Portents in petroleum

The flotation of two subsidiaries of the Malaysian state oil company Petronas raises hopes that the parent company may list. This would help the profile of Malaysia's equity market but could also weaken Petronas's role as the source of almost half of state revenues. Chris Wright **reports**

IN THE NEXT few months, two businesses owned by Malaysian state oil company Petronas will list on Kuala Lumpur's stock exchange. They are big deals in their own right and will probably raise at least $3 billion between them, but it's what they portend that's got people really excited. Could these listings, part of a new national policy of floating more state assets, be a step towards an IPO of Petronas itself?

What a trophy that would be. Malaysia's only Fortune 500 company, ranked 107th in the world in the 2010 list, is extraordinarily powerful, "vested," as Petronas itself puts it, "with the entire ownership and control of the petroleum resources in the country." Petronas is the backstop for the national budget, the best-run company in the country by common opinion, and probably Malaysia's only truly successful multinational. If these two IPOs prefigure the whole thing coming to market, then it's not just the investment bankers who would be salivating: it would transform the Malaysian market.

Petronas started life in August 1974, a function of the five-year-plan launched by the ruling Barisan Nasional Party – still the leadership today – upon the restoration of parliament three years earlier. Modelled on Indonesia's Pertamina, and partly prompted by new technology enabling drilling offshore for high-quality Malaysian crude, it was intended to enshrine national sovereignty over Malaysia's oil and gas reserves. It started out as just a manager and regulator of upstream resources, then went downstream and into exploration in the 1970s, and entered liquefied natural gas, refining and distribution in the 1980s and shipping in the 1990s. At one stage, in an uncharacteristic miscalculation, it even became a banker, taking over Bank Bumiputra; it spent five years trying to bail it out of bad loans to the collapsed Carrian property group before selling it back to the state and deciding to stick to what it is good at.

Petronas is now a fully integrated oil and gas multinational, active in more than 30 countries. It logged M$216.4 billion ($68.8 billion) in revenues, and M$67.3 billion in pre-tax profits, in the year to March 31. Domestically, for an illustration of its status one has only to look at its head office: it and its associates occupy the whole of Tower One of the twin Petronas Towers, Mahathir Mohamed's record-breaking two-towered salute to the world, an expression of Malaysia's post Asian-crisis pluck. Incidentally, Petronas owns the towers, through its KLCC (Holdings) subsidiary.

But Petronas is not just about its scale as an enterprise; it's more about its impact on Malaysia's broader finances. Today Petronas accounts for about 45% of government revenues. One local fund manager calls it "the unofficial banker to the government", while a diplomat familiar with Malaysia calls it "the biggest bucket of money in Malaysia, and they will dip into it and dip into it and dip into it again." And it has every right to do so: as a state utility, Petronas dividends go directly to the state and have funded much of the country's expenditure from mega-projects such as the Petronas Towers to plain old health and education.

"It has represented all that can go right in an emerging market economy," says Raja Teh Maimunah, head of global Islamic markets at Bursa Malaysia, which operates the stock market. And it is interesting that it has done so in a unique way. It has always had a reputation of being run as a state-owned company in which the state itself – in terms of politicians – has been kept firmly at arm's length. "They're unique in the sense that they had the right leadership at the top, and were entrusted to do their job and had the people to try to execute it," says a local analyst, unwilling to be named. (Almost nobody is prepared to be named when talking about Petronas, such is its perceived local status; Petronas's corporate affairs team, up on the 70th floor of the tower, declined comment for the article too.)

What's in a listing?

In a vast, sprawling network of more than 100 subsidiaries and 40 joint venture companies, the listing of a couple of subsidiaries is not, on the face of it, that big a deal. Besides, Petronas has listed subsidiaries before. In the mid-1990s, Petronas Dagangan, the domestic marketing arm, and Petronas Gas, which handles gas transmission and processing and owns the Peninsula Gas Pipeline between Malaysia and Thailand, were listed. They have since been followed by KLCC Property Holdings, which includes the Petronas Towers, and MISC Berhad, which includes shipping interests. Between them, they have a market capitalization of just over $5 billion.

So why is this different? Partly it's about the times: these listings are a function of a political pledge from the very top, one that could lead to a lot more of the group finding its way into public hands.

On March 30, prime minister Najib Razak, rocked by the strong showing of the Anwar Ibrahim-led opposition coalition in the most recent elections, addressed the country's landmark Invest Malaysia conference. Najib did a lot with his address: he announced the effective reversal of the New Economic Policy, an affirmative action approach implemented by his father decades earlier; he pledged an end to onerous requirements that IPOs have a strict quota allocated to Bumiputra (ethnic Malays); and he urged more Malaysian heavyweights to list (or, for those already

Serving Petronas

There are few more highly prized clients than the Petronas group. Deutsche Bank and Morgan Stanley – both fresh from their roles on the record-breaking Agricultural Bank of China IPO, and galvanized by their appointment on the revived AIA flotation – have continued a stellar year by being mandated as joint global coordinators alongside CIMB on the Petronas Petrochemical flotation. On MMHE, the joint leads will be JPMorgan, Credit Suisse and Maybank.

