CHAPTER 2

LITERATURE REVIEW

2.1 Introduction: Bumiputera Policy

The New Economic Policy was initiated in 1970 after the May 13^{th} 1969 riot. The main issue in this riot was that the Malay ethnic group was far behind in the economic sector. Since the Bumiputera, the indigenous group in Malaysia, was at the lowest level in terms of employment and ownership, among the main objectives in the New Economic Policy (NEP) was the restructuring of society through a number of strategies such as the redistribution of income and ownership. Among the intentions was to achieve the target equities of the Bumiputera in a modern corporate sector. The target ownership was to increase Bumiputera ownership to 30% by 1990. However, the statistics show that the Bumiputera only owned 20.3% of the share capital. Statistics from the KLSE showed that, the percentage of individual Bumiputera holding equities was only 8.2% in 1990. Most of the actual Bumiputera holdings were obtained through trust agencies and institutions. Among the examples were Permodalan Nasional Berhad, Lembaga Tabung Angkatan Tentera, and State Corporations.

The National Development Policy replaced the New Economic Policy which ended in 1990. Its major objective was to establish a more united society. The National Development Policy covered the period from 1991 to the year 2000. The NDP expanded the objectives and maintained the previous strategies of the NEP such as poverty elimination and the restructuring of the economy and society. The policy tried to achieve the objectives that were not reached by the NEP. Privatisation helped the NDP's objective to increase the individual Bumiputera ownership in Malaysia. Datuk Seri Dr. Mahathir actually introduced the privatisation policy in mid-1983 after two years of becoming the Prime

Minister. The objectives of the privatisation policy were to relieve the financial and administrative burden of the Government, to improve efficiency and productivity, to facilitate economic growth, to reduce the size of the public sector in the economy and to facilitate the achievement of the National Development Policy target. The last objective not only protected the Bumiputera group but also enhanced their participation in the corporate sector. (Malaysian Incorporated, 1995)

In Malaysia, there are a number of Government bodies that have already been privatized and listed in the KLSE such as Telekom Malaysia Berhad, Tenaga Nasional Berhad, Malaysia Airlines and Proton. These companies had become Bumiputera companies, as they had more than 50% Bumiputera equities or a Bumiputera was a major shareholder in those companies according to the KLSE rules. The State Corporations such as the Terengganu State Government, Johor Corporation, Kumpulan Perancang Selangor, Yayasan Pahang, Perbadanan Kemajuan Negeri Kedah and Perbadanan Kemajuan Negeri Perak were among the corporations that had the Bumiputera control over a few listed companies in the KLSE. (Sally Cheong , 1997).

The outcome of privatisation was impressive. Among the projects under the privatisation program that were completed successfully was the multi-billion Ringgit North-South expressway. It was financed by local financial institutions. The project was awarded to United Engineers Malaysia Berhad (UEM). UEM was a Bumiputera controlled company. (Malaysian Incorporated, 1995).

2.2 Previous Literature Regarding Bumiputera-Controlled Companies

Rohani Ahmad's (1989) project paper briefly discussed the history of the Bumiputera Stock Exchange (BSE) and how it ended up. The Bumiputera Stock Exchange started trading in November 1971. First, it was under the custody of

Mara and then was put under Amanah Saham Mara management. After the Securities Industry Act had been implemented, the BSE was managed by Kompleks Kewangan Malaysia Berhad (KKMB). Even though it was given support from the KKMB and already in the right industry, the BSE was not successful under the KKMB.

After 15 years trading, the Amanah Saham Mara Berhad took over the BSE in early 1984. The rehabilitation plan, known as the 5-year strategy was established. Among the strategies were marketing programmes to promote the BSE and to attract Government companies, Mara subsidiaries and private companies to list under the exchange. Other ambitious strategies were plans for computerization of operations. The BSE expected that with the implementation of the computer systems, 25 companies would be listed by the end of 1984 and 100 by 1990. The response from Government bodies and publicity from the media were good. During this time, share prices for most listed companies were high. Market capitalization of the BSE increased from RM 531,850 in 1983 to RM 2,288,347 in 1985.

