



MALAYSIAN FIRM PERFORMANCE AND
SHAREHOLDER WEALTH CREATION:
COMPARATIVE ANALYSIS OF ECONOMIC VALUE
ADDED AND TRADITIONAL PERFORMANCE
MEASUREMENT

BY

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ABSTRACT

This study empirically examined the claim of the superiority of value-based measure, Economic Value Added (EVA) against the traditional performance measures, Return on Equity (ROE) and Earnings per Share (EPS), in relation to the shareholder wealth creation (stock return) based on different industries in Malaysia. In addition, this study investigated the determinants of firm performance by employing both value-based and traditional performance measures across different industries. One of the pertinent investigations was on the influence of the potential expropriation by the majority shareholders towards minority shareholders, better known as the principal-principal conflict, which has become more prevalent in the emerging markets. The influence of the identity of majority shareholders on the firm performance was also explored. Furthermore, this study examined the impact of board governance mechanisms on the firm performance in a high ownership concentration structure. A sample of 492 Malaysian public listed firms, categorized according to their respective industries during the period of 2006 to 2015, was selected. Pooled ordinary least square (OLS), fixed effects, and random effects model were employed in identifying the best estimation model. The relative information content discovered that EVA outperformed the traditional performance measures in association with the stock return in most of the industries. The incremental information content revealed that one of the EVA components, namely capital charge, was the most significant component in relation to stock return in many industries. There was also significant evidence on the existence of incremental information content between paired EVA components in explaining the stock return. Additionally, this empirical study found inconsistent results pertaining to the determinants of firm performance across different industries. Among others, the principal-principal conflict was shown to have a significant negative impact on the firm performance only in one of the industries. Furthermore, the identity of the majority owners and board governance mechanisms were significant in relation to the firm performance of different industries. Most importantly, the results indicated that the traditional performance measures fit better than the value-based measure in assessing the determinants of firm performance across all industries. In terms of the managerial or practical implications, this study demonstrated the significance of EVA and its components in predicting the shareholder wealth creation. The important determinants of firm performance which the firm managers, policymakers, and regulators should focus on were also identified. In conclusion, corporate governance mechanisms relating to the ownership concentration and the identity of majority owners were imperative in the emerging economies, such as Malaysia.

مُلخَصُ البَحْثِ

يختبر هذا البحث من خلال المنهج التجريبي فرضيةً أفضلية المعايير القائمة على مفهوم القيمة، وتحديدًا؛ معيار القيمة الاقتصادية المضافة؛ على معايير قياس الأداء التقليدية من مثل: العائد على حقوق الملكية، وربحية السهم؛ فيما يتعلق بتكوين ثروة المساهم (عائد الأسهم)، وذلك بالاعتماد على مجموعة من الصناعات في ماليزيا، بالإضافة إلى ذلك اختبار محددات أداء الشركات من خلال استخدام المعايير القائمة على مفهوم القيمة ومقاييس الأداء التقليدية في مختلف الصناعات، ومن الافتراضات التي اختُبرت عواقب احتمال نزع المساهمين الأغلبية ملكية المساهمين الأقلية، وتُعرف باسم "الصراع الرئيس"؛ إذ شاع انتشاره في الأسواق الناشئة، كما تحرى البحث تأثير هوية غالبية المساهمين في أداء الشركة، وتأثير آليات حوكمة مجلس الإدارة في أداء الشركة في إطار تركيز مرتفع للملكية، وقد اختار البحث عينة من 492 شركة مسجلة في ماليزيا صُنِّفت وفق طبيعة نشاطها الصناعي ما بين 2006-2015؛ ثم طُبِّق الأنموذج المجمع للمربعات الصغرى، وأنموذج الآثار الثابتة، وأنموذج الآثار العشوائية؛ لتحديد أفضل أنموذج لتقدير متغيرات الدراسة، وأظهر تحليل المعلومات المقارنة أن معيار القيمة الاقتصادية المضافة يتفوق على مقاييس الأداء التقليدية فيما يتعلق بعائد الأسهم في معظم الصناعات، وبيّن تحليل المعلومات التزايدية أن من مكونات القيمة الاقتصادية المضافة تكلفة رأس المال، وهو المكون الأكثر أهمية فيما يتعلق بعائد الأسهم في عدد من الصناعات، كما أظهرت النتائج دليلاً مهمًا على محتوى معلومات تزايدية بين مكونات القيمة الاقتصادية المضافة المقترنة في تفسير عوائد الأسهم، بالإضافة إلى نتائج غير متسقة فيما يتعلق بالعوامل المحددة لأداء الشركة بين الصناعات المختلفة، وتبيّن أن للصراع الرئيس تأثيرًا سلبيًا كبيرًا في أداء الشركات في واحدة من الصناعات فقط، وأن هوية غالبية المساهمين وآليات حوكمة مجلس الإدارة يرتبطان ارتباطًا مهمًا بالأداء الثابت لمختلف الصناعات، وأن مقاييس الأداء التقليدية تُفضّل المقاييس القائمة على القيمة فيما يتعلق بمحددات أداء الشركة في جميع الصناعات، وفيما يتعلق بالتطبيقات الإدارية أو العملية؛ أظهر البحث أهمية القيمة الاقتصادية المضافة ومكوناتها في التنبؤ بتكوين ثروة المساهمين، مع تحديد العوامل المهمة والمحددة لأداء الشركة وينبغي لمديري الشركات وصناع السياسات والهيئات التنظيمية؛ التركيز عليها، ختامًا؛ بيّن البحث أن لآليات حوكمة الشركات المتعلقة بتركيز الملكية وهوية المساهمين الأغلبية لهما؛ أهمية كبيرة في الاقتصادات الناشئة من مثل ماليزيا.

