07 June 2019 | Sector Update

PLANTATION

***Downgrade to* NEGATIVE**
(previously NEUTRAL)

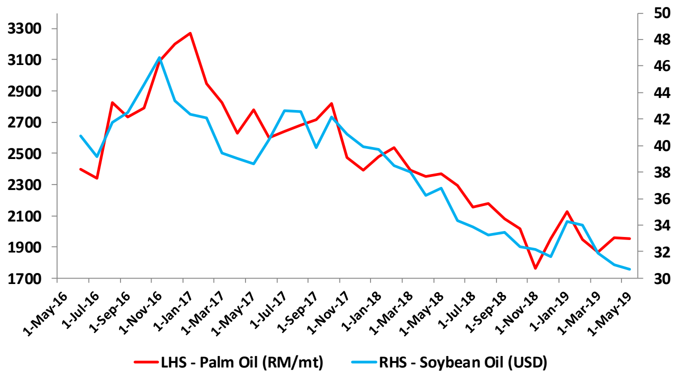
Palm oil industry remains in the trenches

KEY HIGHLIGHTS

- **Weak CPO price environment to persist leading to subdued earnings performance**
- **Growth in production outpace the recovery in export demand, leading to elevated CPO stockpile**
- **Heightened uncertainty of US-China trade dispute, widespread African swine fever and record production of competing oilseeds to be exerting downward pressure on CPO price**
- **EU's upcoming ban on palm-oil based biodiesel and deepened sentiments which extended into the food sector are major concerns to the palm oil industry**
- **Downgrade to NEGATIVE with a revised FY19 CPO target price of RM2,090/mt.**

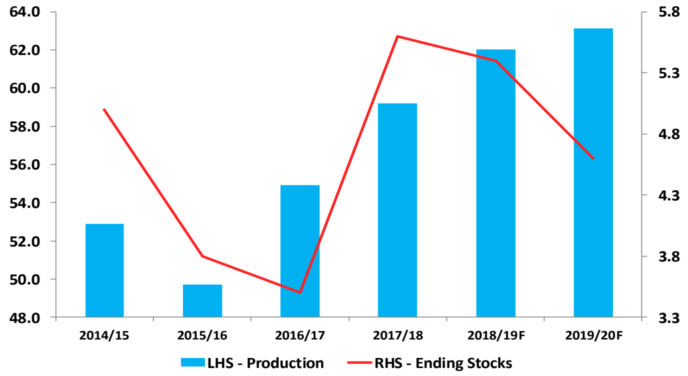
Profitability impacted by sustained weakness in CPO price. Generally, plantation companies under coverage recorded lower earnings mainly due to the weak CPO price. Six out of nine plantation companies under our coverage have performed below expectation in-line with the decline in average CPO Price to RM2,016/mt low (-13.1%yoy). At present, the monthly average CPO price remains subdued, averaging at RM1,954/mt for the month of May 2019 (-17.5%yoy). We believe this was mainly caused by negative ramifications arising from heightened uncertainty of US-China trade dispute, prolonged elevated palm oil stockpiles, tapering demand arising from negative sentiments from EU, record high supply of substitute oilseeds. Moving forward, we opine that the downward pressure on CPO price to be seen throughout 2HCY19. This will lead to depressed earnings performance for plantation companies under coverage, especially those with significant upstream operation.

Chart 1: Price Trend of Palm Oil and Soybean Oil



Source: Bloomberg, MIDFR

Chart 2: Combined Malaysian and Indonesian Palm Oil Stats ('m mt)



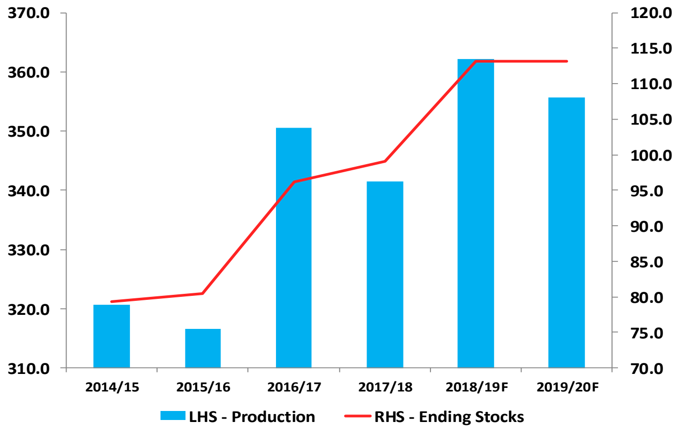
Source: USDA, MIDFR
**October/September Marketing Year*

Production remains in overdrive mode. The production cycle continues to be in overdrive mode, leading to elevated inventory level. Note that as at April 2019 inventory level came in above 2.6m tonnes. On a cumulative basis, we note that 4MCY19 production surged at a faster pace of +8.9%yoy as compared to the recovery in export demand of +5.9%yoy. In addition, the data from the Australia Bureau of Meteorology suggest that the likelihood of a potential production disruption caused by El-Nino in the near term has been easing from the ALERT state (70%) to WATCH state (50%) signalling a lower chance of drought conditions appearing in the region. Meanwhile, according to Oil World, both Malaysia and Indonesia are likely to produce a combined record high CPO output of 61.3m tonnes in CY19 (+4.0%yoy). This will put further pressure on the export front. Moving forward, we view that the oversupply environment is likely to remain and this will likely hinder any possible recovery in CPO price.

