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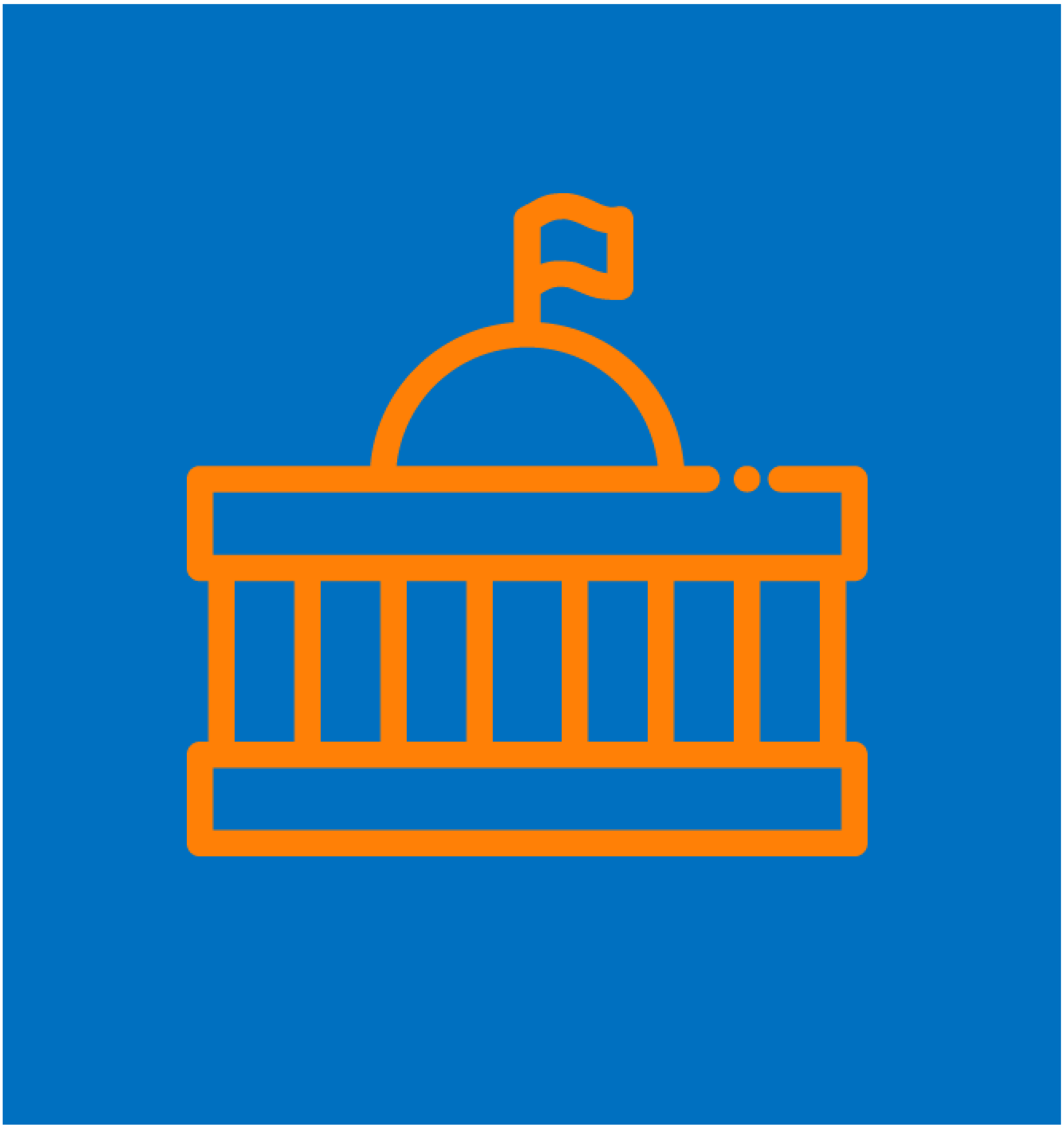
Holding Company for SOEs: Learnings for Sri Lanka



Key Takeaways

- Establishing a super-holding company model in Singapore and Malaysia (Temasek and Khazanah) has led to impressive performance of SOEs.
- This has allowed the government to not only have an arms-length approach for its SOEs but to also use their energy and budget elsewhere.
- Temasek and Khazanah have contributed to the government coffers through dividends as well as through other projects and initiatives.
- Key learnings for Sri Lanka include; operating as private companies under the Companies Act, utilizing a crisis to reform and ensuring strong Corporate Governance

Introduction

A super-holding company for managing State-Owned Enterprises (SOEs) has been identified as a globally successful model for SOE management. This model allows the government to adopt a more arms-length approach to SOEs' operational decision-making, relieving it of the direct responsibility of overseeing all the SOEs dispersed across various industries, and redirect its budget and energy elsewhere. The merits of this model have enabled countries such as Malaysia and Singapore, which have similar holding company structures, to achieve great performances of their SOEs.

