CHIEF EXECUTIVE OFFICER'S REVIEW

By Robert Meyer

At the end of 2018, Halcyon Agri Corporation Limited was 8 years and 8 months old.

Looking back, we acquired our first two factories in 2011, and the immediate focus thereafter was on synchronising the processing operations with our risk-averse marketing model, and, that being done, listing the company on SGX in February 2013. Following that, we expanded our operations both geographically and along the value chain. By the end of 2015, we owned 14 factories, our first greenfield rubber plantation project, and the beginnings of a global distribution network. In our second big growth push, 2016 saw us embark on our most ambitious project to date, the acquisition of Sinochem's global natural rubber business, which included the privatisation of GMG Global Ltd. In 2018, we rounded off our Indonesian portfolio with the acquisition of another five factories, and made a final addition to our global distribution business – by now the world's leading - towards the end of that year.

Halcyon Agri now owns and operates 38 factories, employs over 17,000 people in 35 countries and owns plantations covering more than 100,000 hectares (of which 40,000 are planted). **In 2018 we became the biggest supplier of dry rubber and latex globally**, with an aggregate delivered volume of 1,432,335 mT.

Taking stock, it seems that 2018 was an important year not just for our group, but also for many facets of the global economy and perhaps even for civil society. **Several geopolitical and societal developments strike me as being of particular significance:**

1. The U.S. will not cede its position as the world's leading economy to China without a fight
2. Income inequality within developed economies is producing irrational outcomes at the ballot, and the ever-widening wealth gap between frontier and developed economies has unleashed migratory forces that potentially threaten the World Order
3. Climate change is upon us regardless if politicians and world leaders are prepared to acknowledge or to deal with it

The ongoing tariff dispute between the U.S. and China is a testament to the first point. While there is much political posturing, the strategic rationale for the tariff conflict may well lie in two ideological and systemic differences.

Firstly, most post-war U.S. administrations have engaged in global interventionist policies, while China has continued to pursue its policy of 'non-interference in the domestic affairs of other countries'. Secondly, the American conviction is that government stays out of the business arena, while state-owned enterprises in China account for 30%-40% of Chinese Gross Domestic Product (GDP).

Several decades of pursuing these policies have resulted in imbalances that endanger the friendly coexistence of the two most successful political and macroeconomic systems since World War II.

In an apparent paradox, the U.S. can lay claim to the world's most thriving economy on one hand, and the most indebted government on the other. The National Debt is due, in no small part, to the U.S. providing global security and military support services in the name of upholding the democratic order. In current day, **the United States government has become the world's largest debtor, relying on the world's largest creditor and its principal lender, China, to provide continuously increasing amounts of funding**. Hindsight suggests that this was a tenable situation so long as the American economy was much bigger than the Chinese economy in absolute terms, but the last two years have seen increased friction between the world's leading economic superpowers.

The key driver of the American economy has always been innovation and creativity, both of which require robust safeguarding of intellectual property (IP) to deliver a sustained competitive advantage. At the point in time where China's GDP is threatening to eclipse that of the U.S., Chinese infringement of American IP has become the battle-cry for a critical mission: **defend the economic status quo, with all else up for renegotiation**. Adding further pressure to the American economic outlook, Chinese state-owned enterprises (SOE) have been on a global acquisition spree, cleverly navigating the *laissez-faire* capital markets of the West to gain control of strategically important technologies, raw materials and market access.

The inevitable American response, such as the imposition of trade tariffs, more stringent CFIUS intervention in SOE-driven mergers and acquisitions, and intensified U.S. efforts to denuclearise the Korean peninsula, has increased **global volatility** and taken over the centrestage of global newswires.

Much has been written about income inequality, not only within the U.S. and Europe, but also between regional neighbours such as the European border states and the Middle East North Africa (MENA) region. A **deep sense of disillusionment seems to have taken hold of large parts of the developed world**, leading to irrational outcomes at the ballot box and, as seen recently in France, demonstrations and street protests. The migratory forces originating from the MENA region into Europe are a source of much anxiety for large tracts of the European Union (EU) population, and threaten the prevailing mindset of tolerance and acceptance.

As to my third point on climate change: At the 2018 World Economic Forum (WEF) in Davos, Sir David Attenborough, famed broadcaster and natural historian, warned that human activity has brought about the end of climatic stability. To quote: *"If people can truly understand what is at stake, I believe they will give permission for business and governments to get on with the practical solutions. Get it right, and humans can create a world with clean air and water, unlimited energy and sustainable fish stocks, but only if decisive action is taken now."* A WEF survey taken just prior to the event showed that **environmental threats are now the biggest danger to the global economy**[i].

