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Islamic bonds and the wealth effects: evidence from Malaysia

Abstract

The fast growing numbers of Islamic bonds issuance in Malaysia and worldwide, coupled with the lack of corporate finance literature that integrates the development of Islamic capital market motivate the study on the wealth effects of Islamic debt offerings and their determinants. It is found that the market reaction is significantly positive during event windows -3, 0 and -3, 3 surrounding the announcements of Islamic debt issuance. Five variables suggested by the capital structure literature, namely firms size (SIZE), issue size (AMT), leverage (LEV), free cash flows (FCF) and investment opportunity (TQ) together with two new variables, the syariah compliant status (SYAR) and the Security Commission's (SC) approval (APPROVAL) were modeled as potential explanatory variables of the wealth effects. The study concludes that the wealth effect of Islamic bond issuance announcements is positively influenced by the issuer's investment opportunity and negatively influenced by the issue size, firm size and whether the announcement is accompanied by the SC approval. The finding implies that the positive reaction is not due to investors' preference for Islamic compliant activities but it is due to similar factors found in studies on conventional bonds. The negative influence of SC approval on the wealth effect indicates that many listed companies issuing Islamic debt are not complying with the information disclosure requirement.

Keywords: capital structure, market efficiency, Islamic debt, Sukuk.

JEL Classification: G14, G31, G32.

Introduction

Islamic debt instruments, commonly referred to as sukuk¹, have emerged over the recent years as increasingly important sources of long-term funding among corporate, quasi-sovereign and sovereign organizations all over the world, especially in the Middle Eastern and Asian countries. It is reported that about US\$ 40 bln in Islamic bonds were issued globally during the three year period ending 2006 (Oakley and Tett, 2007). According to a more recent report by Moody's, Islamic bonds are the fast growing segment of Islamic finance with the volume worldwide amounting to US\$ 97.3 billion (The Brunei Times, 27/2/2008). Recent developments show active participation of non-Islamic financial institutions and corporations as arrangers, issuers and investors.

Islamic debt securities are financial securities that are creatively and innovatively structured to resemble conventional debt securities in terms of risk and cash flows but free from elements deemed to be forbidden with reference to the syariah² principles, such as interest, gambling and extreme level of uncertainty, and at the same time incorporates other principles of Islamic doctrine advocating risk sharing, individuals' rights and duties, property right, and sanctity of contracts (Iqbal, 1997; Iqbal and

Mirakhor, 2007; Rosly, 2005). Instead of paying a fixed annual interest, the payouts to investors over the life of an Islamic bond come in the form of either lease payment, profit from the sales of tangible assets, or profit from a joint venture business, depending on the type of Islamic bond.

Malaysia, a predominately Muslim country, is the world largest issuer of Islamic securities where a total of US\$ 30 bln of the US\$ 41 bln in Islamic bonds issued globally since 1996 up to 2006 have been arranged and issued in Malaysia. As of December 2005, outstanding Islamic corporate bonds amounted to about RM 78 billion or 41% of total outstanding corporate bonds (Nik Ramlah, 2005).

The increasing use of Islamic debt securities as capital raising instruments is no doubt having a positive effect on the fund management industry and the Islamic capital market, but its effect on shareholders' wealth is unclear. To the authors' knowledge none of the theoretical and empirical works on the corporate finance aspect of debt offering has considered syariah compliance factors in their model while the focus of the Islamic finance discipline has been mostly on product development and the Islamic capital market in general. Hence this study is an effort to link Islamic finance and corporate finance by examining the wealth effect of Islamic debt issuance and its determinants.

The remainder of the paper is organized as follows. Section 1 discusses the related literature and the theoretical framework guiding the study. Section 2 provides the description on the research methodology adopted to achieve the objectives of the study. Section 3 presents and discusses the findings. The final section concludes.

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¹ *Sukuk* is an Arabic term for the plural of '*suk*', which means certificate. Iqbal and Mirakhor (2007) defined *sukuk* as participation rights in the underlying assets. Based on this definition, shares, notes, unit trust and bonds are all *sukuk*. However, there is a great tendency among practitioners to use *sukuk* interchangeably with bond.

² Syariah principles are those originated from the rules dictated by the Quran and explanations rendered by the Prophet Muhammad.

