

PLANTATION

Maintain NEGATIVE

Championing Sustainability

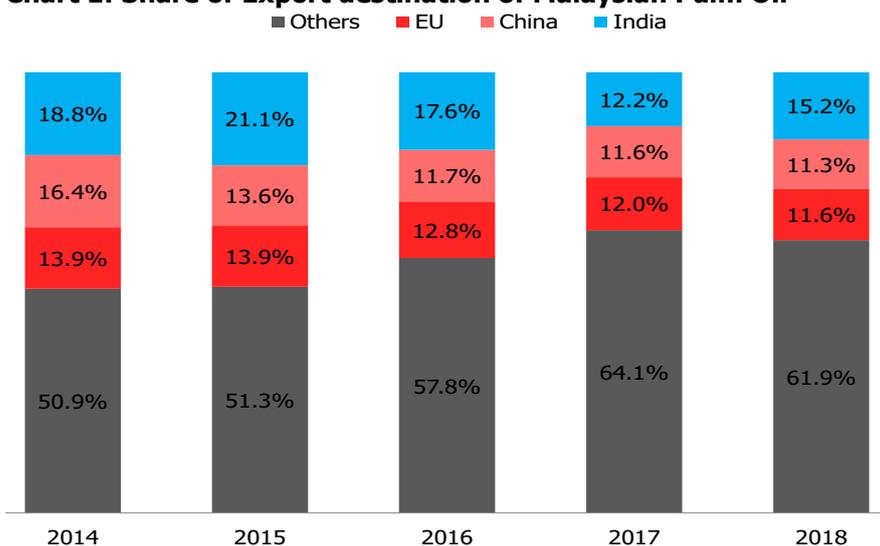
KEY INVESTMENT HIGHLIGHTS

- The phasing out of palm oil-based biodiesel by the European Union presents the palm oil industry a set of sustainability challenges and deepened negative sentiments
- Accelerating the adoption of RSPO and MSPO is the offensive way forward to combat against the negative claims and perception on palm oil
- However, there are a constellation of challenges in achieving 100% MSPO by 2020, including the low up-take of certified sustainable palm oil (CSPO)
- Palm oil producing countries to take matters into their own hands to implement initiatives in the face of the protracted oversupply of palm oil, EU's ban on palm oil biodiesel and low palm oil price
- Maintain NEGATIVE view on the sector with an unchanged CPO price forecast of RM2,090/mt for FY19

THE PALM OIL CONTROVERSY IN THE EU

The trade war on palm oil has begun. On 10 June 2019, the world's second-largest palm oil importer, the European Union (EU), has officially enacted the discriminatory Renewable Energy Directive II (RED II) which defines palm oil as the only crop having "high" indirect land-use change (ILUC) risk when comparing to its peers. That was in spite of all the ongoing sustainability initiatives taken by the palm oil producing countries to ensure its palm oil is sustainably produced. Consequently, the contribution of palm oil as feedstock in EU's biodiesel will be gradually reduced to zero by 2030 (Refer to Chart 3). The analysis from RED II also states that 45.0% of the expansion of palm oil production since 2008 led to destruction of forests, wetlands or peatlands, while it is only 8.0% for soybeans and 1.0% for both sunflowers and rapeseed. However, the result has been repeatedly lambasted by both Malaysia and Indonesia as biased and unfair claims by the EU. The reason being is that oil palm remains the world's most productive vegetable oil crops with yields of 6-10 times more than other rival crops. Post the enactment of RED II, benchmark CPO price fell to the lowest of RM1,951 or -15% decline from January 2019.

Chart 1: Share of Export destination of Malaysian Palm Oil



Source: MPOB, MIDFR

COMPANY IN FOCUS

Ta Ann Holdings Bhd

Maintain **NEUTRAL** | Unchanged Target price: RM2.18
Price @ 18th September 2019: RM2.19

- The group does not have RSPO, ISPO and ISCC certifications, only MSPO
- Palm oil segment continues to be affected by low CPO price
- Partially support from the timber business segment

Share price chart



IJM Plantations Bhd

Maintain **SELL** | Unchanged Target price: RM1.16
Price @ 18th September 2019: RM23.56

- The group views that having MSPO and ISPO certifications are sufficient
- Company's well-being primarily dependent on CPO price
- Elevated cost of production and fertilizer costs to add downward pressure on earnings

Share price chart



ANALYST (S)

