28 March 2019 | Sector Report

PLANTATION

***Maintain* NEUTRAL**

Export to EU Under Threat

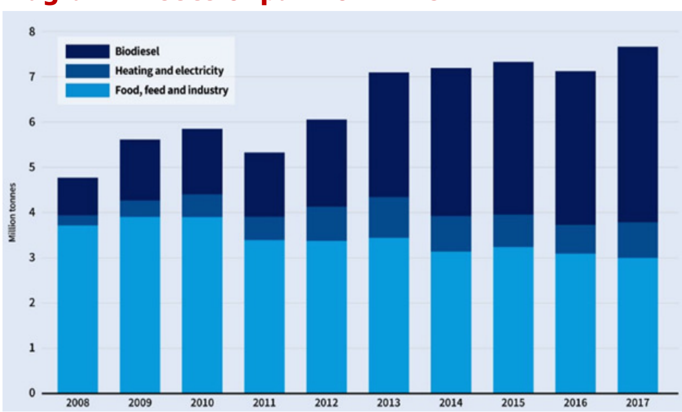
KEY HIGHLIGHTS

- **The Europe Commission seeks to curb and gradually reduce the usage of palm oil-based biofuel in EU, with the goal of zero usage by 2030**
- **Both Indonesia and Malaysia could be at the losing end as EU is the main buyer of CSPO**
- **Progressive biodiesel mandate by Indonesia and Malaysia to improve global consumption of palm oil**
- **Maintain NEUTRAL view on the sector**

Export to the European Union at stake. The European Commission's (EC) draft regulation suggests to capped the usage of palm oil-based biofuels at 2019 levels until 2023 and, subsequently, reduce the usage to zero by 2030. Based on the draft legislation, France will be the first country within the Eurozone to phase out palm oil biofuel in 2020. This indicates that Indonesia and Malaysia, the two top palm oil producing countries, will gradually lose its grips on the European Union (EU) market. Notably, the EC is allowing a number of exceptions. Producers who could show that they had intensified yields may be exempted as it could be argued that the crops cover demand for biofuel without needing expansion onto non-agricultural land. The exemption would indicates that there is possibility that Europe could also keep use the same amount of palm oil in diesel as it does at present. This would suggest that EU's interest in palm oil is still holding up in order to keep up with the rising of biodiesel usage due to its pricing advantage as compared to other competing vegetable oils.

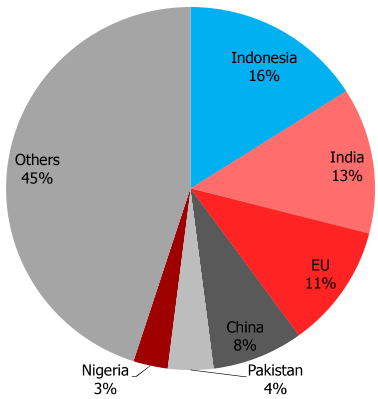
EU is one top export destination. In 2018, the EU market is one of the top the second largest export destination of Malaysian palm oil which constitutes 11.6% of total export. The demand is similar to that of China. However, in recent years China has been importing more soybean, displacing themselves to the third position. More than half of the palm oil in EU was used for biofuel while the remainder was use for food, feed and industry as well as heating and electricity. Globally, EU is the third largest consumer of palm oil, accounting for approximately 11% of total global palm oil consumed. This is after Indonesia (16%) and India (13%). However, we view that the consumption pattern could change should: i) EU implement the ban, ii) Indonesia implement more aggressive biodiesel mandate, and iii) higher export to Africa and Middle East.

