

**R.E.A. Holdings** **485p**  
**Further Upgrade. EPS to More Than Double In Two Years.**

7 July 2010

**Share Price: 485p**



Shares in R.E.A. Holdings have risen by 18% since our last research note and Upgrade in January, considerably outperforming a very dismal looking stock market. The full year results and the Annual Report were encouraging bearing in mind the lower average prices obtainable, and the current year will almost certainly see a larger crop, a higher average palm oil price, and the first contribution from the new open pit coal mining interests. We look for a 75% increase in EPS in the current year, and expect rapid growth in profits, eps and dividends for every year between now and 2014, when, unless new planting permits are received, the growth rate will moderate.

**Key points are:**

- Profits and eps have the potential to more than double during the next two years.
- Even 2009, with its lower underlying profits, saw strong cash flow and the company covering its capital costs with its cash flow for the first time in this expansion cycle. Dividends will rise faster than profits.
- Environmental and ethical concerns have moved to the forefront of the agenda. The company aims to have RSPO accreditation on its estates by end-2011.
- The diversification into opencast coal production is for the first time starting to appear viable, rather than a distraction for management. It could have important medium term implications.
- The opening of a Singapore office is likely to be strategically critical for the group.

This company is trading on a p/e ratio two years forward that is in low single figures and is some way below that of its peers. For income funds, the cumulative preference shares yield 8% and are likely to be increasingly used by the company as a source of additional capital in future.

Agricultural investments need to be considered as a core holding by all professional investment managers. Within agriculture, palm oil is the most productive of all vegetable oil crops. R.E.A. Holdings, as very good value compared to the peer group, deserves serious consideration by investors.

**12m High:** 534p

**12m Low:** 346p

**Market Cap:** £161m

**Shares in Issue:** 33.3m ordinary, fully diluted

Also 16.4m 9% Cumulative Preference Shares

**NAV/Share:** UK£3.12p

**Gearing:** 51% with pref as equity

**Interest Cover:** 6X

**EPIC Code:** Ordinary shares - RE.

Preference shares – RE.B.L.

**Sector:** Food Producers and Processors

**Market:** London Main List

**Broker:** Mirabaud Securities  
 +44 (0)20 7321 2508 Jonathan Colville

**PR:** -

**Website:** [www.rea.co.uk](http://www.rea.co.uk)

**Description:** REA is engaged in the operation and further development of a single site palm oil plantation in East Kalimantan, Indonesia. More recently it has acquired rights in respect of two small coal mining concessions, also in East Kalimantan.

**Analyst:** Roger Hardman (Sonia Kaur is on leave)

**Tel:** +44 (0)20 7929 3565

**Email:** [roger@hardmanandco.com](mailto:roger@hardmanandco.com)

Y/E	Crops	Group Sales	Declared Profit	Adjusted Profit	Adjusted EPS	Adjusted EPS	P/E	Divi	Yield
Dec	tonnes	US\$m	US\$m	US\$m	USc	UKp		UKp.	%
2008A	450,906	79.6	36.3	39.0	86.1	46.8	10.3	3.00	0.6
2009A	490,000	78.9	41.7	31.9	55.3	35.4	13.7	4.00	0.8
2010E	561,000	107.7	54.0	49.0	92.8	61.9	7.8	6.00	1.2
2011E	679,000	136.3	67.3	62.3	114.4	76.3	6.4	9.0	1.8

## R.E.A. Holdings – Background

R.E.A. Holdings is one of the larger and more efficient palm oil producers with a London share quote. It has full title to 52,000 ha of agricultural land in East Kalimantan, Indonesia. A further 43,000 ha are subject to title and an additional 20,000 ha of land has in the past been allocated to R.E.A. but the allocation has since expired. This gives a total existing and potential land area of 115,000 ha. Of this land, 18,736 ha was planted out and 'mature' by end-2009 – in other words contributing some crop during the financial year. A further 3,333 ha of earlier plantings are starting to yield palm oil for the 2010 financial year, and in all 30,990 ha are viewed by the company as being either planted out or under development.

**One of the  
more  
efficient  
producers**

The company plans to plant a further 8,000 ha over the coming two years. This planting programme is partly dependent upon 'permits additional to those that have already been obtained'. Even allowing for some uncertainty over the additional permits, the company is in a significant growth phase. As oil palms only start cropping in their third year and do not reach peak productivity until seven years have passed, there is a very significant increase in output ahead of R.E.A. Holdings.

Environmental issues are a major factor in palm oil plantation operation and development. Indonesia, as a nation, has been subject to some criticism in this respect. R.E.A. Holdings is a member of RSPO, the Roundtable on Sustainable Palm Oil, and has applied for Round Table On Sustainable Palm Oil accreditation, hopefully to be followed by certification during 2011.

R.E.A. Holdings also has 7,500 ha of land in three separate holdings, each with the potential for open pit coal mining. The permitting issues here are complex, because the new Indonesian mining law allowing foreign control of mining companies only came into force in December 2008 and many of the new regulations necessary for the operation of this law have yet to be published. These concessions are currently held by third parties that are being financed by R.E.A. Holdings. It is envisaged that 80% ownership will pass to R.E.A. Holdings upon clarification of this law. In the meantime R.E.A. is receiving payments broadly equivalent to that which would be earned on 80% ownership.

One of the coal holdings began producing coal earlier this year. A second will be brought into production before the current year-end and the third will not be developed until a strong cash flow is being obtained from the first two units.

**Gearing is  
51% and has  
fallen over  
the past year**

R.E.A. Holdings has UK£16.4m of preference shares in issue. It has signalled its intention to issue more preference capital if there is an appetite. Gearing is currently 51%, if the preference shares are considered equity, and has fallen over the last financial year.

## The 2009 Results

2009 financial results showed a profit for the year, net of biological asset gains and losses and associated deferred tax, of US\$31.9m, compared to US\$39.0m in the previous year. This reduction in profit was at first sight disappointing, but needs to be viewed in relation to a fall in the price of palm oil from the speculative peaks reached pre-crash in the 2007 asset bubble. The size of the profit decline was accentuated by a US\$2.1m movement in currency changes, plus US\$0.8m of increased pension liability dating back to 2008 that was put through the p & l account.

Earnings per share, net of biological asset adjustment movements and their associated deferred tax charge, were US\$55cc, vs US\$86c. This was equivalent, at average exchange rates for each year, to 35.4p vs the previous year's 46.8p. The 2009 figure was, obviously, somewhat assisted by a low Sterling exchange rate against the US Dollar.

Ordinary share dividends of 4p/share were paid, an increase on the previous year's 3p. Net interest cover on the debt was 6X.

**Palm Oil**

The price of palm oil has almost doubled over the last five years, but the last five months have been uninspiring, with the spot price in Rotterdam off by about 8%. The history of palm oil pricing, however, is cyclical, as the graph below shows.

Supply is driven as follows:

Supply rises in response to new plantings. Farmers (and plantation companies) plant new trees overwhelmingly because prices have been rising short term. The new trees then take four years (from planting the seedlings in the nursery) to first fruit, then a further three years to reach maximum (or near maximum) production. Other factors in new plantings include freedom from legal/foreign ownership constraints, cessation of civil wars or unrest, and the level of any export duties imposed by a particular country.

