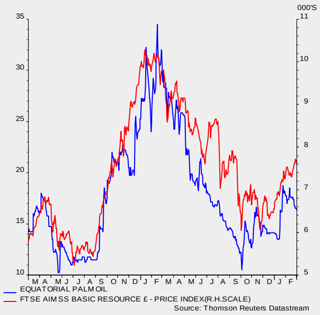
Mining Research

06 March 2012

Company update

Equatorial Palm Oil (EPO) – Joint venture beds down
(PAL LN, 16.4p, Mkt Cap. £21.0m – Buy, valuation 62p)



Source: Datastream

EPO's twin-track strategy involves rehabilitating existing plantations to provide near-term cash flow and expansion of its huge 169,000ha land bank in order to generate long-term growth. Since formation of the 50:50 JV with Biopalm Energy in February 2011, EPO's strategy for development of its Liberian palm oil plantations has moved forward considerably. In particular, funding for the JV will underpin an acceleration of palm plantings and we now expect the 8,000ha pa peak rate of plantings to be achieved in 2014, a year earlier than previously anticipated. We have incorporated some fundamental changes to our DCF analysis and our valuation has increased to 62p per diluted share (previously 40p).

We have adjusted our DCF model from a real to a nominal basis. We continue to assume a long-term CPO price (FOB Monrovia) of US$750/t (expressed in today's money) which we inflate at 2.5% pa, equivalent to our US dollar inflation rate. Operating costs, which are principally tied to the US$, are similarly inflated at 2.5% pa.

Importantly, we have adjusted our project discount rate to 12.5%, from our previous assumption of 15% (in real terms), driven by two important factors. First, we believe last year's peaceful Liberian presidential election is indicative of a more stable social and political environment and is leading a shift in emphasis of the United Nation's role in Liberia, from peacekeeper to one of assistance with in-country economic development. Second, the reduction in discount rate also reflects a change in our approach to assessing project financing and implementation risk. We now apply a higher risk weighting of 50% to include financing risks (previously we assumed a risk weighting of 15% to solely reflect implementation risks).

We have also adjusted EPO's attributable financial position to end-Dec 2011 to US$15.2m (previously US$27.5m), the difference largely reflecting the JV's expenditure on the Liberian assets. Our revised financial position includes group net cash of US$1.7m, a US$9.9m share of JV net cash and financial investments together with US$3.6m for the NPV of proceeds from the exercise of outstanding options and warrants. Finally we have also updated our £/US$ exchange rate to 1.60 (previously 1.50). We highlight that ~18m options and warrants (exercisable at 17.5p) lapsed on 26 February 2012, which was also enhancing to our valuation.

Valuation (long-term CPO price of US$750/t expressed in today's money)

Asset	Net Hectares*	US$/ha	Unrisked US$m	p/shr	Risk weighting†	US$/ha	Risked US$m	p/shr
Palm plantation	50,813	4,999	254.0	110	50%	2,500	127	55
Add: JV Net cash			10.6	5			10.6	5
Add: Net cash			1.7	1			1.7	1
Add: Option/warrant proceeds			3.6	2			3.6	2
Core valuation			**270**	**117**			**143**	**62**

Source: Mirabaud Securities. * Mirabaud assumption, net plantable hectares excluding out-growers. † Discount factor to account for financing and implementation risks. £1= US$1.6

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From rehabilitation to expansion

The JV's extensive land bank totals ~169,000ha, comprising three key assets. The Palm Bay and Butaw Estates, which contain the remnants of abandoned palm oil operations with several thousand hectares of existing palms, total around 89,000ha. In addition, EPO has signed a MOI (Memorandum of Intent) over a third area, River Cess, which lies adjacent to Palm Bay and offers a further 80,000ha of unplanted land.

EPO's two pronged strategy involves rehabilitating existing estates to provide near-term cash flow and development of its huge plantation land bank in order to generate long-term growth. Since formation of the 50:50 JV with Biopalm Energy in February 2011, EOP's two-pronged strategy has moved forward considerably.

