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Remaking Khazanah and the GLCs –
A Capitalist's Approach

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**Views of the speaker are strictly his; usual caveats apply in that the views may or may not reflect those of Khazanah's.
(Abridged Version)*

Distinguished members and guests of the Kuala Lumpur Business Club

Introduction

Thank you for inviting me. My topic this evening is “*Remaking Khazanah and the GLCs – a Capitalist’s Approach*”. The best speeches, I am told, are usually the collegiate ones; those that you offer to your peers and to your seniors. There is usually nowhere to hide and plenty to seek, and Truth is therefore never too far away. *May we be closer by the evening’s end.*

The measure of KLBC’s success is that in a short space of time it is now synonymous with providing original food for thought for the business community and senior policy makers alike. Congratulations are in order to the club and especially its leadership. *May the club build upon its early successes.*

To the sponsors, Telekom Malaysia, a heartfelt thanks. This contribution to an important industry network point² that is KLBC, is an appropriate example of enlightened corporate social responsibility. This is well placed, especially after Telekom Malaysia displayed sterling capital management recently by announcing not only higher dividends but perhaps more importantly giving investors line of sight of a policy on dividends and returns.

We at Khazanah are happy shareholders, ... well, for now at least! Meanwhile, I am told that I would have been flanked this evening by the other capital T – Tenaga Nasional that is – had Tenaga not stopped the proposed joint sponsorship on the grounds that one is quite enough. To that too, we are happy shareholders – such forbearance and cost focus is indeed encouraging, ... although we look forward to the day when Tenaga will be buying us all dinner! And in this little story lies a happy display of a nuanced approach to capital and management. *May such enlightened corporate stewardship continue.*

To the many in the press, and the investment and business community, I say thank you for your patience in allowing us time to formulate our plans and thoughts that we may present a view that has been thought through and, more importantly syndicated. Expectations are indeed great and we would not expect it to be any other way; they can and should be high so long as they are realistic. Early on, I had even resorted to mailing to chief editors the memorable paper by an eminent finance professor³ that found that the best predictor for over-paying in acquisitions was not measures such as

² What Michael Porter in his competitive analysis framework would quite importantly define as an institution for collaboration

³ Richard Roll – *The Hubris Hypothesis of Mergers and Takeovers.*

high PE ratios, it was actually the number of times the acquiring corporate captains appeared on the cover of business magazines. For one who was just starting the heavy task of leading the nation's strategic investment agency it was therefore important that such potentially career limiting exposure was kept to a minimum. It was also important that we went through the diagnostics of the landscape and the syndication of the vision with the major stakeholders. We are now ready to share – within the confines of corporate governance and the nation's competitive positioning – our thoughts and plans. *May we be guided in this important task.*

The topic tonight of remaking Khazanah and GLCs, sub-text from the approach of a capitalist may be particularly interesting to our Chairman,. Being an LSE alumnus our good doctor would have debated at length the roles of the state and the markets. In spite of, or perhaps more precisely because of, the neo-liberal times that we live in, this age old debate is still alive and well today, and is at the heart of tonight's discussion. Sir, I am reminded of the saying that if one is not a socialist by the time one is twenty then one does not have a heart, and that if one is still a socialist by the time one is thirty then one does not have a head. *May we all be well balanced on both counts.*

Overview

This evening I would like to address more on the “why” and “how” of the Khazanah and GLC revamp program, and bore you less on the “what”.

The last, that is the framework of the revamp program, we have recently articulated, and materials to the effect would be distributed that you may refer to if required. Such strategic framework addresses the priorities, mandate and approach of Khazanah in respect of we make of our activist, strategic investment mandate. It outlines our thinking on investment policy, cross-border investments, human capital formation, industry structures, treatment of business partners, and the terms of engagement with our investee companies, i.e. the GLCs.

So that we may focus our discussion tonight, it is worth repeating that early on we at Khazanah asked ourselves what would constitute success for Khazanah and GLCs after three years. Such introspection was a good starting point. We eventually landed on three broad areas; first the financial objectives of achieving superior total shareholders returns; second the strategic objectives, mostly centered around capability building including in the areas of sectoral and geographical exposure, human capital and technological capability; third, the institutional capacity building objectives of Khazanah that is to build the foundations of an important national institution in line with the new mandate. The last involves building strong foundations in terms of processes, charters, systems and controls, work culture and eventually brand equity. This last institutional and capacity building framework

would also apply to GLCs, at least from our standpoint as a shareholder that is. Our collective KPIs are therefore within this framework.

