جدوى للإستثمار
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The Saudi Sukuk Market

The global market for sukuk (Sharia-compliant bonds) has grown tremendously in recent years. Total outstanding sukuk rose from $8 billion in 2003 to around $100 billion in 2008. Sukuk provides companies and governments with access to financing and liquidity and offer a much needed Sharia-compliant instrument to investors. While the growth of the fixed income market in the Kingdom has been dwarfed by that of the equity market, we think that conditions are in place for strong growth in sukuk issuance and trading.

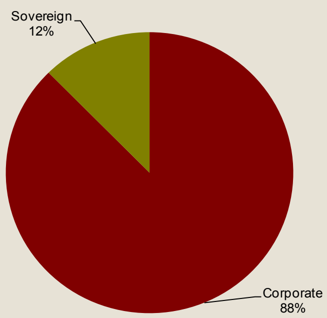
An important step was the launch by Tadawul of an automated order -driven secondary market for sukuk in mid-June. Previously, sukuk transactions were in an over-the-counter market, meaning that they were executed through bank treasuries and settled by Tadawul. Liquidity was very low, as most sukuk issues were held until maturity. The introduction of the new platform is intended to encourage investors to more actively trade sukuk. With the new system, investors can buy and sell sukuk through their brokers.

With the new trading platform in place, we think the following factors will stimulate supply from issuers and demand from investors in Saudi Arabia:

- **Predictability and portfolio diversification:** The collapse in the stock market last year has encouraged investor interest in more predictable assets such as sukuk. Given the very limited investment channels open to investors in the Kingdom, sukuk could also play in important role in portfolio diversification.
- **Problems raising finance from traditional sources:** Companies needing to raise finance have generally used a combination of bank loans and IPOs. With banks reluctant to lend and low valuations making IPOs unattractive, sukuk issuance should emerge as an important source of funding.
- **Balance sheet mismatches:** Little long-term bank lending is available, meaning that companies borrowing to finance long-term projects face an asset-liability mismatch on their balance sheets. Long-term sukuk would ease this problem.
- **Healthy sukuk pipeline:** Following two successful sukuk issues earlier this year, other local companies have announced their intention to issue sukuk, in addition to some GCC governments.

Notwithstanding the bright future for sukuk, there are still formidable challenges may impede growth. Liquidity is very low; there were only 50 transactions in the first two months of trading on the sukuk market. In addition, the local market lacks breadth and depth (there are only five listed sukuk) and there are no indications that the government will begin actively issuing sukuk (government support is generally a key factor in the development of debt markets). Furthermore, the lack of skilled human resources, Sharia-compliance standardization and innovative product development remain serious issues.

Global sukuk market



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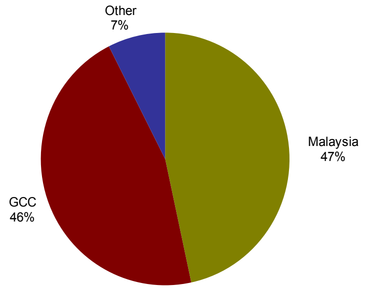
Background

Sukuk (plural of sak) are Sharia-compliant bonds. The main difference between sukuk and bonds is that sukuk holders take direct ownership of an underlying asset or pool of assets, whereas a bond is purely the financial debt of the issuer. Sukuk do not pay interest; rather they generate a return through actual economic transactions in the form of sharing or leasing the underlying assets. Nonetheless, in most other aspects sukuk and conventional bonds are similar.

