the company's future earnings growth or believe that the company's prospects have improved compared to its peers or the broader market.



Our own valuation provides another reference point. The chart below plots our current and original forecasts for EBITA, and our current forecast for EBITA margin. The latter reflects a recovery to the upper end of the historical range. This might be viewed as moderately optimistic, which is also coupled with what we consider to be relatively generous revenue growth assumptions. Nevertheless, these assumptions generate a negative MoS of -8.65%. This observation reinforces the conclusion that a potential earnings recovery is discounted in ING's share price.



Constrained pricing power

A critical issue is the ability to pass through costs to customers, which we now discuss in more depth. ING's business model is heavily dependent on its relationships with key customers, especially its established contractual arrangements with quick service restaurants (e.g., McDonalds and KFC) and grocery providers (e.g., Aldi, Woolworths and Coles). However, recent exposure to elevated costs has not translated through to higher sustained selling prices across the business under these contracts. AAE considers this to be driven by two factors: the capability of ING management to negotiate with customers, and poultry market pricing dynamics.

In relation to management capability, reporting has previously indicated that approximately 60% of contracts with large customers reflect some form of cost pass-through mechanism. In an environment where the company is heavily exposed to external cost events, a clear strategy to manage challenging periods is to have a higher percentage of cost pass-through contracts. In public statements, however, management has indicated that they consider customers to be "strong negotiators". Given that the company has established a leading market share in Australia and New Zealand, and operates in an industry that is reasonably concentrated, we find this admission concerning. It is suggestive of a power imbalance between ING and its customers that leaves ING highly exposed to any increase in costs. A power imbalance also raises the question of whether ING would fully benefit from any cost decreases. This possibility raises the risk of an asymmetry in how costs are passed through, working to ING's detriment.

Also of note is that pricing remains competitive despite industry concentration, with the two largest producers holding approximately 70% share of the poultry market. This reflects that ample supply of poultry is available to the market with scope for customers to select the lowest cost product, with large grocery stores presenting alternatives on the same shelf (particularly from ING's largest competitor, Baiada). A key development during 1H23 is that management indicated it has achieved an average selling price increase of over 8% in response to recent cost pressures. The success of these price increases in boosting earnings relies on them being sustainable and having only limited impact on sales volumes. We note that ING's reported average selling price declined by approximately 6.8% between October 2021 and January 2022. This is evidence that, despite ongoing cost challenges, ING has had to drop prices in the past. This highlights the possibility a stabilisation in costs could simply lead to lower poultry prices due to competitive pressures. Alternatively, should ING try to maintain prices at a level that exceeds competitors, customers will select substitutes resulting in a reduction in ING's underlying market share.

Risks to recommendation

Costs pressures and price increases

In assessing ING's exposure to external cost pressures, there is a possibility that these pressures are largely cyclical and short-term in nature. Macroeconomic factors currently influencing ING appear to be abating, with sharp falls in wheat prices in the first half of 2023 and soymeal prices having been on the decline after reaching a 10-year high in Q1 2023. These trends suggest that peak pricing for these external costs may have passed as supply chain disruptions are resolved. Should lower commodity prices persist, an immediate increase in earnings may result as margins expand, and the market might respond by sending the share price higher.

The prevalent risk for the SMF associated with this scenario is the possibility of divesting too early and missing out on a better exit price. While there is a good chance that cost pressures are indeed now receding, the market has already priced in a substantial earnings recovery. This is reflected not only in our earlier analysis of P/Es and valuations, but also the fact that the ING share price has rallied over 25% from its lows of September 2022.

