PLANTATION SECTOR UPDATE

Never too Early

Industry Has Started to Show Recovery

Indonesian palm oil production recorded a growth of 14.17% YoY to 4.28 million tons in 7M18. This shows a continuous excess supply in Indonesia up to 7M18, as evidenced by total domestic consumption which reached only 1.01 million tons, or far less than the total production. Indonesia's CPO export performance recorded a 26.98% YoY increase in 7M17, reaching 2.53 million tons, up to 4.28 million tons in 7M18.

Potential Payoff from Trade War and Increase in Domestic Consumption Becomes a Positive Catalyst

Trade tensions between the US and China have heated up considerably following the imposition of tit-for-tat import tariffs by each country. Indonesia benefits from increasing demand for CPO from China due to the Trade War. Domestic consumption of palm oil is expected to increase in FY19F. We estimate the potential for an increase in domestic consumption in FY18E/FY19F supported by enactment of mandatory b20. In addition, the Biofuel program enacted by the government, as well as the development of CPO-based downstream industries, illustrates how the need for palm oil has a potential to grow 15.40% to 12.76 billion tons.We expect CPO prices to move in the range RM2,300 - RM2,600 in FY18E and RM 2,100-2,300 in FY19F.

Risks from CPO Import Restrictions imposed by the EU and US

Several regulations implemented by CPO-importing countries such as the EU and the US, related to restrictions on palm oil-based products, are certainly a challenge for the Indonesian CPO sector. The impact of the policy has begun to be seen from Indonesia's palm exports experienced a decline to the country

NEUTRAL Recommendation with Top Picks: LSIP and AALI

We still maintain a **NEUTRAL** outlook for the plantation sector for FY18E / FY19F. We predict the sector has a potential to stay stagnant until the end of 2018. Nevertheless, we see investment opportunities in 2019, along with relatively cheap (undervalued) valuations today, following negative issues that have emerged and are reflected in the current share price decline. We believe that positive issues, either in terms of increasing demand or decreasing inventories due to weather factors will be an interesting turnaround story going forward. We recommend **LSIP (BUY, TP: IDR1,540)** because of its healthy balance sheet, and **AALI (HOLD, TP: IDR14,125)** because of the opportunity for increased CPO demand from the implementation of B20.

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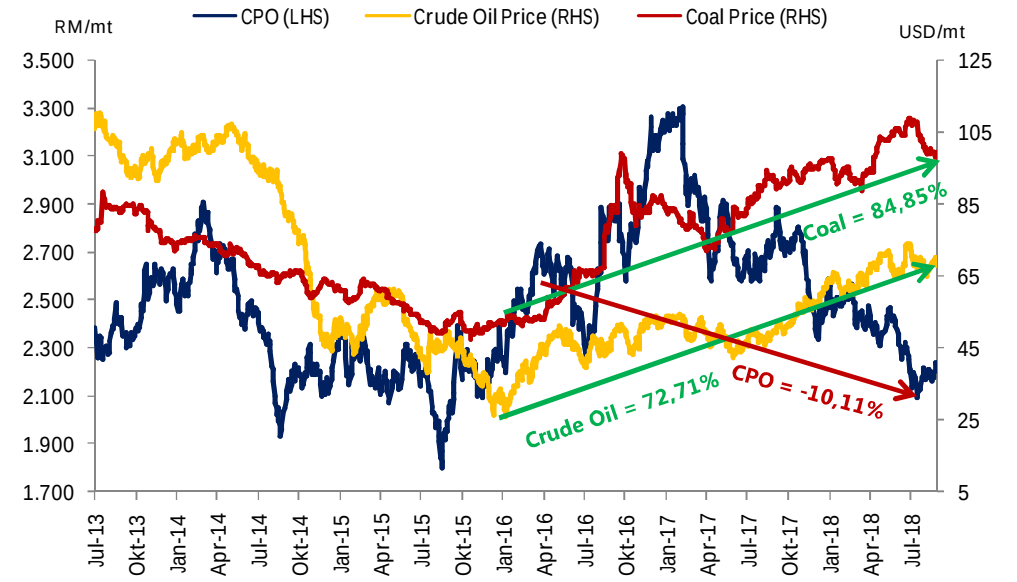
Ticker	Market Cap (IDR bn)	P/E (x)		PBV (x)		Rec.	Target Price (IDR)
		FY18E	FY19F	FY18E	FY19F		
LSIP	7,914.50	13.08	10.35	0.94	0.88	BUY	1,540
AALI	22,374.00	13.76	12.35	1.14	1.10	HOLD	14,125

