CHAPTER V
CONCLUSIONS AND RECOMMENDATIONS

This chapter summarizes and concludes the main findings of the study. The relationship between firm value and equity ownership as well as how the firm value related to a set of control variables are presented in reduced-form. In this regard, efforts are made to link the research results with the relevant finance theories. In addition, some brief discussion is also made to conclude the linkage of ROA with ownership structure.

Firm Value

Overall, the sample financial firms have average firm value below 1 (= 0.456) over the 1995 to 2001 seven-year time frame. This implies that the exercise of consolidation could be a cheaper way to acquire assets than purchase the new assets directly. It partially explains the rationale of mega bank merger effort particularly after the regional financial crisis. It discourages new investment since there is no scope for further profitable investment. After controlling for the size effect, it is found that the larger the size of a firm, the lower the value of the firm on average. The large financial firms that registered the lowest average firm value may due to the highly competition existed within this category of firms rather than inefficiency.

Firm Value and Equity Ownership Structure

Firm Value and Insider Shareholding

For the entire sample firms in the financial sector, there is no significant relationship found between firm value and the fraction of shares owned by insiders.
This may result from the low concentration of ownership held by insiders (8%) and an extremely low central tendency measure (0.62) on average that limited the voting rights of insiders in the financial firms in general. After taking into account the size effect, both of the small and large firms’ value is unrelated significantly to the directors shareholding as well. However, the case of medium-size firms is rather different for the firm value is affected significantly by the insiders ownership. The results show a significant curvilinear relationship between firm value and the insiders shareholding which is in accordance with the studies of Stulz (1988) and Morck (1988). As the insiders shareholding increases, the firm value increases as predicted by the convergence-of-interests proposition. The directors of medium-size firms play an efficient role by aligning the interest of management with those of atomistic outside shareholders. On the other hand, the corporate managers that with little equity stake will be prompted to maximize the firm value or the wealth of shareholders under external environmental forces. Jensen and Ruback (1983) claimed that a competitive takeover market is an essential tool to discipline managers due to the threat of the change in company’s management control and therefore the security of employment. Benston (1979; 1980) suggested that the financial statement audited by independent auditors also is a valuable device for monitoring managerial behavior. Both of the competitive external labor market and two-way managerial monitoring of internal labor market can work together to deter managers from deviating from shareholders’ interest and hence eliminate the agency cost. The shareholder intervention mechanism like corporate charter and by-law amendments, litigation and control contests is also useful to avoid managers from opportunistic behavior. However, when the proportion of shares on the hands of insiders increases beyond some high level, the value of medium-size firms is affected inversely. This is
consistent with prediction of the entrenchment hypothesis that corporate assets become less valuable when managed by insiders who control a substantial fraction of equity and hence have enough voting right to guarantee their employment. Besides, a firm with increasing insiders shareholder is less exposed to the threat of takeover. It is because a hostile bidder has to pay a higher premium to gain control of the target firm, which in turn may reduce the probability of a successful takeover (Stulz 1988).

**Firm Value and Institutional Investors Shareholding**

This study observed some strong significant inverse relationship between firm value and institutional investors shareholding whether for the overall sample firms or different sizes of firms in the financial sector. This result lends support to the study of Sew (1995). It is inconsistent with the prediction that the institutional investors with well-developed managerial hierarchy and professional management teams should be able to act collectively in monitoring the firm towards the best interest of their shareholders. Contrarily, this negative relationship supports either the conflict-of-interest hypothesis or the strategic-alignment hypothesis as suggested by Pound (1988). It means that the cooperation exists between corporate insiders and outsiders i.e. institutional investors in order to achieve their respective goals or a common goal that bring about mutually beneficial interest at the expense of the dispersed shareholders. There is evidence that the cooperation of these two parties drives down the entire sample firm’s value at the 0.10 significance level. This result, however, is quite peculiar after controlling the different sizes of financial firms. For the small firms, the cooperation between insiders and outsiders affect the firm value adversely. The market value of medium-size firms first increases and then decreases, as the percentage of shares owned by these two parties increases. This reflects the active
role taken by insiders of medium-size firms in predicting the direction of votes from the institutional investors who are relatively passive. Thus, the conflict-of-interest effect dominated where the institutional investors are coerced to vote for the management teams resulted from beneficial business relation with the firm or personal linkages to the management. For the case of large financial firms, the finding is inconsistent with the conjecture that both insiders and outsiders operate in conjunction with each other to influence the firm value. This implies that the institutional shareholders that owned a very large fraction of shares in large firms involve actively in monitoring the firms' management and strategy decision making due to their substantial voting right. As a matter of fact, most of the corporate bodies as the substantial shareholders may mobilize their human resource to join the management team and involve in corporate activities in the firms with the purpose to gain the direct control power. According to Finaley (1986), institutional investors that own a very large fraction of shares face with problem to move their money from one company to another. As a result, they seek to increase their latent power to constrain certain decision choices.

