IFN CORPORATE OMAN

Opening doors to new opportunities

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Nuts and bolts: The path to market for corporate issuance

It is all very well to throw around facts and figures and generalize about the overall benefits of Islamic issuance – but what about the nitty gritty details? The headlines only ever laud the latest issuance: but how did they get there, what assets did they use, what challenges did they face and how were they overcome? This month we bring you answers to the questions you may not yet have thought to ask.

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Especially in the Middle East, bank lending has historically been the funding channel of choice for small to mid-sized corporates, with high level of liquidity and large government deposits backing active lending capabilities from local and regional banks.

As the oil price fell, governments withdrew their deposits and liquidity started to dry up, the capital markets have offered companies an alternative route to raising finance — and as more and more sovereigns also turn to the same option, yield curves have been established that offer reassurance and encouragement to first time issuers.

But what does it actually take to issue a Sukuk – and what technical challenges do corporates face when switching from bank lending to capital markets issuance?

Romy Buchari, the head of syndication and capital markets at Emirates Islamic, explains some of the key initial stages.

"Generally tapping the debt capital markets requires would-be issuers to provide more exhaustive information disclosure (publicly) as well as comprehensive legal documentation as compared to bank financing. Furthermore, the papers would have to be rated by external rating agencies in order to reach a sufficiently wide-ranging investor base. These are the major requirements in issuing Sukuk papers, with consequences of longer lead-time and higher initial cost-outlay as compared to the more simple bank financing route.

"Would-be issuers also need to be mindful about actual Sukuk launch timing and pricing, vis-a-vis matters such as benchmark rate movements/trends, economic outlook, general markets sentiment, comparison of existing papers with similar credit profile, the timing of potential launch of competing Sukuk that may cannibalize interests of targeted investors, and so on.

"However, the benefit is typically larger transaction size with longer tenor availability. Furthermore, should the issuer need to do a follow-on financing in the

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Covered Sukuk: A unique option for low-risk issuance

The Malaysia Building Society (MBSB) in November announced plans to swap its structured covered Sukuk with a new covered issuance from its recently acquired subsidiary Asian Finance Bank, pending Sukukholders approval. But what is a covered Sukuk, and what benefits can it offer the issuer? 4

Dubai launches new trade finance facilities to support SMEs

Trade finance is the backbone of the global economy, and yet it can be under-served and under-rated through traditional channels. Conventional banks stepped back during the financial crisis to conserve their capital and reduce risk, and since then this gap has been filled by local and regional institutions offering unique new avenues of access. 5

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future, a Sukuk program can be structured with multiple tranches, where the second and subsequent tranches can be done relatively quickly (and consequently with lower costs)."

Asad Qayyum, senior associate at Al Busaidy, Mansoor Jamal & Co, adds the legal perspective.

"[In Oman] the main issues revolve around the nature of the capital market instrument desired to be employed by the corporate issuer," he told IFN Corporate. "In the event that an issuer is desirous of issuing bonds in the market, it is restricted from issuing bonds over and above its issued capital. In addition, an issuer desirous of tapping the capital market for a conventional fund raise is required to register itself as a joint stock company, given that limited liability companies are not permitted to seek capital subscriptions and investments from the public.

"If, however, the corporate issuer intends on raising the funding through the Islamic finance mode of funding then the most common form of instrument available to them is the Sukuk. The limitation in issuing Sukuk however is that it is required to be either asset-backed or asset-based. Regardless of which option you choose, the availability of an asset is key to a Sukuk issuance."

"What does it actually take to issue a Sukuk – and what technical challenges do corporates face when switching from bank lending to capital markets issuance?"

This brings us to a vital point, and one that can flummox many a potential issuer. How do you identify the assets to use in a Sukuk? How can a corporate figure out which assets are appropriate and who can help them do so?

"Some might think Sukuk can only be done by using specific fixed-assets," said Romy. "However, although a majority of the cases use the sale and leaseback (Ijarah) structure, which requires specific assets, there are other Sukuk structures (e.g. agency (Wakalah) or cost-plus-profit (Murabahah) that do not require fixed-assets. These structures instead use existing cash flows and/or commodity-based (Murabahah) as the underlying assets.

"Corporates will typically appoint bank(s) to advise and guide them in identifying underlying assets, preparing, launching and distribution of the Sukuk papers. The banks will act as the coordinating point in managing various workstreams for a successful Sukuk launch (e.g. info-memo/prospectus preparation, legal documentation & registrations, rating agencies, interaction with investors, pricing, launch timing, etc)."

