



David versus Goliath: Indonesia’s palm oil players in the face of market pressure and government protection

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As the world’s biggest producer – supplying half of the world’s output – and consumer of palm oil, the palm oil sector is critical to Indonesia’s economy. Since 2007, palm oil exports consistently contribute to about 10% of the country’s total exports and make up the largest exported agricultural product. Traditionally regarded as one of the most lucrative sectors in the country, with returns of [tenfold](#) higher per hectare of land as compared to other agricultural plantations, the sector has been faced with factors heightening risks since late 2018. These factors include the drop in rupiah that ballooned companies’ foreign currency debts, fluctuations in exports, and critical scrutiny from environmental movements worldwide. In the face of pressure and unfavorable market conditions, the government has deliberately implemented regulations aimed at protecting and restoring the industry to its past glory. This article, therefore, analyzes the interplays of both the debilitating and hopefully-restorative forces and finds that they affect firms in the sector differently.

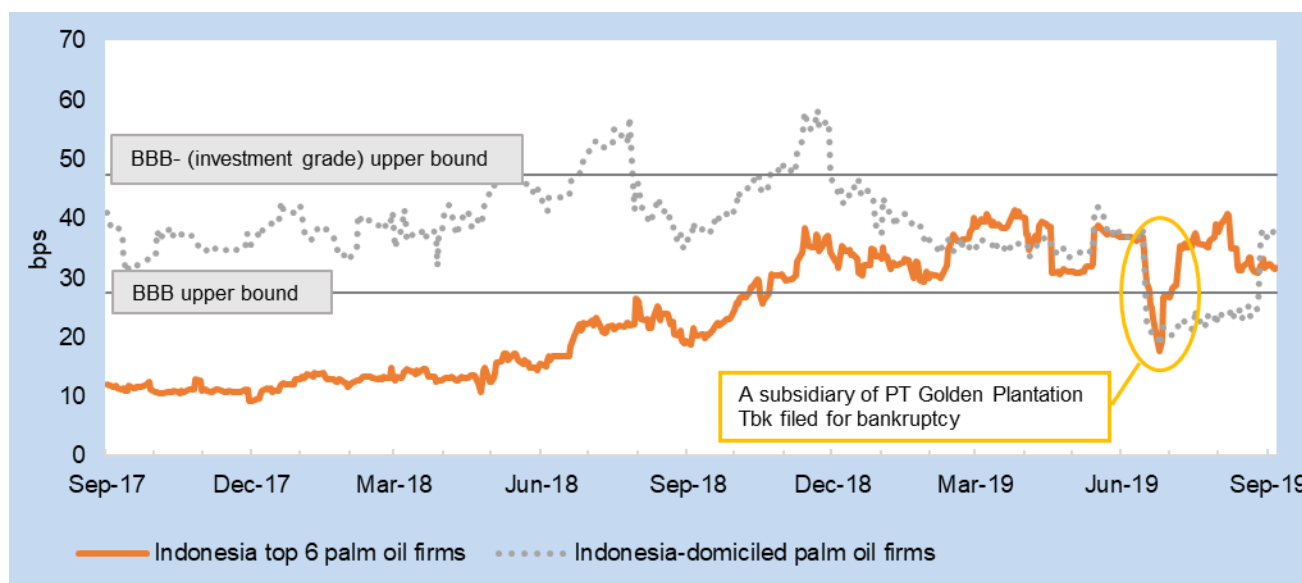


Figure 1. NUS-CRI Aggregate 1-year PD for the largest 6 Indonesia CPO firms and Indonesia CPO firms. Source: NUS-CRI.

One indicator of the different effects is palm oil firms’ credit outlook. Indonesia’s six largest palm oil companies¹ (ranked by market capitalization and consistently capturing 80% of the market share since 2017) conventionally have lower risks as compared to the overall sector as indicated by the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of the companies (Figure 1). This is natural, given that the larger palm oil firms have greater profitability and lower leverage ratio². However, this trend has recently been overturned. While Agg PDs of both the top six palm oil firms and the sector showed a similar overall upward movement since May 2018 – with the latter shooting past the upper bound of investment-grade PD (BBB- rating group of the NUS-CRI PDiR

¹ These companies are PT Astra Agro Lestari Tbk., PT Sinar Mas Agro Resources & Technology Tbk., PT PP Lonsum Indonesia Tbk., PT Sawit Subermas Sarana Tbk., PT Salim Ivomas Pratama Tbk. and PT Tunas Baru Lampung Tbk. (in order of size). Source: Bloomberg.

