

# EQUITIZATION IN VIETNAM: CORPORATE GOVERNANCE PERSPECTIVE

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## **Abstract**

*This paper reviews related literature on the firm and its corporate governance with a view towards making recommendations on the ex-post equitization process in Vietnam. The paper argues that creating sound corporate governance practices is now becoming a more and more important issue alongside with equitization process. The state (through its SCIC) must consider itself as a large investor to make the equitization process achieve its overall goal of enhancing firm efficiency.*

## **1. Introduction**

Vietnam aims at achieving most of the State Owned Enterprises (SOEs) being equitized by 2010. The pilot scheme was launched in 1992 based on a resolution of the tenth session of the Eighth National Assembly and the Prime Minister Decision 202-CT on equitization programs on 8 June 1992. The decision allows small - medium size and profitable but not strategic SOEs to be equitized. The decisions also regulates that the employees of the equitized firms should have the first right to buy the shares. The pilot scheme was very cautious, with only 5 SOEs were equitized during 1992-1996 (see Truong et al, 2006).

On a notable move, in 1994, the government established 18 general corporations and 64 special corporations which were large conglomerates incorporating SOEs operating in various strategic industries and areas. These general and special corporations consisted of around 2,000 of the 6,300 SOEs at the end of 1994 and accounted for about half of the SOE sector's employment (see Sjo-

holm, 2006).

The pilot scheme was extended in 1996, with the issuance of the Decree 28-CP in May 1996 to end the pilot stage and open the new stage for equitization. The decree maintained general principles of the pilot program and allowed the transformation of all small - medium size and non-strategic SOEs into joint-stock firms. This decree required SOEs' controlling agencies (ministries, people's committees and state corporations) to select enterprises for equitization. However, the process was also slow, with only 25 firms added to the list of equitized firms (Truong et al 2006) from 1996 to 1998, of which there were 18 SOEs being equitized as late as in early 1998 (MPDF, 1998).

The speed of equitization however has been accelerated since the opening of the Vietnam Stock Exchange in Ho Chi Minh City in 2000. As of February 2008, there were around 4,000 firms having being equitized, in which 3,400 had been equitized since 2000. Most of them however were small and medium size. Some of large SOEs were scheduled to be equitized in 2007 but the process was seen slower for some reasons, including the gradualism by the government resulting from concerns with the oversupply in the stock market.

As planned previously, there would be around 1,500 SOEs being equitized from 2007 to 2010, in which most of the subsidiaries of general corporations should be equitized in 2008. By the year 2010, there would be 554 SOEs left, including 26 general and special corporations; 178 enterprises in the field of defense, national security; and some other essential subsidiary SOEs. However, the 2007 saw only 2-3 big names (e.g. Bao Viet Insurance, Vietcombank) out of 20 being equitized as initial planning, meaning that now most of them are planned to be implemented in the next two years.

On the exchanges, the number of listed firms is now around 250 with a total market capitalization of around 30-40% of the GDP. This is a significant increase if we know that by the end of 2006, the capitalization was estimated at only 20% of the GDP. The increasing number of listed firms and the proportion of capitalization on one hand shows a greater public attention to the equitization process and equity market, on the other hand indicates that Vietnam has experiencing a bubble emergence which requires appropriate sterilized intervention and improved legislative infrastructure.

At this very recent time, debates on equitization in Vietnam have focused on the analysis of whether or not the equitization process should be initiated as planning. Especially, the continuous correction in 2007 and early 2008 has brought the government into a situation where they have to make a hard choice: to ensure commitment on equitization plan or to sell the state assets at the so-called

“cheap” prices. We are not proposing a discussion on what is “cheap”, but remind that the example of VCB offering is still alive, indicating that it’s not easy to manipulate the market forces.

The equitization process in Vietnam is now in its final stage but the road ahead is not easy to go. It’s because the general economic conditions are not in a good shape, if not being worse, for big name public offerings. The government is suffering an increasing high inflation while the whole economy is exposing to liquidity crisis. In the meantime, there has not been a well coordinated effort between fiscal policies and monetary policies. Monetary tightening policies seem not to be the right tools because they do not solve the roots of inflation: inefficient public investments and especially the overinvestment and diversification by large SOEs. As a result, “we see pressures on banks for liquidity, pressures on households for high inflation and pressures on businesses for working capital, but we may not get the air out of the asset bubble”<sup>1</sup>. All of these clearly are a difficulty test for the government’s commitment.

