

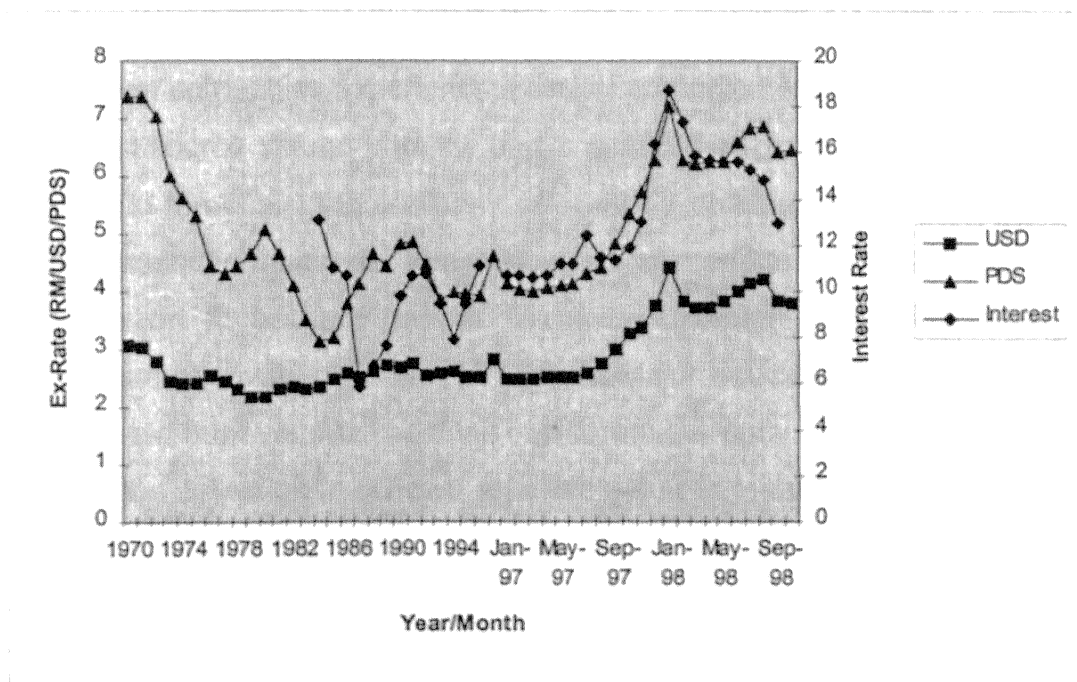
CHAPTER 3

3. Impacts of economic and financial crisis to TENAGA and the power companies.

3.1 The Crisis

Since mid-July 1997, the Ringgit Malaysia has fallen precipitously reaching RM4.88 to the US dollar in early January 1998, its lowest ever level, and this represented a collapse by half within less than half a year from a high of RM2.47 in early July 1997. As for the stock market, it has fallen more severely, with the main Kuala Lumpur Stock Exchange (KLSE) Composite Index (KLCI) dropping to less than 300 point in August 1998 from over 1300 in the first quarter of 1997, wiping out more than 80% of the market value. The performance of Ringgit Malaysia against US dollar and Pound Sterling and the interest rate of banking institution is shown in Figure 1 below.

Figure 1 : Performance of Ringgit Malaysia and Interest Rate



From the perspective of macroeconomic, this twin crisis of plunging share values and the Ringgit Malaysia has prompted the government to reduce its spending, tightening monetary policy to reduce credit growth and contain inflationary expectation, and naturally increase the interest rate.

Whilst from the perspective of firm level, the impacts of the crisis on TENAGA in particular are: -

- reduction in the value of the company's share, from a high RM10.10 early of the year 1998 to a low RM2.00 in the month of August 1998; representing a loss of more than 80% of the company's market value, thus limiting the source of fund from the equity capital market
- increase cost of servicing its Yankee bond due to depreciation of Ringgit Malaysia.
- increase operating cost in terms of imported goods/components due to depreciation of Ringgit Malaysia
- increased borrowing cost of fund to finance its operations due to high interest rates
- cut its capital expenditure to RM1.9 billion from RM4 billion for the current year.

