Delfi Ltd (DELFI SP)

Indonesia’s largest chocolate manufacturer at a >50% discount to global peers

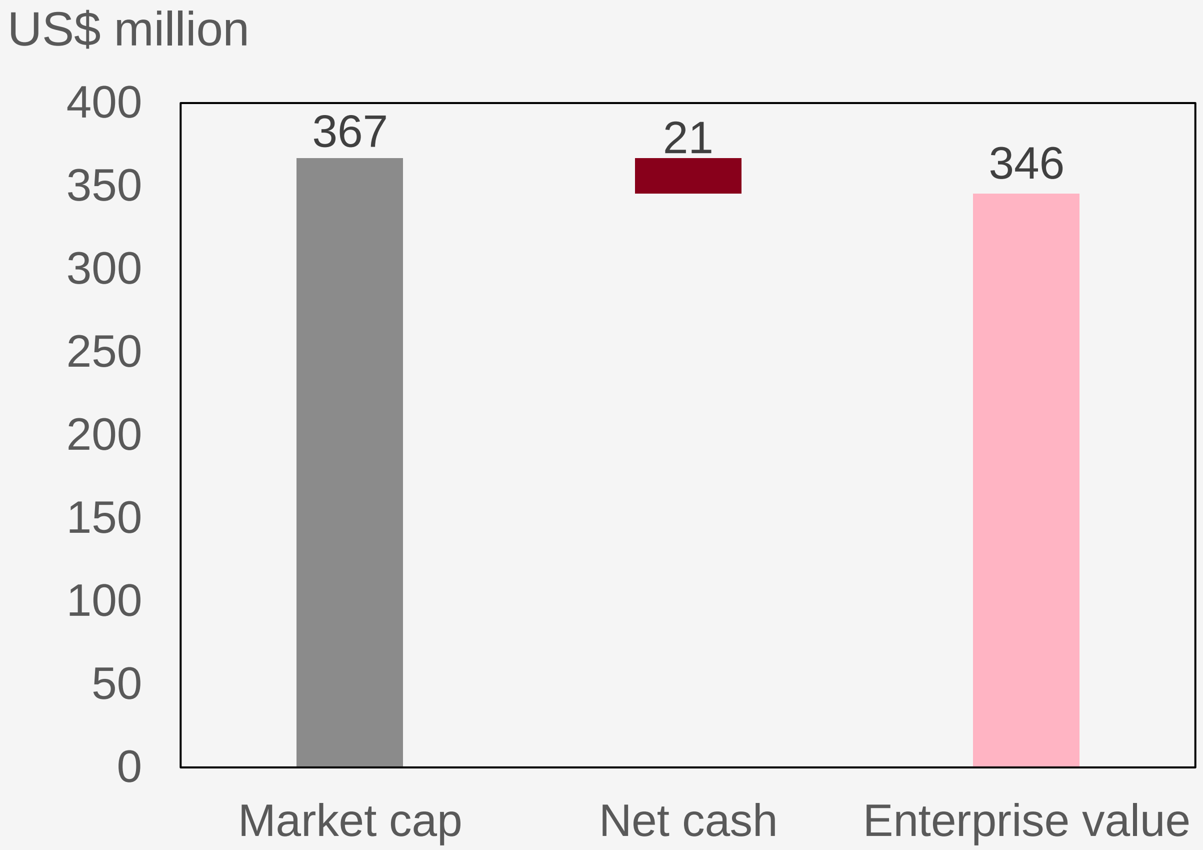
ASIAN CENTURY STOCKS

Summary

1. Delfi has all the hallmarks of a moaty business, with a 45% market share in one of the largest countries in the world with a population of 280 million people. Yet it trades at a US$367 million market cap and an even lower enterprise value.
2. Indonesia’s population is young with a median age of 30. It’s a developing nation with average chocolate consumption one fourth that of Japan and only 1/15 that of the United States.
3. Delfi’s valuation multiple is at a huge discount to global peers. 0.73x sales can be compared to Mayorah Indah’s 2.15x. The forward PE multiple of 12x is about half that of global peers. Adjust for Delfi’s net cash position and the multiple will probably be roughly 1/3 that of global peers (median EV/EBIT of 20x).
4. We think Delfi could potentially be acquired at 2x or 3x the current price. It represents a key strategic asset in the global chocolate market. It has built up a consumer mindshare over the past 60 years. Its brand names are known across three or four generations of Indonesians. Consumers have been conditioned to enjoy Delfi’s less-sweet type of chocolate as opposed to what global MNCs are offering. It has access to 400,000 points-of-sales in a country with 18,000 islands that often don’t have proper cold-chain distribution networks.

Capitalisation

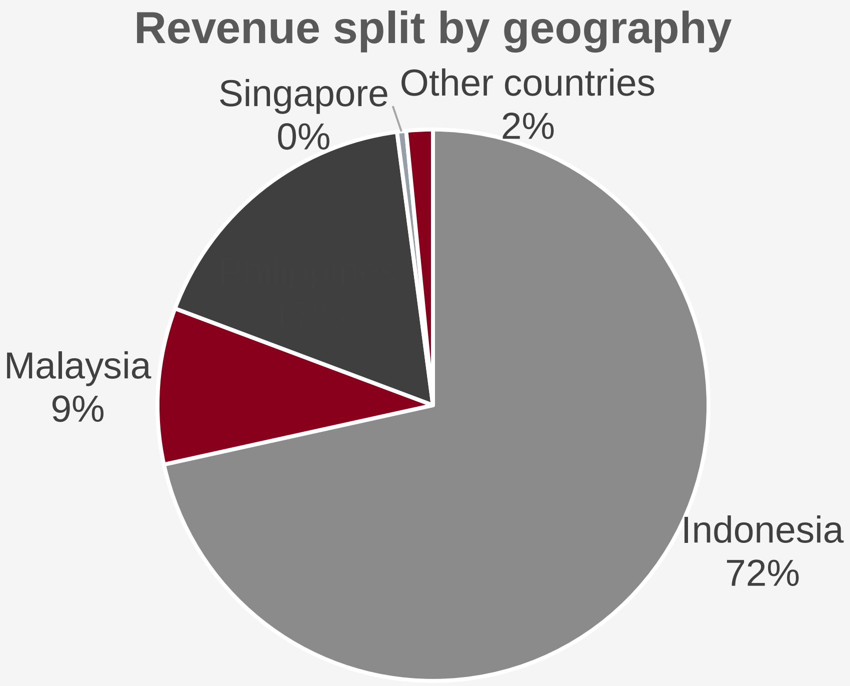
- Share price: SG$0.81
- Shares outstanding: 611 million
- Market cap: US$367 million (reporting currency)
- Net Cash: US$21 million
- Enterprise value: US$346 million