This piece is a three-part series where part one and two would follow an in-depth analysis of the case of Singapore's and Malaysia's SOE holding company models (Singapore's Temasek Holdings and Malaysia's Khazanah Nasional), and their role in enabling economic growth and development for the respective countries. Part three will provide learnings for Sri Lanka, which can be adopted for the country's SOE reform process.

Part One: Singapore's Temasek Holdings

Overview

Temasek was incorporated in 1974 under the Singapore Companies Act to hold and manage assets previously held by the Singapore Government. The objective of transferring assets to a commercial company was to free the Ministry of Finance of the responsibility so that it could focus on its core role of policymaking and regulations, while Temasek would own and manage these SOEs (also known as Government-linked Companies – GLCs) on a commercial basis.

Similar to any commercial company, Temasek has its own Board of Directors and a professional management team. It pays taxes to the government and distributes dividends to its shareholder.

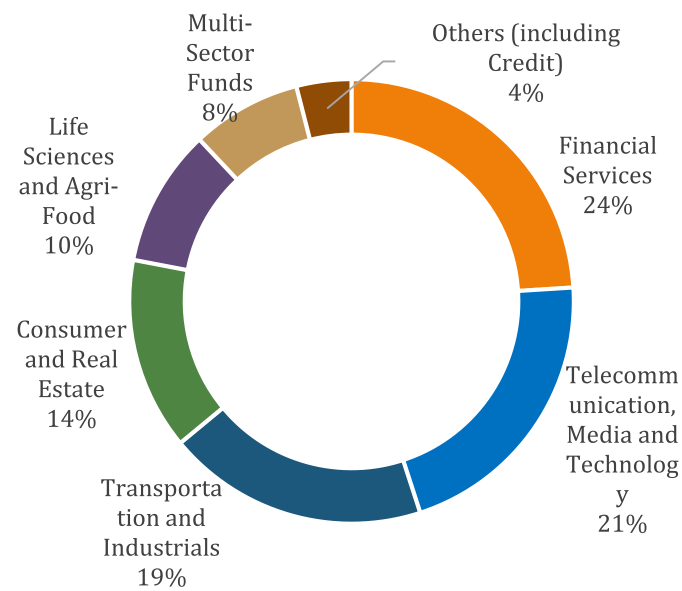
Temasek was established to contribute to Singapore's economic growth by nurturing SOEs into world-class companies through effective stewardship and strategically driven commercial investments. Today, it operates in 9 countries and its portfolio value amounted to SGD 381 billion as at the end of March 2021. This is equivalent to around USD 283 billion, which is about 6 times of Sri Lanka's external debt accumulated over the years and about 4 times the amount of Sri Lanka's Gross Domestic Product (GDP).

Temasek invested mainly in Singaporean companies in its early days, but it has turned into a major global investor in recent years. Geographically, the majority of these investments are in China (27%) followed by Singapore (24%), America (20%) and rest of the world (12%). Temasek operates a diversified portfolio spread across many segments such as Financial Services, Telecom, Media, Technology and Transportation and Industry. Please refer figure 01 for a breakdown of sectors.

Figure 01: Breakdown of Temasek's Portfolio in 2021

SGD 381 Billion

as at March 2021



Source: Temasek Holdings

Why was Temasek Successful?

SOEs are generally regarded as inefficient firms because of political interference, and corruption. Despite this, various studies[1] have shown that Singaporean SOEs exhibit higher valuations than non-SOEs, even after controlling for firm specific factors and also have better corporate governance practices.

[1] This include a research paper done by Singapore Management University and a working paper done by National University of Singapore

The reasons for this lies in the political, social and economic context that Singapore faced during the period of self-governance to the early years of independence from the late 1950s to the early 1970s. The difficult economic conditions coupled with a challenging political environment in Singapore during this period played a significant role in nurturing good political governance in Singapore, which was in turn transposed to Singapore's SOEs with good corporate governance practices. The Temasek corporate governance framework covers the following broad areas:

1. Board Governance

Temasek aims to help SOEs build effective boards by setting out guidelines on the appropriate composition of board, tenure of the directors, their size, and formation of specialized board committees.