Supply falls, in a very broad sense, when the new supply from over-enthusiastic planting of new trees has driven the price of palm oil down. In practical terms, however, supply increases are rarely that straightforward. This is an agricultural commodity; weather patterns, in particularly drought, can seriously affect yields. A drop in prices will force some farmers to cut back on fertiliser application, which can affect crop yields for several years subsequently. A shift of hectares from managed plantation to indigenous farming, as is happening in some Far East countries at present, can reduce yields because, with the best intentions in the world, a section of plantation operated by locals rarely matches the yields on professionally managed land.

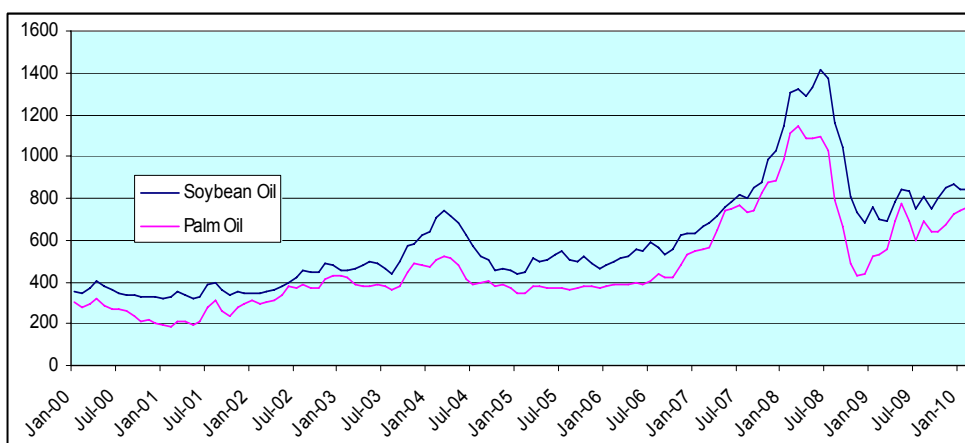
Demand is driven as follows:

- Demand rises as standards of living in Asia rise. Domestic demand in Indonesia and other producing countries, plus imports into India and China, form a firm and steadily rising bedrock of demand.
- Demand from food manufacturers in the Western world fluctuates according to the price of soybean oil, its nearest equivalent. Palm oil is often used as a cheaper replacement for soybean and rape when these prices spike.
- Demand is affected by the needs of the biodiesel market. This has also been rising consistently over the past three years.

**The Palm Oil price has doubled in the past five years**

**Domestic, Indian and Chinese requirements form a firm bedrock of demand**

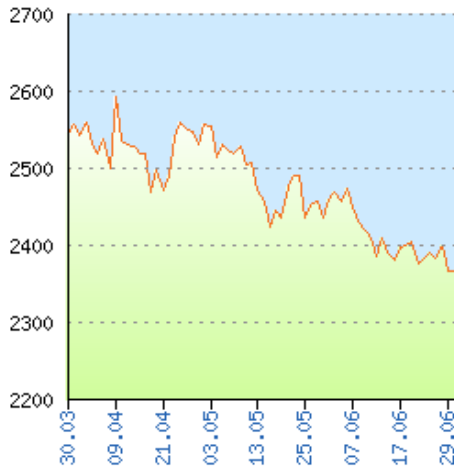
**Palm Oil Price Trends – The Ten Year Record**



(Source: palmoil.com)

The chart shows a cyclical element in palm oil prices that repeats approximately every four years. This may be a coincidence, but it is the time taken for a newly planted oil palm seedling to grow to the size where it begins producing significant quantities of oil. Note that palm oil always tracks, but at a slightly lower price, the performance of soybean oil.

**3 Month Far East Palm Oil Prices, in Malaysian RM**



*The past three months have seen a gentle but steady decline in the price of palm oil, both in Malaysia and in Rotterdam. The price change is not significant to any manufacturer, and is still well above the costs of production of even an inefficient producer. Local economists expect the supply of palm oil to increase over the next two years. Demand is also expected to increase.*

(Source: Palmoil.com)

**Impact by Country**

R.E.A. Holdings is a 'one country' operator. 100% of its plantations are in Indonesia.

The world's largest palm oil exporter is Malaysia. It is the home of half a dozen large palm oil producers that are quoted on the Malaysian stock exchange. It is stable and politically advanced. Land titling issues and disputes with local residents are relatively rare. However it has high costs of development and production relative to other countries. Also, there is little land remaining to develop and the land that does become available is usually expensive. A number of producers, including the London quoted M P Evans and the Kuala Lumpur quoted IOI Holdings, have been switching development from Malaysia to other countries.

**All the company's plantations are in Indonesia**

Indonesia is cheap, both in terms of land purchase and development, but obtaining title to land is not always straightforward and there can be problems with local residents. It is probably fair to say that politically it is less 'westernised' than Malaysia, and plantation operators need to be sensitive to this. There is an export tax, imposed in order to protect local users, but it operates to a published and very transparent sliding scale, and because production costs in Indonesia are relatively low, in practice does not impose a handicap upon companies producing for the export markets.

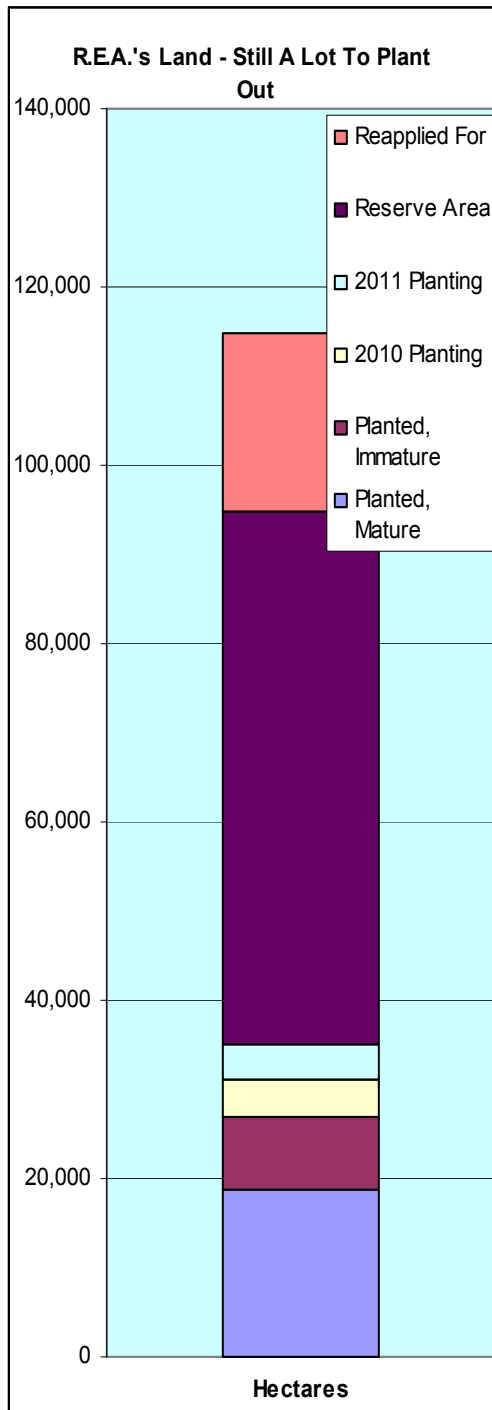
Liberia in West Africa, Guyana in South America and Papua New Guinea in Asia are new upcoming producers. All have low production costs, low land costs and abundant rainfall. They are likely to become more important, although in volume terms Malaysia and Indonesia will still dominate.

