AmInvestment Bank

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PLANTATION

A sigh of relief as CPO prices have stabilised

NEUTRAL

(Upgraded)

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Rationale for report : Sector update

Investment Highlights

- **Upgrade sector to NEUTRAL from UNDERWEIGHT.** We upgrade the recommendations on our plantation stocks from SELL to HOLD. Although we have a **HOLD** on **Kuala Lumpur Kepong (KLK)**, we would recommend KLK **(fair value: RM24.40)** for investors, who would like exposure to the palm oil sector. This is due to KLK's young oil palm trees in Indonesia and cheaper PE relative to the other large-cap planters.

- We are neutral on the plantation sector as we think that there is a balance between the positive and negative factors. Although palm demand from India and China is improving, this is expected to be offset by climbing palm production in Malaysia and Indonesia in 2H2020. As prospects are not as bleak as before, we have raised the fair values for the companies in our stock universe on higher PE assumptions. Our previous PE assumptions were based on trough market conditions. We have assumed PEs of 27x for large-caps like IOI Corporation and Kuala Lumpur Kepong (vs. 20x previously) and 22x–25x for smaller companies like IJM Plantations and TSH Resources (vs. 18x previously).

- **We would turn positive on the plantation sector if palm inventory declines.** Generally, palm production declines when unfavourable weather affects FFB yields. Currently, palm inventory is forecast to rise on the back of higher production. Malaysia's palm inventory stood at 2.03mil tonnes as at end-May 2020 vs. 1.76mil tonnes as at end-January 2020 and 2.45mil tonnes as at end-May 2019.

- **Average CPO price assumption of RM2,300/tonne in 2020F (5M2020 average MPOB price: RM2,497/tonne; 2019 average MPOB price: RM2,119/tonne).** We expect plantation companies to record higher net profits in 2020F underpinned by an average CPO price of RM2,300/tonne vs. the MPOB's average price of RM2,119/tonne in 2019. On the back of an 8.5% increase in average CPO price realised in 2020F, net profit growth is estimated to be 10% to 40% for upstream operations. We believe that upstream earnings would be stronger in 2020F if not for the weak industry FFB production and rising production costs. As for the downstream segment, net earnings of the integrated planters may be affected by erosion in refining or oleochemical EBIT margins. Downstream profit margins are anticipated to be hit by lower selling prices of non-healthcare oleochemical products and sales volume.

Outlook and developments in 2H2020

- **Industry palm demand to recover in 2H2020.** We believe that global palm demand would recover in 2H2020 underpinned by a resumption of business activities. In China, a gradual reopening of restaurants would improve the demand for cooking oil. Based on anecdotal evidence, palm oil is usually mixed with peanut oil or other oils in China. We believe that cooking oil accounts for about 30% of palm usage in China while frying oil accounts for another 25%. Oleochemical takes up another 30% of palm oil used in China. Also, the reopening of India's economy in June 2020 would result in restocking of vegetable oils as stockpiles are currently low. As at 1 March 2020, inventory of edible oils at the pipelines and ports in India stood at 1.53mil tonnes vs. 2.2mil tonnes a year ago.

- **But palm demand may not reach the highs of 2019.** We believe that Malaysia's palm exports in 2020F would not reach 2019's peak of 18.5mil tonnes. In spite of a recovery in demand, we believe that the rate of recovery would be slow in 2H2020. We believe that Chinese consumers would take time to revert to their pre-Covid-19 eating and shopping patterns. Also, China is resuming purchases of soybeans as the African swine fever disease eases and as the country fulfils its phase 1 commitment with the USA. The increase in soybean supply in China is expected to result in higher supply of soybean oil and lower demand for palm oil. China's palm imports dropped by 34% YoY in 1Q2020 in contrast to the 6.2% increase for soybean imports.

- On a positive note as business activities start picking up ahead of the Deepavali festivities in October, we reckon that India's palm demand would rise. India is expected to buy palm oil in crude form from Indonesia and Malaysia Also, India has imposed more restrictions on the imports of palm in refined form to protect its edible oil processors.

- In spite of this, we reckon that India's palm demand in 2020F would not exceed 2019's 9.3mil tonnes due to a series of events in 1H2020. India's edible oil importers switched to cheaper substitutes as palm oil prices surged from December 2019 to January 2020. Thereafter, the fall in palm demand was exacerbated by the Covid-19 pandemic. India's palm demand fell by 28.7% YoY during the November 2019 to April 2020 period. In contrast, India's demand for soft oils (soybean, rapeseed and sunflower) improved by 11.2% YoY during the period.

- **Peak palm production in 2H2020.** As in previous years, we reckon that the palm industry is heading towards the peak production period in 2H. In 2018, 2H accounted for 54% of Malaysia's CPO production while 1H made up the balance 46%. In 2019, 2H accounted for 51% of Malaysia's CPO output while 1H accounted for 49%.

