MARC RATING METHODOLOGY

PALM OIL PRODUCERS

OVERVIEW

Palm oil producers are generally categorised into three different types: upstream, downstream and integrated. Upstream producers are involved in the cultivation of oil palm, production of fresh fruit bunches (FFB) and processing them into crude palm oil (CPO) and palm kernel oil. Downstream players refer to palm oil refiners, palm kernel crushers and manufacturers of palm-based edible products, specialty oils and fats. Integrated players are involved in both upstream and downstream activities. The primary focus of this methodology is on oil palm plantation companies involved in upstream CPO production.

ANALYTICAL FRAMEWORK

MARC's approach to rating oil palm plantation companies considers the macro and strategic factors that will support/inhibit future cash-generating performance as well as available buffers to mitigate the potential effects of cyclical downturns. MARC will consider the issuer's long-term fundamentals given the high initial outlays of plantation companies and the long gestation period before palms bear fruit; an issuer expanding its planted areas will experience negative cash flows in the near term but cash flows will likely turn positive when the palms mature and enter prime production stages. MARC's assessment of the palm oil producer's financial risk, meanwhile considers its level and volatility of profitability, cash flow generation ability in relation to its obligations and financial policies, consistent with the general methodology applied for other non-financial corporate issuers. Therefore, MARC will consider the issuer's short-term performance as well as its longer-term prospects.

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Key rating considerations are:

- Industry risk;
- Business risk;
- Financial risk; and
- Management and other qualitative factors

For an illustration of benchmarks for the abovementioned areas used in our rating considerations, please refer to MARC's Non-Financial Corporates Rating Methodology.

INDUSTRY RISK

Price risk

CPO price volatility is a primary rating consideration of industry risk as palm oil producers are price takers and their cash flow generation is sensitive to market prices. CPO price volatility can stem from supply expectations related to the weather or disease outbreaks, demand factors such as changes in biodiesel mandates, CPO inventory levels and/or the supply-demand dynamics of CPO's main substitutes namely, gasoil and soybean oil. High price levels encourage capital investments which will lead to excess supply and a subsequent downward price cycle. MARC's analysis will focus on the dynamics of these factors which will provide a forward-looking view of the industry. Aside from fundamentals, CPO prices are also subject to speculation and overall market sentiments on commodities and on the other edible oils. For example, the commodity slump which began in late-2014 also caused a slump in CPO prices which registered a nadir of RM1,806/MT in August 2015, the lowest since the Global Financial Crisis. CPO prices that are driven by speculation may not be sustainable and high prices driven by expected future declines in supply may also mean lower prospective revenue for the industry. Given the producers' sensitivity to overall market forces, our assessment will also consider the available mitigating factors that may cushion the effects of declining prices such as availability and strength of financial buffers as well as the issuer's operational efficiencies.

Supply

Supported by productivity improvements and increased planted hectarage, the supply of CPO has been increasing albeit at lower growth rates in recent years. As with most agricultural production, key factors affecting output include diseases and the weather. Depending on their severity, adverse weather conditions such as drought and haze will inhibit pollination and fruiting which will lead to lower yields in the near- and intermediate-term. Meanwhile, diseases can damage trees and fruits. While the resultant reduction in supply could theoretically raise overall CPO prices, supply volatility may result in revenue volatility as the higher prices may not sufficiently compensate for the lower volumes. Within a calendar year, CPO prices tend to rise between December through April which coincides with the low production cycle. Prices tend to decline during peak harvest seasons which usually occur from July through September. MARC's assessment, however, will take into account the average selling price for the prospective year as producers will generally sell as they harvest throughout the year.

Demand

Demand for CPO as an edible oil will continue to rise with the increase in global population and as more uses of the commodity are discovered. In addition, there has been an increasing tendency for producer countries to mandate biodiesel blending to absorb demand and support CPO price levels while simultaneously reducing their reliance on fossil fuels. Notwithstanding these factors, CPO is subject to substitution risk especially from soybean oil as an edible oil and gasoil for biodiesel. In MARC's view, shifts in demand for CPO can be influenced by the price differentials between CPO versus soybean oil and gasoil respectively.

