PLANTATION COMPANIES

OVERVIEW

Similar to the rating methodology in respect of construction companies, the information of plantation-based companies to be evaluated encompass both qualitative and quantitative aspects which can be categorized under the following main headings:

I. Business Risk Analysis
II. Financial Risk Analysis
III. Management and Other Qualitative Factors
IV. Issue Structure and Terms

For plantation companies, business risk analysis essentially covers three areas – industry outlook, competitive position and operations analysis whilst financial risk analysis can be divided into four areas – profitability, cash flow/debt service capacity, capitalization and financial flexibility.

BUSINESS RISK ANALYSIS

Industry Outlook evaluates the level of risk involved in a particular plantation-related business or businesses. Industry assessment covers the essential demand/supply factors, industry structure and characteristics, competitive environment, barriers to entry/trade barriers, market behavior, pricing issues, capital intensity, research and development requirements, regulatory framework etc. Competitive Position involves assessment of an organization's strengths and weaknesses relative to its peers. In particular, the analysis aims to deduce whether the entity's competitive strengths and associated business strategies allow it to favorably differentiate itself from its competitors, translating into competitive advantages. Size can be an advantage if it achieves economies of scale, pricing and cost advantages and bargaining power. For palm oil players, benefits of being integrated and/or diversification will also be evaluated where appropriate. Amongst potentially many other factors, ECRL will make a general assessment of the assets (including estate(s), mill(s), refinery(s) and related infrastructure). Typically, the assessments of estates cover, interalia, planting stands per hectare, maintenance/upkeep, maturity profile, location/accessibility, labour issues, supporting infrastructure, developed best practices, etc. Typical information requested for pure plantation companies include:

- Latest planting profile in terms of hectarage planted, distinguishing between mature and immature plantations. Breakdown by age category, for example 1 to 4 years, 5 to 10 years etc.
- Average FFB yield (in metric tonnes per hectare) for each field and average yield for all fields for the last five (5) years.
- Percentage of mature hectarage occupied by oil palms in their prime age in each of the fields.
- Replanting and new planting schedule (hectares per annum) for the next five (5) years.
- List of the major competitors and strategies in place to counter such competition.

Operations Analysis is an additional sub-sector of Business Risk Analysis pertinent to areas where technical competence and efficiency are critical ingredients of success. For integrated palm oil players, as an example, historical operating performance and key performance indicators (KPI) such as FFB yield and OER are compared to the industry's norms. The extent of mechanization/automation, maintenance of plant and equipment in use, together with the quality of systems and processes, often provide explanation towards the variances in performance. In addition, the analysis would also involve review of the key personnel experience and expertise and level of research and development undertaken. Typical information requested for pure plantation companies include:

- Description of mechanization applied and research and development activities undertaken.
- Description of labour force/total estate workers (and breakdown in terms of skilled and unskilled, local and foreign workers etc) and rate of labour turnover, whether employees/workers are easily sourced.
- Data on planting cost to maturity - based on per hectare (inclusive of the breakdown).
- Description of policy on replanting – based on age of trees, annual allocation/budget etc.
- Reason for significant differences in yield factors across all estates.
- Assessments of asset performances, for example using KPIs.
- Description of maintenance in terms of trees, soil, pest control, manuring program and fruit analysis.
- Details of the planned capital expenditure requirements for the next five (5) years and how the company intends to finance them.
- Description of the steps taken or the company's contingency plans in the event of depressed commodity prices, poor harvest and labour related problems.
- Description of insurance arrangements in place to mitigate risks associated with operational interruption, including the list of insurers together with policies/items covered.

FINANCIAL RISK ANALYSIS

Profitability measures include historical and current operating profit margins wherein a record of reliable profits would lend credibility to the company's assumptions on future trend. Growth pattern, either significantly faster or slower than normal industry cycle, may be a basis for concern and should be analysed accordingly. Based on ECRL's observation, upstream plantation activities generally register double digit margins whilst further downstream or diversified plantation companies tend to enjoy stable albeit mid to high single digit margins. Besides the margins analysis, ECRL's analyst will also evaluate performance by relating profits to assets, to permanent capital and to equity. Return on assets is computed both before and after taxes to measure the productivity of all assets. Return on equity is the narrowest of the return computations and the outcome of the calculation is influenced by the capital structure chosen by the subject company. Other ratios used to gauge the contribution of profits to the company's financial profile include the retained earnings ratio, the dividend pay out ratio and interest coverage ratio. The retained earnings ratio indicates the extent to which profits reinvested in the business have contributed to the funding of the company's assets over a period of time. ECRL's focus is on the trend, with a preference for a stable or rising ratio, indicating that the company is able to rely more on internally generated funds for its growth. Based on ECRL's observation, upstream plantation activities are likely to display rising ratios due to minimal capex, stable or improving profit level. ECRL's analyst will have to consider this fact in the context of whether the company is undergoing rapid expansion or vice versa. The dividend payout ratio considers the portion of earnings paid out as dividends on ordinary shares. Payouts above the norm for the industry may be a source of concern. In addition, ECRL's analyst will question the reasons for a high pay out ratio if the firm faces a large capital investment program. Any dividend payout would normally be subject to certain dividend covenant or restrictions set out in the issue structure. In the absence of profits or the potential for profits, equity capital will be difficult to justify and debt financing will be costly (whether from conventional bank borrowings or issuing private debt securities), if available at all. Established plantation companies with good track records have more flexibility to refinance or retire outstanding debts via access to the capital market, as opposed to being dependent on matching internally generated funds to debt maturities.

