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OWNERSHIP STRUCTURE, RENT SEEKING AND PERFORMANCE: EVIDENCE FROM THE MALAYSIAN MANUFACTURING SECTOR (1994-2000)

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by

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STRUKTUR EKUITI, PENCARIAN SEWA DAN PRESTASI: BUKTI DARIPADA SEKTOR PEMBUATAN DI MALAYSIA (1994 - 2000)

ABSTRAK

Tesis ini mengkaji hubungkait antara struktur ekuiti dan nilai firma. Terdapat tiga objektif dalam kajian ini. Objektif pertama dan kedua bertujuan untuk menilai samada pengurusan firma (konflik agensi I) dan pemegang saham terbesar (konflik agensi II) menggunakan leveraj dan diversifikasi untuk melindungi kepentingan peribadi, terutamanya dalam keadaan wujudnya peluang pencarian sewa ekonomi. Objektif yang ketiga bertujuan mengkaji faktor-faktor yang menentukan pembentukan struktur ekuiti di negara ini.

Kajian ini mengambil kira teori perlindungan sewa (rent protection theory), teori urusan kos ekonomi (transaction cost economics) dan teori agensi (agency theory) dalam satu model. Dari segi operasi, kajian ini mengkaji hubungan interaksi antara struktur ekuiti, leveraj dan diversifikasi berdasarkan keadaaan persekitaran pencarian sewa, yakni aset intangible dan struktur persaingan industri terhadap nilai firma. Kesan ini dimantau dalam keadaan terwujudnya pemegang saham terbesar sebagai ahli lembaga pengarah dan juga bukan sebagai ahli lembaga pengarah.

Sample kajian ini merangkumi 256 firma perkilangan yang disenaraikan di Bursa Saham Malaysia dan meliputi tahun 1994 ke tahun 2000. Hasil kajian utama menunjukkan mekanisasi insentif pengalihan mampu mengurangkan konflik agensi. Namun demikian, leveraj boleh megurangkan kesan “entrenchment” pada tahap ekuiti pemegangan saham yang rendah. Ini menunjukan terdapat peranan institusi kewangan dalam pemantauan firma. Kajian ini juga menunjukkan pada tahap pemegangan saham yang rendah, diversifikasi mampu mengurangkan kos transaksi

dan meningkatkan nilai firma seperti yang dicadangkan dalam teori urusan kos ekonomi.

Sebaliknya, apabila kuasa pemegang saham meningkat, mereka didapati menggunakan leveraj dan diversifikasi dan menyebabkan kemerosotan nilai firma. Dalam industri di mana persaingan adalah rendah, tidak mengira jumlah penguasaan ekuiti saham mereka, pemegang saham utama telah menggunakan leveraj dan diversifikasi untuk tujuan peribadi mereka. Di firma yang mempunyai nilai aset intangible yang tinggi, pemegang saham utama turut menggunakan diversifikasi yang menyebabkan kemerosotan nilai firma. Akan tetapi, peranan pemegang saham utama luaran dan bukan ahli lembaga pengarah adalah pasif dalam pemantauan firma dan tidak memerungi kemerosotan nilai firma di firma yang berdiversifikasi.

Kajian seterusnya juga menunjukkan firma yang berkaitan dengan kerajaan telah menggunakan leveraj yang tinggi jika dibandingkan dengan identiti yang lain. Selain daripada firma yang dikuasai oleh sesuatu keluarga, kumpulan konglomerate, lebaran dan kerajaan telah menggunakan diversifikasi untuk meningkatkan faedah peribadi dan seterusnya menyebabkan kemerosotan dalam nilai firma.

Dalam menilai objektif ketiga, hasil kajian juga mengesahkan pencarian sewa kerana leveraj dan struktur industri mempengaruhi ketumpuan pemegangan saham secara positif. Sebaliknya, struktur ekuiti di ekonomi ini tidak sejajar dengan teori firma. Hasil kajian mendapati risiko firma dan masalah ketidaksinambungan maklumat tidak sejajar dengan struktur ekuiti. Ini menerangkan ketidakupayaan pemegang saham untuk memantau firma di negara ini.

OWNERSHIP STRUCTURE, RENT SEEKING AND PERFORMANCE: EVIDENCE FROM THE MALAYSIAN MANUFACTURING SECTOR (1994 - 2000)

ABSTRACT

This study addresses the relationship between ownership structure and firm value. There are three objectives in the study. The first and second objectives of the study is to examine whether managers (Type I agency conflicts) and controlling large shareholders (Type II agency conflicts) apply excessive leverage and diversification to enhance their private controlling interest, in particular in a rent seeking prevalent environment. The third objective is to examine factors that determine the formation of ownership structures in Malaysia.

The study takes a step forward by including the argument of agency theory, rent seeking theory and transaction costs economics in a singular framework. In operating terms, this study examines the interaction effects of ownership structure and leverage and diversification contingent on rent seeking environments, intangible assets and industrial competition on firms' value. The effects are observed under the presence of the largest shareholder as director and as external shareholder.

A panel of 256 unbalanced Malaysian manufacturing firms over the years 1994 to 2000 periods was used. The findings suggest that Type I and Type II agency conflicts could be mitigated through the incentive alignment mechanism. In addition, the role of leverage to reduce entrenchment effect is found to be effective at the low level of a large shareholder's controlling interest, suggesting the role of financial institutions in exerting governance. Similarly, at this low level, diversification is found to enhance firm value, confirming diversification is able to reduce transaction costs in the firms as suggested in transaction cost economics.

