COMPANY RESEARCH | Company Visit

Maybank Kim Eng

October 17, 2014

Tunas Baru Lampung (TBLA IJ)

Share Price: IDR675	MCap (USD): 275M	Indonesia	Not Rated
Target Price: na	ADTV (USD): 0.1M	Plantations	

Riding two dragons

- **Equal exposure to sugar & palm oil, two of Indonesia's most profitable crops.**
- **One of nine importers of raw sugar. The only one allowed to sell sugar to retail consumers. Palm oil remains highly profitable.**
- **Attractive at 5.4x 2014 consensus earnings, against peers plantation companies.**

Sweet sugar

Sugar appears on track to account for nearly half of its earnings in 2017E with its sugar refinery commenced production in 4Q13 and an integrated sugar mill to be completed in 2016E. Payback could take less than three years, according to the company. EBIT margins are 20-30% for a sugar refinery and 50% for an integrated sugar mill. Such feats are made possible by import restrictions and regulated sugar prices.

Palm oil holding the fort

TBL's palm-oil yields should improve as its trees mature. It will also convert its low-yielding estates into sugarcane plantations. We expect FFB yields to increase to 23 tonnes/ha in 2017E from 18.9 in 2014E. In our assessment, EBIT from palm oil could grow 10% in 2017E from 2014E levels, spurred by higher FFB yields and assuming a CPO price of IDR8,000/kg or USD650/tonne.

Risks to business

Business risks mainly arise from: 1) volatile CPO prices as palm-oil production costs are more or less fixed; 2) raw-sugar prices as domestic sugar selling prices are regulated; and 3) regulatory risks from changes in import quotas for sugar and export taxes for palm oil.

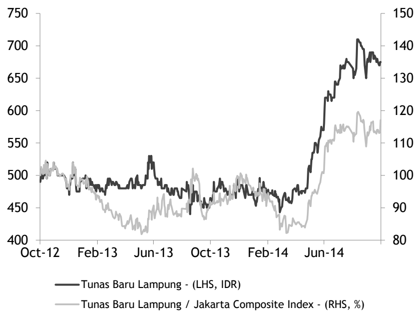
FYE Dec (IDR b)	FY10	FY11	FY12	FY13	FY14E	FY15E
Revenue	2,951	3,732	3,806	3,705	5,147	6,050
EBIT	350	614	498	494	na	na
Net interest	-91	-88	-120	-171	na	na
Other income, FX gains / (losses)	66	14	-67	-205	na	na
Pretax profit	324	540	311	119	611	702
Net profit	**247**	**419**	**242**	**84**	**440**	**522**
EBIT margin (%)	11.8	16.5	13.1	13.3	na	na
PER (x)	9.7	5.7	9.9	28.4	5.4	4.6

Source: Maybank KE, Company, Bloomberg
Note: 2014-15E based on Consensus estimates.

Key Data

52w high/low (IDR)	710/443
3m avg turnover (USDm)	0.1
Free float (%)	41.0
Issued shares (m)	4,942
Market capitalization	IDR3.3T
Major shareholders:	
- PT Budi Delta Swakarya	30%
- PT Sungai Budi	29%

Share Price Performance



	1 Mth	3 Mth	12 Mth
Absolute(%)	2.3	5.5	45.2
Relative to index (%)	6.4	3.5	27.4

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SEE PAGE 12 FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATIONS

Sugar a new earnings sweetener

TBL's EBIT could more than double and its core net profit triple in 2017E from 2014E levels on new contributions from sugar, in our estimation. Its sugar refinery commenced operations in 4Q13 while its sugar mill will be completed in 2016E. Contributions from palm oil remain strong on improving production yields.

At current prices, per-ha sugar profitability in Indonesia matches that of palm oil. But while palm oil is a perennial crop and developing estates is capital-intensive, sugar is a cash crop and it is the sugar mills that are capital-intensive.

