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Maximizing Value – A Look Back at FGV Holdings Berhad

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Abstract

This paper explores a number of relevant capital structure theories that may help explain the real market occurrence. The debt-equity ratio is commonly utilized as a variable of interest by many to evaluate the viability of company's capital structure. Based on Modigliani-Miller Trade-Off theory (1958), their major goal is to examine how firm-specific capital structure determinants may impact the company's capital structure choice. It is essential to comprehend how firm-specific factors could exert a direct impact on a company's share price in both the short and long run. In the case of FGV Holdings Berhad, its capital structure composition has shifted from equity-weighted to debt due to FGV's improved cash flow situations, allowing them to secure wider options of financing from the capital markets. As a result, the company's total debt to total assets ratio has risen dramatically to 76.4 percent. However, it is vital to note that FGV's debt interest payments are not adequately supported by profits before interest and tax (EBIT). Debt financing invariably requires interest payments, regardless of whether it is provided through the bond or banking markets. The net result could jeopardize the company's value through declining share price. The Trade-off theory is seen ideal in explaining the financial conditions in FGV. It is important to balance out the benefits of debt against the costs of debt at all times. Overall, FGV's top management should consider conducting a thorough review on its entire capital structure since the debt levels have climbed dramatically since 2014, along with a declining cash level in mid-2014.

Keywords: Plantation Sector; Share Prices; Debt-Equity Ratio; Capital Structure Theories; FGV Holdings Berhad

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Introduction

The Federal Land Development Authority (FELDA) is a Malaysian government agency that manages the movement of poor rural people to new settlements and facilitates the coordination of agricultural goods for agricultural operations. Since the 1990s, FELDA has not developed new communities, but it has been active in a variety of urban development and commercial business operations. In fact, FELDA has launched a number of private firms locally and internationally.

FGV Holdings Berhad has been well acknowledged as the country's top agricultural producer, especially in Peninsular Malaysia. In particular, FGV manages 811,140 hectares (2,004,400 acres) of oil palms throughout Malaysia. Historically, FELDA was established on July 1, 1956 following the passage of the Land Development Act. The first FELDA community was set up at Air Lanas, Kelantan. Tunku Abdul Rahman, the the first Prime Minister of Malaysia, launched this settlement in 1957. There were 400 farmers who had been chosen to participate in the program. In the following year, FELDA continued its development program by concentrating on 2,946.88 hectares of rubber-focused land at Lurah Bilut, Pahang. This second project involved RM10 million start-up

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investment (Mohamed Noor & Abdul Hadi, 2021).

To avoid being affected by a sudden and significant drop in world rubber prices, federal government began to emphasize a new agricultural growth policy in the 1960s and 1970s. FELDA's largest oil palm community, covering 3.75 square kilometers (1.45 square miles), was first established in 1961. For a record, oil palms were awarded 6.855.2 square kilometers (2.646.8 square miles) of land under the FELDA systems in 2000. Although a lot more government agencies are needed for agricultural expansion in the East Malaysian states of Sabah and Sarawak, FELDA still put its focus on West Malaysia (Peninsular Malaysia).

Listing of FGV at Bursa Malaysia in 2012

In 2009, Felda Global Ventures purchased 51% ownership of Malaysia's largest sugar refiner, MSM Malaysia Holdings Berhad, from PPB Berhad Group for RM1.25 billion (founded by Robert Kuok). This was one of the important events that took place before the company was absorbed into FGV Holdings Berhad (FGV). Today, FGV is a multinational agricultural and agri-business firm with its headquarter in Kuala Lumpur, Malaysia. FGV is a global producer of oil palm and rubber plantation commodities, oleochemicals, and sugar products. It was one of the publicly listed companies at Bursa Malaysia in 2012, becoming the largest IPO in the world after Facebook and the largest IPO in Asia that year. It is currently the world's third largest acreage-grown palm oil enterprise (Mohamed Noor & Abdul Hadi, 2021). FGV holds up to 439,230 acres of farmland in Malaysia and Indonesia, as well as property leased by FELDA under a Land Lease Agreement (LLA). Every year, the palm oil sector produced roughly 3 million metric tonnes (MT) of crude palm oil (CPO).

