SUKUK REVIVAL

THOMSON REUTERS SUKUK MARKET OUTLOOK 2018

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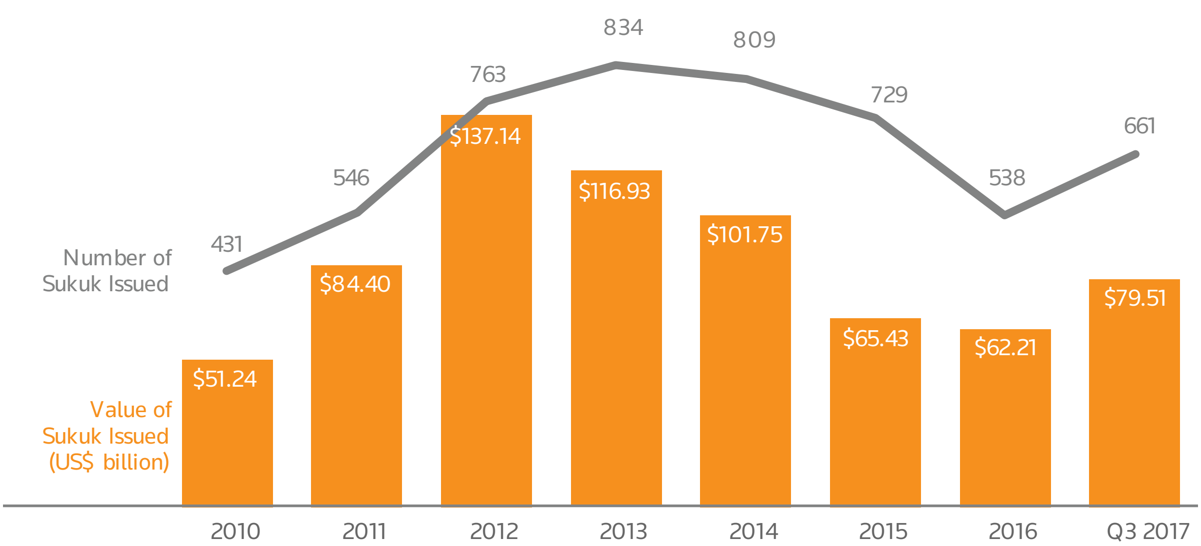
Saudi Arabia becomes the largest sukuk issuer in the first nine months of 2017

The sukuk market recovered in the first nine months of 2017, thanks to Saudi Arabia and Malaysia issuing over $48 billion combined, representing 61% of the total amount issued.

Saudi Arabia has taken the sukuk market to a whole new level by issuing over $25 billion in the first nine months of 2017. The kingdom now for the first time holds the biggest sukuk market share, at 32.0%, followed by Malaysia with 29.3% and Indonesia with 8.8%. The impact of low oil prices has pushed governments to raise substantial capital, and reliance on sukuk has become evident.

Global Sukuk Issuance Historical Trend (2010 – 2017 Q3)

