Several African governments are looking increasingly towards Islamic finance to fund infrastructure projects and legislation is already being drawn up in some states to mainstream this form of finance. Chuks B. Ibechukwu* and Clement Fondufe* explain how one instrument, the sukuk, works and describe how Osun state in Nigeria has already successfully implemented it.

How Islamic finance can bridge funding gaps

Bond issuances by sub-Saharan African (SSA) sovereigns on the international capital markets are a relatively recent phenomenon. With the exception of South Africa, which has been an active issuer for some time, it was not until 2006 and 2007 that the first non-South African Eurobonds were issued by SSA sovereigns (Seychelles in 2006, Congo, Gabon and Ghana in 2007), signalling the beginning of a trend.

According to an October 2013 research report by Moody’s, the rating agency, primary issuances by SSA sovereigns stood at $4.4bn at the time from four issuers alone (Ghana, Nigeria, Rwanda and South Africa). This is up from $2.4bn in 2012 and $2.3bn in 2011. The 2013 full year aggregate could have been higher if Kenya and Senegal had come to market in 2013 as expected – in the case of Kenya, with a $1.5bn debut sovereign bond, which would have been the largest ever debut offering in SSA, that has now been de-
ferred to January 2014. Given the region’s substantial infrastructure needs, the international capital markets have emerged as a significant source of external finance for infrastructure development. According to the relevant offering documents, the net proceeds of Senegal’s $500m bond issuance in 2011 were earmarked for IMF-approved infrastructure projects, including the Dakar toll road project, and the net proceeds from Nigeria’s $1bn bond issuance in July 2013 are to be used in funding various projects in the power sector. Kenya’s National Treasury has also stated that the proceeds from Kenya’s debut sovereign issuance will primarily be directed towards financing infrastructure development.

Governments of SSA countries with sizeable diaspora populations are also looking to use the international capital markets to channel remittances from the diaspora to support infrastructure spending through issuing diaspora bonds. Nigeria, for example, is in discussions with potential transaction advisers for a $100m diaspora bond to raise funds to finance various capital projects as part of the government’s domestic transformation agenda.

International bond issuances accounted for 18% of Africa’s debt stock at year-end 2011, and the rising trend in sovereign issuances is expected to continue as African governments seek greater participation from international investors in funding infrastructure investments.

With total global issuance of sukuk (a Sharia-compliant capital market instrument) for 2012 exceeding $130bn and sukuk issuance in 2013 again expected to breach the $100bn mark, it is no surprise that SSA governments are beginning to introduce tax, regulatory and other measures to facilitate the issuance of sukuk on the international markets.

These sukuk issuances would complement the Eurobond issuances of these governments and invite additional investment from the Gulf, southeast Asia and the increasing number of other investors (within Africa and internationally) seeking Sharia-compliant investment opportunities.

Sukuk are an asset-based financing structure. They are certificates of equal value that represent undivided shares in the ownership of a tangible or an intangible asset that is being financed by way of the sukuk issue. Because the certificates represent an undivided share in an asset, in subscribing for certificates by paying the subscription price to the issuer, the sukuk holders will be entitled to receive a return on their investment that is equivalent to a portion of the income generated from the underlying sukuk asset.

The sukuk issue basically sits on top of an underlying Sharia-compliant financing structure. As part of this structure, the issuer will use the subscription proceeds to acquire the assets that will underpin the sukuk. The structure that is ultimately selected usually will depend on a host of factors, including the nature of the sukuk asset, tax and regulatory considerations, and the views of the Sharia scholars that will vet the structure for compliance with Sharia principles.

The Osun State sukuk
Nigeria is one of several African countries that has announced plans to issue sukuk on the international markets and to position itself as one of the hubs of Islamic finance in Africa. To further this objective, last year, the Securities and Exchange Commission of Nigeria approved a set of rules for the issuance of sukuk in Nigeria by regulated entities, including government agencies and state governments.

