Plantation

Resilient & Defensive

OVERWEIGHT
↑

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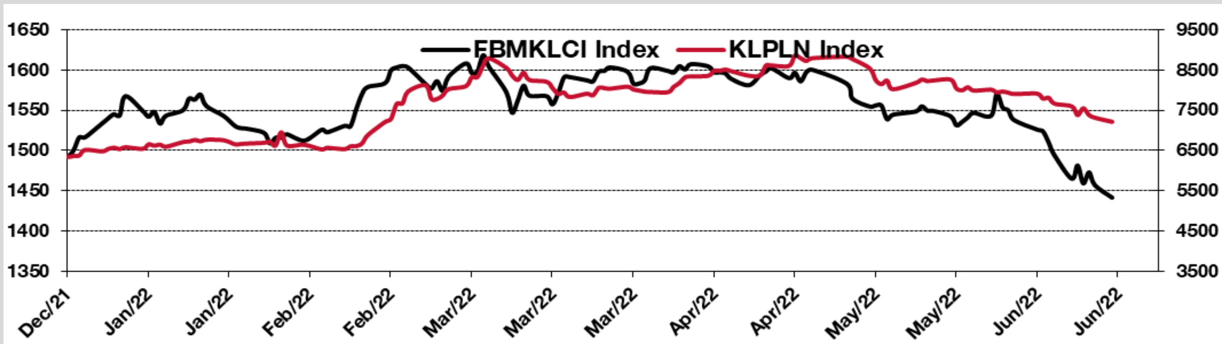
The investment case for the plantation sector is no longer earnings recovery but earning resilience especially when **concerns over high inflation and weakening economy are clouding the market. After outpacing the broader market in 1Q 2022, the KL Plantation Index consolidated for much of 2Q 2022 before dipping this month on broad equity weakness led by the US. CPO prices then fell as Indonesia re-opens for exports coupled with seasonally rising palm oil output as well as pending US soyabean harvest in 3Q/4Q. Peak palm oil prices may be behind us but plantation earnings look set to stay healthy on resilient demand for palm oil. Robust margins are also expected on firm price outlook despite rising cost. The sector's defensive asset-rich NTA is another attraction and valuations are not excessive either, trading at or even below the broad market ratings with some offering good yields. For investors benchmarked against the Shariah Index, the sector is also unavoidable as the plantation sector accounts for 9.6% by weight in the FBM Shariah Index (and 9.4% in the FBMKLCI). Upgrade from NEUTRAL to OVERWEIGHT.**

KLCI vs KLPLN Index



Peering into 2Q 2022 earnings seasons, another good set of plantation earnings can be expected before earnings moderate after 2H on softer CPO price outlook. Nevertheless, we expect CPO prices to stay firm, averaging at RM4,500 per MT in 2022 and RM4,000 per MT in 2023 against production cost of between RM2,000 to 2,500 per MT; hence, margins are attractive. Our expectation of firm CPO prices for 2022 and 2023 hinges on the following:

(a) Supply is likely to be stay fragile until 2023. Any seasonal uptick in 2H of 2022 will provide a welcome relief but unlikely to reverse the overall tightness. An above average season in 2023 could just about reverse the tightness.

(b) Sticky demand is also likely. Edible oils and fats are part of our daily diet. As such, cutting consumption can be done, especially temporarily but deeper more prolonged cuts are less easy.

(c) Elevated fossil fuel prices are supportive of demand for biofuel; thus, demand for edible oils.

Responsible agriculture is important and palm oil - the most widely used edible oil – has drawn more than its rightful share of media and NGO's attention. However, the Russia–Ukraine conflict highlights just how ill prepared the world is in facing a supply shock to the global food chain. This may reset towards a more rounded perspective on food security and ESG going forward. Importantly, the palm oil industry has progressively addressed various ESG issues. Certified palm oil supply is on the rise and they meet some of the highest agriculture standards worldwide.

