

INTRODUCTION TO SUKUK

First Qatar Real Estate Development Company

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DEFINITION: SUKUK

- ❑ In common terms, Sukuk generally refers to the Islamic equivalent of bonds, but in opposition of the conventional form of bonds; which are ownership of debt in simplistic term, the Islamic bonds grant the investor a share of an asset along with the proportionate cash flows as well as the risk.
- ❑ The Islamic Finances Board (IFSB-2) defines Sukuk as:
“Certificates that represent the holder’s proportionate ownership in an undivided part of the underlying asset, where the holder assumes all rights and obligations to such asset.”
- ❑ Sukuk plays a similar role as the conventional financial securities through the generation of a fixed rate of return, however, Sukuk eliminate non-Shariah compliant features such as: uncertainty, interest/usury, and gambling.



INTRODUCTION TO SUKUK

- ❑ Sukuk securities adhere to the Islamic law by following the Islamic principles also known as the Shariah laws, where the charging or payment of interest are prohibited.
- ❑ Sukuk securities simply act as a link between their issuers (who are commonly known as sovereigns and corporations) with a wide range of investors.
- ❑ Sukuk securities are the most active Islamic market debt instruments (in addition to Islamic equity market), and provide an alternative funding opportunity for corporate entities and the government.
- ❑ Sukuk are sold in the primary market an investor buys securities which are issued for the first time. Existing securities are purchased and sold in the secondary market. Primary capital markets are important for capital development of an economy.



SUKUK MARKET TRENDS

- ❑ Sukuk was legitimized in 1988 and in 1990, Sukuk was initially introduced to the world surprisingly by a non-Islamic company; 'Shell MDS', however, it was introduced in the Islamic dominated country of Malaysia. Malaysia is the leader in volume and value within the domestic Sukuk market, followed by Sudan then Saudi Arabia.
- ❑ The Sukuk market is one of the fastest growing segments of the Islamic capital market; where the Islamic financial system expanded into the market since the late 1990s.
- ❑ The emergence of the Sukuk securities has been one of the most significant developments in the Islamic capital markets. In particular, their resilience in the recent global downturn within the capital markets, especially the turbulence observed amongst conventional forms of bonds.



SUKUK MARKET TRENDS

- ❑ The global Sukuk market has also shown resilience in the past year of 2013 given the volatility in the global bond markets. The issuance of Sukuk was \$79.70bn (552 issues) by Q3 2013, lower than that in 2012 at \$109bn (532 issues) due to the fact that the market saw the largest issuance to date in 2012 with higher value deals in that year.
- ❑ Market depth is also increasing through a wider variety of financial instruments being introduced with more equity-like features; and a growing issuer and investor base as well.
- ❑ International Sukuk (Eurobond) issuance was around \$13.11bn (16% of global Sukuk issuance) between Q1-Q3 in 2013, whereas in the same time period in 2012, the value was \$19.1bn (14% of global Sukuk issuance).
- ❑ Domestic Sukuk issuance was up to \$66.6bn (84%) in Q1-Q3 2013 compared to the same time period in 2012 at a higher \$114.62.



SUKUK MARKET TRENDS

- ❑ Malaysia currently dominates the Sukuk volume and value globally. During the period of Q1-Q3 in 2013, Malaysia issued \$54.33bn Sukuk, followed by Saudi Arabia of a value of \$8.69bn, UAE (\$5.17bn), and Indonesia (\$5.03bn). Most recent growth trend is observed in Turkey.
- ❑ In Qatar, there was a plunge in the total value in 2013 at \$824 million from a high \$5.45bn, due in large part to the \$4bn issue completed by the Qatari government in 2012.
- ❑ Government Institutions remain the most active issuers throughout the history of the global Sukuk market, and the leading government is Malaysia.
- ❑ Most Sukuk papers are traded over the counter, therefore, the need for listing Sukuk has been neglected despite the significance of such listing for transparency purposes. Total Sukuk values listed in 2013 Q3 was around \$16.57bn and \$21.4bn in 2012, which comprise of only 6% of total global Sukuk issued.



