Firms' Financials and Return Performance of Shariah Stocks in India

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Abstract

Shariah stocks are stocks of those companies which comply with the Shariah or Islamic law in influence of economic conditions. Both micro and macro-economic determinants have strong linkage with price behaviour in every market mechanism where the dominance of micro level factors is already established in equity research. Hence, this studyempirically examines the firm level factors which are prominent inimpacting the price behaviour of Shariah stocks in India. The study analyses the micro level determinants of stock returns, under a panel regression framework, using published data of share prices andfirm' financials on 50 stocks which constitute the Shariah index of BSE for a period of 10 years from 2008-17. The study captures earnings and earnings growth along with the book value as significant determinants of Shariah stock returns in India.

Keywords: Shariah stocks; Financials; Return performance; BSE; Panel regression.

Introduction

Stock market performance of every economy is under the strong influence of economic conditions. Both micro and macro-economic determinants have strong linkage with price behaviour in every market mechanism. People prefer to be safe at market places and they wish to invest their surplus fund only those investment assets which are stable in performance. However even the economy perform well the stocks traded in its stock market are not getting the benefits of such positives of the economy. This is because the performance of companies which are issuing such stocks is differently reactive to the macro economic performance of the country and the same is reflected in their financial performance. It is a common notion that well performing companies' shares are getting better market valuation and the shares of poor performing firms will fail in markets. Hence it is highly important to assess the financial health of firms while forecasting the market prices of those shares.

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Shariah companies are those companies that complying the Shariah or Islamic law in their business activities. Due to its large number of listed companies, India provides a huge universe for Shariah compliant stocks. Shariah index comprises of stocks issued by such companies which are more conservative in their business operations. Today Shariah compliant indices are operating in seventy four countries around the world including India, of these only thirteen countries are Islamic countries. Persuasion of conservative law in business dealing indirectly provides an insulation of companies against the risk of financial insolvency. However, their stock performances are expected to significantly affect by other performance dimension including profitability, liquidity, and related market factor. This study empirically examines the firm level factors which are prominent in impacting price behaviour of Shariah stocks in India.

Review of Literature

Sakti and Harun (2013) attempts to analyze the relationship between Jakarta Stock Exchange Islamic Index (JII) and selected macroeconomic variables namely exchange rate, industrial production, inflation rate, and money supply. They used monthly data from January 2000 to December 2010. The methodology used in this paper is time series techniques of co-integration and vector auto regression (VAR). The results revealed that there is co-integration between stock prices and macroeconomic variables.

Rashid, Hassan and Yein (2014) examine the level of exposure of conventional and Islamic stock price indices in Malaysia to the relative change in investor sentiment index and macroeconomic factors. The study tested two separate models: one using macroeconomic variables in quarterly time series framework and the other using macroeconomic and sentiment data in a quarterly time series framework. Augmented Dickey-Fuller (ADF) test, Phillips-Perron (PP) test, and Kwiatkowski-Phillips-Schmidt-Shin (KPSS) tests were applied. The study shows that both consumer sentiment and entrepreneurial sentiment are strongly positively connected to stock market in Islamic market.

Jamaludin, Ismail and Manaf (2017) aims to examine the effect of macroeconomic variables namely inflation, money supply (MS), and exchange rate (ER) on both conventional and Islamic stock market returns in the three selected ASEAN countries (Singapore, Malaysia, Indonesia) by utilizing monthly data over the period of January 2005 to December 2015. Applying the panel least square regression techniques, the results show that both stock market returns are significantly affected.

Naseri and Masih (2013) attempt to analyses the causality between Islamic stock market and three macroeconomic variables namely, money supply, consumer price index and exchange rate in the case of Malaysia. The methods applied are the Long run structural modeling, vector error correction and variance decomposition techniques. The stability of the functions has also been tested by CUSUM and CUSUM SQUARE tests. The findings tend to suggest that there is a co-integration between Islamic stock market and chosen macroeconomic variables and as expected.

Rashid (2008) investigates the dynamic interactions between four macroeconomic variables and stock prices in Pakistan, using cointegration and Granger causality tests that are robust to structural breaks. The results strongly suggest cointegration between the stock prices and macroeconomic variables viz. consumer prices, industrial production, exchange rate and the market rate of interest. Estimates of bivariate error-correction models reveal that there is long-run bidirectional causation between the stock prices and all the said macroeconomic variables with the exception of consumer prices that only lead to stock prices.

Statement of the Problem

Stock market investments often exhibit larger volatility as they are under the influence of a host of factors ranging from irrational market sentiments to rational fundamentals. However, in the long run market is under the strong influence of fundamentals particularly at the firm level. One of the serious difficulties faced by an equity investor particularly from an emerging market, is where he should invest and what factors he should consider while taking his investment decisions. Generally, it is believed that the earnings and financial conditions of a firm will be reflected in the prices at which the shares of such firms transacted in market bourses.

Although many studies already dealt this matter under empirical framework, the findings of most of them are not converging in any sense. Still, in an emerging market context, the determinants of market valuation are mysterious and investors are losing their way particularly under abnormal conditions. The classification of Shariah stocks in Indian context is recent origin that aims to protect the investment interests of a specific particular ethnic group who believe that the company who issue stocks resorting to practices many of which are against the belief of Shariah law. Hence, an investor who is looking for investments in Shariah stocks also has to know what are the firm level performance factors affecting the return potentials of his target stock. Thus, this research intends to focus mainly on the effect of firm level performance on the market valuation of Shariah firms in Indian context.

