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R.E.A. Holdings

EPS To Double in 2007

492p 22.5.2007



Full year profits came in at £10.6m, almost precisely on the £10.9m we had forecast, and with the key 'adjusted' profit, ignoring an irrelevant IFRS 'biological adjustment', 10% ahead of our forecast. The current year profits will more than double because rising output and higher palm oil prices more than outweigh negative currency impacts, and we are upgrading. But much more important the medium term outlook is good for the following reasons:

- 6,500 Ha of land were planted out last year, ahead of our forecast and taking the total planted area to 25,000 Ha.
- Land already planted with immature trees will ensure that output nearly doubles by 2010.
- The palm oil price has almost doubled in the past year.
- Yields and operational efficiencies will almost certainly be better in 2007 and 2008.
- The company's past structural weaknesses – the overhanging US legal action and a complex minority structure – have been resolved to REA's advantage.

With the rise in biofuels and the boom in the price of palm oil, R.E.A. Holdings is in an enviable position. Its rivals are scrabbling around looking for new planting areas to buy – R.E.A. can double its size and quadruple its output from its existing land holdings. Additionally it is one of the most efficient companies in the industry. R.E.A. is magnificently placed for 2007.

Share Price: 492p

12m High: 511p

12m Low: 265p

Market Cap: £154m

Shares in Issue: 32.57m

NAV/Share: 185p (after recent capital raising)

Gearing: 43% after recent capital raising. Prefs treated as equity.

Interest Cover: 2.5X

EPIC Code: RE.

Sector: Food Producers and Processors

Market: London Official List

Broker: Mirabaud Securities

PR: -

Website: www.rea.co.uk

Previous Research Note: 'Ordinary Dividends Resumed', 376.5p, 20.10.2006

Analysts: Roger Hardman/Sonia Kaur

Y/E	Sales	Declared	Adjusted*	Adjusted*	P/e ratio	Divi p.	Yield
December	£m	Profit £m	Profit £m	Eps p.			%
2005A	14.9	9.6	5.5	9.6	51.5	0	-
2006A	17.8	10.6	5.9	9.6	51.5	0	-
2007E	30.6	20.8	14.6	23.6	20.8	1	0.2
2008E	36.8	26.4	19.3	30.2	16.2	3	0.6

* excludes IFRS biological adjustment and related deferred tax charge

Background

R.E.A. Holdings produces palm oil in Indonesia. It has no other interests. The Provincial Government of East Kalimantan has undertaken to support the development by R.E.A. Holdings of 125,000 hectares (375,000 acres) in the province. This is a land area the equivalent of a 10 mile strip from London to Brighton. Land titles obtained and in progress now total some 65,000 hectares.

Of this, at present 25,000 hectares is planted out, 13,100 hectares of which is mature and yielding fruit and 11,900 hectares of which is immature and due to come to maturity over the next four years. An additional 1,000 hectares is farmed by local villagers who sell the fruit obtained to R.E.A. Holdings; yields on this land are lower than those obtained by the company.

Historically, R.E.A.'s development was held back by the Asian banking crisis, which led to a five year gap when no significant planting took place on its new estates, and by a legal clash with a minority shareholder of the main operating subsidiary. Both these issues are now well in the past, however, and have ceased to be of any relevance.

The company has recently declared its first dividend.

The Palm Oil Industry

Palm oil has historically been a crop whose prime use has been cooking oil. Over the last twelve months it has become increasingly in demand as biofuel, however, and biofuel demand is proving the swing factor in pricing for two reasons.

First, there is strong demand from biofuel plants that have been built over the past two years, and this will continue as new bio-ethanol and bio-diesel plants come on stream worldwide in the immediate future. Secondly, the USA has chosen corn as the prime route for its biofuel processes, and because of this farmers in the USA are planting corn on land that they would otherwise have planted with soybean.