2. Business Charters

Temasek encourages SOEs to stay focused on their core competencies and it will not disapprove SOEs diversifying if it is done in the best interest of its shareholders.

3. Talent and Remuneration

Temasek encourages SOEs to recruit the best global talent and to reward them competitively.

4. Value Creation

Temasek works closely with their SOEs to adopt appropriate performance benchmarks to maximize returns on shareholder investments. It expects its companies to be profitable and generate a high rate of return on investment like any shareholder.

Therefore, Temasek's stewardship has enabled SOEs to create value for their shareholders. This has led to the SOEs on average demonstrating higher valuations than non-SOEs, even after controlling for firm specific factors such as profitability, leverage, firm size, industry effect, and foreign ownership.

<u>How has it Contributed to Development Goals?</u>

Temasek is a government holding company that acts as a shareholder on behalf of the Singaporean government (Ministry of Finance). It pursues its developmental mandate by buying direct stakes in global companies, mostly in Singapore and Asian, and then reinvesting its proceeds from asset sales and dividend income into foreign assets, acting similar to a private equity fund.

The arms-length approach from the government has made it possible for Temasek to manage its financing and exercise independence. Temasek hasn't received any regular financing from the government in its close to 50-year history, but receives ad-hoc occasional injections from time to time, which are publicly disclosed.

The compounded annualised total shareholder return since inception in 1974 is at 14% in Singapore dollar terms. The Temasek foundation oversees 23 non-profit philanthropic projects, and has positively impacted 1.5 million lives across Asia and Singapore through their community work.

Contribution to Reserves

In terms of the contributions to the Singaporean economy, the Singapore government can include around 50% of Temasek's expected long term returns along with the Government of Singapore Investment Corporation (GIC) and Monetary Authority of Singapore (MAS) investment returns. These three institutions contribute to government reserves through the Net Investment Returns Contribution (NIRC). NIRC is comprised of up to 50% of the Net Investment Returns (NIR) on the net assets invested by GIC, MAS and Temasek, and the Net Investment Income (NII) derived from past reserves from the remaining assets.

The NIRC is estimated to be at SGD 21.56 billion for the financial year of 2022, and helps the government to make further long term investments in sectors such as in Education, Research and Development (R&D), and Healthcare.

Since 2016, the NIRC has been the single largest contributor to government coffers, overtaking corporate and personal income tax, and goods and services tax (GST), which are the next three largest sources of tax revenue in Singapore.

In 2021, NIRC contribution to government revenue stood at 20% while corporate income tax stood at 19%, personal income taxes at 13%, and the goods and services tax at 12%. This helped to fund COVID-19 support measures such as the job support scheme, the care and support package, alongside other long term initiatives such as enhancing Singapore's education, healthcare, transport and social support systems listed in the national budget.

There are very few countries in the world, which have national savings they can tap into, in order to fund their budgets, and it is especially rare for a country like Singapore, which has no natural resources. This endowment, saved over time through hard work and discipline, has enabled the government to ensure fiscal strength. This fiscal strength has allowed the Singaporean government to support strategic entities such as Singapore Airlines and Changi Airport through cash injections during the pandemic.

