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## R.E.A. Holdings Gaining From Soaring Demand 573p 14 September 2007



R.E.A. Holdings continues to benefit from the soaring demand for biofuels that is keeping the palm oil price near record highs.

Interim results were better than we expected, and H2 will be better than H1. The board is expressing caution on several points, but even so we have slightly upgraded our estimates. In particular, the directors warn that palm oil prices are cyclical, and the current high prices will not last for ever.

Key points are:

- Turnover is up 34%.
- Gross Profit has doubled.
- After stripping out the IFRS accounting fiction of biological asset revaluation, pre-tax profits are up 130%, and are higher than for the whole of last year.
- Minority charges have been almost entirely eliminated.
- This has been achieved in spite of the fall in the US Dollar v. Sterling. R.E.A. Holdings reports in £ Sterling.

*We are delighted with the progress that this company is making.*

**Share Price:** 573p

**12m High:** 585p

**12m Low:** 325p

**Market Cap:** £185m

**Shares in Issue:** 32.3m

**NAV/Share:** 198p inc. biological assets

**Gearing:** 40%

**Interest Cover:** 14.6X at interims

**EPIC Code:** RE.

**Sector:** Food Producers and Processors

**Market:** London Main Market

**Broker:** Mirabaud Securities

**PR:** -

**Website:** www.rea.co.uk

**Previous Research Note:** EPS To Double In 2007 225.2007 492p

**Analysts:** Roger Hardman/Sonia Kaur

Y/E	Sales £m	Declared Profit £m	Adjusted Profit £m	Adjusted Eps p.	P/e ratio	Divi p.	Yield %
2005A	14.9	9.6	5.5	3.1	185.0	0	0
2006A	17.8	10.6	5.9	9.6	59.6	1	0.2
2007E	30.6	17.2	14.9	27.2	21.1	2	0.3
2008E	36.8	21.3	18.8	32.3	17.7	3	0.5

## Background

R.E.A. Holdings is the largest of the UK quoted producers of palm oil. It operates in East Kalimantan, Indonesia, where the Provincial Government has undertaken to support the development by R.E.A. of 125,000 hectares (375,000 acres) in the province. Land titles obtained and in progress to date amount to 65,000 Ha. Permitting and approval issues do not always run according to plan, but to date the issues have been minor compared to those we have seen in many other countries.

To date 25,000 Ha have been planted out, of which 13,100 Ha. are mature and yielding fruit, and an additional 1,000 Ha. is being farmed by local villagers who sell their fruit to R.E.A. The remaining land is being planted out at between 5,000 – 7,000 Ha. a year.

The capital structure has been tidied up over the past two years, with minority interests having been almost entirely eliminated. For the 2006 financial year the first dividend for over ten years was paid on the ordinary shares.

R.E.A. carries a significant level of gearing, but is not constrained for cash, particularly at present with the palm oil price having doubled in the past two years. It has, however, used 2007 to increase its capital base. £6.75m of new ordinary shares were issued at 450p in May, and £1m of additional 9% preference shares were placed in early September.

## Interim Results

Results for the six months to end-June 2007 showed strong increases in revenue, profit, margins and earnings per share.

The key drivers, however, were all happening on the plantations. The crop for the half year was down; we knew this, it was a result of weather patterns in 2006. *It is important to remember that palm oil is an agricultural industry and weather can have significant short term influences on output. The January – June 2006 crop figures were abnormally high and these latest results are a 'return to normal'. We expect the full year 2007 crop to be up 13% on 2006.*

The average palm oil price was 59% higher than in H1 2006, so the crop was actually far more valuable. This is in spite of R.E.A. Holdings having sold part of its crop forward at US\$620 a tonne. This contract is for 2,000

tonnes per month, and will amount to roughly 6% of current year output. This appears to be a sensible precautionary measure, and we are glad R.E.A. took this action, even though less revenue has been received than if the company had relied totally on the spot market.

6m ended June	2007	2006
<b>Average Palm Oil Price</b>	US\$686	US\$432
<b>Rainfall</b>	2,790 mm	2,070 mm
<b>Size of Harvest</b>	165,000 tonnes	191,000 tonnes
<b>Crude Palm Oil produced</b>	40,700 tonnes	43,900 tonnes
<b>Extraction Rate</b>	24.5%	23.0%
<b>Kernels</b>	40,700 tonnes	43,900 tonnes
<b>Kernel Yield</b>	4.2%	3.9%

Interestingly, although the harvest was down, the oil extracted per tonne of fruit was up. This again was a function of the weather, and 24.5% is as high as it is reasonable to expect.

