The Neo-governance Model of Malaysian Islamic Real Estate Investment Trusts

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ABSTRACT

With respect to the unique legal setting and organizational structure under which Islamic Real Estate Investment Trusts (I-REITs) operate, this paper tried to explicate its practiced governance model by wading through the quadrilateral structure: market-centric, relationship-based, transition and emerging governance models. Descriptive analysis and content analysis of Annual Report will be performed to assess the ownership structure, the board of directors, leadership structure and financial statements of the companies to determine the optimal type of model that the I-REITs firms belong to. An attempt has been made to ascertain the type of governance model that best suit Malaysian I-REIT companies' by using descriptive and content analysis. Since concentrated and pyramidal model are dominant in I-REIT companies, emerging governance model is the best model to characterize Malaysian I-REIT companies.

Keywords: *Market-centric, relationship-based, transition and emerging governance models, Malaysian I-REIT, corporate governance*

Introduction

The effectiveness of good governance has been a confronting issue since the shocking collapse of giant corporations. The issue has received considerable attention in the field of corporate governance based on an eye-wakening issue ever since the spate of scandals such as Enron which lead to regulatory reforms of corporate governance. The concept of good governance has been extensively discussed in the seminal works done by Berle and Means (1932) and Jensen and Meckling (1976). Among the precedent literature highlights on the role of ownership structure in influencing quality of corporate governance in a company. Previous scholars have found a significant correlation between ownership concentration and performance. Ownership concentration allows for greater incentive to the minority shareholders as the interest of the majority shareholders can be well-aligned. This can be an

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important mechanism to mitigate the typical principal-agent problem as majority shareholders limit the opportunities for managerial expropriation by the board.

There is extensive research being conducted on the assessment of corporate governance of real estate investment trust (REITs). For instance, a study by Hartzell, J, Sun, L and Titman, S., (2006) has been conducted to determine the effect of corporate governance on investment shows strong links between the investment behaviour and ownership. The result showed stronger corporate governance reacts more confidently to their investment opportunities. Their findings shows consistency with the theory of institution and independent directors' responsibility which serve as a monitor and check on management's propensity of overinvest in bad times. Besides, it can be said that governance affects weakly on the influence of raising REITs' capital either equity or debt. However, their findings also highlighted that only institutional ownership has a stronger relationship with changes in debt, while insider ownership is significant for both equity and debt.

In Australia, a study has been carried out to determine the influence of the corporate social responsibility factors and financial factors on REIT performance. Among the three Corporate Social Responsibility (CSR) dimension, corporate governance is seen to be the most influential CSR factor as compared to environmental and social factors towards A-REIT performance by using the Jensen index (Newell and Lee, 2012). In their findings, A-REIT corporate governance is seen to have a more influential role in A-REIT pricing and becomes a critical factor during the Global Financial Crisis (GFC) and its significant impact on A-REIT performance and the needs to address issues such as transparency, disclosure and the effectiveness of board directors' decision making.

On the other hand, Asian REITs can still be considered as greenfield from the perspective of corporate governance because REIT regimes are still relatively new in Asia. For instance, in Singapore, a study has been conducted to examine the relationship of corporate performance and the quality of corporate governance among externally managed listed Singapore REITs (S-REITs). S-REITs with higher corporate governance tend to register better risk-adjusted returns but do not outperform their operational performance (Lecomte, P and Ooi, J. 2013). Their findings indicate that there is a positive relationship between corporate governance and the performance of S-REITs but no relationship between corporate governance and operating performance of S-REITs.

Corporate Governance in Malaysia

Studies and literature documenting the corporate governance and Malaysian property market context are scarce, especially for Malaysia REITs. This is because in Malaysia, the issue of corporate governance was brought to the limelight since the 1997 Asian financial crisis. Hence, the Malaysian Code on Corporate Governance is released in March 2000 and marked a significant milestone of a reform of corporate governance in Malaysia.