² Source: Bloomberg

in June and November 2018³) – the Agg PD of the top six palm oil firms surpassed that of the sector in February 2019 and again in July 2019. As of September 20, 2019, the Agg PD for the top six palm oil firms and all Indonesia-domiciled palm oil firms stood at 27.9 and 33.0bps respectively.

Indonesia’s palm oil firms have been faced with two major factors that result in their worsening risk profiles. Firstly, while the weakening of rupiah by 8.5% over the period of October to December last year did contribute to boosting exports, foreign currency debt-laden companies suffer from ballooning debt. Secondly, Indonesia’s palm oil exports have faced slowing growth. In the period of January-June 2019, Indonesia’s overall palm oil exports rose 10% - a number that [“could have been higher considering the dramatic growth of plantations and production capacity over the past 15 years.”](#) This manifested in company’s profitability, as evident in companies reporting significant fall (or even negative) net income as a result.

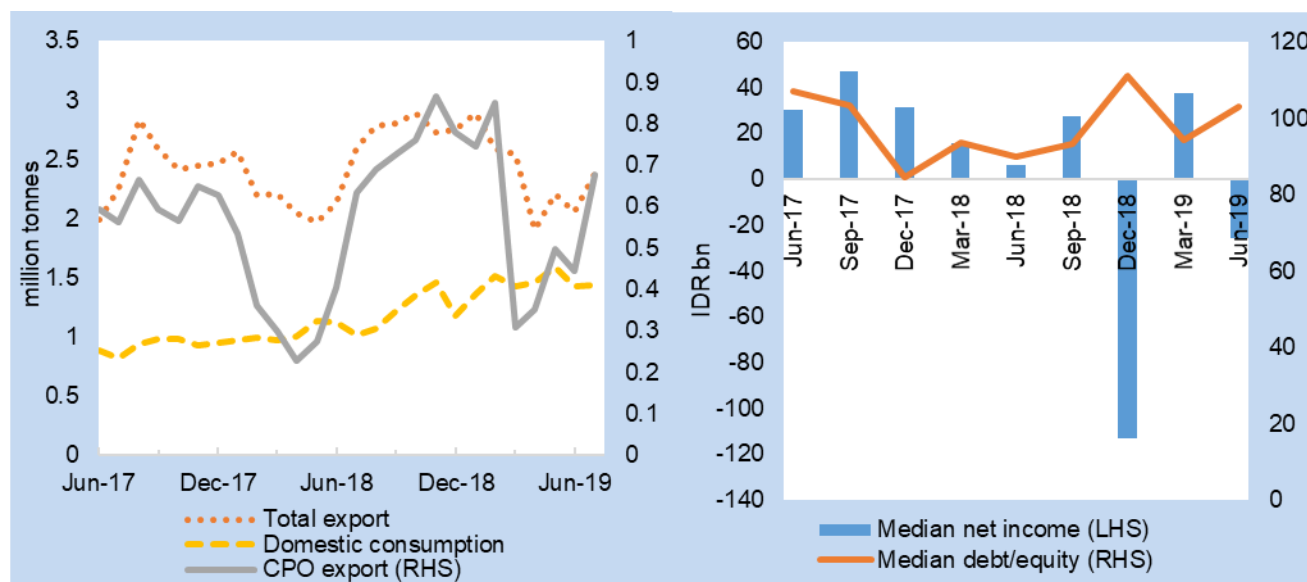


Figure 2a&b. Total export, CPO export and domestic consumption of Indonesia palm oil (LHS). Median net income and median debt-to-equity ratio of Indonesian palm oil companies (RHS). Source: *Indonesia Palm Oil Association, Bloomberg*.

