Sukuk and see

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The issuance of Islamic bonds (sukuk) is expected to increase rapidly in volume during 2004, as more issuers take advantage of high liquidity among Middle Eastern banks, and the shortage of Islamic law-compliant debt instruments for both banks and private investors. They may even be the way for regional governments to finance non-energy-related infrastructure at a time of lowered spending ability.

Both asset backed financings and project finance loans or bonds are ideally suited to creating Islamic structures, since the underlying assets can be used to generate the return on investment, which is thus not directly linked to a set rate of interest.

A growing number of project financings across the Middle East now have Islamic tranches, with the largest so far being the $540 million tranche for the Umm Al-Nar Independent Water and Power Project in Abu Dhabi.

However project financings are by their nature highly complex to arrange, and come to market at unpredictable intervals, depending on the project cycle in a given country. Thus bank investors and arrangers are looking for instruments which are easier to structure, and it is the sukuk (the plural form of suk- the Arabic word for bond) which has emerged as the most popular and fastest growing new product in the world of Islamic investment.

Issuers to date have been a mixture of sovereign, multilateral and some corporate. Standard & Poor's has rated sovereign for Kingdom of Bahrain (single A), State of Qatar (single A) Federation of Malaysia (triple B), and the Islamic Development Bank (triple A).

The sukuk can be backed by the underlying cashflows from a portfolio of ijarah (lease contracts), or other Islamic agreements such as istisna (financing for manufactured goods during the production period).

Islamic finance generally incorporates a degree of risk sharing commonly borne by equity investors. But rental payments can in reality lead to a highly predictable rate of return, and are generally calculated on some floating rate benchmark, often the six-month US Dollar Libor. Sponsors, advisors and governments can therefore be certain that the modelling required for an issue is roughly similar for that of debt facilities.

However, to achieve the same ratings as assigned to the sovereign, the structures include unconditional, irrevocable guarantees and/or purchase agreements from the issuer. In the Bahrain, Malaysia and Qatar deals there is a commitment from the government to buy back the leased assets at a price sufficient to meet the sukuk obligations.

In fact the rating agencies do not look very closely at the assets in the underlying pool- as they would in a conventional asset-backed deal - since they are more concerned with the guarantee provided by the borrower.

Thus the sukuk are more similar to covered bonds than securitizations, since in a covered bond offering (for example the one closed by HBOS in 2003 and backed by mortgage loans) investors have full recourse to the borrower.

In the Qatar deal, which was launched in September 2003 and sized at $700 million, the Qatar Global Sukuk special purpose company purchased a parcel of land from the government, and leases it back to the government for a seven year period. The lease rental payments are calculated based on six month Dollar Libor plus a margin. The offering was led by HSBC and QIIB.

The proceeds of the Qatar offering were partly used to develop the Hamad Medical City in Doha. This project is designed initially to provide accommodation for athletes at the 2006 Asian Games, and to be a medical facility thereafter. The state of Qatar has plenty of other funding sources, and runs a budget surplus, so the aim of the bond offering was more linked to helping develop the market for Islamic investment products than any pressing need for the cash. The deal was marketed around the world, to both Islamic and non-Islamic investors, and there was distribution in Islamic countries in Asia with the help of Kuala Lumpur based Commerce International Merchant Bank.

By creating a sovereign benchmark the way will be opened for companies to follow, and an offering from Qatar Petroleum (which is however state owned) is expected soon.

The yield on the Qatar bonds is estimated to be equivalent to somewhere around 40 basis points over Libor, which compares favourably with cost of funding that could be achieved in other markets such as the US or Europe. That it was used to fund socially-useful works is an indication, however, that it could form part of a regional PPP alternative, should governments so desire.

The size of the Qatar offering gives some indication of how deep the market is, and the first $1billion deal may not be far off. The offering for Malaysia in June 2002 totalled $600 million, and the Bahrain Monetary Agency, which has been issuing sukuk since 2001, has already placed over $1billion locally, and recently broadened its programme by mandating Citi Islamic Investment Bank (CIIB) and Citigroup Global Markets to structure and lead a globally marketed $250 million sukuk offering, this time backed by an ijara lease on Bahrain's airport.

Citigroup already does global bond placements for the Kingdom of Bahrain, and was one of the lead managers on the sovereign Eurobond launched in January of 2003. Islamic bonds are a way to diversify funding sources for the Kingdom.

Citi also sole lead managed the $400 million debut offering from Islamic Development Bank (IsDB). Major buyers here included the UEA Central Bank, plus commercial banks in the UAE, with UAE institutions buying around $150 million worth of the paper.

The IsDB offering was the first international Islamic capital markets bond issue by a non sovereign entity, and only the second globally placed deal. It was launched in July 2003, and the original plan was to raise $300 million, though this was increased to $400 million because of heavy demand. The IsDB could potentially do several billion dollars worth of deals in the next few years.

In the IsDB deal the issuer is Solidarity Trust Services Limited, an SPV located in Jersey. It purchased a pool of Sharia Law compliant assets, and then the ISDB issued a guarantee covering all debt service payments on the assets in the pool or those to be added later. When the deal matures, IsDB will purchase all the outstanding assets from the pool.

