How to Implement Initiatives

Implementation of the best practice guidelines should be addressed separately for (a) capital structure optimisation and (b) capital efficiency improvement. It is imperative that the CEO is the driving force of this effort. The CEO, with the support of a project champion and project team, should lead the implementation of these capital management initiatives.

For capital structure optimisation, the 3-phase implementation approach will be broadly applicable to *all* GLCs:

Phase 1: Diagnostic—Review current practices by using a diagnostic exercise. Identify gaps in current practices from the best practice guidelines set out in the Book.

Phase 2A: Preparation—A preliminary Capital Management Plan (CMP) should be drafted at this phase, using the 4-step Cash Flow Analysis. It should consider any steps required to address gaps identified in Phase 1. Phases 1 and 2A should be completed by June 2007.

Phase 2B: Integration into Business Planning Cycle—Finalise the CMP in the immediate next business planning cycle. Companies with June financial year ends should complete this Phase by June 2007.

Phase 3: Implementation and Monitoring—Implement actions identified in the CMP. It is expected that funding actions will be implemented as and when they are required. Formalised dividend policy should be implemented as soon as practicable. GLCs should monitor progress annually by tracking performance measures.

For capital efficiency improvement, implementation will also follow a 3-phase approach. However, for these initiatives, implementation will be on a case by case basis:

Phase 1: Diagnostic—Assess the GLC's performance in capital efficiency across capex, working capital and non-core assets and activities. Based on their assessed gaps and improvement potential, GLCs should prioritise which areas of capital efficiency, if any, they need to address.

Phase 2: Preparation—Design the capital efficiency improvement initiatives. GLCs should complete Phases 1 and 2 by June 2007.

Phase 3: Implementation and monitoring—Implement the identified initiatives immediately after Phase 2. GLCs should monitor progress by tracking pertinent capital efficiency performance measures.

12 Best Practice Guidelines

HOW TO OPTIMISE CAPITAL STRUCTURE

1. Conduct thorough design and planning to optimise capital structure at least once every 3 years. Conduct subsequent annual reviews to ensure progress and refine capital structure where necessary.
2. Develop coherent and consistent internal processes to ensure accurate, robust and timely financial forecasts and statements, incorporating a full assessment of variables and risks to the business.
3. Set an optimal capital structure using a target credit rating and/or associated proxy financial ratios, which can be determined through a benchmarking process, taking into account specific conditions faced by the company.
4. Develop formalised dividend policies consistent with business strategy and expected earnings growth, taking into account relevant policies and mandates.
5. Distribute excess capital identified through the *4-step Cash Flow Analysis* method—preferably among shareholders—so that capital structure remains within the target band.
6. Explore all financing options—including Islamic finance options —through a rigorous and structured evaluation and selection process to obtain necessary financing at an attractive price.

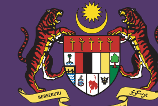
HOW TO IMPROVE CAPITAL EFFICIENCY

7. Adopt a holistic approach for improving capex efficiency of non-recurring /strategic investments, addressing 4 levels of capex management—strategic, portfolio, project and organisation—with clear ownership at each level. *This is especially important for capital-intensive GLCs.*
8. Actively drive improvements in working capital management, ensuring the chief financial officer (CFO) office takes the lead (except for inventories that are typically driven by line functions).
9. Dispose of all non-core assets and activities by using a 3-step test —distinctive risk-return and management capabilities, impact on core business, and feasibility of value-creating disposals. *A few exceptions are outlined in the Silver and Yellow Books.*

HOW TO IMPLEMENT CAPITAL MANAGEMENT INITIATIVES

10. Design and launch capital management initiatives as part of corporate strategy plans. *Initiatives for optimising capital structure to be adopted by all GLCs; initiatives for capital efficiency to be adopted more selectively.*
11. Actively monitor performance measures and other financial parameters that link back to the capital management initiatives.
12. Take full responsibility for implementing and following-up on initiatives, which are driven by the chief executive officer (CEO) and typically championed by the CFO. Government-Linked Investment Companies (GLICs) *may provide active support and expertise as appropriate.*

Putrajaya Committee on GLC High Performance (PCG)
Transformation Management Office (TMO)
Level 37, Tower 2, Petronas Twin Towers
Kuala Lumpur City Centre, 50088 Kuala Lumpur.
Tel : 03-2034 0000 Fax : 03-2034 0008
Email : pcg@treasury.gov.my Website : www.pcg.gov.my



INITIATIVE 7

THE PURPLE BOOK
OPTIMISING CAPITAL MANAGEMENT PRACTICES

Objective

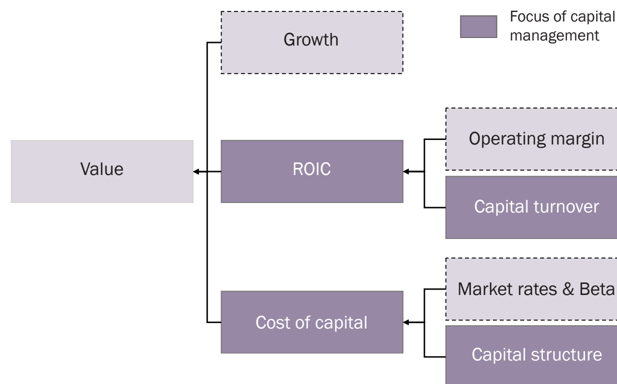
In the GLC Transformation Manual, Policy Thrust 4 advocates the adoption of corporate best practices within GLCs. One of the initiatives identified is optimising capital management practices. The purpose of the Purple Book (the Book) is to support this effort and provide GLCs with clear direction on 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.

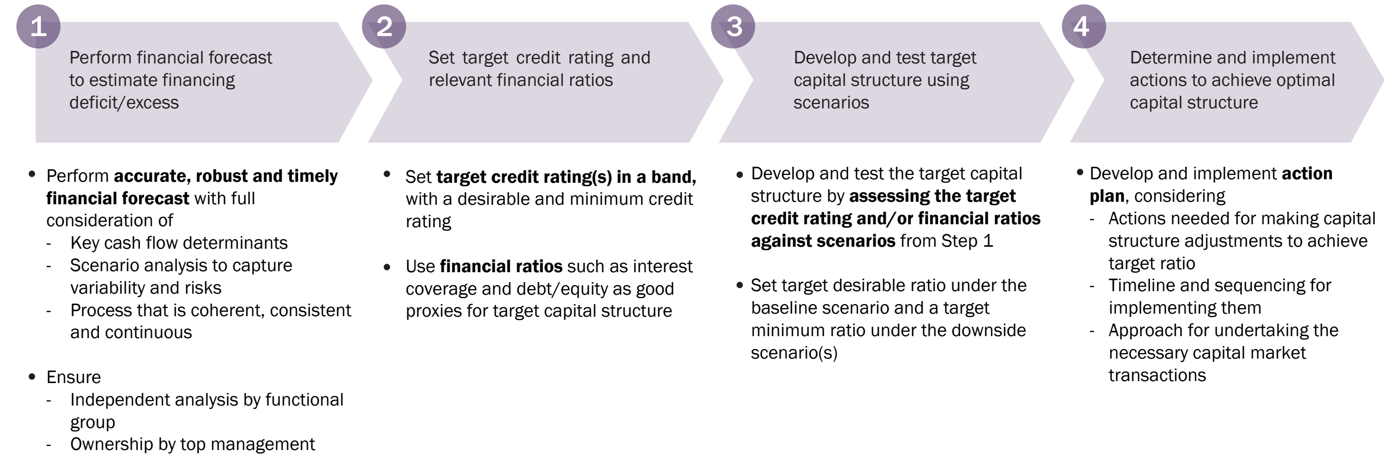
Effective capital management maximises a company's value by optimising capital structure (to achieve a competitive cost of capital) and enhancing capital efficiency (to improve ROIC).



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.



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

THE PURPLE BOOK

OPTIMISING CAPITAL MANAGEMENT PRACTICES

DECEMBER 2006

purple colour.indd 1 12/5/2006 3:03:40 PM

purple colour.indd 2 12/5/2006 3:03:41 PM

TABLE OF CONTENTS

INTRODUCTION 7

CHAPTER 1
How to Optimise Capital Structure 13

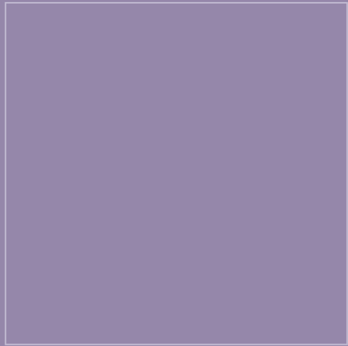
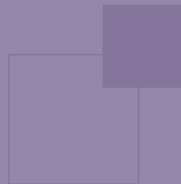
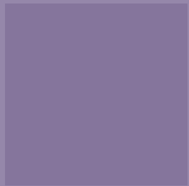
CHAPTER 2
How to Improve Capital Efficiency 29
2.1 Improvements in capex efficiency 29
2.2 Improvements in working capital efficiency 32
2.3 Disposal of non-core assets/activities 34

CHAPTER 3
How to Implement Capital Management Initiatives 39
3.1 Implementing capital structure initiatives 41
3.2 Implementing capital efficiency initiatives 46

EXHIBIT AND TEXT BOX LIST 47

ACRONYMS AND ABBREVIATIONS 48

ACKNOWLEDGEMENTS 49

INTRODUCTION

purple colour.indd 5 12/5/2006 3:03:41 PM

purple colour.indd 6 12/5/2006 3:03:41 PM

INTRODUCTION

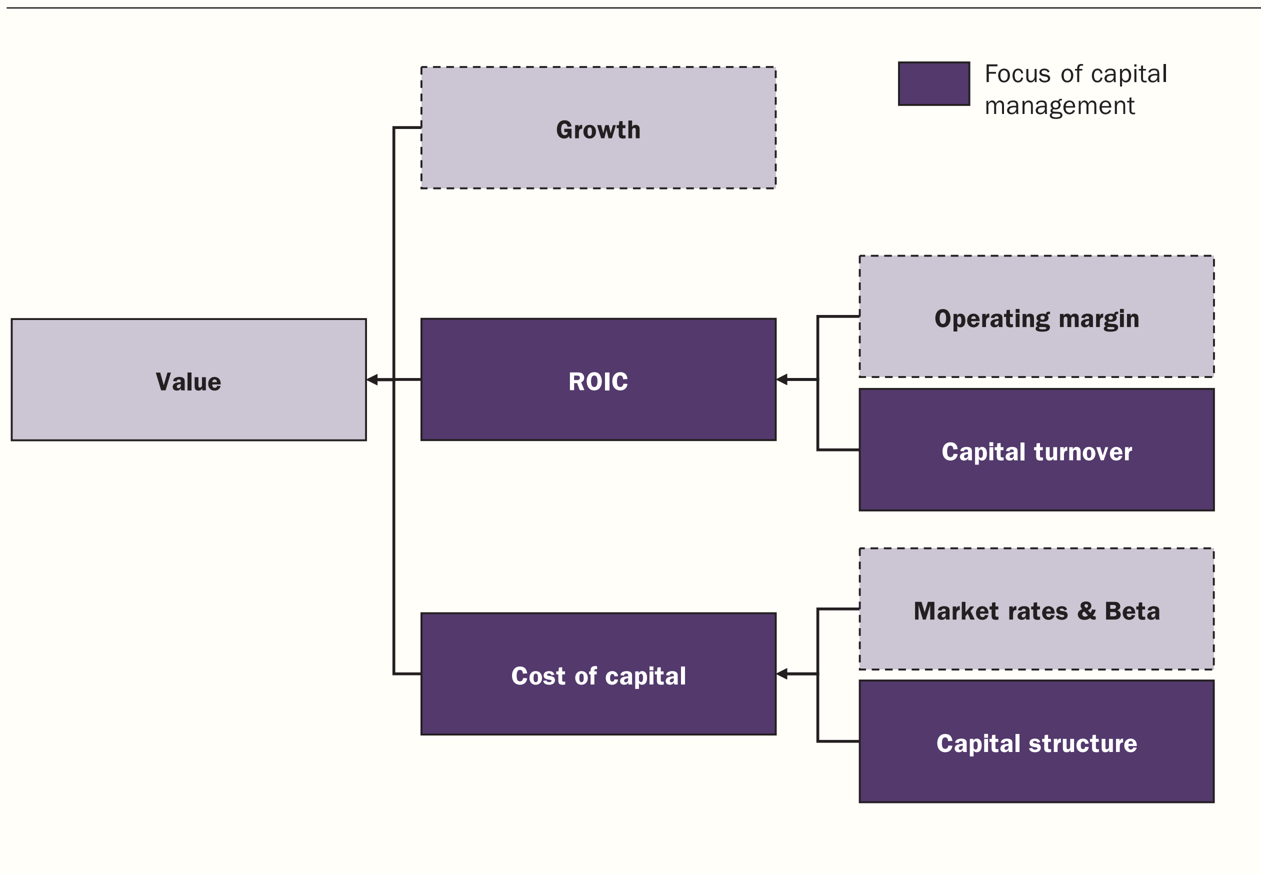
Improving the capital management practices of Government-Linked Companies (GLCs) is one of the initiatives of the overall GLC Transformation Programme put in place by the Putrajaya Committee on GLC High Performance (PCG) in 2005.

