

## PERFORMANCE OF INITIAL PUBLIC OFFERINGS: DOES SHARIAH COMPLIANCE EXTENSIVENESS MAKE A DIFFERENCE?

\*Zunaidah Sulong<sup>1</sup>, Nor Azizan Che Embi<sup>2</sup> and Mohd Rahim Ariffin<sup>3</sup>

<sup>1</sup>Faculty of Economics and Management Sciences Universiti Sultan Zainal Abidin Gong Badak Campus, Terengganu, Malaysia. E-mail: zunaidah@unisza.edu.my.

<sup>2</sup>Kulliyah Economics and Management Sciences International Islamic University of Malaysia

<sup>3</sup>Faculty of Islamic Contemporary Studies Universiti Sultan Zainal Abidin

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**Abstract:** *Despite the popularity and the claim that Shariah companies fare better than their conventional counterparts, both previous studies and market reports show that the Shariah-compliant status does not seem to contribute positively to the Shariah IPO initial performance. This study hypothesizes that this could be due to (i) the characteristic differences between the Shariah IPOs and their conventional counterparts and (ii) the inadequacy of pre-revision Shariah screening methodology since establishment in 1995 to 2013, in which neglects two crucial financial ratios, debt and ARTA (account receivable to total asset), which are emphasised by the Fiqhi Council. Thus, this study is conducted with the objectives: (i) to ascertain the impact of Shariah extensiveness on the IPO initial performance; and if this is so, (ii) to what extent the Shariah status and level of compliance influence initial performance. This study employs a sample of 153 Shariah IPOs issued by Malaysian companies from January 2005 until December 2014. Consistent with past studies, the results show that there are no significant difference between the initial performance of Shariah and non-Shariah IPOs, even after controlling for the IPO characteristics. However, when the level of extensiveness is taken into consideration, the difference in the initial returns prevails. Overall, this study contributes by providing evidence that the existing Shariah screening criteria should incorporate the two financial ratios (debt and ARTA) in order to distinguish the Shariah IPOs from their non-Shariah counterpart.*

**Keywords:** *Initial Public Offerings (IPOs) · Shariah IPOs · Shariah Compliance Extensiveness*

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### Introduction

The current global trend exhibits that there is a shift in the demand for ethical investment particularly those with *Shariah*-compliant status. In fact companies that undergo the *Shariah*-compliant screening process and hold the *Shariah*-compliant status are basically recognized as

the investment with the core market activities that are free from unethical elements. In essence, the elements of certainty, integrity, justice and accountability in the screening process of *Shariah* status, differentiate the quality of the IPOs of the *Shariah*-compliant with the shares traded without the status. The investment with *Shariah*-compliant status is designed not only for the benefits of Muslims investors particularly those who are concerned about *Shariah* compliancy of their investment but it are meant for all investors.

However, it is documented in the literature that the *Shariah*-compliant status does not seem to contribute to IPO initial return performance differential between *Shariah*-compliant companies and their non-*Shariah* counterparts (for example, Abdul Rahim & Yong, 2008). It is predicted that relying on the *Shariah* screening process by *Shariah* Advisory Council (SAC) may not be sufficient as there are two important ratios which are debt ratio and account receivable over total asset ratio (ARTA ratio) highlighted by *Fiqhi* council that are not being used. Among the recent indicators on the insufficient financial risk control elements in *Shariah*-compliant listed companies which highlight the MyETF Dow Jones Islamic Market Malaysian Titan 25 financial performance in 2008. Although the portfolios consist of public listed companies with *Shariah*-compliant status, the performance tumbled down during the year it was launched which triggered the investors and researchers to question the *Shariah* screening process that had already been undergone by the listed companies.

It can be argued that the degree of *Shariah*-compliant extensiveness in IPOs will be beneficial to evaluate the firm's risk. This is because the majority of Malaysian listed companies possess *Shariah*-compliant status. This paper focuses on the *Shariah* screening methods, particularly the general rule for financial ratio screening which imposes certain limits on the debt ratio and ARTA ratio. The Council of the Islamic *Fiqh* Association or CIFA 1993 resolution (Naughton & Naughton, 2000) and some Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) standards are used in classifying the *Shariah*-compliant extensiveness even though the Securities Commission Malaysia applies the Islamic Financial Services Board (IFSB) standard. The Executive Director of International *Shariah* Research Academy for Islamic Finance or ISRA (Mohamad Akram, 2006) also has highlighted the need to examine not only the company's income but also the total debt of the company, its cash and interest bearing securities and the account receivables.

The main purpose of this paper are two folds; first, to ascertain the impact of *Shariah* extensiveness on the IPO initial performance; and second, if it is so, to what extent the *Shariah* status and level of compliance influence initial performance. The rest of the paper is structured as follows. Section 2 provides a review of the related literature and hypotheses. Section 3 presents the variables and methodology. Section 4 discusses the empirical results. Section 5 concludes.

### **Brief Literature Review and Hypotheses**

*The Council of the Islamic Fiqh (CIFA).* Two basic filters approved by CIFA in 1993 are used to identify the equity instruments as *Shariah* permissible investment or to be classified as *Shariah*-compliant:

- (a) The primary business activities of the company must be legally free (*halal*) from activities that involve alcohol, tobacco, pork-related products, conventional financial services, weapons and non-permissible entertainment.

(b) The financial management of the company should be free from *riba* (interest) and impurities. The following ratios are the rules used by CIFA to screen out companies that have any of the below criteria:

- (i) having a debt to total asset ratio of thirty-three percent or more,
- (ii) impure plus non-operating interest income to revenue ratio of five percent or more, and
- (iii) Accounts receivable to total asset ratio of forty-five percent or more.

