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Foreign ownership, foreign directors and the profitability of Malaysian listed companies

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Abstract

With an overall panel of 4,176 firm-year observations drawn from a sample of 348 Malaysia listed companies over the period 1999-2010, fixed-effect panel data regression found that percentage of foreign equity ownership, appointments of foreign chairman and foreign chief executive director did not have any significant relationship with firm's return on equity (ROE). However, increase in percentage of foreign directors sitting on the board significantly improved ROE. Besides, only when foreign investors have dominant (above 50%) voting rights, ROE increased. Construction and wholesale trade sectors sub-panels showed the appointments of foreign chairman and foreign chief executive director negatively influenced ROE.

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Keywords: foreign chairman; foreign executive director; foreign equity ownership; return on equity; upper echelon theory

1. 1. Introduction

Inward foreign direct investment (FDI) plays a crucial role in capital formation and economic development, particularly in developing and emerging economies (Gorg & Greenaway, 2004). Since early 1990s, Southeast Asia has been one of the most attractive regions of FDI inflows, due to abundance of natural resources and relatively cheaper factors of production. The World Factbook (2009) reveals that Singapore is by far the highest ranked Southeast Asia country in terms of accumulated stock of inward FDI as at the end of year 2009 (ranked 16th in the world), followed by Thailand (34th), Malaysia (35th), Indonesia (41st), Vietnam (48th) and Philippines (60th). This is unsurprising because Singapore does not impose any restriction on foreign equity ownership and does not experience any political instability ever since its independence, unlike some of its regional neighbours. Realising the important contribution of inward FDI in the era of globalisation and intensified competition, Malaysian government has liberalised the regulations on foreign equity ownership in its local companies.

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In Malaysia, Foreign Investment Committee (FIC) has allowed foreign investors to hold up to 100% of a firm's equity in all manufacturing sectors during the period from 31st July 1998 to 31st December 2003, except for seven specified manufacturing activities. Prior to this, Industrial Coordination Act 1975 had capped foreign equity ownership in a company at 30%. Subsequently, in June 2003, Malaysia Industrial Development Authority (MIDA) permitted 100% foreign ownership on a permanent basis (Rajenthran, 2002).

Growing trend of globalisation and business expansion by multinational corporations (MNCs) has prompted more studies on foreign ownership structure in developed economies such as United Kingdom (Harris, 2002) and Japan (Kimura & Kiyota, 2007), as well as developing and emerging economies such as India (Chhibber & Majumdar, 1999), Argentina, Brazil, Chile, Colombia and Peru (Pressman, 2004), China (Greenaway, Guariglia & Yu, 2009) and Indonesia (Takii, 2004). However, similar studies on Malaysian firms were very limited. Detragiache and Gupta (2004) is the nearest study of foreign ownership in Malaysia, nevertheless it is conducted on banks rather than non-financial firms. Foreign ownership of banks in Malaysia is separately regulated by Bank Negara Malaysia instead of MDA.

Besides providing some new empirical evidence on the effect of foreign equity ownership on firm's profitability in Malaysia, this paper also aims to explore on whether the appointments of foreign chairman and foreign chief executive director as well as the presence of foreign directors on the company's board of directors influence firm's profitability. Most of the previous studies of foreign ownership structure have overlooked the possibility that executive directors who actually control the daily operations and strategic decision makings might have maximised personal wealth at the expense of shareholders. Studies carried out by Chien (2008) in Taiwan and Masulis, Wang and Xie (2011) in the United States were the only exception. To close out research gap left out by previous researches, this paper ponders to answer the following research questions: (i) does foreign equity ownership influence firm's profitability?; (ii) does a non-linear relationship exist between different categories of foreign equity ownership (below 20%, between 20% to 50%, and above 50%) and firm's profitability?; (iii) are foreign chairman, chief executive director and directors valuable advisors who enhance firm's profitability or ineffective monitors who jeopardise firm's profitability?; (iv) does the effects of foreign equity ownership and presence of foreign directors on firm's profitability vary among different SIC-defined sectors in Malaysia?

2. Literature Review

With various competing theories of how foreign ownership and presence of foreign directors affect firm performance, empirical evidences from previous studies were somehow mixed. Internalisation theory, resource-based theory and upper echelon theory generally predict positive influence, whereas agency theory and rescue acquisition hypothesis predict the opposite.