Companies create value when the return on their invested capital (ROIC[1]) exceeds their cost of capital. The more companies can invest and grow their capital at positive returns, the more value is created.

Effective capital management will *maximise* a company's value by optimising capital structure (to achieve a competitive cost of capital) and enhancing capital efficiency (to improve ROIC through increased capital turnover). See Exhibit 1.

EXHIBIT 1

CREATING VALUE THROUGH HIGHER ROIC AND OPTIMAL COST OF CAPITAL



For Malaysian GLCs as for corporations in most other markets, capital management is often not approached systematically. Observations on capital management practices among GLCs indicate that many would benefit from devoting greater management attention to their balance sheets.

1. ROIC is defined as Net Operating Profit less Adjusted Taxes over Invested Capital (Invested capital is defined as Operating Assets less Operating Liabilities).

purple colour.indd 7 12/5/2006 3:03:41 PM

Furthermore, GLCs can also benefit from better capital management as a business tool providing strategic benefits in two important ways:

- An optimal capital structure would free GLCs from the constraints of a lack of suitable capital and allow management to devote more attention to growing their business and seizing new opportunities
- The ability to manage capital efficiently can give GLCs a competitive advantage over their peers.

Each GLC has its own unique context, so each company's approach to capital management should be tailored to its circumstances. What is common to all GLCs, however, is the requirement to begin work immediately to ensure they adopt sound capital management practices.

The Purple Book (the Book) aims to support this effort. It provides GLCs with a series of best practice guidelines to optimise their capital management practices drawing on, where applicable, international and local examples relevant to the GLC context. The guidelines cover how to design and optimise capital structure and how to improve capital efficiency.

STRUCTURE OF THIS BOOK

Chapter 1 sets out how to **design and optimise capital structure** using the *4-step Cash Flow Analysis* method. This method allows GLCs to determine anticipated capital deficit/excess, set target credit rating/associated financial ratios and test various capital structures under different forecast scenarios, leading to the formulation of a relevant action plan.

Chapter 2 sets out how to **improve capital efficiency** and create more value using less capital. The chapter shows the various levers that GLCs can use to ensure more efficient capital expenditure (capex) and working capital management, and how to approach the disposal of non-core assets and activities.

Chapter 3 outlines how GLCs can **implement capital structure optimisation and capital efficiency improvement initiatives** as discussed in the previous chapters. It sets out the specific actions needed to diagnose current practices, as well as to plan, implement and monitor these initiatives. To guide capital structure optimisation, a Capital Management Plan (CMP) is proposed.

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

The best practice guidelines in this Book, summarised in the table on the next page, are applicable to all GLCs. However, banks and other financial institutions generally fall outside the scope of this Book because their capital management practices are governed by specific rules and regulations. Notwithstanding that, many capital management guidelines in this Book can also serve as useful references for banks and other financial institutions.

purple colour.indd 8 12/5/2006 3:03:41 PM

THE 12 BEST PRACTICE GUIDELINES FOR CAPITAL MANAGEMENT

HOW TO OPTIMISE CAPITAL STRUCTURE

1. Conduct thorough design and planning to optimise capital structure at least once every 3 years. Conduct subsequent annual reviews to ensure progress and refine capital structure where necessary.
2. Develop coherent and consistent internal processes to ensure accurate, robust and timely financial forecasts and statements, incorporating a full assessment of variables and risks to the business.
3. Set an optimal capital structure using a target credit rating and/or associated proxy financial ratios, which can be determined through a benchmarking process, taking into account specific conditions faced by the company.
4. Develop formalised dividend policies consistent with business strategy and expected earnings growth, taking into account relevant policies and mandates.
5. Distribute excess capital identified through the *4-step Cash Flow Analysis* method—preferably among shareholders—so that capital structure remains within the target band.
6. Explore all financing options—including Islamic finance options—through a rigorous and structured evaluation and selection process to obtain necessary financing at an attractive price.

HOW TO IMPROVE CAPITAL EFFICIENCY

7. Adopt a holistic approach for improving capex efficiency of non-recurring/strategic investments, addressing 4 levels of capex management—strategic, portfolio, project and organisation—with clear ownership at each level. *This is especially important for capital-intensive GLCs.*
8. Actively drive improvements in working capital management, ensuring the chief financial officer (CFO) office takes the lead (except for inventories that are typically driven by line functions).
9. Dispose of all non-core assets and activities by using a 3-step test—distinctive risk-return and management capabilities, impact on core business, and feasibility of value-creating disposals. *A few exceptions are outlined in the Silver[2] and Yellow[3] Books.*

HOW TO IMPLEMENT CAPITAL MANAGEMENT INITIATIVES

10. Design and launch capital management initiatives as part of corporate strategy plans. *Initiatives for optimising capital structure to be adopted by all GLCs; initiatives for capital efficiency to be adopted more selectively.*
11. Actively monitor performance measures and other financial parameters that link back to the capital management initiatives.
12. Take full responsibility for implementing and following-up on initiatives, which are driven by the chief executive officer (CEO) and typically championed by the CFO. Government—Linked Investment Companies (GLICs) *may provide active support and expertise as appropriate.*

2. See "Silver Book" on "Achieving Value Through Social Responsibility".
3. See Reference Document for "Framework for Continuous Improvements (FCI)", "Yellow Book".

purple colour.indd 9 12/5/2006 3:03:42 PM

IMPLEMENTATION OF CAPITAL MANAGEMENT INITIATIVES

Implementation of the above best practice guidelines should be addressed separately for capital structure optimisation and capital efficiency improvement. It is imperative that the CEO is the driving force of this effort, and with the support of a project champion and project team, should lead the implementation of these capital management initiatives.

For capital structure optimisation initiatives, a 3-phase implementation approach will be broadly applicable to all GLCs with Phases 1 (diagnostic) and 2A (preparation) to be completed within a 6 month period after the launch of the Book. GLCs should carry out Phase 2B (integration) in the next immediate business planning cycle and Phase 3 (implementation) as soon as practicable with progress monitored annually.

The implementation of capital efficiency improvement initiatives (through a 3-phase implementation approach like that of capital structure optimisation) should be on a case by case basis. GLCs implementing such initiatives should complete Phases 1 (diagnostic) and 2 (preparation) within 6 months after the launch of the Book, and Phase 3 (implementation) immediately after Phase 2. GLCs should then monitor progress at a regular frequency, typically quarterly but not less than once a year.

* * *

Optimising the use of capital has the potential to transform the performance of Malaysia's GLCs. The steps set out in this document constitute the pathway to transform GLCs into dynamic engines of national growth and development, able to compete in the world marketplace in their own right.

purple colour.indd 10 12/5/2006 3:03:42 PM

CHAPTER 1

HOW TO OPTIMISE CAPITAL STRUCTURE

purple colour.indd 11 12/5/2006 3:03:42 PM

CHAPTER 1 HOW TO OPTIMISE CAPITAL STRUCTURE

In recent years, company executives in various markets have had to pay greater attention to their capital structure—that is, how they raise and distribute capital to their capital providers. On the one hand, increasing risks of financial distress have increased focus on the financial resilience of their companies. On the other, growing insistence from investors that companies deliver value has placed greater emphasis on how company executives manage excess capital[1] generated by their businesses.

In spite of this, capital structure is often approached in an ad-hoc and non-systematic way, with many companies still in the 'learning phase'—this is equally true for Malaysian GLCs[2]. Perhaps, given their evolution from state-run to increasingly private-like enterprises, many GLCs might lack clarity on their true cost of capital. Further, the Malaysian business environment, with its high growth and emerging market nature, can cause greater volatility, potentially resulting in some GLCs adopting an overly conservative capital structure.

Given the diverse nature of Malaysia's GLCs, it is not possible to prescribe a single capital structure that GLCs should adopt. Instead, the rest of this chapter sets out the best practice approaches that GLCs should adopt to design and achieve the optimal capital structure most suited to them—that is, the structure that is most conducive to creating shareholder value.

LEVERS FOR OPTIMISING CAPITAL STRUCTURE

To create an optimal capital structure, the fundamental task is to balance debt and equity—that is, to decide the company's *leverage ratio*. Leverage delivers clear benefits; it also carries costs:

- Benefits: tax savings from the tax deductible interest charges for debt, improved investment discipline imposed on managers
- Costs: costs of bankruptcy and business erosion[3], potential costs of investor conflicts—that is, conflicts of interest between debt holders, shareholders and managers.

Empirical research[4] has shown that the optimal leverage ratio for companies—that is, their optimal capital structure—tends to fall in a broad band. Indeed, the curve representing the relationship between weighted average-cost of capital (WACC) and capital structure shows a concave flattening around its optimal range (see Exhibit 2). This implies that while optimising capital structure is important for GLCs to have competitive cost of capital, it should not be narrowly focused on just seeking the lowest cost of capital.

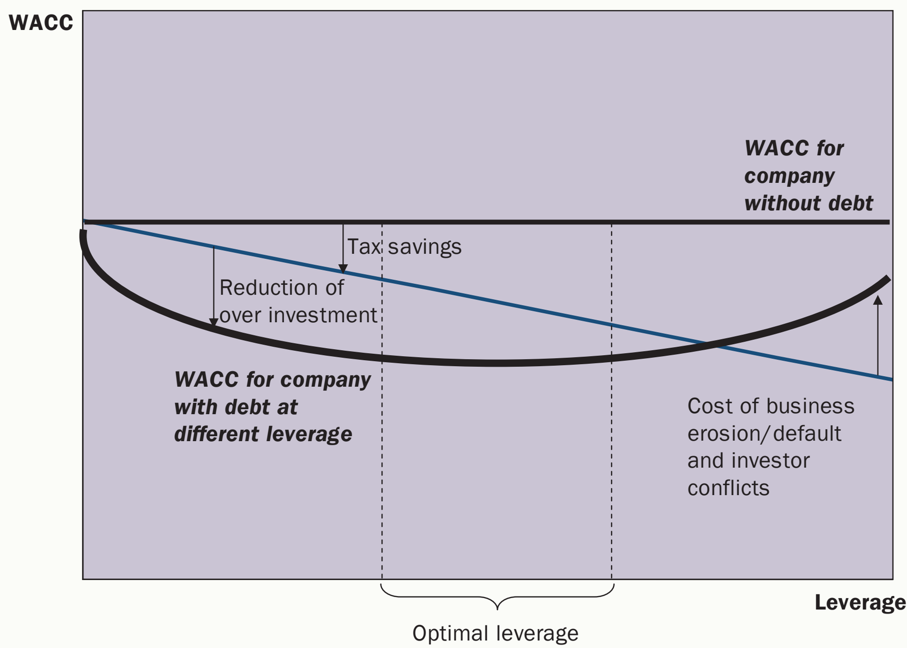
More importantly, designing and achieving an optimal capital structure is indispensable to exercising the proper level of prudence to ensure sufficient financial resilience and the necessary discipline to use capital providers' funds wisely.

1. Excess capital is defined as cash and marketable securities over and above what is needed for operations, taking into account investments on growth opportunities, capital expenditure and financing, existing loan covenants and repatriation restrictions.
2. Results from a survey conducted by PCG in 2006 indicate that very few GLCs responded that they have a 'somewhat tight' or 'strict' target debt/equity ratio.
3. For example, highly levered companies are more likely to forgo investment opportunities with payoffs further. As the risk of financial distress increases, highly levered companies are also more likely to loose customers, employees and suppliers.
4. M. Barclay and C. Smith, "The Capital Structure Puzzle Another Look at the Evidence," *Journal of Applied Corporate Finance,* 12(1) (1999): 8-20.

purple colour.indd 13 12/5/2006 3:03:42 PM

EXHIBIT 2

RELATIONSHIP BETWEEN WACC AND CAPITAL STRUCTURE



Optimising capital structure is primarily considered at the company level, as addressed in this Book. At the same time, GLCs can also make financing decisions at a project or asset level, for example, project financing for a plant or securitising inventory. However, these decisions tend to be driven more by specific operational considerations.[5]

4-STEP CASH FLOW ANALYSIS METHOD TO OPTIMISE CAPITAL STRUCTURE

GUIDELINE 1

- Conduct thorough design and planning to optimise capital structure at least once every 3 years. Conduct subsequent annual reviews to ensure progress and refine capital structure where necessary.