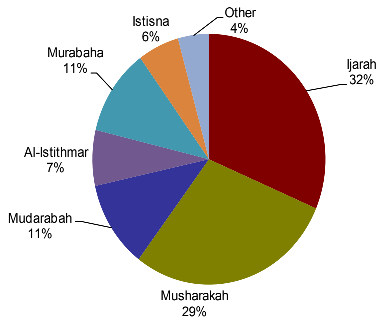
The use of sukuk has become increasingly popular in recent years both for governments and companies. In part this has stemmed from the dramatic growth in Islamic banking that has been the result of the large inflows of liquidity (primarily oil revenues) into the Islamic world and a greater appetite among businesses and individuals to conduct their finances in a Sharia-complaint way. As the take up of Islamic financial services grew, demand from issuers for a product that performs a similar function to a bond leapt. Demand from investors has also surged as growing wealth within the Islamic world has made regional credit risk more attractive and greater understanding of the instrument and clarity of documentation, supported by credit ratings from international agencies, has enhanced investor comfort with sukuk.

Global sukuk market breakdown by region



Malaysia accounts for around 47 percent of global sukuk issuance by market value, followed by the GCC, which is the source of a further 46 percent. Sukuk issuance is not limited to Islamic countries and there have been issues from institutions in Singapore, Sri Lanka, Canada, Thailand, the UK and US. Recently, the second largest bank in Russia, VTB, indicated that it is considering a sukuk. The growing interest in sukuk worldwide reflects the spread of Islamic banking and the desire of foreign issuers to tap the liquidity within the GCC. As it is the structure of the instrument that has to be Sharia-compliant, rather than the issuer or the purchaser, the supply and demand for sukuk is set to grow in nontraditional markets.

Global sukuk market by structure

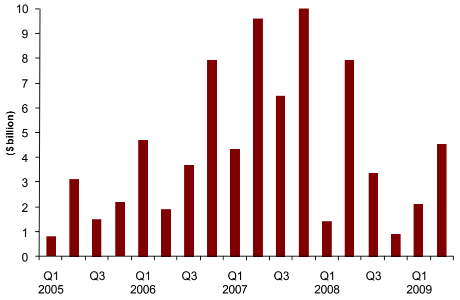


Sukuk are generally built around one of six main contracts: Ijara, Mudaraba, Musharaka, Murabaha, Istisina and Istithmar. Ijara accounts for around 32 percent of global sukuk issuance followed by Musharaka and Mudaraba. The Saudi sukuk market is dominated by the Istithmar. The variation in the dominance of structures is explained by the lack of Sharia-compliance standardization. It is the responsibility of Sharia boards to determine what structures are Sharia-compliant and given that there are no universally agreed standards, boards across countries exercise considerable discretion in arriving at their opinions. Some countries adopt a conservative interpretation of Sharia, while others are more flexible, leading to an inconsistency about what is considered Sharia complaint. For instance, most Ijara structures that have been issued in other countries do not meet Sharia-compliance requirements in Saudi Arabia. This lack of Sharia standardization poses a great challenge to growth of sukuk.

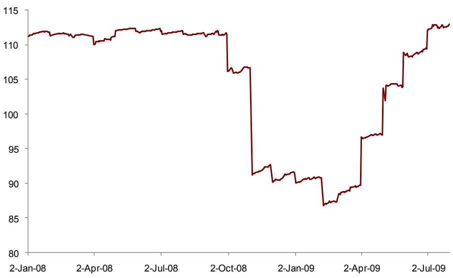
Recent trends in sukuk issuance

The sukuk market was hit by the global financial crisis. Issuance fell to a near four-year low of $0.9 billion in the final quarter of 2008 according to Bloomberg and prices dropped by 18 percent in the fourth quarter and bottomed a further 5 percent lower in mid-

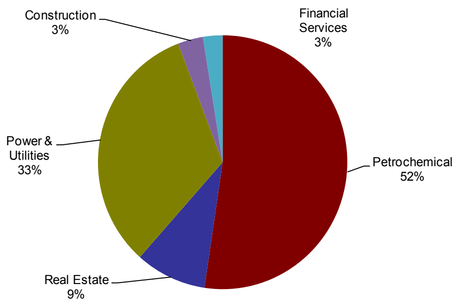
Sukuk issuance



Dow Jones/Cititgroup sukuk price index



Saudi sukuk market



February (measured by the Dow Jones/Citigroup sukuk index). There were no problems specific to sukuk; rather the asset class was affected by the heightened risk aversion that knocked financial markets worldwide. Issuance had slowed throughout 2008 as problems in banking sector intensified and leading scholars questioned the Sharia-compliance of some sukuk structures. Market conditions improved during 2009 due to large issues from outside the GCC (notably Malaysia and the government of Indonesia). Within the GCC the government of Bahrain maintained its program of regular issues. The only corporate issues were both in Saudi Arabia.

