

THE RELEVANCE OF CAPITAL STRUCTURE THEORIES TO CONSUMER PRODUCT FIRMS AT BURSA MALAYSIA

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ABSTRACT

This paper examines the relevance of Capital Structure Management theories to the value of consumer product firms listed at Bursa Malaysia. Within the framework of Modigliani-Miller and Trade-Off theories, this paper uses Generalized Method of Moments (GMM) as an estimation model employing yearly panel data from the year 2010 to 2014. The test results from GMM indicate that earnings per share (EPS) and debt-equity ratio (D/E) have no significant relation with the firm's value as represented by the closing price per share (CP). Even though the findings are rather alarming, one must admit that the Modigliani-Miller and Trade-Off theories are irrelevant to those consumer product companies at Bursa Malaysia. Perhaps, this is an indication that the efficient market hypothesis applicable to certain sectors at Bursa Malaysia.

Keywords: Modigliani-Miller theory, trade-off theory, generalized method of moments, panel data analysis, efficient market hypothesis

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INTRODUCTION

Malaysia is a middle-income country that has one of the highest standards of living in South East Asia, largely attributed to its expanding industrial and service sectors. The Malaysian economy is an open economy with both domestic and the international markets. Malaysia has been enjoying fast growing economy since early 1970s, transforming itself from a producer of raw materials into an emerging multi-sector economy until the Asian Debt Crisis came to the surface in 1998. In the year 2015, Malaysia's economy was adversely affected by the plunge in demand and prices of hydrocarbons and other commodities. As a major producer and exporter of crude oil, natural gas, and palm oil, the net external demand dragged down Gross Domestic Product (GDP) growth in the first half of 2015. In the third quarter of 2015, Malaysia's currency weakened against the dollar in Asia. Malaysia became the worst performer among 11 major Asian currencies tracked by Bloomberg. This undesirable situation has certainly raised concerns among foreign investors in Malaysia and some investors have decided to pull out the Malaysian market. Amid concern of a weaker economic growth, the withdrawal of foreign investors has now become a real trial to both public and private sectors.

The above situation becomes a great challenge to most of the companies in Malaysia on how to sustain their businesses especially in maintaining the cost of financing at the lowest possible level. The cost of financing has become one of the main issues in business management as it could lead to an increase in overall costs of doing business and later reduce the company's price competitiveness. Thus, this problem requires business owners to systematically analyze financing options and continue looking for the right combination of portfolio financing. Only a well-diversified portfolio of financing will be able to minimize the operation costs and at the same time lead towards maximizing the wealth of the shareholders and company's value. The following section describes the problem statement, literature review and methodology used. The last section provides the empirical findings and concludes the discussion.

PROBLEM STATEMENT

Capital structure is considered as one of the important components in business management because it could significantly influence a firm's future business prospects. The structure of firm's sources of capital must be determined in a strategic manner in order to achieve these two-fold long-term goals: minimizing the overall cost of financing and maximizing the wealth of the shareholders (or firm's value). However, a wrongly combined source of capital could trigger negative impacts as each source of capital has its own advantages and disadvantages embedded in it. Besides optimum capital structure, today's Chief Executive Officer (CEO) has also been assigned to the task of maximizing firm's Earning per Share (EPS). Indeed, these two assignments will drive a company to move towards lowering its cost of financing coupled with its ability of maximizing return on investment at the acceptable level of risk.

For that matter, a myriad of studies have developed hypothesis on finding the theoretical relationship between firm's value and its determinants. It is worthy to investigate the ideal debt-to-equity range across all sectors at Bursa Malaysia as well as the roles of future earnings on firm's value. One must admit that each sector in the economy is unique and characterized by different risk components, capital requirements and market potentials. Because of these differences, an optimal capital structure may vary from one sector to another. The study focuses on consumer products because this is a recession-proof sector that could survive in both threatening economic and volatile market conditions. As such, this study is pursued with the motivation to shed some light on the exceptional strength of these companies and their key determinants of value.