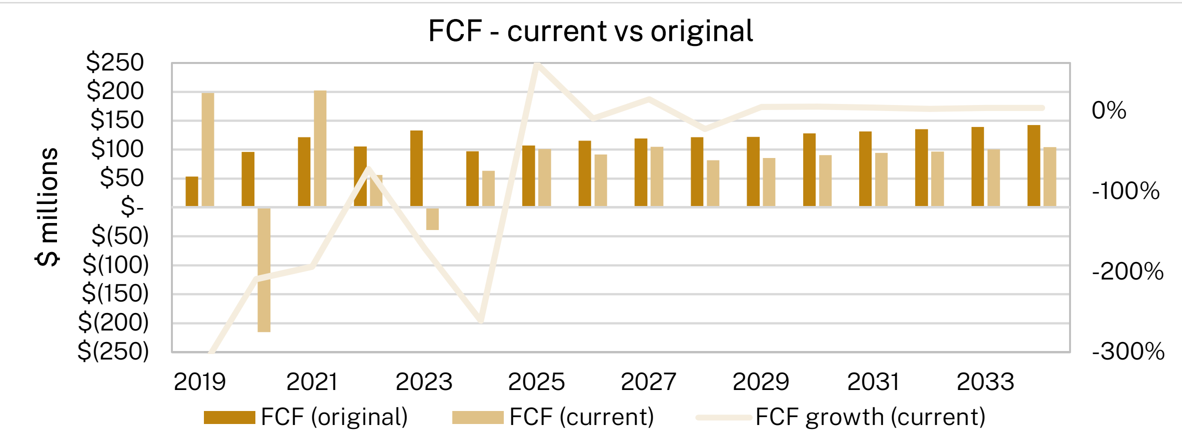
Market restructuring following recent pressures

The recent cost pressures experienced by ING are also likely to have been experienced by their unlisted competitors, largely Baiada (Steggles) and Turosi. If these competitors have found that they are less able to compete on the same scale as ING in a high-cost environment, it could act as a catalyst for industry consolidation or restructuring. ING competitors may also sacrifice capital reinvestment at the expense of long-term growth prospects, operational efficiency and potentially market share. This would provide an opportunity for ING to capture additional market share and improve earnings in the long run. The AAE team does not see potential restructuring as a justification to retain our investment, as it is challenging to predict and has a low likelihood. Our overarching focus remains on ING's potential to deliver long-term sustainable cash flows.

Key model updates

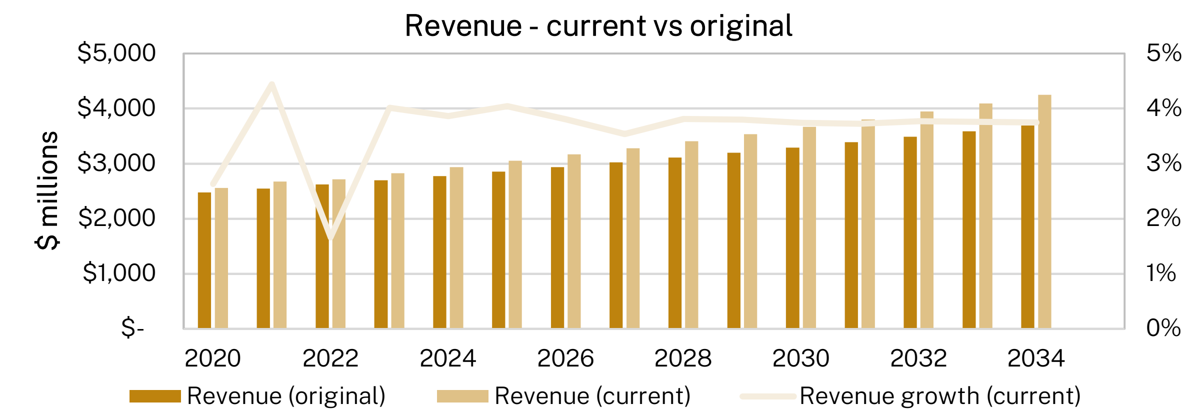
Impact of operating leases

The most significant model update post the initial purchase of ING involved accounting for leases under AASB 16. This entailed bringing operating leases on balance sheet including recognising right of use assets and lease liabilities as debt, as well as adjustments to earnings as operating lease expense was reallocated to depreciation and interest. While adding leases should in theory not impact on the valuation, the mix of these changes resulted in material adjustments for ING noting that the value of leases liabilities dwarfs that of net debt ($1,342 million versus $294 million at December 2022). Major changes included explicit reinvestment in right of use assets becoming a component of investing cash flow, and treating leases as debt impacting on WACC while also creating a large deduction from enterprise value when estimating the value of equity. Along with revisions to the profitability of the underlying business, the balance of lease-related changes contributed to a downward shift in our valuation versus that struck at the time of purchase. The resulting change in forecast free cash flow (FCF) can be seen in the chart below.



