

# Felda Global Ventures Holdings

**AVOID**

Oil palm plantation

Bloomberg ticker: FGVH MK

## Smallholders pay for political profits

Oil palm plantation company Felda Global Ventures Holdings Bhd (FGVH) aims to raise RM 9.95 billion (€ 2.5 billion) from its listing on the Bursa Malaysia, making it the world's second largest IPO this year after Facebook. We initiate coverage on FGVH with an AVOID recommendation as our analysis shows that an accumulation of environmental, social and governance risks will result in serious financial risks for investors.

### Largest CPO producer in the world

Set up in 2007 as the overseas branch of the Federal Land Development Authority (FELDA), FGVH will become the third largest listed oil palm company globally. By taking control of its parent's landbank, it has a total of 424,995 ha of land in Malaysia and Indonesia under management.<sup>1</sup> In addition, the company is the largest crude palm oil (CPO) trader globally, as it also sells most of the CPO produced from the Fresh Fruit Bunches (FFB) grown by 112,635 Malaysian settlers on another 522,000 ha.<sup>2</sup> FGVH also is the leading refined sugar producer in Malaysia. It has interests in palm oil refineries and downstream processing facilities in Malaysia, Indonesia, China, Turkey and South Africa, an oil and fat facility in the United States, and sales and marketing offices in France and Spain.<sup>3</sup>

### Investors face huge risks...

Investors buying FGVH shares will face significant environmental, social and governance risks, which are likely to create financial risks:

- Tensions between the company's ambitions and the Malaysian rural poor are rising because of alleged systemic undervaluation of oil palm fruits and the use of power politics to grab land;
- The company does not have a strong sustainability record, with only 3% of its landbank RSPO certified.<sup>4</sup> 50% of IPO proceeds will be used to develop plantations in vulnerable areas in Africa, Indonesia and elsewhere;<sup>5</sup>
- Malaysia's ruling political party, UMNO, controls company management and lines up state-controlled investors to inflate share demand. Opposition parties favour redistributing FGVH's landbank under the rural poor. With elections upcoming, changes in the political landscape may affect FGVH's access to land and income streams;
- Yields are below average and half of the plantations need to be replanted. Investments needed are much higher than projected.

### and could contribute to new ones

The IPO itself is likely to create new risks, as there is widespread fear that the government's proceeds of the IPO (€ 1.4 billion) will be used by UMNO to buy a favourable result in the upcoming general elections, further undermining Malaysia's fragile democracy.

#### IPO

Stock exchange	Bursa Malaysia
Listing date	28 June 2012
Shares for sale	2,189 million
Proposed price	RM 4.55 (€ 1.14)
Gross proceeds for FGVH	€ 1.12 billion
Issuing syndicate	CIMB, Maybank Deutsche Bank, JP Morgan, Morgan Stanley

#### Company

Land bank	424,995 ha
FFB production	5.2 million MT/yr
CPO sales	3.0 million MT/yr
Annual sales	€ 1.8 billion

#### Social risks

Settlers	112,635
Land bank	522,000 ha
Compensation for land	Insufficient
Payment for fruit	Below market

#### Environmental risks

Deforestation	Indonesia Africa
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#### Political risks

Ruling party in Malaysia	UMNO
FGVH management control	UMNO
IPO proceeds for FELDA	€ 1.38 billion
Opposition parties	Against IPO
Press freedom (RwB)	Partly free
Elections	Coming months

#### Financial risks

Average age of oil palms	20+ years
Profitability	Poor
Governance	Poor
Financial dependency on land lease agreement	High
Continued access to land bank	Uncertain

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## Company background

### Land development for poverty alleviation

The Federal Land Development Authority (FELDA) was founded in 1956 by Malaysia's second Prime Minister, Tun Abdul Razak Hussein, the father of the current Prime Minister Najib Razak. Abdul Razak's vision for FELDA was to develop land for the landless, with the final aim of granting them leasehold titles.<sup>6</sup> With the support of World Bank loans, more than 850 thousand hectares of tropical rainforest were cleared for the resettlement of the rural poor into newly developed areas, planting primarily oil palm plantations.<sup>7</sup> The scheme is widely acknowledged as having contributed to poverty alleviation, which in turn generated a strong political grassroots support base for the United Malays National Organization (UMNO), the political party that has been permanently in power ever since Malaysia's independence in 1957.