The benchmark of one-third is basically referred as the maximum proportion of asset that each leader in the family can give out. This proportion is based on hadith narrated by Bukhari and Muslim. It basically supports the question of the legacy of Sa'ad Ibn Abi Waqas who wants to leave his property as alms. The Prophet s.a.w.'s condition of 1/3 (33.33%) can also be considered as the benchmark for debt usage. This is because the two-third of property for the family members can only be achieved if the borrowing level does not exceed 1/3 of the total asset. The debt issues are among the main concern that will be raised upon and should be settled before the deceased property is divided among the beneficiary. Below are the hadith narrated by Bukhari and Muslim:

*“One day, the Prophet s.a.w. visited Sa'ad bin Abi Waqas who was ill. Sa'ad expressed to the Prophet s.a.w. his feelings that his illness was coming to an end and that death was near. He asked for the Prophet s.a.w.'s opinion on giving his property away as alms for he had only one daughter to inherit his wealth. Therefore, he wished to give as alms 2/3 of his property. However, the Prophet s.a.w. stated his objection. Then Sa'ad asked whether he could give away 1/2 of his property. The Prophet s.a.w. still said no and recommended that 1/3 is enough. The Prophet s.a.w. then said: that too is still too much. Verily, to leave your heir wealthy is far better than to leave you heir impoverished and dependant on other people's charity.”*

The above hadith has been used to set the basis for maximum level of borrowing for the entities i.e., thirty three percent or one third of the total asset value. The proportion of debt that exceeds the benchmark of one third of the total asset value will expose the companies with the bankruptcy risk and business risk which may lead to uncertainty on future prospect of the business. In the context of the stability of the contract that the individual wants to enrol into, the issue of gharar is among the main concern in Fiqh Muamalat. Gharar means uncertainty and cheating (see the discussion on gharar definition-Resolution of the Securities Commission Shariah Advisory Council Shariah Advisory Council, p. 155). It is a negative element that can damage a contract. However, should it arise in a small magnitude, Islamic jurisprudence considers it as common consequence in business transaction and will not harmfully affect the contract's goodwill. Therefore, the features of such a company should be within the tolerable bounds of the Islamic jurisprudence and is allowable if the uncertainty level is low. The basis of the prohibition on gharar is based on a hadith of the Prophet s.a.w narrated by Muslim (see, the gharar prohibition issues-Resolution of the Securities Commission Shariah Advisory Council p.149).

Meaning: *“Verily, the Prophet s.a.w. prohibits gharar transactions.”*

Therefore, as suggested by the Council of Islamic *Fiqh*, the investors should consider the account receivables proportion from the total asset amount in order to identify the amount of assets that are certainly owned by any entity. The element of transparency helps reduce the

element of uncertainty. In dealing with business transactions, the Islamic rules really take the issues of *gharar* seriously. According to Syafi'e Mazhab, *gharar* is defined as something with high risk. This is also supported by another jurist from Mazhab Syafi'e which is Al-Syirazi who defined *gharar* as something that have unknown condition and consequences. The discussion on the *gharar* issues by SAC highlighted the interpretations by Al-Sharqawi, Al-Qalyubi and Al-Ramli that defined *gharar* as something with positive and negative elements whereby, the negative element exceeds the positive element.

Based on the above discussion on the definition of *gharar*, this study supports the CIFA decision to screen out the companies' accounts receivable to total asset ratio of forty-five percent or more. As far as this study is concerned, there are no specific verses from Al-Quran or hadith that specify the benchmark for account receivables proportion over total asset. It is believed that the need of such benchmark is initiated through the discussion by Islamic scholars or *ijmak ulamak* as it is among the secondary sources for making decision. *Ijmak* means unanimous agreement among the qualified scholars of the Muslim community on Shariah rulings imposed during a particular period after the death of the Prophet s.a.w (refer Resolutions of the Securities Commission Shariah Advisory Council, p. 9). The secondary sources that can be used as a basis for decision making in Islamic jurisdiction are *ijmak*, *qiyas*, *maslahah*, *istishsan* and others. It only can be used after the matter in question is not found in primary sources—Refer Resolutions of the Securities Commission Shariah Advisory Council, p. 8-12).

In order to avoid uncertainty for the share market's investors, the realistic percentage of assets that are definitely owned by the companies should be positive or more than the value of assets that are still in doubtful conditions. Therefore, the proportion of assets that should be the least certainly held by any entity is fifty five percent which is exceeding the proportion of assets under uncertain condition which is only forty five percent. With this benchmark included in the screening process for *Shariah*-compliance status, the investors would at least invest in companies with stable and convincing financial condition.

### ***Listing structure of Malaysian IPOs***

Initial Public Offerings (IPOs) are defined as new issues that are sold to investors for the first time. The new shares are traded in a primary market. Due to the new issues perceived to be sold based on the offer price below the true values of the IPO, the activity of flipping on the first day of trading in order to realize quick return is a common situation in most share markets. In order to examine the post listing performance, the structure of Malaysian share market trading should be clarified first, as every country's shares market has its own unique characteristics. The institutional aspects of Malaysian IPOs differ from other markets in many different ways. There are two important features that lead to uniqueness of Malaysian IPOs during the period of study from 1999-2008 such as the *Shariah*-compliant status and thirty percent of Bumiputra mandatory requirement.

In IPO trading systems, there are three parties involved in IPO issuance which are the issuing firms, the underwriters and the investors. Basically, the players in the stock market are divided into two categories: individual investors (retail investors) and institutional investors. Institutional investors are regarded as informed investors while retail investors are considered uninformed investors. Investment banking plays an important role in IPO issuance. The bank acts as underwriter and helps to distribute a new securities issue in the primary market.

Normally, their clients are the companies that will seek the investment banker's advice on how to get capital or on how to raise funds through equities.

