Present Trends & Future Prospects of Sukuk

Presented at IIFM's International Workshop on Sukuk

by

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The Development of the Islamic Bond Markets

- Historical records show that in the 7th century AD, public servants were issued with Sukuk al-Badai (commodity coupons similar to warehouse receipts) by the Umayyad government.
- Imam Malik in his Muwatta has recorded that Sukuk al-Badai which evidences entitlement to certain amount of commodity (like grain) from the treasury was seen traded prior to maturity.
- Malaysia introduced Islamic bonds in the 1990's and they were termed as Bai Bithaman Ajil Bonds.
- In the Middle East, Bahrain introduced the Sukuk al-Ijara instrument to the Islamic market in September 2001and Malaysia pioneered the global Sukuk al-Ijara issue in June 2002.
- The Middle Eastern Islamic bond market is evolving gradually with the support of top-tier issuers like the Islamic Development Bank, the State of Qatar, the Department of Civil Aviation, Dubai, the Republic of Pakistan.
- The Islamic bond market provide investment opportunities to a broad range of investors including public pension fund managers, reserve managers, Central Banks and Awqaf managers.
- Islamic investors need to diversify their investment portfolios and Islamic bonds are important to fill the gap in Shariah-compatible fixed income tradable instruments.
- The growth of Islamic bond markets will further fuel the growth of Islamic institutional investors like takaful operators, Islamic asset management houses and Islamic pension funds.

Factors that Fuelled the Growth of Islamic Bond Markets

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- "Mainstream" Islamic structures
- Flow of funds from conventional to Islamic institutions in many Islamic countries
- More issuers are strategically positioning to tap the growing Islamic bond market as an alternative source of funding
- Higher demand for Islamic bonds resulting in price advantage for the Issuer at the primary market ……often leading to the Islamic bonds trading at a premium
- Governments are playing an active role in promoting Islamic finance industry ……..some countries providing tax and other incentives
- Malaysia has developed a comprehensive capital market plan to nurture the development of domestic Islamic capital market

Size of Islamic Private Debt Securities Market in Malaysia

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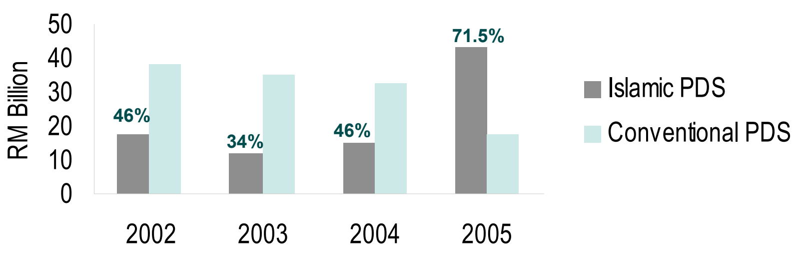
Size of Islamic PDS in the MYR market is growing exponentially



Source: http://www.sc.com.my/

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Notable Sukuk Deals in the Middle East(2003-2005)

The following table lists some of the notable Sukuk transactions arranged in the Islamic Finance Markets:

Name	Islamic Development Bank	State of Qatar	Kingdom of Bahrain	Saxony-Anhalt State	Tabreed	Dept of Civil Avation, Dubai	Munshaat al-Bahrain	Arcapita
Structure	Sukuk al-Istismar	Sukuk al-Ijara	Sukuk al-Ijara	Sukuk al-Ijara	Sukuk al-Ijara	Sukuk al-Ijara	Sukuk al-Intifa	Sukuk al-Murabaha
Size (mn)	$400	$700	$250(2003) $250(2004)	€ 100	100(2002)250(2006)	$1,000	$390	$100(2003) EUR75(2004) $155+EUR46(05)
Tenor (years)	5	7	5	5	5	5	5	3
Country	Saudi Arabia	Qatar	Bahrain	Germany	UAE	UAE	UAE	UAE
Sukuk Format	Reg S	Reg S	Reg S	Reg S	Reg S	Reg S	Reg S	Reg S
Listed / Rated	Listed & Rated	Listed & Rated	Listed& Rated	Listed& Rated	Listed	Listed	Listed	Listed