Neither this paper aims at adding any views on the equitization process with respect to the planning commitments, as many others do, nor on the “whys and hows” of the equitization process. Instead, this paper looks at the ex-post equitization issues as keys to ensure the success of equitization. The ex-post equitization here however is implied at firm level, but some implications may be drawn at policy maker level. Our view is simple that, when a firm is equitized, it enters into a new lifecycle, and thus, finding the right mechanism for it to operate in a new lifecycle is more important than bringing it into. The paper proposes that equitization is not sufficient for achieving efficiency. It requires improved corporate governance practices alongside with.

The paper is organized as follows. The next section discusses the firm and its efficiency, which argues that the firm can attain efficiency through market mechanism. It then discusses the role of equity market as the source of success for equitization process. Specifically, it supposes that the key issue to the firm is its corporate governance, and the equity market would help enforce corporate governance practices. The corporate governance section analyzes the sources of conflicts of interest within the firm and suggests the possible solutions to those conflicts. The conclusion section then summarizes the key points of the paper.

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<sup>1</sup> Jonathan Pincus, chief economist at UNDP Vietnam, Financial Times on 3 Mar 2008.

## **2. The firm and its efficiency**

It's commonly argued that the overall goal of equitization is to create efficiency at firm level. Although the term efficiency is used broadly, we simply imply that the best economic performance by the firm. In Vietnam, the SOEs do not face disciplinary effects of the market and the threat of takeover. Besides, the owners often fail to discipline the firm, partly because most decisions are based on negotiations, and objectives are rightly defined. As a result, SOEs are normally seen less efficient than other firms. Recent studies show the growing role of private and FDI sectors in term of contribution to GDP in Vietnam, while the SOEs sector still dominates the economy<sup>2</sup>.

The lack of managerial incentives and no effective monitoring are the reasons for the old-fashion of SOEs. From our point of views, managerial incentives are weak if managers are appointed on the basis of political decisions rather than of professional capacity and if salaries and job security are not related to economic performance. These, unfortunately, are the common practices in most of SOEs. Besides, the objectives of SOEs are often defined by politicians, and in many case, have multiple objectives which cause performance hard to be monitored, if monitoring indeed exists. Furthermore, for big SOEs such as general and special corporations, they almost do not face any competition and have enough market power to set their own prices, and thus their performance tells nothing about efficiency<sup>3</sup>.

Equitization in general and of the SOEs in particular therefore is expected to increase the firm efficiency, creating a new face for the economy. Indeed, there have been several reports on the improved performance by the equitized firms. The report by Enterprise Innovation Unit (Ban Doi moi Doanh nghiep) affirms that equitization process has positively affected the equitized firms' performance in terms of managerial efforts and capacity. According to this report, 96% of the equitized firms reported increased effort by managers; 88% reported increased working capacity as performance based bonus was applied. These results however are based on the reportings from the equitized firms and really need further verification.

A recent study by Truong et al (2006) may provide a good reference for the effectiveness of the equitization process in Vietnam. This study estimates the impact of equitization on the firm performance in Vietnam by comparing the pre- and post-equitization financial and operating performance of 121 former SOEs.

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<sup>2</sup> Report by Vietnam Program, Kennedy School of Government, Harvard University, 2008.

<sup>3</sup> The case of EVN can be an example.

They indeed find significant increases in profitability, sales revenues, efficiency and employee income, which are associated with equitization event. Their study also emphasizes that firm size, residual state ownership, corporate governance and stock market listing are key determinants of performance improvements

Given these positive results, it's necessary to note that the improved efficiency is not automatically created through the equitization process itself, but through the market mechanism. The common view is that equitization brings firms to the public, enabling efficiency to be achieved through increased monitoring. Failing to understand this will cause serious failure in achieving the overall goal. Our intuition is that, firm ownership restructuring is the necessary condition for enhancing efficiency, but the sufficient condition is the managerial enforcement. These two conditions are practiced and testified in the equity market. Hence, in our views, the equity market plays an important role which decides how efficiency can be achieved.

### **3. The equity market**

Basically, an equity market serves for at least three key functions: (i) financing firms' investments, (ii) improving firms' corporate governance and performance; and (iii) signaling information regarding issuers to public investors through stock prices. It's documented in Greenwald and Stiglitz (1998) that, by issuing equity, firms do not have to face the burden of financial obligation (like with debts) in the state of recession, and thus this enables long term investment and growth. This can be seen as a risk sharing mechanism between the firm and the investors. Levine (2000) adds that, liquid market would also encouraging investors to put more money in equities than in debts.

