Performance of initial public offerings (IPOs): the case of Shariah-compliant companies

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Abstract

Purpose – The purpose of this paper is to examine the informational value of Shariah-compliant disclosure in the Malaysian initial public offerings (IPOs) prospectus and whether Shariah-compliant status has an impact on the IPO initial return when adopted as a signalling mechanism.
Design/methodology/approach – It uses data from 320 IPOs for Shariah-compliant companies listed on the Bursa Malaysia between 2004 and 2013.
Findings – It finds that the degree of IPO underpricing for Shariah-compliant companies is 19.97 per cent with investors earning significant returns on the first trading day. For the effect of different factors on the degree of IPO, we find that the size and type of IPO offers have a significant impact on the degree of IPO underpricing. Other economic confidence factor models fail to yield economically plausible parameter values.
Originality/value – The study contributes to the literature in a number of ways. It is the first to evaluate the effect of Shariah-compliance status regulation in Malaysian market, hence it provides an insight into the effectiveness of such regulation. Second, while the existing Shariah-compliant IPO studies in the same market focus on Shariah status at the date of the studies being conducted, this study uses the information around IPO time. The information that investors receive around IPO time may influence investors' decision and valuation of the IPOs in the aftermarket. Specifically, this study is different from the previous research, as it investigates whether Shariah-compliant companies would change the average degree of IPO underpricing for companies listed on Bursa Malaysia.

Keywords IPO underpricing, Bursa Malaysia, Shariah-compliant companies

Paper type Research paper

1. Introduction

Initial public offerings (IPO) underpricing is an important factor for investors to predict the profit from investment activities. The IPO underpricing phenomenon has existed for a long time in stock markets around the world, although its magnitude varies from country to country (Guo *et al.*, 2011; Sherif *et al.*, 2016; Komenkul *et al.*, 2017) and across all time periods (Loughran *et al.*, 1994; Boulton and Campbell, 2016). However, the factors such as country-specific regulations, contractual mechanisms, institutional settings and firm characteristics that influence IPO underpricing are varying between countries and still remain a largely unexplored (Loughran *et al.*, 1994; Guo *et al.*, 2011).

With regard to IPOs in Malaysia, there are a few empirical studies investigating IPO underpricing reporting underpricing of more than 100 per cent, particularly in IPOs listed

JEL Classification — G02, G12, G17, G17. KAUJIE Classification — I73, I75, L21

between the 1970s and 1990s (Dawson, 1987; Ismail *et al.*, 1993; Sufar, 1993; Mohamad *et al.*, 1994; Ariff *et al.*, 2007; Ahmad-Zaluki and Kect, 2012). Over decades, there has been a declining trend in the level of underpricing in this market, particularly following the market liberalisation in 1996, where the Securities Commission of Malaysia has allowed equity prices to be determined by the market (Abdul Rahim and Yong, 2010). Notably, IPOs listed around the 1990s and 2000s are underpriced at around 60 to 90 per cent (Yong and Isa, 2003; Hiau Abdullah and Mohd, 2004; Uddin, 2008; Moshirian *et al.*, 2010). Later, Malaysian IPO underpricing was found to be around 30 to 40 per cent (Ahmad-Zaluki and Kect, 2012; Sundarasen and Leong, 2012). This indicates that the Malaysian capital market has become more mature and efficient, hence the market is able to price securities more correctly (Corhay *et al.*, 2002).

Recently, the Islamic finance industry, including Islamic capital markets, has grown, on average, by 17.5 per cent since the onset of the global financial crisis in 2008 (Hussain *et al.*, 2016). Furthermore, the international dimension of Islamic finance has gained greater significance, as it has become increasingly integrated with the international financial system, particularly the IPO's Shariah-compliant companies. Since the introduction of Shariah-compliant status on securities listed on Bursa Malaysia in 1997, IPOs sector has gained a significantly high demand and considered as a key aspect for investors to participate in the growing and enhancing the companies. Besides, the regulatory practice in Malaysia has provided further insight into the importance of Shariah-compliant status for IPO initial returns. The importance of understanding IPO for Shariah-compliant companies separately from the common IPO market stems from the basic requirements of Islamic investment that the companies must free from any prohibited element of usury *(riba')*, uncertainty *(gharar)* and gambling *(maisir)*. Other prohibited elements, such as non-halal foods, drinks and immoral activities, also must be absent (Sherif, 2016; Sherif and Erkol, 2017).

