Hardman & Co

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R.E.A. Holdings 247.5p

Ahead Of Expectations

30.4.2004

REA is maturing into one of the world's most efficient producers of palm oil, with economies of scale from its single large plantation that are rare in this fragmented industry. Full year results announced last week show the benefits of this coming through to shareholders for the first time – trees planted in the late 1990's are only now coming up to their full production potential.

Key points are:

- Last year's profits rose 42% and the business threw off an astonishing £7.2m of cash.
- The past banking problems have largely been resolved, and the outstanding legal action in New York is starting to look less of an issue as the company grows.
- Current year profits could quadruple if palm oil prices remain firm.
- Current year crop should be 33% higher than last year, and will continue to rise each year for the next ten years.
- Costs have a high fixed element, and by 2005 R.E.A. will have one of the lowest costs of production in the industry. Central overheads, in particular, are under impressively tight control.

Our forward estimates have been slightly reduced because of the weak Dollar. All other fundamentals are moving strongly in this company's favour. *The shares have risen by 32% since our last research note.*

Share Price: 247.5p

12m High: 282p

12m Low: 98p

Market Cap: £70m on diluted capital

Shares in Issue: 18.7m undiluted

28.5m diluted

NAV/Share: 84p

Gearing: 85%

Interest Cover: 2.2X

EPIC Code: RE.

SEDOL No: 234906

Sector: Food producers and processors

Market: London Full List (FTSE Fledgling)

PR: none

Website: www. rea.co.uk

Analysts: Sonia Kaur/Roger Hardman

Y/E December	Sales £m	Declared Profit £m	Adjusted Profit £m	Adjusted Eps p.	P/e ratio	Divi p.	Yield %
2002A	12.8	1.45	1.45	0.76	322.3	0	-
2003A	13.8	2.07	2.32	3.72	65.9	0	-
2004E	20.0	8.51	8.51	16.07	15.2	0	-
2005E	23.7	11.04	11.04	21.99	11.1	0	-

Background

R.E.A. Holdings is a pure palm oil company based in the Indonesian state of East Kalimantan, where it is developing 125,000 H of land – the equivalent of a 10 mile strip running from London to Brighton. To date only 13,400 H of the available land has been planted out, and for most of this the trees planted have yet to reach full maturity. The company is planning to plant a further 3,000 – 4,000 H each year from 2004 onwards, and will soon become one of South East Asia's biggest single site palm oil plantation companies.

Palm oil production is a long term business. The trees do not produce any fruit at all until they are four years old, and do not reach peak output until they are at least 8 years old. The Asian banking crisis in the late 1990s and then some exceptionally dry weather in 2000-2001 put the company's progress behind its original schedule, but the time lost is being rapidly caught up. The banking crisis strained finances in the early years of the decade, but this has now largely been resolved, and only two 'legacy' issues from this period remain. The first is the presence of a minority shareholder in the operating subsidiary which has a legal action outstanding in the US courts, and the second is an arrears of preference dividend payments that prevent dividends being paid on the ordinary shares. Both these two issues appear to be moving to a conclusion, aided by the rapid improvement in cash generation as the palm oil trees planted in the late 1990's start yielding significant quantities of oil.

Palm oil is primarily used for cooking. Its price is closely interlinked with the price of soya and other vegetable oils. These prices have been rising, partly because of the growing prosperity in the Far East and partly because of a poor soyabean crop in the USA last Autumn.

The 2003 Results

Palm Oil Production

Volumes were 11% up on the previous year, but a little lower than we had expected. We had not taken sufficient account of the impact of dry conditions on the younger trees; dry weather is a much bigger problem in the palm oil business than wet weather. Yields on the more mature trees were only marginally affected. The yield was 24.9%, almost precisely as we expected. Yields were slightly affected (ironically) by wet weather in the last two months of the year, which slowed transport on some roads on the estate and delayed fruit getting to the mill. If it had not been for this, the yield would have been over 25%.

The kernel tonnage produced was very much as we expected, but yields here were higher than we predicted. Revenue from kernels is only a small proportion of the total, but as a marginal input it can have a significant effect on profits.

