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Q2 Results – Still Feeling the Burn

Muddy Waters retains our original investment thesis and Strong Sell rating on Olam's shares. Our analysis of Olam's Q2 2013 results follows.

- Olam's main problems worsened in Q2. Its free cash burn was S$169.6 million for the quarter,[1] and its borrowings increased 5.6% QOQ to S$8,836.4 million. Olam's gross debt to LTM adjusted EBITDA is now 9.5x,[2] compared to 9.3x at the end of Q1. Olam's net debt to LTM adjusted EBITDA is now 8.4x, compared to 7.8x at the end of Q1. These numbers are dangerously high.

- While Olam generated positive operating cash flow in Q2 (for only the 13th time in the 32 quarters it has been public), interest expense was 69.9% of OCF.[3] With Olam's bonds yielding approximately 7% to 8% (which we feel is too low), Olam's interest burden is not sustainable.

- On the positive side, Olam management stated that it does not expect its debt to increase in 2H 2013.[4] Hopefully for investors, this prediction will turn out to be more accurate than Mr. Verghese's November 29, 2012 statement that Olam would not raise money through the markets for at least five months. It announced a US$750 million bond financing four days after he spoke.[5]

- Olam's YOY Q2 sales increase of 24.3% supports our conclusion that Olam's core trading business is faltering.[6] Tonnage grew far faster than sales – 71.9%. Further, Olam's PAT excluding extraordinary gains decreased YOY 6.3%. Note that in Q2 2013 Olam had the benefit of a full quarter of ownership of nine newly acquired companies, which makes the comparison that much more startling.

- One of the bright spots for Olam investors is that the Company appears to be trying to rein in its CapEx and acquisition spending. Some of management's comments during the presentation indicate that it might be heeding our calls to dial back spending. Olam appears to have noted our criticism of the

[1] Including S$25.8 million acquisition of non-controlling interest in the financing section of the cash flow statement.
[2] We adjust EBITDA to exclude biological gains and gains on sale.
[3] Calculated as OCF minus taxes, excluding interest income and expense.
[4] Q2 2013 results presentation ~ 1:03:45.
[5] See MW's December 4, 2012 report.
[6] See our initial report, pp. 22-26.

announced acquisition of a sugar mill in Brazil,[7] as it has cancelled the transaction. This is a positive for investors.

- On the other hand, Olam's acquisition selection is still questionable when viewing its mid-December purchase of Seda Solubles.[8] Olam bought Seda out of receivership for approximately S$65 million. The Seda transaction recalls Olam's acquisition of highly troubled SK Foods, which MW has strongly criticized.[9] Seda was going to be sold to the PE fund Magnum Capital Industrial Partners in July 2011; however, Magnum found accounting problems and did not complete the transaction.[10] Before Seda entered receivership, the controlling family was accused of diverting EUR 62 million from Seda.[11]

- Olam spent S$360.0 million on investments in the quarter, which was a worrying 134.8% increase from the S$153.3 million Olam spent in Q2 2012. As we noted in our initial report, Olam's non-specific CapEx spending levels, which was $296.2 million in Q2 2013, is troublesome.[12]

- We continue to have concerns about the Gabon urea fertilizer project. Management provided some color on the status, stating that it was currently experiencing "cost overruns", which the Company is trying to work through. One issue is that Olam has not even signed the construction contracts yet. The only work that has taken place is some dredging. Given these facts, we would not characterize the budget issues as overruns. Rather, it seems to us that Olam's expectations of project costs were unrealistic, which was likely a result of Olam's inexperience in greenfield production.

  Management addressed our question about whether North American shale gas production eviscerates much of the rationale for the plant by stating that it expects to sell to markets other than North America.[13] However, Olam emphasized the North American market when it announced the project in November 2010.[14] We interpret this redirection as additional evidence of haphazard planning.

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[7] See MW's initial report on Olam dated November 27, 2012, p. 50.
[8] http://olamonline.com/olam-international-acquires-soluble-coffee-assets-and-businesses-of-seda-solubles-for-us52m
[9] See the initial report, pp. 64-75.
[10] http://realdeals.eu.com/article/18815
[11] http://vozpopuli.com/empresas/3028-los-duenos-de-seda-solubles-desviaron-62-millones-antes-de-declararse-insolventes
[12] See our initial report, pp. 49-52.
[13] See our initial report, pp. 87-89.
[14] See Slides 21-22 of http://olamonline.com/wp-content/uploads/2011/12/nov152010-gabon_fertilizer-ppt.pdf

Management stated that production costs at the facility once completed would be US$75 per ton, which would be the lowest in the world. We advise investors to give little credence to this prognostication.

More to the point, we would applaud Olam if it walks away from this project. The Company seems not have a handle on the costs, and certainly has missed its estimate of the timeframe involved. It is a highly complex project that is well outside of Olam's core expertise. As we argued in our initial report, Olam's execution of far simpler projects is often flawed. We view Olam's inability to accurately forecast time and cost as a prelude of more problems to come if the project proceeds.

- "I can give you any IRR you want by changing urea prices by $5 or $10 or changing natural gas prices by a couple of cents to the dollar" said Mr. Verghese at the results presentation in reference to the Gabon fertilizer project. This reality speaks to the speculative nature of the project for one. However, it emphasizes a more important truth about Olam – one that we discussed at length in our initial report. Olam's fair value gains and Level Three derivative valuations are the products of models. The aforementioned quotation is perhaps the best criticism one could level at Olam's accounting practices.

- Olam sold and leased back 4,800 acres of land underneath its California almond orchards, booking proceeds of approximately S$68 million and an accounting profit net of taxes of S$18.1 million. [15] The pre-tax gain was S$27.8 million.[16] Olam touted this transaction as a positive for investors, showing how it can monetize some of its existing assets. Perhaps unsurprisingly, we take a different view.

  First, without the gain on the sale, Olam's PAT would have decreased 6.3% YOY. Second, because Olam realized an approximately 70% gain on the sale, we assume that the lease terms are fairly burdensome to Olam. When Olam sold the land, it also sold it with the lease. If the consideration Olam received for the land was so rich relative to Olam's allocation to the land cost, then it is likely due to Olam's tenancy. (Another possibility is that Olam under-allocated to land its purchase consideration for the ranches.) Regardless, Olam in effect took what was already a levered asset, and levered it even more. One could argue that this is really a case of expensive financing, rather than financial innovation.

[15] Page 19 of http://olamonline.com/wp-content/uploads/2013/02/H1FY2013FinancialStatements.pdf
[16] Page 19 of http://olamonline.com/wp-content/uploads/2013/02/H1FY2013FinancialStatements.pdf