PwC Plantation Newsflash

Industry landscape, regulatory and financial overview

No: 0815/PwC Indonesia

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Considerations surrounding mandatory use of L/C in exports of CPO and CPKO

By Hafidsyah Mochtar

From 1 April 2015, exporters of certain Indonesian commodities including Crude Palm Oil ("CPO") and Crude Palm Kernel Oil ("CPKO") are obliged to use a Letter of Credit (L/C) for their exports due to a new regulation. The regulation of Minister of Trade PMD No. 04/M-DAG/PER/1/2015 is aiming to promote optimization of government revenue through more accurate information on export earnings from selected commodities.

Effectively on the same date, an implementing regulation of PMD Np. 26/M-DAG/3/2015 was also announced, which provides room for exemptions from the obligation, to be granted as postponement of the requirement based on assessed lack of readiness (including if an exporter already had an agreed contracts prior to the effective date of the regulation).

The main operating provisions of the regulation include reporting for L/C as a method of payment in the export declaration document (Pemberitahuan Ekspor Barang or "PEB"). The export price at the minimum should be commensurate with that of the world commodity price. The PEB form should denote accurate data of the L/C. Furthermore, exporters should submit a surveyor report (LS) issued by a government appointed surveyor.

From the government monitoring side, the Ministry of Trade will circulate a monthly report on the realization of the mandatory export L/C to various government institutions. These institutions include the office of the Coordinating Minister of Economic Affairs, the BI Governor, the Minister of Energy and Mineral Resources and Central Bureau of Statistics.

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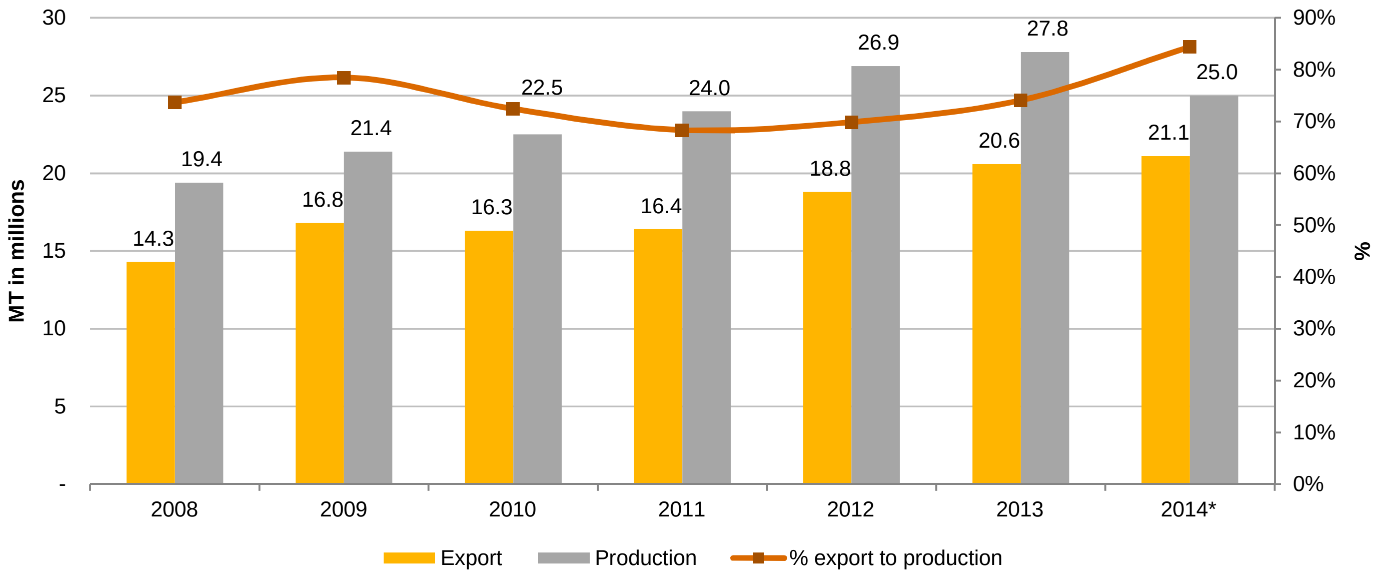
A L/C is basically a promise to pay which allows the seller to significantly reduce the risk of non-payment for the delivered exported commodity by replacing the risk to the banks. Conceptually a L/C provides benefits to both parties, where the seller can be assured that if documents are presented on time as required, the payment will be made, and the buyer can also be assured that the bank will thoroughly examine the presented documents in respect of the transaction's terms and conditions.

