

Transfer of coverage 3 July 2008

# Olam

STOCK RECOMMENDATION  
**OUTPERFORM**

SECTOR  
**Food Producers**

12 MONTH RANGE  
**S\$3.53 – 1.60**

NEXT RESULTS DUE  
**August 2008 (FY)**

LAST RESULTS  
**15 May 2008 (Q3)**

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PRICE  
**S\$2.33**

REUTERS CODE  
**OLAM.SI**

BLOOMBERG CODE  
**OLAM SP**

MARKET CAPITALISATION  
**S\$4.0bn (US\$2.9bn)**

PRINCIPAL LISTING  
**SES**

CHANGE IN STOCK RECOMMENDATION  
**n/a**

CHANGE IN EPS ESTIMATES  
**2008E -3% 2009E +8% 2010E new**

## Opportunities abound for Olam

We believe the answers to **four key questions** capture the key growth dynamics of Olam, which in turn supports our 6–12 month forward **fair value of S\$4.00** (+72%).

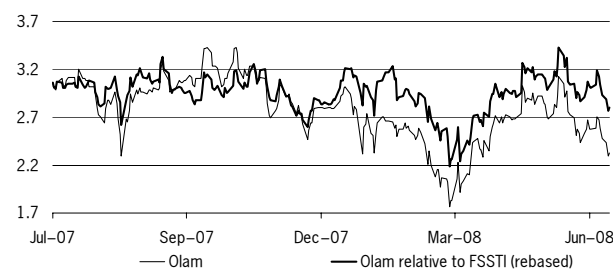
- Will customers **buy** an **extra** dollar / metric tonne of product?
- Will customers pay / will Olam **earn** an **extra** dollar of margin for this product?
- Will Olam be able to **source** an **extra** dollar / metric tonne of product?
- Will Olam be able to secure an **extra** dollar of **capital** to fund growth?

Full answers to each of these four questions are dealt with in detail in this report. **The answer to each, we believe, is a resounding YES.** These characteristics should support long-term above-trend growth rates.

Our **EPS forecasts** for **FY2009E** and **FY2010E** are **7%** and **10% above consensus** and translate into FY2008 – 11E **earnings CAGR of 33%**. We believe there is still upside risk to these shorter-term forecasts given they are based on a volume CAGR of 13% and a net contribution per tonne CAGR of 8% – both below its historic three-year rates of 23% and 13% respectively. **M&A activity**, with 13 deals described as live, has **scope to add further upside**. A first-time contribution from Nauvu (JV with Wilmar) should have a material positive earnings impact in FY2009.

We have captured these robust growth prospects when arriving at our fair value by using a two-stage economic profit model. The resulting fair value of **S\$4.00** implies a not unreasonable **FY2009E PEG of 1.2x**. It also equates to a **FY2010E PER** (June y/e) of **24x** – high, but in twelve months time this will be the one-year forward multiple. The historic **one-year forward average PER** is **26x** (20–35x).

## Share price performance



Source: Bloomberg

Share price (%)	-1 mth	-3 mth	-12 mth	
Ordinary shares	-24	-4	-24	
Relative to sector	-	-	-	
Relative to FSSTI	-16	+4	-8	
Average daily volume shares			5.5m	
FSSTI			2,906	
Year end: June	2007	2008E	2009E	2010E
Turnover (S\$m)	5,456	7,841	9,459	11,115
EBITDA (S\$m)	279	386	518	626
Earnings (S\$m)	109	140	210	279
Tax (%)	14%	15%	16%	17%
EPS (S\$)	0.069	0.085	0.120	0.160
Growth (%)	+24	+23	+42	+33
DPS (S\$)	0.035	0.020	0.031	0.041
Growth (%)	+17	-42	+50	+33
Div cover (x)	2.0	4.0	4.0	4.0
EV/EBITDA (x)	22.6	16.3	12.1	10.1
<b>PER (x)</b>	<b>33.8</b>	<b>27.5</b>	<b>19.3</b>	<b>14.6</b>
PBR (x)	6.2	4.2	3.6	3.1
Market cap:sales (x)	0.7	0.5	0.4	0.4
<b>Yield (%)</b>	<b>1.5</b>	<b>0.9</b>	<b>1.3</b>	<b>1.7</b>
Net margin (%)	2.0	1.8	2.2	2.5
Asset turn (x)	1.7	1.6	1.6	1.7
NAV per share pre FV adj (S\$)	0.4	0.6	0.6	0.8
ROAE (%)	20	18	21	23
ROCE (%)	12	12	13	13
Interest cover (x)	1.9	1.9	2.0	2.2
Net debt/equity (%)	202	178	210	218
Adj net debt/equity (%)	83	72	80	69

Source: Company, Cazenove

## SALES

London +44 (0)20 7588 2828  
Singapore +65 6227 1511

Hong Kong +852 2526 4211

New York +1 212 376 1225

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## 1.0 Key points

Put very simply, Olam's earnings are a function of volume sold (MT), net contribution per tonne of volume sold (S\$/MT), and efficient leverage of SG&A costs:

- Earnings = (volume x net contribution per tonne) – SG&A costs – tax.
- Net contribution = sales – cost of goods, shipping, logistics, commission, claims & net interest.

**robust long-term organic growth story with a bonus M&A angle**

Whilst we applaud Olam's high level of disclosure we believe that there is a resulting tendency to get bogged down in the short-term divisional volume, net contribution and SG&A metrics, when to us this is very much a robust long-term organic growth story with a bonus M&A angle.

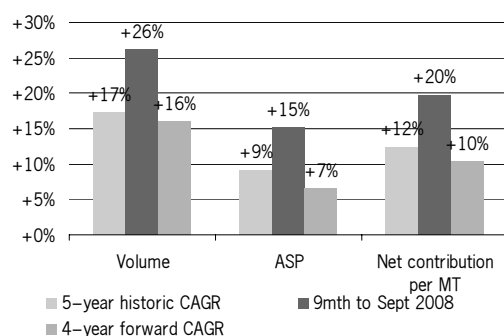
The reality is that Olam, founded in 1989, is still a relatively young company, albeit one with an excellent post listing (February 2005) track record. Led by a dynamic management team, a strong entrepreneurial culture appears to permeate – 13 out of the 14 product heads are internal appointments. This combined with strong risk management systems, a growth vision (aim to be a top 3 player in each commodity in which it is active) and high equity participation (CEO, Sunny Verghese owns 5.1% / other staff own a further 10.4%) gives it a good skeleton for growth.

**forecast four-year earnings CAGR of 33%**

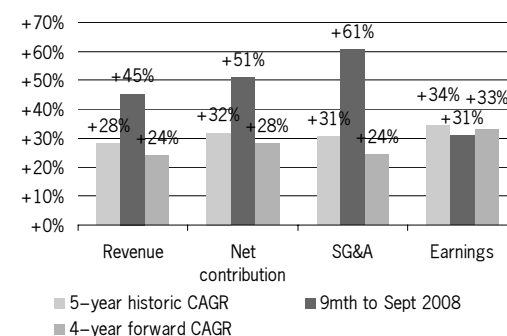
Our forecast for four-year forward earnings CAGR is 33%, but we see growth continuing strongly after this period – which in turn is supportive of premium valuations. Management's guidance is for annual earnings growth of 25–30% over the next six years.

Our fully diluted EPS forecasts for FY2008–10E are 1%, 7% and 10% above consensus respectively, and we believe that there is still scope for Olam to outperform our numbers. M&A activity (10 deals done in the last eighteen months / 32 in the pipe-line / 13 of these described as live) could give earnings a further boost.

