UNIVERSITI TEKNOLOGI MARA

CAPITAL STRUCTURE DETERMINANTS OF ISLAMIC HYBRID SECURITIES

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Thesis submitted in fulfillment
of the requirements for degree of
Doctor of Philosophy

Faculty of Business Management

October 2015

ABSTRACT

Firms raise their capital via the common external funds either debt or equity. However, under certain conditions, firms are required to issue more complex financial engineering instruments namely hybrid securities. Literatures showed that very little studies have been conducted on Islamic Capital Market and in establishing the determinants of hybrid securities. Based on theories of capital structure which related to non hybrid capital structure, the variables and the models on hybrid financing are developed. In further filling the gap of the preceding studies, we developed a dynamic model by incorporating important variables that are associated to macroeconomic indicators that are economic growth (GDP), interest rate (BFR), level of stock market development and bond market development. Several estimation models are developed namely convertible bond plus loan stock which signify for debt treat hybrid (model 1) and warrant which is represent equity treat hybrid (model 2) respectively. This study employs the static model via panel ordinary least square (OLS), fixed effects model and random effects model to identify the best estimation model. Besides that, the study also include dynamic model via General Method of Moment (GMM) – first and second generation GMM, to get the most excellent model. From the analysis of static model, it reveals that the best estimation models for both hybrid securities are from model 1 and 2 of fixed effect model. Meanwhile from dynamic analysis, system GMM is considered the most excellent model. As inferences to the body of knowledge, this research has established several factors that are significant in determining hybrid securities for both debt and equity feature hybrid respectively. For Model 1, risk and profitability is considered the most determinant considerations for issuing convertible bond and loan stock in conjunction with its highest coefficient among all the variables under review. Meanwhile for Model 2, financial risk and adverse financial position is the most determinant factors for issuing hybrid equity. These results suggest that, the firms that expose with high risk but low profitable position will opt for warrant for expansion and the firms that have high risk and strong financial position will choose convertible bond or loan stock. Since the high risk firms but profitable are difficult to secure additional credit facility from the financial institutions, there always opt for hybrid security of convertible bond as proposed by risk shifting theory where hybrid securities allow the high risk firm to further venture into riskier business. For high risk but adverse financial position will opt for warrant securities. Meanwhile, the result from model 1 also support the sequential financial problem theory where the hybrid securities enable the profitable firms to venture into positive NPV project by issuing convertible bond as it offer lower coupon rate as compare to the normal debt rate. These findings can be considered as indication that firms generally use hybrid securities implied by sequential financial problem theory and risk shifting in addition to other capital structure theories such as trade off, pecking order and back door listing.

ACKNOWLEDGEMENT

First and foremost, I would like to express my sincere thanks and gratitude to the Almighty Allah S.W.T, the Lord of the universe, who gave me the will and strength to complete this thesis. Salutations and peace to His righteous messenger, Prophet Mohamed S.A.W. I am thankful for the dedication of many individuals who have assisted in finishing this thesis. Foremost, I would like to express my inmost appreciation to my supervisors, Professor Dr. Ismail Ahmad and Dr. Hairulnizam Hashim for their resourceful input, great support, assistance and supervision and the prospects they have created and offered throughout the whole process of this thesis. Their untiring efforts, prompt review, feedback and guidance in making the completion of this thesis possible deserve special appreciation.

I would also like to express my deepest gratitude to my beloved parents, Jaafar Mohd Jani and Fatimah Abdullah, and my siblings for their unconditional love, prayers and continuous support towards my academic career. My special thanks and love to my wife, Syahzatul Erna binti Taib and my children for their continuous encouragement, sacrifices and emotional support throughout the completion of this thesis. Clearly, their love motivated me to accomplish this tremendous academic goal. Finally, I would also like to thank everybody who have played an important role in the successful realization of this thesis. I would also like to acknowledge support provided by Faculty of Business Mangement, Universiti Teknologi MARA. I own whatever I have accomplished to Allah without Whom I could accomplish nothing. May Allah bless all of you with lot of happiness and prosperity.

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CHAPTER ONE

INTRODUCTION

This chapter begins on the background of the study and followed by the problem statements. The rationale of the study, objectives of the research and research questions are documented in section 1.3, section 1.4 and section 1.5 respectively. It follows by scope of the study, significant contribution of the study, limitation and organization of the study. Lastly but not least, the conclusion in section 1.10

1.1 BACKGROUND OF THE STUDY

The requirement of raising capital is in tandem with the growth of the firm's business. In a capital market, firms have an extensive range of choices to raise external fund for expansion. In general, the two most prominent ways of obtaining external capital is either by issuing equity or via incurring debt respectively. However, the firms face a fundamental issue in corporate finance decision that is what type of capital to rise and what will be the effect of their choices?

Literally, each of security to be issued such as debt or equity, has its trade off benefits to the issuers (Modigliani and Miller, 1958; Shyam-Sunder and Myers, 1999; Bessler, Drobetz and Gruinger, 2011). Firm raise capital by means of debt has the advantages of having no dilution of ownership interest in its firm and leveraging on tax benefit from interest payment. Nonetheless, this endeavor will increase the firm's risk toward bankruptcy. Meanwhile by issuing equity, it helps the firm in expanding the business without having fixed commitment and receive continues support from the existing shareholders. However, this activity is considered to be very costly as compared to raising capital via other means of instruments. In addition, it is very essential for the firm to issue the appropriate type of securities or capital as each of the security has its own different influence on the firm's value. The combination of debt and equity forms firm's capital structure. Nevertheless, the current studies have revealed that there is a considerable shift from a focus on a static trade off model to other capital structure theories in order to search for further explanation on corporate capital structure behavior (Jensen and Meckling, 1976; Smith and Warner, 1979;