**R.E.A. Holdings – Palm Oil Interests**

During 2009, R.E.A. Holdings farmed 18,736 Ha of mature oil palm, with a further 12,254 Ha of palms that were either immature or under development. The total area theoretically available to the company is 114,818 Ha, but most of this is unpermitted at present and also includes land that will need to be set aside as conservation areas.

**Last year R.E.A. was selling forward**

The producing land yielded 490,178 tonnes of fresh fruit, which in turn yielded 118,357 tonnes of oil and 23,740 tonnes of palm kernel. Further tonnages were obtained from smallholders, but this crop was not grown on R.E.A. land. The price obtained per tonne for the palm oil was US\$591, vs US\$664/tonne in the previous year. This was below the ruling market price because for part of the year R.E.A. was selling forward its output into a rising market. The average market price ruling in Rotterdam after adjusting for shipping costs, was c. US\$675/tonne.



*When palms that are currently immature, and the 2010 planting, come on stream, R.E.A.'s income producing land area will increase by 65%. The 2011 planned area is dependent upon receipt of an IPK approval. Theoretically R.E.A. could increase its planted area sixfold, but this is highly unlikely. The 'Reserve' area includes land to be set aside for conservation.*

Costs of production were US\$238/tonne. This indicates the hugely productive nature of the firm's plantations, and the very considerable cushion it has should the palm oil price defy the consensus of informed opinion and head into a serious price drop.

Yields per mature hectare were down, for the second year running. Management puts this down to three factors:

- A significant area of new plantings coming to maturity – tree yields increase considerably from year 4, when they are considered mature, to year 7, when their yield reaches a plateau.
- Some of the trees entering a short 'rest' cycle during the year. Management attaches no significance to this, neither do we.
- Weather.

The oil extraction rate returned to 23.5% after the previous year's modest dip to 23.1%. This was still slightly below management's target of 24%, but is high historically. The kernel extraction rate increased for the third consecutive year and is now at its highest ever.

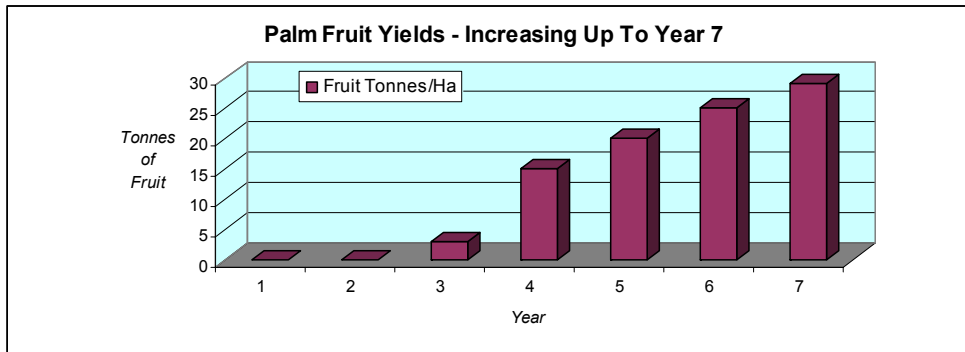
In the current year, for the five months to end-May 2010 the crop was 8% higher. We view this figure as mildly disappointing given the extra hectares of land coming into production this year, and so does the management. Management believes this is because of normal fluctuations and still expects a full year crop of 561,000 tonnes, a 14% increase.

Oil yields have averaged 24.5% over the first five months, the best ever for the company and suggests that a record yield should be seen during the full year. Kernel yields were very slightly down but measures have been taken to improve them to new record levels.

Palm oil prices have been higher than twelve months ago (although they have been gently easing back since February). Prices are US\$199/tonne higher than a year ago. During the first five months of the current year (January-May 2010) prices obtained averaged US\$810/tonne. This is well up on last year's average of US\$580/tonne. Prices for the remaining

**The low costs of production are a very considerable cushion**

**Yields over the first five months of 2010 have been the best ever**



*It takes three years after planting before an oil palm tree is capable of yielding any fruit at all. Year 4, with production of c. 15 tonnes of fruit per hectare, is the first year when a tree can be classed as 'mature'. Even then, the crop will continue increasing, and between year 4 and year 7 will almost double, to 28 – 29 tonnes of fruit per hectare. Each tonne of fruit will yield c. 24% palm oil, plus the kernel.*

months are likely to be lower, but should at least average out at US\$700/tonne CIF, net to the company, for the full twelve months. Palm Oil plantation operation is largely a fixed cost business, this will be very good news for current year profits. Just on the crop harvested and sold until the end of May these numbers suggest that the group may have booked an additional US\$10-12m in revenue over the period.

**The group may have booked an additional US\$10m of revenue**

## Oil Palm Expansion – The Planting Schedule

R.E.A. Holdings intends to plant 4,000 Ha of new palms in each of the two years 2010 and 2011. This is a higher rate of planting than in any year since 2006, and is a formidable farming operation. 4,000 Ha of palm oil will, when mature and at current prices and the yields already being achieved by R.E.A., yield ~100,000 tonnes of fruit, 24,000 tonnes of oil with a sales value of US\$17m and a gross profit of US\$10m.

While R.E.A. Holdings has title to all the land needed for this two year programme, the Indonesian Ministry of Forestry has recently introduced a new permitting system and the company has not yet received all these permits that it requires for intended 2011 plantings. There is still, therefore an element of uncertainty about whether the 2011 planting can be achieved.

The new Ministry of Forestry requirement is an interesting one and illustrates both the growing environmental awareness within Indonesia and the importance of all operators there fully understanding a complex and changing situation. All permits for land development are in place, but before progressing R.E.A. also needs an 'IPK', a formal letter very recently introduced as a requirement for plantation companies.

The IPK is a permit to cut timber, and is a form of forestry logging permit. R.E.A. Holdings does not need to cut timber. The land was logged by forestry operators many years ago, well before R.E.A.'s involvement. Nevertheless R.E.A. must still obtain this letter, even though there is no commercial timber on the sites concerned.

## Smallholder Production

Smallholder production has been a feature of palm oil production in Indonesia (and many other countries) for a number of years. With rising palm oil prices and growing self-confidence nationally, however, it is becoming an increasing feature. During 2009, smallholder production at R.E.A. more than doubled from 6,460 tonnes to 13,248 tonnes. This was equivalent to 2.7% of the crop, and is likely to very much increase in future.