On the other hand, the study shows that leverage and diversification are mechanisms that are able to expropriate shareholder value when the controlling interest is relatively large. Irrespective of the large shareholder's controlling interest, both expropriation through debt and diversification are found to be prevalent in industries with low intensity of competition. In addition, large shareholders also pursue diversification in firms with high intangible assets which lead to a lower performance. The role of the external large shareholder in corporate governance in this economy is however passive and leads to poor performance especially in multiple segment firms.

Controlling for ownership identities, state controlled firms are found to pursue rent seeking through excessive debt financing. With the exception of family controlled firms, other ownership identities, conglomerate, dispersed and state controlled firms are found to diversify in order to further enhance their private interest, especially in rent seeking prevalent environment.

In addressing the third objective, the findings suggest that large shareholders are pursuing rent seeking interest and positively associated with leverage and less competitive industries. In contrast, ownership structures in this economy do not appear to be conformed well to the theory of the firm. The risks and information asymmetric problems are not minimized due to mismatch ownership structure. These findings explain lack of governance by the existing ownership structures in the firms in Malaysia.

Chapter 1

Introduction

1.1 Background

The essential issue in ownership structure of modern corporations is the problem of ownership of firms by shareholders (principals) which are controlled by managers (agents). The study and understanding of ownership structure is crucial for at least two main reasons. First, it influences the allocation of capital efficiency in an economy. Second, it contains a certain degree of required discipline on managers who run the firm on behalf of public shareholders. Both these reasons are significant as these influence firm competitiveness in the market. The first reason implies that the effective firms elicit the cheapest cost of capital from the capital market to enhance their sustainability and growth, while the second reason necessitates firms to operate fairly and efficiently so that capital providers obtain the gains.

The importance of ownership structure is further emphasized by Porter (1990). He conceded that the competitive advantage of a nation comes from firms instead of the nation. Ownership structure is an important variable that could not be neglected. This is reflected when he professed,

> "Company goals are most strongly determined by ownership structure, the motivation of owners and holders of debt, the nature of corporate governance, and the incentive processes that shape the motivation of senior managers. The goals of publicly held corporations reflect the characteristics of that nation's capital market" (Porter, 1990 p110)

The underlying problem in ownership structure lies with agency conflicts. An agency conflict arises when shareholders (principals) yearn for capital return but managers (agents) misappropriate shareholders' investment (Jensen and Meckling,

1976). This creates agency costs as agency decision may diverge from the objective of maximization of the welfare of the principal.[1] The implications of this misalignment of interest between principals and agents can affect a firm's performance.

Literature often identifies the excessive consumption perquisite by the management or controlling owner as the private benefits of control (see surveys' of Short, 1994; Denis and McConnell, 2003). These unscrupulous activities could be reduced by increasing managerial equity interests (incentive alignment mechanisms) in a firm, so that managerial interest could converge with external shareholders, thereby reducing the cost of deviating from value maximisation objectives (Jensen and Meckling, 1976). However, as the managerial interest becomes large, the presence of large shareholders can exacerbate the exploitation problem. Shleifer and Vishny (1989; 1997) asserted that large shareholders could also expropriate shareholder value by way of outright theft, sub-optimal diversification and self-dealing through the purchase or sale of assets at prices that deviate from their fair value. The level of appropriation could be higher if the controlling owner is also involved in the management or as director in a company (Short, Keasey and Duxbury, 2002). It is especially prevalent in the economies where minority interest protection is low (La Porta, Lopez-de-Silanes and Shleifer, 1998; 1999).

These two perspectives have drawn numerous researchers to examine the relationship between ownership structure and performance. Pedersen and Thomsen (2003) classified agency conflicts in Anglo-Saxon countries (i.e. the U.S. and the U.K.) as Type I, the basic conflict of interests between widely dispersed weak shareholders and strong managers. The Type I agency conflicts follow Berle and Means' (1932) conceptualisation of the US dispersed structure which emphasises the maximisation of shareholder value. However, dispersedly held ownership structures are less common

[1]Jensen and Meckling (1976, p308) delineate agency costs as the sum of (i) the cost of creating and structuring contracts between the principal and agent, (ii) the monitoring expenditures by the principal, (iii) the bonding expenditures by the agent and (iv) the residual loss.

in other countries. Agency conflicts in European and East Asian countries are held as Type II, the basic conflict between controlling large shareholders and weak minority shareholders. The classifications show that ownership structures vary according to their economic systems and other institutional backgrounds. The empirical findings on the relationship between ownership structure and performance, either Type I conflicts or Type II conflicts agency problem are also found to be inconsistent and vary across countries (Denis and McConnell, 2003).

Critics attribute this inconsistency in findings to the isolation of agency theory from other institutional factors (Blair, 1995). Gugler (2001) in reviewing various ownership structures across ten different countries concluded that relying on a few tools to solve agency conflicts is not optimal as all constellation of ownership and control structures involve costs and benefits. He postulated that the trade off (complementary or substitution) of one governance mechanism over another yields a better solution than relying solely on one device.