Firm Value and Foreign Shareholding

In sum, the shareholding owned by foreign corporation has a negative impact on the overall sample firms' value at the 0.05 and 0.10 significance level. This relationship remains the same even after controlling for the size effect. This result runs contrary to the prediction that foreign investment that brings in foreign financial capital, technical, managerial and marketing know-how can promote the efficiency in the financial system and hence increase the value of financial firms. It may due to the fact that most of the foreign investment in the sample firms is in the form of portfolio
investment especially equity investment instead of FDI. Portfolio investment is very sensitive to the changes in the economic environment and lack of loyalty to any market due to its highly liquidity and short-term nature. The equity investors have started pulling out their capital from our country and investing in Eastern Europe and South America, which have undergone economic reforms at the mid-1990s. After the bubble economy burst in July 1997, a great fall of confidence among investors coupled with herding behavior caused a substantial portfolio capital outflow from our country and hit the stock market with ferocity. This explains why the foreign shareholding can destabilize the financial system and therefore affect the financial firm value adversely during the study period.

Firm Value and Control Variables

Firm Value and Leverage

Modigliani-Miller (MM) proposition II suggests that since the corporate profits tax allows the deduction of interest payments in calculating taxable income, the greater the debt in capital structure, the lower the corporate tax liability, the higher the after-tax cash flows, and the greater the market value of the firm. In other word, a firm can maximize its market value by taking the maximum amount of debt. In this study, the relationship between firm value and leverage is significant negative for the entire sample firms as well as for the small and medium-size firms, which is inconsistent with the MM theory. However, this inverse relationship supports the trade-off theory of capital structure (Myers 1977). This theory asserts that the firm value will first increase and then decrease as the firm increases the borrowing. It is because of a continuous increase in total borrowing will increase the cost of the financial distress and hence the financial risk of the levered firms. In Malaysia, the
investors are generally risk-averse and tend to expect a higher return to compensate the higher risk they are exposed to for holding equity in a highly levered firm. Generally, these investors react unfavourably to any increase in a firm’s leverage even though it means an increasing tax saving from the point view of the firm. This theory is further supported by Gupta’s study (1982) that the maximization of firm value can be achieved before the maximum available debt is fully utilized. However, the value of large firms is affected positively by debt-assets ratio, which is in support of MM model. This is because of the investors and creditors are more likely to tolerate increased debt in the large financial firms since these firms normally have more stable historical income.

On the other hand, the small sample financial firms have the highest leverage ratio while the large firms with the lowest leverage. This is contradicted to the assumption that large firms with relatively large asset bases to cushion debt service obligations should have higher borrowing capacity. However, this finding supports the study of Remmers et al. (1974) that small firms had higher debt ratios than larger firms similar to the case of Japan, Norway, the Netherlands and France. It may due to the prudence behavior of large financial institutions in this country to rely primarily on equity financing on the capital structure and thrive with little debt. The small financial institutions, however, are more likely to opt for debt financing instead of issuing new shares in the equity market since the latter can dilute equity ownership among the existing shareholders.

**Firm Value and Total Assets (Firm Size)**

The value of the financial firms shows a significant decreasing trend with total assets. It reflects that the managers of sample financial firms are more interested to
adopt size maximization strategy rather than shareholders’ wealth as suggested by Murphy (1985). Since the larger firms are normally pooled with larger total assets and paid-up capital, a bidder has to pay more to acquire control over the target’s resources. Therefore, size maximization that works as a defense against takeover facilitates the managers to escape from the market discipline and diverge from value maximization behavior.

**Firm Value and Total Assets Growth Rate (Firm Size Growth Rate)**

The result of this study found no significant relation between firm value and the firm’s growth rate except for the case of medium-size firms. The medium-size financial firms that have experienced growth in firm size are accompanied by increased firm value during the study period.