Turnover

Turnover for the year was declared at £13.8m compared to our forecast of £14.4m. Strong palm oil prices in the closing months of the year meant that in Dollar terms R.E.A. Holdings performed better than we expected. The weakness of the US Dollar in November and December resulted in Turnover in Pounds Sterling being slightly below our original expectations, however.

Gross Margin

We had expected a gross margin improvement from 38% to 50% for the year 2003. The gross margin came in at 46%, which we view as satisfactory. We expect a significant improvement in the gross margin in the current year. This is because there is a significant element of fixed costs in the cost of production, and because R.E.A. Holdings is learning to operate the plantation more efficiently as it gains experience on the site. Among the factors that will start to influence gross profits this year will be the expansion of the area under cultivation, and the purchase of two company-owned barges to transport the oil to the coast, rather than relying on third party contractors.

Administrative Expenses

These were significantly lower than we expected, at £2.2m, which was down from the previous year's £2.6m. Some of the administrative costs are in local currencies and US Dollars, but this only partly explains the very good performance by the company here. The key factor is that cost control at the centre, both in Indonesia and in London, is very tight indeed. R.E.A. Holdings has one of the most efficiently run Head Offices we know. The figure in the company p & l account for this item understates the actual cash spend, because some admin spending will have been capitalised in line with industry accountancy treatment of new planting expenditure. However, only 3,000 H of land were cleared for planting during the year, compared to the 13,400 H of existing, productive plantation, so this is not a major item. As a proportion of sales, admin expenses fell from 20% to 16.2%, and we expect this percentage to fall again in the current year.

Asset Disposals

R.E.A. Holdings took a £257,000 loss on the sale of some old plantation interests in Bangladesh at the beginning of the year. This was the last remaining residue of the 'old' R.E.A. Holdings remaining to be dealt with, and marks the end of the asset clear-out. Rather more than the actual profit or loss was the £647,000 realised on the sale that was used to help reduce the net debt.

Interest Charges

At £1,749,000 these were a little lower than we had expected, because we underestimated the strength of the cash generation during the year.

Pre-tax Profit

We had forecast an increase in pre-tax profit fom £1.46m to £1.83m. The actual figure produced was £2.07m. We view this as a hugely impressive performance for a company still in the early stages of its development, especially as it is struck after a £257,000 loss on asset disposals, that we had not allowed for in our original forecast.

Tax

Clever accounting has kept the tax charge for the year down to 17%, compared to the 27% that we predicted. 2003 will be the last year when R.E.A. Holdings has a sub-standard tax charge, however. The new rules on deferred tax accounting will almost certainly result in a standard 30% tax charge for 2004 and subsequent years. For the next two years, we expect very little if any of this tax to be a cash item.

Minority Interests

The minority interest charge was a little lower than we expected, and this benefits earnings per share. We believe that 2003 will be the last year of low minority interest charges, however. We expect a big increase in minority interest payments for 2004 and subsequent years as profits of the main trading subsidiary grow.

Preference Shares

Provision for the payment of a full preference dividend of £513,000 has been made. Only half of this sum has actually been paid over, according to the cash flow statement. Priority during the last few years has been given to reducing the bank debt in order to eliminate the vulnerability of the company to some of the more extreme conditions in the old banking covenants. These worries, from now onwards, are history. This is because management has as a priority the elimination of the arrears in preference dividends, which amounts to four semi-annual payments (i.e. £1.15m). Given the very strong cash flow now being generated by the company, we expect these arrears to be eliminated relatively quickly. That, incidentally, will eliminate the last obstacle to payment of a dividend on the ordinary shares. R.E.A. Holdings already has a surplus of retained profits under the 'capital and reserves' heading of its balance sheet.

Balance Sheet and Cash Flow

We have been hugely impressed by the cash flow produced by this company over the past year. £7.2m was generated from operating activities, more than twice the declared operating profit and a huge improvement on the £1.0m of 2002. Our cash flow table, after allowing for capital investment and the movement in working capital items, but also including the £5.0m brought in from the placing of fresh equity, shows a surplus of £5.8m.