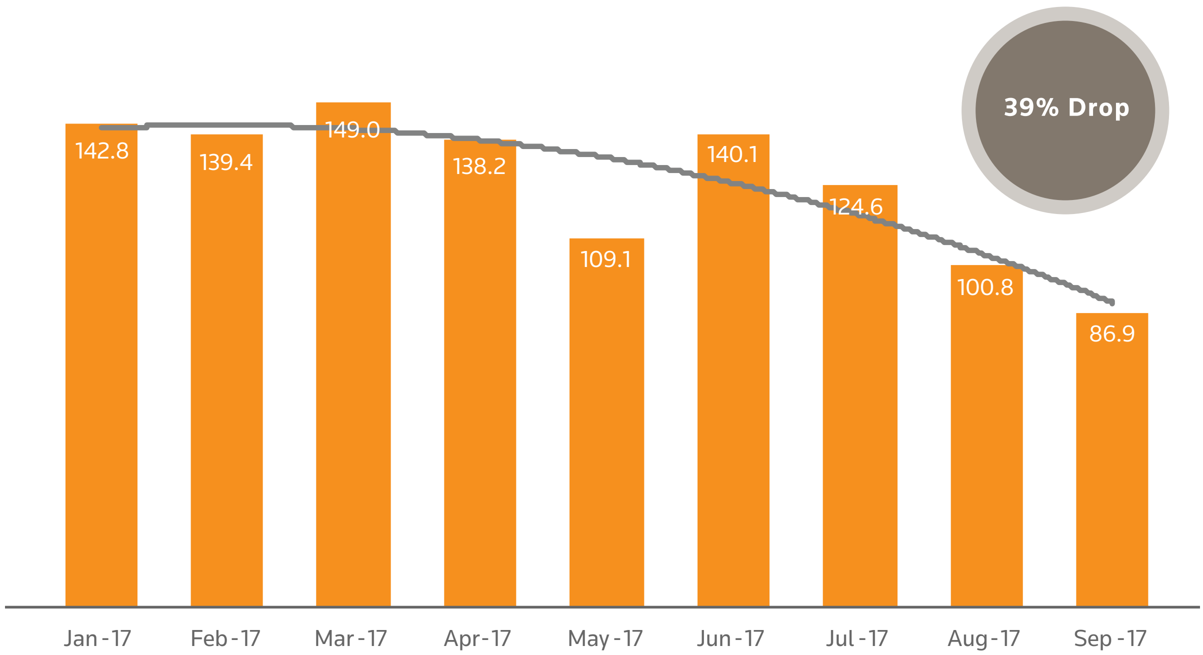


Investors breathe a sigh of relief

Shariah-compliant investors have struggled so long that central banks' low-yielding reserves accounts and interbank deposits had become a new investment avenue for Islamic financial institutions to deploy their excess liquidity. This was the result of low sukuk supply in the market following a drop in annual sukuk issuance to between US$ 50 billion and US$ 60 billion.

This year, however, Saudi Arabia has poured over US$ 25 billion worth of sukuk into the market through domestic and international issuances, creating substantial investment opportunities. The need for sukuk in the local market was so evident that banks deposits held by the Saudi Arabian Monetary Authority (SAMA) witnessed a sharp drop in just nine months. The deposits held by SAMA in excess of statutory reserves in September totalled SAR 86.9 trillion, nearly 40% down from SAR 142.8 trillion in January.

Saudi Banks' Excess Liquidity with SAMA in 2017 (SAR Trillion)



Source: Saudi Arabian Monetary Authority — Figures represent Cash and Deposits in excess of Statutory reserves