The power companies experience a similar contagion effect,

- limited source of fund from the banks due to the tightening of credit growth. Prior to the crisis, the company can easily obtained loans from the bank by presenting their order book values as collateral to the loan.
- obligation to account payable in multiple foreign currencies, while the account receivable are only in Ringgit. Major equipment of the projects is imported from various countries in different currency.
- overdue collection in account receivable due to inability of TENAGA to pay its obligation to the power companies.
- low and no new sales due to the projects deferment by TENAGA. TENAGA has freeze in awarding any new contracts even though the projects had been tendered in the year 1997. Validity of these tenders has expired and

TENAGA did not request for extension of the validity. The total value of these projects was more than RM2 billion. In the first half of 1998, only 3 tenders are being floated by TENAGA which give a total value of less than RM70 million, a far cry value as compared to RM2.4 billion in the year 1997.

- reduction of current sales due to capital expenditure cut by TENAGA. For the first half year of 1997, TENAGA had awarded projects contract with the value of more than RM1.5 billion in transmission and distribution system as part of their transmission and development programme. Even the contracts were awarded, TENAGA has deferred the job to a longer delivery period, and also cut the scope of work, hence reducing the value.
- over-capacity in human resources and production facilities because of the rapid expansion during pre-crisis period. With the number of contracts awarded during the good times, most power companies had to expand their production facilities as well as increasing their manpower in order to execute the contracts. The limit of supply for specialised manpower, in particular power engineers in the market, had contributed to the high cost of recruiting and maintaining these overheads.
- the local power companies are too dependent on TENAGA as their source of revenue. Other source of revenue especially from the domestic private projects (normally 11kV and below) are limited even the market size and value is substantial. Private market projects are considered not attractive due to competition from many capable contractors. Diversification to other foreign market by the local power companies only started a few years ago.

3.2 *The Main Problem in the Crisis - Exchange Risk*

3.2.1 The Problem

A look at the various public listed power companies' annual report and press statements on the effect of devaluation of Ringgit Malaysia against various currency, clearly showed that there is a high level of exchange exposure.

The main financial problem faced by these companies is how to manage the exchange risk . This problem is clearly stated by TENAGA's chairman in the press.

"Tajuddin attributed the RM1.9 billion loss (of Tenaga Nasional in the first half of 1998) to soaring operating costs due to the ringgit's depreciation." ...the Star Business, Friday July 10, 1998

"Tenaga Nasional Berhad is swapping its US dollar debt for more yen-denominated debt after suffering massive translation losses of RM3.5bil this year and RM1.3bil in 1997." ..the Star Business, Wednesday November 11, 1998.

Most of the losses experienced by the power companies are largely due to the depreciation of Ringgit for the current projects undertaken. These projects are the projects that were awarded during the pre-crisis and to be delivered and completed during this 2 to 3 year periods. The foreign currency requirement was either not hedged or partially hedged because of the expensive cost of hedging for the large amount of foreign currency involved, and the timing of the equipment procurement.

3.2.2 Exchange Risks Definitions

Alfred Kenyon(1981) defines risk arising from exchange rate into two categories - economic currency risk and financial currency risk. The economic currency risk refers to the risk that a sustained real rise of a currency against the currencies of competitors will adversely affect a company's competitive costs, and therefore its sales, profit margins and market share, which in turn will reduce the return on the capital and revenue investment previously sunk in its present commercial activity, and the present value of that investment. While, any other risk associated to currency fluctuation and lead to losses realised in cash or unrealised losses which show up in companies' financial statements is called 'financial currency risk'. Financial risks are then subdivided into balanced sheet risk (accounting or translation risk) and trading risk.

