AmInvestment Bank

Thematic Report

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PLANTATION

Whither the palm refining industry?

NEUTRAL

(Maintained)

Rationale for report: Sector update

Investment Highlights

- **Unexciting outlook for the refining industry.** We believe that the outlook for the refining industry in Malaysia and Indonesia is unexciting as current refining capacity is just enough for demand. Going forward, as companies expand their refineries, we believe that there would be excess capacity. We estimate Indonesia's installed refining capacity at 45mil-50mil tonnes compared to CPO production of 48mil tonnes for 2024E. In Malaysia, installed refining capacity is 25mil tonnes vs. CPO output of 18mil-19mil tonnes per year.

- **What are refining margins currently?** Mewah International's (which has refineries in Malaysia and Indonesia) operating profit margin for bulk products dived by 53.5% to US$32.1/tonne in FY23 from US$69.1/tonne in FY22. The group's operating profit margin for consumer pack products, however, rose by 16.4% to US$84.6/tonne in FY23 from US$72.7/tonne in FY22. First Resources' (refineries in Indonesia) refining EBITDA swung into a loss of US$43.8/tonne in FY23 from a positive US$52.6/tonne in FY22.

- **More palm refineries are coming up in Indonesia.** Indonesia's refining capacity is expected to increase further. Apical Group will be building a palm refinery and fractionation plant in West Sumatra, which will be completed in 2025F. The palm refinery will have a capacity of 3,500 tonnes per day or more than 1mil tonnes per year. In early-July 2024, Mewah International completed the construction of its US$95mil palm refinery in Dumai. The refinery has a capacity of 3,500 tonnes per day or more than 1mil tonnes per year. Generally, we estimate the cost of building a palm refinery at US$100/tonne-US$300/tonne.

- **Malaysian companies are also expanding in Indonesia.** KL Kepong's (KLK) palm refinery in East Kalimantan is expected to be completed before year-end. KLK's palm refinery would have a processing capacity of 2,000 tonnes per day or 660,000 tonnes per year upon completion. The total cost of KLK's refinery and oleochemical plant in East Kalimantan is expected at RM700mil. SD Guthrie's (SDG) US$150mil Ser Mangkei palm refinery in North Sumatra would be completed in 2025F and have a capacity of 450,000 tonnes per year. We believe that Malaysian companies are expanding their refining capacity in Indonesia to strengthen their supply chains. KLK and SDG would be able to channel CPO to their own refineries in Indonesia instead of selling to other parties' refineries. About 50% to 60% of KLK's FFB are in Indonesia. Indonesia accounted for 30.8% of SDG's FFB in FY23.

- **Implications – upstream companies to benefit.** First, upstream companies in Indonesia would benefit as demand for CPO is supported by the growing number of palm refineries. Second, competition among refiners is expected to be fierce as everyone would be servicing almost the same portfolio of customers. Refiners in Indonesia sell their products domestically and overseas. The high cost of feedstock coupled with low selling prices are envisaged to cap refining margins. In Indonesia, the main players are Musim Mas Group, Indofood Group, Wilmar International, Apical Group and Golden Agri Group.

- **Why build refineries then?** We believe that the domestic consumption of palm oil in Indonesia is driven by food/cooking oil, B35 biodiesel policy and the oleochemical industry. In the past, the ceiling price for packaged cooking oil was Rp14,000/litre (RM4.04/litre). Hence, there was an incentive for refiners to export their palm products. Also, the domestic market obligation (DMO) is 1 to 4 currently, which allows refiners to export four times the volume of domestic sales. In June 2024, the ceiling price for packaged cooking oil was raised to Rp15,500/litre (US$0.94) to reflect higher costs of production and a stronger Rph. This narrowed the price gap between domestic and export prices and is expected to incentivise refiners to sell more products domestically.

- **B35 consumption is estimated to be 10.9mil tonnes in 2024E vs. 10.6mil tonnes in 2023.** Currently, installed biodiesel production capacity in Indonesia is estimated at 18mil kilolitres or 15.7mil tonnes. Based on the consumption of 11mil tonnes, there is demand for almost 11mil tonnes of fatty acid methyl ester or feedstock for biodiesel.

- **Refining capacity matches demand.** According to GAPKI, Indonesia's domestic consumption (including biodiesel) was 23.3mil tonnes in 2023. GAPKI expects palm exports to drop by 4% in 2024E. Assuming domestic consumption of 23.3mil tonnes and 25.8mil tonnes of exports, this translate to total demand of 49.1mil tonnes for 2024E. In comparison, there are 45mil-50mil tonnes of refining capacity in Indonesia. China's palm imports amounted to 4.3mil tonnes in 2023. China's palm imports fell by 25.6% YoY to 1.2mil tonnes in 1H2024. India's palm imports rose by 5.8% YoY in 1H2024. India's palm imports are mainly in crude form as the country has refineries. 78.3% of the country's palm imports in 2022/2023 were in crude form while the balance 21.7% were refined olein.