Joint venture land bank

Source: Equatorial Palm Oil

In particular, funding in the new JV (which received a cash injection of US$30m (US$22.5m from partner Biopalm Energy – part of the Indian conglomerate the Siva Group - and US$7.5m from EPO) plus an additional bank guarantee to sit behind any development bank funding provided by Siva of US$30m) has underpinned an acceleration of oil palm plantings. We believe the rehabilitation of Palm Bay mature plantings was ahead of our expectations in 2011 with an area of ~3,500ha reactivated by end-December. This exceeds our 2011 forecast for the rehabilitation of 2,400ha and also exceeds the 3,000ha total rehabilitated area which we previously forecast to be achieved by end-2012.

We believe an area of 1,100ha was planted with new palms during 2011. We expect a further 3,000ha to be planted this year. We expect this momentum to be maintained and have therefore pulled forward our forecast plantings. As summarised below we now forecast an 8,000ha pa expansion rate being achieved in 2014 (previously 2015) and being maintained at this rate until 2025.

EPO roll-out, Mirabaud assumptions

(hectares/year)	2011	2012	2013	2014	2015	2016
Previous planting rate	1,200	3,000	5,000	6,500	8,000	8,000
– cumulative planting	*1,200*	*4,200*	*9,200*	*15,500*	*23,500*	*31,500*
Reactivation rate	2,400	600	-	-	-	-
– cumulative reactivation	*2,400*	*3,000*	*3,000*	*3,000*	*3,000*	*3,000*
Revised planting rate	**1,100**	**3,000**	**6,000**	**8,000**	**8,000**	**8,000**
– cumulative planting	*1,100*	*4,100*	*10,100*	*18,100*	*26,100*	*34,100*
Reactivation rate	**3,500**	**0**	**0**	**0**	**0**	**0**
– cumulative reactivation	*3,500*	*3,500*	*3,500*	*3,500*	*3,500*	*3,500*

Source: Mirabaud Securities estimates

First phase mill commissioned

Near-term cash flow will be derived from the production of CPO using fresh fruit bunches (FFB) harvested from existing rehabilitated plantation at the Palm Bay Estate. We believe ~3kt of FFB was supplied to the Palm Bay starter mill in 2011 with initial CPO production totalling ~540t. We expect the rehabilitated mature palms at this plantation to yield ~4.5t/ha of FFB in 2012 which will supply the recently commissioned starter mill with ~17,500t FFB for the year. Operating at ~5tph for 16 hours per day (two shifts) on a six day week we expect an increase in CPO output to ~3.15kt in 2012 with an additional 430t output of by-product kernel cake. We assume the sale of by-products, including high value palm kernel oil (PKO), to commence from 2013.

EPO announced in January that the company's first oil mill, at the Palm Bay Estate, had been operated at its design capacity. The mill has a capacity to process five tonnes of FFB per hour. This capacity is sufficient to support the processing of harvested FFB until end-2015. It is expected that a larger scale mill (with a process capacity of 60tph FFB) will be fully commissioned by end-2014 which will provide sufficient FFB process capacity for a further four years production. We assume a capital cost of US$20m (in today's money) for the first 60tph mill. We forecast subsequent capacity expansions to occur in advance of increased FFB output as the palms mature. We anticipate operating costs to decline to ~US$25/t (expressed in today's money) of FFB once these mills are commissioned.

While initial small scale production will provide some cash flow, the principal value driver for investors is the significant increase in the scale of production afforded by development of the Liberian land bank. EPO has already established nurseries at both Palm Bay and Butaw to feed an aggressive planting programme, which we expect to peak at 8,000ha annually. After taking into account an out-grower scheme, the current land bank has sufficient space for 12 years of rapid expansion, at which point the group would be capable of producing over 400kt of palm oil a year.

Roll-out assumptions

We outline our underlying assumptions for the long-term development of the plantations and crude palm oil prices below.