Internalisation theory, developed by Rugman (1981), explained that MNCs will benefit from creating their own internal market where intra-group transactions can be carried out at lower cost and hence increase profit. Generally, local firms are more knowledgeable about local market, consumer preferences and business practices, thus foreign owners must possess some specific advantages such as managerial expertise or technological advancement in order to be able to compete with them. These intangible assets will be transferred through internalisation and expansion abroad, leading to higher profitability and productivity of foreign-owned firms compared to domestic-owned firms in a host country. Blomström and Kokko (1998) supported internalisation theory, where they concluded that transfer of technology from foreign owners had contributed to higher operating efficiency of domestic firms, through introduction of new know-how and transfer of techniques for inventory and quality controls. Besides that, Dunning (1977) claimed that possession of knowledge is the necessary advantage for a firm to become a multinational and internalise it to improve profitability.

Building a stronger foundation to resource-based theory developed by Wernerfelt in year 1984, Barney (1991) used VRIN model to explain that for a firm to have sustainable competitive advantage in the long run and achieve above average profits, its bundle of resources have to be value-creating, rare, inimitable and non-substitutable by competitors. In today globalized business environment, a firm's access to valuable resources such as cheaper cost of capital, larger customer base, reliable suppliers and strategic business partners could be enhanced through personal networks of its foreign owners and foreign directors. Study by Pfaffermayr and Bellak (2000) found that foreign-owned firms generally possess greater amount of financial capital than domestic-owned firms, thus more likely to set up research and development department to develop better innovative products which suit consumers' needs at greater production

efficiency, hence resulting in higher profitability. Foreign-owned firms also tend to have more high-calibre human capital by virtue of rewarding their expertise with higher salary and better perks. Besides, King (2007) study showed evidence that armed with experience and exposure to global business environment and practices, foreign directors are able to coordinate resources of the company much better than domestic counterparts, hence leading to greater productivity and superior performance. In addition, Masulis et al (2011) found that foreign directors sitting on the board offered their valuable advices in helping their firm to make better cross-border acquisitions, especially when the takeover targets are from their familiar home regions. Such intangible resources will positively influence the performance for firms with a higher ratio of foreigners in their board of directors.

Upper echelons theory originated by Hambrick and Mason (1984) explains that choice of strategies and decisions for the firm are partially influenced by background characteristics of the firm's individual top executives, which include experiences, personalities, values, beliefs and other human factors. On the premise of upper echelons theory, appointing more foreign directors with different nationalities will bring different values, experiences and cognitions to the decision making process, which in turn contribute to more creative and superior strategic solutions. Nielsen and Nielsen (2003) study on top management teams of Swiss MNCs found that nationality diversity among executive directors is positively associated with firm's performance and the effect is more significant for long-tenured top management teams. Apart from that, Liargovas and Skandalis (2010) showed that a heterogeneous board that consists of different races and nationalities will be more creative and eventually contribute to better strategic planning and business decision making as compared to a homogeneous board. Moreover, Choi and Hasan (2005) found that foreign directors are more knowledgeable and experienced about competition and latest development in the global market compared to local directors, and thus has helped local banks to increase revenue by venturing into new businesses and reduce the reliance on traditional businesses. However, studies by Williams and O'Reilly (1998) that claimed board diversity can give rise to group conflict and Tsui and O'Reilly (1992) that concluded ethnic diversity reduces organizational commitment and communication, are both argued against the upper echelons theory and supported a negative relationship between the presence of foreign directors and firm performance.

Agency problem which prevails in many corporations due to separation of ownership and control could potentially be reduced with shareholders appointing the board of directors to whom managers reporting to. However, according to Masulis et al (2011), appointment of foreign directors weakened monitoring effectiveness due to long geographical distance from their domiciled countries and unfamiliarity with local business environment, and hence firms with more foreign directors are associated with greater agency problem and ultimately poorer performance, especially when the domestic firms appointing them do not have much business presence in the foreign directors' origin (home) countries. In contrast, Oxelheim and Randov (2003) study on Swedish companies discovered that foreign owners who can secure at least one foreign representative on the board of directors is a signal of greater commitment towards corporate governance and transparency, and this signal in turn result in better reputation and higher firm value in the financial market.

