Fixed income *sukuk*: prospects for corporate issuance

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1. Introduction

Islamic finance is one of the most exciting areas of the capital markets at the beginning of the twenty-first century, and the *sukuk* is very much a product of the new millennium. The petro-dollars boosting the Gulf countries together with the vibrant economies of South-East Asia have combined to bring Islamic finance to the forefront of the international financial community. As a result, the Islamic capital markets are growing at an exponential rate. In both the leading Islamic centres of the Gulf and South-East Asia, issuers are seeking to tap the capital markets in a *Shariah*-compliant manner. The rest of the world is catching on as well – from the UK to Japan and back across the Pacific Ocean to the United States, issuers are looking to take advantage of investors' increasing demand for *Shariah*-compliant investment products.

Oft-quoted figures from the World Bank cite some 300 Islamic financial institutions and funds with more than US$250bn of assets, growing at approximately 10–15% per annum, with a further US$200bn of assets located in Islamic "windows" or divisions of conventional banks. In October 2006, Standard & Poor's report entitled "The Islamic Financial Industry Comes of Age" estimated the Islamic market to have a potential of US$4 trillion, with current utilisation standing at approximately 10%.

This chapter will examine the current *sukuk* market in more detail and analyse the most popular structuring techniques for *sukuk* issuance. It will also look at the prospects for the sector and, in particular, analyse one recent issue to shed more light on the dynamics of the market and the reasons why corporate issuers are flocking to Islamic finance.

2. The growth of Islamic finance and the *sukuk* market

Sukuk issues are a twenty-first century product, although they draw on centuries of Islamic financial practice. While the 1990s saw a handful of structured-finance corporate deals tailor-made for a carefully delineated audience, the first sovereign issue came in September 2001, with the US$100m *sukuk* issue by the Bahrain Monetary Authority although this was essentially for liquidity management purposes. Other sovereigns soon followed suit, first with the US$600m Malaysia Global *sukuk al-ijara* in June 2002 – the first truly global offering – whilst Qatar maintained the momentum in September 2003 with its debut US$700m *sukuk al-ijara* issue.

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The *sukuk* market has continued to gain pace since those early years and has, more importantly, widened its range of issuers. Total *sukuk* issues in 2004 raised more than US$8bn, with sovereign issuance accounting for just over 20% of the volume; this more than doubled to US$17bn in 2005. The market continued to grow in 2006, with over 50 issues raising more than US$27bn, growing year-on-year by over 125%. Sovereign levels were down to just over 10%, demonstrating the swift pick-up in issuance by the corporate sector. In the GCC, 2005 saw 11 issues raising US$2.3bn, while 2006 saw 17 issues raising almost five times the previous year's volume, with just over US$11.5bn being raised. 2007 is shaping up to be another record year, with global issuance to the end of September reaching almost US$39bn, from approximately 150 issues.

It is clear from these levels that the Islamic finance market in general, and *sukuk* issues in particular, are nevertheless still a "niche within a niche" when compared with the international capital markets as a whole. The industry is in the early stages of its life cycle and, as at the beginning of 2007, new ground is being broken with every issue, whether in terms of structure, volume or country of issuer.

In the Gulf Cooperation Council (or GCC, namely the Kingdom of Bahrain, the Emirate of Kuwait, the Sultanate of Oman, the State of Qatar, the Kingdom of Saudi Arabia and the United Arab Emirates), the growth of Islamic finance has several major drivers. First and foremost is retail demand. One leading player in Islamic finance has described the business as "R2B" (retail to bank), and there is little doubt that it is the retail customer (whether the eponymous "Muslim in the street" or the increasing legions of "high net-worth individuals" and "ultra-high net-worth individuals") who is seeking to invest and deposit money for utilisation in accordance with *Shariah*. As is well known, the amounts available from this sector have grown steadily in this new century, with the repatriation of funds to the Gulf region spurred on by events such as 9/11 and the fall of Saddam Hussein, the continued high oil and gas prices and the continual development of new *Shariah*-compliant products.