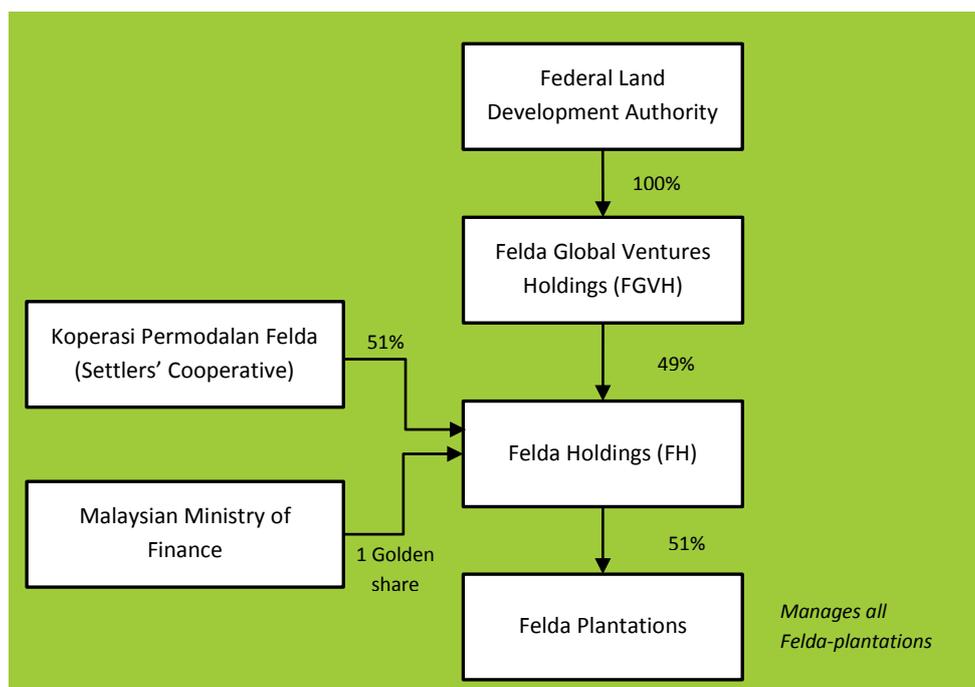
### Commercial plantation development

In 1990, when some 113,000 families were resettled, FELDA stopped accepting new settlers. Although the Group Settlement Areas Act of 1960 stipulates that it is FELDA's duty to manage the land for the settlers and that the Authority should not own land itself, a new course was chosen by focussing on the commercial development of a new plantation land bank. Instead of redistributing the land to settlers, Felda Holdings was incorporated in 1995 as the plantation management arm of FELDA. It soon developed into one of the largest plantation companies in the world.<sup>8</sup>

The plantation area which Felda Holdings managed on behalf of FELDA expanded to a total acreage of 356,000 ha.<sup>9</sup> Government authorities held 49% of the shares of Felda Holdings, while the Felda Settlers Cooperative (KPF) held a 51% majority shareholding. The government did also retain a so-called "Golden Share", allowing the holder to overrule the board or even make boardroom appointments.<sup>10</sup> This arrangement proved to be crucial in the past year.

The collective income from the corporate estates of Felda Holdings helped finance general development activities in the settlements. However, many settlers saw this arrangement as temporary and assumed that the corporate estates developed by Felda Holdings would ultimately be made available to the second and third generation settlers.<sup>11</sup>

#### Pre-IPO ownership structure of FGVH



Source: Felda Global Ventures Holdings, "Initial Public Offering – Prospectus", Felda Global Ventures Holdings, 31 May 2012.