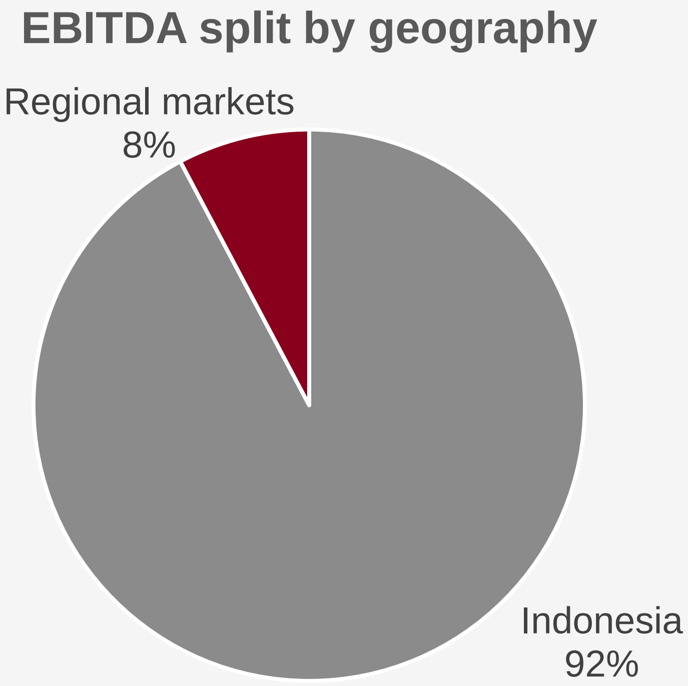


Business overview

- Delfi is an Indonesian chocolate manufacturer, listed in Singapore.
- Their chocolate products are in the lower range, positioned as entry-level products for low-income consumers. The top brand names include Silverqueen, TOPS and Ceres. Instead of cocoa butter, Delfi often uses palm oil for its chocolate. It’s also much less sweet compared to the chocolate of international brands.
- The products are sold primarily in Indonesia, Philippines and Malaysia. Delfi’s market share in the Indonesian chocolate market is 45% - far higher than nearest competitor Mayorah Indah.
- It also acts as a distributor for 80 other brands that complement its own product line-up, including for Fisherman’s Wharf, Toblerone, Kellogg’s etc.
- Over the past few years, organic growth in USD terms has been around 5-10%
- The company has a history of paying out more than 50% of earnings as dividends.

Segments: Indonesia remains the largest segment





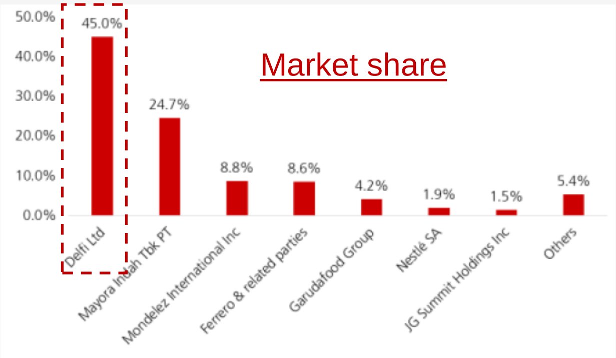
History of Petra Foods, later renamed to Delfi, Ltd

- The company was founded by the Chuang family in the early 1950s as “Petra Foods”. The founder first set up a manufacturing facility in Indonesia. The first two brands launched in the 1950s were SilverQueen and Ceres.
- In the 1970s they added the Selamat line of wafers and chocolate cookie sandwiches. In the 1980s, they launched a European-style of chocolate called Delfi. Over the years, the company has further introduced products within cookies, beverages, spreads and baking ingredients.
- It was in the late 1980s that the company became vertically integrated, processing cocoa beans into cocoa butter, coca cake and powder for both in-house and third-party use, first based out of Thailand.
- Today, the business is run by the three Chuang brothers. In 2006, Delfi entered the Philippines through the acquisition of a local chocolate manufacturer that produced the Goya and Knick Knacks brands. It also entered Malaysia through another acquisition.
- After selling the non-profitable cocoa ingredients business in 2013, the company became a pure-play packaged chocolate manufacturing and distribution business.
- Since Delfi eventually became the biggest brand name, they decided to rename the entire company from Petra Foods to Delfi in 2016.
- Over the past five years, Delfi lost market share due to a rationalization of their product SKUs from about 500 to 200-300. It eliminated 5-10% of revenue. Management felt they needed to adapt to the growing mini-mart penetration which has relatively smaller shelf space. Early signs of success include the fact that modern trade now represents roughly 50% of total sales compared to 30% in the mid-2010s.
- Selling its 50% stake in PT Ceres Meiji Indotama to Meiji for US$8 million also hit revenue negatively, but may increase long-term profitability

Comparative advantages

- Delfi has mindshare across Indonesia by virtue of controlling 50% of the market for many decades. They have also set expectations for taste, with less-sweet chocolate and less-strong flavours.
  - Competitor Mayorah has a 20% of the Indonesian chocolate market, with its long-time chocolate brand selling at low cost (Beng Beng), but that's not the jewel of its product portfolio. Mayorah produces the KopiKo sweet, which probably dominates the market for coffee-flavoured sweets across the region.
  - Global chocolate manufacturers such as Mondelez and Ferrero only account for <10% of the market.
  - Nestlé Indonesia confectionary business manager Rully Gumilar: *“The market leader is very strong because it was the first to set the taste for chocolate in Indonesia… It’s like David fighting Goliath… [Delfi is] very big and has huge power, while we are small even though we are a multinational.”* †
- Extensive distribution network with access to 400,000 retail points-of-sale
- Delfi occupies the lower-end niche, supported by the use of inexpensive palm oil as a cocoa butter substitute that global brands cannot compete with. Indonesians are very price-sensitive compared to other markets.