APPROVAL PAGE

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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This dissertation is dedicated to my beloved parents (Mokhtar Hussein and Umi Kelnam Hj Omar), my children (Anis Sofia and Muhammad Jazlan), my husband (Sukman Suzzak Zakaria) and all family members for their unconditional support and prayers along my PHD journey.

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LIST OF ABBREVIATIONS

ACC	Accruals
ADJ	Accounting Adjustments
ATT	After-tax Interest
BSIZE	Board Size
CC	Capital Charge
CDUAL	CEO Duality
CEO	Chief Executive Officer
CFO	Cash Flow from Operations
CVA	Cash Value Added
DCF	Discounted Cash Flow
DDM	Dividend Discount Model
DIOC	Domestic Institution Ownership
EBEI	Earnings Before Extraordinary Items
EPS	Earnings Per Share
EVA	Economic Value Added
FEM	Fixed Effect Model
FIOC	Foreign Institution Ownership
FOC	Family or Individual Ownership
GLS	Generalized Least Square
GMM	General Method of Moments
INDEP	Independent Director
LEV	Leverage
LIQ	Liquidity
MVA	Market Value Added
NOPAT	Net Operating Profit After Tax

NPV	Net Present Value
OC	Ownership Concentration
OLS	Ordinary Least Square
REM	Random Effect Model
RET	Return
REVA	Refined Economic Value Added
RI	Residual Income
ROA	Return on Assets
ROE	Return on Equity
ROI	Return on Investment
SOC	State or Government Ownership
SVA	Shareholder Value Added
WACC	Weighted Average Cost of Capital

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Shareholder wealth maximization is a well-accepted objective among the firm managers. In the seminal finance theory, Modigliani and Miller (1958) state that it is the managers' fiduciary duty to maximize the shareholders' wealth in whatever decision-making process that they undertake. To create wealth for the shareholders, firms need to undertake projects or investments that provide a positive net present value (NPV). In an investment, positive NPV means that the project is viable and it creates wealth for the shareholders. Essentially, firms with greater wealth creation abilities through their investments have a higher share price in relation to the capital invested. In this regard, creating wealth for the whole company relates to maximizing the firm's total value, and thus increasing the shareholders' wealth (Koller, Goedhart and Wessels, 2010). The changes in the shareholder wealth on a certain periodic basis, which is derived from the changes in stock prices (capital appreciation), dividends payments, and equity raised, are generally associated with the concept of wealth creation (Bacidore, Boquist, Milbourn and Thakor, 1997; Koller et al., 2010).