Soybean oil is generally traded at a premium to CPO. A widening of the premium will drive an increase in demand for CPO while a narrowing of the premium will encourage preference for soybean oil. Gasoil on the other hand, may trade at a premium or discount to CPO. Hence in periods when gasoil is more expensive than CPO, both mandatory and discretionary biodiesel blending will become profitable. Conversely when gasoil prices are lower than CPO prices, discretionary biodiesel blending disappears leaving only mandatory blending which is usually subsidised. Depending on how governments fund the subsidies, mandatory blending may even be unsustainable and may lead to a scaling back of these programmes if the gasoil discount becomes too large. For these reasons, MARC will continue to monitor demand as well as price levels of CPO vis-à-vis soybean oil and gasoil prices in our industry risk review.

Cost structure

Each plantation has a different cost structure which is linked to its tree maturity profile, estate management efficiencies and degree of fertilisation. The biggest cost components are fertiliser and labour. Fertiliser prices tend to rise in tandem with CPO prices but are sticky downwards when CPO prices drop. During periods of declining CPO prices, planters tend to respond by cutting back on fertiliser usage to manage profit margins. In terms of labour, the main issues facing local planters are the shortage of fruit harvesters and dependence on foreign labour. Labour costs and labour availability are also a function of government policies on foreign labour. MARC will analyse the plantation's cost relative to output; the most common ratio is average cost per metric tonne (MT) of CPO produced for a given period of time. Overall, MARC recognises that a higher average cost may not necessarily indicate inefficiencies; for instance, there is a lagged effect of higher fertiliser expenditure where higher yields may only be seen in the following year. Hence the average cost in the year that the expenditure is incurred will be high but will decline subsequently. MARC will also observe the trend in this ratio and seek clarifications on any sharp movements.

Regulatory risk

Several oil palm plantation companies have in recent years expanded their land bank and plantation activities beyond Malaysian borders and as a result, are exposed to regulatory and foreign exchange risks in the domiciled countries. Regulatory changes such as minimum local ownerships can create uncertainties while levies, taxes and labour requirements will add to costs and pressure profit margins. Producers are also often subject to scrutiny from various international organisations and trade protection measures for their exports, especially in countries which produce competing oilseeds such as soybean and rapeseed. MARC monitors these regulatory issues and will factor in their effects on the industry.

Environmental concerns

In order to sell to markets in the US and the European Union, producers are required to adhere to industry best practices which include sustainable palm oil production that is environmentally responsible. Producers can obtain certification from organisations such as the Roundtable on Sustainable Palm Oil (RSPO) which will enable them to gain access to these markets, in addition to selling their palm oil at a Certified Sustainable Palm Oil (CSPO) premium. Producers are required to adhere to the principles and criteria stipulated by the RSPO and any violations may lead to a suspension or withdrawal of the certification which prevents them from selling their palm oil as certified. In these instances, producers not only lose market accessibility, they may suffer costly reputational damage. Any changes in the principles and criteria will impact the industry as a whole. CPO producers also remain under the scrutiny of environmental groups which may trigger boycotts on palm oil products. Downstream producers such as palm oil refiners may also require environmental standards to be adhered to. An example could be refiners not accepting CPO produced from plantations on peatlands. Importing countries may start imposing taxes on CPO that do not meet sustainable planting criteria. Environmental concerns and issues will continue to evolve and MARC will monitor the developments and their impact on the industry as well as individual issuers where applicable.

Capital intensity

Commercial oil palm plantations are capital-intensive. Initial outlays comprise land acquisition, building infrastructure which include roads leading to the plantations, living quarters for workers and often schools for their children as well as associated plants and machinery. Planting endeavours also drain cash, given the incubation period of about 30 months before the new palms bear fruit while additional capex for land clearing, seedlings and fertilisers are invested. MARC will consider the overall outlays needed for producers as they expand either through acquisitions of additional land bank or brownfield plantations, and new planting or replanting to replace older trees. Ideally, a company should balance its cash flow generation and credit metrics with its expansion activities. Expansions/capex requirements funded from internally generated funds/equity will be viewed favourably while expansion/capex requirements that are mostly debt funded will exert downward rating pressure especially if it is stacked on already high gearing.

BUSINESS RISK ANALYSIS

To assess business risks, the following key sub-factors at the issuer level are examined:

- Scale;
- Maturity profile of palm trees and land bank;
- Production and yield;
- Oil extraction rate;
- Estate management; and
- Diversification into downstream palm products.

