



Rating Methodology for Palm Oil Companies

Introduction

The plantation sector especially palm oil has an important role in the Indonesian economy as it is one of the biggest contributors to the non-oil and gas exports. In fact, palm oil is the biggest contributor of export of manufactured products. It represents about 15.1% of total manufactured products or equivalent with USD 17.5 billion in 2014. Relative to total non-oil and gas exports, palm oil's contribution is 11.9%. Further, Indonesia is also the biggest producer of Crude Palm Oil (CPO) in the world whose market share of production and export is about 52.5% and 49.7%, respectively in 2014.

Within this industry, scope of business can be classified into upstream, downstream and integrated. Activities such as the cultivation of oil palm, fresh fruit bunches (FFB) production and processing them into CPO and palm kernel oil (PKO) are considered as upstream. Meanwhile, downstream activities include palm oil refinery, crushing of palm kernel as well as manufacturing of palm-based edible products and specialty oils and fats. An integrated palm oil player covers both upstream and downstream activities and thus is expected to have more stable earnings in spite of CPO price fluctuation.

Palm oil is widely used in the global market for various applications. Palm oil- and PKO-based ingredients are found in approximately 50% of products on supermarket shelves, including food and non food items. Palm oil in many countries is used as simple frying oil, but many other markets make use of both palm and PKO for consumer retail food and snack manufacturers; personal care and cosmetics (mainly PKO); biofuel and energy; animal feed (palm kernel expeller); pharmaceutical; industrial; and food service industry. Harvested all year round, oil palm trees produce on average 10 tons of fruit per hectare - far more than soya, rapeseed and sunflower crops (source: greenpalm.org).

Rating Framework

ICRA Indonesia's rating framework for players in the palm oil industry involves an assessment of the risks which characterize the palm oil industry and an evaluation of a company's operational, market and financial position as well as management quality.

Industry Risk Assessment

Regulatory Risks

The palm oil industry is to some extent regulated by the government. For instance, along the upstream activity, the government has extended moratorium on the conversion of primary forest and peat land to agriculture or other uses until 2015 that may dampen the expansion of oil palm plantations. This policy is aimed at reducing the country's deforestation rate. In the downstream, the government also has a commitment to increase the use of palm oil in the biodiesel fuel mix. The minimum requirement of palm oil as a component of biodiesel is set to increase to 20% in 2016 compared to 10% currently. The implementation of B20 (20% of palm oil methyl ester) diesel program will increase the domestic demand of CPO and consequently might reduce the supply of CPO in the

global market. In addition, the government also determines the export tax for CPO whose purpose is primarily to sustain palm oil supply in the domestic market in addition to augment government's revenue.

Supply and Demand

ICRA Indonesia evaluates the supply and demand of palm oil in the global market especially from the two biggest producing countries, Indonesia and Malaysia. Key risks that affect the palm oil supply are environmental and regulatory factors. Weather phenomenon such as El-Nino can be a key factor affecting CPO production as it can damage crops. Nevertheless, this environmental effect can be mitigated by well managed inventory level and schedule of replanting. Another factor that potentially affects the market of CPO is a regulatory framework such as issued by Indonesian government mentioned above.

CPO demand globally is expected to remain strong backed by robust demand from three biggest importers namely India, European Union and China. India and China with their huge population coupled with expanding economies and income per capita should drive up CPO demand in the future. Another trigger of robust demand is biofuel implementation especially in the European market. In fact, the rising consumption mainly for biofuel since 2006 has placed this region as the second largest importer of CPO in the world. Various applications of CPO and its derivative products for food and industrial segment are also expected to sustain demand of palm oil.

Capital Intensity

The palm oil industry is capital-intensive since it needs a large initial investment to set up a commercial palm oil company. Players in their initial business phase require various investments for land acquisition, clearing of land, basic infrastructure construction, production facilities development, and other palm oil plantation related expenditures. They have to cover agronomic-related expenditures between initial planting and the first fruit harvesting period which typically about 30 months of which no-return booked during this period. Further, the yields are still low and might be unprofitable in the first few years of fruit harvesting. A well-maintained and professional estate management is accordingly needed as plantation's life cycle is relatively long at about 25 years.

Cost Structure

Costs of inputs such as fertilizer and harvesting & maintenance are the biggest part of palm oil company's cost structure. Fertilizers are needed for cultivation and replanting program. As such, maintaining a good relationship with suppliers is expected to help sustain the fertilizer supply for the company. Cost of harvesting and maintenance is dominated by labour expense. However, this may not become a primary issue considering the abundant availability of labour in Indonesia, relative to neighbouring countries such as Malaysia.

Environmental Concern

The environmental challenge on palm oil industry mainly comes from the European countries. Some organizations have raised concern on the environmental sustainability for palm oil. Similarly, worldwide demand for more environmentally sustainable products is expected to increase in the future. The participation of palm oil players on this matter to comply with global climate concern is positive to reduce the impact of negative campaign against palm oil and biodiesel imports particularly from Indonesia. This factor should be seen in relation to the fact that European countries are among the biggest export markets for Indonesia's palm oil.

