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Research article

Assessing business and financial risks: A case study of sapura energy bhd in the oil and gas industry

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ABSTRACT

The study extracts documentary evidence from financial reports and deploys descriptive statistics analysis to understand Sapura Energy's financial profiles and competitive edges. This study also deploys descriptive statistics and trend analysis to understand Sapura Energy's financial profiles and competitive edges. Sapura is one of the local pioneers that provides engineering services in the entire value chain for oil and gas exploration, development, and production. Sapura Energy was a national pride once as it was geared towards becoming a sustainable global energy and engineering solutions company. However, Sapura Energy's underperformance for the past 10 years has become debatable. Sapura is experiencing a burdensome debt from large overdue payments to vendors and some operational issues exacerbated by the COVID-19 pandemic from 2020 to 2021. Sapura should consider downsizing its business operations and recalibrating its capital structure to mitigate most business and financial risks.

Keywords: Oil and Gas Industry; Sapura Energy Bhd; Capital Structure Theories; Liquidity.

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Abstrak

Studi ini mengekstrak bukti dokumenter dari laporan keuangan dan menerapkan analisis statistik deskriptif untuk memahami profil keuangan dan keunggulan kompetitif Sapura Energy. Studi ini juga menggunakan statistik deskriptif dan analisis tren untuk memahami profil keuangan dan keunggulan kompetitif Sapura Energy. Sapura adalah salah satu pionir lokal yang menyediakan layanan teknik di seluruh rantai nilai untuk eksplorasi, pengembangan, dan produksi minyak dan gas. Sapura Energy pernah menjadi kebanggaan nasional karena diarahkan untuk menjadi perusahaan solusi energi dan teknik global yang berkelanjutan. Namun, kinerja buruk Sapura Energy selama 10 tahun terakhir masih menjadi perdebatan. Sapura mengalami utang yang memberatkan akibat tunggakan pembayaran yang besar kepada vendor dan beberapa masalah operasional yang diperburuk oleh pandemi COVID-19 dari tahun 2020 hingga 2021. Sapura harus mempertimbangkan untuk memperkecil operasi bisnisnya dan mengkalibrasi ulang struktur modalnya untuk memitigasi sebagian besar risiko bisnis dan keuangan.

Kata Kunci: Oil and Gas Industry; Sapura Energy Bhd; Capital Structure Theories; Liquidity.

1. Introduction

Sapura Energy Bhd is an important Malaysian oil and gas player. This company is built to specialize in exploration, development, production, rejuvenation, and decommissioning services in the upstream segment of the oil and gas industry. In 2011 the company was incorporated from a merger between Sapura Crest Petroleum and Kencana Petroleum. Since then, fabrication, commissioning, drilling, and engineering services have been the core businesses of Sapura Energy Bhd.

Sapura Energy Bhd used to be one of the largest companies in the oil and gas industry. However, some major financial crises have hit the company in recent years. In FY2022, the company recorded a very significant number of losses reaching RM8.9 billion. Sapura Energy Bhd's poor performance has attracted many parliament members' attention. This development proves that Sapura Energy is a significant company for nation-building, and Sapura Energy Bhd needs to turn around fast.

The significant after-tax losses in FY2022 affect Sapura's liquidity management. The company is now facing a renewed financial challenge: liquidity concerns. The company explained that the net loss was due to recognizing foreseeable losses and higher operating costs on specific projects, emphasizing some operational challenges in Taiwan and India. The latest audited financial report shows that Sapura Energy Bhd had almost RM9 billion in debt in FY2022. This is far beyond its market capitalization. Sapura has breached some of the financial agreements with its creditors. Therefore, Sapura Energy Bhd has to abide by the court ruling that all of Sapura's long-term debts have been reclassified to short-term debts. As a result, Sapura Energy Bhd's net gearing has increased to 1.3 times in the present quarter from 1.1 times in the previous quarter. Despite this, Sapura has access to an RM612 million new working capital facility. Sapura's cash flow might be affected if the vendor imposes severe credit restrictions on its RM3.3 billion trade debt. Now, the company is looking at asset sales to improve its cash flows, which might detrimentally affect its share price at Bursa Malaysia (Kuloviv, 2021).