**Fig 1.1** Volume, ASP and net contribution CAGR



**Fig 1.2** Net contribution, SG&A and earnings CAGR



Source: Cazenove

**fair value of S\$4.00 upside of 72%**

Our **fair value of S\$4.00 represents upside of 72%** to the current share price. This six-to-twelve month forward valuation has been derived using a two-stage economic profit model – an approach that we believe best captures Olam's strong medium to long-term growth profile.

At this level Olam would be trading on a FY2009E PEG of 1.2x (two-year forward EPS CAGR of 27%) and a FY2010E PER (ie one-year forward PER twelve months from now) of 24x – still marginally below its historic average of 26x (range 20–35x).

We believe that Olam's robustness of growth, which is key to supporting our valuations, is illustrated by the answers to four simple questions. Each of these questions is dealt with in detail in the following section.

## 2.0

### Four key questions

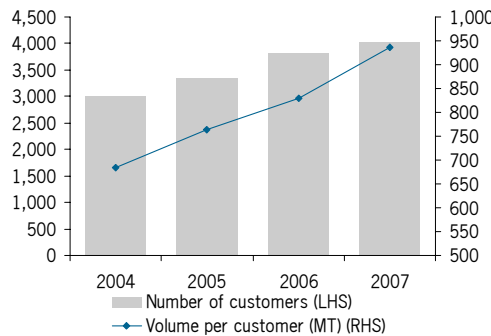
#### 2.1 Question 1

**Q: Will customers buy an extra dollar/MT of product?**

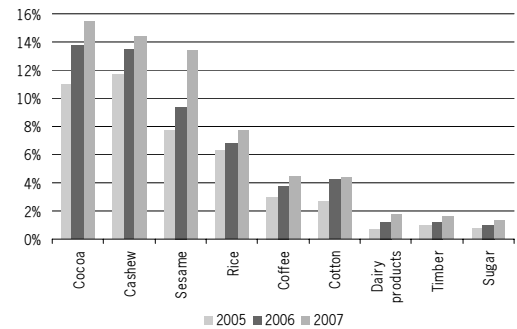
A: Historically yes, and we see multiple reasons why this will continue to hold true.

Olam’s customer base has grown at a CAGR of 10% over the past three years and it targets continued growth of this magnitude. Volume sold per customer has increased at a CAGR of 11% over the same period, resulting in overall sales volume CAGR of 23%. This quantum of volume growth has been maintained in the nine months to March 2007 (+26%). Our forecast is for four-year (FY2007–11E) volume CAGR of 16%, which we believe errs on the conservative side.

**Fig 2.1** Customers and volume per customer



**Fig 2.2** Sales volume by product (000's MT)



Source: Company

1) Olam’s customers are multi-national brands, food producers and domestic distributors / agents. Demand for the products of these customers is a function of population growth, urbanisation, changing wealth patterns and changing dietary habits. In particular, this is an emerging market demand growth story driven by changes in big population countries of China and India – two countries where Olam continues to ramp-up its origin and destination capabilities.

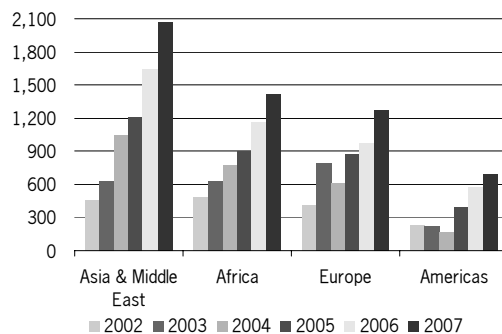
2) While Olam operates a diversified geographic sourcing and destination network, and aims to be a global player in the commodities in which it trades, its bias on the destination side is towards emerging markets. This gives it strong exposure to incremental demand growth.

3) In an environment of growing demand, access to product is a key determinant of ability to trade. Olam’s unique business model which focuses on sourcing at the farm gate gives better security of supply. This should drive incremental demand from existing and new customers.

4) The expansion into new commodities (currently 14, with plans to increase to 25 by 2014), the addition of further basic processing for some commodities and expansion into new sourcing and destination geographies will increase the addressable customer base / increase Olam’s relevance.

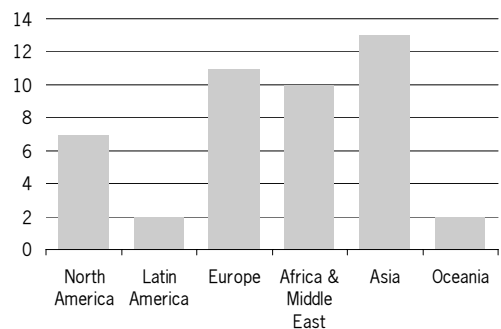
5) One item that could derail demand growth is worries about concentration of supply. FMCG companies often quote >20–25% as a worry level – Olam, in all categories, is well short of this.

**Fig 2.3** Sales revenue by continent (\$\$m)



Source: Company

**Fig 2.4** Number of products sold per destination



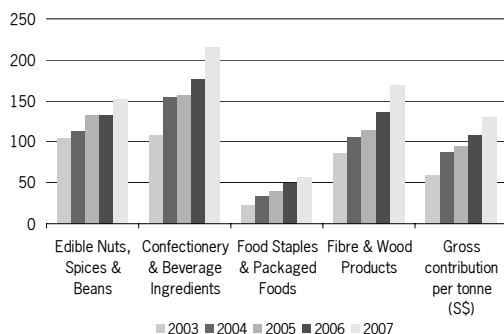
2.2  
Question 2

**Q: Will customers pay / will Olam earn an extra dollar of margin for this product?**

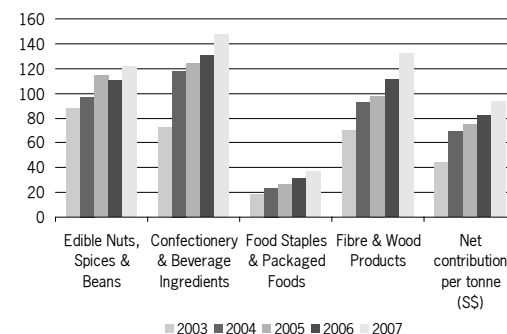
A: Historically yes, and we see multiple reasons why this will continue to hold true.

Olam's ability to capture an extra dollar of margin is best illustrated by net contribution per MT (gross contribution – net interest costs). On an overall basis this has grown at a four-year CAGR of 20% between FY2003–7, and grew by a further 20% in the nine months to March 2008. With the exception of edible nuts, spices and beans, which saw a small contraction in FY2006, growth has been a consistent feature across all product categories every year.

**Fig 2.5** Gross contribution per MT (\$\$)



**Fig 2.6** Net contribution per MT (\$\$)



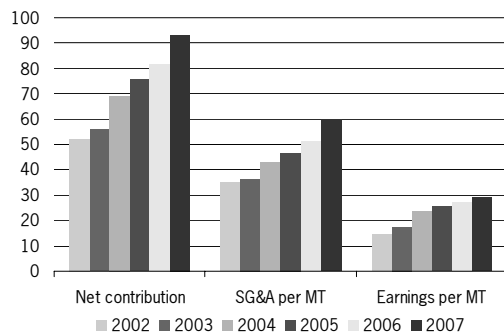
Source: Company

1) Linked to our comment above on Olam's unique business model, which focuses on sourcing at the farm gate, giving it better security of supply, we believe that customers will pay an increasing premium to secure this supply in a growing demand environment. Rising prices lead to an even higher default risk. Put simply, while futures can help hedge costs, real commodity inputs are required to produce product. Without these there is no business to hedge.