Against this performance backdrop, I will address first the question of “why” – that is why the revamp is required, and second the “how” that is how we propose to execute the plans. I will try to share specific examples, again within the confines of disclosure rules and corporate governance. Interspersed will be our approach as capitalists with a twist; that is we will approach the execution, the “how” from the standpoint of not just the obvious financial or physical capital, but also from the standpoint of human capital, knowledge capital and, quite importantly, social capital⁴. This is a mammoth yet worthwhile task, and I submit, one that we – not just Khazanah or GLCs - all have a part to play.

Why?

State ownership, efficiencies and sequencing – the context of change

There are three points to be made

A first and fundamental question is to ask should the Government be in business? The answer we believe is a qualified yes. The textbooks are not entirely correct. Markets are less than perfect, they sometimes fail and most spectacularly so in recent times being the Asian financial crisis. Where the entities are strategic, such private or privatized entities converted or reverted to being GLCs.

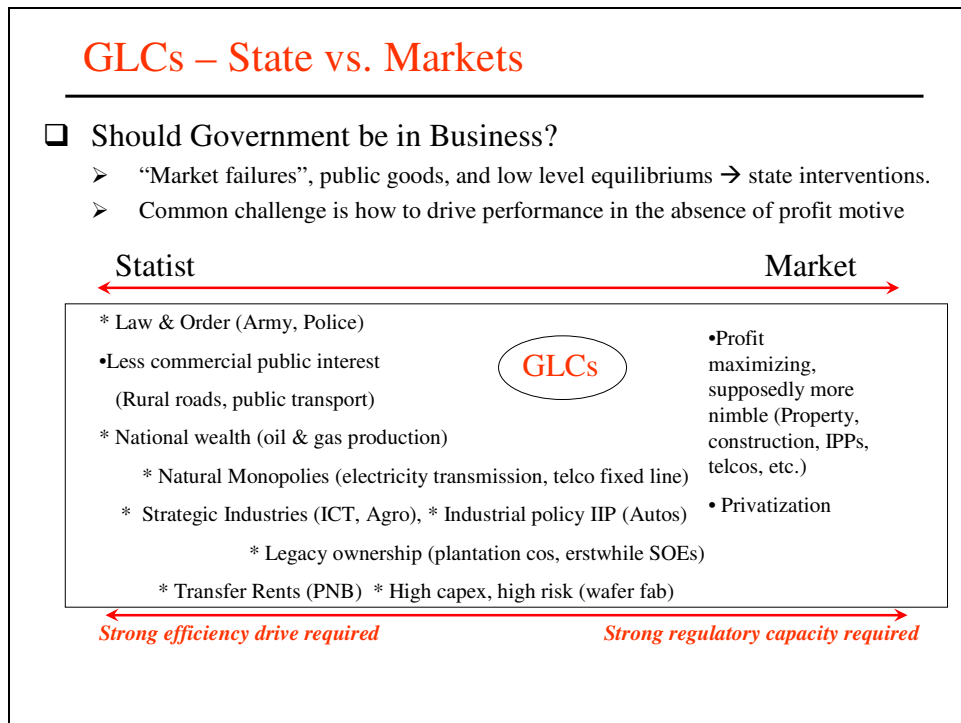
State entrepreneurship is also required in situations of public goods, as custodians to a common wealth, natural monopolies and high capex-high risk projects where the private sector is either unwilling or unable. It also applies where infant industry protection may be required especially in a world where the market power of Transnational corporations (TNCs) are increasingly concentrated and overpowering. Sometimes, it is an issue of sequencing; legacy holdings from a time past where the state held assets taking over from a colonial legacy as in plantations companies or when state owned enterprises were integrated monopolies as in the likes of Tenaga and Telekom.

