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REA Holdings

Time to Reap the Rewards? 192.5p

6.10.2003

REA Holdings is one of the most efficient palm oil producers in South East Asia. It is emerging from a horrific period caused by factors outside its control, has just declared its first profit for many years and by our calculations is due to turn cash positive in 2004. Dividends are likely from 2006. Weather and palm oil prices permitting, we predict strong growth in Earnings Per Share and Net Asset Value every year from now until the end of the decade. Key points are:

- £5m of new equity capital raised this year takes the pressure off the balance sheet and should take care of all funding needs from now on.
- After the hiatus of the last four years planting has been resumed, and the crop size should more than treble from the 2002 level by 2010.
- Economies of scale allow REA to run its own mill exclusively for its own palm products, resulting in quick processing and very high quality oil. Also, because the best modern hybrid trees are used and crop husbandry is good, REA is getting higher yields than competitors.

There are negatives. A legal action by a US minority investor has still to be resolved, capital spend will be high and there are obviously still political and weather risks. However, the good points far outweigh the bad. This company is one of the stars of the sector.

Share Price: 192.5p

12m High: 192.5p

12m Low: 60p

Market Cap: £36m

Shares in Issue

Undiluted: 18.7m

Diluted: 28.5m

NAV/Share: 85p*

Gearing: 125%*

Interest Cover: 2.0X*

EV/EBITBA: 11.7X*

EPIC Code: RE.

SEDOL No: 234906

Sector: Food producers & processors

Market: London Full List (FTSE Fledgling)

PR: None

Previous research note: Initiation of coverage

* *2003 estimates*

Analysts: Roger Hardman/Sonia Kaur

Y/E 31 Dec	Sales £m	Declared Profit £m	Adjusted Profit £m	Eps p.	P/e ratio	Divi p.	Yield %
2002A	12.8	1.46	1.46	0.8	241	-	-
2003E	14.4	1.83	1.83	1.2	160	-	-
2004E	21.2	9.26	9.26	18.6	10.3	-	-
2005E	24.3	11.46	11.46	24.6	7.8	-	-

SWOT Analysis

Strengths

- Palm oil is the fastest growing and most profitable (on a per matured hectare basis) sub-sector of the edible oils industry. It is also the cheapest of the major edible oils.
- The current year to December 2003 will see substantially all of REA's existing planted hectarage reach maturity. With costs per planted hectarage relatively fixed, rising output could lead to a step change in the company's profitability.
- A new joint venture oil palm development with a local Indonesian investor will further increase output levels and group profitability.
- Indonesia is increasingly becoming the destination of choice for palm oil production because of its cheap and plentiful labour supply.
- REA's oil extraction rates are amongst the highest in the industry giving the group a key competitive advantage over rivals.
- Investment in new on-site oil mill facilities will double REA's processing capacity and comfortably support all future FFB production from its existing planted hectarage.
- REA's relationship with its 2,500 strong workforce and the surrounding local villages is very good and the East Kalimantan plantation is widely credited as being a source of increased prosperity for the region.
- The whole of the East Kalimantan plantation is termed as 'conversion' forest. This is distinct from the many plantations that have been illegally built on 'non-conversion' forest, causing widespread deforestation and social unrest in their wake.

Weaknesses

- REA has not had the best of financial track records. No dividend has been paid on its preference shares since 30 June 2001 and net debt of £28m leaves the company looking over-borrowed in comparison to competitors.
- Our output forecasts for the company are subject to weather-related and crop-specific uncertainties.
- REA's profits are heavily exposed to the crude palm oil price, which tends to move in cycles.

Opportunities

- REA's biggest opportunity is to use the increasing cash flows generated by its maturing planted reserves to resume new planting activity. This has started at the rate of 3,000 H in 2003 and if the target of 40,000 H by 2010 is met, REA will almost certainly become one of the biggest single site oil palm plantation companies in SE Asia.
- India and China are the two largest importers of palm oil. Given palm oil consumption per capita in these countries is closely linked to growth in per capita incomes, it is reasonable to expect the demand for palm oil to continue to outstrip the wider edible oils market.

Threats

- US litigation proceedings against the company and two of its executive directors claiming fraud and breach of contract, increase REA's risk profile.
- While the state of East Kalimantan is considered to be politically and economically stable, the legal, political and security situation in Indonesia, and especially in the capital Jakarta, is anything but. This may continue to turn investors away from REA, regardless of its sound underlying business fundamentals.
- A bad crop year, or worse, a repeat of the Asian economic crisis, could lead to additional calls for funding from shareholders.
- Pressure by the green lobby to curb palm oil development could be damaging to the industry.
- The Indonesian Government's interference in the export pricing of palm oil (in times of very high crude oil prices) has led to wide fluctuations in the crude palm oil price in the past. With palm oil still considered to be a basic necessity in Indonesia, further interventionist policies cannot be ruled out.

The Background

London-listed REA Holdings is a pure play palm oil plantation company. All of its activities are concentrated in the Indonesian state of East Kalimantan, where it is currently developing 125,000 H of ‘conversion’ forest. For perspective, that’s the equivalent of a 10-mile strip from London to Brighton. Once complete, and admittedly that is likely to be some time off yet, REA will almost certainly become one of South East Asia’s biggest single-site palm oil plantation companies.

