Islamic Sukuk Come Of Age In Infrastructure And Project Finance

Primary Credit Analyst:
Karim Nassif, London (44) 20-7176-3677; karim_nassif@standardandpoors.com

Secondary Credit Analysts:
Jonathan Manley, London (44) 20-7176-3952; jonathan_manley@standardandpoors.com
James Penrose, London (44) 20-7176-3960; james_penrose@standardandpoors.com

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Sukuk transactions, including nonrecourse financings, appear to be gaining traction in the Gulf region for project and infrastructure funding as investors become familiar with their features and flexibility. While the global economic slowdown may have curtailed the uptake of these transactions for now, investor appetite should recover in line with the business cycle. At the same time, however, the continued success of project and infrastructure sukuk will in Standard & Poor’s Ratings Services’ opinion require the resolution of outstanding compliance and security related issues.

In the time since we last reported on our rated infrastructure and project finance sukuk (see article titled "Credit FAQ: Project Finance Sukuk," published Nov. 16, 2007, on RatingsDirect), we have assigned a rating to the Tabreed 08 Financing Corp. convertible sukuk. This transaction features sharia-compliant trust certificates that are mandatorily exchangeable into ordinary shares of National Central Cooling Co. PJSC (Tabreed; BB/Developing/--). We’ve also rated Sun Finance Ltd. (a United Arab Emirates {UAE} dirham-based securitization of receivables from the sale of plots of land on the Shams Abu Dhabi development on Al Reem Island).

These transactions notwithstanding, project and infrastructure sukuk issuance in the Gulf has stalled. After years of rapid growth, the past few quarters have been difficult in the Gulf Cooperation Council (GCC) states and the project and infrastructure sukuk markets have not grown in 2008 to the levels anticipated. Nevertheless, the Tabreed 08 and Sun Finance issues may provide a basis for future infrastructure and project finance sukuk.

Global Slowdown And Local Factors Crimp Sukuk Issuance

The market’s anticipated growth of sukuk (including those for infrastructure and project finance) failed to materialize in 2008, total sukuk issuance falling 56% to $14.9 billion compared with the previous year. That said, the value of Standard and Poor’s rated project and infrastructure sukuk was broadly similar in both 2007 and 2008.

We believe that the underperformance in sukuk issuance is due in large part to the effects of the global economic downturn, specifically its influence on capital market issuance in GCC states. We are of the view, however, that notwithstanding the current state of the financial markets, the GCC will be the focus of most infrastructure and project finance sukuk activity in the short to medium term. This is because sukuk funding structures provide an alternative to the traditional bank financing that shows no immediate signs of return in the currently dislocated financial markets.

Local factors curb investor appetite for sukuk

The effects of the global downturn aside, the GCC region has its own contributing macroeconomic factors that continue to affect project and infrastructure sukuk issuance, namely:

High costs of financing.

In our experience, the costs of structuring and issuing sukuk remain high relative to conventional bank loans and bond issuance. Legal and accounting fees contribute to this higher cost structure, as does uncertainty regarding the perceived risk associated with these instruments. Moreover, the lack of standard structures, perceived differences in approach to sharia compliance, and a relatively illiquid secondary market may, in our view, discourage investor

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appetite for sukuk.

**Predominantly local investor appeal.**
In 2006 and 2007, there were a number of sukuk placed with international investors, including those of DP World Ltd. (A/Negative/A-1) and Tabreed. In 2008, by contrast, the reduced appetite for sukuk saw many issues taken up by local investors and denominated in local currencies. Furthermore, foreign currency-denominated, cross-border-placed sukuk remain more expensive than their locally placed counterparts. This is due to withholding tax payments applicable to cross-border transactions, on which investors demand a compensating coupon. Finally, we understand that uncertainty over the prevalent practice of pegging GCC state currencies to the U.S. dollar may also make foreign-currency denominated sukuk less attractive than those issued locally. As a consequence, local currency sukuk have been dominant. The relative degree of liquidity tightening in these local markets compared with levels a year earlier also contributed to funding costs.

**Real estate downturn.**
The correction in UAE real estate markets, particularly in Dubai in the second half of 2008, suggests that government-related developers, utilities, and infrastructure companies reliant on third-party construction might be revising their financial and business models to reflect new market circumstances. This, in turn, suggests that funding of discretionary capital expenditures in the second half of 2008 through sukuk issues is likely to have been indirectly affected.

