

Information content of Islamic Private Debt Announcement: Evidence from Malaysia

Sahar Modirzadehbami and Gholamreza Mansourfar

Abstract—Different types of Islamic debts have been increasingly utilized as preferred means of debt funding by Malaysian private firms in recent years. This study examines the impact of Islamic debts announcement on private firms' stock returns. Our sample includes forty five listed companies on Bursa Malaysia involved in issuing of Islamic debts during 2005 to 2008. The abnormal returns and cumulative average abnormal returns are calculated and tested using standard event study methodology. The results show that a significant, negative abnormal return occurs one day before announcement date. This negative abnormal return is representing market participant's adverse attitude toward Islamic private debt announcement during the research period.

Keywords—Announcement effect, Event study, Islamic debts, Malaysia, Sukuk

I. INTRODUCTION

IN the history of the business development in the world, factors that affect on the shareholders wealth have been central issues in the field of finance. Financing decisions, which are to determine how much and what type of debts and equity should be issued to raise required capital are among the factors can affect on the firm value and eventually shareholders wealth.

Asian financial crisis in 1997-98 heightened the need for risk diversification within the financial system. Over reliance on bank loans during crisis period leading to liquidity problems drove Malaysian government to support the development of corporate bond markets in order to make greater diversification of credit risk among economic agents [1]. On the other hand, liquidity problems of the bank made Malaysian firms switch their financing methods to bond offerings instead of bank loan or equity financing that in turn contributed a lot in creating a prosperous domestic private debt securities (PDs) market for raising capital [1]. Over the past years, attempts to develop the Malaysian corporate debt market have been successful in that the corporate bond market has been posting an average annual growth of 7% since 2000, reaching RM124.2 billion as at end-December 2008 [2]. This growing trend of the market and emerging new types of financial instruments day by day call for constant and dynamic market investigations to provide better insight of the

market for firms, investors and government. This paper aims to address the valuation effects of one of the modern financial instrument in this developing market.

A unique aspect of the Malaysian market is the co-existence of an Islamic securities or sukuk market. Islamic securities are structured to comply with Shariah principles, which prohibit the charging of interest. Islamic securities appeal to two very different sets of investors – those investing strictly for religious reasons, and conventional investors seeking liquid, attractively priced instruments to invest in and to diversify their portfolios. Malaysia is the pioneer of the Islamic capital market. Islamic bond was developed in Malaysia in 1990 and spread out to the world rapidly. The corporate sukuk market in Malaysia has grown enormously in recent years, with an average annual growth rate of 21% between 2001 and 2008. In fact, the outstanding amounts of sukuk have surpassed the amount of conventional debt securities in the domestic market. In 2008, the amount of corporate sukuk issued exceeded RM47 billion [2]. Indeed, Malaysia still has the largest sukuk market in the world (countries market share in 2008 is depicted in Fig.1). All in all, everyday much and much attention paid to this new financial product by firms and investors has generated a new series of concerns for researchers to examine different aspects of this modern tool.

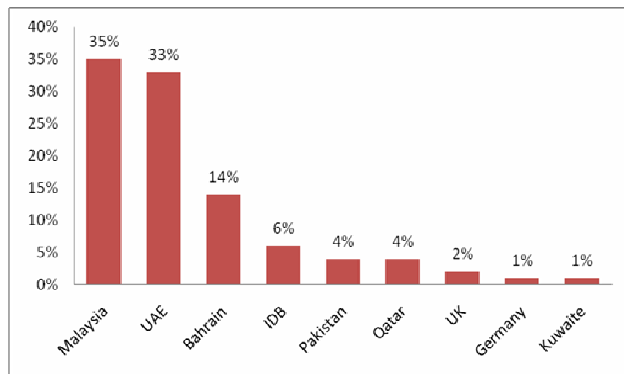


Fig. 1 Sukuk market share in 2008 (Source: Ernest and Young Presentation, Islamic Finance & Investment World, August 26, 2008)

This paper critically discusses the information content of Islamic private debts (IPDs) announcements, and tries to answer the questions of: what kind of information convey to the market after Islamic bond offerings announcement? Will this announcement be perceived favorably or otherwise by investors? These questions are answered by studying changes occurring in company's stock return around the announcement date during research period.

