

## Chapter 2

### LITERATURE REVIEW

#### 2.1. NEP and the Bumiputera

The wide economic gaps among the major races in Malaysia, namely Malays, Chinese, and Indians, had forced the Malaysian government to intervene the country's economy through the implementation of NEP. NEP was aimed to reduce the poverty among races and eliminate the identification of races with economic functions and geographical locations. The priority was given to the Bumiputera or Malays in order to protect their rights, as they are the indigenous group. Fundamentally, the government tried to instill the sense of entrepreneurial among the Malays to help them improve their status of living. According to Jomo (1988), three main strategies that have been used to encourage Malay entrepreneurs include:

- a. *Protection*: Malay quotas were imposed on the award of business licenses, and in the area of government employment and education.
- b. *Assistance*: Facilities were provided in the form of credit, training, and business premises.
- c. *Acquisition*: Malay ownership of the corporate economy was to be expanded.

Further, public enterprises and bumiputera trust agencies have been established to accelerate Malays participation in corporate businesses. Jomo (1990) and Gomez and Jomo (1997) mentioned that two main types of public enterprises established for this purpose are:

- a. Statutory bodies established by special legislation. For example, Malaysian Industrial Development Authority, tourist Development Corporation (TDC), Urban Development Authority (UDA), Petroleum Nasional (Petronas), and various states economic development corporation (SEDCs).
- b. Government-owned private or public limited companies. For example, Heavy Industry Corporation of Malaysia (HICOM) and Paremba property developer. Meanwhile the bumiputera trust agencies include Permodalan Nasional Berhad (PNB) and Perbadanan Nasional Berhad (Pernas).

The objective of these public enterprises and trust agencies is to accumulate wealth on behalf of the bumiputera communities. In other words, these agencies are responsible for "advancing the bumiputera shares of corporate equity by purchasing and holding shares on behalf of the community" (Gomez and Jomo, 1997).

In addition, in 1975, the Industrial Coordination Act (ICA) was introduced. ICA has imposed a ruling saying that foreign and Chinese companies must ensure at least 30% bumiputera ownership in their ventures (Gomez, 1994). As a result, "in the late 1970s, many influential Malays were issued new shares at par value as companies scrambled to fulfill the requirement," (Todd, 1987).

Generally, the actions taken by the government to encourage the Malays to become entrepreneurs have given such a significant impact on the economic aspect of bumiputera. As of 1990, the bumiputera ownership in Malaysian limited companies rose to 20.3%, as compared to 4.3% in 1971 (Lucas and Verry, 1996). Antah Holdings Berhad, led by Tunku Naquiyuddin and Tunku Tan Sri Imran, Arab-Malaysian Corporation Berhad by Tan Sri Dato' Azman Hashim, and Renong Berhad by Tan Sri Halim Saad are among the famous bumiputera entrepreneurs and corporations that have come out during the NEP era (Cheong, 1993).

## **2.2. NEP and the Non-Bumiputera**

NEP may have shown a positive impact on the bumiputera's economic status in general. However, in spite of the 'preferential treatment' received by the bumiputera, the Chinese community has also experienced an increase of the shares owned in Malaysian public listed companies. In 1990, Chinese share ownership was reported to be 55% as compared to 34% in 1971 (Lucas and Verry, 1996).

The Chinese are well known as the community with strong spirit of survival and entrepreneurship. Gomez (1999) admitted the increase in non-bumiputera or mainly the Chinese share capital ownership was due to the fact that they are productive. The entrepreneurial deployment of economic benefits secured from the state and effective use of stock market to secure funds to finance their business expansion are also the contributing factors.

In addition, ICA ruling that requires the non-bumiputera companies to maintain at least 30% bumiputera ownership seems to be the loop hole that enables the non-bumiputera to also benefit from the various government privileges reserved for bumiputera. According to Mehmet (1989), NEP has caused the development of

what he described as 'subsidy mentality' among bumiputeras. Such mentality has led the Malays political elite who has access and control over the state apparatus, like government licenses, finances, and contracts, to jeopardize those privileges as a medium of exchange to gain political influence or patronage of companies.

Further, Gomez and Jomo (1997) commented, in order for the Chinese to get accessed to better business opportunities in the state-protected national economy, they will try to establish a close relationship with the influential Malay politicians and bureaucrats. The influential Malays will be compensated with discounted stock options and directorship on the companies' board of directors. Despite of the Malays patronage and the 30% Malays stock ownership, owning the rest of the shares would still make the Chinese the major shareholders that entitle them to be the controlling shareholders (Gomez, 1999).

