We believe the market is overlooking Hong Kong-based WH Group's high-cash-generating core business, focusing instead on far less material, and likely transitory, headwinds, thereby resulting in a compelling valuation.

Headquartered in Hong Kong, WH Group (WHG) is the world's largest pork company, with leading market share in both China and the US, the top two pork-consuming countries. Via its two subsidiaries—China-based Henan Shuanghui (70% ownership) and US-based, wholly-owned Smithfield—WHG's global operations processed 49 million hogs, and sold 8.7 billion pounds of pork, and 7.0 billion pounds of packaged meats throughout Asia, Europe, and North America last year[1]. Despite WHG's rise from a single, Chinese state-owned processing plant to the global juggernaut it is today, its stock has languished for the better part of the last five years, shedding nearly half its value. In our view, investors are overly fixated on the company's Chinese domicile (despite most of its sales being generated overseas), and the temporarily underperforming (and far less material) commoditized piece of WHG's overall business, resulting in a compelling valuation today.

PORK PAIN

WHG has two operating segments: Pork, which includes hog raising and minimally processed fresh pork, and Packaged Meats, which includes processed products like ham, sausage, and bacon. Packaged Meats' performance has been consistently positive, whereas Pork was significantly loss-making in 2023, due to elevated raw material input costs and industry overcapacity.

The overcapacity problem in the US pork industry can be traced back to mid-2018, when African swine fever swept through China, eliminating nearly half of the country's hog population (roughly a quarter of the global supply). In response to the subsequent surge in export prices, US packers expanded capacity to fill the void. With China's hog population having been fully restored, the US now has far too much capacity, suppressing prices and pushing the US pork industry into the red.

		Earnings Per Share			Price/Earnings		
	Price	FY 24E	FY 25E	Normal*	FY 24E	FY 25E	Normal**
WH Group Ltd.	HKD 5.16	HKD 0.69	HKD 0.79	HKD 1.02	7.5x	6.5x	6.3x

Fiscal year-end March 28.
**Pzena estimate of normal earnings.*
***Globally adjusted price-to-normal multiple based on China discount rate. Source: FactSet, Pzena analysis. Data as of March 28, 2024.*

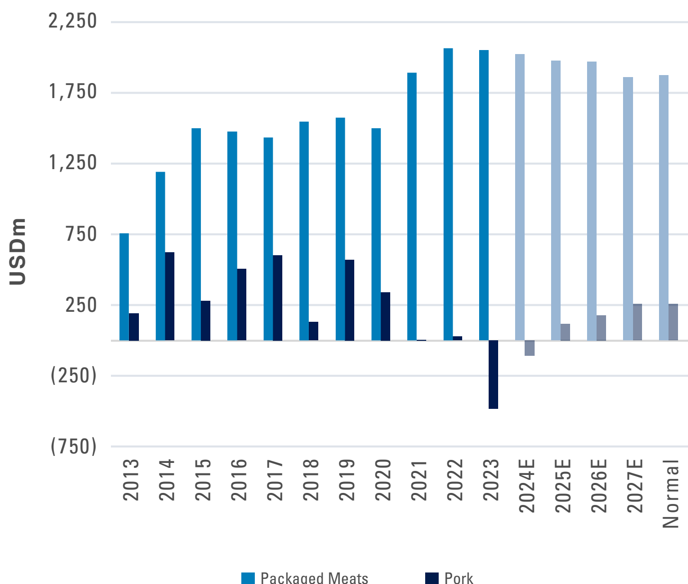
THE MISCONCEPTION

The Pork segment's underperformance in the US has been well-documented and is the main reason WHG's stock hit an all-time low last year. But by placing too much emphasis on the under-earning, commoditized Pork business, we believe investors are failing to appreciate the company's key profit driver: Packaged Meats. As evidenced by Exhibit 1, the profit differential between Pork and Packaged Meats is stark, with the latter constituting ~50% of historical group-level sales but nearly the whole of WHG's operating profit, and crucially, ~90% of our normal earnings estimate. Put simply, we do not believe a roughly 10% slice of WHG's total business being under temporary stress warrants a ~40% decline in the share price[2].

1. Company filings

2. 2019–2024

Exhibit 1: WHG Operating Profit by Segment



Source: Company filings, Pzena forecasts

PACKAGED MEATS: THE CROWN JEWEL

Our research on WHG's Packaged Meats segment uncovered a stable business with leading brands and a high return on capital. We are confident that Packaged Meats will remain a high-quality piece of WHG's business in perpetuity, but for reasons that differ between its two main geographies. The US market is mature, consolidated, and vertically integrated. Consequently, Smithfield's profit margins closely align with those of its peers, Tyson and JBS, historically fluctuating within a range of 8–11%. Smithfield's strong pricing power serves as an offset to fluctuations in cost of goods sold, protecting margins during periods of input cost volatility.