† Source: *https://www.reuters.com/article/us-indonesia-chocolate-idUSKCN11I2MX*



Main products

Delfi

A higher-priced European-style chocolate + spreads

Ceres

The number one brand in “value” priced chocolate products in Indonesia

Silverqueen

The traditional candy bar of the middle class, basically the “Hershey’s of Indonesia”

More on the product portfolio

- Other than Delfi premium chocolate, Silverqueen chocolate bars and Ceres, the company also offers the following brands:
  - Goya chocolate bars and spreads
  - Chacha chocolate milk beans
  - Knick Knacks chocolate coated biscuits
  - Top chocolate bars
  - Funtime crispy wafers
  - Malibu caramel chocolate bar
  - Treasures almond chocolate bar
  - Chew-eez chocolate bites

Manufacturing is done locally in Indonesia and the Philippines

- Delfi operates two chocolate factories: one in Indonesia and one in the Philippines, with a total capacity of 100,000 tonnes per year.
- Prior to the pandemic, they were running at 55% utilisation levels and management didn't see any need for capacity expansion.
- From 2014 to 2019, Delfi invested US$110 million to modernise its production facilities, improve energy and water efficiency and to install ERP systems and those investments are now complete. The new factory in Indonesia was finished in 2016.
- Going going forward is expected to be roughly US$10-15 million per year.

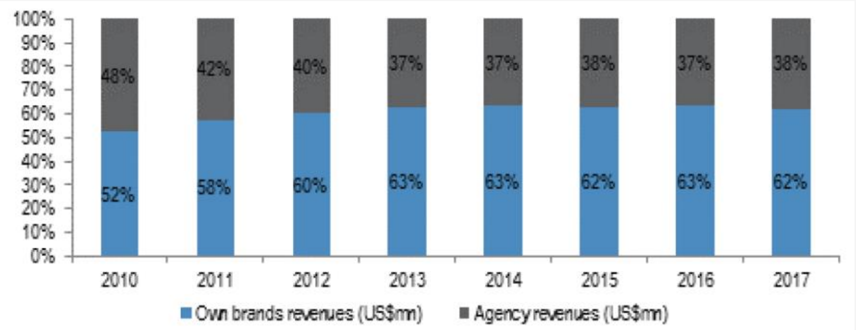
The PT Ceres factory in Bandung, Indonesia

Delfi's distribution system

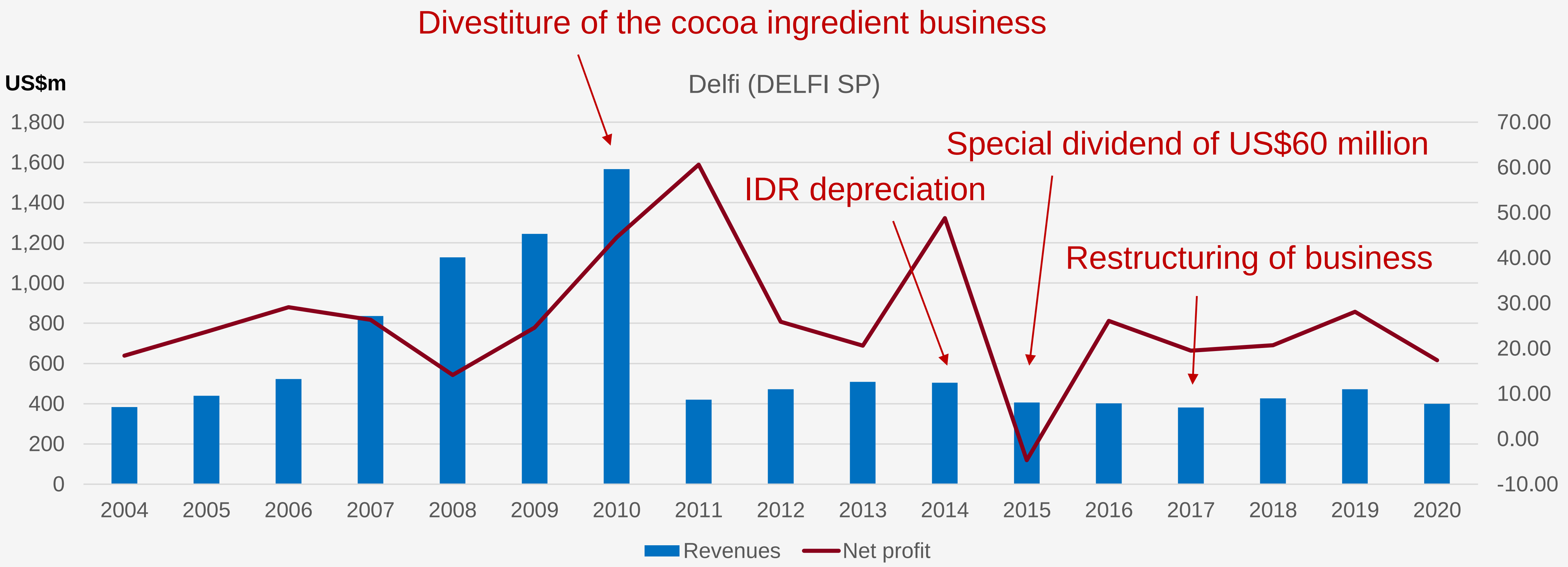
- Delfi has built up an unparalleled distribution network over the past six decades: supermarkets, convenience stores, gas stations as well as traditional mom & pop stores
- The company has roughly 400,000 urban and rural points of sales across Indonesia
- Indonesia's climate with temperatures above 33 degrees Celsius makes distribution of chocolate products difficult: especially to mom & pop stores to which international brands haven't been able to break in

Partnerships with other companies

- Delfi acts as a distributor for major international brands such as Ferrero, Fisherman’s Wharf, etc. Other than confectionary, they also distribute pasta, juices, sauces and breakfast cereals for Kellogg’s, Twinings, Pringles, Huggies, Kleenex, etc. The contribution from agency revenue has decreased over time.
- Entered into a JV with South Korea’s Orion Corporation in 2016 to develop, market and distribute Choco Pie’s
- Japan’s Yuraku Confectionary Company to develop Black Thunder and Big Thunder chocolate snacks for the local market under the Delfi brand
- In 2017, Delfi ended its JV with Japan’s Meiji and received a total consideration of US$8.3 million
- In 2018, Delfi acquired the rights of Dutch chocolate brand Van Houten in key Asian markets for US13m



Revenue growth has been uneven since the divestiture of the cocoa ingredient business, but 5-10% organic growth in 2018 and 2019



The cocoa ingredient business divestiture in 2012 made Delfi into a pure-play consumer products company

- The cocoa ingredients business was built up from the late 1980s onwards. In the early 2010s, Delfi's cocoa ingredient business was the third largest, supplying ingredients to international giants such as Nestlé, Cadbury, Mars, Meiji etc.
- In 2012, Delfi sold the ingredient business "Petra's Cocoa Ingredients" to European chocolate giant Barry Callebaut AG for US$165 million, paid in cash.
- After the sale, Barry Callebaut tried to claw back US$103 million, which Delfi disputed in court. They eventually settled with an exceptional charge of US$19 million in 2015, plus another US$2 million in 2016. The issue was various tax and labour claims from Brazilian tax authorities against a former subsidiary of Delfi sold to Barry Callebaut as part of the ingredient business.