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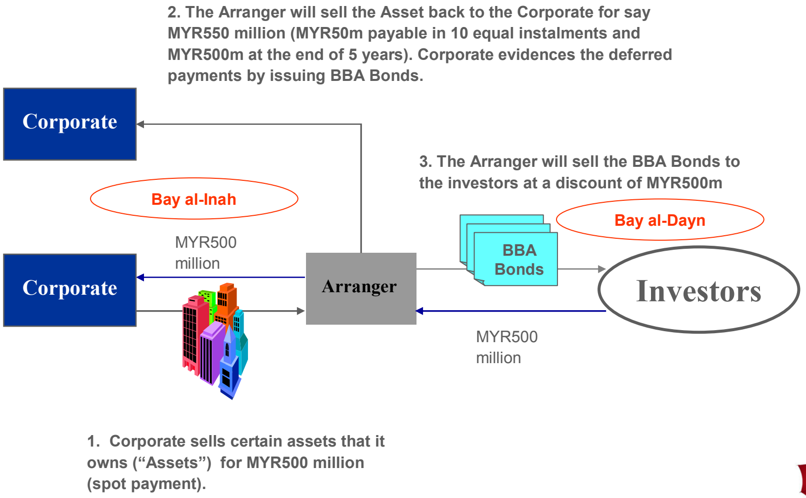
Notable Sukuk Deals in the Middle East (2005 – Q1 2006)

The following table lists some of the notable Sukuk transactions arranged in the Islamic Finance Markets:

Name	Durrat al-Bahrain	Rep. Of Pakistan	Dubai MCE	Emirates Airline	Islamic Development Bank	The Investment Dar	Amlak Finance	Dubai PCFC
Structure	Sukuk al-Ijara	Sukuk al-Ijara	Sukuk al-Musharakah	Sukuk al-Ijara	Sukuk al-Istismar	Sukuk al-Musyarakah	Sukuk al-Istismar	Sukuk al-Istismar (Convert-ible)
Size (mn)	$152.50	$600	$200	$550	$500	$100	$250	$3,500
Tenor (years)	5	5	5	7	5	5	5	2
Country	Bahrain	Pakistan	UAE	UAE	Saudi Arabia	Bahrain	UAE	UAE
Sukuk Format	Reg S	Reg S	Reg S	Reg S	Reg S	Reg S.	Reg S	Reg S
Listed / Rated	Listed	Listed & Rated	Listed	Listed	Listed & Rated	Listed	Listed	Listed

BBA Bonds & Sukuk al-Ijara: The First Phase

(i) Bai Bithaman Ajil Bonds



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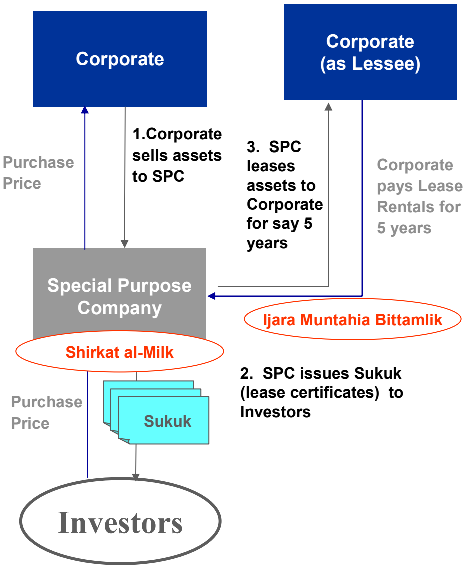
(ii) Sukuk al-Ijara: Sale and Lease-back



Steps:

- *SPC will buy the assets from Corporate at say USD500m.*
- *SPC will lease the assets back to Corporate for, say, 5 years.*
- *Lease Rentals will be payable 6-monthly in arrears and will be benchmarked on USD Libor plus a credit spread.*
- *To raise USD500m, SPC will issue Sukuk at par value of USD500m.*
- *Investors will subscribe to the Sukuk as primary subscribers (similar to the primary subscription in a bond issue).*
- *SPC will collect the Lease Rentals and distribute pro rata to the Sukuk holders.*
- *The Sukuk can be **listed, rated, cleared** through Euroclear / Clearstream and **traded** in the secondary market.*
- *The **Kingdom of Bahrain Sukuk** issues, the **Federation of Malaysia,** the **State of Qatar** and the **Republic of Pakistan** Sukuk issues were structured based on this concept.*

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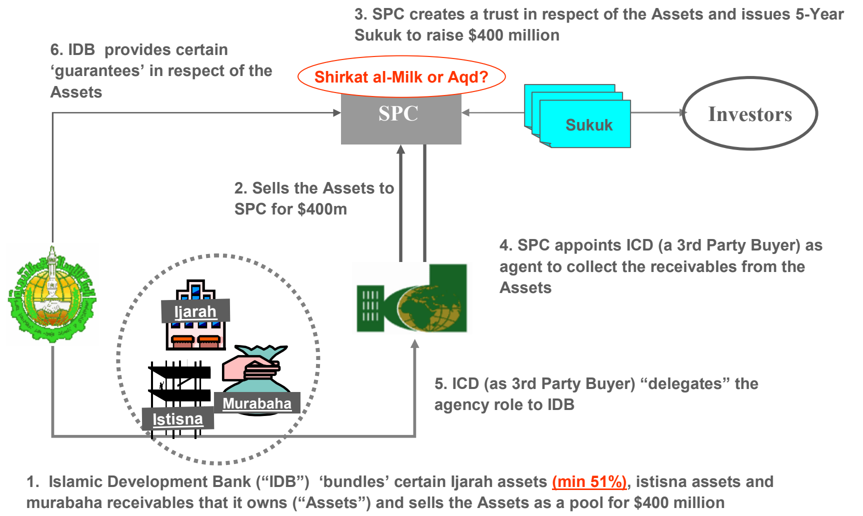
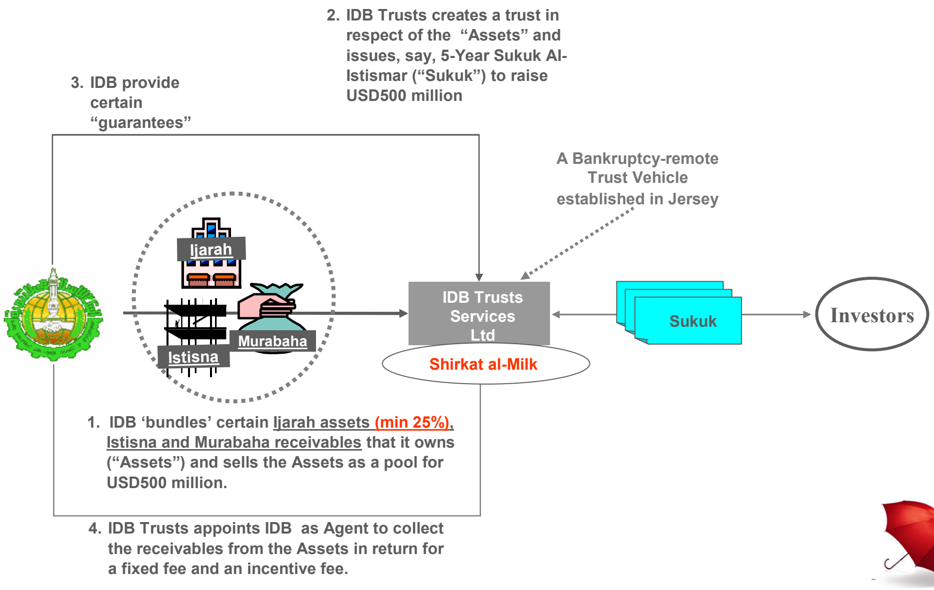
Sukuk al-Istismar & Sukuk al-Musharakah: The Second Phase