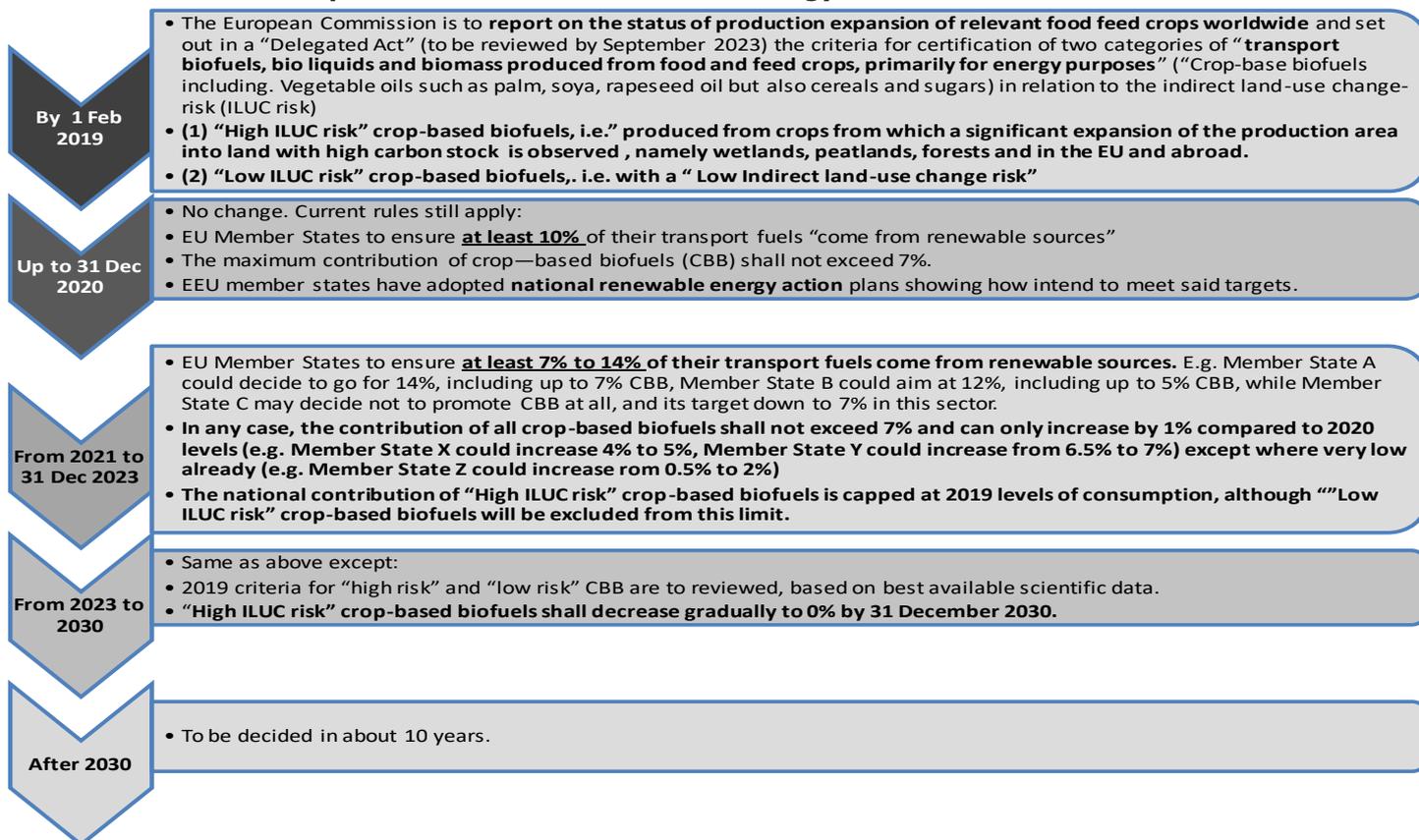
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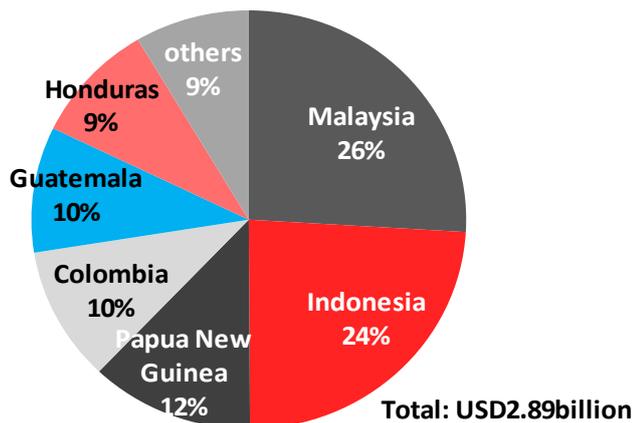
Economics of EU’s palm oil market to Malaysia. The EU remains the second biggest importer for Malaysian palm oil but its share has been on the downtrend from 13.9% in 2014 to 11.6% in 2018 (*refer to Chart 1*) due to the prolonged negative sentiments. In absolute amount, the export to EU has declined by -20.7% to 1.9m mt in 2018 from 2.4m mt in 2014. This illustrates the debilitating effects of the EU’s deepened negative sentiments on palm oil demand from the region. The breakdown of major palm oil importers within the EU and Amsterdam Declaration Partnership (ADP) countries is shown in *Chart 4 and 5*. *Making reference to these charts*, Netherlands has reduced its Malaysian palm oil import by -43.0% over the course of four years. According to International Trade Centre (ITC), Malaysia was the number one supplier to EU’s total palm oil import at 26.0% followed by Indonesia at 24.0% in 2018 in terms of trade value (*Chart 2*). This indicates that EU remains an important palm oil trade partner to Malaysia. Given that EU biofuel producers used about 17-20% of palm oil in 2013-2017, the limit of 7% contribution would no doubt be a detriment to the demand from the EU.