II. LITERATURE REVIEW

The first serious discussions and analyses of relationship between firm value and capital structure in a modern sense emerged with the Modigliani and Miller study [3]. They suggested that the value of the firm and capital structure were

Sahar Modirzadehbami is with Graduate School of Management, Universiti Putra Malaysia, Malaysia (phone: +989124261056, fax: +982122022905, email: sahar_modirzadeh@yahoo.com)

Gholamreza Mansourfar is with Faculty of Economics and Management, Urmia University, Iran (email: g.mansourfar@urmia.ac.ir)

two independent variables in a perfect capital market with no corporate income taxes and the firm value was determined by its investment, not financing decisions. However, In 1984, the Pecking order theory proposed by Myers and Majulif [4] maintained that businesses adhered to a hierarchy of financing sources in that they set a higher priority for internal financing, and then they preferred debt over equity in case of external financing. According to this theory, managers tend to establish their capital structure base on the cost of adverse selection arising from information asymmetry between better-informed managers and less-informed investors, which is much lower for bond than equity. Findings by Abhayankar and Dunning [5] also supported this theory; their analysis showed that pure equity financing had a relatively large negative valuation effect while straight debt financing had a small non-negative effect on the firm value.

So far, many scholars have argued the effects of different capital structures and financing decisions on shareholders wealth [6-9]. Many studies have been exclusively conducted to examine market participant's reaction to bond announcements and its impact on firm value. Nevertheless, to date there has been little agreement on the results.

A considerable amount of literature so far has focused on the group of bonds carrying special feature of having both equity and bond components. An early study by Kang and Stulz [10] provided an evidence of a significantly positive stock price reaction to the announcement of convertible bonds for the Japanese market. Results of the research by Roon and Veld [11] also showed insignificant positive abnormal returns on the announcement date of new issues of convertible bonds in the Dutch market. In contrast, studies by Arshanapalli [12] in the US market and by Cheng et al. [13] in Japanese market discovered significant negative abnormal returns at the announcement time of the convertible bonds. Ammann et al. [14] measured wealth effects of convertible and exchangeable bonds during period of January 1996 to May 2003 for two European markets (Switzerland and Germany) and found significant negative abnormal returns on the announcement date for the complete sample which is consistent with the results of the study by Dann and Mikkelsonv [15] that had indicated a significant negative stock market reaction to announcement of convertible debt offering in the US market during the years 1970 to 1979.

Moreover, there are some researches available studied announcement effects of purely straight bonds which carry no special kind of features. For instance, Study conducted by Stephen and David [16] examined the announcement impact of high-yield straight debt for a sample consisting of 164 bond offerings. The result suggested that there was no significant relationship between high-yield straight debt announcement and stock value. This finding contradicted the result of Shawn [17] found a year after, his result showed that announcement of straight debts were associated with significant negative abnormal return.

The other study by Eckbo [18] examined the valuation effect of corporate debt offering on a sample of different types of debts. This study reported straight debt offerings had non-positive price effects, convertible debt offerings had significantly negative effects and public utility mortgage bond

offerings had marginally negative effects, however; this effect were significantly negative when the proceeds were used to finance the utility's investment program.

However, there has been little discussion about Islamic bonds. The researches, to date, have tended to focus on other types of debt offerings. One of the few studies available on Islamic bond effects is the investigation by Ashhari [19]. He concentrated on the difference between conventional bond and Islamic bond announcements and attempted to show that certain types of debts lead to abnormal returns as previously had claimed by Mikkelson and Partch [8]. The results demonstrated that there was a positive reaction on the Islamic bond issues announcement; however, no wealth effect was associated with the conventional bond announcement.

