

Archer Daniels Midland - The crops are watered...now for growth

Company overview

As the world's population grows, so does demand for quality foods, feed ingredients for livestock, alternative fuels and environmentally friendly alternatives to traditional chemicals. As one of the world's leading agricultural processors, Archer Daniels Midland (NYSE: ADM) plays a pivotal role in meeting all of these needs. The company produces food ingredients, animal feeds and feed ingredients, biofuels and other products which manufacturers around the world use to provide food.

28% of company sales in 2012 came from Soy related products and 11% from Corn. The rest is made up of different segments including agricultural services, dairy, meat, oilseeds processing and financial business units, related principally to futures commission merchant activities and captive insurance.

The Agricultural Services segment utilises its extensive US grain elevator, global transportation network and port operations to buy, store, clean and transport agricultural commodities, such as oilseeds, corn, wheat, oats, rice and barley. It then resells these commodities primarily as food and feed ingredients and as raw materials for the agricultural processing industry. Agricultural Services' grain sourcing, handling and transportation network provides reliable and efficient services to the company's customers and agricultural processing operations. Agricultural Services' transportation network capabilities include barge, ocean-going vessel, truck and rail freight services.

ADM key figures

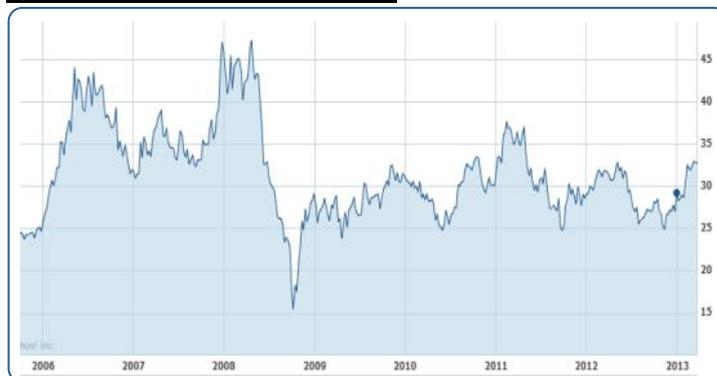
	FY12A	FY13E	FY14E
EPS	1.84	2.52	3.00
DPS	0.69	0.70	0.71
PE	17.8x	13.0x	10.9x
DY	2.1%	2.1%	2.2%

Source: Bloomberg

Why we think it's interesting

Warren Buffett loaded up on shares of Archer Daniels Midland, acquiring 6mn shares towards the end of last year at an average price of \$27/share. Since then the company's share price has risen to almost \$33/share and is showing signs of breaking out of a long-standing trading range, oscillating between \$26 and \$32/share.

ADM share price performance:



Source: Yahoo Finance



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It seems, however, that the big turnaround for Archer Daniels is still a few quarters away, despite Buffett and others having begun buying shares in the company at around current levels.

The company's tangible book value stands at \$29/share and even after the impressive recent spurt in the share price, the shares are trading just above book value. Also, Archer Daniels is copying the moves made so successfully by its rival, Bunge, by opening a series of grain- and soybean-processing facilities across South America to capitalise on a region that is less likely to experience drought.

In addition, Archer Daniels is slowly de-emphasising ethanol production, which has in the past consumed a huge amount of capital with only modest returns. The company is the industry's biggest ethanol producer and if rivals also curtail production, then ethanol pricing will likely firm up. If the US government moves ahead with plans to adopt E15 (gasoline that make use of 15% ethanol), then demand and pricing should also boost Archer Daniels' results. Fuel (or gasoline as it is referred to in the US) prices have also been rising in the past few months, which makes ethanol comparatively more attractive, even if E15 doesn't come to pass and remains E10. As it stands, the national quota for ethanol in the US will rise 4.5% this year to 13.8bn gallons according to the US Energy Department, though that remains below the industry's structural capacity of 14.7bn gallons.

Of course, the near- and mid-term future for Archer Daniels will hinge on US growth during coming quarters. The company is extremely volume-sensitive, which means that if the US corn output rebounds, Archer Daniels' processing facilities will be closer to full utilisation. A firm corn crop also reopens the door to US exports for the company. A Morgan Stanley analyst recently wrote that "ADM has greater exposure to US corn exports than Bunge, and would likely be the bigger beneficiary of the increase in US corn exports we expect starting in February."

Buffett never takes a big position in a large company on a whim that climate conditions MIGHT produce favourable results in coming quarters. Instead, he likes businesses that have wide moats and generate considerable free cash flow. Archer Daniels definitely has such a wide moat, but its cash flow generation has been erratic. The company alternates years of positive free cash flow with negative ones. On a cumulative basis, it has generated a \$5.6bn free cash flow loss during the past six years.

However in the past few quarters, management has begun speaking of a much greater emphasis on capital allocation, returns on investment and, importantly, free cash flow. Indeed, during the past three years, Archer Daniels has invested roughly \$6bn in capital expenditures to boost the profitability of its divisions. Those gains aren't yet in evidence, due in large part to the 2012 US drought, but should bear fruit as crop conditions return to normal. That's surely what Buffett is anticipating.

The stars were last aligned for this company in FY09, when

Archer Daniels generated \$3.1bn in positive free cash flow. Compared with the current \$21bn market value, this ratio impresses.

The key question is whether Archer Daniels will return to that financial strength soon? Analysts at BMO Securities believe so. "ADM's earnings power likely has increased with recent capex projects that have expanded the company's capacity and reduced its cost structure". Although per-share profits have been stuck at around \$2.50 in FY12 and likely again in FY13, earnings per share should approach \$3 in FY14, according to BMO.

Archer Daniels' turnaround story has to a degree slipped under the radar. The company hasn't made bold headlines with its \$6bn business revamp, preferring to let actions (and cash flow) speak for themselves. Although shares have moved up off of their lows, they remain well below the mid-\$40s range seen in the past major agricultural cycle.

Conclusion

In summary we believe Archer Daniel Midland looks like it may have some positive upside after last year's major drought in the US caused some problems for agricultural companies. The company has invested \$6bn to boost the profitability of its divisions over the past three years and we think it is firmly set for the next agricultural cycle which is expected within the next year or so. Although we don't see it breaking any records in the short term, we believe the company has strong potential upside and it might be a company to have a small percentage long-term stake in.

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