Accordingly, the debate in this study stems from the voluntary Shariah- compliant screenings by the Shariah Advisory Council (SAC) conducted before firms going public. In 1999, the SAC introduced the Shariah screening methodology that sets out exclusion criteria for non-Shariah compliance of securities listed on Bursa Malaysia. The exclusion criteria consist of quantitative and qualitative aspects. The former includes financial ratios and business activity benchmarks, while the latter is concerned with public perceptions towards the firms. It is worth noting that the screening criteria excludes companies whose business activities include *riba'* (usury or interests), *maisir* (gambling) and *gharar* (uncertainty). In other words, firms that are involved in the sale or production of prohibited goods and services such as alcoholic drinks, non-halal meat and immoral services like prostitution or pubs and discos will also be excluded. Here, the audit takes place at the end of each financial year of the listed firm and the announcements of Shariah-compliant security list are made twice a year in May (for companies with financial year end (FYE) from 1 April to 30 September) and November (for companies with FYE from 1 October to 31 March). The SAC made it mandatory for all securities already listed on Bursa Malaysia, but not for firms going public. However, since 2004, the SC launched a voluntary practice for firms going public, where they may opt to apply for Shariah-compliance screenings prior to the listing. Applications are subject to a processing fee of over MYR 10,000 ($2,400) to a maximum of MYR 50,000 ($12,200). Firms that undergo the screening may also disclose their Shariah-compliance status in the IPO prospectus (Securities Commission, 2018).

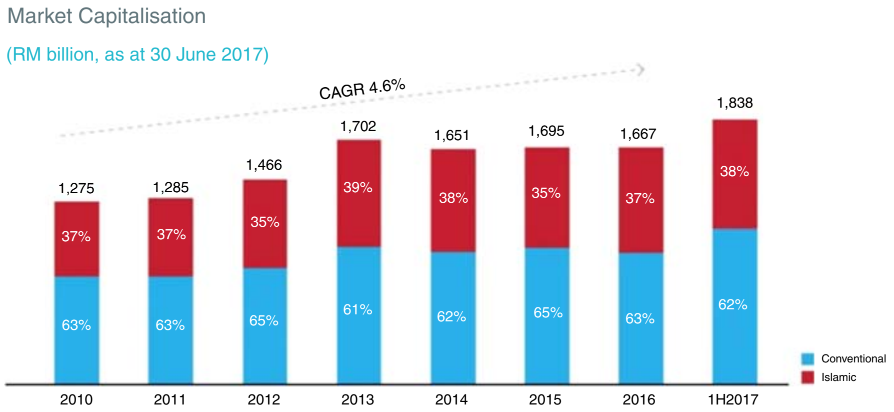
Subsequently, and over the period 2004–2013, 74 securities have complied with the Shariah screening criteria prior to going public. Out of these74 securities, only 54 firms disclosed the sharia-compliant status in their IPO prospectuses. The fact that there is only a small fraction of IPO firms underwent this audit procedure raises the question of the real motive(s) of them investing money and time in the process. For investors, it is important for Shariah-compliant status to disclose informational value, hence reducing information asymmetry between issuing firms and investors. If the disclosure of Shariah status does not help to reduce underpricing, then what message are the firms trying to convey to investors? This study, therefore, attempts to answer those questions by investigating the impact of Shariah-compliant status disclosure in IPO prospectus on underpricing.

Islamic investment (also known as Shariah-compliant investments) principles emphasise ethical investments that comply with the principles of Shariah, which is the Islamic law that governs every facet of each Muslim's life (Lusyana and Sherif, 2017). Investments in financial instruments with fixed incomes, such as preferred stocks, bonds and some derivatives (e.g. options), are unacceptable, as they promise a fixed rate of return and grant no voting rights (Walkshäusl and Lobe, 2012). Again, Islamic investors are not permitted to purchase the stocks of companies whose main business activities are alcohol, gambling, conventional financial services, entertainment, pork-related products, tobacco and weapons (Lusyana and Sherif, 2017).