The palm oil plantation in Indonesia is owned by a local company, PT REA Kaltim Plantations. 95% of PT REA Kaltim Plantations is owned by an intermediate holding company, Makassar Investments plc, with the remaining 5% being owned by a local shareholder, structured in such a way so as to ensure that the majority of the economic benefits from his interest flow directly back to Makassar Investments plc. 79.5% of Makassar is owned by REA Holdings PLC, the quoted company, the minority being owned by a US investor group with which REA does not have a happy relationship.

Major shareholders on the REA Holdings PLC share register include EMBA Holding Ltd, a company controlled by Chairman Richard Robinow and family with a 40% interest and Prudential with 10%.

REA’s management team have credible experience of the palm oil industry. John Oakley, Managing Director and Richard Robinow previously managed a very successful 6,000 H palm oil plantation in Sumatra, Indonesia owned by London-listed competitor Anglo Eastern Plantations.

Palm Oil – The facts

Palm fruits grow in bunches, known in the industry as fresh fruit bunches (FFB), which, when crushed yield two different types of oils: crude palm oil (CPO) and palm kernel oil (PKO).

CPO is obtained from the flesh surrounding the nut and has a wide variety of uses. In the food industry it is used as a cooking oil and in the manufacture of margarines and shortenings. In the beauty industry, it is a key ingredient in many types of soaps and detergents. Unlike some other oils, CPO has a high resistance to oxidation and therefore long shelf life. This makes it particularly suitable for use in tropical countries and in the fast food industry.

PKO is derived by extracting oil from the kernels (which are inside the hard shell of the nut), usually, though not exclusively for use in the cosmetics industry.

The Palm Oil Life Cycle

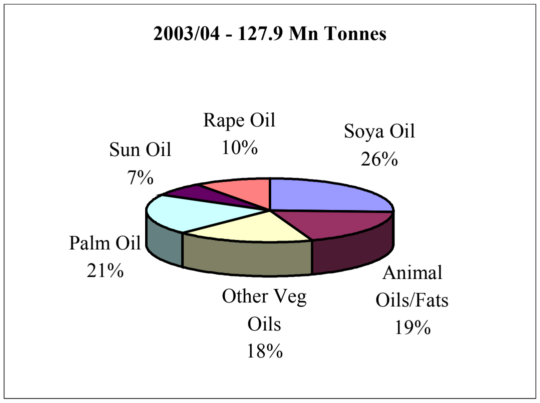
Palm trees have very long life expectancy cycles. In REA’s case, seedlings are grown in nurseries for 12 months before they are planted out in the fields, usually in densities of 143 palms per hectare. The first crop year is not until year 4 and peak output occurs between years 8-15 where the trees yield as much as 28 tonnes per hectare. After that there is a gentle decline in yield until the end of the trees’ useful life in year 25.

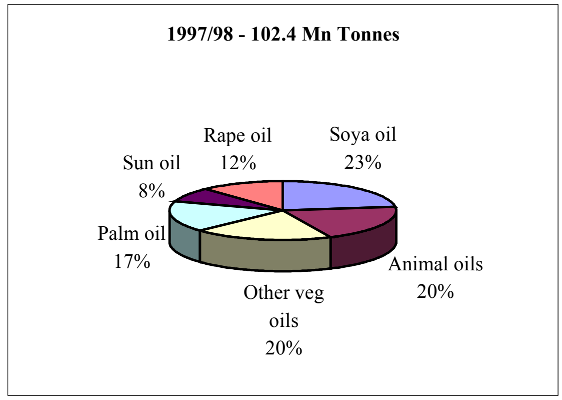
It is worth noting that REA’s yield pattern compares favourably with both the industry average of 20-22 tonnes per hectare and that of wild palm trees, which often struggle to produce anything above 4-5 tonnes per hectare. This is because the East Kalimantan plantation is relatively young compared to rival Malaysian plantations (some of which are over 25 years old) and only uses the best modern hybrid trees, the quality of which is improving all the time through seed hybridisation programmes.

REA’s palm kernel extraction rate at 4.4% is below the industry average of 5%, but fully capable of rising to this level as the plantation continues to mature.

The World Market for Palm Oil: Trends and Outlook

Palm oil is the fastest growing sub-segment of the world edible oils industry. Oil World, in July 2003, forecasts its share of the world edible oils industry will increase from 17% in 1997/98 to 21% in 2003/04. For comparison, aside from soya oil, the market for rape oil, sun oil, animal fats and fish oils are all in decline.

