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Turmoil in Debt Markets May Spell Big Trouble
Bunge Limited (NYSE:BG) Update

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Bunge Limited, through its subsidiaries, operates as an agribusiness and food retail company worldwide. The company operates in three divisions: Agribusiness, Fertilizer, and Food Products. Agribusiness division purchases, stores, transports, processes, and sells agricultural commodities and sells to oilseed processors, feed manufacturers, wheat and corn millers, and edible oil processing companies, as well as to livestock, poultry, and aquaculture producers. Fertilizer division produces and supplies fertilizers to farmers in South America. Food Products division offers edible oil products, including bottled, packaged, and bulk oils, as well as shortenings, margarine, mayonnaise, and other products derived from the vegetable oil refining process; and milling products, such as wheat flours and corn products comprising dry milled corn grits, meal and flours, and soy-fortified corn meal and corn-soy blend. Bunge Limited was founded by Johann Peter Gottlieb Bunge in 1818 and is headquartered in White Plains, New York.

Summary of 3DAdvisors Findings for BG

- **Accounting:** Earnings quality issues accompany increasing appetite for capital
- **Accounting:** Claims about inventory purchases highly suspect
- **Accounting:** Balance sheet risks continue to mount
- **Fundamentals:** Edible Oils the latest segment to run into trouble
- **Governance:** Credibility of CEO in press releases and conference calls
- **Fundamentals:** Debt market turmoil potentially spells big trouble

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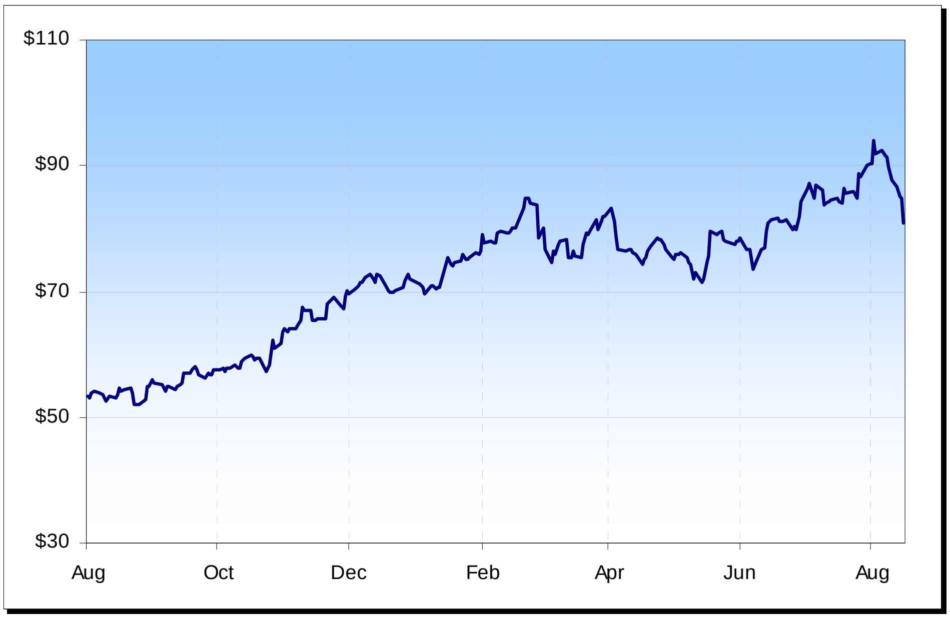
Discussion of 3DAdvisors Findings

For many, the relentless run-up in Bunge shares over the past year has either been frustrating or compelling; frustrating if you had shorted the shares during the past year, compelling if you have been waiting to do so. The shares have been swept higher by optimism over bio-diesel production, the move away from trans-fats and the allure of "Feed the World" companies. It certainly has nothing to do with true financial performance or the fundamentals.