Kernel yields were significantly higher. Also (and this does not show up as a separate item in the figures) the oil yielded was significantly more profitable. R.E.A. has started operating its own kernel oil extraction plant, and is therefore keeping more of the profit from kernels in house than it has done previously.

6m ended June	2007	2006
<b>Revenue</b>	£12.2m*	£9.1m
<b>Gross Profit</b>	£9.78m	£4.80m
<b>Gross Margin</b>	80%*	53%
<b>Adjusted EBITDA</b>	£9.09m	£3.93m
<b>EBITDA Margin</b>	74.4%	43.4%
<b>Interest Income /Charge</b>	-643	92
<b>EBITDA Interest Cover</b>	14.1X	n.a.
<b>Adjusted Profit</b>	£7.77m	£3.13m
<b>Tax Charge</b>	28%	32%
<b>Adjusted diluted eps</b>	19.7p	8.3p
<b>Dividend per Share</b>	1p	nil
<b>Dividend Cover X</b>	1p	n.a.

\* Accounting treatment of a short term inventory position means 'adjusted' figures of £13.8m Revenue and 71% GM are preferable for comparative purposes.

The higher prices, and to a lesser extent the higher yields, have translated through to a much improved gross margin of 80% compared to 53% in H1 last year. This will be the peak in GM for two reasons. First, accounting treatment of an unusual short term inventory position have distorted the published numbers (see table on p. 2) Second, in any case, in H2 it will be lower because of the increase in the Indonesian palm oil export tax.

We have stripped out the 'Change in Fair Value of Biological Assets' IFRS adjustment from our comparative table on p.2. This hypothetical figure is of no use for the purposes of investment analysis.

The adjusted EBITDA is 130% higher than in the corresponding H1, and gives an EBITDA margin on turnover of 74.4%, compared to 43.4%. Administration costs were held down to precisely the same level as in H1 of the previous year. Management has done well here, but R.E.A. is a growing company and investors should expect the admin charge to rise from now on.

R.E.A. Holdings has provided for tax at 29% of the declared pre-tax profit. Of the total £2.8m tax provision, however, only £0.8m is actually to be paid; this is local tax due in Indonesia. The entire UK tax charge is deferred tax, including a notional tax charge on the notional biological asset gain.

## New Land Acquisition

R.E.A. Holdings has agreed to acquire an additional 20,000 Ha. of land already available for planting in East Kalimantan (Indonesia) within reasonable reach of its existing estates. The deal is subject to 'the titling process', which can be an administratively long drawn out affair in Indonesia but which is generally a matter of satisfying clearly defined criteria. The price of US\$3.8m is equivalent to US\$190/Ha. This is less than half the price at which some fully titled palm oil land has been changing hands recently, so we are pleased with this deal. R.E.A. is likely to begin planting during the next six months.

The land acquisition is convenient because R.E.A. has run into a permit issue over part of its undeveloped land. We believe this permitting issue will be resolved within twelve months. The purchase means that the planting programme will be able to continue as expected, with another 6,000 – 7,000 Ha of immature trees being put into the ground in 2007 and again in 2008.

## Palm Oil Price

The palm oil price has continued to be strong, on the back of the burgeoning demand worldwide for biofuels and also the worldwide shortage of cooking oils being created as a result.

R.E.A.'s management has issued a stern warning to investors not to expect these good times to become a permanent feature. Palm oil prices are cyclical, it cautions, and the high prices are almost certain to lead to oversupply and a price reduction at some point in time. That point is highly unlikely to be over the next year, however, unless there is a massive further increase in corn planting at the expense of wheat (rather than at the expense of soybean) in the USA over the spring. Medium term it is almost inevitable that prices will fall because new palm oil estates are being planted throughout Indonesia and Malaysia at present. It takes four years for a new plantation to start yielding significant quantities of fruit.

Short term the biggest issue R.E.A. is likely to face is a possible further rise in the palm oil export tax and possibly a requirement to sell a proportion of output locally for cooking oil purposes. R.E.A.'s position is healthy enough to be able to cope with both possibilities.

## Our Forecasts

We have marginally reduced our crop forecast and £/US\$ exchange rate projections, reduced our expected interest and tax charges, and increased our expected preference outgoings.