The banking network in the whole of the GCC has been impacted by this new liquidity and is reacting to it in a variety of ways. Existing banks are establishing Islamic retail, commercial and investment banking platforms. For example, in Qatar, Al Safa Islamic Bank has appeared via Commercial Bank of Qatar and QNB Al Islami via Qatar National Bank, whilst in the United Arab Emirates MashreqBank has started *Shariah*-compliant operations via Al Badr Al Islami. Other banks have gone one step further and undertaken conversion to be fully *Shariah*-compliant, such as Kuwait Real Estate Bank, Dubai Bank and Saudi Investment Bank. Completely new banks are also being established at a heady pace. Notable recent examples have included Al Rayan Bank in Qatar, Bank Al Bilad in Saudi Arabia, as well as Al Salam Bank and United International Bank in Bahrain. The latter captured the headlines in the financial pages in the GCC due to the initial authorised capital of US$3bn, as well as the public involvement of the family of Prince Al Waleed bin Talal in the establishment of the bank.

Investors in the GCC are spreading their wings outside the immediate region as well. Significant investment is being made by several leading players in South-East Asia, with banks such as Kuwait Finance House and Al Rajhi Bank establishing operations in Malaysia, including significant retail branch networks. Activity has also

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been seen in Western Europe, in particular in the UK where fully *Shariah*-compliant institutions such as the Islamic Bank of Britain and the European Islamic Investment Bank have been established, with further institutions continuing to start up. 2007 has seen the authorisation of the Bank of London and the Middle East, with at least two further institutions seeking the necessary authorisations from the Financial Services Authority to start their Islamic banking businesses.

From an issuer's perspective, Malaysian corporations have for several years benefited from government-led initiatives designed to stimulate *Shariah*-compliant transactions. Companies in the GCC are taking greater strides in the *sukuk* market to broaden their appeal to fixed income investors, whilst at the same time ensuring the issuer's "*Shariah* acceptability" to its shareholders.

Sukuk issuance is also spreading beyond the GCC and South-East Asia and it is worth examining why issuers outside these two main Islamic hubs should be interested in *Shariah*-compliant financing. The growing numbers of potential issuers investigating the advantages of Islamic issuance are primarily focusing on diversifying sources of funding. Potential issuers are in particular attracted by the "double-dip" opportunities afforded by a financing product capable of appealing to "conventional" fixed-income investors, as well as enticing the participation of the vast wall of liquidity latent in the Islamic financial community. The ball started to roll in August 2004 when the German state of Saxony-Anhalt issued its €100m *sukuk al-ijara*. The issue was AA-rated and correspondingly was priced virtually flat to EURIBOR and this has led to some commentators querying the extent to which there was widespread investor interest in the issue. Nonetheless, it remains a landmark transaction in Europe and the prime motives behind the issue were certainly satisfied, particularly in terms of investor diversification and – in the words of the German regional minister – "putting the state of Saxony-Anhalt in the limelight as a suitable and appropriate area for economic investments". The United States broke its duck in 2006, when the US$165m *sukuk al-musharaka* was closed for East Cameron Partners, a Louisiana-based gas exploration and production company, whilst the Sultanate of Brunei also saw its first issue, with the US$150m *sukuk al-ijara* from the Government of Brunei (issued concurrently with two local-currency issues). At the time of writing, debut *sukuk* issues for Japan and China have also been announced (although not yet closed), namely a benchmark issue for JBIC and a US$250m power project respectively. Perhaps most notably, the UK government announced in April 2007 its intention to study the feasibility of a debut *sukuk* issue, with a further discussion paper to be issued before the end of 2007.

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3. What is *sukuk*?

Strictly speaking, a *sukuk* is not a debt product at all. Rather, it represents a proportional beneficial ownership in the asset(s) underlying the issue (the singular form of *sukuk* is *sakk*, a possible source for the Anglo-Saxon "cheque"). The *sukuk*holder's right is to receive its pro rata portion of the income stream of the underlying asset.

