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Palm oil, an investment case? **February 2012**

Our case study about palm oil was triggered in the darker days of late 2011 – where the Greece and the Euro crisis took most of the headlines news – providing us with a slight dose of the same feeling we've had at the time Lehman went down and AIG seemed to follow – and a few months before Mario Draghi came the troubled European lenders to the rescue with the gigantic LTRO loan program – kicking the can way further down the road than anyone would have expected - and thus introduced an European style QE (without actually using the word) – pretty elegant not to "upset" the Germans.

In those days, we at **Helvetic Investments** had a pleasant meeting with a corporation partner, a gentleman from the rural part of Switzerland – as far away as one could imagine from a palm oil plantation. The gentleman – being an investor himself – felt somehow more relaxed than us (to be honest, we actually worried quite a lot), with financial markets at the brink – trying to figure out what would come next. During the discussion it turned out that one of the gentleman's major investments wasn't much influenced by the European debt crisis – no wonder he looked relaxed. He told us he'd invested a substantial part of his savings in palm oil, a somehow new area to our team – and pretty much to everyone we talk to daily.

After looking at the map and doing an hour or two of surfing – we figured out why this gentleman had a good sleep despite the crisis – and after having studied analysis on the issue "palm oil producers" from our prime banking relation, DBS Bank and its brokerage arm (DBS Vickers) as well as from other reliable analysts and brokers – and after having looked closer at some palm oil producers' Q3 P&L and balance sheets, we completely understood the investor from Switzerland's pretty good mood. This was exciting: close to value – slightly boring, but pretty stable (as value investments often are).

The balance sheets from some major palm oil producers (like United Plantation Berhad and First Resources – the first traded in Malaysia and Copenhagen – the later in Singapore) were partly what the big financial guys would call "over capitalized" – a phrase that should have been forbidden post Lehmann and the financial crisis. There simply wasn't much debt on the balance sheets – partly only a bit for tax to be paid later in the year – something every company leader and owner ought to be proud of. Correct, a higher debt ratio would boost "return on equity" (and supply investment bankers with work and fees) – but also increase volatility and the risk of default.

The relative stability of a number of palm oil producers' production and income, the increasing demand for bio fuel (biodiesel) – and the very reasonable evaluations (PE-levels at or slightly above 10) were the issues exciting us (well, agreed, the “Shiller PE” would be higher – but this counts for almost all equities these days).

Sure the risk in investing in palm oil producers (plantation; up stream, and processing; downstream – the bigger players are active in both fields) is completely different compared to a broader based investment into the diversified beverage industry – like an investment in Nestle, Unilever, Danone etc. – but here PEs are substantially higher (15-20) – and growth perspectives are pretty similar – if figures from the Malaysian Palm Oil Council are to be trusted in regard of palm oil. It seems there were some good value to be found right at our doorstep – in Malaysia and Indonesia.

About palm oil

The palm oil tree was originally brought to the Southeast Asian region from West Africa. It came to Malaysia in the 1870’s. In its new home area it was developed into the agricultural palm we know today. In the early 1900s the plantation business developed – and developed steadily into what today is Malaysia’s biggest export business, taking it to a 100 billion Ringgit business with up to 5-600’000 workers employed – and supplying livelihood for double that number. These figures are only for Malaysia – holding a majority part of world market – where around 4.5 million hectares of land is making up the production of palm oil and the so called palm kernel oil (seed of the palm fruit). Malaysia alone has 11% of the world’s oils & fats production.

Malaysia and Indonesia are the largest producers and exporters of palm oil in the world – competing to be number one in a pretty close race – unfortunately with Indonesia lately in the lead, it seems, as it occurs that the regulations here are less strict as in Malaysia, where government control and the implementation of rules and regulations seems stricter – in order to protect workers and the jungle from being eroded – with 15 laws and regulations, not least the Land Acquisition Act 1960.

Fortunately there has been a huge pressure from NGOs and consumers – leading to demands from big users (like Nestle) on palm oil producers and exporters to make sure that certain environmental standards are complied with. Besides using some pesticides which aren’t allowed in the European Union – the major plantations we’ve looked at did a serious struggle trying to be ecological and to show a high degree of social responsibility to environment and society.

The palm oil tree produces bunches of grape-like fruits, weighing between 10-25 kilos, with 1-3’000 fruits per bunch. The color is dark purple and turns to orange red when ripe.

The palm oil tree is ready to bear fruits at age 2.5 years, and will do so almost consistently for another 20-30 years, if proper care and treatment is provided. The production will be around 4-5 tons of CPO (crude palm oil) per hectare yearly with additionally another ton of palm kernels. When this output productivity is compared to soybean, rapeseed and sunflower, the output relation per hectare is 1.5-2 times in favor of palm oil – making it very attractive in regard to bio fuel.

Palm oil price

As can be seen from the chart below, the price for CPO was rather stable from 2002-2007, where a speculative price bubble was finally created and burst – as almost all other asset classes in 2008 – and after the burst the price regained a certain momentum and has been volatile on higher levels with an increasing trend. The newly established appétit for bio fuel should support the price – though it is estimated by business insiders to stay volatile.

KO1 Commodity 10Y graph: 16.02.2002-15.02.2012
Source: Bloomberg

Other regions – like South America – have (lately) also established palm oil plantations – and an increasing supply from this region should be expected. There is less significant production in some regions of Africa. But according to forecast by the Malaysian Palm Oil Council, new production sites would be estimated to meet increasing local demands (bio fuel and demographics) rather than taking market shares from Malaysian producers, and probably shouldn't be a danger to the Malaysian and Indonesian business in the medium term.

Where palm oil is used

Besides the increased usage in the production of bio fuel – mainly biodiesel –, palm oil's traditional usage is in food applications; margarines, chocolates, bakery, pasta, ice cream and frying oil – widely used in Asia.

Palm oil has been used for cooking by mankind for over 5'000 years, and its oils and fats are consumed worldwide. See further http://en.wikipedia.org/wiki/Palm_oil

The longer term outlook – bio fuel

Climbing prices of oil and related products have been the catalyst of the worldwide development of the bio fuel industry. Leading areas so far are the European Union and the US.

In the case of the Indonesian and Malaysian palm oil industry, the increased demand for bio fuel creates a whole new level of demand – though some kind of hidden protectionism has been sensed by local producers – but should eventually lead to a stable increasing demand for palm oil and should reduce the risk of prices returning to their much lower levels in the early 2000s – characterized by a steady oversupply and flat prices as showed above.

The investment case

Looking closer into the plantation and palm oil business, it's very clear that a number of plantations grew bigger over time – partly by buying up smaller competitors – now leaving the market with a rather limited number of very big producers. But even they cultivate vast spaces of land, their stocks are partly traded at rather low volumes – and potential investments need to be carried out carefully and diligently.

The efficient plantations have return on capital invested in the vicinity of 18-20%, and are traded at the level of 1.8 times book value. With dividends comfortably beating a government bond in most regions – at around 3 % or more – we believe that it would be worth for long-term, conservative investors to look closer into the opportunities in this area, of course bearing all associated risks in mind (market risks, environmental risks and political risks).

After a very strong run in January for equities – and for palm oil stocks as well – a potential investor has to care about timing as well.

The team at Helvetic Investments would very much appreciate evaluating how a potential investment in the mentioned field might fit into your strategy and portfolio.

Please don’t hesitate to contact us for an in-depth discussion and potential implementation of an investment.

Your Helvetic team/JW