Bunge owns no crop production and is basically a financier for many of its farmer/producers in Brazil. The Company's loan and receivables book has grown exponentially as it does not sell any of the "paper" associated with its advances to farmers, choosing instead to hold such assets in-house or, if you will, "For Investment". On top of this, add some rather obvious quality of earnings issues that help cover up the fact that the company generates very little if any income or cash flow from operations, and the story begins to get quite interesting, especially now given the run the stock has been on over the past couple of quarters.

Figure 1. BG Daily Closing Price, 08/01/06 through 08/16/07. Source: Reuters.



But all of these issues are well known to us and other long-term followers of Bunge and we have covered them extensively, most notably in our full report published on 06/09/06 and an update report on 08/24/06. What is new, however, and especially pertinent given the recent turmoil in global debt markets, is that management says it continues to consume large amounts of working capital for soy bean inventories, which frankly doesn't add up. In fact, there are a number of inconsistencies related to Bunge's growing soybean inventories, and the associated expense of their financing, that fall short of what we are hearing from reliable sources in Brazil, who tell us that much of the payment for crop inputs (read: fertilizer) and farmer debts are done, in-kind, using soybeans rather than cash. We believe that much of the recent soy inventory increases may have come from these in-kind payments earlier this year as farmers delivered pledged beans to Bunge and thus are not as responsible for the drain on working capital that Bunge CEO **Alberto Weisser** would like us to believe.

So what is really eating up working capital if its not soy bean inventories? What will happen when the Company goes back to the debt market where lending standards are getting tougher by the day? What happens if rating agencies, now under intense pressure "to get it right", actually look at the quality of Bunge's receivables, earnings quality overall and lack of cash flow from operations and downgrade its debt, which now seems likely? Will the company be able to secure additional financing at all in the current environment?

Accounting: Earnings quality issues accompany increasing appetite for capital

Bunge's business of financing both farmer crops and inputs in Brazil has exacerbated its already razor thin profit margins to the point that, without deft earnings management and segment allocations, its largest division, Agribusiness, would produce no profits at all: Agribusiness produced $19 billion in revenues in 2006 but an operating profit of just $86 million. In the subsequent periods, it would seem that things deteriorated:

Management's insistence that the Company's Agribusiness segment performed well in the second quarter of 2007 doesn't stand up to closer scrutiny of the results. Quality of earnings issues virtually jump off the page. For the three months ended 06/30/07, the Agribusiness segment showed an operating profit of $107 million on revenues of $7.5 billion, hardly a good performance. It wasn't even that good once you examine the details. Included in the operating profit number of $107 million is a foreign exchange gain of $47 million. This gain, however, is primarily the result of foreign exchange related to third-party debt held by Bunge's foreign subsidiaries. Stepping aside from accounting considerations and looking at what the Agribusiness segment produced in earnings from buying, processing and selling products, a more realistic operating number would be $60 million on revenues of $7.5 billion. This is good performance?

The same case as to quality of earnings can be made for the six months ended 06/30/07, with less explanation. For the first half of the current year, the Agribusiness segment reported an operating profit of $41 million on revenues of $13.7 billion. Included in the operating profit is a foreign exchange gain of $53 million. The math is pretty simple: absent the foreign exchange gain the Agribusiness segment would have reported no earnings at all.

So Bunge's balance sheet is growing, but not from earnings or operating cash flow. Total assets grew by $2.9 billion, or 25%, in 2006. Of that amount, $677 million was financed from the sale of preferred shares, $525 million from increases in Trade Accounts Payable, $317 million through increases in Long-Term Debt. Of the $1.4 billion increase in Shareholders' Equity for the period, just $443 million came from retained earnings. The situation looks worse through six months of 2007. During this period, assets grew by $3.7 billion (since 12/31/06) or 26%. Increases in Long-Term Debt financed $796 million and Short-Term Debt hikes contributed $379 million. Another $986 million of the asset growth came in the form of Unrealized Gains on Derivative Contracts.