These basic requirements are important in Islamic law albeit no financial institutions and instruments can be totally devoid from the elements of *riba', gharar* and *maysir*. Therefore, the SAC in the Securities Commission of Malaysia has regulated the benchmark for IPO companies to list shares on the Shariah board. The benchmark stated that the revenue for non-Shariah activities should be less than those associated with Shariah-based activities. As at 2017, more than 80 per cent of the companies listed in the Malaysian market is Shariah-compliant (Bursa Malaysia, 2019), that makes up to almost 40 per cent of the total market capitalisation (Figure 1). Despite the majority of shares are Shariah-compliant, a number of top ten largest firms in the market do not comply with the screening criteria, hence giving a strong weightage on the market capitalisation proportion.

Our study contributes to the literature in a number of ways. It is the first to respond to such regulation that is unique to the Malaysian market, hence may provide an insight into the effectiveness of such regulation. Second, while the existing Shariah-compliant IPO studies in the same market focus on Shariah status at the date of the studies being conducted, this study uses the information around IPO time. The information that investors receive around IPO time may influence investors' decision and valuation of the IPOs in the aftermarket. Specifically, this study is different from the previous research, as it investigates whether Shariah-compliant companies would change the average degree of IPO underpricing for companies listed on Bursa Malaysia.

Notwithstanding an increasing demand on the Shariah interest trend and products, there are only a few studies in this field. Along with the increasing number of the investment needed and the potential as the biggest Muslim population in the world, there are more opportunities to develop the Shariah investments (Sherif and Erkol, 2017). This arguably indeed shows that the Shariah investment still has much potential, due to the increasing



Source: Securities Commission of Malaysia

Figure 1. Market capitalisation of Islamic equities listed on Bursa Malaysia

number of investors, whose concern is in the "ethical investing" (Sherif, 2016). Thus, in this paper, we extend the literature on the debate and undertake a comparative performance analysis of the conventional and Islamic stocks. Hence, this paper is one of the earliest to examine the effect of sharia-compliant status on the performance of IPOs.

Furthermore, there has been a long-running debate regarding the IPO underpricing during the trading on the stock exchange. For example, Hiau Abdullah and Mohd (2004) and Abdul-Rahim and Che-Embi (2013) claim that the initial returns of Shariah-compliant IPOs in Malaysia are higher than their conventional counterparts, implying that Shariah-compliant status does not help IPO firms to reduce the "money left on the table" from underpricing. Interestingly, a contrasting finding is documented in Saudi Arabia, where Shariah-compliant status significantly reduces underpricing (Mayes and Alqahtani, 2015). We argue that the difference could be due to the stronger presence of Muslims in Saudi Arabia than in Malaysia. Hence, Saudi Arabian investors may have a higher aversion to non-sharia-compliant firms, leading them to price their IPOs at a higher discount to attract more investors.

The objectives of this paper are twofold: first, to investigate the issues associated with IPO underpricing with considerable focus on the Shariah-compliant companies, specifically, whether the average degree of IPO underpricing in Malaysia is continuously high since the Securities Commission of Malaysia has introduced the Shariah-compliant screening, second, to investigate the growth of Shariah-compliant companies among Islamic countries like Malaysia. Based on the list of listed companies on Bursa Malaysia, around 89 per cent of IPO listed on the Malaysian market are Shariah-compliant companies (Bursa Malaysia, 2019).

The remainder of the paper is set out as follows. Section 2 is a brief literature review. Section 3 provides details of the data, models and methodology. Section 4 presents the empirical findings, and Section 5 concludes.