2. Theoretical background

Modigliani and Miller's Theory

Modigliani and Miller set the foundations for capital structure in the late 1950s (Modigliani & Miller, 1958). They suggest that a firm's value is not dependent on the combination of debt and

equity with the assumptions of perfect markets. In other words, capital structure is irrelevant in a perfect market that ignores corporate tax and transaction costs. Some new theories, like Agency Cost Theory, have challenged this notion. Agency Cost Theory postulates that managers are least interested in maximizing the shareholders' wealth and more interested in maximizing their wealth. Therefore, Agency Cost Theory mainly focuses on controlling and monitoring costs. In 1977, Modigliani-Miller revised their assumption and added the personal income taxes and corporate taxes, whereby they concluded that optimal capital structure is when debts fully finance the company as the company benefits from interest tax shields. The foundations set by Modigliani and Miller have raised many other researchers to find the solution for the optimal capital structure. However, the results vary, and no consistent outcomes exist (Myers, 1984).

Trade-off Theory

This theory, also known as the Static Trade-off Theory, is based on the predictions of a firm's value from the capital mix involving debt and equity financing. According to the Static Trade-off Theory, the optimal debt ratio is determined by a trade-off between the costs and benefits of the debts, the company's assets, and investment plans. The firms will balance the value of interest tax shields against bankruptcy costs. Despite the controversy on the value of the tax shields, it only provides variations. It has been recognized that firms will be unable to minimize the cost of capital continuously. Therefore, as the theory implies, the firm must trade equity and debt financing. This theory is justified if there are no adjustment costs; hence the firm's debt-to-value will be optimal (Myers, 1984). This adjustment cost will exist since firms try to adjust the actual and target debt ratios to account for this cost.

Usually, managers are either unaware of the adjustment costs or ignore them. Thus, the optimal debt ratio remains unknown. For example, a firm might reach a point beyond which its debts become more expensive due to the increased risk of bankruptcy. This Trade-off Theory suggests that when such cases happen, creditors will demand a higher interest rate or might choose not to grant additional debts to the firms. Subsequently, the firms will be made to increase the equity financing to trade off the debt financing as the high debt level puts the shareholder's position in a precarious state. Too high debts increase the cost of capital; therefore, a proper combination of debt and equity helps to minimize the entire company's cost of capital, as suggested by this theory.

Interestingly, the theory also suggests that the optimal mix between debt and equity could maximize shareholder value (Myers, 1984). One major drawback of the static trade-off theory is that the firm can minimize its capital cost and lose its tax advantages. Equity financing is costly as the firm must pay dividends at a higher opportunity cost. Even though the firm has gained from reduced bankruptcy risk, it has also lost its tax advantage. Hence increasing the tax payable results in lower net profit reported. As such, managers need to find the right balance between equity and debt financing (Luigi & Sorin, 2009).

Dynamic Trade-off Theory

The Dynamic Trade-off Theory resolves the issue of a time dimension, expectations, and adjustment costs. In this theory, the firm's financing decision highly depends on the financing margin anticipated in the next period. In general, firms expect to pay out their funds in the next period, whereas other firms expect to raise funds. If firms were to raise funds, they would either take debt or equity or combine these two. Kane mainly contributed to the dynamic theories in 1984, whereby the effects of taxation have been examined. He creates the first dynamic model, considering the trade-off between tax savings and bankruptcy costs. The study by Kane considers the elements of uncertainties, such as taxes and bankruptcy costs, using a continuous time model (Kane et al., 1984).