This Book advocates developing an optimal capital structure through the *4-step Cash Flow Analysis* (see Exhibit 3). This methodology allows companies to design their capital structure based on the analysis of future cash flows formulated on robust assumptions. This means that specific conditions applicable to a company—for example, its particular investment needs, dividend policy and loan covenant requirements—can be taken into consideration.

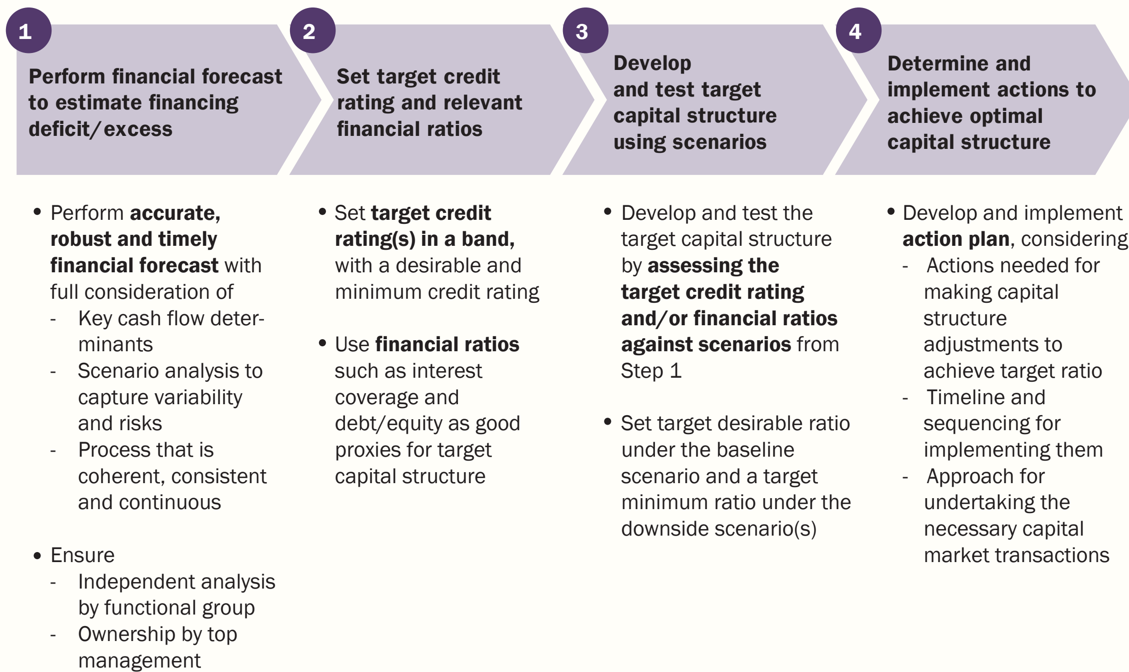
It should be noted that using this methodology to develop an optimal capital structure is an ongoing process. To ensure that GLCs maintain an updated and relevant capital structure policy, especially given developments of general business cycles, a thorough capital structure design and planning should be developed at least every 3 years, with annual reviews.

5. See the Yellow Book on the use of some of these levers, including sale-and-leaseback, project financing and asset-backed securitisation.

purple colour.indd 14 12/5/2006 3:03:43 PM

EXHIBIT 3

OPTIMISING CAPITAL STRUCTURE CAN BE APPROACHED IN 4 STEPS



Source: T.Koller, M.Goedhart and D.Wessels, *Valuation: Measuring and Managing the Value of Companies*, Chapter 17

The rest of this chapter sets out the 4 steps of the *Cash Flow Analysis*, illustrated by two Malaysian GLC examples—Malaysian Airline System Berhad (MAS) and Telekom Malaysia Berhad (TM), as a practical approach to designing and managing an optimal capital structure.

Step 1: Perform Financial Forecast to Estimate Financing Deficit/Excess

GUIDELINE 2

- Develop coherent and consistent internal processes to ensure accurate, robust and timely financial forecasts and statements, incorporating a full assessment of variables and risks to the business.

This first step will project future cash flows based on a company's business plan, holding constant its current capital structure and capital commitments—in order to estimate financing deficit or excess. Most GLCs already have such financial forecasts as part of their regular business planning and budgeting process.

The key here is to ensure the financial forecast is accurate and robust. GLCs must identify and understand all relevant aspects that will influence and determine their cash flows and financing. They also need to account for key variabilities and risks in their business, typically through the use of scenario analysis. Given the complexity involved in forecasting, GLCs also need to ensure that they adopt a process that is coherent, consistent and continuous (see Exhibit 4).[6]

6. The time horizons for such forecasts will naturally vary by industry. For example, GLCs operating in high-growth sectors may have detailed forecasts for shorter time horizon while those in more regulated, mature or stable industries may have forecasts for a longer timeline.

purple colour.indd 15 12/5/2006 3:03:43 PM

EXHIBIT 4

GLCs MUST CONDUCT ACCURATE AND ROBUST FINANCIAL FORECASTS

Key cash flow determinants

- **From operations**—Key components of growth and ROIC such as
  - Industry growth
  - Company market share
  - Expected margins
  - Operations of any acquisitions and disposals
- **From financing**—Various items such as
  - Interest and principal payments
  - Tax and regulatory considerations
  - Existing debt covenants
  - Off-balance sheet items such as guarantees
  - Explicit dividend communicated to shareholders
- **From investments**—Plans for major investments, acquisitions and disposals. GLCs should fully explore and evaluate all growth opportunities in support of current emphasis on private investment in Malaysia

Scenario analysis

- **Market scenarios**—Capture impact from possible external developments such as industry trends and cycles
- **Operational scenarios**—Depict impact from potential internal initiatives regardless of whether they are operational improvements or strategic in nature
- **Baseline scenarios**—Represent the GLCs' most realistic expectations of the market, typically in line with industry forecasts, as well as the impact from planned internal initiatives

Forecasting process needs to be

- **Coherent**—Incorporate and validate business unit (BU) views and inputs (e.g. sales forecasts and production estimates)
- **Consistent**—Have repeatable and consistent process (e.g. by determining key forecast variables and understanding sources for assumptions)
- **Continuous**—Have ongoing forecasts that are timely and relevant to current needs, with reviews and updates at least once a year

At MAS, for example, the financial forecast had to include careful consideration of the growth and also challenges in its external business environment as well as the implications of its internal operations, including efforts on revenue improvement, cost reduction and non-core asset streamlining.

The forecasting process will usually be conducted by a functional group such as Finance or Corporate Planning.[7] Ultimately, the top management at a GLC must ensure their company forecasts represent their best judgement on the future of their businesses. For this reason, they will need to 'own' and drive the forecasting process.

It should be noted that for conglomerates, it is important to consolidate financial forecasts at the level where capital management decisions are made (see Text Box A: Capital Management for Conglomerates).

7. To facilitate inputs from the various relevant business units and divisions. At the same time, they need to provide objective and value-add support to the process.

purple colour.indd 16 12/5/2006 3:03:43 PM

TEXT BOX A: CAPITAL MANAGEMENT FOR CONGLOMERATES

Conglomerate GLCs are typically active owners of their portfolio companies and therefore capital management decisions should be made at the conglomerate level. On the other hand, investment holding companies are usually considered less active owners (even with 100% ownership). Hence for them, capital management decisions should be made at the portfolio company level.

To help conglomerates determine whether they are active owners of their portfolio companies, two assessment criteria are provided below. These will help conglomerates ascertain the level at which decisions on capital management should be taken, and thus the level at which financial forecasts should be consolidated.

Criterion 1

Ascertain what **degree of ownership** the conglomerate has over its portfolio companies.

- If a conglomerate fully owns a portfolio company (that is, 100% ownership) then all financials should be consolidated and all capital management decisions should be made at the conglomerate level as these decisions have direct implications on the conglomerates overall capital structure and capital efficiency.
- For stakes smaller than 100% but significant enough for the conglomerate to have effective control of its portfolio company, capital management decisions should still be made at the conglomerate level.
- For minority stakes where the conglomerate does not have an active role in determining the portfolio company's business or financial activities, move on to *Criterion 2.*

Note: For both the latter cases, the conglomerate will still need to take into consideration minority shareholder interests, whether aligned with its own or not.

Criterion 2

Decide what **degree of recourse** the conglomerate is willing to take in supporting its portfolio companies.

- If a conglomerate has a minority stake and is willing to remain completely independent from a portfolio company—that is, willing to step away from financially supporting a portfolio company—then capital management decisions should be made at the portfolio company level.
- For all other cases, capital management decisions should be made at the conglomerate level, regardless of the size of the conglomerate's stake in the portfolio company.

Once they have determined the level at which capital management decisions should be made, conglomerates will still have to decide the level at which capital is attracted. For example, a conglomerate could determine capital management at the conglomerate level, but still choose to attract capital at the portfolio company level if it can benefit from a lower cost of capital.

purple colour.indd 17 12/5/2006 3:03:43 PM

Step 2: Set Target Credit Rating And Relevant Financial Ratios

GUIDELINE 3

- Set an optimal capital structure using a target credit rating and/or associated proxy financial ratios, which can be determined through a benchmarking process, taking into account specific conditions faced by the company.

Given the wide band of leverage where optimal cost of capital can be achieved (see Exhibit 2), it is difficult to use cost of capital as a target measure. Hence, GLCs can adopt credit rating as a practical measure of their financial risk level as well as the associated financing costs. Indeed, GLCs can use a target credit rating to set their target optimal capital structure. Even GLCs without an explicit credit rating from an established rating agency can use this approach. While a credit rating is determined by considering multiple factors, the most important are typically financial ratios. In particular, interest coverage[8] and debt/equity ratios are usually good proxies for determining credit rating.

Given the broad range of what constitutes 'an optimal capital structure', GLCs should set their target credit rating(s) in a band, consisting of a desirable and minimum credit rating. As an example, many companies target certain investment grades, for instance between A and BBB, as their target band.[9] From this, GLCs can determine the corresponding target band of desirable and minimum interest coverage and/or leverage ratios that will allow them to remain with the relevant rating.

When choosing a target credit rating, GLCs should consider, through benchmarking, the level comparable with industry peers while, at the same time, take into account specific conditions the company is facing.

Benchmarking (to compare credit rating against peers) can be a complicated process. It requires GLCs to conduct a thorough analysis to determine which companies are truly comparable peers as well as to make necessary adjustments to 'normalise' against their peers—for example, capitalising operating leases.[10] Some specific conditions that GLCs might face include loan covenants, potential prerequisites of relevant credit rating agencies as well as allowances for any unique risks associated with an emerging market such as Malaysia.

It is worth noting the particular application to companies facing financial distress. For such companies, rather than a target credit rating, their immediate objectives would primarily be to maintain a certain minimum cash level for operational needs and/or to avoid violating certain covenants that might trigger bankruptcy. Choosing a target credit rating and capital structure would be longer-term considerations once they have successfully achieved an approriate level of business turnaround. Nonetheless, the *4-step Cash Flow Analysis* is still highly applicable to these companies, albeit with this different focus in Step 2. Step 1 will naturally have to incorporate the turnaround plans and their expected impact on company cash flows.