In order to sell the IPOs, there are three types of selling mechanisms being used in share trading. These are auctions, book building concepts and fixed-priced offers. Basically, IPOs in Malaysia are sold using the fixed-price offer mechanism while other country like U.S.A uses book-building mechanism. In Malaysia, the application for IPO is submitted for approval to the Foreign Investment Committee (FIC), and Ministry of International Trade and Industry (MITI). It then is submitted to the SC for approval where it examines the company forecast profits and dividends. The SC limits the market's role in the determination of the subscription price. Most Malaysian IPOs fall within the category of three types of new issues: public issue, offers for sale or a hybrid of public issue and offer for sale. Public issues refer to the IPOs offered to the public for the first time. They are usually allocated to individual investors better known as retail investors. The implication of the issuance of these new shares will result in an increase in the paid up capital of the company. The public issues are known as primary shares. Currently, companies going for IPO must have 25% of shares in public hands and have Bumiputras holding 30% shares under FIC rules.

Offer for sale are basically shares allocated to the original shareholders (owners), but then offered to the public to buy. The owner is discouraged from selling shares before the expiration of the lock-up period. In Malaysia, the original shareholders cannot immediately sell and transfer the IPOs. The Securities Commission has already imposed the regulation on the original shareholder or the owner, pertaining to the sale of the shares that they own. This is somehow not imposed on the retail and institutional investors. In Malaysia, the owner-managers need to face the lock-up period of three years before they can proceed to sell their shares in the secondary market. The lock-up period basically is an agreement between the underwriter and the issuing firm prohibiting the sale of shares by insiders for a certain period of time. The lock-up period averages around six months in other countries such as the U.S.A. Lastly, private placement refers to the IPOs offered to institutional investors.

## **Methodology**

The data set consists of all *Shariah*-compliant IPOs' issued from January 2005 until December 2014 which is listed on the Main Market of Bursa Malaysia (previously known as the Kuala Lumpur Stock Exchange or KLSE). As in April 1999 the Bourse introduced its first *Shariah* index, well-known as the Kuala Lumpur *Shariah* Index (KLSI). This Islamic index outlines the performance of *Shariah*-compliant shares on Bursa Malaysia. At the end of 2008, as in 2009 the Bursa Malaysia combined the main board and the second board together. The listing board was then called as the Main market while the MESDAQ was then introduced as the ACE market.

This study is fully aware on the effort by Bursa Malaysia and SC to upgrade the Malaysian equities market in 2004. Previously, the allocations of new issues for institutional investor were group together under the public issue category. However, the "private placement" category has been separated from public issue category in 2004. Since then, Malaysian IPOs are classified into *offer for sale*, *public issue* and *private placement*. This study also finds that in 2004 SC has introduced the pre-IPO *Shariah* status.

There are two data set which employed in this study; pre-listing and post-listing. Pre-listing data includes consolidated amount of total debt (TD), account receivables and total asset (TA). Moreover, it also includes three-year earnings before interest tax, depreciation and amortization (EBITDA), profit after tax (PAT), subscription/offer price, sector, board of listing, IPO proceeds utilization, offer size, age of the company, and underwriter reputation. Meanwhile post-listing data set includes opening and closing prices, subscription ratio, ownership structure, and total number of IPOs. These data are obtained from the Bursa Malaysia's website and customer service unit, Securities Commission website and it's Islamic Capital Market Unit, company's prospectus and annual report, Investors Digest, Star on-line and OSIRIS database. The *Shariah* status of the company is determined based on the list published by the *Shariah* Advisory Council (SAC) of Securities Commission.

The population and sample used in this study is as reported in Table 1. During the 10-year period, covered in this study, there are a total of 426 new issues. Similar to Abdul Rahim and Yong (2008) and Yong (2007b), this study selects sample of IPOs that are offered as public issue, offer for sale, private placement, hybrid of these forms, and/or hybrid of any of these forms and other type of issues. The study however excludes the rarely type of IPOs, for example restricted offer for sale, restricted public issue, restricted offer for sale to eligible employees, restricted offer for sale to *Bumiputra* investors, special and restricted issue to *Bumiputra* investors, tender offer and special issue. The study also excludes IPOs issued under REITS category due to different format of presentation for its financial statement. The reason to exclude the companies with the uncommonly types of offer is due to only small numbers of companies with this issues that lead to less meaningful outcomes suggested in Abdul Rahim and Yong (2008) and Yong (2007b).

**Table 1: The statistics of IPOs samples by year of listing, 2005 to 2015**

Listing Year	IPO population	Sample IPOs	Shariah-Compliant IPOs	Non-Shariah Compliant IPOs	Drop case
2005	79	72	48	24	7
2006	40	35	23	12	5
2007	28	26	15	11	2
2008	23	23	14	9	-
2009	14	14	8	6	-
2010	28	28	8	20	-
2011	28	28	12	16	-
2012	17	17	8	9	-
2013	17	17	7	10	-
2014	15	15	10	5	-
2015	13	13	10	-	-
<b>TOTAL IPOs</b>	302	288	163	125	14

Note: The *Shariah* classification is based on the list published by the *Shariah* Advisory Councils of Securities Commission as of October/November, 1999-2008, and list provided by Knowledge Centre Bursa Malaysia, 2005-2015.

### ***The Shariah Compliance Extensiveness Framework***

The *Shariah*-compliant extensiveness is defined as the public listed companies that undergo the *Shariah* screening process which includes all the three types of financial ratios suggested by CIFA such as interest income ratio, debt ratio and account receivable over total asset ratio. Previously, the SAC practice in identifying listed companies as *Shariah* compliance is based on the quantitative method and qualitative method mentioned in section 2. In classifying the

securities as *Shariah*-compliant, the SAC received the information from the SC. The SC gathered information on the listed companies from various range of sources, such as company annual financial reports, company responses to survey forms and through inquiries made to the respective company's management. Based on the outcomes of these methods, the listed firms are further classified according to certain benchmarks (5 percent, 10 percent, 20 percent and 25 percent) of the primary activities of the companies that involve non-permissible elements. However, this information is not published by the Securities Commission (SC) but only reveals the final status of the *Shariah* application. Because of the unavailability of the SAC benchmark screening data for public users, this study has no choice but to rely on the basic screening criteria or the general rules used by the Council of the Islamic *Fiqh* (CIFA) as well as by the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI).