Development assumptions (costs expressed in today's money)

Available plantable area, ha	101,627
L-T expansion rate for EPO, ha	8,000
L-T expansion rate for outgrowers, ha	600
Land preparation costs (initial rate), US$/ha	800
Nursery costs, US$/ha	444
Rehabilitation costs, US$/ha	343
Plantation opex, US$/ha	150
Labour costs, US$/t FFB	6.4
Mill opex, inc transportation, US$/t of FFB	50
Subsequent opex for 60tph mills, US$/t of FFB	35 declining to 25

Source: Mirabaud Securities

Land bank and planting: Of the total land bank of 168,947 hectares, we have assumed that 101,627 hectares are available for EPO plantation (including, ultimately, replanting all currently planted areas) and a further 41,978 hectares are set aside for the out-grower programme. In making this calculation, we have estimated that approximately 85% of available expansion land can be used for cultivation, the rest being given over to other facilities. Beyond the medium-term rehabilitation and new plantings rate, discussed previously, we assume that EPO will continue to plant out the available plantation area at a rate of 8,000ha per year until 2024.

FFB yields and extraction rates: FFB yields vary depending on the maturity of the palm trees. In our valuation we assume that the FFB yield for new plantings rises from 6 tonnes per hectare in the third year (the first in which they are productive) to a peak of 21t/ha (previously 22t/ha), before declining to 18 tonnes per hectare. The economic life of each new palm is estimated at 25 years (also the duration of our DCF model). We have assumed that rehabilitated existing palm will yield 4.5t/ha in the first year of harvesting, rising to 5t/ha (previously 6t/ha) from the second year onwards, with a productive life of six years.

For rehabilitated palms we assume an average CPO extraction rate in processing of 18% while for the more productive new palms we are conservatively assuming a rate of 21%.

Operating costs: Plantation opex is estimated at US$150/ha, with labour costs of US$6.4/t of FFB per annum. Milling costs, including local transportation, are estimated at US$50 per tonne of FFB in the early years, declining to US$25/t as larger mills are built and throughput increases. We have assumed G&A costs begin at US$3m per annum in 2010 increasing to US$5m from 2012, and thereafter remain flat.

Capital costs: We assume rehabilitation costs of US$343/ha (previously US$264/ha) for existing plantations; for new planting we assume nursery costs of US$444/ha, other initial land preparation costs of US$800/hectare (rising as plantations expand into remoter parts of the land bank) and upkeep costs for immature plants of US$1,500/ha over three years. In addition, we assume capex of US$20m (expressed in today's money) for one 60tph mill (30% invested in 2013 and the remaining 70% in 2014), followed by future large mill purchases as required at equivalent cost.

CPO price: Our long-term CPO price assumption (FOB Monrovia - which we assume equal to the CIF Rotterdam price), which we apply from 2015, remains unchanged at US$750/t (expressed in today's money). We have increased our near-term CPO price assumptions, as summarised below, though this has very little effect on our valuation due to the limited initial CPO output (with minimal initial FFB production from the immature plantings and the low yields from mature, rehabilitated palms).

Revised CPO price assumptions (US$/t FOB Monrovia – in money of the day)

Y/E Dec	2012	2013	2014	2015
CPO price (US$/t)	1,100	1,009	919	828
% change	47%	35%	22%	10%

Source: Mirabaud Securities. FOB Monrovia price is assumed equal to CIF Rotterdam

Cash flow profile

We summarise below, our cash flow profile during the planned development roll-out. Crucially the group is in the process of securing debt finance of ~US$100m from various development organisations, and management expect debt facilities to be arranged by end-2012.

This funding will support the next stage of expansion which will include a continued ramp-up in annual plantings (from 4,000ha in 2012 to 8,000ha by 2014) and delivery of a larger scale mill (with capacity to process 60t of FFB per hour). As outlined earlier the Liberian JV currently has net cash of ~US$10m, short term investments of ~US$10m and a bank guarantee facility of US$30m (provided by partner Siva), which is sufficient to support continued development activities for the next two years.