8. Interest coverage ratio is defined as the multiple of Net Income (NI), Earnings Before Interest and Tax (EBIT) or Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) over annual interest payment; debt/equity ratio is defined as the market value of debt to market value of equity.
9. A to BBB are Standard & Poor's credit ratings for all US and European companies with a market capitalisation over US$1 billion.
10. The Yellow Book provides further guidelines on benchmarking.

purple colour.indd 18 12/5/2006 3:03:44 PM

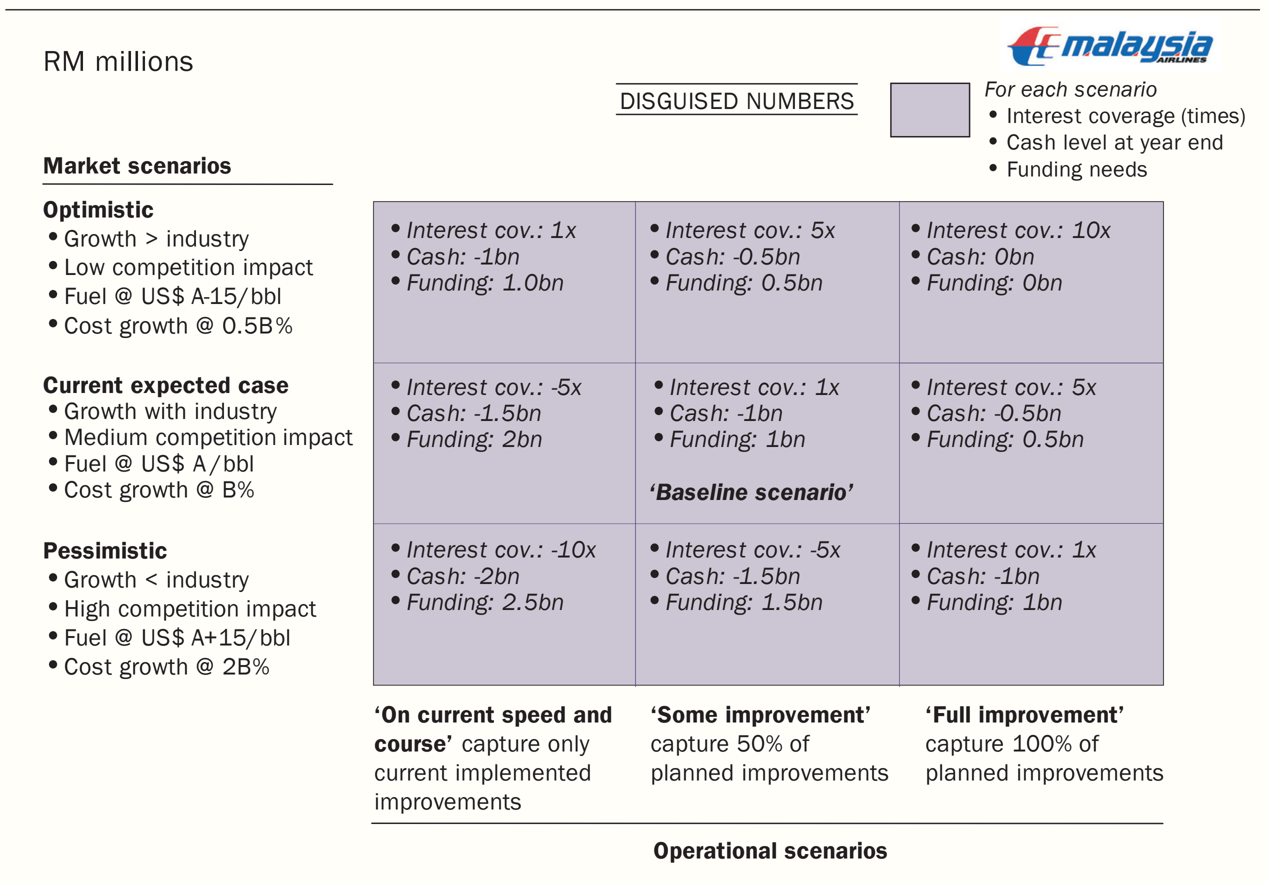
Step 3: Develop And Test Target Capital Structure Using Scenarios

The third step is to develop and test the target capital structure. This is done by assessing the target credit rating and/or associated financial ratios against the scenarios developed in Step 1. The target desirable ratio should be achieved under the baseline scenario and the target minimum ratio should be attained under the downside scenario(s). Through several iterations of testing and adjusting the capital structure plan under different scenarios, GLCs can arrive at the target capital structure that is most robust for the relevant range of scenarios.

For MAS, this part of the process meant factoring both a range of potential growth rates and levels of industry competition that would affect margins and different paces of progress in its internal efforts to improve profitability and generate cash. Each MAS scenario resulted in different cash and funding requirements as well as the associated interest coverage (see Exhibit 5). For TM, this step included balancing higher growth in its international mobile business against faster erosion of the traditional fixed voice revenues.

EXHIBIT 5

TESTING TARGET CAPITAL STRUCTURE USING SCENARIOS



purple colour.indd 19 12/5/2006 3:03:44 PM

Step 4: Determine And Implement Actions To Achieve Optimal Capital Structure

GUIDELINES 4, 5 and 6

- Develop formalised dividend policies consistent with business strategy and expected earnings growth, taking into account relevant policies and mandates.
- Distribute excess capital identified through the *4-step Cash Flow Analysis* method—preferably among shareholders—so that capital structure remains within the target band.
- Explore all financing options—including Islamic finance options—through a rigorous and structured evaluation and selection process to obtain necessary financing at an attractive price.

The fourth and final step is to implement an action plan to achieve the optimal capital structure. GLCs should consider three main elements:

A. The actions needed to make the capital structure adjustments
B. The timeline and sequencing for implementing those actions
C. The approach for undertaking the required transactions in the capital markets.

A. Determining the actions needed to make capital structure adjustments

Once the long-term target capital structure has been determined, GLCs then need to determine the actions required to adjust their capital structure when they fall too far below or above this target. In essence, they need a set of financing and distribution options for addressing capital deficits or excess so that the company's capital structure adheres to its long-term target band.

The basic set of financing and distribution options are:

- Shares (rights) issues, repurchases and capital redemption; typically one-off[11]
- Dividend payment, reduction, increment and one-off payments
- Debt issues and repayment.

In addition, many other options derive from this basic set—for example, convertible bonds and collateralised debt obligations. This Book however, focuses on the basic set of options.

The specific impact of these options for each company needs to be assessed carefully on a case by case basis, taking into account the relevant transaction costs and likely signalling effects to the market.

For transaction costs, GLCs need to consider two main types:

- Costs to the company such as transaction expenses, time required and tax
- Costs to the recipient such as liquidity, tax and flexibility to accept/reject financing option.

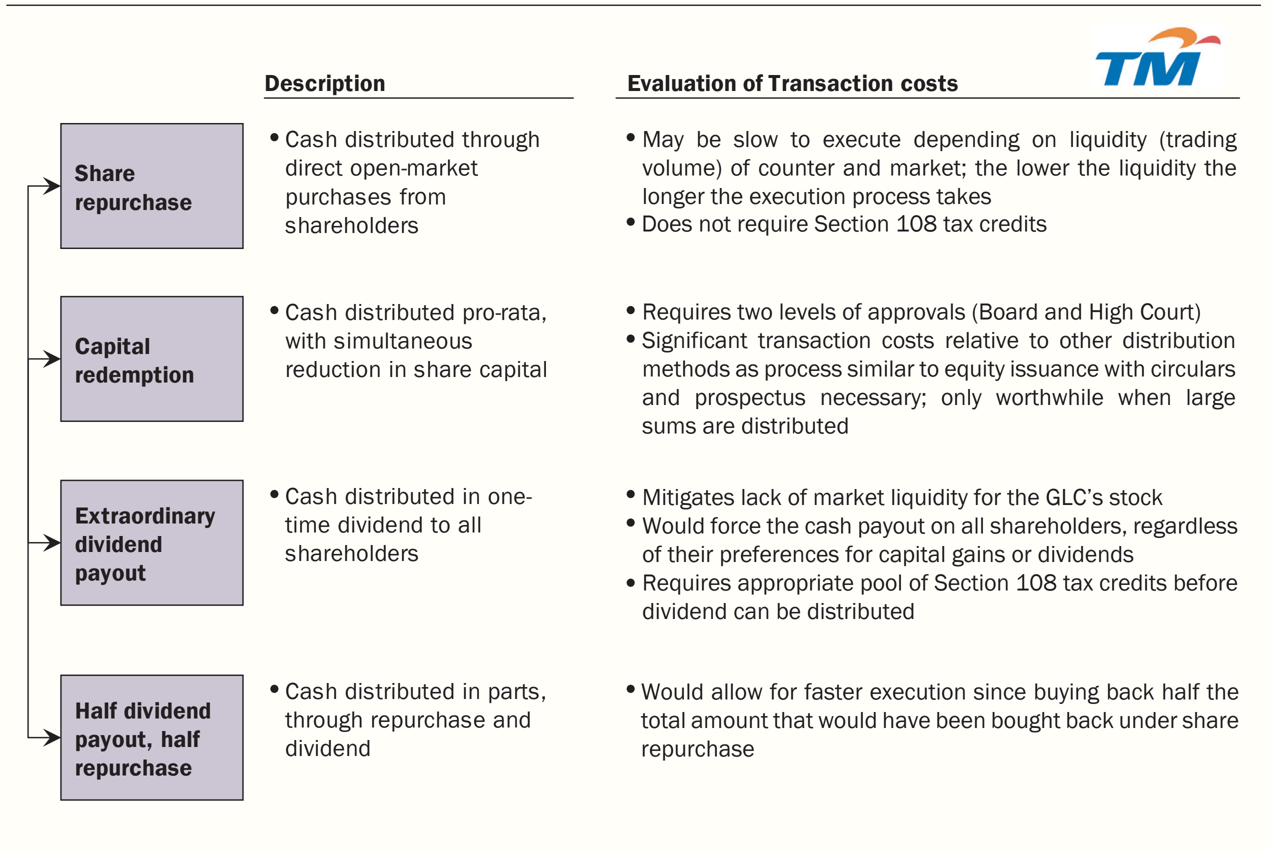
In the case of TM, after it determined the level of excess capital on its balance sheet, the company conducted a detailed analysis of the various equity distribution options, including the transaction costs (see Exhibit 6).[12]

11. Can also be carried out over multiple years.
12. Debt options were considered separately.

purple colour.indd 20 12/5/2006 3:03:45 PM

EXHIBIT 6

TM EVALUATED TRANSACTION COSTS OF A VARIETY OF EQUITY DISTRIBUTION OPTIONS



	Description	Evaluation of Transaction costs
Share repurchase	• Cash distributed through direct open-market purchases from shareholders	• May be slow to execute depending on liquidity (trading volume) of counter and market; the lower the liquidity the longer the execution process takes • Does not require Section 108 tax credits
Capital redemption	• Cash distributed pro-rata, with simultaneous reduction in share capital	• Requires two levels of approvals (Board and High Court) • Significant transaction costs relative to other distribution methods as process similar to equity issuance with circulars and prospectus necessary; only worthwhile when large sums are distributed
Extraordinary dividend payout	• Cash distributed in one-time dividend to all shareholders	• Mitigates lack of market liquidity for the GLC's stock • Would force the cash payout on all shareholders, regardless of their preferences for capital gains or dividends • Requires appropriate pool of Section 108 tax credits before dividend can be distributed
Half dividend payout, half repurchase	• Cash distributed in parts, through repurchase and dividend	• Would allow for faster execution since buying back half the total amount that would have been bought back under share repurchase

For signalling effects, GLCs need to be aware of two primary considerations:

- In a deficit situation, asking investors for more capital typically leads to more negative market reactions than increasing leverage
- In an excess situation, distributing/returning capital to shareholders typically meets with relatively positive market reactions compared with decreasing leverage.

