

INFLUENCE OF FINANCIAL RATIO ON INITIAL PUBLIC OFFERINGS UNDERPRICING: A CASE STUDY ON SHARIA COMPLIANT COMPANIES LISTED ON THE MALAYSIA STOCK MARKET

Nashirah Abu Bakar 

Islamic Business School, College of Business, Universiti Utara Malaysia, Malaysia
nashirah@uum.edu.my

Sofian Rosbi

School of Mechatronic Engineering, Universiti Malaysia Perlis, Malaysia
sofian@unimap.edu.my

Abstract

This study evaluates the impact of financial ratio on the short term performance (underpricing) of Initial public offerings (IPO) for sharia-compliant companies. This study used 18 sharia-complaint companies listed on the Malaysian Stock Exchange from 2014 until 2015. Financial ratios data are collected from database of Datastream Thomson Reutres. This study implemented linear regression analysis to evaluate the association between underpricing (dependent variable) with five independent variables namely gross margin, earnings before interest, taxes, depreciation and amortization (EBITDA) margin, operating margin, pre-tax margin and net margin. Result shows that the level of IPO underpricing for sharia-compliant companies is 19.59%. While, the linear regression analysis indicates that the pre-tax margin and net margin are statistically significant on the level of IPO underpricing. This study seems to suggest that the financial ratio of sharia-compliant companies listed on the Malaysian Stock Exchange have a significant contribution to predict underpricing level. In addition, the finding from this study will help investor make a better decision making in allocating their fund of investment.

Keywords: Initial Public Offerings, Sharia-compliant companies, financial ratio and Malaysian Stock Exchange

INTRODUCTION

Going public is an important stage for companies to become public. It is involved with many processes in order to list shares on stock exchange. In Malaysia, all company seeking to list shares on Malaysian Stock Exchange will require approval from Securities Commission of Malaysia. Securities Commission of Malaysia must review the IPO proposal to ensure IPO companies are compliance with the Equity Guidelines and that the applicant directors and substantial shareholders are free from any adverse records and corporate governance issues. Besides that, the companies that want to list shares on stock exchange must have a good performance such as financial performance in order to fulfill the requirement.

Good financial ratio such as operating margin, pre-tax margin and net margin indicates that the companies are in the health finance and good condition. Therefore, it is important to analyze the financial ratio for companies listed on the Malaysian Stock Exchange. Malaysian Stock Exchange has a unique feature due to provide two types of board namely sharia board and non-sharia board. Sharia board was established because of the demand from Islamic investors. It is also to attract more investors to participant with Islamic investment either Muslim or non-Muslim investors. Therefore sharia board are looking as a good platform in promoting Islamic capital market among a Muslim countries and also worldwide.

A body of literature investigates the level of IPO underpriced (Chahine and Tohme, 2009; Islam, et al., 2010; Chi and Padgett, 2005; Heerden and Alagidede, 2012; Samarakoon, 2010; Ekkayokkaya and pengniti, 2012; Darmadi and Gunawan, 2012; Zhang and King, 2008; Agathee, et al., 2012 Borges, 2007). Such studies found that IPO are underpriced than market value. Study by Islam, et al. (2010) found the level of IPO underpricing in Bangladesh was 480.72%. Chahine and Tohme (2009) found the level of IPO underpricing in Middle East and North Africa was 184.1%. While the study that focus on IPO shares performance in Malaysian Stock Exchange found that IPO are underpriced at 21.22% (Ammer and Ahmad-Zaluki, 2016). However, most of previous studies combined the sharia and non-sharia compliant companies. Therefore, this study tries to fulfill the gap by focusing on the sharia compliant companies only.

The main objective of focusing on sharia compliant companies is to find an appropriate financial performance of sharia companies listed on the Malaysian Stock Exchange. Thus, this paper tries to explore new insight on determinant factors of IPO underpricing for sharia-compliant companies. Specifically, the objectives of this paper are:

1. To examine the average level of IPO underpricing for sharia compliant companies listed on the Malaysian Stock Exchange.
2. To investigates the impact of financial ratio on the average level of IPO underpricing for sharia compliant companies listed on the Malaysian Stock Exchange.