- **2H2020 palm output could be strong.** We believe that the surge in industry CPO production would be robust in 2H2020 compared with 1H2020 as FFB yields are expected to recover. We also think that compared with 2H2019, industry CPO output would be healthy in 2H2020. Recall that the palm industry in Malaysia and Indonesia suffered haze and drought in 3Q2019, which affected output in 3Q2019 and 4Q2019. Currently, *Oil World* forecasts Malaysia's CPO production to be 20mil tonnes in 2020F against 19.9mil tonnes in 2019. Also, *Oil World* estimates Indonesia's CPO output to be 45.4mil tonnes in 2020F vs. 44.1mil tonnes in 2019. *Indonesia Palm Oil Association* forecasts the country's CPO production to rise to 51.0mil tonnes in 2020F from 47.1mil tonnes in 2019.

- **Delay in B20 biodiesel implementation in Malaysia.** In Malaysia, the implementation of B20 in Sabah, Sarawak and Peninsular Malaysia has been postponed. Implementation of B20 in Sabah will only start on 1 January 2021 vs. August 2020 previously. B20 in Sarawak will commence on 1 September 2020 vs. April 2020 originally. In Peninsular Malaysia, B20 will only be implemented in June 2021. Apart from Covid-19, we think that B20 was delayed in Malaysia as more subsidies are needed. Based on prices as at 15 June 2020, gasoil was US$241/tonne cheaper than CPO. Also earlier this year, truck operators in Malaysia said that there were additional costs to retro-fit engines to facilitate the use of B20. B20 is estimated to absorb 1.26mil tonnes of palm oil annually in Malaysia, which is about 6.3% of 2020F CPO production of 20mil tonnes.

- **Indonesia's 2020E biodiesel consumption target has been reduced by 16.7% to 8mil from 9.6mil KL.** In June 2020, a government official said that Indonesia's biodiesel consumption may reach 8mil KL (7mil tonnes) in 2020E compared with the original target of 9.6mil KL (8.4mil tonnes). The biodiesel consumption of 7mil tonnes would be about 13.7% to 15.4% of Indonesia's CPO production of 45.4mil to 51.0mil tonnes for 2020E. Biodiesel consumption in Indonesia in 2020E is not expected to be as strong as before as the Covid-19 outbreak has resulted in a drop in transportation and economic activities. Indonesia's biodiesel consumption was 6.7mil KL (5.8mil tonnes) in 2019. In May 2020, Indonesia allocated US$188mil or 2.78 trillion rupiah from the state budget for biodiesel incentives. Also, the country raised the CPO export levy by US$5/tonne to US$55/tonne for the month of June 2020 to increase funds for biodiesel subsidies.

- **Global soybean production to rise in 2020F.** The USDA (US Department of Agriculture) has forecast average US soybean price to be US$8.20/bushel in 2020E/2021F vs. US$8.50/bushel in 2019/2020E. Global soybean inventory is estimated to ease by 2.9% to 96.3mil tonnes in 2020E/2021F. China's improved soybean demand is envisaged to be offset by rising global soybean output in 2020F.

  Global soybean production is anticipated to expand by 8.2% to 362.85mil tonnes in 2020E/2021F from 335.35mil tonnes in 2019/2020E. The rise in global soybean output is expected to be underpinned by a 16.1% increase in the US, 5.6% expansion in Brazil and 7% climb in Argentina. US soybean production is estimated to rise by 16.1% to 112.26mil tonnes in 2020E/2021F driven by higher planted areas and soybean yields. US farmers are forecast to plant 82.8 acres of soybeans in 2020E/2021F vs. 75.0mil acres in 2019/2020E. US soybean yield is estimated to be 49.8 bushels/acre in 2020E/2021F against 47.4 bushels/acre in 2019/2020E.

TABLE 1 : VALUATION MATRIX

	Share price	Basic EPS (sen)		Basic PE (x)		Fair values	Upside	FY20F	FY20F
	(RM)	FY20F	FY21F	FY20F	FY21F	(RM)		DPS (sen)	Div yield
IOI Corp	4.40	12.6	15.8	34.9	27.8	4.30	-2.3%	8.0	1.8%
KLK	22.22	67.0	90.4	33.2	24.6	24.40	9.8%	55.0	2.5%
SD Plantation	5.05	10.1	13.7	50.0	36.9	5.50	8.9%	5.0	1.0%
TH Plantations	0.31	2.4	3.7	12.9	8.4	0.33	6.5%	2.0	6.5%
Gent Plant	10.00	31.0	36.0	32.3	27.8	9.72	-2.8%	14.0	1.4%
IJM Plantations	1.76	2.8	6.3	62.9	27.9	1.70	-3.4%	2.0	1.1%
TSH Resources	0.86	4.3	4.4	19.9	19.4	0.95	11.1%	1.5	1.8%
FGV Holdings	1.03	-1.4	2.1	-73.6	49.0	1.14	10.7%	2.5	2.4%

Source: AmInvestment Bank Bhd

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