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PP13693/04/2011(029398)

Sector Update **28 July 2010**

Plantation

Neutral
(maintained)

Rain, not always a bad thing

- **First dry and now wet**
  Early in the year, the El Nino was on everyone lips but this of late has switched to the La Nina. As of latest data, the SOI index and the ONI index both point towards a gathering La Nina. It will be important to keep a keen eye on the indices as it would give more clarity to where the sector is heading in the coming 6 months. A very severe and prolonged La Nina could hit production but a mild one could drive production.

- **La Nina's don't measure up to El Nino's**
  The most recent La Nina event occurred over 2007/8. In Malaysia, the heavy rains that occurred in 1QCY08 affected pollination and fertilisation activities and translated into negative production growth in 2009 (decline of 1%). However, interesting to note is that despite the heavy rains during 2008, production growth was still an impressive 12% y-o-y. Also when compared to major El Nino events (like the 1997/8 El Nino), the El Nino caused much more trouble with a severe production dip of 8.3%. Besides that, another La Nina reading in 1999 saw production growth and recovery of a whopping 26.9% after the 1998 production dip. It seems to be the case that a La Nina, in some cases, may actually work favourably for the industry in terms of production.

- **Too early to cry wolf**
  We are sticking to our RM2,400 CPO ASP for the year at this juncture and view it too early to make an actionable call on something as indeterminate as the weather. The weekly reports from the Australian Bureau of Meteorology and the NOAA will surely be monitored closely from here on. Numbers for July into August are critical to watch. To keep our CPO ASP also means that we are expecting that 2HCY10 has a potential to have weaker CPO prices given that stock levels will be rising from here on as the industry goes into the yearly peak production cycle.

- **Maintain Neutral**
  We stick to our Neutral call for now and view that MPOB statistics for July could see a rise in stock levels because of the export dip. To note, besides the La Nina, another event that could drive up CPO prices is soybean growing season in North America which is also being watched for a weather disruption. Also, exports could be strong in August due to festive season stocking, eating into local stocks. Besides that, crude oil prices will always continue to play a role in volatility.

Stock Coverage

Company	Bloomberg Ticker	Call	TP (RM)
Sime Darby	SIME MK	Hold	7.75
IOI Corp	IOI MK	Hold	5.57
KL Kepong	KLK MK	Hold	16.20
Genting Plant	GENP MK	Hold	6.60
Boustead	BOUS MK	Buy	4.48
IJM Plant	IJMP MK	Sell	2.09
TSH Res	TSH MK	Hold	2.00

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Figure 1 : Financial summary of stocks under coverage

Company	Price (RM) @ 27 Jul	Mkt Cap (RM m)	EPS (sen) 2010F	EPS (sen) 2011F	EPS Growth (%) 2010F	EPS Growth (%) 2011F	P/E (x) 2010F	P/E (x) 2011F	P/BV (x) 2010F	P/BV (x) 2011F	ROE (%) 2010F	ROE (%) 2011F	Dividend Yield (%) 2010F	Dividend Yield (%) 2011F
Sime Darby	7.79	46,813.7	30.6	49.8	-19.3	62.7	25.4	15.6	2.1	2.0	8.4	13.2	2.9	2.9
IOI Corporation	5.12	34,179.4	22.3	23.9	-1.9	7.2	23.0	21.4	3.7	3.2	15.9	15.0	0.9	1.0
KL Kepong	16.98	18,126.2	80.5	83.7	40.3	4.0	21.1	20.3	5.5	5.2	14.1	13.9	2.2	2.2
Genting Plant	7.10	5,385.4	44.1	51.1	42.0	15.8	16.1	13.9	1.9	1.7	12.1	12.5	0.5	0.5
Boustead	3.91	3,676.0	44.5	55.9	22.4	25.7	8.8	7.0	1.1	1.0	9.6	11.6	5.8	5.8
IJM Plantations	2.52	2,019.4	9.9	13.1	-43.4	31.9	25.4	19.3	1.7	1.5	4.8	4.7	1.2	1.2

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La Niña brings the rain

La Niña translates from Spanish as "the girl-child". The term "La Niña" has recently become the conventional meteorological label for the opposite of the better known El Niño. The term La Niña refers to the extensive cooling of the central and eastern Pacific Ocean.