All in, Bunge's Working Capital needs for the first six months of 2007 consumed $776 million in Cash compared to $400 million for the same period in 2006. The Company has now produced negative Free Operating Cash Flow in five out of the last six quarters. This prompted an interesting question during the Q2 conference call. We felt CEO Alberto Weisser's response was evasive, to say the least:

> **Analyst:** And then in terms of the high commodity prices, how can we think about working capital and the ability to generate free cash flow to offset your working capital needs? Is there kind of a short-term capital crunch coming? How should we look at that?

> **Alberto Weisser, Chairman & CEO:** Yes. When you think about June of last year, around -- before the increase in commodity prices, our inventories or our working capital - operating working capital, the way we look at it - was around $3 billion and if we take an average of soybeans, corn, wheat, on the main raw materials that we work with, they have risen from last year June to today something around 40%, so 40% to 50%, which means that just because of the increase in prices having the same amount of volume, the value of our inventories because we obviously purchased them more recently, went up by $1.2 to $1.5 billion. This all goes through the cash flow statement. This is investments in working capital. So it has increased. We were prepared for it. We are prepared even for a higher increase. So from a liquidity point of view, from a financing point of view, there is no surprise. There is no problem about it. But if the commodity prices were to stay at the higher level, obviously the margins have to expand to pay for the higher financing cost of them.

Accounting: Claims about inventory purchases highly suspect

Bunge is quick to explain that, when assessing its liquidity position, one should not only take into account cash held but also the Company's amount of "Readily Marketable Inventories" (RMI) which it claims can be converted to cash at any time. As Bunge explains it *"Readily marketable inventories are agricultural commodity inventories, which are readily convertible to cash because of their commodity characteristics, widely available markets and international pricing mechanisms."* [1]

To this, we point to an illuminating disclosure which appears each quarter in Bunge's earnings releases *but is eliminated from any related SEC Form 10-Q or 10-K.* In each release, Bunge discloses the amount of its "Interest Expense on Readily Marketable Inventories" separately from its regular Interest Expense. For example, Bunge's 2Q07 release shows that the first six months of 2007, RMI-related interest expense totaled $57 million ($29 million in Q1 and $28 million in Q2). The obfuscation of this detail in the subsequent SEC Form 10-Q speaks loudly to us since, in that document, only a total Interest Expense figure is shown ($149 million). Bunge is one of the few companies who we have ever found to disclose certain significant items in their earnings releases, but not in the subsequent SEC filings.

The obfuscation caused us to look further into Weisser's claim that inventory purchases at higher market prices were the culprit for eating up so much working capital recently. For one thing, we became very curious that this Company, whose Agribusiness margins have proven to be so razor-thin, would be so willing to spend almost $30 million per quarter to finance inventories that are so readily marketable that it says they should be looked at as if they were cash. Why not just sell off some of them?

To this, we are certain that Weisser's answer would not waver from what he said in the above response in that they had to actually purchase inventories and that recent buys were at higher prices, causing the Company to have to spend more to finance them. Never mind the fact that the question could be asked as to why Bunge had not bought forward any inventory allowing it to mitigate recent price increases. Our question, and it is a material one, goes like this: "How much of your recent inventory

[1] Bunge Ltd. 2007 Q2 SEC Form 10-Q (for the period ending 06/30/07).

purchases were, in reality, non-cash acquisitions of soybeans from farmers in payment for either fertilizer or repayment of earlier crop advances to them?"

We take exceptional note of Weisser's implication that it is Bunge's recent purchases of inventories at high prices are singularly responsible for the increase in working capital consumed by inventories. The disconnect here, to us, is the fact that when it comes to soybean inventory, Bunge acquires much of these in barter from Brazilian farmers in return for fertilizer exchanged or crop advances made prior to the harvest. Our Brazilian agricultural contacts inform us that soybeans are the preferred form of payment for fertilizer. This occurs, we are told, since not only do the majority of farmers lack sufficient cash to pay for crop inputs but also because when they trade beans, they do not have to pay a federal sales tax when the payments are made "in house" in such transactions. We're also told that most farmers in Brazil pay, in kind, with soybeans, whether they are buying fertilizer for cotton, corn or wheat. Only sugar cane farmers tend to pay in cash.