Historically, CPO (including CPKO) export played a significant role in the Indonesian palm oil market. Most of the CPO output of Indonesian palm plantation companies have been exported rather than traded domestically, and the recent trend has been increasing (refer to the chart). The enactment of the new regulation may be supportive to government intentions, but it gives plantation companies some concerns.

Indonesia Palm Oil Production and Export



Source: Directorate General of Agriculture, Badan Pusat Statistik ("BPS")

At this juncture, there are concerns raised by the plantation exporters on the requirement to use a L/C. One relates to the increased cost charged by the banks to facilitate the opening and use of the L/C. There could also be additional charges if any reconciliation is required for differences / inconsistencies between the terms and conditions agreed in the purchase agreement and the actual condition as documented in the surveyor report. During the times of depressed global market prices of CPO products, the additional administrative cost may put additional pressure on profitability and the competitiveness of the exported products.

The other concerns include the anticipated time and cost to revise or revisit contractual aspects of existing trading agreements between exporters and buyers. The renegotiation may trigger changes in the other terms, which could be less advantageous to the CPO product exporters. Furthermore, the mandatory L/C will utilise the external financing capacity of the trading parties - this could have a limiting impact on future financing flexibility.

The effectiveness of the regulation to promote optimizing government revenue from export activities remains to be seen following its implementation. Of equal importance is the bottom line effect of the regulation to the profitability of the palm plantations companies in Indonesia. The issuance of the subsequent regulation No. 26 which provides possibility for exemptions, demonstrated an intention to monitor and fine tune the regulation when required.All stakeholders need to monitor and evaluate the impact on the ground, to maintain the growth momentum of the palm plantations in Indonesia.

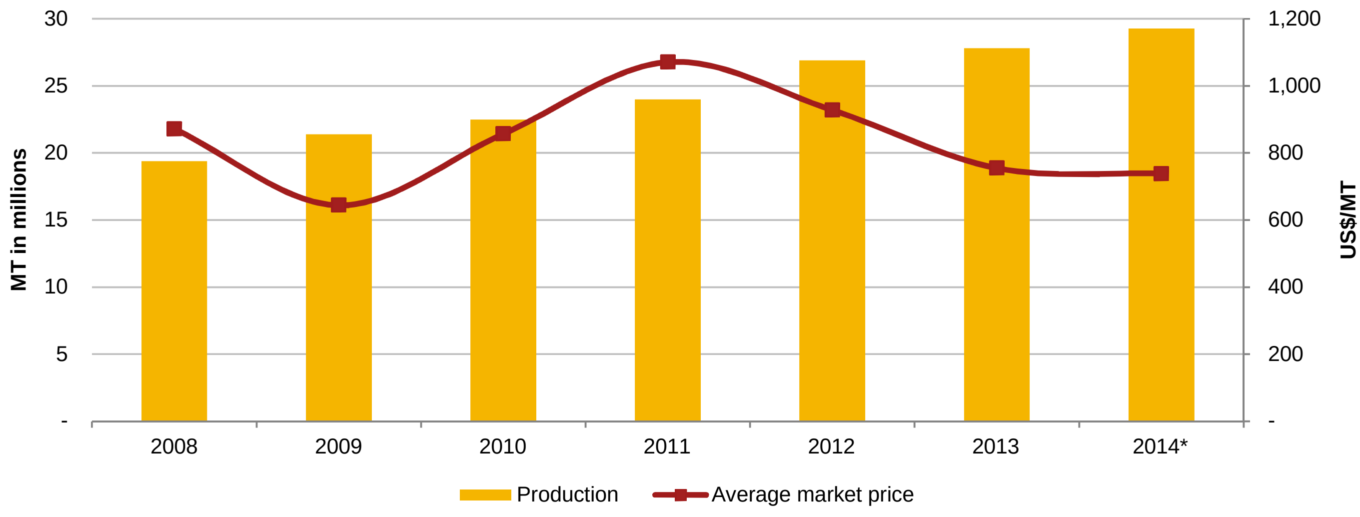
Challenges faced by palm plantation companies

By Hafidsyah Mochtar

The global demand for palm oil has been increasing in line with the growth in the world population, which triggers an increase in the consumption of palm oil products. While global palm oil production is dominated by both Indonesia and Malaysia (whose combined output represents 85%-90% of the total number), Indonesia is currently taking the lead as the largest producer and exporter.