(i) Sukuk al-Istismar (51%) Structure



(i) Sukuk al-Istismar (25%) Structure



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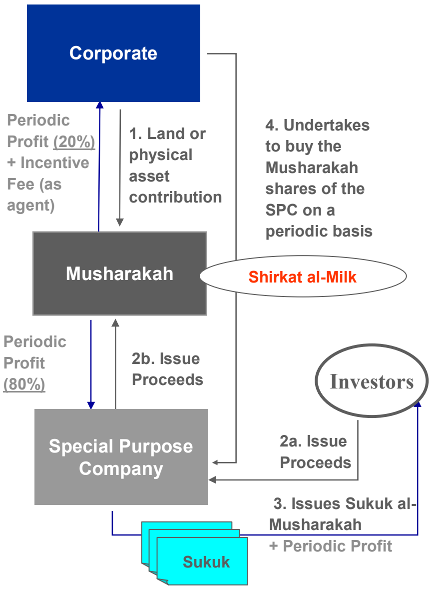
(iii) Sukuk al-Musharakah Structure



- *Corporate and the Special Purpose Company ("SPC") enter into a Musharakah arrangement for a period of say,5 years – Profit-sharing ratio is between the SPC and the Corporate is 80:20*
- *Corporate (as Musharik) contributes land or other physical assets to the Musharakah*
- *SPC (as Musharik) contributes cash (i.e.) the Issue Proceeds to the Musharakah*
- *The Musharakah appoints the Corporate as an agent to develop the land (or other physical assets) with the cash injected into the Musharakah and sell/lease the developed assets on behalf of the Musharakah*
- *In return the agent (i.e., the Corporate) will get a fixed agency fee plus a variable incentive fee payable say, semi-annually. The Net Profit is divided in to 80:20 and from the 80% profit share, the agent will disburse to the SPC an amount equal to Issue Proceeds*Libor+Margin pa and the surplus (if any) would be kept by the agent as Incentive Fee*
- *The Corporate irrevocably undertakes to buy **at a pre-agreed price** the Musharakah shares of the SPC on say semi-annual basis and at the end of 5 years, the SPC would no longer have any shares in the Musharakah*
- *The USD300m **Dubai Metals & Commodity Exchange** Sukuk was structured based on this concept.*

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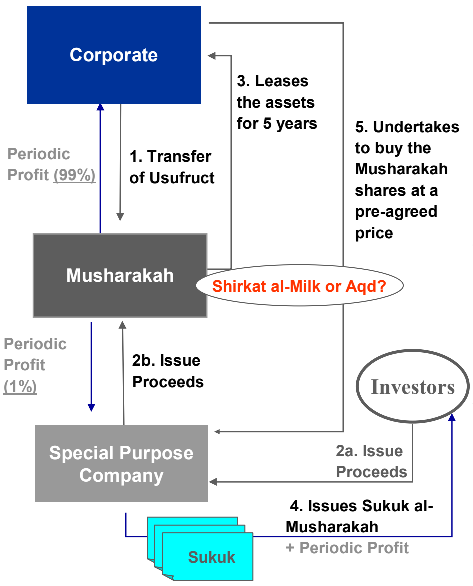
(iv) Sukuk al-Musharakah: an Alternative Structure



