

---

## **SUKUK INVESTMENTS: A SEMINAL YEAR FOR ISLAMIC CAPITAL MARKETS & INVESTORS**

**Eric Uhlfelder**

**Exclusive to Islamic Finance Information Service (IFIS)**

**May 2007**

The past 16 months have proven to be a seminal period for Islamic financing. The market for sukuk—Shariah Law-compliant obligations—has soared from \$1.1 billion [90 issues] in 2005 to more than \$27 billion [188 issues]. But what was extraordinary about this recent surge in sukuk offerings has been the sheer scale of individual issues, which has attracted the attention of increasing numbers of more sophisticated investors.

In January 2006, Dubai-based PCFC [Ports and Customs Free Zone Corporation, a subsidiary of Dubai Ports] brought a record-breaking \$3.50 billion offering to market. But that new threshold didn't last long. In November, Nakheel Properties, which also operates in Dubai, raised \$3.52 billion. Then in February 2007, almost modest in comparison, Abu Dhabi developer Aldar Properties sold a \$2.53 billion sukuk—still five times larger than the average-size offering.

In addition to the scale of these deals, the issuers introduced a new feature to the sukuk market that's far more characteristic of western finance: convertibility of a debt-like obligation into an equity stake.<sup>1</sup>

### **Why is this such a big deal?**

These bonds are opening a potential window into Middle East equity ownership, which has been difficult to access. Market index provider Morgan Stanley Capital International in New York reports that the percentage of the Gulf States stock markets that is open to foreign institutional investors ranges from around 0.20 percent for the United Arab Emirates, Qatar, and Jordan to a high of 0.44 percent for Kuwait.

Jahangir Aka, director of business development for the UK and Arab Middle East for SEI Investments, a global outsource asset advisor with \$550 billion under management, confirms that foreign direct investment into the region is challenging and quite limited.

While common stock of Aldar Properties already trades on the Abu Dhabi Securities Market, both Nakheel's and PCFC's convertibility is dependent on the companies bringing an initial public offering to market before their bonds mature.

"A pre-IPO convertible is a unique phenomenon," says Douglas Decker, head of Convertible Origination at Barclays Capital in London. His team co-underwrote both the PCFC and Nakheel offerings [along with the ALDAR sukuk]. "These issuers were able to attract a broad international investor base by including convertibility," Decker adds, "coupled with additional investor compensation if the companies do not go public before maturity."

If the IPOs do not materialize, initial investors would end up with yields topping 8 percent. In this current rate-starved environment where investors have compressed spreads of even unrated emerging market debt over 6-Month US Dollar LIBOR to under 150 basis points, the potential total return of these sukuk has gotten a host of non-Shariah-compliant investors to sit up and take notice.

---

<sup>1</sup> These three issues were among the first corporate convertibles. In June 2006, Kuwait-based Aabar Petroleum Investment Company PJSC announced a \$460 million issue underwritten by Deutsche Bank, which was the only other convertible.