In this perspective, literature on the Anglo-Saxon model shows that managers or controlling shareholders choose other governance mechanisms such as equity ownership, corporate dividend, and leverage policies to minimise agency conflicts. Chen and Steiner (1999) observed evidence of debt and dividend could substitute managerial ownership as corporate governance mechanisms. A similar findings were also shown in Crutchley and Hansen (1989) and Jensen, Solberg and Zorn (1992). These factors are able to complement each other as governance mechanisms, especially in countries with fully developed financial systems.

In contrast, in a weak institutional environment, the other governance mechanisms such as leverage not only could increase managers' or controlling shareholders' private interest, but accelerate the problem of agency conflicts. Private

interest of control arises when managers or controlling owners take advantage of their privileged position for private gains, which are not shared with other shareholders (Denis and McConnell, 2003). Shleifer and Vishny (1997) also manifested that controlling owners enhance their private interest by engaging in non-value maximization activities. For instance, controlling owners could use leverage (Faccio, Lang and Young, 2003) and diversification (Claessens, Djankov, Fan et al, 2003a) to facilitate entrenchment or expropriation in firms in East Asian economies. Studies also showed that firms with ownership structures prone to the expropriation problem have a lower firm value and lower operating efficiency (Claessens, Djankov, Fan et al, 2002).

The effectiveness of other governance mechanisms is different across countries (Gedajlovic and Shapiro, 1998). It is also dependent upon the type of economic activities such as market competition and type of assets (Thomsen and Pedersen, 2000). However, Jensen and Meckling (1976) maintain that product and factor market competition are unrelated to managerial discretion. It is because owners of a firm with monopoly power have the same incentives to limit divergences of the managers from value maximisation, as do the owners of competitive firms.

Williamson (1988) postulated that transaction cost economics (TCE) could complement agency theory as governance mechanism.[2] Williamson's (1988) TCE claims governance structure can be matched to transaction in a manner that leads to a lower cost of exchange. TCE also cites "opportunist" as the cause of misappropriation in a firm. Firms that are opportunism and do not adopt cost-minimising governance mechanisms would presumably be less efficient and, in the long run, would be replaced. This notion also paves the way for discussing determinants of ownership structure from a wider perspective, such as, industrial competition, industrial growth,

[2] The TCE argues that ownership structure is consisting of transaction costs which consists of costs of ownership (CO) and costs of market contracting (CC). The residual rights of control can be assigned to another patron so as to minimize the transaction costs. The type of ownership is determined when transaction costs is minimised.

profit volatility and others (Thomsen and Pedersen, 1996). For instance, in a highly competitive industry, market competition may alleviate the agency problem between controlling owners and principals. In this perspective, market competition forces firms to operate efficiently and competitively, and reduces the transaction costs of monitoring by the principals. Thus, in a highly competitive industry, a higher concentrated ownership firm is still sustainable despite a higher information asymmetric problem between principals and agents (Thomsen and Pedersen, 1998). Ceteris paribus, in a highly concentrated industry, a dispersed ownership structure with a large number of shareholders could reduce information asymmetric problem in a firm (Thomsen and Pedersen, 1996).

Bebchuk (1999) based on the Williamson's (1988) transaction cost economics argument, proposed that ownership structures follow a rent seeking path in an economy. The rent protection theory suggests that the size of private benefits of control influence the choice of an ownership structure. The controlling owner tends to protect his controlling interest in a rent-interest prevailing environment. A rent-interest prevailing environment is defined as an environment that could provide private benefits and additional income than the minimum that a person could have earned (Bebchuk, 1999). A rent interest prevailing environment could be from a less competitive industry as well as from a firm's size. Bebchuk and Roe (1999) suggested that a large firm's size in a less competitive industry provides rent seeking opportunities for controlling owners. Instead of using leverage as governance mechanism, in the rent seeking opportunities prevailing environment, controlling owners could use leverage to finance investments instead of equity financing so that their relative equity interest in a firm is not threatened. Bebchuk and Roe (1999) also demonstrated that ownership structure is positively related to low intensity of industrial competition, signifying that a controlling owner's interest is associated with rent seeking prevalent environment. Eventually,

these misalignments of mechanisms and resources will increase the cost of transaction and impede the firm's value.

In addition, Williamson (1988) suggested the right matching of financing structure to lower costs of exchange, which is however subjected to the level of asset specificity. A firm with high asset specificity (technology and research and development activities) faces great uncertainty and severe information asymmetric problems which should be better financed with equity financing. By incurring debt financing, it can increase the chance of misappropriation by the controlling shareholders by virtue that debt holders have little control over the managerial action in ensuring resources are utilised efficiently (Jensen, Solberg and Zorn, 1992).

Stein (2003) argued from the TCE's perspective, diversification can be a substitute for an inefficient external capital market, and thereby reduce costs of capital. In this regards, diversification strategies help firms allocate capital effectively, especially in a capital inefficient economy (Martin and Sayrak, 2003). Stein (2003) showed theoretically that diversified firms could face fewer obstacles in accessing external capital when compared to single segment firms. This is due to diversification eliminating information asymmetric problems between managers and external shareholders when funds could be raised from other divisions at a cheaper rate than funds from external capital markets. Thus, a diversification firm could lead to a better performance. This is in sharp contrast to the agency theory argument where diversification is purportedly meant to further enhance controlling owners' private interests in a firm. In this regards, Khanna and Palepu (1997; 2000) showed that the benefits of diversification overwhelm agency conflicts in multiple segment firms in India.