Nonetheless, the fact that, the world over, some infants are still being nursed as consenting adults, is a timely reminder of some of the limitations – in execution, if not in structure - of state ownership. A not uncommon challenge is the need to drive efficiencies in such state owned enterprises, due to the absence or reduced ownership

⁴ *Social capital refers to the institutions, relationships, and norms that shape the quality and quantity of a society's social interactions... Social capital is not just the sum of the institutions which underpin a society – it is the glue that holds them together. Social capital refers to the norms and networks that enable collective action* (The World Bank website)

of the profit motive. Further, the more a market solution is employed, the greater will be a need for strong regulatory capacity

It can be summarized then that there is a role for both state and markets, and the hybrid in between that are the GLCs. An important corollary to this has been made in that the GLC revamp should not crowd out the private sector in as much as there should not be excessive private value capture of public goods. The key to micro-economic value creation would therefore be a balanced co-existence between the private and public or GLC sectors. Khazanah, other national institutions and indeed the private sector each has a role to play in this ecology. And we echo the ministerial view at a recent KLBC dinner that MAS and Air Asia, Tenaga and YTL and Malakoff, Telekom and Maxis and Digi among others, are all national champions in the true spirit of Malaysia Inc.



Second, we often get asked what exactly is a GLC? We submit that the test would be major ownership and control by a major shareholder who is either a government agency such as Khazanah, or by a government related agency where the Government has an interest in by virtue of a financial or legal exposure, contingent or otherwise. By this definition, it would apply to agencies such as PNB or EPF where the Government guarantees at least the capital portion.

GLCs definition

❑ GLCs definition

- Test is “control” rather than % ownership. Control is usually defined as the ability to appoint BOD members, senior management, make major decisions (e.g. contract awards, strategy, restructuring and financing, acquisitions and divestments etc.)
- Definition # 1: Where Government of Malaysia (“GOM”) controls directly – through Khazanah, MOF Inc., KWAP, and BNM.
- Definition #2: (and) where other federal Government linked agencies controls – PNB, EPF, Tabong Haji (technically owned by depositors, but capital (and some income) portion guaranteed by GOM.)
- Definition # 3: (and) where state agencies controls (Selangor, Johor, Pahang, Perak, Sarawak, Terrenganu are particularly active).
- Khazanah uses the definition to be limited to # 1 and # 2.

Third, is the need to understand the context of these changes. When the YAB Prime Minister first announced the framework for change in Khazanah’s mandate in May this year, it was within the broader context of the very important task of improving national competitiveness and total factor productivity. This is especially pertinent in view of the increasing pressures of liberalization and globalization, where the nation’s economic agents needs to be more engaged into the global system and to do so on a sustained basis would mean being ready for competition.

It was felt that Khazanah needed to play a more active role to catalyze the transformation of making our companies and especially GLCs better and more prepared for a more liberalized world. Broadly, Khazanah’s role as an active strategic investor now involves driving and creating greater shareholder and strategic value. The first involves financial returns, the second, generally, in terms of the capabilities of these companies. This also covers, where appropriate making calculated bets on behalf of the nation into new sectors and new geographies that we deem important in terms of penetration, linkages and potential for the nation’s long-run competitiveness.

It was also a logical progression in terms of the micro-economic transformation of the country. Where 10-15 years ago there was a wave of privatization involving a relatively small reduction in Government’s holdings with a focus on infrastructure building, now there is more emphasis on exacting efficiencies out of existing assets, on more optimal shareholding structures and ownership levels by the Government. Various studies have shown that GLCs as a group have basically underperformed on all measures except size. One study by CIMB dated June this year found that GLCs

are less productive users of capital, more geared and has lagged significantly in terms of total shareholders return. Given its heavy presence in both the economy and the market, the need to increase efficiency was therefore obvious.

GLCs performance (or the lack of it)

❑ GLCs performance – Big is not beautiful

- Lagging on almost all fronts (all data from Bursa Top 100 analysis)
- Total shareholder returns has lagged

	Total returns (%)		
	1 Yr	3 Yr	5 Yr
Top 100	30.0	17.9	6.8
GLCs	27.6	14.3	3.6
Others	30.7	18.8	7.5

- GLCs make poorer use of capital – 11.3% ROE vs. 13.7% for non GLCs
- Less productive: Profit/employee of RM109k vs. RM127k for non GLCs
- More geared: Average debt:equity of 60% vs. 35% for non GLCs
- GLCs only ahead on size – 22% of Top 100 companies, but 44% of market cap, and EBIT profitability – 19.4% EBIT margin vs. 18.7% for non GLCs.

Source: CIMB Investment Banking research

Viewed from the timeline of the financial crisis, it is also sensible sequencing; first it was about macro-economic stabilization, then it was what we have termed “war-time restructuring” involving key companies such as Renong-UEM and MAS among others. Now, this is perhaps “peace-time restructuring” where we are addressing several strategic companies and sectors that are not ostensibly in crisis mode. Within that, there is some, although not exclusive focus on key heavyweights such as Tenaga and Telekom as this was where we could potentially have the biggest impact and provide the greatest demonstration effect.