## International expansion

The settlers' hope clearly was not shared by the management of Felda Holdings, which started to expand its corporate activities. Felda Global Ventures Holdings (FGVH) was set up in 2007 as the holding company for the government's 49% stake in Felda Holdings and as the vehicle for overseas investments in upstream and downstream oil palm business as well as other agribusinesses. Activities focussed initially on soybean and canola processing in North America, but in recent years expanded into upstream plantations in Malaysia and Indonesia and into downstream sugar and palm oil refining.<sup>12</sup>

FGVH now is the leading refined sugar producer in Malaysia. Through a joint venture with IFFCO Oil Holdings (United Arab Emirates), FGVH has interests in palm oil refineries and downstream processing facilities in Malaysia, Indonesia, China, Turkey and South Africa, an oil and fat facility in the United States, and sales and marketing offices in France and Spain.<sup>13</sup>

According to the Malaysian opposition leader, Anwar Ibrahim, several of these foreign investments resulted in losses amounting to RM 500 million (€ 123.2 million) between 2007 and 2010.<sup>14</sup>

## Environmental, social and governance risks

### UMNO taking control of Felda Holdings

Plans for a listing of FGVH at the Malaysian stock exchange, to enable further international growth, were first announced in October 2011.<sup>15</sup> But FGVH would be too small and not profitable enough for an IPO, without full control of the assets and income stream of its associate company Felda Holdings (49% owned by FGVH). Through a management contract with FELDA, Felda Holdings operated 356,000 hectares of plantations in peninsular Malaysia, Sabah and Sarawak. Felda Holdings also processed the oil palm fruits grown by the 112,635 settlers on the 522,000 ha which are their property.<sup>16</sup>

In a first step to get control of these assets and income streams, the government used its powers to reshuffle FELDA's management to its own liking. Anyone critical of the envisaged IPO was moved aside. The settlers' cooperative KPF, which owned a 51% shareholding in Felda Holdings, saw its deputy general manager Abidin Abdul Rahman transferred to the Prime Minister's Department for a menial role. And FELDA General Manager Datuk Dzulkifli Abd Wahab was ordered to go on a nine-month study leave, despite being close to retirement.<sup>17</sup>

Isa Samad, the controversial former Chief Minister of the Malaysian state Negri Sembilan, was appointed to direct virtually all FELDA companies from 2010 onward, including the settlers' cooperative KPF. To make this appointment possible, minister of Domestic Trade, Cooperatives and Consumerism Ismail Sabri Yaakob exercised his ministerial powers to exempt Isa Samad from KPF's by-laws.<sup>18</sup>



Isa Samad's installation as chairman of KPF was met with opposition by settlers, as the KPF's by-laws were clearly violated by the appointment. Article 2 and 15 of the KPF by-laws read that only a settler or a full time FELDA staff of two years tenure, is eligible for KPF chairmanship.<sup>19</sup> The Malaysia Cooperatives Society Commission recently ruled that the appointment violated the cooperative's by-laws, but claimed to be unable to do anything about the KPF's "illegal" chair.<sup>20</sup>

### Restructuring of land control to exclude settlers

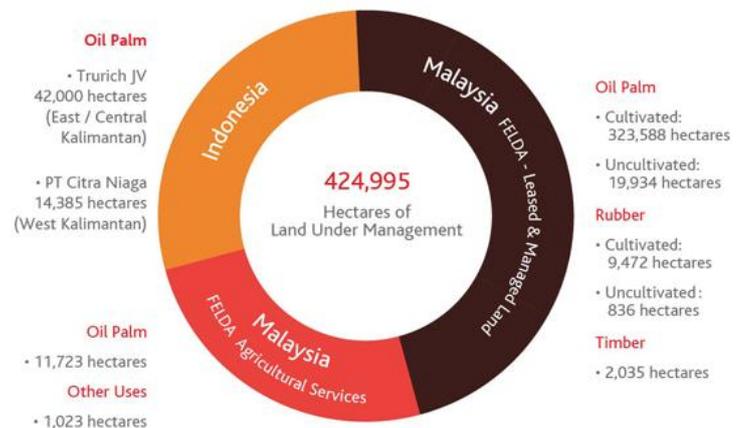
FELDA chairman Isa Samad then tried to use his position as chairman of the settlers' cooperative KPF to transfer KPF's 51% share in Felda Holdings to FGVH. But when a group of settlers managed to obtain an injunction against KPF to transfer its share to FGVH, Samad announced in the beginning of 2012 that the listing would go on without KPF's involvement.<sup>21</sup> In the meantime, the courts refused further injunctions to the settlers.<sup>22</sup>

While bringing Felda Holdings under the full control of FGVH proved difficult, Isa Samad stripped Felda Holdings of its assets: its plantation land and its CPO marketing activities. In January 2012 FELDA signed a 99-year Land Lease Agreement with FGVH, transferring all 355,864 ha of plantation land which were until then managed by Felda Holdings to the direct control of FGVH.<sup>23</sup>

