Q&A with Harj Rai & Lee Irvine

THE FUTURE OF SUKUK

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The sukuk market is proving to be a significant source of capital for many corporate, sovereign and government-related entities in Southeast Asia, the Middle East and North Africa — entities which issued US$116.4 billion worth of global sukuk in 2014. A recent Thomson Reuters report predicts the value of sukuk issuances will rise to US$250 billion by 2020.

Nearly 60 percent of such global forecasts are attributed to the Malaysian sukuk market, however, the credit crisis in Europe and the US combined with the ongoing Eurozone crisis, have led to greater international interest in the increasingly liquid sukuk market.

In this lw.com interview Latham & Watkins partner Harj Rai and associate Lee Irvine discuss the future of the sukuk market and its ongoing globalization.

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What is driving the globalization of sukuk?

Rai: The credit crunch in the US and Europe, coupled with the ongoing Eurozone crisis, has resulted in more companies turning to the increasingly liquid sukuk market. Historically, complications with structuring and less favourable pricing had deterred entities from issuing sukuk, as they favoured the bond market or conventional bank loans provided by European and US banks to raise funds. We are beginning the see a shift towards the sukuk market following the retreat of US and European banks and some greater degree of standardization in documentation.

What is sustaining sukuk demand in the Middle East?

Irvine: Countries in the Gulf Cooperation Council (GCC) are set to host world events in 2020 which is fuelling investment in infrastructure. Dubai, the host of World Expo 2020, has relied heavily on international funding in order to modernize the emirate. Even Qatar, which benefits from plentiful gas revenues, is expected to require external funding to meet the infrastructure demands of the 2020 FIFA World Cup. The sukuk market is poised to fill the funding gap as the European and US lending markets have contracted.

Despite the plummeting oil price, GCC countries — such as the United Arab Emirates and Saudi Arabia — enjoyed strong economic growth in 2014, which led to an increase in the liquidity of local and regional banks. This considerable liquidity has enabled regional financial institutions to become important investors in the growing sukuk market. In addition, Middle East family-owned businesses are beginning to invest closer to home and, where possible, invest in Shari'ah-compliant instruments.

Why select sukuk over conventional financing?

Rai: Typically, investors have purchased sukuk with the intent of holding the sukuk certificates to maturity. As a result, the secondary market performance of sukuk trading prices has remained stable despite wider economic volatility. In addition, most prospective issuers of sukuk are able to achieve at least favourable pricing compared to an equivalent issue in the conventional bond market.

Unlike conventional bonds, sukuk offerings allow issuers to tap into both the growing Islamic investor community as well as the Western institutional investor community. The sukuk market is becoming increasingly attractive to European and US institutional investors as they seek to diversify portfolios and achieve higher returns through emerging market investments. Notably, approximately 27 percent of the order book for the 30-year tranche of Saudi Electricity Company's 2014 sukuk issuance was sold directly to US-based investors — indicative of a potentially important investor base for future sukuk issuances. While most sukuk have a maturity of three or five years, the market has shown a willingness to fund longer maturities, as demonstrated by both Saudi Electricity Company's 2013 and 2014 sukuk issuances.

The market has also seen a revival of sukuk structures. The shift towards hybrid structures is enabling greater flexibility with respect to the underlying assets which can be used whilst still adhering to stringent Islamic finance principles.

Is sukuk a sovereigns-only market?

Irvine: Historically, the sukuk market has been driven by sovereigns and issuances by government-related entities, with an explicit or implicit sovereign guarantee. In 2014 this trend has gone global with sovereign sukuk issuances by the UK government and the Government of the Hong Kong Special Administrative Region. Yet as the sukuk market matures, listed public companies and private entities are beginning to issue sukuk. Notably, Majid Al-Futtaim's sukuk issuance in 2013 demonstrated that family-owned companies with no government support can successfully access the sukuk market. The Saudi real estate developer, Dar Al-Arkan — despite its non-investment grade rating — also successfully issued a first-of-its-kind high yield sukuk offering in 2010 and has continued to tap into the market in 2013 and 2014.

What is the outlook for global sukuk issuances?

Rai: Global sukuk issuances will be driven by relatively limited levels of supply coupled with the continued level of liquidity within the overall Islamic investor base, in particular from Islamic banks. We anticipate that sukuk will increasingly attract the world's largest and most active institutional investors in the US, Europe and Asia, offering a means to invest in strong emerging market companies. Whilst the sukuk market will grow primarily based on support from the Muslim world, the market's ongoing globalization will provide pricing benefits and other advantages to issuers of sukuk.

In addition, we expect to see more sukuk issuances from multi-national corporations, especially those with significant operations in leading Islamic finance markets.

More Information

For more information and case studies on Shari'ah-compliant sukuk structures and the future of the sukuk market, download the Sukuk Structuring Guide.

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