Recent reports indicate that a debut sovereign sukuk remains on the Nigerian government’s agenda. However, there appears to be limited public information on the proposed structure or the timing of the issuance.

While we wait on the international sovereign sukuk, activity at the state level in Nigeria has demonstrated the potential for sukuk to become an important finance source for SSA governments to fund infrastructure and social projects. On 10th October 2013, the Osun State government in Nigeria issued a N11.4bn ($71m) seven-year sukuk denominated in local currency to fund the construction of 27 schools in Osun State over the coming year.

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sukuk denominated in local currency to fund the construction of 27 schools in Osun State over the coming year. Although two other African countries (The Gambia and Sudan) are known to have issued small amounts of sukuk in their domestic markets, the Osun State sukuk is widely viewed as the first sukuk to be issued by the government of a major African economy.

The sukuk is structured as a sukuk al-ijara, a commonly used structure by sovereign issuers, which is based on a lease arrangement supported by rental payments generated from the underlying sukuk assets.

Using this structure, Osun State incorporated a special purpose vehicle, Osun Sukuk Company Plc (the SPV), to which it transferred the land for construction of the schools. The SPV issued sukuk in an aggregate principal amount of $71m representing undivided ownership interests in the land.

The net proceeds of the issuance were used by the SPV to pay the purchase price for the land and fund construction of the schools. The land was leased back to the state government against periodic rental payments and partial redemption repayments, which are passed through to the sukuk holders in proportion to their ownership interest in the underlying asset based on the sukuk they hold.

The sukuk was rated ‘A’ by Agusto & Co, a local credit rating agency, and listed on the Nigerian Stock Exchange. It is understood to have been taken up by local banks, fund managers, insurance companies and high-net-worth individuals and will pay sukuk holders a fixed return of 14.75%.

Sources close to the offering revealed some of the challenges that were encountered in structuring and successfully marketing the sukuk. Some of the challenges noted were the lack of a solid regulatory framework in Nigeria, institutional investors’ limited understanding of certain structuring aspects of a sukuk when compared to conventional bonds, and a general lack of awareness of Islamic finance as an alternative source of public funding.

These challenges notwithstanding, the product was well received and the issuance oversubscribed by N1.4bn ($8.7m), which appears to indicate a measure of appetite for that asset class in Nigeria as well as a measure of confidence by market participants in the structures that already are in place in Nigeria to support Islamic finance.

More sukuk on the way
Alongside Nigeria, other SSA countries are considering a sukuk issue as a way of attracting investment from the Middle East and South-east Asia. Senegal, for example, has plans to issue a $200m debut international sukuk next year to fund infrastructure and energy projects.

Albeit, there is a range of risks and challenges to the development of Islamic finance in SSA. Kenya, Nigeria, Senegal and South Africa, among others, are seen to be addressing some of the perceived legal constraints through implementing or reviewing their respective tax and regulatory frameworks to support sukuk and the development of Islamic finance.

However, as the Osun State sukuk has shown, there are other obstacles that SSA countries must overcome for Islamic finance to take root. This could entail, among other initiatives, capacity-building to increase the number of skilled and qualified personnel in the various stages of structuring a sukuk, including among market participants and supervisory or regulatory bodies; effecting measures to increase public awareness of Islamic finance and the important role it can play in infrastructure development; and investing in money markets and related capital markets infrastructure to improve liquidity in this asset class.

The ninth World Islamic Economic Forum was held last October in London shortly after the Osun State sukuk was issued. At the forum, the UK government announced that it is working on the practicalities of issuing a £200m sukuk. According to the UK chancellor of the exchequer, the debut sukuk will help promote more needed overseas investment in Britain’s infrastructure. Rightly, SSA countries have the same idea.

*Chuks B. Ibechukwu is a senior associate in the project development and finance practice of Latham & Watkins LLP, and based in London.

*Clement Fondufe is a partner in the Paris office of Latham & Watkins LLP and the head of the firm’s Africa Practice.