III. DATA AND SAMPLE

Data on Islamic private debt issues were obtained from the Security Commission Malaysia database for the period of January 1, 2005, to December 31, 2008. The data of the daily closing stock prices for two years before the announcement date of Islamic bond for all the selected companies and for Kuala Lumpur Composite index (KLCI) were collected from DataStream. A final sample of issues satisfies the following selection criteria:

- 1) The issuing company is listed in Bursa Malaysia(KLSE)
- 2) The issuing company's daily common stock prices for the estimation period(two years before announcement) are available in DataStream
- 3) Announcement date is identifiable clearly and accurately
- 4) Maturity of the debt must be 1 year or longer. (This condition was imposed to avoid contaminating our results with those that may arise from the signaling implications of short-term debt.)
- 5) Each company is included in the sample only once; even if, it had more than one announcement in the research period

After applying the above screens, we obtained a sample of 45 Islamic bonds announcement by private firms for the period of 2005 to 2008. In 2005, the number of announcements accounts for 46.6% of the total sample. The number of sample announcements drops largely after year 2005. From 2006 to 2008, there are only 12, 8 and 4 announcements respectively. However, the market size has not declined accordingly.

IV. METHODOLOGY

We use Brown and Warner's [20] standard event study methodology to examine information content of private Islamic debts. Before this, Uday and Nandkumar [21] also used one of the standard event study methodology to test information content of private debt placements in the US market. Standard event study is employed to calculate abnormal returns around each announcement of Islamic bond issue. According to many previous studies on valuation effect of company's different announcement, Islamic bond announcement might have some financial implications for the

issuing firm. It is hypothesized that Islamic bond announcement is associated with a positive market reaction. An event study is considered useful because, with the assumption of rationality in the market place, the share prices will immediately reflect the effects of the event. Therefore, the economic impact of the event can be measured over a shorter period compared to direct productivity related measures, which may take many months or years of observations [22].

Announcement date is a day in which the bond offering is first made known to the public. Event window is considered -15 to +15 days around the announcement date (22 working days). There is no standard for event window period; however, the period of interest is often expanded to multiple days including at least the day of the announcement and the day after the announcement. This captures the price effects of announcements which occur after the stock market closes on the announcement day [22]. And estimation period in this study includes two years (523 working days) daily information until fifteen days before (-15) announcement date. (Fig.2 depicts event window and estimation period timeline)

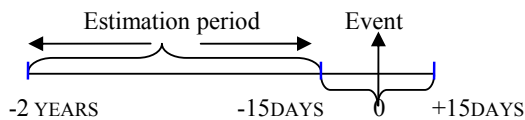


Fig 2 Estimation and event window time line

The abnormal return is defined as the difference between the actual return and the normal return to measure the performance of stock prices of firms on certain days using (1):

$$AR_{it} = R_{it} - (\alpha_i + \beta_i R_{mt}) \text{ where;} \quad (1)$$

AR_{it} : Abnormal returns for firm i at time period t

R_{it} : Actual returns for firm i at time period t

R_{mt} : Returns on market portfolio in period t

α_i : The constant average return of stock i

β_i : Beta estimate of stock

α and β are estimated over the estimation period using market model which relates the return of any given security to the return of the market portfolio. The return on the Kuala Lumpur Composite Index (KLCI) is used as a proxy of market returns [23]. They are calculated by running regression of security returns against the market returns.

After estimating the abnormal returns for each firm, the abnormal return for all of the firms on each day of the event window are then aggregated and averaged. By averaging across all firms, the effects of other events would be minimized. The cross-sectional average abnormal returns for each time period t, are calculated as (2); where N is equal to the number of firms in the sample:

$$AAR_t = \frac{1}{N} \sum_{i=1}^N AR_{it} \quad (2)$$

The AAR_t is the average estimated percentage deviation of the returns of the sampled stock from the normal relationship to the market.

The standard deviation of the AAR of the estimated window calculated as well to test and analyze whether the Average Abnormal Returns (AAR) are statistically different from zero by(3):

$$t - \text{statistic} = AAR_t / \delta(AAR) \text{ where } , \quad (3)$$

AAR_t : Average abnormal return of period t

δ : Standard deviation of average abnormal return over the estimation window

A t-value at 5% significant level means that the particular one-day residual is significantly different from zero at 95% confidence level.

To observe the cumulative effects, the cumulative abnormal returns ($CAAR_{-t_1, +t_2}$) are computed by summing up the AAR_t over various time periods of interest relative to the event period ($-t_1$ to $+t_2$) using (4):

$$CAAR_{(-t_1, +t_2)} = \sum_{-t_1}^{+t_2} AAR \quad (4)$$

$CAAR_t$ is a more precise representative of the longer term effect on share prices from bond offering announcements.