Figure 1: Profit per ha of palm oil

Palm oil (in USD)	Year 7-22
Selling price (CPO)	660
Selling price (kernel)	330
Yield per ha (CPO)	5.5
Yield per ha (kernel)	1.0
Revenue/ha	3,960
Production cost/ha	1,925
Profit/ha (USD)	2,035
IDR/USD	12,500
Profit/ha (IDR m)	**25.4**
Profit margin	51%

Source: Maybank KE

Figure 2: Profit per ha for an integrated sugar mill

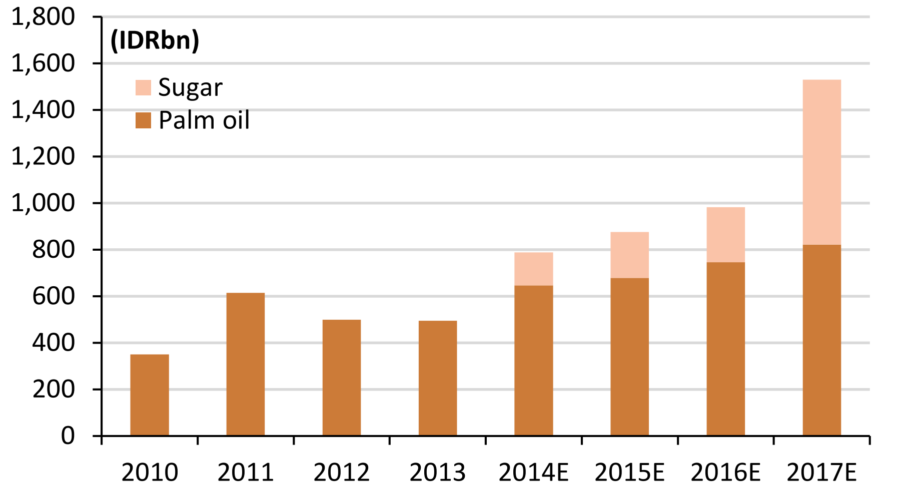
Sugar (in IDR)	Year 1	Years 2-4
Sugar yield (tonnes)	8.1	7.2
Plantation cost/kg	2,809	2,017
Milling cost/kg	2,000	2,001
Production cost/kg	4,809	4,018
Selling price (retail)	8,500	8,500
Revenue/ha (IDR m)	68.9	61.2
Production cost/ha (IDR m)	39.0	28.9
Profit/ha (IDR m)	**29.9**	**32.3**
Profit margin	43%	53%

Source: Maybank KE

Sugar profitability is different for Year 1 and Years 2-4 due to lower land preparation and planting costs in Years 2-4.

TBL's sugar division will have two subdivisions: 1) sugar refineries with installed capacity of 216k tonnes pa; and 2) integrated sugar mills — mills plus sugarcane plantations — with installed capacity of 120k tonnes pa. Sugar only contributed less than 1% to its EBIT in 2013 and around 10% in 1H14. The company is expecting contributions of around half its EBIT in 2017E, once its sugar mill kicks in.

Figure 3: Sugar a new source of growth



Source: Maybank KE

Its sugar refinery commenced operations in 4Q13 while its new sugar mill and sugar plantations are expected to be ready in 4Q16E. TBL was given a licence to import 108k tonnes of raw sugar for its sugar refinery in Apr-Jul 2014. It is one of only nine sugar importers to receive quotas to import raw sugar for refining. It is also the only importer allowed to sell to retail consumers vs industrial users.

In right place, at right time

TBL's sugar opportunity comes at a right time, as Lampung is suitable for sugarcane plantations and TBL's palm-oil estate there is due for replanting. This can be converted into a sugarcane plantation at minimal opportunity costs.

Lampung's generally drier weather renders it more suitable for sugarcane crops than palm oil, according to management. This is positive, given the high margins for sugar mills and plantations at the moment.