We have therefore increased our forecast of fully diluted eps ex the IFRS biological adjustment and its associated tax from 23.6p to 27.4p a share. Our forecasts for 2008, 2009 and 2010 have also been increased. On the other hand we have brought down our dividend forecast in the light of the capital requirements facing the company and the very clear indications given in the Interim Statement, and also reduced our expected Declared IFRS profit and eps because we expect the hypothetical IFRS biological gain to be less than we had previously factored in.

Shareholders have every reason to be pleased. We are delighted with the progress the company is making, but do qualify this with the obvious cautions about the impact of a drop in the palm oil price, when it eventually happens.

# R.E.A. Holdings

14 September 2007

	<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>
Reported Turnover £000	1,326	12,831	13,781	16,052	14,944	17,833	30,640	36,767	43,907
Cost of Sales	403	7,897	7,469	6,072	6,641	8,060	9,500	11,000	12,750
Gross Margin %	70%	38%	46%	62%	56%	55%	69%	70%	71%
Administrative Expenses	1223	2,571	2,236	3,235	1,762	3,287	3,944	4,339	4,773
Admin as % of Sales	92.2%	20.0%	16.2%	20.2%	11.8%	18.4%	12.9%	11.8%	10.9%
Other operating income	122	0	0	1,059	6	5	0	0	0
IFRS Biological Asset Adjustment				2,986	4,133	4,677	2,250	2,500	2,500
Profit/loss on asset disposals	448	-326	-257	0	0	0	0	0	0
Net Interest Charge In/Out	52	-581	-1,749	-1,599	-1,058	-543	-2,250	-2,600	-2,800
Exceptional Item	0	0	0	0	0	0	0	0	0
PTP ex exceptional items	<b>427</b>	<b>1,456</b>	<b>2,070</b>	<b>9,191</b>	<b>9,622</b>	<b>10,625</b>	<b>17,195</b>	<b>21,328</b>	<b>26,085</b>
Declared Pre-Tax Profit	<b>427</b>	<b>1,456</b>	<b>2,070</b>	<b>9,191</b>	<b>9,622</b>	<b>10,625</b>	<b>17,195</b>	<b>21,328</b>	<b>26,085</b>
Adj Pre-tax Profit ex IFRS Bio	<b>427</b>	<b>1,456</b>	<b>2,070</b>	<b>6,205</b>	<b>5,489</b>	<b>5,948</b>	<b>14,945</b>	<b>18,828</b>	<b>23,585</b>
Tax £000	147	49	345	2,654	5,100	3,171	5,159	7,465	9,130
of which: Deferred Tax on Bio Adjustment				862	2,190	1,396	675	875	875
Tax Charge % (on declared profit)	34%	3%	17%	29%	53%	30%	30%	35%	35%
Tax Charge* % (on adj pft)	34%	3%	17%	29%	53%	53%	35%	40%	39%
After Tax Profit	280	1407	1,725	6,537	4,522	7,454	12,037	13,863	16,955
Minority Interests	-59	-725	-383	-1,115	-1,014	-281	-100	-150	-200
Preference Dividends	-512	-512	-513	-639	-765	-965	-1,080	-1,130	-1,130
For Ordinary Shareholders	-291	170	829	4,783	2,809	6,208	10,857	12,583	15,625
Cost of Ordinary Dividend	0	0	0	0	0	289	641	962	1,282
Retained Earnings	-291	170	829	4,783	2,809	5,919	10,216	11,622	14,343
Average No. of Shares	11346	12,628	16,385	19,755	22,631	28,857	32,050	32,050	32,050
Earnings Per Share Undiluted p.	-2.56	1.35	5.06	24.21	12	21.51	33.87	39.26	48.75
Dividend Per Share p.	0	0	0	0	0.00	1.00	2.00	3.00	4.00
Shares in Issue Fully Diluted		22,422	24,965	27,411	27,415	30,523	33,850	33,850	33,850
EPS Fully Diluted		0.76	3.32	17.45	10.25	20.34	32.07	37.17	46.16
EPS fully dil ex IFRS Bio & Associated Tax		<b>0.76</b>	<b>3.32</b>	<b>9.70</b>	<b>3.16</b>	<b>9.59</b>	<b>27.42</b>	<b>32.37</b>	<b>41.36</b>

Figures from 2004 onwards have been calculated on an IFRS basis

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