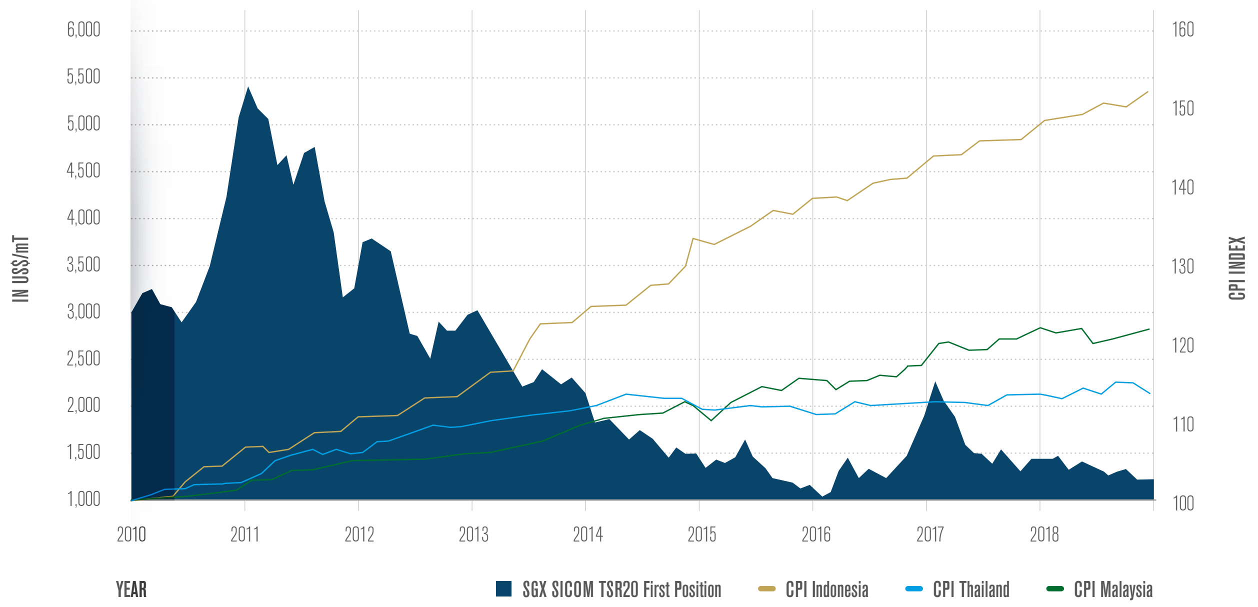
How do these developments impact Halcyon Agri and the global market for natural rubber?

The outlined shifts in geopolitical agendas and voter consciences may well bring to an **end this current era of Globalisation**. Instead, key indicators point towards a resurgence in national security awareness, for instance of the high risk of a supply disruption for a raw material of significant economic importance, such as natural rubber. In September 2017, the European Commission identified natural rubber as a **critical raw material for the European Union**[ii].

Furthermore, an inconvenient, but very real truth is that the technology and low-interest-rate driven economic cycle of the last 10 years has failed to deliver a sustainable price environment for key crops such as natural rubber. While global asset prices and capital market pricing benchmarks have doubled, even trebled, rubber prices have tumbled. Farmers who planted rubber trees during the high-price period of 2005-2011, have had to realise that this has been a poor investment, thus far. **Without exception, all origins of natural rubber have experienced significant consumer price inflation (CPI) over the last 10 years**, which has caused labour costs to more than double in Indonesia, for example. This is in stark contrast to the FOB price of natural rubber, which remains locked 40% below the 10-year average price!

Rubber Price & CPI Indices

(2010 to 2018)



Ecological concerns, brought about by changing weather patterns, impact the natural rubber industry beyond the immediate agricultural effects of climate change. In 2017, General Motors announced a sustainable sourcing strategy[iii] for tyres and the natural rubber they contain. Other major automotive manufacturers have since launched similar initiatives, which has brought a group of principal industry actors together to form the **Global Platform for Sustainable Natural Rubber**[iv] (GPSNR). Halcyon Agri is a founding member of this important platform, which has defined its sustainability principles and has commenced operations.