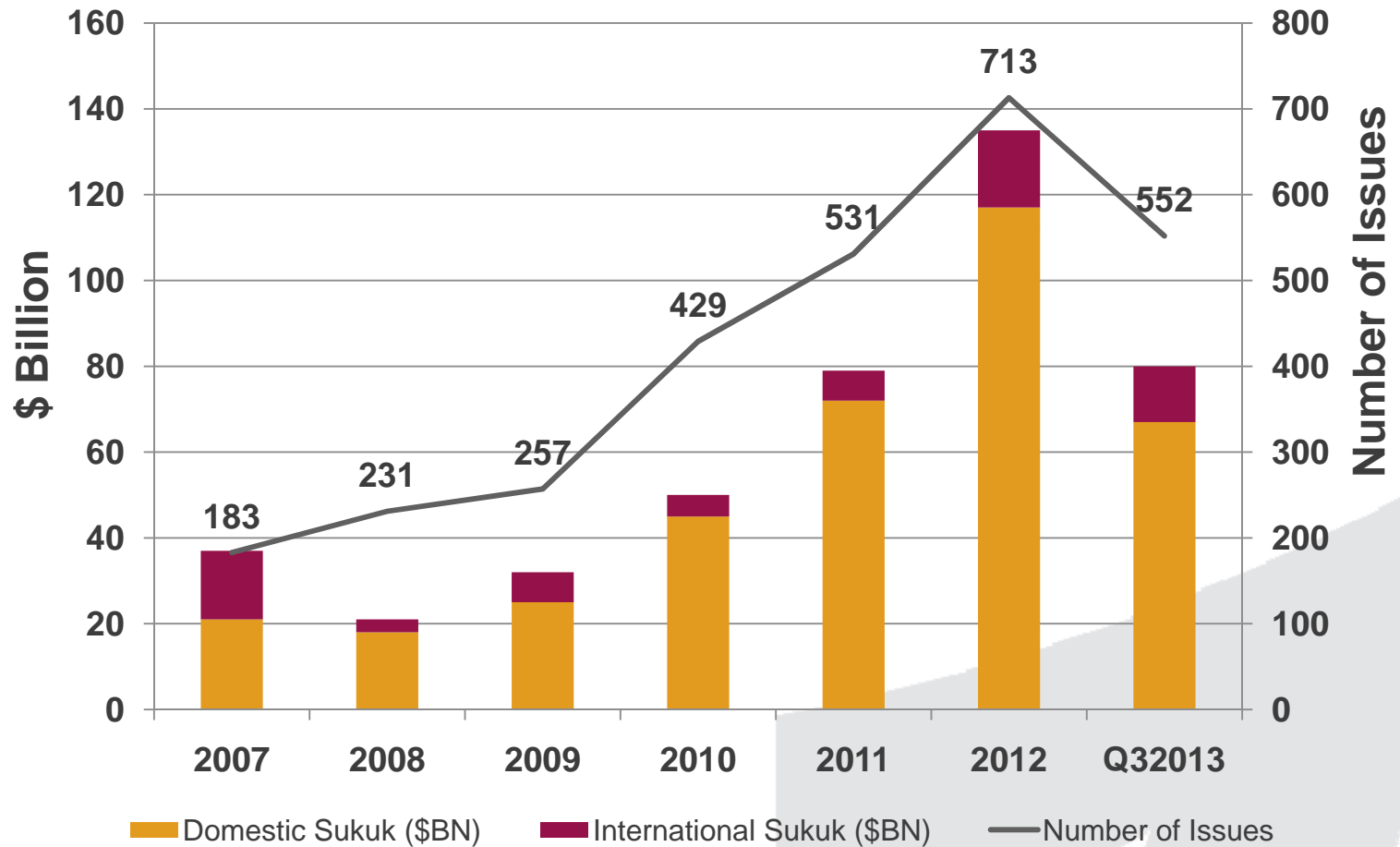
SUKUK DEMAND & SUPPLY



- ❑ Demand is driven by two types of investors – Sharia compliant investors and other global investors seeking diversification and attractive yields. According to the Thomson Reuters Zawya data, Sukuk demand is derived primarily through Shariah requirements; where 54% of investors (mainly Islamic banks) invest in Sukuk due to religious mandate instructing to invest solely in Islamic instruments. The secondary factor driving demand for Sukuk is diversification of investment portfolios to benefit from the attractive yields offered by Sukuk.
- ❑ On average, global investors expect to allocate between \$50 million to \$500 million of their investments to Islamic financial products; which is between 40% and 50% of their portfolios being allocated to Islamic assets.
- ❑ With regards to the Sukuk supply forecast, 60.7% of lead arrangers expect Sukuk value to reach \$150bn-\$175bn in 2014 which is an increment by 30%.

SUKUK MARKET TRENDS

Global Sukuk Historical Trend by Market of Issuance (Q1 2007 – Q3 2013)

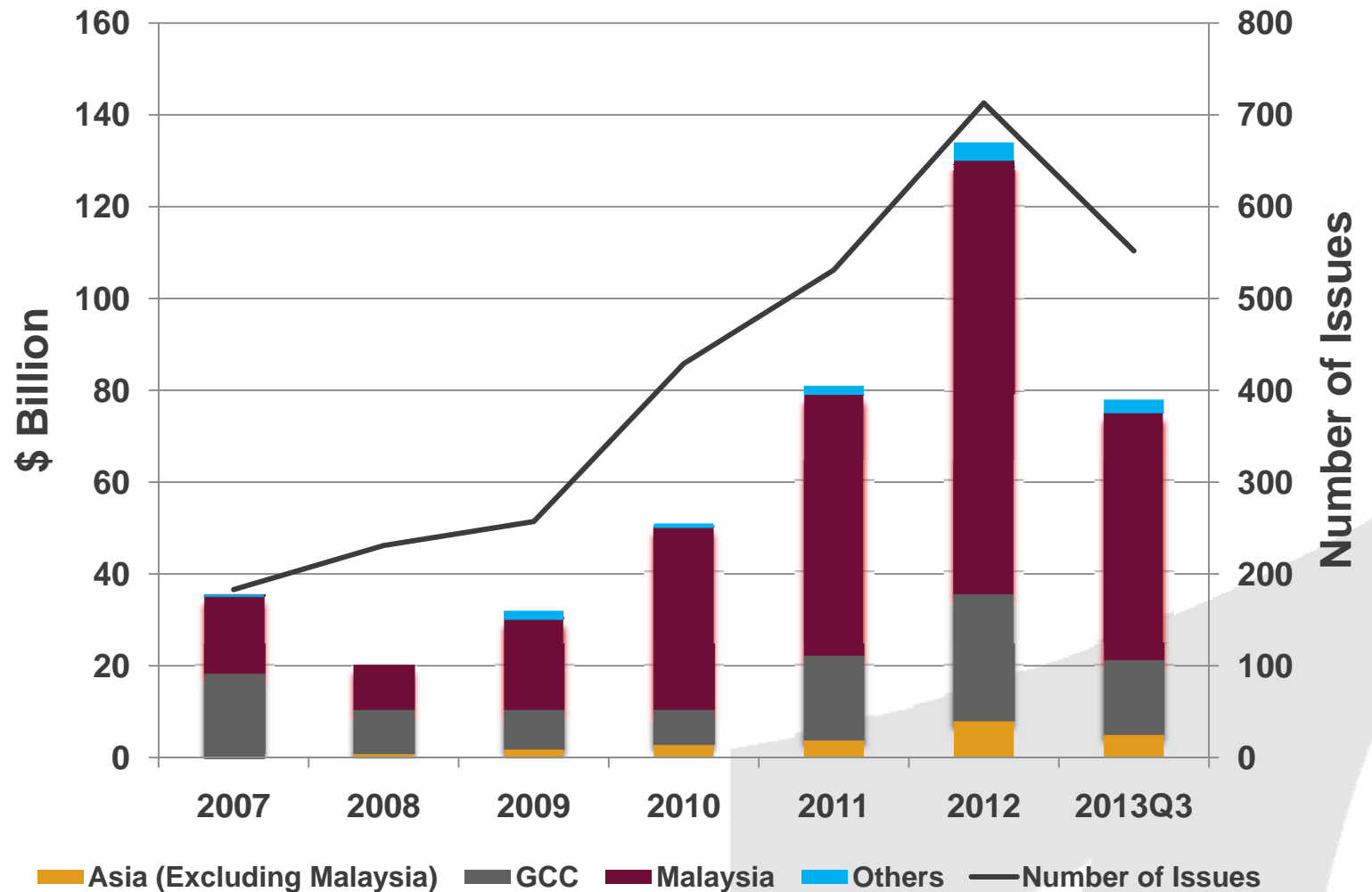


* Source: Thomson Reuters Zawya – Sukuk Perceptions & Forecast Study 2014



SUKUK MARKET TRENDS

Global Sukuk Historical Trend by Region (Q1 2007 – Q3 2013)