Sources: Bloomberg, MNCS (as of October 17, 2018)

CPO Price Lingering in the Lagging Quadrant up to 7M18

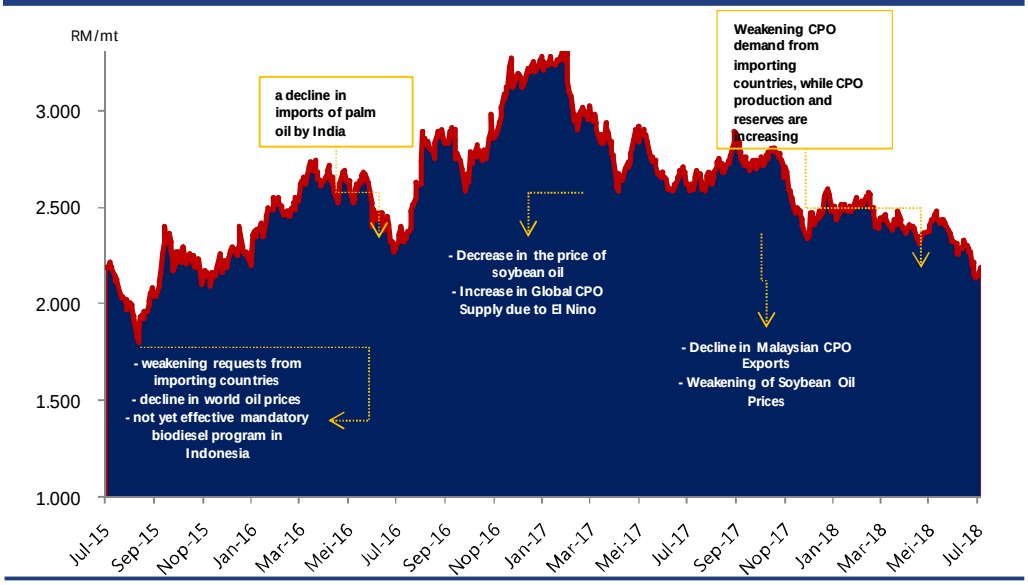
A steady increase in commodity prices was tracked from March 1, 2016 to September 6, 2018, especially for hard commodities such as coal (+84.85%), crude oil (+72.71%), and tin (+17.62%), while other "soft" commodities, such as cpo, are stuck in a lagging quadrant: cpo prices continue poorly, weakening by -10.11% YTD (March 1, 2016 to September 6, 2018). The weakening trend in cpo prices may be attributed to increased production outstripping increases in exports. Other factors that support the weakening of cpo prices include: 1) Negative sentiment from Europe, generated by anti-palm oil campaigns; and 2) India cranking up tariffs on cpo product imports. We conclude that Indonesia's cpo prices are currently more complex, for a variety of reasons: 1) The link between soybean and biodiesel; 2) The challenge of supply and demand for cpo, both domestically and globally. Thus, the current cpo price is depressed to its lowest point. We remain confident that cpo prices have the potential to resist the direction of hard commodity prices, and thus project cpo potentially moving into a range of RM2,300 - RM2,600 in FY18E and RM 2,100-2,300 in FY19F.