**Hydrocarbon prices.**
The reduction in oil prices from around $128 per barrel at the end of June 2008 to around $40 per barrel at the end of December has, in our view, dampened wealth expectations in the GCC. This, in turn, has likely affected expansion plans for government entities by placing more scrutiny on the projects that should progress. Cheaper oil prices may have also affected local issuer and investor appetite for infrastructure and project finance sukuk.

**Accounting issues.**
In our view, the February 2008 announcement by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOFI), which addressed the issue of whether bonds structured with no transfer of collateral were sharia-compliant, contributed to market uncertainty. We understand anecdotally that the AAOFI’s position may have prompted investors to seek a "risk premium" for particular sukuk transactions and, consequently, to a lull in issuance. We are not aware of any subsequent action taken by the AAOFI.

Despite these developments, high-profile sukuk issuance continues in the region. Both the Saudi Electricity Co. and Dubai Electricity and Water Authority issued sukuk in late 2007 and during 2008 to fund capital expansion in Saudi Arabia and Dubai, respectively. Sukuk-based financing remains the most attractive means of raising funding for medium- and long-term capital costs for GCC issuers. It forms the basis of a number of high-profile, hydrocarbon-related GCC project transactions, often split equally with debt-based bond and bank financing. As the Islamic infrastructure and project finance market develops, we anticipate there will be more transactions funded exclusively by sharia-compliant means.

**The Sukuk Instrument Proves Adaptable**
In our opinion, sukuk have proven adaptable to complex infrastructure financings, as evidenced in the Tabreed 08 and Sun Finance projects.
It's our understanding that one of the purposes of the Tabreed 08 sukuk, for instance, was to raise financing for Tabreed's capital facilities expansion without increasing leverage. Tabreed 08 issued nondeferrable, deeply subordinated, and mandatory convertible ijara sukuk notes. In practice, annual profits are distributed to Tabreed 08, which services the notes over three years prior to conversion. Principal and interest payments are subordinated to all of the parent company’s other debt obligations (unless expressly qualified as more junior) and ranked at the time of issuance senior only to common shares. Although the Tabreed 08 notes have sufficient debt-like characteristics to enable them to be rated, Standard & Poor’s treats the principal amount of the notes as equity in order to calculate Tabreed's financial ratios. Similarly, we treat coupon payments as dividends for the purpose of our analysis. Since the Tabreed 08 issue, we have also rated convertible notes issued by Abu Dhabi National Energy Company PJSC (TAQA; AA-/Stable/A-1+). However, these were not structured as Islamic convertible notes.

We believe that once conditions improve in the financial markets, infrastructure developers seeking high equity treatment for capital market issuance may continue to employ sharia-compliant convertible notes to fund their capital needs. As we discuss below, Sun Finance, a construction financing backed by property receivables, has in our opinion already helped to extend the boundaries of nonrecourse project and infrastructure sukuk financings.

Recent Transactions Point The Way Forward

Our analytical approach to rating infrastructure and project finance sukuk is illustrated in the following transactions:

Tabreed 08 Financing Corp.

Tabreed 08 is a special purpose entity wholly owned by Tabreed. Its sukuk issuance is being used to fund the construction of district cooling plants. The structure of this transaction makes use of both an ijara (sale and leaseback) and istisna (construction and delivery) agreement (see chart 1). In fact, the Tabreed 08 structure resembles that of the Tabreed 06 Financing Corp. senior secured sukuk that we rated in June 2006, although there are some important differences.
At closing, Tabreed 08 purchased the cooling plants (or a part thereof) from Tabreed and entered into a lease arrangement, with Tabreed as lessee. Tabreed distributes annual profits (lease payments) to the issuer. Those monies are used by the issuer to service the coupon payments on the notes over the first three years. The proceeds of the sukuk issuance fund construction of the plants, while Tabreed will buy back the cooling plants from Tabreed 08 at maturity at a price payable in Tabreed shares, hence the convertible nature of the instrument.

By contrast, in the Tabreed 06 transaction Tabreed will buy the cooling plants through exercising the purchase undertaking that in turn ultimately redeems the notes.

The following points of comparison exist between the "debt-like" features of the Tabreed 06 sukuk and the "equity-like" features of the Tabreed 08 sukuk:

- Under the Tabreed 08 sukuk, all lease payments are subordinated under normal circumstances to other senior creditors of Tabreed, as well as in the event of a payment default. This subordination of the Tabreed 08 sukuk includes its subordination to payment of the Tabreed 06 sukuk.
Under the Tabreed 08 sukuk, consistent with its equity-like characteristics, lease payments service only the sukuk coupon, not principal. This contrasts with the Tabreed 06 senior sukuk purchase mechanism, which provides for payment of interest and principal on maturity via exercise of the purchase undertaking.