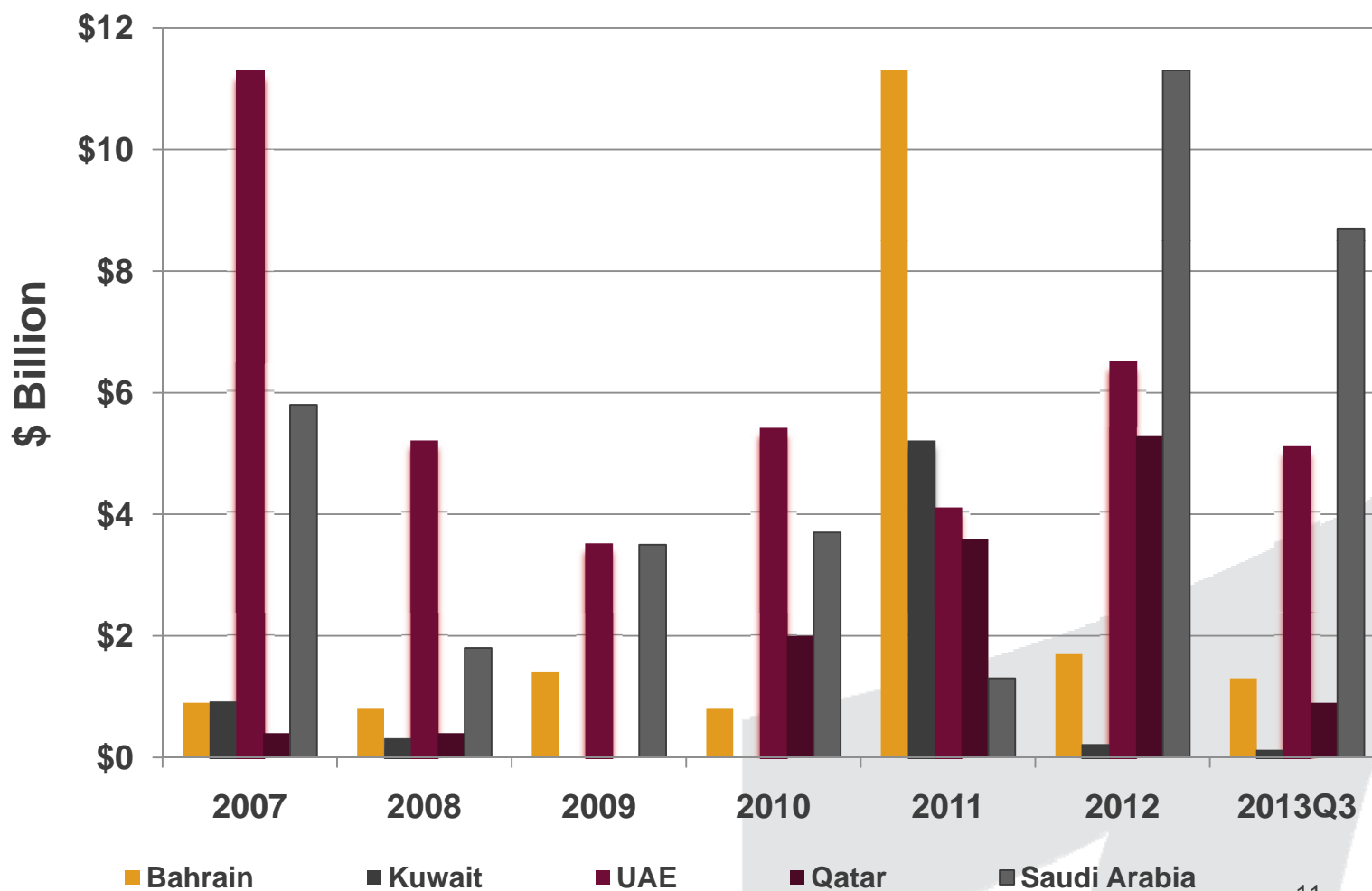


* Source: Thomson Reuters Zawya – Sukuk Perceptions & Forecast Study 2014



SUKUK MARKET TRENDS

GCC Sukuk Historical Trend Breakdown by Country (Q1 2007 – Q3 2013)



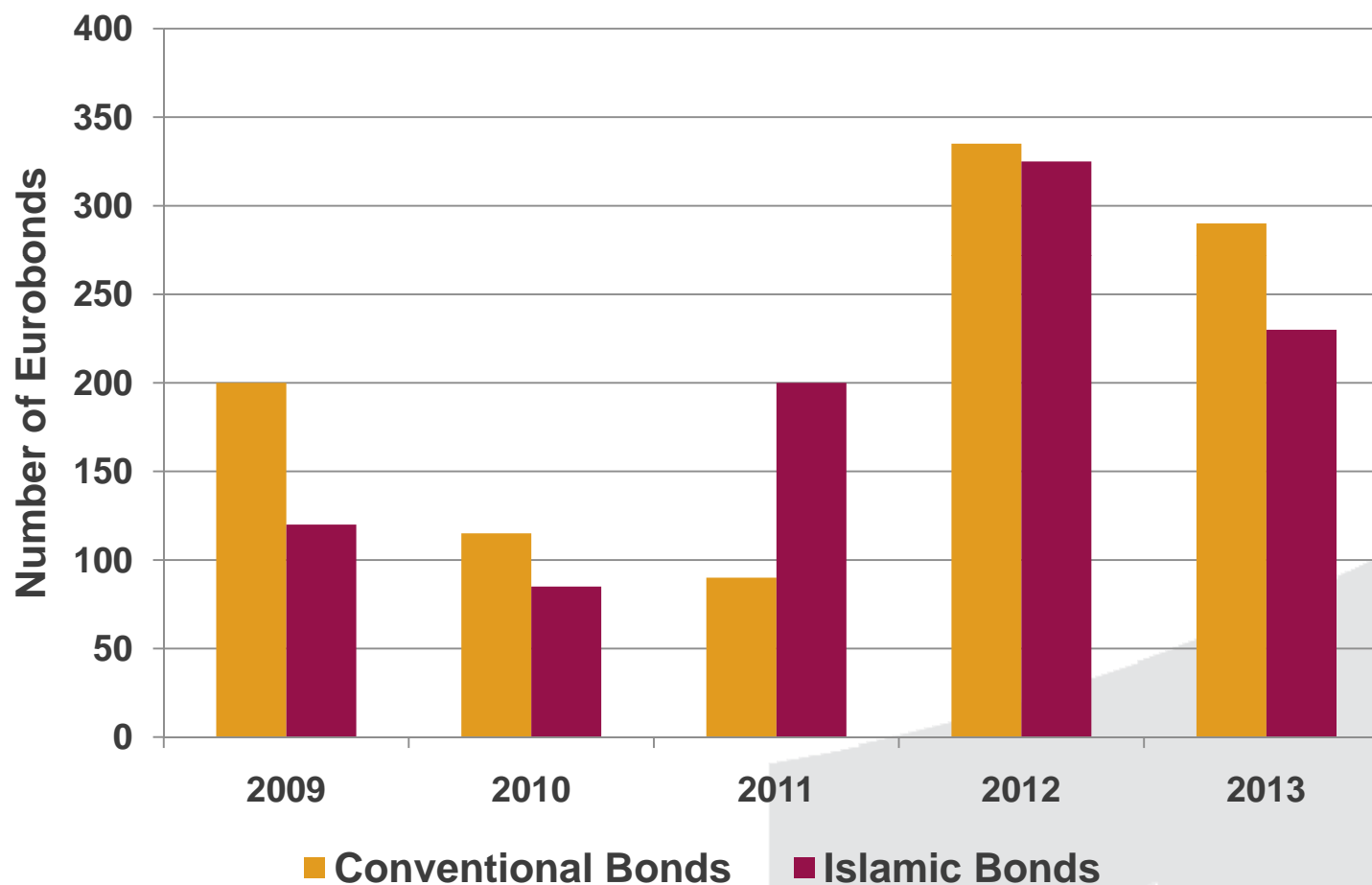
* Source: Thomson Reuters Zawya – Sukuk Perceptions & Forecast Study 2014