A further discussion on signalling effects can be found in Exhibit 7.

purple colour.indd 21 12/5/2006 3:03:45 PM

EXHIBIT 7

EVALUATING SIGNALLING EFFECTS OF MANAGING CAPITAL DEFICIT/EXCESS

Managing capital deficits	Signalling effects (⊖ Negative signal; ⊕ Positive signal)
Shares/rights issuance	⊖ Signals to market that managers consider GLC's shares to be overvalued because investors assume that managers at GLCs have superior insights into a GLC's true business and financial outlook. Likely leads to a drop in share price in the short term ⊖ Incites negative reaction from existing shareholders due to a possible dilution of their stake
Dividend reduction	⊖ Typically indicates to stock market that future cash flows will be lower, and as a result share price declines
Debt issuance	⊕ Signals strongly that future cash flows will be sufficient since GLC is committing to fixed future interest payments that can be withheld only at a considerable cost ⊕ Indicates to some investors that management perceive the GLC's share price to be undervalued
Managing capital excess	
Capital redemption, share repurchase	⊕ Indicates that management believes that the GLC's shares are undervalued ⊕ Shows that the GLC managers are confident that future cash flows are strong enough to support future investments and debt commitments ⊕ Signals that the GLC will not spend its excess cash on value-destroying investments
Extraordinary dividend payout	⊕ Shows that the GLC managers are confident that future cash flows are strong enough to support future investments and debt commitments ⊕ Signals that the GLC will not spend its excess cash on value-destroying investments
Dividend increase	⊕ Indicates good news about the GLC's long-term outlook for future earnings and cash flows. Nonetheless because the stock market penalises companies for cutting dividends from long-term payout levels, GLC managers should be confident that future cash flows will be sufficient to continue paying the higher dividends ⊖ Signals, that the GLC has permanently lower future investment opportunities; could lead to declining share price if the stock market had expected the GLC to continue to invest strongly in value-creating growth opportunities
Debt repayments	⊕ Meets with positive stock market reactions only if debt repayment is part of a recovery from financial distress ⊖ Indicates to market that management believes GLC's shares are overvalued as bonds are less likely to be undervalued ⊖ Signals that future cash flows may not be sufficient to support current debt levels, requiring management to reduce the corporate debt burden now ⊖ Signals a lack of investment opportunities, as in the case of dividend increase as mentioned above

Understanding and managing potential signalling effects to the market should be conducted within the context of a systematic investor relations (IR) programme. A discussion of such a programme's basic principles is provided in Text Box B.

purple colour.indd 22 12/5/2006 3:03:45 PM

TEXT BOX B : BASIC PRINCIPLES OF INVESTOR RELATIONS

The primary objective of IR management is to help align the market price of a company's shares with the company's intrinsic value—the present value of all expected future net cash flows to the company—and not to achieve the highest possible share price.

This objective can be achieved by providing the right information to investors for them to accurately assess the company's intrinsic value (without divulging any confidential information that would lead to competitive disadvantage) and by demonstrating the quality and credibility of management so that they believe management can deliver this intrinsic value.

Therefore, IR has an indirect role in managing the cost of equity for GLCs. While it does not lower cost of equity per se, it helps to ensure the cost of equity for GLCs is in line with the market. As such, best practices in IR and in capital management will both ensure that GLCs are not penalised with a high cost of capital, due to weak IR or sub-optimal capital structure.

The four basic principles that can guide GLCs to better relations with their investors is shown below:

1.
- Ground the IR strategy in a thoughtful analysis of market value relative to GLC management's estimate of **intrinsic value.**
- There should not be significant gaps between intrinsic value and market value—and GLCs should aim to ensure any such gaps are not due to deficient communications with investors.

2.
- Ensure that the GLCs' investment **story is consistent with their underlying strategy** and performance.
- As obvious as this sounds, GLCs sometimes fail to align their message with their strategy, especially in terms of the time they allocate to talk about different BUs or strategic initiatives.
- For example, at General Electric, the Head of IR sits on the corporate executive council (as the only non-operational executive) which meets two days each quarter to develop strategy.

3.
- Provide sufficient **transparency** about performance and value drivers.
- Transparency includes providing pertinent operating measures that the company uses to run its business, as well as meaningful financial results.
- For example, BP reports sales, profits and operating capital analysed by geography and BUs, and benchmarks statistics against the result of other oil majors.

4.
- Understand the **investor base**—particularly how it compares with peers and whether it has changed in recent months or years.
- While there is no evidence that a particular group of investors raises value or lowers volatility, insights from analysing shareholders can help GLCs decide how to shape their message and how senior executives should spend their time.
- In the case of Intel, senior management is heavily involved in IR with the CEO and all senior vice presdents attending most analyst/investor meetings during road shows.

purple colour.indd 23 12/5/2006 3:03:46 PM

In any case, GLCs should develop formalised dividend policies.[13] Such policies—if well-developed and backed by viable commitments to return excess capital—can send positive signals to the market and hence is an important part of best practice IR management. At the same time, equally important is the fact that formalised dividend policies help to impose investment discipline on managers at GLCs. Hence, they can also serve as a valuable management tool.

A discussion of the basic elements in developing formalised dividend policies is provided in Text Box C.

B. Putting in place the right timeline and sequencing

Given the considerations of transaction costs and signalling effects, GLCs should not be expected to immediately correct their capital structure whenever they deviate from long-term targets. It would be better to do this gradually. For this reason, the timing and sequence of actions—what to carry out now and which to defer to when new information is available—need to be considered carefully in the action plan.

C. Crafting the approach for undertaking the required market transactions

GLCs must employ a rigorous and structured evaluation and selection process in undertaking neccessary market transactions, such as seeking financing. This process will help GLCs to obtain the most suitable product and service from financial service providers, at appropriate pricing and terms (taking into account at what level of the GLC capital should be raised to ensure the most optimal cost), with necessary transparency and control. For new loans, this will include ensuring that loan covenants are structured to be consistent with the company's long-term capital structure target. For example, in seeking financing, MAS provides a clear background to its financing needs with indicative financing and pricing options, invites additional financing ideas and provides a clear guideline for the whole fund raising process.

In evaluating various funding options, GLCs should give consideration to Islamic finance in so far as such options maximise shareholder value. Given the efforts to promote Malaysia as a hub for Islamic finance in line with the Malaysia International Islamic Financial Centre (MIFC), the available infrastructure and a substantial capital pool from which to draw from (regionally and in the Middle East)—Islamic finance options can provide viable alternative to conventional financing options. See Examples of Islamic Finance as a Potential Funding Source in Text Box D.

13. Only half of the sixteen GLCs that responded to the PCG survey on capital management maintain a target dividend payout ratio.

purple colour.indd 24 12/5/2006 3:03:46 PM

TEXT BOX C : DEVELOPING A FORMALISED DIVIDEND POLICY

Key considerations in setting dividends

- In determining their dividend policies, GLCs need to take into account their business objectives and strategy, in particular the growth expectations. For example, companies with high growth potential typically pay less (or no) dividends—a practice the market accepts.
- At the same time, some GLCs may need to take into account relevant policies and mandates of their stakeholders. For example, some GLICs may have specific expectations on dividend levels.
- To gain alignment on both considerations, GLCs need to adopt a common and robust framework for developing their dividend policies.

Framework for developing dividend policies

- GLCs should adopt the *4-step Cash Flow Analysis* method as the framework for developing their dividend policies. Business objectives/strategy as well as stakeholder expectations can be explicitly accounted for as part of the forecast in Step 1, allowing meaningful discussions around trade-offs, such as in choosing between growth and returns.
- In addition, GLCs can also compare their dividend policies with that of comparable peers in the same industry. This would provide a practical test against the expectations and requirements for the business, especially taking into consideration potential cash flow volatility and business life-cycles. For example, Bumiputra-Commerce Holdings Berhad (BCHB) studied the dividend policies of other local and international companies to arrive at a manageable gross dividend target of 15 sen per share.

Type/frequency of payment

- GLCs may need to consider between a ratio-based or absolute sum-based dividend pay-out policy.
- Most companies use a ratio-based policy, with dividend typically expressed as a ratio of annual earnings, either as a fixed ratio or as a band. This would allow flexibility to link pay-out with variability in business performance. For example, TM recently announced a dividend ratio of 40-60%. Maxis as well recently committed to a strong progressive dividend policy, with a 55% payout ratio in 2004 and a 60-65% payout ratio in 2005. Also, DiGi has in recent years maintained a dividend policy with a payout ratio of more than 50%.
- Absolute sum-based policies, where dividends of a certain amount are paid each year, are more common in industries with a steady stream of cash flows, such as infrastructure. Such policies can also form a part of best practice communications with investors—for example BCHB recently announced to institute an annual gross dividend target of 15 sen per share so that investors know that there is a firm payout in any given year.
- In terms of frequency of pay-outs, this is typically dependent on the norms of a company's primary investors' markets. For example, most US companies pay dividends on a quarterly basis whilst European companies have a wide range of payout frequencies, due to the differences in each country.

TEXT BOX D : EXAMPLES OF ISLAMIC FINANCE AS A POTENTIAL FUNDING SOURCE

GLCs can benefit from more proactive consideration of Islamic finance alternatives when evaluating options to meet their capital needs, including tapping funds at attractive rates. Two examples illustrate typical applications of Islamic finance, but the scope for its use is increasingly widening.

1. 1st Silicon needed financing for its plan to address a challenging business situation. The Sarawak Economic Development Corporation (SEDC) raised a US$350 million Sukuk by structuring a sale-and-leaseback of 1st Silicon's assets.

   Even though it took a substantial effort to crystallise the conditions the Sukuk placed on the company's obligations, there is no doubt the arrangement helped 1st Silicon with its turnaround efforts in the business.

   For example, the arrangement made explicit the risk-reward tradeoffs of various actions the company was planning to take.

2. Projek Lebuhraya Utara-Selatan Berhad (PLUS) had on 10 October 2006 issued a total nominal amount of RM9.2 billion of Sukuk based on the Islamic principle of Musyarakah.

   This exercise allowed PLUS to convert some of its current debt into globally Shariah-compliant instruments, as well as established a Medium Term Note (MTN) programme that provides more financial flexibility.

   The Sukuk issues enable PLUS Group to eventually tap into a broader investor base, in particular the Middle East market. Such debt structure effectively securitises the cash flow from its concession on a long tenure basis and helps to improve the capital structure of PLUS.

purple colour.indd 26 12/5/2006 3:03:46 PM

CHAPTER 2

HOW TO IMPROVE CAPITAL EFFICIENCY

purple colour.indd 27 12/5/2006 3:03:46 PM

purple colour.indd 28 12/5/2006 3:03:47 PM

CHAPTER 2 HOW TO IMPROVE CAPITAL EFFICIENCY

Apart from optimising their capital structure, companies must also strive to improve their capital efficiency. This has three fundamental aspects: capex efficiency, working capital efficiency and the disposal of non-core assets and activities.

GLCs can look at each of these three areas to determine how they can improve and thus have significant impact on their overall capital management.

CHAPTER 2.1: IMPROVEMENTS IN CAPEX EFFICIENCY

Capex efficiency is typically the most important determinant of capital efficiency. It usually contributes the largest share of balance sheet assets and therefore significantly affects capital turnover, which in turn influences ROIC. In capital-intensive industries such as pulp and paper or chemicals and petroleum, for example, the short-term impact of integrated capital efficiency initiatives (for example, reduction in non-value creating projects, reduced project capex and opex) has seen a 15–25% reduction in capex leading to a long-term impact of a 2–4% increase on ROIC.

Compared with their industry peers, Malaysian GLCs often deploy a higher level of assets to support their businesses,[1] indicating scope to improve capex efficiency. Malaysian GLCs can achieve better performance in this area in a number of ways: by pursuing systematic rather than ad-hoc initiatives, ensuring these initiatives are comprehensive rather than localised, demonstrating clear accountability and ownership as opposed to being unclear and consensus-driven, and to always strive for continual improvement.

LEVERS FOR IMPROVING CAPEX EFFICIENCY

To improve their capex efficiency, GLCs must first examine their capex practices for recurring and non-recurring (or strategic) investments within both the company and their subsidiaries.[2] Managing recurring investments—that is, multiple smaller, ongoing investments—and existing assets usually forms part of business operations. Hence, the primary focus here is on how to address non-recurring capex investments. For non-recurring/strategic investment projects, GLCs can improve capex efficiency by employing four levers:

- Make go/no-go decisions on projects
- Prioritise projects (and delay non-critical projects)
- Decide on the degree of spend for each project, cutting unnecessary expenditure
- Ensure capex spend achieves pre-determined target objectives and value.

The rest of this chapter focuses on how to address non-recurring/strategic capex investments.

