The Effect of PRE-IPO Shari’ah Compliance Status on the Initial Return of Malaysian IPOS

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Abstract: This study examines the impact Shari’ah compliance status on the initial return of Malaysian IPOs between 2004 to 2017. We use a pre-IPO status to obtain a more robust result on the influence of SC status towards the IPO initial return. The initial result shows that on average, the initial return of Malaysian IPOs shows a substantial decline as compared to results in the previous studies. The result from OLS regression reveals that the pre-IPO Shari’ah compliance status does play a significant role in reducing the underpricing level of Shari’ah compliance IPOs. The company’s age and the level of volatility also are found to have predictive power in explaining IPO initial returns.

Keywords: Pre-IPO, Shari’ah compliance, IPO underpricing

1. INTRODUCTION

Research on the performance of Shari’ah compliance (SC) IPOs is relatively scarce, as the popularity of these securities is limited to certain Muslim majority countries, such as Gulf Cooperation Council (GCC) countries, Malaysia and Indonesia. Alanazi and Liu (2013) report that Saudi Arabian IPOs are significantly underpriced at a much larger magnitude than other markets worldwide. D. G. Mayes and Alqahtani (2014) extend this study by adjusting the return to market movements and include SC status as one of the variables and they find that SC status alters the underpricing level significantly. Although Alanazi and Liu (2013) and D. G. Mayes and Alqahtani (2014) have already shown that SC status is positively associated with IPO performance, their analysis is based on privately-owned companies only.

In the Malaysian context, researchers have only recently began to investigate the performance of the SC IPOs. Rahim and Yong (2010), Rahim and Che (2013), Abu Bakar and Uzaki (2013) and Bakar and Rosbi (2017) have empirically tested the performance of Malaysian IPOs with a major focus on the SC status of those IPOs. Rahim and Yong (2010) compare the profiles of initial return between SC IPOs and non-SC IPOs and find that the difference between the two groups is less significant, but there are some indications that SC IPOs have higher returns and risk than non-SC IPOs. The authors have ascribed the higher returns with the
growing popularity of the Shari'ah investment and higher risks with the risk-return theory. Rahim and Che (2013) further added that the SC status does not play any particular role in altering the pattern of the initial returns. On the other hand, Abu Bakar and Uzaki (2013) find that the SC IPOs suffer more underpricing than its counterparts. Recently, Bakar and Rosbi (2017) find that the SC status does significantly affects the underpricing of SC IPOs.

The main difference between SC and non-SC IPOs lies in the Shari'ah status that the firms possess. To earn this status, the firms have to undergo several screening stages to comply with Shari’ah law. After quantitative and qualitative screening, the firms that have successfully passed the screening are expected to have lower debt levels, higher cash levels and higher receivables levels which accordingly mark them as lower risk companies (Pok, 2012). The list of firms that passed the screening process is produced and published twice a year at the Securities Commission’s website. The existing studies on the performance of Malaysian SC IPOs (for instance Rahim and Yong (2010) and Rahim and Che (2013)) utilize this list to determine the SC status of IPOs in their sample and find that the SC status does not have an explanatory power on the performance of SC IPOs. We argue that their study may suffer from an important bias as they base their decision of whether the IPO firms comply with the Shari’ah law on the current Shari’ah status rather than its status at the pre-IPO level. Even though the firms are included in the list, they might not have possessed the SC status at the time they issue their IPO. The pre-IPO status indicates that the firms are certified as SC during the IPO. Hence, we intend to repeat the analysis by using a cleaner sample which is based on the pre-IPO status of the issuing firms. The use of pre-IPO status is expected to better reflect the SC status of the IPOs and enhance the regression result of our study. In addition, we extend the sample by including more recent IPOs.