- *Corporate and the Special Purpose Company ("SPC") enter into a Musharakah arrangement for a period of say, 5 years – Profit-sharing ratio between the SPC and the Corporate is 99:1*
- *Corporate (as Musharik) transfers usufruct rights over land and other physical assets to the Musharakah*
- *SPC (as Musharik) contributes cash (i.e.) the Issue Proceeds to the Musharakah*
- *The Musharakah appoints Corporate as an agent to develop the land (or other physical assets) with the cash injected into the Musharakah and lease the assets to Corporate for say, 5 years. The Lease Rentals payable by Corporate would be benchmarked on USD Libor plus the credit spread.*
- *The net profit of the Musharakah (viz. the Lease Rentals) is divided between the SPC and Corporate in the ratio of 99:1 and the SPC will then distribute the Net Profit as Sukuk Distribution to the Investors.*
- *Corporate also irrevocably undertakes to buy **at a pre-agreed price** (viz. the Issue Price) the Musharakah shares of the SPC at the end of 5 years or upon any default under the Lease to Corporate. Upon such exercise, the SPC would no longer have any shares in the Musharakah*
- *The USD550m **Emirates Airline** Sukuk was structured based on this concept.*

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Hybrid Structures: The Third Phase

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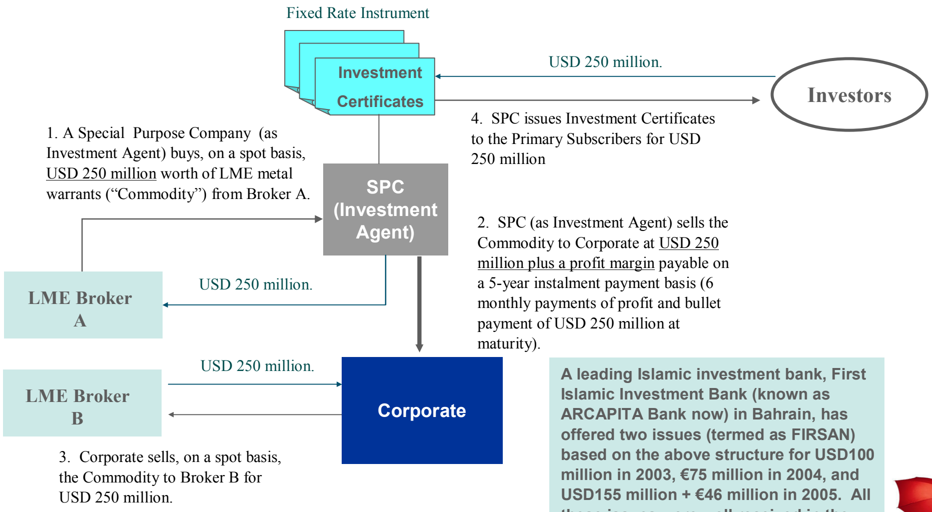
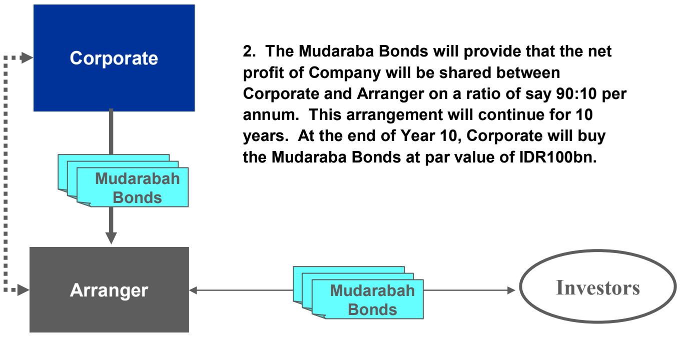
(i) Murabaha-based Investment Certificates



A leading Islamic investment bank, First Islamic Investment Bank (known as ARCAPITA Bank now) in Bahrain, has offered two issues (termed as FIRSAN) based on the above structure for USD100 million in 2003, €75 million in 2004, and USD155 million + €46 million in 2005. All these issues were well received in the market.

(ii) Mudaraba Bond

1. Arranger invests IDR100bn in Corporate and Corporate issues investment certificates (Mudaraba Bonds) with face value of IDR100bn. [Concept:Mudaraba (as interpreted in Indonesia)]



2. The Mudaraba Bonds will provide that the net profit of Company will be shared between Corporate and Arranger on a ratio of say 90:10 per annum. This arrangement will continue for 10 years. At the end of Year 10, Corporate will buy the Mudaraba Bonds at par value of IDR100bn.

