

1MDB may be killing its only cash cow

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In selling Edra, is 1MDB slaughtering its cash cow for its meat? Meantime, while the sale seems inevitable, its handling requires transparency and candour given that much public interest rides on the process.

Should 1Malaysia Development Bhd (1MDB) really sell its power assets? It's a tricky question to address, though likely inevitable eventually. And all eyes are on how the company handles the sale given its history of dodgy dealings.

It has been coming for some time since Arul Kanda came in as the new person in charge in January this year, obviously tasked with turning things around. After the strategic review of the situation, he announced in February that part of the rationalisation of 1MDB's RM42 billion in borrowings will entail the monetisation of Edra Global Energy, the entity which the power assets are parked under.

While the process had seen some interesting twists especially in respect of the initial public offering that eventually wasn't, a question that plays in the back of observers' minds would be whether selling off the power assets is ultimately the right decision after all.

Mired in RM42 billion in borrowings, an oft-repeated defence against criticism has been a reiteration that 1MDB's alleged assets amount to more than that at RM51 billion. However since its inception, it has never made realised profits after adjusting for paper gains from land revaluation (see chart).

More importantly, a big chunk of what cash flow 1MDB has comes from its power assets. It is difficult to establish the proportion in terms of net profits, but in the financial year ended March 31, 2013 (FY13), revenue from power assets amounted to 80% of 1MDB's total turnover.

In FY14, this percentage was about 77% – still unnervingly disproportionate considering the power assets, even at the optimistic valuation of RM12 billion bandied about, only represent less than a quarter of 1MDB's total assets of RM51 billion.

While selling the power assets would realise a one-off cash gain for 1MDB to use for paring down its debts, would this be akin to killing the cow for its milk?

It bears repeating that a significant proportion of 1MDB's borrowings are in bonds, meaning they require consistent servicing as opposed to one-off settlements. Based on KINIBIZ analysis (see the previous article), at best the sale may realise proceeds of RM8.9 billion at best – likely lower.

Even without taking into account costs of undertaking the sale, applying this amount to 1MDB's borrowings will still leave it with double-digit billions in borrowings with a huge chunk of its revenue now out of the picture. This raises concerns on how 1MDB will continue servicing the rest of its debt.

In any case, the sale process is already under way and seems unlikely to be called off. Some feel a clear frontrunner among the three “binding, fully funded” bids may emerge as early as mid-November.

Transparency vital

Yet there is also a concern in how 1MDB goes about selling its power assets given its history and there needs to be much transparency over how things are done. In essence, the transaction must be unambiguous and straightforward.

This, of course, should also take into account the sensitivity surrounding such a process where official disclosure of some specific information, such as specific bid amounts, may prejudice one bidder or another unfairly.

At the heart of it, once a winning bid is selected the public should be informed of why it was superior to the other two. As much as possible, the rationale for the selection should be thoroughly explained to the public, who are indirectly vested in 1MDB's well-being through its sole shareholder, the Finance Ministry.

Disclosure should also extend to payment terms for the winning bid and how the selected buyer intends to finance the acquisition – given the inherent intention of the sale, this should naturally preclude share issuances from the buyer in lieu of cash and must unambiguously in cash terms.

And the cash payment, in cash terms and not “fund units” or any such form, must also be immediately credited into bank accounts under 1MDB's direct control.

Similarly there should not be any accompanying side-deals to sweeten the transaction, for instance allowing the winning party to acquire 1MDB land at discounted prices or having the government make a concession or another in other areas.

This is because questions would arise if a foreign entity is able to bid higher than Tenaga Nasional, who boasts the lowest costs in the Malaysian power sector compared to independent power producers. If a foreign entity bids a higher amount, how it is able to do so must also be disclosed lest any such premium is offset by a concession somewhere which may be detrimental to the public.

These conditions may seem strict but they are necessary to ensure no further controversy arises from the sale.

Recall that throughout its lifespan, 1MDB has been making corporate and investment decisions that are, at best, can be described mysterious and self-defeating.

A glaring example is its first joint venture in 2009, which was concluded at breakneck pace – according to its annual reports – and later reported by whistleblower website Sarawak Report as being undertaken without board consent, leading to the immediate resignation of two board members. 1MDB had not specifically and categorically denied this allegation.

It was fishy. 1MDB put in US\$1 billion for a 40% stake but its partner did not inject cash, only assets. Sarawak Report claimed US\$700 million (RM2.6 billion) of the funds was transferred to a bank account unrelated to the joint venture, a claim also not specifically refuted.

Six months later, the joint venture was terminated yet 1MDB did not withdraw its investment, instead converting it into a loan to its now ex-partner and further advancing more funds as loans, raising questions on whether it was essentially looking for strategic moves in the moneylending business.

Fast forward to 2015, Bank Negara Malaysia declared that it found 1MDB had obtained permissions for these transfers in 2009 in breach of the Exchange Control Act by providing inaccurate or misleading information. The central bank's call for criminal prosecution against the company underlines the seriousness of the offence.

Regulatory assurance needed

Coming back to the sale, in the event a foreign party wins the bidding then the government, via power sector regulator the Energy Commission (EC), should also step forward and provide clarifications to address public concerns which would arise.

In other words, the EC should clarify to the concerned public on whether such a scenario, which requires an exemption for the buyer vis-a-vis the 49% shareholding cap for foreign entities, would in turn jeopardise the country's energy security.

Recall that concerns among some industry observers that allowing foreigners to own local power plants may give foreign interests a foothold in what is essentially the national economic backbone – electricity supply.

There is a further concern on whether such presence may in turn present foreign interests with bargaining chips which may be wielded against public interest in respect of potentially influencing government policies going forward.

What the EC needs to disclose is how the unprecedented scenario would affect public interest. Are such fears reasonable? Why or why not?

The EC should address concerns that foreigners with stronger financial muscle may undercut locals to such an extent that local players are driven out of business, allowing increased foreign ownership over time.

It should also disclose what safeguards are in place against such risks arising from foreign ownership of local power plants and what mitigating factors are present. Among others the EC should outline steps to ensure the precedent set by allowing foreigners to own more than 49% will not lead to local players selling their stakes in power plants for a quick buck.

Done immediately, such a reaction would inspire further confidence in the commission at a time when questions abound on its independence as a regulating body amidst controversies on the past several power plant awards (see the previous article).

In fact, it would not be amiss for the EC to step forward now and pre-empt the bidding result with a clarification on these concerns, given the potential stakes riding on the implications that arise from the foreign ownership issue.

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