This transaction was strongly criticized because it undermines the hope of the underemployed second and third generation settlers to obtain their own piece of land. “Assuming 10 acres per settler, the plantation land leased to FGVH could instead accommodate some 80,000 new Malaysian settler families, if FELDA were to resume its original mission.”<sup>24</sup> Another point of criticism is that lands encumbered with Native Customary Rights and Malay Reserved Lands have also been transferred to a private, listed company. About 24.5% of the land has never been licensed and demarcated out.<sup>25</sup>

For the financial viability of FGVH, the Land Lease Agreement is crucial. Total land under FGVH management now adds up to 424,995 ha, of which 56,385 ha in Indonesia. The vast majority of land is dedicated to oil palm, a small amount is used for rubber plantations.<sup>26</sup>

The Land Lease Agreement allows FGVH to pay a below market price annual rent of an estimated at RM 1,490 per hectare as opposed to RM 3,358 that is for example paid by fellow Malaysian plantation company Boustead Plantation under a comparable construction.<sup>27</sup>



In a separate agreement, FGVH agreed to sell all its Fresh Fruit Bunches (FFB) to a subsidiary of Felda Holdings, which processes the FFB into Crude Palm Oil (CPO). As Felda Holdings also processes the FFB produced by the settlers on their own land, it is the largest CPO producer in the world with an annual output of 3.3 million tonnes. The agreement with FGVH also stipulates that more than 90% of this CPO production (3.0 million tonnes) is now sold to FGVH, which turns the company into the largest CPO trader in the world.<sup>28</sup>

### Small compensation for the loss of their land

While FGVH already had taken control over the land initially controlled by Felda Holdings and of the marketing of their CPO production, the settlers’ cooperative had not much choice than to agree with the proposal to convert its 51% shareholding in Felda Holdings into a 37% stake in the listed FGVH. But just days after KFP voted in favour of the transaction, FELDA chairman Isa Samad announced that the listing would go ahead without KFP regardless. The 37% stake reserved for the settlers would now be divided between FELDA and a new entity that would look after the interest of the settlers, disbursing its dividends from FGVH profits to the settlers.<sup>29</sup> Of course strong protests were voiced that KFP’s rights to protect its own interests were removed.<sup>30</sup>

During the IPO, FELDA will sell almost half of the existing FGVH shares while FGVH will issue 980 million new shares. The shares on offer represent 60% of the enlarged share capital of FGVH. This leaves 40% of the shares in the hands of FELDA.<sup>31</sup>

The prospectus shows that FELDA recently has transferred part of its FGVH shares to a new subsidiary, Felda Asset Holdings Company (FAHC). After the IPO, FELDA will own 23% of the FGVH shares directly and 17% indirectly via FAHC. Probably FAHC is the “new entity that would look after the interest of the settlers”, as announced by Isa Samad. If so, it is not clear if it will offer the settlers any ownership rights as FAHC at the moment is fully owned by FELDA.

After the IPO the settlers will own only 2.5% of the FGVH shares, the portion reserved for them out of the 60% on offer. With 112,635 settlers and if fully subscribed, the average IPO allocation could be 810 shares per settler, generating perhaps a few hundred ringgit of gain from the IPO itself.<sup>32</sup> When critique was voiced on this percentage, Isa Samad announced, a day after the launch of the prospectus, that a special Trust Fund would be established to capture 20% of the dividend to be paid out directly to the settlers. If FAHC will be this trust fund is not clarified in the prospectus. Suspicions were voiced that the proposed trust fund was merely an afterthought expressed to placate the settlers.

The number of shares allocated to the settlers (91 million) also contrasts strongly with the 420 million shares set aside for an undisclosed list of rich individuals and private Malaysian companies. To qualify, individuals must have at least RM3 million in assets and companies must be worth RM10 million. Questions are raised how many of these investors are linked to UMNO.<sup>33</sup>



## Foreign expansion poses sustainability risks

The relationship with the settlers is not the only example of FGVH's poor CSR record. In its eagerness to expand internationally, FGVH also does not seem to be keen in avoiding environmental and social risks abroad. In 2009, FGVH announced plans to invest more than RM 6 billion (€ 1.5 billion) over the next five years to expand its overseas presence in plantations and related businesses. However, when the company unfolded plans to open up 100,000 hectares of tropical rainforest in the remotest part of the Amazon, NGO campaigners all over the world quickly overwhelmed FGVH with protest emails, forcing FGVH to pull out from the project.<sup>40</sup>