1. From surveying capital turnover and other relevant metrics for GLCs and their peers in several industries such as infrastructure, telecommunications, manufacturing and conglomerates.
2. In doing this, some GLCs also have to take into account the exceptions regarding capex as outlined in the Silver Book.

purple colour.indd 29 12/5/2006 3:03:47 PM

THE PYRAMID APPROACH TO IMPROVING CAPEX EFFICIENCY

GUIDELINE 7

- Adopt a holistic approach for improving capex efficiency of non-recurring/strategic investments, addressing 4 levels of capex management—strategic, portfolio, project and organisation—with clear ownership at each level. *This is especially important for capital-intensive GLCs.*

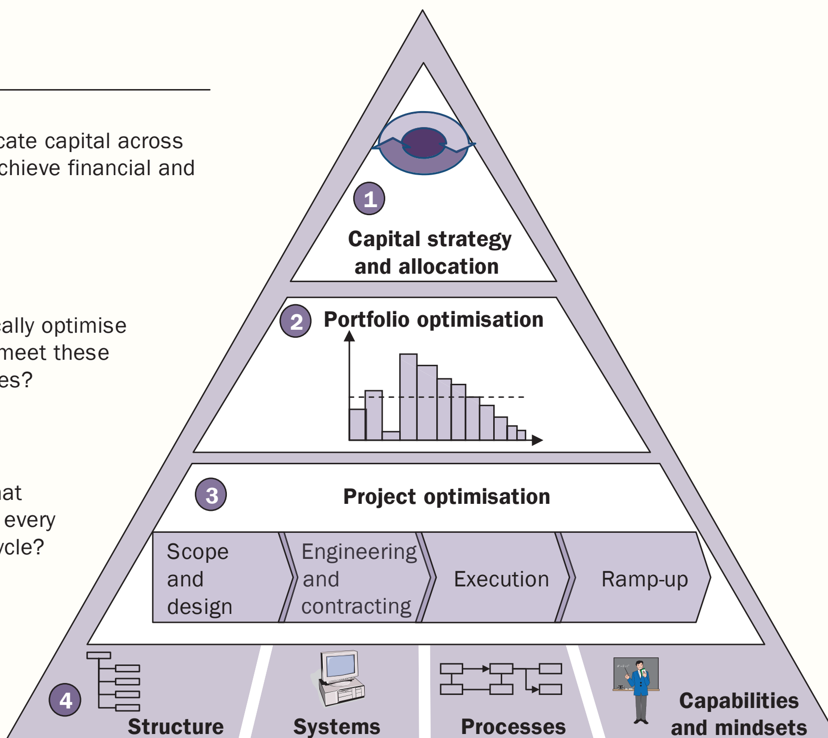
To decide which levers to employ to address capex efficiency of non-recurring strategic/investments, GLCs must first determine where the most important challenges and gaps are in the capex process. They can do this by analysing their current position against relevant performance benchmarks such as competitors or past capex projects. GLCs can then develop initiatives to improve capex efficiency using a holistic approach, the best practice for which can be summarised with the Capex Pyramid approach (see Exhibit 8).

EXHIBIT 8

THE PYRAMID APPROACH TO IMPROVING CAPEX EFFICIENCY

Key questions

1. **Strategic:** How should we allocate capital across opportunities/businesses to achieve financial and strategic goals?
2. **Portfolio:** How can we dynamically optimise our capital project portfolio to meet these financial and strategic objectives?
3. **Project:** How can we ensure that maximum value is captured by every project, through its entire lifecycle?
4. **Organisation:** How can we mobilise our organisation towards world-class capital performance?



The pyramid approach looks at four levels of capex management—strategic, portfolio, project and organisation—where appropriate best practices should be put in place to better prepare GLCs to improve capex efficiency. The application of these best practices will of course vary in type and importance from one GLC to another.

purple colour.indd 30 12/5/2006 3:03:47 PM

1. STRATEGIC

- GLCs need to adopt a 'top-down' strategic approach whereby capital allocation is integrated as a core part of the GLC's strategic planning process (on top of the 'bottom-up' capital budgeting that many GLCs now employ).
- To do so, top management—led by the CEO/CFO/Chief Strategy Officer—needs to take full ownership of capital allocation decisions with supporting staff functions providing the necessary analytical rigour.
- *At MAS, for example, to make decisions on fleet changes, top management needs to ensure alignment with the airlines network and marketing strategy.*

2. PORTFOLIO

- GLCs need to manage and optimise their portfolio of capex projects carefully. This process should be sponsored by one or several top management executives along with a professional support function. Four types of tools and processes can be used:
  - Standardised project evaluation frameworks, particularly cost-benefit analyses using net present value (NPV) based metrics
  - Rigorous and objective project screening
  - Ranking and prioritisation processes
  - Stringent scrutiny of mandatory projects—for example, those required for regulatory reasons.
- *At MAS, top management evaluates and challenges the airline's portfolio of capex projects by using key performance indicators (KPIs) and ranking mechanisms to ensure only those projects with true merit are executed.*

3. PROJECT

- At this level, relevant project owners and managers can pursue optimisation using a range of tools, including:
  - Analysing a full set of design alternatives
  - Planning for and enforcing decision checkpoints (to ensure decisions are made on a timely basis) and quality standards
  - Using a well designed procurement process.[3]

4. ORGANISATION

- GLCs need to develop common organisational structures, systems, processes and mindsets to support world-class capital performance. Examples of what needs to be done at the organisation level include:
  - Defining responsibility and accountability for capital processes
  - Setting performance targets
  - Developing an open knowledge management system for project proposal and performance tracking
  - Conducting routine post-project audits
  - Developing and maintaining skilled project managers.
- *At MAS for example, a project expenditure committee has been set up to review only those projects that have passed a robust cost-benefit analysis and to track performance of these projects at pre-determined milestones.*

3. Further guidelines on the procurement process are covered in the Red Book on "Procurement Guidelines and Best Practices".

purple colour.indd 31 12/5/2006 3:03:48 PM

CHAPTER 2.2: IMPROVEMENTS IN WORKING CAPITAL EFFICIENCY

Working capital is also an important determinant of improving capital efficiency. A 10%-point reduction in working capital as a percentage of sales, for example, can lead to a 10% increase in market capitalisation. Typically, there are large performance variations within industries and companies, illustrating the significant improvement potential for many GLCs.

Today, many Malaysian GLCs lack a systematic approach to managing their working capital and treat the issue in an ad-hoc and decentralised way. Few GLCs run improvement programmes or company-wide initiatives in this area. Multi-national corporations (MNCs), on the other hand, have embarked on improvement programmes in this area during the last business cycle, applying pressure on GLCs' receivables and worsening payables. This was evident for MAS in 2006 when reviewing its working capital.

LEVERS FOR IMPROVING WORKING CAPITAL EFFICIENCY

To optimise working capital, managers should look at improvement levers in four areas: accounts receivable (A/R), accounts payable (A/P), cash and inventory management.

The levers to improve A/R address time lags between the delivery of services/products and payment. The levers for A/P are the same as for A/R, however, with the opposite objective (see Exhibit 9).

EXHIBIT 9

THREE LEVERS FOR IMPROVING A/R AND A/P PERFORMANCE

Improving A/R Performance

Lever	Actions
Time-to-payment 'Improve collection'	• Reduce/eliminate grace days • Redesign credit assessment and claim processes • Reduce invoicing mistakes
Time-to-due-date 'Shorten customer terms'	• Shorten terms • Vary terms for different customers • Enforce current terms
Time-to-invoice 'Upgrade payment model/billing process'	• Increase billing frequency • Increase share of pre-payments • Address inefficiencies in billing process

Improving A/P Performance

Lever	Actions
Time-to-payment "Rearrange payment"	• Make use of grace days • Pay based on implicit terms • Withhold payments by careful contract design
Time-to-due-date 'Negotiate terms with suppliers'	• Increase length of terms in a fair and equitable manner • Vary terms for different suppliers • Procurement professionals to analyse/manage suppliers more strategically
Fully exploit agreements 'Enforce current terms'	• Take full advantage of negotiated terms • Maintain up-to-date file of negotiated payment terms • Include automatic matching of invoice to receipt note and purchase order

purple colour.indd 32 12/5/2006 3:03:48 PM

The levers for cash management ensure that all funds are collected quickly and managed efficiently:

- Concentrating and settling funds
- Investing all funds in a timely fashion
- Maximising net rate of risk-adjusted return on investments.

The fourth area, inventory, has several levers to consider including safety stock levels and order/manufacturing quantities as well as accurate forecasting and service-level targeting. However, this area needs to be tailored to specific industries and companies and most often is best run in the line organisation because of its close link with operations.

A SEQUENTIAL APPROACH TO IMPROVING WORKING CAPITAL

GUIDELINE 8

- Actively drive improvements in working capital management, ensuring the CFO office takes the lead (except for inventories that are typically driven by line functions).

GLCs can deploy a sequential approach to improve their working capital management:

1. Analyse working capital performance against peers and benchmarks with a CFO-led task force and a cross-functional team. Comparisons should be carried out at a detailed level—for example, comparing BU A/R performance on terms and net days sales outstanding for key customer groups. Cross-functional participation could include, for example, Finance/Treasury, Sales, IT and Procurement
2. Derive root causes for identified gaps and prioritise which parts of the business—and which specific improvement levers—to target. The outcome of this step can vary from a need to rework A/R, A/P, cash and inventory management across the whole company, to a more focused effort to address terms for receivables in certain parts of the business
3. Design an implementation plan, based on targeted improvement potential and areas, with pilots. In this step, the CFO office should also ensure that all key working capital measurements are monitored monthly. Moreover, working capital levers should be incorporated into the KPIs of the CFO and his or her direct reports, as has been practised at MAS, for example. A cross-functional team should be responsible for planning and executing the pilots and overall effort.

CHAPTER 2.3: DISPOSAL OF NON-CORE ASSETS/ACTIVITIES

In pursuing the aim of creating more value with less capital, GLCs will need to consider whether and how they can remove non-core assets and activities—and the associated risks—from their balance sheets.[4]

One important reason for this is that there could in fact be better owners for these assets—that is, natural owners that can manage them at a lower cost, with the lowest amount of capital and perhaps generate the greatest value from them. The second reason is that it will free up additional time for managers to focus on core business activities that make up the bulk of the company's value. The disposal of non-core assets and activities is particularly pertinent for Malaysian GLCs, many of which retain significant non-core businesses and assets on their balance sheets. This could be because of the need to capture ancillary value created by a GLC's businesses (for example, holding property to capture any increase in value), to internally fulfil services not adequately provided by the market (such as dedicated training facilities), or the need to meet certain social obligations. However, with the more advanced state of economic development, GLCs now operate in a more robust market environment. This, coupled with increasing emphasis on capital management, means GLCs have to carefully consider their treatment of non-core assets and activities.

Consider these examples from MAS and TM. The business turnaround efforts at MAS included a significant review of its non-core investments, which then led to a systematic disposal of its various properties. Even though this exercise was undertaken mainly to generate cash, MAS had to take into account other strategic considerations such as freeing up management time and the potential longer-term strategic impact on the airline. In TM's case, management felt that the time and attention spent on managing the company's non-core investments distracted them from running the core business. Top managers were on the Boards of a number of companies unrelated to their core business. To address this, TM set up a separate vehicle, TM Ventures, and hired a dedicated executive to manage the portfolio, which consisted of the non-core holdings.

LEVERS FOR DISPOSING NON-CORE ASSETS AND ACTIVITIES

The key levers for GLCs to optimise performance in their non-core assets and activities include:

- Disposal of non-core assets such as real estate and car fleets
- Disposal of non-core investments—for example, partial ownership in companies without a clear link to the core business
- Disposal of non-core businesses—for example, complete businesses that could be disposed to a better owner
- Disaggregation of the core business system to carve out a non-core business or activity, either through a disposal or an outsourcing agreement.

In addition to the 'ownership restructuring' levers above, the overall risk-return profile of companies can be realigned through financial restructuring, such as asset securitisation, sale-and-leaseback and hedging.[5]

4. The Yellow Book provides an approach for determining non-core activities by considering if activities on a GLC's value chain meet business plan deliverables and also contains guidelines for implementing disposals. Exceptions for disposal of non-core assets / activities, to fulfil relevant social responsibilities, are addressed in the Silver Book.
5. The Yellow Book provides further guidelines on financial restructuring levers such as sale-and-leaseback and asset backed securitisation.

purple colour.indd 34 12/5/2006 3:03:49 PM

3-STEP TEST TO DETERMINE NON-CORE ASSET/ACTIVITY DISPOSAL

GUIDELINE 9

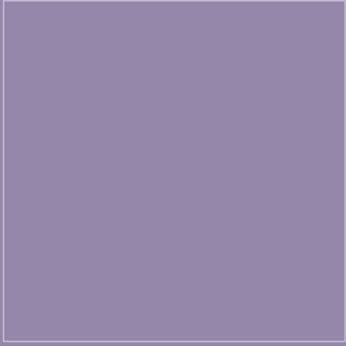
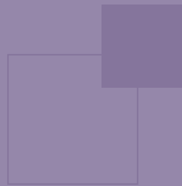
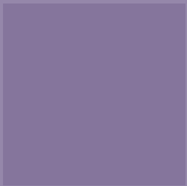
- Dispose of all non-core assets and activities by using a 3-step test—distinctive risk-return and management capabilities, impact on core business, and feasibility of value-creating disposals. *A few exceptions are outlined in the Silver and Yellow Books.*

The decision on whether or not to own a particular asset or activity can be made by considering the necessary ingredients to create value with these assets and activities—is it management focus? commercial skills? appropriate capital?—and which owner is the best to provide such ingredients. At all times, the ultimate objective is to maximise GLC shareholder value.

