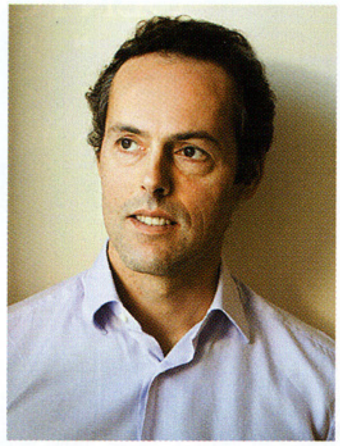


Finisterre Capital's Yan Swiderski is venturing into the *sukuk* market

Broadening Their Horizons

The booming market for sharia-compliant bonds is attracting non-Islamic investors.

BY ERIC UHLFELDER

UNTIL RECENTLY, EMERGING-markets investors could be forgiven for overlooking the burgeoning market for *sukuk*s, which are bonds issued in accordance with sharia, the Islamic legal code that bans interest. But last December's $3.52 billion bond flotation by Dubai property developer Nakheel Group underscored just how rapidly this market is maturing. At ten times the average size of prior sukuk offerings, it was the biggest such flotation ever and was twice oversubscribed by investors, even though the company — which is building a trio of palm tree–shaped resort and residential islands off of Dubai's coast — is only a few years old and has yet to turn a profit.

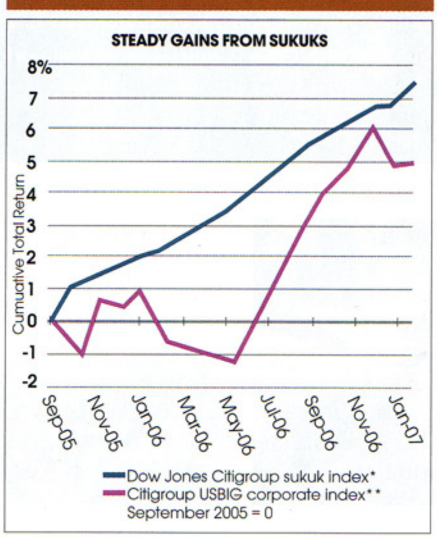
Yan Swiderski, co-founder of London-based hedge fund Finisterre Capital, sensed a unique opportunity. The three-year bond was priced at 120 basis points over the six-month U.S.-dollar LIBOR, producing a yield of 6.35 percent — nearly 100 basis points above the five-year yield of the closest comparable benchmark, the Dow Jones Citigroup sukuk index. The biggest attraction, Swiderski says, is that bondholders can convert up to 25 percent of the unrated bonds' nominal value into IPO shares at a 5 percent discount to the offering price if Nakheel Group, which is wholly owned by Dubai World, a government enterprise, goes public before the bonds mature. If the company remains private, the sukuks pay an additional 6 percent of principal at maturity, boosting the annualized return to 8.35 percent.

"The bond is guaranteed by a government-owned corporation that has more than $30 billion in assets, which is greater than three times liabilities," says Swiderski, whose firm manages $350 million. He bought a big position, Finisterre's first-ever sukuk investment.

Swiderski wasn't the only non-Islamic buyer to snap up the bonds, which comply with sharia law by paying investors a cash stream generated from assets that are placed in a special-purpose vehicle: European and Asian investors purchased 40 percent of the offering. Demand in the secondary market remains strong; after a month of trading, the spread over LIBOR fell to 90 basis points.

Last month Western investors again demonstrated their growing interest in sukuks. When United Arab Emirates developer Aldar Properties priced an Islamic bond, more than 70 percent of the buyers were from Europe, compared to 20 percent from the Middle East and 6 percent from Asia and offshore locales. In response to the surprisingly strong demand, Aldar raised the amount of its issuance from $2.2 billion to $2.5 billion.

Sukuk issuance is taking off, driven by surging oil revenue in the Gulf states and the growing number of Muslim investors demanding sharia-compliant instruments. According to the Islamic Finance Information Service, a data provider owned by Euromoney Institutional Investor, *Institutional Investor*'s parent company, only three sukuks worth a combined $340 million were issued in 2000. In 2006, 188 issues worth more than $27 billion came to market. And that may be just the beginning: Arul Kandasamy, the Dubai-based head of Islamic finance at Barclays Capital, estimates that the Gulf region will need $1 trillion in financing over the next decade and expects a significant portion of the capital to be raised through sukuks.



* Measures U.S. dollar–denominated investment-grade sukuk market.
** Tracks U.S. investment-grade bonds.
Source: Dow Jones indexes/Citigroup index.

Some companies in the region are tapping the market by collateralizing specific cash streams, says Hossam Rageh, head Gulf representative of Cairo-based Commercial International Bank, which manages a $200 million sharia-compliant loan portfolio that includes a 25 percent allocation to sukuks. These bonds' short maturities — typically three to five years — match the bank's liquidity and risk management needs. In July, Commercial International bought a $10 million stake in a sukuk issued by a Gulf-based national airline that is in the midst of a turnaround effort. The bonds are backed by revenue from a major U.S. route.

"Being that it was a first lien on one of this government-owned airline's most profitable routes, we saw value," says Rageh. His bank bought the sukuk at 160 basis points over LIBOR and sold the position in October after the spread fell to 135 basis points.

Sukuks, which are still mostly unrated, involve myriad risks. Although the move toward multibillion-dollar issues is helping to promote a secondary market, most investors still buy and hold the securities to maturity, stifling liquidity. The bonds are listed on several exchanges, but the size of the market — still tiny in absolute terms — inhibits accurate pricing and trading. Tax treatment is a work in progress in many jurisdictions. And investors have scant experience with defaults. They can arbitrate disputes involving most sukuks under English common law in the U.K., but whether these conflicts can be brokered effectively remains to be seen.

Barring a collapse in oil prices, though, or a dramatic tightening of liquidity, sukuks are likely to tempt a growing number of investors eager to tap the Gulf's economic boom. Finisterre's Swiderski, for one, will be watching.

HARRY BORDEN