**Firm Value and ROA**

Market value of the overall sample firms as well as small and medium-size firms are unrelated to ROA ratio. Contrarily, ROA varies significantly in explaining the value of large firms at the 0.01 significance level.

**Firm Value and Trend**

In general, the value of the entire financial firms shows a downward trend but not significant during the period 1995 to 2001. After considering the size effect, the smaller firms suffer more severely from this downward trend compared with larger firms.
ROA and Equity Ownership

ROA and Insiders Shareholding

ROA shows no statistical significant relationship with insider ownership for all the sample firms as well as for small and large firms. This result is consistent with Kesner (1987) but contradicted to Radice (1971). It may result from the varying accounting practices adopted by different firms and the non-market measure of performance per se is not a sufficient indicator of true performance. Nevertheless, the medium-size firms’ performance is significantly influenced by insiders shareholding with a curvilinear pattern. This is because the corporate managers are able to utilize the corporate assets effectively and efficiently to generate profits under monitoring of directors as there is an increase in insiders shareholding. This relationship is reversed when the fraction of shares owned by insiders reach at a certain high level. The managers’ natural tendency to deploy corporate resources for their own best interests dominates over the opposing force that pushing them towards value maximization behavior as suggested by Morck et al. (1988). With this respect, managers act to pursue their personal goals such as empire building, power, prestige, perquisite-taking and job security that take precedence over corporate profits. In addition, some managers may spend a lot for doing charities (Manne 1962) and improving the conditions of employees (Berle 1962) rather than reinvest these resources to generate more profits. Even though these non-profit-maximizing behaviors diverge from the wealth maximization objective, however, can increase the firm’s reputation and boost the motivation of employees towards better performance that should benefit the firm as a whole in the long run.
ROA and Institutional Investors Shareholding

Overall, ROA is unrelated significantly to shareholdings owned by institutional investors. This could be because of the institutional investors of Malaysian financial firms on average are still passive in exercising their latent power to constraint decision making of corporate investment, marketing and financing policies. There is also no significant evidence both of insiders and institutional investors cooperate to influence the profit maximization.

ROA and Foreign Shareholding

The positive relationship of foreign shareholding owned by corporations and ROA is not significant for the overall sample firms as well as the small and large firms. For the case of medium-size firms, however, the foreign ownership is inversely correlated with firm performance at the 0.01 and 0.05 significance level. This may due to the proportion of short-term equity investment concentrated in the medium-size firms is relatively high. The equity investors could simply take out their monies as their targeted return is not achieved by the firm. The imprudent foreign investor behavior and speculative activity severely hit the financial firms' performance following the outbreak of East Asian financial crisis.

ROA and Control Variables

ROA and Leverage

ROA of the entire sample firms as well as the medium-size and large firms is adversely affected by the leverage, which is in line with the pecking order theory of capital structure as suggested by Myers and Majluf (1984). This theory states that firms will opt for internal finance whenever available and choose debt over equity if
external finance is required in order to avoid deriving adverse signals to market participants that may lower the stock price in relation to the announcement of an equity issue. In Malaysia, the most profitable financial firms tend to borrow less since they have sufficient internal finance, whereas the less profitable financial firms normally lack of internal funds to finance their capital investment project but need to depend upon debt as the second best alternative. The corporate managers will only opt for issuing debt that can result a worrisome signal to investors as a last resort.

**ROA and Total Assets (Firm Size)**

There is no any significant relationship between firm size and ROA.

**ROA and Total Assets Growth Rate (Firm Size Growth Rate)**

The firm size growth rate is related positively to ROA of small firms. This implies that the growing firms within this category are relatively more profitable in term of ROA over the study period.

**ROA and Trend**

Over the year 1995 to 2001, ROA of the financial firms follows an upward trend on average. After controlling for size effect, however, the medium-size firms’ profitability shows a significant downward trend.

**Suggestions for Future Research**

The relationship between equity ownership structure and market value of financial firms needs further investigations. It is suggested that influence of the CEO
duality (if a CEO is also as the chairman in the board of directors) and board composition (the proportion of external directors to the total number of directors) on firm value can be concentrated in the future study. In addition, most of corporations are not independent units but linked through interlocking directorates as a director of a company can hold directorships in the other companies as well. Therefore, the extent to which this directorate linkage contributes to firm value is also an interesting subject to be studied.