Unfortunately, after the key figure in this plan was transferred to another department in the middle of 1985 and the computerization plans were not successful, the BSE faced problems again. In 1986 the market capitalization reduced to RM140, 614. In October 1986, the BSE refered to Mara again for a brighter future of the exchange and to study their problems. After MARA received a new chairman in 1988, the future of the BSE changed as he announced that the BSE would be closed and transferred to the KLSE second board.

The author then listed the problems faced by the BSE in the 20 years of its existence. Among the major problems were a lack of skills as qualified and interested Bumiputera companies prefered to list with the KLSE, an outdated trading system that restricted entry and exit as the BSE used whispering systems and management discontinuity. She also addressed the problems that the companies listed in the BSE might have faced if they wanted to list in the KLSE. Lastly she offered a number of recommendations regarding the BSE problems.

A project paper by Abdul Kamil (1990) studied the entrepreneur development training programmes for Bumiputera entrepreneurs. In this paper, he looked at the important roles of the Malaysian Entrepreneur Development Center (MEDEC) and Mara. Both of the organisations were given responsibilities to prepare Bumiputera for the 1990s through their own programmes and curriculum in the training of entrepreneurs.

Patmawati (1992) wrote a thesis on "Potential contribution of the voluntary sector to complement NDP for the Bumiputera community". The objective of this paper is to look at how Bumiputera Muslims can benefit from the NDP to uplift them. In her thesis, she studied the achievement of Bumiputera during the NEP period. Through the statistics provided by the First and Second Outline Perspective Plan Report, the general observations were made. In conclusion, the Bumiputera were among the poorest community, having the least household income compared to other ethnic groups in Malaysia, lacking of skills and expertise for economics and technological challenges of the 1990's, holding the smallest proportion of income and lastly having a significant number of unsuccessful entrepreneurs compared to other groupings.

M. Fazilah's (1996) dissertation studied the performance of politically affiliated business groups in Malaysia. She divided her observations into two sub-periods; the first sub-period is between 1985 to 1989, and the second sub-period is between 1990 to 1994. She divided the study period into two in order to examine the Malaysian economic impact on the political business groups. In this paper the result showed that during the first sub-period the performance of politically affiliated business groups was lower compared to independent groups but in the second sub-period the government privatization plans improved the group's profitability. This indicates that during the NEP era, the policy did not really produce the quality Bumiputera entrepreneur group. The company performance was lower in the first period of the study as a result of the impact of the recession period. The results also showed that the firms in the politically affiliated group helped each other in times of financial distress. The political pressure helps the companies that had a problem to get financial assistance from the commercial banks.

By 1993, there were increasing numbers of Bumiputera who were successful in their businesses and owned growing companies. Sally Cheong was a famous author who produced a series of books about Bumiputera companies. The first book produced by her is the "Bumiputera-controlled companies". In her book she mentioned the growing trend of Bumiputera-Chinese business partnerships. One aspect of the new phenomenon of Bumiputera companies was their taking over of Chinese companies. The best example was the Renong takeover of the Park May companies. In 1997, she produced the book on "Bumiputera Entrepreneurs in the KLSE: volume two ". Tan Sri Dato' Tajudin Ramli, Allahyarham Tan Sri Dato' Seri Yahaya Ahmad, Tan Sri Dato' Azman Hashim, Tan Sri Halim Saad and Tan Sri Dato' Abdul Rashid Hussain were considered the powerful Malay elite.

In Malaysia, many Bumiputera companies were involved in conglomerate businesses. The Permodalan Nasional Berhad, DRB-Hicom, Renong and Johor Corporation were among the companies involved in conglomerate businesses. Renong is a good example to illustrate the impact of the economic crisis on conglomerate businesses. Renong is one of the biggest conglomerates Bumiputera companies. In 1999, the Renong related companies were Faber Group Berhad, Park May Berhad, Crest Petroleum, Cement Industries (M) Berhad, EPE Power Corporation Berhad, Kinta Kelas Public Limited Co, Time Engineering Berhad, United Engineers (M) Berhad, and Projek Penyelanggaraan Lebuhraya Berhad. The business activities of Renong were financial services, oil and gas, telecommunications, public transportation and construction. The

Bloomberg news agency reported that the group lost RM 794.1 million for the financial year ended June 30th, 1998 compared to a profit of RM 469.5 million the year before.