For the 2007 crop season, corn plantings in the USA are up 9%, and soybean plantings are down 11%. Soybean oil is a direct competitor to palm oil for cooking, and any shortage of soybean oil will drive displacement purchase of palm oil.

Palm oil is an interesting commodity, because it competes as a cooking oil with a range of alternative vegetable oils, and its price is driven by the price position in these other oil crops, which are much larger in quantity than palm oil. Palm oil accounts for just less than 25% of the world total supply of edible oils and fats.

Most of the competing vegetable oils however (sunflower oil, rape, soya oil) are annual crops, and the supply situation changes annually. The palms that yield palm oil, however, take four years from planting to yield commercial quantities of oil, and then yield for a further 20 years. New palm oil plantings do not necessarily lead to a glut of product and therefore a price reduction. A glut of palm oil can theoretically lead to a very much smaller drop in the price of all the major cooking oils. The current rush to lay out new plantations, therefore, will not necessarily have a major adverse impact on future prices – particularly if the quantity of land planted out to other cooking oil crops is reduced, and particularly as long as the current boom in biofuels continues.

Indonesia has recently overtaken Malaysia as the world's largest producer of palm oil and the two countries between them account for 85% of world production. Operating costs are cheaper in Indonesia than Malaysia, largely because of the lower cost of labour.

Latest statistics from Malaysia show a reduction in palm oil stocks to the lowest level since May 2004, because of low production and strong export demand from China, Pakistan and the USA. China is the world's largest consumer of palm oil, followed by India.

Palm oil prices have risen 25% since the beginning of March.

Frost & Sullivan, the consulting firm, expect the bull run in palm oil to last for at least another decade, with prices reaching US\$1,000 a tonne, 50% higher than at present, before the end of the decade.

The Environment

R.E.A. Holdings only plants on vacant land. It does not clear rainforest, and it has no involvement whatsoever in the logging industry, which has a long history of rain forest destruction brought about by illegal over logging.

Independent environmental consultants were used before the current plantation was

established, and their work is periodically updated. As it grows, the company is actively recruiting new personnel in the areas of community development and conservation.

In our opinion, R.E.A. Holdings qualifies as an environmental company.

The Capital Raising

On May 2, R.E.A. announced that it had placed 1.5m additional shares at 450p a share, raising an additional £6.5m of new capital for the company.

The driver behind this capital raising has been the possibility of sizeable future planting programmes on the increasing land bank available for development. Before the placing R.E.A had been operating conservatively with net debt of £32.6m compared to equity of £53.8m, giving gearing of only 61%.

Furthermore, while the company is still cash flow negative because it has been spending more on developing its new estates each year than it gets in EBITDA, the gap will narrow progressively.

The new capital gives R.E.A. Holdings the capability to take on new land areas, probably still in Indonesia but possibly also elsewhere.

Already, the current development programme entails raising some 1.5 m seedlings a year in its nurseries, and planting out over 1m seedlings a year by hand. It also means looking after 25,000 Ha of trees – some 3.5 m. trees – in the production and pre-production stages of their 25 year life.

The company is currently looking at a new development area of some 8,000 Ha and discussions have commenced on a further two areas that may have development potential.

Values in Indonesia for undeveloped scrubland are rising rapidly. This is largely because of the rapid increase in the price of palm oil, but also because Indonesia is overall experiencing rapid economic growth at present. Good palm oil growing land is currently selling for \$400/Ha.

Full legal title can take three to four years to obtain so capital can be tied up for some considerable time before the first returns are obtained. Also, the costs of developing any newly acquired land would be considerable.

We can certainly see the R.E.A. board's viewpoint that a certain safety cushion is advisable.

The 2007 Results

The full year results were pleasing.

The Crop The fresh fruit bunch crop amounted to 334,000 tonnes, only slightly short of our 353,000 tonne forecast in spite of the poor weather conditions in the early part of the year. Oil extraction rates were also a little below our expectations, at 23.2% (we had looked for 23.5%). The price per tonne realised was higher than we thought likely, however, because the company had sold less of its crop forward than we had budgeted for, and therefore had gained more than we expected from the rise in the palm oil price at the end of the year.