Chart 2: Timeline of European Commission’s Renewable Energy Directive II



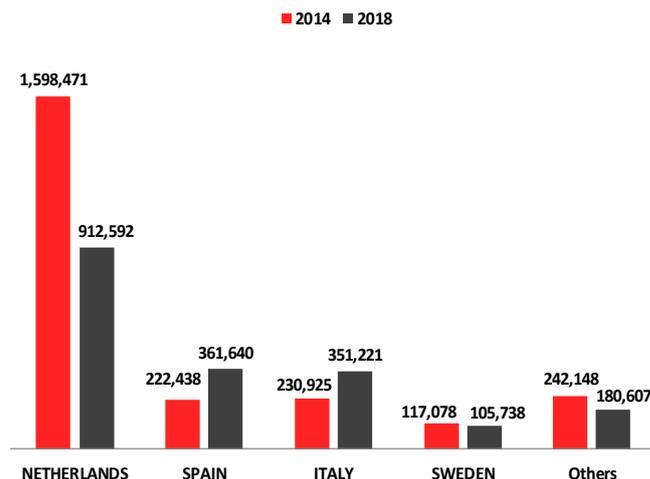
Source: European Union External Action, MIDFR

Chart 3: Share of EU Suppliers of CPO (2018)



Source: ITC Trade Map, MIDFR

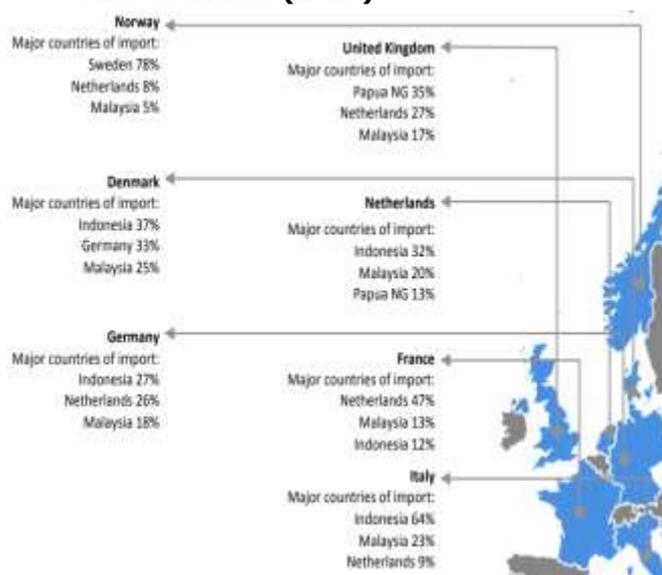
Chart 4: Major EU Importers of Malaysian CPO (mt)