Net cash flow during 2004 and 2005 will be less spectacular. There are unlikely to be any further share issues in the current year. Some of the cash flow improvement was due to favourable working capital movements, which are probably not repeatable. Minority interests will be higher. Spending on planting out new areas on the plantation will be very much higher – probably in the region of £7m. Also, spending on a second mill, that we had not expected to take place until 2007, is now being brought forward to 2005. Net cash flow will still be positive, however.

In terms of the Balance Sheet, net debt at the year end was £20m. The reduction in debt levels is somewhat greater than the net cash flow. This is because the debt is Dollar denominated, and the US Dollar fell against the Pound Sterling during 2003. We expect net debt to fall again in the current year, but only modestly because of the massive investment taking place in expanding the area of planted out estate. Gearing at end-2003 was 85%, taking in the minority interests and the preference shares as part of the equity. Because the capital invested in the estate will be rising at the same time as debt is falling, there will be a significant reduction in the gearing level during the year year, we estimate to possibly as little as 48%.

Gearing will continue to be a feature of the R.E.A. balance sheet for the remainder of the decade. As cash flow increases, we expect R.E.A. Holdings to push up the scale of its new plantings. Also, there is the impact of the plantings in the 'joint venture' areas to be considered. Part of R.E.A's original planting conditions was a requirement to plant out half its acreage to joint ventures, in order to give local interests a stake in the fortunes of palm oil locally. It appears that, because of a lack of capital among local business interests, R.E.A. will retain a 95% interest in the Joint Venture element of the plantings being carried out in 2004, but that local investors will be given their 5% as a free, carried interest.

Net assets per ordinary share have increased from 76p to 84p.

Return on capital is rising, but is as yet still relatively modest at 7.9%, as is to be expected from a company in such an early stage of maturity.

The cash flow and balance sheet figures in this research document are to some extent provisional, because the company has yet to publish its full annual report.

The Legal Action

There has been no change on the situation of the New York legal action since our last research note, but the strong forward progress made by R.E.A Holdings since then, both in terms of its balance sheet and in terms of its trading, make this issue somewhat less of a concern than it was two years ago.

To recap, Mr. M. E. Zukerman, a US based investor who is a minority investor in the main trading subsidiary, claims 'fraud, fraudulent inducement, promissory estoppel and tortious interference'. Save for one minor component, all the claims for fraud, fraudulent inducement and tortious interference have been recommended for dismissal, but stated that the contract related claims could not be dismissed without an investigation of the facts. Objections have been lodged on both sides and a 'final' ruling is awaited.

This issue is likely to feature in the Annual Report as a 'Contingent Liability' for several years yet.

Accountancy Standards

A new international accountancy standard, IAS 41, may force plantation companies to revalue their estates every year, rather than include them in the balance sheet at cost minus depreciation.

In the case of R.E.A. Holdings, which has a young estate that has yet to reach its full production potential, the result would be an increase in the value of the plantation each year, and the elimination of the bulk of its current depreciation charge. The effect of the new Standard will be to boost declared profits. We cannot be certain of its effect on asset values, because we do not know what value a firm of outside valuers would place on the existing estate. We suspect, however, the valuation would be at least equal to the current book figure, and possibly somewhat higher.

Theoretically, IAS 41 will have to be adopted by all plantation companies from the June 2004 interim figures. Its introduction, however has proved to be a very controversial issue, with many trade bodies and individual companies protesting against its introduction.

We have continued to present our forecasts on the basis of the 'old', traditional accountancy principles. Investors need to be aware of the issue, however, and above all be aware of the need to watch the next two sets of results for any distortions caused by a change of accountancy methods.

Forecasts

We expect profits in the current year to more than quadruple at the pre-tax level to approximately £8.5m, and to show another large increase the following year. After that, growth is likely to be less exciting, until 2004 and 2005 plantings start producing fruit in quantity in the final years of the decade.

The crop figure indicated by the management for 2004, of 298,000 tonnes, is a 32% increase on the 2003 figure, and only fractionally below the theoretical crop for the year that we indicated in our original research note.