Cash Flow Generating Ability/Debt Servicing Capacity

Evaluates the strength of a company's cash flow, which is the principal source of repayment for the debt obligations. Cash flow can either be from operating or from non-operating sources. Operating cash flow is derived from pre-tax profits adjusted for items not involving movement of funds, principally depreciation, amortization and other non-cash items, plus interest. Non-operating cash flows are normally derived from sales of long term assets, which may include property or equipment, parts of or entire business units, or investments in affiliates. In general, ECRL's cash flow assessment considers four ratios; Cash Flow from Operations (CFO) Interest Coverage, CFO Debt Coverage, CFO Capital Expenditure (Capex), and Capex/Depreciation. Cash outflows include capital expenditure, long-term investments, dividend payments, interest expense and working capital changes. A company's historical record of cash flow surpluses or deficits must be evaluated in terms of the reasons for the performance. Cash surpluses are of little comfort if they result from the company cutting back on expenses to maintain competitiveness of its assets, for instance on fertilization, on plant and equipment, etc. Cash deficits, in contrast, would warrant greater concern if they stem from high dividend payouts or working capital changes unrelated to the development of the business in contrast to capital investments incurred for new or expanded production facility. ECRL's observation on cash flow movements of more established or growing plantation companies found that they are heavily influenced by business cycles, unplanned working capital changes, and sometimes opportunistic transactions. Thus, in gauging the reasonableness of a company's future cash flow projections, ECRL's analyst will seek to understand the underlying assumptions; how these relate to what the company has previously accomplished and take into account the outlook for the industry and the overall economy. When conducting sensitivity analyses on a plantation company's cash flow projections, good risk scores would not automatically be given to companies whose forecasts, even when stressed via lower pricing or weaker production or combined, indicate future cash flow surpluses. The cash flow surplus needs to be considered in terms of the debt interest (CFO Interest Coverage ratio) and principal (CFO Debt Coverage ratio) – the company's requirement and capacity to service both and to a certain extent, the competitive health of the business if the surplus is utilized to reduce debt rather than reinvested. Based on ECRL's experience, plantation companies in the single A category have consistently demonstrated interest coverage of above three times. It is common that plantation companies have non-core assets which could be sold to raise cash. Notwithstanding, for ECRL's analyst to give positive consideration to such assets (further discussed in the Financial Flexibility section), companies should be able to demonstrate sound knowledge of the extent of their holdings together with approximate market values and appropriately tie back to its strategic direction and/or justify the purpose of divestment. On liquidity, based on ECRL's observation, most pure plantation companies experience seasonal flows, suggesting temporary boost in cash balances during peak season, for instance, which ECRL would not assume as a permanent fixture. Important information can be compiled from "turnover" ratios for the asset categories of receivables and inventory, to gauge the level of funds tied up in these activities, and from the liability category of trade payables, to ascertain whether the company is stretching out or expediting payments to its creditors. Based on ECRL's observation, most pure plantation companies' liquidity position can be compared based on trend assessment by tracking turnover rates over time as well as relative to key competitors/rated peers. In terms of flexibility derived from potential sale of tangible assets such as plantation land, the marketability and independent valuation of the land are important considerations.

Capitalization/Financial Policies evaluate a company's risk orientation.
ECRL's analyst would seek to understand the basis of a company's financial policies and its capital structure before drawing conclusions in this section of the credit analysis. The extent to which a company decides to finance its operations with debt rather than equity will influence ECRL's rating recommendation. It is not unusual to find the management of some companies that have not thought through their financial policies thoroughly. For plantation companies, several ratios are normally computed to enable ECRL to measure debt leverage. The universal standard leverage measure is Total Debt/Equity, which considers all on-balance sheet debt obligations, including such short-term liabilities as bank overdrafts, relative to equity (defined as shareholders' funds plus minority interest). The Total Debt/Equity calculation can be broken down into Long- Term Debt/Equity and Short-Term Debt/Equity components. While short term debt exposes a company to liquidity and refinancing risks, its use within reasonable limits is justified by cost and asset-matching considerations. Based on ECRL's experience, plantation companies in the single A category have consistently demonstrated Total Debt/Equity or debt leverage ratio of below 0.8 times.