Turnover and Profit The result was turnover of £17.8m, which was within 2% of our forecast of £18.1m, and a gross profit of £9.8m compared to our forecast of £10.1m.

The cost of sales was precisely as we forecast, giving an almost identical gross margin to the previous year.

Administrative expenses almost doubled, because of a reversal of the previous year's currency gain and a one-off National Insurance bill on the exercise of director share options. On the plus side, interest costs have been considerably reduced. The end result is a pre-tax profit, net of the meaningless IFRS adjustment on biological asset values (see below) of £5.9m.

This is a 10% improvement on the previous year and the management deserves a lot of credit for producing this number in the combined face of low rainfall and high one-off costs. The figure is 10% higher than we had been expecting.

Tax The tax provision has been reduced from last year's 34.5% of declared profits (which includes the biological charge) to 30% of declared profits. This is as we predicted. Once again, taxes actually paid have been minimal, because the group has accumulated tax losses from the period when it was just beginning to establish its plantation (and before even that), and almost the entire tax charge is deferred tax that will probably never be paid.

Tax paid will start to become an issue in the current financial year, when it will make a first appearance at in the region of 10% of adjusted, non-biological profits. It will probably rise to 30% over the course of the following three years.

Minorities and Preference

Dividends These in the past have been very significant items – in 2005 they absorbed 86% of the after tax underlying profit. This is where the real benefit of the clever restructuring work undertaken by management over the past two years has its biggest effect. The minority interest has been cut from £1.0m to just £0.28m. The preference dividend is higher at £0.96m (£076m) but the net effect is to leave a far greater proportion of profits in the hands of R.E.A. ordinary shareholders.

Declared Earnings Per Share have consequently increased from 16.7p by 21% to 20.3p. The far more important Adjusted Earnings Per Share, stripping out the biological adjustment, is unchanged at 9.6p. This is a third year of static eps, before a step change in 2007 that will see the real eps figure more than double.

IFRS Under IFRS Accounting, R.E.A. Holdings has to include in its p & l account for the gain in the value of the trees in its plantations.

This is clearly a nonsense. The trees cannot be uprooted and planted anywhere else, and the plantation land itself is not covered by this requirement. R.E.A. is required to use a complex formula discounting future production over the economic life of each tree, and we shadow this model for the purposes of being able to produce an IFRS compliant forecast.

For 2006, there has been a slight reduction in the discount rate used. This has had the impact of very modestly increasing the biological profit compared to the number that would have been reached with the previous formula. Also, the palm oil price used in the theoretical model has been pushed out to a 20 year historical average, rather than the 10 years used previously. This has had no impact whatsoever.

We recommend that investment managers totally ignore the IFRS profit figure, and work instead with our 'adjusted' profit figure, which strips it out. We believe it very likely that the regulations will be changed shortly and the whole concept dropped.

Current Year Prospects

The current year is, in our view, likely to see profits more than double once the IFRS biological crop adjustment is stripped out.

Even with this adjustment included, the official reported numbers are likely to be nearly doubled.

There are several reasons for this:

- The fruit crop is likely to be up 15% this year, as the first yields from 2004 plantings are obtained and the established trees recover from the effects of the early 2006 water shortage. We expect the oil extraction rate from the crop to be up from 23.2% to 24% in the current year.
- The palm oil price is higher – US\$700 a tonne compared to just over \$400 a tonne a year ago. R.E.A. Holdings has hedged approximately 20% of its current year crop forward so will not reap the full benefit of this, but even so, when combined with the larger crop and the higher yields, current year turnover could be up as much as 70%, to UK£30m.
- The palm oil price is not likely to fall for at least twelve months, because of the reduction in planting of rival crops in the Northern Hemisphere this summer.
- The cost of harvesting and processing the fruit will not rise nearly as fast as turnover. We predict an 18% rise in costs of production, compared to the 15% increase in tonnage of fruit harvested.
- Admin costs will rise, but as a proportion of sales they will fall dramatically. These are largely fixed costs.