2) Increased penetration of origination and destination markets (a key focus of Olam's strategy with multiple products per country) should lead to increased scale, better utilisation of the fixed element of country cost bases and greater volume benefits. This, in turn, should improve margins at both the net contribution level and PBT/earnings (ie post SG&A) level.

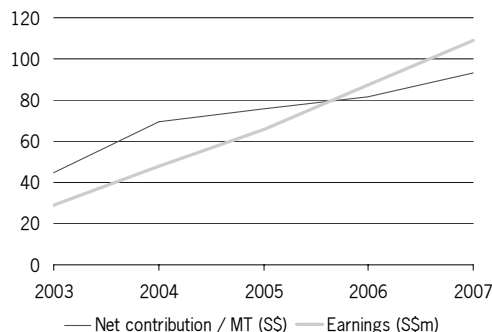
3) The move to add basic processing has led to concerns that Olam is diluting its attractive 'fixed asset-light' dynamics. Whilst partially true, we would note that the addition of processing should add to increased capture of the supply chain margins, thereby benefiting overall margins. It should also have the added benefit of increasing the addressable customer base – important in areas such as cocoa, cashews and cotton where it already has large market shares.

**Fig 2.7** Net contribution, SG&A & Earnings (\$\$/MT)



Source: Company

**Fig 2.8** Net contribution (\$\$/MT) & Earnings (\$\$/m)



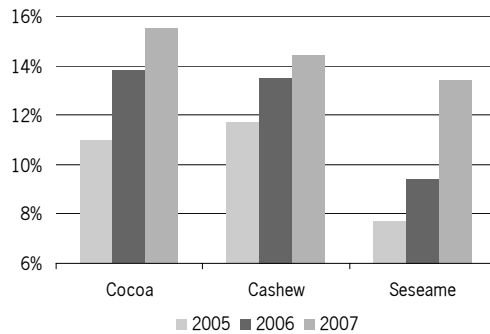
2.3  
Question 3

**Q: Will Olam be able to source an extra dollar/MT of product?**

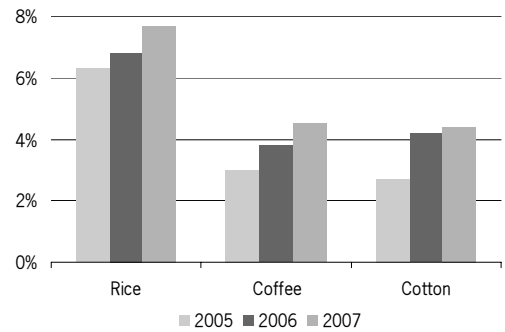
A: Historically yes, and we see multiple reasons why this will continue to hold true.

Olam has established a fantastic track record of securing product to support volume growth / drive market share expansion. Until recently (from 1 product/1 country in 1989 to 14 products & 56 countries in FY2007) this has been purely organic. Organic volume growth was 16% in the nine months to March 2008 and M&A related volumes have pushed overall growth up to 26%.

**Fig 2.9** Market share: cocoa, cashew, sesame

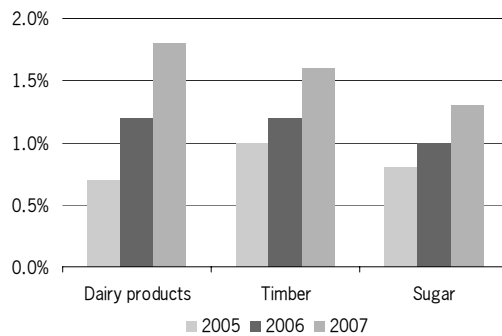


**Fig 2.10** Market share: rice, coffee, cotton

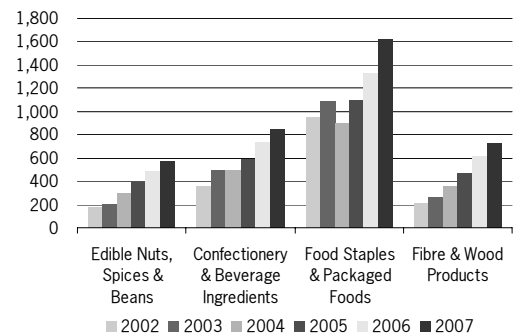


Source: Company

**Fig 2.11** Market share: dairy, timber, sugar



**Fig 2.12** Sales volume by product



Source: Company

**further consolidation of the agricultural supply chain forecast**

1) Linked to our comments on rising demand / rising prices above, we believe there will be increased pressure, particularly working capital funding pressure, on smaller operators (few countries / few products) and particularly those who rely on positional trading profit. As a result, we expect consolidation of the agricultural supply chain to be an ongoing feature, and for Olam to be a net volume winner through a combination of organic growth and strategic acquisitions.

**Olam's M&A activity adds new product and new sources of supply**

2) On the M&A front Olam, since February 2007, has announced 10 transactions at a total cost of US\$457m and has a further 32 deals under consideration, of which 13 are reported to be live. Transactions to date, in addition to fitting Olam's pre-defined deal parameters on size and value accretion, meet one or more of Olam's four strategic goals: scaling-up volumes in existing products; integrating into higher value-add adjacencies; driving cost reduction in existing supply chain, and selectively entering attractive related products. Two of these four pillars support volume growth. The acquisition of Queensland Cotton, the largest single acquisition at US\$136m, is a perfect example. This deal moved Olam from being the fifth to third largest player (will be #2 when Chinatex deal closes), added access to more premium grade cotton, increased sourcing scale in the USA and Brazil, and added new origin sourcing in Australia (the seventh largest cotton production market and fifth largest export market). This Australian presence will now offer Olam the ability to source other commodities from what has so far been an untapped geography.

3) Olam's policy of common costs sharing across products on a country by country basis gives it economies of scale, which in turn allows it to explore sourcing volumes of commodities that would be un-economic for others to source from that origin on a stand-alone basis. The resulting wide geographic spread, and a culture of encouraging cross-sourcing / selling, should give it access to incremental product (organic market share growth), while also better utilising fixed overheads and thereby improving margins.

4) Olam also has a clear route map in terms of deepening its portfolio of commodities handled, which in turn should be supportive of supply volume growth if successfully executed. From its current portfolio of 14 (see figure 2.13 for details / 17 if palm, rubber and high-intensity sweeteners are included from the yet to close JVs with Wilmar), management's target is to expand this to around 25 products over the next six years. Possibilities include further participation in nuts (pecan, walnut, macadamia and pinenut), grains (barley and wheat – first moves already made in Australia via the setting up of a marketing office within QLC), oilseeds (soybean), dairy and fertilisers.

5) One major topic of late, which could be seen as de-railing Olam's supply growth, is the introduction of export restrictions to ensure domestic supply/moderate domestic prices in an environment of demand growth /supply shortages /high commodity prices. The most notable illustration of this has been in rice – a commodity in which Olam is active with a c.8% share of global trade. We would note, however, that rice is more of the odd-one-out rather than the norm, with low traded volume relative to production rates (ie grown domestically for domestic consumption). This is not the case for most other crops, where production exceeds domestic demand, and hence exports are a crucial currency earner. As such we expect little in the way of negative change and on rice an improvement (as already seen) given the short crop cycle. Olam's diverse origin network also provides it with a better ability to manage any individual country risk.

