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REA 301.5p

Legal dispute resolved and trading update

31 January 2006



Palm oil plantation group REA has settled its long-running legal dispute with US based minority shareholder the MEZ Group. We are pleased by this development - it removes what was arguably the single biggest uncertainty facing the group going forward and will free up valuable management time.

The settlement has been structured so as to give REA full control of subsidiary company Makassar, itself a substantial and growing business. Whilst we had not allowed for any form of settlement in our estimates model the agreed sum of \$19m appears, in our opinion, to be a fair price to pay for MEZ's 12.3% stake in this company.

Payment will be satisfied via the issue of \$19m new 7.5% dollar denominated loan notes payable in 2012/14. \$6m is also payable as accrued interest on former MEZ loans and in settlement of other claims; the consolidated balance sheet to end December 2004 included a provision against this liability of \$3.6m. We expect this to be taken through the p & l account as an exceptional item, probably in 2005.

On the trading front, REA has confirmed that both FFB crop output volumes and extraction rates fell short of expectations for the year to December 2005 due to exceptionally heavy rainfall.

We have adjusted our estimates model to account for scaled back crop output projections, higher freight costs and most significantly the move to IFRS Accounting. The combined effect of these changes is a significant increase in group profitability.

Share Price: 301.5p

12m High: 301.5p

12m Low: 215p

Market Cap: £80.5m

Shares in Issue

Fully Diluted: 26.7m

Gearing: 85% (2004 historic)

Interest Cover: 2.2X (2004 historic)

EPIC Code: RE.

SEDOL No: 234906

Sector: Food producers and processors

Market: London Full List (FTSE Fledgling)

Broker: Mirabaud Securities

Website: www.rea.co.uk

Previous research note: 25.5.05

Analysts: Sonia Kaur / Roger Hardman

Y/E	Sales £m	Declared Profit £m	Adjusted Profit £m	Fully diluted Eps p.	P/e ratio	Divi p.	Yield %
2003A	13.8	2.07	2.07	3.8	79	0	-
2004A	16.05	4.69	4.69	7.6	40	0	-
2005E	14.85	7.42	8.77	16.1	19	0	-
2006E	17.89	10.03	10.03	24.3	12	0	-

*All estimates are calculated on an IFRS basis

The Settlement

REA has settled its legal dispute with US based minority shareholder the MEZ group. To recap, this case was first lodged in 2001 and claimed, amongst other things, fraud and breach of contract in respect of an alleged verbal promise that subsidiaries REA Kaltim and Makassar pay a return of 30% on an \$8m loan and on financial support of US\$ 5.5 million. In 2002, a New York judge rejected almost all of the claims relating to fraud but ruled that the contract related claims could proceed.

Our estimates model did not take account of REA's potential liability in this case, partly so as to avoid prejudicing the final outcome and partly because of the high margin for error. In the event, the total settlement amounts to \$25m, the equivalent of £14.1m at current exchange rates consisting of \$19m for the MEZ group's 12.3% stake and \$6m in accrued interest on former MEZ loans and in settlement of other claims. Each side will be responsible for meeting its own legal fees.

If we take £76.5m (95% of REA's current market capitalisation of £80.5m) as being a good indication of the current market worth of Makassar then 12.3% of this company is worth c.£9.5m. This is before factoring in the growth potential, of course - remember this is a plantation that is expanding its planted hectareage by 25% in the current financial year.

The agreed sum of \$19m will be satisfied by the issue of \$19m in new dollar denominated loan notes payable in 2012/2014 and bearing interest at the rate of 7.5% per annum. This takes the total number of 7.5% dollar denominated loan notes outstanding to \$24m, including the \$5m issued back in September as part of the conversion of REA's 4% convertible loan stock, and will increase the annual interest charge taken through the p & l account by £1m per annum.

We expect the \$6m to be paid in cash, subject to the approval of REA's bankers. REA's consolidated balance sheet to end December 2004 included a provision against this liability of \$3.6m. We believe this will be taken through the p & l account as an exceptional item in 2005 and have adjusted our estimates accordingly.

REA and IFRS Accounting

REA will be adopting IFRS Accounting Standards for its full year results to end December 2005, which we expect to be announced sometime in April.

Oil palm plantings are classified as biological assets under IFRS Accounting Standards. IFRS requires that biological assets are no longer depreciated but are marked to market at the end of each reporting period. Any surplus or deficiency on marking to market, after allowance for the capital expenditure incurred on the biological assets during the period, is taken through the p & l account.