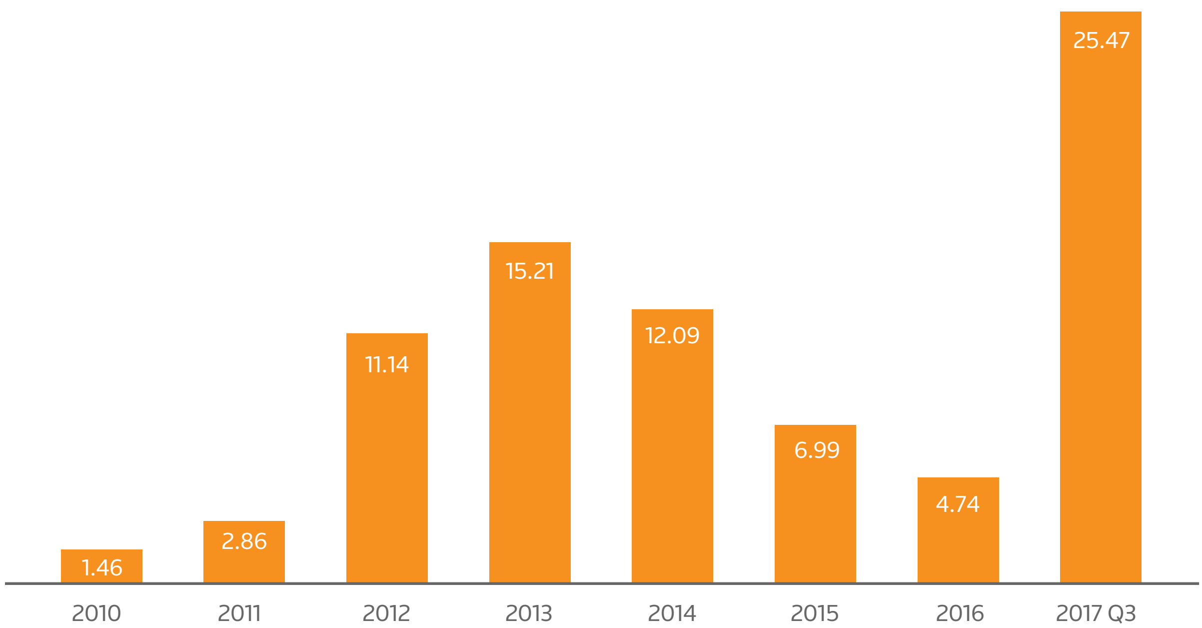
The Saudi Vision 2030 announced in April 2016 — an ambitious plan of reform to diversify the economy away from reliance on oil and to attract foreign investment — will open the door to greater sukuk issuance. The Saudi government has directed the newly established Debt Management Office to find the financing needed to realise its vision. After opening up its equity market to foreign direct investment in June 2015, the country in 2017 allowed qualified foreign investors to buy listed debt instruments such as bonds and sukuk in the hope that foreign asset managers will tap into the market.

Saudi Aramco and debut sovereign sukuk

The substantial amounts of issuance in the Saudi market came mainly from the government. Oil giant Saudi Aramco began its first fund-raising exercise in March with a 7-year, riyal-denominated, sukuk issuance that raised US$ 3 billion. This was the first move in the company's US$ 10 billion sukuk programme. This and the planned IPO of 5% of its shares on overseas stock markets — with an estimated total company value of US$ 2 trillion this would make it the biggest IPO in world history — are aimed at diversifying revenue sources after the sharp drop in oil prices. Aramco's sukuk was shortly followed by the Saudi government's record-breaking, debut dollar sukuk issuance amounting to US$ 9 billion across two 5- and 10-year tranches. The international sukuk followed the same hybrid structure as Aramco's, being based on mudaraba and murabaha, though this is more common in the local market. The complexity of the structure, however, did not hinder the order book from reaching in excess of US$ 33 billion.

This sukuk followed Saudi Arabia's and emerging markets' largest-ever bond issuance, of US$ 17.5 billion, in October 2016. This mammoth bond was the Kingdom's first international debt offer, and attracted orders totalling four times the needed amount. As a result, it both paved the way and acted as a benchmark for the first Saudi sovereign international sukuk. Both issuances were helped by a bounce-back in oil prices to above US$ 50 per barrel, from US$ 30 at the beginning of 2016, as Saudi Arabia decided to support oil output cuts by OPEC. The Kingdom also launched its debut domestic riyal-denominated sukuk in July in three tranches amounting to US$ 4.5 billion, which received US$ 13.6 billion of investors' orders.

Saudi Arabia Sukuk Issuances 2010 – 2017 Q3 (US$ Billion)



Source: Thomson Reuters

Sukuk gaining ground in other parts of MENA

Government sukuk were also popular elsewhere in the Middle East and North Africa (MENA) region during 2016 and 2017. Jordan made its sukuk debut in May 2016, amounting to US$ 105.9 million, in order to finance purchases by the National Electric Power Company.

In North Africa, countries such as Tunisia and Morocco put sukuk at the forefront of their funding options. Although we are yet to see concrete developments, however, initiatives in Tunisia have been witnessed following the announcement in May 2017 that the government was preparing a first-ever sukuk issuance. The country needed around US$ 2.85 billion in external funding in 2017 and was planning a US$ 500 million sukuk to cover its budget deficit. Similarly, Morocco also announced it was aiming for sovereign sukuk issuance during 2017. Algeria plans to issue sukuk in 2018 to counter an economic recession caused by a drop in energy revenues.