## Sukuk Analysis

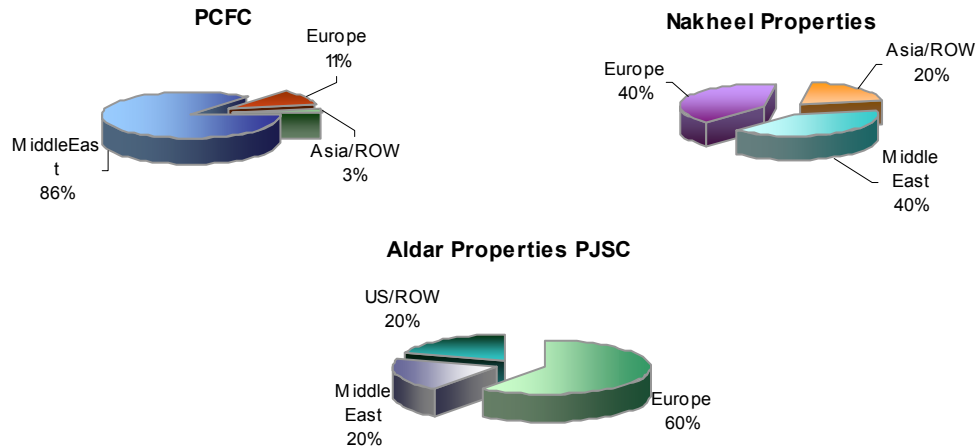
Sukuk	PCFC	Nakheel Properties	Aldar Properties PJSC	Comments
Parent Company	DP World	Dubai World	NA	
Parent Company Guarantee	Yes	Yes	NA	Purchase undertaking by the obligor for the three sukuk
Country	U.A.E (Dubai)	U.A.E (Dubai)	U.A.E (Abu Dhabi)	
Industry	Transportation	Real Estate	Real Estate	
Sukuk Type	Pre-IPO	Pre-IPO	Exchangeable	
Sukuk Structure	Sukuk al-Musharaka	Sukuk al-Ijara	Sukuk al-Mudarabah	Different Sharia compliant structures
Issue Date	12-Jan-06	29-Nov-06	20-Feb-07	
Maturity	2 years	3 years	4 years, 9 months	
Maturity Date	23-Jan-08	14-Dec-09	10-Nov-11	
Issue upsized by	25%	41%	94.6%	
% Oversubscribed	3x	2x	5x	All transactions were well received by investors
Base Currency	AED	AED	AED	
Fixed Exchange Rate: US\$/AED	3.67	3.67	3.67	
Credit Rating	NR	NR	NR	
Initial Spread Talk (bps)	250 - 350	95 - 145	75 - 125	All spreads are over US mid swaps
Final Spread (bps)	200	120	65	Tighter spreads achieved
Issue Price	100	100	100	
Coupon / Yield	7.125% (10.125% if no IPO)	6.345% + up to 2% per annum at maturity	5.767%	For Nakheel, additional 2% p.a. yield depends on the value of Subscription Rights attributed to Sukuk holders prior and up to redemption
Periodic Distribution	Single payment at maturity (Zero Coupon)	50% of the yield paid semi-annually, 50% at maturity	Quarterly	
Redemption Price	114.25+	109.518+	100	
Early Redemption	(Partial) mandatory redemption upon QPO event - 30% paid in QPO shares	Right to subscribe for up to 30% of QPO at 5% discount	Exchange into Aldar shares	QPO: Qualifying Public Offering
Convertibility	Yes	Yes	Yes	For PCFC & Nakheel, conversion is conditional upon IPO
Stock Price on Issue Date	NA	NA	US\$ 1.13	
Conversion Premium	NA	5% discount (for up to 30% of the shares offered)	37%	For Aldar, premium was set at top end of 27% - 37% range
Conversion Price	NA	NA	US\$ 1.55	
Sukuk Traded to date (US\$)	2 billion+	1 billion+	1 billion+	Estimate is based on trading volumes at Barclays Capital
Daily Liquidity (US\$ m)	c. 10 million+	c. 10 million+	c. 20 million+	Average liquidity since issue--based on Barclays estimates
Joint Bookrunners	Barclays Capital, Dubai Islamic Bank	Barclays Capital, Dubai Islamic Bank	Barclays Capital, Credit Suisse, National Bank of Abu Dhabi	
Website	<a href="http://www.dpa.co.ae">www.dpa.co.ae</a>	<a href="http://www.nakheel.com">www.nakheel.com</a>	<a href="http://www.aldar.com">www.aldar.com</a>	

Source: Barclays Capital CB Origination

Date: 19 April 2007

---

## Distribution



Source: Barclays Capital CB Origination

### Nakheel Properties

One such investor is Yan Swiderski, a partner and portfolio manager at London-based hedge fund Finisterre Capital, which has over \$300 million in assets in its Sovereign Debt and Global Opportunity Funds. Swiderski purchased the Nakheel sukuk during the primary market offering in December 2006 and added to his position over the next two months.