China is a much more fragmented and less vertically integrated market. Yet, China is where WHG's Packaged Meats division shines, with operating margins consistently exceeding 20%, twice that of its US operations. This performance places WHG in a league of its own, miles ahead of any Chinese peer. The drivers behind its substantial margin advantage include leading scale, brand power, expansive distribution, and continual innovation. Despite an already dominant 19% market position, more than the aggregate share of its closest 10 competitors, we expect WHG to continue taking share from smaller players, as the industry consolidates over time. Given the company's consistent track record and the structural advantages underpinning it, we view the current level of profitability in China Packaged Meats as sustainable.

THE PATH TO NORMALIZATION

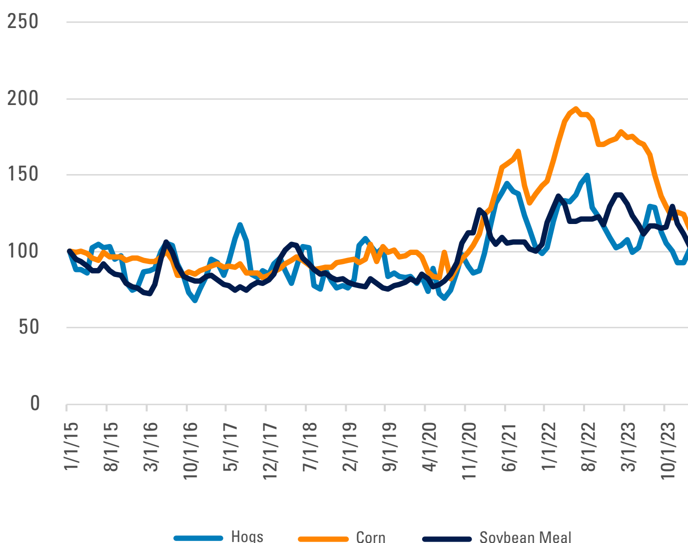
WHG's Pork segment reported a $480M overall loss in 2023, with $624M in losses from the US alone[3]. Although the unit does not account for a significant portion of the company's normal earnings power, even a positive inflection to above breakeven would provide a considerable boost to the group's bottom line (and likely investor sentiment), and we believe that there is a clear path to normalization.

US pork's pain largely stems from WHG's hog raising operations, where profitability is a function of hog prices and raw material inputs, such as corn and soybean meal. While hog prices have not been particularly low, the price of feed (constituting more than half of pork production expenses) surged in 2022. As a result, the average hog farmer was incurring a net loss of around $32 for every hog sold in 2023[4]. Given that WHG produced 15.8 million hogs in the US last year[5], it is not surprising to see its Pork unit post historically bad results.

Industrywide supply has started to decline in response to 2023's red ink. In addition, grain prices have fallen considerably in the last few months, and if this trend persists, hog production could return to profitability by the end of this year or the next (Exhibit 2). Longer-term, WHG expects to decrease its hog production to less than 10 million per year, reducing exposure to this volatile piece of the value chain.

3. Company filings
4. Nebraska Public Media
5. Company filings

Exhibit 2: Input Costs are Moderating, Supporting Pork's Bottom Line



Source: USDA, IndexMundi (prices indexed to Jan. 2015)

Fresh pork is also depressed, albeit much less so than hog production, and the pain could linger for longer. The main players—Smithfield, JBS, and Tyson—appear to be engaged in a strategic holdout, rooted in game-theory principles. WHG's Smithfield has taken the lead in announcing some farm/plant closures, but further action is needed, given the magnitude of the industry's overcapacity. JBS and Tyson have thus far been slow to announce closures, despite negative margins in their pork businesses. We see this current dynamic as unsustainable in the longer term, as supply should eventually be curtailed. In the near term, however, the industry supply picture remains uncertain, with management teams hanging on to recovery hopes. Regardless, the major producers will ultimately be forced to rationalize capacity to improve profitability, an eventuality we believe investors are overlooking.

THE CHINA DISCOUNT

WHG's share price was hit in 2018 after China raised tariffs on US pork, severely limiting US exports and impacting about 10% of WHG's sales. Investors generally favor more open trade policies that would enable WHG to leverage its unique position in the US–China pork trade market, where significant price variations have historically offered profitable arbitrage opportunities. We point out, however, that WHG's US and China businesses today operate largely independently of each other, suggesting that further strains in US–China relations, if they were to occur, are unlikely to directly impact WHG's financials. And despite WHG's Hong Kong domicile, the company generates about two thirds of its revenue outside of its domestic market, rendering any material China discount in the stock unjustified, in our view.

CONCLUSION

WHG represents the quintessential value stock: an excellent franchise in a strong competitive position that is experiencing temporary pain. We believe the current headwinds facing WHG's commoditized Pork segment are overshadowing the quality of the Packaged Meats segment, and investors are overly fixated on the company's domicile, given negative sentiment surrounding Chinese stocks today. The Pork segment will likely take some time to normalize, as capacity gets taken out; in the interim, we are perfectly content holding a financially strong industry leader trading at 6.3x our normal earnings estimate, with a 6% dividend yield[6] that is covered entirely by the profits from Packaged Meats.

6. FactSet – NTM div. yield

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WH Group Ltd. was held in our Emerging Markets Focused Value, International Focused Value, and other strategies during the first quarter of 2024.

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