The palm oil price is higher, but we need to inject a note of caution here. First, the palm oil price is quoted in US Dollars, and the Dollar has been weak. Second, the Dollar palm oil price has eased off its peaks a little during April, and expectations of a good US Soya crop this year could influence the price over the summer. Third, the prices obtained by R.E.A. do not match the official price quoted CIF Rotterdam. It costs $50/tonne in shipping costs to get palm oil from the Far East to Europe, and also the price for oil sold locally tends very much to reflect the European price minus the shipping cost.

Yields for 2004 will be slightly reduced by the very wet weather. We have allowed for this in our forecasts. However, wet weather produces ideal growing conditions for young palm oil trees, so any income lost through yield reduction in 2004 will be more than made up in terms of larger crop in 2005. It must be pointed out that R.E.A's yields are among the best in the industry, partly because it is using modern high yielding varieties of tree and partly because as a single estate producer it owns its own mill and therefore has huge efficiency advantages over most of its competitors.

The lower US Dollar will help keep down costs in the current year, and the industry standard formula used for capitalising expenditure on new estate plantings will also work in the company's favour as the hectareage is increased.

On the other hand the company faces a full tax charge for the first time, minority interest charges that will almost certainly be significantly higher than we originally forecast, and the cash costs of eliminating the preference dividend arrears.

The gearing effect of the preference and minority deductions below the line mean that even so fully diluted eps are likely to more than quadruple from 3.7p to in the region of 16p.

As for the balance sheet, by end-2004 the gearing level will be an unexciting 50%. By end-2005, it will be looking conservative, and shareholders might even start calling for term debt finance to be used to a greater extent.

By 2006 the preference share arrears will probably have been paid off and in 2007 shareholders could get a first dividend.

Looking further forward, even if R.E.A. Holdings makes no new plantings at all after this year, its profits will continue rising until 2010.

Year by year profits will always be subject to some variation because of the weather, the palm oil price and currency movements. There are also, obviously, political risks. But overall there are few companies around with prospects this good on such a time frame.

The five year share price performance of the four palm oil producers quoted on the London stock markets. R.E.A. Holdings has been the best performer, largely because of the share price gains seen since last Autumn. Anglo-Eastern has been the second best performer in share price terms, followed by Rowe Evans Investments and then Bertram Investments.

R.A. HOLDINGS HARDMAN & CO CROP FORECASTS 30.4.2004

Palm Oil Production	Hectares		Theoretical Tonnes Yield								
Year of Planting	**Planted**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
1994	500	10,000	12,500	14,000	14,000	14,000	14,000	14,000	14,000	14,000	14,000
1995	2,000	30,000	40,000	50,000	56,000	56,000	56,000	56,000	56,000	56,000	56,000
1996	2,300	18,400	34,500	46,000	57,500	64,400	64,400	64,400	64,400	64,400	64,400
1997	2,400	19,200	36,000	43,200	60,000	67,200	67,200	67,200	67,200	67,200	67,200
1998	5,000	0	40,000	65,513	100,000	125,000	140,000	140,000	140,000	140,000	140,000
1999	300	0	2,400	3,000	4,500	7,500	8,400	8,400	8,400	8,400	8,400
2000	900	0	0	1,000	6,000	18,000	22,500	25,200	25,200	25,200	25,200
2001	0		0	0	0	0	0	0	0	0	0
2002	0			0	0	0	0	0	0	0	0
2003E	0				0	0	0	0	0	0	0
2004E	3,000					0	0	24,000	45,000	60000	75,000
2005E	4,000						0	0	32,000	60000	80,000
2006E	4,000							0	0	32000	60000
2007E	4,000								0	0	32,000
TOTAL THEORETICAL CROP				222,713	298,000	352,100	372,500	399,200	452,200	527,200	622,200
% Yield				24.9%	24.5%	24.5%	24.5%	24.5%	24.5%	24.5%	24.5%
Oil Tonnage Produced****				55,456	73,010	86,265	91,263	97,804	110,789	129,164	152,439
Kernel Tonnage Produced		34,000	59,000	10,022	13,410	15,845	16,763	17,964	20,349	23,724	27,999
Total Palm Products Tonnes		34,000	59,000	65,478	86,420	102,109	108,025	115,768	131,138	152,888	180,438
Price Per Tonne US$ FOB Borneo		286	391	370	450	450	450	450	450	450	450
Price per Tonne £UK		191	261	231	256	256	256	256	256	256	256
Palm Oil Revenue		0	0	12,824	18,667	22,056	23,334	25,007	28,327	33,025	38,976
Palm Kernel Revenue***		0	0	927	1,371	1,620	1,714	1,837	2,081	2,426	2,864
Cy Theoretical Turnover £000		0	0	13,751	20,039	23,677	25,049	26,844	30,408	35,451	41,839
Reported Fresh Fruit Crop		123,992	199,184	222,713	298,000	352,100	372,500	399,200	452,200	527,200	622,200
Reported Palm Oil tonnage		28,557	49,604	55,456	73,010	86,265	91,263	97,804	110,789	129,164	152,439
Extraction Rate		23%	25%	24.9%	24.5%	24.5%	24.5%	24.5%	24.5%	24.5%	24.5%