**Smallholder production is an increasing feature**

Some of the land granted to R.E.A. under the permitting system already has people living on it, and their way of life and need to earn a living has to be catered for as part of R.E.A.'s business development plan. Under a scheme known as "Program Pengembang Masyarakat Desa", or PPMD, R.E.A. gives smallholders support each to develop a 2 Ha plot on their own

## R.E.A. Holdings

7 July 2010

land. It provides technical help, and supplies smallholders with fertilisers and chemicals on deferred payment terms. When mature, the crop is sold to R.E.A. at commercial rates, and money owing for fertiliser and chemicals is deducted.

By end-December 2009, 1,560 Ha of smallholder plantings had been established across 14 villages in the company's area. The company does not include this land in the total that it describes as being under development.

The PPMD system is far from perfect, and R.E.A. has been taking steps to improve upon it, with a new system known as a "plasma scheme", which is based very much more on a co-operative model. This provides economies for villages and the company alike in that production takes place in larger, more financially viable units. The plasma system has other benefits for the company in that it makes a charge for its advice, and that the funding is provided by the local Development Bank (with R.E.A. guaranteeing the loans, so shareholders have a contingent liability here that needs to be recognised).

770 Ha were planted out under the first plasma scheme last year, and a further 530 Ha will be planted out during 2010. A second scheme will be initiated in 2010.

We think it is prudent to allow for possibly up to 20% of land development to be undertaken in future years by R.E.A. to be under the plasma and PPMD systems. The way the company reports excludes this land area from its own planting figures, there is no double counting, but the revenue from the smallholder crop purchases and sales will be included in the company accounts.

It is in everybody's interests for the smallholder developments to be farmed well and to produce high yields of high quality crops.

## Ethical Issues

R.E.A. Holdings devoted three pages of its 2009 Annual Report to ethical and sustainability issues. There is no doubt in our minds that management takes these issues seriously. For shareholders the most important issue here is accreditation by the RSPO, the Round Table on Sustainable Palm Oil. The group has applied for RSPO accreditation with a view to final certification being obtained during 2011. Accreditation under RSPO will increasingly influence price and ease of sale in export markets – the quoted Papua New Guinea producer New Britain Palm Oil managed to obtain a term contract from McVitie's biscuits by obtaining this certification.

The Indonesian Government promotes an additional system which consists of a gold flag being awarded to the best producers and a black flag for the worst. In 2009, R.E.A. Kaltim was awarded a green flag by the Provincial Government assessment, but the National Government downgraded from a green flag to a blue flag because of a boiler combustion problem that is currently being tackled.

We estimate that possibly 20% of the notional 114,000 Ha of land that R.E.A. lists as being held for palm oil development is likely to be devoted to conservation purposes and not planted out with palms.

Improvements need to be made. However, there is no doubt in our minds that R.E.A.'s management takes ethical and environmental issues seriously.

## Expansion Into Coal

Indonesia has large coal reserves and coal is one of the most important power sources for the country. The coal industry locally is heavily fragmented, however, and under-capitalised, so much of the nation's production is small scale and inefficient. There is a major opportunity here for consolidation, the application of modern mining techniques, economies of scale and sale of coal into export, rather than just local, markets.

R.E.A. Holdings has, over the past three years, purchased coal mining concessions covering a total of 7,500 Ha in Indonesia. The concessions are as follows

**A new  
smallholder  
planting aid  
scheme**

**The  
Indonesian  
coal industry  
is  
fragmented  
and under-  
capitalised**

R.E.A. Holdings

7 July 2010

Concession	Area, Ha	Location
Liburdinding	1,000 Ha	Southern part of East Kalimantan, near Tanah Grogot
Muser	2,100 Ha	Southern part of East Kalimantan, near Tanah Grogot
Kota Bangun	4,400 Ha	Central part of East Kalimantan

The concessions are subject to Indonesia's new mining law, which permits up to 80% foreign ownership of coal mining businesses for the first time. Regulations governing implementation of the law have yet to be published, and in the meantime local investors own the concessions, with R.E.A. having the right to acquire them at their original cost, and R.E.A. providing funding to the local owners in the meantime.

Technical details concerning the three concessions are as follows:

Concession	Type of Coal	Royalty Rate
Liburdinding	High (2%) Sulphur. Modest (7:1) strip ratio.	13%
Muser	High Sulphur. Modest (7:1) strip ratio.	9%
Kota Bangun	Low Sulphur High Calorific Value. However, very high (up to 30:1) strip ratio. 4 kilometres from a river, with a port nearby.	13%

All the concessions are subject to R.E.A. restoring the land to original condition once mining operations have finished. Also, while R.E.A. has purchased the concessions, further payments will be necessary to local villagers before large scale mining operations can commence. Both these factors need to be taken into account when examining the likely future profitability of the businesses.

The Liburdinding concession is already producing coal, at the relatively modest rate of 3,000 tonnes/month. This is being sold into the local market. The sulphur content, at 2%, is too high for this coal to be sold into export markets, where the generally accepted sulphur limit is 1%. In order to reach this grade, the coal will have to be blended with other local sources of lower sulphur coal.

**Liburdinding is already producing coal**

	Liburdinding	Muser	Kota Bangun
Date of Start of Mining	Already producing in small volumes	2011	Final quarter 2010
Inferred Resource (Company Estimates)	14.7m tonnes	17.6m tonnes	>2m tonnes
Calorific Value	5,800 – 6,200 Kcal/kg	7,000 – 7,200 Kcal/kg	8,500 – 9,500 Kcal/kg
Value per tonne	US\$45/tonne	US\$45/tonne	US\$95/tonne
Extraction Cost	US\$15/tonne	US\$15/tonne	US\$55/tonne
Gross Margin	US\$30/tonne	US\$30/tonne	US\$40/tonne
Cleaning cost	US\$5/tonne	US\$5/tonne	-
Transport to river port	US\$10/tonne	US\$10/tonne	US\$5/tonne
Royalty	US\$6/tonne	US\$4/tonne	US\$12/tonne
EBITDA before overhead and administration	US\$9/tonne	US\$11/tonne	US\$23/tonne

As it expands, R.E.A. is likely to contract out the mining operations rather than operate its own staff and equipment. The current rate for contract mining operations in Indonesia is approximately US\$2/m<sup>3</sup> for stripping the cover and replacing it in void space, and \$1/tonne

## R.E.A. Holdings

7 July 2010

for the mined coal. Production at Liburdinding and Muser will be cheap. The coal is high in sulphur but is mid range in terms of calorific value; coal is priced according to its calorific value.

It is too early yet for us to be able to produce precise estimates for the economics of the three sites. Certain key information is missing, such as width of coal seams. Also the geological information is not yet sufficiently detailed for any of the three coal deposits to be classified as a resource, or for a mine plan to be drawn up. Further drilling is currently taking place and the results announced to the market, with a Competent Person's Report, in due course.

At present, the tonnages concerned are classified as 'Inferred Resource', which is the least demanding of the categories of reporting permitted under the JORC Code.

