

Commodities Sector

Positioning for a recovery

Optimism over economic recovery sparks re-rating. Commodities-related shares have staged a strong rally in recent weeks, driven by hopes of resurgence in demand, as measures taken by US policy-makers spurred optimism that a global economic recovery could be in sight. Commodities stocks surged by an average of 18% during the month of March, outperforming the Straits Times Index's (STI) 11% return. In particular, Olam Int'l (Olam) outperformed its peers with an impressive 27% gain.

The haze has yet to clear. In our view, it could be premature to call a bottom at this juncture. Economic indicators remain mixed - while inflation has been tapering off and commodity prices have somewhat stabilized, weakness in global trade persists, credit markets are still in the process of thawing and growing unemployment could continue to weigh on demand. A sustainable improvement in demand and supply fundamentals must be backed by a convincing recovery of the real economy, which we have yet to see. In the near term, potential earnings disappointment could create more downside risk.

Olam offers earnings stability, but Noble is better poised to ride economic recovery. Among the realm of commodities-related companies, Olam will continue to gain favour in the *near term* for its resilient earnings growth profile amid an environment of earnings contraction. However, in the *medium term*, Noble Group Ltd (Noble) is better poised to reap the benefits of economic recovery. Our view stems from their respective product portfolios - Olam deals solely in agricultural commodities (mainly food, for which demand is relatively inelastic), whereas Noble's portfolio encompasses a broader spectrum of commodities spanning agriculture, energy, metals, minerals and ores. Metals and energy expose the group's earnings to more cyclical volatility, but also enable the group to participate in governments' pump-priming initiatives.

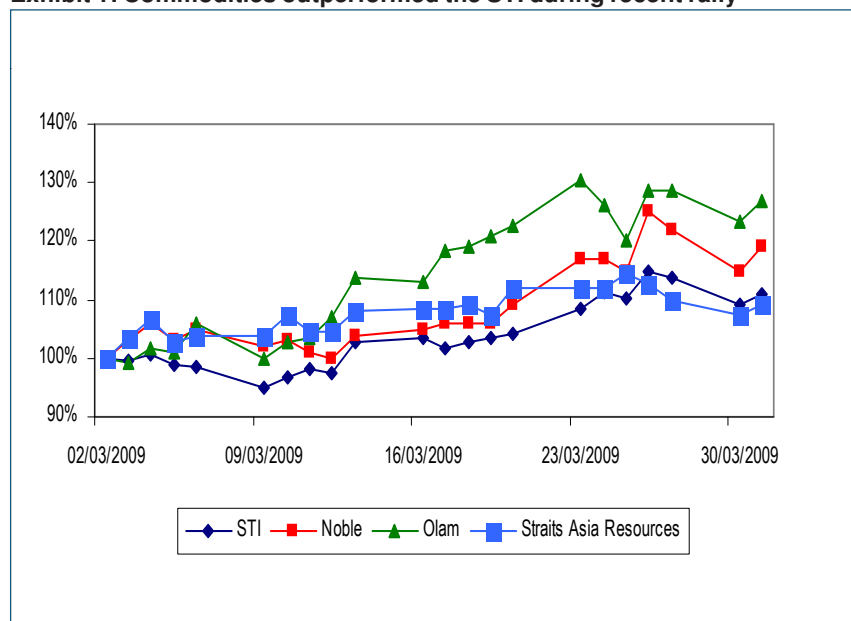
Noble is our preferred choice. We are anticipating positive earnings growth from Olam and Straits Asia Resources Ltd (SAR) and negative growth from Noble for 1Q CY09. Nevertheless, Noble remains our top pick in the sector as it will be the key beneficiary of macroeconomic recovery. In addition, Noble enjoys the healthiest balance sheet and is trading at a substantial discount to Olam. We retain our **BUY** ratings on Noble (fair value S\$1.33) and Straits Asia Resources (fair value S\$1.15). We are downgrading Olam to **HOLD** on valuation grounds given the recent run-up, but raising our fair value estimate to S\$1.51 (from S\$1.37). Catalysts for the sector include: (i) economic recovery, (ii) improvement in credit markets, and (iii) pump-priming initiatives.