Source: Oil World, MPOB, MIDFR

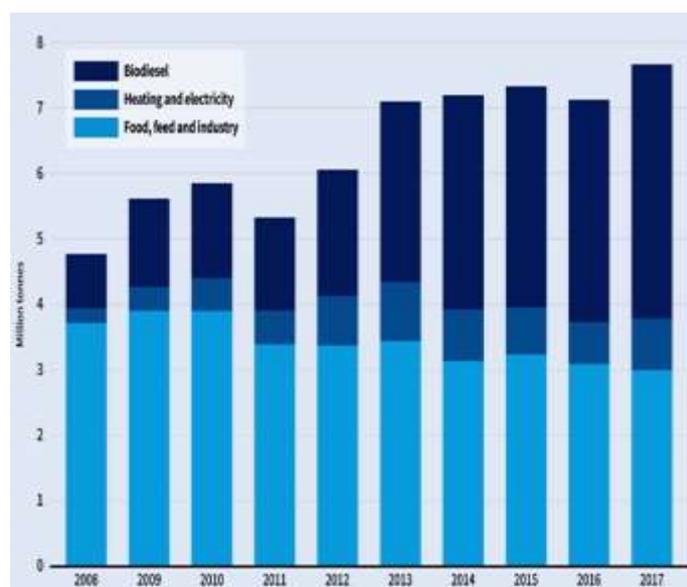
Negative repercussions on long-term demand. Currently, about 800k mt of palm oil was used in the production of biofuel in EU for cars and trucks. This represents 5% of total Malaysian palm oil export or half of the palm oil import to the EU (*refer to Chart 5*). In effect, we should see similar amount of excess in the market should the ban was accounted for. On another note, we are concerned that ban from EU could send negative ripple effects to the palm oil industry. Norway's palm oil import has fallen sharply by -70.0% from 2.6m mt in 2017 to 0.8m mt in 2018 as well as a -25.0% decline in the trade of biofuels in 2018 due to concern of deforestation. Apart from that, the negative sentiments has also extended into the EU's food and household product segments where major UK retailer like Selfridges has made its 300 products to be free of palm oil. In addition, we also do not discount the possibility that major palm oil-importing countries such as India and China would eventually place more emphasis over the sustainability of palm oil. Thus, it is of utmost pressing for the palm oil-producing countries to address the current negative perception of palm oil before it spiraling out of control.

Chart 5: Percentage of major palm oil exporters to ADP countries (2017)



Source: ADP

Chart 6: Uses of Palm Oil In EU



Source: Transportenvironment.org

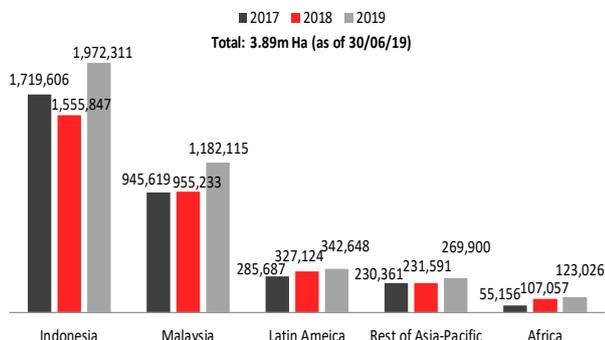
RSPO AS THE FIRST INTERNATIONAL CERTIFICATION STANDARD FOR SUSTAINABLE PALM OIL

The establishment of RSPO to tackle palm oil sustainability issue. International environmentalists have long placed palm oil under scrutiny for its perceived negative environment effects in early 2000s. In response to the conundrum, the Roundtable of Sustainable Palm Oil (RSPO) is formed in year 2004 which is a multi-stakeholder non-profit organization from the 7 sectors of the palm oil industry. Its objective is to promote the production and use of RSPO-certified sustainable palm oil (CSPO) according to its own sets of principles and criteria (*Table 1*). CSPO is referred to palm oil produced by palm oil plantations which have been independently audited and certified against the RSPO standard. RSPO certification has since grown to represent the global standard for sustainable palm oil industry with about 4,100 members in 92 countries including palm oil producers, processors or traders, consumer goods manufacturers, retailers, banks/investors, and environmental and social non-governmental organisations.

Growing importance of RSPO in top palm oil-producing countries. According to RSPO, Malaysia and Indonesia's certified oil palm area jumped to 1.2m ha and 2.0m ha respectively as of 30 June 2019 from 2018 (*refer to Chart 8*). The certification effort is expected to prevent the EU from labelling palm oil as a high ILUC risk crop. Despite this, the effort does not seem to be recognised by the EU. We also gather that Malaysia's 1.2m ha of RSPO's certified oil palm area has produced 4.3m mt of CSPO which constitutes approximately 5.7% of global palm oil volume. To accelerate the adoption, Sabah, which has the second largest oil palm planted area of 1.55m ha as of 2018, has set a goal of achieving 100.0% RSPO certified by 2025. On the demand side, both EU and North America committed to fully source for 100.0% CSPO for their palm oil usage in their continents. Meanwhile, India, China and Indonesia are seeking to source at least 30.0%, 10.0%, and 50.0% of CSPO respectively by 2020. In addition, global companies have started to commit to using 100.0% CSPO in their products or source for brands that carry the RSPO Trademark.