So the next question is related to how many beans can Bunge expect to acquire in this way, as opposed to paying cash, as Weisser implies. A simple analysis provided an estimate that surprised us:

After its merger with Fostertil, Bunge has about a 50% share of fertilizer sales in Brazil. Last year, there were about 21 million metric tons (mmt) of fertilizer sold in Brazil. Sales this year are estimated to be about 23 mmt. In the 2006-2007 season (last year), given our market share assumption, Bunge would have sold about 10.5 mmt during the year. The current barter exchange rate for this fertilizer is 28 sacs of soy beans per metric ton.

For this example, our expert sources in Brazil suggest that it is reasonable to assume that 60% of Bunge's Brazilian fertilizer sales are done using barter. One "sac" of soybeans is equal to 2.2 bushels. The average rate, in U.S. dollars for soybeans last year in Brazil was $6/bushel in Mato Grosso and about $6.75 in regions to the south. Mato Grosso comprised about 25% of last year's soy production. Consequently, we will use $6.50/bushel for an average price, in U.S. dollars, for last year's production.

So, assuming Bunge's 50% market share, and subsequent 10.5 mmt of fertilizer sales, the Company would have expected to receive in-kind payments, of soybeans, for about 6.3 mmt of fertilizer during the 2006-07 growing season. At a conversion rate of 28 sacs per ton, this would work out to 177 million sacs of beans. With 2.2 bushels to a sac, and a $6.50 average price, this translates to $2.53 billion in beans that could have been received by Bunge in payment for fertilizer-related debt.

The above figures do not take into account the fact that advances to farmers are paid in the same fashion, and probably at a much higher level of barter than the 60% we have estimated for fertilizer sales. For farmer advance paybacks, it's closer to 100%. As of this writing, advances to farmers, admittedly many very long in the tooth, total over $906 million.

Keep in mind that, although Bunge claims to currently have $3.2 billion in Readily Marketable Inventories as of 06/30/07, the number has expanded dramatically of late. During 2006, these RMIs averaged just $2 billion per quarter. Readily marketable may well be an acceptable accounting consideration for valuing inventories. However, readily marketable does not necessarily mean *salable*. For salability to exist there must be sufficient demand in the market place. We question if indeed the readily marketable inventories are in an excess mode and not readily salable in the near term. Why else would Bunge be willing to incur nearly $30 million per quarter in interest expense in order to finance them? One might expect the auditors to raise a similar question in the not too distant future.

Accounting: Balance sheet risks continue to mount

Though Weisser would like us to think the opposite, perhaps it is not simply inventories that are putting the strain on Bunge's cash flow. For instance, Bunge's Advances to Farmers, Accounts Receivables and Off Balance Sheet Guarantees continue to grow:

As of 06/30/07, Bunge's $903 million outstanding Advances to Farmers, designed to finance a farmer's next crop, continued to show a significant amount of $251 million (28%) that is now considered long-term. The Company indicates that it has "initiated legal action to collect the outstanding balance of $137 million" as of the end of 06/30/07. This is up from $104 million at year-end. The Company now carries an allowance of $45 million related to these advances, up from $40 million at year-end. Bunge has only begun disclosing the new detail concerning long-term and defaulting advances this year. To this, we should note that this year, Bunge has also begun disclosing interest income from these advances. Through the first six months, Bunge has recognized $30 million in interest income on these ($45 million for the same six months of 2006) with no indication of how much has been booked in prior periods that could be at risk of being reversed should the related loans be written off.