Diagram 1: Uses of palm oil in EU



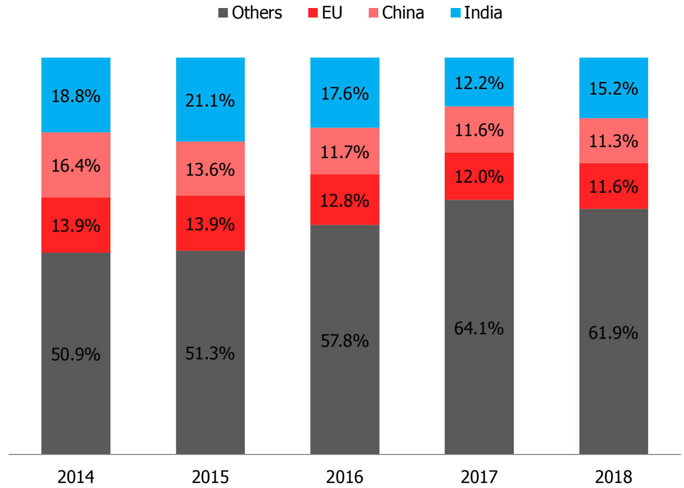
Source: Transport & Environment

Diagram 2: 2018 global palm oil consumption



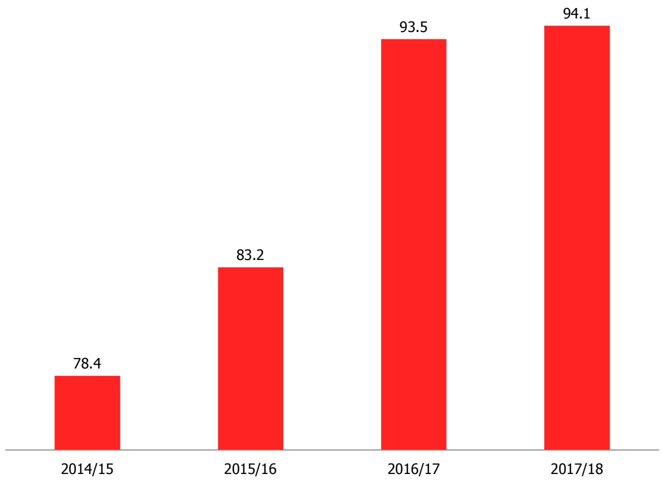
Source: MPOB, MIDFR

Diagram 1: Export destination of Malaysian Palm Oil



Source: MPOB, MIDFR

Diagram 2: China's import of soybean



Source: USDA, MIDFR

Possible impact on lower export demand. Tapering demand from the EU will likely have negative repercussion on palm oil price. However, this could potentially lead to higher demand outside of EU as export of palm oil product will be directed to other potential destination. In addition, lower palm oil price will make the commodity more attractive as compared with other vegetable oils. However, we view that industry players who advocate sustainable production practices could be at the losing end as other export destination may place lower importance on buying Certified Sustainable Palm Oil (CSPO).

Expelling the deforestation myth. The EC concluded that palm oil cultivation is the main cause of deforestation. However, according to studies done, oil palm use the least (circa 7.0%) of harvested area to produce the most oils and fasts (circa 32.0%) in the world due to its high-yielding properties. To put in in perspective, oil palm needs nine times less land as compared to its closest substitute, i.e. soybean, to produce the same quantity of oil. Moreover, cattle farming activity is the main cause of forest and land deforestation. Generally speaking, livestock occupies approximately 83.0% of the total land are used for agriculture as opposed to oil palm which is only about 0.3%.

Responding to the ban. Given that the ban is still at proposal level, Indonesia and Malaysia would have some time to take proactive and/or offensive countermeasure. Indonesia has threatened to launch a challenge at the World Trade Organisation (WTO) against the EU and also encouraged companies and industry associations to combat through legal means. Meanwhile, Malaysia is looking at restricting imports of French products over French plan to remove palm oil from biofuel in 2020. This latter could include sourcing of fighter jet imports from China rather than EU.

Further inroads into Middle East and Africa. To counter the risk of declining demand from Europe, The Primary Industry Minister Teresa Kok has taken initial steps to further deepen its reach in Middle East and Africa. She also acknowledged the need to quickly capture these markets, considering other competing oil products like rapeseed oil have also made entry in several of the countries eyed by Malaysia to compensate the possible loss of demand in Europe. In 2018, export of palm oil to Middle East and Africa regions amounted to 1.7m and 2.8m tonnes respectively. This constitutes 10.4% and 16.7% of total palm oil export.

Progressive biodiesel mandate. The Malaysian Government has begun implementing the biodiesel mandate via the B10 and B7 programmes for the transportation sector and the industrial sector respectively to drive the demand for palm oil and increase the sustainability of energy resources. The B10 programme has commenced in February 2019 while the B7 programme is schedule to be implemented from July 2019 onwards. These programme are expected to double the usage of palm oil to 761k tonnes annually. Furthermore, the Government has also plans to accelerate the biodiesel mandate to B20 by 2020. While we are positive on the development, we view that there is ample room for improvement. Taking cue from Indonesia, it plans to bring forward B30 implemention to 2019 from 2020. On a longer-term horizon, Indonesia will also continue its effort in making B100 a reality in 2022.

Maintain Neutral. EU's proposal on banning palm oil-based biodiesel serves as a dampener in the palm oil industry as it is one of the palm oil consuming markets. Fortunately, based on the draft regulation, total ban on palm oil will not happen immediately and there is exemption to the ban which serves as loophole. This would provide time for Indonesia and Malaysia to react accordingly. This would include creating awareness on the main reason behind deforestation, making further inroad into new and existing market as well as expediting the biodiesel mandate. To be on the offensive, Malaysia is also looking at restricting imports of EU products, especially French products. Pending further development surrounding the EU, we are maintaining our **NEUTRAL** view on the sector.

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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 *rise* 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 *fall* 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.