The Yellow Book provides guidelines for managing non-core assets and activities based on the assessment of a GLC's value chain. In addition, from the capital management perspective, the following 3-step test (see Exhibit 10) provides further guidelines to determining the ownership of a particular asset or activity.

With the ownership question clarified—that is having identified the non-core assets/activities—GLCs should then proceed to implement their disposal.

purple colour.indd 35 12/5/2006 3:03:49 PM

CHAPTER 3

HOW TO IMPLEMENT CAPITAL MANAGEMENT INITIATIVES

purple colour.indd 37 12/5/2006 3:03:50 PM

purple colour.indd 38 12/5/2006 3:03:50 PM

CHAPTER 3 HOW TO IMPLEMENT CAPITAL MANAGEMENT INITIATIVES

GUIDELINES 10, 11 and 12

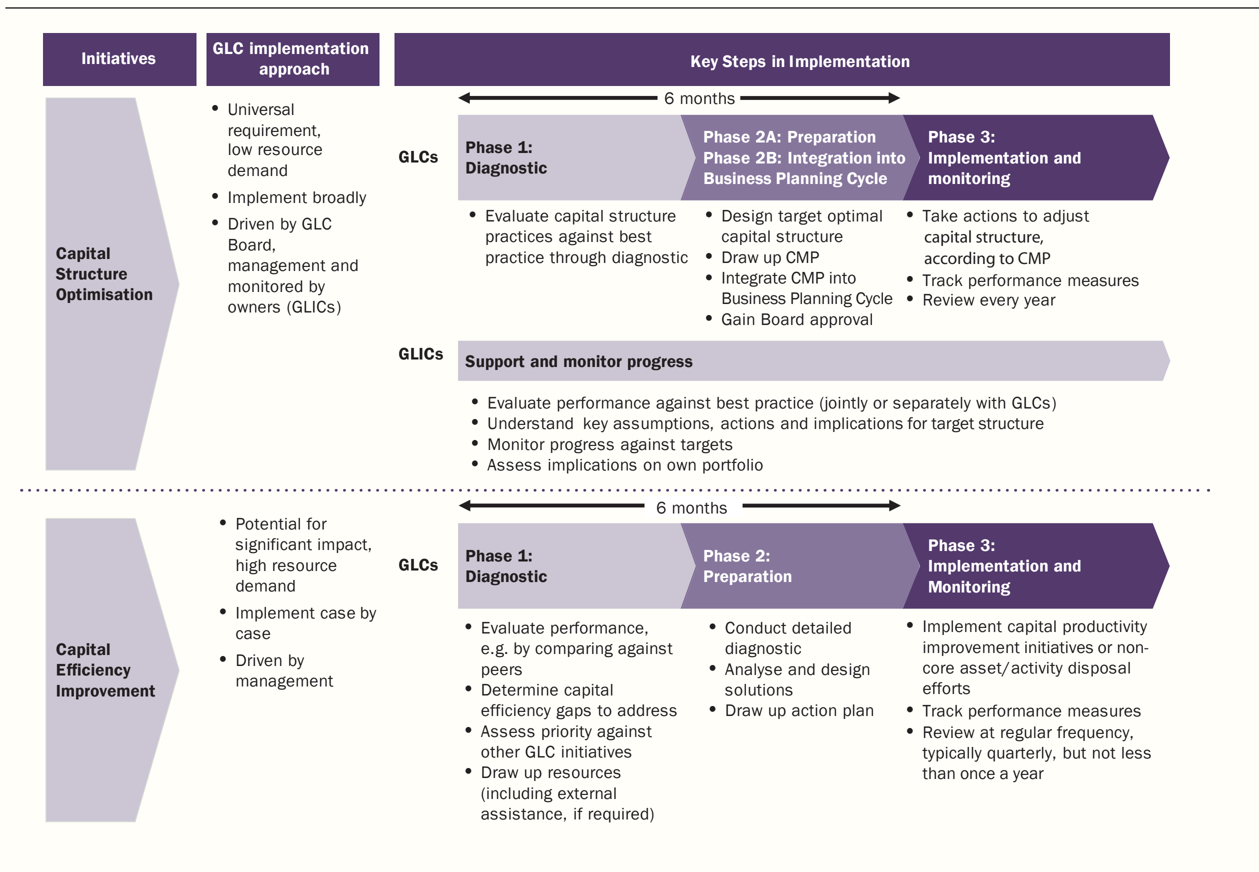
- Design and launch capital management initiatives as part of corporate strategy plans. *Initiatives for optimising capital structure to be adopted by all GLCs; initiatives for capital efficiency to be adopted more selectively.*
- Actively monitor performance measures and other financial parameters that link back to the capital management initiatives.
- Take full responsibility for implementing and following-up on initiatives, which are driven by the CEO and typically championed by the CFO. *GLICs may provide active support and expertise as appropriate.*

This chapter sets out how to implement the two types of capital management initiatives addressed in this book: optimising capital structure and improving capital efficiency. Although each will follow its own approach and timeline, they both share the same three fundamental phases (See Exhibit 11):

1. Diagnostic of current performance
2. Preparation of capital structure/efficiency plan
3. Implementation and monitoring of progress.

EXHIBIT 11

IMPLEMENTING CAPITAL MANAGEMENT INITIATIVES



purple colour.indd 39 12/5/2006 3:03:50 PM

GLC CEOs should spearhead the implementation of capital management initiatives at their organisations. Exhibit 12 sets out key actions that the CEO, with the support of a project champion, should take immediately after the launch of the Book. With the CEO as the driving force, the capital management initiatives will:

- Gain the support of, and approval from, the Board
- Be viewed as a business and strategic priority that garners appropriate internal support and resources
- Achieve immediate and sustainable traction within the GLC.

EXHIBIT 12

CEO'S ACTIONS TO IMPLEMENT CAPITAL MANAGEMENT INITIATIVES

Phase	Main areas to address	CEO actions
1. Diagnostic	Appoint internal project champion	Assign roles and responsibilities and clarify mandate of project champion, who will typically be the CFO
	Validate diagnostic findings	Validate diagnostic evaluation (led by project champion) of current capital structure practices against best practice and capital efficiency performance against peers or other benchmarks
	Determine priority of capital management initiatives	• Establish priority of capital management initiatives vis-à-vis other GLC Transformation initiatives • Determine priority capital structure and capital efficiency initiatives using this Book as a guide • Set the scope of implementation
2. Preparation	Allocate appropriate resources	Align with project champion on required resources and approve identified external help, if required
	Approve high-level timelines, targets and reporting frequency	After necessary analysis to plan and design initiative deliverables (led by a project champion), obtain alignment from project champion on: • Initiative timelines • Target KPIs • Expected benefits • Reporting frequency to top management and Board
	Gain Board approval	Brief Board and obtain its approval on milestones, targets and ownership for the capital management initiatives
3. Implementation and Monitoring	Track performance measures	Establish programme management plan with milestones, targets and associated responsibilities
	Conduct thorough review	Oversee thorough review of capital structure and capital efficiency performance with appropriate frequency

purple colour.indd 40 12/5/2006 3:03:51 PM

CHAPTER 3.1: IMPLEMENTING CAPITAL STRUCTURE INITIATIVES

Optimising capital structure is a universal requirement that usually requires fewer resources. For this reason, the implementation approach set out here will be broadly applicable to all GLCs. Specifically, GLCs will need to embark on three major phases of implementation.

The requirements of each phase are generally applicable to all GLCs. However, GLCs are likely to already have existing plans that relate to capital structure and as such, the extent and nature of implementation of requirements for each phase will differ according to their respective situations.

Phase 1: Diagnostic—Review current practices by using a diagnostic exercise. Identify gaps in current practices from the best practice guidelines set out in this Book. An example gap analysis is shown in Exhibit 15.

Phase 2A: Preparation—Revisit the existing capital-related plan by performing the *4-step Cash Flow Analysis*. Existing business plans can be used as a basis and source of information. A preliminary CMP should be drafted at this phase. The CMP should serve as the GLC's primary document on its capital structure, consisting of design and analyses (to design optimal capital structure), action plan (to achieve target capital structure) and continuous improvements (see Exhibit 13). It should also consider any steps required to address gaps identified in Phase 1. Phases 1 and 2A should be completed by 30 June 2007.

EXHIBIT 13

OUTLINE OF A CAPITAL MANAGEMENT PLAN

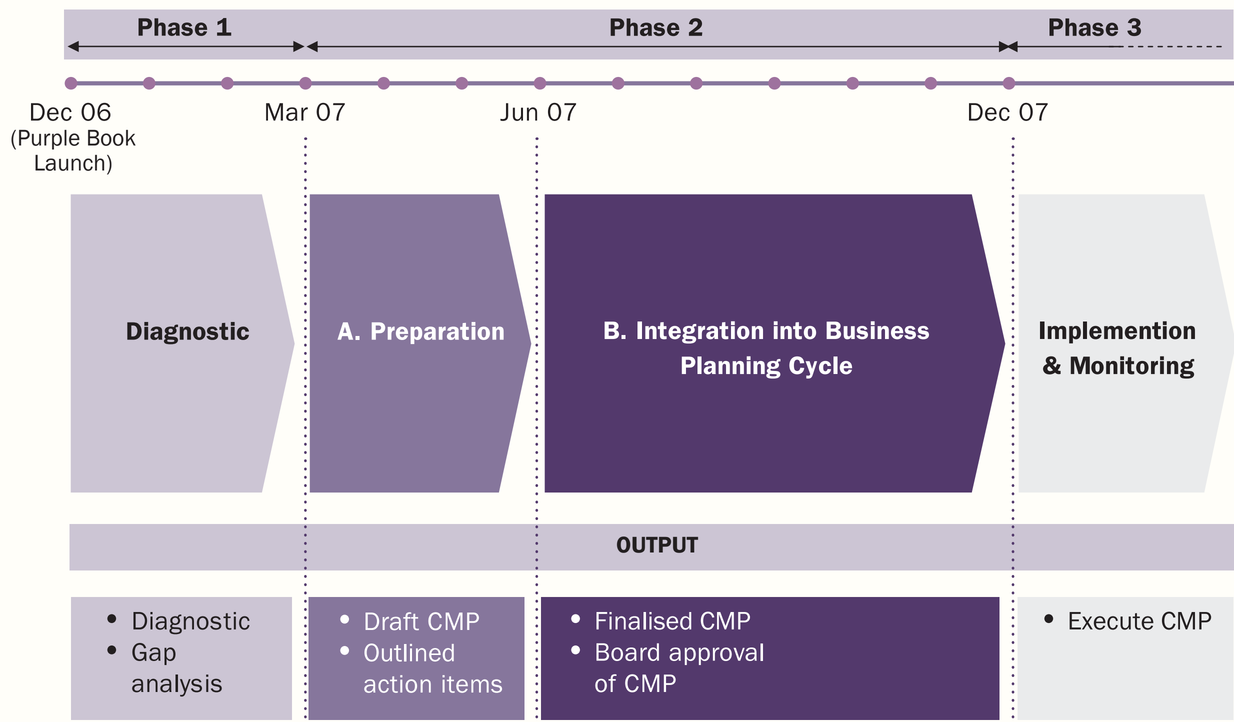
Section	Area
1.	**Design and analysis** • Financial forecasts to estimate financing deficit/excess • Target capital structure (via credit rating or other financial ratios) • Scenario analysis to develop and test target capital structure
2.	**Action plan** • Actions needed to make the capital structure adjustments • Timeline and sequencing for implementing those actions • Approach for undertaking the required transactions in the capital markets
3.	**Continuous improvements** • Performance measures to monitor progress • Addressing possible gaps versus best practices

Phase 2B: Integration into Business Planning Cycle—Finalise the CMP in the immediate next business planning cycle. This may include updating the *4-step Cash Flow Analysis*. Obtain Board approval of CMP—this will typically be done together with the approval of the Business Plan. Companies with financial year ending 30 June should complete Phase 2B by June 2007. Application of the phases for a company with financial year ending 31 December is shown in Exhibit 14.