The role of equity market in developing countries is also seen from the lack of alternative financing options. Due to asymmetric information problem and limited collateral, firms normally find it difficult to raise funds through debt markets, such as bank loans and bonds, and thus they rely largely on equity as the only source of finance. Hence, from the investor's point of view, with equity investments, they can claim unlimited gains while risk is limited to the initial investments. The equity market is also helps venture capitalist through IPO process.

Levine (2000) also argues that well functioning equity markets may help to strengthen accounting, auditing and disclosure system that are applicable to issuing firms and thus stimulate standardization of information. Stiglitz (1985) adds another view on this, arguing that the availability of information to investors at large would lead to the emergence of a large number of information producing

firms, which sells their information at reasonable cost and thus reduce the cost of information for the investors as a whole.

Furthermore, the equity markets provide an alternative tool for corporate governance through the use of shareholders' monitoring devices as well as market for corporate control where badly managed firms can be bought, replaced the management and make capital gains (Allen and Gale, 2000). The urge for a market based monitoring system is critically important as we observed the collapse of Asian financial market in 1997, which was based mainly on relationship monitoring system (Shirai, 2004).

Given the above findings, it's clear that developing a sound equity market is a condition for the success of equitization. The role of financing firms' investments can be achieved only if the equity market creates enough liquidity and reduces policy risks. In the case of Vietnam, such conditions as the T+3 settlements have been seen as constraints to liquidity, which increase risks to investors, especially under chaotic conditions. Besides, there is no framework for the unlisted - equitized firms, causing serious concerns over the liquidity. The equity market can also improve the corporate governance of the firms if there is a framework for monitoring and disclosure. Perhaps individual investors may not have enough incentives, but the listed firms should be regulated to provide information about performance for the shareholders in time. Such information as the updated financial statements, firm profiles should be posted and updated on the website of the stock exchanges, at least. The role of signaling can be achieved if the first two roles are strengthened. If more information is available to the public, investors may act appropriately. If their actions can be implemented as quickly as they expect, information could eventually result in the correction in prices. Only then, the changes in prices could signal the performance, or the efficiency, of the listed firms in an appropriate way. Otherwise, we would see a stock market with no fundamental effect and insider trading would cause serious concerns with the investors' confidence and fall of the stock market as consequences. Perhaps, a Chinese lesson can be learnt in this case.

#### **4. Chinese lesson**

A good lesson learnt from the equitization in China can be seen from an empirical study by Shirai (2004). Briefly, equitization process of SOEs in China started in early 1990s with an initial focus on small SOEs. Since 1998, the process continued with increasing larger firms and with increasing speed. In 1996, there was around 114,000 SOEs, in 2003, this figure was around 34,000 (Garnaut et al., 2005). The state ownership in the overall economy declined from around 41 per-

cent in 1998 to around 34 percent in 2003 (Garnaut et al., 2005). By 2005, there were around 1,400 large SOEs listed and their market capitalization amounted to about 40 percent of GDP (Garnaut et al, 2005).

One of the notable features of ownership structure in China is that individuals can own only one-third of the publicly listed form SOEs. The two-thirds remained owned by the state or the institutions which are also state-owned. The shares of the SOEs are also classified into different groups, in which A-shares are owned and traded only by Chinese while B-shares listed in Shanghai and Shenzhen are owned and traded only by foreigners. Oversea listings, including H-shares in Hong Kong and N-shares in New York are also restricted to foreign investors. With this classification, it's hard to measure the performance of the equitized firms (Meggison and Netter 2001).

The empirical findings do not favour the success of the equitization in China. Shirai (2004) finds that, the equity market in China has contributed little to financing firms' investment, while there was a significant positive impact of loan finance. These results imply that the issuers increasingly use newly raised funds from the equity markets for nonproductive purposes, such as repaying debt, purchasing other firms, supplementing working capital, etc. In addition, public investors hold stocks for only short-term gains, making stock prices volatile and equity an unstable source of external finance for investment.