The Pecking Order Theory

Pecking Order Theory is based on internal financing and only seeks equity financing as its last resort. According to this theory, firms will be utilizing their internal and existing funds from the issuance of debts, and once it is depleted, the firms will be financing with equity financing (Myers, 1984). The logical argument is that internal funds, such as retained earnings, are better than debts, and debts are better than equity. According to this theory, the hierarchy of financing choices is internal financing first, then debt financing, and finally, equity financing. The firm's chosen hierarchy depends highly on its financial growth cycle. In some cases, the theory suggests that equity financing comes first, such as for venture capitalists, whereby equity financing is better due to the uncertainty of startup companies.

The issue identified with the theory is that the theory assumes that managers are acting in the best interest of shareholders. The theory does not include why managers will be concerned over the value of the issuance of stocks. Hence, the decisions on the optimal capital structure are not assured. Moreover, the theory fails to explain why the choice of financing is not developed to avoid the manager's superior information (Myers, 1984). Managers are more aware of the information available today, which will only be available to shareholders at a future date; hence the pecking order theory fails to address this issue. Last but not least, the pecking order theory was developed for simple financial settings and not complicated settings; therefore, firms are only given a choice between equity and debt financing.

The Market Timing Theory

The market timing theory argues that firms tend to issue new stocks if they perceive the stock prices to be overvalued, and when the stock prices are undervalued, the firms will buy back their shares. As a result, the firm's capital structure is very much influenced by fluctuations in stock prices. Two assumptions support the market timing theory. Firstly, the theory assumes that there is a rationale behind the economic agents. When there is a positive information release that reduces the asymmetry issues between the stockholders and management of the firm, the firms are assumed to issue equity. On the other hand, stock prices will increase if there is a lack of information asymmetry between the stockholders and the firm's management (Myers, 1984). In this situation, firms will be creating their timing opportunities.

Secondly, the theory assumes that economic agents are irrational. When economic agents are irrational, there will be time-dependent of the stocks to be mispriced. In such a situation, the financial managers will issue equity as they believe the cost is low, and when they believe it is high, they will repurchase equity. The second assumption of the marketing timing theory does not require an inefficient market, which means the financial managers do not need to project the stock returns successfully (Baker & Wurgler, 2002). This is due to the assumption that financial managers can time the market. In many instances, financial managers try to time the equity market, and they have stated that the quantity in which the stocks are undervalued or overvalued becomes an essential consideration before they can issue the common stocks. However, even so, it is essential to highlight that financial managers may be able to time the market but not immediately distinguish between asymmetric information and mispricing (Graham & Harvey, 2001). There is evidence of a persistent effect on the capital structure due to equity market timing. The market timing pressure is defined as the weighted average of external capital needs, and these weights are considered a market-to-book value. It has been concluded that a firm's capital structure combines results from past attempts to time the equity market (Baker & Wurgler, 2002).

Agency Theory

Agency theory is another celebrated capital structure theory based on the fact that financial managers make decisions for their best interests and are reluctant to maximize shareholders'

wealth. This theory is based on the conflict between financial managers and shareholders. As financial managers are inclined to maximize their wealth, the shareholders are limited in monitoring and controlling costs (Mostafa & Boregowda, 2014). As a result, the pecking order theory was established, whereby shareholders are paid dividends to decrease the resources the manager control. A firm's growth is strongly associated with managerial incentives. Therefore as the firm grows, the management control by the financial managers will also grow and eventually increases their dominance. This has led to another conflict between the financial managers and shareholders over the pay-out policy, especially when the firm has much cash (Jensen, 1999).

Debt financing will help the managers make better investment decisions as they will bear the bankruptcy cost. On the other hand, debts have consequences too, whereby the managers might choose to invest in safer stocks and miss out on investing in some good projects (Grossman & Hart, 1982). Agency theory clearly states that the firm's value is directly related to debts. Debts are also directly related to free cash flow, liquidity, and managerial reputation (Mostafa & Boregowda, 2014). The theory also suggests that debts negatively affect the firm's growth, opportunities, interest coverage, and investigation cost. A study by Bradley in 1984 stated that their findings were consistent with the agency theory. Their study also stated that increased liquidation would increase the debts (Bradley et al., 1984). Moreover, debts are related to managerial equity ownership, but some researchers have disputed this. They argue that there is no relation between debts and managerial equity ownership (Friend & Lang, 1988).