Underpricing is considered as a dependent variable in this multiple linear regression analysis model. Thus, the hypotheses are constructed as follow:

H_0 : There is a no significant relationship between independent variable (gross margin, EBITDA margin, operating margin, pre-tax margin, effective tax rate and net margin) on the average level of IPO underpricing for sharia compliant companies.

H_1 : There is a positive significant relationship between independent variable (gross margin, EBITDA margin, operating margin, pre-tax margin, effective tax rate and net margin) on the average level of IPO underpricing for sharia compliant companies.

LITERATURE REVIEW

It has been well documented in literature regarding the performance of IPO shares. Companies are experience with initial short-run underpricing (positive return) and a subsequent long-run overpricing (negative returns) (Ahmad-Zaluki and Kect, 2012; Islam et al., 2010; Samarakon, 2010; Goergen, et al., 2007; Chi and Padgett, 2005; Drobetz, et al., 2005; Chan, et al., 2004; Ritter, 1991; Carter et al., 1998; Lee, et al., 1996). Bansal and Khanna (2012) found the average level of underpricing in Bombay Stock Exchange within the range of 50% and show that the ex-ante information has a significant positive impact on the level of underpriced. Borge (2007) examines the performance of IPO underpricing in Portugal found that the IPO was underpriced at 11.1%. While, Chi and Padgett (2005) found the average degree of IPO underpricing in China is 129.16 percent during the period of study 1996-2000.

There are many factors influence the performance of IPO underpricing. Study by Boulton *et al.* (2011) found IPO underpricing is depends on the quality earnings information in each country. Besides that Boulton *et al.* (2014) also found that the country-level institutional quality is positively correlated with the underpricing of IPO. Benerjee et al. (2011) examine the impact of country-level information asymmetry, investors' home country bias, effectiveness of contract enforcement mechanisms and accessibility of legal recourse on IPOs underpricing in 36 countries around the world found that all the variable have significance impact on the degree of IPO underpricing. Ariff *et al.* (2007) examine the IPO underpricing in United Kingdom, Singapore and Malaysia found that the IPO underpricing is strongly related with government-linked companies (GLC). Studies by Yip, et al., (2009) regarding the effects of underwriters, venture capital and industry on long-term initial public offering performance found that the underwriter and venture capital are significantly effects. Dawson, (1987) examines IPO in three Asian countries found the existing of underpricing during the initial trading. Therefore, most of the previous study suggested that the information regarding the performance of companies is important in determent the level of underpricing.

There are a number of theories that have developed to explain the determinant of IPO underpricing phenomenon. The main theories found in the IPO literature are the winner's curse hypothesis, bookbuilding theories and the principal-agent hypothesis, signaling theories, the law-suit avoidance hypothesis, the ownership and control hypothesis and the investor sentiment theory (Bansal and Khanna, 2012). Ken, et al., 2005 investigate the relationship between audit quality and earning management for Taiwan IPO firms. They found that big five auditors are related to less earnings management for IPO in Taiwan. Carter *et al.* (1998) found that IPO companies managed by high prestige underwriter have a less short-run IPO underpricing compare with low underwriter prestige. While, Goergen et al., (2007) focus on the long-run performance of IPO in UK and found that the small firms behave differently from large firms and suffer from worse long run performance than large firms.

RESEARCH METHODOLOGY

This study used data obtained from Malaysian Stock Exchange (MSE) and the financial ratios data are collected from database of Datastream Thomson Reutres. The sample used in this study consists 18 sharia compliant companies listed on the MSE since 2014 till 2015 due to the crisis in oil and gas sector in Malaysian market (Abu Bakar and Rosbi, 2016).

The analytical approach implemented in this study is multiple linear regressions. As a predictive analysis, the multiple linear regressions are used to explain the relationship between one continuous dependent variable and two or more independent variables. In developing model of multiple regressions, Durbin Watson test is implemented to check for autocorrelation in the residuals from a statistical regression analysis. If there is no autocorrelation (where subsequent observations are related), the Durbin-Watson statistic should be between 1.5 and 2.5.