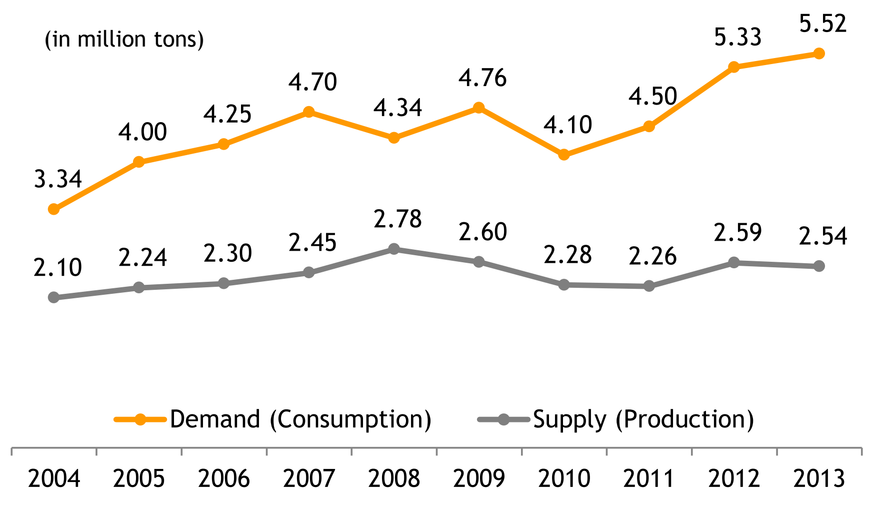
Domestic sugar prices are protected by import quotas and minimum prices, to protect small holders and state-owned sugar mills. The government aims to keep the profitability of efficient sugar refineries and mills high in order to attract new investments, as Indonesia imported half of its sugar in 2013. This protection is also expected to revitalise existing sugar mills.

Sweet prospects…

Sugar is very profitable for Indonesia's efficient sugar mills and refineries as a result of the price controls and import restrictions. Demand continues to outstrip supply, necessitating more imports.

In the past decade, Indonesian sugar consumption leapt 65% from 3.34m tonnes in 2004 to 5.52m by 2013. As domestic production barely increased to 2.54m tonnes in 2013 from 2.1m in 2004, sugar imports more than doubled from 1.24m tonnes to 2.98m.

Figure 4: Indonesia's sugar demand has been outstripping supply



Source: Statistics Indonesia, Kontan

The government periodically sets the minimum domestic sugar price, which is used as a reference price for sugar mills when millers buy sugarcane from the small farmers.

Its latest reference price is IDR8,500/kg vs an international price of around IDR5,500/kg. Theoretically, this price is arrived at using estimated production costs for the small farmers plus a profit margin.

The reference price tends to be higher than international prices because of the general inefficiency of the country's small farmers and sugar mills. Small farmers lack scale. On top of that, many rent their land, adding to their production costs. Sugar mills in Indonesia are also inefficient and outdated with low extraction rates of 7-8% vs 10-12% for modern sugar mills.

Although sugar's high profitability is attractive for investors, barriers to entry are high. Establishing a sugar refinery is generally very risky without an import quota. This is hard to obtain and is issued case by case. Setting up an integrated sugar mill is much easier, as the government is keen to boost sugar production and create more value and jobs through mills and sugarcane plantations than pure refining. However, sugar milling requires a large land bank for developing sugarcane estates and large capital to build the mills.

TBL has it all. It has the import quota for its refinery, land for sugarcane plantations and capital to build modern sugar mills.

Regulatory environment

Government regulations divide sugar consumers into three groups: 1) exporters which can directly import refined sugar for use in their exports; 2) industrial users which can source from sugar refineries; and 3) retail consumers who can buy from domestic sugar producers and selected sugar refineries, by far only TBL.

Selling prices to industrial consumers are not regulated. This group can buy their sugar from refineries with the quota to import raw sugar. There is an import duty of IDR550 per kg of raw sugar.

