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HALLGARTEN & COMPANY

Results Note

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Feronia (FRN.v)

Strategy: SHORT

Key Metrics	
Price (CAD)	$ 0.185
12-Month Target Price (CAD)	$ 0.080
Upside to Target	-57%
High-low (12 mth)	$0.06 - $0.21
Market Cap (CAD mn)	$ 64.18
Shares Outstanding (millions)	346.9

	2015	2016e	2017e
Consensus EPS		n/a	n/a
Hallgarten EPS (est.)		($0.02)	($0.02)
Actual EPS	($0.20)		
P/E	n/a	n/a	n/a

Feronia

Red Ink Continues to Flow

- + Revenues and production rising, though net result is still heavily in the red
- ✘ Conversion of debenture in April blew out shares on issue from 55 million to over 300 million
- ✘ Problems with plant and insect infestations resulted in substantial replantings being required
- ✘ New plantings are suspended since early 2015 due to lack of funds
- ✘ New government rules from 2011 have yet to be implemented but could threaten the company's control position in its plantations and estates
- ✘ Company's website is woefully out of date stating a mere fraction of the number of shares actually on issue
- ✘ The travails of other companies in the same corporate grouping reflect negatively on the company in the minds of institutional and London investors

Those Who Forget History Are…..

In many ways Feronia is a microcosm of what ails the plantation sector, with an added overlay of unimpressive management. The sector seems attractive on paper and the dynamics may seem promising but the reality is very long lead times on cropping, thus investment without return for a long period, variable prices over that long period then an almost inevitable accumulation of debt and drainage of capital followed by a decision to "suspend planting for a short period" that ends up in the situation that made the previous holder vend a plantation in the first place. We can note that actions in the last two years at Feronia are already reminiscent of those in the dying years of Unilever ownership of these assets.

Like all "high-grading" what is jam for today becomes misery for tomorrow. The worst part of Feronia is that there is not even any jam today as the company continues to wallow in losses despite having shrunk investment and ceased plantings quite a while ago. In this brief note we shall look at the performance thus far in 2016.

Laying All its Bets on the DRC

Feronia is a large-scale commercial agricultural company which is currently focused on two operations in the Democratic Republic of Congo: palm oil plantations and arable farmland. The plantations were purchased from Unilever at the end of last decade after the multinational group decided to exit a business activity that it had been engaged in for most of the preceding century.

The business model consists of identifying and consolidating farm land and operations in the DRC and rehabilitating them back into production using modern agricultural techniques and practices. However thus far it has achieved virtually nothing with its arable land project and it has replaced a significant amount of the old plantations but has suspended ongoing plantings due to tough financing conditions.

The Plantings

The usual lifespan of an oil palm is over in around 25 years. The first three/four years of the palm's existence are non-productive as it grows to maturity, thus the productive life of the average palm is a bit over twenty years. With Unilever gradually exiting oil palm plantations over the decade before Feronia acquired its DRC position, investment was low in replanting of the existing stock of oil palms.

Plantations (Hectares)

		As at June 30, 2016			Total as at June 30		
		Lokutu	Yaligimba	Boteka	2016	2015	2014
Immature							
Year 0		-	-	-	-	-	1,859
Year 1		140	3,032	-	3,172	4,639	5,007
Year 2		2,400	902	437	3,739	5,007	3,924
Year 3		2,200	-	675	2,875	3,924	2,110
	Total	4,740	3,934	1,112	9,786	13,570	12,900
Producing							
4 - 7 Years		3,286	2,732	1,756	7,774	5,293	3,941
8 – 18 Years		1,057	948	800	2,805	1,362	1,198
19 – 25 Years		2,584	1,108	-	3,692	4,246	4,469
	Total	6,927	4,788	2,556	14,271	10,901	9,608
Total Planted		**11,667**	**8,722**	**3,668**	**24,057**	**24,471**	**22,508**

As the preceding table shows planting activity has been quite intense in recent years with the peak of activity being 2013 after which planting trailed off with no planting claimed to have been done since the start of 2015.

However the company also reported (in March quarter MD&A) that the loss rate of young palms planted in Yaligimba in 2013 and 2014 was unusually high due to a severe infestation of *Cromolaena* (a rampant weed, pictured at right) and termites. Due to the high loss rate and subsequent replanting with younger palms at Yaligimba, management decided, rather confusingly, to reclassify 3,032 hectares of the 2013 and 2014 plantings as 2015 plantings. Management claims that improved plantation practices, including the introduction of chemical spraying, means that these high loss rates should not recur.

The effect of the coming on stream of the newer trees is evident in the production number for the three months ended June 30, 2016 as the company processed 35,560 tonnes of Fresh Fruit Bunches (FFB) and produced 6,968 tonnes of Crude Palm Oil (CPO), representing increases on the three months ended June 30, 2015 production levels of 52% and 54% respectively. In 1H16, the company processed 56,836 tonnes of FFB and produced 11,013 tonnes of CPO, representing increases over the corresponding period in 2015 of 35% for both. These increases were due to an increase in the number of producing hectares of 3,370 ha to 14,271 ha compared to the same period in FY15.