At the time of its offering in November 2006, Nakheel's annualized yield was 6.35 percent. Half its semi-annual coupon is deferred until maturity. This means the sukuk's redemption price in December 2009 is 109.52 percent of par.

Though this was his firm's original foray into Islamic finance, Finisterre felt confident moving into this new sphere because the fund specializes in emerging market securities. Interestingly what Swiderski found was an under priced bond with unique characteristics.

The offering was twice oversubscribed, coming to market pretty much in the middle of its initial spread range of 95 to 145 basis

points. But Swiderski felt the final price of 120 basis points above LIBOR was rich. The reason: He saw the sukuk as a proxy of Dubai's macroeconomic conditions. "The country's GDP has been growing by more than 12 per cent a year," Swiderski notes, "and Nakheel is part of a sector that plays an integral roll in the country's development strategy."

Also compelling is the fact that the bond is guaranteed by a government-owned corporation, Dubai World, which has more than \$30 billion in assets (three times greater than its liabilities). With government bonds trading at approximately 25 points above Labor, Swiderski believed that 70 basis points was a more appropriate credit spread. Within two months of the offering, the spread did close to 90 basis points.

If Nakheel manages a public stock offering before the bond matures in December 2009, then sukuk investors can convert 25 percent of the bond's nominal value into stock at a five percent discount to the initial offering price. Given the low-float of public shares and the market's limited liquidity, foreign investors usually covet such local equity exposure.

But it was Nakheel's guaranteed premium of 2 percent a year--which comes on top of its coupon--if the company fails to go public--that sold Swiderski on the sukuk. "Without that benefit, which can push the annualized rate of return to 8.35 percent" he says, "I wouldn't have made the investment."

While it's too early to tell if Nakheel is merely testing the equity waters or is truly prepared to go public, recent regional stock performance suggests that Swiderski may indeed receive that premium as regional equity markets have struggled so far this year.

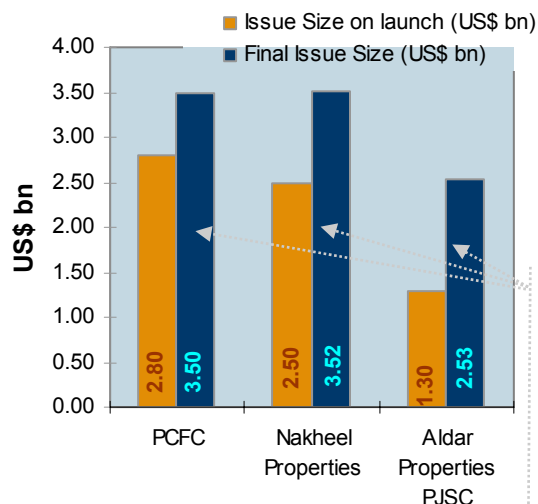
The Dubai Financial Market General Index, for example, started 2007 at 4127. It fell to 3658 as of early March. While it has since made up some ground, having traded at 3812 as of 27 April, the index is down by 7.63 percent for the first four months of the year.

From a technical point of view, the sukuk's price as of mid-April of 100.78 percent of par suggests that it's trading more on yield than its potential equity conversion. The good news for sukuk investors is that unlike smaller illiquid issues that were virtually unavailable on the secondary market, the average daily trading volume of Nakheel passing through Barclay's convertible trading desk alone is in excess of \$10 million. This suggests that whether they are looking for yield or potential access in the Dubai stock market, foreign investors can gain local exposure through this sukuk.

### PCFC [DP World]

The same investment case is being made for exposure to the two-year unrated PCFC sukuk that was issued in January 2006. A relatively new multinational hedge fund, based in London with \$4.5 billion in assets [that prefers to remain anonymous], invested \$100 million in the three largest convertibles, including \$25 million into PCFC via the

**Issue Size and Total Order Book**



Source: Barclays Capital CB Origination

All sukuk were upsized due to high demand

secondary market. [The fund wasn't established before the original offering.] Like Swiderski, the fund is holding PCFC because of the likelihood of receiving the additional yield payment that would be triggered if PCFC opts not to bring an IPO to market before the sukuk matures in January 2008.

