midf RESEARCH

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Dual does not mean cruel

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KLCI: 1,772.39 points

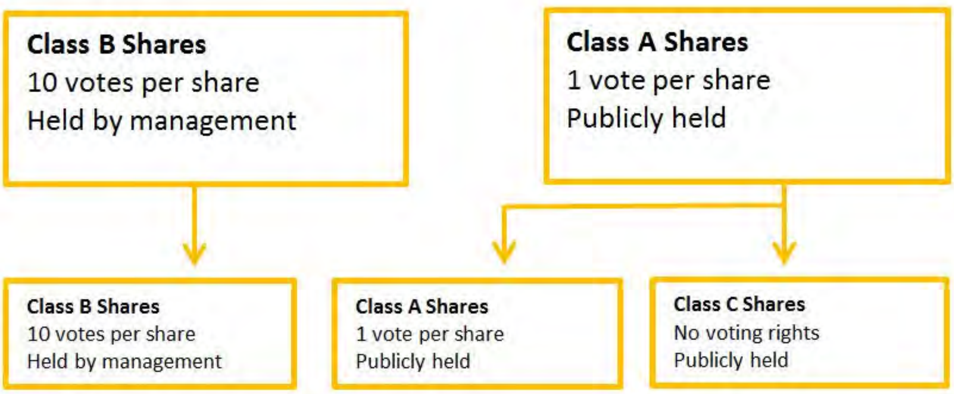
2017 Year-end Target: 1,830 points

What is multi class share structure?

Dual or multi-class structure allows company to issue various classes of shares, usually named as but not limited to class A and B. One class will have higher voting rights than the other, giving shareholders superior control in the company. It is commonly offered to founders, family members and executives (refer Exhibit 1) giving them more controlling power even with relatively smaller shareholding volumes compared to minority shareholders. Despite the resistance faced from many parties i.e. investors, we observe that such shares are gaining more traction among stock issuers as they plan to go public.

Permitted in nine bourses around the world. Also known as weighted voting right shares, it has been allowed in the world's biggest stock exchange, namely the New York Stock Exchange. Interestingly, such shares are also permitted in nine other bourses around the globe, including in Brazil, Canada, France, Italy, Sweden, Switzerland, Denmark, Russia and Finland. Although the dual listing mechanism is similar by nature, each of those stock exchanges applies its own rules and formats, to adapt with the local ecosystem.

Exhibit 1: Dual-class structure



Why should an issuer consider it?

As dual-class became the subject of heightened attention, we believe it is important to highlight some of the central issues surrounding it, in order to examine the impact, it might leave on the financial market. The following briefly sets out the pros and cons (refer Exhibit 2) of dual class.

Exhibit 2: Pros and cons of dual-class structure

Pros	Cons
1. Insulate management from stock market's short-term mindset 2. Provide company the ability to focus on long-term financial return 3. Open the door for greater innovative development (take more risk)	1. Superior voting rights by management could lead to abuse of shareholders rights 2. Lack of market liquidity as investors lose interest to invest

Historically, the idea on dual class has been running on resistance since its introduction in 1925. It happened when a company called Dodge Brothers filed an initial public offering with objective to raise significant amount of capital for business' expansion. The issue emerged when the shares being offered to public are only of inferior class, with downgraded voting power while the company retain almost all of the voting rights to themselves. To mitigate the risk of such shares issuance, SEC in 1988 had passed a law which required that listing standards prevent companies from issuing new shares with per-share voting rights greater than those of current outstanding shares.