We forecast that earnings per share, ignoring the IFRS biological adjustment, will rise from 9.6p to 23.7p. The declared numbers including the hypothetical IFRS gain, will probably rise from 20p to 37p.

2008 And Beyond

If the palm oil price manages to maintain its current levels, there will be a dramatic increase in profits between 2008 and 2012.

This is because:

- With new planting progressing at 7,000 hectares a year, R.E.A. Holdings will have doubled its planted land area between 2006 and 2010, and have increased it a further 50% by 2013. Many of these trees will be immature and yielding little or no oil, but even

so the crop is likely to increase by 90% between 2006 and 2010.

- The fixed costs will be spread over a very much larger business.
- Strong cash flow and increased size will enable R.E.A. Holdings to negotiate better borrowing terms from its bankers.

Risk Factors

Price Risk. There is a risk that the palm oil price could collapse back to \$400 a tonne or less, under the influence of either a collapse in the biofuel industry or the impact of new plantations opening up in the future and increased planting of other cooking oil crops. If this happens, R.E.A. Holdings is well placed to withstand the shocks. Its cost of sales per tonne is less than US\$150.

Political Risk. All R.E.A. Holdings' assets are in one country, Indonesia. In one previous palm oil boom, Indonesia imposed an export tax. There is a risk of this happening again, but it may not be high. The Indonesian economy is stronger than it has ever been, and the need for tax revenues is not as pressing as it once was. Indonesia is relatively strong. In recent years it has become a stable democracy.

Conclusion

R.E.A. Holdings is sounder financially than it has ever been and the 2006 restructuring has been hugely beneficial, Eps are likely to double in the current year, and will be more than four times the 2006 level in 2010 if our forecasts prove to be accurate. Growth will continue from then until 2015, even without any new land acquisition, and if R.E.A. Holdings is successful in its quest for development, growth will continue beyond that.

This all makes for a compelling investment package. This company has a good future ahead of it.