Exhibit 01. CPO Price vs Hard Commodity Price



Source : Bloomberg

Exhibit 02. CPO Price Movement Cycle



Source : Bloomberg

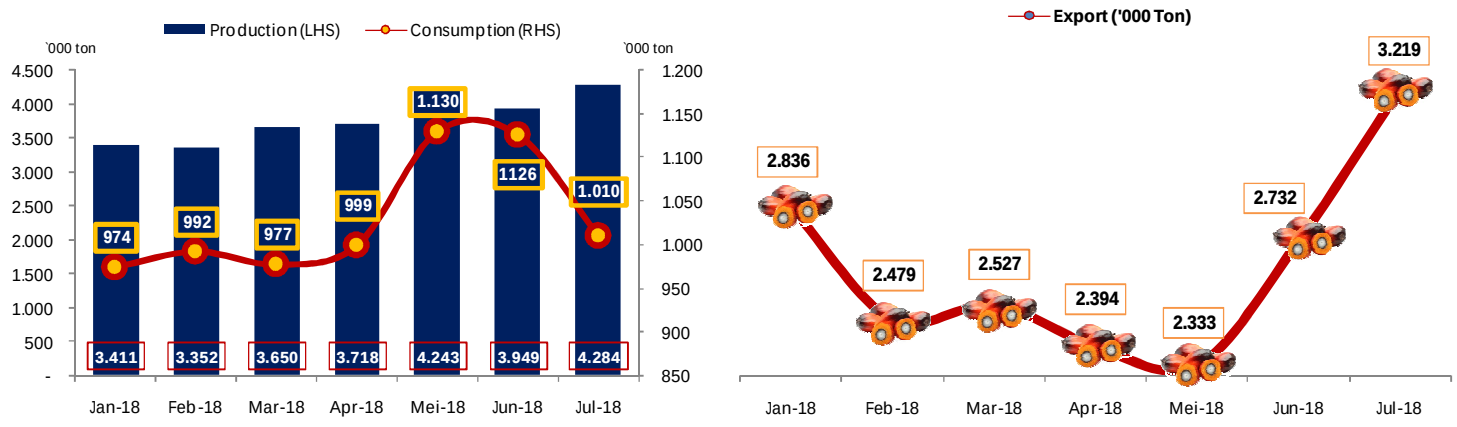
Potential Payoff from Trade War: Growth in Demand New Interest from Chinese Markets

Trade tensions between the US and China have heated up considerably following the imposition of tit-for-tat import tariffs by each country. On July 6, 2018, the US began to impose a border rate of 25% on goods imported from China, affecting a total of USD34 billion in trade. In reaction, China imposed an identical tariff of 25% on goods imported from the US, including soybeans, which are in fact one of the main sources fulfilling Chinese vegetable oil needs. Increased tariffs on soybean oil imports have resulted in prices shooting up, which had an impact: reducing the supply of soybean oil from the US, and switching to other vegetable oils – such as CPO – at more competitive prices. We suggest that Indonesia has a golden opportunity to increase the volume of CPO exports to China as a result of the Trade War. On July 12, 2018, the Chinese Government began to increase the volume of Indonesian palm oil imports, as Chinese businessmen signed a purchase contract for palm oil and its derivative products from Indonesia worth USD726 million, active for the coming year. This is reflected in the value of China's CPO imports in FY17 which increased by 3.73 million tons, or by 15.48% YoY.

The Key to Growth is in the Domestic Market!

Indonesian palm oil production recorded growth of 14.17% YoY to 4.28 million tons in 7M18 compared to 7M17, reporting 3.75 million tons. This points to persistent oversupply in Indonesia up to 7M18, as evidenced from total domestic consumption reaching just 1.01 million tons, or considerably less than total production. Indonesia's CPO export performance recorded an increase of 26.98% YoY in 7M17, reaching 2.53 million tons, rising to 4.28 million tons in 7M18. Oversupply is still visible in the second-largest palm oil producing country, namely, Malaysia. Based on MPOB data, Malaysian CPO production grew 2.34% YoY to 8.91 million tons in 6M18 (vs. 8.71 million tons in 6M17). Their CPO exports also declined in 6M18, by 12.60% MoM to 1.13 million tons. However, we foresee a potential increase in domestic Indonesian consumption in FY18E, supported by several events: 1) 2018 Asian Games; 2) IMF Annual Meeting; and 3) Election Campaigns. In addition, the Biofuel program enacted by the government, as well as the development of CPO-based downstream industries, illustrates how the need for palm oil has a potential to grow 15.40% to 12.76 billion tons.

Exhibit 03. Indonesia 2018 CPO Production, Consumption and Export Market!