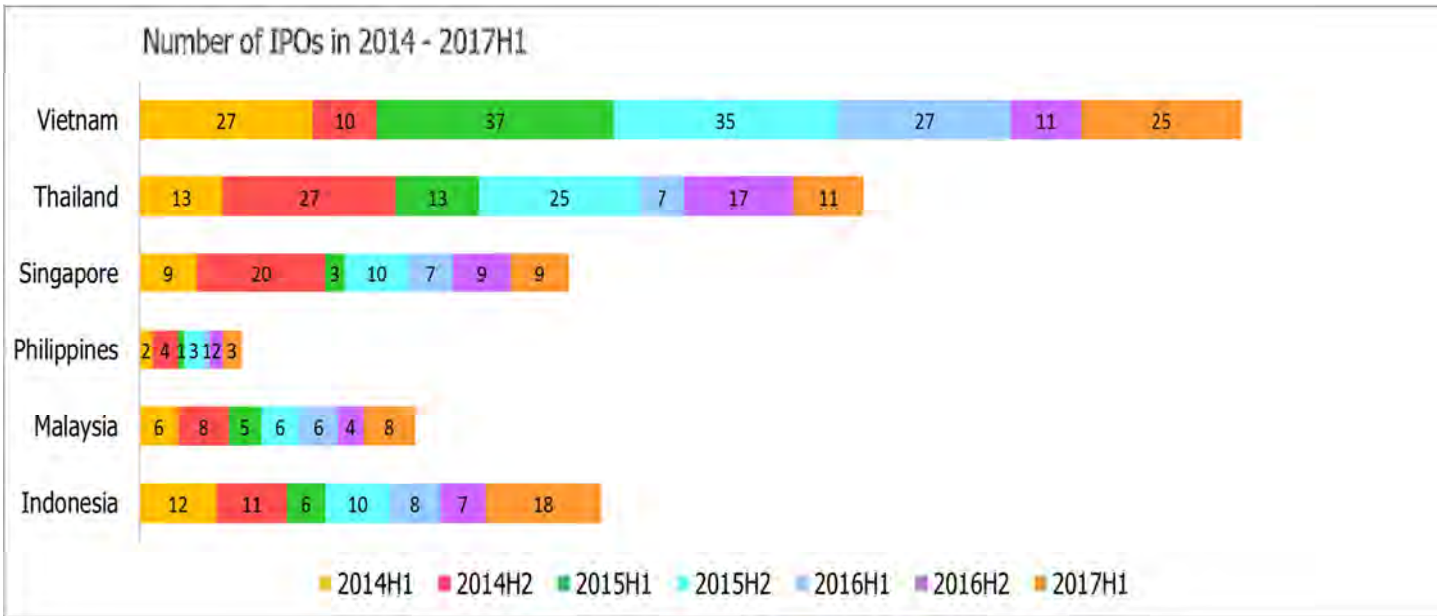
Hong Kong and Singapore are considering it. Notably, Hong Kong and Singapore are among the exchanges that have been mulling to consider permitting such structure but ended up banning them, after seeing opposition from the regulators. Interestingly, the stock exchanges are reviewing back their policy with the intention to allow the issuance of such structure again. After a long period of heated discussions, SGX is now on track of enabling dual share, subject to various corporate governance safeguard. Hong Kong at the same time is on track to reform its listing rule as well, a move deemed to increase its global competitiveness after losing the much-anticipated IPO Ali Baba to NYSE, USA. The pursuit of enabling dual class is believed to be a strategical play to maintain its status as financial hub in Asia.

In Malaysia, we ought to approach this new development proactively as we move forward, figuring out whether or not dual-class will benefit the overall market. Pursuant to that, we will discuss further on some of the pros and cons of such structure, and consider some of the safeguards that may be applied to mitigate the risks associated with it. We need to remind that some of the studies done by us on were heavily focused on past trends, as we use the data for reference and benchmarking purposes.

IPO Fundraising in Asean

Better IPO market in 1HFY17. Briefly on the local market, it is shaping up to be better in 2017 with 10 IPOs for the first half, compared with 12 for the whole last year. This is attributable to the recovery in oil prices and an improving economy since the beginning of the year. At this juncture, we view that the trend is showing some positive indicators, providing an encouraging signs that the progressive performance will continue in 2HCY17. However, despite the good numbers, we have to agree with some industry observers who claimed the local exchange is having difficulty to attract more IPOs into the market. This is proven to be true based on the number of local IPOs for the year 2014 to 1H2017. Our local market recorded 35 IPOs in the span of 3 years, which only accounted 51% of the average SEA IPO numbers. Moving forward, we opine that the local market needs to accentuate its competitiveness in the region to pull large and quality IPOs, if done right will drive both trading activities and volumes higher. Refer to Exhibit 3 for illustration on SEA IPO Market.