Half of the proceeds of the IPO, about € 550 million, will be used by FGVH to develop new plantations, focussing on expansions in Africa and Southeast Asia.<sup>41</sup> The company still has vast tracks of undeveloped land in parts of Malaysia and in Indonesia, some of which are forested. And media reports indicate that FGVH is also eyeing expansion possibilities in Cambodia, Burma, Papua New Guinea, Liberia and Cameroon.<sup>42</sup> Plantation expansion in all these countries is highly contentious and could trigger land conflicts and environmental degradation. Subsidiaries of Trurich Resources, FGVH's joint venture with Tabung Haji Plantations, for instance are already facing land conflicts with local communities in Central Kalimantan (Indonesia).<sup>43</sup>

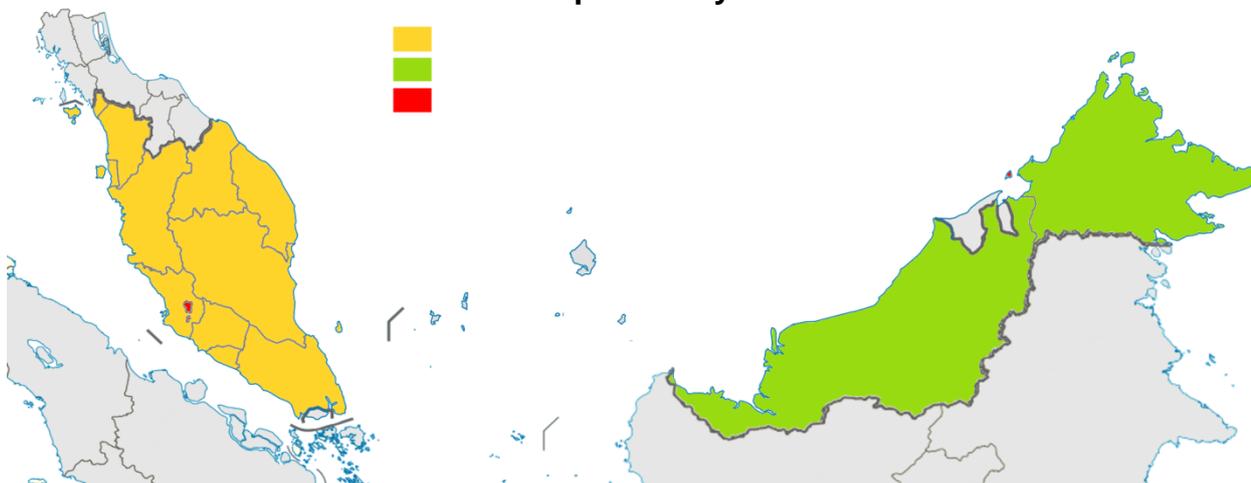
FGVH's sustainability profile provides little guarantee that it will do anything in its power to prevent deforestation and land conflicts. Only 3% of FGVH's total land bank has so far been certified by the Roundtable on Sustainable Palm Oil.<sup>44</sup>

## Growing political opposition may undo agreements

Malaysia's political situation is another risk factor. Although Malaysia formally is a democracy, the uninterrupted government control by the UMNO party since independence indicates that its democracy is not very mature. According to the American non-profit organization Freedom House, Malaysia ranks as only "partly free".<sup>45</sup> Malaysia ranks 5<sup>th</sup> on Global Financial Integrity's ranking of illicit financial flows from developing countries in the period 2000-2009.<sup>46</sup> And Malaysian media freedom has been compromised as well. In the Press Freedom Index 2011-12 published by Reporters Without Borders, Malaysia ranks among the bottom 33% of 179 countries.<sup>47</sup>

Malaysia's former Prime Minister Dr. Mahathir recently essentially affirmed this situation as desirable for the UMNO-led government. In a speech he said that for Malaysia "a little democracy would be good" - and not much more. He argued that full democracy requires that many things are added to it including human rights and many forms of freedom, which could lead to destruction and instability.<sup>48</sup>

**Map of Malaysia**



Yellow: 11 states of peninsular Malaysia; Green = East Kalimantan (Sabah and Sarawak); Red = federal territories. Source: Wikimedia.