As all production is to be contracted out, capital costs should be relatively modest. There will be working capital requirements, however. Also our estimates in the table above are before overheads.

**'Inferred Resource' under the JORC code**

## Possible Customers

For Liburdinding and Muser, the requirement to reduce the sulphur content is a problem. Buying in low sulphur coal for blending down to <1% will be necessary, either that or R.E.A. will have to develop its own low sulphur coal deposits in the vicinity of Liburdinding and Muser.

The State electricity producer, PLN, is also a possible customer for the coal, and has the appetite, in a new power station that came on stream in May, to take up to 50,000 tonnes/yr. PLN is undergoing a significant capacity expansion, and 10,000MW of new coal fired generation capacity is likely to come on stream during 2010.

R.E.A. is one of only five pre-cleared suppliers to PLN at present – one of the others is Churchill Mining, which recently signed a contract of the kind the R.E.A. would like to negotiate. PLN is happy to burn low - medium calorific value coal (5,200 – 5,500 btu), and may turn out to be more flexible on sulphur content than export purchasers if the pricing is right.

## Impact on Current Year Profits

If R.E.A. produces at the rate of 3,000 tonnes/month for the first nine months, then 10,000 tonnes/month for the final quarter, then the year's production would be 57,000 tonnes, for a value (assuming output is primarily the low calorific value coal ) of approximately US\$2.6m. In terms of profit, this would add US\$0.5m – 0.6m to operating profit before admin and management costs, possibly US\$0.2m – 0.3m after them.

For 2011, if production averages 20,000 tonnes/month, and includes some higher grade coal, then revenues of US\$15m might be possible, with a profit contribution, again before interest, admin and management costs, of possibly US\$3m. At this stage, the calculations start to get interesting, although it would still mean coal contributing less than 10% to group profit.

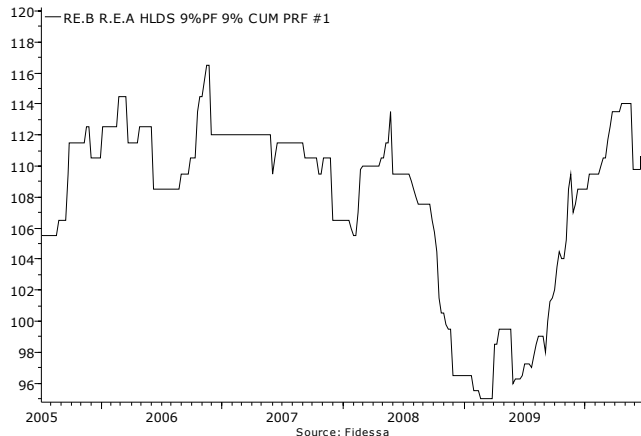
**Coal will be less than 10% of group profit**

## Funding Future Coal Expansion

If R.E.A.'s diversification into coal proves to be a success then it may well decide to expand further in this business. It may then need access to additional risk capital. We foresee this being supplied by further issues of Preference Shares. The current Preference Share issue carries a coupon of 9%, which is heavy but a reflection of the risks of operating in Indonesia rather than, say, in the more stable and legally more predictable neighbour Malaysia. Return on capital both from the group as a whole currently and from the coal businesses from 2011 onwards will in our opinion be more than sufficient to service the dividends on the additional preference shares.

## The Preference Shares

A preference share issue may also take place in the second half of 2010. This will not be tied to any capital projects, but instead will be to refinance debt. It is also possible that the company may offer a scrip issue of preference shares to holders of the ordinary shares.



*R.E.A. 9% Cumulative Preference Shares – 5 Year Performance*

Unlike most UK domiciled companies, R.E.A. Holdings bears no Corporation Tax penalties by issuing preference shares. All its tax is Indonesian, and the company pays no UK Corporation Tax (for UK companies, preference share dividends are paid from after-tax earnings, compared to loan and bank interest which offsettable against Corporation Tax).

The preference shares are interesting, particularly to income funds and the private client broker community. While the high 9% coupon, 8% yield is influenced by the fact that the company's base of operations in Indonesia, R.E.A.'s economic exposure to the country is not as great as it appears at first sight. The company's earning power is derived from an internationally priced commodity (palm oil) that is independent of any movements in the Indonesian Rupiah or any balance of payments problems that the country may have. There is political risk exposure, of course.

**The  
preference  
shares yield  
8%**

The current price of the preference shares is 108 – 12 in 5,000 shares. The spread between buying and selling prices therefore is 4%, and the yield at the bid price is 8.0%. The prefs traded 26 times in June, with a total volume of 121,000 shares (there is some double counting of trades in Stock Exchange reporting figures). By comparison, the Ordinary Shares trade 100 – 200 bargains a month.

As the chart shows, the preferences shares have relatively low volatility. Their high point over the past five years has been 114, their low point 95.

## Balance Sheet

At end-December 2009 the R.E.A. balance sheet was carrying net debt of US\$93.5m, all but US\$2m of which was (and is) term. Some hedging was in place, and the debt was split approximately equally between UK£ and US\$. This was being carried by shareholders' funds, ex goodwill, of US\$183m, giving gearing, of 51%. The gearing figure for ordinary shareholders is higher, because US\$30m of the equity is in the form of 9% cumulative preference shares; gearing as far as ordinary shareholders are concerned is 81%. In practice the pref shareholders have relatively few rights however (their main leverage is that no ordinary dividends can be paid until all preference arrears have been extinguished).

Included in the asset figure are US\$204m of biological assets, at valuation as required by IAS16. Another way of looking at the debt would be to strip out the US\$12m spent on the coal assets and apply the rest of the debt to the hectares of mature oil palm. The debt in this case equates of ~US\$5,700 per hectare, which is considerably less than half its probable market value; mature producing oil palm plantations in Indonesia currently change hands for in the region of US\$20,000 per hectare.

## R.E.A. Holdings

7 July 2010

## R.E.A. HOLDINGS GEARING CALCULATIONS

YEAR	2009A
Sht Tm Bank Loans	1.5
Other Sht Tm Loans	0.4
Non-Current Bank Loans	8.7
Sterling Notes	57.0
US Dollar Notes	29.7
Hedging Instruments	13.6
Other Loans and Payables	4.7
MINUS Cash and Equivalents	-22.1
NET DEBT	93.5

Total Equity inc Minorities	194.7
MINUS Goodwill	-12.6
NET EQUITY FOR CALCULATION	182.1

Gearing 51%

## TREATING THE PREFS AS A PRIOR CHARGE

Net Debt to banks etc	93.5
ADD Prefs	30.0
TOTAL PRIOR CHARGES	123.5

Exclude Prefs from Equity	182.1
MINUS Prefs	-30.0
Ords and Minorities	152.1

Gearing 81%

Net asset value per ordinary share, on the basis of the Consolidated Balance Sheet but stripping out goodwill, is US\$4.68, or 312p. R.E.A. Holdings shares are therefore trading in excess of their book asset value.