2. LITERATURE REVIEW

There are several arguments that religious brings a positive influence towards the companies’ performance (Dyreng, Mayew, & Williams, 2012; McGuire, Omer, & Sharp, 2012). Dyreng et al. (2012) investigate the relationship between religious influence and aggressive financial accounting and find that companies that are religion-influenced are less involved in aggressive financial reporting and experience higher accrual quality, lower risk of fraudulent accounting and lower forecast error. Parallel with this, McGuire et al. (2012) find that religion reduces unethical considerations and firms are less likely to be involved in the financial reporting regularities. Further added, Grullon et al. (2010) find that religion and regulation perform as substitute mechanisms for controlling business activities. Empirically, Alam and Rajjaque (2010) provide an evidence that the portfolio of SC equities have less variability which implies that they are less risky. They also show that in European market, SC equities are significantly outperformed the market especially during the period of market downturn. In another study, Rahman, Rahman, and Courtenay (2012) use a sample of SC and non-SC firms to investigate the effect of Islamic ethical principles with accounting practices in Malaysia and conclude that SC firms have higher accounting conservatism as a result of the adherence to ethical values that reduce the aggressive reporting practices and managerial opportunism. Hamid (2010) also argues that investors may benefit from the Shari’ah screening process as it increases the transparency of the offered products that lead to a lower risk level. These are parallel to what have been said by Paul Hoff, the director of FTSE group that, the fact that SC securities are of lower leverage, high transparency.
and no speculation has increased the number of investors’ interest that are currently seeking for a ‘new way of screening practices’ (Hua, 2009).

Within the context of IPO, the literature shows mixed result concerning the effect of SC screening on the performance of IPOs. D. Mayes and Alqahtani (2015) find that SC status alters the underpricing level of Saudi Arabian IPO significantly. The result shows that the underpricing level of SC firms are lower than the non-SC IPOs and the authors attribute this findings to the fact that the SC firms has taken into consideration the costs of compliance to SC status and therefore, price their IPOs carefully to lessen the cost of underpricing. Further, the authors posit that the higher underpricing level in non-SC IPOs is considered as marketing strategy undertaken by the firms to attract the religiously concern investors to invest in their firms. In terms of long-term performance, Alqahtani (2012) reports that in privately-owned companies, the average one year cumulative average ratio (CAR) and buy-and-hold abnormal return (BHAR) for SC IPOs are significantly positive implying that the firms do not suffer from underperformance problem while for non-SC firms, a significantly negative CAR and BHAR is evidenced. Similarly, Suherman and Buchdadi (2011) find that the CAR analysis on the SC firms of Indonesian IPOs provides a positive result for almost every month over two years following IPO while non-SC firms suffer underperformance during similar period. In Malaysia, several studies have been conducted to test the effect of SC status on the performance of IPOs. Rahim and Yong (2010), Rahim and Che (2013) and Abu Bakar and Uzaki (2013) have empirically tested the influence of SC status on the performance of Malaysian IPOs. Using the current SC status provided by the Securities Commission Malaysia to indicate SC firms, collectively, these studies find that the initial return and risks of SC IPOs is higher than the non-SC IPOs. However, the difference is not statistically significant. The authors ascribe the higher returns associated with SC IPOs to the growing popularity of Shari’ah investment which resulted in oversubscription of SC IPOs and higher risk with the risk-return trade off theory. These studies also show that the SC status does not play any particular role in altering the pattern of the initial returns.

Even though all studies which focus on SC status of Malaysian IPOs show a similar result that is, SC status does not alter the initial return of IPOs, we still believe and argue that the SC status does play an important role in reducing the underpricing level of SC IPOs. We base our argument on the fact that the multi-level SC screening should result in carefully selected firms that are of high quality and less risky. Furthermore, instead of using pre-IPO SC status that indicate the firms are certified as SC at the time of IPO, the previous studies use the current list of SC firms to determine the SC status of firms in their sample. This particular list provides the firms’ names that pass the current screening test only and not at the time of IPO therefore, using the current SC list might introduce bias to the results. Based on the above arguments, we expect that the SC status does play an important role in altering the initial return of SC IPOs by reducing the underpricing level of SC IPOs.

3. METHODOLOGY

3.1. Data

Our sample used in this study comprises of all IPOs listed on the Bursa Malaysia for the period of January 2004 to December 2017. From the total IPO firms that went public during our study period, several firms are dropped due to unavailability of prospectuses and following Rahim and Che (2013), another 16 real estate investment trusts IPOs were excluded due
to the difference in financial statement presentations. The final sample includes 376 IPOs, of which 89 were SC IPOs.

**Error! Reference source not found.** shows the percentage number of SC IPOs and non-SC IPOs offered according to a year of listing, within our period of study. According to the figure, the number of non-SC IPOs is consistently lower than its counterparts except for the year 2010 where the SC IPOs are higher than non-SC IPOs.