Companies are required to present good business track records in order to fulfil the requirements for admission to the Bursa Malaysia. The firm is deserving of being included in the stock exchange for a number of good possible reasons. Normally, the main reason is to compete for funding with other listed companies on the Bursa Malaysia. Because FGV is now listed at Bursa Malaysia, it may compete with other listed companies to attract as many investors as possible. The funds from these shareholders will be used to appropriately grow the company in the long haul. Furthermore, having good access to capital markets, companies will be able to sustain their long run growth and profitability.

Failure to take over FGV private

The Federal Land Development Authority (Felda) failed in its attempt to buy FGV Holdings Bhd for RM1.30 per share in 2021. This leads to the question of Felda's alternative strategy, given that it cannot fully acquire the listed plantation company. According to a filing with Bursa Malaysia, Felda only secured an 81 percent ownership stake in the FGV after the offer was concluded at 5 p.m. on March 15, 2021. This suggests that the authorities need to receive approval from other shareholders who jointly own FGV shares, equating to a 95 percent equity stake in this giant plantation company, or around 3.46 billion shares.

It is important to note that Felda also acquired 455,800 shares, or 0.1 percent of the total number of shares from owners who approved the takeover offer. Felda needs to address the minimal requirement on public ownership distributed at FGV as a result of the failed attempt. Bursa Malaysia mandates a public ownership spread of 25%, whilst FGV presently delivers only 19%.

Felda completed the valuation requirement and its buyout bid on FGV was valued at RM4.74 billion, or RM1.30 per share. This represents a 71.43 percent drop from its initial public offering price of RM4.55 per share in 2012. The offer, which was initially publicized on December 7, 2020 and became unconditional on December 23. In fact, the deadline had been pushed back three

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times, from February 2 to March 15. Felda's effort to take over FGV coincided with Felda's plans to

FGV. For a record, FGV rents 350,000 hectares of plantation land for RM248 million per year together with 15% profit for 99 years under the LLA. It is estimated that the termination of the LLA might cost Felda roughly RM4 billion.

Following the unsuccessful takeover, the federal government are currently devising new strategies in beefing up Felda's financial sustainability including Felda's lower-than-expected earnings from the leasing agreement with FGV.

Literature Review

There are many finance theories that explain how share or stock prices are determined either by

terminate its land leasing agreement (LLA) with

the internal factors or external forces. In most cases, both internal and external factors are the key determinants that could influence company's share price. It is also important to understand how sensitive those stock prices to the changes in the two factors (Friends & Lang, 1988). This stock price sensitivity towards changes in these factors may take place almost immediately or over long haul. Previous studies have shown that share price is frequently used by researchers as a proxy for measuring company's performance. Looking at Figure 1 below, the FGV's share price movement had been plateau since 2016 and it could hardly break the resistance level of RM2.00 per share.

Figure 1. Historical Prices for FGV Holdings Berhad

The declining share price since 2014 had sent a clear signal that FGV was grappling with some issues. The business prospects and the management style were put into test by the critics. FGV was associated with poor management and operational inefficiency. Audit reports finally confirmed that some pressing issues were discovered in the business processes and financial management. As a result, FGV succumbed to a poor financial performance and its stock prices were traded at tight range between RM1.15 and RM1.35 per share.

The Trade-off theory seems fit to explain the financial situation in FGV since its inception. This theory is also known as the Static Trade-off Theory and is based upon the expectations of firm's value from the capital mix that involves both of debt and equity financing. According to the Static Trade-off Theory, the optimal debt ratio is determined by a tradeoff between costs and benefits of the debts, company's assets and its investment plans (Kane, Marcus & McDonald, 1984). The value of interest tax shields will be balanced by the firms against the cost of bankruptcy (Myers, 1984).

There are non-core businesses in FGV that also require additional funds and good initiatives but do not produce the kind of monetary returns

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that a rational investor would anticipate. There is no doubt that palm oil sector is a very competitive business and therefore efforts to promote good governance and best practices should be hailed. The market and public perception matter as they could project a good corporate image about the company. Yet, this giant plantation company is still being prejudiced by the ongoing public misunderstanding about the land leasing arrangements and this problem must be rectified as soon as possible. The business activities of FELDA agency, FELDA Investment Corp (FIC), and FGV Holdings Berhad are always under the scrutiny of many parties. The previous board of directors and top management were unable to effectively examine numerous issues in hand. As such, there is no clear direction as to how those problems should be resolved until a new management team steps in.