### **2.3. Ownership Structure and Firms' Performance**

Separation of ownership and control is a sure dilemma in any public listed companies. Although shareholders are fundamentally the legal owners of the firms, the dispersed structure of equity ownership makes it almost impossible for each equity holder to actively take part in the management of the firms. Berle and Means (1932), commented that due to the dispersion of share ownership, 'the owner of industrial wealth is left a mere symbol of ownership, while the power, the responsibility and the substance which have been an integral part of ownership in the past are being transferred to a separate group in whose hands lies control.' (Abdul Samad, 1996). In Malaysia, as described in the previous sections, there will be cases when companies patronized by Malays, yet controlled by Chinese.



### 2.3.1. Agency Problem and Managerial Ownership

Jensen and Mecklin (1976) in *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, explained that the separation of ownership and control in firms has brought about to another dilemma known as agency problem. Agency relationship is defined when the principals delegate some decisions making authority to other people (agents) to allow them (the agents) to do particular works on their behalf. The conflicts arise in most public listed companies when the agents (managers) do not act or make decisions according to the principals' (equity owners or shareholders) priorities. Managers are claimed to deploy corporate resources to maximize their utility rather than to maximize the owners' utility, which is value maximization. This may due to the fact that those managers mostly hold only small fractions of a firm's equity. Therefore, managers are less motivated to constantly devote their time and effort pursuing for profitable investments, as the benefits would be less pronounced on their part.

Further, Jensen and Mecklin suggested that agency problem could be reduced through what the researchers in this field have been referring to as "*convergence-of-interest hypothesis*." According to the hypothesis as managers' ownership in the firm increases, their interest will tend to coincide with the interest of the outside equity holders. This is because when managers hold more equity, it tells that they are also holding more risk of losing. Thus, they will always want to avoid the risk and protect the firms' profitability by bearing the agency cost. The agency cost includes monitoring cost, bonding cost, and residual loss (Jensen and Mecklin, 1976). Hence, the assumption is as managers hold more equity in the firm, the goals towards value and profit maximization will be assured.

The findings of the studies done by Demsetz (1983) and Fama and Jensen (1983) are another fundamental theory in the study of ownership structure. Their theory, however, is contrasting to Jensen and Mecklin's. According to their findings, ownership structure does not have significant impact on the firm profitability. Although having a low level of equity ownership, managers would always pursue for value maximization due to the force of market discipline, product market, and market for corporate control (Morck, Shleifer and Vishny, 1986, pp.293-294). In addition, the theory argues that the increase in equity would cause "*entrenchment*" and the outside shareholders would find it difficult to control the actions by those managers-cum-owners of the firms. This is because, "at certain levels of ownership, managers find it worthwhile to consume perquisites which reduces the firm's value and, moreover, they have sufficient control to follow their own objectives without having to take much consideration on interests of other shareholders. The combination of the convergence-of-interest and entrenchment effects point towards a non-linear relation between the performance of firms and managerial ownership" (Keasy and Short, 1996).

The contrasting theories of the consequences of increasing the managerial ownership, the convergence-of-interest and the entrenchment effect, is clarified further by Morck, Shleifer, and Vishny (1986). In their study on 371 Fortune 500 firms in United States of America (USA), they found a significant non-monotonous relationship between managerial ownership and firms value. The study shows that at 0% to 5% level of managerial ownership, the firms value increase. Morck et al. argued this could possibly be due to the stock remuneration received by the managers as an incentive to them for the high performance of the firms. Further, as the ownership level rises between 5% to 25%, the impact on firms' performance is negative. The negative performance indicates that entrenchment effects could exist at this level of managerial ownership. In addition, Morck et al. found that the presence of

founding family would also give negative effect on firms' performance. Therefore, they concluded that the presence of founding family could also facilitate entrenchment. However, as the ownership level goes beyond the range of 25% to 30%, the entrenchment effects is believed to be declining (Morck et al., 1986). On the other hand, convergence-of-interest is perceived to be developing as managers are holding more risk. Hence, in order to avoid the risk, managers would be more concern to increase the value of the firm rather than pursuing their self-interests.

The recent study by Ki, Suk, and David (1999) examined the performance of firms from seven major industrialized countries, namely Canada, France, Germany, Italy, Japan, United Kingdom (UK), and USA. Return on equity (ROE) was used in the study as an indicator for firm performance. The study concluded that there was no evidence to prove that increase in managerial ownership could have positive impact on firms' performance. However, when ROE is replaced with its components like asset turnover and net profit margin, some positive impact could be observed on firms' performance (Ki, Suk, and David, 1999).

### 2.3.2. Agency Problem and Concentration of Ownership

Theories on managerial ownership may suggest some logical explanation to reduce agency problem. However, if managerial ownership increases substantially, it will limit the opportunity for external investors to come in. When owners are also the managers of the firms, then it will go back to the traditional way of doing business. Therefore, concentration of ownership by external shareholders or institutional shareholders could offer an alternative to handle agency problems.