Measure of IPO Underpricing

Underpricing is calculated as the changing from the offer price to the closing price. The calculation is expressed as:

$$UP_i = \frac{P_1 - P_0}{P_0} \times 100$$

Where,

UP_i : The underpricing of company i on the first day of issuing IPO

P_1 : The closing price of company i on the first day of issuing IPO

P_0 : The offering price of company i on the first day of issuing IPO

The impact of the independent variables namely, gross margin, EBITDA margin, operating margin, pre-tax margin, effective tax rate and net margin on the average level of IPO underpricing for sharia compliant companies is modelled through multiple linear regression.

$$UP_i = \alpha_i + \beta_1(GM_i) + \beta_2(EBIT_i) + \beta_3(OM_i) + \beta_4(PM_i) + \beta_5(ETR_i) + \beta_6(NM_i) + \varepsilon_i$$

Where,

UP_i : Underpricing of company i

GM_i : Gross Margin of company i

$EBIT_i$: EBITDA Margin of company i

OM_i : Operating Margin of company i

PM_i : Pre-tax Margin of company i

ETR_i : Effective Tax Rate of company i

NM_i : Net Margin of company i

RESULT AND DISCUSSIONS

There is a substantial level of underpricing in the Malaysian market, with an underpricing of 19.59% as shown in Table 1. This finding is consistent with many studies conducted worldwide. Agathee *et al.* (2012) examine the evidence on the short-run underpricing of IPO listed on the Stock Exchange of Mauritius since 1989 till 2010. The average initial return is 13.14%. Samarakoon (2010) investigates underpricing of IPO in Sri Lanka stock market found that average IPO underpricing was 34% from 1987-2008. Borges (2006) examines the IPO underpricing phenomenon in Portugal using a data from 1988 till 2004. This study found that IPO was underpriced at 11.1%.

Table 1: Descriptive Statistics for Underpricing

N	Range	Minimum	Maximum	Mean	Std. Deviation	Variance
Statistic	Statistic	Statistic	Statistic	Statistic	Std. Error	Statistic
18	1.0436	-0.2538	0.7898	0.19599	0.058862	0.2497332

While, Table 2 shows the correlation between dependent variable and independent variable. The results show that pre-tax margin is statistically significant correlation with underpricing level of IPO for sharia compliant companies in Malaysian market. Pre-tax margin is used for measure the efficiency of operation in companies. High pre-tax margins are desirable and indicative that

the managements are able to keep operating costs low. This study suggested that the pre-tax margin can be used in measuring the financial health in the sharia compliant companies.

Table 2: Correlation Analysis (Spearman's rho)

		Underpricing	Gross Margin	EBITDA Margin	Operating Margin	Pre-tax Margin	Effective Tax Rate	Net Margin
Underpricing	Correlation	1.000	0.277	0.158	0.310	0.488*	-0.077	0.450
	Coefficient							
	Sig. (2-tailed)	.	0.266	0.531	0.211	0.040	0.760	0.061
	N	18	18	18	18	18	18	18
Gross Margin	Correlation	0.277	1.000	0.756**	0.831**	0.840**	-0.670**	0.921**
	Coefficient							
	Sig. (2-tailed)	0.266	.	0.000	0.000	0.000	0.002	0.000
	N	18	18	18	18	18	18	18
EBITDA Margin	Correlation	0.158	0.756**	1.000	0.955**	0.835**	-0.416	0.793**
	Coefficient							
	Sig. (2-tailed)	0.531	0.000	.	0.000	0.000	0.086	0.000
	N	18	18	18	18	18	18	18
Operating Margin	Correlation	0.310	0.831**	0.955**	1.000	0.924**	-0.496*	0.872**
	Coefficient							
	Sig. (2-tailed)	0.211	0.000	0.000	.	0.000	0.036	0.000
	N	18	18	18	18	18	18	18
Pre-tax Margin	Correlation	0.488	0.840**	0.835**	0.924**	1.000	-0.485*	0.929**
	Coefficient							
	Sig. (2-tailed)	0.040	0.000	0.000	0.000	.	0.042	0.000
	N	18	18	18	18	18	18	18
Effective Tax Rate	Correlation	-0.077	-0.670**	-0.416	-0.496*	-0.485*	1.000	-0.697**
	Coefficient							
	Sig. (2-tailed)	0.760	0.002	0.086	0.036	0.042	.	0.001
	N	18	18	18	18	18	18	18
Net Margin	Correlation	0.450	0.921**	0.793**	0.872**	0.929**	-0.697**	1.000
	Coefficient							
	Sig. (2-tailed)	0.061	0.000	0.000	0.000	0.000	0.001	.
	N	18	18	18	18	18	18	18

*. Correlation is significant at the 0.05 level (2-tailed).