SUKUK MARKET TRENDS



Number of Eurobonds Issued (2009 – 2013)



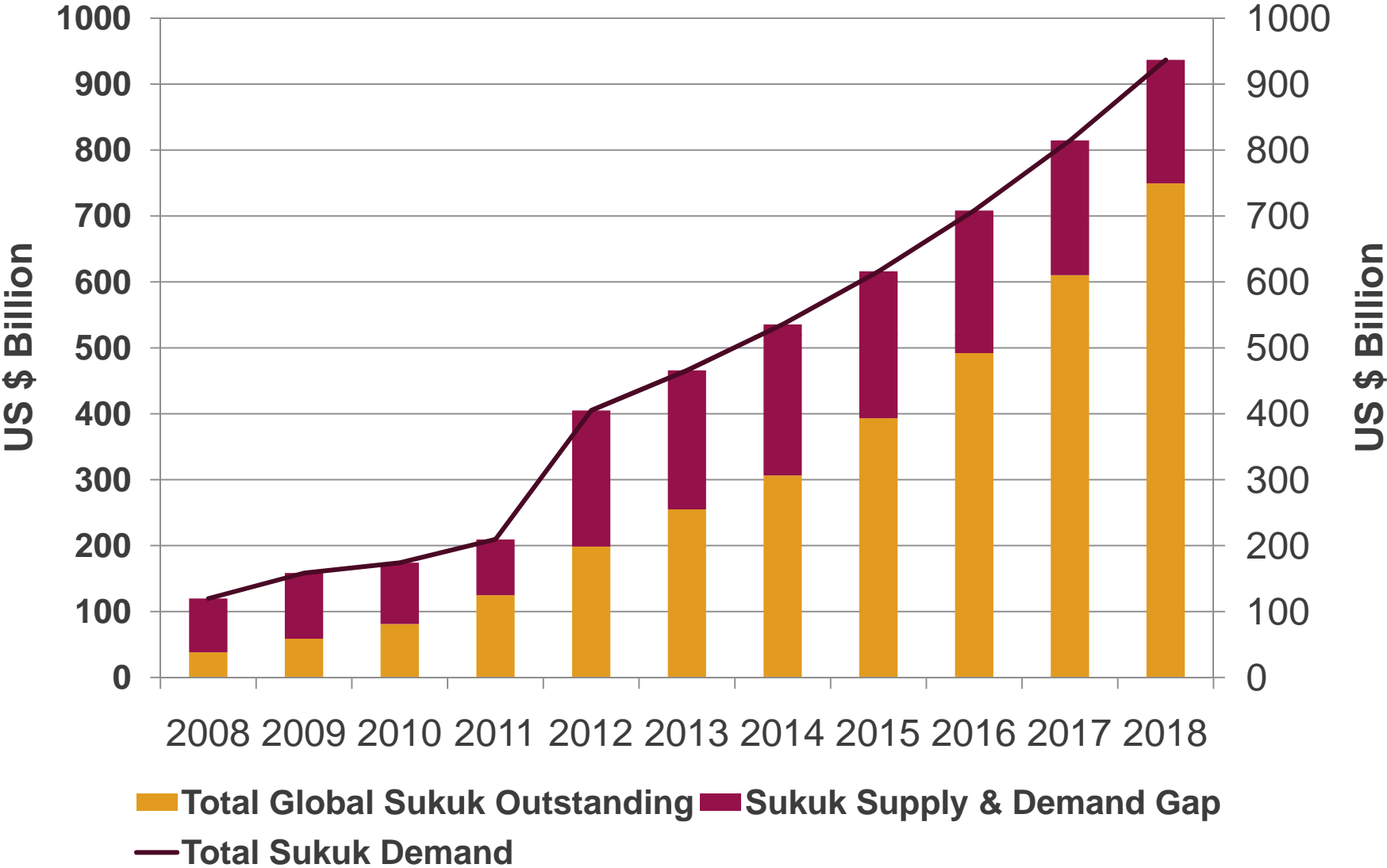
* Source: Thomson Reuters Zawya – Sukuk Perceptions & Forecast Study 2014

SUKUK SUPPLY & DEMAND

*US \$ Billion	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
% Sukuk Growth	-48%	69%	57%	58%	57%	-25%	30%	20%	15%	15%	15%
Total Global Sukuk Issued	20.21	34.12	53.71	85.12	133.72	100	130	156	179.4	206.31	237.26
Total Global Sukuk Matured	6.34	11.35	27.02	39.46	70.99	74.58	36.93	19.29	23.22	22.09	22.18
Total Global Sukuk Outstanding	38.11	58.68	81.16	124.69	198.61	255	306.47	393.26	492.03	610.23	749.38
Total Sukuk Demand	119.7	158.4	174	209.4	405	465.75	535.61	615.95	708.35	814.6	936.79
Sukuk Supply & Demand Gap	81.59	99.72	92.84	84.71	206.39	210.75	229.14	222.7	216.32	204.37	187.41