According to Dr. Ishak Shari, director of the Institute of International and Malaysian Studies, many Bumiputera entrepreneurs were affected as a result of their over exposure in terms of debt. Corporations, which had over geared because of over expansion then faced operating problems due to loss in capital. The situation of the companies then became more critical as the interest rate rose and credit was tightened by the banks. During the currency crisis of 1998, the Bumiputera-controlled companies such as infrastructure developer Renong, Konsortium Perkapalan, Idris Hydraulic, Hicom, Tenaga Nasional Berhad, and United Engineering Malaysia were among the companies that faced a debt problem. This was because the companies had been exposed to foreign loans and dealings in foreign currency.

Some of the Bumiputera-controlled companies were unique because they also had a high percentage of Government equities as they had been Government agencies before being privatised. Ferdinand A. Gul (1999) in his study examined the relationship between Government ownership of shares and corporate policy choices. He also examined the relation between growth opportunities and corporate policy decisions. The study observed the companies listed on the Shanghai Stock Exchange from 1990 to 1995. In the study, the firm size was used, as a control variable for all the regressions while profitability was included as a control variable for some of the regressions. In this research the author addressed the unique feature of ownership structure in Chinese companies where many companies have varying levels of government ownership because they were state owned enterprises before being listed. It is quite similar to the Malaysian scenario.

In this study the author refers to the efficient monitoring hypothesis, and institutional ownership of shares by Pound, (1988); Bushee, (1998). According to the hypothesis, institutional ownership has contracting and monitoring implications. It is likely to affect the managers' incentives differently. For example, it might monitor the managers' actions. The Monitoring hypothesis can be applied to government ownership as it is a form of, or at least similar to, institutional ownership. Some evidence suggests a positive association between government ownership and dividends since firms with government ownership basically have less difficulty raising funds to finance investment. That is why they can afford to pay dividends. The results of the study showed that firms with higher level of Government ownership are associated with higher debt and dividend payments.

Ferdinand A. Gul also looks at the growth opportunities and their association with corporate policy. He extends the studies done by Smith and Watts, (1992) and Gaver and Gaver, (1993). The results show that firms with higher levels of government ownership are associated with higher debt. Growth firms have lower debt or equity ratios than non-growth firms and also tend to have lower dividend yields. However, in the Malaysia scenario, the case might have been different where many growth companies had a higher debt because the companies were expanding but then were left with their excessive borrowing when the currency crisis affected their business.

2.3 Literature On Currency Crisis

Bijan B. Aghevli (1999), in his paper "The Asian Crisis: Causes and Remedies", stated that the underlying causes of the Asian crisis were the massive capital inflows and weakening exports in the mid-1990s. According to him, during boom cycles in Asia, stock and real estate prices increased. During that time, foreign funds became available at low interest rates. So there were massive amounts of capital shifting in Asia. However, the allocation of these borrowed foreign resources was inefficient as the banking system was weak, there was poor corporate governance and a lack of transparency in the financial sector. The above situation was reflected in the widening current account deficits. Once the crisis broke out in Thailand, the markets overreacted and it spread to other Asian countries, as the situation was similar. The reasons behind the Asian crisis led the author to suggest that capital market liberalization in Asia must be undertaken with care. He observed that most of the capital accounts in the Asian countries are liberalized short-term capital inflows before foreign direct investment.

Jayasankaran, S. (1998), in his articles in the Far Eastern Economic Review pinpointed dismal corporate governance and concentration on share-price movements rather than management as contributing to the second board's poor standing in the KLSE. He comments on the action of Malaysia's capital market regulators and the KLSE for allowing share prices on the second board to float far above reality during the boom time of 1996.

Michael Alan Hamlin, (1999) in his paper "Myth vs. reality in Malaysia", stated that Malaysia's corporate and banking sectors lack transparent corporate governance. The companies that had problems during the currency crisis were saved by acquisition by public sector companies or received additional debt financing which they clearly did not deserve.