In Saudi Arabia, the impact of the crisis on sukuk has been mixed. As elsewhere, investor appetite for risk and financial assets has diminished. However, the tightening of bank lending policies and the reduced attractiveness of IPOs means that companies are examining alternative sources of funding, particularly sukuk. As a result several companies have raised funds through sukuk since the crisis intensified in September of last year. Pricing of the new sukuk reflects the higher risk aversion in the market, with the Saudi Electricity Company (SEC) issue in June priced to yield 160 basis points (1.6 percentage points) over the prevailing three month Saudi interbank rate, compared to a spread of just 45 basis points over the same period for the sukuk it issued in July 2007. Dar al-Arkan and Saudi Hollandi Bank paid higher premiums earlier this year and late last year, respectively, but they do not have the large government ownership that reassures investors.

The Saudi sukuk market

The Saudi sukuk market is still nascent, with only five publicly listed sukuk issued by two companies, Sabic and SEC. In addition, Saudi Hollandi Bank, Dar Al-Arkan and the Bin Laden group have privately placed sukuk. An over-the-counter market was launched in August 2006 with the first listing a Sabic sukuk. Under this system trades are negotiated off the exchange and there is no system to match buy and sell orders; most trades were done through the treasury departments of local banks. The lack of depth of the market, lack of transparency and the lack of historical trade information meant that sukuk was very thinly traded. For the whole of 2008, there were only 85 trades executed with a value of SR1.3 billion, compared to 52 million share transactions worth SR2 trillion over the same period.

Sukuk issue	Year issued	Size (SR million)	Yield	Term (years)	Offering
SABIC 1	2006	3,000	3M SIBOR+40bps	5	Public
SEC 1	2007	5,000	3M SIBOR+45bps	5	Public
SABIC 2	2007	8,000	3M SIBOR+38bps	5	Public
SABIC 3	2008	5,000	3M SIBOR+48bps	5	Public
Bin Laden Group	2008	1,000	7% fixed	5	Private
Saudi Hollandi Bank	2008	775	6M SIBOR+200bps	5	Private
Dar Al-Arkan	2009	750	3M SIBOR+400bps	5	Private
SEC 2	2009	5,000	3M SIBOR+160bps	5	Public

The new sukuk market platform

Recognizing the need to enhance the debt capital market, on June 13 the Capital Market Authority and Tadawul launched a new platform for sukuk trading. This new platform is an order-driven market which means that all traders publicly post their orders and the best buy and sell orders are automatically matched. Automation brings major improvements in the speed and cost of trading and greatly enhances transparency and the process of price discovery. The only disadvantage of an electronic order-driven system is its inability to execute large trades. In the absence of market makers, investors wanting to trade large blocks of shares may be forced to accept a less advantageous price. Normally, blocks are traded off exchange to avoid that risk.

The main order types are limit orders (with specified bid price) and market orders (buy or sell at the prevailing bid or ask price). The new sukuk system only allows limit orders. Best priced orders are processed first and in the event that there is more than one order at the best price, the one received earliest is prioritized. Clearing and settlement occur two days after the transaction.

The new platform consists of four phases, which are the same as those for trades in equity through the Tadawul. Namely:

- **Pre-open market:** 11:15 to 11:30: An order book is built through the accumulation of buy and sell orders, no trade matching occurs at this point.

- **Continuous trading market:** 11:30 to 3:30: Orders are matched and best buy and sell orders are displayed.

- **Pre-close market:** 3:30 to 4:30: At this phase no price or quantity modification is possible, although previously entered orders can be deleted.