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	Share price (S\$)	PER (x)	Dividend Yield (%)	Price/NAV (x)	Fair Value (S\$)	Rating
Noble	1.20	7.2	3.5	1.5	1.33	BUY
Olam	1.44	13.3	2.9	3.9	1.51	HOLD
Straits Asia Resources	0.81	2.2	18.5	1.7	1.15	BUY

Raw materials reaching a fundamental trough? Commodities stocks generally outperformed the broad market in March. Olam surged by 27%, Noble gained 19% and Straits Asia Resources rose 9%. In comparison, the Straits Times Index (STI) turned in an 11% increment (exhibit 1). The positive re-rating came on the back of expected improvements in demand and supply fundamentals as the effects of pump-priming initiatives are expected to start flowing into the real economy. In addition, lower inventory levels have fuelled sentiment that re-stocking could occur soon.

Exhibit 1: Commodities outperformed the STI during recent rally

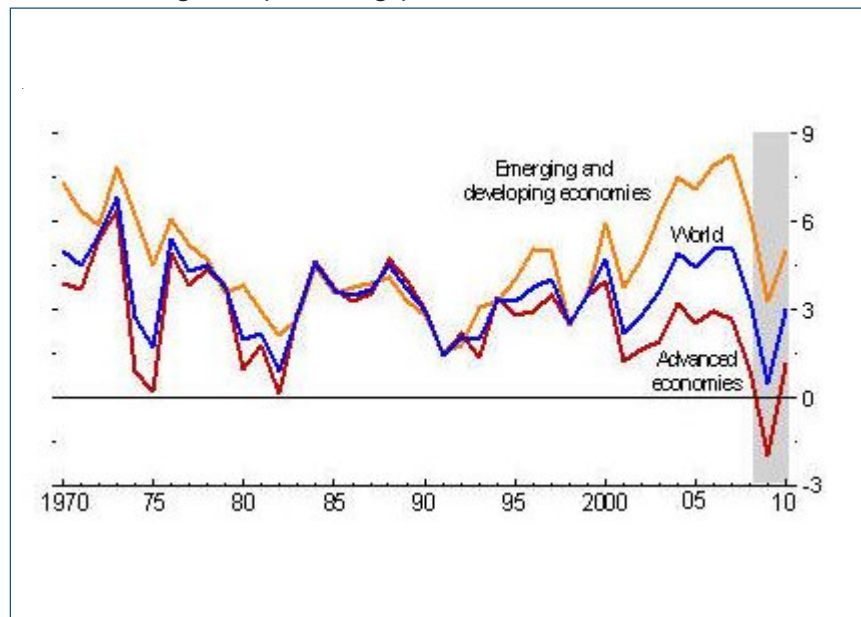


Source: Bloomberg

Economic indicators remain mixed. Measures taken by US policy-makers have spurred hopes that a global economic recovery could be in sight. In addition, coordinated pump-priming activities across nations could arouse an economic recovery in the near future. Positive economic indicators so far include easing inflation and stabilization of commodity prices. However, data from the International Monetary Fund (IMF) and World Bank paint a less sanguine picture. The IMF has revised its 2009 growth forecast downward to 0.5% from 1.2%, while the World Bank predicts that global GDP could shrink by 1.7% this year, making it the first fall on record¹. As such, we remain cautious on earnings outlook.

¹ *Business Times, 1 April 2009: Global economy stares at first contraction on record*