Malaysia has a favorable concentrated ownership structure due to the prevalence of family-controlled and state-controlled firms (Shakir R., 2008b). A conflicting view arises with regards to the relationship between ownership structures with agency problem. On one hand, scholar like Shleifer and Vishny (1997) argue that domination by large shareholders can address the agency problem as they are in a better position to control the assets and the management of the company to align with their interests. In a similar vein, although Jensen and Meckling (1976) suggest that by linking remuneration of the management to the performance of the company could align their interest with shareholders interest, Morck,

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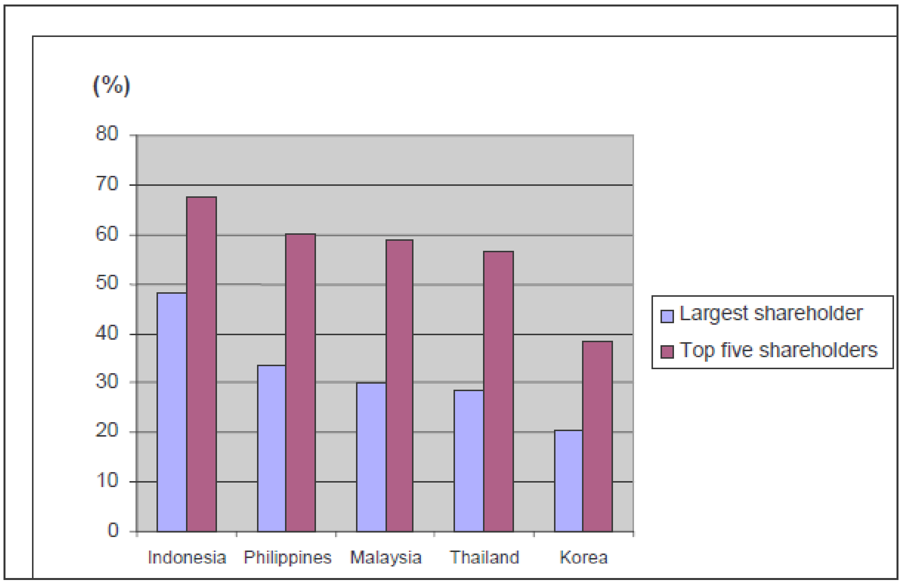
Shleifer and Vishny (1988) and McConnell and Servaes (1990) oppose that expropriation can still exists when large shareholdings are conquered by the management who clearly have power to run the firm. This is because with large shareholdings, they can better sustain their position even at the expense of minority shareholders.

A comprehensive study by Zhuang, Edwards and Capulong (2001) conducted in 1998 found that Malaysia has a considerably high concentration of ownership with 58.8 per cent of the the total shareholdings (Figure 1), and the largest shareholders own 30 per cent of the shares. In terms of block ownership, Figure 2 shows that the largest sharheolders in Malaysian property firm consists of CEOs or owner, Directors, institutions and state governments.

Figure 1: Ownership concentration



Source: Zhuang, Edwards and Capulong (2001)

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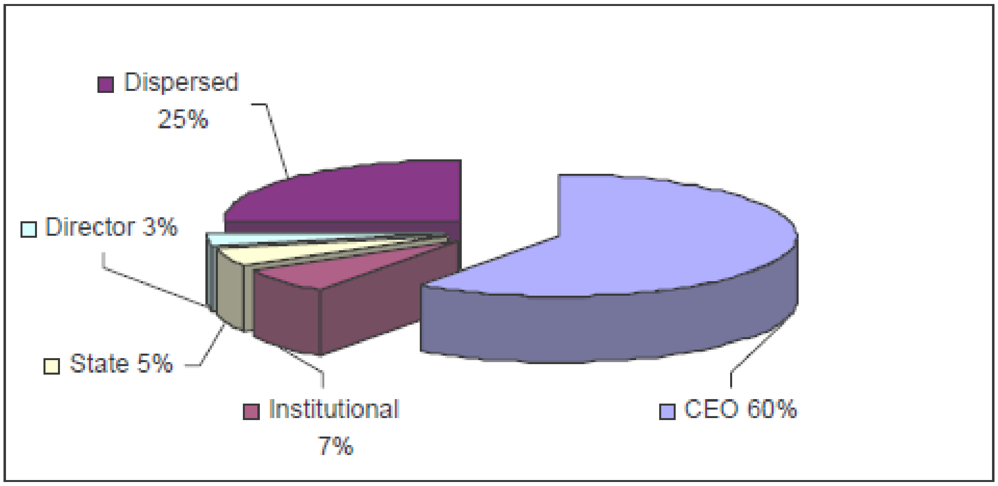
Figure 2: Block ownership



Source: Shakir (2007)

Given the multiplicity of governors, a fundamental question arises: which ownership structure best characterized REIT firms in Malaysia and which structure dominates the I-REITs firms. REITs companies have a unique legal setting and organizational structure. It's more stringent regulation is said to increase the chances of mitigating agency problem better.