Part Two: Malaysia's Khazanah Nasional Berhad

Overview

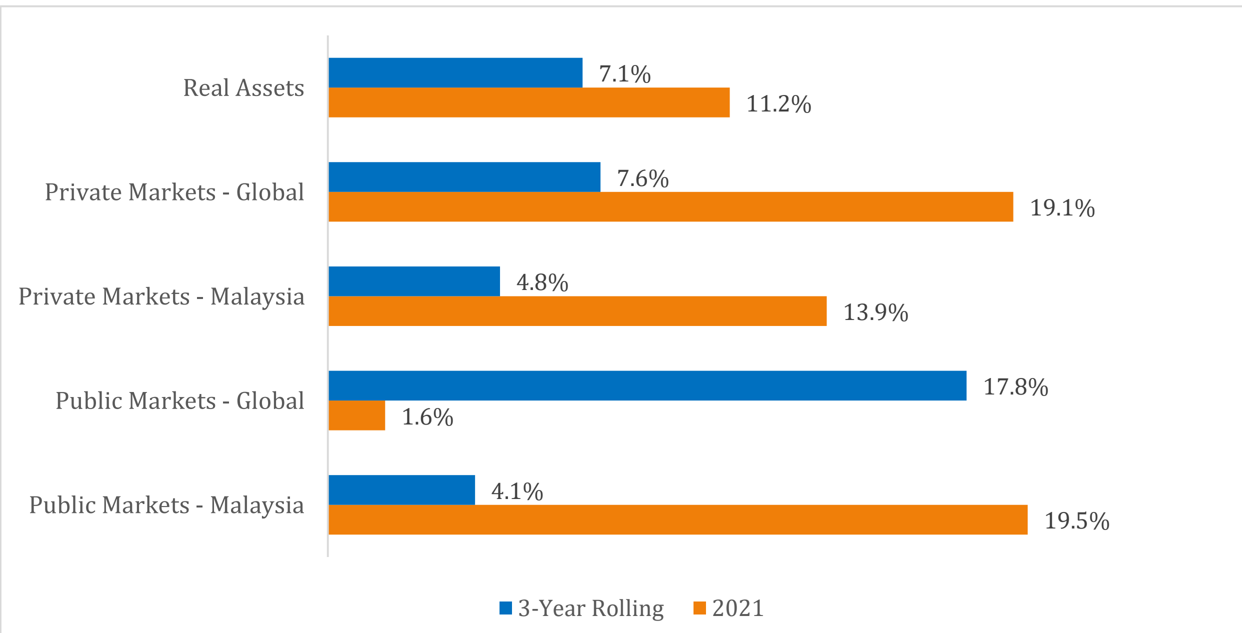
Khazanah is a Malay word that originated from an Arabic word, which means 'treasure' so, Khazanah Nasional translates to 'national treasure'. Khazanah was incorporated under the Companies Act in Malaysia in 1993 as a public limited company, that manages state assets in selected sectors on behalf of the Malaysian government. It also takes investment decisions on behalf of the government, including listing, divestment, and acquisition of shares.

To balance the dual objectives required by the Malaysian economy, two separate funds have been established, namely; Commercial Fund (CF) and the Strategic Fund (SF) with distinct objectives, policies and strategies.

The SF undertakes investments to deliver impactful and measurable economic and societal returns for Malaysian economy and its people, while CF focuses on investing responsibly and commercially to preserve and grow the long-term value of assets.

The CF generated a three-year rolling Time-Weighted Rate of Return (TWRR) of 7.0% against the targeted return of the Malaysian Consumer Price Index (CPI) at 3% on a five-year rolling basis. In 2021, the TWRR stood at a significant 19%. This was led by asset classes such as global private markets and public markets in Malaysia, which outperformed in 2021 when compared to the 3 year rolling of 7.6% and 4.1% respectively of the same asset classes (refer figure 02).

Figure 02: CF Portfolio Annual Return by Asset Class



Source: Khazanah Nasional Berhad

The two funds were valued RM 106 billion (around USD 25 billion) and RM 28 billion (around USD 7 billion) for CF and SF, respectively at the end of 2021. A majority of the investments (63.5%) were made within Malaysia, with the rest in China (14.8%), Asia – excluding China (12%), and around 10% in Europe, the Middle East, Africa (EMEA) and North America by the end of 2021.

Consumer Goods, Energy, Financials, Healthcare, Industrials, Information Technology, Media, Real Estate, Telecommunications and Utilities are among the sectors Khazanah has invested in.

Why was Khazanah Successful?

Post the Asian Financial Crisis, most SOEs in Malaysia were not performing well. To address this Khazanah was revamped in 2004 to play an active role from the previous passive role to enable efficiency and to drive growth of the SOEs. This was coupled with major corporate restructuring and institutional reforms through the GLC Transformation Program (2005-2015) for which Khazanah functioned as the secretariat.

The revamp shifted Khazanah's focus from a Sovereign Wealth Fund (SWF) to a Sovereign Development Fund (SDF). The salient feature of a SDF is that it not only delivers high financial performance but also fosters development. Today, Khazanah comprises of two funds (CF and SF), which aims to achieve the dual objectives and its total Net Asset Value (NAV) has grown from RM79 billion to RM86 billion in 2021. The 10 key factors that were critical to its success are outlined below[2]:

1. Clear Objectives

Khazanah focused on three clear objectives to drive its financial, economic and societal returns as given below.