Shareholders expect companies to utilize their invested capital wisely and provide them decent returns to increase their wealth. Shareholders are concerned with the stock return in which they expect to be compensated for the risk associated with their investment. A positive return signifies that the shareholders have covered their risk-adjusted opportunity cost in providing the capital, whereas a negative return reflects that the shareholders have been inadequately compensated for the risk (Bacidore et al., 1997).

Performance measurement is evidently one of the key elements for the management to focus on during the wealth creation processes in a firm. An appropriate performance measurement should highly correlate with the shareholders' return and signal the extent of wealth creation (Bacidore et al., 1997; Johnson, Natarajan and Rappaport, 1986; Mazzi, 2011). Accordingly, the firm performance would be judged in relation to the interest of the shareholders, in which the firms that are able to create wealth for their shareholders are regarded as superior.

It is crucial for the companies to devise and innovate their performance measures. There are many measurements available to evaluate firm performance. Previous studies, such as Hawawini, Subramanian and Verdin (2003) and Mazzi (2011) stated that management and shareholders generally depend on the traditional performance measures, such as earnings per share (EPS), return on equity (ROE), return on assets (ROA), return on sales, and net income as indicators of how the firms are performing. The usefulness of traditional performance measures has long been discussed. Among the reasons why these traditional performance measures remain relevant and widely used in evaluating the performance of firms are the ease of computation, worldwide recognition, and motivation by tradition (Lev and Sunder, 1979; Liargovas and Skandalis, 2010). Besides, traditional performance measures depend on the firm's financial data that are generally available and accessible. Furthermore, the traditional performance measures have been claimed to be reliable in explaining the variation of stock returns and value (Alkhalialeh, 2008; Hall, 2016; Kyriazis and Anastassis, 2007).

Despite the advantages and relevancy of the traditional measures of performance, there has been an increasing concern that these measures have limitations. Some of the limitations highlighted by the previous studies were exposure

to accounting distortions, one-dimensional evaluation, and inability to capture and measure a firm's value (Chen and Dodd, 1997; Fernández, 2003; Hillman and Keim, 2001; Sharma and Kumar, 2010). In overcoming the limitations, various alternative performance measures have been developed. Each of the proposed measures considers new or adjusted elements and factors into its calculations. One of the alternative performance measure known as the value-based measure has been gaining popularity. The fundamental idea of this value-based measurement is to reveal the creation of shareholder wealth as it simultaneously accounts for both the return generated from the invested capital and the cost of those capital invested (Rappaport, 1986).

One of the popular performance measure under value-based measurement is Economic Value Added (EVA) which was developed by (Stewart, 1991). EVA is comprised of several main components, namely the cash flow from operations (CFO), operating accruals, after-tax interest, capital charge (cost of capital), and accounting adjustments. The incorporation of the cost of capital in its calculation renders EVA unique and enables the firm to measure its true or economic profit. This economic profit provides an indication of the minimum profitability which needs to be earned by the firm to cover its cost of capital employed. Proponents of EVA, such as Rappaport (1982), Stewart (1991), and Young (1997) claimed that EVA not only represents the firm's true performance but also simultaneously captures the real value creation by including the risk notion. EVA is claimed to be consistent with the firm's primary objective of maximizing the shareholder wealth as shareholders would be aware of the value creation ability of the firm, which depends on the extent to which shareholders expect future profit to exceed or fall short of the cost of capital contributed by them. Moreover, it is believed that the implementation of EVA could solve some of the corporate governance issues as the managers would act like the firm's owners since

they are not compensated solely based on the profit or return generated but rather the value created from maximizing the projects or investments that have been undertaken (Chen and Dodd, 1997; Mamun and Mansor, 2012).

Despite the emergence of various invented alternative performance measures, firm managers and business analysts have been debating on the dominance of the alternative measure over traditional performance measures in explaining the shareholder wealth. Review of the literature revealed mixed and inconclusive results, where one branch of the studies suggested EVA as a better measure in explaining the shareholder wealth than the traditional performance measures, while other studies claimed that the traditional performance measures outperformed EVA in explaining the shareholder wealth (Lee and Kim, 2009; Gupta and Sikarwar, 2016; Sharma and Kumar, 2010; Worthington and West, 2004).