Shirai (2004) also finds that firms whose state ownership is in the range of 41-60% tend to produce lower profitability, probably due to asset stripping by managers or officials in charge of them. These results indicate that the government urgently needs to introduce measures to cease such practices before promoting further privatization. This finding is crucial because it shows the effect of the large state ownership in the firms. Besides, Shirai suggests that the performance of B-share and H-share firms was inferior to that of the A-share firms. This can be understood as the result of reported accounting manipulation practices frequently performed in the A-share market and the inability of foreign investors to monitor the firms in the absence of well-defined minority shareholders' rights.

More interestingly, Shirai shows that public listing has not helped firms to improve their performance. This could imply that the role of corporate governance indeed should be strengthened. The solution is that the government should allow more firms to be listed in the domestic exchanges, which increase competitive, transparently-managed firms and encourage existing listed firms to improve their corporate governance, which would in turn encourage investors to hold the stock longer. Given the above findings, we suppose that to ensure the success of equitization, we need to improve the corporate governance.

## **5. Corporate governance**

It can be argued that, the nature of equitization process is changing the corporate governance. However, the role of corporate governance is not only at the time of change, but also ex-post. In other words, equitization process restructures the firm ownership, but the corporate governance will control the new structure in the way that increases firm's efficiency. Corporate governance however is not as simple as the firm's charter or regulation - it's all about how to control the conflicts of interest among parties within the firm. Hence, the firm owners should, at the first stage, identify the potential conflicts of interest within their firm. Our discussion below follows a framework by McColgan (2001).

### *The conflicts*

The conflicts in the firm are subjects of corporate governance. Conflicts are understood to derive from the existence of asymmetric information between parties in a firm, say shareholders, debtors and managers. In the seminal framework by Jensen and Meckling (1976), they discuss these conflicts of interest as the theory of the firm, in the sense that it is what a firm should do to get developed. The conflicts of interest eventually incur costs, which ultimately reduce the firm efficiency. These costs are mentioned largely in the literature as agency costs or agency problems.

Jensen and Meckling (1976) define agency relationship as that one party (principal) engages another party (agent) to perform some service on their behalf. By doing so, the principal delegates some of the authority to its agent. However, because there is no perfect contracting for every possible action of the agent, while these actions affect both the agent's and principal's welfare, agency problem arises. The standard agency problem is supposed by Jensen and Meckling (1976) who observe that managers bear all the cost of failing to pursue their goals but capture only a small portion of benefits. They suggest that the problem could be decreased if the managerial incentives increase.

Jensen and Meckling (1976) summarize agency cost as the sum of monitoring cost, bonding cost and residual loss. Monitoring costs are the expenditures paid by principal to measure, observe and control an agent's behaviors. They can be the audit costs, compensation packages or the cost of firing managers. These costs are eventually borne by managers because their compensation will be adjusted to cover these costs (Fama and Jensen, 1983). Bonding costs are the expenditures that managers spend on constructing a system to ensure that they behave on the shareholders' benefits. These can be the additional information disclosures to shareholders. Notably, these can be seen benefit to both parties:

shareholders and managers, and thus they are additional costs to shareholders. The residual cost is the difference between the expected outcome and the actual outcome. Normally, this is acknowledged because the cost of enforcing the principal – agent contract would outweigh benefit from it.

Although the work by Jensen and Meckling is basic, it gives us some intuition on the equitization process. First, it indicates why SOEs in generally is less effective than the other sectors. That is because when managers work for themselves, they have more incentives to do the best things for the firm. But, with the SOEs structure, managers are allocated and thus they do not have enough incentives. Second, with the firms being equitized, and with the existence of equity market, agency cost could be reduced as it can be captured and monitored by the market. In other words, equitization creates chance for improving efficiency through reducing agency cost. However, we should note that the level of state ownership may decide how effective the market monitoring could be, especially if the SCIC – a state representative in most of the equitized SOEs - is not been seen active as a large shareholder.

### ***The nature of conflicts***

The nature of conflicts of interest within a firm is explained from different perspectives in the literature. Jensen and Meckling (1976) see the moral – hazard conflict in their model which assumes managers initially owning a firm but they then start consuming private perquisites rather than investing in NPV projects as their ownership stake in the company declines. Shleifer and Vishny (1989) add that, instead of not investing, managers may pursue projects that best suit their personal skills, to maximize their benefits (e.g. high remuneration, high cost of firing) rather than of the shareholders. The moral – hazard framework also suggests that the managerial effort also decreases as managers own smaller stake in the company and thus have less incentives to work at best effort. Rosenstein and Wyatt (1994) confirm this phenomenon by showing the negative market reaction to announcement of a firm’s directors as an outsider to another board. The moral hazard is seen to be high in large companies because the complexity and difficulty in contracting managers (Jensen 1993).

