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Pursuing the Sustainable Growth Path -

Reflections of one micro-economic change agent

Azman Hj. Mokhtar*

Khazanah Nasional Berhad

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

Distinguished members of the audience, ladies and gentlemen

Introduction

Thank you for inviting me to deliver the keynote address this morning. CNBC's interest in showcasing Malaysia and our strategic growth aspirations is indeed timely and commendable. I believe this is a good time to take stock coming towards the end of an eventful first year of the new administration of the YAB Prime Minister Dato' Seri Abdullah Badawi, and as we prepare to enter the period of the Ninth Malaysia Plan commencing in 2006.

Setting the conditions for sustainable growth: the context for change

Seven years and more than a cycle away from the Asian financial crisis, I may not be exaggerating to say that South-East Asia is in the middle of a quiet revolution that will lay the economic foundations for at least the next five years. We are indeed living in interesting times and 2004 has been both a global election year and a year of transition for many governments. Malaysia and our closest neighbors in Singapore and Indonesia, and in Thailand not too long ago, have all seen the entry of new administrations and with that a whiff of change and anticipation.

For Malaysia, the change has been incredibly smooth. In an Olympic year where our sportsmen and women performed lamentably, our politicians would have done much better. Indeed if there is an Olympic event for baton relay where the contestants were ruling governments, Malaysia would have had a podium finish, such has been the smoothness and speed of the baton transfers.

The nation's finances are in good order. Growth is expected to accelerate this year to one of its strongest level since the crisis. Foreign reserves have exceeded foreign debt and the import cover is at an all-time high. Commitment to fiscal discipline has been convincingly demonstrated. Liquidity is ample. Inflation is creeping up but benign by any standards. The banking system is sound and growing. Systemic risk from the corporate sector has been mostly removed, and corporate earnings are running at double digit growth.

All around we look, the numbers build a good story. While there is some nostalgia for the pre-crisis go-go years, the capital markets has become more measured and less prone to bouts of misplaced exuberance. The quantum and quality of direct investments are on the uptick, with a more balanced loading on the public and private sectors as engines of growth. While growth is expected to moderate next year on the back of slower global growth from high oil prices and higher interest rates, Malaysia is better insulated by way of our more diversified economic base, including as a net exporter of oil and gas.

Yet amidst these benign trends lies a certain disquiet as to where is Malaysia's place in a world of great change in increased economic liberalization and competition and in the awakening of economic superpowers in China and India. Hence, the focus of this forum on sustainable growth is indeed pertinent.

We are reminded of the Chinese proverb that what you cannot avoid you must welcome. Indeed, Malaysia's economic history has been a chronicle of how successful and balanced policies have been tempered when necessary with pragmatic and non-dogmatic adjustments. I submit that this is one of the great strengths of Malaysia to make these seamless adjustments, anchored in the continuity provided by a stable political climate and a long tradition of a pro-business environment.

This ability to make the necessary institutional arrangements and adjustments at various key points in Malaysia's economic history from the 1970 New Economic Policy to the mid-80s post recession FDI focus, the 1990s privatization and the stabilization responses to the 1997-1998 financial crisis have served us rather well. This was the backdrop that allowed the nation to gradually and sequentially transform from an agrarian, factor-driven economy to the diversified investment driven economy with multiple engines of growth in services, manufacturing and resource and resource-based sectors that we are today.

Nonetheless, we are now on the crest of making that most challenging adjustment faced by all graduating developing economies; that is to move towards an innovation-driven economy where knowledge is the greatest source of competitive advantage.

These challenges are well known by the leadership of Malaysia, her economic planners and the economic agents. Indeed, the first year of the new administration and more than the last third of the previous administration has been devoted to putting the foundations in place to rise to this challenge. Investments in education and human capital, ICT, physical and soft infrastructure, developing and broadening the financial system among others have been the thrust of these policies.

