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## PNB at the crossroads

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AFTER 25 years in existence, asset manager Permodalan Nasional Bhd (PNB) is at the crossroads.

Gone are the days when the giant government agency could depend on being given discounted shares by the government or new shares at preferential prices including par value. In fact, initial public offerings (IPOs) are rarely fetching premiums these days.

So the challenge ahead for PNB is to enhance shareholder value. It must seek ways to build on what it has and not depend on government largesse any more.

Critics of the company say it lacks the drive evident in privately run companies; that although PNB's professional managers have to some extent done well, they lack the entrepreneurial spirit.

Thus, a recent proposal that PNB merge its plantation operations is timely. The move, when effected, would virtually create the world's largest plantation company and reduce operating costs by as much as 15%.

There is also talk that PNB will restructure its property and finance-related businesses next. Analysts say the move will enhance value of operations.

Needless to say, PNB's plantation stocks are trading below their net tangible assets (NTA) value. Even Primary Industries Minister Datuk Seri Dr Lim Keng Yaik is critical of the companies. Recently, he hit out at them for 'not contributing enough to the healthy development of Malaysia's palm oil industry'.

The merger will, for one, increase efficiency. Many say PNB is not reaping fully the economies of scale due to the existence of overlapping businesses and different ways of running listed entities.

PNB was set up to increase Bumiputera participation in the corporate sector as part of the objectives of the New Economic Policy. Over the years, millions of unitholders of its unit trust schemes have reaped the rewards of their investments.

But times are changing and so are the demands of unitholders. PNB cannot merely depend on the government to allocate it cheap shares. Not in today's market conditions, anyway. What it needs to do is to enhance its level of professionalism.

Among the main grouses of detractors is PNB's somewhat laid-back and passive investment stance. They say PNB should do more to create value to unitholders than merely investing in hundreds of listed and non-listed companies.

Ironically, it was this 'prudent policy', as PNB would have preferred to call it, that kept it on the right track over the years and allowed it to give competitive returns by continuously realigning stock selection and asset allocation in its portfolios.

In the early years, this was made possible by the fact that it could reap huge profits from the sale of government-owned shares that it received at par value.

Nevertheless, the uncertainties in the global and domestic economies, exacerbated by the war in Iraq, a languishing stock market and an unfavourable business atmosphere, could take their toll on the earnings of many companies.

Lower earnings would translate into lower dividends. In this eventuality, how does PNB plan to keep up its commendable dividend payout?

PNB chief executive, Datuk Hamad Kama Piah, was unable to respond in time to queries by Malaysian Business.

The fact that PNB is reviewing its operations is a good start. Many saw the plantation restructuring coming. Last month, Acting Prime Minister Datuk Seri Abdullah Ahmad Badawi announced a move to merge government-linked companies within a common sector.

He was quoted as saying that plantation companies under PNB could be consolidated into a premier company to increase the presence of large entities on the Kuala Lumpur Stock Exchange (KLSE), a move prompted by complaints from foreign investors on the dearth of big companies to invest in.

'The strength and stability (of the merged concern) will be an incentive for investors,' Abdullah told a media conference last month. This is the firmest statement yet on the consolidation proposal of government-linked companies. With this push, the market can anticipate the start of a re-organisation of certain government agencies.

This, too, is perhaps an example of value creation the critics have in mind, and could be the way forward for the stalwart fund management company. For the year ended Dec 31, 2001, PNB chalked up a net profit of RM938.4 million on a revenue of RM1.4 billion. This was despite a provision of RM237 million for diminution in value of investments.

At present, PNB manages 10 unit trust schemes. Excluding its latest fund, Amanah Saham Gemilang, the fund manager has eight million account-holders with investments of over 40 billion units, including some 700,000 non-Bumiputera investors accounting for 4.2 billion units.

Based on its portfolio, as of early this year PNB has investments in 361 companies from various sectors of the economy, of which 304 or 84% are listed companies.