## Defined Benefit Pension Scheme

There is a group defined benefit pension scheme that is in deficit, and whose liabilities are not included in the consolidated accounts. This is a 'multi-employer' scheme, and includes employees of some private companies that are not part of R.E.A. Holdings, so the deficit is not the sole responsibility of R.E.A. The total deficit is modest at UK£3.6m at end-December 2008, and 'significantly' less (but not calculated) at end-December 2009. We estimate that approximately half the deficit, or UK£1.8m, is attributable to R.E.A. The deficit is so modest in comparison to the assets and profitability of the group that we feel that for most practical purposes it can be ignored.

**The pension deficit is so modest that it can be ignored**

## Cash Flow

Stripping out the new coal investments, R.E.A. Holdings spend US\$27m on investment activities last year, in a combination of expenditure on biological assets and purchases of property plant and equipment. This was less than the net cash received from operating activities of US\$29.6m – a figure struck after paying US\$6.1m of interest.

In 2008, R.E.A. Holdings was modestly cash negative, but has now clearly tripped over into net cash generation. This is hugely encouraging, not least because last year's new planting rate was almost double the rate in the previous year and it is quite clear that the 2010 cash generation will be significantly greater than the development costs of even the expanded 4,000 Hectares of new plantings management has as its target in the current year.

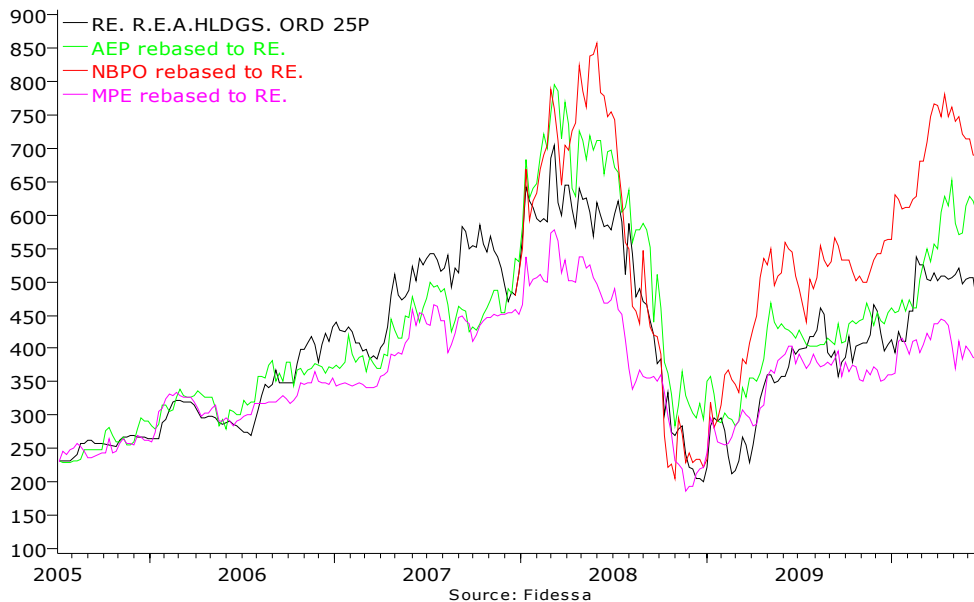
## Singapore, The Management, and Succession Planning

R.E.A. Holdings has the highest average age of any board of directors that we know of – average age is 69 years. Only one director is under the age of 60, three are over the age of 70. Richard Robinow and John Oakley, are aged respectively 64 and 61. John Oakley has for several years been the only executive director. Richard Robinow is designated non-executive but effectively works almost full time; he is also the largest shareholder.

It is scarcely surprising that the board's attentions have been turning to succession planning.

The group aims in 2010 to recruit an experienced commercial manager to head a new regional office to be established in Singapore. This Singapore office will have the dual function of taking some of the much increased workload off the two current executive directors, and giving the group flexibility to move its base of operations and its domicile at some point to the Far East should it be sensible to do so. Once the new Singapore office is fully operational, the board will be 'reconstituted'. We read into this that other, local directors will be appointed, probably both executive and non-executive.

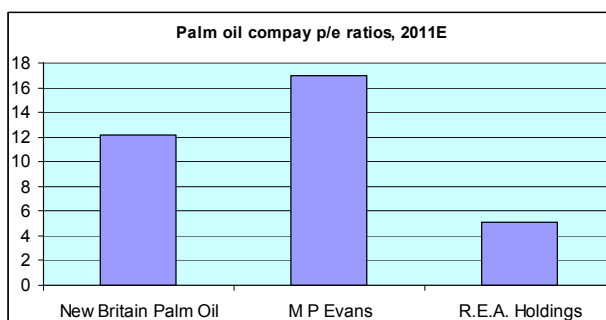
## Relative Share Price Performance



On a five year view the stock market has made little effort to differentiate R.E.A. Holdings from the two other long-established quoted companies on the London Stock Exchange Official List, Anglo-Eastern Plantations and M P Evans. The largest company in the sector, New Britain Palm Oil, was only floated three years ago, and has outperformed the others since early 2009, although its shares are also significantly more volatile.

## Relative Share Ratings

In terms of historic, 2009 price earnings ratios, R.E.A. Holdings appears fairly rated; it is on approximately the same p/e ratio as M P Evans, more expensive than the other two profitable UK based palm oil companies (a further two early stage producers were loss-making in 2009). R.E.A. appears to be trading at less than half the rating, on 2009 earnings, of the major Malaysian based companies such as IOI Corporation and Kuala Lumpur Kepong.



With regard to prospects two years out, however, a very different picture emerges. R.E.A. Holdings is trading on a much lower p/e ratio, on consensus estimates of 2011 earnings, than either of its two main comparators, New Britain Palm Oil and M P Evans. Comparison is not possible in the case of other companies in the sector. Anglo-Eastern

**Higher crop tonnages and higher product prices should leverage profits on a relatively fixed cost business model**

Plantations has no analyst forecasts in place, and Asian Plantations and Equatorial Palm Oil are early stage operators that are still loss making.

R.E.A. Holdings ought to trade at a discount to its true underlying value because of the political risks associated with Indonesia. We also point out that R.E.A.'s coal earnings would merit a lower p/e ratio than those of palm oil. However, the difference between 2011 p/e ratios is very large indeed, and suggests to us that the investment markets have not taken on board the very significant increase in earnings likely as higher crop tonnages and higher product prices combine to leverage profits on a relatively fixed cost business model.

## Conclusion

R.E.A. Holdings has successfully established itself as one of the largest foreign-owned palm oil producers in Indonesia, and one of the lowest cost operators in the industry worldwide. The importance of this cannot be under-estimated, because palm oil is the cheapest of the world's vegetable oils, and this means that R.E.A. Holdings can take its place in the front rank of food producers in terms of cost per tonne and cost per calorie, at a time when demand is growing rapidly, both in the world as a whole and in the Far East in particular.

The operating margin of the group is sufficient for it to be able to operate at a profit even if the world price of palm oil were to halve (which it is not). It is sufficiently cash generative to be able to throw off cash and pay dividends out of its own resources even on a more active planting/development programme.