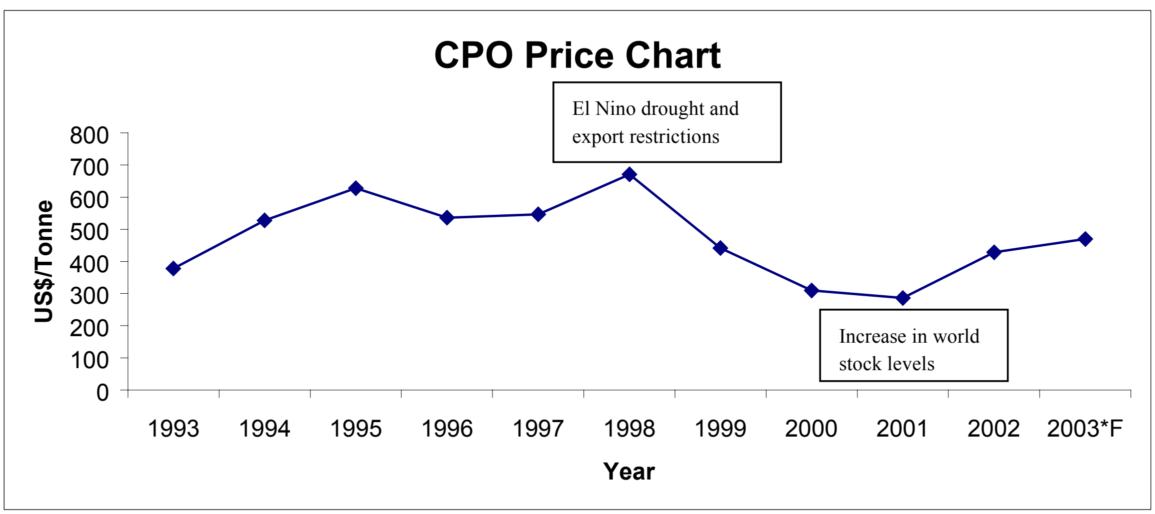




Source: Oil World Annual 2003

Reasons for the rising demand of palm oil include its price competitiveness (palm oil remains the cheapest of all of the major vegetable oils to produce) and variety of end-uses. Also relevant is the growing world market for edible oils, at circa 3.8% per annum. It's growing through two factors: population growth and economic growth. While richer countries use far more oil than poorer ones (US consumption of 45 kilos/pp/pa compares with India's 16), future increases in per capita income are likely to be greatest in countries such as India and China - the two biggest importers of Indonesian and Malaysian origin palm oil produce.

On the supply side, world stocks of oil palm are currently at a 4-year low and there is very little in the way of new planting activity going on worldwide.



Source: Oil World

We believe that while the CIF Rotterdam CPO price has shown significant price movement over the past decade, the tightness of world supply combined with continued robust demand should lead to the prospect of higher CPO prices going forward. Indeed, Oil World forecasts a CIF Rotterdam CPO price of $470 per tonne by July 2004, comfortably above July 2003's average of $429 and capable of boosting REA's gross profits by as much as $328 per hectare. The reverse is also true of course; should the CPO price plunge to 2001 lows then gross profits per hectare could fall by as much as two-thirds.

The development of the East Kalimantan project

The initial development phase of the East Kalimantan project has been expensive and lengthy, spanning 12 years since the project started in 1989.

During the early years, funding was relatively easy to come by. But in 1997, the onset of the Asian Economic Crisis dealt a heavy blow to the company's progress, closing the doors on debt finance for Indonesian-based investments at a time when REA's working capital reserves were close to running dry.

Immediately following the 1997 Asian Economic Crisis, REA was hit by another unavoidable event that had an equally devastating effect on the company. A major climatic switch brought on two years of El Nino, with parching sunshine and spells of drought throughout much of the region, including the REA estates. The uneven falls of rain on the immature trees caused huge problems; tree deaths ran at double the normal rate for immature plantings of 10% a year, forest fires singed and damaged some trees (although none were actually destroyed by fire) and most of the other trees shut down and matured, in effect, two years later than they would otherwise have done. Worse, the fixed costs of running the plantation still had to be paid. The effects of this are very evident in our spreadsheet on page 12.

In order to continue its operations, REA was forced to rely on equity and equity related funding. $8m of this, a relatively modest sum of money for a company of this size, came from the MEZ Group, funds associated with US financial M E Zukerman and a minority shareholder in REA's subsidiary company Makassar.

Despite the capital injection, REA's trading failed to pick up as output targets were missed and the price of crude palm oil (CPO) on world markets plunged from $400 per tonne to a new low of $250 in 2001. As a result, relations with the MEZ group became strained and in October of the same year, the MEZ group initiated legal proceedings against both the company and its two executive directors Richard Robinow and John Oakley.

The Legal Action

The case claims 'fraud, fraudulent inducement, breach of contract, promissory estoppel and tortious interference', and relates to an alleged verbal promise by subsidiaries REA Kaltim and Makassar to pay a rate of return of 30% on a loan. In 2002 a New York judge rejected almost all the claims relating to fraud, but ruled that the contract related claims could proceed. The MEZ group is appealing this decision, and a further court hearing is some way off.

The MEZ group has also threatened bankruptcy proceedings against REA Kaltim.

The directors intend to 'vigorously defend' the claims to the extent that they cannot be resolved by mediation.

As the only court hearing to date has gone largely in REA's favour, and a US organisation investing $8m on the basis of a verbal contract is quite unusual, we are inclined to side with REA in our view of this action. We are conducting this analysis on the basis that the MEZ group claim will not succeed.

To quantify this, on the assumption that the MEZ group has a 10% chance of winning a claim totalling possibly $30m, we would deduct $3m from the market capitalisation of the company – i.e. the stock should trade at a discount of around 7% to what would otherwise be a fair rating.

Where Now?