Nevertheless: political opposition to the UMNO party has been growing in recent years in Malaysia, which consists of thirteen states and three federal territories. The March 2008 elections had shaken up the UMNO led government when the Pakatan Rakyat opposition coalition gained 49% popular support and denied UMNO and its allies the two-third majority in parliament for the first time since independence. Five out of 13 states fell into opposition hands, including the two richest states Selangor and Penang.<sup>49</sup>

Opposition parties are vehemently opposing the way in which FGVH took control of the land formerly managed by Felda Holding. They want FELDA's "corporate land bank" to be distributed among 2<sup>nd</sup> and 3<sup>rd</sup> generation settlers, not to be made available to investors. Three states controlled by the Pakatan Rakyat opposition (Kelantan, Kedah and Selangor) will not surrender land to FGVH if this is legally possible.<sup>50</sup> With the possibility that more states are falling into opposition hands during the upcoming general elections, the government under Najib Razak seems keen to list FGVH on the stock exchange as soon as possible.

If the opposition parties win the elections, it remains to be seen if they will force FELDA to end the Land Lease Agreement with FGVH and distribute the land to the settlers. But if this would happen, the consequences would be huge for the company. FGVH itself acknowledges in its prospectus that the leased land is "the source of substantially all of our Fresh Fruit Bunches production, and, if we lose the right to use this land, this loss would have a materially adverse effect on our FFB production. Compensation provided by FELDA, if any, for any termination of the lease or tenancy in respect of this land may not be sufficient to cover our losses".<sup>51</sup>

### Poor governance structures surround FGVH

When UMNO stays in power, the governance structures surrounding the company are likely to remain poor. Prime Minister Najib Razak himself is believed to have been involved in syphoning off millions in a submarine acquisition deal with a French company when he was Minister of Defence. Interpol may issue a warrant for the arrest of Malaysia's Prime Minister if he continues to refuse to appear before the French court where the case is presently being heard.<sup>52</sup>

The people he pushed forward to lead FGVH also have a tarnished reputation. Director Isa Samad in 2005 was stripped of his UMNO vice-presidency after being found guilty of money politics by the UMNO disciplinary board. His six-year suspension was commuted to three years upon appeal and ended in June 2008.<sup>53</sup> FGVH's second man, Sabri Ahmad, had to resign from the board of plantation company Golden Hope (now part of Sime Darby) in November 2007 because the company lost RM 120 million (€ 30.2 million) with futures trading.<sup>54</sup>



Director Isa Samad (2<sup>nd</sup> from right) handing the FGVH prospectus to Prime Minister Najib Razak (left) - The Star/KevinTan

With such leadership, it comes as no surprise that a study by the Boston Consulting Group (BCG) reportedly found that 65% of FGVH's management staff believes that the IPO will fail. Some 55 per cent were of the view that FGVH was not ready for the listing, while only 20 per cent of top management supported the plan.<sup>55</sup>

But even more worrying is the way in which FELDA's weak financial performance has been compensated by state-owned pension fund Employees Provident Fund (EPF). Between 2004 and 2009, FELDA's reserves plummeted by RM 2.73 billion (€ 686 million) in spite of strong CPO prices. FELDA secured a RM 6.5 billion (€ 1.6 billion) loan from EPF, half of which was actually taken up. When challenged by NGO's to explain where the loan was spent on, a minister in June 2011 claimed that RM 2 billion (€ 503 million) was spent on replanting.<sup>56</sup> Such huge investments in replanting are very unlikely to have occurred, as the current average replanting costs per hectare are around RM 12,055 (€ 2,971).<sup>57</sup> If RM 2 billion was spent on replanting in the past few years, the company should now have 166,000 ha of newly planted plantations. In reality, only 99,400 ha are below 10 years of age.<sup>58</sup>

Despite this weak financial governance, UMNO-controlled states and government-controlled pension and investment funds now seem to be used to inflate FGVH's share price. State-controlled funds Permodalan Nasional Berhad (PNB) and Lembaga Tabung Haji (LTH) will each take 7.5% of the FGVH shares. Together

with pension fund EPF and some smaller funds, they will buy 19.8%.<sup>59</sup> Additionally, five Malaysian states controlled by UMNO-governments will buy 10.84% of the shares.<sup>60</sup> As these are existing shares sold by FELDA, an opposition party MP wonders why a federal government-owned body should sell its shares to a number of Malaysian states. Does this mean that investor demand is much lower than claimed?<sup>61</sup>