LITERATURE REVIEW

Capital structure is defined as relative proportions of debt, equity and other securities in firm's total financing of its operating assets. A business must plan its capital structure so as to optimize the application of its funds and ultimately be able to adapt to the changing environments. There are several significant theories of capital structure in financial management that have emerged (Kovenock & Phillips, 1995; Kovenock & Phillips,

1997). The traditional theory of capital structure tells us that wealth is not just created through investments in assets that yield positive return on investment, purchasing those assets with an optimal blend of equity and debt is equally important. This theory believes that when the Weighted Average Cost of Capital (WACC) is minimized, thus the market value of assets are maximized, an optimal structure of capital will come to the surface. In sum, it says that a firm's value increases to a certain level of debt capital, after which it tends to remain constant and eventually begins to decrease. The modern theory of capital structure began with the celebrated paper of Modigliani and Miller in 1950s, fondly known as MM1. From their analysis, they have pointed the direction that such theories must take that capital-structure irrelevance proposition. Essentially, they hypothesized that in perfect markets, it does not matter what capital structure a company uses to finance its operations. They theorized that the market value of a firm is determined by its earning power and by the risk of its underlying assets, and that its value is independent of the way it chooses to finance its investments or distribute dividends. The essence of MM1 is based upon six key assumptions; (1) No taxes (2) No transaction costs (3) No bankruptcy costs (4) Equivalence in borrowing costs for both companies and investors (5) Symmetry of market information, meaning companies and investors have the same set of information; and (6) No effect of debt on a company's earnings before interest and taxes.

Another theory of capital structure that is very much related to MM1 is the Trade-Off Theory (and sometimes referred to as Static Theory). The Trade-Off Theory advocates the idea that a company's selection on their preferred debt-equity capital structure will be determined by balancing the costs and benefits associated with the two. This theory is often regarded as a competitor theory to the Pecking Order Theory of capital structure. Pecking Order Theory suggests that a company prioritizes its sources of financing according to its relative cost. First, a company will opt for internal financing, followed by debt financing. The last resort will be equity financing as it is deemed the most expensive of all. Looking at all the three theories, a decision maker must weigh the different costs and benefits stem from the use of alternative financing plans. The Trade-Off Theory assumes that you can gain benefits from leverage within a capital structure until at one point where optimum capital structure is achieved. This theory acknowledges the importance of the tax advantage from interest payments as well as

the concepts of financial distress plus agency costs. A major strength of the trade-off theory is the enlightenment on how businesses are generally funded partially by debt and equity.

The relationship between capital structure and company performance is still debatable as many studies which have been conducted revealed various findings. Some of the studies (Krishnan & Moyer, 1997; Zeitun & Tian, 2007) significantly discovered that there were negative relationship between leverage and the firm's performance. Similar findings of this negative relationship between firm's performance and financial leverage were also known in several countries as conducted by other researchers (Brigham & Gapenski, 1996; Majumdar & Chhibber, 1997; Rao, Al-Yahyaee & Syed, 2007). Specifically, Gleason, Mathur and Mathur (2000) also revealed the same findings and the issue of this negative relationship has been associated with the changes in economic condition as observed during Asian financial crisis in 1998. The study pointed out that the detrimental impact from the use of leverage (financial risk) has been magnified during the period of financial crisis since many financial institutions were facing short of liquidity in the financial system.

There are also many studies conducted and their empirical findings supported positive direction of the relationship between firm's performance and financial leverage from the capital structure. Most of the studies found out that financial leverage would contribute positively towards improving the performance of the firms as reflected in increased productivity level, higher profitability as well as growing EPS value (Huyghebaert, 2006; Titman & Wessels, 1998; Myers, 2001; Ross, 1977; Noe, 1988). Some studies in 1990s have confirmed similar results in that firm's value is positively influenced by certain combination of capital structure which is closer to the optimum level category (Maksimovic, Stomper & Zechner, 1999; Barclay, Smith & Watts, 1995). Generally, an optimum capital structure with certain amount of leverage enables a firm to minimize the overall cost of its financing as well as maximizing the portfolio return from its business investment activities (Hadlock & James, 2002; Coriceli, Driffield, Pal & Roland, 2011). Other researcher who shared similar findings and postulated that debt financing has positive influence on increasing firm's value, its long run profitability plus sustainable growth in productivity (Roden & Lewellen, 1995; Sharma, 2006; Ehrhardt & Brigham, 2006).