In contrast, the government sets a domestic benchmark price at the beginning of each harvesting season for retail consumers. Sugar mills are required to use this to calculate their price for buying sugar cane from farmers. Theoretically, this benchmark is arrived at using an assumed production cost for the sugarcane farmers plus sugar-milling costs and a profit margin.

The benchmark price tends to be higher than international sugar prices due to the lower productivity of Indonesia's sugar industry.

This policy is unlikely to change as sugar is part of Jokowi's road map for achieving food sovereignty. He has been quoted by the media as suggesting that food sovereignty will only be reached if farmers are prosperous. If this plays out, the country's high regulated benchmark price and the high profitability of modern integrated sugar mills should persist, in our view, at least until domestic production suffices or the small farmers are efficient enough to compete. This could be years away, in all probability.

The sweet toothed Indonesians

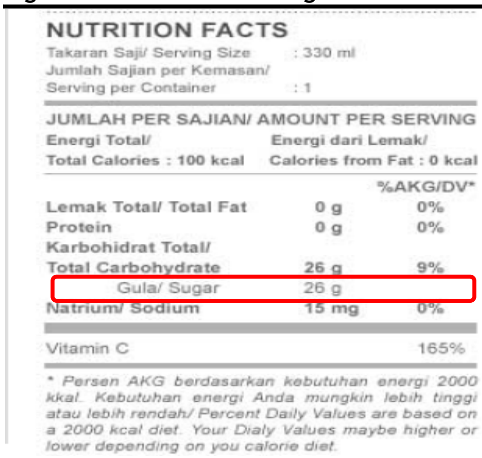
Indonesians love sugar. In many places all over the archipelago, tea means sweetened tea and coffee means sweetened coffee, although they may not necessarily come with milk. Indonesians even add sugar to their green teas! One of the best-selling ready-to-drink green teas in the country has 26g of sugar per 330ml of drink (Figures 5-6).

The government is also trying to find alternative energy sources to complement fossil fuels. This could potentially boost sugar demand, if there are incentives to burn sugar-based ethanol as fuel.

Figure 5: One of the best-selling bottled drinks in Indonesia...

Source: www.abcpresident.com

Figure 6: …is a sweetened green tea!



Source: www.abcpresident.com

Sugar refining

Sugar refining is a simple operation of melting/dissolving raw sugar, filtering out the molasses, and decolouring and recrystallising the sugar. Main costs of production are raw sugar (73%), import duties (9%), energy (6%) and depreciation (6%). Profit margins could be volatile, at the mercy of raw-sugar prices. Still, sugar refineries in Indonesia historically do not run at operating costs, given a lack of competition and the regulated environment.

Sugar refineries import raw ICUMSA 800-2000 sugar and refine it into industrial-grade ICUMSA 45-100 sugar. Based on today's prices, the refineries should generate gross margins of 17.5% if they sell to industrial users and 27.1% to retail consumers.

The ICUMSA numbers refer to the purity levels assessed by the International Commission for Uniform Methods of Sugar Analysis. The lower the number, the higher the purity ie more refined.

Figure 4: Sugar refineries' profits from sales to industrial and retail customers

Sugar refinery	Industrial user	Retail consumer
Selling price/kg	7,514	8,500
Production costs	6,201	6,201
Raw sugar	4,500	4,500
Import duty	550	550
Energy	356	356
Depreciation	356	356
Labour	108	108
Additives	32	32
Others	300	300
Profit/kg	1,314	2,300
Gross profit margin	17.5%	27.1%

Source: Maybank KE

Other than TBL, Indonesia's import and refinery licensees are only allowed to sell their refined sugar to industrial users. Selling prices to this group are not regulated and tend to be lower, closer to international prices. This implies industrial sugar is not as profitable as retail-consumer sugar.

Based on our understanding, TBL is the only sugar refinery with the permit to sell its refined sugar to retail customers. This probably explains its higher profitability than peers. Arguably, such profit margins should be even more sustainable once its sugar mill and plantations are operational.