Yet the government had not been standing still. Domestic absorption impressively from 1.35mn tonnes in 1H18 to 3.29mn tonnes in 1H19 compared to the same period in the previous year (Figure 2a). The figure is a manifestation of the 20% palm biodiesel regulation (B20 program) enacted by the government. Current developments have also not closed the door for the level to be increased to 30%. In view of the incoming threats and uncertainties of the international market, the government has been pushing for increased domestic consumption of palm oil to lessen dependency on exports.

Despite both large and small palm oil companies suffering from the same blow and benefitting from the same aid, risk profiles of the top six palm oil companies in the country seem to worsen more than their smaller counterparts. This can be explained by the difference in debt structures and international business exposure of the two groups, which will be elaborated in the following paragraphs.

Indonesia’s palm oil firms have been borrowing overseas to invest as rising crude oil prices encourage the country to boost biofuel usage. The government, for instance, ordered railways and electricity generators to use fuel blended with 20% palm biodiesel. As observed in Figure 3a, the top six Indonesia palm oil companies generally hold larger percentage of foreign currency-denominated debt. When the rupiah weakened, the local-currency value of their overseas debts swelled, eroding retained earnings, cutting equity and worsening debt-to-equity ratios. In October 2018, two out of the top six companies had more than 80% of its debt in foreign currency, while another three held between 5%-15%.

³ The NUS-CRI Probability of Default Implied Rating (PDiR) provides a more conventional interpretation of PDs – it translates NUS-CRI 1-year PDs to letter ratings by taking reference from the historical observed default rates of S&P’s rating categories.

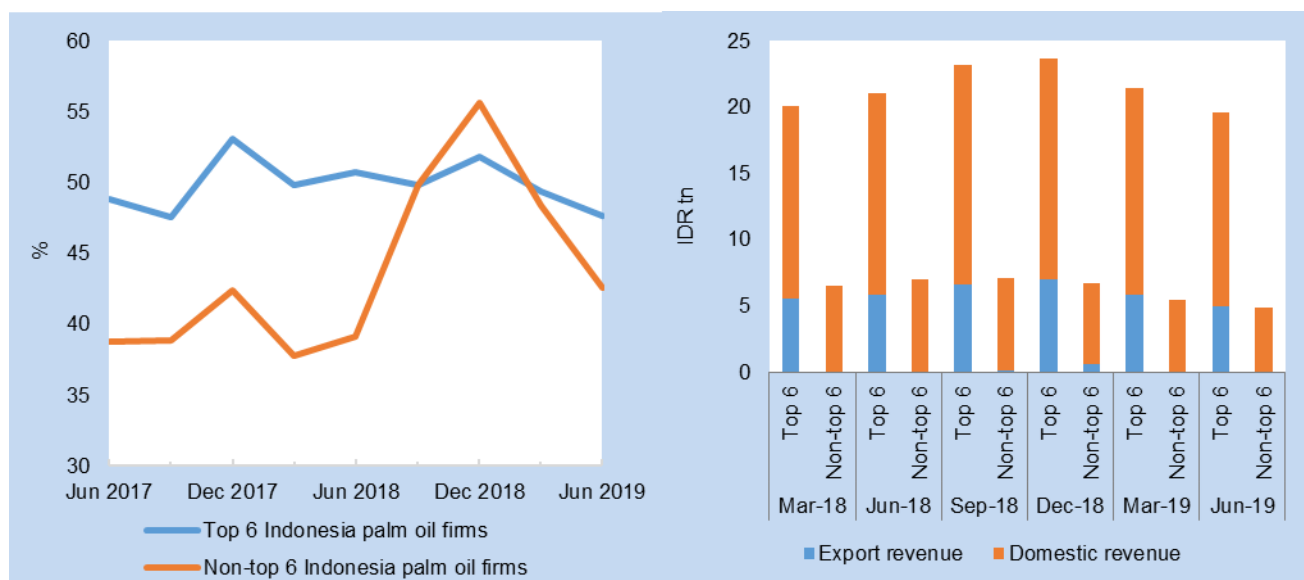


Figure 3a&b. Percentage of foreign currency-denominated debt to total debt held by the top 6 and non-top 6 Indonesian palm oil firms (LHS). Total sales by export and domestic sales of the top 6 and non-top 6 Indonesian palm oil firms (RHS). Source: *Indonesia Palm Oil Association, Bloomberg*.