Revenue and margins

The long-term average revenue growth rate has been increased from 3% to 4%, with reference to historical revenue growth (see chart below). Growth of 4% reflects a mixture of increasing poultry volumes of 1.7% (below the historical average of 2.1%) and poultry price growth of 2.5% (above historical average of 1.4%). This reflects our expectation of reduced volumes driven by saturation of chicken consumption as a proportion of total meat consumption and industry poultry price increases. Noting total revenue forecasts are 1% higher than originally forecast, this adds a degree of optimism in our model despite still achieving a negative MoS.



As previously mentioned, EBITA forecasts are similar to those in the original investment thesis. This reflects two offsetting effects, being an underlying cost-margin squeeze and the removal of the interest component that was previously included in the operating lease expense. A recovery in EBITA margins is assumed to occur after 2023-24 (noting that 1H23 EBITDA was 10.6% below the prior comparable period) as cost pressures subside and the impact of price increases flow through. The long-term forecast EBITA margin is assumed to settle at 6.8%, which we view as a moderating optimistic assumption given it sits in the upper part of the historical range.

Scenarios

Our scenario analysis focuses on the impact of COGS movements, in recognition of ING's earnings sensitivity to movements in input costs and uncertainties around how changes in costs flow through to margins and prices. Our scenario analysis is based on the following assumptions:

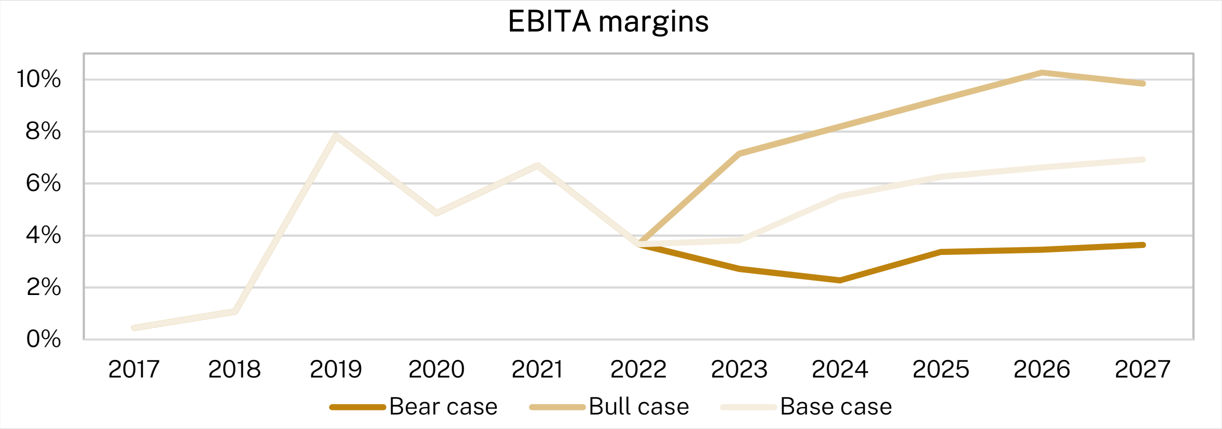
- We assume for simplicity that revenue remains static relative to the base case, i.e. that the full impact of cost changes is borne by margins, without any price adjustments; and
- COGS are variable and largely subject to fluctuations in the feed prices, specifically events that impact the price of wheat and soy including global crop yields and supply shortages.

Our bear case scenario assumes that cost pressures exceed expectations, driven by a constrained global supply of wheat and soymeal stemming from persistent pressures on crop yields and the ongoing conflict between Ukraine and Russia. While these cost pressures may be alleviated as alternative feed input sources emerge, the bear scenario might be interpreted as implicitly assuming that margins do not benefit if this occurs due to the highly competitive nature of the poultry industry, such that any cost reductions pass through into lower poultry prices.