REA currently has 13,400 H of planted reserves, 30,000 H of land released on full-title – that's land the company has been given the legal right to utilise and which has been fully surveyed with boundary markers etc - and another 12,000 H of land due to be fully-titled within the next four months.

While the 13,400 H of planted reserves are reaching maturity in different stages, our research indicates that the yield profile is now looking very favourable. All of the trees will be yielding oil by the end of the current year and substantially all will hit peak yields in 2006. The expected effect on REA's palm oil and kernel output levels can be seen from the table below:

Palm oil and kernel output (actual and forecast figures)

YEAR (to December)	OUTPUT ('000 tonnes)
1999 A	5
2000 A	15
2001 A	34
2002 A	59
2003 F	71
2004 F	89
2005 F	102
2006 F	108

We estimate REA's peak FFB yield is between 28-30 tonnes per hectare, based on the group's experience of its 1994 plantings. Given oil extraction rates of 24.5% - ahead of industry rivals – and a kernel oil extraction rate of 5%, annual peak output is around 8 tonnes per mature hectare and is expected to stay at around these levels for a period of 7-8 years. Thereafter, output is likely to gently decline (in line with the palm oil life cycle) until the end of the trees useful life in year 25. With cash costs of production running at $120 per tonne presently, falling to $100 per tonne with volume, and an average FOB Borneo CPO price of $420 per tonne, REA could potentially generate gross profits of between $2,400 and $2560 per hectare.

While that is certainly good news from a company that has spent over a decade in the development phase, investors should be aware that growing palm oil is an agricultural business, not a statistical exercise. It is important to remember that climatic changes can happen at any time. Our forecasts for future profits are based on normal weather conditions and usual patterns of growth; sometimes real life doesn't happen that way.

Output forecasts have already been scaled back in the first half of the current year, from 80,000 to 71,000 tonnes following an extended dry season across REA's estates. In addition, while CPO prices have held up well throughout 2002 and the first half of 2003, a pronounced decline would have serious implications for group profitability given the company's fixed cost base and the speed at which supply responds to changes in demand. At current levels of indebtedness, it is also the case that REA has little margin for error - a bad year could even lead to calls for additional funding from shareholders to meet the costs of working capital.

Those uncertainties aside, we understand REA's crops are picking up strongly ahead of the August-December peak cropping season and work on a second 40 tonne/hr on-site processing mill, to support all future output from the existing hectarage, is on track. Initiatives are also in place to bring production costs down, principally in the area of transportation. REA currently operates three 1,000 tonne barges to take its crops down river at a cost of $3 per tonne against the $8 tonne charged by contractors and it now seems likely that further barges will be purchased in the coming years to support increased output levels.

East Kalimantan: Key Indicators and Comparisons:

VARIABLES	EAST KALIMANTAN	INDONESIA	MALAYSIA
Palm oil production	REA is the only major private palm oil plantation company in the State.	The world's second largest developer of palm oil producing 9 Mn T in 2002.	Is the world's largest developer producing 11.9 Mn T in 2002.
Tax rates	Corporation tax is 30%, but (illegal) tax rises by empowered local authorities could push the overall tax burden higher.	Corporation tax is 30%, but there is a 100% investment allowance so REA has a big tax loss. The export tax on palm oil is 4.8%.	Corporation tax is levied at 28%
Economic stability	An abundance of natural resource – oil, coal, gas and timber – makes EK look prosperous compared to some parts of Indonesia It also enjoys virtually full employment.	The economy and investment climate remain weak and unemployment, despite lower labour costs, is stubbornly high. Much of this is down to poor progress in judicial and legal reform. Heightened security uncertainty hasn't helped.	The Malaysian economy has remained resilient despite heightened uncertainty in the region and the impact of SARS. Monetary and fiscal policies are accommodative, inflation is low and the job market is stable.
Security record	Very good. No major incidents reported in the last 12 years since its inception.	Poor. The capital Jakarta has been subjected to a number of terrorist bombings, while the loss of East Timor has fuelled independence demands.	Vulnerable to spates of ethnic clashes, but on a much smaller scale than the problems faced by Indonesia.
GDP Growth (2002)	-	3.7%	4.2%
GDP per capita (US$, 2002)	-	US $ 710	US $3,540
Unemployment rate	Negligible	8%	3.6%
Exports	To date, all output has been to the domestic market.	Palm oil exports totalled over $1bn in 2002.	Palm oil exports totalled over $5bn in 2002.

Source: World Bank, Malaysian Dept of Statistics, Indonesian Dept of Statistics and Oil World Annual 2003.

The 2003 Interim results

The interim results for the six months to June show REA back in profit to the tune of £0.76m, against a loss of £0.38m for the same period last year. While crop output fell short of targeted levels because of an extended dry season in East Kalimantan, the company's exceptional CPO extraction rates have been maintained. We have reduced our CPO and kernel output estimate for 2003 by 9,000 M/T and now expect production to be 71,000 M/T for the year. CPO and kernel output forecasts for 2004-2006 remain unchanged, however. The extended dry spell is now over and crop production is picking up strongly ahead of the peak-cropping season.

For the remainder of the current year, REA intends to focus on two major areas of investor concern. First, and foremost in our view, is the need to restructure the company's debt. We believe much of this has already taken place following a share placing that injected £1.8m of fresh capital into the company and increased the number of shares in issue by 1.3 million.