Since the rest of the study concentrates on the impact of the extensiveness of *Shariah* compliance on the IPOs' performance, this study segregates the *Shariah* IPOs into four groups according to ratios used in the CIFA second tier of *Shariah* screening test. Basically, CIFA suggested that the first criterion requires that the listed companies must be free from *riba* (interest). Due to the difficulty in monitoring the use of interest-free debts among the listed companies, *Shariah* council impose several ratios in their second criteria to help to identify the companies' financial management status. The screening out process by CIFA on the financial management of the companies through three types of ratios: (i) debt to total assets ratio of 33 percent or more. (ii) Impure plus non-operating interest income to revenue ratio of 5 percent or more. (iii) Accounts receivable to total assets ratio of 45 percent or more. For the purpose of this study, the extensiveness of *Shariah* compliance are measured based on two of the ratios:

*(i) Debt to total assets ratio.*

The sample will be partitioned into two sub-samples according to the median of the sample's debt ratio. The high *Shariah* compliance sub-sample consists of firms with less than median debt ratios, while the low *Shariah* compliance sub-sample consists of firms with debt ratios more than the median value. The median value for debt to total assets ratio is 28.65 percent.

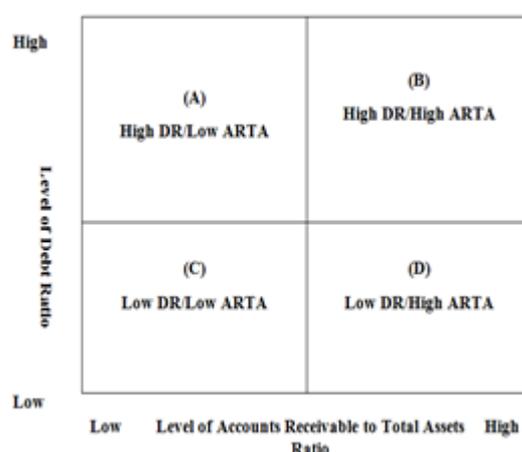
*(ii) Accounts receivable to total assets ratio (ARTA ratio).*

The sample will again be partitioned into two sub-samples according to the median of the sample's ARTA ratio. The high *Shariah* compliance sub-sample consists of firms with less than median ARTA ratios, while the low *Shariah* compliance sub-sample consists of firms with ARTA ratios more than the median value. The median value for ARTA ratios is 17.10 percent.

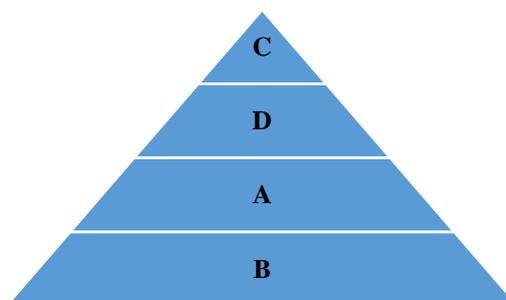
These descriptions show that this study deviates slightly from the benchmarks outlined by CIFA (refer to footnote 5) with respect to the operationalization of the levels of debt ratio and ARTA ratio. The justifications for using median values instead are as follows. Following the CIFA original benchmark level will create uneven sample size for each quadrant basically because it puts a large number of companies with debt ratio approaching closely 33 percent in the low debt ratio category. More importantly, our approach in using the median (28.65%) is not against the CIFA guidelines because the 33 percent debt ratio is actually the maximum level of debt that a company seeking *Shariah* status should use. The same justification is true for using the median value of ARTA ratio.

This study does not use the impure plus non-operating interest income to revenue ratio of 5 percent or more due to inaccessibility of the data. The main reason is because the changes in financial statement format in Malaysia. Starting from the year 2005, as Malaysia Accounting

Standard Board (MASB) follows the International Reporting Standard Board (IRSB), there are few changes in financial statement presentation (FRS 1). These changes among others combine the non-operating income information together with the operating income. As this study extracts the financial data of IPO issued from 1999 to 2008, the ratio on impure plus non-operating interest income to revenue ratio need to be excluded due to unavailability of the data for the year 2005 onwards. However, by using the SAC list of approved securities, the samples that are used in this study already screened for interest income to revenue ratio. Therefore, Shariah extensiveness screening process suggested by this study indirectly used the three types of financial ratio as suggested by Fiqhi Council. Figure 1 illustrates the construction of these sub-samples. This method helps the study to form four types of Shariah extensiveness quadrants known as quadrant A, B, C, and D. The level of debt over total asset and the level of the account receivable over total asset are the basis that are used to form the four types of Shariah extensiveness quadrants.



Based on the above quadrant, the *Shariah*-compliant extensiveness level are ranked from one with the most extensiveness to the least extensiveness, whereby the highest ranking are represent by the IPOs' in C quadrant, followed by the IPOs' in D quadrant, then IPOs' in A quadrant. The IPOs' in B quadrant represents the new issues that have the lowest level of *Shariah*-compliant. Through Figure 2 below, the study arrange the quadrant with the highest level of *Shariah*-compliant extensiveness on the top of pyramid diagram followed by the lesser *Shariah*-compliant extensive quadrant.