purple colour.indd 41 12/5/2006 3:03:51 PM

EXHIBIT 14

EXAMPLE OF AN IMPLEMENTATION TIMELINE FOR A COMPANY WITH A 31 DECEMBER YEAR-END



purple colour.indd 42 12/5/2006 3:03:51 PM

EXHIBIT 15

EXAMPLE OF A CAPITAL MANAGEMENT GAP ANALYSIS

Topics	Assessment* (Lagging 1 – 2 – 3 Best Practice)	Rationale for assessment	Potential action steps to address gaps
1. Assessment, design and review of optimal capital structure	3	• Utilise a structured cash flow-based method to design capital structure • Review capital structure annually	• Thoroughly design and review capital structure every 3 years
2. Internal processes to ensure accurate and timely financial forecasts	3	• Financial forecast part of regular business planning and budgeting process • Financial forecasts take into account all relevant drivers of financing situations, including key components of operations, financing and investment cash flows	• Continue current actions
3. Benchmarking process and credit rating proxies	3	• Have an explicit target credit rating • Have target financial ratios • Benchmark against peer group • Also use other metrics based on credit rating agency criteria	• Maintain rigorous and repeatable benchmarking process to determine meaningful proxies
4. Dividend policy	2	• Have an internally explicit but irregular dividend policy	• Formalise dividend policy within top management and Board
5. Excess capital	1	• Keep excess capital on balance sheet • Do not always distribute back to shareholders	• Consider all options to distribute excess capital to shareholders
6. Evaluation and selection process of financing options	2	• Explore all financing options • Never explored Islamic financing	• Include Islamic finance when assessing financing options
7. Process for capexmanagement and ownership at each level of the organisation	1	• Not embarked or planning to embark on capex improvement initiatives	• Adopt an established process for improving capex management
8. Process for working capital management	1	• Have not recently embarked on working capital management improvement initiatives • Working capital levers not incorporated into the KPIs of the CFO and his direct reports	• Embark on A/R, A/P initiatives with CFO-led cross-functional team • Levers incorporated into relevant KPIs
9. Non-core asset and/or activity disposal	2	• Have previously addressed issue of non-core asset/activity disposal • Not identified parts of business, that have distinct risk-return profiles or management capabilities	• Employ 3-step non-core asset disposal test
10. Design and launch of capital management initiatives	2	• Capital management initiatives currently part of annual corporate strategy plans • Initiatives not championed or driven by top management and/or Board	• Project champion to be appointed and top management and Board to drive and monitor initiatives
11. Monitoring of performance measures and other financial parameters, with respect to the balance sheet, that link back to capital management initiatives	1	• Progress or performance of capital management initiatives not monitored actively	• Begin active monitoring process of capital management initiatives
• For capital structure-related initiatives	1	• No clarity on progress to designed plan	• Measure progress towards the desired credit rating or target coverage ratio
• For capital efficiency-related initiatives	1	• Do not measure capexefficiency by benchmarking capital turnover, and other capital efficiency ratios, against peers/competitors and against past capex projects	• Measure capex, working capital efficiency by employing robust benchmarking process
12. Responsibility for implementation and follow-up	1	• No top management champion of capital management initiatives	• Appoint CFOas champion for implementing and following-up these initiatives • Seek support and expertise from GLICs, as appropriate

*The assessment ratings are as follows:
1 Do not fulfill most guidelines as set out in this Book.
2 Fulfills some guidelines as set out in this Book.
3 Fulfills all guidelines as set out in this Book. In fulfilling these guidelines, GLCs are expected to implement them, as well as ensure they achieve the intended input—for e.g. conducting the 4-step Cash Flow Analysis and ensuring that meaningful management insights are incorporated to make this analysis robust.

purple colour.indd 43 12/5/2006 3:03:52 PM

Phase 3: Implementation and Monitoring—Implement actions identified in the CMP. It is expected that funding actions will be implemented as and when they are required. Formalised dividend policy should be implemented as soon as practicable. GLCs should monitor progress annually by tracking performance measures that may include:

- Robustness of capital structure—mitigating risk of cash flow volatility and forecasting inaccuracies
- Progress towards the desired capital structure—that is, credit rating or target coverage ratio
- Management of market reaction to adjustments through a well planned and communicated process.

To fulfil their duties in making the necessary capital management improvements and ensure sufficient progress, the GLC Board and management can use a checklist, an example of which is shown in Exhibit 16.

As active owners, GLICs should support and monitor progress of the implementation process at each phase, by:

- Evaluating performance of existing GLC capital management practices (jointly or separately with GLCs)
- Understanding and challenging the key assumptions and implications of the determined target capital structure
- Monitoring progress of GLCs against targets
- Assessing the implications of the capital structure optimisation on its own portfolio.

purple colour.indd 44 12/5/2006 3:03:53 PM

EXHIBIT 16

EXAMPLE OF A CAPITAL MANAGEMENT INITIATIVE CHECKLIST

Key focus areas	Key tasks to be completed by (insert GLC name)	Completed		Rationale/ references
		Yes	No	
Capital structure initiatives	1. Financial forecast to estimate financing surplus/deficit performed			(Please attach relevant exhibits and supporting documents)
	2. Target credit rating and other financial ratios such as interest coverage, debt/equity and other relevant ratios set with minimum and maximum thresholds			
	3. Baseline, aggressive and downside scenarios developed			
	4. Target capital structure developed and tested using scenarios			
	5. For funding deficit, Islamic finance considered			
	6. For funding surplus, how much and when to distribute to shareholders evaluated (including establishing formalised dividend policy)			
	7. Actions to achieve target optimal capital structure determined and under implementation			
Capex management initiatives	1. Capex management benchmarking/peer analysis conducted			
	2. Based on results of diagnostics, a capex management initiative developed			
	3. Capex management function re-organisation (if necessary) underway			
Working capital initiatives	1. CFO-led taskforce with cross-functional participation formed peers/benchmarks			
	2. Based on results of diagnostics, a working capital management initiative developed			
	3. Working capital levers incorporated into the KPIs of the CFO and his/her direct reports			
Non-core asset/activity disposal	1. Separate and distinct (in terms of risk-return profile and management capability) parts of the business identified			
	2. Impact of each distinct activity/asset on core business considered (i.e. synergies or potential implications on other parts of the business)			
	3. Feasibility of achieving disposals that successfully deliver the anticipated value creation potential considered and analysed			
Capital targets	1. Target for KPIs set and endorsed by the Board			
	2. KPI 'owners' identified			
	3. Frequency for monitoring progress established			

We hereby acknowledge that the above is true and that proper analyses have been performed to ensure that targets above are relevant for the organisation. We also acknowledge that the above has been fully endorsed by the Board of Directors.

Signed: ______________________
CEO

Signed: ______________________
Chairman, Board of Directors

Date:

Date:

purple colour.indd 45 12/5/2006 3:03:53 PM

CHAPTER 3.2: IMPLEMENTING CAPITAL EFFICIENCY INITIATIVES

Capital efficiency improvement initiatives should be implemented by GLCs on a case by case basis. Although there is clearly the potential for significant impact, this will usually require a higher degree of resource allocation compared with capital structure. The three phases (introduced in Exhibit 11) are as follows:

Phase 1: Diagnostic—Assess the GLC's performance in capital efficiency across capex, working capital and non-core assets and activities. Exhibit 15 provides an example of such a gap analysis. Based on their assessed gaps and improvement potential, GLCs should prioritise which areas of capital efficiency, if any, they need to address. They should also consider other planned initiatives and improvement actions and ensure there are enough resources to pursue the desired capital efficiency improvements.

Phase 2: Preparation—Design the capital efficiency improvement initiatives. This would likely include: conducting detailed diagnostic, analysing and designing solutions as well as drawing up an action plan. As with capital structure optimisation, GLCs must ensure that appropriate capabilities, tools and work plans are in place to facilitate implementation. GLCs should complete their assessment of current performance and launch capital efficiency initiatives as needed by June 2007.

Phase 3: Implementation and monitoring—Implement the identified initiatives for capex efficiency, working capital efficiency or non-core asset or activity disposal immediately after Phase 2. GLCs should monitor progress, at a regular frequency (typically quarterly but not less than once a year), by tracking pertinent capital efficiency performance measures such as:

- Capex efficiency as measured by capital turnover and other capital efficiency ratios against peers and competitors, and against past capex projects
- Working capital efficiency as measured by analysing working capital performance against peers and benchmarks.

The capital management initiative checklist, shown in Exhibit 16, can also be used by GLC Board and management to guide implementation progress.

purple colour.indd 46 12/5/2006 3:03:53 PM

EXHIBIT AND TEXT BOX LIST

Exhibit 1	Creating value through higher ROIC and optimal cost of capital
Exhibit 2	Relationship between WACC and capital structure
Exhibit 3	Optimising capital structure can be approached in 4 steps
Exhibit 4	GLCs must conduct accurate and robust financial forecasts
Exhibit 5	Testing target capital structure using scenarios
Exhibit 6	TM evaluated transaction costs of a variety of equity distribution options
Exhibit 7	Evaluating signalling effects of managing capital deficit/excess
Exhibit 8	The Pyramid Approach to improving capex efficiency
Exhibit 9	Three levers for improving A/R and A/P performance
Exhibit 10	3-step test to determine non-core asset/activity ownership and disposal
Exhibit 11	Implementing capital management initiatives
Exhibit 12	CEO's actions to implement capital management initiatives
Exhibit 13	Outline of a capital management plan
Exhibit 14	Example of an implementation timeline for a company with a 31 December Year-End
Exhibit 15	Example of a capital management gap analysis
Exhibit 16	Example of a capital management initiative checklist
Text Box A	Capital management for conglomerates
Text Box B	Basic principles of investor relations
Text Box C	Developing a formalised dividend policy
Text Box D	Examples of Islamic Finance as a potential funding source

purple colour.indd 47 12/5/2006 3:03:53 PM

ACRONYMNS AND ABBREVIATIONS

A/P	Accounts Payable
A/R	Accounts Receivable
BCHB	Bumiputra-Commerce Holdings Berhad
BU	Business Unit
CAPEX	Capital Expenditure
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CMP	Capital Management Plan
CSO	Chief Strategy Officer
GLC	Government-linked Company
GLIC	Government-Linked Investment Company
EBIT	Earnings Before Interest and Taxes
EBITDA	Earnings Before Interest, Taxes, Depreciation and Amortisation
FCI	Framework for Continuous Improvement
IR	Investor Relations
KPI	Key Performance Indicator
MAS	Malaysian Airline System Berhad
MIFC	Malaysia International Islamic Financial Centre
MNC	Multi-national Corporation
MTN	Medium Term Note
NI	Net Income
NOPLAT	Net Operating Profit Less Adjusted Taxes
NPV	Net Present Value
PCG	Putrajaya Committee on GLC High Performance
PLUS	Projek Lebuhraya Utara-Selatan Berhad
ROIC	Return on Invested Capital
SEDC	Sarawak Economic Development Corporation Berhad
TM	Telekom Malaysia
WACC	Weighted Average Cost of Capital

purple colour.indd 48 12/5/2006 3:03:53 PM

ACKNOWLEDGEMENTS

The PCG would like to thank the following for their support and input into the development of this book.

BI Walden Management Ketiga Sdn Bhd

Boustead Holdings Berhad

Chemical Company of Malaysia Berhad

CIMB Group Berhad

Employees Provident Fund

Golden Hope Plantations Berhad

Khazanah Nasional Berhad

Kumpulan Guthrie Berhad

Lembaga Tabung Angkatan Tentera

Lembaga Tabung Haji

Malayan Banking Berhad

Malaysian Airline System Berhad

Malaysia Airports Holdings Berhad

Malaysian Resources Corporation Berhad

McKinsey & Company

Ministry of Finance

Penerbangan Malaysia Berhad

Permodalan Nasional Berhad

PLUS Expressways Berhad

Prime Minister's Office

Silterra Malaysia Sdn Berhad

Sime Darby Berhad

Telekom Malaysia Berhad

Tenaga Nasional Berhad

TH Plantations Berhad

UEM World Berhad

purple colour.indd 49 12/5/2006 3:03:54 PM

purple colour.indd 51 12/5/2006 3:03:54 PM

Putrajaya Committee on GLC High Performance (PCG)
Transformation Management Office,
Level 37, Tower 2, Petronas Twin Towers,
Kuala Lumpur City Centre,
50088 Kuala Lumpur, Malaysia
Tel: +(603) 2034 0000 Fax: +(603) 2034 0008
Email: pcg@treasury.gov.my Website: www.pcg.gov.my