Tax

One is used to seeing little to no tax payable on mining company earnings statements and it is rare also to see it on perpetually loss-making companies but in the case of Feronia it has registered tax liabilities in both of the quarters so far reported for FY16 but moreover reported a surprising tax liability of $7.925mn in FY15 despite a pre-tax loss of $17mn. Therefore the post-tax loss ended up at over $24mn.

This intriguing situation sent us probing the notes to the FY15 results. Some $7.5mn of the tax liability was described as "Origination and reversal of temporary differences". This is a novel description of an accounting item that we have not encountered before. A closer examination of the breakdown of the full $7.925mn can be seen in the table below.

Feronia - FY2015 Tax Liability Breakdown

Loss before tax	(17,021,898)
Tax recovery calculated at Canadian statutory rate	(4,510,803)
Tax effects of difference of foreign tax rates	(1,298,398)
Recognition of benefit previously not recognised to equity	181,584
Impact of differences between current and future tax rates	1,354,338
Non-deductible expenses	261,974
Losses not recognized	11,603,678
Other	333,506
Income tax expense	7,925,879

The most intriguing thing about this table is the reference to "losses not recognized". In the absence of any explanatory notes, one can only presume that the tax authorities of the DRC have decided to NOT recognize certain things that the company has deemed to be losses. Looking at the balance sheets subsequent to this revelation we see only very small amounts booked as Deferred Tax Liabilities ($1.24mn as at June 2016). We are taking it to mean that the company will not be able to offset profits (if they have any) against tax losses in the future and realising this decided to declare the liability early, thus bundling it in a year which had super-losses on operations and other things.

Some Debt Mitigation at Massive Dilution Cost

Debt at this company, like others in the same corporate grouping, does not seem to concern management overly, but it does concern us. In April the company undertook its first drawdown (of $15mn of a $49mn facility. At the same time, all of the secured convertible debentures issued in 2015 and 2016 automatically converted into common shares of Feronia. As a result, a total of $31,330,000 principal amount of debentures and $2,700,946 of accrued interest converted into an aggregate of 291,693,813 common shares. This exploded the shares on issue from around 55mn to over 300mn. The dilution of minorities was brutal. This is a scenario we have seen repeated this year at Galane Gold.