Data on IPO characteristics such as offer price, opening price, closing price, price low and price high are obtained from Bursa Malaysia Information Services. The information on the managing underwriters and underwriters’ fees as well as the pre-IPO SC status are collected from the companies’ prospectuses available on the Bursa Malaysia website while the underwriter’s ranking is obtained from Bloomberg. The age of the companies and market price are gathered from Thomson Eikon and Datastream.

### 3.2. Dependent Variable

IPO underpricing is measured using the initial return (IR) of the IPOs. Existing studies propose two main methods for computing IR. The first is based on the opening price on the first day of trading, while the second is based on the closing price on the first day of trading (Agarwal, Liu, & Rhee, 2008; Booth & Chua, 1996; Dawson, 1987; Rahim & Che, 2013). However, the calculation using the opening price is preferred over the closing price based on the argument that it is less influenced by trading noise (Rahim & Che, 2013). The calculation of the initial return based on the opening price is shown below:

\[ IR_i = \frac{(P_{o,1} - P_{o,0})}{P_{o,0}} \times 100, \]

where \( IR_i \) is the first day return (in percentage) of an IPO \( I \); \( P_{o,1} \) is opening price on the first listing day; and \( P_{o,0} \) is the offer price.

### 3.3. Explanatory Variables

The independent variables are the pre-IPO SC status and several ex-ante uncertainty proxies that include company’s age, underwriters’ fees, market volatility, number of risk factors and the firm’s industry. We expect a negative relationship between the pre-IPO SC status and the initial return of Malaysian SC IPOs based on the argument that the screened portfolios have higher transparency regarding their financial position which subsequently may represent a lower risk company hence, lower underpricing (Hamid, 2010). Firms with longer operating history have a longer track record of published information regarding their performance prior to going public and firms with lesser operation history may be risky as investors could not evaluate their past performance (Kooli & Suret, 2004). Hence, we expect a negative relationship between age and underpricing. Beatty and Welch (1996) and Arnold, Fishe, and North (2010) suggest that firms are citing more risk factors in the IPO prospectus as a way of mitigating litigation risk in the future if the IPO offerings face problems. The authors document a positive relationship between risk factors disclosed and IPO underpricing. Following these authors, we expect a positive relationship between risk factors and IPO underpricing. Loughran and Ritter (2002) and Lowry, Officer, and Schwert (2010) show the evidence that the market condition prior to the IPO offering is significantly related to the underpricing level and show that the average initial return and volatility of initial return are high when the market volatility is high. Accordingly, a positive relationship between market volatility and initial return is expected. Additionally, we expect a negative relationship between underwriter’s fees and underpricing based on the study by Ljungqvist (2003) who
finds that when issuers pay underwriter abnormally high commission, underpricing is substantially reduced. The industry in which the IPO companies belong to is shown to influence the initial return of the IPO. In our study, we identify the technology-based firms from the category of industry specified by Bursa Malaysia. Prior studies suggest that the level of ex-ante uncertainty of technology-based firms is generally higher than another type of firms (Ritter, 1984). The underpricing level is expected to be higher in the technology-based firms as compared to other firms operating in other industries therefore, we presume a positive relationship between industry and the IPO underpricing.

3.4. Descriptive Statistics

Table 1 reports descriptive statistics of Malaysian IPOs and the characteristics of SC IPOs, non-SC IPOs and total IPO samples. The figures show the existence of some systematic differences between SC IPOs and non-SC IPOs. In general, both the standard t-test and Mann-Whitney test indicate that the two groups differ significantly in every aspect except for the number of risk factors that appears to be significantly different according to the t-test, but not with Mann-Whitney test.

On average, the result shows a substantial decline in the initial return of Malaysian IPOs as compared to results that have been reported in previous studies. The mean (median) initial return of non-SC IPOs as compared to mean (median) initial return of SC IPOs are 27.37% (14.29%) and 15.42% (8.11%), respectively. Both the t-test and Mann-Whitney of raw and market adjusted initial return show that the non-SC IPOs experience significantly higher underpricing than their SC counterparts. This result is not consistent with earlier studies, e.g., Rahim and Yong (2010) and Rahim and Che (2013), which find that the initial return of SC IPOs is higher than the counterparts. However, our result supports the study D. G. Mayes and Alqahtani (2014) which also find that the non-SC IPOs suffer more underpricing than SC IPOs.