The fall in exports have also impacted the two groups differently. Export revenue makes up almost 30% of the top 6 companies' total revenue, while it only comprises less than 5% of the non-top 6 firms'. This renders the top 6 palm oil companies more vulnerable to fluctuations in exports (Figure 3b). In India, Indonesia's export recently lost in competition to Malaysia, especially for exports of refined products. Import duties for refined products from Indonesia stands at [9% higher](#) than Malaysia's. In the other part of the world, the European Commission sounded the gong of the second Renewable Energy Directive on the indirect land-use change of biofuels (RED II ILUC). Under the directive, the EU [set limits](#) on high ILUC-risk biofuels, bioliquids and biomass fuels given their high correlation with deforestation. The limit is frozen at 2019 levels for the period of 2021-2023, and will gradually decrease to zero by 2030. Some countries such as Norway had agreed to phase-out high ILUC risk biofuels as of 2020 while France decided to end the tax incentives for palm oil-based products in fuels as of 2020.

As a result of the top 6 companies' great exposure to the international market, the government's cushioning effort through boosting domestic consumption may also not be as significant of a protection, explaining why the Agg PDs of the top 6 companies have entered the BBB- range and remained in the range (Figure 1).

Entering 2H19, troubles seemed to ease slightly. Production and exports data show hopeful recovery with domestic consumption continuing its momentum (Figure 2a). Exports to India and China picked up as the African swine fever and tariff on the US soybeans oil made palm oil the next best alternative. Yet prices remain extendedly below the 2017 hey-day, partly a spillover effect of US-China trade war that resulted in increased soybeans inventory in the US. Given its perishable nature, the US has been pushed to dump soybeans in other markets at cheaper prices, undercutting the palm oil markets. Several companies in the country have been severely affected, nonetheless. In February this year, two subsidiaries of PT Golden Plantation Tbk., filed for deferment of debt payment obligations and in June, one of them filed for bankruptcy. Overall, credit risks continue to rise, as the fall in exports outweighed the rise in domestic consumption. Companies in the industry have reported net losses since December 2018 and debt-to-equity ratio has increased as well (Figure 2b).