Standard & Poor’s assigns a high equity content to the Tabreed 08 notes for three main reasons: They mandatorily convert into ordinary shares of Tabreed in three years; coupon payments are generally subordinated to Tabreed’s other debt obligations; and the notes currently rank senior only to common shares. The notes were originally rated two notches lower than the long-term corporate credit rating on Tabreed. This is because of their subordination and to reflect the market risk resulting from the relative evolution of the share price and of the conversion ratio of the notes.

Since the ratings were assigned on April 14, 2008, the long-term rating on Tabreed has been lowered to 'BB' with a developing outlook. Following the downgrade in December 2008, we increased the differential between Tabreed’s long-term rating and the Tabreed 08 convertible notes to three notches from two to reflect the latter’s lower recovery potential.

Sun Finance Ltd.
The purpose of the Sun Finance securitization is to allow Sorouh Real Estate PJSC (Sorouh; not rated) to monetize future cash flows from the sale of real estate plots to property developers. Sorouh applied the proceeds of the monetization toward funding the utility infrastructure for two sites. One is Shams Abu Dhabi, a 170-hectare development on Al Reem Island, and the other is the Saraya development in Abu Dhabi’s central business district.

In essence, there are three principle parties involved in this transaction: Sorouh, a project developer that sells the plots; Sorouh Abu Dhabi Real Estate LLC (Propco), that purchases the plots and, in turn, sells them to individual developers; and Sun Finance (Issuer) that issues the Al-Mudaraba Al-Muqayyada certificates to investors.

The transaction is capitalized by Sun Finance applying the certificate proceeds toward a mudareb (investor of capital). The certificate proceeds amount to the Issuer’s beneficial interest in the mudareb. Propco, effectively a partner in the mudareb, buys the plots from Sorouh, sells them to the developers, and puts the purchase price toward the investors’ (that is, trust certificate holders’) returns and funding for the infrastructure works.

As payments from the developers come in through plot sales, ownership of the land incrementally shifts to the developers. In turn, Propco incrementally purchases the Issuer’s beneficial interest in the mudaraba (trust) as it receives funds from plot sales, thereby amortizing the certificates (see chart 2). When a plot sale payment is received, Propco releases the relevant plot to the developer.
The Sun Finance transaction shares similarities with the DP World transaction. In that transaction, cash flow movement occurs in the following manner: First, investors pay the issue price for the sukuk and Dubai World Sukuk Ltd. (in its capacity as rab el-maal, or provider of capital) applies the proceeds as the capital of the mudareba, pursuant to a mudareba agreement entered into between the issuer and DP World (the latter acting in its capacity as the mudareb). Second, the mudareb invests the capital of the mudareba in DP World's business activities, in accordance with an agreed sharia-compliant investment plan prepared by the mudareb. The plan is designed to generate "profits," which will be used to service the notes. If insufficient profit is generated, DP World (in its capacity as mudareb) will be required to provide sharia-compliant funding to meet the payments in full.

The basis of repayment is the "profit" generated by the mudareba (or joint investment trust). If the mudareba does not generate enough "profit," DP World is required to provide funds to meet the shortfall in returns generated by
the mudareba. DP World does this by exercising the purchase undertaking. For this reason, credit risk is linked not only to the mudareba, but also to DP World.

In comparing the Sun Finance and DP World transactions, we make several observations. One observation is that should DP World prove unable to generate sufficient profits to service the certificates, certificate holders have recourse to a purchase undertaking by DP World for the amounts due under the certificates. Therefore, the rating on the transaction is constrained by the rating on DP World. In Sun Finance, the Propco purchase undertaking is backed solely by the sale proceeds from the real estate plots. If plots are not sold or purchase prices not achieved, Propco will likely not be in a position to meet is obligations under the purchase undertaking. The Issuer’s ability to service the certificates lies ultimately in the ability of Propco to sell and be paid for the plots. The significance of this feature is that the credit quality of Sorouh is effectively not an issue once the sale of the plots to Propco is completed, effectively making the Sun Finance transaction a nonrecourse sukuk.

Sun Finance features both senior and subordinated certificates. Standard & Poor’s notes that the structure benefits from a fatw’a to the effect that it’s sharia-compliant, although we do not verify shariah compliance.