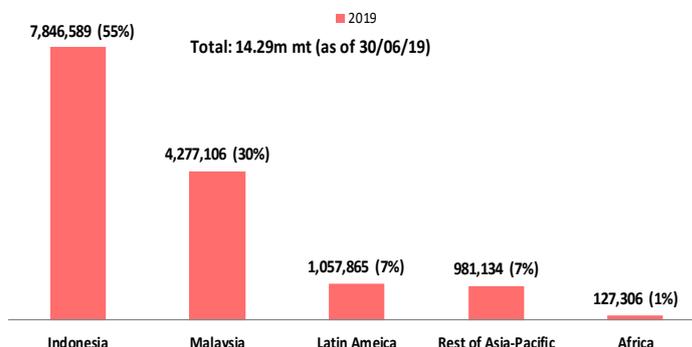
RSPO-RED Scheme. RSPO has engaged with the EU back in year 2012 regard to the RED II legislation. This led to the creation of the RSPO-RED scheme which allows its members to be in compliance with the requirements of RED II. However, the minimal number of certified members under the scheme illustrates the stringent criteria imposed. This could be due to the additional EU's RED II stretched requirements for biofuels on top of the rigorous RSPO's criteria to produce certified sustainable palm oil (CSPO). Despite this, non-members remain committed to prevent deforestation as the number of palm oil companies that take the Zero Deforestation Commitment (ZDC) has increased to 38.0% in 2018 from 7.0% in 2015, according to a survey done by Forest500.org.

Chart 7: Certified Oil Palm Area by RSPO



Source: RSPO, MIDFR

Chart 8: Certified Production Volume of CSPO (MT)



Source: RSPO, MIDFR

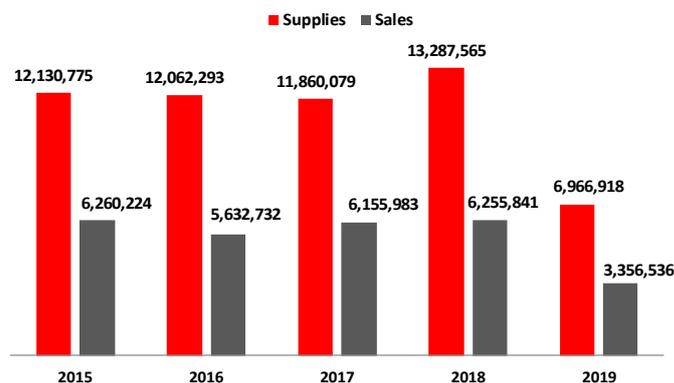
EU-the largest buyer of CSPO. EU is the largest importer of CSPO at this current juncture in view of the Amsterdam Declaration's target of using 100.0% CSPO in the EU by 2020. According to IDH's the Sustainable Trade Initiative report, only about 74.0% of palm oil imported for food into Europe was RSPO-certified. Hence, the target seems to be a stretch goal. At this juncture, Spain, Italy and Denmark are falling behind the goal (refer to *Chart 10*). This might be due to buyers not willing to pay a premium on CSPO of about USD30/mt. Meanwhile, the ban on palm oil usage in biofuel regardless of whether it is CSPO certified might have dampening effects on the sustainability efforts made by the palm oil producers. As such, the EU, being a strong advocate for CSPO, might need to step up and could possibly include CSPO as low ILUC risk crop to be used in its biofuels to ensure an environmentally friendly supply of palm oil could be accelerated.

The emergence of national standards for palm oil sustainability. Initially, the RSPO certification is the only standard for sustainable palm oil and highly regarded by the major palm oil exporters who market their products to the environmentally sensitive countries like the EU. Later on, this set as the guidelines for the establishment of Malaysian Sustainable Palm Oil (MSPO) and Indonesian Sustainable Palm Oil (ISPO) in 2015 and 2011 respectively. The two national standards have also been made mandatory for its domestic palm oil supply chain to ensure they are conforming to higher agricultural standards while RSPO certification remains voluntary. The reasons for the creation of these national standards include: (i) more affordable to smallholders as RSPO certification cost is higher, (ii) ensure domestic palm oil supply chain are sustainably operated and not just for the export market, (iii) promote the national standards to be on par with globally-accepted environmental standards, and (iv) to comply with existing national laws and regulations. We view that national standards are a stepping stone to make palm oil sustainability a prevalent norm in their own country.

Chart 9: Percentage of CSPO uptake by EU members (2017) **Chart 10: Annual Supplies and Sales of CSPO (MT)**



Source: IDH, ESPO



Source: RSPO, MIDFR (2019 as of 30/06/19)

COMPARISON OF THE DIFFERENT CERTIFICATION STANDARDS

Four main standards in the global palm oil market. Making reference to *Table 1*, there are four different types of certifications and its stated principles. While the ICSS certification is mostly for biomass products, its principles are mostly similar to that of the other three certifications. Note that ICSS stands for International Sustainability & Carbon Certification which is another international certification system covering all kinds of bio-based feedstocks and renewables. ICSS is particularly important for biodiesel exporters to facilitate its trades to European Union Renewable Energy market as it is also compliant to the EU's REDII sustainability criteria. For example, companies normally convert RSPO-certified palm oil to biodiesel which later need to be ISCC-certified before it is exported to Europe. Nonetheless, the central theme of the four certifications is premised on championing sustainability issues surrounding the palm oil industry.