The additional three percent per annum premium PCFC has promised stands to produce total returns that go beyond Nakheel's healthy yield. This may help explain why the order was three times oversubscribed, which helped push down spreads below the initial range of 250 to 350 basis points above LIBOR to 200 basis points. This produced a coupon of 7.13 percent, and encouraged PCFC to increase the size of its offering from \$2.8 billion to \$3.5 billion.

However, a less attractive feature of the sukuk is that its yield isn't paid until redemption. This means the sukuk trades like a zero-coupon bond that's redeemed at 114.25 percent of par [before any premium payment resulting from PCFC deciding not to go public before maturity].

But this feature hasn't dampened demand for the sukuk. In mid April, it was trading at 112.925. This translates into a current yield of just 1.57 percent [again without premium consideration]. However, if the IPO fails to materialize before next January, the bond's annualized rate of return soars to 8.65 percent, or 30 basis points higher than Nakheel's premium-plus yield.

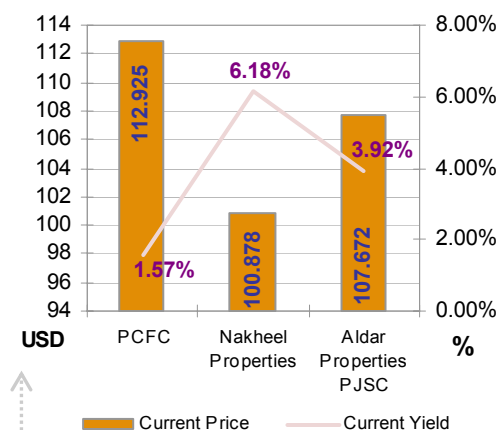
Given that the bond's price action would be likely strengthened if the market was anticipating a public offering, the current price and yield suggests the market is valuing the sukuk primarily on income. Barclays is seeing daily trading volume that's comparable to Nakheel's—running around \$10 million.

Still, the fund manager wouldn't be unhappy if PCFC managed to offer conversion into stock before the sukuk matures. "In the current challenging equity environment," he explains, "such an offering would likely occur at a discount to the company's net asset value. Given that the long-term economic outlook remains promising for PCFC and Dubai, converting to equity may mean giving up the more certain high-yield short-term gain from redemption in exchange for greater longer term equity upside."

### ALDAR Properties PJSC

The ALDAR Properties sukuk is the only convertible that came to market with a stock that was already trading on the Abu Dhabi Securities Market. That moved the matter of conversion from an abstract possibility to a more distinct reality, making the convertible—and its trading—more akin to its western cousins, offering quarterly payments and redeemable at a par price of 100. This greater transparency and familiarity triggered unprecedented demand and liquidity. Barclays estimates daily trading volume at

**Current Price and Current Yield**



Source: Barclays Capital CB Origination

20 million—twice the average of the Nakheel and PCFC sukuk.

Originally seeking to raise \$1.3 billion, the total order book for the five-year sukuk was ten times oversubscribed, having topped out at \$13 billion—larger than either Nakheel or PSFC. The road show anticipated a spread of between 75 and 125 basis points above 5-Year US dollar Swaps. But when the sukuk came to market in February of this year, it did so at just 65 points above the Swap rate or 5.76 percent. This allowed ALDAR to raise nearly twice the capital it originally intended.

When the sukuk came to market, ALDAR's stock was trading at a dollar-equivalent of \$1.13. With a conversion premium set at 37 percent, this means that the stock needs to reach \$1.55 for investors to opt for conversion.<sup>2</sup> In mid-April, the stock was rising despite the regions negative market sentiment, trading at \$1.29. This has helped to propel the price of the sukuk to above 108 percent of par. Alex Williamson, an analyst at Finisterre, says that at this price, the

<sup>2</sup> Sukuk holders that convert their shares would result in the loss of the last coupon payment. Accounting for this loss, Barclays' Becker figures sukuk investors need the stock to price two cents higher to break even—or \$1.57.