14 products today – target of 25 by 2014

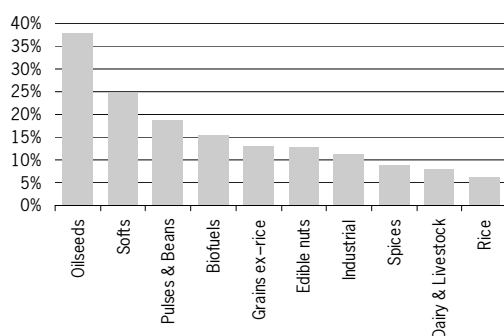
rice export embargoes not expected to repeat in other commodities

Fig 2.13 Olam's commodities and market share of traded volume by complex

Complex	Olam's volume (MT m)	Olam's share of traded volume (%)	Commodity Details									
Edible nuts	0.5	10.0%	Cashew	Peanut	Almond	Pecan	Walnut	Macadamia	Pistachio	Hazelnut		
Pulses & beans	0.2	2.2%	Lentils	Beans	Peas							
Softs	1.3	1.9%	Coffee	Cocoa	Sugar	Shea	Citrus					
Spices	0.0	0.7%	Pepper	Nutmeg	Cassia	Cumin	Gambier	Ginger	Onion	Desiccated coconut		
Industrial	0.9	0.6%	Cotton	Timber	Rubber	Wool	Fertiliser					
Grains	0.8	0.3%	Rice	Wheat	Corn	Barley	Oats	Sorghum	Millet			
Dairy & Livestock	0.1	0.1%	Dairy	Eggs	Pork	Beef	Chicken					
Oilseeds	0.1	0.1%	Sesame	Palm	Soybean	Cottonseed	Linseed	Rapeseed	Sunflower	Peanut		
Biofuels	Nil	NA	Biodiesel	Ethanol								
Overall	3.92	0.5%										

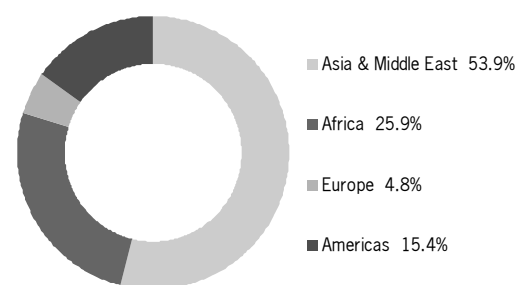
Source: Company / Note: light shaded area = existing participation by Olam / dark shaded area = new product areas announced by not yet commenced.

Fig 2.14 Complex trade to production ratios



Source: Company

Fig 2.15 Sourcing volume by origin (12mth rolling)



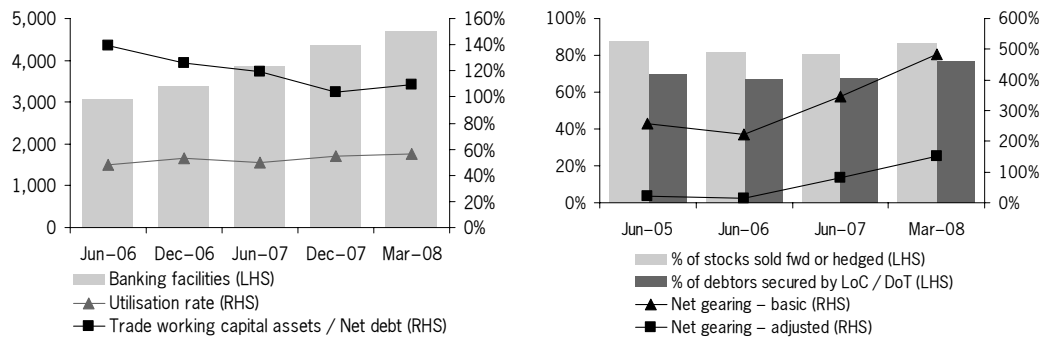
2.4  
Question 4

**Q: Will Olam be able to secure an extra dollar of capital to fund growth?**

A: Historically yes, and we see multiple reasons why this will continue to hold true.

From its IPO in February 2005 until its 1-for-10 preferential offering in March 2008 Olam has successfully relied on bank borrowing to fund its growth. With high working capital requirements, traditional gearing levels are, and will continue to appear to be, high. We believe, however, that banks understand Olam's business model and the resulting risks, and hence they continue to extend funding, as best illustrated by utilisation rates relative to facilities available constantly running below 60%. We expect this propensity to lend to continue for the following reasons:

**Fig 2.16** Facilities & utilisation & trade WC / net debt **Fig 2.17** Basic and adjusted net gearing



Source: Company  
 Note: net gearing = net debt / tangible shareholders' funds pre fair value adjustment  
 Note: adjusted net gearing = net debt less stocks sold forward or hedged and debtors secured by letters of credit or deeds of transfer / tangible shareholders' funds pre fair value adjustment

**equity fund raising gives Olam US\$1.4bn of expansion capacity**

1) The equity base has been expanded by S\$302.6m, following the 1-for-10 preferential offering announced in March 2008. We estimate that on a tangible basis, pre fair value reserves, the equity base will expand to S\$845m as at June 2008 (S\$506m as at March 2008). This, and the resulting cash inflow from the equity raising, we estimate will reduce net gearing to 2.7x. Assuming a continuation of current debt covenants (long-term maximum of 5x net gearing / no covenants for short-term) this gives Olam S\$1.9bn/US\$1.4bn of expansion (organic and M&A) capacity. Assuming this is utilised in full, debt would still be marginally within current committed facilities of S\$4.7bn (as at March 2008).

2) Olam's strategy of participating in the volume and value, but not pricing, segments of the commodity supply chain is attractive from a risk perspective – the opposite of position taking principal traders. While pricing risk cannot be completely removed (there is no futures market or forward physical purchase possible for certain commodities) Olam actively manages its risk exposure via value-at-risk (VAR) modelling – an approach adopted by banks themselves, and therefore well understood by these lenders. According to the company VAR as a proportion of equity was low at only 1.54% in FY2006 and 1.84% in FY2007.

3) Inventory, trade receivables, margin accounts with brokers and advances to suppliers (Olam's trade working capital assets) are a function of volume and price. As a result higher business levels and higher commodity prices result in higher working capital funding requirements. These trade working capital assets have consistently exceeded net debt (1.1x as at March 2008) and act as a major source of security to lenders. With 86% of inventory hedged or sold forward and 77% of trade debtors secured by letters of credit or deeds of title, the level of security / comfort is further enhanced. This should match the debt with realisable physical (or hedged) trade working capital assets supporting the extension of further credit.

### 3.0

#### PureCircle – the latest deal

Pure Circle is the leading producer of natural high-intensity sweeteners

On 1 July 2008 Olam announced the formation of a second 50:50 JV with Wilmar [WIL SP / In-Line]. This OlamWilmar JV (OW JV) is acquiring a 20% stake in PureCircle [PURE LN / No Recommendation], an AIM listed producer of natural sweeteners derived from the stevia plant.

The OW JV, which will become the largest single shareholder in PureCircle, has also signed a memorandum of understanding (MOU) with PureCircle for the development of a strategic partnership to: i) determine a plan for development and management of commercial scale stevia plantations and outgrower programmes in existing (China) and new (African and South American) locations; ii) develop commercial scale crude extraction facilities of stevia (basic processing at source); and iii) assist in developing a sales and marketing strategy for natural 'high-intensity sweeteners' (HIS) including leveraging Olam's and Wilmar's respective distribution networks.