- This structure was used by PT Indosat and PT Berlian Laju Tanker and is only suitable for corporates with identifiable cash flows which can be dedicated for profit and loss sharing with the Mudaraba Bondholders

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(iii) Sukuk al-Musharakah Islamic Convertible Sukuk

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Transaction Summary

Issuer	**PCFC Development FZCO ("PCFC Development"), owned 90% by PCFC and 10% by Dubai Islamic Bank as agent for the Sukuk holders**
Size	USD 3,500,000,000
Musharaka Partners	**The Issuer and Ports, Customs & Free Zone Corp. ("PCFC")**
Musharaka Assets	Issuer contributes USD3.5bln cash (35mln units) and PCFC contributes the usufruct rights of 53 cranes valued at USD1.5bln (15 mln units)
Facility Structure	**PCFC is appointed as Managing Agent to manage the Musharaka**
Redemption	PCFC undertakes to purchase the Issuers 35mln units at US$3.5bln plus Distribution Amount of 10.125%pa or if a Qualifying Public Offering occurs at 7.125% pa
Tenor	**2 Years**
JLMs	Barclays Capital and Dubai Islamic Bank
Security	**Senior & Unsecured claim against PCFC and pledge of 49% shareholding of Thunder FZE (Bidco of P&O Group)**
Profit Ratio	30%: PCFC & 70%: Issuer. If profit payable to Issuer is greater than the Distribution Amount, the surplus is distributed to the Managing Agent (PCFC) as incentive fees
Convertibility	**If a QPO occurs, 30% of the Sukuk Repayment Amount will be paid in QPO shares (based on the QPO share price) & 70% Cash**

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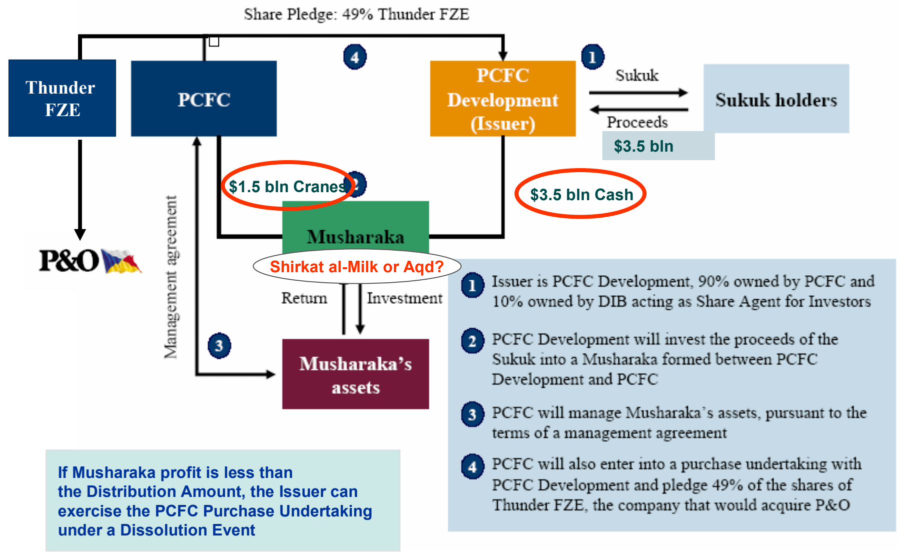
Convertible Sukuk Structure



Convertible Sukuk Structure if QPO occurs

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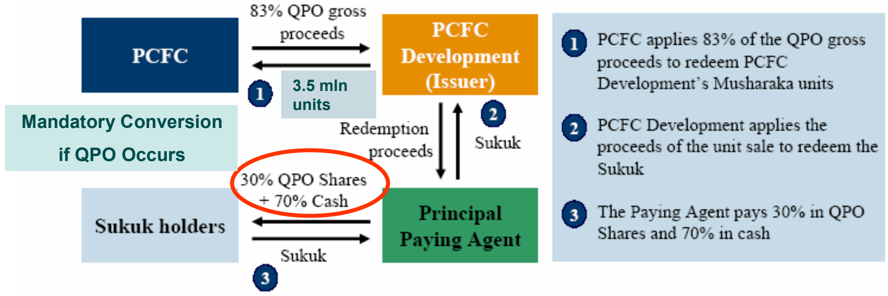
- In case of a Qualifying Public Offering of PCFC and/or subsidiaries (QPO), 83% of the QPO gross proceeds will be used to redeem the Sukuk
- Sukuk will be redeemed at their principal plus accretion in value, based on 7.125% pa