2. Literature review

This study is motivated by the existing literature on IPO underpricing and is closely related to the signalling hypothesis. With regards to IPO underpricing, the literature documents that underpricing phenomena occurs in capital markets around the globe. For example, the average underpricing in the US market is 16.80 per cent (Ibbotson *et al.*, 1988). For the UK market, Levis (1993) found a similar level of underpricing at 16.10 per cent. Elsewhere, Swedish IPOs are underpriced at 26.10 per cent (Rydqvist, 1997), while Poland at 21.20 per cent (Woloszyn and Zarzecki, 2013). Underpricing is higher in China and Saudi A rabia (Alanazi *et al.*, 2011) at 264.50 per cent. In Malaysia, historically the underpricing was at 167 per cent during the years 1978–1983 (Dawson, 1987). Interestingly, the more recent data show that the underpricing level has tremendously decreased to 24.04 per cent for IPOs listed between 2001 and 2010 (Mohd Rashid and Abdul-Rahim, 2012).

In line with the vast development of Islamic finance, the behaviour of Shariah-compliant IPOs has become an emerging research area. An early study reports that in Malaysia, Shariah-compliant IPOs are underpriced at 32.10 per cent, vs 31.20 per cent for their conventional counterparts (Rahim and Yong, 2010). A similar finding is reported in a different time period, where Shariah and conventional IPOs are underpriced at 28.2 and 26.63 per cent, respectively (Abu Bakar and Uzaki, 2013). In another study, Abdul-Rahim and Che-Embi (2013) report a significant difference between Shariah (32.17 per cent) and conventional (26.76 per cent) IPO underpricing. In contrast, Saudi Arabian Shariah IPOs have a lower level of underpricing than their conventional counterparts at 164.50 and 428.43 per cent, respectively (Mayes and Alqahtani, 2015).

IPO underpricing occurs when IPO shares are priced below what the market is willing to pay (Logue, 1973; Ibbotson, 1975), hence issuing firms end up "leaving money on the table". For example, Ritter (1984) suggests that underpricing is the highest cost of going public. Had the IPOs been priced correctly, issuing firms could have raised more money from the new issue, which in turn reduces their cost of going public. In the light of this global phenomena, researchers for decades have attempted to find an explanation to underpricing. To date, there is no single explanation to underpricing, but the literature has broadly classified the theories in to three categories, namely asymmetric information models (Ibbotson, 1975; Rock, 1986; Welch, 1989, 1996), institutional explanation (Logue, 1973; Ibbotson, 1975; Tinic, 1988) and ownership and control (Brennan and Franks, 1997; Stoughton and Zechner, 1998).

Asymmetric information models are the most widely discussed set of theories in the IPO literature. This study particularly stems out from the signalling hypothesis that assumes issuers have more information on the true present value and risk of the future cash flow of the firm (Allen and Faulhaber, 1989; Grinblatt and Hwang, 1989; Welch, 1989). High-quality firms underprice to signal their quality and differentiate themselves from low-quality firms. As money left on the table for underpricing is costly, lower quality firms cannot afford to copy this move. Thus, the cost of underpricing will be recovered during subsequent offerings where they can issue shares at a higher price than the IPOs.

In order to obtain Shariah-compliant status prior to listing, firms need to pay up to MYR 50,000. Firms that are willing to invest such amount on top of other listing-related costs must be trying to convey the message that investing in their firms is a lucrative decision. The Shariah-compliant status also serves as an incentive for investors from the Middle East and other Islamic countries, as it implies that a firm adheres to a set of Islamic dogma and may transpire a firm's ethical identity. For firms with foreign economy, it implied the need for signals about the quality of the firm to ensure that their investment is a worthy decision. In this line, Grinblatt and Hwang (1989) argue that investors are uncertain about the present value of firms' future cash flows. Hence, firms would signal their quality using underpricing. Equipped with the above, we argue that Shariah-compliant IPO firms underprice more to convince their target investors that their firms are worth investing in.

From the review of the literature, some notable points have been derived. As reported by Abdul Rahim and Yong (2010) and Abdul-Rahim and Che-Embi (2013), Shariah-compliant status does not significantly alter the underpricing pattern in Malaysian IPOs. However, they document that Shariah status does, to some degree, increase underpricing. Meanwhile, Shariah status significantly reduces underpricing in Saudi Arabian IPOs. In a country with a very strong presence of the Muslim community, it implies that non-Shariah-compliant firms need to underprice more to lure more investors, as they are more comfortable with Shariah-compliant investment. They rest assured that firms are in line with their religious beliefs.