The management team is experienced and are known for strong execution

- Delfi is run by the three Chuang Tiong brothers, and they own 53% of the company. They seem to have a good reputation in Singapore:
  - CEO John Chuang Tiong Choon was vice-Chairman of the Independence Bank of California from 1979 to 1983 before establishing the overall group structure for Delfi in 1984. He is responsible for overall planning, management and business development ever since.
  - Group Chief Growth and Marketing Officer Joseph Chuang Tiong Liep has been responsible for the consumer business in Indonesia for over 3 decades
  - Third brother William Chuang Tiong Kie is responsible for seeking partnerships and joint ventures with global brands, also for over 3 decades
- The three brothers combined take home roughly ~$3 million per year for serving in their senior operational roles; the next top five officers combined make about $2 million. Together, they own roughly 50% of the shares of the business.
- Neither of their children are involved in the business, which opens up the question of whether it might eventually be sold to an MNC

John Chuang Tiong Choon

CEO

Joseph Chuang Tiong Liep

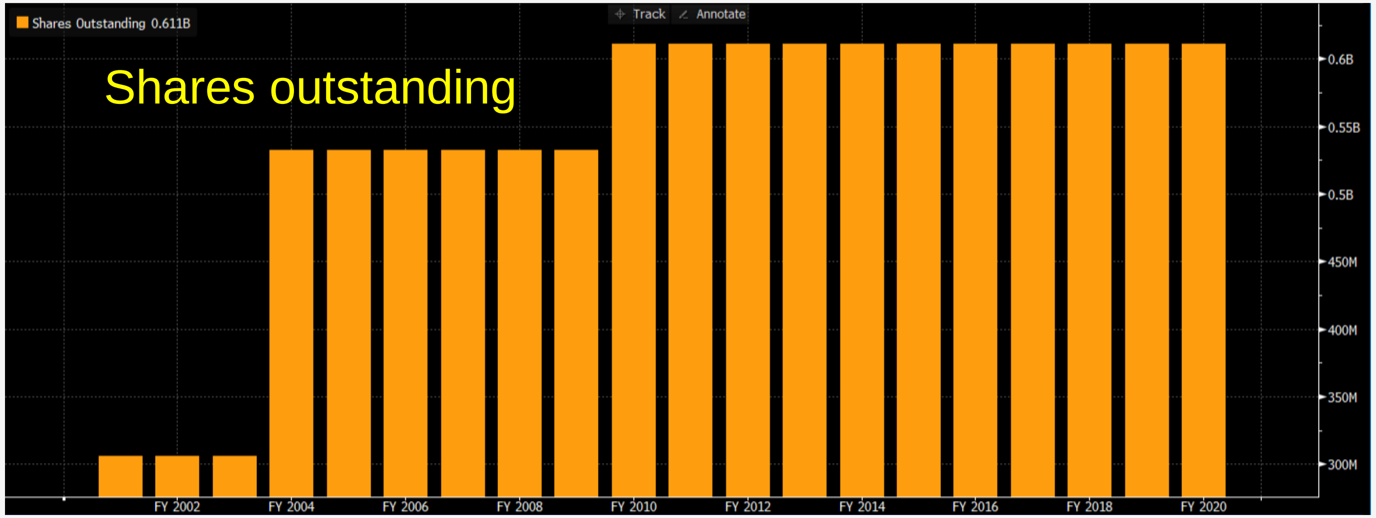
Group Chief Growth and Marketing Officer