Nonetheless, studies involving direct inter relationships between ownership structure and other governance mechanisms which subsequently affect performance

are still limited (Gugler, 2001). Most studies focus on the incentive alignment mechanism when addressing the relationship between ownership structure and performance. There is limited literature that deals explicitly with other arguments such as private interest of control, asset specificity and the industrial competition argument in a singular framework. Furthermore, most research has concentrated on the Anglo-Saxon governance regime characterised by a well developed capital market.

In the case of Malaysia, as in most developing economies, some of the control devices may not work as well as in countries with fully developed financial systems. Malaysia provides a number of characteristics that make it particularly suited to the investigation of the relationship between ownership structure and performance based on the framework of agency theory, rent seeking path theory and transaction costs economic arguments. The following section highlights some problem statements that lead to the study in this thesis.

1.2 Problem Statements

Less attention had been given to the Malaysian corporate ownership until the recent financial crisis where firms' moral hazard and weak governance were highlighted as two of the factors for firm failure (Dickinson 2000). Claessens, Djankov and Lang (1998a) reported the financing patterns in the pre-crisis period in East Asian economies. They highlighted that during the 1990s, the average investment and leverage (Debt over Asset) in Malaysia showed an increasing trend, 10.7% and 0.908%, respectively. However, Return on Asset (ROA) had shown a declining trend during the same period. Moreover, the percentage of short-term loans in domestic borrowing and foreign borrowing for the year 1996 in Malaysia was higher than that in other East Asian countries. The financing and investment patterns during the pre-crisis period revealed that investment and financing were not determined according to value maximisation principles. Claessens, Djankov, Fan et al (2003b) also elucidated that

firms in Malaysia pursue misallocation of capital diversification. It is therefore interesting to know whether managers and controlling shareholders were accused, for purportedly being involved in unscrupulous decisions in debt financing and diversification, which subsequently lead to a poorer performance. Furthermore, finance literature documents that debt financing could further enhance performance, whilst diversification in a weak external capital market could reduce cost of financing, thereby improving firm performance (Khanna and Palepu, 1997; 2000). The chances of misappropriation through debt and diversification could be caused by rent seeking factors in financial sector and highly concentrated industries that enhance financial rent and industrial rent in Malaysia. These rents benefit managers and controlling owners as it allows additional income than the minimum that they would have accepted.

Malaysia provides the opportunity to study the influence of rent seeking factors. The following first and second statements highlight that Malaysia provides a rent seeking opportunities environment through a financial restraint policy and highly protected industrial policy. The third issue emphasises the problem involving the issues of the diversification in Malaysia and lastly, the shortfall of the studies on agency problem in Malaysia is highlighted.

First, the high debt ratio prior to the financial crisis period is always suggested as the factor that led to a lower firm value in the economy. The studies are also not concrete in explaining high debt ratio in this economy. For instance, Deesomsak, Paudyal and Pescetto (2004) cross sectional studies (Malaysia, Thailand, Singapore and Australia) showed that firms established a positive relationship between ownership concentration and leverage for the sample period from 1993 to 2001. However, the positive relationship between debt and the controlling owner did not seem to be consistent with other single nation studies. In Thailand, large shareholders were found to negatively explain debt ratios for the sample period of 1996 (Wiwattanakantang,

1999). Suto (2003) showed that top ten shareholdings in Malaysia were negatively related to debt ratio for each cross-sectional year study from 1995 to 1999. Pandey (2002) also noted a similar negative relationship between debt ratio and number of outstanding shares for the study for the sample period from 1994 to 2000. It is assumed that a larger number of shares imply diffused ownership. The inconsistencies in the findings show that there are gaps in the study of ownership structure and leverage. Nonetheless, the above studies do not assess the direct impact of the relationship between ownership structure and debt towards firm value. One possible answer to the high debt in the economy could be due to Bebchuk's (1999) rent seeking theory, where the insiders or controlling owners have intentionally increased debt to enhance their private interest in environments with higher rent seeking opportunities, which is subsequently leading to reducing firm value. However, it is a priori uncertain on this particular issue in this economy.

An alternative explanation to the issue of high leverage is resorting to "financial restraint policy" advocated by Hellmann, Murdock and Stiglitz (1996). The policy suggests that financial institutions in East Asian economies are more inclined to lend. The financial restraint policy aims at promoting overall economic growth through lending at a lower interest rate with higher volume of loans. The policy creates "financial rent" benefits (excess profit opportunities) which are the incentives for firms and financial institutions to borrow and prudently monitor their client firms, respectively. The "financial rent" could also provide the opportunities to the insiders and controlling owners to incur higher leverage so as to enhance their controlling interests, which could lead to a lower firm value. On the other hand, if the financial restraint policy is effective, we may observe a higher firm value as financial institutions govern the firms. If the financial restraint policy is effective, a higher leverage could lead to a higher firm value as financial institutions govern their loan portfolio which they lend their loans to. Nonetheless, FIs in Malaysia are largely relationship based and are not effective in

monitoring firms (Section 2.4.1 provides the details). Moreover, the issue of agency problem could overwhelm the financial restraint policy, where rent seeking by insiders and controlling owner lead to a higher leverage and causes moral hazard to firms.