**Figure 2: Pyramid Diagram of *Shariah*-compliant Extensiveness**

Basically lower debt ratio portrays that the IPO have a higher level of extensiveness. This means that the lower the use of debt by the company's prior to listing, the lower the uncertainty element (*gharar*) and the lower the company's involvement with the non-permissible financial sources

(*riba*). For ARTA ratio, a company is classified as a company with a high level of extensiveness if it has a low level of ARTA ratio. This is because the small proportion of account receivable over total asset amount represents a large amount of asset that the company surely own. This again reduces the risk of liquidity and uncertainty (*gharar*) for the investor as the ARTA ratio express the asset that definitely in the company's hand.

Therefore the IPOs in quadrant C are chosen as the most *Shariah*-compliant IPOs as they have lower debt ratio and lower ARTA ratio. The opposite of this is the IPOs under quadrant B which have higher level of debt ratio and ARTA ratio. Between the IPOs in quadrants D and A, the study classifies the IPOs in quadrant D as the companies that have a better rank of *Shariah*-compliant extensiveness compared to IPOs in quadrant A. This is because in Islam, debt issue is considered as a serious topic in *fiqh* whereby the *riba* element is impermissible (haram) in any activity. Therefore, the IPOs with low level of debt ratio and high level of ARTA ratio in quadrant D is rank as IPOs with a better position compared to the IPOs in quadrant A that have a high level of debt ratio but a low level of ARTA ratio. To evaluate the association between underpricing and the extensiveness of *Shariah*-compliance, the study introduces three dummy variables (*DEXT*) as follows;

*DEXTA* = a dummy variable that takes a value of 1 if the *Shariah* IPO is in quadrant A

$$DEXTA = \begin{cases} 1 & \text{Quadrant A} \\ 0 & \text{Otherwise} \end{cases}$$

and 0 otherwise =

*DEXTB* = a dummy variable that takes a value of 1 if the *Shariah* IPO is in quadrant B and 0

$$DEXTB = \begin{cases} 1 & \text{Quadrant B} \\ 0 & \text{Otherwise} \end{cases}$$

otherwise =

*DEXTC* = a dummy variable that takes a value of 1 if the *Shariah* IPO is in quadrant C and 0

$$DEXTC = \begin{cases} 1 & \text{Quadrant C} \\ 0 & \text{Otherwise} \end{cases}$$

otherwise =

## Summary of Findings

### *Profiles of IPOs by Quadrants of Shariah Extensiveness.*

Table 2 focuses on the profiles of IPOs for each quadrants of *Shariah* extensiveness that is represented by quadrant A, B, C and D. Based on the average results, the study finds that the offer prices of quadrants C and D are set lower than the other *Shariah* extensiveness quadrants. This table also indicates that the average opening and closing prices for quadrant C and D are also lower as compared to quadrants A and B. In term of demand, quadrant C is oversubscribed by 40.42 times and this shows that the demand for the IPOs under these quadrants is higher compared to the remaining quadrants. The IPOs under quadrant C also indicates that it has higher percentage of reputable underwriters (55.56%). This means that its listing processes are conducted by more reputable underwriters compared to the other quadrants. In terms of offer size, quadrant A records the greatest amount of offer size (RM89,966,094.29), while quadrant D indicates the smallest average of offer size (RM20,258,413.78).

Table 2 also reports the financial strengths of each quadrant based on the average values of financial data such as account receivables, total asset, total debt, and earnings. In general, quadrant C reports the lowest average value of accounts receivable which is opposite to quadrant B which reports six times larger than quadrant C. The other average values correctly reflect the specific criteria that are used to rank the IPOs based on their Shariah extensiveness quadrants. For instance, quadrant C, which is supposed to represent the highest level of Shariah extensiveness, has a very low ARTA ratio (4.48%) and debt ratio (15.43%). It is then followed by quadrant D that consists of IPOs with high ARTA ratio (24.82%) but with lower debt ratio (20.60%). Then, the third rank is quadrant A with high debt ratio (64.02%) but lower ARTA (7.59%). Lastly, quadrant B as the least Shariah extensiveness quadrant possesses the characteristics of high debt ratio with high ARTA ratio. The IPOs under this quadrant, on average reports a debt ratio of 47.34 percent and an ARTA ratio of 32.88 percent.

Based on the average value of total assets, the study finds that IPOs in quadrant A on average consists of larger companies as compared to quadrant B, C and D. In terms of earnings prior to listings, IPOs in quadrant A also indicate the highest earnings. In general, the IPOs under quadrant C tend to be relatively younger companies than those IPOs under quadrant A, which are slightly more experienced companies.

**Table 2: Profiles of IPOs by Quadrants of Shariah Extensiveness from 2005-2014**

Items	Quadrants <sup>c</sup>			
	A (n=76)	B (n=97)	C (n=99)	D (n=75)
Offer Price(RM) <sup>a</sup>	1.38	1.24	0.85	0.88
Opening Price (RM)	1.74	1.67	1.17	1.06
Closing Price (RM)	1.74	1.66	1.17	1.03
Over-Subscription (times)	22.60	30.38	40.42	34.80
IPOs with Reputable Underwriter	51.32%	48.45%	55.56%	52%
Offer Size (RM'000)	89966.09	34868.00	53476.66	20258.41
Accounts Receivable (RM'000)	30886.97	50060.46	7824.79	14880.95
ARTA (%)	7.59	32.88	4.48	24.82
Total Asset (RM'000)	407172.44	152265.64	174812.48	59956.30
Debt (RM'000)	260686.79	72078.56	26974.71	12348.57
Debt ratio (%)	64.02	47.34	15.43	20.60
Average EBITDA <sup>b</sup> (RM'000)	29711.72	19054.74	15759.18	9087.01
Average PAT (RM'000)	12645.84	9793.89	1629.19	4995.69
Firm's Age (Year)	6.17	4.97	3.47	3.89
Top 5 Ownership (%)	59.3	59.20	59.60	58.57
Proceeds for Growth (RM'000)	20206.32	15087.79	30745.53	12925.79
Total Proceeds (RM'000)	43602.30	27357.38	39997.45	18547.14
Growth to Proceeds (%)	46.34	55.15	76.87	69.69

**Notes:**

<sup>a</sup> The weighted average offer price basically the total proceeds divide with total units issued.