- **Implications on Malaysian refiners: stiff competition from Indonesia.** We believe that Malaysian refiners would experience weak profit margins due to competition from their Indonesian counterparts. Indonesian players have a cost advantage, which allows them to sell their products competitively. This is due to the country's CPO export tax and levy, which are passed down to upstream companies in the form of lower selling prices. Presently, we estimate the price differential between CPO in Indonesia and Malaysia at US$118/tonne (RM550/tonne). CPO export tax and levy in Indonesia were US$118/tonne in July vs. US$93/tonne (RM433/tonne) in June.

- **What can be done to expand refining margins?** We think that processing margins for differentiated products and consumer packs are higher than bulk. 76.3% of SDG's downstream EBIT came from differentiated products in 1QFY24 while bulk accounted for a smaller 5.9%. Trading made up the balance 31.9% of SDG's downstream EBIT. KLK plans to expand into value-added refined products in Malaysia. Also, we believe that some refiners trade CPO futures to improve profit margins.

- **What about the oleochemical industry?** In contrast to refining, we believe that there are green shoots in the oleochemical industry. Demand for oleochemical products is improving in Europe and Asia Pacific. We believe that this is driven by the personal healthcare industry. In contrast to Europe and Asia Pacific, we gather that demand from China is soft.

- **Risk in rising oleohemical capacity in Asia.** In 2023, Apical Group's oleochemical plant in Taixing, China commenced operations. Phase 1's capacity is 577,000 tonnes. Eventually, the plant would have 1mil tonnes of oleochemical capacity per year. KLK would be completing its oleochemical plant in East Kalimantan in 2025F. The oleochemical plant, which is next to the refinery, would have a capacity of 1,000 tonnes per day or 330,000 tonnes per year.

- **Expect refining margins to remain negative or barely profitable in the short-term.** We believe that refining margins would remain in the doldrums. At the peak in FY22, we estimate that refining accounted for 5% of KLK's EBIT. Currently, we believe that earnings contribution of refining to KLK and IOI's earnings is small or negligible. Downstream accounted for 34% of SDG's EBIT in 1QFY24. Genting Plantation's (GenP) downstream unit (refining and biodiesel) recorded EBITDA of RM6.1mil in FY23 and RM0.9mil in 1QFY24.

- **Which companies have refineries in Indonesia?** In our coverage, KLK and SDG have palm refineries in Indonesia. Including the Ser Mangkei refinery, we estimate that SDG would have refining capacity of 1.3mil tonnes in Indonesia. Including the refinery in East Kalimantan, we reckon that KLK would also have refining capacity of 1.3mil tonnes in Indonesia. In addition to this, KLK currently has oleochemical processing capacity of 165,000 tonnes in Indonesia (excluding the new plant in East Kalimantan). In our stock universe, SDG, KLK, IOI Corporation, GenP and TSH Resources have palm refineries in Malaysia.

- **Upstream earnings are strong enough to offset weak refining margins.** In spite of the poor refining outlook, we maintain BUY on KLK (Fair Value: RM25.20/share) and Gen Plantations (Fair Value: RM6.80/share). KLK's FY24E earnings are expected to be driven by improvement in oleochemical and plantation earnings and absence of asset impairments. Gen Plantations' FY24E earnings are envisaged to be underpinned by lower fertiliser costs, higher FFB production and stronger earnings from Premium Outlets. We maintain Neutral on the plantation sector with an average 2024E CPO price assumption of RM4,000/tonne for the pure planters in Malaysia (2023: RM3,833/tonne).

EXHIBIT 1: PEER COMPARISONS

	Share price	EPS (sen)		PE (x)		Fair values	Upside	FY24F	FY24F	Rec
	(RM)	FY24F	FY25F	FY24F/FY25F	FY25F/FY26F	(RM)		DPS (sen)	Div yield	
IOI Corp	3.78	18.5	22.9	20.4	16.5	4.10	8.5%	11.0	2.9%	Hold
KLK	20.64	83.6	140.1	24.7	14.7	25.20	22.1%	70.0	3.4%	Buy
SD Guthrie	4.45	15.7	25.2	28.3	17.7	4.55	2.2%	16.0	3.6%	Hold
Gent Plant	5.73	34.8	37.8	16.5	15.2	6.80	18.7%	25.0	4.4%	Buy
Hap Seng Plant	1.74	15.5	15.9	11.2	10.9	2.40	37.9%	7.0	4.0%	Buy
TSH Resources	1.20	7.2	8.2	16.7	14.6	1.20	0.0%	3.0	2.5%	Hold

Source: AmInvestment Bank

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