The diversification into coal may require some additional funding, but this is likely to be in the form of preference shares rather than ordinary shares, and is likely to be beneficial to ordinary shareholders. That said, it will be at least 2012 before coal activities become a noticeable feature in the group's earnings, and this will continue to be a palm oil producer, rather than a coal miner, for the foreseeable future.

The shares trade on a low prospective p/e, a reasonable yield, and a reasonable market cap and EV per hectare, for the sector. The potential for dividend increases over the next three years is significant even allowing for future capital spending requirements. In our forecasts we have allowed for a lower but still very healthy dividend cover. This suggests near market average yield of 2.4% on the ordinaries. The preference shares yield a more attractive 8%, but of course preference holders do not share in the capital growth upside.

We believe that every institutional investment manager ought to consider holding a position in the palm oil industry. In particular, we remain huge enthusiasts of R.E.A. Holdings and believe there is a great deal of value in this company that will be unlocked over the coming three years.

## R.E.A. Holdings

7 July 2010

	<u>2008A</u>	<u>2009A</u>	<u>2010E</u>	<u>2011E</u>	<u>2012E</u>	<u>2013E</u>	<u>2014E</u>
<b>CROP, MANAGED PLANTATIONS</b>	<b>457,867</b>	<b>490,000</b>	<b>561,000</b>	<b>641,365</b>	<b>703,545</b>	<b>764,413</b>	<b>886,548</b>
Smallholder FFB purchases	6,460	13,248	15,000	20,000	25,000	30,000	35,000
<b>Total Crop - Managed and Smallholder</b>	<b>464,327</b>	<b>503,248</b>	<b>576,000</b>	<b>661,365</b>	<b>728,545</b>	<b>794,413</b>	<b>921,548</b>
% Yield	23.1%	23.5%	24.0%	24.0%	24.0%	24.0%	24.0%
Oil Tonnage Produced	105,957	118,357	138,240	158,728	174,851	190,659	221,172
Oil Tonnage Sold	105,957	118,357	138,240	158,728	174,851	190,659	221,172
Kernel Tonnage Produced	<u>21,359</u>	<u>23,740</u>	<u>25,806</u>	<u>29,503</u>	<u>32,363</u>	<u>35,163</u>	<u>40,781</u>
Total Palm Products Tonnes	127,316	142,097	164,046	188,230	207,214	225,822	261,953
Average Price Per Tonne US\$ FOB Borneo	664	580	700	700	700	700	700
Palm Oil Revenue US\$	69,827	68,647	96,768	111,109	122,396	133,461	154,820
Palm Kernel Revenue*	6,156	6,531	8,400	9,603	10,534	11,446	13,274
Palm Oil Theoretical Turnover US\$000	75,983	75,178	105,168	120,712	132,930	144,907	168,094
Revenue from services	523	49	200	400	600	800	1,000
<b>COAL PRODUCTION</b>	<b>2008A</b>	<b>2009A</b>	<b>2010E</b>	<b>2011E</b>	<b>2012E</b>	<b>2013E</b>	<b>2014E</b>
Tonnage		0	57,000	240,000	360,000	500,000	500,000
Average Price per Tonne US\$			45	65	70	70	70
Total Coal Revenue US\$000			2,565	15,600	25,200	35,000	35,000
Direct Production and Transport Costs US\$000			2,000	11,000	18,400	25,700	25,700
Overheads US\$000			300	600	900	1,100	1,100
Operating Profit US\$000			265	4,000	5,900	8,200	8,200
<b>ALL US\$000 Year ended December</b>	<b>2008A</b>	<b>2009A</b>	<b>2010E</b>	<b>2011E</b>	<b>2012E</b>	<b>2013E</b>	<b>2014E</b>
Palm Oil Revenue US\$000	79,630	78,885	105,168	120,712	132,930	144,907	168,094
Coal Revenue			2,565	15,600	25,200	35,000	35,000
<b>Total Revenue, Palm and Coal</b>	<b>79,630</b>	<b>78,885</b>	<b>107,733</b>	<b>136,312</b>	<b>158,130</b>	<b>179,907</b>	<b>203,094</b>
<b>ALL US\$000 Year ended December</b>	<b>2008A</b>	<b>2009A</b>	<b>2010E</b>	<b>2011E</b>	<b>2012E</b>	<b>2013E</b>	<b>2014E</b>
Palm Oil Revenue US\$000	79,630	78,885	105,168	120,712	132,930	144,907	168,094
Inventory Gain	-4,214	1,556	0	0	0	0	0
Cost of Sales, Palm	27,682	33,951	39,044	44,900	49,390	53,094	57,077
Gross Margin %, Palm	65%	57%	63%	63%	63%	63%	66%
Gross Profit, Palm	47,734	46,490	66,124	75,812	83,540	91,812	111,018
Administrative & Distribution Expenses	4,515	8,537	10,350	10,500	11,500	12,500	13,000
Admin & Dist as % of Sales	5.7%	10.8%	9.8%	8.7%	8.7%	8.6%	7.7%
Other operating income	4	0	0	0	0	0	0
IAS Biological Asset Adjustment	-2,660	9,765	5,000	5,000	5,000	5,000	5,000
Palm Oil Operating Profit	40,563	47,718	60,774	70,312	77,040	84,312	103,018
Coal Operating Profit		0	265	4,000	5,900	8,200	8,200
Combined Operating Profit	40,563	47,718	61,039	74,312	82,940	92,512	111,218
Investment Revenues	1,185	827	500	500	500	500	500
Interest Charge in/-Out	-5,439	-6,828	-7,500	-7,500	-7,500	-7,500	-7,500
Net Interest Cover X	6.1	6.2	7.6	9.3	10.4	11.6	13.9
Declared Pre-Tax Profit	<b>36,309</b>	<b>41,717</b>	<b>54,039</b>	<b>67,312</b>	<b>75,940</b>	<b>85,512</b>	<b>104,218</b>
Adj Pre-tax Profit ex IFRS Bio	<b>38,969</b>	<b>31,952</b>	<b>49,039</b>	<b>62,312</b>	<b>70,940</b>	<b>80,512</b>	<b>99,218</b>
Tax £000	10,536	11,861	14,591	18,174	20,504	23,088	28,139
of which: Deferred Tax on Bio Adjustment	-772	2,637	1,350	1,350	1,350	1,350	1,350
Tax Charge % (on declared profit)	29%	27%	27%	27%	27%	27%	27%
Tax Charge* % (on adj pft)	27%	37%	30%	29%	29%	29%	28%
After Tax Profit	25,774	29,856	39,449	49,138	55,436	62,424	76,079
Minority Interests - Palm Oil	420	-518	-750	-1,000	-1,150	-1,300	-1,450
Minority Interests - Coal			-53	-800	-1,180	-1,640	-1,640
Minority Interests - Total	420	-518	-803	-1,800	-2,330	-2,940	-3,090
Preference Dividends	-2,360	-2,219	-3,248	-3,748	-3,748	-3,748	-3,748
For Ordinary Shareholders	23,834	27,119	34,594	41,790	47,028	52,796	66,151
Cost of Ordinary Dividend	1,498	1,954	2,932	4,397	5,863	7,329	8,795
Retained Earnings	22,336	25,165	31,663	37,392	41,165	45,467	57,356
Average No. of Shares	32,574	32,574	32,574	32,574	32,574	32,574	32,574
Earnings Per Share Undiluted US cents	73.17	83.25	106.20	128.29	144.37	162.08	203.08
Average Exchange Rate US\$/UK£	1.84	1.56	1.50	1.50	1.50	1.50	1.50
EPS equivalent in UK p.	39.76	53.37	70.80	85.53	96.25	108.05	135.39
Dividend Per Share UKp.	3.00	4.00	6.00	9.00	12.00	15.00	18.00
Dividend Cover X on Declared eps	13.25	13.34	11.80	9.50	8.02	7.20	7.52
Shares in Issue Fully Diluted	33,335	33,335	33,335	33,335	33,335	33,335	33,335
EPS Fully Diluted US cents	71.50	81.35	103.78	125.36	141.08	158.38	198.44
EPS fully dil ex Bio & Associated Tax, Usc.	<b>77.16</b>	<b>59.97</b>	<b>92.83</b>	<b>114.41</b>	<b>130.13</b>	<b>147.43</b>	<b>187.49</b>
EPS fully dil ex Bio & Associated Tax, Ukp.	<b>41.94</b>	<b>38.44</b>	<b>61.89</b>	<b>76.28</b>	<b>86.75</b>	<b>98.29</b>	<b>125.00</b>