There have so far been fewer corporate deals, but here too there is expected to be a fast developing market. One deal which has already been closed in the United Arab Emirates involves Emaar Properties, which tapped the market for Dirham184 million ($50 million).

The Dubai based Emaar Properties deal was led by the Bahrain based Liquidity Management Centre. The 4.9 year floating rate notes are listed on the Bahrain Stock Exchange.

The proceeds will be used to fund an expanding portfolio of commercial and residential properties in and around Dubai, as well as the growing mortgage portfolio of its subsidiary Amlak Finance. Emaar Properties is currently pressing ahead with plans to build the tallest skyscraper in the world, Burj Dubai (Dubai Tower).

Because of shortage of Shariah compliant investment instruments, the sukuk offerings tend to be bought and kept by investors, and there is a problem establishing secondary market trading, though the Bahrain Stock Exchange is trying to establish itself as a trading centre for the bonds.

More Islamic debt instruments soon

S&P say that it expects to rate more Islamic debt instruments, and of different types, over the near term. One groundbreaking deal is likely to be the first sukuk from an entity in a non-Islamic country. The state government of Sachsen-Anhalt in eastern Germany is planning to diversify its funding sources via a Euro denominated offering, which is expected to be sized in the region of Eu100 million.

In 2001 Sachsen-Anhalt did a conventional Eurobond offering totalling Eu1bn, and found that demand had been heavy from Middle Eastern investors, with Eu50 million worth of the bonds sold in Bahrain alone.

The Ministry of Finance then began to look at offering Islamic compliant bonds as a better way to reach this investor base. The basic structure will involve real estate leases of state government-owned buildings, leased via a foundation in The Netherlands. The term of the bonds is likely to be around five years.

Sachsen-Anhalt has mandated Citibank as lead manager for the deal. A growing number of global banks such as BNP Paribas, Citibank and UBS are getting involved in Islamic bond arranging, using their global placement capabilities to spread distribution outside the Middle East region. They are adding to the already substantial underwriting capabilities of institutions such as Arab Banking Corporation, National Bank of Kuwait, Qatar National Bank and National Bank of Abu Dhabi.

Bahrain has the largest concentration of Islamic financial institutions in the world, and both Citibank and BNP Paribas have their Islamic banking operations based there. BNP Paribas opened its Islamic Banking Unit in Bahrain in September 2003.

"The level of pricing achieved by sukuk offerings is similar to bonds out of other markets such as Europe," says Jean Marc Riegel at BNP Paribas in Bahrain, who therefore sees more non-Islamic countries such as those in the EU doing future offerings as a way to broaden their investor base..

He also expects to see more Islamic compliant tranches being used on project financings. In fact BNP Paribas arranged an Islamic tranche in 2002 for the Al Hidd power and desalination project in Bahrain.

The facilities for Al Hidd comprised a $200 million conventional loan with cover provided the Export Risk Guarantee Agency of Switzerland, plus a $55 million Islamic finance facility incorporating an Istisna'a (construction financing) and Ijara (lease financing structure).

This deal was the first ever where an Islamic financing was combined with ECA cover. Kuwait Finance House and the Islamic Development Bank joined BNP Paribas and HSBC Amanah Finance as lead arrangers on the Islamic tranche.

"We don't see any problems in terms of size and maturity any more, but of course it all depends on the quality of the project," says Riegel.

Other forms of Islamic finance are also becoming more common, in addition to the sukuk offerings. In May of 2003 Citi Islamic Investment Bank arranged a $150 million Islamic lease facility for Pakistan International Airlines (PIA).

Citi was joined as arranger by the Islamic Development Bank and Pakistan's United Bank Limited (UBL), while other participants included Abu Dhabi Islamic Bank, ABC Islamic Bank, Emirates Bank International and Saudi National Commercial Bank.

The three year facility is being used for pre-delivery finance for three Boeing 777 aircraft. Citibank will later provide the long term financing for the aircraft with conventional financing supported by US Exim.

The project deals flow on

Meanwhile 2004 is expected to be a busy year for project financings in areas such as oil & gas and Independent Water and Power Projects (IWPP), after many deals fell behind schedule in 2003 because of the Iraq war and general feeling of uncertainty in the Middle East.

Many of these deals are expected to involve Islamic funding of some sort. "There are live deals being worked on at the moment that may ultimately look at Islamic financing, and generally, if you look at the size of some of the deals coming through, realistically Islamic finance will have to be taken up by some of the projects," comments one Riyadh based banker.

And he views the potential size of these tranches as being quite big. "When you start adding these regional institutions together they are pretty robust and could underwrite $250 million individually on an Islamic basis," he says. "No one seems to be exactly sure how big the Islamic pot is, but the suspicion is that if you came out looking for $1 billion to $1.5 billion you could probably find it from Islamic sources. There are Islamic funds or investors with Islamic preferences looking for homes for their money, for the right project with the right pricing and good security structure."