How?

Strategies ... and execution, execution, execution

There are of course no lack of vision, mission, good ideas and strategies. Where we are short, we can and do lease the talent, the ideas and the strategies. The key is of course implementation and execution. One eminent strategy consultancy out of its KL office concluded that the execution-capacity deficit across 3 major GLCs is a staggering 1,500 leaders. Strategies and frameworks are nonetheless important and should not be underestimated as the catastrophe of wrong planning and bad thinking is usually of very high impact.

Before we discuss in greater detail of how to restructure GLCs, let us consider some examples of how GLCs have demonstrated excellence.

- Petronas in the national development of oil and gas and international investing
- MISC, demonstrating how growth can be achieved through both acquisition and organic improvement
- PTP – it started as a GLC – in world class port operations
- Petronas in implementing procurement systems and a vendor development program that has seen the likes of Crest, Scomi and others graduating to become internationally competitive service providers.
- Celcom in having independently certified better call quality
- CIMB, in creating such a dominant market position and brand equity as an example of what empowered management properly incentivized can achieve
- Tenaga, in spite of heavily publicized blackouts in the 1990s, have demonstrated sharply improved supply efficiency.
- Telekom, in learning and building on its international experience and in better capital management.
- MAS, in its world class cabin service, engineering and pilots. And in its operating unit cost reductions. Also, in unbundling excessive social obligations and in its financial restructuring.
- Maybank and MAS, and, Bumiputra-Commerce before that, have crossed a mental block and have seen the logic of outsourcing its IT operations to focus on their core operations.
- Mutiara Damansara as an example of measured, value creating property development, as is Petronas in Suria KLCC.
- Ironically, Tenaga when it was LLN, was recognized by the World Bank as being the best run electric utility in the developing world, both operationally and financially. It certainly posted greater returns at the 8% ROA required by multi lateral agencies against the 3-4% currently.
- PLUS for building then running world class infrastructure and so on.

These are GLCs, and there are other examples. They have shown that it can be done. The key is that these pockets of excellence need to become the norm rather than the exception. In our analysis, we hypothesize that the major conditions for success⁵ are

- 1) Clear industry and regulatory structure and reporting lines
- 2) Professional management and Board working in unison,
- 3) Independence in key decision making,
- 4) Strong internal culture of performance and emphasis on systems and controls,
- 5) Focus on financial discipline in addition to service delivery,
- 6) Disciplined access to credit and orderly competition

⁵ At the risk of “Richard Rolling” Petronas, refer to the appendix for an analysis postulating Petronas as a best in class GLC against representative “inhibited GLCs”.

Against this backdrop, we can share that we, that is Khazanah, is approaching the solutions with a focus on implementation as follows;

1. ***Get the setting right #1 – separate the various roles of Government.*** To echo the ministerial view of putting the right objectives of Government into the right boxes. Hence, the three broad roles of Government in economic participation as **regulator** (public interest, level playing field), **developer** of public goods (i.e. socio-economic objectives such as public transport) and as **investor** (i.e. pursuing shareholder value). This is not just more efficient from a division of labor standpoint, but perhaps more importantly it resolves inherent conflicts between the rights of minority shareholders and taxpayers. Hence, in public equity, agencies such as Khazanah will principally pursue total shareholder return. The changes with respect to Board composition and the consolidation of MOF listed companies under Khazanah reflect this view.
2. ***Get the setting right #2 - Mandate the “mothership” to macro-manage.*** Investment holding companies such as Khazanah needed to be re-mandated to actively drive GLC transformation. In doing so, we needed to understand and establish our relationship with the investee GLCs. It is important to demarcate our respective roles as there is a risk that we may inadvertently get into each other’s role. Corporate governance need to be observed in its most enlightened form of meaning both conformance or value protection and just as importantly performance and value creation. Hence, the view that we should not micro-manage but we must and will actively macro-manage.
3. ***Get the setting right #3 – specify the terms for engagement for GLCs. Our five point framework***

As major and strategic shareholders, our five-fold framework for GLC transformation is by now well documented. First, to ensure that the right “bench” or leadership in terms of the Board and senior management is in place. Hence, you have begun to see, through the appropriate channels, changes in senior management and board composition. Second, to ensure that the right strategies are in place. This is ongoing and there is active review going on all fronts as this is the starting point of the KPIs and PLC (Performance Linked Compensation). This would vary by company. At the UEM Group and MAS for example it is about growth and building on the financial restructuring platform. At Tenaga and Malaysia Airports it will probably have a lot of concentration on both financial and operational restructuring.