In contrast, Malaysian IPO firms are trying to lure investment by the Middle Eastern investors. There is a potential need to attract local investors, the majority of whom come from the non-Muslim community, hence have little knowledge of the Islamic practice. As such, Shariah-compliant IPO firms need to convince the investors that their firms are as good as their conventional counterparts by underpricing. In addition, Shariah-compliant status is disseminated to investors by disclosing such status in the IPO prospectus. As such, we hypothesise that Shariah disclosure has a positive relationship with underpricing.

3. Data, models and methodology

This study has adopted the IPO sample listed in Bursa Malaysia, the Malaysian stock market between 2004 and 2013. The year 2004 is chosen as start year to reflect the introduction of the voluntary practice of Shariah-compliant screening for firms going public. The period of study ends in 2013 as the data from the Securities Commission of Malaysia are only available up to that point. We exclude IPOs from financial services sector due to the difference in financial reporting requirements. Other than that, we also exclude samples with insufficient data. After the filtration, the final sample is 320 IPO firms. In total, 54 firms disclose Shariah-compliant status in their IPO prospectus, while 266 firms do not have such disclosure.

The data for this study are obtained from various sources. IPO list, price and size are obtained from Bursa Malaysia Information Department. Shariah-compliant disclosures are obtained from IPO prospectus of the sample firms that were downloaded from the Bursa Malaysia website and Thomson One Banker database. IPO firm industry classification, IPO closing price on listing day and market return were obtained from DataStream. IPO closing date, listing market and market capitalisation are obtained from Bursa Malaysia Information Services, Bursa Malaysia website, IPO prospectus. Finally, the incorporation year of sample firms was obtained from the OSIRIS database and IPO prospectus.

In essence, we examine the relationship between pre-IPO Shariah-compliant status on IPO underpricing in the Malaysian market. Hence, IPO initial return serves as the dependent variable. IPO initial return or underpricing is identified as:

$$UNDP_{i,1} = \left(P_{i,1} - P_{i,0}\right)/P_{i,0}, \tag{1}$$

where $P_{i,t1}$ is the closing price of IPO *i* at the end of the first trading day, and $P_{i,0}$ is the offer price of an IPO *i*.

The main objective of this study is to test the relationship between Shariah-compliant status and IPO underpricing. We employ ordinary least squares regression to quantify this relationship. Therefore, our model specification is defined as follows:

$$\begin{aligned} UNDP_{i,1} = {} & \alpha + \beta_1 Shariah_{i,0} + \beta_2 LNIPOSZ_{i,0} + \beta_3 LAG_{i,0} + \beta_3 MKT_{i,0} + \beta_5 SIZE_{i,0} \\ & + \beta_6 AGE_{i,0} + \beta_7 IND_{i,0} + \beta_8 MKTRTN_{i,0} + c_{i,0}, \end{aligned} \tag{2}$$

where *UNDP* is the underpricing or the return of IPO *i* at the end of first trading day; *LNIPOSZ* represents IPO size; *LAG* is the length between IPO offer closing and listing dates in days; *MKT* represents listing market; *SIZE* is IPO firm size; *AGE* is IPO firm age; *IND* represents industry effect; *MKTRTN* is the stock market returns prior to a listing; and $c_{i,1}$ is the error term.

The main explanatory variable is Shariah-compliant status (*Shariah*). We use Shariah-compliant status disclosure in IPO prospectus as a proxy. Here, we argue that IPO prospectus serves as an introductory document for investors to know about a particular offering, hence is appropriate a proxy of Shariah-compliant status. Accordingly, we hypothesise a positive relationship between Shariah-compliant status and IPO underpricing.