* Source: Thomson Reuters Zawya – Sukuk Perceptions & Forecast Study 2014

SUKUK SUPPLY & DEMAND GAP



* Source: Thomson Reuters Zawya – Sukuk Perceptions & Forecast Study 2014

SUKUK FUTURE OUTLOOK

- ❑ Moody's had stated earlier towards the end of 2013 that the global Sukuk issuance is likely to maintain its positive long-term growth trends due in large part to the demand for Islamic banking assets and the increasing familiarity of both Islamic and conventional investors with these instruments. Other reasons are mainly attributed to the attempts of Muslim country governments to promote financial instruments.
- ❑ Investors are confident that Sukuk and bonds will generate positive returns in 2014 according to Thomson Reuters Zawya Report on the Sukuk Perceptions and Forecast Study 2014.
- ❑ Emerging market fixed-income investors is anticipated to be higher in 2014.
- ❑ Sukuk generally have a higher issuance cost than conventional bonds in accordance with the report stated in the previous point, however, Sukuk have benefited from specialist investors who deal only with Islamic-compliant products.



SUKUK FUTURE OUTLOOK

- ❑ Sukuk Supply & Demand gap is to drop significantly by 2018 to \$187.4bn from \$230bn in 2014. Demand will continue to exceed supply up but the gap will drop by 2015 and continue to drop slightly each year until 2018 as per forecasted data.
- ❑ Oman is currently rated by investors as one of the most attractive emerging Islamic finance market for Sukuk investment highly due to the governmental support with the establishment of industry-specific legislation and infrastructure.
- ❑ African markets are considered to have the highest potential for Sukuk growth given the enabling of frameworks is established. Both sellers and buyers favor markets such as: Tunisia, Libya, Morocco, and Egypt to issue and invest in Sukuk.



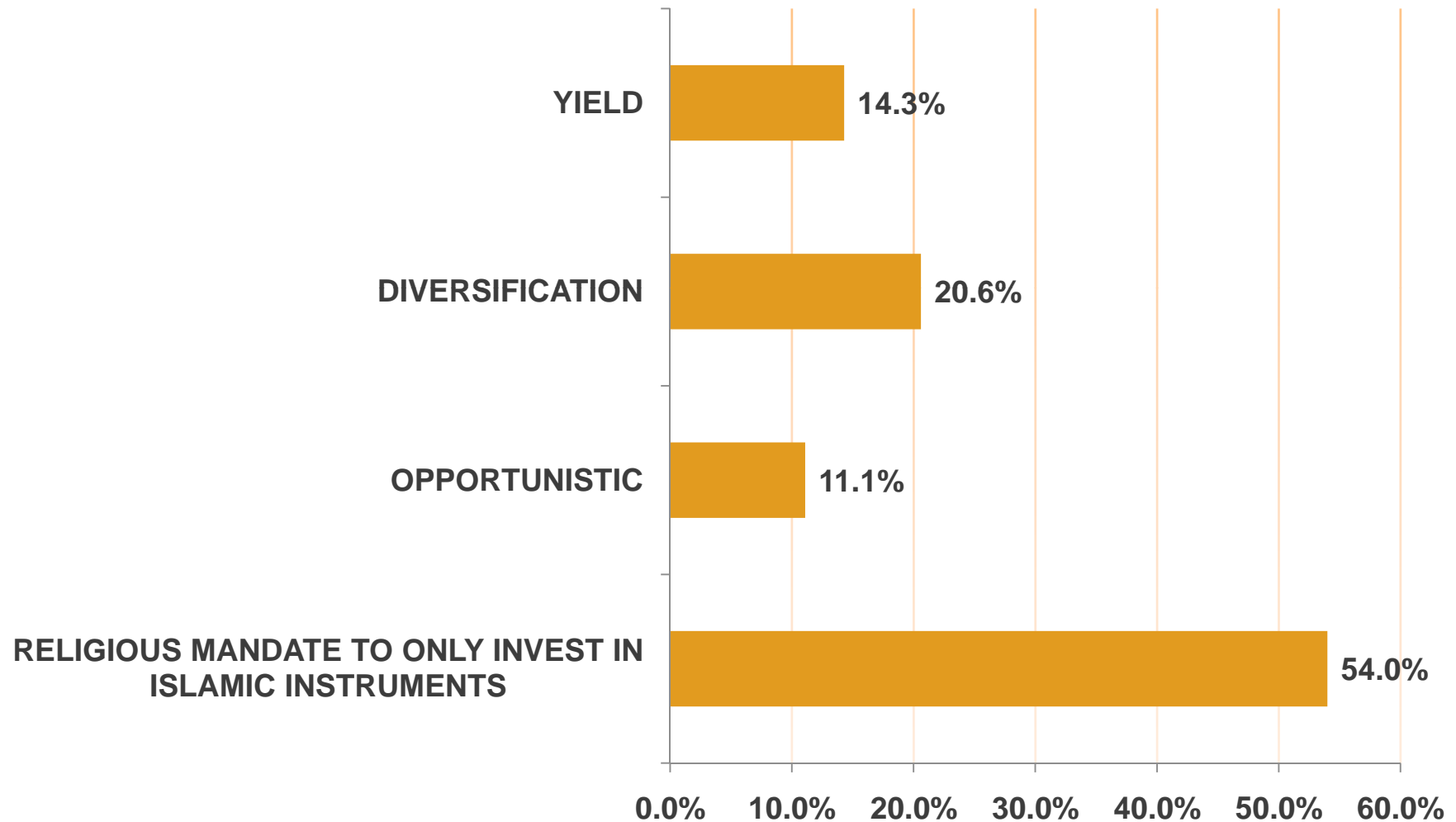
SUKUK VS. CONVENTIONAL BONDS

	CONVENTIONAL BOND	SUKUK
Primary Level Relationship	Lending and borrowing transaction (loan); which is prohibited by Islam	Variety underlying Shariah contract
Return to Investors	Interest on loan; prohibited by Islam	Profit elements in underlying contracts (sale, lease, or partnership)
Recourse	To issuer	To the rights & obligations of the contract
Tradability in Secondary Market	Sale of debt	Depends on nature of underlying assets. Majority scholars allow sale of tangible asset, some intangible asset and interest in ventures, except issues on receivables.