While the moral hazard framework emphasizes on the managerial effort and the issue of under-investment as the cause of conflicts, the earnings retention approach see the problem of over-investment. Brennan (1995) argues that the grandiose visions and cash distributions are of more concern. Empirical studies show that, the director remuneration increases with firm size, giving managers with direct incentive to size growth, rather than shareholder returns (Jensen and Murphy, 1990; Conyon and Murphy, 2000). Specifically, managers prefer to re-

tain earnings, which help increasing size, while shareholders prefer high levels of cash distributions, e.g. dividends (Jensen, 1986).

Furthermore, increasing with the firm size is the tendency of more diversification for job security purpose (Jensen, 1986). This clearly is not of investors' interest as they already hold diversified portfolios. Lang and Stulz (1994) confirm this by showing that returns to shareholders in more diversified firms are significantly lower than in less diversified, and moreover, firm value decreases when firms become more diversified. Besides, earnings retention ultimately reduces external funding and thus reduces external monitoring power, which benefits the managers (Easterbrook, 1984).

The conflicts between shareholders and management can be arisen from the timing of cash flows, which normally are discussed in the literature as the short-sighted perspective. Managers are assumed to be concerned more with the cash flows during the employment term, while shareholders are concerned with all future cash flows. This problem is especially seen as top executives approach their retirement or have made plan to leave the firm. For example, Dechow and Sloan (1996) show that the R&D expenditure as top executives approach their retirement tend to decline, simply because R&D expenditures reduce the management compensation in the short term.

It is also well documented that risk aversion is a source of conflicts between shareholders and managers. Because managers devote most of their human capital to the firm, and their income depends on the firm's performance, they are risk averse and tend to make diversified investments to minimize the risk associated with the firm's performance (Jensen, 1986). The risk aversion is also seen from the capital structure policy, that managers prefer equity to debt financing because debts increase the probability of bankruptcy and defaults (Brennan, 1995). Besides, empirical evidence from Demsetz and Lehn (1985) suggests that high risk firm is more related to those with low firm's ownership by managers. This indicates that risk – aversion is dependent on the level of firm ownership by managers.

Given the above findings from the literature, we see almost all potential for all of the above agency problems in Vietnam. As mentioned, in many cases, managers are allocated on the basis of political decisions. Besides, the common ownership structure shows the larger portion to the State, while the active monitoring bodies including strategic partners, employees, managers and public investors hold the smaller part. Thus, there are reasons to believe that managers may lack managerial effort which may cause under-investment. More seriously, there is increasing managerial effort of transforming the state assets into private assets

during the equitization process, which sees several manipulated offerings. It's also observed that many listed firms in the year 2007 announced new equity issuance and paid dividends by shares. This obviously is a signal of over-investment with a firm-size growth vision, which improves managerial benefits but ultimately reduces those of shareholders.

Besides, many listed firms have not focused on their core operations, but have expanded to other sectors, making them being hybrid and more diversified. Increasing firm size and being more diversified is clearly what the investors do not expect. On one hand, they hold diversified portfolios already (this is especially true with the State – SCIC) and thus further diversification may result in low return. On the other hand, increasing size and more diversification means that investors may find it hard to monitor the firm's performance, further encouraging managers to act on their own benefits. All of these clearly require appropriate actions to control for agency costs, alongside with the equitization process. Especially, the SCIC, the largest shareholder in most of the equitized SOEs, should be more active in agency controlling. If this body is not, it's hard to believe that smaller shareholders will find enough incentives to monitor the firms. The next section will briefly discuss the use of agency cost controls that are largely discussed in the literature.

## **6. Agency cost controls**

### *Managerial labor market*

Fama (1980) supposes that a managerial labor market would help to control the agency problem. He argues that corporate managers will be compensated in accordance with the market's perception of how well they are aligned with shareholders' interests based on previous performance with other firms. The Fama's hypothesis can be understood as that market can normally observe the managerial preferences with respect to firm size (earnings retention), their age and the amount of time they are likely to spend on the firm, and their preferences for diversification, then revise the wage to resolve any problem with these preferences. However, Fama accepts that due to market imperfections, it's not always that managers are rewarded for the level of alignment they achieve with the interests of shareholders. Jensen and Murphy (1990) also suggest that equilibrium in the managerial labor market is likely to prevent large penalties for poor performance.