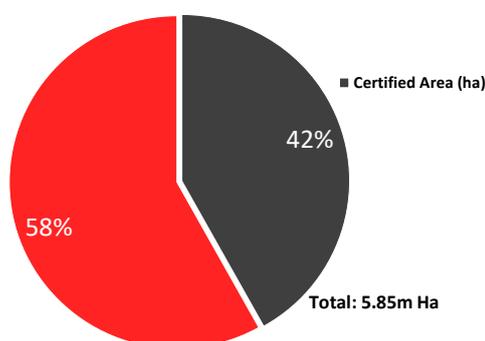
RSPO is more stringent and comprehensive. Based on the studies from Efeca, a consultancy specializing in the field of natural resources management, there are several key distinguishing factors between RSPO, MSPO, ISPO and ISCC. It indicates that some of RSPO's standards are beyond the national laws, making it much more difficult to be conformed to as compared to MSPO/ISPO which is heavily reliant on national legislation. In addition, it also stated that RSPO has a much streamlined and transparent process in its standard development and auditing results as well as more comprehensive Environmental Impact Assessment (EIA) requirements. RSPO certification are said to have more details and guidance on policy matters such as worker rights, compliance, forced labour and environment in upholding the standards of palm oil sustainability. Thus, we presume that companies should be able to easily pass through MSPO and ISPO standards if it were already RSPO-certified (refer to *Table 3*).

Key differentiating criteria. On 15 November 2018, members of RSPO have voted in favour for the complete ban for oil palm planting on peatlands and high carbon stock (HCS) forests as part of the RSPO certification requirements. This resulted in the stark difference between RSPO/ISCC and MSPO/ISPO where planting on peatlands is not allowable for the former and allowable with conditions for the latter. In terms of the cost structure, the cost of audit certification compliance ranges between RM2,500 and RM3,000 for MSPO certification renewal whereas RSPO is more than RM3,000, indicating the high cost incurred for planters with both certification. In addition, there is a commission contribution for the trade of RSPO-certified palm oil of USD1/mt whereas MSPO does not have such commission structure. This further exerts pressure on the already slim premium of USD30/mt on CSPO which has not included the typical production cost of USD18/mt. In a nutshell, attaining RSPO certification normally lies in the hands of larger plantation companies which have the required resources but this begets a challenging task for smallholders. Thus, national standards are in part of a solution to help palm oil smallholders to kick start their sustainability journey.

ACCELERATING THE ADOPTION OF MSPO AND ITS CHALLENGES

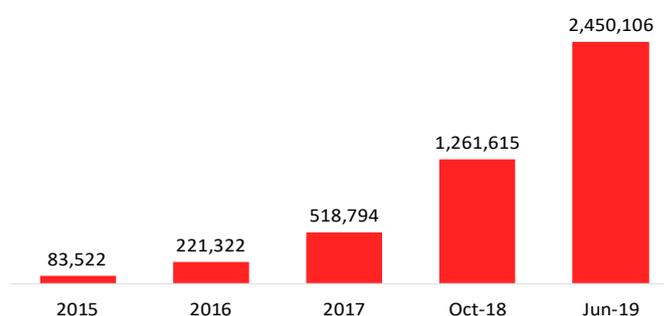
Current MSPO development. The Malaysian government has mandated that all oil palm groups are to be MSPO-certified including those who have obtained RSPO status in the country by the end of 2019. As of June 2019, less than 50.0% of oil palm land area is certified as of 30 June 2019 (*Chart 12*). However, this was a great improvement from 26.0% as at February 2019. Sabah, Sarawak, Johor and Pahang states are major contributors (*Chart 13 and 14*). The MSPO mandate is set to fulfill EU's commitment of consuming 100.0% CSPO by 2020 as well as for the Malaysian government to lobby the EU to recognize MSPO as a low ILUC risk crop. However, we are of the view this pose as a significant challenge because MSPO requirement is generally more lenient.