Earlier researchers have concentrated on the study of ownership structure in REIT firms. However there is a dearth of research examining the governance model adopted by I-REIT firms. Therefore, this paper tries to explore the four different governance mechanisms namely market-centric, relationship-based, transition and emerging governance model that best characterize I-REIT firms in Malaysia taking into account the unique legal setting and organizational structure under which Real Estate Investment Trusts (REITs) operate, changes the traditional principal-agent problem.

Literature Review

Ownership Structure and Firm Performance

A retrospective empirical study on the relationship between ownership and firm performance has produced mixed findings. A positive relationship was found by Tan (2005) who studied 221 Malaysian listed firms without identifying the identity of the block owners. In contradict Haniffa and Hudaib (2006) reported a negative association between market performance and the proportion of shares held by the five largest shareholders when they examined 347 firms during the period 1996-2000. This could be due to the economic recession during the period which makes any efforts towards increasing firm performance futile. However, a study by Haniffa and Hudaib (2006) found no association between managerial ownership and market performance.

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Ownership Structure of Malaysian Property Companies

A common occurrence in East Asian economies is a block ownership by family and state. This pattern of ownership structure makes Asian countries different from the Western countries. Another sailent feature is leadership because market performance is also affected by the leadership structure. For instance, Malaysian property firms have a dual leadership strucuture in which the positions of chairman and CEO are held by different individuals indicating that although family firms are common in Malaysian firms, they are seldom dominated by one individual as CEO tenure are not lengthy (Shakir, 2009).

Another unique setting of Asian countries is the adoption of pyramid structures and cross-holdings. Control through a pyramid structure can be defined as owning a majority of the stock of one corporation that holds a majority of stock in another corporation. Crossholdings, which can be defined as ownership of shares in a company by another company is less visible in all countries except for Malaysia and Singapore, where cross-holding is evident in about 15 per cent of its corporations (Shakir, 2007). This structure allows for a greater control by shareholders even with small ownership stakes (Claessens, Djankov and Lang, 1999).

The Quadrilateral

Study conducted by Bhasa (2004) has contributed to a new paradigm in the standard governance model around the world. His new emerging governance model extend the existing models; market-centric, relationship-based and transition governance model. The distinguishing aspect between these four models are the ownership structure and identity of block ownership.

Type I: market centric governance model

The market centric is common in developed countries such as US and UK. This model is characterised by diffusion of ownership across shareholders. The diffused ownership enables shareholders to diversify their own portfolio across different corporations, thereby lowering their dependency on only one corporation. However, agency cost may arise as shareholder is distanced from monitoring the management's behaviour. The absence of large shareholders to represent the minority shareholders' interest may create governance problems when the management create information asymmetries and expropriate shareholder value. On another perspective, however, the agency problems can be mitigated by threats of takeover by the shareholders if the managers are found to be under-performing. The general assumption of this model are capital markets are strong and liquid; there exists a ready market for corporate control and ready access to managerial labor markets.

Type II: relationship-based governance model

Relationship-based governance model is an opposite from the market-centric model. In this model, ownership is largely concentrated and capital market is illiquid. Large shareholding is dominated by banks. The model is called as relationship-based because of the commitment entered into by the bank which is prepared to bail out corporations that are facing bad times. The Anglo-American countries like Japan, Korea and German are the glaring examples of this

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model of governance. Despite the effectiveness of bank as a monitoring mechanism to managerial behavior, it poses its own shortcoming when the bank dominates the corporation's decision-making process; they steal the professional expertise from the management.

Type III: transition governance model

Transition governance model is more prevalence in Central and Eastern European countries where restructuring was mass implemented. Upon privatization, this model tries to emulate the market model of governance. Akin to the type II firms, transition governance firms are also characterized by cross shareholding namely individuals and corporations. The model is named as transition to reflect the transition of firms from state-owned to private ownership. The "spontaneous privatization" makes it difficult to the privatized company to stand with its own leg because the state intervention has taken a heavy toll beforehand. Though this model shift the system toward more competitive and functional system, the general apathy is that market may lose confidence and are cynical to the ability of the corporation to protect their investment interests due to the weak institutional set up to confront financial problem. In terms of the ownership structure, it may look like that the firm has moved to a dispersed ownership, yet the nature of cross shareholdings casts a doubt on the diffuse nature of ownership. Hence, this model is a mixture of concentrated and diffused ownership.