The second, less immediate concern is getting the company's extension planting programme back on track. On the Northern side of the East Kalimantan estate, this has already begun at a rate of 3,000 H per annum. On the Southern side, a new joint venture (95% owned by REA) is due to start shortly with the aim of planting out 1,500 H per year, over the next four years. Efficiencies should be greatly improved as a result. The 13,400 H capacity Southern factory is presently being kept busy with output ferried across the Belayan river from the Northern part of the estate, but as volume increases transportation and processing costs per tonne should fall considerably.

Balance Sheet and Cash Flow

The Balance Sheet at REA is not only complex but has been subject to many changes over the course of the current financial year.

The end-2002 balance sheet showed gearing down to 162%, including the preference shares as part of equity, but ignoring the Minority Interests. This was a substantial improvement on the end-2001 position, partly because of the clear-out of non-palm oil interests, and partly because of the issue of additional Ordinary Shares. Gearing by June 2003 was down to 121%.

If Minority Interests are included as equity in the gearing calculation (and banking analysts would certainly include them, because they are risk capital), then the gearing level is already below 100%. Also we have included the convertible loan stock as debt, even though REA shares are trading well above the conversion price.

Now that REA Holdings is profitable, the only issue of any substance affecting balance sheet gearing will be the level of capital spending. To a large extent this is under the control of the company. If the borrowing position becomes tight, then all REA Holdings will need to do is cut back on new estate plantings, as indeed it did in the aftermath off the Asian banking crisis from 1998-2002. Because depreciation is such a major item - £1.6m in 2002 and probably £1.8m for 2003 – the balance sheet will be able to bear a higher level of capital spending than might seem likely at first glance. Working capital movements, on the basis of previous group balance sheets, are subject to sudden shifts but show no discernible trend in either direction.

Potential Dilution

Gearing will drop still further once the £3.8m of Convertible Loan Stock is turned into ordinary shares. Conversion can take place at any time between now and 2012. As conversion takes place at the equivalent of 53p, a third of the current share price, and the CULS carries a coupon of only 4%, conversions are likely to start as soon as REA Holdings starts paying a dividend on the ordinary shares of 1.5p. That in turn would lead to the issue of 7.17m new ordinary shares and £3.8m being cut from the debt figure and being placed in shareholders' funds. If, hypothetically, this conversion took place immediately, it would reduce gearing in the 2003 balance sheet from our predicted 125% to below 100%.

There are 1.6m warrants in issue, giving the right to buy stock at the equivalent of 73.5p/share. The Managing Director, John Oakley, has 1m options to buy shares at 45p/share, an option that already shows him a paper profit of over £1m but which, given the performance of the company since he took over in January 2002, he clearly deserves.

Valuation

There are three separate ways of looking at assessing how much REA Holdings is worth. These are:

1. The value of company on break-up, i.e. how much palm oil acreage is selling for in the Far East at present.
2. A discounted cash flow calculation on the future income stream.
3. A comparison with other quoted companies in the palm oil industry.

How Much Are The Assets Worth?

Arguably the biggest palm oil plantation sale of all time took place in early 2001, when 220,000 Hectares of palm oil in Indonesia was sold by Salim Group to Malaysia's Kumpulan Guthrie Berhad. The value of the transaction was SU$386m, of US$1,750 per Hectare.

Before applying that valuation to REA, some allowances need to be made. Firstly, the palm oil price was only in the $250 region when the sale took place, and this will have depressed the price somewhat. Secondly, a large proportion of the area, probably over half, had yet to be planted out. Thirdly, the planted area was very run down, with elephant grass having been allowed to spring up in some areas, roads and bridges not being maintained and much work needing to be done before the plantation was at an acceptable standard. Industry estimates at the time suggested that it would cost possibly US$1,500/HA to get the planted areas back to a standard yield, and US$1,700/HA to plant out the unplanted areas. Some suggestions were that the true cost of the plantations could have been $4,500/HA. That price, remember, was paid at a time when the oil price was so low as to make some plantations unprofitable.

Other transactions recently appear to have been taking place at around the $6,000 - $6,500 mark.

Unilever, for example, has 21,700 Hectares of plantation for sale in Kuala Lumpur and is expecting to raise between \$131m and \$210m from the sale, pointing at a value of between \$6,000 and \$9,700 per Hectare. This valuation would justify a rather higher share price for REA Holdings than the current market price. A real estate agency is selling a 400 Hectare plantation near Sepang International Aiport, Malaysia, for the equivalent of \$163,000 per hectare. There appears to be a significant development premium in the price here, however.

Oil palm plantations in other countries are worth rather more than those in Indonesia, and this appears to be purely a reflection of the political situation. In theory one would expect plantations in Indonesia to be more valuable than those in Malaysia, because Indonesia has lower labour costs.