DATA AND METHODOLOGY

This paper focuses on 27 companies listed at Consumer Products sector at Bursa Malaysia. The companies with negative earnings per share were omitted from this study. The data was extracted from Bloomberg database involving annual price data, debt-equity data and earnings per share data from 2010 through 2014. The data measure firm's value, leverage and company's earnings respectively. Panel data analysis via SAS program was deployed in this study. Specifically, the research model is expressed as follows:

$$CP_{it} = f(\text{lag}CP_{it}, EPS_{it}, DE_{it}) \dots\dots\dots (1)$$

Where: CP_{it} = Closing Price (dependent variable)
 $\text{lag}CP_{it}$ = lag1 Closing Price
 EPS_{it} = Earnings Per Share
 DE_{it} = Debt-Equity Ratio
 $i=1, \dots, N$ (cross sectional).
 $t=1, \dots, \text{time series}$.

Estimation method via Generalized Method of Moments (GMM) is employed and findings are reported in the following section. Generalized Method of Moments (GMM) is chosen in testing the determinants of firm's value and its relations to leverage (debt/equity ratio) and earnings because it provides the panel data with efficient econometric estimators. GMM is an efficient test and tool that can reduce and ease endogeneity problem effectively. Endogeneity is the correlation between the parameters or variables with the error term. This test controls the endogeneity problem by employing unobservable shocks in the cross-sectional component. The research instruments used in this study involve diagnostic tests for GMM validity which are tests of the non-existence of serial correlation of the error terms using the first and second order serial correlation, test for exogeneity of instruments that ensures the consistency of estimates using the Sargan tests.

The research framework of the GMM is shown in Figure 1 below. It is developed to test the determinants of firm's value. In producing reliable GMM results, a set of diagnostic tests must be performed. First, Sargan test is conducted to measure the exogeneity and validity of instruments,

while the serial correlation is examined by Autocorrelation test. The panel data definitely increases the number of observations. This set improves efficiency by reducing the multicollinearity problem and increase the degree of freedom between the explanatory variables. Thus, panel data approach has the advantage of solving the unobserved firm-specific effects. Moreover, compared to cross-sectional data, choosing variables and instruments is easier and more flexible. The endogeneity problem is one of the factors that supports the implementation of GMM. Observable as well as unobservable shocks affect the corporate capital structure decisions and firm-specific characteristics.