This scenario involves a significant reduction in EBITA margins that persists in the long run due to the combined impact of heightened cost pressures and aggressive competitive pricing. The EBITA margin falls to 2.71% in the first year and 2.28% in the second year before tapering off at around 3.5%, which is a bit lower than the 3.7%-3.8% observed during 2021-22 and our forecasts for 2022-23. This scenario yields a valuation of $1.54 with a MoS of -46.71%.

Our bull case foresees a rapid and substantial improvement in wheat and soymeal supply chains, resulting in a marked decrease in their prices. Under this scenario, we assume that ING's input costs revert to pre-COVID levels while the selling prices of ING's products remain unchanged, allowing ING to fully capitalise on the lower input costs. Consequently, we project that margins approach all-time highs and are sustained at those levels. This favourable outcome hinges on the assumption that ING's competitors face difficulties adapting to the evolving market conditions, thereby preventing them from aggressively undercutting prices. This scenario also implies strong ability to pass through costs into product products, such that the assumed higher margins are protected from any additional cost fluctuations over the long run.

Under this scenario, the EBITA margin rises to 7.15% in our first forecasting period and increases until the margins peak in 2026 at 10.27%. The increase in EBITA margins corresponds to a decrease in the COGS/revenue margins, which drop to a 5-year low with no adjustment to prices and present a quite optimistic view given historical experience. This scenario results in a valuation of $3.63 and a MoS of 25.61%. The margin scenarios are illustrated in the chart below.



The scenario analysis indicates a negative skew in the valuation relative to the current share price, as illustrated in the table below. The bull case valuation of $3.63 implies a MoS of 25.61% and is considered of low likelihood given it entails very optimistic assumptions. In contrast, the bear case valuation of $1.54 delivers a wider MoS of -46.71%. In summary, our scenario analysis suggests that there is more downside risk than upside potential at the current price level.

Scenario valuations

Scenario	Bull	Base	Bear
Share price	$3.63	$2.64	$1.54
MoS excluding FC	25.61%	-8.65%	-46.71%
MoS including FC	42.21%	2.77%	-40.83%

Recommendation summary

Our recommendation to sell ING reflects an updated assessment of earnings potential and risks with reference to the SMF's long-term objectives and hence focus. The predominance of downside risk over upside potential is driven by ING's sensitivity to external costs and limited pricing power. More specifically, recent earnings performance as well as the impact of accounting changes related to leases under AASB 16 have significantly altered our stance on the level and reliability of the cash flows that ING can generate over the long run. Nevertheless, we acknowledge that there are elements of risk to selling the stock at the current time, specifically if we have underestimated the extent to which cost pressures are transitory and recent price increases are sustainable. After evaluating the return and risk trade-off to this decision, our assessment is that ING should not remain within the SMF portfolio as it does not offer good value and carries an unacceptable level of risk.