To control for other possible factors that may influence IPO underpricing, we employ several control variables. The first control variable *LNIPOSZ* is the natural log of IPO proceeds. We calculate IPO proceeds by multiplying the total units of IPO offer by offer price. We hypothesise a negative relationship between IPO size and underpricing. Next, we consider the effect of time lag *LAG* between IPO offer closing date and listing date. The longer the time between the two dates, the more investors are exposed to market uncertainty. Hence, investors require a higher initial return to compensate for the *ex ante* uncertainty. We predict a positive relation between time lag and underpricing. To consider the market microstructure effect, we use a dummy variable (*MKT*) that represents the listing market on which the IPO is listed. IPOs listed in ACE Market take the value of 1, while IPOs listed on the Main Market take the value of 0. We hypothesise a positive relationship between *MKT* and underpricing.

Larger firm tend to have higher underpricing as they are more financially stable, hence can afford to leave more money on the table from underpricing (Ritter, 1991). We use market capitalisation on IPO date to proxy for firm size (*SIZE*), calculated as total number shares outstanding multiplied by IPO offer price. We expect a positive relationship between firm size and underpricing (Ritter, 1991; Ahmad-Zaluki *et al.*, 2007). The older firm represents lower information asymmetry, as there is more publicly available information about the firms.

Hence, we expect a negative relationship between firm age (*AGE*) and underpricing. Age is represented by the natural log of firm age, identified as the number of years from the incorporation to listing year. We capture industry effect (*IND*) using a dummy variable that takes the value of 1 for high-technology firms and zero otherwise. Finally, we consider the market sentiment effect (*RM*) on IPO initial returns. Following Ahmad-Zaluki *et al.* (2007) we use FBM EMAS index return seven days prior to listing. A higher market return is expected to stimulate IPO returns, thus a positive relationship.

4. Empirical findings

We begin our analysis with the descriptive statistics of Malaysian IPOs listed between 2004 and 2013, as presented in Table I. The average initial return in Malaysian IPOs is 17.53 per cent. This finding is lower than the previous findings in the same market (Mohd Rashid *et al.*, 2013). Panel B and C show sub-samples of Shariah-compliant and conventional IPOs, respectively. Shariah-compliant IPOs (19.97 per cent) are more underpriced than their conventional counterparts (17.03 per cent). Our findings are consistent with Abdul Rahim and Yong (2010); Abu Bakar and Uzaki (2013) and Abdul-Rahim and Che-Embi (2013) that study IPO underpricing in the same market. They contrast with Mayes and Alqahtani (2015) that report lower underpricing in Shariah IPOs in Saudi Arabia, as compared to conventional IPOs. This result provides an initial insight that Shariah-compliant status does not reduce underpricing in the Malaysian market, in contrast with the Saudi Arabian market. Rather, it may be a contributing factor to underpricing.

The average size of the Malaysian IPO is MYR 233.01m. Shariah-compliant IPO size appears to be much larger than conventional IPOs. The average Shariah-compliant IPO size is MYR 1.04bn, while conventional IPOs are only MYR 71.89m on average. The largest IPO

Variable	Mean	SD	Min.	Max.
Panel A: all samples n = 320				
Initial return	0.1753	0.4115	−0.75	1.84
IPO size	233.01	1,117.46	2	12,499.20
Firm size	511.5215	1,988.81	7.65	23,019.08
Firm age	5.1594	7.7833	0	68
Time lag	14.3031	4.5388	7	47
Market return	0.0024	0.0205	−0.1054	0.064
Panel B: Shariah-compliant IPOs n = 54				
Initial return	0.1997	0.3744	−0.5455	1.6
IPO size	1,035.65	2,533.95	8.4	12,499.20
Firm size	1,377.15	3,996.81	16.2477	23,019.08
Firm age	7.0556	10.6919	0	68
Time lag	14.8519	6.7051	8	47
Market return	0.0019	0.0176	−0.0653	0.0321
Panel C: conventional IPOs IPOs n = 266				
Initial return	0.1703	0.4191	−0.75	1.84
IPO size	71.89	273.23	2	3,132.00
Firm size	337.75	1,188.23	7.65	15,600.00
Firm age	4.7744	7.0128	0	39
Time lag	14.1917	3.9665	7	29
Market return	0.0025	0.0211	−0.1054	0.064

Notes: This table reports the mean, median, maximum, minimum and standard deviation of initial returns of Malaysian IPOs listed between 2004 and 2013. It also shows the IPO size, IPO firm size and age, time lag between closing date of offering and listing date, and seven-day FBM EMAS Index return prior to IPO dates

Table I. Descriptive statistics

in our sample is by Petronas Chemicals Group Berhad, which is valued at MYR 12.50bn, is Shariah-compliant. This contributes to the high mean IPO size for Shariah-compliant IPOs.