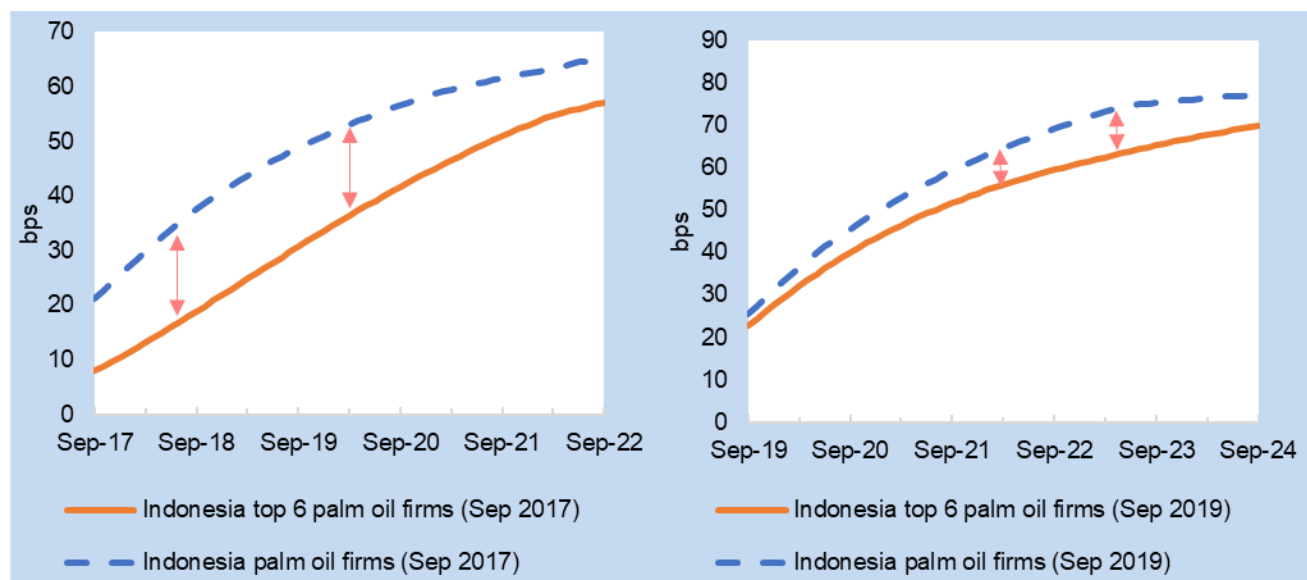


Figure 4a&b. NUS-CRI Forward 1-year PD term the largest 6 Indonesia CPO firms and all Indonesia palm oil firms based on information on September 2017 and September 2019. Source: NUS-CRI

The NUS-CRI Aggregate (median) Forward 1-year PD accurately reflects the heightened credit risks among palm oil companies. The NUS-CRI Aggregate Forward PD represents the credit risk of a company in a future period. For instance, the 6-month forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 1 year plus 6 months, conditional on the firm surviving the initial 6 months. While the Forward PDs of both top 6 and non-top 6 Indonesia palm oil companies increase over the period of 2017 to 2019, in line with our analysis, the gap between the future credit risks of the two groups have converged significantly (Figure 4a&b). As of September 2017, the Forward PD of the top 6 palm oil firms is less than half of the sector's; in September 2019, it is only marginally lower.

Moving forward, the interplay of market forces, pressure from environmentalists, government's support as well as the industry's operational efficiency and productivity will play a key role in determining the fate of the sector. Not only do companies have to hold competitive price edge in a market of perfectly substitutable commodity, they also have to make sure not to strike a chord with the environmental movements. Although the campaign for clean, sustainable and renewable energy seem to be a bandwagon that biofuel can jump on, critical eyes have turned the table over. Clearing of high carbon stock forests through slash-and-burn methods to make way for palm oil plantations have discounted the environmental value of biofuel. Most recently, plantation (including palm oil) companies have received blames for the haze shrouding the region. Local authorities had [sealed off plantations](#) operated by 29 companies after fires were detected in their concessions and the media have not missed the opportunity to highlight palm oil's role in the environmental debacle. All in all, Indonesia palm oil companies may henceforth have to practice caution and be strategic in their actions: tactful price competition, good practice and publicity, as well as tapping on developing markets may pave way for a recovery.

Credit News

Booming securitized loan market has echoes of financial crisis, BIS warns

Sep 23. The Bank for International Settlements (BIS) warned that lending standards in the loan market are deteriorating and complex financial products that mask risks to banks have parallels with the run-up to the 2008 financial crisis. The number of collateralized loan obligations (CLOs), a form of securitization which pools bank loans to companies, has increased in recent years as investors scrambled for higher yields by buying into loans to riskier companies. Currently, more than 50% of outstanding leveraged loans in the US dollars and about 60% of those in Euros are securitized via CLOs. While CLOs are regarded as a less

complex and less risky alternative to the collateralized debt obligations (CDOs), loosening credit standards can lead to an increased in potential credit losses when a default eventually occurs. ([Reuters](#))

Time to worry about corporate debt again

Sep 22. The record high level of corporate debt standing at 47% of gross domestic product wasn't seen as risky as it appeared at first blush because the debt level in relation to corporate profits didn't appear all that high compared with where it was before the past few recessions. However, after the Commerce Department revised the profit figures economists were using to make their calculations, corporate profits were about a tenth lower in the first quarter than previously reported. As a result, the level of corporate debt to income levels increased to around the levels before the previous two downturns, representing a vulnerability. ([WSJ](#))