Trading currency risk refers to the risk of not achieving the planned profit margin on sales where the selling price and the costs are not in the same currency, due to the adverse movement in the exchange rate from the rate used in pricing decision and the receipt of payment. The main elements in this risk are the currency mismatch and the time lag between the pricing decision and the collection of payment, which constitutes the opportunity to convert the currency received into the currency cost.

A trading risk begins with the pricing decision and ends with the cash conversion. Between these two events, there may be well one or several annual accounting dates (especially in the construction projects or where long term credit is involved), at which the trading items may feature in the balance sheet as inventory, receivable or payable. Balance sheet risk which is more commonly known as transaction risk, arise from the fact that the balance sheets from different individual foreign subsidiaries goes into the consolidation balance sheet of the parent company. The risk arise from having either more or less assets than liabilities in any given currency other than the currency in which measure gains and losses (in most cases the reporting currency) of the parent company.

3.2.3 Attributes of Exchange Risks for Power Companies

In the power companies, both the economic risk and financial risk largely attribute the exchange exposure. These risks arise from the movement of currency cost of the prospective or undergoing projects while the selling currency is the local currency. The attributes to these risks are as follows:-

- the nature of the business that involves imported high technology equipment. Typical transmission and distribution project's content is shown Table 10. It can be seen that, more than 50% of the project cost came

from imported items denominated by multiple foreign currency. It is unlikely that these imported equipment for a project comes from a single country.

- contractual payment terms by TENAGA that do not allow payment to its local contractors in multiple currencies except for Ringgit Malaysia. Even though the imported portion of the contract can be quoted in US dollar, the payment will still be in Ringgit. The US dollar portion will be converted to Ringgit at an agreed rate (the rate during the signing of the contract) when payment is made to the local contractors. The provision for foreign currency payment in the contract does not provide any advantages to the contractors since the rate had been agreed during the awarding stage which may be 6 to one year earlier. Due to the competition during the tendering stage (typical number of bidders for TENAGA tenders can go as high as 30 bidders for one particular tender) and the steady Ringgit prior to the crisis, most of the local companies quoted their tenders' price in Ringgit rather than combination of Ringgit and US dollars. This is not the case for foreign owned incorporated company whereby their pricing is in combination of US dollar and Ringgit. This pricing approach gives the competitive edge to the local contractors against the foreign owned company.
- contractual fixed price of the projects by TENAGA that does not allow any variation for changes in exchange rate except for variation in the scope of work agreed by TENAGA.
- sudden depreciation of Ringgit Malaysia beyond expectation during the period of project. Most of TENAGA projects take about 24 months for completion.
- most borrowings of the power companies are in Ringgit Malaysia to pay the imported equipment in multiple currencies. Very limited borrowing in foreign currency is available from the local banks in Malaysia. Even if the foreign currency borrowing is possible, the ability of the local company to generate foreign exchange to service the loan is limited because of very limited export activities.

- equipment price quoted by suppliers during tendering stage of the current projects is no longer valid, and as such the local equipment suppliers are now adopting their pricing in foreign currency since the crisis, to insulate themselves from the risk. However, due to local requirement regulation on transaction between local companies, payment of the equipment will be in Ringgit at the prevailing rate of the equipment delivery. Therefore, the currency risk is now transferred to the contractors.
- Restricted credit terms and conditions are imposed on the contractors by equipment suppliers, such as letter of credit or bank guarantee instead of open account terms (during pre-crisis) to ensure secured payment from the contractors. The restricted credit term has greatly affected the working capital of the power companies.
- contract price quoted to TENAGA prior to the crisis that was agreed to be extended by contractors. Validity of TENAGA tenders is normally 6 calendar months from the closing date. However, the awarding date of the tenders can sometimes goes into 12 calendar months, subject to the price agreement by the contractors. The problem applies for those tenders that were floated in third and fourth quarter of 1996, which the validity has, been extended and agreed by contractors before July 1997.