REA Holdings has 13,400 acres of planted area, plus a further 100,000 Hectares of as yet unplanted land where it has rights to a greater or lesser extent. These 13,400 HA, at US\$6,500/HA, would be worthUS\$87m. Of course, the unplanted acreage has significant value, and there are other important assets such as the bulk storage and port facilities at the river estuary. Putting a notional values of, say US\$4m on the port and bulk facilities, and US\$1,500/Hectare for the unplanted 40,000 HA where all the permits are in place, adds another US\$64m to the total, raising the possible value to US\$155m – or £97m. If these rule-of-thumb calculations are correct, then REA Holdings, with an enterprise value of £62m, is trading at a 38% discount to the underlying market value of its assets.

Discounted Cash Flow

Palm oil trees take 8 years to reach full maturity, and the 1994-1997 plantings will only reach full production in 2005. 2003, 2004 and 2005 plantings will not start yielding until 2007 – 2010.

Taking a DCF rate of 10% on all fully diluted earnings in our projection, up to 2010 and no further, gives a figure less than the current share price – 139p. Taking the DCF projection a further ten years out, with all plantings yielding at the 2010 and making no allowance for further growth of immature trees, gives a hugely higher figure, of 287p; the current share price compares very favourably indeed to that. We have not included plantings beyond 2007 in that figure, because then the projections into the future would become ludicrous, and imply an unlimited market for palm oil. Also, taking calculations beyond 2020 would be highly misleading, because the earlier plantings reach the end of their commercial lives from this point.

It needs to be pointed out, also, that DCF calculations usually prove hugely unsatisfactory in terms of calculating the future worth of equity investments. Too many variables and unpredictable elements enter the equation, and the accuracy of this valuation method is poor.

The Quoted Competition

Anglo-Eastern Plantations owns 23,000 Hectares of oil palm plantations, primarily in Indonesia. Its market capitalisation is £44m, and its net debt is £9.3m, giving an enterprise value of £53.3m and a valuation per Hectare of £2,300. This is an almost identical valuation to REA Holdings.

Anglo-Eastern is experiencing very good trading conditions at present, partly as a result of new plantings coming on stream and partly as a result of higher palm oil prices. Anglo-Eastern's interim results for the six months to end-June 2003 showed eps of 6.2p. This company is not researched and no reliable analyst estimates are available for the company. Full year eps of 13.2p/share appear probable, however, and that suggests a current year p/e ratio of in the region of 8. In p/e ratio terms, therefore, Anglo-Eastern is cheaper, but Anglo-Eastern does not appear to have anything like the potential for increasing its planted acreage that REA Holdings has. Also, Anglo-Eastern does not appear to be as efficient a plantation, and that ought to be reflected in the rating as well.

On asset valuation and p/e ratio terms, therefore, neither company has a clear advantage over the other. Anglo-Eastern scores clear wins on a sounder balance-sheet, the lack of legal actions and the fact that it is already paying a small dividend, but loses – by a huge margin – on potential upside.

Bertam Holdings is a mixed palm oil plantation and rubber processing company, and also has property development interests. Its estates and property are located in Malaysia, rather than Indonesia. Its estates are somewhat smaller than REA's, and because of the other interests involved it cannot be rated on the same basis as REA and Anglo-Eastern. Bertam pays a dividend, the shares yield 2.2% and trade on a p/e ratio of 31, so on an earnings basis this company is expensive. Bertam's property assets appear to be heavily understated in its balance-sheet, however, and the company has initiated a major share buy-in programme.

Rowe Evans Investments owns palm oil plantations in Indonesia, but on Sumatra rather than Kalimantan. Its Enterprise Value is £59m therefore with only 7,000 HA of directly owned plantations its valuation per planted Hectare is considerably more expensive than that of REA Holdings. Rowe Evans has a string of associated interests, however, including a 47% shareholding in Bertam Holdings, that distort the position. There is clearly some confidence within the boardroom that its shares represent good value, because Rowe Evans Investments, like its associate Bertam, is running an extensive share buyback programme.

Comparisons here do not present a totally clear picture, but they do suggest that REA Holdings can justify a stock market capitalisation in excess of the current figure, particularly if allowance is made for its exceptionally efficient operational performance and the extensive area of available but unplanted land.

Likelihood of Dividends

The company will, in our opinion, be consistently profitable from now onwards. Gearing at present is high but cash flow will be strong, and is getting stronger. Both the Company and the Consolidated balance sheets have a surplus of distributable reserves. The only barrier in the way of payment of dividends on the ordinary shares is eighteen months of arrears on the £5.7m of 9% cumulative preference stock. Once these arrears have been cleared, and we expect this to be tackled by end-2006 at the latest, dividend payments on the ordinary shares can be made. We look for a first dividend to be declared with the 2006 results. While capital requirements on the planting programme remain high, dividends are likely to be well covered – possibly four times – by ordinary share earnings.

The Preference Shares

These carry a 9% coupon, and are eighteen months in arrears. REA Holdings intends to resume dividend payments in December 2003, but the arrears, which amount to £768,000, will not be cleared straight away. We expect the backlog – which must be cleared before a dividend can be paid on the Ordinary Shares – to be paid out in stages.

We have not included the Preference dividend backlog as debt in our gearing calculations because the Preference holders cannot compel the company to pay. It needs to be borne in mind, however, that as these payments are made the group debt figure will rise by an equivalent amount.

