Objective

In the GLC Transformation Manual, Policy Thrust 4 advocates the adoption of corporate best practices within GLCs. One of the initiatives identified is optimising capital management practices. The purpose of the Purple Book (the Book) is to support this effort and provide GLCs with clear direction on implementing sound capital management practices. It does this by establishing a series of best practice guidelines for capital management. These guidelines draw on, where applicable, international and local examples relevant to the GLC context.

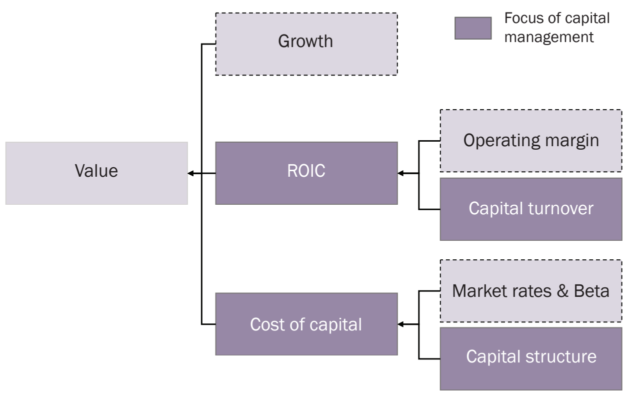
The Book focuses on capital structure optimisation, and although the Book also looks at capital efficiency improvements, it considers selective topics most applicable to GLCs.

Improving Capital Management

Companies create value by investing capital to earn a return that is greater than the cost of the capital—in other words, when the return on invested capital (ROIC) exceeds the weighted average cost of capital (WACC). The more that companies can invest and grow their capital at positive returns, the more value is created.

Effective capital management maximises a company's value by optimising capital structure (to achieve a competitive cost of capital) and enhancing capital efficiency (to improve ROIC).

CREATING VALUE THROUGH HIGHER ROIC AND OPTIMAL COST OF CAPITAL



Observations on capital management practices among GLCs indicate that many would benefit from devoting greater management attention on their balance sheets. Optimal capital structure would enable GLCs to pursue business growth and seize opportunities. Managing capital efficiency will enable GLCs to enjoy a competitive advantage over their peers.

How To Optimise The Capital Structure

Designing and achieving an optimal capital structure is indispensable to a company being able to ensure sufficient financial resilience and the necessary discipline to use capital providers' funds wisely. The fundamental task is to decide between debt and equity—that is, to decide what the company's leverage ratio should be. To design and achieve an optimal capital structure, GLCs can employ a *4-step Cash Flow Analysis*. This methodology allows companies to design their capital structure based on the analysis of future cash flows formulated on robust assumptions. Specific conditions applicable to a company—for example, its particular investment needs, dividend policy and loan covenant requirements—should be taken into consideration.

OPTIMISING CAPITAL STRUCTURE CAN BE APPROACHED IN 4 STEPS

1 Perform financial forecast to estimate financing deficit/excess

- Perform **accurate, robust and timely financial forecast** with full consideration of
  - Key cash flow determinants
  - Scenario analysis to capture variability and risks
  - Process that is coherent, consistent and continuous
- Ensure
  - Independent analysis by functional group
  - Ownership by top management

2 Set target credit rating and relevant financial ratios

- Set **target credit rating(s) in a band,** with a desirable and minimum credit rating
- Use **financial ratios** such as interest coverage and debt/equity as good proxies for target capital structure

3 Develop and test target capital structure using scenarios

- Develop and test the target capital structure by **assessing the target credit rating and/or financial ratios against scenarios** from Step 1
- Set target desirable ratio under the baseline scenario and a target minimum ratio under the downside scenario(s)

4 Determine and implement actions to achieve optimal capital structure

- Develop and implement **action plan**, considering
  - Actions needed for making capital structure adjustments to achieve target ratio
  - Timeline and sequencing for implementing them
  - Approach for undertaking the necessary capital market transactions

Investor Relations and Islamic Finance

In designing and optimising their capital structure, two specific considerations applicable to GLCs are: investor relations (IR) management and Islamic finance.

IR management: The primary objective is to help align the market price of a company's shares with its intrinsic value. Sound IR management can help ensure that the cost of equity for GLCs is in line with the market. Four basic principles that GLCs can adopt to improve their IR management are:

- Ground IR strategy on clear understanding of **intrinsic value**
- Ensure investment **story is consistent with strategy** and performance
- Provide sufficient **transparency** about performance and the value drivers (without divulging any confidential information)
- Understand **investor base** to help shape their message

Islamic finance: GLCs should consider using Islamic finance options when evaluating funding options, in so far as these provide comparable economics in line with maximising shareholder value. Given the efforts to promote Malaysia as a hub for Islamic finance in line with the Malaysia International Islamic Financial Centre, the available infrastructure and a substantial capital pool to draw from (regionally and in the Middle East) - Islamic finance can provide viable alternatives to conventional financing options.

How to Improve Capital Efficiency

Apart from optimising capital structure, companies must also strive to improve their capital efficiency.

There are three fundamental aspects to capital efficiency:

- Capex efficiency
- Working capital efficiency
- Disposal of non-core assets and activities

GLCs can employ various tools to improve their capital efficiency

- **Improve capex efficiency of non-recurring/strategic investments**: the Pyramid Approach (that looks at the strategic, portfolio, project and organisation levels of capex management) will help GLCs to make go/no-go decisions, prioritise initiatives, decide on the degree of spend for each initiative and ensure that capex achieves target objectives and values
- **Improve working capital efficiency**: through managing accounts receivable, accounts payable, cash and inventory management
- **Determine disposal of non-core assets/activities**: a 3-step test will help GLCs to determine whether or not to dispose a particular asset or activity