Exhibit 3: Southeast Asia IPO market

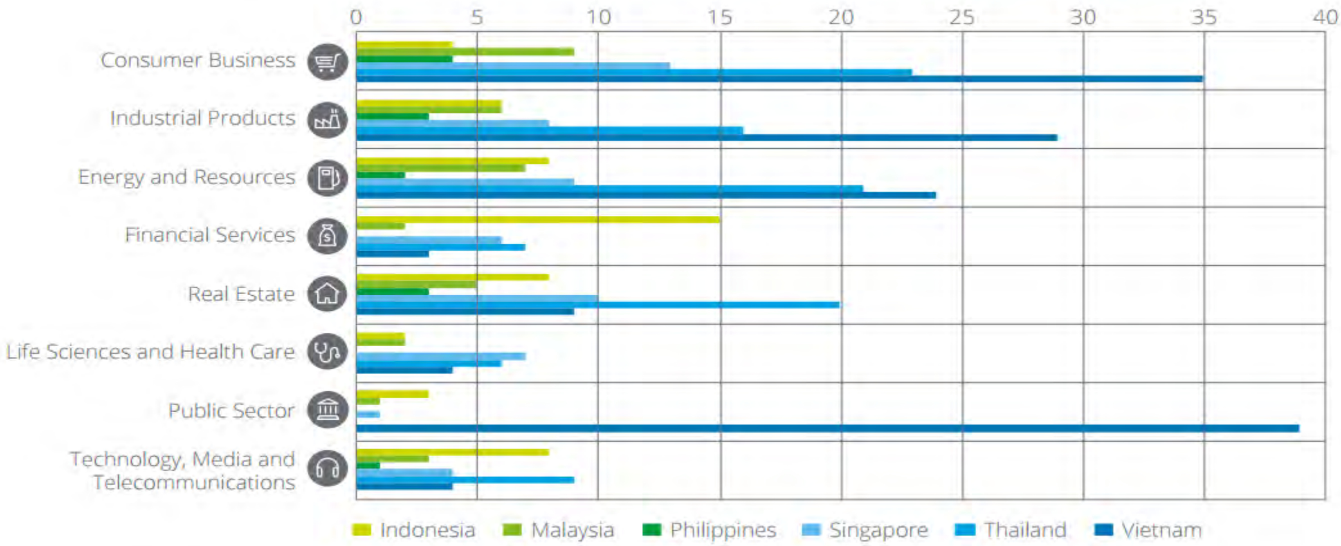


Source: Deloitte Southeast Asia IPO Market 2016 Report, MIDFR, Bloomberg

As we mull on the possibility of dual class, the introduction of such structure might help in solving this issue. This is premised on the advantages that are potentially favourable to company's management and founder. This means providing them the channel to get funding access of a public company while having minimal interference from minority shareholders, in carrying out company's long-term economic goals. It will eliminate the concern when acquiring more capital from public investors, just to have their voting rights diluted. With dual structure, we understand that company is given outsized power enabling them to control company's strategic decision even with relatively small percentage in holding. Additionally, it will insulate itself from the pressure of stock market, to deliver short-term financial returns which might be detrimental to the business' main objective.

Such advantage will provide rooms for company to innovate and take more risks. This is believed to be imperative for companies at early stage of issuance, providing support to stimulate long-term growth. At the same time, having autonomy control means that management could strategize its business objectively.

Exhibit 4: Total number of IPOs in 2014 – 2016 in the SEA by sectors



Source: Deloitte Southeast Asia IPO Market 2016 Report

The US experience

Historically, dual class were quite prominent in media companies. It was claimed that the isolation from short-term market pressure served as an anchor to keep their journalistic integrity intact. Notably, New York Times and Washington Post are among the earliest examples of dual class issuers coming from the said sectors.

Over time, dual class has also been gaining popularity among companies from technology and start-up space. The trend started in 2004, when the tech sector initiate a new wave of multi-class equity, with companies like Google, Facebook, Zynga, Box, GoPro and Snap adopting dual-class share structures.

As of now, we have not seen much interest from tech companies or start-ups in Malaysia to list public shares. We believe that constant pressure from the market to yield short-term return has been a barrier for these companies to go public. Tech company is about creating long-term values for the shareholders, and this require constant innovation and that means taking more risk. The current standard of one-share one vote might dampen this, thus would appear unfavourable to company' founders or owners.

However, if a reform in share structure was to take place in Malaysia, the real question is, are we ready?