Integrated sugar mills

Sugar mills are a highly profitable investment in Indonesia due to the sugar floor price set by the government. Unlike sugar refineries, all mills are allowed to sell their products to retail customers. Licensing is also easier to obtain. Gross margins are high at around 50% for integrated sugar mills and plantations with a global average yield of seven tonnes of sugar per ha.

Production costs are generally stable as the mills normally source their sugarcane from their own plantations or buy from farmers.

A significant barrier to entry is the availability of land to plant sugar. Sugar itself is an easy crop to grow and planting and harvesting can be mechanised. This contrasts with palm oil, which is more labour-intensive.

Investing in sugar is slightly different from investing in palm oil. Sugar is capital-intensive for mills, while palm oil requires more capital for plantations. This means that to be able to protect returns on investment, sugar mills have to secure their sugarcane supplies from independent farmers or develop their own cane plantations.

TBL's sugar mill will be supplied largely by its own plantations. As such, its production costs should consist of labour, seed & fertiliser costs for its plantations and depreciation, labour & maintenance costs for its mills.

Such integrated operations provide much better earnings visibility as both costs and selling prices are more stable than for sugar refineries, which are exposed to the cost of imported raw sugar.

Figure ___ breaks down the main costs and potential profit margins of a well-run integrated sugar mill and sugarcane plantation. Among all the associated costs, we note that only fertiliser and chemical costs are influenced by international prices and exchange rates. The remainder are relatively fixed. Labour costs are adjusted annually while depreciation costs are usually steady. Profit visibility is overall good, in our assessment.

Sugarcane plantations

Sugarcane requires a tropical climate with 600mm of minimum rainfall for maximum growth. In prime growing areas, sugarcane yields can reach 150 tonnes/ha while a good estate can yield an average 90 tonnes/ha. This implies 15 and nine tonnes of yields respectively, assuming a 10% extraction rate.

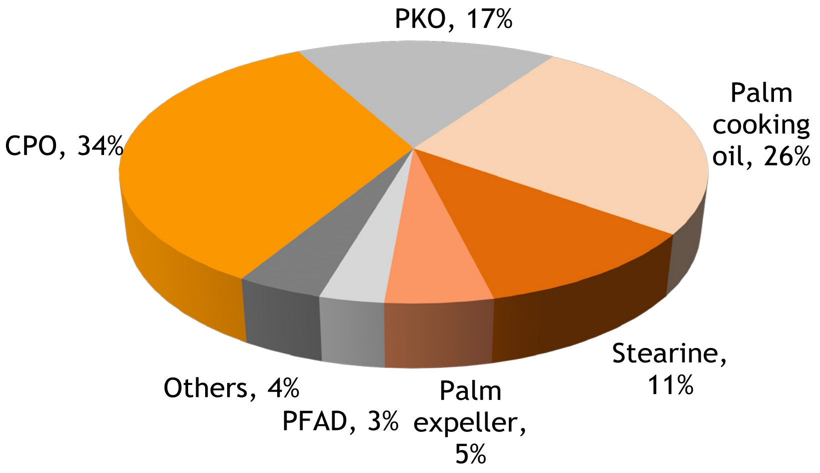
Indonesia's yield averages 5.45 tonnes of sugar per ha, according to Statistics Indonesia. This low yield can be traced to a combination of low sugarcane yields of 72 tonnes per ha and low sugar-extraction rate of 7-8%.

Palm-oil division still very profitable

TBL owns 56,747 ha of palm-oil plantations in Lampung (Sumatra), Palembang (Sumatra), and Pontianak (Kalimantan). Group production yield of 18.8 tonnes FFB per ha in 2013 was sub-standard, largely because of its low-yielding old estates in Lampung.