3. Methods

This study adopts a case study approach whereby we extract documentary evidence from financial reports to generate an in-depth and multi-faceted understanding of the business issue in the company's real-life context. This study also deploys descriptive statistics and trend analysis to understand Sapura Energy's financial profiles and competitive edges. Some classical and contemporary capital structure theories are also presented in this research. The most relevant theory that best explains the financial conditions of Sapura will be further deliberated in the results and discussion section

Figure 1 above shows Sapura Energy Bhd's share price over the five years from FY2018 to FY2022. The figures are expressed in Malaysia Ringgit. Overall, Sapura Energy Bhd has gone through many crises that have deteriorated the firm's value. Nearly a 96% decrease in Sapura Energy Bhd's share price has been realized over the past five years. After this, Sapura Energy's largest shareholder, Permodalan Nasional Bhd, injected RM2.67 billion into Sapura Energy in 2018 by taking up the unsubscribed portion of the company's shares (Aziz, 2021). However, Sapura Energy's share price continues to fall to its record low. The best explanation is the surge in direct costs due to the Covid-19 pandemic. The total direct costs have escalated to RM 397 million as of July 31, 2021, with RM 111 million incurred in the first half of 2022. The sudden increase in this operating cost has resulted in project delays, primarily in Taiwan and India.

Table 1 above shows Sapura Energy Bhd's financial performance from FY2018 till FY2022. Financial performance refers to a firm's ability to generate new resources from daily operations. This financial performance considers the level of operational efficiencies and cash flow management of Sapura Energy Bhd. It is essential to see how the company has allocated its financial resources over these five years.

Figure 1. Sapura Energy Bhd - Share Prices From 2018 Through 2022
Source: Bursa Malaysia Securities Berhad

Table 1. Sapura Energy Financial Performance 2018-2022

RM million	FY2018 31/1/2018	FY2019 31/1/2019	FY2020 31/1/2020	FY2021 31/1/2021	FY2022 31/1/2022	Total from FY2018 to FY2022
Revenue	5,051	4,568	6,449	5,348	4,127	25,543
Earnings before interest, taxes, depreciation, and amortization	1,177	482	(252)	810	(2,252)	(35)
Depreciation and amortization	(1,062)	(925)	(525)	(544)	(522)	(3,578)
Earnings before interest and taxes	115	(443)	(777)	266	(2775)	(3,614)
Implements	(2,123)	(1,520)	(3,284)	-	(5,606)	(12,533)
Interest income	19	27	19	36	21	122
Interest expenses	(829)	(979)	(665)	(492)	(522)	(3,487)
Share results from associates and joint venture	277	341	155	159	84	1016
Profit before tax	(2,550)	(2,575)	(4,552)	(32)	(8,797)	(18,506)
Tax expenses	(175)	(143)	(13)	(129)	(102)	(562)
Profit after tax from continuing operation	(2,726)	(2,718)	(4,565)	(160)	(8,900)	(19,069)
Profit after tax from discontinued operation, including gain on disposal	221	2,921	-	-	-	3,142
Profit after tax	(2,505)	203	(4,565)	(160)	(8,900)	(19,069)
Non-controlling interests	(1)	(4)	(4)	1	(4)	(12)
Net profit attributable to the owner of the company	(2,506)	199	(4,568)	(1600)	(8,904)	(17,379)

Sapura Energy Bhd earned an interest income of RM122 million and paid interest expenses of RM 3.5 billion. The company paid interest expenses more than what it earned from the interest income. Sapura's income from joint venture projects contributed as much as RM1.016 billion. Interestingly, the company also paid a high tax bill of RM562 million. Over the five-year observation period, Sapura's total net loss settled at RM19.07 billion from its continuing operations. As a whole, it is clear to us that the costs of debt have far exceeded the benefits of debt, and Sapura is anticipated to look into its business transformation plan in due course.