The role of managerial labor market is supported by large amount of empirical evidence. Most of the studies are consistent that poor managers will lose their jobs. Gilson (1989) finds that external labor market use evidence on past

performance in defining the job opportunities and compensation levels for firm executives. Kaplan and Reishus (1990) also find that managers in firms that have cut dividends are less likely to receive roles as outside directors in other firms as they are perceived as poor managers. However, some evidence suggests that the market is only effective in disciplining the poorest performance managers (Jensen and Murphy, 1990; Kaplan and Reishus, 1990).

In Vietnam, the market for managerial labor is just at the beginning, if exists. Some of the big SOEs have announced plans to recruit CEOs on market basis, but the results have not been known. Perhaps, the current salary and compensation package is the most constraint for the development of managerial labor market. What we do think we can do is to change the philosophy of managerial labor: it's the labor goods rather than the human beings. If we don't improve this market, we lack one of the effective mechanisms for improving efficiency.

### *Corporate boards*

The role of corporate boards on agency cost controls has been well studied in the literature. Fama and Jensen (1983) suppose that an effective board must separate the decision management and the decision control. To attain this, the corporate board should be composed largely of independently directors holding managerial positions in other firms. Outside directors are able to separate the above functions and exercise the decision control since reputational concerns and equity stakes give them sufficient incentives to do so.

This phenomenon is supported by some of the empirical evidence. For example, Rosenstein and Wyatt (1990) find that a firm's stock price rises significantly upon the announcement of an outside director to a firm's board. They also find that, the greatest increase arise in the sub-sample of smaller firms while insignificant increases for the sample of larger firms. This could be due to the asymmetric information problem and the fewer existing outside board members in smaller firms. The evidence however is subjected to cautious comments that the finding simply reflects the correction of a disequilibrium within the individual firm (Hermalin and Weisbach, 1991), and thus should not be understood as that continuous appointment of outside directors would increase the stock prices.

It is argued that CEO tends to dominate the board nomination process and will choose directors most in line with their own preferences. Core, Holthausen and Larcker (1999) find that CEO compensation is an increasing function of board size, the percentage of outside directors appointed by the CEO, and the percentage of directors serving on three or more boards. Jensen (1993) argues that corporate board becomes less effective when the size increases and. Yermack

(1996) and Eisenberg, Sundgren and Wells (1998) find empirical confirmation of this, where they document an inverse relationship between board size and corporate value for large and small companies respectively.

Although this tool to agency problem is somewhat familiar in Vietnam, the practice of appointing outside directors to the board of an outstanding firm in Vietnam is still a nominal process. In many cases, the outside directors are chosen by the CEO of the outstanding firm, and thus their role of decision control is limited. Alternatively, outside directors are normally from the cross-holding firms, and thus they lack monitoring incentives. Furthermore, most of the outside directors do not really understand the firm's business and thus they cannot make appropriate decision controls. All of these make the "outside directors on the board" not an effective tool, although the approach is appropriate.

### ***Financial policy issues***

Financial policies toward capital structure could be also an effective for agency controls. However, in Vietnam, issuing debts is not a common practice. Specifically, issuing debts is constrained by both the internal and external factors. The market for debt issuance is non-existent while access to bank loans is not easy. In the meantime, managers find it easier and more incentive to issue equity. The danger is that, too much equity would lead to the risk of lacking external monitoring and thus increasing the cost to shareholders.

Jensen and Meckling (1976) argue that the existence of debt reduces the proportion of equity and therefore enables higher levels of insider ownership. Jensen (1986) also argues that the existence of debt in the firm's capital structure acts as a bonding mechanism for company managers. By issuing debt, rather than paying dividends, managers contractually bind themselves to pay out future cash flows in a way unachievable through dividends. Easterbrook (1984) argues that external capital market monitoring brought to companies by debt financing forces managers in value maximizing strategies, rather than personal utility maximization. From the social point of view, Brennan (1995b) argues that the role of a firm's capital structure should be to ensure its socially optimal liquidation.