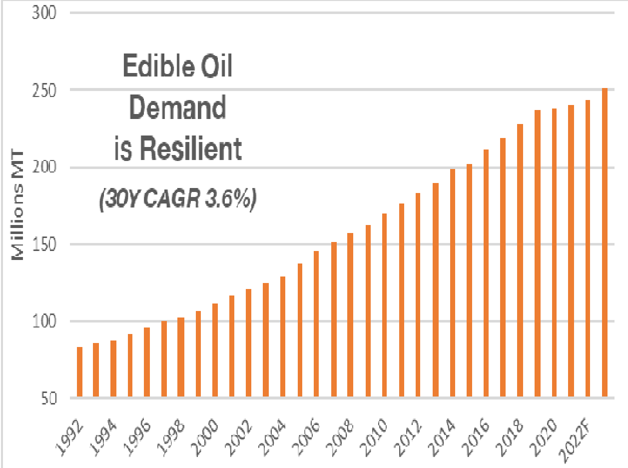
Importantly, recent market sell-down has rendered the sector even more attractive considering the sector's defensive business and solid asset base. We are upgrading the sector from NEUTRAL to OUTPERFORM. Our top integrated pick is KLK (OP, TP: RM30.00) which offers strong YoY earnings growth in FY22, a beneficiary of firm prices of edible oils and biofuels with strong balance sheet and track record. We also like mid-cap such as BPLANT (OP, TP RM1.00) and HAPLNT (OP, TP RM3.30) for generous dividends and TSH (OP, TP RM1.90) for long-term growth as it seeks to expands its planted area from under 40k Ha to 60-65K Ha over the next 6-8 years.

Outlook for 2022 and 2023

The edible oils market is dominated by palm oil (c.35% market share) and soyabean oil (c.25% share). Both are expected to enjoy seasonal uptrend in production in the latter half of this year. However, this pending 2H supply uptick is unlikely to resolve the overstretched supply situation. However, it should prevent the current tightness from getting worse. Therefore, relatively firm CPO prices is likely for the rest of 2022 and, increasingly, into 2023 as well due to the following reasons:

a) **Supply needs more time to recover.** Current global edible oils tightness began when production dipped and failed to meet demand in 2020. Inventory slipped and continued doing so in 2021. If the pending 2H season does go well, 2022 inventory should edge up YoY but unlikely to exceed 2019 levels. An above average 2023 season is needed for inventory to surpass 2019 levels but even so the inventory-to-usage ratio will likely stay under the 10-year average. A favourable 2023 scenario is possible given that prices are still good but helpful weather is also needed and Malaysia's labour shortage does not curtail palm oil output substantially.

b) **Historically, demand has been rather resilient.** Underpinned by rising population and affluence, annual consumption grew 3% on average for the past 10 years (30-year average is 3.6% p.a.). However, growth during the Covid-19 years of 2020-21 moderated to around 1% and we suspect 2022 growth is still hovering around 1-2%, dampened by high prices. However, a reversion back to 3% growth as the world adapts to a new post-Covid norm is likely. It is noteworthy that China has yet to fully emerge out of its zero-Covid policy and edible oil demand thus far has been subdued. Also, in the event of a global economic slowdown, demand contraction cannot be ruled out but it will probably be a long and severe downturn to produce such a negative outcome.

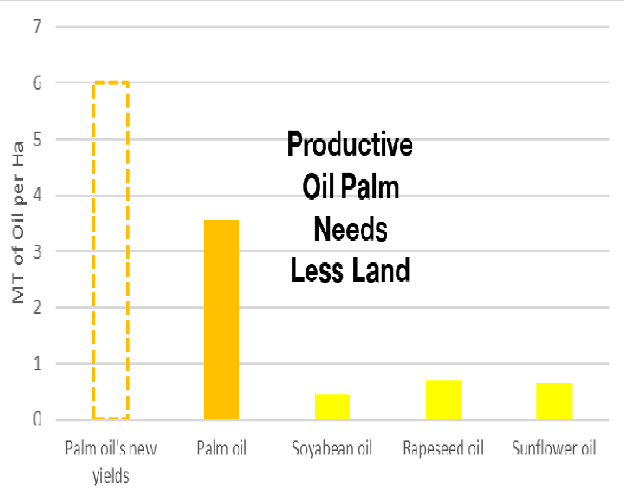


Sources: Oilworld, Kenanga

c) Supportive biofuel demand. About 70% of edible oils is consumed as food, hence the demand resilience but just over 20% ended up as biofuel last year. Due to elevated fossil fuel prices, especially after the Russia-Ukraine conflict, demand for biofuel has been good and is likely to stay supportive.