Twenty of the 361 companies are subsidiaries, 59 associates and the remaining 282, investment companies. The financial sector accounts for PNB's biggest exposure at 37%, followed by trading & services at 26%, and plantations 10%. The remaining 27% are of various other sectors.

In essence, PNB's investments include substantial stakes in banking & finance, insurance, plantations, property and property investments, ports, manufacturing, telecommunications, infrastructure and others. Besides PNB, it is common to have other government agencies such as the Ministry of Finance Inc (MoF), the Employees Provident Fund, Kumpulan Amanah Wang Pecen and Khazanah Nasional Bhd owning stakes in these listed companies.

For example, in banking, PNB and other government agencies hold over half of Malayan Banking Bhd and 57% of Commerce Asset-Holding Bhd, while Khazanah owns 30% of RHB Bank Bhd. PNB also controls financial services group Malaysian Industrial Development Finance Bhd, itself fresh from a merger with Amanah Capital Partners Bhd.

Besides controlling stakes in plantation companies, PNB also has substantial interests in port operator NCB Holdings Bhd, insurance group MNI Holdings Bhd, motor company UMW Holdings Bhd and steel-based Amalgamated Industrial Steel Bhd. It also holds major stakes in unlisted companies including Pernec Corp Bhd, Titan Petrochemicals & Polymers Bhd, Projek Lintasan Kota Holdings Sdn Bhd and Cerebos (M) Sdn Bhd.

With such enormous holdings, any attempt at re-organisation and rationalisation would seem a massive task indeed.

The grand plan

The proposed merger of the plantation companies under PNB has been a hot topic among corporate players, in particular the investing community which speculated on the possible scenarios. It is learnt that the idea for such a merger was put forward by an ex-broker, Chua Ma Yu, to Prime Minister Datuk Seri Dr Mahathir Mohamad last October.

Apart from Sime Darby Bhd, PNB has six listed plantation companies in its stable - Kumpulan Guthrie Bhd (KGB), Island & Peninsular Bhd (I&P), Austral Enterprises Bhd, Golden Hope Plantations Bhd, Guthrie Ropel Bhd (GRopel) and Highlands & Lowlands Bhd (Hi&Lo).

PNB owns 73.2% of KGB, 50.6% of GHope and 71.5% of I&P. KGB controls two listed plantation companies via a 58% stake in GRopel and 55% in Hi&Lo.

It should be noted that some of these plantation units are also pursuing merger possibilities on their own. Property group I&P is undergoing a merger with its 57.9%-owned subsidiary Austral and is taking the latter private, while KGB is exploring similar possibilities with its two subsidiaries GRopel and Hi&Lo.

KGB, the largest of the six companies after the acquisition of the huge Minamas plantations in Indonesia, is mired in debt and has been selling vast tracts of its landbank to raise cash.

It appears that KGB would have to revise its plans in view of the grandiose merger that PNB may implement. It seems that the government's aim is to prop up the agriculture sector as the nation's third engine of growth, after manufacturing and services.

A mammoth plantation company would preserve and elevate Malaysia's competitiveness in the palm oil industry. Merged entities would have increased opportunities and be better positioned to compete globally, says Aseambankers Malaysia Bhd's chief executive officer/director Agil Natt.

'Companies with a significant presence could attract more attention from foreign investment funds due to the strength and resilience inherently created in such mergers,' he says.

Under the proposal, PNB would inject its shareholdings in six plantation companies into Sime Darby in a share swap deal.

Sime Darby's shares would be valued at a 10% premium to their three-month moving average price and the acquiree companies at 20% premium, also to their three-month moving average prices. Based on these valuations and prices at end-2002, the acquisitions would have a price tag of RM8.81 billion, to be paid for via the issuance of new Sime Darby shares (see Table 1).

Subsequently, Sime Darby would mop up the balance of interests in the companies held by minority shareholders, on the same terms. The plantation companies would become wholly owned subsidiaries of Sime Darby and eventually delisted from the KLSE. The mega plantations would be streamlined into three divisions - West Malaysia, East Malaysia (Sabah & Sarawak) and overseas (Indonesia and others).