Hardman & Co forecasts are based on an FOB Borneo price of US$450 and an exchange rate of US$1.76 to £1. The current palm oil price is US$545 CIF Rotterdam, which translates to approximately US$495 FOB Borneo. The exchange rate is currently US$1.77/£1.

R.E.A. HOLDINGS P & L FORECASTS 30.4.2004

	2001A	2002A	2003A	2004E	2005E	2006E	2007E	2008E	2009E	2010E
Reported Turnover £000	1,326	12,831	13,781	20,039	23,677	25,049	26,844	30,408	35,451	41,839
Cost of Sales	403	7,897	7,469	7,014	7,813	8,767	10,201	11,555	12,408	13,807
Gross Margin %	70%	38%	46%	65%	67%	65%	62%	62%	65%	67%
Administrative Expenses	1223	2,571	2,236	3,111	3,422	3,764	4,141	4,555	5,010	5,511
Admin as % of Sales	92.2%	20.0%	16.2%	15.5%	14.5%	15.0%	15.4%	15.0%	14.1%	13.2%
Associates	122	0	0	0	0	0	0	0	0	0
Profit/loss on asset disposals	448	-326	-257	0	0	0	0	0	0	0
Interest Charge In/Out	52	-581	-1,749	-1,400	-1,400	-1,200	-900	-400	-200	-50
Pre-tax Profit	**427**	**1,456**	**2,070**	**8,514**	**11,041**	**11,317**	**11,602**	**13,898**	**17,833**	**22,471**
Tax £000	147	49	345	2,725	3,312	3,395	3,481	4,169	5,350	6,741
Tax Charge* %	34%	3%	17%	32%	30%	30%	30%	30%	30%	30%
After Tax Profit	280	1407	1,725	5,790	7,729	7,922	8,122	9,729	12,483	15,730
Minority Interests	-59	-725	-383	-851	-1,104	-1,132	-1,160	-1,390	-1,783	-2,247
Preference Dividends**	-512	-512	-513	-513	-513	-513	-513	-513	-513	-513
For Ordinary Shareholders	-291	170	829	4,425	6,112	6,277	6,448	7,826	10,187	12,970
Cost of Ordinary Dividend	0	0	0	0	0	280	753	1,255	1,757	3,263
Retained Earnings	-291	170	829	4,425	6,112	5,997	5,695	6,571	8,430	9,707
Average No. of Shares	11346	12,628	16,520	18,683	18,683	18,683	25,100	25,100	25,100	25,100
Earnings Per Share Undiluted p.	-2.56	1.35	5.02	23.69	32.71	33.60	25.69	31.18	40.58	51.67
Dividend Per Share p.	0	0	0	0	0.00	1.50	3.00	5.00	7.00	13.00
Shares in Issue Fully Diluted		22,422	26,314	28,477	28,477	28,477	28,477	28,477	28,477	28,477
EPS Fully Diluted		**0.76**	**3.72**	**16.07**	**21.99**	**22.57**	**22.64**	**27.48**	**35.77**	**45.54**