REA Holdings

11.5.2007

Y/E December

Palm Oil Production

Year of Planting

Year of Planting	Hectares	Theoretical Tonnes Yield									
	Planted	2001A	2002A	2003A	2004A	2005A	2006A	2007E	2008E	2009E	2010E
1994	500	10,000	12,500	14,000	14,000	13,000	14,000	14,000	14,000	14,000	14,000
1995	2,000	30,000	40,000	50,000	56,000	52,000	56,000	56,000	56,000	56,000	56,000
1996	2,300	18,400	34,500	46,000	57,500	57,500	59,800	62,100	62,100	62,100	62,100
1997	2,400	19,200	36,000	43,200	60,000	58,500	62,400	64,800	64,800	64,800	64,800
1998	5,000	0	40,000	65,513	100,000	120,000	130,000	135,000	135,000	135,000	140,000
1999	300	0	2,400	3,000	2,500	3,000	7,800	7,800	7,800	7,800	8,400
2000	900	0	0	1,000	3,883	9,355	23,400	23,400	23,400	23,400	25,200
2001	0		0	0	0	0	0	0	0	0	0
2002	0			0	0	0	0	0	0	0	0
2003A	0				0	0	0	0	0	0	0
2004A	3,000					0	0	24,000	45,000	60,000	75,000
2005A	2,250						0	0	18,000	33,750	45,000
2006A	6,500							0	0	52,000	97,500
2007E	7,000								0	0	56,000
2008E	7,000										
2009E	7,000										
2010E	7,000										
2011E	7,000										
2012E	7,000										
2013E	7,000										
2014E	7,000										
Total Planted Hectares		13,400	13,400	13,400	16,400	18,650	25,150	32,150	39,150	46,150	53,150
TOTAL THEORETICAL CROP		2001A	2002A	2003A	2004A	2005A	2006A	2007E	2008E	2009E	2010E
% Yield				222,713	293,883	313,355	334,076	387,100	426,100	508,850	644,000
Oil Tonnage Produced				24.9%	24.3%	23.4%	23.2%	24.0%	24.0%	24.0%	24.0%
Kernel Tonnage Produced				55,456	71,473	73,262	77,506	92,904	102,264	122,124	154,560
Total Palm Products Tonnes		34,000	59,000	10,022	12,169	12,647	12,695	15,484	19,175	22,898	28,980
Price Per Tonne US\$ FOB Borneo		34,000	59,000	65,478	83,642	85,909	90,201	108,388	121,439	145,022	183,540
Assumed US\$/UK£ Exchange Rate		286	391	370	385	333	400	600	650	650	650
Price per Tonne £UK				1.80	1.83	2.00	2.00	2.00	2.00	2.00	2.00
Palm Oil Revenue		191	261	231	209	185	219	300	325	325	325
Palm Kernel Revenue*		0	0	12,824	14,955	13,553	16,941	27,871	33,236	39,690	50,232
Cy Theoretical Turnover £000		0	0	927	1,033	1,391	1,665	2,787	3,531	4,217	5,337
		0	0	13,751	15,988	14,944	18,606	30,658	36,767	43,907	55,569
Reported Fresh Fruit Crop		123,992	199,184	222,713	293,883	313,355	334,076	387,100	426,100	508,850	644,000
Reported Palm Oil tonnage		28,557	49,604	55,456	71,473	73,262	77,506	92,904	102,264	122,124	154,560
Extraction Rate		23%	25%	24.9%	24.3%	23.4%	23.2%	24.0%	24.0%	24.0%	24.0%

Cash Flow

	<u>2001A</u>	<u>2002A</u>	<u>2003A</u>	<u>2004A</u>	<u>2005A</u>	<u>2006A</u>	<u>2007E</u>	<u>2008E</u>	<u>2009E</u>	<u>2010E</u>
Operating Profit	-178	2,363	4,076	10,790	10,680	11,168	23,514	29,028	35,935	46,519
Depreciation	137	1,616	2,114	639	806	843	1,200	1,250	1,300	1,350
Amortisation of operating leases	0	0	57	9	19	50	20	20	20	20
Reversal of IFRS Biological gain	0	0	0	-2,986	-4,133	-4,677	-6,300	-7,100	-7,800	-8,200
Working Capital	-2,464	-2,944	1,069	-2,751	1,665	-1,549	0	0	0	0
Biological Gain					0	31	0	0	0	0
Profit/Loss on disposal of assets	0	0	0	-7	4	0	0	0	0	0
Operating Cash Flow	-2,505	1,035	7,316	5,701	9,037	5,866	18,434	23,198	29,455	39,689
Interest	-272	-669	-1,914	-800	-1,008	-1,482	-2,650	-2,600	-2,800	-3,000
Tax paid (much of provision is deferred tax)	-147	-49	-11	-118	-59	-119	1,456	2,899	5,067	8,830
Net Cash Flow from Operating Activities	-2,924	317	5,391	4,783	7,970	4,265	17,240	23,498	31,722	45,519
Capex	1,888	-2,094	-4,675	-3,420	-8,923	-18,104	-6,000	-5,000	-5,000	-5,000
Acquisitions and disposals	3,245	-560	0	-1,067	1,058	-199	0	0	0	0
Preference Dividends	-256	0	0	-639	-765	-900	-900	-900	-900	-900
Issue of preference shares	0	0	0	1,600	0	3,071	0	0	0	0
Issue of new equity	1,268	-5	4,901	47	-138	12,252	0	0	0	0
New borrowings raised						17,495				
Redemption of preference shares by subsidiary						-3,094				
Net Cash Flow	3,221	-2,342	5,617	1,304	-798	14,786	10,340	17,598	25,822	39,619