The t-value for the $CAAR_t$ is given as (5):

$$t = CAAR / \delta(CAAR)_t \quad (5)$$

The standard deviation of $CAAR$ is defined as (6); where N is the number of days in the $CAAR$ statistic:

$$\delta(CAAR) = \delta(AAR) \sqrt{N} \quad (6)$$

V.RESULTS

Abnormal returns are calculated for 22 days during the event window. A cumulative average abnormal return is also computed to test cumulative effect of information for the market reaction. Table 1 demonstrates a summary of average abnormal returns and their t-tests on day -1, day 0 and day +1 of bond announcement. The average abnormal returns (AAR) are -0.00132 on day 0, -0.0023 on day +1 and -0.00724 for day -1. The negative abnormal return on day before announcement is highly significant at 5% level and t-values for the announcement day and day +1 are insignificant. This early market reaction to Islamic bond announcements was also discovered previously by Ashhari [19]; where it was found that the early market reaction was positive. Regardless of the reaction kind (to be positive or negative), possible reason for early response could be the fact that information of Islamic bond offering often leaks out to the market before the announcement. It is also well known that event study accurately explained 80-90 percent of information content reflected in prices before the announcement date

[24]. Significant negative abnormal return on the day before announcement shows that the announcement of Islamic bonds in the market has reflected a bad news during the years of 2005 to 2008 in Malaysian market.

Fig 3 shows AAR during the 22-day event window. The market abnormal return has a sharp downward trend over days -3, -2 and -1 and experience negative values for the period

from day -2 to day +2 which would be a result of falling demand for the stock on those days. After day +2, the negative trend goes up and adjusts gradually in the following days.

TABLE I
SUMMARY OF THE AVERAGE ABNORMAL RETURN (AAR_t) ON DAY -1 TO DAY +1

Measure	Day -2	Day -1	0	Day+1	Day+2
AAR	-0.00365	-0.00724	-0.00132	-0.0023	-0.00232
T-statistics	-1.0480797	-2.080332	-0.3783392	-0.6618723	-0.6651651
Result	Negative & insignificant	Negative & significant	Negative & insignificant	Negative & insignificant	Negative & insignificant



Fig. 3 Market reaction in the form of average abnormal return to the Islamic Private Debt

The cumulative average abnormal returns (CAAR) for three sub-periods are shown in Table 2. Besides AAR, CAAR is a useful statistical analysis which helps to get a sense of the aggregate effect of the abnormal returns. Particularly, the CAAR can prove very useful, if the influence of the event during the event window is not limited only to the event date. As illustrated in the table, CAAR for the periods of day-1 to day +1, day -1 to day0 and day0 to day+1 are -0.01087, -0.00856 and -0.00362 respectively. As it is seen in the table, although t-statistics for the periods (-1,+1) and (-1,0) show values almost significant, none of the t-values are absolutely significant at 5% level.

According to Fig 4 depicting Graph CAAR on the event window, CAAR values are entirely positive before day -1 and after +4. Negative CAAR values for the days -1 to day +4 represent the negative interpretation of Islamic bond announcement by market participants. Moreover, a downward trend starting from day -3 to day +2 of CAAR can be considered as a sign of anomaly in the market when there is a general upward trend for the whole period.

TABLE II
SUMMARY OF THE CUMULATIVE AVERAGE ABNORMAL RETURN (CAAR)

Measure	Day(-1,1)	Day(-1,0)	Day(0,+1)
CAAR	-0.01087	-0.00856	-0.00362
T-test	-1.80165	-1.73854	-0.73554
Result	Negative & insignificant	Negative & insignificant	Negative & insignificant