Second, the state is in favour of the protectionism policy to develop industries in the economy. A study by Bhattacharya (2002) showed that the mean of industrial concentration ratio in Malaysia was 0.55 in 1996, and only 31% of the manufacturing industries appeared to be competitive. In this regard, controlling owners in low competition intensity industries are more inclined to extravagance in their daily operations. Moreover, the average debt financing in the Malaysian manufacturing sector was on the average 72.67%, of which 97% was contributed by the banking system in the economy for the period from 1994 to 1996 (Malaysia, 1996). Following the argument of Bebchuk and Roe's (1999), a less competitive industry creates industrial rent which could lead to managerial slacks and poor discretions in decisions. The managers can avoid monitoring from external capital providers due to self sufficient profits internally in a highly concentrated industry (Roe, 2001). Therefore, in this economy, we are uncertain whether managers and controlling owners intentionally pursue higher debt financing to protect their private interest especially in industries with low intensity of competition where rent seeking opportunities are prevalent.

Third, Claessens, Djankov, Fan et al, (2003b) showed that approximately 70% of the Malaysian firms pursue the diversification policy. Their findings also indicate that diversification in Malaysia was carried out for the purpose of misallocation of capital. The values of diversified firms were found to be lower in the short term as well as long term. Debt financing in Malaysia was also positively related to the investment in the 1990s (Suto, 2003). Nonetheless, there are no empirical works offered on whether debt financing and the level of diversification is related to managers and controlling owners to enhance their private interest. On the other hand, the literature related to

diversification also argues that diversification can substitute for an inefficient external capital market, and lead to a cheaper and efficient internal capital markets (Stein, 2003). However, the purposes of firms pursuing diversification are uncertain in this economy. A manager or controlling owner may pursue diversification strategy to overcome a weak internal capital market. We are also uncertain that a manager or controlling owner pursues diversification in this economy especially in an environment where rent seeking opportunities is prevailing so as to protect their private interests.

Fourth, the knowledge and understanding of ownership structure in Malaysia is not well established. An earlier study by Lim (1981) focused on the formation of ownership structure of the one hundred largest firms during the 1970s. Ling (1982), on the other hand, assessed the distribution of ownership structure from the social economic and income distribution perspectives. Both studies indicate that the determinants of ownership structure in Malaysia are driven by socio-economic factors. The intervention from the state to reallocate equity among different races has transformed the determinants of ownership structure in the country (Chapter 2 provides the discussion).

Ownership structure in Malaysia is characterized as highly concentrated. For instance, La Porta, De Silanes and Shleifer (1999) showed that the top three largest shareholders hold 46% of the voting stock in the 10 largest firms. It is generally argued that the tendency for large shareholders to extract private benefits increases in tandem with their controlling interest (Barclay and Holderness, 1989; Shleifer and Vishny, 1997; Claessens, Djankov, Fan et al, 1999; Lemmon and Lins, 2003). The studies by Noor, Said and Redzuan (1999) and Ali (2001), on the other hand, focused on the issue of agency conflicts. Both studies conclude that firm performance follows a non-linear inverted U relationship with insider ownership, confirming that as insider equity interest in the firms becomes large, the firms are prone to expropriation. However, despite of

the presence of large shareholder in the Malaysian firms, both studies assumed the incentive alignment mechanism argument (Type I agency conflicts) and did not controlled for the presence of large shareholders as director or as external shareholder (Type II agency conflicts) which could either function as internal governance mechanism or could accelerate the expropriation on firm value.

These issues generate some questions that need to be addressed. Do managers and controlling owners pursue excessive leverage and diversification in a rent-seeking prevalent environment in Malaysia? What are the roles of the large shareholders? In addition to industrial rent and financial rent addressed above, asset specificity could also provide opportunities for managers or controlling owners to enhance their private interest through debt and diversification. This issue has not been addressed in this economy. In order to address these questions, the study has taken a more comprehensive approach to encompass agency theory (Jensen and Meckling, 1976), rent seeking path theory (Bebchuk, 1999) and the argument of transaction cost economics (Williamson, 1988) in a singular framework. It also assesses the influence of large shareholders on directors.

1.3 Objectives of the Study

The purpose of this study is to investigate the conditions under which managers, owners' involvement as directors or external shareholders pursue rent seeking objectives. The objectives of the study are:

(i) To examine whether managers (Type I agency conflicts) and controlling large shareholders (Type II agency conflicts) apply excessive leverage to entrench or expropriate firms' value in firms with highly intangible assets and industries with low intensity of competition.

(ii) To examine whether managers (Type I agency conflicts) and controlling large shareholders (Type II agency conflicts) apply diversification to entrench or expropriate firms' value in firms with highly intangible assets and industries with low intensity of competition.

(iii) To evaluate the determinants of ownership structures.

1.4 Summary of the Hypotheses

Three sets of hypotheses are developed in the thesis. The hypotheses address Type I agency conflicts- between external shareholders and managers, and Type II agency conflicts- between large shareholders and minority shareholders. All else being equal, incentive alignment may reduce agency costs as suggested in Jensen and Meckling (1976). However, by incurring higher debt, managers could reduce the entrenchment effect, as debt could function as a governance mechanism and improve firm value. Nonetheless, the rent seeking theory suggests that the incentive for controlling managers to use debt to protect their interest increases in correspondence to their equity interest, this leads to a declining firm value. The issues involves Type I agency conflicts are further examined in firms with highly intangible assets and highly concentrated industry. Therefore,

H_{1a}: In Type I agency conflicts, interaction effects between insider ownership and higher leverage on firm value follow a non-linear inverted U relationship.