Another way of looking at it is to see the *sukuk* as a capital markets overlay to an underlying Islamic structure. In that regard, it is clear that for a corporate to consider

issuing a *sukuk* it must be able to satisfy certain essential criteria in relation to compliance with *Shariah* principles. To begin with, the company must not engage in any *haram* activity – the best known examples relate to pork, alcohol, gambling, armaments and certain types of media activity. Beyond that, the *sukuk* issue itself must be structured to ensure adherence to Islamic principles. The most famous of these is perhaps the banning of any interest (*riba*), although profit is very much encouraged, as is risk sharing. One other major criterion is that an issuer must own the asset or assets it intends to utilise in any particular financing structure – although there is one notable exception to this (highlighted below).

The *sukuk* is nevertheless a highly flexible product. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) lists 14 authorised types of *sukuk*, ranging from the familiar *ijara* (sale and leaseback) to *sukuk al-musharaka* (joint venture-based issues, a particular feature of the Malaysian market), to more esoteric structures such as *sukuk al-muzra* (allowing *sukuk*holders a share of the produce of agricultural land) or *sukuk al-muqarasa* (land and trees/crops). In the brief history of the market to date, it is the *ijara* structure which has featured most prominently, followed by *musharaka*-based issues, which are gaining ground in the GCC in addition to their well-established precedence in South-East Asia.

Other chapters in this book go into some detail regarding Islamic structures, but it is worth focusing on the *ijara* and *musharaka* structures to demonstrate how they can be tailor-made to fit into a company's business and asset base. These structures are the most commonly utilised in the market and in 2006 accounted for 19.2% and 36.4% of total issuance respectively.

An *ijara* facility can, in essence, be structured as a sale and leaseback, consisting of a sale from the party requiring funds to the financiers of lease of equipment or other asset(s) for rent, with such assets being rented with full maintenance assumed by the lessee. In order to facilitate the leasing structure, the funding banks will purchase an asset or pool of assets from the issuer and then lease it or them back to the issuer on the agreed commercial terms. Such structures are often used in project finance and in sovereign *sukuk* issues but are increasingly used in corporate *sukuk* issues as well. Key conditions include the asset being fit for purpose and having a value at least equal to the amount of financing being raised, whilst the amount and timing of lease payments must be agreed in advance. In project finance, a forward *ijara* arrangement will often follow an *istisna* (construction) contract, where at the beginning of the financing there is no asset yet completed. The *istisna* is an exception to the usual *Shariah* requirement that an asset must exist at the time of contract, and it involves a commitment on the part of the issuer to produce a designated asset with payment either in a lump sum or in instalments.

The classic *istisna*/*ijara* structure is illustrated by the US$1bn syndicated financing for Dolphin Energy in the United Arab Emirates funded in July 2005. Whilst not a *sukuk* issue, the transaction is also a good example of how Islamic finance can work alongside the conventional market, as the Islamic tranche formed only part of the larger US$3.45bn financing. Under the structure, rental payments will begin under the *ijara* structure following completion of the *istisna* contract and the delivery of the now-constructed assets to the Islamic financiers (see diagram overleaf):