---

sukuk is trading at a negative spread to the Swaps, suggesting that the market is currently considering conversion a realistic possibility.

Barclay's Decker adds that the stock is beginning to drive the price of the sukuk. "Being still a fair distance from conversion and more than four years away from maturity, the market translates approximately 40 percent of the stock's upward move into the sukuk's price," explains Decker. "That means if the stock rises 10 percent, the bond should appreciate by about 4 percent."

Like traditional convertibles, the closer the stock gets to the conversion price, the greater the correlation between its price movement and that of the sukuk. "But if the stock falters," Decker notes, "the yield component of the sukuk will help sustain its value, producing more uncorrelated price movements between the two securities."

The price of the sukuk may also be affected by call features that the other two convertibles do not have. Between September 2009 and February 2010, ALDAR may call the issue if its conversion value reaches 140 percent of par. Then, afterwards through maturity in November 2011, the company can call the sukuk at a conversion value of 125 percent. Such early redemption would likely be contingent upon very strong stock performance.

Finisterre Capital's Yan Swiderski established his second sukuk position in ALDAR when it came to market in February. Where he was attracted to the Nakheel offering because of yield premium paid if the company doesn't go public before the sukuk matures, Swiderski invested into ALDAR because of the underlying health of the local economy and the more traditional convertible characteristic of the issue.

"As one of Abu Dhabi's leading property developers that's indirectly owned by the

state," Swiderski explains, "ALDAR is a proxy for a diversified economy that's been growing at an annual rate of six percent a year." Unlike other Middle Eastern economies, two thirds of Abu Dhabi's GDP is generated from non-oil and gas activities, led by services, tourism, and industry. This sukuk is the first direct property investment instrument available to foreign investors in Abu Dhabi—among the richest and largest of the Arab Emirates.

The main macro risks are the usual suspects: the ratcheting up geopolitical tensions and a sustained collapse of oil below \$30 a barrel. At the corporate level, ALDAR could fail to efficiently execute its development plans. But the company has addressed this concern, explains Swiderski, by having recently replaced management with a proven development team from Western Europe.

"We are seeing the growing sophistication of Shariah-compliant securities," Swiderski says. That's producing attractive means in which Middle Eastern nations can tap into liquid global capital markets.

END

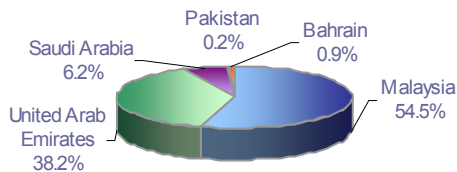


## Overview of Sukuk Market as of May 2007

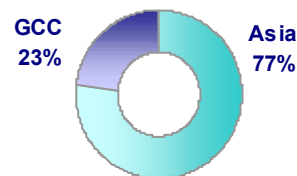
### Highlights

- ◆ Global Sukuk Issuance stood at USD9.6bn as of May 2007
- ◆ CIMB Islamic Top IFIS Bookrunners League Table as of May 2007 with a total of USD2.67bn
- ◆ Malaysia has the largest Sukuk issuance with USD5.26bn or 54.5% of total Sukuk issued globally
- ◆ Islamic Exchangeable Bonds and Musyarakah represented 51% of total Sukuk issued

**Sukuk Issued by Country as of May 2007**



**Sukuk Issued by Region as of May 2007**



Source: IFIS [www.securities.com/IFIS](http://www.securities.com/IFIS)