** . Correlation is significant at the 0.01 level (2-tailed).

The outcomes of multiple linear regression analysis reveal that gross margin, EBITDA margin, operating margin, pre-tax margin, effective tax margin and net margin explained 62.7% of the variation in IPO underpricing. This study suggested that the variable used in this study is important in measure the performance of IPO underpricing for sharia compliant companies. While the Durbin Watson's value subsisted 1.708, which indicates that there is a positive sequential relationship between variable.

Table 3: Model Summary

Model Summary ^b										
Model	R	Adjusted R Square	Std. Error of the Estimate	Change Statistics			Sig.	Durbin-Watson		
				R Square	F Change	df1			df2	F Change
1	0.792 ^a	0.627	0.424	0.1895509	0.627	3.085	6	11	0.050	1.708

a. Predictors: (Constant), nm, etr, ebit, gm, pm, om

b. Dependent Variable: up

The multiple linear regression analysis is performed using IBM SPSS Statistics 24. The result of regression is presented on the Table 4. The pre-tax margin and net margin are statistically significant on the level of IPO underpricing for sharia compliant companies listed on the Malaysian Stock Exchange. This study indicates that pre-tax margin and net margin is important in determine the profitability and the performance of company. This study also suggested that company can analyze the pre-tax margin and net margin in order to evaluate the sales growth performance. In addition, all company can monitor the pre-tax margin and net margin in order to build the sales performance and reduce expenses.

Table 4: Coefficients

Coefficients ^a								
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95.0% Confidence Interval for B	
		B	Std. Error	Beta			Lower Bound	Upper Bound
1	(Constant)	0.147	0.230		0.642	0.534	-0.358	0.653
	Gross Margin	0.005	0.006	0.326	0.837	0.420	-0.008	0.018
	EBITDA Margin	-0.005	0.013	-0.416	-0.391	0.703	-0.035	0.024

Operating Margin	-0.008	0.034	-0.578	-0.225	0.826	-0.083	0.068
Pre-tax Margin	0.072	0.023	5.735	3.090	0.010	0.021	0.123
Effective Tax Rate	-0.008	0.006	-0.492	-1.445	0.176	-0.021	0.004
Net Margin	-0.065	0.026	-4.840	-2.523	0.028	-0.122	-0.008

Table 4...

a. Dependent Variable: up

CONCLUSION

This paper examines the impact of financial performance on the short term performance (underpricing) of IPO for sharia compliant companies listed on the Bursa Malaysia. This study provides empirical evidence on the unique feature of sharia compliant companies. As shown in the results the level of IPO underpricing is 19.59%. The results obtained from this study show that the level of IPO underpricing for sharia compliant companies are consistent with developed and other emerging markets.

While the multiple linear regression analysis show that the pre-tax margin and net margin are statistically significant on the level of IPO underpricing for sharia compliant companies. Pre-tax margin and net margin is very important to measure because it shows the efficiency, profitability and financial health of the companies. This study concluded that the sharia compliant companies have good performance in financial ratio. The further research should be expended to investigate the others factors that contribute to the level of underpricing for sharia compliant companies listed on the Bursa Malaysia.

REFERENCES

- Abu Bakar, N. and Rosbi, S. (2016). Reliability of Exponential Smoothing Method for forecasting Islamic Share Price to oil and gas sector in Malaysian Stock Exchange, *International Academic Research Journal of Business and Technology*, 2(2), 38-44.
- Agathe, U. S., Sannasse, R. V., and Brooks, C. (2012). The underpricing of IPOs on the Stock Exchange of Mauritius, *Research in International Business and Finance*, 26(2), 281–303.
- Ahmad-Zaluki, N.A. and Abidin, S. (2011). IPO Pricing in Malaysia: An Analysis of REITs and Non-REITs. *International Journal of Economics and Management*, 5(1), 319-332.
- Ammer, M. A. and Ahmad-Zaluki, N. (2016). The effect of underwriter's market share, spread and management earnings forecasts bias and accuracy on underpricing of Malaysian IPOs, *International Journal of Managerial Finance*, 12(3), 351-371.
- Ariff, M., Prasad, D., and Vozikis, G. S. (2007). Are Government-Linked IPOs Underpriced? A Three Country Privatization Effort Comparison. *International Entrepreneurship and Management Journal*, 3(3), 293–307.
- Banerjee, S., Dai, L., and Shrestha, K. (2011). Cross-country IPOs: What explains differences in underpricing? *Journal of Corporate Finance*, 17(5), 1289-1305.