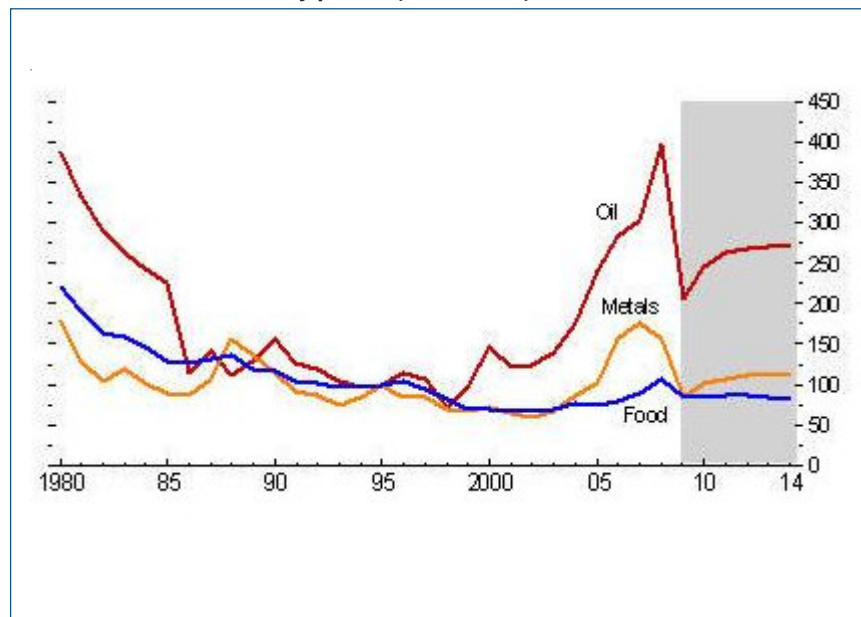
Exhibit 2: GDP growth (YoY change)



Source: IMF estimates

Positioning for the recovery. On the bright side, the economy is widely expected to bottom out in 2009 and stage a recovery by 2010. Commodity prices are expected to recover from their recent troughs. As exhibit 3 illustrates, the IMF expects the oil and metals markets to rebound rather strongly, while projecting relative stability for food. This supports our judgment that Noble could outperform Olam once an economic recovery is in sight, given its exposure to hard commodities. Since equities are typically leading indicators of the real economy, Noble's shares could re-rate before the real economy picks up.

Exhibit 3: Real commodity prices (1995 = 100)



Source: IMF estimates

Exhibit 4: Comparison of business models

	Noble	Olam	Straits Asia Resources
Description	Supply chain manager	Supply chain manager	Coal miner
Product portfolio	- Agriculture - Energy - Metals, minerals and ores	- Agriculture	- Thermal coal
Key earnings driver	Volume	Volume	Coal price
Inventory hedge ratio	91%	86%	73%*

* Refers to the proportion of FY09 output committed

Source: OIR

Noble is our preferred choice. Among the realm of commodities-related companies, Olam will continue to gain favour in the *near term* for its resilient earnings growth profile amid an environment of earnings contraction. However, in the *medium term*, Noble is better poised to reap the benefits of economic recovery given its exposure to hard commodities. As for Straits Asia Resources, it is on track for a year of record earnings in FY09, but lower coal prices going forward imply lower revenue, earnings and margins from FY10 onwards.

Olam will likely command a premium to Noble in the near term by virtue of its continued earnings accretion. In contrast, we are anticipating a contraction in Noble's earnings in FY09 due its exposure to cyclical commodities. However, Olam's merits may already be priced in at current levels. It is trading at 13.3x current PER, exceeding the STI's (11.4x) and Noble's (7.2x) valuations. At current prices, we prefer Noble for its more attractive valuations and stronger balance sheet - it is in an adjusted net cash position, whereas Olam has an adjusted net gearing of 0.55x.

We are keeping our estimates intact but raising Olam's fair value estimate to S\$1.51 (from S\$1.37) as we realign it with the STI's 11x PER (previously 10x). Given the limited upside to our target, we downgrade Olam to **HOLD**. We retain our **BUY** ratings on Noble (fair value S\$1.33) and Straits Asia Resources (fair value S\$1.15).

Exhibit 5: Peers comparison

	Price	Mkt	Net	Historical	Est	P/Bk	Div	ROE
		Cap	Margin	PER	PER		Yield	
	(S\$)	(\$m)	(%)	(x)	(x)	(x)	(%)	(%)
Noble	1.20	3,877	1.6	4.8	7.2	1.5	3.5	34.0
Olam	1.44	2,467	2.1	14.3	13.3	3.9	2.9	23.6
Straits Asia Resources	0.81	885	21.3	5.0	2.2	1.7	18.5	33.1
Average			8.3	8.0	7.6	2.3	8.3	30.2

Source: OIR estimates

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