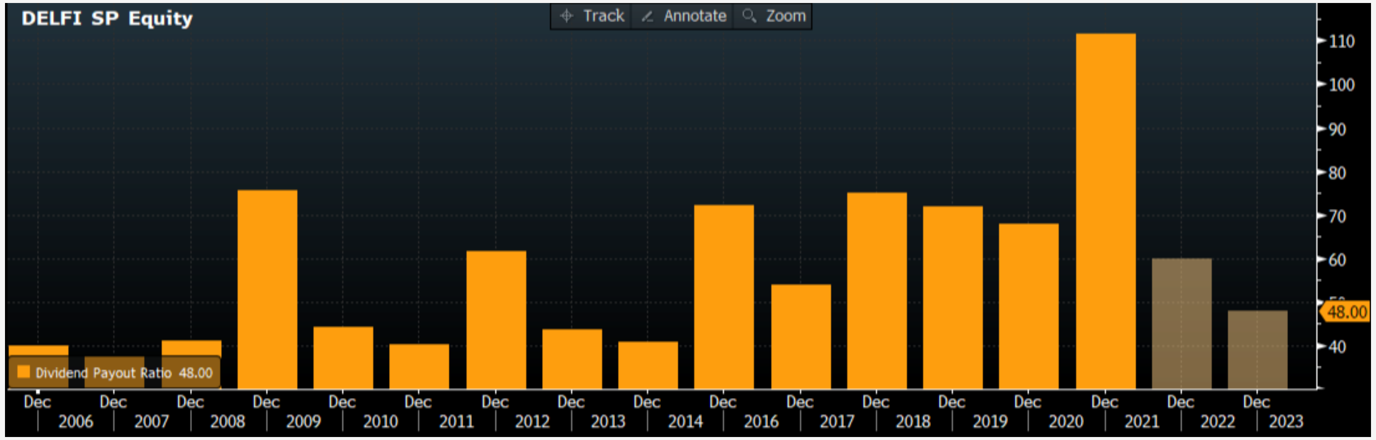
William Chuang Tiong Kie

Business Development Director

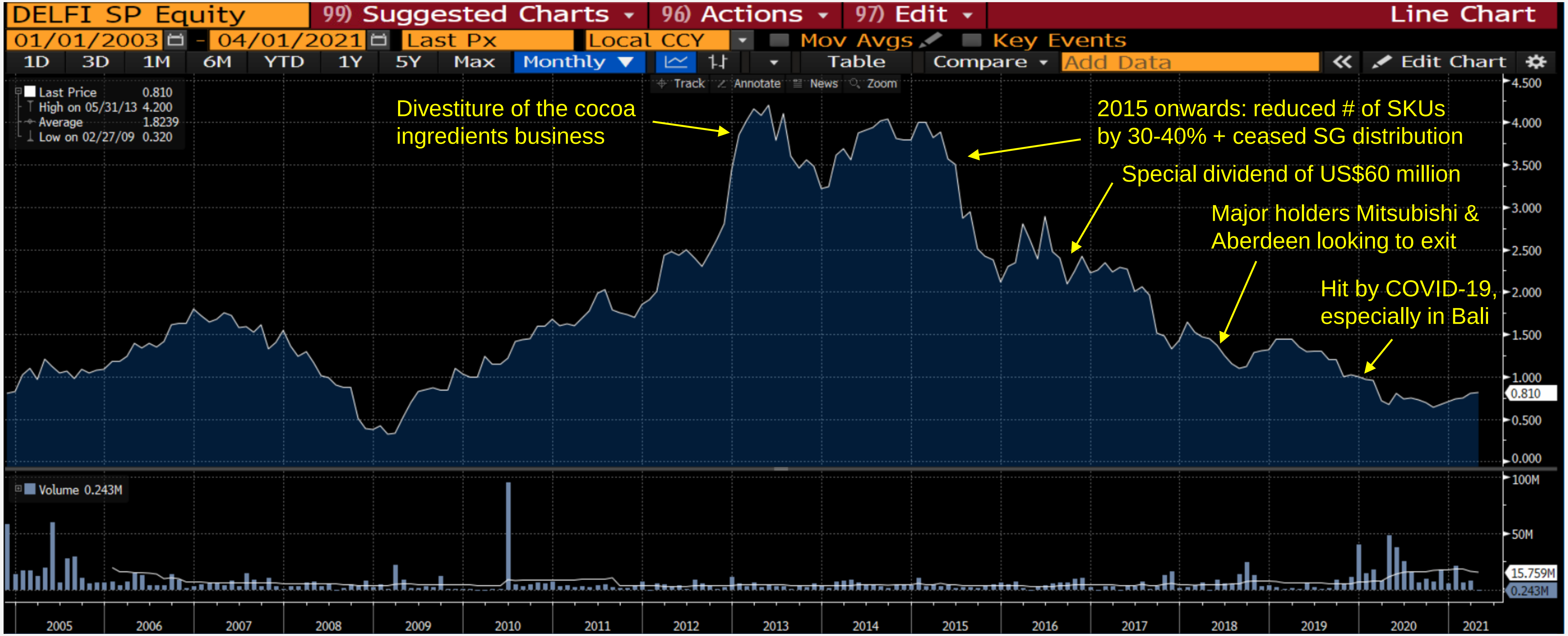
Capital allocation

- While Delfi has never repurchased shares, the share count has stayed flat over the past decade i.e. zero dilution
- The acquisition of the rights to the Van Houten brand in 2018 seems to have been done at a reasonable price: US$13 million vs US$14 million in yearly revenue for Delfi in 2019
- The median dividend pay-out ratio has been generous at 62% over the past decade, excluding the one-off special dividend of US$60 million, paid out in 2016.

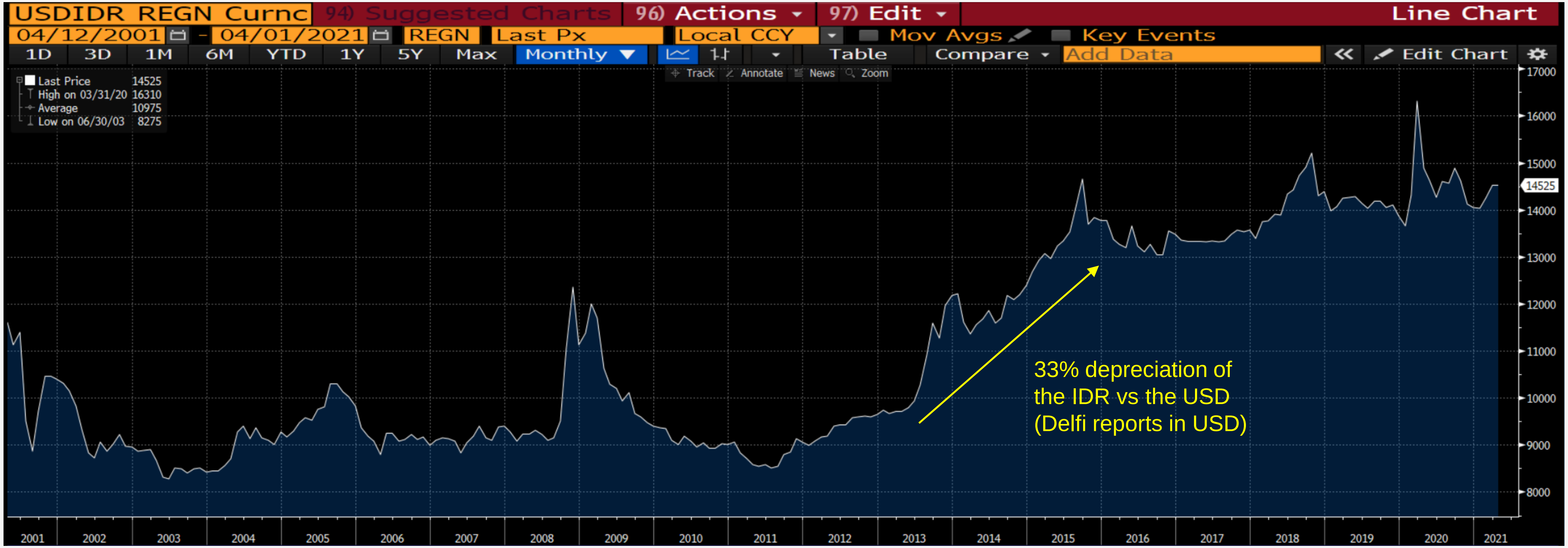




Why is the stock languishing at 10-year lows?



