OPINION

COBUS CILLIERS: Unearthing investment gems amid the manure

A look up and down any value chain and how it is placed can yield surprising benefits

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Picture: 123RF/GREGORYLEE

Every now and then, a specific phrase gets coined to refer to an event which affects financial markets and it appears in business and investment headlines. The genesis of these phrases make for interesting reading, such as the "taper tantrum" in 2013 when the US Treasury yields surged, or the "Asian Contagion" in 1997, which refers to the Asian financial crisis in 1997.

Most of these terms eventually find their way into corporate results season reporting and are especially used during earnings calls. One phrase in particular that has been making headlines is “supply chain constraints” or its quasi-synonym “shipping bottlenecks”.

A suitable visual representation of these supply chain issues would be the Evergreen blocking the Suez Canal. Though this literal shipping blockage was short-lived, it provides a great metaphor for what is happening around the world.

One of the more pronounced challenges over the past six to 12 months, has been the global semiconductor shortage which has had far reaching implications for the entire world, and is still negatively affecting several companies, though for a select few companies it was (and still has) a positive impact. The SA market was not spared with the auto production industry negatively affected by chip shortages, due to these small vital parts either causing lower production volumes or, in some cases, complete stoppages of production lines.

Despite all the uncertainty, in a world with so many challenges, there is good news for investors as hidden in this uncertain environment are unique investment opportunities, if you know where to look. The key to identifying these investment gems can be illusive, but if done correctly (and there are many ways to go about this process) can lead to considerable outperformance.

The way to go about this process is to first identify the specific challenge faced in the market or industry, and understand how this specific item, product, service, or risk factor will affect the different stakeholders in its value chain. This is where a detailed bottom-up analysis, combined with top-down analysis can assist the portfolio manager in making the correct investment decision.

As with most things in life, it is always easier to illustrate this process with a real-life example: let us look at the fertiliser value chain.

During 2021, natural gas prices increased dramatically. This price increase, combined with a few other factors, has drastically increased the cost of producing ammonia nitrate, which is crucial for making fertiliser and mining explosives. Throw higher shipping costs and actual shipping constraints into the equation and you have an

In SA, there are two JSE-listed companies that produce fertiliser and mining explosives, namely Omnia and AECI. Both companies have ample ammonia nitrate inventory on hand, and mentioned in 2021 (during results presentations where they also talked about shipping constraints) that they are more than able to supply customers with their requirements. Thus, things seem to be looking positive for these two companies, given that they have the necessary feedstock at the previous lower prices (they bought the ammonia nitrate well in advance), and can now sell most of the end-product at the prevailing market prices (which is considerably higher due to the high import parity price, again due to shipping constraints and higher feedcosts). This could (and for Omnia, it partly already has) translate into positive financial results.

Looking a bit further down the value chain. Farmers are willing to pay higher prices for fertiliser, due to the higher soft commodity prices. This makes for a much more challenging environment further down the value chain, specifically for the food producers. The effect of higher soft commodity prices, which form a key part of the input costs for food producers, will make 2022 challenging, as some of these food producers might not be able to pass these higher costs on to their customers, which translate to lower earnings for these companies.

The above is only one piece of the investment puzzle. There are further fundamental analyses, valuations and additional research required before a well-informed investment decision can be made by the portfolio manager. Mastering this skill set can prove to be elusive, as many analysts easily fall victim to overconfidence bias and in turn *not* seeing the forest for the trees. However looking at the full value chain will assist in this process.

In conclusion, when managing your own capital, or the capital of clients during uncertain times, the requirement to look at the value chain as well as the bigger picture can make a significant difference to your overall performance. Ensuring you have a view of how relevant companies are affected by factors in the value chain, and how these risk factors contribute to your entire portfolio's risk, can set you up not only for a diversified portfolio, but also a well performing one.