Changes to the atmosphere and ocean circulation during La Niña events include:

- Cooler than normal ocean temperatures across the central and eastern tropical Pacific Ocean.
- Increased convection or cloudiness over tropical Australia, Papua New-Guinea, Malaysia and Indonesia.
- Stronger than normal (easterly) trade winds across the Pacific Ocean

(excerpt from Wikipedia)

SOI and ONI indices point towards occurrence of La Nina

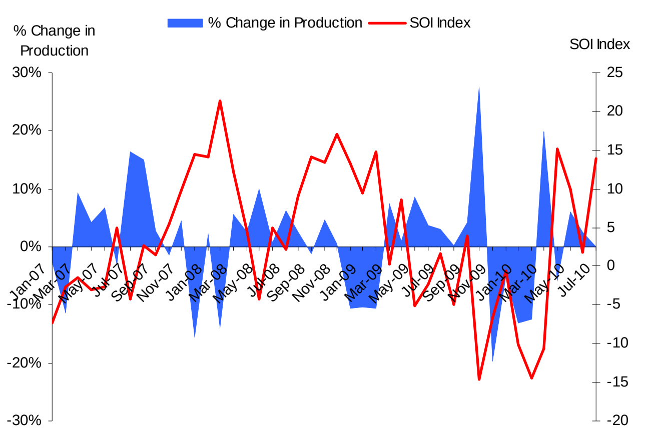
Looking at readings off the SOI Index (Southern Oscillation Index) as well as the ONI Index (Oceanic Nino Index), both indicate signs of a La Niña. La Niña indications in the SOI Index look to be gathering strength in July (figure 2, positive numbers above 8) while in the ONI Index (negative numbers past 0.5, figure 3) shows a similar scenario. News has been rife in the media on the potential impact of the La Niña. So far some comments from planters in the media include:-

Felda Global Ventures:- CPO prices should be in the RM2,600-2,800 per mt level in 2H in view of a potential La Niña and also because of the El Nino effects from 1QCY10 kicking in.

IOI – Said a brewing La Niña will have severe impact on production as it would likely hit during the peak harvesting season.

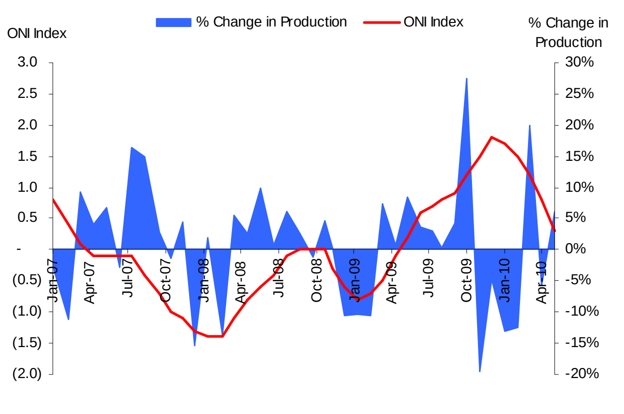
TH Plantations – Said oil palm trees generally do require a good deal of moistures but too much can destroy trees and cause flooding. Companies without good road infrastructure would be most at risk.

Figure 2 : SOI Index vs changes in production



Source: Australian Bureau of Meteorology, MPOB

Figure 3 : ONI Index vs changes in production



Source: MPOB, NOAA

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La Nina effects not typically as severe as El Nino

The most recent La Nina event occurred over 2007/8

The most recent La Niña event occurred over 2007/8 (and 1995/6 before that). Recall that during that time, CPO prices went crazy, not just because of the weather event that posed threat to CPO production but also because of exogenous factors at the time (biodiesel story, weakening of the USD, and speculative activity in commodities). To note, the La Niña was also responsible for the major hurricane season in the Gulf of Mexico which in turn fanned crude oil prices higher. In other words, it occurred at a time when all hell broke loose on commodities. In Malaysia, the heavy rains that occurred in 1QCY08 affected pollination and fertilisation activities hence it translated into negative production growth in Malaysia in 2009 (decline of 1%). However, interesting to note is that despite the heavy rains during 2008, production growth was still an impressive 12% y-o-y during the said year. Let's take a closer look at monthly data for further analysis.