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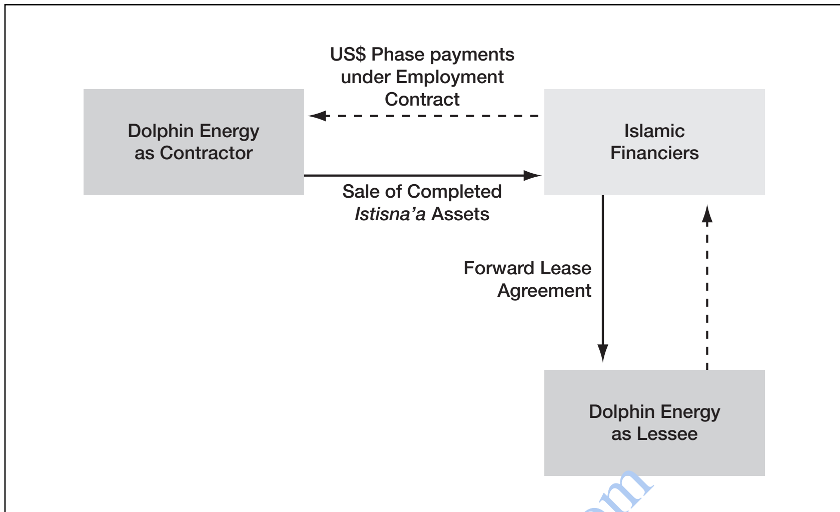
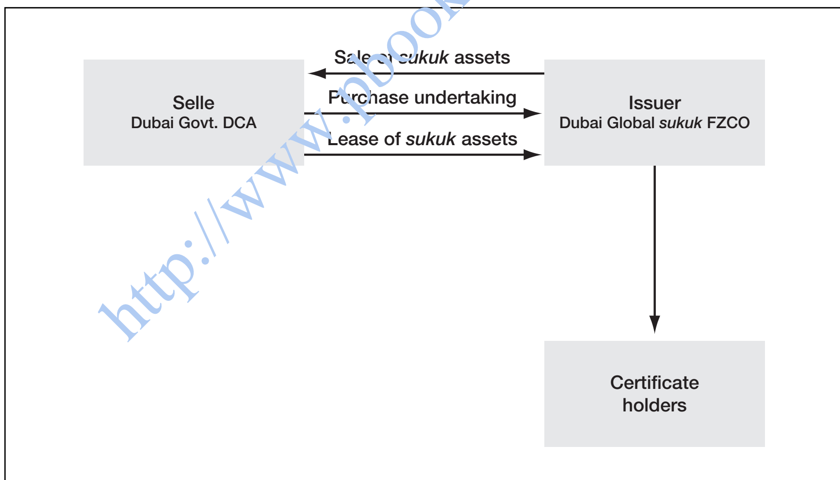


The *ijara* structure is, as mentioned above, increasingly seen in the capital markets as well, and the diagram below illustrates the structure for the US$1bn *sukuk al-ijara* issue by the Dubai Civil Aviation Authority in November 2004:



The *musharaka* structure is constructed along different lines, and involves the formation of an unincorporated joint venture between the Islamic financiers and the issuer. In essence, the partners invest capital or services and share in the resulting profits and losses. On this basis, the issuer contributes assets to the unincorporated *musharaka* joint venture, whilst *sukuk*holders contribute capital (via an SPV) to enable the joint venture to buy the assets and make a profit from them, in accordance with an agreed business plan. *Sukuk*holders retain the credit risk of the issuer via a purchase undertaking and it is pursuant to this contract that repayment

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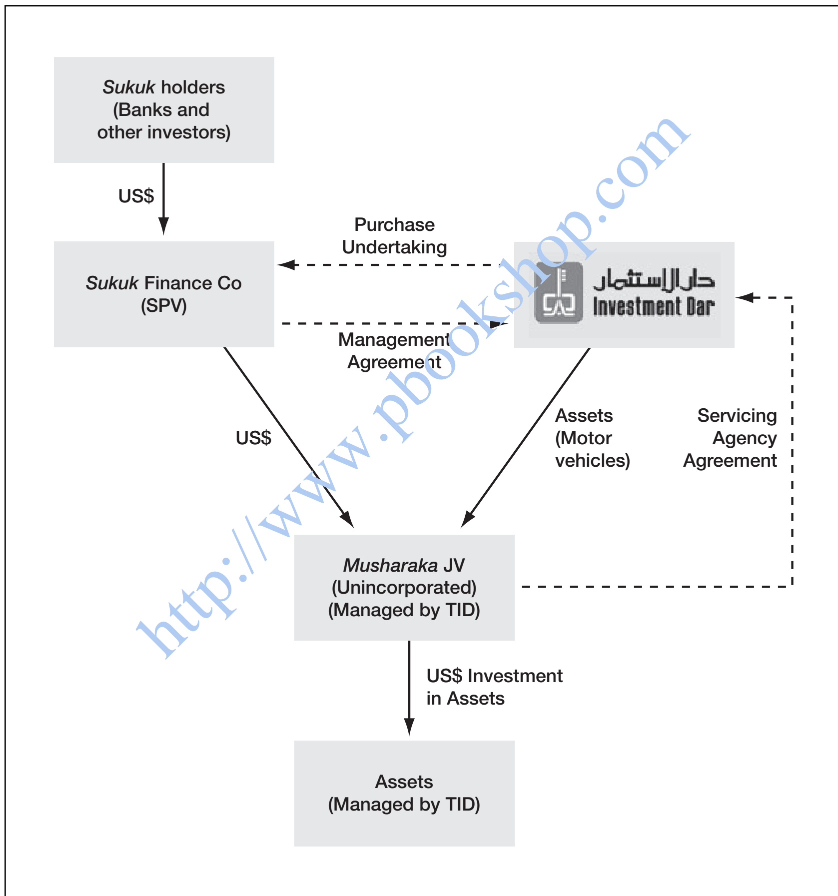
is effected, by the issuer purchasing "units" in the *musharaka* on each periodic distribution date for a price equal to the agreed return (which could also include amortisation of principal, if required). This agreement also contains the representations, warranties, covenants and events of default typically found in financing agreements and it is pursuant to the purchase undertaking that the issuer will agree that if required by the majority *sukuk*holders (eg following a default) it will purchase from the SPV all of its *musharaka* units for a pre-agreed price (which will reflect outstanding amounts under the financing).