Fertilizer Receivables, now at $792 million, are arguably Bunge's most vulnerable collectable, and continue to rise as well, as has the related allowance. The fact that the Company is more inclined to discuss the poor quality of these receivables, than it has been in past periods, perhaps speaks to the deterioration in their quality. On no less than four occasions during Bunge's recent Q2 conference call, Weisser referred to farmer debts as either "overdue" or "bad". In the past, he has avoided such references and now may be telegraphing that an acceleration of write-offs here may soon be in the offing. The Company continues to shift its allowance for bad fertilizer Accounts Receivable upwards to where it now stands at $171 million, or 22% of the outstanding amount. In spite of this, however, the fact that the Company continues to disclose that it has increased related collateral requirements "for certain customers" suggests that even with this boost, the allowance may still be inadequate.

Though Customer Financing may not drain cash, Bunge discloses growing exposure where it has "issued guarantees to financial institutions in Brazil related to amounts owed the institutions by certain of our customers." These guarantees are now up to $257 million, up from just $162 million at 12/31/06, and remain an off-balance sheet item. Perhaps the most telling detail related to these is that up until Q3 of 2006 these guarantees were stated as being for a period "as short as 120 days or as long as 360 days". But not only has the dollar amount of the guarantees jumped, the Company has dramatically stretched out the time line as well: Since the 2006 SEC Form 10-K, Bunge has quietly been disclosing that these guarantees can now "range from 120 days to five years". We are left to wonder whether some of these customers of financial institutions may overlap situations where farmers already had owed Bunge under past arrangements, opening the door for possible double-hits down the road in the event of default.

Fundamentals: Edible oils the latest segment to run into trouble

A developing situation, emerging during the past quarter and largely overlooked at the time of the release, has surfaced in Bunge's Edible Oils segment where the Company has been having difficulties passing higher edible oil prices on to customers. This segment's 6 month operating profits have slipped dramatically this year to just $3 million at 06/30/07 down from $22 million the same period last year. To this, Weisser states that the problem lies in the U.S., where there are high stocks of oils, making good margins difficult, and Europe where the Company has been experiencing difficulty raising prices to final customers. Weisser goes on to state that "we expect to have some trouble in the second half of the year" and that although "eventually we will be able to pass on all the necessary price increases, we will not be completely finished by this year." [2]

Governance: Credibility of CEO in press releases and conference calls

We have already commented on the fact that Bunge's 2Q07 results were really not as good as they appeared on the surface when taking into account several quality of earnings issues, and we have also covered in detail the problems with fertilizer A/Rs and the related issue of soy bean inventories. So when CEO Alberto Weisser is quoted in the 2Q07 earnings press release saying "Bunge's strong second quarter earnings were driven by a good performance in agribusiness and outstanding results in our fertilizer operations" [3], we can't help but feel: Here we go again.

Over the course of the past year while we have followed Bunge, we have been struck time and again by misstatements and obfuscations attributed directly to the CEO. One that really caught our attention came in the 1Q07 conference call in response to a question about the abrupt departure of CFO **William Wells**:

> **Analyst:** Just the departure of Bill Wells kind of I think opens the chance to change some things. I think a lot of the questions I get have kind of dealt with the tax rate and whether or not this whole tax rate trend, which did reverse in this quarter, your operating tax rate last year was 5%. I do see you paid a lot more than that in cash taxes. Can you give us some kind of assurances that these lower tax rates won't come back to hurt you in audits and also just on Bill, he was able to sell some stock, or I guess he had to sell some stock just dealing with options. But he had to know there was kind of a bad hedge going in place. How was he able to sell stock knowing there was going to be the mark-to-market losses?
>
> **Weisser:** Look when let's first talk about the last one; we announced, Bill announced that he was leaving around February 8 if I'm not mistaken. And at that time, if you leave it is very clear that, especially on the options with our plan, once you leave you

[2] Bunge Ltd. 2007 Q2 conference call.
[3] "Bunge Reports Second Quarter 2007 Results", PRNewswire-First Call, July 26, 2007.

> have to sell them or they are forfeited. And so at that time he took the decision to sell most of it, and if there were sales in February, it was on the 10b5 Plan, so I think we feel that this was all proper. And it's in his right, he took the decision I think everything -- Bill was always very, very, has been and is being very careful with all these kinds of things. Integrity is very important.