Research Objectives

I. To analyse the financials of Shariah index included companies in Indian Stock market.

II. To evaluate the return performance of Shariah stocks listed in Indian stock market.

III. To assess the company specific determinants of Shariah stock returns in Indian context.

Methodology

Period of study: Time series data of monthly prices of BSE stocks for a period of ten years (2008-2017) have been accessed for this study. The rationale behind the selection of this period is manifold. First this period covers different phases of an economic cycle including recession, resilience and recovery. Secondly, the Shariah index was

introduced in India during this period.

Sample and Data: The study uses published data of stock prices and the firm level financial data of 50 stocks which constitute the Shariah index of BSE. These companies do not engage in any of the activities which are against the Islamic Shariah law. The secondary data on stock prices needed for the study are collected from the official website of Bombay Stock Exchange (BSE) and annual reports provide the needed financial data required for the empirical analysis. The financial variables of Earning Per Share (EPS), Dividend Per Share (DPS), Book Value, Profit Margin, Return on Investments (ROI), Profit Growth, Current Ratio and Debt Equity ratio are used for assessing the firm level performance impact on Shariah stocks listed in Indian stock market.

Tools of Analysis: Panel regression framework that uses annual stock returns as endogenous variable and selects company financials as exogenous construct has been used to investigate and identify the significant firm level fundamentals that impact the price performance of Shariah stocks listed in BSE.

The model estimated for the purpose is: $y_{it} = \alpha_i + \beta_i x_{it} + e_t$

Where 'y_{it}' is the return of ith stock at time period 't' and 'x_{it}' is the financial variable of ith stock at time period 't' and 'e_t' is the error term.

Results and Discussion

The study assesses the firm level performance of Shariah stock returns for a period of 10 years from 2008-17. While analysing the financials of the firm during the entire sample period, we came to know that the performance of Shariah firms in India are really well. The firms are able to transact business profitably which is evident in terms of all parameters. On considering the ROI of 21.57 per cent, it is right to say that the firms are not only able to generate a profit margin of 28.30 per cent, but also utilize their assets efficiently to generate better revenues. The share investment with the company offers an average annual return of 17.74 per cent which seems to be a very good return. The debt content in the capital structure is low impelling the lower degree of financial risk and the relatively better ratio of current assets, 2.69, signals low liquidity risk in the business operations of firms. In sum, during the period of 2008-2017, the Shariah firms in India performed efficiently and same is reflected in their share prices also.

Firms Financials and Stock returns: Panel Regression Analysis

The study uses panel regression methodology to assess the impact of financials of Shariah firms on their stock returns. The research performs regression analysis in order to see whether any change occurred in the performance of stock determinants at firm level. Full period data analysis produces more positive results on the impact of financials of Shariah firms on their stock return performance. Here, three financial fundamentals; two are earnings factors -EPS and Profit growth, and

Table 1: Summary Statistics on firm financials and stock returns: 2008-17

Variable	Mean	Std. Dev.	C.V.
EPS	73.0266	339.171	4.64448
Book Value	342.240	1382.77	4.04034
DPS	12.4153	17.4399	1.40470
Profit Margin	28.3038	243.410	8.59992
ROI	21.5784	21.3423	0.989058
Current ratio	2.68864	12.4444	4.62852
Debt Equity	0.199293	0.258697	1.29807
Stock Return	17.7433	61.6285	3.47335
Profit Growth	15.5200	144.846	9.33285

Table 2: Firms' Financials Effect in Stock Returns: 2008-17

Exogenous Variable	Coefficient	Std. Error	t-ratio	p-value		R²
Constant	16.379	7.38696	2.2173	0.02891	**	
EPS	26.0032	8.36114	3.1100	0.00245	***	
Book Value	9.96875	4.92606	2.0237	0.04573	**	
DPS	3.93405	5.83477	0.6742	0.50174		0.672
ROI	1.20677	1.9944	0.6051	0.54652		
Profit Growth	29.7699	9.84805	3.0229	0.00319	***	
Current ratio	28.5314	20.309	1.4049	0.16322		

** significant at five percent level
*** significant at one percent level

third is book value are found statistically significant at one per cent and five per cent levels respectively. These three corporate fundamentals together explain more than two-third portion of the variation in Shariah stock returns. From this it is concluded that firms' financials, particularly profit factors are highly significant in determining market valuation of Shariah stocks.

Conclusion

The study assessed impact of the firms' return on the return performance of Shariah stocks in India. The study founds very good financial performance of Shariah companies and the same is benefited to investors in the form of enhanced returns on their investments. The earning conditions are the most important factor influencing price behaviour of Shariah stocks. Hence, investor should assess earning fundamentals before selecting a particular stock for their investment. More initiative is needed from the part of policy makers and regulators to attract large number of people who are keeping away from the financial system under the constraint of religious faith. Such measures definitely improve the inclusive growth conditions of the country thereby enhance the economic growth and living conditions in the country.

Limitations of the study
- The study focuses only on selected 50 companies that compliant with Islamic or Shariah law.

- The data used in this study are limited to the Islamic stock market located in India.

- Analysis is based on selected number of financial performance indicators.

Scope for further research

Collecting information about more Shariah firms from different economic settings and analysis is made with advanced econometric techniques like panel cointegration; the results of the study can be made better. This is possible and certainly be future lines of research in the area.

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