According to sources, the 20% premium for the acquiree units would be a palatable offer to minority shareholders, considering that all the six companies are trading below their NTA and some with paltry market liquidity. Conversely, Sime Darby is trading higher than its NTA, which is one of the reasons for it being chosen as the anchor company despite not being a pure plantation play.

A research manager of a local stock brokerage concurs. Sime Darby would be the natural pick due to its well-established name locally and globally. It has a long listing track record, big capitalisation and a large following among global funds.

With Sime Darby's good profile and distribution network spanning the globe, it would boost the marketing of CPO (crude palm oil) and palm products.

A jumbo plantation group

Based on the proposal, Sime Darby's total landbank would increase more than five-fold from 100,000 hectares (ha) to 626,094ha, of which 314,227ha are located in Malaysia and the other 311,867ha in Indonesia.

This would result in the creation of the world's largest oil palm

company accounting for 1.1 million tonnes of CPO or 10% of the nation's output and 5% of global supply. When fully planted, CPO production would more than double to 2.5 million tonnes, representing some 11% of the world's supply.

How would the merger impact on Sime Darby's financial position?

The conglomerate has the potential to chalk up net earnings of RM1.92 billion based on figures for the year ended June 30, 2001, when it posted a net profit of RM617 million. Which means that the additional plantation assets would stand to contribute some RM1.85 billion at the pre-tax level.

This is assuming that the average CPO price is RM1,250 per tonne, average production cost RM630 per tonne and average profit for palm kernel RM475 per tonne.

Sime Darby's paid-up capital would balloon from 2.32 billion to 3.96 billion shares, giving it an earnings per share of 48 sen, against 27 sen in FY01. Shareholders' funds would rise from RM6.80 billion to RM15.6 billion, up 130%. NTA per share would rise 33%, from RM2.92 to RM3.88.

At a price-earnings multiple of 15x, Sime Darby could have a market capitalisation of over RM28 billion, putting it nicely among the top heavyweights like Malayan Banking, Tenaga Nasional Bhd and Telekom Malaysia Bhd.

The consolidation would also effectively enhance the value of PNB and unit trustholders' investments. Following the merger, PNB would end up with a 18.2% stake in the enlarged Sime Darby, while Amanah Saham Bumiputera would hold 28.6% and EPF 7.7%.

It looks good on paper, for Sime Darby that is, and several research houses have given the thumbs-up for the merger as far as the numbers go.

Is it as simple as it looks? Will the mergers be successful?

Pros and cons

The government has stated its case for creating leaner and meaner premier companies with focus on certain sectors - to attract foreign investors and institutional funds and bolster these companies' financial position to face global challenges.

Indeed, some of the foreign funds are restricted in terms of stock selection due to their portfolio requirements, says Dr Sheikh Awab Sheikh Abod, deputy CEO of Malaysian International Merchant Bankers Bhd (MIMB).

'The mergers would certainly strengthen our capital market and ma attract foreign funds to invest here on a more long-term basis,' he says, adding that it would be good for the KLSE as it could lead to more big-capitalised companies on the bourse.

Aseambankers' Agil agrees, saying that it would add size and depth to the market and make these companies more attractive, particularly to foreign investors. 'It is apparent that after the crisis, financial resilience is the key to sustainable performance,' he says. On the flip side, of course, investors would have less choice in plantation-sector companies to choose from.

The creation of a giant oil-palm company would also increase the country's competitiveness and give it a global attractiveness. The head of research of a local stockbroking firm says this could be a good move to raise the profile of Malaysian plantation companies. 'When you're big, you have the bargaining power to better position yourself when dealing with large commercial buyers.'

Malaysia may be the largest producer of CPO, supplying some 50% of the global market, but not many companies stand out as world class. 'If we're fundamentally strong and with marketing strategy, there is a natural tendency for buyers to look at us,' he says, adding that local companies are not aggressive in marketing their products. Improving productivity and quality would be a boon.