Environment, Social & Governance

Kenanga believes in responsible investing but we also believe that palm oil is here to stay despite some ESG overhangs. Palm oil is, first and foremost, food and it is the most widely used edible oil in the world. Replacing palm oil will be a challenge. Palm oil is very cost competitive despite being taxed and enjoy no subsidy. It is also flexible enough to meet the demands of high temperature frying, bread making, cocoa butter substitute to being a salad oil. Yielding 3.5 MT of oil per Ha, it is also the most productive oil crop in the world thus leaving a much smaller environmental footprint compared to other oil crops. Yet 3.5 MT per ha is considered low among better managed groups which averaged 4-5 MT of palm oil per Ha a year. Increasingly, the target is for 6 MT of palm oil per Ha or approximately 10x more land-efficient than other oil crops.



Source: Kenanga

Importantly, the plantation sector has responded positively and improved on the ESG front. Today, about 16m MT of palm oil is certified, an amount not too far from Malaysia's entire annual production. It is also worth noting that certified palm oil meets some of the highest ESG standards for agriculture products internationally. Therefore, the issue is not about survival but more about adapting and many planters have successfully done so despite the lack of recognition.

Our thoughts on the sector

Monthly palm oil production typically bottoms around February and peaks in September or October. Therefore, during 2Q, CPO prices often come under downward pressures. However, for 2Q 2022, CPO prices stayed at near record levels until June on the back of tight edible oils supply, as the Russia-Ukraine conflict (Ukraine exports almost half the world's sunflower oil of 6-7m MT) and subsequent economic sanctions on Russia which disrupted global supply of fossil fuels and fertillser caused the prices of such commodities to rise. Hari Raya Aidilfitri also fell on 1 May, which supported palm oil demand for a good portion of 2Q 2022.

Altogether, 2Q 2022 plantation earnings should enjoy stronger prices and output compared to 1Q 2022. **Nevertheless, CPO prices have probably peaked and earnings should ease after 2Q 2022. However,** we are still expecting firm CPO price of RM4,500 per MT for 2022 and RM4,000 per MT for 2023. Margins are thus expected to stay robust with **production cost hovering between RM2,000 to 2,500 per MT after taking into consideration higher labour, fertiliser as well as fuel costs.**

Overall, the appeal of the plantation sector is no longer about earnings recovery but earning resilience especially when **concerns over high inflation and weakening economy are clouding the market. Firstly, plantation earnings look set to stay healthy on resilient demand for palm oil. Robust margins are also expected on firm price outlook despite rising cost. The sector's defensive asset-rich NTA is another attraction and valuations are not excessive either. For investors benchmarked against the Shariah Index, the sector is also unavoidable as the plantation sector accounts for 9.6% by weight in the FBM Shariah Index (and 9.4% in the FBMKLCI).**

More importantly, we are upgrading the sector from NEUTRAL to OUTPERFORM following recent market sell-down which has made the sector even more attractive considering the sector's defensive business and asset base. PERs are at or even below broad market ratings with good dividends expected for 2022 and 2023. Our top integrated pick is still KLK (OP, TP: RM30.00) which offers strong YoY earnings growth in FY22, a beneficiary of firm prices in edible oils and biofuels with strong balance sheet and track record. We also like mid-cap such as BPLANT (OP, TP: RM1.00) and HAPLNT (OP, TP: RM3.30) for good dividends and TSH (OP, TP: RM1.90) for long-term growth as it is expanding its planted area from under 40k Ha to 60-65K Ha over the next 6-8 years.