Figures are calculated in US dollars and have been computed on an IFRS basis

Preference Shares in Issue 16.4m

Assumes further loan raise in 2010 and prefs in 2011

R.E.A. Holdings

7 July 2010

Management	Major Shareholders								
<p><b>Chairman:</b> Richard Robinow</p> <p><b>Managing Director:</b> John Oakley</p> <p><b>Non-Executive Director:</b> Chan Lok Lim</p> <p><b>Non-Executive Director:</b> David Blackett</p> <p><b>Non-Executive Director:</b> John Green-Armytage</p> <p><b>Non-Executive Director:</b> John Keatley</p> <p><b>Non-Executive Director:</b> David Killick</p> <p><b>Non-Executive Director:</b> Charles Letts</p>	<table> <tr> <td><b>Richard Robinow</b></td> <td>30.79%</td> </tr> <tr> <td><b>Prudential</b></td> <td>13.05%</td> </tr> <tr> <td><b>Alcatel Bell Pension Fund</b></td> <td>12.30%</td> </tr> <tr> <td><b>Artemis UK Smaller Cos</b></td> <td>5.9%</td> </tr> </table>	<b>Richard Robinow</b>	30.79%	<b>Prudential</b>	13.05%	<b>Alcatel Bell Pension Fund</b>	12.30%	<b>Artemis UK Smaller Cos</b>	5.9%
<b>Richard Robinow</b>	30.79%								
<b>Prudential</b>	13.05%								
<b>Alcatel Bell Pension Fund</b>	12.30%								
<b>Artemis UK Smaller Cos</b>	5.9%								
Key Dates	Key Milestones								
<p><b>Interim Management Statement:</b> August 2010</p> <p><b>Interim Results:</b> October 2010</p>	<p><b>1989:</b> Commences the East Kalimantan project, a 125,000 H single site oil palm plantation in Indonesia.</p> <p><b>1997:</b> Asian Economic Crisis closes the door on debt finance. Seeks equity finance, part of which is provided by the MEZ Group.</p> <p><b>October 2001:</b> Palm oil price plunges to \$250m/t and REA halts new planting activity. Also, the MEZ group launches legal proceedings against both the company and its two executive directors.</p> <p><b>2004:</b> Extension planting is resumed at the rate of 3,000 – 4,000 H per annum.</p> <p><b>2005:</b> Restructures Indonesian banking facilities. Two share placings at 260p/share raise 10.24m.</p> <p><b>2006:</b> Resolves legal dispute with the MEZ group. Issues \$30m of 7.5% dollar-denominated loan notes 2012/14.</p> <p><b>September 2006:</b> Acquires PBJ, a 20,000 H land allotment in East Kalimantan.</p> <p><b>January 2007:</b> £22m nominal of 9.5% sterling loan notes 2015/17 issued.</p> <p><b>March 2008:</b> Acquires a further two land allocations in East Kalimantan, KMS and CDM, totalling 37,000 H.</p> <p><b>August 2008:</b> £15m nominal of 9.5% sterling loan notes 2015/17 issued.</p> <p><b>August 2008:</b> Acquires rights in respect of two adjoining coal concessions, Liburdinding and Muser.</p> <p><b>December 2009:</b> Acquires a further coal concession at Kota Bangun.</p>								

**Disclaimer**

The conclusions and opinions expressed in the investment research accurately reflect the views of the first named analyst. Hardman & Co provides professional independent research services and the companies researched pay a set fee in order for this research to be made available. While the information in the research is believed to be correct, this cannot be guaranteed. There are no other conflicts of interest.

Neither Hardman & Co nor the analysts responsible for this research own shares in the companies analysed in this research note. Neither do they hold any other securities or derivatives (including options and warrants) in the companies concerned. Hardman & Co does not transact corporate finance and therefore does not earn corporate finance fees. It does not buy or sell shares, and does not undertake investment business either in the UK or elsewhere.

Hardman & Co does not make recommendations. Accordingly we do not publish records of our past recommendations. Where a Fair Value price is given in a research note this is the theoretical result of a study of a range of possible outcomes, and not a forecast of a likely share price.

Our research is issued in good faith but without legal responsibility and is subject to change or withdrawal without notice. Members of the professional investment community are encouraged to contact the analyst concerned.

This research is provided for the use of the professional investment community, market counterparties and sophisticated and high net worth investors as defined in the rules of the regulatory bodies. It is not intended to be made available to unsophisticated individuals. In the UK, any such individual who comes into possession of this research should consult their properly authorized professional adviser, or undertake one of the 'self certified' sophisticated investor tests that are available.

This research is not an offer to buy or sell any security.

Past performance is not necessarily a guide to the future and the price of shares, and the income derived from them, may fall as well as rise and the amount realised may be less than the original sum invested. For AIM and PLUS shares, it is the opinion of the regulator that risks are higher. Furthermore the marketability of these shares is often restricted.

This document must not be accessed or used in any way that would be illegal in any jurisdiction.

In some cases research is only issued electronically and in some cases printed research will be received by those on our distribution lists later than those receiving research electronically.

The report may be reproduced either whole or in part on condition that attribution is given to Hardman & Co, and on condition that Hardman & Co accepts no liability whatsoever for the actions of third parties in this respect.

Hardman & Co is not regulated by the Financial Services Authority (FSA).

© Hardman & Co.

**Hardman & Co**

4-5 Castle Court  
London  
EC3V 9DL  
United Kingdom

Tel: +44(0)20 7929 3399  
Fax: +44(0)20 7929 3377

[www.hardmanandco.com](http://www.hardmanandco.com)

