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European Union Sugar Reform: a sweet deal for Illovo

Illovo's South African operation produces about 0.8m tons of sugar annually. It also has operations in Zambia, Malawi, Swaziland, Tanzania and Mozambique which when combined with the SA operation, produce a total of 1.7m tons a year. This makes it Africa's largest sugar producer. Why did Illovo choose to invest in these African countries? More importantly, why are Allan Gray investors shareholders in Illovo?

Cost drives Illovo production, with a focus on protected European and US markets
Illovo's strategy is to produce sugar in countries that have cost advantages and sell its sugar in markets that offer some protection to sugar producers against the volatile world sugar price. The world sugar price, currently around 9.5 UScents/lbs, is essentially a 'dump' price that is used by Brazil (the world's biggest producer of sugar with around 33.5m tons) to rid itself of excess sugar. Zambia, Malawi, Swaziland, Tanzania and Mozambique are on the list of lowest cost producers of sugar in the world. In order to protect its sugar operations from the volatile world sugar price, Illovo focuses on producing in countries that have preferential access to protected sugar markets within Europe.

European Union sugar reforms increase access, impose price cuts and increase import opportunities
The European Union produces about 17m tons of sugar, of which 1.2m tons are exported. It is currently implementing far-reaching reforms to the European sugar industry in response to World Trade Organisation pressure. The regulatory framework has remained largely unchanged for the past 40 years and the European Union is modernizing this. However it will continue to offer preferential access to Europe's sugar market for developing countries at an attractive price well above the world sugar price. Least developed countries like Zambia, Malawi, Tanzania and Mozambique will benefit from an assistance program. This will increase access to the European Union market gradually until 2009 when they have unrestricted access.

The reforms include a total cumulative 39% price cut for raw sugar. This price cut will be in three-phases, declining from around 30 UScents/lbs in 2006 to 18.5 UScents/lbs in 2009. This lowest price is still almost double the current world sugar price.

The cut-in prices will apply equally to European Union sugar farmers who are significantly less competitive than the least developed countries. Consequently, the European Union estimates that 4m tons of their sugar will have to be shed. As a result it will become a net importer of around 3m tons of sugar. A substantial portion of this shortage will be imported from least developed countries like those in which Illovo has invested.

Illovo is well-positioned to take advantage of European Union reforms
Illovo will be able to offset the negative price impact by increasing its European Union exports, despite the steep decline in the European preferential price. Illovo's expansion projects in Zambia and Malawi will significantly increase the group's sugar production and are timed to coincide with the changes in the European market. Our estimate of normalised earnings for Illovo, including the impact of the European Union sugar reforms and Illovo's expansion plans, are substantially higher than the group's current level of earnings. We believe that it will be able to grow its earnings much faster than the market over the next few years.

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