'We are losing out to Indonesia which offers cheaper CPO and is now aggressively pursuing the booming Chinese market,' he adds.

If the merger is well restructured, the pooling of resources should be able to support research and development as well as marketing needs to better position the company internationally.

As with any merger, that of the plantations is bound to result in operational cost savings stemming from economies of scale and greater efficiencies. This could be in the areas of bulk purchasing for fertilisers, logistics related to milling, harvesting, cultivation and the elimination of duplication in overheads and fixed assets (see Table 2).

Cost savings could be limited, however, as the plantations are managed separately and require sufficient resources to operate, unlike services-oriented mergers where branches in the same location could be closed. The six plantation companies own estates scattered all over the country and this would make them difficult to rationalise. So it all boils down to how best the plantations are merged. For contiguous estates, cost savings would be higher after merger.

Despite this, analysts are estimating cost savings of 10% per tonne which, according to a foreign broker, would translate into RM70 per tonne. When fully operational, the merged plantation giant with an annual production of 2.5 million tonnes could stand to save RM175 million.

The merger proposal is not without its drawbacks. At present, there is healthy competition between the oil palm companies, giving them the chance to benchmark against competitors. Such benchmarking ensures they don't slip into complacency.

As it now stands, the six plantation companies have a yield per mature hectare averaging 20-21%, still below the 23%-24% rate achieved by their more efficient peers such as IOI Corp Bhd and United Plantations Bhd.

When the plantations get too big, the desire to increase productivity may take a back seat, which ultimately would result in inefficiencies and wastage. Still, the individual plantations can achieve efficiency based on their location, soil fertility and production techniques adopted.

Additionally, mega plantations may be faced with other problems. 'The bigger you are, the more coordination is required. Communication could be stumped by layers of bureaucracy and red tape,' notes a plantation analyst. 'They need to form good linkages with each other to work as a team.'

There are also cases where workers down the hierarchy engage in unethical practices like selling fertilisers to outsiders when the organisation gets too big. 'The merged plantation must install the relevant systems and good controls to keep operations in check,' says an analyst with a foreign broker.

There are other issues that promoters need to mull over. The crux of the merger exercise is surely the valuation. The promoters must put on the table a palatable offer to appease minorities of the acquiree companies and that of Sime Darby. Some analysts are speculating a premium as high as 30% to win over the minorities of target companies.

Since the merger is not market-driven, its cost could escalate due to potential integration issues such as unsuitability of assets, says MIMB's Sheikh Awab. Management efficiency may also be hampered to a certain extent if different management styles and organisation cultures are not streamlined, he adds.

The top management of the acquiree companies may oppose the proposed merger as it would mean the elimination of senior management positions. 'The key issue here is that top management must be willing to relinquish their posts. Inevitably, some names would be dropped,' says a foreign broker.

Sheikh Awab also opines that the creation of big companies may subject the economy to greater vulnerability as any corporate failure carries a significant impact to the particular sector. `Hence, any merger without deriving targeted benefits including economies of scale, efficiency and improved services must be avoided.'

To ensure successful implementation, the proposed merger would need a strong political will as it could result in some single largest shareholders losing control; those to be dropped should not add to the problems.

The task before PNB is arduous and massive. For sure, it is not something that can crystallise within a short time. Timing is also crucial - it must be noted that the CPO market is now heading for a soft landing and by the time the merger is implemented, the sector could already be in a down cycle, with the euphoria dying with it. By then, the merged plantation could be faced with new challenges.

As Affin Merchant Bank Bhd president/chief executive Datin Zuraidah Atan puts it, `The merger seems to be highly complex in that it will entail valuation and pricing, the different risk profiles of companies, minority shareholders' acceptance and the possibility of retrenchment.'

It is certainly worthwhile pursuing the potential mergers. Nevertheless, PNB must scrutinise the deal with a fine-tooth comb to ensure that its objectives and targets are met for the good of the sector and the country, while appeasing both major and minority shareholders.

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