Olam's cost of investment (50% of the total purchase consideration of US\$106.2m) is relatively small at US\$53.1m, equivalent to 1.8% of its market capitalisation. The price paid by OW JV represents a 0.5% premium to the last traded price and an 18% premium to the IPO price (December 2007) of £1.70. We have not adjusted our forecasts for this deal, but believe it has the potential to make a material contribution to earnings in FY2010 and beyond if it executes well.

#### General observations

- This is another example of the M&A opportunities that are available to Olam, which in turn will supplement what we view as robust rates of organic growth.
- The move into natural sweeteners demonstrates Olam's ability to think 'outside the box' when looking at adding new agricultural product capabilities. It is also a strategic fit with sugar.
- The deal fits with Olam's blueprint of leveraging both its origination and destination capabilities. On the distribution side we would note that 'HIS' is complimentary to existing products supplied to the food and beverage industries, and should as a result have high customer commonality.
- This is also an example of Olam increasing its exposure to upstream agriculture. This move to a fully integrated structure is being done in a controlled low risk manner – shortage of stevia / good economics of crop / participation of experienced plantation partner in the form of Wilmar.

complimentary product leveraging Olam's origination and destination capabilities

#### PureCircle detail

Founded in 2002, PureCircle manufactures and markets a range of natural high intensity sweeteners (HIS) made from the leaves of the stevia plant. Stevia has been used as a sweetener in Asia for over forty years, with 80% of the global crop grown in China. To date, however, it has been used largely in a crude extract form. The resulting lack of consistency has precluded it from gaining US or EU regulatory approval for food use. The US and the EU are the two largest markets for sweeteners (predominantly synthetic) accounting for 44% and 21% respectively of what is estimated to be a US\$1.3bn global market.

the US and the EU are the two largest markets for sweeteners

PureCircle's patented refinery processes enables it to extract Rebaudioside A (Reb A), the 'sweet character' molecule in stevia up to 97% purity. This has enabled clinical trials to take place. FDA approval is expected in Q3/Q4 2008 and EU approval six months later. This approval should transform the demand profile given that: a) RebA is natural, whereas the alternatives are synthetic, and b) it is reported to have a sweet taste factor much more similar to sugar. The carbonated beverage industry is expected to be a major source of demand, with Coca-Cola already publicly expressing an interest. PureCircle generated US\$4.6m of earnings in FY2007 and the consensus (2) forecast is for US\$24m in FY2008E and US\$132m in FY2009E. There is clearly a high degree of forecasting risk, but based on consensus the JV's entry price is just 4x FY2009E earnings.

US and EU approval for PureCircle's product should materially change demand

PureCircle has gained first-mover advantage and is the leading producer of natural HIS. The company plans to increase its processing capacity ten-fold over the next five years from 1,000MT per annum currently to 10,000MT per annum by 2012. Key to utilising this capacity and to satisfying this demand will be access to stevia leaves – a reason for the OW JV involvement. Global production of stevia leaves is estimated at 40,000MT and the Reb-A extraction rate relative to stevia leaves is 1-to-30. Planting and security of supply is therefore important.

## 4.0

### Forecasts

- Our new FY2008–10E EPS forecasts are 1%, 7% and 10% above consensus respectively.
- FY2008E EPS forecast has been revised down by 3% (1–for–10 dilution impact), but FY2009E has been revised up by 8%. The forecasts for FY2010–11E are new.
- Our forecast is for three–year FY2008–11E earnings CAGR of 34%, supported by volume CAGR of 13%, net contribution/MT CAGR of 8% and a drop in SG&A/sales from 4.5% to 4.2%.
- Our forecast for FY2009E is a much higher rate of growth of 50% due to the first time contribution from the Nauvu (Ivory Coast palm and rubber JV with Wilmar) and reducing losses from Queensland Cotton (QLC, from S\$13.5m in FY2008E to S\$5.4m in FY2009E).
- Excluding these items (Nauvu JV and QLC) we forecast growth of 27% in FY2009E.
- Further M&A activity could drive further upside to our forecasts. With the exception of QLC, the other deals have all been earnings accretive. 32 deals are currently under consideration.
- Equally important, we believe that growth rates should continue at high levels for a considerable period of time for the reasons detailed in the previous section of this report.

**Fig 4.1** Assumptions summary

Year end: June	2006	2007	2008E	2009E	2010E	2011E	9m 07	9m 08
Change in ASP (%)	+4%	+5%	+15%	+4%	+4%	+4%		+15%
Volume growth (%)	+24%	+19%	+25%	+16%	+13%	+11%		+26%
Net contribution per MT (S\$)	82	93	110	122	132	138	78	93
SG&A / sales (%)	3.7%	4.1%	4.5%	4.4%	4.3%	4.2%	3.6%	4.0%
Effective tax rate (%)	10%	14%	15%	16%	17%	17%	11%	13%
Trade working capital / sales (%)	35%	32%	30%	30%	30%	30%	37%	29%
Effective interest rate	8.1%	8.4%	8.5%	8.0%	8.0%	8.1%	8.9%	8.8%
Net contribution pre acq	82	93	102	113	122	128	78	86
SG&A / sales pre acq	3.7%	4.1%	3.9%	4.1%	4.1%	4.0%	3.6%	3.5%

Source: Cazenove

**Fig 4.2** P&L summary

Year end: June	2006	2007	2008E	2009E	2010E	2011E	9m 07	9m 08
Revenue (S\$m)	4,361	5,456	7,841	9,459	11,115	12,830	3,947	5,730
Gross contribution (S\$m)	343	487	706	912	1,085	1,255	344	500
Net interest (S\$m)	-84	-135	-188	-245	-270	-306	-112	-151
Net contribution (S\$m)	259	351	518	667	814	949	232	350
SG&A (S\$m)	-163	-225	-353	-416	-478	-539	-144	-231
Tax (S\$m)	-10	-17	-25	-41	-58	-71	-9	-16
Earnings (S\$m)	87	109	140	210	279	339	79	103
Earnings growth (%)	+32%	+25%	+28%	+50%	+33%	+22%		+31%
EPS – FD (S\$)	0.056	0.069	0.085	0.120	0.160	0.194	0.049	0.063
DPS (S\$)	0.030	0.035	0.020	0.031	0.041	0.050	nil	nil

Source: Cazenove

**Fig 4.3** Pre and post acquisition earnings

Year end: June	2006	2007	2008E	2009E	2010E	2011E	9m 07	9m 08
Operations ex–acquisitions	87	109	140	198	250	290	79	106
Acquisitions ex QLC and Nauvu				5	7	9		4.52
QLC				-13	-5	5		-8
Nauvu				20	27	35		0
Earnings	87	109	140	210	279	339	79	103

Source: Cazenove

forecast three–year  
FY2008–11E earnings  
CAGR of 34%

earnings uplift from  
Nauvu JV contribution  
and turnaround of QLC

Olam's two largest investments to-date, Queensland Cotton and the Nauvu JV with Wilmar, which in turn is acquiring palm oil and rubber plantation assets in the Ivory Coast, are both major earnings swing factors. Investments total US\$136m and US\$122m respectively out of total acquisition spend of US\$457m.

### Queensland Cotton

For Queensland Cotton (QLC), much will depend on the cotton harvest in Australia following many years of drought depressed yields. This is a hard call to make.

We would, however, note that Olam has revised its guidance on for the level of loss for QLC in FY2008E from S\$16m–\$19m shortly after acquisition to S\$13m–\$14m following the release of Q3 2008 results. It has also revised upwards its expected steady state profit contribution, targeted for 2012, from S\$19m to S\$27m, and believe further upside exists from crop adjacencies (scaling up fixed back office / network cost), crop financing and warehousing.