How does a bank win a Petronas mandate? Neither Morgan nor Deutsche were obvious ECM choices in Malaysia, neither having handled a decent equity deal there since a rights issue by Axiata in April 2009. Neither made it on to the Maxis IPO, a deal that included some 14 banks.

Instead, it seems to be more about loyalty for other work. Morgan Stanley was a lead manager on the vast Petronas bond and sukuk issue that raised a combined $4.5 billion in August 2009, while Deutsche has an M&A relationship with the group.

Some banks grumble that Petronas does not always put out a request for proposal (RFP), although others consider this suggestion sour grapes. Nevertheless, it is rumoured that more banks might be added to the Petrochemical float; and with CIMB and Maybank already represented between the two listings, it would be something of a surprise if RHB did not get a role. This is partly because it has a Petronas relationship – in particular it has handled a $1.5 billion rights issue for Misc, the shipping subsidiary that oversees the MMHE business – and partly because, as well as being a good bank, it more or less guarantees participation of the Employee Provident Fund in the flotation (EPF, the biggest institutional fund in Malaysia by a mile, is a big RHB stakeholder).

Petronas Chemicals' draft prospectus, without timetable or pricing information, was lodged on September 7 following a listing document from MMHE in July. Both flotations are expected to appear in the fourth quarter. MMHE is curious in that its cornerstone buyer, the French engineering and construction group Technip, will come in at a premium of 2% to the institutional price. MMHE is likely to raise about $600 million, Petrochemical at least $2 billion.

In the debt markets, representing Petronas is seen as something akin to representing Malaysia itself. Particularly on the Islamic side, it has been so long since the sovereign has issued a sukuk that Petronas is seen very much as a proxy for the state.

"People do essentially look at them as the sovereign," says Raja Teh Maimunah at Bursa Malaysia. "When you see the pricing of Petronas paper, they don't trade like your typical single A across the eurozone. They trade very tightly."

listed, he urged them to expand their free float).

The new Petronas listings fall within that context. They are substantial businesses: Malaysia Marine and Heavy Engineering (MMHE), part of the Misc subsidiary, had revenues of more than M$4 billion for the year to March 31 2009, driven by engineering and construction services, marine conversion and marine repair.

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Raja Teh Maimunah

The petrochemicals business is bigger still: M$12.2 billion in the year to March 31, from olefins, polyolefins, fertilizers, and industrial and speciality chemicals, with more than 10 million tonnes of petrochemicals production annually. It is, among other things, Asia's biggest producer of methanol. Some feel that the petrochemicals business will be the first time a successful Malaysian global player has been listed.

Petronas clearly does not need the money, so the new listings have instead been portrayed very much as an act of public service. "Speaking as a citizen, Petronas floating two more of their companies means a lot because we know for a fact they do not need to tap the equity markets," Raja Teh at Bursa says. "It's about allowing Malaysians to participate and deepening the capital markets." Shamsul Azhar Abbas, the Petronas chief executive, said in April: "Like our other listed subsidiaries, these two new listings will allow the investing public to participate directly in some of Petronas's businesses. We hope that these listings will add further depth to the Bursa Malaysia." And that's exactly what market participants are hoping for, not just from these listings but others that might follow.

So just what would a full listing entail? A Deutsche Bank report earlier this year argued that as a publicly listed company, assuming a price to earnings ratio of 15, it could be worth $207 billion – not far short of Malaysia's entire market capitalization of $257 billion at the time. Petronas, if fully listed, could make up 40% of the entire bourse.

Nobody is suggesting a complete listing is on the way but even a 25% flotation could make all the difference to Malaysia's standing in Asian markets. That volume, Deutsche concluded, would get Malaysia's weighting in the MSCI Asia ex-Japan index back on a par with Singapore, which accounts for 6.6% of the index; Malaysia's share is just 3.8% today. It would also move it ahead of Indonesia, Thailand and the Philippines.

This is what local fund managers want to see. "The MSCI weighting of Malaysia is getting smaller and smaller, and we are being overtaken by less-developed neighbours such as Indonesia," says one. "FDI is falling. We don't have that many world-class companies here in Malaysia. We really need Petronas to jump start the capital markets." Foreign direct investment last year fell off a cliff: it was down 81% on 2008, and down 66% on its annual average from 1995 to 2005. It is in the light of numbers like this that Najib seeks to revamp his markets and economy.