* Source: Sukuk: Shariah Guidelines for Islamic Bonds

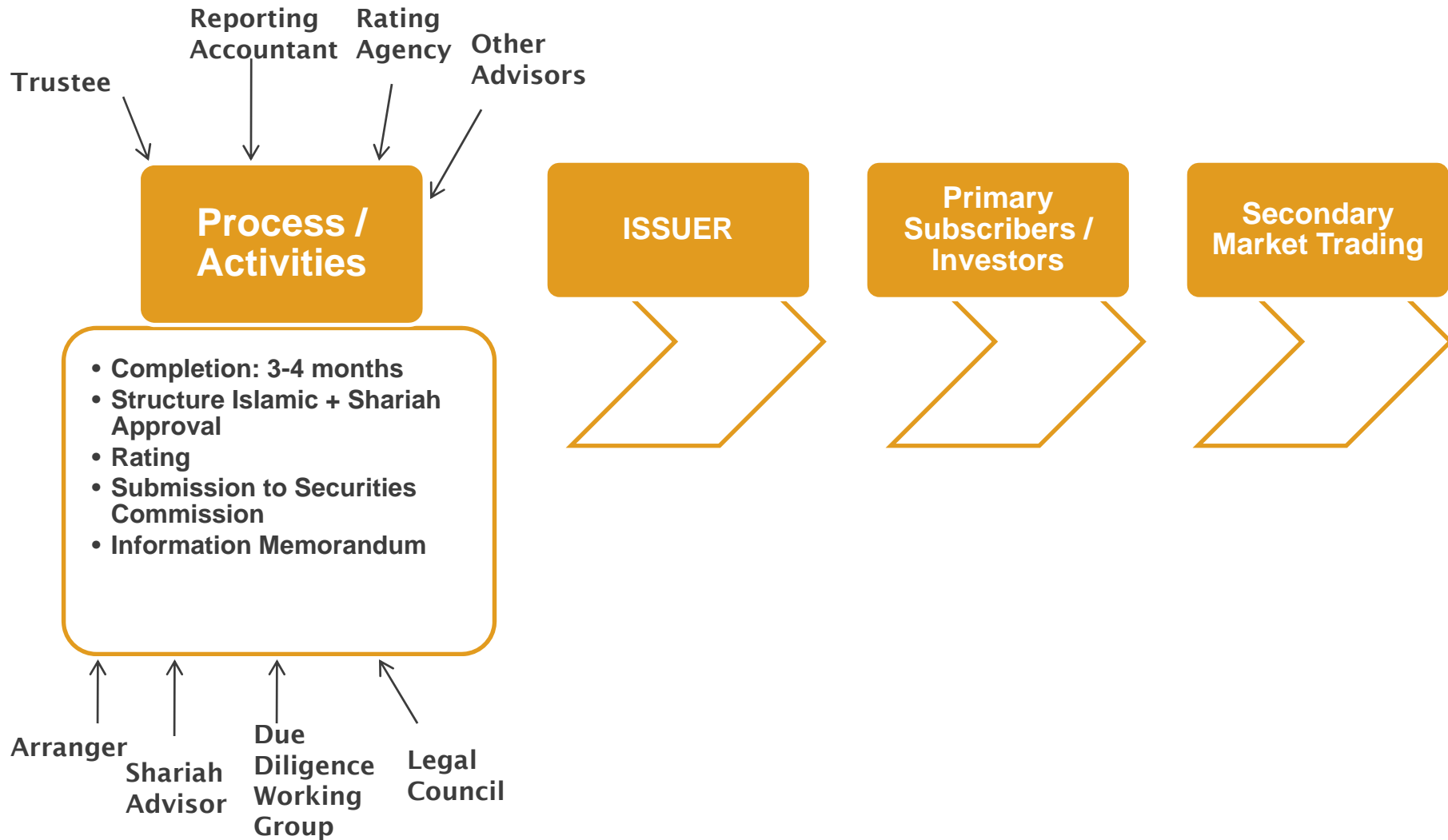
SUKUK VS. CONVENTIONAL BONDS

% of Survey Respondents on Drivers of Sukuk Demand



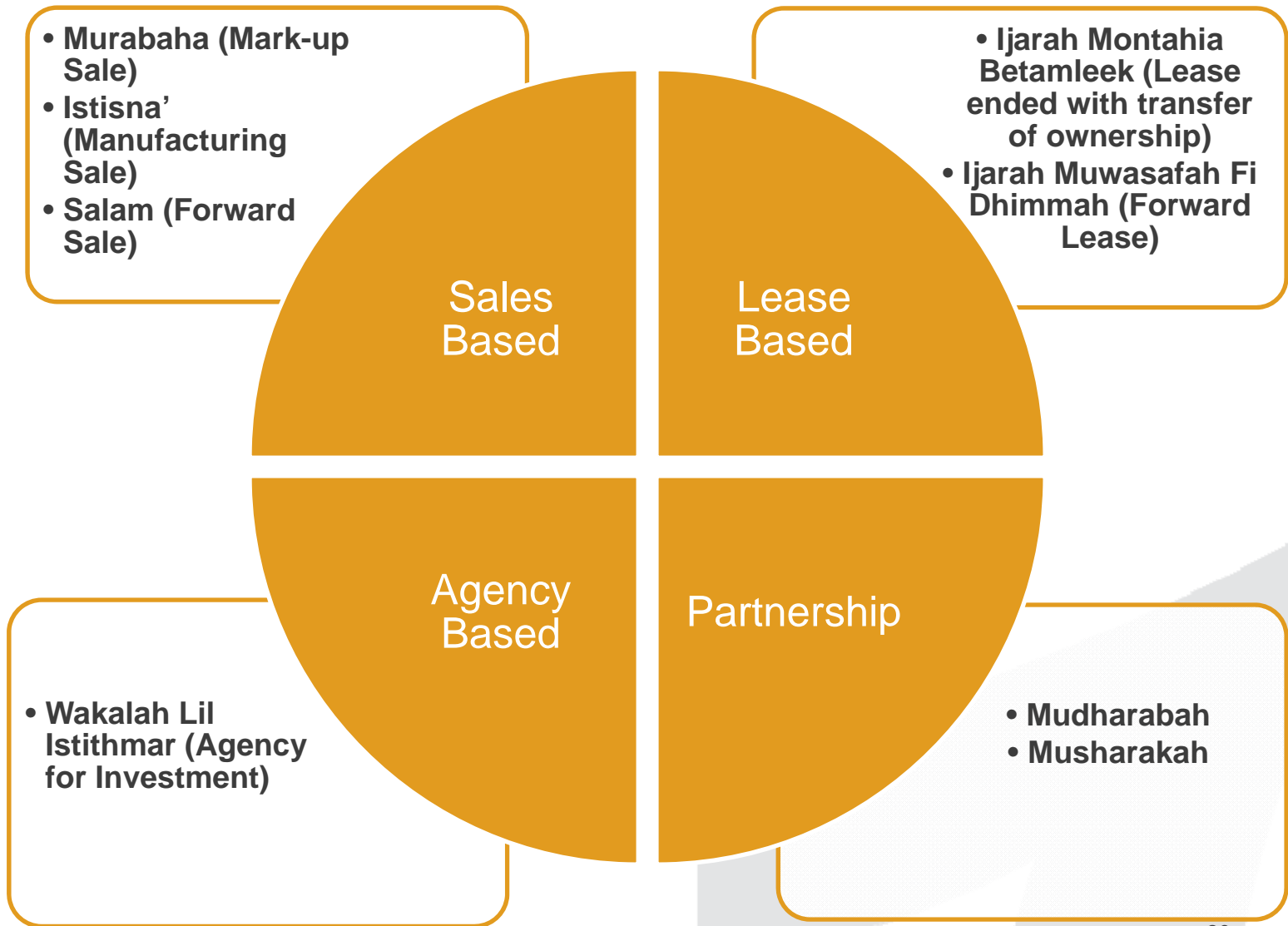
* Source: Thomson Reuters Zawya – Sukuk Perceptions & Forecast Study 2014