Scale

Scale refers to the relative size of mature hectarage, planted hectarage by country and annual FFB output. Larger and more established palm producers have higher planted hectarage which translates to competitive advantages in market access. Additionally, geographic diversification helps mitigate weather-related event risks and unfavourable changes in regulatory regimes. Scale would also translate to lower average fixed costs such as in areas pertaining to application and meeting the criteria for certification with the RSPO.

Maturity profile of palm trees and land bank

Oil palms have an economic life cycle of about 25 years; fruiting usually starts around 30 months and reaches prime production age at between eight years and 18 years. Palms will start ageing after that and are regarded as old at around 25 years during which plantation companies will start replanting as FFB yields decline. Harvesting also gets more costly on average as the trees grow taller. The desired maturity profile for plantations is one which has a higher percentage of young and prime age trees. A favourable tree maturity profile (average age of less than 10 years) will likely translate into lower per unit cost of production and hence higher profitability as well as cash flows. MARC analyses the maturity profile to make an assessment of the issuer’s production capacity as well as prospective performance and replanting strategy. A tree maturity profile of above 18 years will potentially require replanting allocations in the near term. MARC will also take into consideration the size of the unplanted land bank to assess the issuer’s growth prospects as well as capex requirements for tree planting.

Production and yield

To ascertain the productivity of oil palm plantations, MARC uses the average FFB yield of an issuer and benchmarks it against other plantation companies as well as industry averages reported by the Malaysian Palm Oil Board (MPOB). The main reasons for different yields among planters are varying estate management practices, age profile of trees where a higher proportion of trees in prime age (eight to 18 years) tend to produce higher yields than those outside this age bracket, quality seedlings, fertilisation, loose fruit collection and weather conditions. MARC will analyse any material variations from industry averages to identify their cause(s) and to further ascertain whether they are transitory (such as drier conditions compared to other locations in a particular year) or if they indicate more permanent trends in productivity levels. In general, an issuer with FFB yields that are substantially above the industry's average has considerable competitive strength while an issuer with FFB yields below the industry's average is in a weak competitive position.

Oil extraction rate (OER)

OER is the percentage of oil that can be recovered from processed FFB. The OER is an important tool in assessing the performance of the issuer's mill and plantations as a higher extraction rate contributes to profitability and provides an indication of tree quality, mill efficiency and estate management practices. As with FFB yield, the OER is benchmarked against industry and peer averages. OER rates that are higher than the industry average, especially those published by MPOB are considered favourable and positive in assessing the issuer's competitiveness. Notwithstanding the industry benchmark, MARC takes into consideration other qualitative factors such as management practices, adherence to optimum fruit ripeness, fruit quality and supervision of the harvesting process. Other factors include, but are not limited to, proper maintenance of processing machinery, climate, seasonal and geographical disparity.

Estate management

Estate management involves day-to-day decisions on how to efficiently operate and maintain the plantations to ensure the highest possible productivity, yield and OER. Good estate management practices include complying with agreed fertilisation and weeding programmes, maintenance of transport infrastructure, speedy transportation of FFB to processing mills, security of estate perimeters, labour supervision and sourcing, harvesting practices and the rate of mechanisation. These assessments are not as straightforward but will be reflected in other quantitative factors such as OER and FFB yields as well as average production cost. For a proper evaluation, MARC would normally request for a site/plant visit to verify the practices adopted at the estates. MARC will also consider the issuer's adherence to industry best practices and potential cost of any violations where applicable. Estates that meet the criteria for and have obtained CSPO certification will have access to more markets and enjoy a pricing premium. A CSPO certification is viewed as credit positive vis-a-vis an uncertified palm oil producer.

Diversification into downstream activities

Palm oil producers with downstream activities may be able to weather volatilities in CPO prices which can affect the cyclical revenue and profit margins of upstream operations. These activities, if well managed, will cushion peaks and troughs in cashflows caused by weather conditions or unexpected competition from substitutes. MARC therefore will consider additional support for overall profitability and cashflows from downstream activities in our assessment.