1. Literature review and theoretical framework

Given the lack of literature on corporate finance aspects of Islamic debt issuance, mainstream capital structure literature is reviewed to guide the theoretical framework on the wealth effect of Islamic debt offerings by incorporating characteristics of Islamic debt securities.

1.1. Literature review. Modigliani and Miller (1958) were the first who theorized the effect of financing mode on shareholders wealth through their classic 'capital structure irrelevant' theory. They proved that under the perfect market condition, when debt usage is increased, the value increasing effect of lower cost of debt is offset by the value decreasing effect of increasing cost of equity resulting in unchanged value. Five years later, Miller and Modigliani (1963) posted an argument that in the world with corporate taxes, shareholders wealth would increase with the increase in debt usage due to the interest tax shield benefit of debt.

The imperfections of the capital markets underpin the proposed by other capital structure theories. One of the widely acceptable theories is the so called 'static trade-off theory' (De Angelo & Masulis, 1980), which claims that there is a limit to the advantage of increasing usage of debt since increasing debt not only results in the increasing tax shield benefits but also is accompanied by increasing financial distress costs. The need to balance these two opposite forces on value leads to an optimal capital mix.

In addition to the above, the information asymmetry hypothesis by Myer and Majluf (1984) which incorporates the existence of information asymmetry between managers and shareholders, with managers having superior information about the true value of the company, argues that managers will issue equity only when the share is overvalued by the market. Hence, an equity issuance announcement signals that the share price is overvalued, thus market would react negatively to the announcement. The speed at which the information is reflected in the stock price is determined by whether the capital market is efficient in the semi-strong form or not (Fama, 1998).

Jensen's (1986) argument on the potential existence of agency conflict between managers and shareholders where managers have the tendency to over-invest excess cash flows under their control supports the hypothesis that market would react positively to debt issues since the financing mechanism that forces managers to make future payments is capable of reducing agency costs. Jensen, however, acknowledges that in the case of straight bond issuance, additional

cash is placed under the control of the managers, resulting in increased agency conflict causing negative market reaction following the issuance.

Howton et al. (1998) attempted to investigate Jensen's free cash flow argument relating to straight bond issuance. They found that market reacts negatively to straight bond issuances made by industrial companies and that the announcement day reaction is inversely related to the level of free cash flow prior to the debt issue and inversely related to the investment opportunities of the firm as measured by the marginal q .

Irvine and Rosenfeld (2000) argue that using proceed from preferred stock to retire long-term debt reduces the present value of financial distress cost (PVFDC), reduces the agency cost of debt and at the same time increases the agency cost of equity. These forces result in the expected share prices changes to be indeterminate. Using similar arguments, it is hypothesized that using proceed from bond issuances to retire long-term debt will not change the present value of financial distress cost (PVFDC), the agency cost of debt and the agency cost of equity, but will reduce bank monitoring. These forces are expected to result in negative effect on share prices.

Brounen and Eichholtz (2001) derived what they called the 'debt market accessibility theory' from Bayless and Chaplinsky (1991). They theorize that for highly levered companies, assessing debt market would be less attractive, since they are regarded as relatively risky to capital supplier. Hence, highly levered companies that issue equity are perceived by investors to have better post-issue performance than highly levered companies that issue debt. Market reaction to the former case, therefore, is theorized to be better than reaction to the later case. They also claim that raising additional resources signals that the net operating cash flows of current operation are disappointing. The larger the amount raised, the more cash flow shortage is signaled, and hence the more severe the price reaction is anticipated.

In a more recent study, Shao et al. (2007) examine the role of investment opportunities and free cash flow in explaining the source of the stock valuation effects of secured debt offerings. They find a significantly positive relation between a firm's investment opportunities and its stock price response to announcements of secured debt issues but lack of support for the free cash flow hypothesis.

The limited amount of studies published on Malaysian companies' capital structure focus on the determinants of capital structure rather than examine the wealth effects of debt issuance announcements

(e.g., Deesomsak et al., 2004; Fraser et al., 2005). There are, however, several studies on market reactions to other events such as merger announcements by Isa and Yap (2004) and dividend changes announcements by Abdullah et al. (2004) and these studies show the presence of abnormal returns in a short window period (e.g., event window [-1,0] in the study of Abdullah et al.) supporting that Malaysian capital market is efficient in the semi-strong form.