- Bansal, R. and Khanna, A. (2012). Determinants of IPOs Initial Return: Extreme Analysis of Indian Market, *Journal of Financial Risk Management*, 1(4), 68-74.
- Borges, M. R. (2006). Underpricing of Initial Public Offerings: The Case of Portugal, *International Advances in Economic Research*, 13(1), 65–80.
- Boulton, T. J., Smart, S. B. and Zutter, C. J. (2011). Earnings Quality and International IPO Underpricing. *The Accounting Review*, 86(2), 483–505.
- Boulton, T. J., Smart, S. B. and Zutter, C. J. (2014). The Impact of Institutional Quality on Initial Public Offerings, *Journal of Economics and Business*, Vol. 73, 65-96.
- Carter, R.B., Dark F. H., and Singh, A.K. (1998) Underwriter Reputation, Initial Return and Long-Run Performance of IPO stocks, *The Journal of Finance*, Vol 53(1), 283-311.
- Chahine, S. and Tohme, N.S. (2009). Is CEO Duality Always Negative? A Exploration of CEO Duality and Ownership Structure in the Arab IPO Context, *Corporate Governance: An International Review*, 17(2), 123-141.
- Chan, K., Wang, J. and Wei K.C.J. (2004). Underpricing and long term performance of IPOs in China, *Journal of Corporate Finance*, 10(3), 409-430.
- Chi, J., & Padgett, C. (2005). Short-run underpricing and its characteristics in Chinese initial public offering (IPO) markets, *Research in International Business and Finance*, 19(1), 71–93.
- Darmadi, S. and Gunawan, R. (2013). Underpricing, board structure, and ownership: An empirical examination of Indonesian IPO firms, *Managerial Finance*, 39(2), 181-200.
- Dawson, S.M. (1987). Secondary Stock Market Performance of Initial Public Offers, Hong Kong, Singapore and Malaysia: 1978-1984, *Journal of Business, Finance & Accounting*, 14(1), 65-76.
- Drobetz, W., Kammermann, M. and Walchli, U., (2005). Performance of Initial Public Offerings: The Evidence for Switzerland, *Schmalenbach Business Review*, 57 (3), pp 253–275.
- Ekkayokkaya, M., and Pengniti, T. (2012). Governance reform and IPO underpricing, *Journal of Corporate Finance*, 18(2), 238–253.
- Goergen, M., Khurshed, A. and Mudambi, R. (2007) The long-run performance of UK IPOs: can it be predicted? *Managerial Finance*, 33(6), 401-419.
- Heerden, G.V., and Alagidede, P. (2012). Short run underpricing of initial public offerings (IPOs) in the Johannesburg Stock Exchange (JSE), *Review of Development Finance*, 2, 130–138.
- Islam, A., Ali, R., and Ahmad, Z. (2010). An Empirical Investigation of the Underpricing of Initial Public Offerings in the Chittagong Stock Exchange, *International Journal of Economics and Finance*, 2(4), 36–46.
- Lee, P.J, Taylor, S.L. and Walter, T.S. (1996). Australian IPO pricing in the short and long run, *Journal of Banking and Finance*, 20, 1189-1210.
- Ritter, J.R. (1991). The Long Run Performance of Initial Public offerings, *Journal of Finance*, 46(1), 3-27.
- Samarakon, L.P. (2010). The Short-Run Underpricing of Initial Public Offerings in the Sri Lankan Stock Market, *Journal of Multinational Financial Management*, 20, 197-213.
- Yip, Y., Su, Y. and Ang, J.B. (2009). Effects of underwriters, venture capital and industry on long-term initial public offering performance, *Managerial Finance*, 35(8), 700-715.
- Zhang, C. (Xinde), & King, T.-H.D. (2008). The Decision to Cross-List: The Case of Chinese IPOs and ADRs. *SSRN Electronic Journal*.