The size of IPO firms in Malaysia is heavily dispersed. The average market capitalisation of IPO firms in our sample is MYR 511.52m. On average, Shariah-compliant IPO issuers (MYR 1.37bn) are larger than conventional issuers (MYR 337.75). These findings are sensible as larger firms tend to make larger offerings than smaller firms. As Shariah-compliant firms tend to be larger and have larger offerings, it is sensible to suggest that Malaysian firms may disclose Shariah-compliant status to signal their quality to investors.

On average, IPO firms have been established 5.15 years prior to listing. Shariah-compliant firms are more mature than the conventional IPO, averaging at seven years. The average days between offer closing date and listing date are around 14 days for Malaysian IPOs.

Table II shows the correlation matrix between the variables. As can be seen from Table II, none of the variables is correlated at above 0.70 level, suggesting that multicollinearity issue does not exist in the regression model. The results show moderate correlations between the listing market and industry (0.4305). All other variables have low correlations.

We now move on to examining the relationship between Shariah-compliant status and IPO underpricing. Our regression results are presented in Table III. We begin by estimating the relationship between all the dummy variables and underpricing (Model 1). When Shariah is included in the model (Model 2), the findings were not altered. Consistent

Table II. Pearson correlations

Variables	*UNDP*	*Shariah*	*IPOSZ*	*LAG*	*MKT*	*IND*	*SIZE*	*AGE*	*RM*
IR	1								
Shariah	0.0268	1							
IPOSZ	−0.0489	0.3288	1						
LAG	−0.0495	0.0546	0.0906	1					
MKT	0.0124	−0.1803	−0.1287	−0.0484	1				
IND	0.0487	−0.0758	−0.08	−0.0471	0.4305	1			
SIZE	0.014	−0.0111	0.0292	−0.0081	−0.0451	−0.0306	1		
AGE	−0.0155	0.1099	0.0556	0.0376	−0.1264	−0.1163	−0.0294	1	
MKTRTN	0.1844	−0.0115	−0.0254	0.0395	−0.0882	−0.0317	−0.0239	0.0193	1

Table III. Shariah-compliant status and underpricing

	(1) *UNDP*	(2) *UNDP*
Shariah		0.121 (1.74)*
IPOSZ	−0.518 (−1.88)*	−0.045 (−2.14)*
LAG	−0.002 (−0.38)	−0.002 (−0.55)
MKT	−0.078 (−1.26)	−0.056 (−0.98)
SIZE	−0.04 (−1.58)	−0.027 (−1.26)
AGE	0.029 (−1.14)	0.025 (−0.8)
IND	0.094 (−1.13)	0.041 (−0.54)
MKTRTN	3.457 (2.88)**	3.427 (3.17)**
α	1.791 (3.71)***	1.461 (4.43)**
Adjusted R^2	0.085	0.076

Notes: This table reports the ordinary least square regression results of Shariah-compliant status on underpricing. *UNDP* is IPO underpricing. *Shariah* is a dummy variable of pre-IPO Shariah-compliant status, where 1 represents IPOs granted the status, and 0 otherwise. *IPOSZ* is offering size in MYR million. *LAG* is the length between IPO offer closing and listing dates in days. *MKT* is a listing market dummy variable, where 1 represents IPOs listed in the ACE (alternative) Market, and 0 for the Main Market in Bursa Malaysia. *SIZE* is IPO firm size in MYR million. *AGE* is firm age in years. *IND* represents industry effect, and *MKTRTN* is the stock market returns prior to a listing. *$p < 0.05$; **$p < 0.01$; ***$p < 0.001$

with our hypothesis, we find a significant positive relationship between Shariah-compliant status and IPO initial return ($p < 0.01$). This finding is similar to Abdul-Rahim and Che-Embi (2013) that documents Shariah-compliant status increases underpricing. In contrast, Shariah-compliant status reduces underpricing in Saudi Arabia (Mayes and Alqahtani, 2015). The contrasting findings imply that investors in Saudi Arabia perceive that investment in firms that suit their religious value, i.e. Shariah-compliant firms are more important than having a lucrative investment return.