SUKUK PROCESS STRUCTURE



* Source: Sukuk: Shariah Guidelines for Islamic Bonds

SUKUK STRUCTURES



* Source: Sukuk: Shariah Guidelines for Islamic Bonds

FACTORS AFFECTING SUKUK PRICING

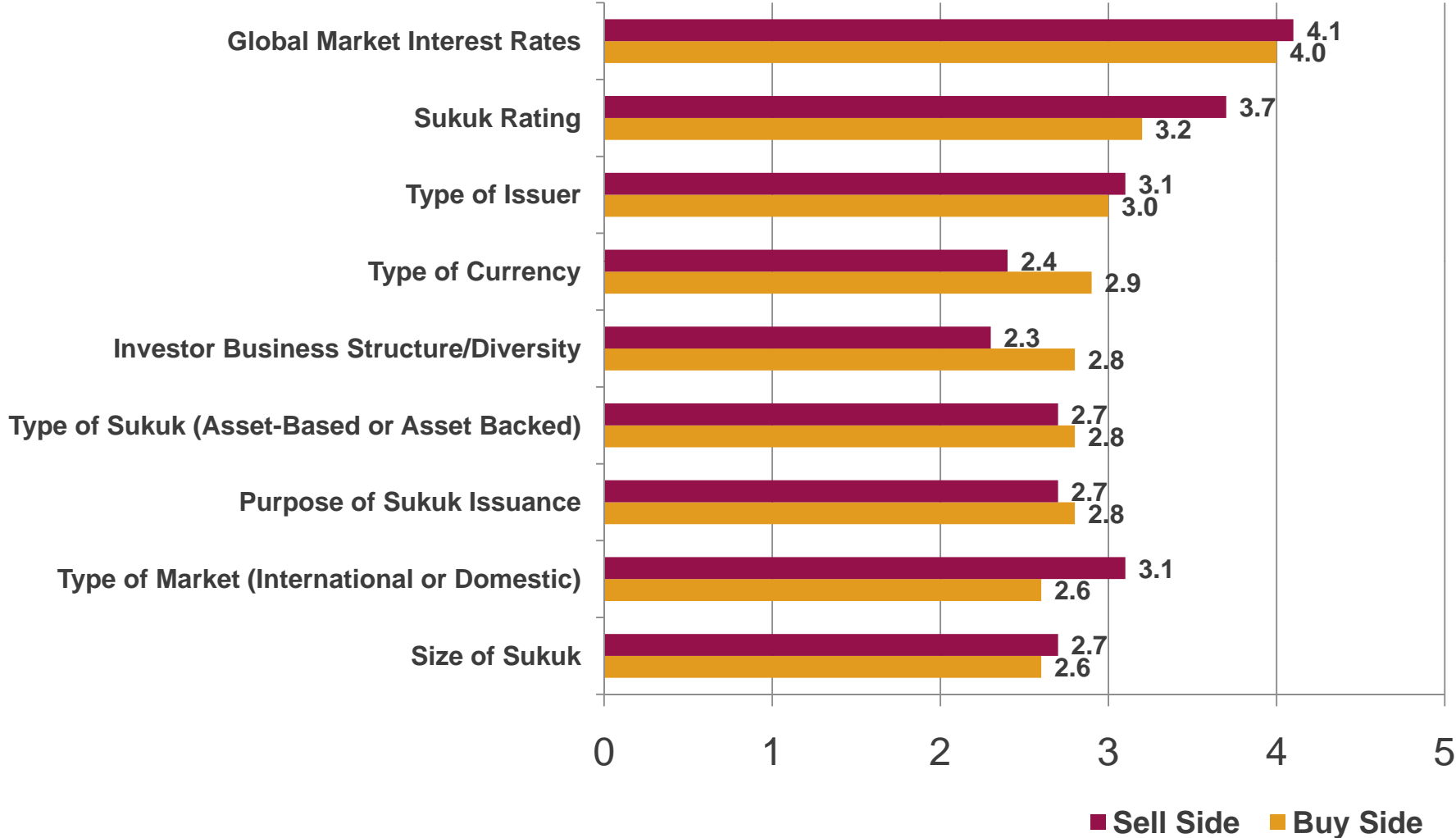
- Global market interest rates are the most important factor affecting Sukuk pricing in accordance with lead arrangers and investors.
- Sukuk rating is also deemed second in importance towards Sukuk pricing, as per the survey findings by Thomson Reuters Zawya.
- Type of issuer/SPV.
- Type of currency.
- Investor business structure/diversity.
- Type of Sukuk – Asset Based or Asset Backed.
- Purpose of Sukuk issuance.
- Type of market (International or Domestic).
- Size of Sukuk