Chart 11: Total Malaysia Oil Palm Land (30 June 2019)

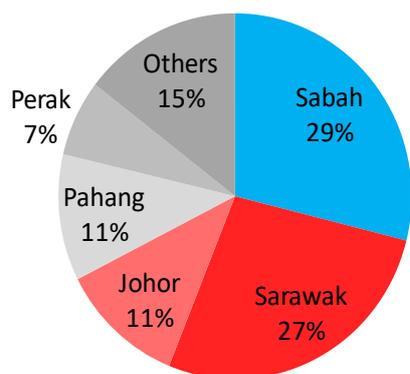


Source: MPOCC, MIDFR

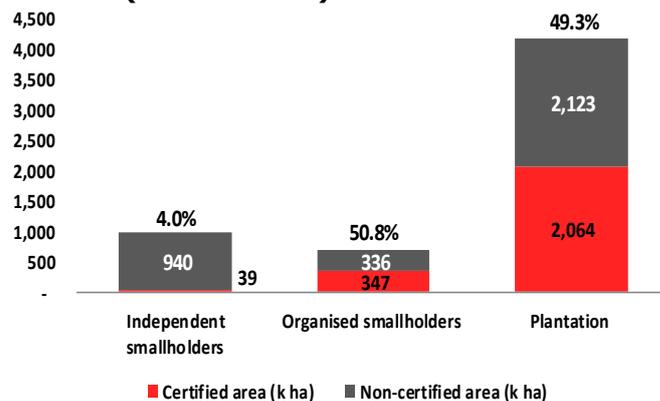
Chart 12: Malaysia Certified Oil Palm Area by MSPO (ha)



Source: MPOCC, MIDFR

Chart 13: Share of Certified Malaysia Oil Palm Land by States (June 2-19)

Source: MPOCC, MIDFR

Chart 14: Malaysia's Oil Palm Area by Group (30 June 2019)

Source: MPOCC, MIDFR

Table 1: Comparison of Different Certification's Principles

No.	RSPO	MSPO	ISPO	ISCC (Biomass)
1	Behave ethically and transparently	Transparency	Licensing system and plantation management	Produced on land with higher biodiversity value or high carbon stock and not from peat land. HCV areas shall be protected.
2	Operate legally and respect rights	Compliance to legal requirements	Technical guidelines for palm oil cultivation and processing	In compliance with all applicable regional and national laws and shall follow relevant international treaties
3	Optimise productivity, efficiency, positive impacts and resilience	Best practices	Sustainable business development	Good management practices shall be implemented
4	Respect community and human rights and deliver benefits	Social responsibility, health, safety and employment conditions	Strengthening community economic activities	Shall not violate human rights labour rights or land rights
5	Protect, conserve and enhance ecosystems and the environment	Environment, natural resources, biodiversity and ecosystem services	Environment management and monitoring	Shall be produced in an environmentally responsible way.
6	Respect workers' rights and conditions	Management commitment and responsibility	Responsibilities for workers	Safe working conditions
7	Support smallholder inclusion	Development of new plantings	Social and community responsibility	N/A

Source: RSPO, MPOCC, ISPO, ISCC, MIDFR

National initiatives to mitigate EU's demand loss. In light of the exemptions from EU's RED II for oil palm smallholders, the Malaysian government has announced a RM500m soft loan fund with low interest rates of 2.0% for the replanting of higher-yielding oil palm crops. The government has also called for smallholders' land to be amalgamated and managed by professional estate managers to produce higher yields. On the external front, the Malaysian Palm Oil Certification Council (MPOCC) has signed a MoU with the China Green Food Development Centre in May 2019 to recognize the MSPO certification and MSPO-certified products. Japan will also source both edible and non-edible products with MSPO, RSPO or ISPO certifications after approval was obtained from the Tokyo 2020 Olympics and Paralympics Games Sustainable Sourcing Code Committee. Apart from raising the international recognition of MSPO, this is expected to further boost the export of Malaysian palm oil to China and Japan. Locally, the government also plans to double the biodiesel mandate to B20 by 2020 to help drive the domestic demand of palm oil. However, the lower number of diesel cars compared to EU may not necessarily accommodate for the higher supply.

Impediments en route to full MSPO. Palm oil producers might be reluctant to obtain MSPO in view of the additional costs and unattractive premium which weigh on their profitability. The negative perception on the business feasibility on MSPO is also stemmed from the fact that half of the CSPO supply is not being taken up even by its own RSPO members, adding greater concern on the proclaimed premium on sustainable palm oil is able to receive (*Chart 11*). MSPO certification is also currently not being widely recognised in the international market where sustainable palm oil is more desirable, further hindering the willingness of getting MSPO-certified among the planters. In addition, there is a lack of general awareness and education among the smallholders on the importance of MSPO certification. The other challenges include time constraints and insufficient experienced personnel to help producers in getting MSPO-certified in a more efficient and correct manner. Thus, the cooperation amongst the government, private sectors and local community is of paramount importance in achieving 100.0% MSPO by 2020.