Rescue acquisition hypothesis claimed that poorly performing domestic firms likely to add more foreign equity participation and lead to substantially high degree of foreign ownership. The phenomenon of foreign acquisitions of poorly performing domestic firms has been observed in several emerging markets after Asian financial crisis in 1997 because Asian firms that were in dire need of capital for survival were willing to accept lower bid price from acquirers. Since it is unlikely that foreign owners could improve these poorly performing firms overnight after the acquisition, foreign-owned firms' performance will still lag behind domestic-owned counterparts at least in the short run period post-acquisition.

3. Methodology

This paper examines the effects of foreign ownership and presence of foreign directors on the profitability of Malaysia listed companies over the period from year 1999 to year 2010. From the target population of 978 companies listed on Bursa Malaysia as at 31st December 2010, judgmental sampling method is adopted to select sample firms that meet certain criteria. Exclusion criteria for this study are: (i) companies that are listed on Bursa Malaysia after financial year 1999, change in company's name after merger and acquisition, or delisted at any point of time during the sample period of year 1999 to year 2010 in order to avoid incomplete data for certain year(s); (ii) companies from banking and finance sector and real estate investment trusts (REITs) due to the different nature of their capital structure from non-financial companies (Hovakimian, 2001); (iii) companies categorized in SIC-defined sectors that have less than

30 companies to avoid sampling bias due to too few observations; (iv) companies that failed to comply with the obligations under Practice Note 17 (PN17) or Guidance Note 3 (GN3) because companies undergone restructuring could have significant impact on financial performance (Ling et al, 2008); (v) companies that do not disclose the list of top 30 shareholders as such data are needed to compute the percentage of foreign equity ownership; (vi) multi-segment firms whose segmented accounting in the annual reports do not divide different segments a firm involved in the same manner as the international SIC code used by WVB database. The 348 selected samples are then classified into different sectors based on first two digits of the four-digit International Standard Industrial Classification (SIC) code. After filtered with exclusion criteria (iii) above, only five out of the ten sectors remained in this study. The 348 selected sample companies include 219 companies in manufacturing sector (SIC code begins with 20 to 39), 36 companies in construction sector (code 15 to 17), 31 companies in transportation, communication, electric, gas and sanitary (TCUS) sector (code 40 to 49), 25 companies in wholesale trade sector (code 50 to 51) and 37 companies in services sector (code 70 to 88).

Based on the statistical test results from Redundant Test and Hausman Test, this study adopts fixed-effect panel data regression to examine the effects of foreign equity ownership and presence of foreign directors on the profitability of Malaysia listed companies. The panel data regression model is stated as Equation 1 below:

$$ROE_{it} = \beta_0 + \beta_1 FOWN_{it} + \beta_2 FDIR_{it} + \beta_3 HFOD_{it} + \beta_4 MFOD_{it} + \beta_5 FCHM_{it} + \beta_6 FEXD_{it} + \beta_7 SIZE_{it} + \beta_8 CAPI_{it} + \delta t + \mu_{it} \quad \text{(Eq. 1)}$$

where $\mu_{it} = \alpha_i + \varepsilon_{it}$, α_i is the joint effects of unobserved variable on firm profitability, ε_{it} it the error term, δ is the shift of intercept over time, i denotes each individual listed company in Malaysia, and t denotes each financial reporting year from 1999 to 2010. Variables in Equation 1 are defined as follows:

- Return on Equity (ROE) is net income divided by ordinary shareholders' equity, where net income equals to earnings after tax minus preferred dividends (Marimuthu & Kolandaisamy, 2009; Haslindar & Fazilah, 2011).
- Percentage of foreign equity ownership (FOWN) is the sum of ordinary shares owned by foreign individuals and institutions obtained from the annual report's list of top 30 shareholders, divided by total number of ordinary shares issued and outstanding of a sample firm.
- Percentage of foreign directors (FDIR) is the number of foreign directors divided by total number of directors sitting on a sample firm's board of directors. This measure is borrowed from Marimuthu and Kolandaisamy (2009) study that measures the percentage of non-indigenous directors.
- Percentage of foreign equity ownership are categorized into high degree (50% and above), medium degree (20% to 49.99%) and low degree (0% to 19.99%) because Aydin et al (2007) study on foreign ownership and Lyidmila (2005) study on state ownership have both discovered a non-linear relationship to firm performance. In this paper, high degree of foreign ownership dummy (HFOD) takes a value of "1" if foreign equity ownership is 50% and above or "0" otherwise, while medium degree of foreign ownership dummy (MFOD) takes a value of "1" if foreign equity ownership is between 20% and 49.99% or "0" otherwise.
- Foreign chairman dummy (FCHM) takes a value of "1" if the firm's chairman is a foreign resident or "0" otherwise.
- Foreign executive director dummy (FEXD) takes a value of "1" if the firm's executive director is a foreign resident or "0" otherwise.
- Firm size (SIZE) is the natural logarithm of the firm's total asset.
- Capital intensity ratio (CAPI) is total tangible asset divided by total sales.

The above fixed-effect panel data regression model will first be run on country panel of firm-year observations to test the following hypotheses, and then separately on five sub-panels of SIC-defined sectors. Hypotheses to be tested in this paper are as follows:

- H1: There is a relationship between percentage of foreign equity ownership and firm's profitability.
- H2: There is a relationship between percentage of foreign directors and firm's profitability.
- H3: The degrees of foreign equity ownership affect firm's profitability.
- H4: The appointment of foreign chairman affects firm's profitability.

- H5: The appointment of foreign executive director affects firm's profitability.

4. Discussion of Results

Table 1 revealed that majority of the Malaysian listed companies has low degree of foreign ownership, averaged at 80.68% over the period 1999 to 2010. Companies with high and medium degrees of foreign ownership comprised only 9.10% and 10.22% on average over similar period. This is unsurprising given that Malaysia has the minimum 30% indigenous ownership requirement implemented since the New Economic Policy (NEP) which indirectly restrict foreign ownership. Transitions among foreign ownership categories over the years are quite insignificant. Compare year 1999 to year 2010, 2.89% of listed companies have migrated from low degree to high degree foreign ownership category and 0.53% have shifted from medium degree to high degree foreign ownership category. In terms of corporate governance structure, only 5.46% of Malaysian listed companies have appointed a foreign resident as chairman over the period 1999 to 2010. On the other hand, appointment of foreign executive directors seems to be more prevalent, averaged at 11.62% over the period 1999 to 2010, which was more than double compared to the former.

Table 1: Frequency distribution of foreign ownership categories, foreign chairman and foreign executive director among Malaysian listed companies over the period 1999-2010

Year	Foreign ownership categories			With Foreign Chairman (FCHM)	With Foreign Executive Director (FEXD)
	Low	Medium	High		
1999	83.42%	9.21%	7.37%	4.47%	10.79%
2000	82.37%	9.74%	7.89%	4.47%	12.11%
2001	82.89%	8.95%	8.16%	5.00%	11.58%
2002	83.16%	8.16%	8.68%	5.00%	12.11%
2003	82.11%	9.74%	8.16%	5.53%	10.26%
2004	82.11%	9.21%	8.68%	5.79%	11.58%
2005	80.26%	10.53%	9.21%	5.53%	11.84%
2006	77.37%	12.89%	9.74%	5.53%	11.58%
2007	75.79%	13.68%	10.53%	5.53%	11.84%
2008	78.42%	11.84%	9.74%	5.79%	12.11%
2009	79.74%	10.00%	10.26%	6.32%	11.84%
2010	80.53%	8.68%	10.79%	6.58%	11.84%

Low = low degree of Chinese equity ownership, ranging from 0% to 19.99%

Average	80.68%	10.22%	9.10%	5.46%	11.62%

Medium = medium degree of Chinese equity ownership, ranging from 20% to 49.9Low = Low = low degree of Chinese equity ownership, ranging from 0% to 19.99%
Medium = medium degree of Chinese equity ownership, ranging from 20% to 49.99%
High = high degree of Chinese equity ownership, ranging from 50% to 100%