Oddly absent, in the first iteration of sustainability principles, is the notion of fair prices. **Ensuring sustainable economic outcomes along rubber's value chain has long been a focal point of Halcyon's corporate strategy**. In part because higher prices deliver us better operating margins, but largely because we depend on a continued supply of smallholder-produced raw material to meet the ever-growing demand for natural rubber. The reality is that subsistence farmers produce more than 90% of global natural rubber supply. Rising CPI and minimum wages have made even the most basic and unskilled jobs in construction or manufacturing pay twice as much as the average farmer can earn from tapping his rubber trees.

Lured by the high-price period from 2005 to 2011, increased planting mainly in Thailand, Indochina and Ivory Coast has masked a significant increase in global demand. Annual consumption has expanded by more than 30% to 13.8 million mT between 2010 and 2018. **In absolute terms, demand has grown by 3 million mT over eight years – which has required an increase in planted acreage by 30,000 square kilometres – roughly the size of Belgium!** There is little reason to believe that demand growth will slow down, but how can we expect supply to keep up when prices are at historical lows and further land clearing for new plantings is no longer feasible?

In addition to the increasingly complex framework of supply, demand and sustainability principles, 2018 saw a group of relative newcomers to the natural rubber industry firmly taking their seat at the table, **Non-Governmental Organisations or NGOs**. Equipped with war chests that are much bigger than any rubber planters could ever be, they **pursue a twin agenda**: socio-economic development of indigenous communities, and ecological conservation. With prior experience from the pulp & paper and oil palm sectors, NGOs have gained much traction in the rubber business within a very short period of engagement. They are a force for good, and one that, carefully harnessed and directed, will help rubber market participants to build a sustainable future.

So let us take stock of where we are today. **The New Normal, as we might call it, is a state of contradiction: increased demand and supply, low prices leading to record-lows in actual farmer incomes, set against a backdrop of rising ecological and socio-economic awareness**. The obvious remedy might be to cut down trees, and then prices might rise? Perhaps, but who will bear the immediate economic loss? Political agendas, a painful reality in most rubber-producing regions, render this obvious remedy inexpedient. Austere logic has never won many votes.

My view is that technology has the potential to reverse rubber's declining fortunes. Mobility **apps are making it easier and cheaper for people to commute**. Historical entry barriers, such as vehicle ownership itself, regulatory hurdles such as driving permits, and even basic health requirements, are falling away. Consequently, **the world is likely to consume more mobility at lower levels of per capita GDP** – which suggests further expansion of rubber demand. Tyre technology will have to evolve to cater to these new developments, as will regulation, but driven miles - *the single largest demand driver for natural rubber* – **is a metric that is likely to keep increasing**.

While some countries still permit legal deforestation, the global market place will not accept an irresponsible supply chain much longer. **Sustainably farmed and produced rubber must offer better returns than commodity grade rubber**, and technology will help to distinguish the one from the other. Mobile **technology provides the technical means to connect with smallholders**, to assess their farming, harvesting and delivery models and to monetise that information along with the physical product.

The benefits of new technology are thus twofold: one, **stimulating rubber demand** by making 'mobility' more accessible, two, **stabilising supply chain returns** by financially rewarding responsible and sustainable behaviour.

Halcyon Agri has spearheaded the development of this technological evolution of the industry. In 2018, we incorporated HeveaConnect as a digital marketplace to merchandise our TÜV SÜD -audited HEVEA*PRO* grade of responsibly produced rubber. As we further integrate traceability and ultimately agronomical data, we will expand the sustainable certification options to HEVEA*TRACE* and HEVEA*GROW*.

In December, HeveaConnect received an unprecedented endorsement in the form of a **direct equity investment** by South East Asia's largest financial institution, **DBS Bank Ltd**. A forerunner in digital financial services, DBS Bank will support the growth of HeveaConnect to include a suite of financing options for value chain participants. Trade finance, simplified documentation, and smallholder microfinancing – these are exciting future possibilities for discerning producers and consumers of HEVEA*PRO*. From its launch in Q1 2019, HeveaConnect will invite other producers to invest in its share capital and to adopt the HEVEA*PRO* methodology. In March 2019, **ITOCHU Corporation** of Japan joined the ranks of HeveaConnect shareholders - another milestone event.