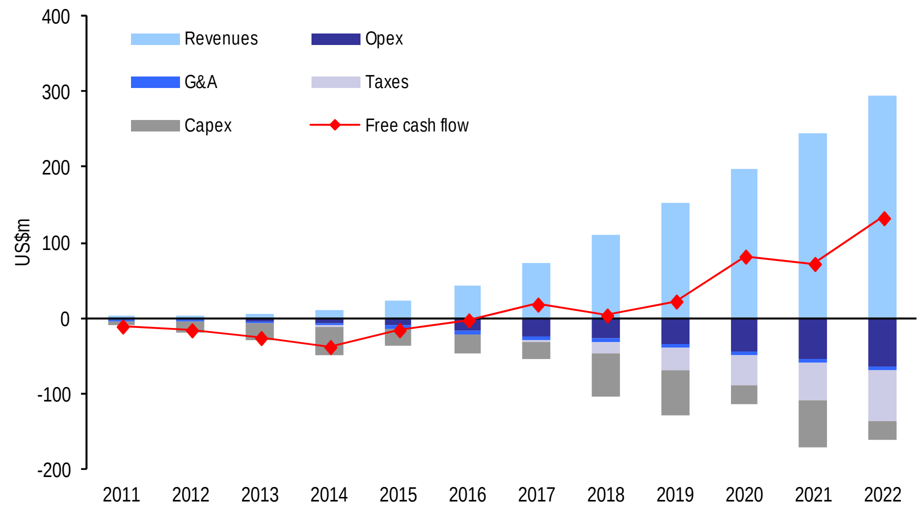
Key operational and cash-flow forecasts (US$m unless otherwise stated)

	Units	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Mature palms	**Hectares**	**3,500**	**3,500**	**3,500**	**4,600**	**7,600**	**13,700**	**21,900**	**26,700**	**35,100**	**43,600**
New palms planted	Hectares	1,100	3,000	6,000	8,000	8,000	8,000	8,000	8,000	8,000	8,000
Out-grower plantings	Hectares	-	-	100	200	300	400	500	600	600	600
Reactivated palms	Hectares	3,500	-	-	-	-	-	-	-	-	-
FFB production	**Tonnes**	**3,000**	**17,500**	**23,000**	**44,600**	**96,650**	**190,160**	**318,280**	**462,500**	**630,980**	**804,720**
Average FFB yield	*tonnes/ha*	0.9	5.0	6.6	9.7	12.7	13.9	14.5	17.3	18.0	18.5
CPO production	**Tonnes**	**540**	**3,150**	**4,305**	**8,841**	**19,824**	**39,514**	**66,509**	**97,125**	**132,506**	**168,991**
PKO production	Tonnes	-	-	138	678	2,023	4,404	7,682	11,563	15,775	20,118
Kernel cake prod.	Tonnes	-	438	603	1,251	2,821	5,635	9,493	13,875	18,929	24,142
CPO extraction rate	%	18%	18%	19%	20%	21%	21%	21%	21%	21%	21%
CPO (FOB Monrov)	**US$/t**	**750**	**1,100**	**1,009**	**919**	**828**	**849**	**870**	**892**	**914**	**937**
Revenues		**0.4**	**3.7**	**4.8**	**9.4**	**19.5**	**40.3**	**69.7**	**104.7**	**146.5**	**191.4**
Opex		(0.9)	(2.1)	(3.4)	(6.0)	(9.1)	(15.0)	(22.8)	(25.5)	(33.8)	(42.7)
G&A		(2.5)	(3.0)	(3.5)	(4.0)	(4.5)	(5.0)	(5.0)	(5.0)	(5.0)	(5.0)
Taxes		(0.0)	(0.1)	(0.2)	(0.4)	(0.7)	(1.5)	(2.6)	(12.4)	(28.6)	(40.8)
Op.cash flow		**(3.0)**	**(1.5)**	**(2.3)**	**(0.9)**	**5.2**	**18.8**	**39.4**	**61.8**	**79.0**	**103.0**
Capex		(5.9)	(13.0)	(22.5)	(36.6)	(21.9)	(23.2)	(23.6)	(51.7)	(52.7)	(24.5)
Free cash flow		**(8.9)**	**(14.6)**	**(24.8)**	**(37.5)**	**(16.7)**	**(4.5)**	**15.8**	**10.1**	**26.3**	**78.5**
Attributable FCF		**(4.4)**	**(7.3)**	**(12.4)**	**(18.8)**	**(8.3)**	**(2.2)**	**7.9**	**5.1**	**13.2**	**39.3**

Source: Mirabaud Securities estimates. * Assume discounted prices achieved from inaugural CPO production.