## Financial risks for investors

The myriad of environmental, social and governance risks connected to an investment in FGVH, also creates material financial risks for investors. To summarize:

- Tensions between the company's ambitions and the Malaysian rural poor are rising because FGVH has grabbed the land which second and third generation settlers hoped to gain access to, and because various Felda CPO mills are alleged to have undervalued settlers' oil palm fruits for years. Social unrest can cripple part of the company's operations and reduce its income stream. The prospectus does not explain how the company wants to provide the settlers a fair share in the ownership and dividends of the company;
- The company does not demonstrate a strong sustainability record, with only 3% of its landbank RSPO certified. 50% of IPO proceeds will be used to develop plantations in vulnerable areas in Africa, Indonesia and elsewhere. NGO protests and conflicts with local communities might hinder the company's expansion plans;
- Malaysia's ruling political party, UMNO, controls company management and lines up state-controlled investors to inflate the demand for its shares. Share prices probably will drop when this artificial demand dries up;
- Opposition parties favour redistributing FGVH's landbank under the rural poor. After the upcoming elections, changes in the political landscape may result in adjustments of the Land Lease Agreement and the CPO processing agreement between FELDA and FGVH. This would have serious implications for the company's income streams. At present, it is not clear if these agreements will be legally challenged in the courts

Additionally, it is clear that FGVH will not be as profitable as it suggests. The plantations held by the company are old, 53% of the oil palms are over 20 years old and need to be replanted in the coming years as production drops strongly when age rises above 25 years.<sup>62</sup> The company has only reserved funds to replant 4.4% annually in the coming four years.<sup>63</sup> Replanting will then take 12 years, during which production will drop and another 16% of the oil palms will become older than 20 years. This means that the company should either spend more than projected on replanting, or risks a serious drop in the productivity level of its plantations. Both options would result in a lower cash-flow than projected in the prospectus.

After Facebook's IPO in May, many investors complained that the underwriting syndicate (including Morgan Stanley and JP Morgan) had not revealed all relevant facts in the prospectus. Also, many investors were unpleasantly surprised by the large amount of shares released on the market by the existing shareholders.<sup>64</sup> With this experience in mind, the FGVH listing is likely to turn out worse than Facebook's IPO. Morgan Stanley and JP Morgan are involved in FGVH's underwriting syndicate as well. Together with Deutsche Bank have the task to attract foreign investors. They have already convinced the French commodity trader Louis Dreyfus, the Middle Eastern sovereign fund Qatar Holding, insurance company AIA Group (Hong Kong) and asset managers Fidelity (United States) and Value Partners (Hong Kong) to invest in FVGH shares.<sup>65</sup>

But if Morgan Stanley c.s. have offered these investors adequate information concerning the environmental, social and governance risks of an investment in FGVH, including their possible financial implications, has to be questioned. The prospectus for instance fails to explain which relationship the settlers' cooperative KPF will have to the company, after the IPO. Two weeks after the prospectus was released, the government admitted that it "has to think about" how to give the settlers a voice on the board of FGVH.<sup>66</sup> The prospectus also fails to detail where the announced investments in new plantations will take place and how deforestation and land conflicts will be prevented. And the prospectus does not clarify how the company thinks to maintain its current production level, now many of its old plantations are getting too old and are only replanted in a slow pace.

What the prospectus does make clear is that - even worse than in the case of Facebook - the majority of the shares on offer will be existing shares offered by the existing shareholder, FELDA, which is an UMNO-controlled government authority. Each settler is already promised a windfall profit of 15,000 ringgit (€ 417 million in total). What will happen with the rest of the estimated proceeds of € 1.38 billion flowing into FELDA's pockets, remains an open question. But there is widespread fear that the proceeds of the IPO will be used by UMNO to buy a favourable result in the upcoming general elections, further undermining Malaysia's fragile democracy.<sup>67</sup>

This analyst report aims to give an overview of the criticism voiced with respect to FGVH's IPO, using the prospectus, Malaysian media reports and other sources.  
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