Note: In case QPO proceeds are insufficient to redeem all the Sukuk, a partial redemption will take place. Several rounds of redemption may take place until all Sukuk are redeemed or mature

Convertible Sukuk Structure at Maturity

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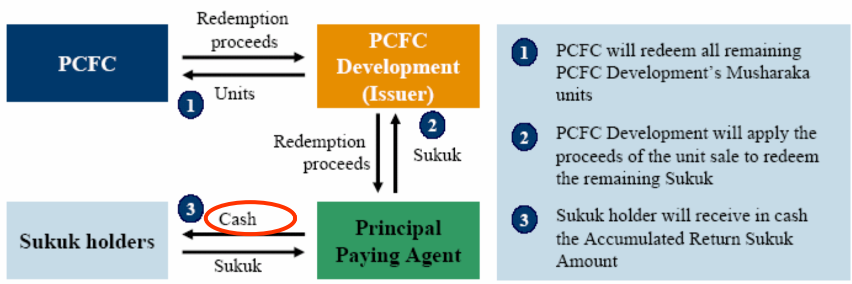
- Any outstanding amount at maturity will be redeemed at their principal plus accretion in value, based on an enhanced yield of 10.125% pa which is 3% higher than QPO Yield



- The same redemption mechanism will be used in case of a Dissolution event

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(iv) Sukuk al-Mudaraba
Islamic Convertible Sukuk

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Transaction Summary

Issuer/Rab al-Maal	**Aabar Sukuk Limited, a charitable trust-owned company incorporated in Cayman Islands**
Size	USD460,000,000
Mudarib/Obligor	**Aabar Petroleum Investments Company PJSC ("Aabar")**
Mudaraba	Issuer contributes USD [ ] as capital for the Mudaraba and the Mudarib invests the capital in Aabar's business activities in accordance with an investment plan prepared by Mudarib
Redemption	At the end of 4 years, Mudarib/Obligor undertakes to purchase the Issuer/Rab al-Maal's Mudaraba/Trust Assets for a sum equal to USD460,000,000
Tenor	**4 Years**
JLMs	Deutsche Bank and Abu Dhabi Commercial Bank
Periodic Distribution	**6.894% pa on a quarterly basis**
Profit Ratio	1%: Mudarib & 99%: Issuer (if profit payable is greater than Periodic Distribution amount, the Mudarib is entitled to keep the excess as incentive fees)

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Transaction Summary

Exchangeability	**If an Exchange Condition has been met (15 days before maturity of 4 years) the Issuer (on behalf of Aabar) can elect for the Mudarib/Obligor to purchase the Mudaraba/Trust assets by either (i) physical settlement of Exchange Shares; or (ii) cash settlement of Redemption Reference Price (volume weighted average trading price of the Exchange Shares) multiplied by the number of Exchange Shares**
Exchange Condition	Exchange Condition is satisfied if the Redemption Reference Price is greater than the Current Exchange Price (i.e.,USD460,000,000 divided by number of listed ordinary shares of Aabar in existence)
Exchange Shares	**422,212,024 listed ordinary shares of Aabar**
Early Redemption	If Mudaraba does not yield any profit and consequently the Issuer fails to pay a Periodic Distribution (or other Dissolution Events occur) the Mudarib/Obligor undertakes to purchase the Issuer/Rab al-Maal's Mudaraba/Trust Assets for a sum equal to USD460,000,000 plus the unpaid Periodic Distribution Amount. If an Exchange Condition has been met (15 days before Early Redemption Trigger Date) the Issuer can elect for the Mudarib/Obligor to purchase the Mudaraba/Trust assets by (i) physical settlement (at the option of Aabar) up to 50 per cent of the Exchange Shares ("Early redemption Shares") and (iii) payment of an amount (in U.S. dollars) equal to the Redemption Reference Price multiplied by (x) the number of Exchange Shares less (y) the number of Early Redemption Shares.