For the Malaysian market, disclosure of Shariah-compliance information attracts a different market reaction. Shariah-compliant IPO firms are more underpriced than their conventional counterparts, indicating that these firms use underpricing to signal their quality to lure two groups of target investors. The first group is the local retail investors, who are mainly non-Bumiputra who potentially have little knowledge about Islam. Hence, they may have a limited understanding of Shariah-compliance. To gain their confidence that Shariah-compliant IPOs can be an as lucrative investment as the conventional IPOs, the investors need to be convinced about the future value of the cash flows. The second group is investors from the Middle East and other Islamic countries. To participate in foreign investment, investors are facing more risks than when they invest locally. They need to be assured of the quality of the firms that they will invest in. Responding to this, Shariah-compliant IPO firms underprice to gain these investors' confidence about the present value of their future cash flows.

It is worth noting that in all our models, IPO size has a significant inverse relationship with underpricing, implying that when the supply is high, more subscriptions can be satisfied. Hence, the price pressure will be low (Abdul Rahim and Yong, 2010). The industry effect plays a more significant role among conventional IPOs than Shariah-compliant IPOs. As seen in Table III, the high-tech industry is negatively related to underpricing, implying that conventional high-tech IPOs have lower underpricing. On the other hand, high-tech firms in our Shariah-compliant sub-sample have higher underpricing. This finding is more consistent with the literature. Market sentiment around IPO time, as represented by market return seven days prior to the listing date, have a positive influence on IPO underpricing. However, the results are significant for Shariah-compliant firms, but not for conventional IPOs. These findings imply that investors regard market sentiment as useful information in IPO valuation. When the market return is high, they expect IPO initial return to reflect the market return, hence expecting a high IPO return.

5. Conclusions

This study examines the initial returns of Shariah-compliant and conventional IPOs listed in the Malaysian market between 2004 and 2013, with the main focus of whether voluntary disclosure of Shariah-compliance in IPO prospectus is significant in explaining underpricing. Overall, we find that Shariah-compliant IPOs are more underpriced than their conventional counterparts, implying that IPO investors in Malaysia earn better profit by investing in Shariah-compliant IPOs as compared to conventional IPOs. Importantly, these findings imply that IPO issuers may use Shariah-compliant as a signalling mechanism to attract investors to participate in their offerings. Given the cost and time involved the process of voluntary disclosure of Shariah-compliance, only firms with strong financial standing can afford to commit the expenses.

Our findings suggest that the voluntary disclosure of Shariah-compliance in IPO prospectus have informational value as the disclosure significantly increases underpricing, and appear to be beneficial for IPO investors. In particular, when investors pay attention to the Shariah-compliance status disclosed in IPO prospectus and perceive such information as an incentive to participate in the offerings, they may receive high gains in the day of listing. In order to increase investor participation, listing firms should capitalise on this voluntary practice. Likewise, investors could use this signal to build their IPO investment portfolios. It is suggested that further researches consider long-run performance and volatility of Shariah-compliant IPOs to determine whether Shariah-compliant IPOs make a worthwhile long-term investment. For firms, our findings may suggest whether opting for the voluntary pre-IPO Shariah-compliant audit would be necessary to support their listing objectives.

One of the limitations of this study is that it does not explore the characteristics of firms that undertook the voluntary pre-IPO Shariah-compliant status audit. This limits the understanding of whether these firms are actually of "high quality"; or whether they are exploiting on the Shariah-compliance status to portray that they are associated with low *ex ante* risks. Second, in order to validate our argument that Shariah-compliant firms use the status to signal their quality, an examination of secondary offering performances of these shares could be conducted to determine the extent to which these firms recover their money during the secondary offering. This, however, had not been addressed in this paper. These limitations provide a clear avenue for further research, to strengthen the understanding of the role of pre-IPO Shariah-compliant status on IPO underpricing.

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