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Peer Comparison

Name	Last Price (RM)	Market Cap (RM'm)	Shariah Compliant	Current FYE	Revenue Growth		Core Earnings Growth		PER (x) - Core Earnings			PBV (x)		ROE (%)	Net Div. Yld. (%)	Target Price (RM)	Rating
					1-Yr. Fwd.	2-Yr. Fwd.	1-Yr. Fwd.	2-Yr. Fwd.	Hist.	1-Yr. Fwd.	2-Yr. Fwd.	Hist.	1-Yr. Fwd.	1-Yr. Fwd.	1-Yr. Fwd.		
STOCKS UNDER COVERAGE																	
BOUSTEAD PLANTATIONS BHD	0.83	1,859.2	Y	12/2022	30.7%	-27.7%	35.1%	-48.2%	7.7	5.7	10.9	0.7	0.6	24.4%	16.9%	1.00	OP
FGV HOLDINGS BHD	1.50	5,472.2	Y	12/2022	10.9%	-6.1%	-2.2%	-20.9%	22.2	10.6	15.3	1.3	1.2	19.5%	5.7%	2.30	MP
GENTING PLANTATIONS BHD	6.55	5,876.6	Y	12/2022	23.0%	-5.4%	32.1%	-6.2%	24.6	14.2	16.1	1.2	1.2	10.4%	4.4%	9.50	OP
HAP SENG PLANTATIONS HOLDINGS	2.26	1,807.3	Y	12/2022	32.0%	-14.7%	15.0%	-17.2%	26.1	9.5	14.9	1.1	1.0	13.1%	6.2%	3.30	OP
IOI CORP BHD	3.82	23,733.6	Y	06/2022	46.7%	-15.7%	64.6%	-17.5%	28.5	18.4	21.4	2.4	2.2	15.8%	2.5%	4.65	MP
KUALA LUMPUR KEPONG BHD	22.84	24,625.1	Y	09/2022	26.1%	-2.8%	23.4%	-3.3%	14.7	17.2	18.6	2.1	2.0	17.3%	2.4%	30.00	OP
PPB GROUP BHD	15.14	21,538.2	Y	12/2022	12.0%	5.2%	-7.7%	7.9%	16.5	15.9	15.1	1.0	0.9	5.7%	2.6%	15.00	UP
SIME DARBY PLANTATION BHD	4.29	29,668.4	Y	12/2022	19.9%	-13.2%	39.1%	-23.0%	35.6	12.2	18.9	2.2	2.0	17.4%	4.9%	5.25	MP
TA ANN HOLDINGS BHD	4.28	1,885.2	Y	12/2022	17.7%	-6.5%	-7.4%	-3.7%	29.8	7.3	12.8	1.3	1.2	16.3%	7.0%	6.00	MP
TSH RESOURCES BHD	1.14	1,573.4	Y	12/2022	38.4%	-8.9%	9.9%	1.0%	21.8	8.3	15.5	1.0	0.9	13.7%	3.5%	1.90	OP
UNITED MALACCA BHD	5.35	1,122.3	Y	04/2022	20.4%	-5.6%	297.5%	-4.9%	39.5	17.7	23.9	0.8	0.8	8.5%	2.8%	5.90	MP
Simple Average					**24.7%**	**-7.4%**	**46.4%**	**-8.8%**	**25.9**	**13.1**	**17.3**	**1.4**	**1.3**	**13.8%**	**4.2%**		

Source: Bloomberg, Kenanga Research

Stock Ratings are defined as follows:

Stock Recommendations

OUTPERFORM	: A particular stock's Expected Total Return is MORE than 10%
MARKET PERFORM	: A particular stock's Expected Total Return is WITHIN the range of -5% to 10%
UNDERPERFORM	: A particular stock's Expected Total Return is LESS than -5%

Sector Recommendations***

OVERWEIGHT	: A particular sector's Expected Total Return is MORE than 10%
NEUTRAL	: A particular sector's Expected Total Return is WITHIN the range of -5% to 10%
UNDERWEIGHT	: A particular sector's Expected Total Return is LESS than -5%

******Sector recommendations are defined based on market capitalisation weighted average expected total return for stocks under our coverage.***

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