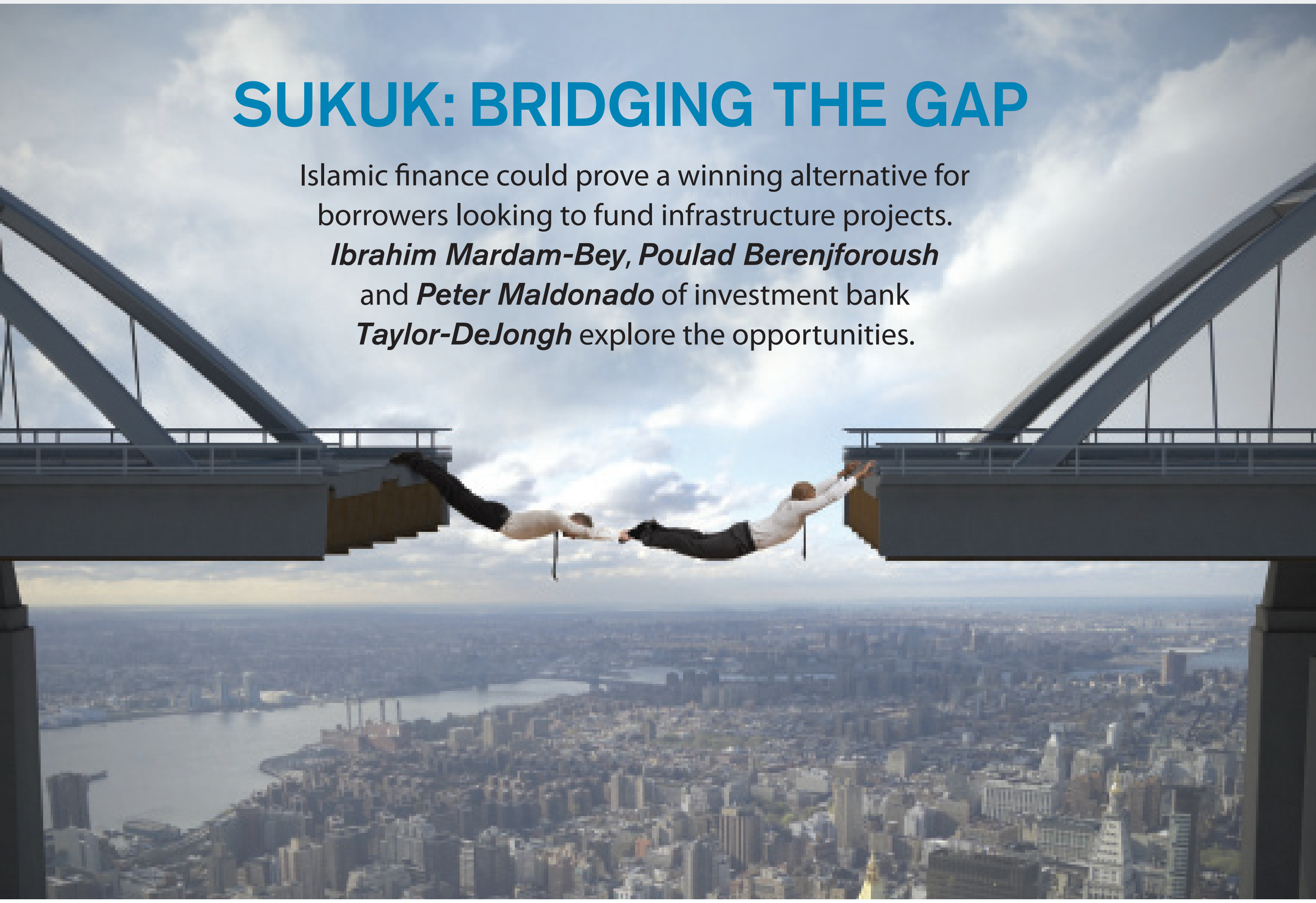

SUKUK: BRIDGING THE GAP

Islamic finance could prove a winning alternative for borrowers looking to fund infrastructure projects. ***Ibrahim Mardam-Bey***, ***Poulad Berenjforoush*** and ***Peter Maldonado*** of investment bank ***Taylor-DeJongh*** explore the opportunities.

The financing of infrastructure through sukuk, an Islamic financing instrument that resembles asset-backed securities, is beginning to mature and could contribute to filling the investment gap that exists in infrastructure markets, particularly in the US.

Sukuk, as a form of Islamic finance, consider money as a medium of exchange instead of an asset by itself. Therefore an underlying asset that is compliant with Islamic principles must be available to back the sukuk. Like conventional bonds, sukuk can be traded, rated by credit agencies and redeemed. However, they are not considered as a pure debt instrument; rather, they represent an ownership stake in existing or well-defined assets. Sukuk must comply with shariah or Islamic law, which can be simplified to be a ban on receiving and paying interest (riba), a ban on excessive risk (gharar) and a ban on investments that promote Islamic vices or are discouraged by shariah (such as alcohol and gambling).

Global demand for investment in infrastructure is growing inexorably as existing infrastructure is pushed to its limit by a growing population and urbanization. The OECD estimates that globally US$71trn is needed for investment in infrastructure by 2030. The US is confronted with one of the greatest challenges, as the country faces an infrastructure gap of US$1trn by 2020. Roads and bridges in the US form the greatest shortfall, estimated to be US$549.5bn by 2014.

The dangers of the infrastructure gap in the US will be felt on various fronts. In its 2012 annual executive survey on countries' global competitiveness, the World Economic Forum ranks the US 24th in overall infrastructure quality, including roads, bridges and rails. An alarming 26% of US roads and bridges are deemed structurally deficient or functionally obsolete. Poor infrastructure hinders growth, while good infrastructure can promote economic growth. The World Bank has estimated that growth of 1% in a country's stock of infrastructure is commonly associated with an increase of 1% in its gross domestic product.

