

Potential Surplus in Palm Oil Could Create Acquisition Opportunities

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The European Union's (EU) recent decision to support phasing-out palm oil in biofuels, coupled with other developments in the palm oil industry, could lead to an increase in the commodity's global stock level, pushing prices downward and putting pressure on producers. The [United States Department of Agriculture \(USDA\)](#) expects global, ending stock levels for palm oil in 2018 to increase 27%, suggesting production will exceed demand.¹²

- In mid-January, the EU voted to support a draft law that calls for reducing to zero by 2021 the use of biofuels produced from palm oil, [according to the European Parliament](#), probably for environmental reasons.³ The EU is the world's second largest importer of palm oil, [according to the USDA](#), and in 2014, almost half of its imports were used as

transport fuel, [according to the European Parliament](#).

- In late 2017, India doubled to 30% its import tax on crude palm oil to boost local production, [according to CNBC](#), which could dampen its demand for imports. India has been the world's largest importer of palm oil each year since 2012, [according to data from the USDA](#).
- Since reaching their peak in 2013, palm oil imports from China, the world's third largest importer of palm oil, have fallen 26%, [according to USDA data](#). The decline in China's palm oil imports coincides with its decreasing economic expansion—growth in gross domestic product has fallen from 10.6% in 2010 to 6.7% in 2017, [according to data from the World Bank](#)—and, at times, tighter credit for commodity importers, [according to Reuters](#).
- [USDA data](#) indicates demand for palm oil substitutes, such as rapeseed and soy oils, will exceed production, which would contribute to less demand for palm oil. On the supply side, maturing trees, strong yields, and favorable weather should lead to greater palm oil production in 2018, according to [reporting from Bloomberg](#) and [The Edge Markets](#).

¹ All data from the United States Department of Agriculture was accessed on 15 February 2018.

² Data from the United States Department of Agriculture is quoted on an October-September basis. For readability, this paper uses the first year as the beginning year and the second year as the ending year. For instance, 2010/11 – 2016/17 is written as 2010-2017.

³ Deforestation associated with palm oil production can result in biofuels indirectly generating greater emissions than fossil fuels, according to a [European Union-commissioned report](#) published in 2016 and a report in 2017 from the United Kingdom's [Royal Academy of Engineering](#).

Risks to Thesis

Several events could undermine the thesis that recent developments could increase palm oil stock levels and result in a decline in prices. These events are not mutually exclusive and could happen in combination, even leading to excess demand for palm oil.

- European Union (EU) countries may not implement the ban on palm oil-based biofuels. As of early February, representatives from France, the Netherlands, Sweden, and the United Kingdom have expressed disagreement with the ban, [according to The New Straits Times](#), [The Star Online](#), and [The Sun Daily](#).
- India could reduce its import tax on palm oil. In late January, India's prime minister indicated he would consider reviewing the country's recent doubling of import duties on palm oil in response to a request from the Malaysian prime minister, [according to The Sun Daily](#).
- China also may attempt to reverse its decline of palm oil imports to increase goodwill toward Malaysia. In early February—and almost certainly in response to the proposed EU ban—the Chinese Ambassador to Malaysia stated China would import more palm-based products and that Malaysia could rely on China as a “friendly party,” [according to The New Straits Times](#).
- Additionally, other countries could increase their demand for palm oil. From 2010-2017, palm oil consumption in Pakistan, the Philippines, and Thailand increased 47% to 3.1 million

tons, 168% to 1.2 million tons, and 60% to 2.1 million tons, respectively, [according to data from the United States Department of Agriculture](#).

A decrease in demand and an increase in the global supply of palm oil, causing a decline in prices, probably would have the greatest impact on plantations in Malaysia, which is the world's second largest producer of palm oil behind Indonesia. In 2017, Indonesia and Malaysia generated more than 84% of the 64.9 million tons that were produced globally, [according to USDA data](#).

- Since 2000, Malaysia consistently has exported a greater percentage of its palm oil production than Indonesia, suggesting an inability to replace import demand would have more impact on Malaysian producers. From 2000-2017, Malaysia exported on average 91% of its palm oil production, whereas Indonesia exported on average 71%, [according to data from the USDA](#).
- The palm oil industry estimates labor shortages in Malaysia's palm oil sector typically lead to the waste of approximately 10% of fruit bunches, which are the source of the oil, [according to Bloomberg](#) and [Reuters](#). Greater labor availability in Indonesia curbs production losses, according to the same articles.

Four companies listed under the “plantation” sector of Bursa Malaysia's main market—there are 40 companies in total in this sector—have low liquidity and solvency ratios, suggesting they could face financial distress were demand for palm oil to decrease or prices decline. Moreover,

two of these companies have a relatively high ratio of fixed costs to variable costs—their degree of operating leverage—which means their profits or losses are amplified when demand or prices change.

- To evaluate each company’s liquidity, we use their most recent annual report and calculate their current ratio, which reflects the value of current assets to current liabilities. Eleven companies have a current ratio that is less than one.⁴
- Of these 11 companies, we then evaluate their solvency based on their interest coverage ratio (ICR), which we define as the ratio of operating income—excluding “other” expenses and income—to interest expense. We remove those companies with an ICR greater than 2.0, leaving four companies that we assess could seek an acquirer if palm oil prices further decline.
- Finally, two of these companies have relatively high degree of operating leverage—measured as the percent change in operating income divided by the percent change in sales—which indicates these firms would face greater losses than companies with a lower degree of operating leverage, were revenues to decline. For comparison, three of the 11 companies initially

reviewed have an operating leverage less than 3.0.

Figure 1.1: Liquidity, Solvency, and Leverage Ratios for Select Companies in Bursa Malaysia’s Plantation Sector

Company ⁵	Liquidity	Solvency	Leverage
	Current Ratio	Interest Coverage Ratio	Degree of Operating Leverage
	0.24	0.30	N/A ⁶
	0.40	0.20	8.79
	0.49	0.25	N/A
	0.97	1.29	10.15

Opportunities for Additional Analysis

Deeper analysis of potential opportunities for mergers and acquisitions in the palm oil sector should include information on the average age of a firm’s oil palms. Oil palms generally begin to bear fruit at 30 months, with peak production between years 7-18, at which point they begin to fall, [according to Wilmar-International](#), an agribusiness group based in Singapore.

⁴ This analysis does not include those companies with negative operating income in the year of their most recent annual report, nor does it reflect the impact of operating leases.

⁵ Contact for company names.

⁶ “N/A” indicates these companies have negative operating income in the prior reporting year.