H_{1b}: In Type I agency conflicts, the utilization of higher leverage in firms with high intangible assets leads to a lower firm value

H_{1c}: In Type I agency conflicts, the utilization of higher leverage in industries with low intensity of competition leads to a lower firm value.

In Type II agency conflicts, the agency conflicts and rent seeking is viewed to be more severe and could lead to a decline in firm value.

H_{1d}: In Type II agency conflicts, the utilization of higher leverage, with the presence of the relatively large shareholder as director, leads to deterioration in firm value.

H_{1e}: In Type II agency conflicts, the utilization of higher leverage, with the presence of large external shareholders, leads to deterioration in firm value.

H_{1f}: In Type II agency conflicts, the utilization of higher leverage in the firm with high intangible assets leads to a lower firm value.

H_{1g}: In Type II agency conflicts, the utilization of higher leverage in industries with low intensity of competition leads to a lower firm value.

The second group of hypotheses argue that diversification by managers (Type I agency conflicts) follow the incentive alignment argument. Large shareholders, due to their larger stake in a firm could build upon diversification but at the expense of minority shareholders (Type II agency conflicts). Diversification in a highly concentrated industry is deemed as unnecessary. Moreover, agency conflicts could lead to high diversification in highly concentrated industries. In a firm with intangible assets, diversification could reduce information asymmetric problems and transaction costs in the firm and therefore enhance firms' performance. However, the presence of Type I and Type II agency conflicts, could lead to deterioration in firm value.

H_{2a}: In Type I agency conflicts, interaction effects between insider ownership and diversification on firm value follow a U –shape relationship.

H_{2b}: In Type II agency conflicts, the interaction term between relatively large shareholders and diversification could lead to decline in firm value.

$H_{2c,}$: In Type II agency conflicts, the interaction term between relatively large shareholders and diversification in industries with lower intensity of competition could lead to a deterioration in firm value,

H_{2d}: In Type I and Type II agency conflicts, the interaction effects between ownership and diversification in firms with high intangible assets could lead to deterioration in firm value.

The last group of hypotheses built upon ownership concentrations are subject to rent seeking theory (Bebcuk, 1999) and the nature of the firm theory (Putterman,

1993). According to rent seeking theory, a controlling owner may increase leverage to enhance their private interest. However, as their controlling interest increases, the controlling owner will have incentives to decrease debt levels. The controlling interest is also expected to increase correspondingly to the degree of industrial concentration. In this regard, the controlling owner could use diversification to enhance his interest in an industry with low intensity of competition. Lastly, there are possibilities that large shareholders extract their private interest in firms with high intangible assets due to the problem of information asymmetry. The significant findings from the below hypotheses will further confirm that ownership structures in this economy are pursuing rent seeking interest. Therefore,

H_{3a}: There is a non-linear inverted U relationship between ownership concentration and leverage in a firm.

H_{3b}: There is a positive relationship between ownership concentration and industries with lower intensity of competition.

H_{3c}: Ownership concentration is positively related to higher levels of diversification.

H_{3d}: Ownership concentration is positively associated with interaction effects of diversification and industries with less intensity of competition

H_{3e}: Ownership concentration is positively associated with the firms with intangible assets.

Based on the nature of the firm theory (Putterman, 1993), which suggests information asymmetric problem is more severe in firms with a larger size and cash flow, a dispersed ownership structure will reduce the risk among shareholders. Lastly, a large shareholder is associated with higher risk corresponding to their equity interest in a firm. This prompts them to be risk averse in business ventures. The significance findings will illustrate that ownership structures in this economy function according to costs and benefits of the nature of the firm theory. Conversely, it illustrates that ownership structures in this economy are inefficient. The hypotheses suggest that:

H_{3f}: Ownership concentration is negatively related to firm size and cash flow.

H_{3g}: Ownership concentration is negatively related to business risk.

1.5 Significance of the Study

The contributions of this study are two- fold. First, the study extends the scope in finance literature, especially in the area of corporate governance. The agency theory focuses primarily on ex-ante incentive alignment mechanisms. Our study includes ex-post governance issues such as diversification, industrial competition and firm specific assets which are not discussed in agency theory. Furthermore, the study explores the influence of large shareholders on managers. Thus far, studies which have addressed the influence of large shareholders are very limited (Holderness, 2003).

The study also offers an additional perspective to the study of ownership structure in an emerging economy. This is vital as researchers have, so far, disagreed upon which system of ownership structure is the most efficient. For instance, Roe (1994) argued that competitive forces would prompt nations to adopt a single efficient governance form that is compatible with their existing institutional arrangements and economic development.

Second, variables such as debt, diversification, intangible assets and industrial rent have some policy implications. They could be interpreted from various institutional perspectives. Positive interaction effects of excessive leverage and ownership structure towards performance will illustrate whether financial institutions could complement ownership structure in corporate governance or not. It is therefore, essential to address the policy of financial institutions on corporate governance, such as the appointment of representatives from financial institutions in firms where they provide loans or have direct investment. A negative result implies that financial institutions substitute the role of ownership structure in corporate governance. The substitution effects also imply that either financial institutions or ownership structure are redundant in the role of

monitoring the firm. An alternative explanation could be that financial institutions may not be an effective mechanism in corporate governance. Therefore, corporate governance should focus on either one of the mechanisms.