Management continues to guide that QLC will be profitable in FY2009 if a normal crop pattern resumes. We have taken a slightly more conservative stance at this stage and forecast a loss, albeit a reduced one, of S\$5.4m.

### Nauvu

The Nauvu JV with Wilmar (50:50) is expected to close shortly and should contribute in full to FY2009 results. The JV will invest in three entities in the Ivory Coast: a 25% interest in SIFCA Group (the largest private Ivorian agro-industrial group, with interest natural rubber, sugar and cotton seed oil and stakes of 49.5% in Newco and 51.5% in Palm-Ci), a 50.5% interest in Newco (new company that will own SIFCA and Unilever's palm oil refining assets) and a 26.7% interest in Palm-Ci (36,000ha of palm oil plantations with CPO production pa of 200–230,000MT).

At the time of announcing the deal Olam guided steady-state profit contribution for its 50% stake in the JV of US\$16.8m, but also noted that this would be nearer to US\$23.4m on a short-term basis because of high CPO prices (Palm-Ci profit of US\$45m vs US\$15m steady state). The reality is that CPO has increased 24% since the deal was announced and rubber prices (which impact SIFCA's profit) have increased by a similar magnitude. As a result, we believe there is further upside risk to short-term earnings contributions.

We have used S\$31m (US\$23m) pre-funding and S\$20m post-funding as Olam's profit share in modelling FY2009E contribution from Nauvu. As detailed above we believe risk, because of higher commodity prices is on the upside. Our house view on palm oil is that the price risk remains firmly on the upside. This and operating improvements – better yield through improved plantation management and expanded/improved refining capacity – should ensure multiple years of growth.

**Fig 4.4** Nauvu P&L impact

	SIFCA owns	JV owns	2009E	2010E	2011E	Steady- state	Near- term
Newco earnings (US\$m)	49.5%	50.5%	30	35	46	30	30
Palm-Ci earnings (US\$m)	51.2%	26.7%	45	59	62	15	45
SIFCA earnings (US\$m)		25.0%	73	88	104	63	78
JV interest in Newco (US\$m)			18	22	26	16	20
JV interest in Palm-Ci (US\$m)			15	18	23	15	15
JV interest in SIFCA (US\$m)			12	16	17	4	12
<b>JV earnings (US\$m)</b>			<b>45</b>	<b>55</b>	<b>66</b>	<b>35</b>	<b>47</b>
Olam's 50% share (US\$m)			23	28	33	17	23
Olam's 50% share (S\$m)			31	38	45	24	32
Funding cost of investment (S\$m)			-11	-11	-11		
<b>Olam net earnings impact (S\$m)</b>			<b>20</b>	<b>27</b>	<b>35</b>		

Source: Cazenove

Note: Steady-state and near-term earnings figures provided by Olam/Wilmar when deal announced in November 2007.

cost savings reducing QLC losses, but end of drought needed for a return to profit

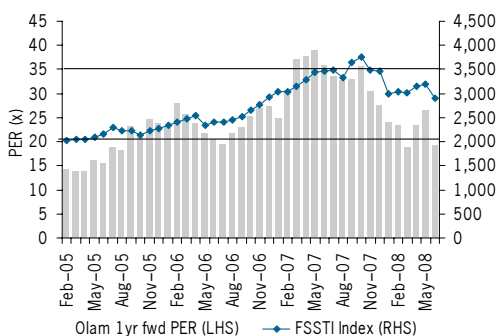
higher palm oil and rubber prices should result in higher profit

## 5.0 Valuation

At 19.3x FY2009E (June year-end) Olam is trading at the bottom of its one-year forward historical PER trading range of 20–35x (excluding the first few months post-IPO). Given the track record Olam has established, the additional capital raised from its 1-for-10 preferential offering (dilution accounted for in our forecasts), its robust business model, its growth prospects (2008–11E EPS CAGR of 32%) and the fact that it operates in the ‘in-vogue’ agricultural space (demand exposure without price risk), in our view, is unjustified. We view Olam as a key long-term holding and would use opportunities of weakness to build a position. We believe now is such a time.

**Fig 5.1** One-year forward PER

**19x FY2009E PER – at the bottom of the one year forward historical range of 20–35x**



Source: Cazenove / Bloomberg

A simple re-rating to its 36-month average one-year forward PER of 26.4x would imply a share price of S\$3.18 – upside of 36% – we view this as the short-term trade. More significantly, we expect Olam to retain a premium rating in the medium to long term, and this combined with continued high earnings growth should support share price appreciation. Arriving at a hard fair value today, because of these growth dynamics, is difficult, however.

### Economic value

Our preferred methodology remains an economic value model, which captures both Olam’s growth profile and its above normal returns on equity (trending upwards, with a three-year forward average of 23%). To capture this growth we continue to prefer a two-stage model covering a six-year period (explicit forecasts plus superior growth for the remainder) followed by a more normal growth profile thereafter. We believe that, as discussed in the main body of this report, this could still be under-capturing the real tenure of Olam’s growth prospects.

Simply taking our estimated June 2008 book value (ie today’s balance sheet), our explicit forecasts for FY2009–11E, a further three-year superior growth of 20% and a terminal growth rate of 5%, and discounting the results to present value at a cost of equity of 10% results in a valuation of S\$3.27 per share – upside of 40% – again we see this as the short-term trade.

Given that we are at the end of FY2008, and our fair value is meant to reflect a 6–12 month forward valuation, we prefer however to use June 2009 as our starting point. On this basis, using our explicit forecasts, growth for the remainder of the six-year period at 20%, a terminal growth rate of 5% and a cost of equity of 10%, results in a fair value of **S\$4.00 – upside of 72%**.

This fair value of S\$4.00 translates into an **FY2010E PER (ie one-year forward in twelve months time) of 24x**...still marginally below Olam’s historic average. It also equates to an **FY2009E (ie one-year forward now) PEG of 1.2x** (PER of 33x / 2-year forward EPS CAGR of 27%) which does not appear as an unreasonable premium given Olam’s quality and growth.

Our new fair value is 17% higher than our previous fair value of S\$3.40 (set on 29 August 2007) reflecting the shift from 2008 to 2009 as the starting year for our economic profit model and our new higher forecasts, partially offset by an increase in the cost of equity from 9% to 10%.

**fair value of S\$4.00 based on two-stage economic profit model**

**S\$4.00 = FY2009E PEG of 1.2x**

**Fig 5.2** Fair value (economic profit model) detail

<b>Year end: June</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>Terminal</b>	<b>Total</b>
Net profit (S\$m)	210	279	339	407	488	586	703	703	
Terminal value net profit (S\$m)								14,187	
Dividend payout ratio (%)	25%	25%	25%	30%	35%	40%	50%		
Starting Equity – pre FV adj (S\$m)	1,100								1,100
Avg equity – pre FV adj (S\$m)		1,200	1,416	1,686	2,012	2,380	2,780	2,985	
ROE (%)		23%	24%	24%	24%	25%	25%	24%	
Estimated cost of capital (%)		10%	10%	10%	10%	10%	10%	10%	
Capital charge (S\$m)		120	142	169	201	238	278	298	
Terminal value – capital charge (S\$m)								6,022	
Economic profit (S\$m)		159	197	238	287	348	425		
Terminal value – EVA (S\$m)								8,165	
PV of economic profit (S\$m)		145	163	179	196	216	240	4,610	5,749
<b>Total value (S\$m)</b>									<b>6,849</b>
# shares outstanding (m)									1,712
<b>Value per share (S\$)</b>									<b>4.00</b>

Source: Cazenove

Our cost of equity of equity has been calculated using a risk free rate of 3.6%, an equity risk premium of 4%, a country risk premium of 1% and a beta of 1.27.

