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# GLCs, GLICs and Market Efficiency

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# Outline

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1. Definitions
2. History of GLCs and GLICs
3. Performance of Khazanah
4. Main Lessons and conclusions
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***GLICs*** are federal government linked investment companies that allocate some or all of their funds to GLC investments.

*“**GLCs** are defined as companies that have a primary commercial objective and are under the control of a GLIC. A GLIC has control over a GLC when it is the majority shareholder or single largest shareholder and when it has the ability to exercise and influence major decisions such as appointment of board members and senior management and so on.”*

*[Ministry of Finance, 2018]*

- Prices should reflect all available, relevant information.
- Competitive markets incentivize firms to be **allocatively efficient** via the market clearing mechanism; i.e. firms produce only what the market demands and thus allocate their resources and align their production in the most efficient manner.
- Another crucial aspect … is the organic triumph of the most dynamic and efficient firms (i.e. industry champions) and the unhindered failure of inefficient firms.
- *This topic is sort of oxymoronic…*

# History of GLCs and GLICs (1/3)

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1. **1950**: Rural and Industrial Development Authority (RIDA), which later turned into the Majlis Amanah Rakyat (MARA).
2. **1957**: the Ministry of Finance Incorporated (MoF Inc.). This entity was established in 1957 through the Ministry of Finance (Incorporated) Act 1957 and is the top of the 'pyramid structure' of all government corporations to come.
3. **1965**: Bank Bumiputera was incorporated to provide ethnic-Malays an avenue to obtain credit to develop start-ups.
4. **1965:** Federal Agriculture Marketing Authority (FAMA)
5. **1966:** Federal Land Consolidation and Rehabilitation Authority (FELCRA) and the Rubber Industry Smallholders Development Authority (RISDA).
6. **1969:** Pernas, a trust agency, was created to acquire leading foreign-owned publicly listed companies in Malaysia, such as London Tin and Sime Darby Bhd.

**7. 1974:** Petronas was established as the national oil company for Malaysia, which is wholly owned by the government through MoF Inc. It is vested with the entire oil and gas resources in Malaysia and is entrusted with the responsibility of developing and adding value to these resources.

**8. 1978:** One of the largest and most influential GLICs, Permodalan Nasional Bhd (PNB), as an investment house and fund manager, which would channel investment-generated dividends to Bumiputera unit trusts holders to promote the distribution of corporate wealth returns to the ethnic-Malays.

# History of GLCs and GLICs (3/3)

**9. 1980:** The Heavy Industries Corporation of Malaysia (HICOM) was a publicly-funded corporation created to pursue the policy objective of strengthening the foundation of the manufacturing sector. These GLCs were also instructed to pursue joint-ventures with private sector firms as a government mechanism to direct industrialization, stimulate the economy and occupy the gaps in the economy that lacked entrepreneurship.

10. **1993:** Khazanah Nasional Bhd, a sovereign wealth fund, which is wholly owned by MoF Inc. Khazanah operated as a nation building apparatus more than a sovereign wealth fund, often venturing into strategic areas and investing in line with the policies of the Prime Minister, who would traditionally sit as the chairman of the board.

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- Indeed, it is clear that the omnipresence of GLCs in the economy continues to endure. Gomez et. al. (2018) estimates that these companies constitute about 42% of the total market capitalization of Bursa Malaysia. Several key sectors of the Malaysian economy are dominated by GLCs.
- **Menon (2014) finds that the government has an almost monopolistic influence in utilities (93%) and transportation and warehousing (80%) sectors, and accounts for over 50 percent of the agriculture, transportation, financial services, information communications, and retail trade sectors.**
- In terms of countries that have the highest SOE presence among their largest firms, Malaysia ranks fifth highest in the world.

  [Kowalski et al (2013)]