The issue of diversification is related to the policy on merger and acquisition as well as disclosure on self-dealing. Controlling owners pursue a diversification strategy to protect their interests, and this subsequently leads to a negative firm value. This implies that there are weaknesses in merger and acquisition regulations, regulation and disclosures on transaction between bidder and seller, and disclosure of the diversification. The managers or controlling owners could increase diversification through acquisitions that boost the chances of misallocation of capital, transfer pricing, insider trading and others. Hence, a negative finding on the interaction relationship of ownership and diversification implies the weakness of these regulations.

Lastly, industrial rent is crucial to the industrialization process of an economy. Although an industry with lower intensity of competition is significant at the initial level of a country's industrialisation process, a higher level of industrial competition could also exert the role of monitoring and reinforcing the managers or controlling owners to enhance their performance. A lower level of industrial competition may reduce the effectiveness of regulation and other corporate governance mechanism instruments. Therefore, a negative finding on the interaction term between industry with a lower level of industrial competition and ownership structure suggests that emphasis should be placed on the industrial competition policy to further improve corporate governance.

1.6 Limitations of the Study

Using an unbalanced sample of 256 firms from the Malaysian manufacturing sector over the period of 1994 –2000, the study endeavours to illustrate that managers and controlling owners enhance their private interest through excessive debt and

diversification, which could lead to the detriment of firm value. This study has focused on the Malaysia manufacturing sector. However, the issue of rent seeking is not confined to the manufacturing sector. It is essential to compare and contrast the issues of ownership and private interest in other sectors. Other sectors which involve regulations and licensing from authority such as financial banking and insurance services or transportation services illustrate the possibility of rent value which could enhance controlling owners' private interest. However, the lack of industrial competition data from other sectors has precluded the possibility of comparing manufacturing sector and other sectors in this study.

Secondly, the main model of this study employs multiple regressions with interaction terms which encompass excessive leverage, multiple segment, highly intangible assets, and high industrial concentration. The dependent variable, applies the difference of firm value (Tobin's Q) between year t and t-1, while the independent variable uses a lag year of t-1. Although, the study emphasises ex-ante alignment of managers, measured by their controlling interest and ex-post alignment such as diversification, the study could not accurately estimate the actual timing when managers or controlling owners use debt or diversification to enhance their private interest. In this perspective, the ownership variable is always a variable that is measured at a single point in time. However, other variables such as debt ratio, diversification and Tobin's Q are flow variables during the reported financial year. An ideal procedure is to obtain an average measure of ownership data in the same period. For instance, if one uses the yearly leverage ratio, ideally, it should be regressed against the average ownership for that year. Unfortunately, there is not a single study that adopts this procedure.

Moreover, a variable like diversification is considered an ex-post alignment mechanism to the private interest of the controlling owner, but it could become an ex-

ante determinant to the ownership in the subsequent year. This issue is not addressed in this study.

Thirdly, it is assumed in this study that managerial ownership determines economic performance and not vice-versa. In other words, a direct approach, such as the two- stage- least- square method (2SLS), is not applied to analyse whether there is a reverse effect from performance on ownership structure or not. We are unable to address causality effects as the independent variables consist of non-linear and interaction terms. This causes an "identification problem" in a simultaneous equation.

1.7 Outline of the Study

The study is organised into six chapters. Following this introduction, Chapter two outlines the salient features of the Malaysian institutional background. Focus is also given to the manufacturing sector from where the sample of this thesis is drawn from. The level of industrial competition where rent seeking could be derived from is put forth to enhance understanding. Besides, economic policies that result in financial rent which leads to excessive debt in the economy are also emphasized. The chapter then examines capital market development as well as financing patterns in the economy. It also outlines the issues of shareholders and the development of ownership structure under the New Economic Policy. The chapter highlights the issues of rent seeking in this economy which paves the way for the understanding of the background of institutions in this study.

Chapter 3 provides a detailed analysis of the theories that explain ownership structure. The limitations of the agency theory to explain ownership structure and performance are emphasised. Hence, the chapter highlights the alternative theoretical framework in addressing corporate governance. The chapter proposes that transaction cost economics (TCE) and rent-seeking argument are two important assertions to be

included when addressing agency conflicts and performance. The chapter continues to discuss the literature on the relationship between ownership structure and leverage, and ownership structure and diversification and its implications on firms' value. These two issues are further discussed upon the conditionals of industrial competition and intangible assets with ownership structure. Previous literature related to this study is also reviewed.

Chapter 4 introduces the hypotheses and methodology used. Three groups of hypotheses are formulated: ownership structure and leverage, ownership structure and diversification, and lastly the factors that determine the ownership structures. The models used are discussed in the methodology section. The chapter also suggests the use of changes in the dependent variable, and lag year in the independent variables. The variables and their proxies used in the study as well as the sample selection are also discussed in this chapter.

Chapter 5 presents the findings and discussion of the empirical investigation of the study. The first part of the findings provides the results and analysis of the regression involving ownership and leverage while the second part provides the findings involving ownership structure and diversification. The robustness tests controlling for firm size, year effects and alternative measurements are also provided. In addition, we also provide an alternative test based on productivity measurement. Lastly, findings on factors that determine ownership structures in this economy are also presented.

The concluding chapter provides an overview of the implications of the study. Several policy implications on the corporate governance of financial institutions, the disclosure policy pertaining to diversification, the issue of industrial competition and

lastly the effectiveness of market information are presented. Finally, suggestions for future research are offered to end the chapter.