- **Market close:** 4:30 to 11:15 next trading day: Market is closed, no action can be performed.

Pricing and valuation of sukuk

Investors can make money in two ways from sukuk; through payments by the issuer and by trading. The payments are determined by the coupon, which is the rate of profit share for a sukuk or the interest rate for a bond. Coupons can be variable (generally taking the form of a fixed spread over a variable reference rate) or fixed. In Saudi Arabia the former dominate, with the reference rate being three-month SAIBOR (Saudi interbank offer rate, the rate at which banks offer to lend to other banks). This means that issuers will pay investors an annual sum that exceeds SAIBOR by the spread. So if SAIBOR is 3 percent and the spread is 100 basis points (one percentage point), then assuming neither of these changed for the whole year, an investor would receive SR400 (4 percent) on a sukuk with a face value of SR10,000. The Bin Laden Group sukuk is the only Saudi sukuk priced at a fixed coupon, of 7 percent. In this case, the issuer will pay the bond holder 7 percent of the par value of the sukuk per year. So on a sukuk with a face value of SR10,000, an investor would receive SR700.

The following factors are the main influences on the price of a sukuk:

- **Reference rates:** An increase in the interest rates set by SAMA makes a fixed coupon sukuk less attractive and therefore lowers its price. A cut in interest rates has the opposite impact. The lower the coupon rate the greater the effect of a change in interest rates on price. Variable coupon sukuk are much less affected by changes in interest rates.

- **Time to maturity:** The nearer the sukuk is to maturity, the closer the price will be to its face value.

- **Credit risk:** The issuer's ability to pay coupons and principal on time (and market views about this ability) has an impact on the price and volatility of sukuk. Credit ratings aim to capture this risk.

- **Market conditions:** Sukuk prices can vary with market conditions even if there is no change to the fundamentals of the issuer. For example, during the financial crisis prices of debt considered very safe, such as those issued by governments, rose, while prices of those considered risky fell sharply. Since the credit crisis, investors have required higher returns, meaning that spreads on new issues are wider than they were for most of last year.

- **Liquidity:** Difficulty in finding buyers or sellers may prevent investors from trading sukuk at the price suggested by recent transactions. The primary measure of liquidity is the size of the bid-ask spread; the wider the spread, the greater the liquidity risk. A drying up of liquidity will be reflected in lower prices.

- **Inflation:** Inflation reducers the real value of coupon payments and will lower the price the investors are prepared to pay for these payments.

- **Sharia-compliance:** A possible change of opinion by scholars may jeopardize the market views of the Sharia-compliance of a sukuk, affecting the willingness of some investors to hold the instrument and hitting prices.

- **Coupon level:** If a sukuk has a significantly higher coupon than others on the market then all else being equal it would trade at a price premium over those with lower coupons as investors would be unable to generate similar coupon payments elsewhere (this is particularly the case when investors tend hold to maturity).

Price reflects the market value of the sukuk, but not the intrinsic value, and there can be a notable difference between the two. Intrinsic value is the present value of the cash flows (the coupon and principal payments) generated by the sukuk. Unless the coupon is fixed, the cash flows are unknown as they are affected by movements in SAIBOR. Therefore, valuing variable coupon sukuk requires assumptions about future moves in SAIBOR in addition to the discount rate needed to calculate net present value.

The role of the debt/sukuk market

Debt markets are an integral part of the capital markets and their development provides significant benefits for companies, governments and investors. In the near term, Saudi companies are likely to benefit the most from more sukuk, as raising finance from traditional sources (banks loans and the stock market) has become problematic with banks cautious about lending and IPOs subdued since the collapse of share prices last year. In addition, unlike conventional bank loans, companies have the ability to choose the term over which they want to borrow in a sukuk issue and there is an urgent need for more long-term financing options in the Kingdom.