FFB harvested from its nucleus plantations was 618,651 tonnes in 2013, with a yield of 18.8 tonnes/ha. Together with 415,861 tonnes of FFB purchased from plasma farmers and third parties, FFB processed was 1,034,511 tonnes. With an extraction rate of 21.6%, TBL produced 223k tonnes of CPO in 2013. About half went to its refineries to make bulk and branded cooking oil.

Figure 5: Revenue breakdown

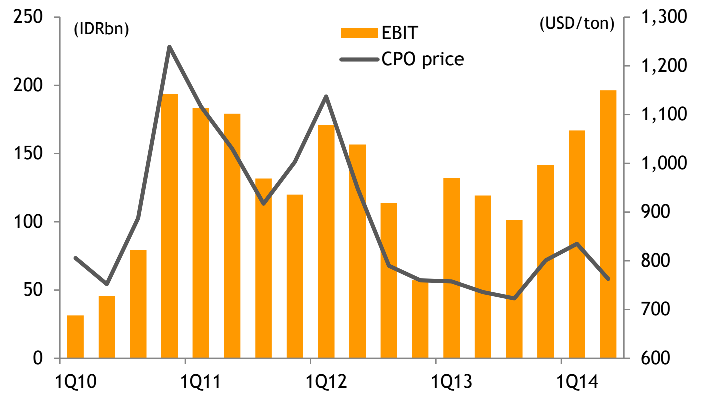


Source: Maybank KE

FFB production from its nucleus plantations could increase by 10% pa from 601,481 tonnes in 2013 to 667,614 in 2014E, 748,504 in 2015E and 768,960 in 2017E, in our estimation. This is even after the conversion of 15k ha of its old palm-oil estates into sugarcane plantations. A normal yield curve has been assumed for its estates planted with Tenera (DxP) palm-oil seeds.

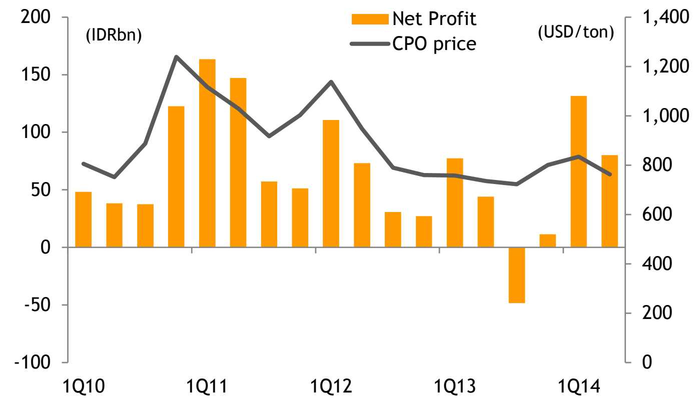
Despite its low FFB yields, TBL managed to deliver a 25.6% gross margin and 13.3% EBIT margin in 2013. Reported net profit was IDR84bn. Core earnings were IDR274bn, excluding forex losses. EBIT was up 44.5% YoY to IDR363bn in 1H14. Net profit was up 74.8% YoY to IDR213m, all on higher CPO prices and initial sugar contributions.