Renewed escalation of US-China trade war. The recent announcement by U.S. on its decision to increase the tariff rate from current rate of 10% to 25% on USD200b worth of Chinese goods effective 10th May has further intensified the trade tension between the two of the biggest economies. We view that this will have negative repercussion on the US soybean inventory which is at historic high of 24.5m mt as at April 2019. To recall, historically China is the biggest purchaser of US soybean. The heightened uncertainty of the trade deal has also caused commercial buyers to adopt a 'wait and see' approach. Should the trade war persist, we view that there will be no reprieve in soybean price which will in-turn inhibit the recovery of palm oi price. The soybean price has hit near decade low subsequent to the announcement of upward revision of US tariff rate on China goods.

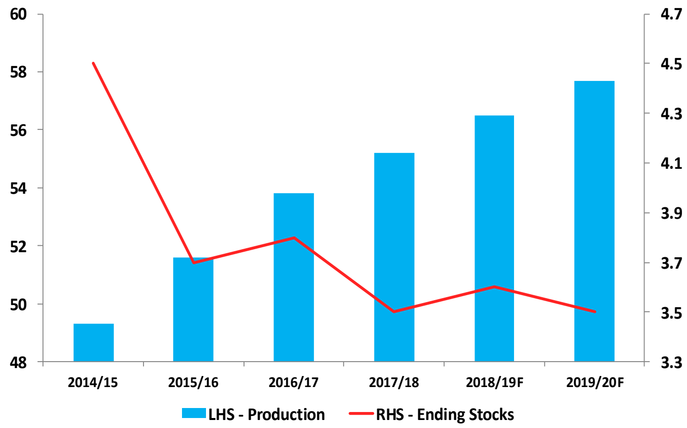
African swine fever virus (ASF) places further dent on the global soybean market. According to China's Ministry of Agriculture and Rural Affairs, China's hog industry has been severely affected by the ASF. The hog population has shrunk by -20% since ASF was first reported in early August 2018. The mass mortality of hog herd is expected to lead to a significant reduction in soybean imports, which serves as a feed meal for the hog. In view of this, the U.S. Department of Agriculture (USDA) is expecting China's soybean demand to reduce by -17.0m tonnes and -22.0m tonnes in 2018/19 and 2019/20 respectively. Conversely, the USDA's data shows that the global production of soybean is expected to reach a new high of 362.1m tonnes, primarily stemming from the US (123.6m), Argentina (56.0m) and Brazil (117.0m).

Chart 3: Global Soybean Stats (m mt)



Source: USDA, MIDFR
**October/September Marketing Year*

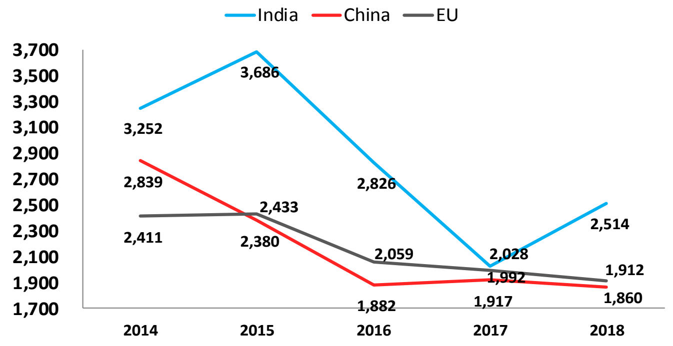
Chart 4: Global Soybean Oil Stats (m mt)