P & L Account

	<u>2001A</u>	<u>2002A</u>	<u>2003A</u>	<u>2004A</u>	<u>2005A</u>	<u>2006A</u>	<u>2007E</u>	<u>2008E</u>	<u>2009E</u>	<u>2010E</u>
Reported Turnover £000	1,326	12,831	13,781	16,052	14,944	17,833	30,658	36,767	43,907	55,569
Cost of Sales	403	7,897	7,469	6,072	6,641	8,060	9,500	10,500	11,000	12,000
Gross Margin %	70%	38%	46%	62%	56%	55%	69%	71%	75%	78%
Administrative Expenses	1223	2,571	2,236	3,235	1,762	3,287	3,944	4,339	4,773	5,250
Admin as % of Sales	92.2%	20.0%	16.2%	20.2%	11.8%	18.4%	12.9%	11.8%	10.9%	9.4%
Other operating income	122	0	0	1,059	6	5	0	0	0	0
IFRS Biological Asset Adjustment				2,986	4,133	4,677	6,300	7,100	7,800	8,200
Profit/loss on asset disposals	448	-326	-257	0	0	0	0	0	0	0
Net Interest Charge In/Out	52	-581	-1,749	-1,599	-1,058	-543	-2,650	-2,600	-2,800	-3,000
Exceptional Item	0	0	0	0	0	0	0	0	0	0
PTP ex exceptional items	0	1,456	2,070	9,191	9,622	10,625	20,864	26,428	33,135	43,519
Declared Pre-Tax Profit	427	1,456	2,070	9,191	9,622	10,625	20,864	26,428	33,135	43,519
Adj Pre-tax Profit ex IFRS Bio	1,456	1,456	2,070	6,205	5,489	5,948	14,564	19,328	25,335	35,319
Tax £000	147	49	345	2,654	3,323	3,171	7,719	10,244	13,427	18,719
of which: Deferred Tax on Bio Adjustment				896	1,240	1,403	1,890	2,130	2,340	
Tax Charge % (on declared profit)	17%	3%	17%	29%	17%	30%	37%	39%	41%	43%
Tax Charge* % (on adj pft)	34%	3%	17%	29%	53%	53%	53%	53%	53%	53%
After Tax Profit	280	1407	1,725	6,537	6,299	7,454	13,145	16,184	19,707	24,800
Minority Interests	-59	-725	-383	-1,115	-1,014	-281	-340	-340	-340	-340
Preference Dividends	-512	-512	-513	-639	-765	-965	-1,030	-1,030	-1,030	-1,030
For Ordinary Shareholders	-291	170	829	4,783	4,586	6,208	11,775	14,814	18,337	23,430
Cost of Ordinary Dividend	0	0	0	0	0	289	293	440	880	1,320
Retained Earnings	-291	170	829	4,783	4,586	5,919	11,482	14,374	17,457	22,110
Average No. of Shares	11346	12,628	16,385	19,755	22,631	28,857	29,340	29,340	29,340	29,340
Earnings Per Share Undiluted p.	-2.56	1.35	5.06	24.21	20	21.51	40.13	50.49	62.50	79.86
Dividend Per Share p.	0	0	0	0	0.00	1.00	3.00	5.0	7.00	10.0
Shares in Issue Fully Diluted		22,422	24,965	27,411	27,415	30,523	31,135	32,574	32,574	32,574
EPS Fully Diluted		0.76	3.32	17.45	16.73	20.34	37.82	45.48	56.29	71.93
EPS fully dil ex IFRS Bio & Associated Tax		0.76	3.32	9.82	9.61	9.61	23.66	30.22	39.53	46.76

Figures from 2004 onwards have been calculated on an IFRS basis

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