This structure was utilised by The Investment Dar for its US$150m *sukuk al-musharaka* issue in September 2006:



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The flexibility afforded by the different types of structures capable of being used in a *Shariah*-compliant capital markets transaction serves to widen an issuer's target audience. For a corporation in the GCC, a *sukuk* issue offers it the chance to widen the diversity of its funding base as the *sukuk* has had increasing success in attracting non-GCC investors. For issuers outside the GCC, the converse applies, with *Shariah*-

compliant investors wishing to take advantage of the, still comparatively rare, opportunities to diversify the geographic spread of their asset base outside the region.

Evidence for this reasoning is strong and issuers, particularly in the GCC, have taken advantage of accessing these two distinct pools of liquidity. Bookrunners of issues ranging across the Gulf have consistently emphasised the extent to which the "conventional" investor base has been a strong supporter of *sukuk* issuance. In December 2004, more than 25% of the US$1bn five-year *sukuk al-ijara* issue by the Dubai Civil Aviation Authority was placed outside the GCC, with just over 30% of the issue being taken up by non-Islamic buyers. The Islamic Development Bank also benefited from this wide appeal with the benchmark US$500m drawdown by IDB Trust Services in June 2005 under its ground-breaking US$1bn medium-term note programme, which reached an almost entirely non-Islamic investor base. The AAA-rated issue was priced at launch at 12.5 basis points over the benchmark and more than 90% of the accounts were conventional buyers, with Asia taking more than 35% and investors in Europe slightly more than 25%. More recently, the record-breaking convertible *sukuk al-ijara* three-year issue from Dubai-based Nakheel closed at US$3.52bn in December 2006 and achieved a 40% take-up outside the GCC.

This diversity is augmented by the fact that, at the moment, there is little doubt that the *sukuk* market is a hybrid one, combining characteristics of the conventional capital markets (listings, utilisation of the clearing systems etc.) but also those more often seen in the syndicated financing market. For example, in the GCC, issuers often expect a firm price to be quoted by lead managers and for issues to be underwritten, whilst investors expect to receive not only the spread on the asset but "up-front" fees as well. All of these features are more commonly seen in the syndicated financing market. It is going to take some time to bring both issuers and end-investors closer to the more transparent market conventions of the international bond markets, where lead managers are mandated to build a market and engage in a process of "price discovery" and where investors base their appetite on the yield of the issue, without the added sweetener of up-front fees. Of course, the counter-argument to this is that nearly all *sukuk* issues to date have been floating-rate instruments, almost invariably issued at par. Contrast this with the conventional fixed-income market, where bond issues usually carry a fixed coupon but are typically issued at a discount to par to enhance the yield for investors.

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4. Development and innovation of structures

A notable feature of the Islamic *sukuk* market to date has not only been the degree of innovation and creativity involved, but also the pace at which those skills have been, and are increasingly, deployed. Each new issue brings a new structure or a significant refinement of a previously utilised mechanism. This is, of course, to be expected given the youth of the modern-day Islamic finance market, but there is also little doubt that the overall trend is one of positive and constructive development, with structures tending to be simplified as the underlying *Shariah* principles become better understood in the context of today's financial environment. The simpler the structures, the more capable they