According to Demsetz (1986), what motivates concentration of ownership or owning a large fraction of shares, is when shareholders perceive that they have comparative advantages in exercising control. The advantages could be in terms of pecuniary or non-pecuniary. In spite of the greater advantages, large shareholders would also have to bear more firm specific risk as compared to minority shareholders. For example, in the case of losing, large shareholders would lose the most as they invested such a large amount. Meanwhile, increase in the firm value and stock prices will give the large shareholders greater returns. Therefore, because of greater advantages and risks, the existence of continuous monitoring management is important to large shareholders in ensuring that their interests are protected.

Demsetz's (1986) argument is consistent with the study done Shleifer and Vishny (1986). They found that large shareholders could give positive impact on firms' performance. Similarly, the argument is that large shareholders hold more risk and possess greater rights in the firms. Thus, they should monitor the managers' activities to ensure that the firms' management is in line with their interests. As a result, shareholders' interests are secured and firms' value increases (Claessens et. al., 1998, pp.13).

In addition, according to Holderness and Sheehan (1987), large shareholders are usually directly involved in firms' management. In other words, large shareholders do not normally monitor the management solely; they also lead the management. Therefore, they suggested that the theories on managerial ownership could also be the reason that motivates concentration of ownership. Large shareholders may pursue the theory of convergence-of-interest when they take a role in the management. Berle and Means (1932) commented "when stockholdings are concentrated, it is relatively easy for individual stockholders to coordinate action and demand information from management, thereby overcoming information asymmetries," (Hill and Snell, 1989). Moreover, large shareholders may also cause entrenchment.

When stockholders involve in the highest level of management, like becoming a director, it allows them for a direct access to corporate resources and opportunities to consume the resources (Holderness and Sheehan, 1987). However, the study by Holderness and Sheehan (1987), shows inconsistent result on entrenchment and large shareholders. Their argument is that large shareholders are mostly being passive rather than actively playing roles in management.

Furthermore, what motivates individual large shareholders might be slightly different than what motivates institutional large shareholders. Specifically for institutional shareholders, economy of scale and greater capital appear to be the advantages they possess over the small shareholders. This explains how Pond (1988) managed to prove his hypothesis on efficient-monitoring by institutional shareholders is pertinent. According to his findings, institutional shareholders have greater expertise and can monitor management at lower cost. Therefore, the hypothesis suggests a positive relationship between institutional investors and firms' performance (McConnell and Servaes, 1990, pp.599).

Claessens et. al (1998) had also conducted a study on this field, but the concentration was East Asia. The findings imply that in less developed countries as well as in countries with more corruption and inadequate shareholder protection, concentration of ownership is more pronounced, in a negative manner. The study shows concentration is actually hurting the operational performance and market value of the region (pp.17). The problem identified by La Porta et al. (1998) could be the possible reason why some studies found concentration of ownership is either hurting or not significantly related to firms' performance. The problem is large shareholders have the tendency to neglect and expropriate the right of the minority shareholders (pp.13).

All in all, the economic benefits offered by concentration of ownership make the theory still relevant. One of the benefits could be the improvement in corporate governance when there is monitoring process by shareholders. Among the dilemmas in handling agency problem is who should be responsible for the agency cost. Large shareholders could solve the problem, as monitoring is really important to them because they have locked in more capital and risk in the firms. The other benefit would be "the reduction in transaction costs in negotiating and enforcing corporate contracts with various stakeholders," (Claessens et al., 1998).

### 2.3.3. Malaysian Findings on Ownership Structure and Firms Performance

Kwabena Yeboah-Duah (1993) had done quite a thorough insight on the impact of ownership structure on Malaysian firms. He studied the contribution of high concentration firms as compared to low concentration firms. He found that these two groups of firms do not have significant difference in their performance. He also observed the performance of firms controlled by the foreigners, Chinese ethnic of Malaysia, and the Bumiputera. The result shows that it makes no difference in performance, regardless who control the firms.

Ling's (1995) findings on the relationship between equity ownership and firms' value are consistent with Kwabena's (1993) findings. Ling studied 312 Malaysia listed companies for one-year period, January 1992 to December 1992. He found the relationship was insignificant. The reason was that the external environment factors force managers to constantly improve the firms' value, although having small percentage of ownership. An example would be the threat of takeover. Managers must work hard against the takeover. Otherwise, takeover would result in restructuring that involves middle and upper level management.

Consistently with the two studies on Malaysian firms, the recent study by Yee (1998) also gives the similar results. Although Yee had extended the study for the period of 1992 to 1995, the ownership structure was still not showing any significant relationship with returns. Investors' investment decision should be indifferent with who control the firms. He concluded that the most important element in making investment decision would be on the basis of current performance and growth opportunities of the firms.