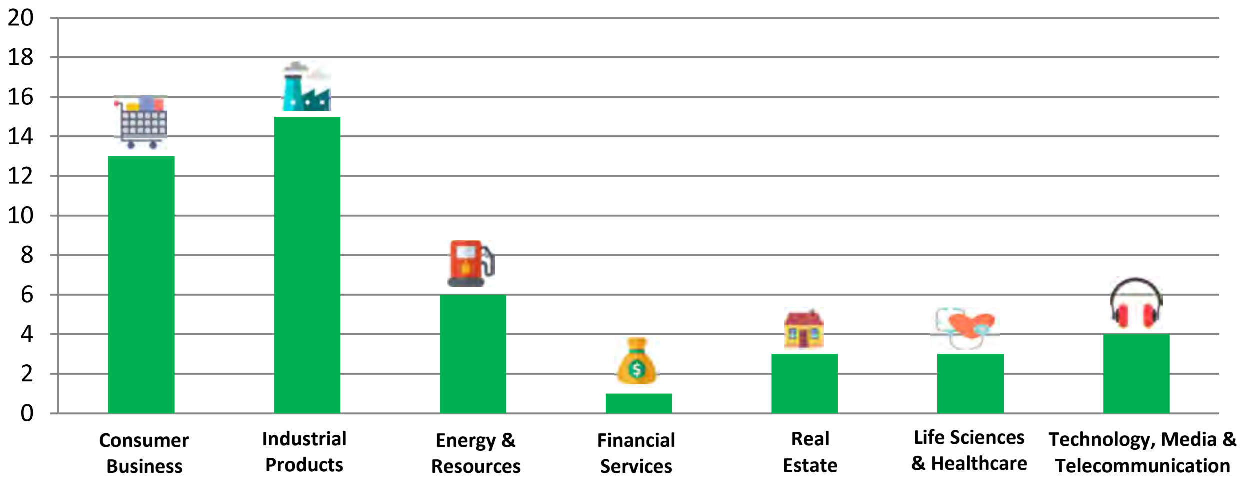
Exhibit 5: Issuance of dual class shares in USA

Source: Bloomberg, MIDFR

Should Malaysia do it too?

Draw interest from local tech sectors. In Malaysia, it is worth noting that tech companies and start-ups are slowly spreading its influence, accompanied with the potential to grow exponentially. Although it was claimed that it is pretty much at the infant stage, the growth trend should not go unnoticed while some local companies making its mark in the industry. We believe that eventually these companies will need access to capital, and getting listed on the exchange is viewed to be one of the better options. For these type of companies, dual structure will be favourable to them as it allows the economic interests of external shareholders and internal management to be more aligned, it is able to attract more entrepreneurially run companies to list in the country.

Exhibit 6: Total number of IPOs in 2014 to 1H2017 – Malaysia



Source: MIDFR, Bloomberg

Downside risks. But first, we need to identify few downside risks associated with it. This may include the possibility of investors losing interest in the stock market or the lack in minority shareholders' protection as a result of unequal voting power among shareholders.

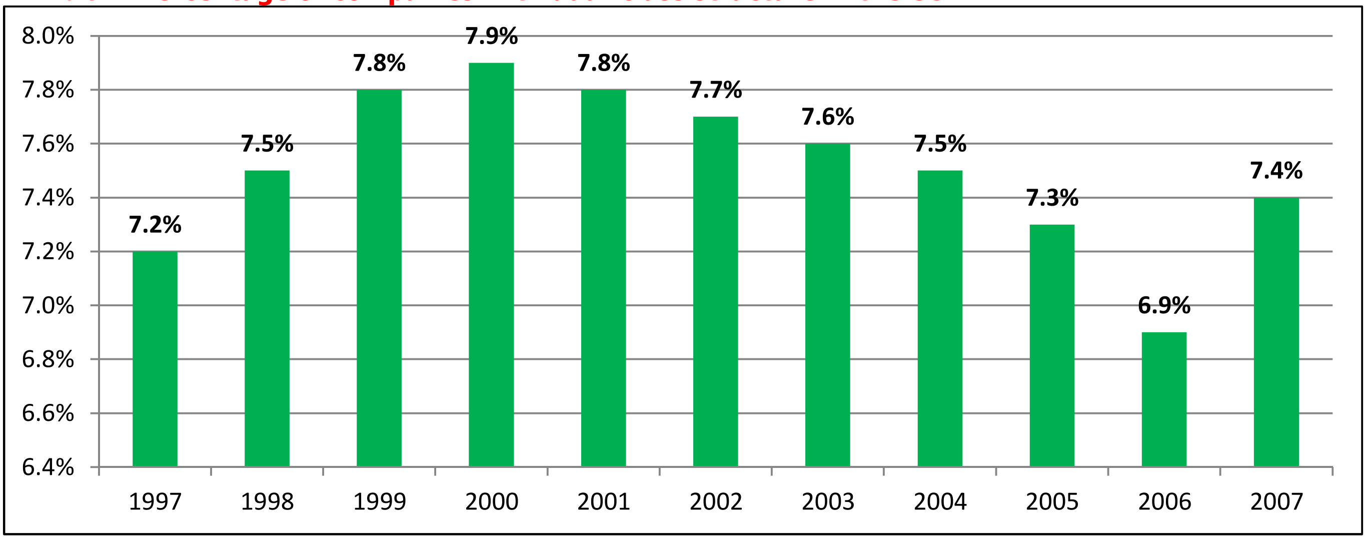
Such risks are seen to be minimal if proper monitoring is exercised. Safeguard needs to be enforced, providing more stability in the local exchange. It is imperative as to gain confidence of both retail and institutional investors in the market, preserving the sustainability of trading activities.

