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Why do issuers issue *Sukuk* or conventional bond? Evidence from Malaysian listed firms using partial adjustment models☆

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A B S T R A C T

Although *sukuk* has been dominating the Malaysian capital market, the motivations of the firms issuing *sukuk* or conventional bonds remained largely unexplored. Using the partial adjustment model, we make the initial attempt, to test a firm's target debt optimizing behavior and secondly, to find the firm specific determinants of target debt ratio using a *sukuk* or conventional bond issuance[3] dataset. Our sample consists of 120 conventional bonds and 80 *sukuk* issuers from 2000 to 2012. We employ two recent dynamic panel data estimators,[4] which resulted in three major findings. Firstly, our results provide stronger support for trade-off view based on a firm's optimizing behavior among *sukuk* and conventional bond issuers, however with different issuance motives. Secondly, issuers of partnership-based *sukuk* and convertible bonds closely follow the pecking order view, in which the former is chosen based on firms facing a higher information asymmetry cost. Finally, while both exchange-based *sukuk* and straight bond issuers align towards a particular target, only firms with higher sales growth

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[3] *Sukuk* samples are split into exchange-based *sukuk* and partnership-based *sukuk*, while conventional bond samples are split into convertible bond and straight bond.

[4] Standard-GMM and System-GMM.

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prefer the former. Reinforced by industry insights, our findings evidence that the *sukuk* offers bring unique “benefits” to corporate issuers unlike those of the conventional bonds.

1. Introduction

Malaysia has been recognized to be at the forefront of Islamic finance internationally. Within the Islamic finance, the development of *sukuk* (Islamic debt securities) is often referred to as a benchmark to indicate achievement in this field. Anecdotal evidence indicates that the *Sukuk*[5] market has shown remarkable progress since its introduction in early 2000[6] by both public and private sectors. These enabled Malaysia to be listed as one of the world's largest *sukuk* markets up to the year 2012, where 70% of the total global *sukuk* were issued in Malaysia.[7] In the corporate issuance regime, the *sukuk* market has grown with an annual average growth of 20% between 2001 and 2012.[8] Our data, among non-financial issuers, display *Sukuk* issuance in ringgit from the year 2000 until 2012, which accounts for 56% of the total issuance of private debt securities among publicly listed firms in Malaysia.[9] Among these, there are only 16 out of 200 sample firms that used both issuance, i.e. *sukuk* and conventional bonds but in different periods. Hence, from both theoretical and practical perspectives, it is still largely unknown why some firms may choose to consider *sukuk* while the overwhelming majorities consistently rely on conventional bond offers.

In spite of the rising interest among issuers in *sukuk* offers, research to appraise firm motivations to issue specific *Sukuk* type remains limited. A notable exception is the work recently published by Azmat et al. (2014) on the issuer's choice for specific *Sukuk* offers in Malaysia. This study finds that the issuer's choice for specific *sukuk* is not the same as for conventional bonds. Our study is an improvement on Azmat et al. (2014) in two ways. Firstly, to provide comparative analysis on a firm's issuance motives, we include different types of conventional bond offers and compare them with *sukuk* structured with underlying contracts based on Islamic Securities Guidelines 2011 classifications. Secondly, we employed relatively advanced econometric techniques for our dynamic panel data model to provide stronger evidence for bond/*sukuk* issuance motives based on the test of optimality in a firm's capital structure. Finally, we provide a link between our empirical findings and the real world practices through discussions with industry experts.

In this paper, we examine firms' dynamic adjustment process and firm's specific determinants of the target debt ratio when issuing *sukuk* and conventional bonds together with its respective sub-category. Therefore, the focal point of this paper is on answering the following questions:

(1) What are the significant determinants of target debt ratio and its dynamic adjustment behavior for the two dominant principles of issuance, *sukuk* and conventional bonds?
(2) What are the significant determinants of target debt ratio and its dynamic adjustment behavior in each sub-category of *sukuk* and conventional bond offers?

As a preview of our results, we acknowledge that the issuance of *sukuk* and conventional bonds can be explained by the existing corporate financing theories. In addition, owing to the unique features of *sukuk*, we argue that its issuance is motivated by “benefits” that are uncommonly interpreted by previous empirical research. Our estimated partial adjustment model also provides evidences, which are contrary to theoretical expectations, when each debt security principle is examined separately. The remainder of this paper is organized as follows: In Section 2, the literature review is mainly on corporate financing followed by Section 3 on the data set and methodology. In Section 4, we present analyses of the data and discuss results

[5] Securities Commission guidelines allow the terms *Sukuk* and IPDS to be used interchangeably.
[6] Source: Malaysian sukuk market reported an average growth of 22% from 2000 – 2007; Financial Stability and Payment Systems Report 2007, Bank Negara Malaysia.
[7] Islamic Finance Information Service, http://www.islamicfinanceservice.com/Sukuk.html.
[8] Source: Securities Commission, Malaysia.
[9] Source: Bondstream based on own calculations.