Table 2 provides information on the Sapura Energy Bhd balance sheet from 2018 to 2022. Net debt is a financial liquidity metric used to measure a company's ability to pay its obligations by comparing its total debt with its liquid assets. Based on Table 2, the average net debt of Sapura Energy Bhd from the fiscal year ended January 31, 2018, till 2022 is estimated at RM 10.5 billion. The sizeable net debt in any company could send a negative signal to investors as the company is now exposed to a higher probability of bankruptcy. Investors and bankers use the net debt analysis to predict the withstanding power of a company in dealing with adverse economic conditions.

Table 2. Balance Sheet of Sapura Energy Berhad

BALANCE SHEET SAPURA ENERGY BHD' 5-YEAR FROM FY2018 TO FY2022						
RM in millions	**FY2018**	**FY2019**	**FY2020**	**FY 2021**	**FY 2022**	**Total from FY2018 to FY2022**
Cash and cash equivalents	1,716	8,098	722	489	718	11,743
Total asset	29,993	33,567	22,748	22,665	16,236	125,209
Total liabilities	20,542	19,705	13,574	13,728	15,982	83,531
Total equity	9,450	13,875	9,183	8,946	255	41,709
Net debt	14,607	8,811	9,425	9,787	9,957	42,640

Table 2 also shows that Sapura Energy Bhd reduced its total liabilities by RM6.8 billion from FY2018 to FY2021. However, there was an increase of RM2.3 billion from FY2021 to FY2022. There has been an outstanding achievement in how Sapura handled its total liabilities over the past five years. Sapura seemed focused on reducing its total liabilities since such a move could improve Sapura's capability to repay its debts on time. As of FY2022, the number of total liabilities remains high compared to the amount of total equity. Understanding the unique characteristics of the oil and gas industry is essential. This industry differs from others because its players must have reasonable access to capital markets to finance their oil and gas projects. These projects are demanding as they require high capital expenditure (or fixed asset investment), solid project financing, and very high net working capital.

The book value of Sapura's total assets has plummeted significantly from FY2018 till FY2022 are referred to as total assets. By definition, assets are items with a monetary value used over time to support the company's business operations and future growth. There is no doubt that Sapura Energy Bhd needs to increase its investment in fixed assets to support the current business. From Table 2 above, Sapura Energy's total assets decreased from RM30 billion in FY2018 to RM16.2 billion in FY2022. It is pretty shocking to see how the value of the assets of this company has decreased so rapidly in the last five years. This financial condition can harm the company, particularly in managing its current working capital.

Looking at the balance sheet of Sapura Energy Bhd, it can be seen that this company needs to improve specific business segments within the organization. This is because their financial situation in the last five years could put their existing investors in a position not to continue their support for this international company. If Sapura Energy Bhd wants to attract more investors, it must convince potential investors that its financial performance will improve in the next quarter.

Table 3. Financial Ratios of Sapura Energy Bhd

FINANCIAL RATIO SAPURA ENERGY BHD' 5-YEAR FROM FY2018 TO FY2022					
	FY2018	**FY2019**	**FY2020**	**FY 2021**	**FY 2022**
Earnings per share (cent)	(42.10)	3.43	(28.60)	(1.01)	(0.56)
Price-to-earnings ratio	-11.5x	-1.4x	-1.5x	-0.4x	-0.2x
Current ratio	1.02	1.35	0.63	0.65	0.21
Quick ratio	0.18	0.58	0.57	1.31	0.94
Cash ratio	0.05	0.08	0.12	0.97	0.37

The price-to-earnings ratio (PE) is the financial ratio that measures the company's current share price to its earnings per share (EPS). The price-to-earnings ratio is sometimes called the price multiple or the earnings multiple. Investors and security analysts commonly use this PE ratio to

determine the relative value of a company's share. It can also be used to compute a company's intrinsic value.