Methods

This study embraces a case study approach in which we extract documentary evidence from financial reports to generate an in-depth and multi-faceted understanding of business issue in the company's real-life context. This study also employs descriptive statistics and trend analysis in order to understand FGV's financial profiles and its pressing issues lingering in the company. Some classical and contemporary capital structure theories are also presented in this research. The most relevant theory that best explain the financial conditions of FGV will be further deliberated in the analysis and discussion section.

FGV needs to strategize a better business plan in order to turnaround its problematic business operations. Some of FGV's productive resources have been drained out due to aging factor. At listing in 2012, as many as half of FGV's plantations were already excessively old and replanting projects had been planned throughout Malaysia. However, the replanting activities were not carried out on schedule and the delay was extended for a few more years, leading to a worsening financial condition. It is evident at this point the FGV was engulfed with managerial and monitoring issues.

Furthermore, the funds generated from the IPO had not been fully optimized, and not much of it would have been effectively used. The Roundtable Sustainable Palm Oil (RSPO) non-profit organization has accused FGV of labour exploitation and human rights abuses. The RSPO audit committee discovered more than 40 deficiencies at FGV. At this point, FGV has no choice but to address the issue of corporate governance and sustainability objectively.

Results and Discussion

There are some interesting findings about FGV in this study. As mention earlier, there is a strong connection between FGV's share prices and its D/E ratio over time. Table 1 below shows that results of correlation analysis between price and D/E. There is a significant strong negative correlation between them as indicated by the correlation coefficient of -0.8149.

Table 1. Pearson Correlation Analysis (H_0: Rho=0)

Variable (N=10)	Share Price	D/E Ratio
Share Price	1.00	-0.8149
p-value		0.0041*
D/E Ratio	-0.8149	1.00
p-value	0.0041*	

* significant at 5% level

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Table 2 reports the data tabulation of share price and D/E over 10-year period. The highest price was RM4.61 in 2012, the year that FGV got listed at Bursa Malaysia. The lowest price was registered in 2019 hovering around RM1.18. The mean value of FGV's share price during this observed period is RM2.30 but its standard deviation is quite high at RM1.35.

Table 2. Tabulation of Share Price, D/E Ratio and Sales

Years	Share price	D/e	Sales (rm '000)
2012	4.61	1.37	16,499,301
2013	4.50	1.32	20, 721,565
2014	3.43	1.35	16,369,273
2015	1.71	1.49	15,558, 769
2016	1.92	1.56	17,241,275
2017	1.78	1.62	16,921,774
2018	1.20	1.83	13,464,480
2019	1.18	1.90	13,259,012
2020	1.22	1.81	14,075,712
2021	1.47	1.50	19,565,891

The downward trend in share prices is very obvious over the 10-year period as presented in Figure 2. As highlighted earlier, FGV could suffer from internal issues or its inability to deal with external forces that are beyond FGV's control. In financial theory, these uncontrollable risks are normally associated with market risks.