Despite the downward trend in the global Crude Palm Oil ("CPO") price, the production of palm oil in the last five years has grown. Refer to the chart attached.

Indonesia Palm Oil Production vs Average Market Price



* Estimated production quantity

Source: Directorate General of Agriculture, BPS.

Under these current circumstances, palm plantation companies are required to achieve their profitability and cash flow targets in order to cover operating expenses and capex spending requirements. The following are points we noted as the main challenges which palm plantation companies in Indonesia should manage:

- Cost components driven by external factors – components that are sensitive to changes such as on global market price (e.g. fertilizer) and government regulations (e.g. minimum wage);

- Technical factors in plantations, including the following:
  - Soil specifications which drive the costs of growing the plants;

- Regularity and quality of maintenance and upkeep;
- FFB harvesting, logistics and processing efficiency;

- Capital expenditure funding – includes financing for land compensation, plants maintenance and expansion, and mill construction spending;

- Plasma related matters, which include:
  - Recoverability of plasma-related expenditure spent by the nucleus plantation company;
  - Debt service of plasma loans – to any extent, the nucleus palm plantation company will be responsible on the affairs of its plasma, including any issues on the repayment of the loan provided to develop the respective plasma plantation;

- Others – regulatory and legal matters

Furthermore, there could be an additional concern areas pertinent to the specific business model of a palm plantation companies. A proper and closer assessment or due diligence is required to comprehensively understand the specific business process and identify the risk and exposure areas of a palm plantation companies.

Nonetheless, in general, how successful a plantation company is in managing the above key areas will more or less determine its ability to survive the profitability challenges and achieve its long term growth targets.

Traceability, the first step towards sustainability

By Susetyo Priyojati

Demonstrating the traceability of palm oil products through a company's supply chain is quickly becoming a commercial, legal and social requirement. The palm oil industry is increasingly expected by buyers, government, and society to maintain sustainability throughout the supply chain.

The Consumer Goods Forum ("CGF"), an industry association of over 400 retailers, manufacturers, service providers and other stakeholders across 70 countries, signed a zero deforestation pledge in 2010. Participating companies, which have combined annual sales worth 2.5 trillion euros [1], agreed to work towards zero net deforestation by 2020, sourcing commodities such as palm oil in a sustainable fashion. Among these companies are Unilever, Wal-Mart, Carrefour, Heineken, Kellogg, Nestle, Procter & Gamble, and Danone.

Subsequent to that, under the Indonesia Palm Oil Pledge ("IPOP") signed during Climate Week in New York in September 2014, Golden Agri Resources, Wilmar, Asian Agri and Cargill committed to extend their zero-deforestation sourcing policies to cover all palm oil products that they produce, trade or process. All third-party suppliers with whom they have a trading relationship must also adhere to zero-deforestation policies. Musim Mas also recently joined the IPOP group, meaning that now a large majority of internationally-traded palm oil is produced under a no-deforestation policy.

This is great news for the forests in theory, but the difficulty comes in implementation. Mills have a moral obligation to buy Fresh Fruit Bunches (FFB) from smallholders, whose livelihood depends on selling their produce. At the same time, refineries demand that mills only supply them with oil produced from FFB of demonstrable origin. For a mill that depends on smallholder-produced FFB for 100% of its supply, this presents a significant challenge.

Under such conditions, how can a mill know (and credibly demonstrate to its customers and stakeholders) that the FFB it is buying are from areas that have not been recently deforested?

[1] The Consumer Goods Forum, Corporate Brochure, June 2012

The answer lies in gathering increased data on the location and status of the smallholder suppliers and the precise boundaries of their farms. Once all FFB are traceable back to the field, this effectively extends the mill's planted area, giving the mill the same level of confidence on product origin as if the FFB came from its own plantation.

The benefits of traceability do not end there. Data analysis could also boost the reliability and efficiency of FFB procurement. This in turn will improve the quality of FFB supply and improve relations with smallholder suppliers. Such a system could also be effectively combined with extension services, such as good agricultural practice training and fertiliser provision, in order to improve smallholders' yield, oil extraction rate, and loyalty.

GeoTraceability – putting smallholders on the map

GeoTraceability (GeoT) is an innovative tool that can assist FFB buyers in mapping the geographical boundaries of smallholder farms, and tracking FFB from farm to mill.