Mohd Radzuan, (1999) gave his opinion in the Edge Magazines regarding the currency crisis and the KLSE. He wrote in My Say columns an article entitled "The Government Should Avoid Targeting KLSE Index". According to him, the share market must reflect the general economy. If the economy is doing well, it will have good productivity; high corporate profits, stable prices and the result will be that the stock market is naturally at a high level. Stock market indices should represent the valuation of the respective companies. The Government should not get involved in targeting the index as it can lead to serious conflicts of interest and other unacceptable situations. Such situations include, for example, the government rescuing corporate bigwigs from their loan and commercial obligations. The arguments of their creditors would make the market unstable. He suggested that the KLSE should promote strict governance of public companies.

2.4 Previous Studies of the Effects of the Currency Crisis on the KLSE.

Othman Yong and Zaidi Isa (1999) examined the relationship between the currency market and the local stock market, before and during the period of currency turmoil in Malaysia. In this study, the author used two types of method to calculate the stock performance. First, the author used the average of closing and opening of the Kuala Lumpur Stock Exchange Composite Index. Second, the author used the average of high and low of the KLSE CI to measure the stock performance. The outcome of the study showed that the depreciation of the Malaysian currency affected the local stock market after the six months following the beginning of the currency turmoil when the measure of stock performance is based on the high and low of the KLSE CI.

Fauzias Mat Nor, Norazlan Alias and Zaidi Isa (1999), look at the relationship between the stock market, exchange rates and interest rates before and during the currency turmoil. The authors used the co-integration and causality tests to establish the relationships between the variables for both periods. The results showed that the KLSE CI (stock market) is the most volatile, but during the turmoil, the ringgit (exchange rates) became more volatile than the KLIBOR (interest) compared to before the turmoil. Fauzias Mat Nor, Zaidi Isa and Noor Azudin Yakob (1999), also investigate the volatility of the Malaysian financial markets before and during the Asian currency crisis. In this paper the authors used the ARCH and GARCH model. The results suggest that the stock market, interest rate and exchange rate had the ARCH effect during the turmoil but only the KLSE CI had the ARCH effect before the turmoil.

2.5 Theoretical Issues

The next section will review all literature pertaining to studies prior to the two sub-periods, the methods of calculating the stock return and the behaviour of the Malaysian stock market.

The Capital Asset Pricing Model (CAPM) was a popular model developed by three economists, William F. Sharpe, John Lintner and Harry Markowitz. They stated that stocks with higher betas have higher returns. However, the theory has been criticized as the relationship between beta and actual average return has not been a strong one since the mid-1960s. An alternative to this theory was the arbitrage pricing theories. Stephen Ross's arbitrage pricing theories assume that each stock's return depends partly on pervasive macroeconomic influences or factors and partly on noise-events that are unique to that company.[1]

Shyan-Rong Chou and Keith H. Johnson (1990) did an empirical analysis of the Taiwan stock market anomalies. The objectives of this paper were to test the three market anomalies such as the size effect, the seasonality of common stock returns and low P/E effect. The period of the study was from 1974 to 1988. In analyzing the data, the authors took certain factors into consideration such as the fact that the years 1987 and 1988 were represented as unusual years. In 1988, individuals preferred to realize existing gains at a later date as it was announced that capital gain in 1988 would be taxed in 1989. The impact of the NYSE market decline in October 1987 is reflected in the decline of the Taiwan Stock Exchange.

[1] This arbitrage pricing theory says that some stocks will be more sensitive to a particular factor than other stocks . There are two types of risk such as the risk from the pervasive macroeconomic factors which cannot be eliminated by diversification and unique risk. Unique risk is the risk that arises from possible events that are unique to the company.

The test of seasonal effect was significant for only the sub-periods that include 1987-1988. The major findings of this study are that the seasonal effect was not significant during the period when capital gains taxes were suspended. The study found no evidence of a significant size effect but found significant P/E effect.

Chan, M W L; Khanthavit, Anya; Thomas, and Hugh (1996), stated that daily returns are used to identify seasonality on the Kuala Lumpur Stock Exchange (KLSE), the Stock Exchange of Bombay (SEB), the Stock Exchange of Singapore (SES) and the Stock Exchange of Thailand (SET). The authors did a study on the seasonality and cultural influences on four Asian stocks markets. These results confirm the importance of cultural influences in the pricing of stocks.