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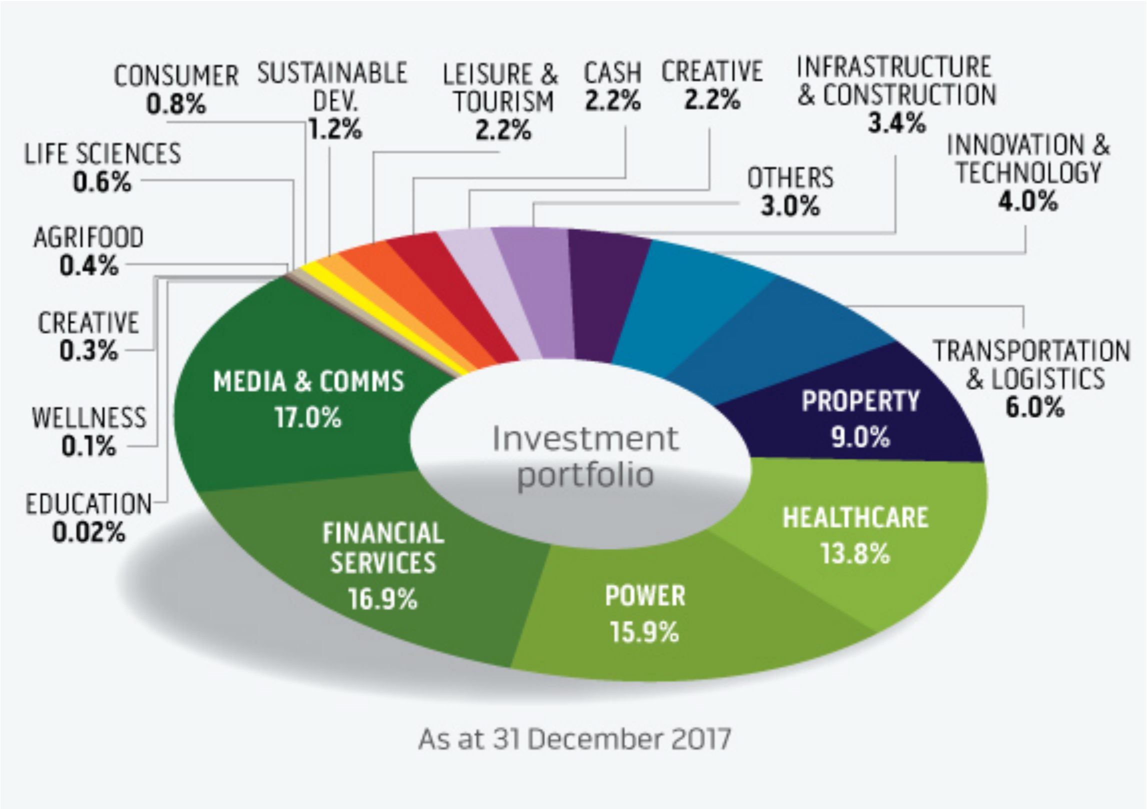
1. When Malaysia showed negative economic growth in 1985-86, GLICs played a key role in stimulating the economy and capital markets through the **privatization and the liquidation of public equity in GLCs. However, this trend was more resembling of a stimulus package than a practice of privatization,** as numerous privatized companies were still retained via majority ownership and control by the GLICs (Boubakri et. al., 2004, Gomez et. al., 2017).
2. **HICOM** most notably acted as the government's corporate body to implement policy objectives through collaboration with foreign companies, leading to the development of several industrial players, namely **Perwaja Steel, Kedah Cement and Proton**. Although these companies provided an economic boost and grew the industrial sector, they came short of developing a globally competitive industry and constantly required large government allocations to promote productive growth (Dewenter and Malatesta, 2001).

- Khazanah is a government-linked investment company (GLIC) and it has to fulfil the mandate given by the government, which is to "to hold and manage the commercial assets of the government, and to undertake strategic investments on behalf of the nation."
- Khazanah was used to play a strategic role in developing industries in Malaysia, where it took equity stakes in some of the iconic projects the country had embarked on during the industrialisation phase.
- All the share capital of Khazanah is owned by the Minister of Finance Incorporated (MOF Inc.), except one share owned by Federal Lands Commissioner.

- The key listed companies in Khazanah's portfolio consists of Malaysia's key playing companies:

  - Axiata Group Berhad (telecoms)
  - CIMB Group Holdings Berhad (banking)
  - Tenaga Nasional Berhad (power)
  - Telekom Malaysia Berhad (telecoms)
  - IHH Healthcare Berhad (health)
  - UEM Sunrise Berhad (conglomerate)

# Khazanah: Investment Portfolio




*Source: Khazanah Nasional 2018 Annual Review*

# Khazanah: Ownership Structure

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| Sector | GLC | Substantial shareholdings | Joint ownership |
|---|---|---|---|
| Banking | / | / | / |
| Construction and property | / | / | / |
| Plantation | / | / | X |
| Oil and gas | / | / | / |
| Industrial products | / | / | X |
| Technology | / | / | / |

# Has Khazanah model been successful…Yes

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- Transformed since 2004 into a solid entity which has strong controls, procedures, a chain of accountability, and a team of competent professionals managing over RM145 billion in investments, top 15 sovereign wealth funds.
- G20 market capitalisation grew 3.2 times (or RM297.3 billion) from RM133.8 billion to RM431.1 billion from 14 May 2004 to 7 April 2015.
- Investment in Alibaba alone, an online e-commerce company, generated more than RM6bil.
- With strong management it is possible to insulate GLIC from political influence and develop well performing company