***GeoTraceability (GeoT)** is an innovative tool that can assist FFB buyers in mapping the geographical boundaries of smallholder farms, and tracking FFB from farm to mill.*

Developed originally for the cacao sector, GeoTraceability (GeoT) offers an industry-developed solution to the challenge of integrating third-party suppliers and smallholders in high-performance, traceable supply chains. Its strong track record of successful deployments in cacao, coffee, cotton, nuts and minerals demonstrates the business benefits of increased data capture and analytical capabilities when dealing with a large smallholder supply base. The GeoT platform is now being adapted to the specifics of the palm oil supply chain.

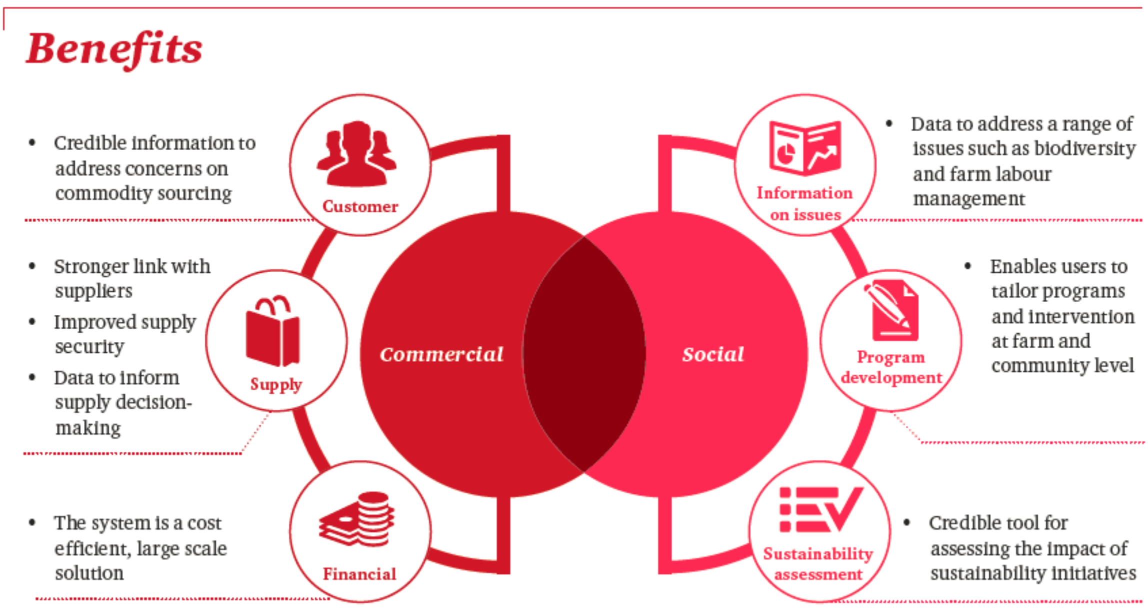
Using the GeoT platform, businesses will be able to visualise and prove the origin of their FFB and palm oil. The reporting and analysis functionality of the platform also supports the development of cost-effective strategies to boost the productivity of smallholder suppliers, thus reducing pressure to expand their farms.

The GeoTraceability Platform: Top Three Benefits

The platform can help improve traceability. Palm oil companies will know the precise, Global Positioning System (GPS)-referenced origin of all FFB arriving at their mills. This will satisfy demands for traceability and confirm practical compliance with zero-deforestation commitments. Companies will also be able to share selected, aggregated data with buyers, allowing verification of conformance to procurement policies, which may help the companies to secure preferred supplier status.

The platform can help verify financial compliance. With the new VAT requirements for all FFB transactions in Indonesia, the GeoT platform will assist in verifying to government officials and customers that the company takes seriously its responsibility to ensure that all applicable taxes have been paid. In addition, principles and criteria of certification schemes can be easily integrated in the platform to accelerate training for certification and reduce the cost of audits.

The platform can help improve quality. A direct benefit will be improved logistics for FFB collection: reducing fuel costs, collection times, and time spent queuing to unload at the mill. This will allow smallholders to supply FFB of improved quality. Furthermore, better data and analytical tools will support the measurement of farm performance as well as the assessment of factors impacting on high-performing vs. underperforming areas. This information could help decide the most effective ways to improve performance of farms. In particular, the improved information exchange with smallholder supplier base will allow the mill to supply extension services such as fertiliser and instructions for its application, and to measure yield improvement.



GeoTraceability Ltd. is a UK-based company and member of the PwC network with offices around the world. The company was founded in 2012 and specialises in large-scale data collection and traceability programs adapted to small producers and smallholders in developing and emerging countries. GeoTraceability (GeoT) builds trust and transparency throughout supply chains.

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