1) **Performance** – focusing on corporate restructuring to improve efficiency, productivity and value creation. This was achieved by issuing guidelines on KPIs and anchoring KPI's to performance. Relevant KPIs were developed together with appropriate benchmarks and targets, and rewards were linked to performance coupled with time based contracts such as 3-year contracts. This was also enabled through reconstituting the senior management and implementing board composition reforms.

2) **National Development** – focusing on national development goals such as creating jobs and economic multipliers. Supporting government policy formation and adopting a long-term view in catalysing social progress in Malaysia to deliver high social impact in communities.

3) **Good Governance** –took a holistic and multipronged approach to measure how public institutions conduct and manage public resources.

2. National Support

A degree of national consensus is vital with all relevant stakeholder groups involved and powered by political will. The reform process was carried out over 10 years from 2005 onwards where the reform

[2] For more details, this can be accessed at; https://www.youtube.com/watch?v=GJql48ag0Zw

of Khazanah started under the 4th Prime Minister of Malaysia, the GLC Transformation (GLCT) Programme under the 5th Prime Minister and continued under the 6th Prime Minister.

3. Communications, transparency, public accountability

Transparency and consistent periodic reporting are vital to the success of the programme. KPIs were announced publicly with regular public updates, with internal KPIs being identical to external KPIs. This was followed by consistent and relevant stakeholder engagement across multiple categories.

4. Active, competent, and empowered Holding Company

Khazanah was revamped as an active and strategic SDF (Sovereign Development Fund). Khazanah was also tasked to come up with an overarching programme for other funds from 2005 to 2015. This programme was known as the GLC Transformation Program (GLCT) with Khazanah acting as its Secretariat.

5. A robust Programme Management approach over 10 to 15 years

The GLCT Programme was carried out for 10 years with a careful designed implementation structure. It consisted of 22,981 man days of programme management and 29 meetings were chaired by the Prime Minister to review progress over the 10-year period. It is imperative to stay the course since the prize of seeing it through and the price of not doing so is large. However, it must be ensured that it's done correctly.

6. Talent and Leadership

Right leadership is critical. Therefore, the Chief Executive Officer. the Board and the Senior Management should be selected under specified criteria to appoint individuals based on their capacity and knowledge to deliver in their role. This should also be followed by a robust selection process.

7. Transformation Acupuncture

Targeted 10 critical areas for improvement in corporate restructuring in key companies. The critical areas included Board governance, CSR, procurement, leadership development, performance based compensation, regulation, operational improvement and finance.

8. Accountability

This included headline KPIs, performance-based compensation, senior management limited to 3-year performance based contracts and a robust appointment process, emulating a carrot and stick approach.

9. Getting key sectors right in terms of the policy mix

It is important to identify the critical sectors such as electricity, telecom, banks, aviation, infrastructure, etc. that play a vital role in the economy. Planning the sector strategy, regulation, pricing, social policy, etc. for the selected sectors instead of reforming all the sectors will also divert resources to effective and efficient use.

10. Using the levers of ownership, financing and controls

Sorting between principally commercial and principally social enterprises is also pertinent. Understanding which particular category enterprises come under will provide clarity on how to run these enterprises such as whether to list or delist, to conduct partial or full asset sales and to understand the required capital structure controls, debt discipline, and external audits.

<u>How has it contributed to Development Goals?</u>

Khazanah's principal funding is from shareholder equity. It utilises debt financing and proceeds from divestment activities to fund its investment activities. Khazanah's ultimate holding body and hence the sole shareholder, is the Ministry of Finance (MoF).

In terms of contribution, between 2004 and 2021, Khazanah paid RM15.6 billion in dividends to the government (or MoF) averaging RM 1.3 billion a year over the past five years. Dividends of RM2 billion each had been declared in 2020 and 2021.

Investment income contributed to 16.3% of total government revenue in 2021, of which Khazanah contributed to about 6% of investment income through its dividends. Though the contribution to government revenue through dividends remains marginal when compared to other tax revenue streams, Khazanah continued to deliver societal value and impact through various other initiatives.

During the pandemic, RM20 million was contributed by Khazanah as COVID-19 relief to the government. Therefore, Khazanah acts as a buffer against future pandemics and can assist the government in its relief measures.

One of Khazanah's foundations - Yayasan Hasanah - directly and indirectly assisted 1.5 million people through COVID-19 relief efforts and various other programmes, with an allocation of RM554 million in 2021.

The Khazanah Research Institute was set up to undertake analysis and research on the pressing issues of Malaysia, and based on the research, it provides policy recommendations to improve the well-being of Malaysians. A total of 30 publications were released in 2021.