### DJ Citigroup Sukuk Index



DJ Citigroup Sukuk Index Components Performance (May 2007)							
Name	Coupon	Maturity	PAR(\$MM)	Rating	Country	YTM	Effective Duration to LIBOR
Kingdom of Bahrain	5.8106	06/30/09	250	A	Bahrain	5.3070	0.1733
DIB Sukuk F/R	5.6800	03/22/12	750	A	UAE	5.2487	0.2074
Govt of Dubai	5.8038	11/04/09	1000	A+	UAE	5.2833	0.0192
IDB	3.6250	08/12/08	400	AAA	Saudi Arabia	5.2473	1.2186
IDB	5.4906	06/22/10	500	AAA	Saudi Arabia	5.0455	0.1484
State of Qatar	5.7356	10/06/10	560	AA-	Qatar	5.2421	0.4395
Abu Dhabi Comm Bank F/R	5.7556	12/12/11	800	A	UAE	5.3108	0.1786
Sarawak Intl.	6.4706	12/22/09	350	A-	Malaysia	5.3107	0.1738

Notes:  
YTM– Yield to Maturity  
IDB– Islamic Development Bank

Source: DJ Indexes

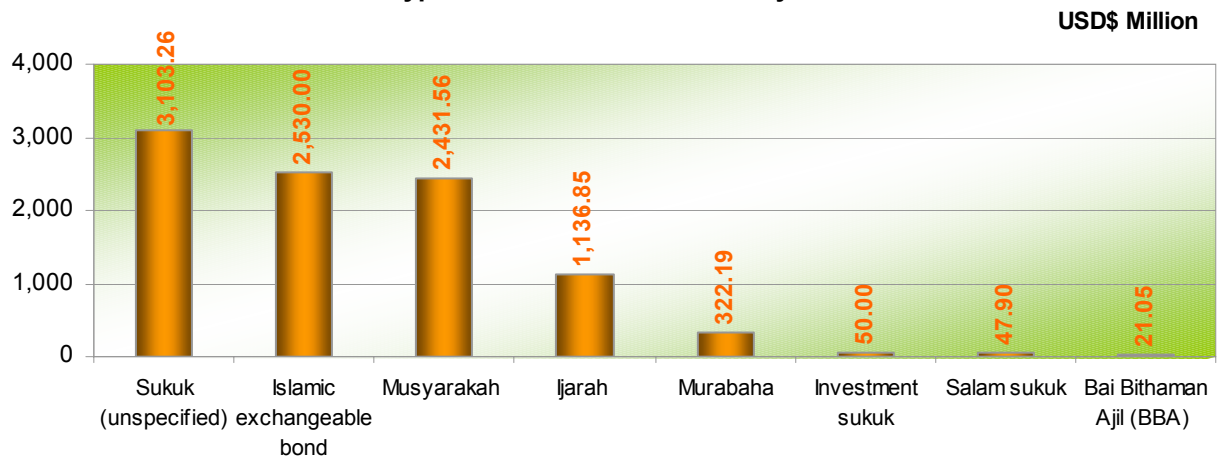
### Top 10 Bookrunners as of May 2007

Ranking	Bookrunner	Amount in US \$m	No.Issues
1	CIMB Islamic	2,667.83	17
2	Barclays Capital	683.00	2
3	Aseambankers Malaysia	452.97	7
4	National Bank of Abu Dhabi	433.00	1
4	Credit Suisse	433.00	1
5	HSBC Amanah	428.66	3
6	Standard Chartered Bank	258.24	2
7	Citigroup	250.00	1
8	ABC Islamic Bank	207.50	2
9	Kuwait Finance House	191.50	2
10	Standard Bank	120.00	1
10	Arab National Bank	120.00	1
10	WestLB AG (London)	120.00	1
10	Unicorn Investment Bank	120.00	1
<b>Total</b>		<b>6,485.70</b>	<b>42</b>

Source: IFIS

[www.securities.com/IFIS](http://www.securities.com/IFIS)

### Type of Sukuk Issued as of May 2007



Source: IFIS

[www.securities.com/IFIS](http://www.securities.com/IFIS)