Appendix

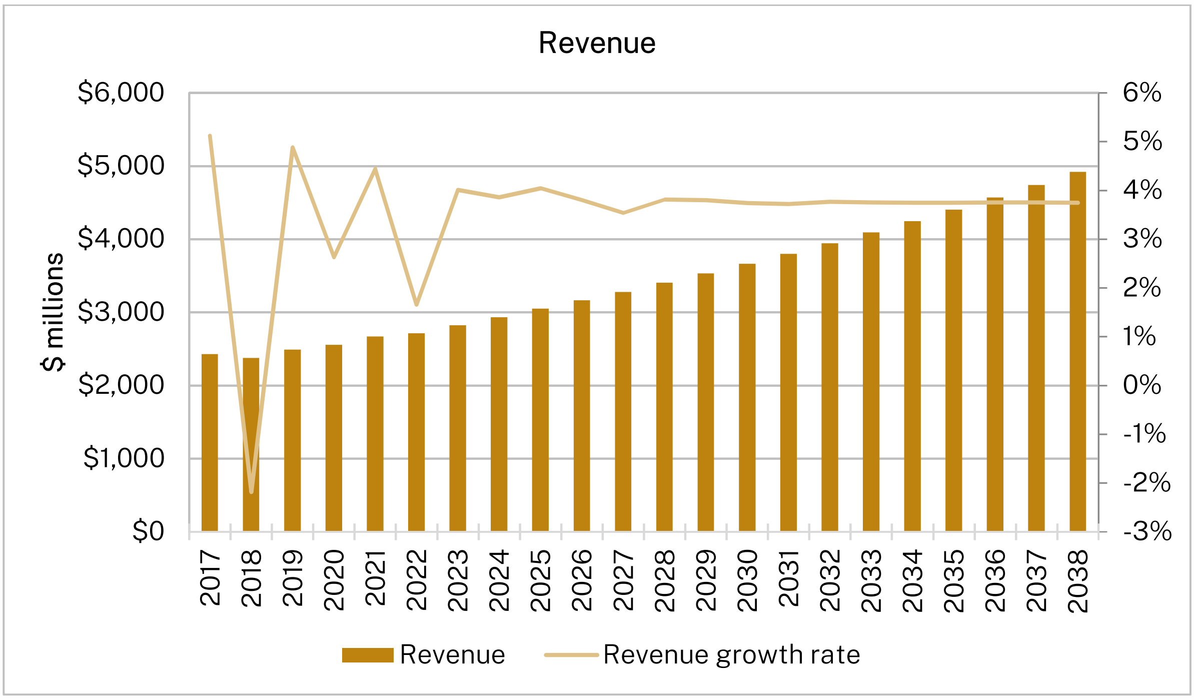
Appendix A: Valuation summary

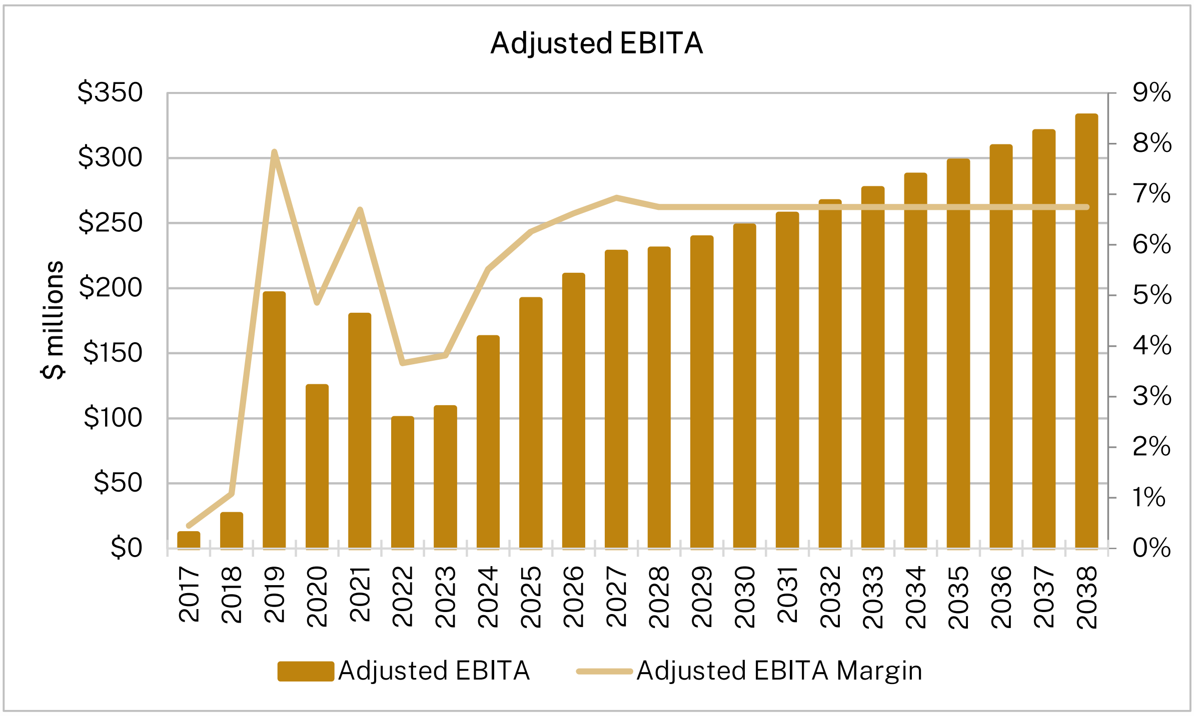
	Bear case	Base case	Bull case
Share price (08/04/2023)	$2.89	$2.89	$2.89
Valuation, ex. FC	$1.54	$2.64	$3.63
Valuation, inc. FC	$1.71	$2.97	$4.11
Margin of safety, ex. FC	**-46.71%**	**-8.65%**	**25.61%**
Margin of safety, inc. FC	-40.83%	2.77%	42.21%
Required return on equity	7.48%	7.48%	7.48%
Cost of debt (after tax)	4.77%	4.77%	4.77%
WACC	5.84%	5.84%	5.84%