The structure of the Sun Finance transaction reflects certain aspects of our project finance criteria. That said, we do not view it as a traditional project financing. This is because the transaction has much in common with structured financings such as residential mortgage-backed securitizations and corporate securitizations.

Differences between the Sun Finance transaction and more traditional types of project financing include the nature of the special purpose entity, attributes of the Issuer, the security structure, and payment flows.

Propco is 99%-owned by the chairman and managing director of Sorouh, the remaining 1% being held by an independent director. In the event of a payment default by Sorouh, transaction documentation indicates that the 99% share would be transferred to the independent director, who would then own 100% of Propco. Based on the information available, Standard & Poor’s takes comfort that this structure is enforceable under applicable law.

As with the DP World transaction, investors do not have security as much as they hold a beneficial ownership interest in the mudareb. We understand that such interest is not the same as outright legal ownership. While the Issuer has a fixed and floating charge under U.K. law over the assets of Propco, there is some question as to whether such charge would be enforceable in the UAE where the assets are located. In practice, we believe that the fixed and floating charge would likely only provide lenders with recourse to offshore assets of Propco. As noted above, in the event of the insolvency of Sorouh, the issuer is entitled to instruct the independent director to force a sale of the assets held by Propco. In summary, there is a degree of legal and country risk in each transaction.

Finally, in the Sun Finance transaction, the plots are not sold to the Issuer but to Propco. On a plot sale, the Issuer is paid through an onshore cash management agreement. Typically, offshore accounts are established where sale proceeds are deposited. Payments are made from such accounts to investors and back onshore.

Standard & Poor’s ratings on structures such as Sun Finance and DP World rely on the economic fundamentals of such transactions as well as their structural and legal aspects.
Will Sukuk Flexibility Lead To Greater Take-Up In The Future?

In 2008, the project and infrastructure asset class accounted for around $1.6 billion (10%) of the $14.9 billion of sukuk issues that came to market. In 2009, the development of the sukuk market will depend on economic recovery, increases in oil and gas prices, and the stabilization of real estate markets in the GCC.

In our opinion, there are four important considerations that need to be addressed for sukuk financing to become a major component of project and infrastructure funding in the Gulf as well as in other markets such as Malaysia, Indonesia, Pakistan, and Gambia:

- Greater clarity in transaction structures. Improved documentation, increased standardization, and lower overall complexity;
- Consensus among Islamic scholars around the world, including better issuer and investor education about sukuk and sharia compliance generally;
- A liquid secondary market; and
- A more predictable legal framework. There is a lack of clarity of local law in a number of markets where sukuk issuance is prevalent. In particular, we consider that there are issues surrounding the enforceability of collateral.

Infrastructure financing needs remain significant in GCC states. According to The Middle East Economic Digest, about $2 trillion of planned and anticipated project and infrastructure financings will be undertaken in the region by 2020. Meanwhile, there remains the more immediate concern of refinancing existing bank loans, which may prove difficult given the reduced appetite for bank lending.

Many of the principles inherent in project financings are found in Islamic finance transactions. Consequently, as project financing matures as an asset class in the Gulf, we believe Islamic finance will continue to adapt to traditional project structures. Similarly, we see Islamic finance structures being applied to public-private partnerships, and independent water and power projects as these programs evolve in the Middle East.

We believe that the use of nonrecourse finance vehicles may continue to be used in securitizing future payment streams and providing short-term liquidity. We observe that securitization and monetization structures are assisting developers such as Sorouh in removing the immediate debt burden of such financings off their balance sheets. However, there’s no track record of sukuk enforcements to date, and the issue of effective legal ownership of assets between a company and its related sovereign have yet to be tested.

In fact, the first infrastructure sukukas rated by Standard & Poor’s such as Tabreed 06 and Tabreed 08, are more akin to corporate financing rather than project financing. Furthermore, on a corporate basis it’s unlikely that there would be a significant difference in the risk component between a sukuk and secured corporate lending, assuming that the same underlying assets constitute security under the two different issues. It’s possible, however, that by having less off-balance-sheet and derivative type counterparty risks, a sukuk transaction could be considered less exposed than a secured transaction with the same underlying assets.

Ultimately, the flexibility of the sukuk instrument may hold key to it increasing its share in financial markets. Although most sukuk issues so far have been debt-like, their ability to be structured as an equity instrument through convertibility means they could access a much wider investor base than traditional loan financing.

Additional Contact:

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