<sup>b</sup> The average values are calculated over three years period prior to listing.

<sup>c</sup> A, B, C and D represent *Shariah* extensiveness quadrants. The top rank is quadrant C with low ARTA and debt ratio, second rank is quadrant D with high ARTA but low debt ratio, third rank is quadrant A with low ARTA but high debt ratio, and the lowest rank is quadrant B, with high ARTA and debt ratio.

This is based on average age of quadrant C which is 3.47 years as compared to quadrant A which is 6.17 years. The ownership structure for all quadrants is more or less similar. The highest average amount of proceeds used for growth purposes is recorded by quadrant C. Therefore, as expected, the ratio of growth to proceeds is also the highest as it reaches 76.87

percent out of total proceeds. This value is highest compared to quadrants A, B and D that report 46.34, 55.15 and 69.69 percent of growth to proceed ratios, respectively.

### Results of Multiple Regressions

This study conducts the cross-sectional multiple regression analyses to test hypotheses. Basically, this study has found that the variance inflation factors (VIF) range for all the regression analyses do not exceed 10 points. Therefore, the results are free from the serious issue of multicollinearity (Kleinbaum et al., 1998). The results are more reliable with the use of Breusch-Godfrey Lagrange Multiplier statistics test that helps to identify autocorrelation and heterokedasticity problems in each model. Any of the regression analysis results with significant existence of autocorrelation and heterokedasticity issues, are treated with Newey–West covariance estimator. Therefore, the results are more precise in estimating the coefficient covariance in the presence of heterokedasticity and autocorrelation of unknown form.

**Table 3: Multiple regression result analysis on Shariah IPOs**

<b>Panel Shariah Sample</b>				
$IPORTN_{S_i} = \alpha + \beta_1 ALLOCT_i + \beta_2 GROTOPROCEEDS_i + \beta_3 LNRISK EBITDA_i + \beta_j \sum_{j=1}^J CV_{j,i} + \varepsilon_j$				
	<b>Coefficient</b>		<b>t-Statistics</b>	
<b>Variable</b>	<b>IPORTN<sup>OPEN</sup></b>	<b>IPORTN<sup>CLOSE</sup></b>	<b>IPORTN<sup>OPEN</sup>#</b>	<b>IPORTN<sup>CLOSE</sup>#</b>
ALLOCT <sub>j</sub>	-24.727	-27.004	-3.884***	-4.554***
GROTOPROCEEDS	4.969	4.300	0.634	0.533
LNRISKEBITDA	-0.495	-1.590	-0.245	-0.684
<b>CONTROL VARIABLES (CV)</b>				
LNOFFERSIZE	-7.845	-4.280	-2.077**	-0.958
LNAGE	5.261	3.058	2.051**	1.116
LNTA	1.678	-1.008	0.424	-0.198
OWNERFIVE	-0.375	-0.370	-2.139**	-2.054**
DWRITER	-3.395	-1.625	-0.827	-0.359
DMKT	-2.107	-5.040	-0.308	-0.658
INTERCEPT	135.658	113.380	3.074***	2.667***
Adjusted R-Squared	0.147	0.112		
F-Statistics	7.626***	5.862***		
F-Statistics Probability	0.000	0.000		
Durbin-Watson stat.	1.461	1.661		
VIF range	1.030-3.420			

**Notes:**

Autocorrelation and heteroskedasticity in the analysis are identified through Breusch-Godfrey Lagrange multiplier test and corrected with Newey-West covariance estimator. The adjusted values are highlighted by symbol #. The symbols \*\*\*, \*\*, \* denote significance at the 1%, 5% and 10% levels respectively.

## *The Impact of Shariah Extensiveness Quadrants on the Factors that Influence the Initial Performance of IPOs*

The construction of Shariah-compliant extensiveness quadrants has segregated the 347 IPO issues into four quadrants (A, B, C and D). The hypothesis is basically to discover whether the factors that influence the initial returns of each quadrant might be different.

Panel A of Table 4 describes the results for quadrant A. The regression results derived from Equation (1a) show that  $IPORTN^{OPEN}$  of quadrant A are influenced by  $ALLOCT_j$  and  $DWRITER$ . Meanwhile for  $IPORTN^{CLOSE}$ , the variables are  $ALLOCT_j$  and  $DMKT$ . Through Panel B of Table 4, the results for the least extensive IPOs represented by quadrant B suggest that  $ALLOCT_j$ ,  $OWNERFIVE$  and  $DMKT$  are variables that influence  $IPORTN^{OPEN}$ , while  $IPORTN^{CLOSE}$  are influenced by variables of  $ALLOCT_j$ ,  $GROTOPROCEEDS$ ,  $LNTA$  and  $OWNERFIVE$ .

Next, the regression results from Panel C of Table 4 presents the determinant factors that explain the initial returns for quadrant C. The study finds that  $IPORTN^{OPEN}$  is significantly influenced by  $ALLOCT_j$ ,  $LNOFFERSIZE$  and  $LNAGE$ , while  $IPORTN^{CLOSE}$  is influenced by  $ALLOCT_j$ . Lastly, Panel D of Table 4 illustrates quadrant D regression results. The results indicate that  $ALLOCT_j$  and  $LNRISKEBITDA$  are the two determinant factors that explain the  $IPORTN^{OPEN}$  while,  $IPORTN^{CLOSE}$  is only influenced by  $ALLOCT_j$ .