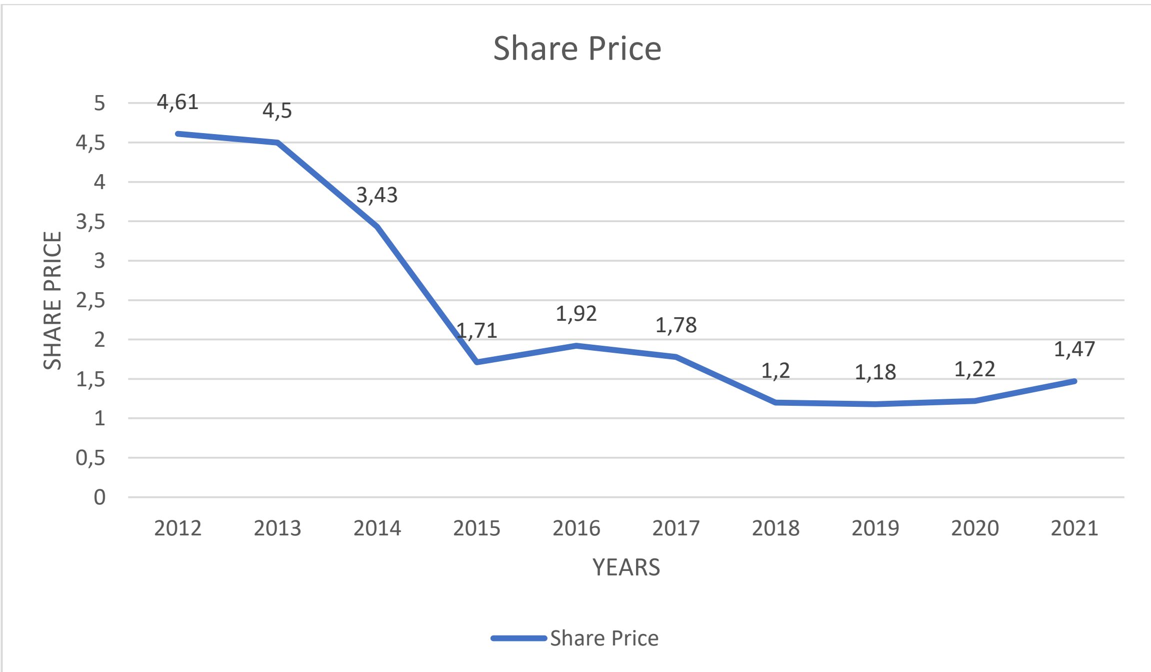

Figure 2. Downward movement in FGV's Share Price

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The debt-to-equity (D/E) ratio illustrates the proportions of equity and debt used to fund a company's assets and its working capital. This ratio also indicates the extent to which shareholder equity can fulfil commitments to creditors if the company is forced into liquidation (Luigi & Sorin, 2009). Technically, a low debt-to-equity ratio implies that the company uses less debt from lenders and more equity from shareholders. A greater ratio implies that the company is borrowing money for more of its funding, which exposes the company to possible danger if debt levels are too high. This financial condition is clearly explained by the Trade-off Theory. It is evident in Figure 3 that FGV's D/E has continued to increase each year, with the exception of year 2020 and 2021.

It is also known that the debt-to-equity ratio could influence stock prices in a favorable and unfavorable way. The lower debt-to-equity ratio signals that borrowing activities in the company have been reduced and this is translated into risk mitigation which in turn might trigger share prices to rise.

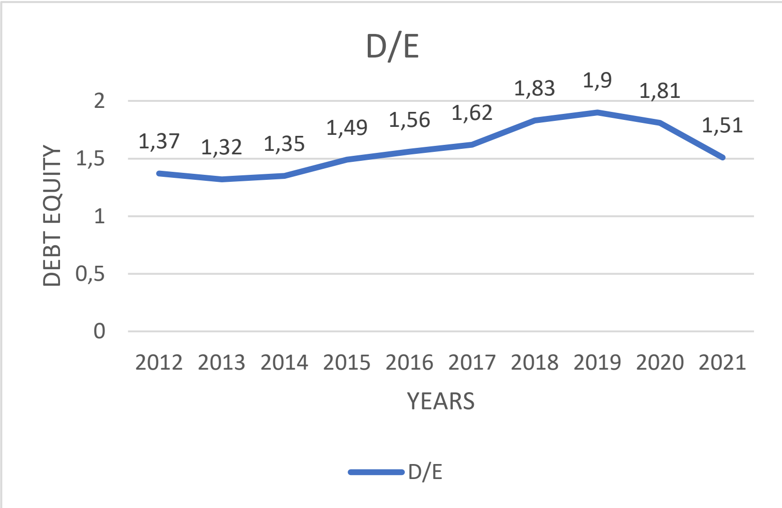

Figure 3. FGV's Debt Equity Ratio Over Time

In general, significant improvement in company's earnings and optimal capital structure (as measured by debt-to-equity ratio) may lead to an increase in the stock price and vice versa. However, there are instances whereby some companies that are not producing much profits could also have skyrocketing stock prices. This upward movement in share prices simply demonstrates investor confidence in the company's future profitability. Regardless of the share prices, there is no assurance that a company could always meet investors' expectations of higher return on investment consistently.

Sales revenue is sometimes used as a proxy for company's size (Ying, 1966). Although sales do have some effect on future share prices, profits or earnings seem to be a more credible determinant for company's value (Modigliani-Miller, 1958). It is acknowledged that sales and profits are highly correlated but it is the company's total operating costs that controls the final profit margin (Sholikah & Nurasik, 2021). Hence, cost management is critical in managing a giant corporation like FGV. A tremendous decline in FGV's oil palm sales between 2018 and 2020 as depicted in Figure 4 was attributed to statewide replanting activities. Farming activity accounts for around 75% of FGV's total revenue and significant disruptions in this upstream segment would detrimentally affect FGV's bottom line. It is worthy to note that the price of crude palm oil is also dictated by the worldwide commodity markets and this pricing issue does not impact not just FGV alone but also the entire farming industry in Malaysia.