In addition to the ratios discussed, ECRL's analyst will also consider the debt amortization schedule as part of the evaluation of debt protection measures and debt leverage position. For example, bullet maturities indicate that the debt may have to be refinanced at maturity with new debt or other forms of external capital, hence higher risk of refinancing. Nonetheless, companies those are able to address these debt spikes well in advance are certainly preferable to those that wait until nearer to maturity date. Most plantation companies rated by ECRL have debt amortization schedules as opposed to bullet repayments; mitigating refinancing risk Financial Flexibility principally incorporates the concepts of liquidity and access to alternate financial sources. A number of ratios can be used to evaluate a company's liquidity including the Cash Ratio (cash and equivalents/current liabilities), the Quick Assets Ratio (cash and equivalents plus trade receivables/current liabilities), and the Current Ratio (current assets/current liabilities). Some positive consideration may also be given to unencumbered assets available for pledge to secure further funding. In addition to internally generated liquidity, most companies arrange alternative financing to protect against contingencies and to take advantage of opportunities. More established plantation companies usually have extensive bank facilities of various types. This, however, may involve the company(s) paying additional commitment fees or other forms of compensation to the bank(s) for those facilities. It should be recognized that most bank facilities have "material adverse change" clauses which pre-emptively releases the bank from any obligation to lend or withdraw the facilities if the company experiences significant negative business impact, for example a down cycle in the CPO price. Trade financing lines, due to the need for presentation of documents related to a specific transaction, are not flexible to be used as general financing requirement, hence viewed as limited flexibility.

MANAGEMENT AND OTHER QUALITATIVE FACTORS
Evaluation of the management of plantation companies involves understanding the key management business decisions and strategic directions; how they are implemented and through what form of financing, among others. Ideally, a company's business goals and financial policies should be clear, consistently pursued and are realistic based on the understanding of the surrounding risk elements. ECRL's analyst would assess the reasonableness of the company's strategic direction and future plans, which justifies ECRL to

conduct interviews with the company's top management or sometimes controlling shareholders – typically assessment of key management profile and track record, commitment level, corporate governance issues, management-shareholders relationship, implementation of strategies, succession planning etc.

ISSUE STRUCTURE AND TERMS

Important terms under the issue structure include such characteristics as priority of payments, security, positive and negative covenants, underwriting requirements, sinking funds, repayment schedule etc. The tenure of the instrument being rated should preferably be related to the assets or activities financed by the instrument. This consideration diminishes in importance as the issuing entity becomes stronger or in cases where the issuer's standalone rating is in fact very strong hence repayment of the instrument will typically be less directly reliant on cash flows attributable to the investment financed by the debt issue proceeds. Given the business/group structure and financial profile, key considerations include the priority or rank of cash flow utilization to service the debt obligations of the particular issue vis-à-vis any other concurrent or future borrowings and other financial covenants attached. Considerations on security also cover priority wherein senior secured debt has priority over senior unsecured debt which has priority over subordinated debt and so forth. Each of these different classes of debt securities can be issued by a subsidiary or by a holding company. Typically, all borrowings undertaken by a subsidiary have priority with respect to that subsidiary's assets over any claims of the holding company. Priority comes into play upon a default. Theoretically, those with higher priority are fully paid before other claims are considered.

It is also recognized that tax authorities and possibly other government/statutory bodies have higher priority than any debt holder. In respect of the plantation companies rated by ECRL, Reserve Funds or Designated Accounts for assignments of revenue can be considered a norm. This will facilitate the accumulation of funds for debt service on a timely basis. To be considered positively in the rating process, accounts established have to be separately managed by responsible parties and mechanisms must be established to assure that the pledged revenues are in fact captured. In addition, for plantation companies, it is common to establish a Commodity Reserve Account as a means to provide additional liquidity buffer (in good times - bumper crop or high prices) over and above the normal reserve fund and sinking fund set up to service the debt obligations. The covenants that ECRL's analyst would assess (even if the issue being rated is expected to be bank guaranteed) include, inter-alia, maximum debt leverage ratio, events of default which spell out the conditions under which a bondholder has the right to accelerate repayment and cross default provisions, limits on distributions (such as controls on dividends, advances or loans upstream or downstream and utilization of proceeds from disposals etc) and other positive and negative pledges. The inclusion of covenants, even in bank guaranteed issues, is a statement by management that it is willing to operate within certain boundaries, and as such should be viewed positively. Of course, a company agreeing to abide by indenture covenants does not guarantee that it will be able to fully comply if events beyond its control occur. ECRL would express concern if covenants imposed are too tight that only a small variation from the covenanted terms would cause an event of default.