**Table 4: Regression Analysis on Shariah Extensiveness Quadrants**

**Panel A : Quadrant A**

$$IPORTN_{QA} = \alpha + \beta_1 ALLOCT_j + \beta_2 GROTOPROCEEDS_j + \beta_3 LNRISKEBITDA_j + \beta_j \sum_{i=1}^J CV_{j,i} + \varepsilon_i$$

(2a)

Variable	Coefficient		t-Statistics	
	$IPORTN^{OPEN}$	$IPORTN^{CLOSE}$	$IPORTN^{OPEN}$	$IPORTN^{CLOSE}$
$ALLOCT_j$	-37.340	-35.690	-6.316***	-5.255***
$GROTOPROCEEDS$	-1.201	6.228	-0.113	0.508
$LNRISKEBITDA$	-0.642	-2.973	-0.251	-1.013
<b>CONTROL VARIABLES (CV)</b>				
$LNOFFERSIZE$	-0.738	2.448	-0.133	0.385
$LNAGE$	0.918	2.208	0.305	0.638
$LNTA$	-1.947	-3.444	-0.353	-0.544
$OWNERFIVE$	-0.011	-0.174	-0.052	-0.724
$DWRITER$	-10.634	-9.102	-1.755*	-1.308
$DMKT$	-8.002	-15.920	-1.270	-2.200**
INTERCEPT	34.535	23.576	0.636	0.378
Adjusted R-Squared	0.379	0.320		
F-Statistics	6.085***	4.922***		
F-Statistics Probability	0.000	0.000		
Durbin-Watson stat.	1.678	1.563		
VIF range	1.07- 4.34			

**Panel B: Quadrant B**

$$\begin{aligned} \text{IPORTN}_{QB} = & \alpha + \beta_1 \text{ALLOCT}_j + \\ & \beta_2 \text{GROTOPROCEEDS}_j + \\ & \beta_3 \text{LNRISK EBITDA}_j \\ & + \beta_J \sum_{j=1}^J \text{CV}_{j,i} + \varepsilon_i \end{aligned}$$

(2b)

Variable	Coefficient		t-Statistics	
	IPORTN <sup>OPEN</sup>	IPORTN <sup>CLOSE</sup>	IPORTN <sup>OPEN</sup>	IPORTN <sup>CLOSE</sup> #
ALLOCT <sub>j</sub>	-16.453	-30.319	-1.847*	-2.290**
GROTOPROCEEDS	18.670	25.611	1.088	2.004**
LNRISKEBITDA	-1.346	-2.098	-0.227	-0.639
<b>CONTROL VARIABLES (CV)</b>				
LNOFFERSIZE	-7.656	-6.556	-0.923	-0.971
LNAGE	1.799	-1.240	0.378	-0.261
LNTA	12.560	12.282	1.368	2.101**
OWNERFIVE	-0.836	-0.556	-2.463**	-1.673*
DWRITER	0.081	0.525	0.009	0.065
DMKT	-15.186	-13.463	-1.682*	-1.328
INTERCEPT	53.729	7.806	0.519	0.068
Adjusted R-Squared	0.057	0.134		
F-Statistics	1.646	2.645***		
F-Statistics Probability	0.115	0.009		
Durbin-Watson stat.	1.722	1.692		
VIF range	1.058-2.525			

**Panel C : Quadrant C**

$$\begin{aligned} \text{IPORTN}_{QC} = & \alpha + \beta_1 \text{ALLOCT}_j + \\ & \beta_2 \text{GROTOPROCEEDS}_j + \\ & \beta_3 \text{LNRISK EBITDA}_j \\ & + \beta_J \sum_{j=1}^J \text{CV}_{j,i} + \varepsilon_i \end{aligned}$$

(2a)

Variable	Coefficient		t-Statistics	
	IPORTN <sup>OPEN</sup>	IPORTN <sup>CLOSE</sup>	IPORTN <sup>OPEN</sup> #	IPORTN <sup>CLOSE</sup>
ALLOCT <sub>j</sub>	-21.972	-19.811	-2.469**	-1.871*
GROTOPROCEEDS	3.059	-16.669	0.138	-0.555
LNRISKEBITDA	7.413	7.185	1.240	0.671
<b>CONTROL VARIABLES (CV)</b>				
LNOFFERSIZE	-24.383	-13.854	-2.252**	-0.944
LNAGE	9.559	2.441	1.748*	0.317
LNTA	5.936	-5.378	0.557	-0.403
OWNERFIVE	-0.433	-0.561	-1.265	-0.925
DWRITER	-6.353	1.563	-0.640	0.119
DMKT	3.705	-5.854	0.268	-0.382
INTERCEPT	319.540	300.344	2.964***	2.208**
Adjusted R-Squared	0.164	0.040		
F-Statistics	3.133***	1.455		
F-Statistics Probability	0.003	0.178		
Durbin-Watson stat.	1.291	1.615		
VIF range	1.056 – 6.250			

**Panel D : Quadrant D**

$$IPORTN_{QD} = \alpha + \beta_1 ALLOCT_j + \beta_2 GROTOPROCEEDS_j + \beta_3 LNRISK\_EBITDA_j + \beta_J \sum_{j=1}^J CV_{j,i} + \varepsilon_i$$

(2a)

Variable	Coefficient		t-Statistics	
	IPORTN <sup>OPEN</sup>	IPORTN <sup>CLOSE</sup>	IPORTN <sup>OPEN</sup> #	IPORTN <sup>CLOSE</sup>
ALLOCT <sub>j</sub>	-33.949	-40.221	-3.792***	-3.520***
GROTOPROCEEDS	-4.918	4.370	-0.281	0.196
LNRISKEBITDA	-12.850	-10.144	-2.424**	-1.499
<b>CONTROL VARIABLES (CV)</b>				
LNOFFERSIZE	5.360	3.691	0.504	0.272
LNAGE	6.898	5.442	1.352	0.836
LNTA	0.443	-0.333	0.055	-0.032
OWNERFIVE	-0.137	0.040	-0.354	0.081
DWRITER	0.474	0.498	0.060	0.049
DMKT	1.352	5.601	0.160	0.521
INTERCEPT	-17.350	-31.287	-0.150	-0.212
Adjusted R-Squared	0.225	0.131		
F-Statistics	3.385***	2.234**		
F-Statistics Probability	0.002	0.031		
Durbin-Watson stat.	1.586	1.816		
VIF range	1.029 – 3.407			

**Notes:**

Autocorrelation and heteroskedasticity in the analysis are identified through Breusch-Godfrey Lagrange multiplier test and corrected with Newey-West Covariance estimator. The adjusted values are highlighted by symbol #. The symbol \*, \*\* and \*\*\* denote significance at 10 percent, 5 percent, and 1 percent level respectively.