Most bank lending in the Kingdom is short-term and little is available beyond five years, meaning that companies borrowing to finance long-term projects face an asset-liability mismatch on their balance sheets. The need for long-term borrowing will become more pressing when the mortgage market takes off, as for the health of their balance sheets, banks will need to borrow over the long term in order to lend over the long term. Similarly, insurance companies need long -term investments in order to meet the need to make long-term payouts on life insurance policies.

In general, the development of debt markets, both in terms of maturity structure and liquidity, is driven by the government. For most central banks across the world government debt plays a vital role in monetary policy. For example, a central bank would buy debt from or sell debt to commercial banks depending on whether it wanted to increase or reduce commercial bank liquidity, allowing monetary policy to be fine tuned on a daily basis rather than taking the blunt approach of using reserve requirements. A yield curve (which is derived from the relationship between the interest rate and maturity of a bond) reflects the bond market's consensus opinion of future economic activity, levels of inflation and interest rates and can be a helpful guide to policy making. While the Saudi government issues some debt, it has not indicated that it will issue any sukuk. A lack of active government issuance may prevent the sukuk market from fulfilling its full potential.

The development of an active sukuk market would be of great value to Saudi investors. Local investors have limited investment channels and the bulk of their funds are in the stock market or real estate. Both are subject to considerable volatility and in the case of the former, many investors have made large losses in the last few years. Given the much lower risk associated with debt, a vibrant and liquid sukuk market will help asset allocation decisions and allow portfolio diversification.

Sukuk pipeline

A number of companies and institutions have indicated that they plan to issue sukuk in the near future. Broad details of the four issues that are currently scheduled for 2009 are in the table below.

Announced Saudi sukuk for 2009

Issuer	Structure	Currency	Value (million)
Al Oula Development	Ijara	Riyal	3000
Islamic Development Bank	-	US dollar	500
Jabal Omar	-	-	-
Saudi Hollandi Bank	Mudaraba	Riyal	725

Source: Zawya

Challenges

It is clear that the Kingdom would benefit from a well functioning sukuk market. We think that the following important challenges need to be addressed for the market to develop:

- **Lack of breadth**: Only two companies currently have sukuk listed (Sabic and SEC). Both issuers have significant state ownership and the assumption of government support means that they both trade at low spreads over SAIBOR. There is a clear need for a more diversified range of sukuk both in terms of risk profile and sector representation.

- **Lack of liquidity**: Liquidity affects how efficiently and easily market participants can transact and lack of liquidity is one of the main risks associated with investing in sukuk in the Kingdom. Investors tend to require a premium for investing in illiquid instruments, but the returns offered by listed sukuk do not compensate for this illiquidity. The isolated trading over the first months on the new platform shows the ongoing presence of a significant liquidity risk.

- **Lack of skilled human resources**: Issuing sukuk requires a combination of complex legal, financial and religious knowledge that is in short supply in the Kingdom. In addition, most brokerage houses are not equipped with experienced fixed income brokers. Adequate training is urgently needed to enhance brokerage firms' ability to deal with the new sukuk market.

- **Lack of familiarity with the product:** Owing to the new and underdeveloped state of the market, the average Saudi investor lacks understanding of sukuk and fixed income instruments in general. This makes them cautious about investing in sukuk. A minimum order size of SR10,000 could also put off smaller investors.

- **Lack of Sharia standardization**: While not a problem within the Kingdom, the different interpretation of key Sharia issues between issuer countries (and even individual Sharia boards) means that there are not universally agreed standards, so products considered Sharia-complaint in one country are not necessarily considered in compliance in other countries. This lack of coordination is a hindrance to the development of the asset class on a global basis.

Conclusion

The Saudi sukuk market has grown considerably over the last few years and has the potential to become a major funding tool for companies and avenue for portfolio diversification for investors. However, the introduction of an automated order-driven secondary exchange will not on its own transform the sukuk market; it is merely one step of a long process to enhance the debt capital market in the Kingdom. Much greater market breadth and depth are essential. How long this takes to develop is open to question, through we think the current tough fund raising environment might expedite the process.

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