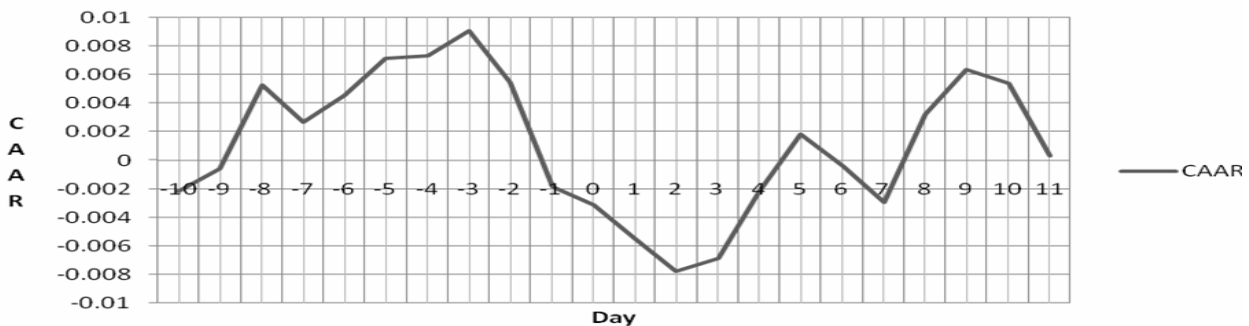


Fig.4 overall market reactions in the form of cumulative abnormal return to the special dividend announcement

The result of negative market reaction to the Islamic Private debt of this study is in contrast with the findings of the study by Ashhari [19] that found a wealth effect on the Islamic bond issues in Malaysia for the period 2001 to 2006. This contradiction can be explained by the different time periods of two studies. This study covers the period of financial crisis time starting in 2007 that probably is a reason of investor's averseness.

The other reason might explain this conflict of results would be investor's misconception about the real nature of the Islamic bonds. They attributed their features to bond and failed to recognize their similarities to equities' features in primary years. However, after a while, investors became more informed about the true characteristics of Islamic bonds and learned about its more common features with equity than bond. As a result, they started to treat Islamic bonds as equities rather than bonds. Islamic bond carries specific features that differentiate it from conventional bonds. Characteristic of Islamic bond issues have to comply with *Shari'ah* that approved by Shariah Advisory Council (SAC) of the Securities Commission Malaysia. Base on *Shariah*, Islamic bonds transform bilateral risk-reward sharing between borrowers and lenders into the market-based refinancing of *shari'ah*-compliant lending or trust-based investment and Investors own the underlying asset via SPV that funds (un)secured payments to investors from direct investment in real, religiously-sanctioned economic activity. Islamic bonds do not pay interest, but generate returns through commoditization of capital gains. Islamic bond cannot be classified exclusively in debt category because it also shares some stock features. Thus, considering the similar characteristics of Islamic bonds and equity, we are able to explain negative market reaction to Islamic bond offering by relying on the results of prior studies on the negative impact of equity announcement on the stock return. The empirical evidence suggests that pure equity offers have a relatively large negative effect while issues of straight debt have a small non-negative effect on the value of the issuing firm. Offers for sale of convertible securities, which combine characteristics of both debt and equity, have negative wealth effects that lie between those observed for pure equity and straight debt [5].

VI. CONCLUSION

This study set out to determine the information content of Islamic private debt offerings. For this purpose, we examined stock price reaction to the announcement of IPD_s issuance during the period 2005 through 2008 in Malaysian market for a sample consisting of forty five listed companies in Bursa Malaysia. The average abnormal return and cumulative average abnormal returns around announcement date were examined using standard event study methodology. The average abnormal return was significantly negative on day -1 but not on day 0 and day +1. The day -1 average abnormal return was also the lowest during the 22 days event windows. The possible reason is the leakage of information to the market before IPDs announcements. The cumulative abnormal return

for three sub-periods of (-1,+1),(-1,0) and (0,+1) were also analyzed; the results revealed insignificant negative CAAR. This finding is neither consistent with the results of the previous study by Ashhari [19] using the IPD_s data during years 2001 through 2006 in Malaysia nor does it support the pecking order theory which expects debts to create value for a firm. Thus, the result rejects our hypothesis of a positive market reaction on Islamic bond announcement. This diverse market reaction would be attributed to the investors increased awareness regarding Islamic bonds features having in common with equity. Moreover, financial crisis of 2007 can be considered as a major contributing factor in the investor's reluctance.