Malaysia has had a moderately active bourse but the market has been short of landmarks. "The last exciting IPO was Maxis and that was a re-listing," says another fund manager. "So, yes, we're very happy to get the two new subsidiaries, but at the same time why not list Petronas itself? The concern of the government is to say why would they put their cash cow in public hands, but you don't have to put the entire company on the exchange."

A third manager says: "The fact that the government has said we will list two subsidiaries shows they realize they have got to do it [list the whole business] eventually."

If it happens, Bursa certainly won't be complaining. "There's a lot of excitement," says Raja Teh. "Petronas hasn't come out and done any listings except for its downstream operations 15 years ago; offering the petrochem and heavy engineering business will, we hope, add some depth to the market." As head of Islamic development, she is particularly excited since Petronas and its subsidiaries are Shariah-compliant, although she is more pragmatic about the parent ever appearing on the exchange. "The parent, as in the holding company, I don't think will ever be listed."

International managers like the idea of a full listing but question its likelihood. "It would be big, and it is a success," says Hugh Young, who runs the Asian portfolios at Aberdeen Asset Management from Singapore. "But would the government want to share its cashflow and open it to scrutiny?" Of the new listings, he says Aberdeen will "take a look".

Others find the idea of a full listing absurd. "The real meat of it will forever remain private," says a leading local analyst. "Petronas is not just a company. It's as much an agency as it is a GLC [government-linked company]. It is supposed to be the custodian of all our assets. To list it in its entirety, while exciting for bankers, would be politically suicidal and deeply undesirable even if you take out the politics. Why should foreigners share in our oil when there's so little of it left?"

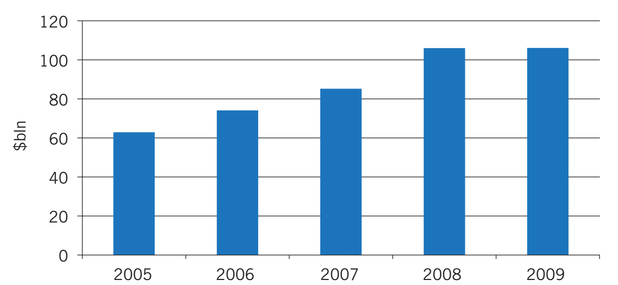
He swiftly disregards the argument that a listing brings market discipline. "I've always thought Enron told you otherwise. Petronas, quietly, privately, has grown from a small government agency into what it is today."

A new leader

There is another very important element to the story: the change of leadership at Petronas.

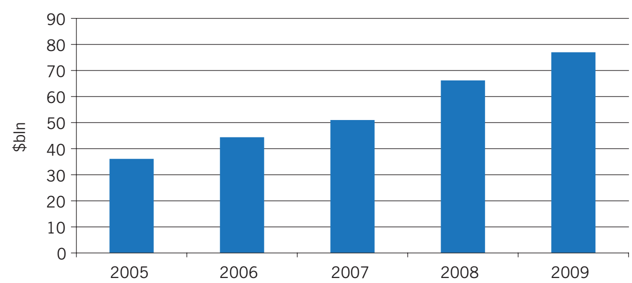
Late last year, it became clear that the chief executive, president and chairman at the time, Hassan Merican, would be expected

PETRONAS' FIGURES
Total assets 2005 to 2009



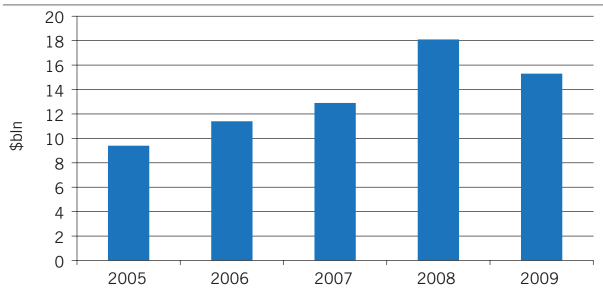
Source: Petronas

Revenue 2005 to 2009



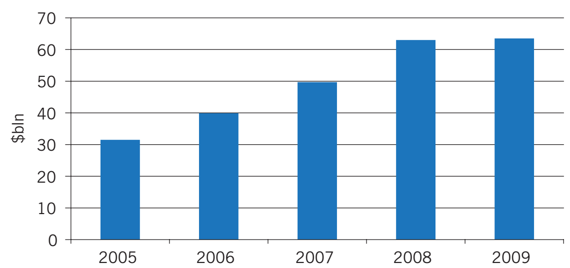
Source: Petronas

Net income 2005 to 2009



Source: Petronas

Shareholders' funds 2005 to 2009



Source: Petronas

to step down when his term expired after 15 years at the helm in February 2010. Merican is a tough act to follow: he, more than anyone, is associated with Petronas's rise from modest utility to national champion and Malaysia's global corporate figurehead. He carries off the extremely difficult double act of being widely admired both inside and outside Malaysia. "Hassan Merican has been one of those brilliant personalities," says a senior Malaysian. "There was a sense that he was doing this in the interests of the country and would never allow politics to be mixed with it."