Depreciation and the New Accountancy Standard

Depreciation is a very significant item in REA's P & L Account. In 2002, it was £1.6m, and in 2003 it will be in the region of £1.8m. This is equivalent to 15% of turnover. The depreciation charge will rise substantially in 2004 and subsequent years, although as we expect a substantial jump in turnover in 2004, the depreciation/turnover ratio has probably peaked. REA depreciates its planted trees to zero over a 20 year period, and from end-2003 of course there will be the extension to the mill and the other capital equipment to add to the depreciation schedule as well.

This high depreciation figure is important for two reasons.

The first is that it goes some way to offsetting the high levels of capital expenditure as REA plants out new hectares of palm oil. The drain on cash is still substantial, but the plant-out is at least made manageable because depreciation is a non-cash item.

The second is that a change in accountancy standards will eliminate over half of this depreciation charge short term, and result in a dramatic upgrading of REA's reported results. The changes will all be non-cash items, and most sophisticated investors will probably view them as both irrelevant and potentially misleading. But the new Standard is mandatory, and REA, in common with all quoted plantation companies, will be forced to adopt it from the June 2004 interim results onwards.

The new Standard is IAS 41, and applies to agricultural companies. It requires companies to revalue the estate every year, and to include the rise or fall in value as a profit or loss in the P & L Account. Under this Standard, depreciation on the planted estate will be more than outweighed by the upvaluing of the estate as immature trees move towards maturity and full production. REA will be hugely profitable under this standard, although of course there will be absolutely no difference in its cash flow.

Our spreadsheet is worked under the old, traditional accountancy system that we believe to be far more relevant. We have maintained the old methodology because 1) it gives a better comparison of progress or otherwise, 2) the new system risks misleading everyone as to the true level of profitability, and 3) the new Standard is causing such uproar that it may well be repealed before it ever gets applied in practice.

Depreciation is categorised in cost of goods sold in REA's group accounts. Part of the depreciation charge is capitalised in the balance sheet and the rest is taken through the profit and loss account. The split is determined by the ratio of mature to immature plantings. In 2003 there was 13,400 Hectares of mature plantings and 3,000 Hectares of immature plantings which means 18% of the total depreciation charge for the year will be capitalised in the 2003 balance sheet.

Tax

Britain has a Double Taxation Agreement with Indonesia. This is very important long term. Short term, however, REA is unlikely to pay any appreciable amounts of tax.

There are £25m of tax losses in Indonesia. There is no time limit on the use of these, but they will be used up, if the company meets our estimates, by 2006.

There are some UK tax losses. They are not huge, but in the early years at least REA intends to repatriate money to the UK in the form of loan repayments (the Indonesian subsidiary owes the UK parent company substantial sums), and these will not be liable for tax.

Deferred tax may be chargeable (but obviously not payable) in the UK under the new Accountancy Standard. This remains to be settled, but 1) will be ignored by most sophisticated investors and 2) may not apply to REA anyway as the directors will be able to claim that they have no intention of selling the plantations and therefore crystalising a gain.

Conclusion

REA did well to survive the traumas of 1998-2002. Prospects now appear to be better than at any time in recent history, however, and subject to all the usual risk caveats, the company should have a great future ahead of it.

Cash Flow	**2001A**	**2002A**	**2003E**	**2004E**	**2005E**	**2006E**	**2007E**	**2008E**	**2009E**	**2010E**
Retained Earnings	-291	170	326	5,288	7,013	6,934	6,617	7,714	9,994	11,728
Deferred Tax	0	0	495	2,965	3,439	0	0	0	0	0
Unpaid Preference Dividend	257	513	257	-257	-513	-257	0	0	0	0
Depreciation	137	1,616	1,800	2,200	2,300	2,400	2,500	2,600	2,700	2,800
Asset Sales	5,697	60	0	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	-6,000	-7,000	-7,000	-7,000	-7,000	-7,000	-7,000	-7,000
Other Investment#	0	-560	-2,300	-750	-800	-850	-2,500	-1,000	-1,000	-1,000
Working Capital	-2,464	-2,944	200	0	0	0	0	0	0	0
Net Cash Flow	**3,940**	**-3,304**	**-228**	**2,446**	**4,439**	**1,227**	**-383**	**2,314**	**4,694**	**6,528**

Balance Sheet	**2001A**	**2002A**	**2003E**	**2004E**	**2005E**	**2006E**	**2007E**	**2008E**	**2009E**	**2010E**
Estates Land and Buildings	45,071	45,577	50,371	55,897	61,356	66,748	72,073	77,331	82,522	87,646
Plant and Machinery	4,532	4,727	6,433	6,457	6,498	6,556	8,231	8,373	8,482	8,558
Stocks	1,143	857	857	857	857	857	857	857	857	857
Debtors	2,892	4,544	4,744	4,744	4,744	4,744	4,744	4,744	4,744	4,744
Cash	5,398	5,156	5,156	5,156	5,156	5,156	5,156	5,156	5,156	5,156
Short term Loans Agricltr##	27,931	3,416	8,722	6,276	1,836	610	992	-1,321	-6,016	-12,544
Short term Loans -MEZ Grp	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/accruals	4,437	4,461	4,461	4,461	4,461	4,461	4,461	4,461	4,461	4,461
Convertible Loan Stock	0	3,419	3,419	3,419	3,419	3,419	3,419	3,419	3,419	3,419
Other term loans	1,871	21,134	21,134	21,134	21,134	21,134	21,134	21,134	21,134	21,134
Term Leases	94	68	68	68	68	68	68	68	68	68
Minority Interests	4,403	4,574	4,574	4,574	4,574	4,574	4,574	4,574	4,574	4,574
Preference Shares	5,705	5,705	5,705	5,705	5,705	5,705	5,705	5,705	5,705	5,705
Ordinary Sh'hlders' Funds	8,892	11,563	16,883	22,172	29,185	36,118	42,736	50,449	60,444	72,172
Net Debt	30,219	28,030	28,258	25,812	21,372	16,727	17,109	14,796	10,101	3,573
Gearing %###	**207%**	**162%**	**125%**	**93%**	**61%**	**40%**	**35%**	**26%**	**15%**	**5%**
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	91	119	156	144	170	201	241	288
nav per share, diluted, p.		**76**	**85**	**97**	**122**	**146**	**169**	**196**	**231**	**273**