1.2. Theoretical framework on the wealth effect of Islamic debt issuance in Malaysia. The corporate finance literature reviewed highlights that key factors leading to positive wealth effects of debt offering announcements are tax, agency cost and signaling effect and that Malaysian capital market is not efficient. Based on this literature, literature on Islamic bonds and insights from bond market players (as key informants), a positive reaction is hypothesized following Islamic debt issuance announcements and that the reaction is more positive than the reaction on conventional debt issuance announcements due to the following:

- ♦ Cheaper financing cost: Higher liquidity of Islamic debt securities due to wider investor base relative to conventional debts arguably results in the transaction costs of issuing Islamic debts and the cost of debt being lower than similar costs of conventional debts.
- ♦ Attractiveness to investors: As with syariah compliant debts, syariah compliant stocks have wider investor base encompassing of both Islamic and conventional investors. The tremendous growth of Islamic funds in Malaysia in the recent years creates even higher demand for syariah compliant stocks relative to non-syariah compliant stocks. This explains the scenario where 85% of total securities listed in Bursa Malaysia are syariah compliant. It is argued that announcements of Islamic debt offering enhance the syariah compliance status of these companies, hence attract more investors leading to increase stock prices.
- ♦ Funds raised from the Islamic debt offerings are used to finance new activities: Akhigbe et al. (1997) argue that the wealth effect following announcements of new capital raised is influenced by the issuer motivations. According to the report from the SC, 78.8% of fund raised through Islamic bond issuances were for funding of new activities, only 15% were for refinancing existing debts and 6.2% for expense related to bond issuances (SC Annual Report, 2005).

Based on the previous arguments, it is also hypothesized that *ceteris paribus*:

- ♦ issuer's size is negatively related to the wealth effect since larger firms have less asymmetric information problem;
- ♦ issue size is positively related to the wealth effect since the bigger the issue, the bigger is the information content of the announcement;
- ♦ issuer's investment opportunity is positively related to the wealth effect since the greater the opportunity, the higher is the chance that the debt will be used to finance investment;
- ♦ issuer's free cash flows are positively related to the wealth effect since the larger the free cash flow, the higher reduction in agency cost could be achieved through the use of debt financing;
- ♦ issuer's leverage is negatively related to the wealth effect since the lower the leverage, the greater is the probability that the company might be able to take advantage of the tax-deductibility of interest;
- ♦ issuance announcements accompanied by the SC approval have less wealth effect since information leakage may have taken place;
- ♦ issuance announcements made by syariah compliant companies have greater wealth effect since the announcements enhance the syariah compliant status of the companies.

2. Research method

The population of the study consists of all long-term private debt announcements made by companies listed in Bursa Malaysia during the period of January 2000-June 2006. Announcement dates were defined as dates on which an announcement on the debt undertaking is made for the first time. Several of the debt issuances have to be omitted due to multiple events and multiple issues problems. The number of observations for the debt announcement effect is 81 for Islamic bonds and 69 for the conventional bonds. The final number of observations for the multivariate analysis is 76 due to the omission of 3 issuances made by finance companies and 2 issuances made by companies that were disposed off or taken over during the period of the study.

This study uses event study and market model to measure initial market reaction to debt announcements. The parameters of the market model are estimated using daily returns for a period of 140 days starting from 200 days before the announcements. From the parameters estimated, abnormal returns for a period of 120 days, from 60 days before the announcement to 59 days after the announcement, are

computed. By using a longer window period, information leakage might be captured. Bursa Malaysia Composite Index (CI) is used as the market index. Daily prices for each company and CI are gathered beginning from 201 days prior to the announcement date to 59 days after the announcement date.

Abnormal return for each firm i on day t is computed as follows:

$$AR_{i,t} = R_{i,t} - (\alpha_i + \beta_i R_{m,t}), \tag{1}$$

where $AR_{i,t}$ – abnormal return of firm i on day t ; $R_{i,t}$ – return of firm i on day t ; $R_{m,t}$ – return of Composite Index on day t ; α_i and β_i – parameters estimated using the market model.