Table 2 showed that manufacturing sector has 11.42% of the firms belongs to high foreign ownership category, the highest proportion among all the five sectors and also the only sector that surpasses overall country average of 9.10%. This coincides with FIC and MIDA relaxation of foreign equity ownership cap on manufacturing sector companies to 100%. In contrast, TCUS sector has the largest proportion of firms in low foreign ownership category, recorded at 89.25% which exceeds the overall country average of 80.68%. Services (14.86%), construction (13.19%) and wholesale trade (11.70%) were the three sectors that have greater proportion of firms belong to medium degree foreign ownership category compared to overall country average of 10.22%. In terms of corporate governance structure, manufacturing sector has the highest appointment of foreign chairman (11.42%) and foreign executive director (25.97%) among all the five SIC-defined sectors, followed by services sector which recorded 8.11% and 13.56% respectively. Many MNCs that established their subsidiaries in Malaysia since 1970s are mainly involved in manufacturing products to satisfy local and regional sales, and these subsidiaries are mostly managed by foreign chairman and foreign executive director expatriated from MNCs' parent company abroad.

Table 2: Frequency distribution of foreign ownership categories, foreign chairman and foreign executive director by SIC-defined sectors in Malaysia over the period 1999-2010

Sector	**Number of Companies**	**Foreign ownership categories**			**With Foreign Chairman (FCHM)**	**With Foreign Executive Director (FEXD)**
		Low	**Medium**	**High**		
Construction	36	84.03%	13.19%	2.78%	2.55%	1.69%
Manufacturing	219	79.41%	9.17%	11.42%	11.42%	25.97%
TCUS	31	89.25%	5.91%	4.84%	4.84%	3.34%
Wholesale Trade	25	81.14%	11.70%	7.16%	5.85%	10.14%
Services	37	77.03%	14.86%	8.11%	8.11%	13.56%

Low = low degree of Chinese equity ownership, ranging from 0% to 19.99%
Medium = medium degree of Chinese equity ownership, ranging from 20% to 49.99%
High = high degree of Chinese equity ownership, ranging from 50% to 100%

Refer to Table 3 below, regression model defined in Equation 1 above showed good model fit with the p-value of the F-test significant even at 1% level for overall panel and all sector sub-panels. Based on overall panel of 4,176 firm-year observations, all the explanatory variables together explained 37.37.76% of the variation in firm's return on equity (ROE). On a sector-by-sector basis, adjusted R-squared range from the highest (42.76%) for manufacturing sector to the lowest (24.69%) for wholesale trade sector.

Foreign equity ownership (FOWN) did not have any significant relationship with firm's ROE according to overall panel and sector sub-panels results, hence insufficient evidence to reject null hypothesis of H1. There was only a weak

negative relationship between FOWN and ROE at 10% level for wholesale trade sector sub-panel. In contrast, foreign directors' presence (FDIR) had a significant positive relationship with firm's ROE based on overall panel and 3 out of the 5 sector sub-panels (manufacturing, construction and wholesale trade), consistent with upper echelon theory and the findings of Liargovas and Skandalis (2010). Therefore, there was enough evidence to reject null hypothesis of H2.

Results from overall panel and manufacturing sector sub-panel showed some evidence of non-linear relationship between foreign equity ownership and firm's ROE to reject null hypothesis of H3, consistent with findings from Greenaway et al (2009) study in China. Coefficients for HFOD were significant at 1% and the transition from low degree to high degree foreign ownership category could generally increase ROE by 9.08% and specifically improve manufacturing company's ROE by 11.23%. Nevertheless, coefficient for MFOD was mildly significant at 10% level and the shift from low degree to medium degree foreign ownership category only yield additional 3.99% ROE. These indicate that foreign shareholders need dominant voting rights in a company to be able to improve the firm's profitability since significant voting rights are still insufficient.

Table 3: Summary results of Panel Data Regression – overall panel and sub-panels by SIC-defined sectors in Malaysia