Mansor Md. Isa (1989) examined the behaviour of Malaysian stock market prices. This paper concentrates mainly on testing the price changes to determine whether the market is weak form efficient. The author's finding that the KLSE daily stock returns are not normally distributed. The author comments that the outcomes do not present a good description of Malaysian stock prices as most of the samples were dependent but the random walk model required independent price changes.

Rosita P.Chang, Jun-Koo Kang and S. Ghon Rhee (1994) also examined the behaviour of Malaysian stock prices. They analysed the return and risk behaviour of both the KLSE CI and its stock component. The objectives of this study were to examine the intraday and interday price behaviour of Malaysian common stock. From the findings, the author discovered some evidence that trading volume and firm size were factors that can explain autocorrelations, price reversals and the behaviour of intra and interday returns.

Othman Yong (1991), used the t-statistic test to compare between the average returns in January and other individual months. He tried to find out whether the seasonal effect exists in all sectors of the KLSE. The study indicates that the average returns in January were not much different from any other months except for the industrials and plantations sectors.

Mansor Md Isa and Tan Kok Hong (1997) conducted a study on the announcement effects of rights and bonus issues on Malaysian stock prices. The authors' study period was 30 trading days before and 30 trading days after the announcement date. Returns were based on the stocks' daily closing prices .The result of these studies conclude that there was a positive price reaction prior to a rights issue announcement but that a significant portion is immediately lost after the announcement.

Wang Loke Kiat and Liow Kim Hiang (1999), examined the time-varying abnormal performance for Singapore property stocks due to the currency crisis. The study period for this research was between 2nd July 1997 to 13th August 1999. The authors used weekly returns in their study, and the performance of property stocks over the study period was investigated by measuring the correlation. The study also used the two-tailed test in order to see whether the stock outperformed the market or not. There were two findings from this study; firstly property stocks under-perform the market and secondly, there are greater chances of experiencing consistent under-performance in down market.

2.6 High Leverage And Low Leverage

Financial leverage or, in other words, debt financing affects risk and return. Firms with relatively high debt ratios have higher expected returns especially when the economy is normal. Unfortunately, the companies with high debt ratios are exposed to risk of loss when the economy goes into a recession.[2] Firms with low debt ratios are less risky, but investors need to forego the opportunity to have higher returns. In order for financial leverage to be a benefit to the companies and shareholders, the cost of debt must be less than the return on assets. Operating leverage and financial leverage normally work in a similar way as both increase expected ROE and also increase the risk borne by shareholders.[3]

Jeffrey W. Allen and John J. McConnell (1998), in their study investigate the financial and operating performance of firms that undertake equity carve-outs and analyse the cross section of excess stock returns around the announcement of these transactions. The authors in this study defined carve-out as the sale of an asset, which is intended to raise funds to finance other activities of the parent or the subsidiary. The author used the multivariate analysis. In this study the results showed that the firms that carve out subsidiaries are likely to be highly leveraged and have a poor operating performance. The result of the study also showed that the funds raised from carve-outs are used to pay out creditors.

Paul K. Chaney, Chris E. Hogan and Debra C. Jeter (1999), did a study on the effect of reporting restructuring charges on analyst' forecast revisions and errors. They found evidence that the restructuring process for the companies gave a negative signal to the investors at least for the short run.

Waheed Rahman (1999), did a study on the wealth effect on high and low leverage companies due to the currency crisis in Malaysia. The study stated that the companies with high beta should not go for high leverage. This is because of the possibility of the company getting into cash flow problems in times of difficulty. In his hypotheses, he expected that high leverage companies would be affected negatively due to crisis and low leverage companies would be minimally

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[2] Effects of financial leverage on stockholders' return during the normal and bad conditions was illustrated in Chapter 2: Analysis of Financial Statement, Financial Management, Theory and Practice Book by Eugene F.Brigham and Louis C. Gapenski, 8th ed. Florida: Dryden Press.

affected. Unfortunately, the results of the study showed that the low leveraged companies were affected more than high leveraged companies. Among the reasons that the author gives to explain the results was, the longer-term lease faced by the low leveraged companies.

[3] An example on the effects of leverage is illustrated in Eugene F. Brigham and Louis C. Gapenski, "Financial Risk," Financial Management, Practice and Theory 8th ed. Dryden Press, 577-578.