Asad elaborates further.

"Sukuk may be issued with a multitude of assets (or even rights relating to such assets e.g. usufruct or easement in the case of real estate assets) serving as underlying assets. Such assets may include tangible assets, whether immovable, such as real estate properties, or movable, e.g. vehicles, equipment etc., or intangible assets e.g. intellectual property rights. Companies may

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determine which assets could be employed as underlying assets based depending on (i) the value of the issued Sukuk, which should correspond to the value of the underlying asset in the case of asset-backed Sukuk, (ii) the nature of its activity, (iii) the importance of such assets for their activities, and (iv) how attractive is such an asset to the investors. Financial experts may be appointed by companies in order to assist them with selecting the most suitable assets for the transaction.

"In addition, a corporate issuer which is involved in any regulated activities may also require consents of the relevant regulator before it can dispose of or lease any of its assets for the purpose of the Sukuk issuance.

"There may also be other restrictions on transfer of assets which one should be mindful of, such as, the restriction on disposal of any assets by an obligor where such assets have been declared a public utility. For example, the land designated for the Muscat International Airport was designated a public utility land and therefore cannot be used for the purpose of Sukuk by the relevant Ministry."

Another frequently asked question is how these identified assets are then treated on the balance sheet — do they remain on or are they transferred away, and do the Sukuk investors have actual access/recourse to them?

"The underlying asset used in a Sukuk issuance would actually be transferred to the Special Purpose Vehicle [used to issue the Sukuk]," explained Romy. "There are Sukuk structured with security/collateral of specific assets, with investors having special rights/recourse in the case of default. However, most Sukuk are done under a 'clean-basis', as in the case for most conventional bonds. On a clean-base Sukuk, the asset is used as the underlying platform to facilitate issuance, not to serve as security. Which means that for this kind of Sukuk, investors will not have any preferential rights to the asset in the event of default."

"Corporate bodies wishing to issue Sukuk may adopt an asset-based structure for their issuances in order to avoid enforcement against the transferred assets"

One of the key issues when looking at how the assets are treated on the balance sheet is the question of whether the Sukuk is asset-based or asset-backed. "If asset-backed, it is necessary to undertake a real transfer of ownership to the trustee or Sukukholders' agent (which can require registration with the authorities)," explained Asad. "This should then entail de-recognition of the assets from the beneficiary's balance sheet. However, should the Sukuk be asset-based, the Sukukholders cannot enforce against the underlying assets but only against the originator by forcing it to re-purchase the assets." In many jurisdictions, the Islamic banking framework therefore provides that the assets do not qualify for de-recognition from the balance sheet.

"Consequently, corporate bodies wishing to issue Sukuk may adopt an asset-based structure for their issuances in order to avoid enforcement against the transferred assets," noted Asad.

So realistically, how difficult is it to create a pool of assets for Sukuk issuance, and is it cost-effective for small companies? Romy believes that it is. "Assets to be used to facilitate Sukuk issuance are quite straightforward, be it property/plant/cashflows or other. In general, as long as the asset is of a Shariah compliant nature and with consolidated value sufficient to back the issuance size, then it can be used as an underlying asset."

"Sukuk can basically be issued in any size — however, the high upfront outlay/cost nature of Sukuk will make it more economical for larger-size issuance (i.e. larger corporates). One way to alleviate this and make Sukuk more accessible to smaller companies is to instead issue a 'private-placement' Sukuk, where a limited range of investors are targeted. Hence, there are fewer disclosure and legal requirements, with typically no rating exercise to be done, reducing overall issuance costs."

So far so good, and it is clear that corporates have multiple options ahead of them when preparing for market. Yet while the process may be straightforward, it must be remembered that it is a very different animal from a conventional bond or a bank loan.

"It is always a challenge dealing with a client that has no previous experience in issuing Sukuk, as the client may not always be appreciative of the special and distinctive characteristics of the Sukuk and how it differs from conventional financing instruments," warned Asad. "Additionally, sometimes the corporate client would decide to substantially alter the structure of the transaction after discovering that the initial structure is difficult to achieve in light of existing laws and regulations. Further, it can sometimes be challenging to steer the transaction towards legal compliance whilst minimizing potential breaches of Islamic law, which does not always match with what conventional legal provisions provide for."