Competitive Position Assessment

Plantation Profile

A palm oil company's competitive position can be assessed from its plantation profile including land bank availability and its aging profile. Land bank availability coupled with infrastructure and facilities for plantation will enable it to grow in the future. Meanwhile, aging or maturity profile of plantation is

also an important factor to assess. A normal palm oil tree is productive until the period of 20-25 years after its first harvesting at 30 months of age. However, prime age is 8-20 years. Replanting program for palm oil trees is commonly implemented after crossing the 25-year threshold. Therefore, different aging profile could reflect different business risk as it will correlate with the company's cost structure which mainly is dominated by fertilizer and maintenance costs.

Productivity Measurement

There are common measures used for productivity assessment along the palm oil industry such as FFB production (tons); and FFB yield. FFB is the fruits produced by palm oil trees and can be measured by calculating its production per year. Meanwhile, FFB yield is based on FFB tons per hectare calculation. In this case, average FFB yield is calculated on a palm oil company basis and then compared it to other similar companies as well as industry average to assess its productivity. There will be different yields among palm oil players as affected by, amongst others, bigger portion of young planted areas, estate management and seedlings quality.

There is also another measurement namely Oil Extraction Rate (OER). OER is the measurement of CPO extracted per unit of FFB which is measured as a percentage. This parameter can be a tool to assess palm oil's mill and plantation performance. A higher extraction rate is expected to improve its profitability and reflects the quality of palm oil trees as well as practices on estate management. In tandem with FFB yield, OER ratio is also benchmarked against averages of peers and industry.

Vertical Integration

Level of integration of palm oil companies can be traced from planting, cultivating, harvesting, and production process for CPO and its derivative products. Sales of CPO production to third party mainly due to insufficient downstream production capacity might result in thinner margins. Likewise, having a big mill capacity but with a low utilization rate reflects inefficiency. On the other hand, a palm oil company with ability to produce various derivative products will lead to lower exposures to the fluctuation of commodity price. Further, derivative or value added products such as for consumer goods coupled with strong brand, well distribution and marketing channel will be of advantages.

Diversification

The level of diversification of a palm oil company in terms of geographical location of the plantation areas, product, market and customer will be analyzed. Such diversification can reduce concentration risk for a palm oil company. It is also expected to sustain revenue and cash flow stability in particular considering the fluctuation in product prices affecting the demand.

Financial Risk Assessment

Profitability

Apart from standalone analysis, a comparison on profitability amongst players is assessed to analyze its competitive strength and operating efficiency. The assessment will start from operating margin to return on invested capital. Higher margins and returns will result in a better ability to withstand the volatility of the CPO prices. The margin analysis will further be correlated with other profitability measures such as retained earnings or dividend payment, return on equity and on capital employed. A strong profitability will provide a company with higher flexibility to go through the cycle and finance its growth.

Capital Structure

The assessment of capital structure will include the palm oil company's leverage for its historical, current and forecast such as total debt to equity and total debt to operating profit before depreciation, interest, tax and amortization (OPBDITA) ratios. A deeper analysis of the capital structure will include the short-term and long-term debt profile of the company, interest and currency risk exposure, as well as comparing it with peers and industry averages.

Cash Flow Adequacy

An assessment on palm oil company's cash flow is important as it constitutes major source of debt repayment for both short term and long term. Ideally, cash flow from operations should be positive and well-maintained since it covers daily operation of the company. Further, availability of free cash flow is positive as it can reflect the ability to meet financial obligations and business commitments in the future. However, a palm oil company having significant replanting or expanding new planted areas will potentially be exposed to negative free cash flow. As such, the company at this stage would need additional borrowings to meet the commitments. All of the analyses will be compared against its peers and industry's norms.

Financial Flexibility

Financial flexibility basically refers to options owned by the palm oil company to repay debt obligation or during any financial distress. Assessment on it will include its current financial stance, in particular leverage, apart from its competitive position that enables it to attract interest of investors or lenders. In addition, the availability of liquid or unencumbered assets, banking facilities, capital market access and group/shareholders' support is also analysed.

Management Quality

All debt ratings necessarily incorporate an assessment on the quality of the company's management, as well as the strengths/weaknesses arising from its being a part of a "group". Also of importance are the company's likely cash outflows arising from the possible need to support other group entities, in case the concerned company is among the stronger entities within the group. Usually, a detailed discussion is held with the management to understand its business objectives, plans, and strategies, and views on past performance, besides the outlook on the industry. Some of the other points assessed are:

- Experience of the promoter/management in the line of business concerned
- Commitment of the promoter/management in the line of business concerned
- Attitude of the promoter/management to risk taking and containment
- The company's policies on leveraging, interest rate and currency risks
- The company's plans on new projects, acquisitions, expansions, etc
- Strength of the other companies belonging to the same group
- The ability and willingness of the group to support the company through measures such as capital infusion, etc., if required.

Summing up

ICRA Indonesia's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the instrument being rated. This opinion is arrived at following a detailed evaluation of the company's business and financial risks, competitive strengths, management, as well as its likely cash flows over the life of the instrument being rated and the adequacy of such cash flows vis-à-vis its debt servicing obligations.

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