Both the t-test and Mann-Whitney test indicate that SC IPOs are older in age and have less number of technology-based firms than their non-SC counterparts. Meanwhile, the risk of SC IPOs as measured by the number of risk factors disclosed in the prospectus is significantly higher than the non-SC IPOs with an average of 24.72 risks as compared to 22.56 risks for the latter group. This result is consistent with Rahim and Yong (2010), but contradicts to McGowan and Muhammad (2010) which suggests that the SC stocks are less risky as a result from their thorough screening process that has screened out everything that involves interest, uncertainty and other factors as well. The level of volatility between SC and non-SC IPOs is also significantly different in both measures. The intraday volatility is significantly higher in non-SC IPOs than in SC-IPOs suggesting that the non-SC IPOs are more volatile. With respect to the underwriting fees, the underwriter for SC IPOs is paid higher fees than the underwriter of non-SC IPOs. This result supports Ljungqvist (2003) that suggests, when the issuers pay high underwriters’ commission, the underpricing is substantially reduced which implies that the contract design of paying high commission to the underwriter will mitigate the agency problem.

3.5. Empirical Analysis

In order to examine the role of SC status other explanatory variables in influencing the initial return of Malaysian IPOs, we run an ordinary least square (OLS) regression as:

$$IR_i = \alpha + \beta_1 SC + \beta_2 LnAge + \beta_3 LnFees + \beta_4 LnVolatility + \beta_5 RiskFactors + \beta_6 D\_Industry + \varepsilon_i$$

Where;
IR = raw initial return for IPO firms
\( \alpha \) = intercept term of regression equation
\( \beta \) = estimated coefficient if the explanatory factor
SC = dummy variable of 1 if the IPO is SC IPOs and 0 if otherwise
\( \text{LnAge} \) = natural logarithm of the period between the companies' year of incorporation to the year they are listed in Bursa Malaysia
\( \text{LnFees} \) = natural logarithm of total underwriters’ fees agreed between the issuers and underwriters
\( \text{LnVolatility} \) = natural logarithm of the first day high price divided by first day low price
RiskFactors = the number of risk factors listed in the prospectus;
D_Industry = dummy variable of 1 for the technology-based companies and 0 if otherwise.

Table 2 reports the OLS regression on the initial return of IPOs in Malaysia. Collectively, the variables presented in the Model 1 explain 11.40% of the variation in initial return. From the table, it can be seen SC and \( \text{LnAge} \) are statistically significant at 5% level in explaining the underpricing level of Malaysian IPOs. A significantly negative coefficient of SC indicates that the SC status reduces underpricing hence which supports our initial argument that the screened firms are less risky which lead to lower initial return and subsequently lower underpricing. This result is in contrast with previous studies by Rahim and Yong (2010) and Rahim and Che (2013) who claim that SC status plays no particular role in altering the pattern of initial returns in Malaysian IPOs. However, our result lends strong support to D. G. Mayes and Alqahtani (2014) who find that the SC status is negatively and significantly explains the underpricing level in Saudi Arabian IPOs. \( \text{LnAge} \) shows positive and significant in explaining the initial return of Malaysian IPOs. This result indicates that the older the IPO firms, the higher initial returns and subsequently higher underpricing they will experience. This finding contradicts our earlier prediction and findings from previous research by (Kooli & Suret, 2004) and (Shmuel Hauser, Uzi Yaari, Yael Tanchuma, & Harold Baker, 2006). The coefficient of \( \text{Ln_IntradayVol} \) in both models shows a positive and significant in explaining the initial return level of Malaysian IPOs. This result lends strong support to the aforementioned claim by Rashid, Rahim, Hadori, and Tanha (2012) who find that the intraday volatility does positively and significantly explain the initial return which also means that the more volatile the market, the higher the underpricing is.