Khazanah also works on development projects for the improvement of the Malaysian economy. This includes Dana Impak, which is a newly created project with an allocation of RM6 billion over 5 years. This is carried out to increase Malaysia's economic competitiveness and build national resilience. This focuses on 6 areas namely; digital society and technology hub, quality health and education for all, decent work and social mobility, food and energy security, building climate resilience, and competing in global markets.

Part Three: Learnings for Sri Lanka

3 key learning for Sri Lanka;

- Operating as private companies under the Companies Act
- Utilizing a crisis to reform
- Strong Corporate Governance

There are a multitude of reasons as to why the Temasek and Khazanah models were successful. One of the main reasons is that both Temasek and Khazanah are registered as companies under the Companies Act of the relevant countries, subjecting the holding companies to the same requirements as a private sector business.

Another parallel that can be drawn, is from the economic crisis Sri Lanka is currently facing. It was noted that both Singapore and Malaysia faced a crisis period that enabled the formation of Temasek and revamping of Khazanah for reforms to take place. Singapore's political and social environment during the late 1950s to the early 1970s during which it obtained independence from the British rule, was a major factor in the development and governance of SOEs. The harsh economic conditions coupled with a challenging political environment in Singapore during this period played a significant role in nurturing good political governance in Singapore, which was in turn transposed to the SOEs.

In Malaysia, though Khazanah was established in 1993, it did not play an active role until the Asian financial crisis. Following this crisis, the inefficiencies and suboptimal performance of SOEs were deeply felt by the Malaysian economy. This led to the major transformation of Khazanah along with major corporate restructuring and institutional reforms to SOEs.

One of the main the reasons for the success of Singapore's Temasek model is based on its impressive track record of corporate governance. The World Bank on many occasions has recognised Singapore as having the best regulatory and economic environment in the world for doing business. Other institutions such as Transparency International and the Asian Corporate Governance Association too have repeatedly ranked Singapore as having the best corporate governance and lowest levels of corruption in Asia.

Singapore's leading rankings suggest that it may be a poster child for the Western model for good corporate governance. However, if one drills down, going beyond the rankings, it will become apparent that Singapore's corporate governance model is distinctly different from Western principles of corporate governance.

A majority of Singapore's largest listed companies are SOEs, which account for almost 37% of the capitalisation of the Singapore Exchange Limited (SGX). Hence, the Singapore government is by far the most powerful shareholder. This is incongruent with Western principles of market-oriented and shareholder-centric models.

This a good learning for Sri Lanka that the government being the most powerful shareholder does not necessarily affect the performance rather strong corporate governance - something which Sri Lanka has tended to elude from – becomes a key factor for its success. Therefore, it provides a highly successful model in which the government remains the linchpin of corporate governance and the economy.

Even though, the Singaporean SOE holding company model may prove to be difficult to replicate, it suggests that there are many paths to successful corporate governance even in today's global economy. Therefore, the key to effective corporate governance is finding a system that fits a particular country's economic, institutional, historical, political, and cultural environment, which will vary from country to country.

Therefore, building a corporate governance framework that suits the Sri Lankan economy will be pertinent. A good example of this is observed in the divestments that took place during the 1989 - 2000 period, which offered part of the company's shares to employees in order help overcome resistance. This enabled successful divestments to take place without much resistance and built employees' commitment to remain and support the new management after the sale.

Value creation from talent and leadership was another reason for the success of these models where accountability and transparency were inculcated in the organisations, with appropriate performance benchmarks. Sri Lanka, however, lacks proper performance appraisal systems that incentivise efficiency and effectiveness, and promote transparency. Therefore, ensuring rigorous standards of transparency and accountability, guided by a framework that sets clear responsibility, authority and governance structures can be envisaged for Sri Lankan SOEs.

Board governance is another learning point for Sri Lanka. A Board bears the ultimate responsibility for stewardship and performance of SOEs, hence its composition and functioning have a significant impact on the SOE's operational and financial performance. A Board should be comprised of the right number of Directors, and ensure a relevant mix of competent individuals is achieved through a robust selection process. Maintaining the continuity of Boards is also imperative so that its objectives and goals do not change with changes in its composition.

Finally, a degree of national consensus where the leadership at the highest level is involved in the reform process and powered by political will, is necessary. Malaysia and Singapore had its Prime

Ministers driving the reform agenda, ensuring interest from the highest level to effect change that is required.

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