The Indonesian Rupiah weakened from 2013 onwards



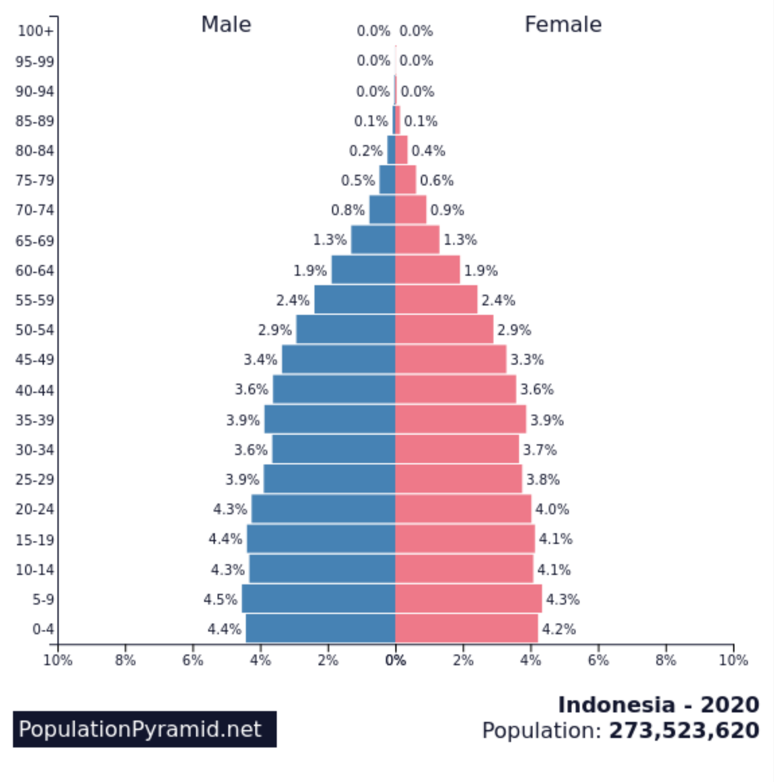
Industry trends

- Global cocoa demand has been rising by an average of 3% per year over the past century and faster in Asia.
- Indonesia's demographics are excellent with a median age of 30, a very large young population and decent long-term growth prospects for the country's middle class
- Modern retail (supermarkets, convenience stores) has been growing fast and taken share from mom & pop stores
- Multinational brands have been trying to gain a share of the Indonesian market since 2015, though have had a tough time convincing Indonesian consumers to eat sweeter Western-style chocolate.

Asia cocoa bean grindings statistics: chocolate is a growth business in Asia

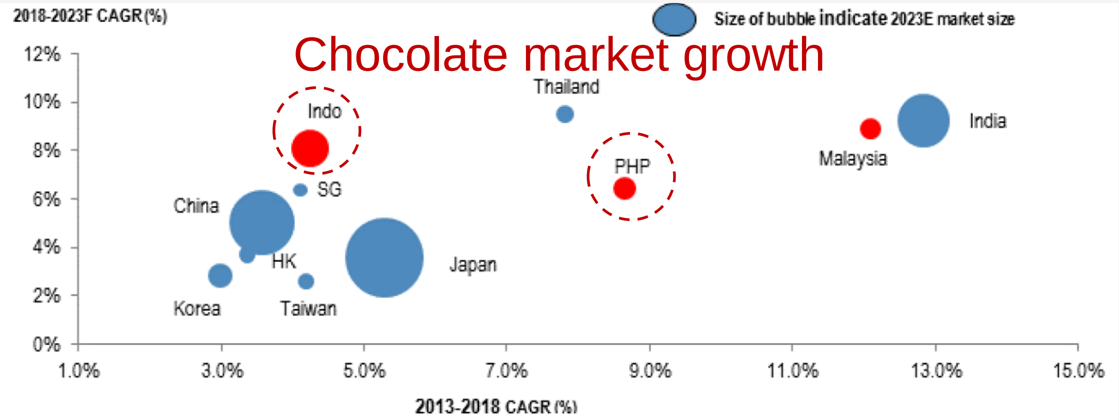
Indonesian demographics

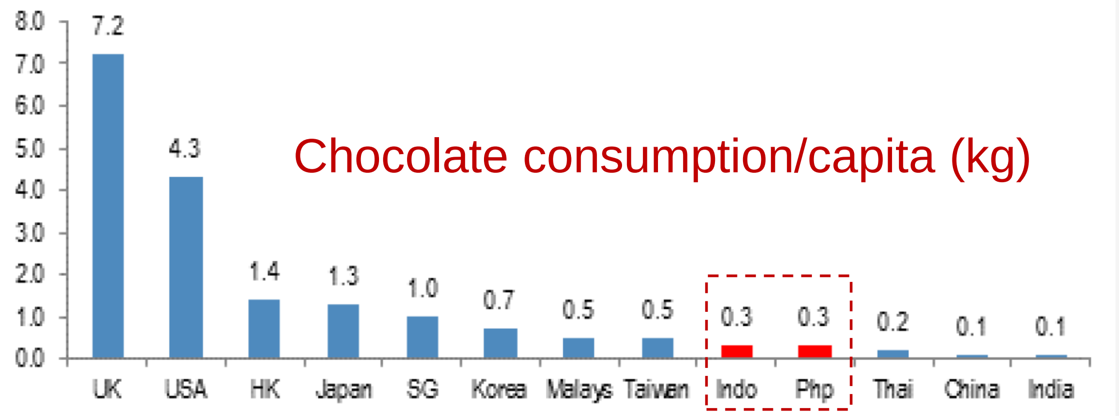
- Indonesia has a population of 274 million people while the Philippines has a population of 109 million
- Demographics are excellent, with a median age of 30
- The country also has decent growth prospects, with a nominal disposable income growth of 7-8%. Domestic reforms such as the omnibus law is improving the prospects for Indonesia to take market share from China in light manufacturing exports. Indonesia's GDP per capita is only US$4,451 vs US$10,267 in China and US$65,233 in neighbouring Singapore.



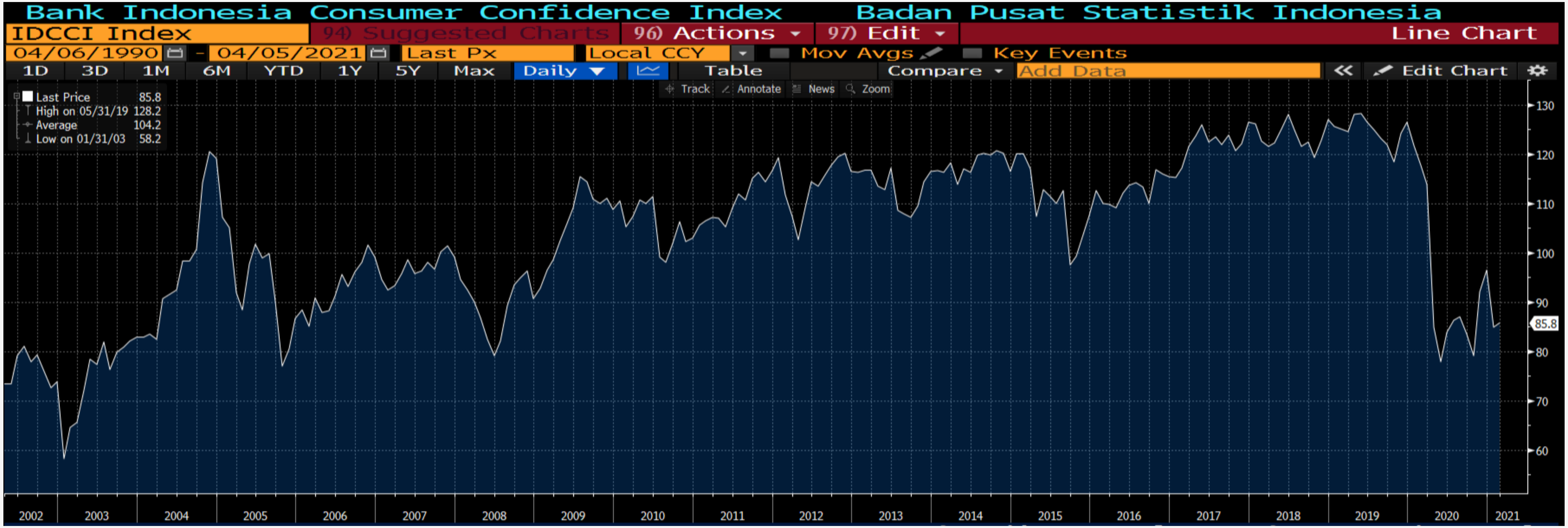
The Indonesian chocolate market has strong growth potential