Heavy rain in 1QCY08 resulted in marginally lower production in 2009 but significantly higher production in 2008

Figure 4 : Months where the La Nina intensified

Month	SOI Index	ONI Index	% m-o-m change in production	Notes
Dec-07	14.4	-1.3	-15.4%	La Niña started to intensify exacerbating the start of the low production period
Jan-08	14.1	-1.4	2.0%	Both indexes continued to read strongly positive for La Nina
Feb-08	21.3	-1.4	-13.8%	Peak of most recent major La Niña event, also concurred with seasonal low in production
Mar-08	12.2	-1.1	5.4%	
Sep-08	14.1	0.0	-1.3%	
Oct-08	13.4	0.0	4.6%	
Nov-08	17.1	-0.3	0.4%	La Niña continued to be relatively intense throughout the year. Affecting year end harvesting.
Dec-08	13.3	-0.6	-10.6%	
Jan-09	9.4	-0.8	-10.3%	Impact from 2008 mostly felt in 2009 only with lukewarm production throughout the year
Feb-09	14.8	-0.7	-10.7%	
Apr-10	15.2	0.8	-5.8%	Recent event already caused some production blip coupled with the medium strength El Nino in 1Q
May-10	10	0.3	6.1%	
Jun-10	1.8	0.0	2.5%	The SOI index tapered off in June but has seen a sharp increase in July.

Source: Australian Bureau of Meteorology, NOAA, MPOB

Only prolonged La Nina poses threat to production

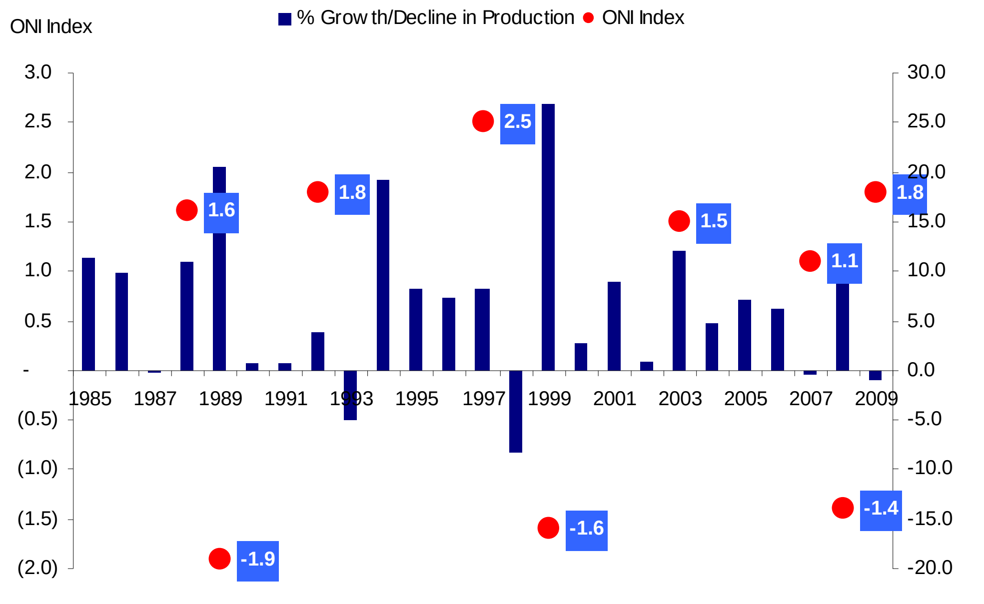
El Nino is a bigger threat to production than La Nina

Similar to our theories on the El Nino, we confirm that only a severe prolonged La Niña event can present itself to be a threat to production. For reading of the indices, that means the SOI index typically has to pass the 15 level and the ONI index chart a value of -1 and below for a prolonged period. In fact, the El Nino presents itself to be more of a threat to production than the La Nina historically as seen in the Figure 5 charting yearly changes in production and the ONI Index.

In 1997/8, El Nino caused a 8.3% production dip as compared to just 1% production dip caused by La Nina in 2009

As a quick example of severity (and based on Figure 5), the 1997/8 El Nino caused a severe production dip of 8.3% while the recent severe La Nina only caused a 1% dip in 2009. Another La Nina reading in 1999 saw production growth and recovery of a whopping 26.9% after the 1998 production dip. We note here that at times it can appear as if the La Nina helps production along. This is given that oil palm trees require some 10mm of rain a day or irrigation with similar amounts.

Figure 5 : La Nina tends to have some impact, but only in the following year



Source: NOAA, MPOB

Past CPO production dips have largely been caused by El Nino

2010 however presents itself with a slightly different scenario because of the 1QCY10 El Nino event. If a severe La Niña occurred this year during peak production season, we think it could be a double whammy for the industry. First, production is already lukewarm this year because of the El Nino that intensified in 1QCY10 combined with reported tree stress sporadically across Malaysia. This coupled with unusually wet weather that will slow/hurt harvesting activities further could result in an un-seasonal continued decline in CPO stock levels locally.