** Deferred tax provision only until 2006*

*** In Arrears since June 2001*

**** 4.5% yield @40% of Palm Oil price*

Cash Flow	2001A	2002A	2003A	2004E	2005E	2006E	2007E	2008E	2009E	2010E
Retained Earnings	-291	170	829	4,425	6,112	5,997	5,695	6,571	8,430	9,707
Deferred Tax	0	0	345	2,725	3,312	0	0	0	0	0
Unpaid Preference Dividend	257	513	257	-257	-513	-257	0	0	0	0
Depreciation	137	1,616	2,100	2,300	2,400	2,500	2,600	2,700	2,800	3,000
Asset Sales	5,697	60	647	0	0	0	0	0	0	0
Conversion of Convertible Loan						-3,419				
Issue of New Equity	1,268	-5	4,994	0	0	3,419	0	0	0	0
Investment in new Plantations	-664	-2,154	-2,300	-7,000	-7,000	-7,000	-7,000	-7,000	-7,000	-7,000
Other Investment#	0	-560	-2,375	-750	-2,500	-850	-1,000	-1,000	-1,000	-1,000
Working Capital etc	-2,464	-2,944	1,346	0	0	0	0	0	0	0
Net Cash Flow	**3,940**	**-3,304**	**5,843**	**1,443**	**1,811**	**390**	**295**	**1,271**	**3,230**	**4,707**

R.E.A. HOLDINGS BALANCE SHEET FORECASTS 30.4.2004

Balance Sheet	**2001A**	**2002A**	**2003A**	**2004E**	**2005E**	**2006E**	**2007E**	**2008E**	**2009E**	**2010E**
Estates Land and Buildings	45,071	45,577	45,000	50,459	55,851	61,176	66,434	71,625	76,749	81,739
Plant and Machinery	4,532	4,727	5,238	5,229	6,937	6,962	7,104	7,213	7,289	7,299
Stocks	1,143	857	1,346	1,346	1,346	1,346	1,346	1,346	1,346	1,346
Debtors	2,892	4,544	3,710	3,710	3,710	3,710	3,710	3,710	3,710	3,710
Cash	5,398	5,156	6,790	6,790	6,790	6,790	6,790	6,790	6,790	6,790
Short term Loans - Agriculture##	27,931	3,416	2,651	1,208	-603	-993	-1,289	-2,559	-5,789	-10,496
Short term Loans -MEZ Group	5,638	5,078	0	0	0	0	0	0	0	0
Leases	83	71	71	71	71	71	71	71	71	71
Trade Creditors	1,284	739	739	739	739	739	739	739	739	739
Other Creditors and accruals	4,437	4,461	11,784	11,784	11,784	11,784	11,784	11,784	11,784	11,784
Convertible Loan Stock	0	3,419	3,463	3,463	3,463	3,463	3,463	3,463	3,463	3,463
Other term loans	1,871	21,134	15,312	15,312	15,312	15,312	15,312	15,312	15,312	15,312
Term Leases	94	68	0	0	0	0	0	0	0	0
Minority Interests	4,403	4,574	4,308	4,308	4,308	4,308	4,308	4,308	4,308	4,308
Preference Shares	5,705	5,705	6,732	6,732	6,732	6,732	6,732	6,732	6,732	6,732
Ordinary Shareholders' Funds	8,892	11,563	16,737	21,162	27,274	33,271	38,967	45,537	53,967	63,674
Net Debt	30,219	28,030	20,000	18,557	16,746	16,356	16,060	14,790	11,560	6,853
Gearing %###	**207%**	**162%**	**85%**	**67%**	**49%**	**41%**	**35%**	**28%**	**19%**	**10%**
Year end Shares in Issue	12,427	12,727	18,650	18,650	18,650	25,100	25,100	25,100	25,100	25,100
nav per share, undiluted, p.	72	91	90	113	146	133	155	181	215	254
nav per share, diluted, p.		**76**	**84**	**93**	**115**	**136**	**156**	**179**	**209**	**243**

 # Mill extension in 2003, 2nd mill in 2005 *## negative equates to spare cash*

Convertible Loan Stock included in debt

2003 Cash Flow and Balance Sheet Provisional until full Annual Report is available