# Eagle High Plantations: Examples From the Palm Oil Industry Relating to Natural Capital

June 26, 2015, Palm Oil Plantation Owned by Eagle High Plantations.

In 2015, Felda Global Ventures – now FGV Holdings – (FGV) hired KPMG to conduct a fair market valuation due diligence on Eagle High in connection with FGV's acquisition of a minority stake in Eagle High. KPMG's report found that Eagle High generated over 80% of its revenues by selling crude palm oil (CPO) at the time.

It also noted that Eagle High, a large publicly traded firm, was in urgent need of cash to fund its operations; had violated loan covenants due to poor past performance; and, that 17 of its plantations' permits and land rights had expired. KPMG advised FGV to revise down its valuation to $680 million to better account for the reported ESG, sustainability, and credit risks.

In 2015, KPMG warned Eagle High Plantations about its material concerns regarding the company's proposed partial sale, inability to pay smallholders, not paying the Government of Indonesia income taxes payable, and other financial concerns. At issue was Eagle High Plantation's potential misapplication of IFRS 16: Leases. [Note: IFRS 16 replaced IAS 17 on 1 January 2019.]

IFRS 16 specifies how leases are to be recognized, measured, presented, and disclosed within financial statements. IFRS 16 stipulates that leases are required to be classified as one of the two following types:

- Finance leases: This transfers substantially all the risks and rewards of ownership and give rise to asset and liability recognition by the lessee and a receivable by the lessor; in some jurisdictions, such as the United States, these are known as capital leases.
- Operating leases: This results in expense recognition by the lessee, with the asset remaining recognized by the lessor.

KPMG noted that Eagle High Plantations' proposed sale of 37% to FGV Holdings for $680 million was based on Eagle High's listed planted area of 136,677 hectares valued at $17,400 a hectare. However, KPMG noted that the 136,677 hectares were overstated by the inclusion of smallholders' land of (est.) 3,259 hectares. KPMG went on to conclude that the information provided by management identified a potential shortfall of 8,000 hectares.

> "From our due diligence, we noted the reported INTI planted areas of 136,677 ha may be overstated:
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> - total PLASMA planted area of 18,677 ha provided by Target's agronomy team was higher than the recorded planted area provided by the Vendor (RCI), which is used for the Group's valuation of 15,418 ha. The variance of 3,259 ha is currently recorded as part of INTI's 136,677 ha and will form part of the PLASMA planted area once the exact locations of the allocated concessions are finalized with the cooperatives.
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> - plantation companies in Indonesia are required under the Plantations Act and Ministry of Agriculture Regulation 98/2013 to develop an area surrounding community estates at a minimum of 20% of total planted area. Management stated the 205 obligation is only applicable to planted areas after 2007. Using the information provided by management (e.g., total planted area by year of planting, operational plasma reports and breakdowns), we noted a potential shortfall of approximately 8,000 ha. Management explained the potential shortfall computed may not be accurate as there are planted INTI areas to be allocated for the PLASMA program pending the formation of plasma cooperatives, which can take up to a few years to complete; and
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> - planted areas for certain entities (e.g., PT Sawit Sukses Sejahtera, PT Bumilanggeng Perdanatrada, and PT Bumihutani Lestari) were approximately 6,000 ha higher than the land concession area (over planted), which may lead to land disputes (e.g., claims by third parties)."

Eagle High Plantation noted that the deficiency in hectares related to Indonesia's plasma program stating: "[T]here are planted nucleus areas to be allocated for plasma programmes, pending the formation of plasma cooperatives, which can take up to a few years to complete."

Eagle High's 2016 annual report clarified its holdings after accounting for its leases within the plasma program under IFRS 16. As part of its new reporting, Eagle High Plantation lowered its reported land holdings from 136,677 to 133,457 hectares. The leases are also secured by the Plasma farmers' crops and the company's inventory of crops.

KPMG stated:

> "We noted potential breaches of financial ratios for certain subsidiaries as of 31 December 2014. Total outstanding loan balances in relation to these facilities amounted to $239.7 million."
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> "Total planted area for certain entities were higher than the land concession area, which may result in land disputes (e.g., claims made by third parties) – KPMG comment – FGV to adjust their valuation as appropriate."

Eagle High's issues involving IFRS 16: Leases resulted in an understatement of its total liabilities. In turn, this would result in investors underestimating its leverage and financial position, overestimating its operating performance, and overestimating its valuation.

IAS 1.69 requires that, if an "entity does not have an unconditional right to defer settlement beyond 12 months," then liabilities should be classified as current. The KPMG due diligence report found violations of covenants, which essentially strip Eagle High's right to defer settlements. Therefore, long term notes with violated covenants should have been reported as short-term liabilities. The classification as long-term caused the company to misrepresent its liquidity risk and long-term solvency. Consequently, all investors, not just FGV were likely to understate the risks to the company, and to overvalue Eagle High's equity.

IAS 41 falls within the general definition of assets, which only includes the resources from which the entity has full title and rights. The fact that plantations with expired rights were reported as assets undermined the company's legal risk exposure, which generally would allow Eagle High to borrow at a lower rate. Because valuation models for financial assets take as key inputs market borrowing rates, investors were likely to, again, misunderstand the financial condition of Eagle High.

IFRS 13 requires the disclosure of information that permits companies to arrive at the amounts reported for biological assets in their financial statements. Had Eagle High disclosed this information, readers would have been able to independently verify the assumptions and results of valuation models.