Too early to cry wolf

Maintain CPO ASP at RM2,400 for CY2010

We are sticking to our RM2,400 CPO ASP for the year at this juncture and view it too early to make an actionable call on something as indeterminate as the weather. The weekly reports from the Australian Bureau of Meteorology and the NOAA will surely be monitored closely from here on. To keep our CPO ASP also means that we are expecting that 2H has a potential to have weaker CPO prices given that stock levels will be rising from here on as the industry goes into the yearly peak production cycle. To note, upgrading our CPO ASP would give the sector some mild upside in our view, but not quite enough to render an Overweight call. To note, we have included a sensitivity test in the following page.

Just to round up some items on our watch list for the sector now that could tip things either way (overweight or underweight):-

- La Niña developments that could affect the upcoming peak production period or the lack of any major event will leave industry fundamentals status quo or boost production. Stock level rise will surely be a downer for CPO prices.
- Soy bean growing season in the US of which August is a critical month to determine potential harvest for early next year. Some weather threats now might hurt production but its early days to tell To note, for now news continues to be overall bearish. It still stands that plantings are a record at 2% above 2009's record corp.
- Exports from Malaysia could look to be strong in the coming 2 months due to festive season restocking. Currently though, July numbers are so far showing a slow month. Exports this year are strong so far with a 9% y-o-y increase. Should production continue to fall short then we could see stock levels continue to dip which will be positive for CPO prices.

Sensitivity test

We did a quick sensitivity test to see what level share prices could trade to depending on what level CPO prices could rise to. The results indicate that increases in CPO prices will have the most positive impact on companies with optimum and increasing maturities like KLK, Genting Plantations and IJM Plantations. Impact is natural to mild for conglomerates. We note that the test is not an extensive one as if the La Niña really kicks in, some of the gain from the increase in selling prices of CPO will be offset by declines in FFB yields.

Figure 6 : Sensitivity tests

Company	TP@CPO RM2600	% Change	TP@CPO RM2800	% Change	TP@CPO RM3000	% Change
Sime Darby	8.16	5.3%	8.43	8.8%	8.70	12.3%
IOI Corp	5.69	2.1%	6.12	9.9%	6.55	17.6%
KL Kepong	19.01	17.3%	21.27	31.3%	23.54	45.3%
Genting Plant	7.30	10.5%	7.97	20.8%	8.65	31.0%
IJM Plant	2.54	21.5%	2.98	42.8%	3.43	64.1%
Boustead	4.71	5.1%	4.97	19.1%	5.23	16.8%
TSH Resources	2.04	7.6%	2.26	19.1%	2.48	30.6%

Source: ECM Libra

Figure 7: Investment merits

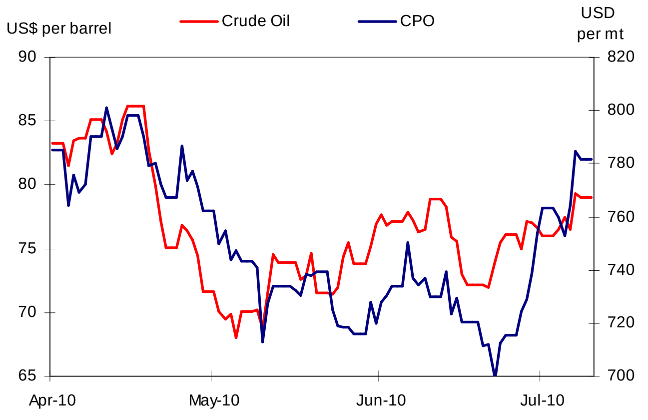
Company	Call	Last Price RM	Target Price RM	Upside %	Valuation basis	Investment merits
Sime Darby	Hold	7.79	7.75	-0.5	Sum of parts	Currently fully valued, better to pick at lower levels.
IOI Corporation	Hold	5.12	5.57	8.8	22x P/E	Looking more attractive at current levels. However, growth prospects limited for now with lack of new maturities.
KL Kepong	Hold	16.98	16.20	-4.6	20x P/E	FFB growth to be 5-10% in coming years from newly matured hectarage in Indonesia. However, Crabtree causing a major drag on earnings.
Genting Plant	Hold	7.10	6.60	-7.0	15x P/E	Clean balance sheet. Growth potential when Indonesian plantations reach maturity but only in 2012. Fully valued for now
Boustead	Buy	3.91	4.48	14.6	Sum of parts	Upside from property and heavy industries segment while sale of Indonesian assets will significantly up group yields. Good dividends yield above 5%.
IJM Plantations	Sell	2.52	2.09	-17.1	16x P/E	Fully valued at current levels. No major growth until 2013 from Indonesian hectarage.
TSH Resources	Hold	1.91	2.00	4.7	10x P/E	Fully valued for now. Ekowood putting a dent in earnings.