In term of the adjusted R-squared values for each quadrant, the study finds that quadrant A has the most of its variance in initial returns (37.90 %) explained by the determinant variables, followed by quadrant D with 22.48 percent, quadrant C with 16.38 percent and lastly quadrant B with only 5.71 percent.

The study concludes that each of the quadrants has a different set of variables that significantly influence the initial returns. Each measure of initial returns also indicates that it is basically affected by different types of determinant variables. Obviously, it is only ALLOCT<sub>j</sub> that significantly has shown as the common determinant factor of the initial returns or underpricing of IPOs' for all the quadrants. Overall, the results of these analyses lead to the rejection of the hypothesis which proposes that the different sub-samples with different extensiveness of Shariah compliance (as indicated by the four quadrants) have the same determinant factors that influence the initial returns of IPOs.

**Conclusion Remarks**

The main motivation for the present study to examine the initial performance of *Shariah* IPOs is that despite the emphasis and importance given on attaining the status of *Shariah* compliance and despite the claims that *Shariah* investment should perform better than those investments that do not comply to *Shariah* criteria, *Shariah* investment in general and IPOs in specific still fail to show any significance difference in term of their performance as compared to investment

in non-*Shariah* equities. This can be obviously witnessed through the financial performance of MyETF Dow Jones Islamic Market Malaysian Titan 25 in 2008. Although the portfolios consist of public listed companies with *Shariah*-compliant status, the performance tumbled down during the year it was launched. While the existing empirical studies on *Shariah* IPOs are still lacking, those by Abdul Rahim and Yong (2008 & 2010) basically leave the questions on the seemingly similar performance between the *Shariah* and non-*Shariah* IPOs remained unanswered. The present study addresses the puzzle by examining two possible explanations, firstly the characteristics of the two groups of IPOs and secondly the inadequacy of the existing screening criteria of *Shariah* equities including IPOs.

Based on the international standard, by undergoing all the relevant processes and consistent monitoring, *Shariah* equities are expected to outperform their conventional counterparts. This expectation somehow increases the investors' trust especially institutional investors that require a lot of *Shariah* equities for their portfolios. Hence, in Malaysia it is understandable why almost 89 percent of shares traded in the equities market seek and possess the *Shariah*-compliant status. However, in reality, the rising trend of equities with *Shariah*-compliant status does not seem to contribute to an increase in performance. This implies that, the pre-revision screening status before revised SAC *Shariah* screening in 2013 failed to differentiate the performance of *Shariah* from the non-*Shariah* IPOs. This study produces the second evidence after Abdul Rahim and Yong (2008 & 2010) that there is no statistical difference in term of performance by comparing the non-*Shariah* IPOs with the *Shariah* IPOs in general and with a matched sample *Shariah* IPOs.

This finding implies that the pre-revision screening criteria adopted by SAC may need to be modified to include debt ratio and ARTA ratio in order to differentiate the *Shariah* IPOs from their conventional counterparts. Even though the proposed, more stringent screening criteria might defer firms' ability to comply with and obtain the *Shariah*-compliant status, there are several advantages that can potentially be benefited from it. One of them is that when the Malaysian IPOs (and equities in general) are screened based on the international standards e.g. Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI), they can more easily gain the trust from the international fund or portfolio managers. The trust brings in foreign investment which will increase the liquidity for *Shariah* IPOs market.

The importance of the financial ratios particularly debt and ARTA ratios in selecting *Shariah* investment implies that the Malaysian regulators and policy makers must come up with a solution to address this issue. The findings of the study show the importance of adopting stricter *Shariah* screening methodologies in Malaysian IPOs. An advantage of the proposed screening methodology is it helps to tackle the issues of *gharar* or uncertainty factor and liquidity risk as discussed by *fiqhi* scholars. Any improvement in the existing practices is expected to boost back the Malaysian equities market particularly the Malaysian *Shariah* IPOs segment that had experienced slow performance after the Asian financial crisis in 1997/1998 and Global financial crisis in 2008.

Complying with *Shariah* rules is the main motivation Muslim investors choose to invest in *Shariah*-compliant IPOs. When prompted with *Shariah*-compliant IPOs in specific, of most important are the investors' perceptions that these assets are free from all the prohibited elements including *gharar*, *riba* and forbidden sector by Islam. The fact that debt usage and accounts receivable are indefinitely tolerated can potentially contribute to these elements particularly the riskiness of the investment suggest that having these financial ratios

incorporated in the screening practice will improve the quality of *Shariah* IPOs toward being an investment that is more consistent with the requirement of Islamic rules.

In addition, the results which show that the most conservative *Shariah* IPOs group (represented by quadrant C) offers the highest initial returns imply that there are at least two ways in which the investors can benefit from an investment in these assets. First and foremost is the quality of these IPOs which are more consistent with the *Shariah* requirement. Second, the investors could enjoy a high returns despite the lower financial risks which results from the issuing companies employing lower debt level and less accounts receivable per dollar of their assets.

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