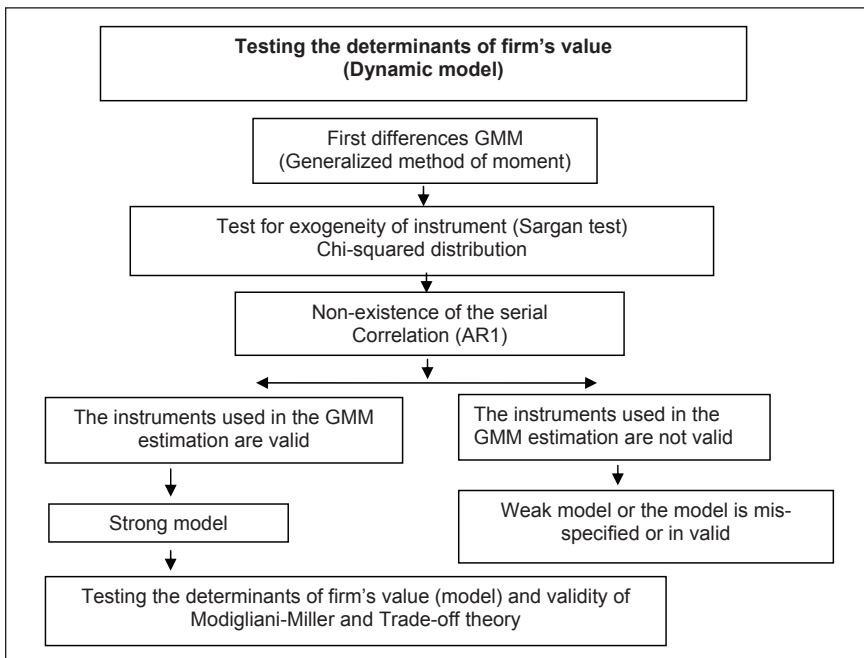


Figure 1: Generalized Methods of Moments

The GMM research framework process is summarized by the following steps. It starts with the diagnostic tests, then to the main research method of GMM, a method that alleviates the deformation caused by fixed effects, simultaneity and endogeneity. The study applied the GMM on a panel data that considers both dimensions of cross-sectional and time-series estimates. The GMM model structure is discussed in the following paragraphs:

Consider the Single Equation Linear GMM as:

$$y_t = z_t\delta_0 + \epsilon_t, t = 1, \dots, n \quad \dots \dots \dots (2)$$

Where z_t is an $L \times 1$ vector of explanatory variables, δ_0 is a vector of unknown coefficients and ϵ_t is a random error term. In this model elements of z_t may be correlated with the error term ϵ_t . In case of the existence of endogenous variables in z_t , the least squares estimator of δ_0 is biased and inconsistent. Related to the model, a $K \times 1$ vector of instrumental variables x_t is assumed that many contain elements of z_t . Let w_t represent the vector of unique and non-constant elements of $\{y_t, z_t, x_t\}$. It is assumed that $\{w_t\}$ is a stationary and ergodicstochastic process.

The instrumental variables x_t satisfy the set of K orthogonality conditions

$$E [gt(w_t, \delta_0)] = E[x_t\epsilon_t] = E [x_t (y_t - z_t\delta_0)] = 0 \quad \dots \dots \dots (3)$$

Where: $gt(w_t, \delta_0) = x_t\epsilon_t = x_t(y_t - z_t\delta_0)$. Expanding (3), gives the relation

$$\Sigma_{xy} = \Sigma_{xz}\delta_0 \quad \dots \dots \dots (4)$$

Where: $\Sigma_{xy} = E[x_t y_t]$ and $\Sigma_{xz} = E [x_t z_t]$. For identification of δ_0 , it is required that the $K \times L$ matrix $E[x_t z_t] = \Sigma_{xz}$ be of full rank L . Note, if $K = L$, then Σ_{xz} is invertible and δ_0 may be determined using $\delta_0 = \Sigma^{-1} xz \Sigma_{xy}$

A necessary condition for the identification of δ_0 is the order condition

$$K \geq L \quad \dots \dots \dots (5)$$

The above equation simply states that the number of instrumental variables must be greater than or equal to the number of explanatory variables. If $K = L$ then δ_0 is said to be (apparently) just identified; if $K > L$ then δ_0 is said to be (apparently) over-identified; if $K < L$ then δ_0 is not identified.

To solve the problem of endogeneity of independent and explanatory variables, a two-step GMM method is used to control the correlation error

over time that is, mitigating the effect of orthogonality conditions on errors, and heteroskedasticity across firms. Observed and unobserved firm-specific determinants determine the optimal capital structure. These firm and time specifics make changes on capital structure and the optimal leverage point.

The lagged values of the dependent variable of the GMM model are examined to evaluate the consistency and the validity of the other explanatory variables. The error terms must not exhibit any serial correlation. The diagnostic tests that evaluate the validity of the GMM panel data model are (1) Test of exogeneity of instruments, (Sargan test) measured via Chi-squared distribution; and (2) Non-existence of the serial correlation AR1 & AR2.

Serial correlation is often observed in time series data, but not in cross-section. Due to this limitation, the panel data approach is recommended. In order to avoid the problem of serial correlation, the first and second order serial correlation test is conducted. The AR1 and AR2 must provide negative significant results and there should not be any evidence of second order autocorrelation. The error is assumed to be independent of its past; it has no memory of its past values. See equations 5, 6, 7.