 # Mill extensions in 2003 and 2007 ## negative equates to spare cash

Convertible Loan Stock included in debt

REA Holdings

6.10.2003

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	75,000	100,000	125,000	140,000	140,000	140,000	140,000	140,000
1999	300	0	2,400	4,500	6,000	7,500	8,400	8,400	8,400	8,400	8,400
2000	900	0	0	7,200	13,500	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				239,900	307,000	352,100	372,500	399,200	452,200	527,200	622,200
% Yield				25.0%	24.5%	24.5%	24.5%	24.5%	24.5%	24.5%	24.5%
Oil Tonnage Produced				59,975	75,215	86,265	91,263	97,804	110,789	129,164	152,439
Kernel Tonnage Produced		34,000	59,000	10,796	13,815	15,845	16,763	17,964	20,349	23,724	27,999
Total Palm Products Tonnes		34,000	59,000	70,771	89,030	102,109	108,025	115,768	131,138	152,888	180,438
Price Per Tonne US$ FOB Borneo		286	391	360	420	420	420	420	420	420	420
Price per Tonne £UK		191	261	225	263	263	263	263	263	263	263
Palm Oil Revenue		0	0	13,494	19,744	22,644	23,956	25,674	29,082	33,906	40,015
Palm Kernel Revenue* **		0	0	972	1,451	1,664	1,760	1,886	2,137	2,491	2,940
Cy Theoretical Turnover £000		0	0	14,466	21,195	24,308	25,716	27,560	31,219	36,397	42,955
Reported Fresh Fruit Crop		123,992	199,184	239,900	307,000	352,100	372,500	399,200	452,200	527,200	622,200
Reported Palm Oil tonnage		28,557	49,604	59,975	75,215	86,265	91,263	97,804	110,789	129,164	152,439
Extraction Rate		23%	25%	25%	24.5%	24.5%	24.5%	24.5%	24.5%	24.5%	24.5%

	2001A	**2002A**	**2003E**	**2004E**	**2005E**	**2006E**	**2007E**	**2008E**	**2009E**	**2010E**
Reported Turnover £000	1,326	12,831	14,466	21,195	24,308	25,716	27,560	31,219	36,397	42,955
Cost of Sales	403	7,897	7,233	7,418	8,022	9,001	10,473	11,863	12,739	14,175
Gross Margin %	70%	38%	50%	65%	67%	65%	62%	62%	65%	67%
Administrative Expenses	1223	2,571	3,500	3,111	3,422	3,764	4,141	4,555	5,010	5,511
Admin as % of Sales	92.2%	20.0%	24.2%	14.7%	14.1%	14.6%	15.0%	14.6%	13.8%	12.8%
Associates	122	0	0	0	0	0	0	0	0	0
Profit/loss on asset disposals	448	-326	0	0	0	0	0	0	0	0
Interest Charge In/Out	52	-581	-1,900	-1,400	-1,400	-1,200	-900	-400	-200	-50
Pre-tax Profit	**427**	**1,456**	**1,833**	**9,265**	**11,464**	**11,751**	**12,046**	**14,401**	**18,447**	**23,219**
Tax £000	147	49	495	2,965	3,439	3,525	3,614	4,320	5,534	6,966
Tax Charge* %	34%	3%	27%	32%	30%	30%	30%	30%	30%	30%
After Tax Profit	280	1407	1,338	6,300	8,025	8,226	8,432	10,081	12,913	16,253
Minority Interests	-59	-725	-500	-500	-500	-500	-550	-600	-650	-750
Preference Dividends**	-512	-512	-512	-512	-512	-512	-512	-512	-512	-512
For Ordinary Shareholders	-291	170	326	5,288	7,013	7,214	7,370	8,969	11,751	14,991
Cost of Ordinary Dividend	0	0	0	0	0	280	753	1,255	1,757	3,263
Retained Earnings	-291	170	326	5,288	7,013	6,934	6,617	7,714	9,994	11,728
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	1.97	28.31	37.54	38.61	29.36	35.73	46.82	59.73
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**	**1.24**	**18.57**	**24.63**	**25.33**	**25.88**	**31.49**	**41.27**	**52.64**

** Deferred tax provision only until 2006*

*** In Arrears since June 2001*

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