

# Hardman & Co

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## REA 262.5p F/y profits on course to almost treble 20/09/04



Interim results announced earlier in the week showed good forward progress with sales up 43% to £8.8m and pre-tax profit up 247% to £2.6m. The weakness of the US dollar (REA is principally a dollar-denominated business) hit profits in the period by 11%, although this was more than offset by a gain of £471,000 on repurchase of group loan balances.

Both the H1 crop output at 147,000 tonnes and the oil extraction rate at 24.1% were close to our estimates. The one major disappointment was the softening of the CPO price, a factor highlighted in our previous research note back in April and one that, for obvious reasons, REA has no influence over.

It now looks increasingly unlikely that the officially quoted CPO Price, CIF Rotterdam will return to the peaks reached earlier in the year. At the current US\$430, most industry observers believe it is factoring in expectations of a good US soya crop this Autumn against a very poor season last year. It is also worth remembering that REA has to pay \$50/tonne in shipping costs to get the palm oil from its plantations in the Far East to Europe. As a result we are reducing our US\$ FOB Borneo CPO price/tonne from \$450 to \$380 for both this year and next.

The high fixed cost element to REA's operations means this fall in the CPO price flows straight through to the company's bottom line. Despite this, forward momentum in the business remains strong and we still expect pre-tax profits to almost treble from £2.07m to £5.9m in the current y/e December 2004.

**Share Price:** 262.5p  
**12m High:** 289p  
**12m Low:** 150p  
**Market Cap:** £72.5m (on fully diluted capital)  
**Shares in Issue:** 19.4m undiluted  
27.6m fully diluted  
**NAV/Share:** 84p (historic)  
**Gearing:** 85% (historic)  
**Interest Cover:** 2.2X (historic)  
**EPIC Code:** RE.  
**SEDOL No:** 234906  
**Sector:** Food producers and processors  
**Market:** London Full List (FTSE Fledgling)  
**Broker:** Canaccord Europe  
**Website:** www.rea.co.uk  
**Previous research note:** 30/4/04

**Analysts:** Sonia Kaur/Roger Hardman

| Y/E      | Sales | Declared  | Adjusted  | Eps p. | P/e ratio | Divi p. | Yield |
|----------|-------|-----------|-----------|--------|-----------|---------|-------|
| December | £m    | Profit £m | Profit £m |        |           |         | %     |
| 2002A    | 12.8  | 1.45      | 1.45      | 0.76   | 345       | 0       | -     |
| 2003A    | 13.8  | 2.07      | 2.32      | 3.72   | 71        | 0       | -     |
| 2004E    | 16.9  | 5.4       | 5.4       | 9.78   | 26.8      | 0       | -     |
| 2005E    | 20.0  | 7.1       | 7.1       | 13.60  | 21.3      | 0       | -     |

## **Palm Oil Production on Target**

FFB crop output for the first half was ahead of expectations at 147,000 tonnes. This was just short of 50% of the company's year end target of 298,000 tonnes in what is traditionally a quieter period for production in the palm oil industry. Production has been helped by higher than average rainfall levels across the East Kalimantan estate in 2003 and the first half of 2004; wet weather makes for ideal growing conditions for young palms.

The current H2 has got off to a drier start, but management remain confident that with the peak cropping months of October-December still to go, full year production targets are achievable.

While wet weather has been good for output, there has been a negative impact on yields. These were 24.1% in the period under review against our estimate of 24.5% because rain tends to slow the transportation of FFB crop from the plantations to the mill. Kernel production and yields were also a little below forecast, but with modification to the palm oil mills now complete, these should be capable of improvement in H2. It should be stressed that the quality of both REA's FFB output and its kernels remains first rate.

## **Extension of the Planted Estate**

Management say the first 3,000H of extension planting on the Northern side of the East Kalimantan estate is proceeding satisfactorily and land preparation for 2005's 3,000 H of plantings is in hand. The resumption in planting after a four year hiatus has been made possible by increasing cash flows from trees on the existing estate, the majority of which will be peak producers by 2006. On the Southern side of the estate, where REA is working in joint venture with local interests to plant out 5,000H over the next four years, the first nursery for young seedlings has been established. The financial constraints of local business interests means REA will retain 95% of this joint venture, while local interests will be given their 5% as free, carried interest.

Given the substantial investment taking place in expanding the area of planted out estate and the build up of immature plantings, capex spending is likely to rise to £7m this year (on the assumption that the Indonesian rupiah stays steady at its current rate of \$1/IDR 9300) against £2.3m in 2003. The end-2004 gearing level will be 80%.

## **Preference Shares**

REA has finally cleared arrears amounting to £1,026,643 in its preference dividends. This has been achieved via a scrip issue of £1,026,643 new preference shares to existing holders (at the rate of 18 new prefs, credited as fully paid, for every 100 held) and the cancellation of arrears to the same amount. In a separate development, the company also issued a further 1 million new preference shares at par for cash to be invested in new plantations. REA's preference shares carry a separate quote on the London Stock Exchange, currently trade at 110p, and carry a 9% coupon. The total number of preference shares in circulation following the scrip issue and placing is now 7.72 million which will increase the annual preference dividend bill to £695,000 in a full year. The high cost and short term maturity of debt in Indonesia makes this method of raising new finance attractive.

## **Near-Term Prospects**

Despite the drop in the CPO price, all other fundamentals are working strongly in REA's favour and 2004 will still be a very good year for the company. We expect profits to almost triple to £5.4m in the current y/e December 2004 based on total FFB output of 298,000 tonnes, an oil extraction rate of 24.5%, total kernel tonnage of 13,410 and a US\$ FOB Borneo CPO price/tonne of \$380. In 2005 we expect FFB output to rise to 352,100 tonnes and total kernel tonnage of 15,845 to give profits of £7.1m pre-tax.

In addition, with its financing and debt rescheduling now complete, REA's financial position is stronger now than at any time in the company's history. 2005 will probably see the refinancing of its syndicate of Indonesian bank debt in 2005 (we understand the Indonesian banking system is under great strain). Solving the legal action in NY will be more tricky, although everything we are hearing from our sources in New York back REA's position. In any case, given the forward progress being made, this issue is clearly less of a concern than it was two years ago.

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