Source: USDA, MIDFR
**October/September Marketing Year*

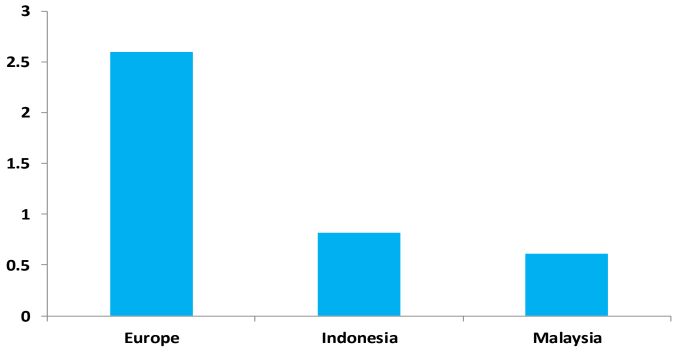
Negative sentiments extend into EU's food sector. The discriminatory Renewable Energy Directorite II (RED II) palm oil ban will commence on the 10th June 2019. We expect negative spill over effects from the ban, especially on the palm oil-based food and household products which made up of approximately 70% of global palm oil usage. France, which consumes the largest amount of biodiesel, is planning to phase out palm oil from its list of biofuels tax break from 2020 onwards. The ban is also supported by major UK supermarket and retailers. For instance, an Iceland supermarket has called for its own-brand products to be free of palm oil. Subsequently, major UK retailer, Selfridges, announced in May 2019 that all of its 300 products in its Selfridges Selection range are now free of palm oil. This will hurt the palm oil industry. To recall, the EU is the second largest trading partner for Malaysia's palm oil. The share of export demand from the region has been on a declining trend to 11.6% in 2018 from 13.9% in 2014. On a year-to-date basis, 4MCY19's palm oil export to EU has tapered further by -4.5%yoy.

Chart 5: Share of Top Three Malaysian Palm Oil Export Market ('thousands)



Source: MPOB, MIDFR

Chart 6: Vehicle Diesel-to-Gasoline Usage Ratio



Source: Bloomberg, MIDFR

Domestic biodiesel mandates is insufficient to offset for the declining demand from the EU. In anticipation of lower demand from EU, both Indonesia and Malaysia are committed to increase its domestic biodiesel mandate to make up for the potential loss from EU demand. Locally, the government is raising the blend levels in the transportation sector to 30% by 3QCY19 and 10% in February 2019 from 20% and 7% respectively. The biodiesel mandate is expected to increase both Indonesia and Malaysia biodiesel output by +2.3m mt and +700k mt respectively. Nonetheless, we view that this is insufficient to offset the potential loss of up to 3.9m mt from the EU. On another note, the lower number of diesel car may not necessary accommodate for the higher supply. Comparatively, the vehicle diesel-to-gasoline usage ratio in EU is 2.6l whereas Malaysia and Indonesia is 0.6l and 0.8l respectively.

Downgrade to NEGATIVE. We do not expect any significant recovery in CPO price in view of the multiple headwinds the industry is facing. The overall weakening palm oil outlook to be primarily coming from sustained downward pricing pressure from record high competing oils and subdued export demand which is unable to significant reduced the stockpiles. Meanwhile, the prolonged US-China trade war and widespread African swine fever lead to high soybean inventory which in-turn depressed the price of soybean. In view of this, CPO price has been pressured to remain at low level to maintain its competitiveness. Meanwhile, we expect production to peak in 3QCY19 , in-line with historical trend. This could potentially reverse the gradual decline in inventory. Note that CPO price normally trended lower in view of the high production. The deepened negative sentiments from the EU is also likely dampened the demand of palm oil. While there are the palm oil purchase intent deals from China, we view that the demand is insufficient to overcome the elevated stockpiles issue. All factors considered, we are downgrading our sector recommendation to **NEGATIVE** (previously NEUTRAL) with a revised CPO target price of RM2,090/mt (previously RM2,280/mt).

Table 1: Peer Comparison

Stock	FYE	Rec.	Price @	Tgt Price (RM)	Core EPS (sen)		CORE PE (x)		Net DPS (sen)		Net Dvd Yield (%)	
			04-Jun-19		FY19F	FY20F	FY19F	FY20F	FY19F	FY20F	FY19F	FY20F
Genting Plantation	Dec	SELL	10.12	8.9	25	31.8	40.5	31.8	13.3	15.9	1.3	1.6
IOI Corporation	Jun	SELL	4.25	3.48	11.6	13.9	36.6	30.6	9	10.5	2.1	2.5
IJM Plantation	Mar	SELL	1.5	1.13	-1.3	5.2	N/A	28.8	2	3	1.3	2.0
Kuala Lumpur Kepong	Sep	SELL	24.58	18.77	62.7	78.2	39.2	31.4	45	45	1.8	1.8
PPB Group	Dec	NEUTRAL	18.74	17.48	70.8	72.4	26.5	25.9	21.2	21.7	1.1	1.2
Ta Ann Holdings	Dec	NEUTRAL	2.4	2.22	15.4	18.6	15.6	12.9	10	10	4.2	4.2
Sime Darby Plantation	Dec	NEUTRAL	4.58	4.5	8.8	13.6	52.0	33.7	4.9	8.2	1.1	1.8
TSH Resources	Dec	NEUTRAL	0.93	0.89	3.63	4.61	25.6	20.2	1	1.2	1.1	1.3
FGV Holdings	Dec	NEUTRAL	1.12	1.26	1.5	2.4	74.7	46.7	N/A	N/A	N/A	N/A

Source: Company, MIDFR

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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.