Source : GAPKI

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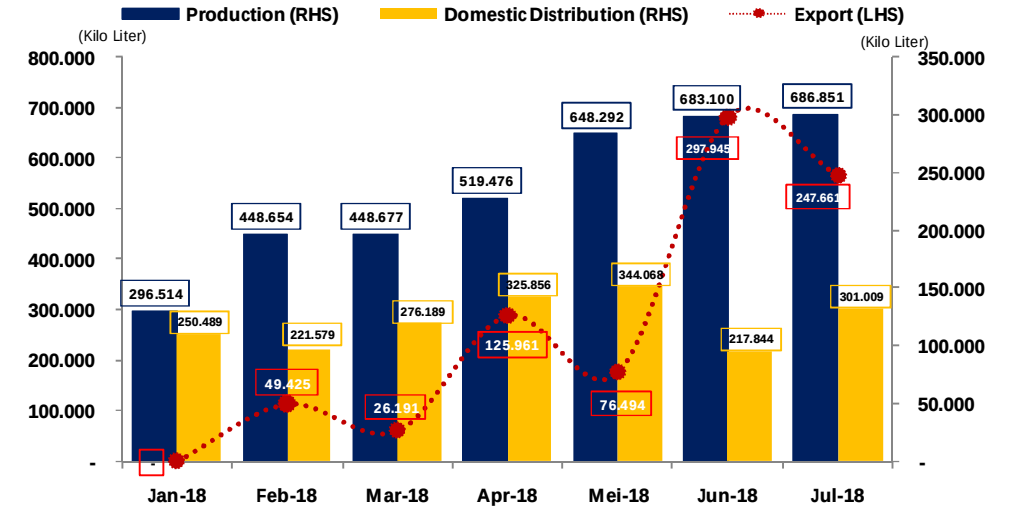
Opportunities for Downstream Palm Oil – Biodiesel

Up to 5M18, domestic CPO consumption reached 5.07 billion tons and is expected to reach 12.76 billion tons in FY18E, an increase of 15.40% YoY from 11.05 billion tons in FY17. Based on data from the Indonesian Vegetable Oil Industry Association (GIMNI), around 8.41 billion tons of CPO is used for food and specialty fats, 845 thousand tons for oleochemicals, and 3.50 million tons for biodiesel. At present, the Government plays an active role in encouraging biodiesel demand, through the implementation of B20 for non-Public Service Obligation (PSO) vehicles such as trains and buses, as well as for non-Public Service Obligation (PSO) private vehicles. The government also plans to increase the use of biodiesel, with the application of a 25% FAME mixture scheme in diesel (B25) to be implemented in 2019. The movement of the world vegetable oil market (production and consumption) is starting to shift toward downstream vegetable oil products, such as food ingredients (oleofood), oleochemicals (soap, detergent, toiletries and cosmetic ingredients), as well as biodiesel. At present, the world's principal use of CPO is in the processed food division, with a portion of around 60%. Therefore, we see that CPO downstream products will continue to expand in the future, supported by a biodiesel consumption target raised by the Government by 22.4% YoY to 3.5 million kiloliters in FY18E.

Exhibit 05. Indonesian Biodiesel Production and Distribution Volume January-May 2018 Period