Previously REA, in common with other plantation companies, had capitalised the costs of developing its plantations until the palm oil trees reached maturity, and from that point on (four years after planting) it depreciated them to zero on a straight line basis over 20 years. Our spreadsheets, which forecast declared profits up to and including the year 2010, now carry plantation yield calculations out to 2035.

The new accounting rules have had two main effects on REA, therefore. First, the depreciation charge is much reduced - we believe that the current year depreciation charge will be less than £1.0m, whereas under UK GAAP Accounting it would have been £2.4m. Second, the change in the value of the group's assets are now being put in the p & l Account - for the current year this will increase profits by £4.8m, i.e. it will double them.

The new accountancy rules have no effect on cash flow or the level of debt. They will probably be largely ignored by institutions and professional investors. The overall level of debt at REA is likely to rise, however, reflecting the issue of \$25m new 7.5% dollar denominated loan notes.

We have adapted our spreadsheet to predict the impact that the IFRS annual revaluations will have on the group p & l account, using similar techniques to the ones used by the company.

The company revalues its biological assets using a discounted cash flow method. We have calculated the likely crop for the plantation for each year, until the end of the working life of each tree 25 years after planting. We have worked on the assumption that there will be no yield on the trees for the first three years after planting, then in the following years the yields will rise to 8, 15, 20, 25 and then 28 tonnes per hectare. We have assumed that yields currently being obtained will continue to be achieved. In preparing our own valuation of biological assets, we have used a discount rate of 19% p.a.

The company's calculations make allowance for detailed development and operating costs, and also translate crops into money by taking an average of palm oil prices over the past ten years. We have short cut this by working purely on total yields, assuming no change in costs or prices. This is because the change in value each year is the important factor, not the absolute number.

REA is involved in an active and major planting programme that is expanding the plantation size, yet even the oldest of the existing tree stock does not reach the end of its life until 2020. As a result, the IFRS adjustment is large, and will continue to be so for several years. The Interim Report to June 2005 gave the adjustment at that point as £2.4m, indicating strongly that the full year figure would be £4.8m. We believe that it will be £5.6m for 2006, rising to £6.3m, £7.1m, £7.8m and £8.2m for the years 2007, 2008, 2009 and 2010 respectively.

Current Trading

In terms of current trading REA has confirmed that FFB crop output for the year ending December 2005 was 313,000 tonnes, 6% ahead of 2004 but 9.5% shy of the 331,000 tonnes we were expecting. Heavy rainfall in April / May and then again in November / December (the peak cropping season for REA Kaltim's plantation) is to blame.

Wet weather makes for ideal growing conditions for oil palm trees, but heavy rains, particularly during the day, can be hugely disruptive to operations. Harvesting becomes less frequent, instead of picking fruit every 10 days REA was only making it to the fields after 25 days in many of its areas, thereby reducing fresh fruit bunch volumes.

The wet weather also had a negative impact on oil extraction rates, which were 23.4% during the period against our forecast of 25%. The main reason for this was sub-optimal pollination. Palm oil plantations rely on weevils, insects originating from Africa that were introduced to the palm oil industry in the 1970's as an efficient and cost effective method of pollinating the fruit on palm trees. Wet weather discourages weevil activity and this has significantly impacted extraction rates during the period.

Had it not been for the unseasonably wet weather which led to 5000mm of rain falling over 2005

against 3877mm in 2004, management say both budgeted FFB crop output and oil extraction rates would have been eminently achievable.

High freight costs - we've heard that inter-island freight rates in Indonesia have hit levels well in excess of \$20 per tonne, whilst the costs of shipping direct to Europe are now close to \$70 per tonne – pushed the average US\$ FOB CPO price down to \$331 tonne in 2005, 14% below the average price achieved in 2004. With freight costs showing no signs of coming off the boil we are trimming our forward US\$ FOB CPO price expectations accordingly.

So what does all this mean for our forecasts?

Under UK GAAP Accounting REA's reported sales and profits would have been substantially below our expectations. This is because costs have a high fixed element so changes in the FOB CPO price, extraction rates and output fall straight through to the bottom line. However the adoption of IFRS Accountancy Standards will deliver a significant boost to profits. According to our estimates, REA will report 2005 pre-tax, pre-exceptional profits of £8.77m and eps of 16.1p. For 2006 we look for pre-tax profits on the same basis of £10.03m and eps 24.3p assuming FFB crop output of 353,000 tonnes, an extraction rate of 24% and US\$ FOB CPO price of \$345 tonne.

Conclusion

REA operates one of the largest and most efficient single site oil palm plantations in the world. The settlement of the long-running legal dispute removes what we believe was the single biggest uncertainty facing the company going forward and is excellent news for shareholders.

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