Type IV: emerging governance model

Type IV model is said to be a successful governance model to replicate successful economies. It characterizes the successful of type III model whereby successful transition from state-held firms to private-owned firms, with an existence of vibrant capital markets, existence of both large shareholding and minority shareholding. Business groups dominate the type IV economies with family retaining a significant amount of shareholding across a wider cross-section on industries. Thus, cross-shareholding coupled with concentrated and pyramidal ownership structures is the best feature of this model. India and Taiwan set the best examples of this model. However, agency cost may arise as control by the family over the large shareholding is high and may consequently expropriate the minority's interest. However, the existence of vibrant stock market, the existence of the market for corporate control and a strong legal system in place may mitigate this agency problem.

Malaysian Islamic REITs

Malaysia currently has 16 Real Estate Investment Trusts (M-REITs), of which three are Shariah compliant with one Islamic REIT (I-REITs) being Malaysia's first stapled REIT, KLCC Property REIT (KLCCP REIT). Islamic REITs are different from conventional REITs as they have to comply with Shariah principles as outlined by the Guidelines for Islamic REITs issued on 21st November 2005 by Securities Commission (Securities Commission, 2005). The guidelines are: 1) Non-permissible rental activities; 2) Rental from tenant who operates mixed activities; 3) Method of calculating the ratio of rental of non-permissible activities; 4) Acquisition of real estate; 5) Renting out to new tenant; 6) Instruments used in investment, deposit and financing for Islamic REITs; 7) Takaful coverage and 8) Risk management issues.

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Many of the literature focus on the REIT performance as a whole and did not treat I-REITs as a different category of REITs which has a unique ethical Shariah compliant framework. For instance, there are many studies on the performance analysis on Malaysian REITs (M-REITs) was conducted. Previous research indicates REITs outperformed market indices during and post GFC period (Ong et al, 2012; Yusof and Nawawi, 2012). M-REITs are considered as a less risky alternative investment as opposed to listed equity because M-REITs possess lower degree of overall risk or volatility as compared to the broader market (Mohamad and Zolkifli, 2014; Chai et al, 2011; Tan, 2009). Apart from that, M-REITs which are traded at Net Asset Value (NAV) premium are generally better companies in terms of disclosure, transparency, liquidity, corporate democracy and management (Ong et. al., 2011). In term of relationship between M-REITs and Asian REITs, there is a positive correlation and Malaysian REIT is found to be lagging against the Asian REITs for up to two months (Nawawi et.al., 2010).

In term of the performance of Islamic REITs as compared to the conventional REITs, many research shows that I-REITs have performed well especially during the GFC. Islamic M-REITs have shown a high degree of robustness during the GFC and outperform conventional REITs. (Helmi, 2013; Alhenwi and Hassan, 2011; Newell and Osmadi, 2009). Conversely, by using different approach of measurement, the findings conclude that Shariah Compliant portfolios tend to underperform the REIT portfolio (Mohamad and Saad, 2012; Ibrahim and Ong, 2006).

Apart from that, according to a study conducted on three Islamic REITs' Return on Equity (ROE) as compared to conventional M-REITs, it has shown that Islamic REIT perform well in providing results with a high quality of the management strength during the GFC (Osmadi and Razali, 2013). Besides, previous studies discovered that when there is an increased of dividend, normally the performance of I-REITs will also increase (Hashim et. al., 2013).

Methodology

Sample Data

The sample data comprise firms listed under the property counter which traded at Bursa Malaysia and comply with the Shariah guidelines. There were 16 Real Estate Investment Trusts (M-REITs) in the Bursa Malaysia, but only three are Shariah compliant which are: *Axis REITs, Al-Aqar Healthcare REIT and KLCC Property Holdings Berhad.*

Sources of data

Relevant data pertaining to the ownership structure, board of directors, leadership structure and financial statements of the companies are retrieved from the annual reports 2013 of the individual companies which can be assessed online via the Bursa Malaysia website.

Data Measurement

Descriptive analysis and content analysis of Annual Report will be performed to assess the ownership structure, the board of directors, leadership structure and financial statements of the companies to determine the optimal type of model that the I-REITs firms belong to.

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Descriptive analysis was used to explain the pattern of ownership structure, the board of directors and leadership structure. Analysis was made from two sources which are literature review and Annual Report. The content of Annual Report was used to derive at the required data and literature review was used to comprehend the model that the I-REITs firms belong to.