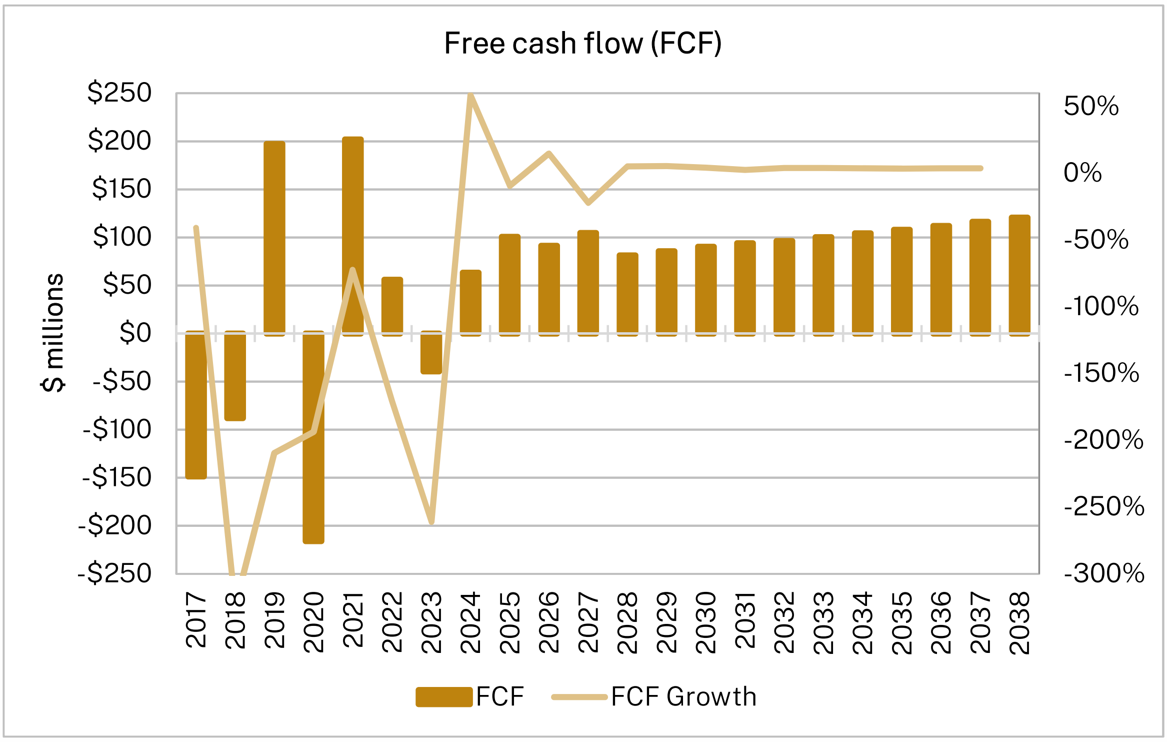
Appendix B: Key financial summary

Financial year ($million)	2019(A)	2020(A)	2021(A)	2022(A)	2023(E)	2024(E)	2025(E)
Total revenue	2490	2555	2669	2713	2822	2931	3049
Revenue growth	4.88%	2.63%	4.44%	1.66%	4.01%	3.86%	4.04%
Adjusted EBITA	195.2	124.1	178.7	99.4	107.7	161.6	190.9
Adjusted EBITA margins	7.84%	4.86%	6.70%	3.66%	3.82%	5.51%	6.26%
NOPLAT	149	81	117	84	80	119	142
NOPLAT margin	5.98%	3.18%	4.39%	3.09%	2.82%	4.08%	4.64%
Invested capital	1716	2013	1928	1956	2075	2130	2171
ROIC	8.68%	4.04%	6.07%	4.29%	3.84%	5.61%	6.52%
Free cash flow	197	(216)	202	56	(39)	63	101
IC turnover (ex. goodwill)	1.45x	1.27x	1.38x	1.39x	1.36x	1.38x	1.40x
Financial year ($ million)	2026(E)	2027(E)	2028(E)	2029(E)	2030(E)	2031(E)	2032(E)
Total revenue	3165	3277	3402	3532	3664	3800	3943
Revenue growth	3.80%	3.54%	3.81%	3.80%	3.74%	3.72%	3.77%
Adjusted EBITA	209.6	227.2	229.7	238.4	247.3	256.5	266.2
Adjusted EBITA margins	6.62%	6.93%	6.75%	6.75%	6.75%	6.75%	6.75%
NOPLAT	155	169	170	176	183	190	197
NOPLAT margin	4.90%	5.15%	4.99%	4.99%	4.99%	4.99%	4.99%
Invested capital	2235	2299	2388	2479	2572	2668	2768
ROIC	6.93%	7.34%	7.11%	7.11%	7.11%	7.11%	7.11%
Free cash flow	91	105	81	85	90	94	96
IC turnover (ex. goodwill)	1.42x	1.42x	1.42x	1.42x	1.42x	1.42x	1.42x