This gap is not helped by the fact that spending on infrastructure in the US, as a percentage of GDP, has declined from a high of 3.1% in 1960 to only 2.4% in 2007. In contrast, Europe invested 5% of its GDP on infrastructure and China 9% in 2007. These factors, along with aggressive fiscal austerity measures taken by governments around the world, have combined to create significant infrastructure funding deficits.

The predictable, long-term returns from good infrastructure projects have often been favored by debt capital markets, though financing infrastructure projects has become more challenging in this capital constrained environment where capital is being "rationed". The current liquidity restraints experienced by the global lending markets have pressured banks to shorten maturity and increase interest rates for debt. This trend will continue into the foreseeable future, as long as the new Basel III directives for higher capitalisation requirements incentivise lenders to be more selective.

In the face of such challenges, financing of infrastructure is at a crossroads of either stagnation or finding alternatives to conventional financing. The costs of stagnation are too high and have a direct impact on GDP, employment and general economic growth. This means opportunities exist for private domestic and international capital to fill the existing gaps. Access to traditional lines of liquidity are becoming less available to all but a few projects, requiring a financing strategy that steps outside the boundaries of what is common.

A tested alternative

Infrastructure projects such as toll roads or bridges provide long-term concessions and stable cash flows that are derived from clear asset sources. Such features make infrastructure projects suitable to be financed with sukuk, as Islamic finance is based on principles of risk-sharing among all participants in transactions that are underpinned by physical assets. These strong underlying assets attract liquidity from both Islamic and conventional investors in local and international markets.

Moreover, such instruments may be exempt from registration in the United States, as per the US Securities Act of 1933, under Section 4(2), which exempts securities when the issuer doesn't involve any public offering; Rule 144A, which exempts securities offered to qualified institutional buyers as long as the securities are not listed in the US; and Regulation S, which exempts securities offered outside the US to non-US persons.

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Infrastructure sukuk have the potential not only to deepen the available capital pool for projects, but also to reduce the cost of financing, as this pool of capital would add competitive pressure on traditional financing. Furthermore, this financing mechanism offers the possibility to plug funding gaps for sound projects and to provide financing for projects that might be neglected by traditional investors, such as small power plants or waste water treatment facilities. Finally, infrastructure sukuk will help reduce common equity needs by banks to fulfill Basel III capital requirements that aim to improve bank capital adequacy ratios.

While the use of sukuk is a novel financing option for most developers seeking financing within the US, the structure has been tested and US courts have established a legal precedent by protecting the rights of sukuk investors during bankruptcy. Furthermore, international sukuk investors and stakeholders feel more protected by the established regulatory and legal structure in the US and market demand will set competitive yields that will be attractive to foreign investors.

Sukuk have already begun to play a significant role in Asia and the Middle East. Beginning in 1990 with the first ringgit sukuk issuance for US$33mn, the global sukuk market broke the US$130bn mark in 2012, according to KFH Research. The market has experienced a compound growth rate of 27% for the last five years. Sukuk have been issued in various corners of the world, from the US for East Cameron Partners, used to finance operating costs associated with drilling and operating wells in the Gulf of Mexico, to more recent sukuk issued in Central Asia's largest economy, Kazakhstan.

Malaysia has led the way in pioneering sukuk to fund infrastructure projects, but in recent years has been joined by GCC states, in particular Saudi Arabia. According to the data from Standard & Poor's, during the period 2006-2010, Malaysia issued about US$12.6bn in infrastructure sukuk, and a further US$17.2bn was issued within another year and a half. The funds were to upgrade or invest in infrastructure, such as Kuala Lumpur International Airport, Westport and Tangjong Pelepas marine ports, and to construct roads and bridges including Southern Link, Senai Desru Expressway, Maju Expressway and Penang Bridge.

Malaysia's experience shows sukuk can be an appropriate financing mechanism for infrastructure. Similarly, infrastructure sukuk have shown significant growth in the GCC, from only 7% of 2011 sukuk issuance to 30% of total issuance for the first half of 2012. One example in the GCC is the US$4.1bn in infrastructure sukuk used by Saudi Arabia's General Authority for Civil Aviation to assist in the funding of Jeddah's airport expansion.

The sukuk market is today challenged by a unique trend where there is significant and growing demand for sukuk issuances, coupled with a low supply in the market. It is estimated that the demand for sukuk will exceed US$600bn by 2015, compared with a supply of only US$500bn, say Standard & Poor's and Ernst & Young. In order to close this gap, investors will seek new markets that are in need of capital. US infrastructure can be such a haven for liquidity in international markets and sukuk investors in particular. The gap in general sukuk demand and supply profiles well with the gap for infrastructure finance in the US.

Why US?

To investors, US infrastructure offers an attractive opportunity as it has the largest stock of infrastructure, valued at over US$15trn. As a newer type of investment vehicle in the US, sukuk have faced challenges largely due to a constrained secondary market and the smaller scale of financing expertise capable of unlocking this pool of liquidity. Neither of these is a permanent challenge, and may in fact offer first-movers the chance to tap greater amounts of financing from infrastructure sukuk.

Sukuk investors would be attracted to the US market because it offers a stable and mature supply of infrastructure projects. The US regulatory environment is investor-friendly and would protect investor rights and recourse. And, most importantly, these projects can offer attractive risk-reward yields to investors that are looking to diversify out of their local markets.

Here at Taylor-DeJongh we feel confident that Islamic finance and sukuk offer a new pathway for matching capital with projects and have recently launched a new initiative in financial advisory for Islamic financing. ●