Daily abnormal returns on event day t for all sample firms are summed and divided by the number of observations to give the average abnormal returns on event day t , AAR_t , as in equation (2).

$$AAR_t = \frac{\sum_i^n 1^{AR_{i,t}}}{n_t} \tag{2}$$

Cumulative average abnormal returns (CAAR) are calculated for the window period from an earlier date, t_1 , to a later date, t_2 as in equation (3)

$$CAAR_{t_1,t_2} = \sum_{t=t_1}^{t=t_2} AAR_t, \tag{3}$$

where $CAAR_{t_1,t_2}$ is normally distributed with mean zero and variance of $\sigma^2(CAAR_{t_1,t_2})$ where $\sigma^2(CAAR_{t_1,t_2}) = \sum_{t=t_1}^{t_2} \sigma^2(AAR_t)$. The significance of $CAAR_{t_1,t_2}$ then can be tested by using Z-statistic, where

$$Z - \text{statistic} = \frac{CAAR_{t_1,t_2}}{\sigma^2(CAAR_{t_1,t_2})} \tag{4}$$

A multivariate regression was then estimated to determine the nature of relationship between anticipated variables and abnormal returns associated with debt announcements. More specifically, the following model is tested:

$$CAR_{t_1,t_2,i} = \alpha + \beta_1 SIZE_i + \beta_2 FCF_i + \beta_3 AMT_i + \beta_4 TQ_i + \beta_5 LEV_i + \beta_6 SYAR_i + \beta_7 APPROV_i + \varepsilon, \tag{5}$$

where $CAR_{t_1,t_2,i}$ – the cumulative abnormal returns for issuer i from the window period of t_1 to t_2 ; $SIZE_i$ – the size of issuer i , estimated by the natural log of its total asset; AMT_i – the amount of issuance, measured by the size of issuance as the percentage of the total asset of issuer i ; FCF_i – the level of free cash flows of issuer i . Two measures of FCF are used separately. The first is denoted by FCF_a , where $FCF_a = (\text{operating income} - \text{interest} - \text{net taxes}^*) / BV$ asset, where taxes = current tax – change in differed tax (as in Howton et al. (1998) and Shao et al. (2007)). The second proxy for the issuer’s FCF , denoted by FCF_b , is EBITDA. TQ_i – the Tobin’s q of issuer i . Two proxies Tobin’s q were used separately. The first is denoted by TQ_a , where $TQ_a = ((\text{share outstanding} * \text{price}) + \text{liquidating value for PS} + (\text{current liability} - \text{current asset}) + BV \text{ of long-term debt}) / (\text{total BV of asset})$ (as in Howton et al. (1998) and Shao et al. (2007)). The second is denoted by TQ_b , where $TQ_b = \text{market value of equity} / \text{book value of equity}$. LEV_i – the level of leverage of firm i , where $LEV = \text{total firm debt} / \text{book value of the asset}$. $SYAR_i$ – the syariah compliant status of firm i , where $SYAR_i = 1$ if firm i is syariah compliant and 0 otherwise. $APPROV_i$ – the SC approval status at the time of the Islamic bond issuance announcement of firm i , where $APPROV_i = 1$ if the SC approval has been given to the Islamic bond issuance and 0 otherwise.

3. Findings and discussion

3.1. Event study analysis. The result of the event study analysis is presented in Table 1. The market reaction is found to be significantly positive for the [-3,0] 4-day announcement period and for the [-3, 3] 6-day surrounding the announcements of Islamic debt issuance while no significant abnormal return is recorded for conventional bond issuance announcements. The average [-3,0] announcement period abnormal return of firms announcing Islamic bond issuance is 1.58% while the average [-3,3] announcement period abnormal return is 1.89%. No significant abnormal returns are observed preceding and following conventional bond issuance announcements.

