Islamic capital markets: Here to stay

In the backdrop of capricious global financial markets, 2013 was a year the Islamic capital markets were presented with the opportunity to demonstrate their resilience in the face of challenging economic conditions.

With US$66.6 billion-worth of Sukuk issuance for the first nine months of 2013 (according to Dealogic), the Islamic debt sector missed the projections of optimistic bankers and analysts with its less-than-robust performance, particularly when compared to the record-breaking year of 2012 which saw total Sukuk offering of US$140 billion. A major contributing factor to the slow-down in Islamic issuance last year was the uncertainty surrounding the tapering of the US Federal Reserve's quantitative easing program which sent shockwaves across markets shaking investor confidence, and in turn led to a three-month market "shutdown" from July to September.

Despite this, the year was nonetheless stage to a steady performance by the industry's leading markets (Malaysia and Saudi Arabia), which continued to enhance their positions as industry stalwarts, as well as an arena for the showcase of formidable strength by new entrants such as Turkey. Beyond the Sukuk sector, the overall Islamic funds sector demonstrated considerable growth in 2013 with the launch of at least 78 new Shariah compliant funds, marking an impressive 10.2% growth in assets under management (AuM), according to figures from Eurekahedge and KFH Research. Posting a cumulative annual growth rate of 9.41% since 2009, the Halal fund industry is valued at approximately US$73.7 billion (as at the 9th December 2013) and has seen the number of funds grow four-fold, from 285 funds in 2004 to approximately 1,053 funds as at the end of 2013.

Emergence of different asset classes

Since the inception of Islamic banking operations in the 1970s, Shariah-seeking investor appetite has grown in its sophistication reflected in the innovative Islamic financial products available. Moving away from senior unsecured debt capital market instruments, which were most popular in 2012, 2013 saw the emergence of different assets classes and notably the rise of syndicated financing.

"Within the Sukuk space itself, we have seen the transition from pure debt capital instruments into hybrid and equity-like structures," elucidated Ahsan Ali, the head of Islamic origination at Standard Chartered Bank (Dubai), to Islamic Finance *news*. "This allows concepts such as Mudarabah and Musharakah to be applied instead of just Ijarah," added Ahsan.

Last year marked the debut of the Arabian Gulf's first-ever hybrid Sukuk issue by Saudi Arabia-based dairy producer Almarai followed by global private school operator GEMS Education. Facing a dearth of hard assets, companies and governments were more creative in the structuring of their products by utilizing non-asset-based or asset-light structures to back Sukuk as exemplified by Emirates Airline who came to market with a 10-year amortizing Sukuk.

Tier 1 Sukuk became an increasingly attractive cost-effective funding vehicle, as demonstrated by the launch of Tier 1 capital

Sukuk by Abu Dhabi Islamic Bank (at the end of 2012) and Dubai Islamic Bank; bearing testament to the appeal of Tier-1 issuances as means to reach a wider investor base without diluting shareholders.

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Such offerings were not only driven by the growing demand among investors for equity-based products but also illustrative of the adaptive nature of issuers preparing themselves to meet Basel III standards as financial institutions would require relatively high levels of capital adequacy to protect depositors and borrowers. And the move into hybrid capital instruments is expected to continue in 2014 especially among corporates.

Syndicated financing: On the rise

In the case of the growing popularity of syndicated financing, Ahsan said: "Issuers in the GCC and Malaysia are trying to maximize the investor base by carving out Islamic tranches either in the form of Sukuk or syndicated financing. Within the project financing and corporate financing areas, we saw more big ticket deals comprising both Islamic and conventional facilities."

Islamic syndicated financing will continue to be a major theme in 2014 especially in the light of massive infrastructure investment across key Islamic markets including Dubai, Saudi Arabia and Qatar, and in the broader Gulf region as economic growth in the GCC is expected to rise to 4.7% from 2013's 3.7%, boosted by expected non-oil sector infrastructure spending.

It is projected that the infrastructure sector could be worth up to US$2.5 trillion as Middle Eastern countries commit themselves to development plans. These include: Kuwait with a US$108 billion economic development strategy and Oman, which recently affirmed that it will continue its infrastructure projects in a bid to diversify its economy; the sultanate allocated US$4.7 billion for development projects in its 2013 budget. Major projects are also in the pipeline for Qatar, as it will host the 2022 World Cup, and Dubai following its win of the World Expo 2020. This spate of infrastructure funding needs will indeed spur the Islamic capital markets in the region.

Longer-term funding appeal

Last year, Saudi Electricity Company carved a name for itself by becoming the world pioneer of an international 30-year Sukuk which was oversubscribed by over five times to the tune of US$5 billion – a landmark deal that paved the way for longer tenor financing.