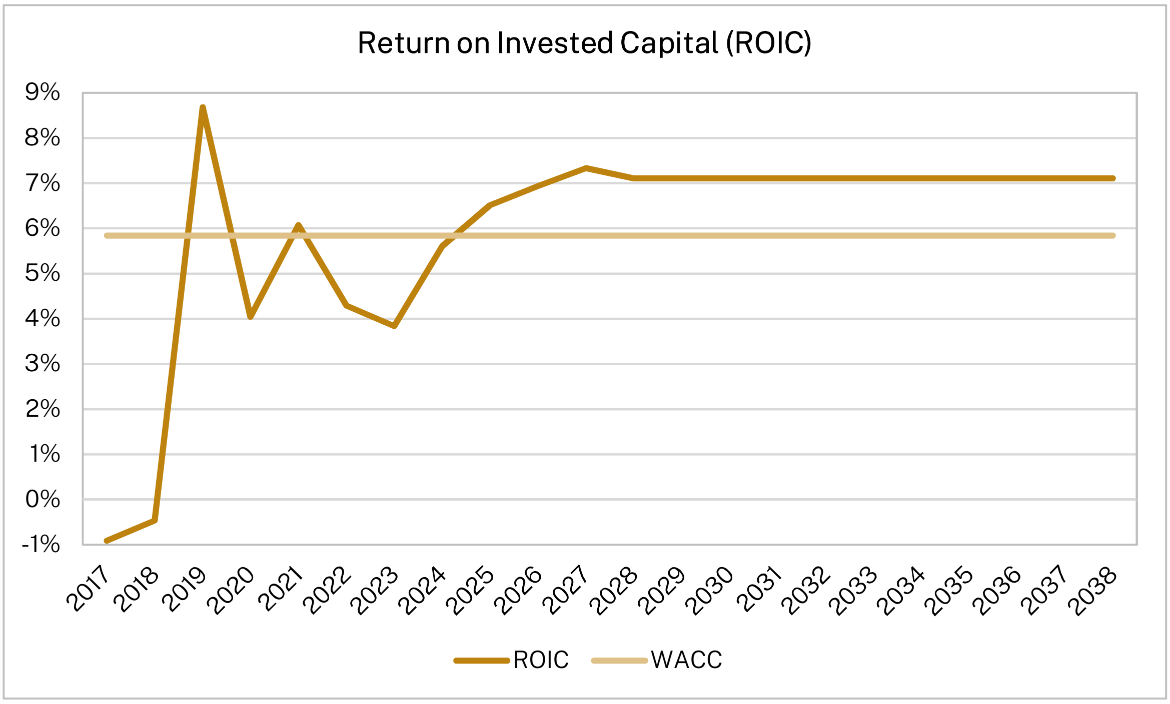
Appendix C: Key financial drivers



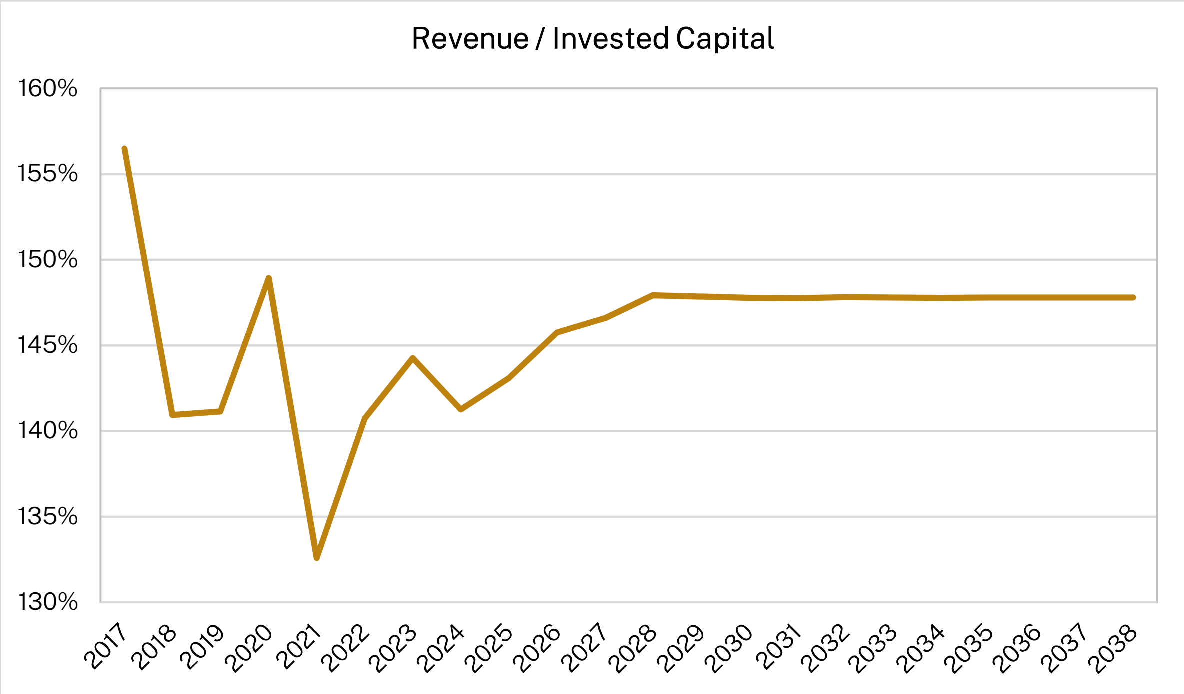




Free cash flow (FCF)
$ millions
$250
$200
$150
$100
$50
$0
-$50
-$100
-$150
-$200
-$250
50%
0%
-50%
-100%
-150%
-200%
-250%
-300%
2017 2018 2019 2020 2021 2022 2023 2024 2025 2026 2027 2028 2029 2030 2031 2032 2033 2034 2035 2036 2037 2038
FCF
FCF Growth



Return on Invested Capital (ROIC)
9%
8%
7%
6%
5%
4%
3%
2%
1%
0%
-1%
2017 2018 2019 2020 2021 2022 2023 2024 2025 2026 2027 2028 2029 2030 2031 2032 2033 2034 2035 2036 2037 2038
ROIC
WACC



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