Table 1. Abnormal returns of Islamic and conventional debt issuers surrounding the announcement dates

Event window	Islamic bonds		Conventional bonds	
	CAAR	z-statistics	CAAR	z-statistics
CAR-60,60	5.44%	1.399	0.49%	0.135
CAR-60,0	3.83%	1.386	-0.63%	-0.244
CAR-20,5	1.62%	0.896	-0.19%	-0.115

Table 1 (cont.). Abnormal returns of Islamic and conventional debt issuers surrounding the announcement dates

Event window	Islamic bonds		Conventional bonds	
	CAAR	z-statistics	CAAR	z-statistics
CAR-10,5	1.64%	1.162	0.24%	0.179
CAR-5,5	0.91%	0.772	1.05%	0.966
CAR-5,0	0.89%	1.024	0.40%	0.501
CAR-3,0	1.58%	2.232*	-0.03%	-0.048
CAR-1,0	0.80%	1.591	0.15%	0.328
CAR5,60	1.65%	0.622	0.33%	0.134
CAR0,2	0.17%	0.282	1.01%	1.540
CAR-5,3	1.19%	1.126	0.94%	0.954
CAR1,3	0.31%	0.503	0.54%	0.944
CAR1,2	-0.17%	-0.334	0.62%	1.330
CAR0,3	0.65%	0.916	0.93%	1.410
CAR-3,3	1.89%	2.016*	0.51%	0.582

Note: * denotes significance at the 0.05 level.

Two-sample t-test was then executed to compare the abnormal returns for the two types of debt announcement and the results are presented in Table 2. The evidence shows that the abnormal return of Islamic bond issuance announcement is more than that of conventional bond announcements for the [-3,0] announcement period at 10% significance

level. Non parametric tests using Kolmogorov-Smirnov Test are also executed since the sample sizes are quite small. The results as shown in Table 2 indicate that the difference between the abnormal returns for Islamic bond announcement and those for conventional bond announcement is more significant for both event windows.

Table 2. Test of difference-in-mean of abnormal returns surrounding debt issuance announcements between the two debt groups

	CAR (-3,3)		CAR (-3,0)	
	Islamic	Conventional	Islamic	Conventional
Mean	0.506%	1.887%	1.578%	-0.032%
Std. dev.	.078798	.0885138	.065740	.033616
t-stat (p-value)	-.983 (0.321)		-1.914* (0.058)	
Kolmogorov-Smirnov (p-value)	1.485** (0.024)		1.571** (0.014)	

Note: ** and * denote significance at the 0.05 and 0.10 levels respectively.

One potential explanation for the greater wealth effect of Islamic bond issuance announcements relative to conventional bond issuance announcements is that the larger investor base for Islamic debt securities relative to that for conventional debt creates cost advantages leading to a lower cost of capital. Another potential explanation is that announcements of Islamic debt offering enhance the syariah compli-

ance status of these companies, hence attract more investors leading to stock prices increase.

3.2. Cross sectional regression analyses. Descriptive analysis of variables modeled in the regression analysis is presented in Table 3 while the outputs of the regression analysis are presented in Table 4. The regression models are free of multicollinearity, serial correlation and heteroscedasticity problems.

Table 3. Descriptive statistics of the dependent and independent variables

	N	Minimum	Maximum	Mean	Std. deviation
FCFa	76	-.08230	.12971	.04723	.03923
FCFb	76	-.02913	.25592	.10186	.05385

Table 3 (cont.). Descriptive statistics of the dependent and independent variables

	N	Minimum	Maximum	Mean	Std. deviation
LEV	76	.00000	.75010	.32324	.15376
TQa	76	.27342	10.199	1.49140	1.39471
TQb	76	.50923	5.0242	1.25163	.70458
lnAMT	76	17.50439	22.22734	19.14049	.99673
lnMV	76	17.55655	24.5190	19.86447	1.65569
CAR-3,3	76	-.170946	.384964	.020057	.09121

Table 4. Results of regression of CAR (-3,3) on Islamic bonds' and issuing firm's characteristics

	Model 1	Model 2	Model 3	Model 4
Independent variables	Parameter estimate [p-value] ^a	Parameter estimate [p-value] ^a	Parameter estimate [p-value] ^a	Parameter estimate [p-value] ^a
FCFa	-0.35739 [0.207]	-	-	-0.40505 [0.198]
FCFb	-	-0.54826 [0.2890]	-0.58140 [0.264]	-
TQa	0.01228 * [0.060]	0.012648 [0.100]	-	-
TQb	-	-	0.02722* [0.097]	0.02560* [0.083]
AMT	-0.06354** [0.001]	-0.065758** [0.000]	-0.06951** [0.000]	-0.06185** [0.001]
LNMV	-0.01170** [0.048]	-0.011770** [0.038]	-0.01133** [0.050]	-0.01135** [0.049]
APPROVAL	-0.0396* [0.060]	-0.040566* [0.053]	-0.03921** [0.049]	-0.04100* [0.052]
SYAR	-0.019496 [0.557]	-	-	-
LEV	0.065638 [0.307]	0.030067 [0.588]	-	.062385 [0.299]

Notes: ^a indicates that error has been corrected based on White's heteroscedasticity adjusted standard errors; ** and * denote significance at the 5% and 10% levels respectively.