Based on Table 3 above, Sapura Energy's latest 12 months PE ratio is -0.2x. The average PE of Sapura Energy for fiscal years from January 2018 to 2022 is around -3.0x. The median PE for the corresponding period is -1.4x. The PE hit its five-year low in January 2018 at -11.5x. The negative PE is attributed to negative earnings in Sapura over the observed period. From a liquidity perspective, Sapura's current ratios were less than 1.00 for three consecutive years. This downward trend in the company's liquidity signals a severe cash flow problem.

4. Results and implications

The financial fiasco faced by Sapura Energy Bhd worries not only investors, shareholders, and their stakeholders. As such, Sapura Energy Bhd must set clear goals, particularly in recalibrating the firm's financial landscape. There is an urgency for Sapura to relook at its present capital structure and work on finding its optimal level. A firm's value can be maximized when it operates at an optimal capital structure. Based on this premise, Sapura must convince its employees to boost their productivity and work collectively with top management to minimize total operating costs. Sapura Energy Bhd must also explore new revenue streams to improve its earnings expectations. Whoever leads the new management of Sapura, the team must relax its high operating leverage by scaling the capital expenditure down. Reducing the firm's fixed asset investment is no longer an option. The financial and business transformation in Sapura must occur immediately since any delay will jeopardize the company's financial viability and expose it further to bankruptcy risk (Putri et al., 2021).

Over the past five years, Sapura has been operating at very high financial leverage. The company is heavily laden with debts (both short-term and long-term debts), and striking a balance between the costs of debt and the benefits of debt is now an essential task for the new management to start with. All in all, the financial conditions of Sapura over the observed period are best explained by the classical Trade-off theory advocated by Modigliani-Miller in 1958. The agency theory is also relevant in explaining Sapura's financial chaos. Even though Sapura's share price had been experiencing a downtrend in the past five years, the top management still enjoyed some excellent perks.

Research Implication

Sapura Energy Bhd is recommended to conduct a forensic audit for the company to find the root cause of its lingering internal issues. Violating corporate governance is a common problem for a large company like Sapura, and forensic audits are conducted to investigate this delinquent. By examining the firm's financial statements and records, the findings from this audit exercise will be presented as evidence in a court of law or for any legal proceedings. In addition, the main objective of a forensic audit is to build a case and prosecute any party involved in fraud, misconduct, or criminal offenses (Purnamasari, 2022). A forensic audit is sometimes conducted to regain public confidence that may be diminished due to false allegations made by others against the firm.

Concerning financial resource mismanagement, Sapura needs to relook at the effectiveness of its risk management committee. Perhaps, it is timely for Sapura to redefine the roles of the committee members and beef up their functions. It is seen as a practical way to restore the company's corporate governance, which will attract some new investors.

5. Conclussion

Our thorough investigation shows that the Trade-off Theory seems fit to elaborate on the financial turmoil in Sapura Energy Bhd. Sapura Energy operates in 20 countries and has long

been recognized as a credible upstream player in the oil and gas industry. This study clearly shows how a highly leveraged company like Sapura is being pushed to its limit. Sapura is one of the credible pioneers in the Malaysian oil and gas industry, but this company has lost its value drastically due to mismanagement and overburdening debts. Sapura Energy is geared towards becoming a trusted and sustainable global energy company, but its future is now uncertain. From descriptive statistics and trend analysis, it is evident that Sapura Energy's underperformance for the past 10 years has been associated with burdensome debt resulting from large amounts of overdue payments to its vendors and some operational issues exacerbated by the COVID-19 pandemic from 2020 to 2021. Sapura Energy Bhd should consider downsizing its business operations and recalibrating its capital structure to mitigate most business and financial risks.

This study solely focuses on Sapura Energy, and future studies need to examine firm-specifics from different perspectives. The future researcher should continue looking into the capital structure characteristics of Malaysian oil and gas companies, particularly those directly involved in the upstream segment. Cash management seems to be an actual trade in this oil and gas business; hence, new studies should also examine how the company's cash balances could affect its future performance and capital structure characteristics.

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