However, how much debt is sufficient is a question on the other side. The optimal capital structure should be where the marginal costs of debt equal its marginal benefits. This is the point where the value of the firm is maximized. Nevertheless, issuing debt beyond optimal levels will increase its risk and reduce the value of the company. Stulz (1990) argues that, while debt may reduce the risk of over-investment, there will always be a danger that it could lead to under-investment due to the costs of raising new finance. Another solution to

reduce the agency cost is dividend payment. However, because paying dividend is not a legal commitment as compared with debt payment, so the use of it is less efficient (Jensen, 1986).

Clearly, an appropriate use of debts is a tool for improving efficiency within the firm. However, in the year 2007, many of the listed firms in Vietnam have issued new equity to the market, instead of using debt finance. This on one hand is a signal of over-valuation, on the other hand shows the over investment problem. The correction of the market following the trend of new equity issuances is the worst market reaction that we have seen in the history of the equity market. We understand that the choice of debt or equity is entirely of the firm, but if monitoring devices are enhanced, e.g. information disclosures are enforced, then investors would have had an apparent pictures on the firms, avoiding surprising collapses.

### ***Large shareholdings***

Another solution to agency problem can be the use of block shareholders and institutional investors. This is because normally individual do not have skills, time and interest to monitor the managerial incentives, or otherwise, they do not have sufficient incentives to monitor the firm's management due to small ownership and free-rider problem, so they do not have enough pressure on the firm management board. The CEO may also tend to be more willing to bear bonding cost to block shareholders and institutional investors. Large ownership by outside investors represents a large threat control to firm management and provides pressure for internal governance systems to operate more efficiently. Mikkelson and Ruback (1985) report significantly positive market reactions to block purchases, but that these disappear quickly unless the acquirer initiates some form of corporate restructuring. McConnell and Servaes (1990) find a positive relationship between institutional ownership and corporate value.

However, the use of block shareholders may also lead to negative effect on the firm value. Shleifer and Vishny (1997) argue that firms holding large blocks of shares in other firms may pursue their own interests at the expense other shareholders. This may include trying to acquire the firm for their own value-destroying diversification purposes. Similarly, Denis (2001) contends that whilst block shareholders seek to increase firm value, they may also attempt to enjoy benefits not available to other shareholders. In addition, Holmstrom and Tirole (1993) find that such blocks can reduce the liquidity of a stock and the supply of company information to the market.

Although there are clearly advantages and disadvantages of block shareh

olding and institutional investors, we do believe that the use of them is necessary. However, block shareholding does not work in Vietnam, while the role of institutional investors is limited. This is because the shares held by the public are normally too small for them to have any incentives to monitor the management's activities. In the meantime, institutional investors are in most cases financial institutions, holding diversified portfolios already and thus preventing them from monitoring individual firms. The other reason is that most of the firms are cross-holdings, so they may find hard to monitor each others.

### ***Takeovers***

Poor performance should be in pressure of takeovers. However, the current situation does not support this tool. It's because that firms are controlled by the States, while the managers are normally allocated on political basis. Takeovers may occur in relation to the earnings retention conflict between shareholders and management. Jensen (1986) argues that takeovers occur in response to breakdowns of internal control systems in firms with substantial free cash flows and organizational policies which are wasting resources. Takeovers threat works in two different ways: first, managers who fear of losing jobs may react by investing these free cash flows in more efficient investment projects; second, successful takeover targets realize substantial wealth increases, indicating a potential for improved performance which the previous management had failed to utilize (Jensen and Ruback, 1983).

Martin and McConnell (1991) identify two motives for takeover: efficiency gains and disciplining poorly performing management. They find the performance of disciplinary targets, where top management depart following the takeover, was no worse than the market average, but worse than their industry average. Non-disciplinary targets perform as well as their industry average. They find that CEO turnover in target firms increases following a takeover. This is consistent with the takeover market disciplining managers who fail to maximize shareholder wealth.

### ***Managerial Remuneration***

Remuneration package is an important factor affecting the conflict of interests between shareholders and managers. Basically, high levels of remuneration would result in high performance (Jensen and Meckling, 1976). Remuneration package can take three standard forms: basic salary, performance based bonuses and stock option schemes. While the salary is a basic tool and determined through managerial labor market mechanism, it's arguable that this tool works only with the poorest performance managers (Jensen and Murphy

1990). This would imply that basic salary alone is insufficient for agency cost control.