Source : APROBI

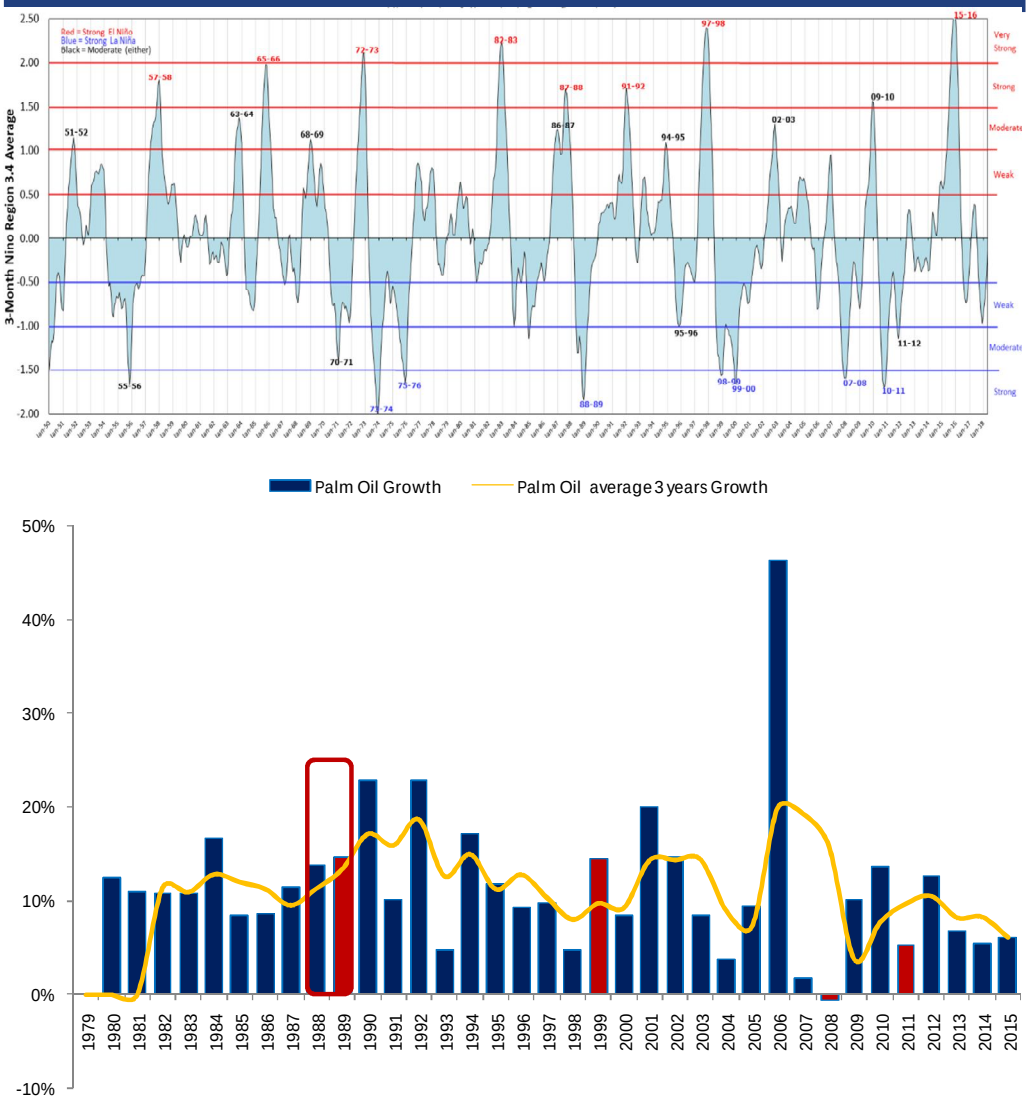
Risks from CPO Import Restrictions imposed by the EU, India and the US

Several regulations implemented by CPO-importing countries such as the EU and the US, related to restrictions on palm oil-based products, are certainly a challenge for the Indonesian CPO sector. The European Union issued a policy to eliminate the use of palm oil-based biodiesel in 2030. The impact of the policy has begun to be seen from Indonesia's palm exports to Europe in 7M18, which declined by -4.61% MoM from 443.66 thousand tons to 423.17 thousand tons. In addition, the US implemented an anti-dumping policy which resulted in a decline in their palm oil imports by -11.52% MoM in 7M18 to 70.66 thousand tons (vs. 79.80 thousand tons in 6M18).

The Effect of La Niña on the CPO Industry

The Meteorology, Climatology and Geophysics Agency (BMKG) stated that Indonesia will enter the rainy season evenly throughout the region from October to December 2018. The National Oceanic and Atmospheric Administration (NOAA) and BMKG estimate wetter weather conditions, with a probability of 65% -75%, pointing to La Niña arriving in 2018. Based on the latest historical data, La Niña will exert an impact resulting in lower production: high rainfall results in flooding and can impede CPO harvest. However, the 2018 La Niña is estimated to be relatively weak, due to a lack of certainty about rainfall at the end of this year, with an anomaly of -0.1 to 3M18. We estimate that this year's La Niña will exert an impact on increasing palm oil production, encouraging an increased supply of CPO, and will thus put pressure on CPO prices again in FY18.

Exhibit 06. Growth of Indonesia CPO Production vs. Strong La Nina



Source : http://ggweather.com, Bloomberg

NEUTRAL Recommendation with Selected Shares: LSIP, AALI

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MNC Research Investment Ratings Guidance

BUY : Share price may exceed 10% over the next 12 months
HOLD : Share price may fall within the range of +/- 10% of the next 12 months
SELL : Share price may fall by more than 10% over the next 12 months
Not Rated : Stock is not within regular research coverage

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