There is a serious problem with Weisser's comments where he implies that Wells' sales were under a 10b5-1 plan. Simply put, they absolutely were not. Wells had already sold the lion's share of his holdings, almost 228,000 shares, between February 13th and 26th of 2007. His 10b5-1 was not filed until February 28th. The plan only covered his sales of an additional 35,000 shares.

The assumption that Weisser simply made a mistake on this would be naïve since practically all of Bunge's recent insider sales we have been following, including Weisser's, have been done under the cover of 10b5 plans. Given the apparent cognizance of such plans within the Bunge hierarchy, we find it difficult to accept that Weisser simply did not know that one of his key reports had sold almost his entire holdings prior to the application of the camouflage.

In another notable Weisser "misspeak" that we have identified in the 2Q07 conference call, upon being asked about the farm economics in Brazil and whether or not they remain positive, Weisser responds with the following quote:

> **Analyst:** Are our farm economics still consistent with what you said in you prepared remarks?
>
> **Weisser:** Yes. They are still very positive. Even in the northern part of Mato Grosso the farm economics are very positive. So no worry there but we have to see where the commodity prices go.

Knowing how difficult the environment continues to be in Mato Grosso, we asked our contacts there to respond to Weisser's assertion that farm economics are "positive" in the region. Their comment, roughly translated from the Portuguese: B.S.

<u>Fundamentals: Debt market turmoil potentially spells big trouble</u>

With short-term debt of $833 million and trade payables of $3 billion, Bunge's $466 million cash position does not look very large, especially given the Company's nagging inability to generate consistent positive cash flow for the past six quarters. Indeed, much of the $670 million raised in last November's preferred share offering has been burned through as working capital needs consumed $776 million during the first six months of this year. Given multiple earnings quality issues, rapidly growing balance sheet risks, a voracious appetite for capital and the current turmoil in the debt markets which has been particularly harsh on poor credits, **Jacqualyn Fouse**, Bunge's new CFO, has to be sweating bullets over the prospect of going into the market for new debt financing any time soon.

Bunge claims that it earns 2% over its cost of capital. Given the Company's dependence on non-core and/or non-cash earnings, one is left to wonder the validity of such a claim. In practically each quarter, for instance, Bunge records non-cash income related to foreign exchange gains on third-party debt held by its foreign subsidiaries. For the first six months of 2007, this gain totaled $92 million and $114 million for the same six months of 2006, and so it goes on each period. Additionally, given the high level of long-in-the tooth advances to farmers, where interest income has been recognized but not received, the total amount of which has not been disclosed, we are left to wonder how much of this will ever be collected. Bunge may face having to reverse much of these out should it eventually bite the bullet on bad loans.

All this segues into the current credit crisis and the fact that past loose policies of the key rating agencies, with regards to credit derivatives, has put them in a tenuous position of possibly being named culpable accomplices in the current chaos. Even before the events of late, S&P, Moody's and Fitch Ratings had carried just-above-junk ratings for Bunge's unsecured guaranteed senior notes. Bunge's Risk section discloses that although ratings downgrades will not accelerate the maturity of its debt, tighter ratings "*would increase our borrowing costs under our credit facilities and, depending on their severity, affect our ability to renew existing or to obtain new credit facilities or access the capital markets in the future on favorable terms. We may also be required to post collateral or provide third-party credit support under certain agreements as a result of such downgrades.* ***An interruption of our access to credit or a significant increase in our borrowing costs could impair our ability to compete effectively in our business relative to competitors*** *with lower amounts of indebtedness and/or higher credit ratings*." [4]

We would venture to say that when Bunge eventually re-visits the well, and it is just a matter of time, it will not find allies in the now-battered rating agencies who will be more likely to downgrade Bunge further rather than face further scrutiny the likes of which they are about to experience en masse from both the public and regulators. In other words, the fuse is finally looking short on the Bunge Bomb.

[4] Bunge Ltd. 2006 SEC Form 10-K, page 22.