Revamp planned for ailing debt market in Iran

In Iran, the financial market infrastructure is still lacking for the country's debt markets, including sukuk. According to the IMF's February 2017 country report, devising a debt market plan would help the Iranian government develop its open market operations so it can implement its economic reform plans. This could help to bring its inflation under control, with liquidity in Iran controlled more by rationing than pricing. One possible financial reform to improve Iran's capital market would be to issue inflation-adjusted bonds to clear debts, a plan announced by the Central Bank governor last year. Another is the securitization of Islamic banking facilities such as mortgage-backed securities and other receivables from non-bank companies.

More sub-Saharan countries moving towards sovereign sukuk

Sukuk is also gaining traction in sub-Saharan Africa, which had total sukuk outstanding of US$ 1.5 billion in 2016, growing from US$ 273 million in 2015. Ivory Coast, Togo and Senegal issued sukuk worth US$ 263 million each in 2016.

In January 2017, the Nigeria-based Africa Finance Corp. (AFC) issued a US$ 150 million, 3-year sukuk. This paved the way for Nigeria's US$ 328 million sovereign sukuk issuance in September. This sukuk was intended to fund road projects using retail and institutional investors' funds and set the benchmark for local corporates to follow. Despite criticism of the issue, the paper was still oversubscribed by 5.8%, demonstrating there is still more demand that could be tapped into by the Nigerian government in the future. By adding sukuk to its current debt portfolio, which also included this year a first 'diaspora bond' targeted at Nigerian citizens abroad, the country could plug a budget deficit caused by low oil revenues, which constitute 70% of the government's revenue. The country suffered economically when oil prices tumbled in 2016, with the Nigerian naira plunging 37% against the dollar.

World's first ever green sukuk in Malaysia

In a boost to Malaysia's desire to incorporate social responsibility in its investment mandate, Tadau Energy in June 2017 issued the world's first ever green sukuk, amounting to MYR 250 million (US$ 58.4 million). The proceeds will be used to finance a major solar-power project in Sabah state. The sukuk was a joint effort between Malaysia's Securities Commission, its central bank, and the World Bank Group. The sukuk also exemplifies Chinese participation in Malaysia's sukuk market given that Tadau Energy is owned by China's Edra Power.

The green sukuk was not the first SRI sukuk, however. Khazanah Nasional issued this in 2015 to fund a trust school programme. A second tranche issued in August 2017 had a retail offering, which provided the retail public with an opportunity for impact investing. This was followed by Quantum Solar Park's green SRI sukuk in October 2017 of up to MYR 1 billion (US$ 238 million), which benefited from robust demand and tax incentives granted by the Malaysian government to both issuers and investors.

Indonesia planning to introduce sukuk based on Waqf

Indonesia's OJK financial authority is also working towards launching a green bond framework, which would create the opportunity to introduce green sukuk. The move could complement Indonesia's sukuk masterplan, unveiled in September 2016, aimed at raising sovereign sukuk to 50% of total debt issuance over the following 10 years and at encouraging government funding of infrastructure, education and agriculture projects. This could encourage Indonesian companies to follow suit and provide Islamic banks with Shariah-compliant investment tools to meet their liquidity requirements.

Towards this end, the government also plans to introduce sukuk based on waqf (charitable endowment) and remittances from Indonesian migrant labour to fund infrastructure projects. The government also launched in August 2016 non-tradable savings sukuk aimed at reaching retail investors' savings. The sukuk offered higher returns than bank savings or deposits. Another incentive to buy into the retail sukuk was a minimum purchase of IDR2 million, compared to government bonds' minimum of IDR5 million. The sukuk proved popular, with sales beating the targeted amount.

To read more about Sukuk and Islamic finance, please click here to download the Islamic Finance Development Indicator Report 2017