Sensitivity to our cost of equity and mid-term growth rates is illustrated in figure 4.4.

**Fig 5.3** Fair value sensitivity to varying cost of equity and mid-term growth rates

		<b>FY2012–2015 growth</b>				
		<b>+10%</b>	<b>+15%</b>	<b>+20%</b>	<b>+25%</b>	<b>+30%</b>
<b>Cost of Equity</b>	9.0%	3.50	4.29	5.20	6.23	7.39
	9.5%	3.06	3.74	4.53	5.42	6.42
	<b>10.0%</b>	2.71	3.31	<b>4.00</b>	4.78	5.66
	10.5%	2.42	2.95	3.19	4.25	5.03
	11.0%	2.18	2.66	3.20	3.82	4.52

Source: Cazenove

## 6.0

### Balance sheet, accounting and miscellaneous items

#### 6.1 Equity and the impact of FRS 39

The economics of Olam's business are relatively simple. If it can buy a tonne of commodity A at say S\$1,000 and sell it at S\$1,100 it will enter into this contract thereby netting itself a profit of S\$100. The nature of the agricultural supply chain, however, means there is a time lag between sourcing the product and the booking of the sale (delivering the product to the end customer). Without hedging the supply chain manager would be exposed to price risk during this period.

#### fair value adjustments for hedges distort reported reserves

Olam, however, actively removes (hedges out) this pricing risk via the use of derivatives (sale of futures) or forward selling. At any given balance sheet date Olam will have physical inventory on its books (at cost) and a number of open hedging positions related to this inventory. Under FRS39 it is required to re-value these cash flow hedges based on current prices. Any unrealised profit (if price has decreased) or loss (if price has increased) is taken directly to reserves (profit increases reserves / loss decreases reserves).

At the point of shipment/sale these hedging transactions are unwound and any realised profit or loss is taken to the P&L and in turn netted-off with the profit and loss based on actual selling price less inventory cost. The net result is a profit (and equity uplift) equivalent to that envisaged at the outset (ie the net economics, P&L, balance sheet and cashflow impact of the trade are unchanged).

Hence, at any balance sheet date Olam will have unrealised hedging gains or losses impacting reserves. The quantum of these in turn is a function of volume (increasing) and price. Higher volumes and higher price – the operating dynamics of Olam currently – translate into a bigger unrealised loss. This in turn depresses reported equity.

#### ratios based on a pre fair value adjustment basis more appropriate

Given that the overall economics of the contract have not changed, we believe it is better to look at reserves (shareholders' funds) excluding these items when calculating NAV per share, gearing levels and returns on equity.

**Fig 6.1** Net assets pre and post FRS39 adjustments (\$m)

Year end: June	2005	2006	2007	Mar-08	2008E	2009E	2010E
Opening revenue reserves	57	101	155	217	217	302	457
Profit for the period	66	87	109	103	140	210	279
Dividends paid	-24	-34	-47	-54	-54	-35	-53
<b>Closing revenue reserves</b>	<b>101</b>	<b>155</b>	<b>217</b>	<b>266</b>	<b>302</b>	<b>457</b>	<b>656</b>
Equity capital	397	397	398	400	702	702	702
Forex, share based compensation and others	3	-22	-31	-59	-59	-59	-59
<b>Adjusted equity / net assets</b>	<b>501</b>	<b>530</b>	<b>584</b>	<b>606</b>	<b>945</b>	<b>1,100</b>	<b>1,299</b>
FRS39 adjustment for unrealised hedging gains / (losses)	-32	-42	-151	-130	-130	-130	-130
<b>Reported equity / net assets</b>	<b>469</b>	<b>488</b>	<b>433</b>	<b>476</b>	<b>815</b>	<b>970</b>	<b>1,169</b>
<b>Adjusted NAV per share (\$)</b>	<b>0.32</b>	<b>0.34</b>	<b>0.38</b>	<b>0.39</b>	<b>0.55</b>	<b>0.64</b>	<b>0.76</b>
Reported NAV per share (\$)	0.30	0.31	0.28	0.31	0.48	0.57	0.68

Source: Cazenove

These FRS39 adjustments are impossible to model. As a result, our forecasts for both reported and pre-FRS39 adjusted equity assume no change in the level of FRS39 adjustment since the last balance sheet date (31 March 2008). The forecast increase in equity (both reported and adjusted) solely reflects the impact of realised profit and new equity capital raised, net of dividends paid.

## 6.2 Gearing and adjusted gearing

significant portions of  
inventory and debtors  
are 'cash-like' in nature

Even using the adjusted pre-FRS39 equity figures outlined above, net gearing levels for Olam still look high – 403% as at 31 March 2008, and even higher at 482% if calculated using tangible net asset. These high headline ratios however, ignore the fact that a significant portion of Olam's inventory is either hedged or liquid in nature. The net result is dynamics that are much more akin to a 'cash' asset than typical inventory. Furthermore, a significant portion of Olam's debtors are secured by letters of credit or deeds of title, again making these also essentially 'cash-like' assets.

If adjustments are made for these 'cash-like' inventory and debtor amounts, then net gearing drops by a significant quantum. The raising of new equity via the 1-for-10 preferential offer completed in April 2008 we estimate will pull adjusted tangible net gearing down to 72% as at June 2008.

**Fig 6.2** Net gearing

Year end: June	2005	2006	2007	Mar-08	2008E	2009E	2010E
<b>Adjusted tangible net assets (S\$m)</b>	<b>501</b>	<b>530</b>	<b>487</b>	<b>506</b>	<b>845</b>	<b>1,000</b>	<b>1,199</b>
Intangible net assets (S\$m)	0	0	96	100	100	100	100
Adjusted net assets (S\$m)	501	530	584	606	945	1,100	1,299
<b>Inventory hedged or sold forward (%)</b>	<b>88%</b>	<b>82%</b>	<b>81%</b>	<b>86%</b>	<b>85%</b>	<b>85%</b>	<b>85%</b>
<b>Debtors with letters of credit or deed of title (%)</b>	<b>70%</b>	<b>67%</b>	<b>67%</b>	<b>77%</b>	<b>75%</b>	<b>75%</b>	<b>75%</b>
Net debt (S\$m)	-1,285	-1,181	-1,682	-2,440	-2,305	-2,846	-3,230
add back – hedged & liquid inventory (S\$m)	887	829	937	1,399	1,400	1,688	1,984
add back – secured debtors (S\$m)	298	286	343	279	294	355	417
<b>Adjusted net debt (S\$m)</b>	<b>-100</b>	<b>-66</b>	<b>-402</b>	<b>-762</b>	<b>-611</b>	<b>-803</b>	<b>-829</b>
Net debt / reported net assets (%)	274%	242%	389%	513%	283%	294%	276%
Net debt / adjusted net assets (%)	257%	223%	288%	403%	244%	259%	249%
<b>Adjusted net debt / adj. tangible net assets (%)</b>	<b>20%</b>	<b>12%</b>	<b>83%</b>	<b>151%</b>	<b>72%</b>	<b>80%</b>	<b>69%</b>

Source: Cazenove

## 6.3 Net margins

higher commodity  
prices depress net  
margin

While Olam has developed a fantastic track record, one of the few areas where criticism is levied is the lack of net margin expansion, especially in light of expanding net contribution per MT.

