MARC ASSIGNS AAA CORPORATE CREDIT RATING TO SIME DARBY PLANTATION SDN BHD; OUTLOOK STABLE

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MARC has assigned a corporate credit rating of **AAA** to Sime Darby Plantation Sdn Bhd (SDP) with a **stable** outlook. The long-term rating benefits from a one-notch rating uplift for implicit support from government-linked investment company Permodalan Nasional Berhad (PNB), who will become SDP's new direct majority shareholder upon the completion of the reorganisation of conglomerate Sime Darby Berhad (Sime Darby). SDP, the plantation and agri-business arm of the group, will be separately listed on Bursa Malaysia after the corporate exercise, currently anticipated to be completed in December 2017. MARC is of the view that PNB, which has historically supported Sime Darby's capital raising and dividend retention programmes, will continue to extend support to SDP should the need arise.

SDP's standalone rating considers its geographically diversified oil palm operations, its vertically integrated business structure and sizeable cultivated plantation land which are supportive of strong cash flow generation. These factors are offset by SDP's exposure to crude palm oil (CPO) price volatility and its post-reorganisation leverage position.

Post-reorganisation, SDP will assume US dollar borrowings equivalent to RM2.7 billion (US$600 million) and the perpetual sukuk of RM2.2 billion from Sime Darby to partly offset an outstanding RM8.2 billion loan from the holding company as at June 30, 2016. The remainder of the intercompany loans will be set off against a settlement in kind through transfer of SDP's land to Sime Darby. SDP's total adjusted debt will stand at about RM9.2 billion, leading to a gross debt-to-equity (DE) ratio of about 0.58 times (net DE: 0.53 times). MARC expects moderation of SDP's leverage to below 0.5 times in the near term to be assisted by a supportive CPO pricing environment and higher earnings retention. In addition to earnings retention, SDP possesses the flexibility to undertake assets divestitures, proceeds from which could be used to reduce its leverage.

SDP is the world's largest palm oil producer with over 603,000ha of cultivated oil palm plantation land of its total land bank of about 1.0 million hectares, and accounts for about 4% of global crude palm oil (CPO) production in 2016. It has significant presence in upstream operations in Malaysia, Indonesia and Papua New Guinea following the acquisition of New Britain Palm Oil Limited (NBPOL) in 2015 and sizeable downstream capacity in these countries as well as in the Netherlands, United Kingdom, Thailand, Vietnam and South Africa. Its annual fresh fruit bunch (FFB) production volume remains considerable, although weather conditions and the maturity profile of its oil palm plantation have weighed on output in the recent year.

For the six-month period ended December 31, 2016 (1HFY2017), SDP registered an FFB yield of 9.65 MT/ha and oil extraction rate (OER) of 21.29% (1HFY2016: 10.5 MT/ha; 22%). The weaker production yields were partly affected by unfavourable weather conditions in all its geographies; however, SDP's current productivity measures continued to lag its peers, mainly as a result of its Indonesian plantations, which recorded an FFB yield of 15.50 MT/ha as at end-June 2016 due mainly to its maturity profile. Of its 202,796 ha of cultivated land in Indonesia, about 40% is above 19 years. Its Malaysian plantations remain comparable to its domestic peers while the average FFB yield for NBPOL remains strong at 21.85 MT/ha for FY2016.

MARC notes that to improve the overall maturity profile, SDP is intensifying its replanting efforts, earmarking an annual capex of RM800 million to RM1.0 billion for replanting and new planting. From FY2017 and FY2019, SDP will replant up to 15,000 ha of oil palms annually each in Malaysia and Indonesia. The programme covers about 5.2% of the total planted area and is expected to reduce its average plantation age to 10 years from the current 13.8 years over the long term. While SDP has budgeted total capex of RM1.7 billion annually for the next three years, it has the flexibility to reduce replacement and expansion capex should CPO prices decline sharply. At a CPO price of RM1,800/MT, MARC estimates that SDP should generate cash flow from operations (CFO) of about RM2.2 billion, which would allow capital expenditures to be wholly funded by internally generated cash flow. For FY2018 and FY2019, assuming average CPO price of RM2,400/MT, SDP's cash flow coverages would be sustained between 6.4 and 6.9 times for interest cover and 0.41 and 0.44 times for debt cover.

For 1HFY2017, SDP recorded a significantly higher average CPO price of RM2,739/MT, leading to revenue and operating profit of RM6.7 billion and RM841 million respectively (1HFY2016: RM2,077/MT; RM6.0 billion; RM461 million). The group's downstream operations continued to be dragged by thin operating margins of 3.1% (1HFY2016: 3.0%); however, the average utilisation rate rose to 77% (1HFY2016: 67%). By shifting into high margin products such as premium quality oils, its near-term performance could improve. In addition, as a key certified sustainable palm oil (CSPO) producer, accounting for 21% of global CSPO production as at end-February 2017, SDP has a competitive advantage to penetrate specialty product segments in developed countries.

SDP's financial flexibility remains strong; it has RM1.6 billion in undrawn credit facilities as at December 31, 2016 which will be augmented by RM6.7 billion of borrowing headroom under existing programmes to be novated from Sime Darby. The company also has flexibility to monetise assets that would allow it to reduce balance sheet debt further. The rating agency also opines that as a pure play entity, SDP will have better flexibility than Sime Darby previously had in undertaking opportunities and proactively responding to industry developments.

SDP's stable rating outlook reflects MARC's expectations that CPO prices and the company's increased productivity will remain supportive of its borrowing levels and replanting capex requirements. MARC also expects SDP's leverage position to strengthen to a level below 0.5 times over the near term to be commensurate with the rating band. The rating/outlook could be revised downward should there be a sharp reversal in CPO price trajectory that would result in SDP failing to meet MARC's expectations for its cash flow and leverage metrics.

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