SWEET SUKUK

ISLAMIC BONDS CAN BE AN IMPORTANT SOURCE OF CAPITAL FOR EUROPEAN CORPORATES, SAYS NOEL LOURDES

For investment-grade corporates, raising finance is no longer an issue in the bond markets due to the slush of money available in the wake of quantitative easing. But it was not so long ago – 2008, in fact – that the corporate bond markets seized up, shy of entertaining new issuance. The conventional bond market is fickle, easily spooked and, right now, desperately chasing yield. Without central bank intervention, this market would probably cease or, at least, become less active.

The Islamic bond market, or sukuk market, on the other hand, offers an alternative and sustainable source of capital. The ultimate investor pools are sovereign wealth funds, occupational pension funds and the retail and corporate Islamic financial institutions of the Arabian Gulf, which generate their capital from real economic activity and high savings rates within their domestic economies.

The Islamic institutional (sharia-compliant) investor will not invest in a conventional bond since it is structured as an interest-bearing instrument. Under Islamic law the charging of interest is prohibited. But these sharia-compliant investors do operate under the fixed income investment model. Therefore, their tolerance towards risk and reward is no different to the conventional fixed income manager.

With Islamic bonds, fixed rates of interest are replaced with leasing structures or other mechanisms that tie the underlying revenue of the issuer to the investor, thereby establishing a closer relationship between reward for effort or risk. Without changing the commercial terms of the transaction, the issuer can amend the documentation and put in place an Islamic structure to facilitate a bond issuance that could be placed globally and include investors in the Middle East and most of Southeast Asia. Contrary to the conventional bond, an Islamic bond (or sukuk) can be purchased by all investors.

There are myths that the execution costs are prohibitive. Five years ago they probably were, but this is no longer the case. Sukuk documents are now 'commoditised' and top-tier law firms are familiar with the work and time that is required to execute them.

The cost of capital in the Islamic bond market is competitive. The risk-free rate is US treasury yield for bonds issued from the countries in the Gulf Cooperation Council (GCC), which consists of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates, and Malaysian government securities for bonds issued out of Malaysia. Overall, our experience is that investment-grade entities can attract similar (or better) pricing from the Islamic capital markets. On rare occasions, investors will buy bonds issued by sub-investment-grade entities. For example, during the height of the Greek bond crisis, the Turkish government issued its inaugural Islamic bond. It raised $1.5bn over five and a half years with this bond, which was rated BB. The bond had a coupon of 2.8% (8bps lower than the Turkish government's conventional cost of financing). Demand for the issuance was high. It was more than four times oversubscribed and 58% of investors came from the Middle

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ISLAMIC FINANCE: WHAT YOU NEED TO KNOW

- The best time to look for new sources of capital is when you don't need them.
- **Get an investment-grade rating from an international rating agency.**
- Use any deals or operations you have in the Middle East or Asia to sell your story.
- **Minimum issuance size is €100m. Tenure should not exceed seven years.**
- The sweet spot for bonds is three- to five-year maturity. There is a shortage of short-term papers.
- **The global investment banks are not independent and they do not control this market.**
- Prepare a programme issuance in Malaysia. The set-up costs are low and you have two years in which to issue your paper.
- **It does not cost to explore Islamic finance. If it works, it will be worth the effort.**
- Get an independent adviser to ensure that you get the best deal for you.
- **If your company is expanding its operations into the GCC region or Malaysia, it can issue sukuk to raise funding and increase awareness in the way that Tesco has.**

East. And although the bond was not actively marketed in the US or Europe, 13% of investors were from Europe and 8% from the US. This demonstrates the wide appeal of the Islamic bond.

Multinational corporates that have tapped into the Islamic bond markets include US conglomerate General Electric, supermarket giant Tesco and banks Nomura and the International Bank for Reconstruction and Development.

The two main capital markets for issuing sukuk are the GCC and Malaysia. Foreign issuers will need to have a minimum Standard & Poor's BBB- rating or equivalent.

Interestingly, Malaysia as a single jurisdiction accounts for over 60% of global sukuk issuance. It has more transactions than the entire GCC combined. The reasons for this are its strong securities commission and central bank, which provide a robust regulatory framework, its English-speaking workforce, low transaction costs and deep pool of capital. Nevertheless, the situation is slowly changing as the GCC markets that have long lagged behind Malaysia are beginning to catch up. This is good for issuers since greater competition among investors from both regions leads to innovation and better pricing.

Traditionally, sukuk issued in Malaysia are only rarely subscribed to by Middle Eastern investors due to their marked preference for locally originated deals. In the past, there have been a few issues with interpretation of Islamic law, which proved a deterrent to the growth of the sukuk market. Now sukuk structures exist that have been widely distributed into both Malaysia and the GCC countries.

Once a corporate treasurer has made a decision to diversify their source of capital by accessing the Islamic capital markets, the next decision is to choose a jurisdiction in which to originate the issuance: Malaysia or the GCC. The table (below left) is a brief comparison for a €1bn programme.

Both markets have their own merits. If the cross-currency SWAPs make sense, we have a preference for structuring a deal out of Malaysia and placing it in both territories since this can work out cheaper.

Certain sectors are prohibited from tapping into the Islamic capital markets. Under Islamic law, the following sectors are prohibited: alcohol, tobacco, gambling, military, conventional financial and insurance entities, and certain forms of entertainment.

Conventional banks are prohibited from issuing capital into the Islamic capital markets. But some global banks have been smart in reorganising themselves by opening Islamic windows (subsidiaries) to raise Islamic funds and use them in a sharia-compliant manner.

Islamic investors have a preference for real estate with long-term income. In time, we may see a sharia-compliant real estate investment trust for UK and European real estate. The other two asset classes of choice are infrastructure and aviation. Many aviation leasing companies are exploring the potential of securitising their leasing income through the Islamic capital markets.

Ignoring the Islamic capital markets is no longer an option for the savvy corporate treasurer. It is a €1.6 trillion-a-year market with an annual growth rate of 15% to 20%. If you can structure your next bond issuance so that it can be placed in both your traditional market (Europe or US) and the Middle East and Southeast Asia, then you're widening your investor pool, diversifying your sources of funding and potentially securing a better cost of capital.

ISLAMIC CAPITAL MARKET JURISDICTIONS

	MALAYSIA	MIDDLE EAST
CURRENCY OF ISSUANCE	Malaysian ringgit	US dollar
STRUCTURE	Regulators are open to a wide variety of structures to enable unsecured issuance	Less variety due to more strict interpretation of Islamic law
RATING REQUIREMENT	Essential to get rating from local rating agency	Issuer can use existing international rating
LEGAL FEES	Up to $200K	Up to $400K
GOVERNING LAW	Malaysian law	English law
ISSUING FORMAT	Securities Commission Malaysia format	Regulation S
TIME TO EXECUTION	8-10 weeks	8-10 weeks

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