The reality, however, is that comparing these two metrics isn't entirely fair: rising commodity prices have an impact on the denominator (sales) part of the net margin equation, whereas the numerator (earnings), in the case of Olam, is not a function of commodity price.

Our forecast is for a net margin decline at the headline level in FY2008E. However, this is the result of the impact that new acquisitions are having – particularly Queensland Cotton which is currently loss-making. Excluding these new acquisitions we are forecasting modest net margin expansion from 2.0% to 2.1% – in-line with that reported for the first nine months of 2008, which in itself is an impressive performance given average prices increased by 15% in this period.

**Fig 6.3** Net margin

Year end: June	2004	2005	2006	2007	2008E	2009E	2010E	2011E
Headline net margin (%)	1.8%	2.0%	2.0%	2.0%	1.8%	2.2%	2.5%	2.6%
Net margin pre-Nauvu (%)	1.8%	2.0%	2.0%	2.0%	1.8%	2.0%	2.3%	2.4%
Net margin pre-Nauvu & other acquisitions (%)	1.8%	2.0%	2.0%	2.0%	2.1%	2.3%	2.4%	2.5%

Source: Cazenove

but net margin forecast  
to rise post 2008  
helped by Nauvu and  
turnaround of QLC

Going forward we are forecasting continued improvement in net margin to 2.5%. In part this should be driven by Nauvu which, as a JV, will lift earnings but not revenue. Even ex-Nauvu, we are forecasting margin improvement – partly as a result of an anticipated turnaround of QLC and partly because of better absorption of SG&A costs, particularly those relating to new acquisitions, as new revenue streams are built around existing costs. The move to add wheat and barley sourcing and marketing to QLC is an example of progress on this front.

## 6.4 Export incentives and subsidies

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Another area that has attracted investor interest is the inclusion of credit in the cost of goods sold relating to 'export incentives and subsidies received'. These are payments from governments of producing countries to encourage export of agricultural product / generate foreign exchange / support domestic agriculture.

This is the widespread practise in countries which export a significant amount of their agricultural product and would include the US, the EU, Nigeria, Vietnam and India to name a few. In some instances these incentives/subsidies are put in place to offset higher production costs in that country thereby bringing the net price of that commodity into line with crops grown elsewhere.

Looking at this figure in isolation and viewing it as a straight contribution to earnings is incorrect. In reality it is part of the overall economics of any individual trade. If the incentive/subsidy was not available either the selling price would be adjusted to generate the same net contribution for or the product would be sourced from another origin with a different cost structure.

The only foreseeable negative if a change of price / change of sourcing could not take place, thereby eroding the economics of the trade, is that this volume would be forgone. With Olam's multi-product / multi-origin structure we see the net risk as low.

**Profit and loss account**

Year end: June	2006	2007	2008E	2009E	2010E
Sales (S\$m)	4,361	5,456	7,841	9,459	11,115
Gross contribution (S\$m)	343	487	706	912	1,085
Net interest (S\$m)	-84	-135	-188	-245	-270
Net contribution (S\$m)	259	351	518	667	814
SG&A (S\$m)	-163	-225	-353	-416	-478
Tax (%)	10%	14%	15%	16%	17%
Earnings (S\$m)	87	109	140	210	279
EPS (S\$) (basic)	0.056	0.070	0.086	0.123	0.163
EPS (S\$) (fully diluted)	0.056	0.069	0.085	0.120	0.160
DPS (S\$)	0.030	0.035	0.020	0.031	0.041
Volume growth (%)	+24.2	+18.9	+25.0	+16.0	+13.0
Sales growth (%)	+29.4	+25.1	+43.7	+20.6	+17.5
Net contribution growth (%)	+34.4	+35.5	+47.5	+28.8	+22.0
Earnings growth (%)	+32.4	+25.0	+28.4	+50.0	+32.8
EPS growth (%)	+10.8	+23.6	+22.6	+42.3	+32.8
Dividend payout (x)	53	50	25	25	25

Source: Cazenove

**Cash flow statement**

Year end: June	2006	2007	2008E	2009E	2010E
	S\$m	S\$m	S\$m	S\$m	S\$m
EBITDA	192	279	386	518	626
Working capital	98	-310	-492	-534	-547
Other	1	6	7	0	0
Cash flow from operations	292	-26	-99	-15	79
Interest	-72	-127	-188	-231	-256
Tax	-6	-8	-45	-25	-41
Operating cash flow	213	-161	-332	-272	-218
Capex (net)	-48	-43	-64	-80	-100
Acquisitions/disposals	-1	-124	-190	-140	0
Other	0	-95	13	0	0
Free cash flow	165	-422	-573	-492	-318
Dividends	-34	-47	-54	-35	-53
Cash flows pre financing	132	-469	-627	-526	-370
Issue of shares	0	1	304	0	0
Other	-27	-34	-300	0	0
Net cash flow	105	-502	-623	-526	-370
Closing net cash / (debt)	-1,285	-1,181	-1,682	-2,305	-2,831

Source: Cazenove

**Balance sheet**

Year end: June	2006	2007	2008E	2009E	2010E
	S\$m	S\$m	S\$m	S\$m	S\$m
FAs – tangible	73	129	428	465	518
FAs – intangible	0	96	100	100	100
Other non-current assets	7	100	55	195	195
Inventories	1,014	1,163	1,647	1,986	2,334
Trade debtors	427	508	392	473	556
Margin a/c & advances	204	342	784	946	1,111
Cash & equivalents	296	238	314	378	445
Other current assets	338	601	1,256	1,353	1,452
Total assets	2,358	3,178	4,974	5,896	6,711
Trade creditors	-135	-256	-470	-568	-667
Borrowings	-1,477	-1,920	-2,618	-3,224	-3,675
Other liabilities	-258	-569	-1,070	-1,135	-1,201
Net assets	488	433	815	970	1,169
Fair value reserves	-42	-151	-130	-130	-130
Net assets ex-FV reserves	530	584	945	1,100	1,299

Source: Cazenove

**Key ratios**

Year end: June	2006	2007	2008E	2009E	2010E
Sales volume (000's MT)	3,172	3,773	4,716	5,471	6,182
ASP (S\$/MT)	1,375	1,446	1,663	1,729	1,799
Gross contribution (per MT S\$)	108	129	150	167	175
Net contribution (per MT S\$)	82	93	110	122	132
Net margin (%)	2.0	2.0	1.8	2.2	2.5
Op cash/op profit (x)	1.5	-0.1	-0.3	0.0	0.1
Depn/capex (x)	0.3	0.4	0.5	0.5	0.5
Quick ratio (x)	0.7	0.6	0.9	0.9	0.9
ROAE (%)	17	20	18	21	23
ROACE (%)	9	12	12	13	13
Net debt/equity (%)	243	202	178	210	218
Inventory hedged / sold fwd (%)	82	81	85	85	85
Debtors secured (%)	67	67	75	75	75
Adj net debt/equity (%)	12	83	72	80	69
Working cap/sales (%)	35	32	30	30	30
Receivables days	36	34	18	18	18
Inventories turnover (x)	4.3	4.7	4.8	4.8	4.8
Asset turnover (x)	1.8	1.7	1.6	1.6	1.7
FD wtd avg # shs	1,563	1,580	1,654	1,744	1,744
Period end # shs	1,555	1,555	1,712	1,712	1,712

Source: Cazenove



## APPENDIX

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No changes in recommendation over the last 12 months.

12 months recommendation changes for Wilmar International;  
31-Jan-2008 IN-LINE

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