In order to prepare Halcyon Agri for these anticipated future shifts, we embarked on a **strategic review** of our asset base in 2018. Two key realisations stand out: Firstly, fundamentals differ greatly across origins, mainly due to labour costs and raw material availability; secondly, and most importantly, **Halcyon Agri's market capitalisation represents a deep discount to the sum-of-the-parts value** of our constituent entities. This is frustrating and seems to stem from the diverging cash flow & income profiles of the individual business units, coupled with a certain conglomerate discount.

In response, we have formulated a strategic road map for 2019/2020 that will not only tick the boxes outlined above, but also generate significant liquidity to **accelerate the deleveraging of our balance sheet**. In the face of rising macro-economic uncertainties, potentially rising interest rates and ultimately rebounding rubber prices, **balance sheet strength** is a source of **enduring competitive advantage** – especially now that we have substantially completed our asset buy & build programme.

The salient points of our strategic road map are:

- Consolidate our TSR production platforms to **focus on the global market for tyre rubber**; this will ultimately lead to a combination of our HRC and SINRIO units into one global franchise with four origination & processing platforms
- **Carve-out HeveaConnect** and invite other producers to adopt the HEVEA*PRO* standard, as well as broaden its shareholder base to include strategic partners who can contribute to achieving the vision of a sustainable natural rubber industry
- **Spin-off Corrie MacColl into a separate listed entity**, thereby offering investors the tailored option of investing in Halcyon Agri, and/or Corrie MacColl

Complementing the above, we will rationalise non-core investments, which will further strengthen our balance sheet and facilitate sustainable and recurring distributions to shareholders.

Finally, a couple of thoughts on the **natural rubber market**, which remains doggedly stuck in a narrow trading range at historically low levels. In the context of demand, supplier economics and consumer price inflation in most producing economies, this is counterintuitive.

There is however, a plausible reason for this. In the high-price period from 2005 to 2012, **non-traditional origins** (NTO) entered the fray: North-east Thailand, Vietnam, Cambodia and Ivory Coast have planted approximately **2 – 2.5 million hectares of rubber**, most of which are currently being tapped. In 2018, a safe estimate is that NTO rubber amounted to almost **3.5 million mT of total output**. This NTO volume is substantial and has, in the period from 2012 - 2018, outpaced the growth in global demand.

NTO producers face a couple of problems though: **Rubber factory homologation** requirements of global tyre majors, coupled with increased ecological and social oversight by NGOs **make it difficult to find acceptance for NTO production in the global marketplace**. There is only one certain destination for this cargo, and that is China, where the degree of scrutiny of both factory quality and supply chain integrity is less rigorous. China, being very much a spot buyer however, forces **NTO producers to hedge their production in the rubber futures market**, which has consequently remained depressed.

This pressure on the rubber futures markets has caused problems in traditional origins, where production costs tend to be higher. Compounded by the distorting effects of misguided policy responses, the persistent low prices are now having an **adverse impact on the replanting of old rubber** trees in Indonesia, Malaysia and Southern Thailand. **Public perception is that natural rubber is an oversupplied commodity, when, in effect, this is not the case**. There may well be too much NTO rubber, but supply from traditional, homologated origins is increasingly tight.

To conclude, Halcyon Agri is prepared for the challenges that lie ahead. Our HeveaConnect initiative is both timely and necessary. By opening the HEVEA*PRO*, HEVEA*TRACE* and HEVEA*GROW* sustainability standards to third-party producers, we have equipped the natural rubber market with a tool to differentiate pricing and **reward responsible behaviour**. The vast majority of our assets are strategically well placed and will provide us with **dependable income as we decouple from the pricing vagaries of the futures markets**. Finally, we have a clear and actionable plan to delever our balance sheet and unlock significant amounts of trapped value for our shareholders.

At this point, I would like to thank all members of the Halcyon Agri family for their hard work and dedication. My sincere appreciation extends to our esteemed Board Members, our Joint-venture Partners, our bankers and all other external stakeholders for their unwavering support. 2018 was a disappointing year financially, but I can assure you that the best is yet to come.

Robert Meyer
Co-founder and Chief Executive Officer

i *https://www.cnbc.com/2018/01/17/world-entering-critical-period-of-intensified-risks-in-2018-wef-says.html*
ii *https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52017DC0490*
iii *https://www.gmsustainability.com*
iv https://www.wbcsd.org/Sector-Projects/Tire-Industry-Project/News/Stakeholders-launch-Global-Platform-for-Sustainable-Natural-Rubber