Inherently, due to the time-lag in coming to maturity, the full impact of the project will not filter through to free cash flows for a number of years as illustrated below.

EPO forecast growth and cash flow profile, 2011-22



Source: Mirabaud Securities

Sensitivity analysis

As illustrated above, free cash flow generation from early-stage palm plantation projects, such as EPO's, are back-end loaded. During the early years, the plantation is maturing and has relatively low yields, while at the same being burdened by start-up investment. As a result, our valuation is extremely sensitive to changes in the discount rate. Due to the improvement in Liberia's economic and stability and as the palm oil operation financially de-risks, we believe further reductions may be appropriate. The table also shows the sensitivity of our valuation to long-term palm oil prices. We highlight that our conservative CPO price assumptions which we forecast to decline to US$750/t (expressed in today's money).

Long-term CPO price sensitivity analysis (core valuation, p/shr)

	CPO price CIF Rotterdam (US$/tonne)					
%	**US$550/t**	**US$650/t**	**US$750/t**	**US$850/t**	**US$950/t**	**US$1050/t**
10	54	72	90	108	125	143
11	46	62	77	93	108	124
12	40	53	67	80	94	107
12.5	37	49	62	75	87	100
13	34	46	58	70	81	93
14	29	40	50	61	71	81
15	25	35	44	53	62	71

Source: Mirabaud Securities estimates.

Comparables analysis

There are a total of seven London-listed palm oil plantation companies, primarily mature plantation businesses with established operations in Southeast Asia. Overall, given the immature nature of the business, we believe a DCF-derived valuation is likely to remain the best way of valuing the company for the foreseeable future.

Valuation (long-term CPO price of US$750/t expressed in today's money)

Asset	Gross hectares	Interest	Net hectares	US$/ha	US$m	Unrisked p/shr	Risk weighting†	US$/ha	US$m	Risked p/shr
Palm plantation	101,627	50%	50,813	4,999	254.0	110	50%	2,500	127	55
Add: JV Net cash		50%			10.6	5			10.6	5
Add: Net cash		100%			1.7	1			1.7	1
Add: Option/warrant proceeds		100%			3.6	2			3.6	2
Core valuation					270	117			143	62

Source: Mirabaud Securities. * Mirabaud assumption, net plantable hectares excluding out-growers. † Discount factor to account for financing and implementation risks. £1= US$1.6

However, the average valuation for London-listed companies of almost US$22,000 per mature hectare offers a useful indicator as to the scale of the valuation uplift EPO can hope to achieve as it rolls out its development strategy and its estates mature.

London-listed comparables

Company	Stock ticker	EV US$m	Plantation Locations	Attributable Mature Hectares	EV/ha US$/ha	FFB yield tonne/ha	Other assets
Producers							
New Britain Palm Oil	NBPO LN	2,189	Papua New G.	77,060	28,407	28.6	Refinery, sugar, cattle
REA Holdings	RE/ LN	438	Indonesia	24,941	17,571	23.6	Coal
Anglo-Eastern Plant.	AEP LN	389	Indon. & Malay.	33,773	13,733	18.7	Rubber
MP Evans Group	MPE LN	389	Indonesia	12,985	29,986	17.4	Beef, rubber
Narborough Plant.	NBP LN	13	Malaysia	555	22,573	23.0	-
Weighted Average					**22,454**		
Development							
Asian Plantations*	PALM LN	172	Malaysia	4,000	43,926	na	-
Equatorial Palm Oil*	PAL LN	18	Liberia	1,750	10,172	na	-

Source: Bloomberg; Company data; Mirabaud Securities. FFB production excludes out-grower contributions.* Yields for developers derived from partial year production. Shares priced at close of business 5 March 2012.

RECOMMENDATIONS HISTORY

Market index	FTSE AIM Basic Resources			
Date	Market Index	Stock Price	Valuation (p)	Opinion
08-Jul-2010	5,441	11.50	40.0	Buy
07-Sep-2010	5,975	11.75	35.0	Buy
11-Mar-2011	9,098	28.75	40.0	Buy
06-Mar-2012	7,612	16.38	62.0	Buy

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