FERONIA

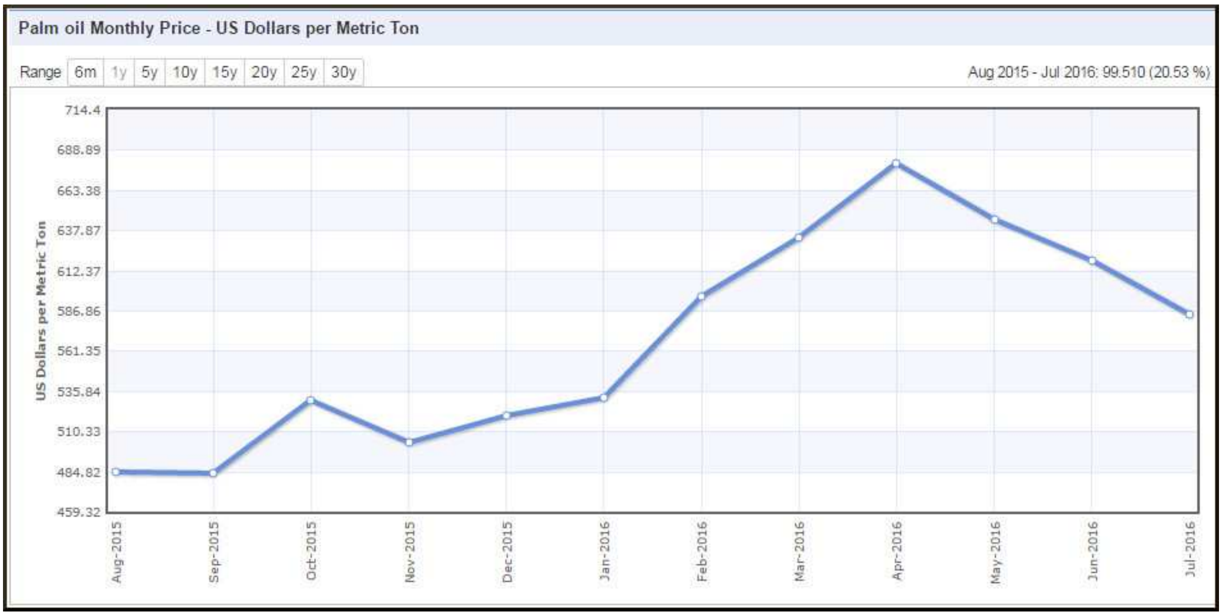
In Millions of USD

	FY17e	FY16e	4Q16	3Q16	FY15	4Q15	3Q15	2Q15	1Q15	FY14	FY13	FY12	FY11
Total Revenue	18.46	16.25	3.90	3.966	10.936	4.20	0.79	3.46	2.49	10.83	6.69	7.13	7.45
Cost of Revenue, Total	15.70	15.27	2.37	6.406	14.367	6.33	1.34	2.83	3.87	15.113	9.58	9.68	6.83
Impairment of Arable Assets					4.231	4.23				0.496			
Gross Profit	2.76	0.977	1.54	-2.44	-7.662	-1.45	-0.55	0.63	-1.38	-4.779	-2.9	-2.55	0.61
Selling/General/Admin. Expenses	10.2	9.86	2.39	2.583	13.479	4.20	3.35	2.77	3.16	11.723	10.59	9.76	11.05
Depreciation/Amortisation					0.00	0.00	0.00	0.00	0.00	0.02	0.06	0.06	-
Revaluation of Biological assets					-15.04	-9.87	3.70	3.78	-12.65	1.69	-3.51	-5.12	-0.65
Other Operating Expenses, Total					0.153	0.13	0.03	0.06	-0.07	0.438	0.05	0.06	0.03
Total Operating Expense	25.90	25.13	4.76	8.99	12.96	2.87	8.42	9.45	-5.69	29.46	16.76	14.45	17.25
Operating Income	-7.44	-8.883	-0.85	-5.02	-2.03	-0.57	-7.63	-5.99	8.18	-18.63	-10.08	-7.32	-9.8
Interest Income (Expense)	-4.48	-4.67	-4.14	4.87	-11.745	-8.27	-1.45	-1.087	-0.944	-1.081	-	-	-
Other, Net	0.10	-0.36	0.96	-0.09	0.982	-0.59	-4.67	4.573	1.664	-0.22	-0.20	-0.08	0.00
Income Before Tax	-7.34	-9.24	-4.031	-0.252	-17.02	-9.424	-13.75	-2.50	8.90	-19.71	-11.00	-7.01	-5.62
Tax	1.13	0.81	0.48	0.076	7.925	5.76	-2.95	0.59	4.53	0.56	1.86	1.94	1.21
Income After Tax	-8.47	-10.05	-4.51	-0.328	-24.95	-15.18	-10.8	-3.09	4.37	-20.27	-12.86	-8.95	-6.83
Minority Interest	-1.69	-2.01	-0.87	-1.732	-3.564	-6.37	1.95	1.73	-0.87	4.62	2.75	2.29	1.11
Net Income After Minorities	-6.78	-8.04	-3.64	1.404	-21.38	-14.68	-8.85	-1.35	3.5	-15.65	-10.12	-6.66	-5.71
Diluted Weighted Average Shares	352.00	346.94	305.261	55.24	55.21	55.22	55.24	55.23	73.81	55.21	31.02	15.51	13.36
Diluted EPS Excluding Extraordinary Items	-0.02	-0.02	-0.01	0.03	-0.39	-0.05	-0.16	-0.02	0.05	-0.28	-0.33	-0.43	-0.43
Diluted Normalised EPS	-0.02	-0.02	-0.01	0.03	-0.20	-0.1	-0.12	0.02	-0.06	-0.26	-0.4	-0.64	-0.46
Tax Rate	-15.4%	-8.8%	-11.8%	-30.2%	-46.6%	-61.1%	21.5%	-23.6%	50.9%	-2.8%	-16.9%	-27.7%	-21.5%

In the March quarter the company stated that its finance costs related largely to the interest on debentures. The 21% increase in costs in H1 2016 compared to the same period in the prior year was due to the increased number of debentures outstanding in 1H16.

One thing that struck us was the massive $6.292mn positive "finance income" number that managed to turn what would have been a sizeable loss to a positive bottom line. They did something similar in the same quarter of FY15, but in that case it was a novel revaluation of biological assets.

The company claims that this financial income reflected the change in the IFRS valuation of warrants and derivatives related to the convertible debentures issued in 2015 and 2016, even though the debentures were gone two weeks after the end of the quarter. The finance income was a non-cash item.



Risks

Where to start? The risks pile up and many, quite literally "come with the territory". The obvious unavoidable risks are:

- Political risk in the DRC is always a paramount concern, this includes not only government measures but insurgent action
- Weather issues are always a factor in agriculture
- Weak palm oil prices. These have been sliding since April of 2016.
- High debt burden
- Ongoing losses leading to financing difficulties
- Reputational risk of being associated with the current corporate grouping
- Environmentalist action as part of on-going global campaign against oil palm plantations
- Further dilution of minorities by "related parties"

Conclusion

Feronia's project in the DRC is starting to look like a black hole. By this stage we should have been seeing steeply rising revenues and net cashflow. Instead sales have not moved in line with volume increases, the price of palm oil has eased off substantially since April and the company is still reporting a bottom line in the red and has resorted to the age-old firefighting technique of stopping new plantings.

The market took some brief solace from some multi-lateral financial institutions extending credit to this company but then the reality set in and the stock plunged to 10cts where it dallied along while before bizarrely rallying on no particular news. The stock is chronically illquid despite the massive issuance of new shares. Shareholders who agonized through the lengthy plantation rehabilitation process are now being squeezed out through a creeping takeover by "related parties".

The company distanced itself slightly from the corporate grouping it has long belonged to, but unfortunately still shares a director in common.

We reiterate our **SHORT** stance on this company with our twelve-month target price being CAD$0.08.

Important disclosures

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