The measurement of variables can be seen in Table 1. The terms of measurement used is similar to the study conducted by Shakir (2008b). Shakir (2008b) measured blocked ownerhsip as percentage of shares owned more than 5% of the overall outstanding shareholders in the company. Board size indicates number of directors in the board. Outside directors representation is measured based on the number of non-management executive directors in the board and high outside directors representation is classified if they represent 1/3 or over from the number of all directors in the company. This indicator is in line with the criteria stated in the Malaysian Code of Corporate Governance (2007). *Outside Directors (%)* is a proxy for board independence, and the researchers expect that the higher the degree of board independence, the stronger the monitoring role the board can provide (*e.g.*, see Weisbach 1988). Our other governance variable is a measure of share ownership of the CEO.

Table 1: The measurement of variables

Variables	Terms of measurement
Block ownership	% of shares held by shareholders owning 5% or more
Board size	Total number of directors on the board
Outside directors	Total number of outside directors on the board
Family business	Dummy variable 1 if it is a family business and 0 if it is not
CEO ownership	% of shares held by CEO divided by total outstanding shares
Equity	Fully issued and paid-up share capital of ordinary shares at the end of the financial year of each company (measured in logarithm)
Market value	Equity multiplied by share price(measured in logarithm)

Findings

Descriptive statistics of ownership structure

Descriptive statistics on overall data are presented in Table 2. The statistics in Table 2 showed an average of 48.88 per cent of block ownership found in property firms. The ownership pattern is similar to those reported by Claessens, Djankov and Lang in 1999 who found that concentrated ownership is common in Asian listed corporations. CEOs owned a very insignificant number of shares in the company with percentage close to zero per cent. Board size is in an ideal number which is 8, considered not too large or too small and the outside director representation mean of 6.67 which is approximately 80% is seen as good. This evaluation is given based on the benchmark of at least 60% outside representation as ideal board stated in Weisbach (1988). Family business is nil in the i-REIT companies indicating full-pledge companies.

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Table 2: Descriptive statistics

Variables	Mean	Standard Error	Median
Block ownership (%)	48.88	13.30	36.3
Board size	8.33	0.33	8
Outside directors	6.67	0.88	7
Family business	0	0	0
CEO ownership(%)	0.08012	0.07497	0.0089
Equity	1079660499.67	363371294.24	750966000
Market value (RM billion)	4.56	3.03	2.2

Analysis of Findings

The finding signifies that Malaysian Islamic property firms have the same structure as other listed firms in terms of block ownership. The mean figure of 48.88% is considered as high as in block ownership. Unlike other studies, this study found no block of ownership by family firm. These results imply that institutional ownership being block owners monitors the firms' investment policies better as they own the majority voice during general meeting to align the company's direction to their interest. This reflects a good projection for performance because as stated by Baek, Kang and Park (2004), firms with high family concentrated ownership tend to have low stock performance.

Apart from that, the findings indicate a mean of 8 for board size. This supports the findings of Shakir (2008a) which market seems to have a preference for small boards with lesser number of outside directors, but with more executive working directors and a mean of 7 directors for Malaysian listed properties companies is similar to those of American, British, Canadian and European firms.

Similarly, the study also found small CEOs ownership of shares contribute better to outside director representation as the result found by propenents such as Ghosh and Sirmans (2003) which has found strong CEOs ownership structure with small outside representation. The insignificant CEO ownership (value: 0.08012%) may reduce expropriation of rent by the CEOs and thus, maintaining a sound corporate governance in place.

Based on this finding, putting all the puzzles together, Malaysian I-REIT has an ideal governance structure with high institutional ownership with insignificant family and CEO ownership. The institutional ownership represents the minority shareholders' voice to ensure firms invest in assets that will maximize the shareholders' interest.

Based on the above results, it can be concluded that Malaysian I-REITs firm best characterized the type IV model except for the family ownership. Type IV (*emerging governance model*) is dominated by large cross-shareholding coupled with concentrated and pyramidal ownership structures.

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Conclusion

Corporate governance deals with various aspects including governance structures. Similar to their counterparts in other Asian countries, high concentrated ownership is very common in Malaysian I-REIT firms with an average of 48.88 per cent of block ownership. However, the case of I-REIT firms are more favorable because the block ownership is not dominated by either family business or CEO owenership. This put I-REIT firms under the type IV model (emerging governance model), but in a better position. Perhaps, a neo-governance model may be introduced to supplant the emerging governance model. The Islamic concept adopted by the firms may contribute to this favorable figure as over-domination by individual for own benefit without considering others is prohibited in Islam. Given the unique result, future studies could incorporate the role of islamic and conventional concept to solve the causality between ownership structure and firm performance.

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