# Has Khazanah been successful…No

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- There were companies Khazanah had failed or not been able to turn around completely Malaysia Airlines Bhd and semiconductor company Silterra Malaysia.
- Constantly associated with bail out of companies due to political reasons. The Ministry of Finance (MoF) has confirmed that the former government led by Barisan Nasional had bailed out troubled 1Malaysia Development Bhd (1MDB) through funds raised from Bank Negara Malaysia's (BNM) purchase of a piece of land for RM2 billion and a RM3 billion Redeemable Cumulative Convertible Preference Shares (RCCPS) issued by Khazanah Nasional Bhd.
- The appointment of prime minister, Tun Dr. Mahathir and Economic Affairs Minister Azmin Ali to the board of Khazanah Nasional Berhad could lead to weak accountability and unnecessary exposure to liabilities as there is no check and balances.

# Khazanah: Performance in 2018

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**Selected locally listed companies in Khazanah's portfolio**

(as at Nov 22)

| Company | Khazanah's Holdings (%) | Share price (RM) | Year-to-date change in share price (%) | Year-to-date change in market cap (RM bil) |
|---|---|---|---|---|
| Axiata Group Bhd | 37.2% | 3.43 | -37.5% | -18.7 |
| Telekom Malaysia Bhd | 26.2% | 2.35 | -62.7% | -14.8 |
| IHH Healthcare Bhd | 41.6% | 4.81 | -17.9% | -8.7 |
| CIMB Group Holdings Bhd | 27.5% | 5.65 | -13.6% | -8.5 |
| Astro Malaysia Holdings Bhd | 20.7% | 1.17 | -55.9% | -7.7 |
| Tenaga Nasional Bhd | 28.8% | 14.78 | -3.2% | -2.7 |
| Malaysia Airports Holdings Bhd | 33.2% | 7.85 | -10.7% | -1.6 |
| UEM Sunrise Bhd | 66.1% | 0.79 | -24.0% | -1.1 |
| Time dotCom Bhd | 11.2% | 7.86 | -12.4% | -0.6 |
| UEM Edgenta Bhd | 69.1% | 2.61 | 12.2% | 0.2 |

Sources: Khazanah, Bloomberg, Bursa Malaysia

The Star Online (24th November 2018)

- Complex overlay of profit motivation and development objectives leads to sub-optimal decision making leading to inefficient outcomes.
- Tun Mahathir declared that Khazanah had deviated from its original objectives... "Khazanah was initially formed to buy up the shares allocated to the Bumiputera, because when [the Bumiputera] buys shares, they immediately sell them to others [as some do not have the monetary capacity to hold them for long-term]. So to stop them from doing that, we created Khazanah."

# GLCs in Malaysia…Where do we stand today (1/3)

- The importance of government ownership in determining firm value by reinforcing public confidence in GLCs. **The institutional connection between GLCs and the government provides signals to investors that these firms have an advantage in terms of their access to funds, tenders and opportunities.** Furthermore, investors see government ownership as an added reassurance that GLCs will not be allowed to fail during times of economic hardship. (Najib and Rahman (2011))
- **Politically connected firms are more likely to receive bailouts than non-connected firms. Indeed, this point was affirmed through the various instances in which government funds were diverted into bailing out large and financially burdened Malaysian GLCs. (**Faccio et al. (2006))
- For example, Perwaja Steel, a Japan-Malaysia joint-venture created out of the 1980s, required a RM2 billion government bailout as it faced productivity issues and was confronted with huge interest payments. In 1984, Bank Bumiputera, a GLC under PNB ownership, required a bailout from Petroliam Nasional Bhd (Petronas) as a result of its RM2.5 billion in faulty loans to the highly risky Hong Kong-based property speculator, Carrian Group. In 1995, Pernas had difficulties servicing loans worth around RM900 million and had to be rescued by the government (Gomez et. al., 2017).

## GLCs in Malaysia…Where do we stand today (2/3)

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- A study by Mohamad and Said (2011) observed decreasing returns to scale from a majority of the 39 GLCs, which suggests that there may be an excess utilization of both labour and capital inputs from large government companies.
- Companies and individuals that collect their funds from a large public coffer rather than from their own private purse will lack the private incentive to minimize costs.
- Additionally, the government's centralized effort to create Cyberjaya, a spatially concentrated technological hub, via an inorganic top-down GLC-led process of development has largely failed in creating Malaysia's Silicon Valley (Salman, 2018).

# GLCs in Malaysia…Where do we stand today (3/3)

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- National innovation policies have succeeded in directing investment into key sectors of economic growth, technological growth and innovation can be stifled when the government tries to steer business activity.
- Wong and Govindaraju (2012) shows evidence that Malaysian GLCs that operate in a protected industry, particularly in the case of the automotive (Proton) and energy (Tenaga Nasional Bhd) sector, have little technology contributions to growth and low technological progress.