Third, we look for improvements in key systems and controls as a means to underwrite future growth and efficiency improvements. This will again vary by company, but will typically cover key systems such as risk management and

internal audit, the performance linked compensation system, procurement and so on.

Fourth, we also look to add value in how industry structure or groupings emerge either through our role as shareholders in sectors where we have a critical holding mass or as a strategic national economic agency where we will argue for a more optimal industry and regulatory structure. In Tenaga's case, for example, we believe there is an optimal industry position that optimizes the trade-offs between shareholder value, industrial competitiveness and public interest. We will argue for this optimal position through the levers of government in as much as we are driving through the Board of the need to exact internal efficiencies before submitting for a tariff increase.

The fifth principle is actually quite simple in that if the previous four is in place, the best thing that a major shareholder can do we believe is to forebear, not to micro manage and to merely monitor and empower. We know that the devil will be in the execution and this needs to be rightly driven by the respective management teams.

4. ***KPIs – what we are looking for.*** We are principally driven through financial measures, typically by total shareholder returns, and second, by strategic and institutional value creation. Broadly, this means, we first and foremost look for share price performance and dividend returns, good and transparent capital management, ROE focus, reducing vulnerabilities to business cycles (such as lowering breakeven load factors) and cost focus. Increasingly, we will try to focus on good proxies such as unit procurement costs and medical costs per employee as levers for change. The targets are set against a combination of improvements over historical performance as well as against best in class benchmarks. For some companies, this means they need to start with benchmarking. For strategic and institutional value creation, this means we look for improvements in indicators such as customer satisfaction, employee engagement, brand equity, market share and so on, that can help predict the sustainability of the business.
5. ***PLC – Performance Linked Compensation.*** PLC deserves special mention as the best way of aligning interests is to give management and staff an incentive structure that drives performance. Of course, there are risks that that we could get badly designed or badly implemented schemes, but there are clear guidelines to be observed where for example such schemes are to be self-funded from excess returns over and above what is due to shareholders. This is to be implemented by FY 2005. We want to share that in one company at least security guards now know the word if not the full meaning of EBITDA. When security guards start talking like security analysts, perhaps we are on to something.

6. ***Levers of value creation – working with investee companies on some macro ideas.*** Without getting into specifics, and in addition to the kind of efforts that we have described earlier, we are also focusing on several key macro areas that we believe can be significant levers of value creation. This includes the focus on capital management; outsourcing or selling non core operations, assets and processes; mitigating excessive corporate social responsibility through unbundling or re-bundling of such obligations such as education and socio-economic services; possibilities of creating synergies through mergers and alliances among group companies and with external entities; and careful expansion where appropriate into cross border markets;
7. ***Building Khazanah’s capability to deliver above tasks.*** Briefly, only a strong and capable Khazanah would be able to play the above roles well. In this regard, we are busy working unseen on rather significant capacity building in the area of restructuring our financial portfolio, revamping processes and systems and building up human capital and knowledge capital. The last for example will see the creation of a Khazanah research institute as an internal think tank for micro economic research that we will hopefully and eventually offer to the nation as both a resource and a catalyst for change.
8. ***Execution, execution, execution.*** All said and done, we know the key will be the ability to execute, and this will primarily be in the hands of the investee companies. This is especially so in operational, so-called “peace time” restructuring, where the urgency of crisis restructuring or the quick impact of financial restructuring is absent. Moreover, as major strategic shareholders we cannot be as footloose or nimble as portfolio investors. Our work as major shareholders will be to see the fruits of our labor delivered by the management and staff of the investee companies. Khazanah’s task is principally to give the right framework, support and tools to management to execute. That is why we have also instituted performance contracts – and this starts at Khazanah. A final word on this is worth sharing that at a recent board retreat we concluded that we had better execute the strategies, otherwise we would get executed ourselves.

Social Capital

The importance of trust and collective action

In addition to the importance of financial, knowledge and human capital, I must share this concept that I am sure we are all familiar with in all but its name of **social capital**. The seminal work of Robert Putnam⁶ showed the strong correlation between economic development among local governments in Italy and the preponderance of **social capital** as measured through various indicators ranging from singing clubs, football associations and thousand year old public complaint bureaus. Trust, reciprocity, commonality of purpose, collective action, working towards the greater good of nation building for the current and future generations of all Malaysians must rightly be the bedrock of our joint mission. This is a mammoth but worthwhile undertaking and I invite you all to play your part.