In addition to the inconclusive findings, it was also argued that the findings of the existing literature such as Wet (2005) and Sharma and Kumar (2010) could not be generalized as the extant empirical works focused only on a single industry (sector) and the sample sizes were relatively small. Hence, more studies should be conducted across different industries (sectors) to validate the propositions that EVA is a better performance measure in association with shareholder wealth. Stewart (2014) argued that different sectors or industries differed in terms of its profit generated, capital employed, and the cost associated with the capital which consequently could affect its relationship with the shareholder wealth. The inconclusive results and limited studies have ignited researchers' curiosity to further explore and determine the most appropriate performance measurement in explaining the shareholder wealth.

Other than the discussions on the dominance of either performance measures in explaining the shareholder wealth, firm performance is subjected to the influence of

various factors such as firm-specific factors (Hawawini et al., 2003). Based on the existing empirical literature, the firm-specific factors include both financial and non-financial factors that influence firm's performance. The financial factors are firms' liquidity, leverage, growth, age, and size (see among others, Ha, Dang, Tran, Van Vu, and Trung, 2019; Dawar, 2014; Delmar, Davidsson and Gartner, 2003; Mohamad and Saad, 2010; Yazdanfar and Öhman, 2015; Zeitun and Tian, 2007; Alarussi and Alhaderi, 2018). Meanwhile, in terms of the non-financial factors, the most commonly associated factor is related to the corporate governance mechanisms. The extant empirical literature showed that both internal and external governance mechanisms have been examined (see, for instance, Claessens and Yurtoglu, 2013; Ducassy and Guyot, 2017; Faccio and Lang, 2002; Omran, Bolbol and Fatheldin, 2008; Villalonga and Amit, 2006).

Many studies on corporate governance have been conducted to explore the effect of the internal governance mechanisms, such as a firm's ownership structure and concentration, characteristics and composition of board of directors (BOD), and executive compensations packages on the performance of a firm (Brown, Beekes and Verhoeven, 2011; Claessens, Djankov, Fan and Lang, 2002; Demsetz and Villalonga, 2001; Lin and Chuang, 2011). Ownership structure is one of the internal governance mechanisms that signifies how the firms are grouped, either widely held or concentrated. Firms with a widely held ownership are firms without owners with substantial control rights, while firms with concentrated ownership are firms whose owners have substantial control rights.

The work of Claessens and Yurtoglu (2013) further revealed that half of the East Asian firms were highly concentrated in which they were largely controlled by the majority shareholders. Essentially, this concentrated ownership structure aimed to

assist the firms in mitigating the agency conflict that may arise between the principal (owner) and the agent (manager) (Anderson and Reeb, 2003). Several studies conducted on the emerging markets revealed that higher occurrence of concentrated ownership and limited protection towards minority shareholders intensified the possibility of conflict between the majority (controlling) and minority shareholders, which was referred as the principal-principal conflict (Li and Qian, 2013; Renders and Gaeremynck, 2012; Young, Peng, Ahlstrom, Bruton and Jiang, 2008). Previous studies highlighted that the existence of controlling (majority) shareholders led to a situation where the principal-principal conflicts were at its extreme because these majority shareholders were able to carry out their control of the company's affairs and derive private benefits of control, dampening the firm's performance and value (Banchit and Locke, 2011; Li and Qian, 2013; Morck, Shleifer and Vishny, 1988; Su, Xu and Phan, 2008).

Another important aspect of the issue of ownership concentration is the identity of the majority shareholders. Previous studies such as Allam (2018), Ducassy and Guyot (2017) and Basu, Paeglis and Rahnamaei (2016) argued that these majority shareholders cannot be assumed as a homogenous group of shareholders because their influence among others depends on their ownership stakes and identity. The identity of these majority shareholders are important because they have different investment objectives, capacity for monitoring and decision making, and resource endowments which could determine their relative power and incentives (Boone, Colombage and Gunasekarage, 2011; Wiwattanakantang, 2001).

Furthermore, in a high ownership concentration structure, other governance mechanisms, such as board governance should effectively play its supervisory function to safeguard the interests of the minority shareholders, particularly from the