Error Term has a mean of zero:

$$E(e) = 0 \rightarrow E(y) = b_1 + b_2x \quad \dots\dots\dots (6)$$

Error term has constant variance:

$$\text{Var}(e) = E(e^2) = s^2 \quad \dots\dots\dots (7)$$

Error term is not correlated with itself (no serial correlation):

$$\text{Cov}(e_i, e_j) = E(e_i e_j) = 0 \quad i \neq j \quad \dots\dots\dots (8)$$

The autocorrelation coefficient must lie between -1 and 1:

$$-1 < r < 1,$$

Anything outside this range is considered to be unstable and very unlikely for economic models.

The Sargan test is proposed by John Denis Sargan in 1958, sometimes called the Hansen test or J-test. It is used to examine the exogeneity of the instruments and their consistency. It is aimed at exploring variables and finding if they are uncorrelated to some sets of residual. If the Sargan test is not valid, the model is classified as weak. Under the null-hypotheses the chi square is employed to test the overall validity of the instruments and the existence of over-identifying restrictions. The degrees of freedom are found by calculating the difference between the number of instruments and the number of regressors. If the null hypothesis is confirmed statistically (that is, not rejected), the instruments pass the test; they are valid by this criterion. These two diagnostic tests are important for depending on GMM results. The GMM is used to generate consistent and efficient estimators of the parameters of interest. That consistency is not achieved if the error term exhibits serial correlation. The System GMM estimate is employed in our test. It is obviously more efficient than the other GMM estimates, since it makes the Sargan test of over identifying restriction in a heteroscedasticity consistent position.

EMPIRICAL FINDINGS

All data including the year under study, closing price (CP), earnings per share (EPS), and Debt/Equity ratio (DE) was analysed using SAS Program. The statistical results are presented in the following tables.

Table 1: GMM1 First Differences Transformation – The PANEL Procedure

Dependent Variable: lcp

Model Description	
Estimation Method	GMM1
Number of Cross Sections	27
Time Series Length	5
Estimate Stage	1
Maximum Number of Time Periods (MAXBAND)	5

Fit Statistics			
SSE	141.6468	DFE	78
MSE	1.8160	Root MSE	1.3476

Sargan Test		
DF	Statistic	Prob > ChiSq
2	4.43	0.1090

The results from the panel procedures show that the number of cross-sectional observation is 27, while time-series stand at 5 (from 2010 till 2014). In general, short time series would not give a statistically reliable result. However, by the virtue of panel data, the results can be interpreted well and reliable conclusions could be drawn from the analysis.

Fit Statistics explains the goodness-of-fit statistics and it measures how well different models fit into the data. The value of SSE is very high (far from 0) which implies that the model has a bigger random error component, and therefore possesses weak predictive power. As for MSE and Root MSE, their values are closer to 0 with potential predictive power. The Sargan test examines the validity of instrumental variables. It is a test of over identifying restrictions in the statistical model. The hypothesis is set such that the instrumental variables are uncorrelated to some set of residuals, and therefore they are acceptable, healthy, instruments. If the null hypothesis is not rejected, then the tested instruments are considered valid by this criterion. From the result of the Sargan test, the null hypothesis is accepted; implying the instrumental variables are both valid and uncorrelated with the residuals.

Table 2: Parameter Estimates via GMM1

Parameter Estimates					
Variable	DF	Estimate	Standard Error	t Value	Pr > t
lcp_1	1	0.912638	0.6575	1.39	0.1691
Lde	1	-0.106722	0.1557	0.69	0.4951
Leps	1	-0.33803	0.3759	-0.90	0.3713

AR(m) test		
Lag	Statistic	Pr > Statistic
1	-0.57.	0.7169.

The results of parameter estimates are reported in Table 2. The statistical results demonstrate the efficient use of data in validating and estimating some values in mathematical models (Z. Zhang, 2004). Looking at the reported p-values, none of the explanatory variable is significant in influencing firm's value. All p-values are higher than α 5%. The coefficient for D/E is -0.106722. For every unit increase in D/E, a -0.106722 drop in price is predicted, holding all other variables constant. Furthermore, the coefficient for EPS is -0.33803. For every unit increase in EPS, the price is expected to fall by -0.33803 times, while holding all other variables constant. As a whole, the results show D/E and EPS has no significant relationship with closing price (CP). Interestingly, the p-value 0.7169 from AR(m) test is larger than 5% indicating an absence of autocorrelation problem.