- In a 2018 report, Euromonitor expected the Indonesian chocolate market to grow at an 8% CAGR the following five years. This compares to a 4% CAGR the prior five years – a period of relative weakness following the commodity bust.
- Indonesia's chocolate consumption per capita is only 0.3kg per year. Average consumption would have to quadruple to reach Japan's level of 1.3kg and go up 15x to reach America's level of 4.3kg.
- Indonesia's chocolate wallet share is currently 0.11%, a similar level to that of Philippines, Japan and the United States. Suggesting that higher incomes might be needed for consumption to rise.





Indonesia's consumer confidence index is still weak



What is going to change in the coming years?

1. In 2016, Delfi embarked on a new strategy to rationalise the product portfolio to better suit the requirements of the modern trade channel. Since then, the majority is now targeting modern trade (convenience stores, supermarkets). Whereas they used to launch 10-15 new products per year, they now put greater focus on their most iconic brand name products. They are also trying to cut out the middleman and deliver directly to the end-customer, leading to higher accounts receivable days.
2. From 2017 onwards, the company has brought in key executives from multinationals to modernise the company's manufacturing and marketing efforts. In 2019, Delfi hired Michael Roberts Wynne as head of manufacturing as well as Lim Hock Thye in finance & general affairs. Competitors have commented that Delfi maintains great execution. In the two years prior to COVID-19, the company achieved 5-10% organic growth rates, suggesting that the company is on an underlying growth trajectory.
3. The biggest expenses include raw materials and selling & marketing expenses. The most important raw materials include cocoa, milk and sugar, representing 60-65% of cost of goods sold. Delfi does not hedge any currency exposure but enters into forward contracts for the purchase of these commodities. Gross profit margins have historically been around 32-35% and we think gross margins could be in the higher part of that range short-term due to rising milk prices.
4. Delfi just recently launched two new healthier products as well as a redesigned SilverQueen brand to target Gen-Z / Millenn.
5. Van Houten is doing very well in Indonesia under Delfi's stewardship, growing roughly 15-20% in 2020 with a redesign also coming
6. The company's general trade segment was hit hard during the pandemic as many mom & pop stores ("warungs") closed temporarily. With vaccine distribution ramping up, many are hopeful that we are nearing the end of the pandemic.
7. The Philippines segment has just turned profitable after a few years of losses. It represents hidden value, given the ownership of the Goya and Knick Knacks brands, which enjoy strong mindshare in the country.
8. Delfi has previously said they want to enter new markets such as India or China, provided they find a suitable partner.

Redesigned SilverQueen brands

- The new products include two healthier options within the SilverQueen line-up:
  - The Very Berry Yoghurt
  - Green Tea Matcha
- In addition, Delfi just redesigned the packaging for SilverQueen brand to adopt a “fresher” look, specifically to target Gen-Z and Millennials

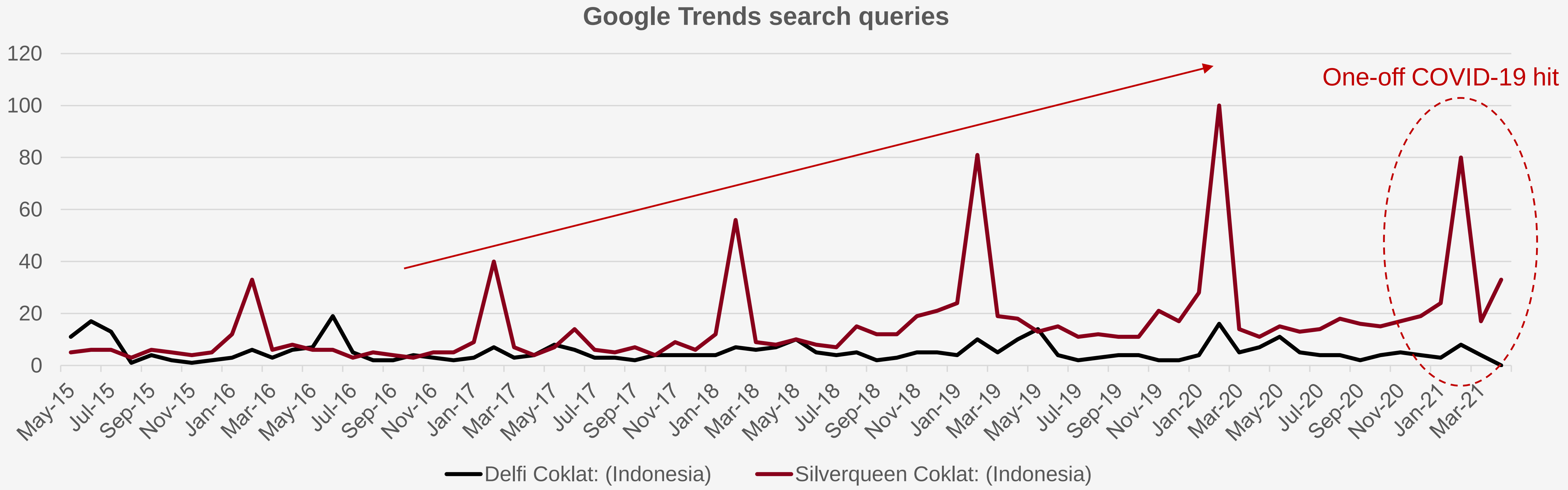
Delfi's New Products

Source: Delfi

Redesigned Packaging for SilverQueen

Source: Delfi

Google search queries are particularly positive for the Silverqueen brand



Milk prices are a little bit elevated; cocoa prices in line with prior years

Peers trade at much higher multiples: 2.3x sales, 17x EBIT, 21x PE. The valuation difference to domestic peer Mayorah Indah is striking.