Figure 6: EBIT and CPO prices



Source: Maybank KE, Bloomberg

Figure 7: Net profit and CPO prices

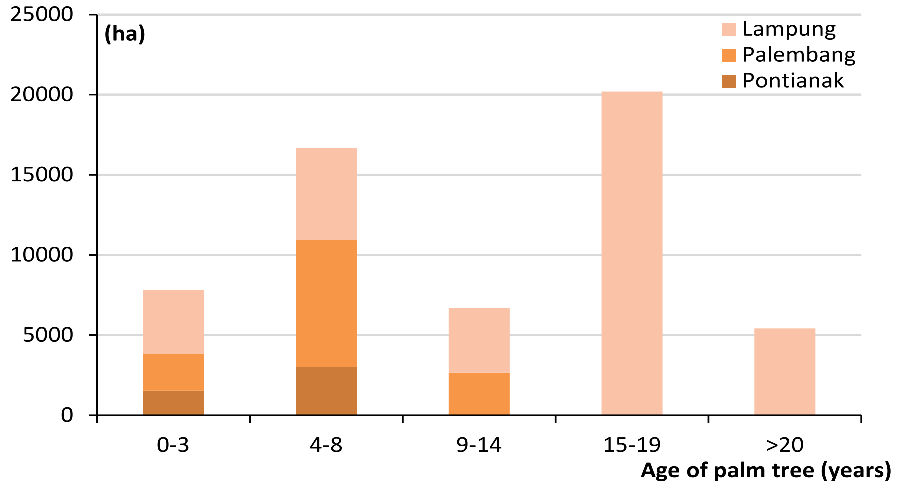


Source: Maybank KE, Bloomberg

Net profit in some quarters distorted by forex gains / (losses)

TBL expects its palm-oil yields and profitability to improve once its Palembang and Pontianak trees reach their prime age and old palm estates in Lampung are converted into sugarcane plantations.

Figure 8: Age of TBL's oil palms



Source: Company

Also, it expects FFB yields in Pontianak and Palembang to beat those of its older plantations in Lampung because of the better quality of the seeds planted and Pontianak/Palembang's more suitable climate. Rainfall in both locations is better distributed throughout the year.

Lampung, by nature, is more suitable for sugarcane as sugarcane only needs good rainfall during its early growth and less towards its harvesting.

Figure 9: Annual rainfall (mm pa)

	Palembang	Lampung	Pontianak
2008	2,686	1,940	3,132
2009	2,389	1,789	2,989
2010	3,080	2,710	3,518
2011	2,593	1,568	3,129
2012	3,083	1,685	3,081

Source: Statistics Indonesia

TBL is converting about 40% of its post-prime palm-oil estates in Lampung into sugarcane plantations by end-2016. This will involve about 15k ha of its 39k ha land. At the same time, it is constructing an 8,000 TCD (tonnes of cane per day) sugar mill, to mill 120k tonnes of sugar pa.

Risks to its plantations will mainly come from volatile CPO and sugar prices and regulatory risks from import quotas and taxes. Bad weather could also hurt harvests, although the impact is likely to be assuaged by higher selling prices from supply disruptions.

Palm oil is a simple business, in which TBL processes fresh fruit bunches (FFB) from its own estates and whatever is purchased from plasma farmers and third parties.

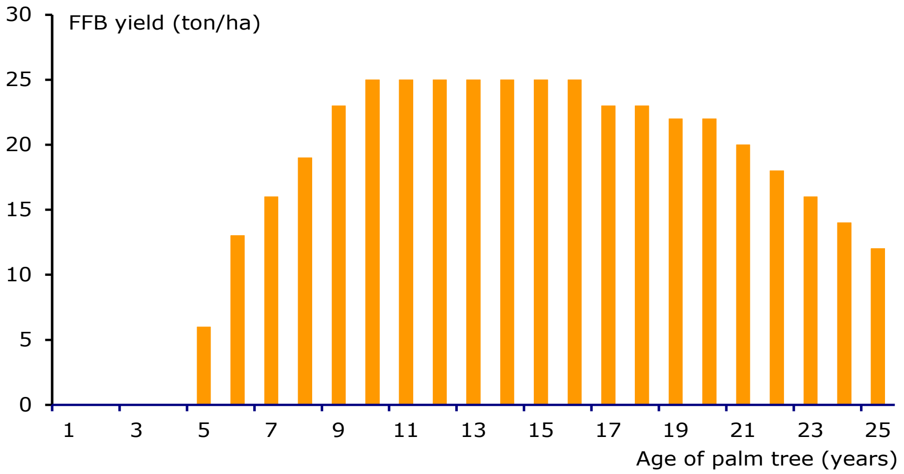
Processing FFB from its own estates yields higher gross margins of 65%, based on a CPO price of USD650/tonne and production cost of USD360/tonne. Production costs for its own estates are stable, usually consisting of depreciation, labour and fertiliser costs.