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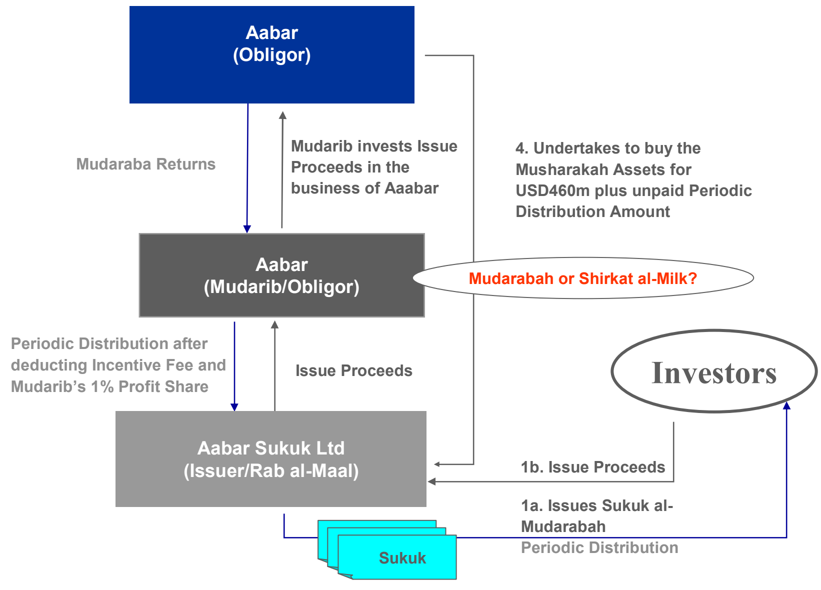
(iii) Transaction Structure



Do we need a Shift from "Mainstream" to "Pure-stream" Islamic structures?

The Steps Toward The Future

The Innovation Stage
- Dominant Market Share will lead to new products and practices that conform to the higher ideals of Islamic economics

2035?

The Improvement Stage
- Significant Market Share will lead to improvements in the product range and Risk & Return profile

2015?

The Conforming Stage
- Need to conform to conventional Risk & Return profile to gain market share

2006

Glossary

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• **Sukuk (Sakk. singular):** Certificate of Title

• **Istismar:** Investment

• **Bai Bithaman Ajil (sale on credit):** The financier purchases assets/goods from a third party or the client at the request of the client. The financier then immediately resells the assets/goods to the client at a higher price on deferred payment terms.

•**Murabaha (cost-plus financing):** The financier purchases assets/goods from a third party at the request of the client (who acts as the financier's undisclosed agent). The financier then immediately resells the assets/goods to the client at a higher price on deferred payment terms.

•**Mudarabah (Partnership/Trust Financing):** A form of partnership where one partner provides capital and the other labour/expertise only. Profits arising from the partnership are shared between the partners on a pre-agreed ratio while any losses are born entirely by the capital provider unless such loss arises out of the negligence or misconduct of the managing partner or other violation by him of the partnership agreement.

•**Musharakah (Partnership Finance):** This is similar to Mudaraba with the difference that in Musharakah all the partners provide some capital. Profits are shared in the pre-agreed ratio while losses are shared in the proportion of the capital contributions.

•**Ijara (Leasing):** Similar in most aspects to an operating lease. If there is an undertaking by the client to purchase the leased asset at a pre-agreed price at the end of the lease period, this is known as Ijara wa-Iqtina (hire purchase or finance lease).