CONCLUSION

This paper aims to develop in-depth understanding on the relationship between firm's value and its capital structure for Consumer Product companies listed at Bursa Malaysia. By examining all the 27 companies with respect to their closing prices, D/E and EPS, it is now evident that there is no statistically significant relationship between the firm's value and its tested determinants: D/E and EPS. These empirical results do not support the presence of Trade-Off theory or Modigliani-Miller theory on the Consumer Product sector. Perhaps, future research should consider incorporating a more robust estimation models that could address the issue of survivorship bias in this analysis. From the Sargan test, all the instrumental variables are uncorrelated to some set of residuals, and therefore they are proven to be valid instruments. The result of AR (m) confirms the absence of autocorrelation in the estimation model. Perhaps, this is an indication that the Efficient Market Hypothesis (EMH) prevails to a certain sector at Bursa Malaysia.

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APPENDIX 1

Companies Listed at Consumer Products Sector

No	Company Name		Product
1	AF MK EQUITY	ASIA FILE CORP BHD.	Stationery & Office Equipment
2	AMTK MK EQUITY	AMTEK HOLDINGS BHD.	Garments, Safety, Canvas, Casual Shoes & Property Investment
3	BON MK EQUITY	BONIA CORP BHD.	Specialty Apparel
4	CAB MK EQUITY	CARLSBERG BREWERY MALAYSIA BHD.	Liquor
5	CABC MK EQUITY	CAB CAKARAN CORP BHD.	Food & Agriculture
6	CAM MK EQUITY	CAM RESOURCES BHD.	Aluminums & Stainless Steel Kitchen Ware, Sinks & Melamine Table Ware
7	CCK MK EQUITY	CCK CONSOLIDATED HOLDINGS BHD.	Food & Agriculture
8	CCMD MK EQUITY	CCM DUOPHARMA BIOTECH BHD.	Pharmaceutical, Fertilization & Chemical
9	CHB MK EQUITY	CAELY HOLDINGS BHD.	Fashion & Attire
10	COLA MK EQUITY	COCOALAND HOLDINGS BHD.	Food
11	DGEM MK EQUITY	DEGEM BHD.	Jeweller
12	DLM MK EQUITY	DUTCH LADY MILK INDUSTRIES BHD.	Milk & Beverages
13	EMI MK EQUITY	EMICO HOLDINGS BHD.	Home & Sports Equipment
14	FARM MK EQUITY	FARM'S BEST BHD.	Food & Agriculture
15	FCW MK EQUITY	FCW HOLDINGS BHD.	Cosmetics, Toiletries & Household Products
16	FFHB MK EQUITY	FEDERAL FURNITURE HOLDINGS BHD.	Furniture Manufacturing, Retailing & Interior Fit-Out Company.

No	Company Name		Product
17	FNH MK EQUITY	FRASER & NEAVE HOLDINGS BHD.	Soft Drink & Dairy Product
18	GOLD MK EQUITY	GOLDIS BHD.	Water/Wastewater Treatment, Aquaculture, Property Investment & Investments In Emerging Markets
19	GPB MK EQUITY	GOLDEN PHAROS BHD.	Solid Wooden Doors & Glass
20	GUAN MK EQUITY	GUAN CHONG BHD.	Packaged Food
21	HBGLOB MK EQUITY	HB GLOBAL LTD.	Convenient Food Specialist
22	HMCB MK EQUITY	HOMERITZ CORP BHD.	Furniture
23	NESZ MK EQUITY	NESTLE MALAYSIA BHD.	Food & Beverages
24	PAD MK EQUITY	PADINI HOLDINGS BHD.	Specialty Apparel
25	PEP MK EQUITY	PPB GROUP BHD.	Food, Flour Mining, Manufacturing & Service
26	PMM MK EQUITY	PANASONIC MANUFACTURING MALAYSIA BHD.	Home Appliances
27	ROTH MK EQUITY	BRITISH AMERICAN TOBACCO MALAYSIA BHD.	Cigarette