In contrast, processing FFB bought from external parties yields fixed low gross margins of 10-15%. This is because the price of FFB purchased from external parties is determined by a formula linked to CPO prices. Still, for many plantation companies, processing FFB from external parties allows them to lock in profitability, increase capacity utilisation during poor harvests and also fulfil social responsibility.

In view of the above, simply comparing the consolidated reported gross margins of listed plantation companies does not provide a clear picture of their true cost-competitiveness.

The loss of TBL's production from the 15k ha of its estates converted into sugarcane plantations should be compensated by newly matured trees from its Palembang and Pontianak estates, according to the company. These two estates should have higher productivity and lower production costs going forward.

Figure 10: Normal yield curve of palm oil



Source: Maybank KE

Financial upside potential

Earnings upside in the next three years could emanate from its venture into sugar, in our view. We believe EBIT has the potential to double while core net profit has room to triple in 2017 from 2014E levels, from sugar contributions.

1H14 revenue was already up 63% YoY to IDR2.7t. EBIT was up 44% YoY to IDR363bn. Net profit grew 75% to IDR213bn. The strength was largely due to higher average palm product prices, a surge in FFB output from nucleus estates and new sugar-refinery contributions.

Figure 11: 1H14 results

(IDR b)	1H13	1H14	+/- yoy
Revenue	1,681	2,733	63%
Palm products	1,661	2,391	44%
Sugar	19	342	1713%
Others	1	2	114%
EBIT	251	363	44%
FX gains / (losses)	-35	-21	-40%
Net interest income (charges)	-81	-103	27%
Others	17	34	106%
Pretax profit	153	274	79%
Net profit	**122**	**213**	**75%**
FFB production from nucleus (tonnes)	199,174	333,526	67%
CPO price (IDR/kg)	7,377	9,143	24%
Palm kernel oil price (IDR/kg)	6,775	11,877	75%

Source: Company

Balance sheet

Net gearing was 132% as at end-Jun 2014. Of its IDR3,047b debt, about 71% was in USD loans. Although such loans are naturally hedged by its revenue largely linked to international CPO prices in USD, a volatile rupiah could swing its earnings with translation gains/losses.

Debt servicing remained healthy at less than 3.8x EBITDA, annualised. This might fall further once sugar contributions increase. That said, balance sheet remains at risk from CPO price oscillations, which could significantly alter its EBITDA.

We estimate operating cash flow of IDR300b for 2014E after interest payment. The company has budgeted IDR1t pa for capex, mainly for building sugar mills which will cost IDR1.3t over two years, developing 15,000 ha of sugarcane plantations at IDR345bn over two years and palm-oil planting. The last should cost IDR216bn pa, according to the company.

Cash flows could be very tight, based on our calculations. The company may need external funding of at least IDR1.5t for its capex till end-2016E, in our estimation. It has room to gear up as we believe its equity could climb from IDR2.0t in Jun 2014 to IDR3.1t by Dec 2016E, assuming a net-profit run rate of IDR213bn, as in 1H14.

If the above scenario pans out, net gearing should remain more or less at 135% by Dec 2016E vs 132% in Jun 2014.

TBL's debt covenants currently limit its net gearing to 200% and dividend payout ratio to 50% of its net profits.

Figure 12: Balance sheet (IDR b)

Assets	IDR b	Liabilities	IDR b
Cash and cash equivalents	402	Short-term debts	1,483
Accounts receivable	450	Accounts payable	203
Inventory	16	Advances received	341
Other current assets	1,495	Other current liabilities	113
Plantation assets	1,264	Long-term debts	1,565
Fixed assets	2,592	Advances received	452
Other non-current assets	159	Other non-current liabilities	210
		Total liabilities	4,367
		Minority interests	16
		Shareholders' equity	1,995
Total assets	**6,377**	**Total liabilities and equity**	**6,377**

Source: Company

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