FINANCIAL RISK ANALYSIS

Key rating considerations include factors that support current and prospective cash flow from operations (CFO) and free cash flows (FCF). Ideally, higher industry and/or business risks should be buffered by stronger debt protection metrics, liquidity and prudent capitalisation. MARC's financial risk assessment incorporates the following analysis:

- Profitability;
- Cash flow protection/debt servicing capability; and
- Capital structure and financial flexibility

Profitability

Measures of profitability used by MARC are the operating profit margin, operating profit before interest and taxes (OPBIT) and operating profit before interest, taxes and depreciation (OPBITDA). MARC's evaluation involves analysing the trend relative to the issuer's cost efficiencies, productivity as well as industry-wide factors. A peer comparison based on publicly available information is also used to gauge a firm's competitive strengths and operating efficiency. The issuer's profitability will also form the basis for an assessment of the credibility of its assumption of future profitability. Profitability is also viewed in relation to the issuer's debt obligations, as aggressive debt financing will adversely affect prospective earnings due to higher financing costs. The OPBIT interest coverage (number of times OPBIT covers gross interest) is used to draw distinctions on whether profitability is attributable to its operational efficiencies or capital structure.

Cash flow protection/debt servicing capability

MARC will assess cash flows from the issuer's ongoing operations to get an indication of the internally generated funds available for expansion, dividends as well as debt servicing. While CFO should be positive in the long run, negative CFO will be viewed within the context of the macro environment; weather anomalies may bring about poor harvests in a given year, or, as price-takers, revenue and hence, profitability and CFO are subject to price cyclicality of the commodity. MARC will also assess potential recurrences, for example, negative CFO may be due to timing issues with regards to working capital requirement and will be reversed in the following reporting period. MARC's analysis of the issuer's debt servicing capabilities includes looking at the CFO interest coverage and CFO debt coverage ratios for a gauge on debt protection. Given that these ratios indicate the availability of funds to honour upcoming debt obligations and flexibility in changing a company's debt structure through early debt repayments, higher ratios will be viewed positively while lower ratios indicate poor debt service capability.

Another indicator of cash flow protection is FCF which comprises CFO after deducting net capex and dividend. Companies with high replanting and/or new planting commitments will need cash and unless they can generate sufficient CFO, these companies will have persistent negative FCF due to the gestation period between planting and fruiting by the new palms. Ideally, issuers should have a good balance of young and mature palms for cash flow generation as well as an unplanted land bank if they aspire to have future expansion. It is very important that plantation companies balance their expansion requirements with their cash flow generation and credit capacity. Persistent FCF deficits funded by borrowings will weigh on the company's credit metrics and may exert rating pressure to the down side. Dividend payouts above industry norms may be a source of concern, especially if they widen the FCF deficit.

For liquidity, issuers will experience cyclical as well as seasonal flows with a temporary build-up of cash balances during periods of economic expansions and peak seasons, and vice versa. Important information can be compiled from 'turnover' ratios for inventory, receivables and trade payables. These turnover ratios can be used to gauge the issuer's ability to convert working capital to cash. MARC will also consider the cash reserves and avenues available to raise cash in the short term to meet payment obligations in our assessment of the issuer's liquidity position.

Capital structure and financial flexibility

Plantation companies, particularly those in the midst of expansion either of land bank or planted hectarage, will typically rely on medium- to long-term borrowings. Working capital requirements are usually met by trade facilities and short-term borrowings. MARC will examine the balance sheet structure for asset-liability matching; any mismatch can be costly and may pose refinancing risks. MARC's approach to rating the capital structure incorporates an assessment of the credit buffers available to meet commitments to repay debtholders. A high debt-to-equity (DE) ratio will restrict the issuer's borrowing capacity and financial flexibility. While an issuer may have unutilised bank lines, most banking facilities have covenants which if breached, will release said banks from any obligation to lend. MARC will also weigh other avenues available for the issuer to raise cash. These would include an assessment of accessibility to capital markets, affiliations with other entities within the group, likely proceeds from disposal of assets and/or availability of unencumbered assets as security to obtain additional borrowings.

MANAGEMENT AND OTHER QUALITATIVE FACTORS ANALYSIS

Management is evaluated for its role in determining the operational success and risk tolerance level of the issuer. This includes understanding their key business decisions and strategic directions, manner of implementation and monitoring the issuer's initiatives, performance tracking, corporate governance, succession planning and financial management. An issuer's business goals and financial policies should be clear, consistently pursued and realistic, taking into account the surrounding risk elements and macro-economic conditions. This would then translate into an assessment of the credibility, track record and experience of the management team.

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