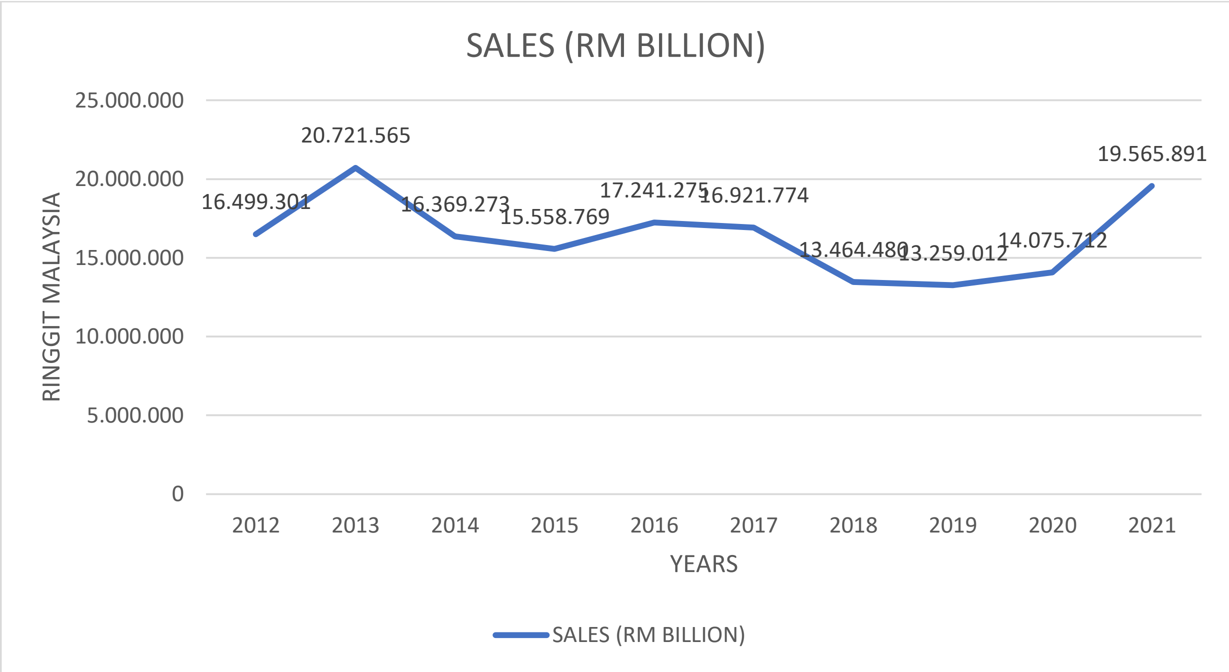

Figure 4. Sales Performance of FGV

Conclusions

This study looks at how large changes in a company's capital structure, particularly among Malaysian listed businesses on the Bursa Malaysia, might affect its value. This study also explores various relevant capital structure ideas that may help explain the real market situations. The debt-equity ratio is commonly utilized as a variable of interest by academics to assess company's capital structure. Based on Modigliani-Miller's work in 1958, their main focus is on understanding how firm-specific capital structure determinants like current assets, sales, total assets, earnings per share, fixed assets, and return on equity may impact the company's capital structure formulation. It is essential to comprehend how liquidity, marketability and profitability may influence a company's share price over short run and long run period.

Based upon FGV's Annual Report 2018, the company's capital structure composition has shifted from equity-weighted to debt in view of FGV's improved cash flow management. This situation permitted the company to secure long-term debt financing from the capital markets. As a result, the company's total debt to total assets ratio has risen dramatically to 76.4 percent. However, it is vital to note that FGV's debt interest payments have not adequately supported by its profits before interest and tax (EBIT) during the repayment tenure. Debt financing consistently requires interest payments, regardless of whether the financing is provided through the bond or banking markets. The advantage of debt financing is that it is less expensive than equity financing. There is no doubt that debt financing is a more desirable source of funding, especially when the company is capable of obtaining higher rate of return. As a whole, FGV's top management should monitor how the current business model could fit into delivering investors' expectation of improved business performance.

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