The evidence shows that both the amount raised (AMT) and the issuer's size (LNMV) are highly significant in influencing the abnormal return. The negative relationships between AMT and abnormal returns can be explained by Miller and Rock (1985) argument that higher unexpected external financing signals larger future cash insufficiency, hence resulting in higher drop in abnormal return. The negative relationship between LNMV and CAR is as hypothesized by the asymmetric information hypothesis since the degree of asymmetric problem of smaller firms is typically more than that of larger firms.

The market reaction to Islamic bond issuance is also found to be positively related to the issuing companies' Tobin's Q. This means that if the announcement is made by companies with high investment potential, the abnormal return would be higher and this is consistent with the finding by Akhigbe et al. (1997) and Irvine and Rosenfield (2000) who found that the underlying motive of capital expenditure results in higher abnormal return during the announcement period.

Another variable found to be significant is the SC approval status (APPROVAL) and this indicates that the abnormal return surrounding the announcements of Islamic bond issuance without the SC approval is more than that for announcements with the SC approval. This finding implies the presence of information leakage during the SC approval process, before official announcement on the debt issuance is made to the public.

The insignificance of syariah compliant status (SYAR) in influencing the abnormal returns is an interesting result as it invalidates earlier argument that the wealth effect of Islamic bond issuance announcement is due to the enhancement of issuing firms' syariah compliant status.

Conclusion

Much discussion on Islamic debt securities has centered around the syariah compliant and capital market issues with limited literature on the corporate finance perspective of Islamic debt issues. This

study, therefore, is a preliminary attempt to fill this gap in literature by looking at the announcement effects of Islamic debt securities. Bond issues in Malaysia are used as the sample due to her well-developed Islamic and conventional bond market.

Through an event study analysis, the study found that investors reacted positively to the announcements of Islamic debt issues while they are indifferent to the announcements of conventional issues. The reactions are found to be significant at the 5% level for event windows [-3,3] and [-3,0]. This finding implies that the issuance of Islamic bond by Malaysian companies benefits the shareholders through wealth increase. The wealth created from Islamic bond issuance announcement is also found to be higher relative to that of conventional bonds. These findings might be attributed to the larger investor base for Islamic debt securities relative to that for conventional debt, which creates cost advantages leading to a lower cost of capital. The short event windows within which significant wealth effect is recorded provide additional support for semi-strong form efficiency of Malaysia capital market as in Isa and Yap (2004) and Abdullah et al. (2004).

Further analysis through regression analysis provides more explanations for the sources of wealth creation of Islamic bond announcements. The findings show that the positive wealth effect is not due to investors' preference for Islamic compliant activities but it is due to several factors theorized by the existing capital structure theories and found in studies on conventional bonds. The negative relation-

ship between wealth effect and firm size and the positive relationship between wealth effect and investment opportunity suggests that smaller size firms with greater investment opportunity should issue Islamic bonds since they can benefit more from the information content and the signaling role of Islamic bond issuance announcements relative to larger firms. Our evidence also suggests that Jensen's free cash flow theory may not apply to Islamic debt offerings in Malaysia, similar to that concluded by Shao et al. (2007) in their study on secured debt offering in the U.S. In other words, this finding means that Islamic bonds are not used as agency cost reduction mechanism.

The presence of information leakage during the SC approval process as implied by the finding that firms with SC approval experience less abnormal returns than those without SC approval suggests that the stock market regulator should enforce stricter rule on bond issuance disclosure requirements to further enhance disclosure activities of companies issuing debt securities. As for researchers attempt to perform event studies, it is suggested that special attention should be given to selecting appropriate announcement dates as there are great variations in the information content of each announcement.

It is also suggested that this study should be extended by conducting a cross sectional regression analysis on a sample of both Islamic and conventional debts and including motive and some interaction variables as potential explanatory variables to provide further verification of the findings found in this study.

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