At Khazanah, we hope to earn your trust, that, firstly, we are doing what we are doing not for any narrow interests but always for the greater good of the nation. We therefore need to first conduct ourselves with integrity and professionalism in deed and not just in intent. We will welcome all constructive criticism and may our friends be our fiercest critics. And in our capacity building, we are also designing flexible and hopefully clever mechanisms where we hope you can come forward and contribute. These include serving as nominee directors, as part of advisory panels, as visiting fellows, our research institute, and as our business partners. As we build our capability, we hope we will be of use to the nation as a resource and eventually as a centre of excellence.

When?

Measuring and judging on the right horizon

As any student of investment will know one important parameter is to always know your investment horizon. Our task, our success or otherwise, I believe should be measured over the medium-term, three years to be exact being the standard length of performance contracts. Of course, there needs to be performance milestones way before that.

As Keynes rightly observed in the long run we are all dead, and that there is no long term without surviving the short run. At this point, the key in my view will be to concentrate on building the conditions to allow for meaningful and sustainable change. Of course we have short run targets to deliver on, but we must resist the temptation to be overly governed by quarterly announcements. In the long run, share prices will reflect the true fundamental value.

⁶ Making Democracy Work: Civic Traditions in Modern Italy (1993)

Focus on fundamentals

We note that the markets seem to have factored in some approval for what's happening. Since the YAB Prime Minister announced the GLC changes in May this year, our listed portfolio is up more than 18% compared to a KLCI rise of 8%. I do not know for sure if this is deserved or indeed sustainable, although we would like to believe this is just the beginning. When the CFO of Tenaga recently asked what this major shareholder wanted for the share price to close for the week – I said minus 20 sen – it was rising too quickly. My advice would be to cut the hype and judge us strictly on fundamentals; let's all focus on meaningful and sustainable value creation.

*Kuala Lumpur
4th October 2004*

Appendix: Analysis of GLCs drivers of performance

GLCs - drivers of performance

Performance Driver	Performing GLC - Petronas	Inhibited GLC
Clear and orderly Industry and Regulatory Structure	<ul style="list-style-type: none"> • Reports directly to YAB PM • Clarity on most regulatory issues • # of industry players well planned. No oversupply 	<ul style="list-style-type: none"> • No clarity on key issues such as tariffs, capacity planning • Industry plagued by bouts of overcapacity and shortages • Overlicensing in mobile telcos
Professional management and BOD	<ul style="list-style-type: none"> • Very stable management and BOD, long tenures, with clear succession history • Pays reasonably competitive compensation packages • Performance pay in place 	<ul style="list-style-type: none"> • Short tenures of CEOs • Unstable (or worse) dysfunctional and antagonistic BOD/Senior Management teams • Till now, uncompetitive pay, with little performance element if any
Decision Making	<ul style="list-style-type: none"> • Relative autonomy – reports directly to YAB PM 	<ul style="list-style-type: none"> • Multiple “regulators” • Quite common in the past to use listed GLCs for social objectives

GLCs - drivers of performance

Driver	Performing GLC - Petronas	Inhibited GLC
Internal DNA and culture – performance, systems and controls	<ul style="list-style-type: none"> • Strong, almost overbearing culture of systems and controls • Culture of performance and empowerment is rising • Reasonably good HCM 	<ul style="list-style-type: none"> • Degree of systems and controls generally low • Greatly bureaucratic generally, very low empowerment. • Generally poor HCM • Note: UEM has relatively strong controls and systems, empowerment
Financial discipline in addition to service delivery	<ul style="list-style-type: none"> • Relatively strong financial focus – ROI, project evaluation • Strong financial position gives long run orientation crucial for strategic development of industry 	<ul style="list-style-type: none"> • Generally poor financial or ROI focus • More service delivery focus, with little attention to “at what cost”
Access to credit and orderly competition	<ul style="list-style-type: none"> • Strong funding capacity has generally not resulted in lax financials • Well managed industry – oligopolistic • International competition has sharpened Petronas 	<ul style="list-style-type: none"> • Easy money contributed to financial indiscipline • Overcompetition has damaged financials • More global and regional competition should sharpen performance (MAS)