- **GLCs and GLICs worked as government extensions and were motivated to serve a social function**, i.e. they made investments that were too large or risky for private companies, provided affordable goods and services to the public, grew infant industries, earned dividends for the government and created jobs.
- These corporations were inherently functioning with goals that came in direct conflict with the profit maximization objective. [Boycko et. al. (1994)]

# Overall lessons (2/4)

- GLCs are often not subject to these market signals due to their dominance of certain markets (Janang et al., 2015; Gomez et. al., 2018) and the preferential treatment they receive from the government in receiving contract awards (Menon and Ng, 2017).
- Furthermore, the demand for GLC goods and services is often artificially generated through the benefits gained from government contracts, projects and regulations, which lead to the distortion of market signals that would otherwise motivate GLCs to increase their allocative efficiency (Menon, 2014).
- Some exceptions exist such as Petronas, which is professionally managed and exposed to international competition but enjoys monopoly at home, with a status of both a regulator and a business entity.

- Government ownership can also undermine allocative efficiency if GLCs are tasked with equitably redistributing wealth and increasing social welfare, which may limit their ability to charge efficient prices when they are instructed to sell their products at low price.
- **An example of this would be the lenient terms and extraordinary dividend returns for the Bumiputera-exclusive unit trusts provided by Amanah Saham Nasional Bhd (ASNB) under PNB.**

# Overall Lessons (4/4)

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- **Marizah and Mazni (2014)** posits that the executive compensation structure and the discouraging level of equity ownership in GLCs' executives results in the lack of incentive for GLC executives to work towards improving firm performance.
- Without the proper awarding of executive compensation that is commensurate to firm performance, guaranteed executive pay in GLCs can resemble a wasteful transfer of taxpayers' income to rent-seeking and politically connected executives.
- Furthermore, the government injection to exogenously create industrial development, like in heavy machinery, may pose opportunity costs as these funds could be better allocated to improve infrastructure, build human capital, incentivize entrepreneurship and promote innovation.

# Conclusions (1/2)

- **GLCs have greater ease and access to procuring loans compared to private firms due to their connection to deep-pocketed GLICs and the guarantee of bailouts as done by the government in the past**. This structure of uneven competition between government and private companies can lead to the development of uncompetitive GLCs and the increasingly burdensome fiscal pressure to support them.
- Even through its heavy involvement of GLICs in economic development, Malaysia has yet to create successful stories of exporting champions like Samsung Electronics Co. in South Korea.

# Conclusion (2/2)

- One of the reasons for this is Malaysia’s lack of a clear intention and definition of the motive for government investment in a corporation. **The government employs a dualistic rationale for ownership of commercial entities: one being to support national economic and strategic interests, while the other objective is to supply a specific public good or service.** These two rationales are often overlapping, which results in the absence of a GLC that purely operates with industry and export discipline.
- The governance of state owned enterprises in South Korea were guided by the goal to establish an export-oriented manufacturing leader that could compete in the global marketplace. GLCs in Malaysia were entrusted with production responsibilities, yet their poor governance and misguided objectives harboured inefficient domestic leaders that fall behind in global competition (Janang et. al., 2015; Mohamad and Said, 2011).

- **The Malaysian government has continually recognized the need to rectify the perverse effect of GLC dominance** through the eventual privatization of public entities, but they have yet to propose a timeline for such a process. Furthermore, the perpetuating association between government companies and socio-political development has made it politically difficult for the government to step back from its operations, especially in areas that directly benefit Bumiputera welfare.
- Five years prior to the ETP, the government began a ten-year initiative called the GLC Transformation Programme (GLCT) in an attempt to reduce its investment into GLCs and improve the management and performance in top strategic GLCs (PCG, 2015). However, an observation by Menon (2017) indicated that this GLCT program resembled more of a practice of diversification than divestment, as GLC asset acquisition greatly outpaced the asset disposal from the period between 2009 to 2015.

# What needs to be done?

- PH manifesto: to have **a transparent open-tender system for public procurement** to avoid the wasteful misallocation of government funds that have happened in the past (Pakatan Harapan, 2018). **We need to see a phase-wise action plan to implement this.**
- **Periodic, transparent reporting** on the state of affairs in the GLCs need to be ensured as committed in the PH manifesto.
- We support the **Minister of Finance: that the government will reduce its direct participation in the equity ownership of companies so that the private sector can play a larger role.** This practice of liquidating government ownership would help to stimulate private sector investment by reducing the crowding out effect caused by government investment.
- However, the government has sent **contradictory messages in its Midterm Review of the 11th Malaysia Plan (11MP)**. As an effort to continue the agenda of Bumiputera equity ownership, the government has indicated that GLICs will adopt an active strategy to invest in high-growth industries. We do not support this.