(2022e)	Ticker	Country	Mkt cap (US$m)	EV/S	EV/EBIT	P/E	Div yield
Delfi	DELFI SP	Indonesia	368	0.73x	7.2x	12.1x	4.0%
Mayorah Indah	MYOR IJ	Indonesia	3,938	2.15x	17.4x	24.4x	1.5%
Indofood Sukses	ICBP IJ	Indonesia	7,198	2.44x	12.2x	14.4x	3.1%
Britannia	BRIT IN	India	11,910	6.38x	37.5x	45.4x	1.3%
Universal Robina	URC PM	Philippines	6,036	2.11x	17.3x	21.0x	2.7%
Nestlé India	NEST IN	India	22,506	9.72x	42.9x	57.9x	1.4%
Want Want	151 HK	China	9,088	2.30x	9.4x	14.1x	6.1%
Tingyi	322 HK	China	10,373	0.87x	9.6x	16.0x	6.0%
Kraft Heinz	KHC US	United States	48,961	3.03x	15.0x	15.2x	4.1%
Mondelez	MDLZ US	United States	82,524	3.42x	19.7x	18.9x	2.5%
Kellogg	K US	United States	21,558	15.17x	16.5x	15.2x	3.8%
Hershey	HSY US	United States	32,890	4.26x	18.5x	22.2x	2.2%
Nestlé	NESN SW	Switzerland	322,687	3.83x	21.3x	22.6x	2.8%
Danone	BN FP	France	47,035	2.14x	14.6x	16.0x	3.7%
Average ex-Delfi			11,982	4.28x	23.3x	30.9x	3.5%
Median ex-Delfi			10,373	2.30x	17.3x	21.0x	2.7%

The stock trades at low double-digit forward PE multiples, despite a net cash position and long-term margin potential

Delfi (DELFI SP)	2018	2019	2020	2021	2022	2023	2024	2025
Revenues	427	472	385	430	473	520	572	630
Cost of sales	-279	-301	-275	-280	-307	-338	-372	-409
Gross profit	148	171	110	151	166	182	200	220
Other operating income	3	3	2	3	3	3	3	3
Selling and distribution costs	-83	-97	-55	-86	-95	-104	-114	-126
Administrative expenses	-26	-27	-25	-26	-29	-32	-35	-38
Other operating expenses	-1	-1	-1	-1	-1	-2	-2	-2
Exceptional items	-2	0	0	0	0	0	0	0
Operating profit	39	48	31	40	44	48	53	57
Finance costs	-3	-4	-3	-3	-4	-4	-5	-5
Associates/JV	0	-1	0	0	0	0	0	0
Pretax profit	36	44	28	36	40	43	47	52
Income tax	-15	-15	-10	-13	-14	-16	-17	-19
Net profit	21	28	17	23	25	28	30	33
P/E	17.6x	13.0x	21.0x	15.7x	14.4x	13.2x	12.1x	11.0x
EV/EBIT	8.9x	7.2x	11.1x	8.6x	7.9x	7.2x	6.6x	6.0x

The stock has historically traded at median multiples of 19x EBIT, 27x PE

John has continued purchasing shares throughout 2020

- CEO John Chuang has continued buying shares for his personal accounts throughout 2020
- Roughly 3.5 million shares purchased last year
- At a weighted average price of SG$0.71
- Represents a discount of just 12% to the latest closing price

Insider Trades

Insider Trades Filter

Buyer/Seller : Chuang Tiong Choon

Year : 2020 Type : Filter

Quotes Delayed 10 Minutes

Updated: 05 Apr 2021 13:23

SGX Symbol:	P34	Currency:	SGD
Last Done:	0.800	Volume ('000):	66.4
Change:	-0.010	% Change:	-1.2
Day's Range:	0.800 - 0.810	52 Weeks' Range:	0.560 - 0.870

Announce Date [Date of Effective Change]	Buyer/ Seller Name [Type*]	S/ W/ U **	Bought/ (Sold) ('000)	Price ($)	After Trade No. of Shares ('000) ***	After Trade % Held ***	Note
11/12/20 [10/12/20]	Chuang Tiong Choon [DIR]	S/U	622	-	317,581	51.97	Note
13/04/20 [10/04/20]	Chuang Tiong Choon [DIR]	S/U	1,425	-	316,959	51.87	Note
03/04/20 [02/04/20]	Chuang Tiong Choon [DIR]	S/U	1,450	-	315,534	51.63	Note

Catalysts

- Potential take-over. John Chuang is in his 70s and starting to get old. Will he one day retire? Will he then sell his stake in the business? The next generation does not seem to be involved in the business. Apparently, Delfi has been approached multiple times by potential suitors. Everyone realizes that Delfi sits on a strategic asset: important brand names with consumer mindshare and a distribution network of 400,000 points-of-sale across an undeveloped country.
- Recovery from COVID-19 will help with the general trade segment (non-modern retail), since many mom & pop stores have been closed during the pandemic.
- Further insider transactions by John or the others in the management team

Potential acquirers:

- Nestlé
- Mondelez
- Hershey
- Lindt & Sprüngli
- Meiji
- Orion Corp
- Calbee
- Ezaki Glico
- Morinaga
- Cloetta
- Lotte

Potential downside risks

- Fluctuation in the Indonesian Rupiah. The currency is highly volatile and tends to weaken over time compared to developed market currencies. Delfi reports in US Dollar, making it suffer during times of Rupiah weakness. The company is somewhat hedged given that most of its expenses are also in the local currency. But top-line growth may seem less impressive than for competitors who report in Rupiah.
- The modern trade channel (supermarkets, convenience stores) has been gaining ground at the expense of mom & pop shops, thus reducing the advantage that Delfi's superior distribution traditionally had. That said, competitor Mayorah Indah is more reliant on mom & pop shops than Delfi is.
- E-commerce provides greater options for consumers. At the same time, the move online also increases the value of brand names, where Delfi has particular strength.
- A 2013 lawsuit by Nestlé alleged that Delfi had copied the shape of Kit Kat in its Take-it product.
- Longer-than-expected recovery from COVID-19 could weigh on general trade / mom & pop stores
- Claims from the Barry Callegaut's lawsuit still stand at roughly US$25 million (worst-case scenario).
- There was an improper transaction in Delfi's Philippines subsidiary in 2018. E&Y carried out an investigation, and the company sent over a team from the head office to restructure the local finance function. In total, they identified improper transactions worth US$3.1 million over 2013-2018.