	Overall Panel	**Sub-Panels**				
		Construction	**Manufacturing**	**TCUS**	**Wholesale Trade**	**Services**
Constant	-51.2590	-19.3574	-57.0558	-29.4788	-37.7679	-58.8443
FOWN	-0.1619	8.5746	-0.1724	-9.8549	-27.1383*	19.2834
FDIR	19.8042***	96.3534***	23.1773***	-8.3739	23.5132***	0.6211
HFOD	9.0819***	-3.8277	11.2244***	16.2322	-0.5150	4.3047
MFOD	3.9851*	-1.4233	5.0305	9.2463	0.5826	6.0683
FCHM	-0.6713	-44.9160**	4.9050	12.5537	-19.9683**	-18.6547*
FEXD	2.9254	-35.1979**	0.5868	14.4671	12.8862	13.9887
SIZE	9.8290	3.9415	10.9878	5.7080	8.5995	11.2822
CAPI	0.0019	0.0677	-0.2873	0.0019	-0.0678	-0.2043
Number of firm-year observations	4,176	432	2,628	372	300	444
Adjusted R-squared	0.3776	0.3710	0.4276	0.3123	0.2469	0.2754
F-statistic	7.8971	6.9518	9.4096	5.3634	4.4518	5.0123

P-value	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000

***, ** and * denote the coefficient is significant at 1%, 5% and 10% level respectively.

Results from overall panel did not show any significant effect on ROE due to the appointments of both foreign chairman (FCHM) and foreign executive director (FEXD). Nonetheless, results from sector sub-panels provided some evidence to reject null hypotheses of H4 and H5 at 5% level. Appointment of FCHM reduced firm's ROE in construction and wholesale trade sectors, whereas the appointment of FEXD pushed down firm's ROE in construction sector. These negative effects could possibly due to foreign chairmen and executive directors do not understand local business environment in Malaysia, or face difficulties to mesh different culture and management styles between their origin country and Malaysia.

5. Conclusion

Although mean percentage of foreign directors (FDIR) of 7.06% might indicate low diversity on a company's board of directors, regression results had proven that their presence improved profitability. Being a harmony multi-ethnic nation, hiring of various indigenous and non-indigenous local individuals to hold director positions perhaps have already increased the degree of board diversity, albeit low diversity in terms of nationalities. Therefore, foreign directors and multi-ethnic Malaysian directors could share new ideas, knowledge, expertise and valuable advises that help to improve their company performance, as predicted by upper echelon theory. Armed with the highest mean FDIR among all the five SIC-defined sectors, foreign directors could actually help Malaysian manufacturing companies to penetrate and expand product sales back to their home (origin) countries in which they are familiar with. Larger product market base enables Malaysian manufacturers to enjoy economies of scale, leading to lower cost and higher profit. Expanding merchandise exports by Malaysian manufacturers have contributed to continuous balance of trade surplus for Malaysia over the years.

Since high degree of foreign ownership (HFOD) proven to increase firm's ROE significantly, foreign investors should increase their equity stake to above 50%. With low political risk in Malaysia compared to regional neighbours such as Thailand, Myanmar and Philippines, foreign investors are not advised to invite domestic owners as joint venture partners because medium degree of foreign ownership (MFOD) did not bring significant improvement in ROE. When political risk is high, as in the case of China, Greenaway et al (2009) found that foreign equity ownership in the range of 47% to 64% (joint ventures between foreign owners and local Chinese firms) positively affect return on asset (ROA), but negatively affect ROA when foreign owners' stake increase thereafter. Therefore in the case of Malaysia, foreign MNCs are encouraged to establish their subsidiaries in which they hold a controlling stake, i.e. 50% equity ownership or abvove (HFOD), in order to enjoy increased profitability.

Negative coefficients of FCHM and FEXD from construction and wholesale trade sub-panels and generally insignificant results from overall panel suggest that when a Malaysian company, especially in construction and wholesale trade sectors, wishes to appoint either a foreign chairman or a foreign chief executive director, it is advisable that the origin country of the foreign candidates has to be taken into consideration. According to Benfratello and Sembenelli (2002) in Italy and Bilyk (2003) in Ukraine, foreign owners and directors from other regions (off-shore) showed significant negative effects on firm performance whilst their counterparts from the same region (non off-shore) did not exert any significant influence, possibly due to the former's lack of understanding of local cultural, social and business environment.

There are some limitations of this research in which future researchers could embark on. Firstly, inward FDI might also takes place in private limited companies, hence a study that also covers non-listed companies will give a more meaningful comparison among sectors. Secondly, this study did not look into whether the origins of foreign owners and directors influence firm's performance due to limitation of such specific data. Doing so enables precise recommendation to be given to companies on equity investors from which origins they should attract and directors from which origins they should hire.

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