Correspondingly, the process of selecting his replacement was closely watched, particularly for signs of political interference. When the winner was announced, some were surprised: Shamsul Azhar Abbas, previously head of the shipping unit Misc, was seen as something of an outsider despite three decades in the company, including stints in oil trading and upstream exploration.

Where Merican was well known for resisting suggestions foisted upon him by government, whether of politically helpful investments or staff being earmarked for senior positions in the company, many wonder whether Shamsul will be willing or able to exercise the same pro-company belligerence, and see in his appointment an erosion of the separation that has made Petronas what it is. Analyst David Kiu calls it "the key question about the tension between running Petronas as a profitable company and using Petronas as an instrument for state policy".

Others – notably founding chairman Tengku Razaleigh Hamzah – find it ridiculous to imagine Petronas ever having been separate from politics, since the company's Articles of Association expressly give the prime minister power to appoint and remove anyone he wants to and from the board. Mahathir Mohamed has for years held a "special adviser" role and was instrumental in appointing Merican himself.

"How can it not have had political interference?" says an analyst. "In my view that's not really the point. The concern is more: you're changing the players and you don't know who the players are. After 30 years everyone's cynical about why you would want to change something that's working."

The relevance of the change of leadership in the listing debate is that Shamsul came on board just before Najib announced the policy of more stock market flotations. And since he rose up through the Misc business, which is already separately listed, he is likely to be amenable to greater listings.

If we do see more and more of Petronas enter the public scrutiny that comes with listing, it will face the challenge of accounting for some of the unsavoury places it does business. Some 40% of group revenue in 2008 came from international projects, which included Iran and Sudan. Operations in Myanmar are proudly highlighted in a rotating series of images on the Petronas home page; and in December Petronas, alongside Total and China National Petroleum Corporation, won the rights to develop Iraq's Halfaya oil field. None of this makes much difference in a private company, but it is curious there is no mention of the group's Sudan refinery in the Petronas Chemicals draft prospectus, suggesting it may have been removed from the business to be listed.

Discussion about a listing of the parent will gather pace as the subsidiaries float later this year, but in the end it comes down to a single issue. "It's Malaysia's gem, isn't it?" says a local fund manager. "The issue is, do you want to privatize the national cow?" EM

The politics debate

One of the most popular debates on the Malaysian blogosphere is about political intervention in Petronas. An example is the venom that accompanied the appointment of Sheryl Stothard into the corporate affairs team; Stothard had previously been a senior figure in Parti Rakyat Malaysia, a political party.

An interesting twist, though, came as Hassan Merican's successor was being debated, and it came from Tengku Razaleigh Hamzah, a former Malaysian finance minister who was also the founding chairman of Petronas. Tengku knows Petronas as well as anyone, and his points on corporate governance and separation of commerce and government were revealing about the unique institution Petronas has become.

"The question of a tussle of wills between the board of Petronas and the prime minister does not arise," he wrote in a contributed article to the *Malaysian Insider* publication. "The Articles of Association governing Petronas give the prime minister the absolute power to appoint and remove every single member of the board and management. The prime minister has the right to appoint or remove anyone, from the president and chief executive officer down to the company drivers."

He added: "It is puzzling that appeals are being made for the prime minister not to interfere in the composition of the board of Petronas, when it is in fact his duty and sole prerogative to appoint members of the board who will help him in his function of overseeing the running of this wholly state-owned enterprise and seeing to the disposal of the wealth that it generates."

Tengku also sought to distance Petronas from other government-linked companies (GLCs). "Petronas is unlike any other GLC. It has only one shareholder: the state." He added: "The entire oil and gas wealth of Malaysia is vested in Petronas… it was not formed to privatize our oil and gas reserves but to safeguard our national sovereignty over them… it is charged with ensuring our energy security."

Tengku moves into less palatable territory for corporate governance advocates when he says: "If any member of the board disagrees on principle with the prime minister's decision to appoint someone, he should resign.

"Those calls being made in the name of good governance for the prime minister not to interfere unwittingly advocate bad governance because they are framed on a misunderstanding about the nature of Petronas and therefore about who it is accountable to."

Tengku is in a good position to know this: he helped draft the Petroleum Development Act, which enshrines Petronas's very existence. When he did so, he says, the Act "did not envisage Petronas becoming a mega-corporation accountable only to privileged insiders".