It is in this context of addressing the challenge of transitioning into a more innovation and knowledge driven economy and in the context of building on the strong foundations laid by the previous governments that the new administration over the past eleven months have clearly defined a socio-economic agenda that is focused on the long-run factors of national competitiveness. Emphasis has therefore shifted to a greater focus on total factor productivity and on improving efficiency of existing assets, in delivery systems. Concomitantly, this means more focus on the longer run factors of knowledge based competitiveness and therefore in investments in human capital, education, improvements in key institutions of law and order, and in the legitimacy that needs to be sustained in the embedded autonomy of the government through an equitable socio-economic agenda.

To the keynote topic of "*Pursuing the Sustainable Growth Path*", I therefore conclude that the macro-economic backdrop of stability and the conditions for growth has been well crafted and well laid out. The challenge of transitioning toward a more innovation driven economy is well recognized and indeed the focus and emphasis of policies have been clearly and thoughtfully articulated. The key will now be on the execution and delivery of this vision. One of these paths of delivery will be the improvements required in the corporate sector, and in particular the Government-Linked Companies (GLC) sector.

In this regard, in addition to keynote topic of "*Pursuing the Sustainable Growth Path*", I have added the sub-text of "*Reflections of one micro-economic change agent*" in our role as Khazanah Nasional as the strategic investment arm and micro-economic change agent of the Government of Malaysia.

Khazanah and GLCs

When the YAB Prime Minister first announced the framework for change in Khazanah's mandate in May this year, it was within this 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.

Various studies have shown that GLCs as a group have basically underperformed on all measures except size. Given its heavy presence in both the economy and the market, where 40 listed GLCs constituted more than RM200bn or more than a third of Bursa Malaysia's market capitalization, the need to increase efficiency was therefore obvious

In this regard, Khazanah is mandated 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. Early on we at Khazanah asked ourselves what would constitute success for Khazanah and GLCs over the medium-term, that is over the first three years of what will necessarily be a longer-term restructuring that I have termed a "peace-time restructuring". 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.

Strategies and execution

At various for forums, we have made the point that there are no lack of vision, mission, good ideas and strategies. The key is of course implementation and execution. In our analysis, we conclude that that the major conditions for success 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

Against this backdrop, we had shared recently with senior members of the Kuala Lumpur business community that the approach by the Malaysian government and Khazanah will now increasingly move towards a more execution focus within the following framework;

1. ***Getting the landscape right #1 – separate the various roles of Government***. To echo the views of Government of giving context to 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.

2. ***Get the landscape right #2 - Mandate investment holding companies 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 landscape 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, some will be focused on growth and building on a financial restructuring platform while others will be more focused on financial and operational restructuring.

Third, we look for improvements in key systems and controls as a means to underwrite future growth and efficiency improvements and 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. The fifth principle is 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 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. This is to be implemented by FY 2005.

6. ***Levers of value creation – working with investee companies on some macro ideas***. Without getting into specifics, 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. ***Execution and performance contracts.*** 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. We have continuously reminded ourselves and the investee companies that we had better execute the strategies, otherwise we would get executed ourselves!

Conclusions

From the standpoint of a keen observer, analyst and now micro-economic change agent, I believe the conditions are now well in place for a new platform for sustainable high quality growth to take place. It is a multi-track and holistic approach that is focused on a self-reinforcing development model that has served Malaysia well that intertwines social and political legitimacy through economic growth with equity.

We are successfully diversifying our economy to have multiple engines of growth in services, manufacturing, resources and resource based and now in agriculture. Investments in education, human capital, improvements in delivery systems and in the GLC sector among others we believe will begin to bear fruit over the medium to longer term. New growth sectors that builds on various niches and latent competitive advantages in sectors such as BPO, Islamic Financial Services, medical tourism, education, Halal food processing among others have begun to show promising results.

Malaysia has always risen to the challenge and this time will be no exception, God willing.

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