4. CONCLUSION

This study examines the initial return of Malaysian IPOs for the period of 2004 to 2017 with a focus on finding whether the SC status alters the performance of the IPOs. Our result indicates that the average initial return of Malaysian IPOs shows a declining pattern from what have been evidenced in previous studies. For instance, Dawson (1987) and Ismail, Zainal A., and Zainudin (1993) report that in the period from 1978 to 1989, the initial returns of Malaysian IPOs are higher than 100 per cent. Later, Yong, Yatim, and Sapian (2001) show an average initial return of 81 per cent for the period from 1990 to 1995. For the period between 2000 to 2007, Low and Yong (2011) report the average initial return of 30.83 per cent. In this study, we cover the most recent period from 2004 to 2013 and find a further decline on the average initial return of Malaysian IPOs that is 24.26 per cent.
In our analysis, we find that SC IPOs differ significantly from non-SC IPOs in every aspect. The SC IPOs appear to have a significantly lower initial return than non-SC IPOs which is contrasted with earlier studies conducted in Malaysia by Rahim and Yong (2010) and Rahim and Che (2013) but in support with D. G. Mayes and Alqahtani (2014) that find the initial return of SC IPOs is significantly lower than the non-SC counterparts based on Saudi Arabian context. Our result from OLS regression shows that only SC status, age and intraday volatility do contribute to the variation of Malaysian IPOs.

Overall, our finding supports our earlier presumption that the SC status does play a significant impact on reducing the underpricing level of SC IPOs. This result also indicates that the screening process contribute to the lower level of risk in SC IPOs. In addition, the result shows that in the absence of SC status, the IPOs suffer higher underpricing. The underpricing might be costly particularly for new firms therefore, considering getting the pre-IPO SC status may benefit them during the IPO as well as in the long-run. Thus, this study is expected to give an idea to the future IPO issuers in formulating their respected strategies.

REFERENCES


Figure 1: SC and non-SC IPOs distribution based on year of listing

<table>
<thead>
<tr>
<th>Table 1: Descriptive Statistics</th>
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</thead>
<tbody>
<tr>
<td>Non-SC</td>
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<tr>
<td>--------</td>
</tr>
<tr>
<td>N=287</td>
</tr>
<tr>
<td>mean</td>
</tr>
<tr>
<td>median</td>
</tr>
<tr>
<td>Initial Return</td>
</tr>
<tr>
<td>Ln_Age</td>
</tr>
<tr>
<td>Ln_Fees</td>
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<tr>
<td>Ln_Volatility</td>
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<tr>
<td>Risk Factors</td>
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<tr>
<td>D_Industry</td>
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</tbody>
</table>

This table provides summary statistics for all variables used in this chapter. The sample contains 376 IPO firms from the period of 2004 to 2017. Initial_Return is the percentage changes between the opening price of Day 1 and the offer price; Ln_Age is natural logarithm of the period between the companies’ year of incorporation to the year they are listed in Bursa Malaysia; Ln_Volatility is natural logarithm of the first day high price divided by first day low price; Ln_Fees is the natural logarithm of the amount of underwriters fees stated in the prospectus; Risk_Factors is the number of risk factors listed in the prospectus; D_Industry is the dummy variable of 1 for the technology-based companies and 0 if otherwise.

*, ** and *** indicate significance at 10%, 5% and 1% levels, respectively.

Table 2: OLS Regression

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Dependent Variable: Initial Return

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coef</th>
<th>t-stat</th>
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</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>8.425</td>
<td>0.58</td>
</tr>
<tr>
<td>SC</td>
<td>-8.998</td>
<td>-1.94</td>
</tr>
<tr>
<td>Ln_Age</td>
<td>5.297</td>
<td>1.98</td>
</tr>
<tr>
<td>Ln_Fees</td>
<td>-0.652</td>
<td>-0.54</td>
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<tr>
<td>Ln_Volatility</td>
<td>93.780</td>
<td>3.02</td>
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<tr>
<td>Risk_Factors</td>
<td>0.063</td>
<td>0.21</td>
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<tr>
<td>D_Industry</td>
<td>-6.543</td>
<td>-1.01</td>
</tr>
</tbody>
</table>

R2: 0.1139
F-value: 3.20

This table reports the result from OLS regression. SC is a dummy variable of 1 for SC IPOs and 0 for non-SC IPOs; Ln_Age is natural logarithm of the period between the companies' year of incorporation to the year they are listed in Bursa Malaysia; Ln_Fees is the natural logarithm of the amount of underwriters fees stated in the prospectus; Risk_Factors is the number of risk factors listed in the prospectus; Ln_Volatility is natural logarithm of the first day high price divided by first day low price; D_Industry is the dummy variable of 1 for the technology-based companies and 0 if otherwise. We make use of robust standard errors.

*, ** and *** indicate significance at 10%, 5% and 1% levels, respectively.