Latest data from Dealogic shows that more than half (65.9%) the Islamic financing facilities signed in 2013 carried tenors of at least

Case Study: Emirates

Issuer	Emirates/Medjool
Instrument	Regulation S/Senior unsecured amortizing Sukuk
Issuer principal activities	Airline
Issue size & pricing	US$1 billion
Date	12th March 2013
Profit Rate	3.875%
Spread vs mid-swap	Five-year mid-swap + 300bps
Joint Lead Managers	Standard Chartered Bank, Abu Dhabi Commercial Bank, Abu Dhabi Islamic Bank, Citigroup, Dubai Islamic Bank and Emirates NBD
Legal counsel for issuer	Allen & Overy
Legal counsel for arrangers	Linklaters
Listing	NASDAQ Dubai

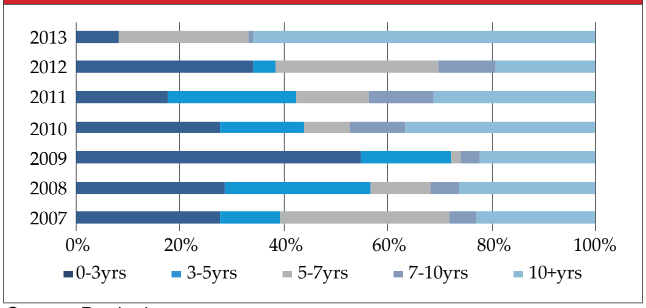
In March 2013, Emirates Airline, a leading international air carrier, issued a 10-year US$1 billion Reg S Senior Unsecured Sukuk due in 2023. The 10-year Sukuk has an average life of five years and was executed as a standalone issuance.

Standard Chartered acted as joint global coordinator and joint lead manager. The innovative issuance represents the first ever amortizing Sukuk executed in the international markets as well as the first Wakalah structure based on rights to travel and services relating to passenger routes operated by Emirates.

- Under the Islamic structure, Emirates sells to an SPV, out of Emirates' total available capacity measured in available ton kilometers (ATKMS), certain rights and services comprising (i) the right to travel on any passenger route operated by Emirates and (ii) services ordinarily provided by Emirates to passengers travelling on such route (the rights to travel) in each case in accordance with its normal terms of business and operating procedures applicable thereto. ATKM is the airline industry measure of total capacity calculated as the total tonnage available for the carriage of passengers and freight multiplied by the distance flown.
- The SPV subsequently appoints Emirates as its service agent to periodically sell passenger tickets corresponding to the rights to travel a minimum sale price sufficient to fund the periodic distribution amounts and principal payments payable to the certificateholders.
- Pursuant to a Purchase Undertaking or Sale Undertaking (as applicable) Emirates shall purchase, upon the occurrence of an event of default (or any other early redemption event as applicable), any unsold rights to travel at an exercise price sufficient to redeem any outstanding certificates in full.

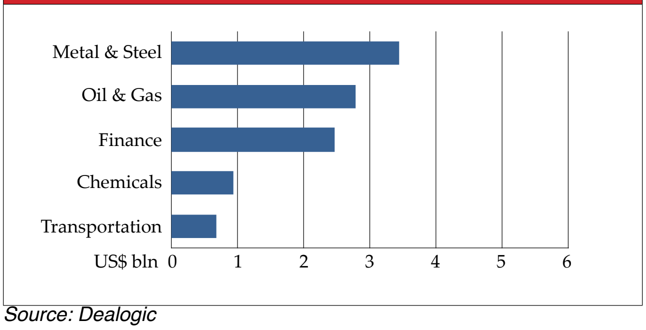
Execution occurred amid a busy issuance window for the region's credit market and its success highlights the effectiveness of the overall marketing strategy and the continued appeal of Emirates credit in the international markets. The appeal of the issuance was also reflected by the pricing achieved on the transaction at US$ five-year mid-swap plus 300bps for an issuance size of US$1 billion. The Sukuk orderbook was well diversified and three times oversubscribed. Emirates was able to further diversify its sources of financing and capitalize on the strong Islamic liquidity to achieve its overall objectives.

Global Islamic loans - years to maturity (YTD comparison)



Source: Dealogic

Top Islamic finance related loans by sector *12 Months*



Source: Dealogic

10 years, a significant leap from the 19.27% recorded in 2012. From the pool of Islamic financing issued in 2012, the largest share was held by facilities with maturities of 0-3 years (34%), however this figure fell to less than 10% last year reaching 8.2%.

This shift towards Shariah compliant papers of longer maturities is attributed to the increased number of long-term infrastructure projects underway and the lingering after-effects of the financial crises which opened the eyes of investors to the advantages of longer-term financing; and it is anticipated that this trend will continue in 2014.

> **"Malaysia and Saudi Arabia also led the Islamic funds market with both accounting for 63.1% (US$46.5 billion) of the total industry AuM as at the 9th December 2013"**

Reigning champions

Heavyweights Malaysia and Saudi Arabia continue to dominate the Islamic capital landscape with Malaysia's domestic market accounting for 63.6% of the total global Sukuk market share (as at the end of last August) and also US$54.33 billion of the US$75 billion new Sukuk issued globally over the first nine months of 2013; while the Saudi domestic market continues to grow from strength to strength issuing US$8.69 billion in the same period, followed by the UAE at US$5.17 billion. Malaysia and Saudi Arabia also led the Islamic funds market with both accounting for 63.1% (US$46.5 billion) of the total industry AuM as at the 9th December 2013.