Chapter 2

Malaysia Institutional Background

2.1 Introduction

The implementation of the New Economic Policy (NEP) since 1971 marks the watershed of the national socio- economic development in Malaysia. During the first 20 years of the NEP, the economy grew at a rather impressive average rate of 6.7% per annum (Malaysia, various years). The economy enjoyed a tremendous growth of 8.0% from 1990 to 1995, 8.6% in 1996, and 7.7% in 1997, before plunging to -6.7% in 1998 due to the financial crisis (Malaysia, 1999). Over the decades, due to the rapid changes in world economic growth as well as the pressure of deficit in public finance, the government has taken steps to introduce some policy reforms in the Malaysian product and capital market.

The chapter proceeds with the explanation of industrial sector development. Particular attention is given to the manufacturing sector where rent seeking could prevail due to the low intensity of competition. Section 2.2 provides a brief background of the manufacturing sector in Malaysia. Financial structures and ownership structures are not mutually exclusive as both simultaneously affect each other. As specific literature on financing and ownership issues in the manufacturing sector is limited, we restrict our discussion to a general perspective of financial pattern and capital development to facilitate our understanding of the issues. Section 2.3 discusses the Malaysian capital market. Section 2.4 shows the issues of financial rent created by the government and its implications on corporate governance. Section 2.5 deals with the formation of ownership structure in Malaysia. We highlight that ownership structure is linked to rent seeking created through the process of equity distribution. Section 2.6 concludes the chapter.

2.2 Manufacturing Sector

In 1994, the manufacturing sector contributed 31.7% to the country's GDP, after the services sector (Malaysia, 1994a). In fact, from 1994 to 2000, the contribution of the manufacturing sector to the GDP as well as its export exhibited an increasing trend (Table 2-1). The share of the average manufacturing sector to the GDP was 35% for the period 1995 to 2000, while total export reached 85% in 2000. The sector also provided an average of 27% of the total employment in the Malaysian labour market from 1996 to 2003.

In terms of value-added activities created, table 2-1 clearly indicates that the Malaysian manufacturing sector incorporated a higher intensity of technology as the value added increased from RM40 billion in 1995 to RM50 billion in 1997, before it was affected by the financial crisis. Although there was an improvement in value added in 2003, the share to total export had shown a reduction to 83.6% as the manufacturing sector growth rate was a low 6.5% as compared to 18.3% in 2000. In 2005, the growth rate and share to total export showed a slow improvement to 8.5% and 84%, respectively. The figures also clearly reflect that the manufacturing sector is vulnerable to external market volatility as it is largely export based and dependent on the import of capital input. Besides, the sector also involves long vertical integration organizations from the input stage until the final product stage, which exposes it to various types of risks. The manufacturing sector, as the locomotive engine of growth in the country, is the catalyst to the country's economy. It also leads the different levels of the supply chain and other supporting industries. Therefore, a study on the impacts of ownership structure in the manufacturing sector is essential as it helps in policy formulation regarding capital allocation efficiency as well as ownership control. This would enhance diligent decision making and governance that would preserve the efficiency of firms.

Table 2- 1 Major indicators of the manufacturing sector

Indicators	1995	1996	1997	1998	96-98	99-2000	2000	2003	2005
Manufacturing Value Added (RM million in 1987 prices)**	39,790	44,684	50,270	45,155	140,109	93,740	67,250	70,225	81,651
Annual Growth Rate (%)	14.2	12.3	12.5	-10.2	4.3	3.4	18.3	6.5	8.5
Share to GDP(%)	33.1	34.2	35.7	34.4	34.8		32	30.6	31.7
Share to Total Export (%)	79.6	80.5	81	82.9	81.5	84.5	85.2	83	84
Share to Total Employment	25.7	26.4	27.1	27	26.9	27.2	27.6	27.9	29.3

** Year 1995-1998 was based on 1978 prices

Source: 8th Malaysia Plan, 2001-2005, p202; Mid Term Review of the Seventh Malaysia Plan 1996-2000, p 196, Mid Term Review of the Eight Malaysia Plan 2001-2005, p202

2.2.1 Industrial Policies

The improvement in the manufacturing sector is largely due to the government's Industrial Master Plan to transform Malaysia into an industrialised country. Since 1970, the state has successfully transformed the industrial policy from one of import substitution (phase 1-1957:1970) to export oriented (phase 2-1970:1980). The introduction of the heavy industrialisation policy plan in the 1980s (phase 3-1980-1985) drove the Malaysian industries to invest in expensive foreign technology, which also led to large amounts of government borrowings. During the later stage of the export-oriented strategy (Phase 4-1980:1990s), the manufacturing sector was well diversified in both resource based and non-resource based sectors (Malaysia Industry of Trade and Investment, 1994). The second Industrial Master Plan was later implemented, in accordance with the Seventh and Eighth Malaysian Plans (1996-2005).

The underlying argument for the industrial policy implemented in Malaysia is fundamentally based on the "infant industry" argument (see Jomo, Felker and Rasiah, 1999; Alavi, 1996). Therefore, various types of tax incentives, subsidies and trade protections have been introduced to promote and protect those industries until such time the industries become internationally competitive. However, the policy attracts criticism in terms of protection given to the domestic market as well as the time to