REFERENCES

- [1] I. Muhammad bin, and W. Adrian, "The corporate bond market in Malaysia Developing corporate bond markets in Asia." *Bank Negara Malaysia*, 2006.
- [2] Bank Negara Malaysia and Securities Commission Malaysia, "Malaysian Debt Securities and Sukuk Market." 2009
- [3] F. Modigliani, and M.H. Miller, "The Cost of Capital, Corporation Finance and The Theory of Investment." *American Economic Review*, vol. XLVIII(3), pp. 261-297, 1958.
- [4] S.C. Myers, and N.S. Majluf, "Corporate financing and investment decisions when firms have information that investors do not have." *Journal of Financial Economics*, vol. 13, pp. 187-221, 1984.
- [5] A. Abhayankar, and A. Dunning, "Wealth effects of convertible bond and convertible preference share issues: An empirical analysis of the UK market." *Journal of Banking & Finance*, vol. 23 .pp. 1043-1065, 1999.
- [6] M.T. Bradshaw, S.A. Richardson, and R.G. Sloan, "The relation between corporate financing activities, analysts' forecasts and stock returns." *Journal of Accounting and Economics*, vol 42, pp. 53-85, 2006.
- [7] D. Magennis, E. Watts, and S. Wright, "Convertible notes: the debt versus equity classification problem." *Journal of Multinational Financial Management*, vol.8, pp.303-315,1998.
- [8] W.H. Mikkelson, and M.M. Partch, "Valuation effects of security offerings and the issuance process." *Journal of Financial Economics*, vol. 15, pp. 31-60, 1986.
- [9] C.R. Harvey , K.V. Lins, and A.H. Roper, "The effect of capital structure when expected agency costs are extreme." *Journal of Financial Economics*, vol.74, pp. 3-30, 2004
- [10] J.K. Kang, and R.M. Stulz, "How different is Japanese corporate finance? an investigation of the information content of new security issues." *The Review of Financial Studies*, vol. 9, pp. 109-139, 1996.
- [11] De. F. Roon, and C. Veld, "Announcement effects of convertible bond loans and warrant-bond loans: An empirical analysis for the Dutch market." *Journal of Banking & Finance*, vol. 22, pp. 1481-1506, 1998
- [12] B. Arshanapalli, F. Fabozzi, L. N. Switzer, and G. Gosselin, "New evidence on the market impact of Convertible Bond Issues in U.S." *Paper presented at annual meeting of the California*, Oct 2004.
- [13] W. Cheng, N. Visaltanachoti, and P. Kesayan, "A Stock Market Reaction Following Convertible Bond Issuance: Evidence from Japan." *International Journal of Business*, 10(4), 2005
- [14] M. Ammann, M. Fehr, and R. Seiz, "New evidence on the announcement effect of convertible and exchangeable bonds." *Journal of Multinational Financial Management*, vol. 16, pp. 43-63, 2006.
- [15] L.Y. Dann, and W.H. Mikkelson, "Convertible debt issuance, capital structure change and financing-related information - Some new evidence." *Journal of Financial Economics*, vol. 13, pp. 157-186, 1984
- [16] P. Stephen, and J. David, "Stock price effect of high yield debt issues." *The Review of Financial Studies*, vol. 71, pp. 393-410, 1990.
- [17] D.H. Shawn, E.H. Shelly, and B.H. Steven, "The market reaction to straight debt issues: the effect of free cash flow." *The Journal of Financial Research*, vol. XXI, pp. 219-228, 1998.
- [18] B.E. Eckbo, "Valuation effects of corporate debt offerings." *Journal of Financial Economics*, vol.15, pp.119-151, 1986.

- [19] Z.M. Ashhari, “ Conventional vs Islamic Bond Announcements: The Effects on Shareholders’ Wealth.” *International Journal of Business and Management*, vol 4,pp. 6,2009
- [20] S.J Brown, and J.B. Warner, “Using daily stock returns: the case of event studies.” *Journal of Financial Economics*, vol. 14, pp. 3–31, 1985.
- [21] C. Uday, and N. Nandkumar, “The Information Content of Private Debt Placements.” *Journal of Business Finance & Accounting*, vol. 35, pp. 1164-1195, 2008.
- [22] A.C. MacKinlay, “Event Studies in Economics and Finance. *Journal of Economic Literature*,” vol. 35, pp. 13-39, 1997.
- [23] M.N. Annuar, and M. Shamsheer, “Capital structure.” *Capital Market Review*, vol. 2,pp. 171-177, 1993.
- [24] M.a. Shamsheer, and H. Taufiq, “Political Events and Share Prices of Politically-Connected Firms.” *Working Paper*, 2009.