A generally used tool is the bonus system, which relies on accounting measures of performance. Banker, Lee and Potter (1996) support the use of it by showing that the sales of the firms in their study indeed improve after the introduction of the performance based bonus system. However, there are also some concerns with the manipulation issues and the short-sighted incentives relating to the performance based bonus (Healy, 1985; Jensen and Murphy, 1990). Moreover, bonuses related to the earnings might lead to firm size preferences, which eventually damage the shareholder's benefits. Thus, designing a bonus system is not an easy task as said.

The use of stock option is one the most effective tools in reducing agency cost as it is seen as a substitution for managerial ownership. These options give managers the right to buy stocks at a fixed price at given times in the future. The higher the value of the firm, the higher the the value of the options and the profit managers can make upon exercising them.

While the salary may have increased in recently years in the equitized SOEs, the bonus system and especially the stock option has not been used. Perhaps, we need to change the approach which focuses not only on the level of pay, but also the structure of it. Baker, Jensen and Murphy (1988) argue that the level of pay determines where managers work, but the structure of the compensation contract determines how hard they work. Effective compensation contracts should provide management with sufficient incentive to make value maximizing decisions at the lowest possible cost to shareholders.

### ***Managerial share ownership***

Giving managers some ownership of the firm is a direct tool to manage the agency cost (Jensen and Meckling, 1976). Benston (1985) confirms this hypothesis, finding a significantly positive relationship between shareholder's wealth and changes in value of managerial ownership. This is because managers are tied close to shareholders' gain and loss. For example, Hull and Mazachek (2001) find a positive market reaction following a new equity issuance to high level of managerial ownership. This is because market perceps that managers in high managerial ownership firms have less incentives to issue overvalued equity as they are likely to suffer from price falls.

However, inside ownership may lead to the problem of managerial entrenchment, in which managers gain too much voting power within the firm and are able to pursue their own interest at the expense of outside shareholders (Fama

and Jensen, 1983). In the meantime, it's hard to remove managers where they own a large portion of the firm. Bethel et al. (1998) and Weisbach (1988) find an inverse relationship between disciplinary events and managerial share holdings. This indicates that powerful managers are difficult to discipline even when they are poor performers. The example of FPT with their diversification strategies could be an example of managerial entrenchment.

## **7. Conclusion**

Although there are too many things untouched relating to the equitization process, we have analyzed some of the points, which from our point of views, are important for the success of equitization process. We have proposed that, equitization process itself does not create higher firm value, or efficiency, but the corporate governance through market mechanism does. Hence, we suggest that, the corporate governance practices should be enhanced, together with equitization process, and they – the corporate governance practices - are indeed the ex-post equitization concerns as well.

In some of our specific arguments, we have presented that the equity market plays an important role in the economy, especially in the developing economies. Its roles include financing firms' investments, enhancing corporate governance and making information more available and transparent to the public. However, the level of importance depends very much on how the corporate governance is strengthened, or in other words, how equity market is interactive to the corporate governance practices. The Chinese lesson is somewhat meaningful to Vietnam as it indicates that the equity market does not help financing the firms' investments, implying the non-productive uses of equity issuance and that the listing does not increases the firms' efficiency. These all findings are due to the lack of corporate governance practices that should help the equity market work well in the first instance.

The paper also suggests that Vietnam has been facing almost all aspects of agency problems, which are the subjects of corporate governance. They are the moral hazard conflicts where managers lack managerial efforts or the over investment problem where managers act on their own benefits. Increasing firm size and diversification is also a reality in Vietnam where managers strengthen their individual positions at the cost of shareholders. Some of the agency controls have been proposed based on the literature review. Although these tools are seen from the general literature, i.e. more from developed markets, they indeed give some intuitions to the ex-post equitization in Vietnam. Among other things, we see enforcement of managerial labor market, the use of compensation structure, of

block shareholding and institutional investors, and managerial ownership are the appropriate tools that can be applied to Vietnam at this moment. Somewhere in our arguments, we do imply that the SCIC should play a more active role in controlling agency problem.

In short, this paper adds a theoretical approach to the equitization process in Vietnam, with a focus on agency problem and the role of corporate governance. Further empirical research may explore the role of equity market and the performance of the equitized firms as a background for further recommendations on the equitization. Alternatively, research may also focus directly on the comparison of performance between firms with and without corporate governance practices. Only then, we may have a comprehensive picture of the role and importance of equity market, as well as of the corporate governance in attaining the overall goal of efficiency – which basically is defined as the supreme goal of the equitization process.

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