Table 2: Revision on subsidies on auditing fees and preparation costs

Categories	Prior to 30 June 2019		From 1 July 2019 to 31 December 2019	
	Auditing Fees	Preparation Costs	Auditing Fees	Preparation Costs
Estates 40.46 ha – 1,000 ha	70%	Not Available	100%	50%
Estates > 1,000 ha	30%	Not Available	30%	Not Available
Processing facilities under MSPO Part 4 and SCCS	30%	Not Available	30%	Not Available

Source: MPOCC, MIDFR

Table 3: Certified Plantation Companies under Our Coverage

Company	MSPO (Mandatory by 2019)	RSPO	ISPO (Mandatory by 2022)	ISCC
Genting Plantation	✓	✓	×	✓
IOI Corporation	✓	✓	×	✓
IJM Plantation	✓	×	#	✓
Kuala Lumpur Kepong	✓	✓	#	✓
PPB Group*	✓	✓	✓	✓
Ta Ann Holdings	✓	×	×	×
Sime Darby Plantation	✓	✓	✓	✓
TSH Resources	#	✓	^	✓
FGV Holdings	✓	✓	×	✓

Source: MPOCC, RSPO, MIDFR

* Via its associate company, Wilmar International Limited

By 2019

^ By 2021

A longstanding fight for palm oil sustainability. The palm oil industry has been in the limelight due to various sustainability issues. This includes being labelled as the main cause of rapid deforestation and wildlife extinction, especially from the EU. The negative perception has put palm oil in a less favourable position as compared to the other rival crops despite the fact that palm oil is the most efficient and versatile oil crop. The matter was made worst as EU labels palm oil as a high ILUC risk crop and has earmarked to exclude palm oil as a source for biofuel by 2030. We view that this would have adverse effects on the long-term demand of palm oil, given that environmental sustainability and climate change are now one of the main areas of focus, especially on international arena. This could lead to an oversupply of MSPO-certified palm oil in the market. Being the world's second largest producer of palm oil, Malaysia has been actively dispelling the myth and championing green practices in its palm oil industry through the adoption of RSPO and MSPO. On a positive note, the increasing recognition of RSPO and MSPO amidst a rising class of environmentally-conscious consumers has seen openness among the buyers to willingly pay for the premium attached. In addition, the Council of Palm Oil Producing Countries (CPOPC) which is led by Malaysia and Indonesia will jointly seek a more equitable treatment for palm oil at the World Trade Organisation (WTO) on the EU's ban on palm oil in its biofuel sector. At this juncture, pending further development, we are maintaining our **NEGATIVE** view on the sector with an unchanged CPO price of RM2,090/mt for 2019. 

PEER COMPARISON TABLE

Stock	FYE	Rec.	Price @	Tgt Price	Core EPS (sen)		CORE PE (x)		Net DPS (sen)		Net Dvd Yield (%)	
			18-Sep-19	(RM)	CY19F	CY20F	CY19F	CY20F	CY19F	CY20F	CY19F	CY20F
Genting Plantation	Dec	SELL	10.08	8.40	20.6	30.1	48.9	33.5	10.9	12.1	1.1	1.2
IOI Corporation	Jun	SELL	4.42	3.48	12.6	14.0	35.1	31.7	9.3	11.0	2.1	2.5
IJM Plantation	Mar	SELL	1.52	1.16	3.9	4.5	39.0	33.5	2.0	3.0	1.3	2.0
Kuala Lumpur Kepong	Sep	SELL	23.36	18.78	67.3	75.6	34.7	30.9	45.0	45.0	1.9	1.9
Sime Darby Plantation	Dec	SELL	4.90	4.08	2.1	6.3	233.3	77.8	1.1	3.8	0.2	0.8
PPB Group	Dec	NEUTRAL	18.22	17.43	64.6	72.1	28.2	25.3	19.4	21.6	1.1	1.2
Ta Ann Holdings	Dec	NEUTRAL	2.19	2.18	8.5	18.2	25.7	12.0	10.0	10.0	4.6	4.6
TSH Resources	Dec	NEUTRAL	0.90	0.89	3.6	4.6	24.8	19.5	1.0	1.2	1.1	1.3
FGV Holdings	Dec	NEUTRAL	0.94	0.96	-3.0	-2.1	-30.9	-45.4	N/A	N/A	N/A	N/A

Source: Company, MIDFR

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MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS

STOCK RECOMMENDATIONS

BUY	Total return is expected to be >10% over the next 12 months.
TRADING BUY	Stock price is expected to <i>rise</i> by >10% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -10% and +10% over the next 12 months.
SELL	Total return is expected to be <10% over the next 12 months.
TRADING SELL	Stock price is expected to <i>fall</i> by >10% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.

SECTOR RECOMMENDATIONS

POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.