* Source: Thomson Reuters Zawya – Sukuk Perceptions & Forecast Study 2014



FACTORS AFFECTING SUKUK PRICING

*Ranking is taken out of 5.0 from respondents of both sell side and buy side, based on the factors' importance and significance to Sukuk pricing



* Source: Thomson Reuters Zawya – Sukuk Perceptions & Forecast Study 2014

DISTINCTION BETWEEN SUKUK

NATURE	SUKUK NAME	DESCRIPTION
<p>Represents ownership of asset, its usufruct or services (the “Underlying Asset”)</p>	<p>IJARAH</p>	<p>Ijarah Sukuk is a certificate the holder of which owns in common part of an asset that has been transferred on the Ijarah contract basis. It has a fixed yield and it can be transferred to other party in the secondary market.</p> <p>Ijarah Sukuk has various types of Sukuk such as Liquidity Ijarah Sukuk, Financing Ijarah Sukuk and leasing Ijarah Sukuk.</p>
<p>Evidences of indebtedness arising from sale of asset</p>	<p>MURABAHA</p>	<p>Murabaha Sukuk are certificates of equal value issued for the purpose of financing the purchase of commodities. The Islamic financial institution purchases and takes title of the necessary equipment or goods from a third party, and sells the equipment or goods to its customer at cost plus a reasonable profit.</p>



DISTINCTION BETWEEN SUKUK



NATURE	SUKUK NAME	DESCRIPTION
<p>Evidences of indebtedness arising from sale of asset</p>	<p>ISTISNA'A</p>	<p>Istisna'a are certificates of equal value issued with the aim of mobilizing funds. This type of Sukuk has been used for advance funding of Real Estate development, major industrial projects or large equipment. The Islamic financial institution funds the manufacturer or the contractor during the construction of the asset, acquires title to that asset and upon completion either immediately passes title to the developer on agreed deferred payment terms or, possibly, leases the asset to the developer under an Ijarah Sukuk.</p>
<p>Represents ownership of units of equal value in the equity and are registered in the names of holders on the basis of undivided ownership of shares in the scheme</p>	<p>MUSHARAKAH</p>	<p>Musharakah Sukuk are securities in which its holders are owners of a specified property in common. Its holders will gain from any increase or loss from any decrease in the underlying assets prices. It has specified maturity date and is negotiable in the secondary market.</p>

DISTINCTION BETWEEN SUKUK

NATURE	SUKUK NAME	DESCRIPTION
<p>Represents ownership of units of equal value in the equity and are registered in the names of holders on the basis of undivided ownership of shares in the scheme</p>	<p>MUDHARABAH</p>	<p>Mudharabah Sukuk Are certificates that represent projects or activities managed on the basis of Mudarabah. This is an agreement made between a party who provides the capital and another party (an entrepreneur), to enable the entrepreneur to carry out business projects, which will be on a profit sharing basis, according to pre-determined ratios agreed on earlier (participation or trust financing). In the case of losses, the losses are born by the provider of the funds only.</p>



* Source: International Islamic Financial Market – Sukuk Report

SUKUK STRUCTURAL PROCESS

□ **Ijarah Sukuk:**

- 1) Issuer/SPV issues sukuk to raise funds from investors.
- 2) SPV (directly or via company as agent) purchases the asset from supplier.
- 3) SPV leases the asset to company (*Ijarah*).
- 4) Company takes delivery of the asset.
- 5) Purchase undertaking is given to ensure redemption of Sukuk.
- 6) Company makes periodic payments.
- 7) SPV distributes payments to investors.
- 8) Upon maturity, purchase undertaking is exercised and asset is transferred to company.



SUKUK STRUCTURAL PROCESS



❑ Murabahah Sukuk:

- 1) Issuer/SPV issues Sukuk to raise funds from investors.
- 2) SPV (directly or via the company as agent) purchases the asset from supplier.
- 3) Company takes delivery of the asset.
- 4) Company makes periodic payments. SPV distributes payments to investors.

❑ Istina'a Sukuk:

- 1) Issuer/SPV issues Sukuk to raise funds from investors.
- 2) SPV uses the Sukuk proceeds to pay the contractor under the Istisna` contract to build and deliver the project.
- 3) SPV sells the asset to the end user under another Istisna` contract.
- 4) End user makes periodic payment. SPV distributes payments to investors. Upon completion, the asset is delivered to end user.

SUKUK STRUCTURAL PROCESS

❑ **Musharakah Sukuk:**

- 1) Issuer/SPV issues Sukuk. Investors subscribe for Sukuk and pay proceeds to Issuer SPV.
- 2) Issuer also appointed as Trustee to manage on behalf of investors.
- 3) Trustee enters into Musharakah agreement with Originator (Obligor under Purchase undertaking and under Sale undertaking) and contributes proceeds from issuance of Sukuk into the Musharakah and is allocated a number of units in the Musharakah in proportion to its capital contribution.
- 4) Then Originator enters into sale and purchase agreement with Trustee; where Originator agrees to sell and Trustee agrees to purchase certain assets from Originator.
- 5) Issuer SPV pays each Periodic Distribution Amount to the Investors using the profit it has received from the Musharaka Assets.



SUKUK STRUCTURAL PROCESS



❑ Mudharabah Sukuk:

- 1) Investors will enter into a *Mudharabah* arrangement with the issuer (*Mudharib*) to invest in a business venture which is Shariah-compliant. The investors (as the sole primary subscribers) and the issuer shall participate in the venture. Investors shall provide the capital pursuant to the subscription of the Sukuk (Investment Certificate) issued by the Issuer and the Issuer will thereafter use the capital for the purpose of the said venture. The investor and issuer will agree upfront the profit distribution that will be shared based on a profit-sharing ratio.
- 2) The Issuer will make a Trust Declaration over Trust Assets for the benefit of the Sukuk-holders who are participating in the business venture.
- 3) The Issuer will also grant a purchase undertaking to the Trustee whereby the Issuer will acquire the Sukuk upon maturity or dissolution event.
- 4) Income from the venture will be distributed periodically as agreed.

REFERENCE / RESEARCH

- ❑ Thomson Reuters Zawya – Sukuk Perceptions & Forecast 2014
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- ❑ Sukuk: Shariah Guidelines for Islamic Bonds by Bank Islam Malaysia Berhad & Amana Bank
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- ❑ Moodys.com –Investor Service – Global Credit Research (27 Nov 2013)
- ❑ <http://Sukuk.info/>
- ❑ Islamic Development Bank Website
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THANK YOU FOR YOUR KIND ATTENTION !

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