An option worth considering is the adoption of sunset provision within its governance structure. This means that, at predetermined date or upon reaching some strategic or growth milestone in the future, the sunset will be triggered and will automatically convert dual-structure to ordinary shares. Voting rights will be distributed equally to ordinary shareholders, giving them equal votes proportionate to their holding. We also believe that such a move will alleviate the concerns on corporate governance, and at the same time spur more institutional and retail interest when the shares convert.

Based on our studies, we note that below criteria could serve as additional safeguards for public listed companies:
- permitting only companies with a large market capitalization, such as a high minimum valuation to be eligible for the dual class share structure;
- cap on votes per share;
- board structure with a greater proportion of independent non-executive directors;
- higher dividend for shares of inferior class;
- prohibit the conversion from single-class to dual-class structure of companies already listed on the exchange.

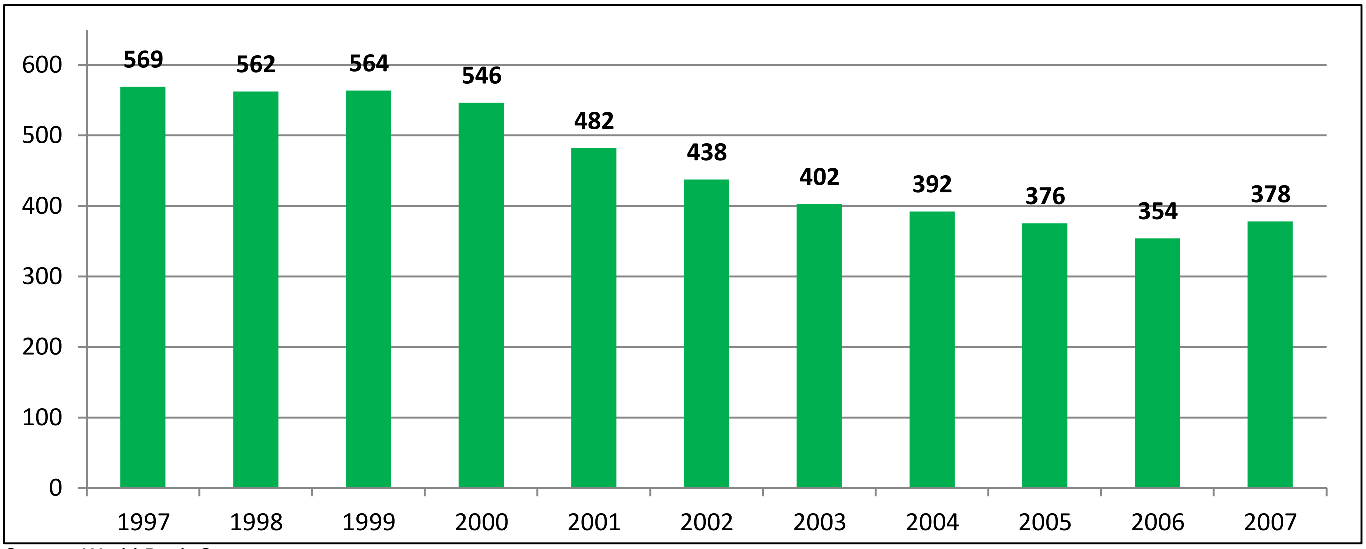
Statistically, dual-class shares only account 7% of listed companies in the US. Refer Exhibit 5.

Exhibit 7: Percentage of companies with dual-class structure in the USA



Source: Scielo

Exhibit 8: Listed companies with dual-class structures in the USA



Source: World Bank Group

Conclusion

Regulators to play their role. While it is still not very clear how dual class will impact the market, we opine that regulators are to play their role to strengthen the structural fundamental to prepare for any future reform as the market environment evolves over time. It is best to start the discussion on dual-class by educating investors about the issues important to them, making them well informed about their every right as shareholders. At the same time, we believe that safeguard will act as the backbone of market stability. If dual-class structure is ever going to be implemented in Malaysia, it is up to the regulators and market participants to engage in further discussions as to identify what is best for the market, striking the balance between stability and competitiveness.

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BUY	Total return is expected to be >15% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >15% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -15% and +15% over the next 12 months.
SELL	Total return is expected to be <-15% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >15% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.
SECTOR RECOMMENDATIONS	
POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.