In addition to that, almost half (48%) of the world's Islamic funds were domiciled in these two jurisdictions, proving again in 2013 that Malaysia and Saudi Arabia were the preferred Islamic funds domiciles. Analysts predict these two major players will continue to be the Shariah compliant fund origination destination for 2014 due to the availability of a diverse range of Islamic capital market instruments, comprehensive legal and regulatory frameworks and a ready pool of interested investors with high liquidity.

In terms of top Islamic finance-related financing by sector, the metal and steel sector topped the table with a 29.1% share according to January data from Dealogic (12 months rolling), followed by the oil and gas sector (24%), finance (21.3%), chemical (8.1%) and transportation (5.6%).

Ahsan predicts that the Islamic finance landscape in 2014 will see the emergence of the power and utilities sector, the continued dominance of the oil and gas industry and a spike in demand for Halal financing from the transportation and infrastructure as well as real estate sectors.

Exciting markets

Beyond the Middle East and Malaysia, industry participants have kept their eyes on Africa in recent years especially over the

last year as countries such as Nigeria and Kenya reaffirm their Islamic finance ambitions through strong political will.

While Kenya may bear the torch for the Takaful sector in the African continent, Nigeria cemented its position in the Islamic capital market with its debut Sukuk, worth NGN10 billion (US$62.53 million), out of the state of Osun. Following suit in Nigeria's landmark step, the government of Senegal in October signed a Sukuk agreement with the Islamic Corporation for the Development of the Private Sector, becoming the first country in the West African Economic and Monetary Union to do so. Other sub-Saharan nations including South Africa and Kenya have also been laying plans to issue Sukuk, with South Africa expected to join the market in the first quarter of this year.

"The Sukuk market will continue to develop at a good rate of growth. There may have been some ups and downs, but the overall market momentum over the past 10 years has been quite positive. We believe this positive momentum and growth will continue in the foreseeable future"

"Currently, most of the African countries are in early stages of Islamic finance and Islamic capital market development. We expect to see some issuances coming from this region in 2014, and we hope these issuances can act as catalysts to quicken the pace of Sukuk market development in this region," commented Ahsan.

Stepping out of African borders, the most exciting emerging market in 2013 could have very well been Turkey. The government's US$1.25 billion sovereign Sukuk offering last October continued the momentum gained in the Turkish Islamic debt capital space which kick-started with a US$250 million subordinated Sukuk issuance earlier in the year, followed by Bank Asya's application to the Capital Markets Authority to sell Sukuk worth up to TRY1 billion (US$443.18 million); and Ahsan is optimistic on a corporate Sukuk issuance from Turkey this year. Yet despite the good record set, it will take more than Islamic debt issuances to keep the Islamic capital gears moving as the republic struggles to rebuild itself from the recent political scandals that have shaken the core of Turkish society and had an adverse effect to its economy.

Moving into the west, making headlines across the world in October was the UK with its long-awaited announcement of a sovereign Sukuk. The GBP200 million (US$330.34 million) Sukuk, while a relatively small issuance, has and will continue to create waves in the industry as players are optimistic of the long-term impact this high quality instrument will have on the global Islamic capital markets including a spur in activities within the pensions and insurance space.

Growing pool of liquidity: Cannot be ignored

While the Islamic finance industry was relatively shielded from the global financial crisis, last year's issue with the US Federal Reserve quantitative easing program illustrated the interconnectedness of the Islamic capital markets with the international markets.

"The Sukuk market is tied to emerging markets as majority of issuers are from emerging markets. Hence, whatever that affects these emerging markets will affect Islamic capital markets as well," explained Ahsan.

Unresolved challenges of the sector include relatively lower secondary market liquidity compared to conventional bonds, limited availability of risk management and liquidity tools, the lack of enabling regulations as well as discrepancies in Shariah standards.

Yet despite these challenges and a subdued 2013, the Islamic capital market, in particular the Sukuk market, is here to stay. "The Sukuk market will continue to develop at a good rate of growth. There may have been some ups and downs, but the overall market momentum over the past 10 years has been quite positive. We believe this positive momentum and growth will continue in the foreseeable future," affirmed Ahsan.

Challenges will always be present including external funding challenges that are beyond the control of the issuers and investors; however the Islamic liquidity pool is also growing and issuers, both conventional and Islamic, cannot afford to ignore the immense opportunities that come with it. And the general sentiment is that 2014 will be a fruitful year for the Islamic capital markets. Experts' opinion is that issuers should complete all the required groundwork and be ready and prepared to issue when the opportune market window opens to tap into this vibrant space.