Muni-bond investors embrace higher-risk issuers

Sep 21. Yield-seeking investors are flooding into the riskier corners of the traditionally safe municipal bond market amid super-low interest rates this year. These high-yield municipal bonds, including those issued for energy projects and upstart charter schools, aren't backed by a promise to raise taxes if necessary, as is often the case with cities and states seeking funds. The high-yield municipal funds have attracted more money in the year to August than in any other year on record but there are some worrisome signs. The probability of a speculative-grade muni bond defaulting within 10 years has risen to 12% and some investment-grade rated bonds are also deteriorating quickly. The sale of the riskier new bonds, combined with the deterioration of some existing debt, has increased the amount of junk-rated and unrated debt outstanding by 20% since 2012. ([WSJ](#))

China's outlook hit by prolonged credit risk

Sep 20. China's corporate debt defaults have not shown any signs of improvement this year as corporate debt defaults from January to July amounted to just under CNY 71bn, 60% of last year's default. A report by the Korea Center for International Finance (KICF) cited increased maturity, economic slowdown, and stricter government regulation on debts issuance as the main issues related to China's rising default risk. The report also stated that increasing defaults on corporate bonds may lead to a shrinking in the primary market by weakening investor sentiment, which can also lead to another cycle of default. While the People's Bank of China has decreased its one-year Loan Prime Rate (LPR) to 4.2% earlier this month in a bid to lower its corporate borrowing costs, it remains cautious about pumping liquidity due to the still high debt ratio in China. ([Asia Times](#))

Corporate treasurers pounce on ultra-low borrowing costs

Sep 18. The rapid decline in Treasury yields in August that was partly caused by the renewed US-China trade tensions opened up an opportunity for corporate treasurers. Corporate treasurers are now taking advantage of the ultra-low financing costs to pay off existing, more expensive debt and lengthen the amount of time the companies have to pay it back. So far in Sep 2019, US Corporate treasurers have sold USD 120bn worth of new bonds across more than 100 different deals, making it one of the best months for bond sales in 2019. While the yield on investment grade corporate bond index has increased this month, the junk bond market has experienced a fall in yield, suggesting there is an increased demand for high-yield bonds. ([FT](#))

Reliance Capital's USD 5bn debt at risk after D rating ([Bloomberg](#))

Chalco approved to issue CNY 10bn of corporate bonds ([Xinhua](#))

Sanjeev Gupta faces steep borrowing costs in junk bond sale ([FT](#))

Regulatory updates**Fed will weigh resuming balance sheet growth at October meeting**

Sep 19. The Fed is considering to increase its holdings of Treasury securities, sometimes referred to as its balance sheet, for the first time in five years due to a sudden spike in overnight lending rates. The decision to resume the growth of the Fed's balance sheet wouldn't mirror its policies in the aftermath of the 2008 crisis but instead will mark a return to the normal pre-crisis practice of allowing the balance sheet to grow in line with the broader economy. An analyst at Cornerstone Macro stated that by expanding its balance sheet, the Fed would simply accommodate the market demand for liquidity, not provide excess liquidity, which is a characteristic implicit in quantitative easing. Fed officials will also face other thorny questions in the future such as whether to change the mix of the Treasury securities they are purchasing and whether to become more involved in money markets ([WSJ](#))

Bank of Japan keeps monetary policy on hold

Sep 19. The Bank of Japan (BoJ) on Thursday held overnight interest rates at -0.1%, its target for 10-year bond yields at around 0%, and the pace of its asset purchases at JPY 80tn (USD 740bn) a year. The decision indicated that BoJ is reluctant to add more monetary stimulus while trying to manage the impact from US interest rate cuts and a slowing economy. Many BoJ officials believe that their remaining policy options, such as deeper negative interest rates, pose a risk to financial stability and could undermine its inflation target. However, Mr. Kuroda, the BoJ governor, has repeatedly promised to act if necessary in order to maintain momentum towards the inflation target. ([FT](#))

China urges banks to step-up collateral-free loans to small firms ([Reuters](#))

Bank Indonesia carries out third rate cut in three months ([Nikkei Asian Review](#))

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