Source: ECM Libra

Recent market movements

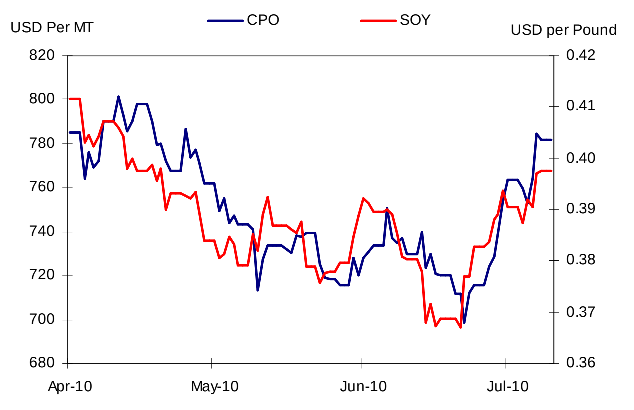
The following is just to keep up to date of movements in crude oil, soybean oil, and also fertiliser prices. Recent market movements have continued to see CPO, crude oil and soybean oil have a tight correlation. That said, CPO prices continue to have a potential to rise if crude oil prices do. Fundamental factors to watch for crude oil now is the ongoing hurricane season in the US. Besides that, major exogenous factor, the USD, continues to play an important role in all major commodities. On commodities, there appear to be no price shocks in sight this year that could see planter margins declining.

Figure 8 : CPO and Crude oil prices in USD



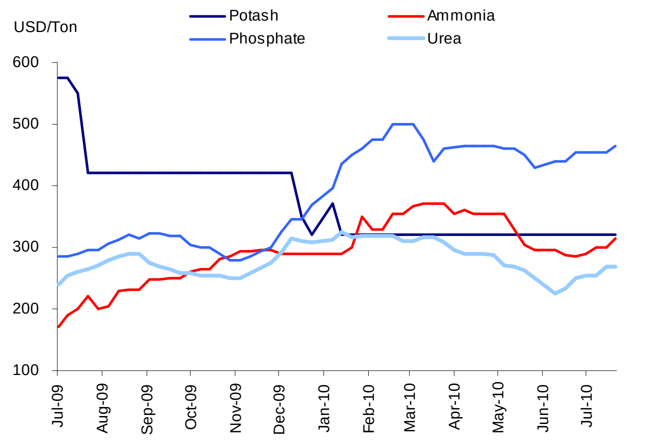
Source: Bloomberg

Figure 9 : CPO and soy oil prices in USD



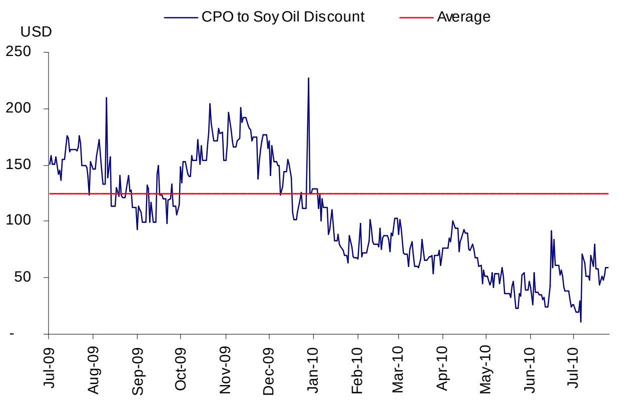
Source: Bloomberg

Figure 10 : Weekly fertilizer tracker



Source: Bloomberg

Figure 11 : RBD Palm Olein-Soybean oil discount



Source: Bloomberg

Key to stock recommendations:

Buy = Share price is expected to appreciate by >10% over the next 12 months

Hold = Share price is expected to move by less than +/-10% over the next 12 months

Sell = Share price is expected to decline by >10% over the next 12 months

Key to sector recommendations:

Overweight = Industry expected to outperform the market over the next 12 months

Neutral = Industry expected to perform in-line with the market over the next 12 months

Underweight = Industry expected to underperform the market over the next 12 months

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