

Introduction to Sukuk

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What are Sukuk?

Sukuk are a dynamic and ethical financial instrument that offers investors a unique avenue for financial growth and the opportunity to support Sharia-compliant ventures.

Sukuk represent ownership in an underlying asset, project, or business activity that generates returns based on the asset's performance. Unlike conventional bonds, Sukuk adhere to Shariah principles, ensuring ethical and interest-free investment opportunities.

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) defines Sukuk as "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity".

Sukuk can therefore be described more accurately as 'Islamic investment trust certificates'. Whereas bonds evidence a debt the issuer owes to the bond holders, Sukuk certificates evidence the investors' ownership rights in the underlying Sukuk asset, business, enterprise or project which entitles them to receive a share of the income generated thereby.

Sukuk characteristics compared against conventional bonds and equities:

| Characteristics | Sukuk | Bonds | Equity Securities |
|----------------------------|--|---|--|
| Participants | Sukuk Holder | Bond Holders | Shareholders |
| Type of Return | Coupon | Coupon | Dividend based on company performance |
| Maturity Date | Fixed Maturity Date; except Perpetual Sukuk | Fixed Maturity Date; except Perpetual Bonds | Open-ended |
| Principal Repayment | Paid at maturity | Paid at maturity | No repayment obligation |
| Risk | Generally less risky; Issuer dependent | Generally less risky; Issuer dependent | High risk, subject to market movements |
| Voting Rights | Not Entitled | Not Entitled | Entitled |
| Shariah Compliance | YES | NO | Depends on issuer and terms of issue |
| | Sukuk certificates represent the investors' ownership interest in the underlying Sukuk asset, business, enterprise, or project for which a Sukuk Holder receives a share in the income generated. Whereas, a Bond represents a debt the issuer owes to Bond Holders and pays interest. | | |

Getting Started: Buying and Selling Sukuk

How to Buy Sukuk?



- **Secondary Market:** Investors can learn more on available and suitable Sukuks and place a buy order by contacting Al Hilal Bank.
- **Primary Market:** For a newly announced Sukuk offering (similar to applying for an IPO), investors can register their interest with Al Hilal Bank.

At Al Hilal Bank, we offer a diverse range of Sukuk and would be delighted to help you with your investment goals.

To invest, please contact your dedicated Al Hilal Bank Relationship Manager or Customer Support at 600 522 229. You can also e-mail us at TharwaContactCenter@AlHilalBank.ae.

How to Sell Sukuk?



- **Before Sukuk Maturity:** Investors can place a sell order to sell their existing Sukuk holdings by contacting Al Hilal Bank.
- **At Sukuk Maturity:** Upon maturity, investors will get back the agreed upon amount as outlined in the Prospectus.

For inquiries, please contact your dedicated Al Hilal Bank Relationship Manager or call Customer Support at 600 522 229. You can also e-mail us at TharwaContactCenter@AlHilalBank.ae.



How you earn from a Sukuk investment:

- Receipt of regular coupon payment.
- Capital gains

Purpose, Benefits and Risks of Sukuk

Who issues Sukuk and why?

Sukuk are issued by various entities, including governments, corporations, and financial institutions. The funds raised are directed towards diverse projects such as infrastructure development, real estate, and business expansion, contributing to economic growth while adhering to ethical principles.

Benefits of Sukuk Investments

- **Stable Returns:** Sukuk provide predictable and stable returns, often in the form of profit-sharing or rental income. This consistency can be appealing to risk-averse investors looking for reliable income sources.
- **Ethical:** Sukuk adhere to Sharia principles, ensuring investments are aligned with ethical guidelines. This appeals to investors seeking financial growth while upholding their values and principles.
- **Diversification:** Sukuk enable investors to diversify their portfolios across various sectors and projects. This diversification can help mitigate risks and reduce the impact of poor-performing assets on the overall portfolio.
- **Global Reach:** Sukuk markets have expanded globally, offering investors access to international investment opportunities. This global reach aids in portfolio diversification across different regions and economies.

Risks Associated

- **Market Risk:** Sukuk prices can fluctuate based on changes in interest rates, economic conditions, and supply-demand dynamics. Economic downturns or global financial instability can impact Sukuk valuations, potentially leading to capital losses.
- **Liquidity Risk:** Sukuk may have varying degrees of liquidity, making it challenging to sell them quickly at desired prices. Illiquid markets can result in difficulties when investors need to exit their positions promptly.
- **Credit Risk:** The issuer's creditworthiness plays a significant role in Sukuk investments. There's a risk that the issuer may default on its obligations, resulting in delayed or missed payments. Careful analysis of the issuer's financial health is crucial to mitigate this risk.
- **Project-specific Risk:** Certain Sukuk are tied to specific projects or ventures. If those projects face delays, cost overruns, or other issues, it can impact the returns generated from the Sukuk.

Sukuk investments are ideal for those seeking ethical financial growth and diversification. Investors interested in supporting infrastructure projects, real estate, and socially responsible ventures will find Sukuk an attractive addition to their portfolios.

Investor Awareness

Before investing in Sukuk, it's crucial to:

- Understand the specific type of Sukuk being offered.
- Assess the issuer's financial health and reputation.
- Consult with financial advisors knowledgeable in Islamic finance.

The performance of Sukuk can vary based on market conditions, economic factors, and issuer credibility. While Sukuk generally offer stable and predictable returns, investors should be mindful of the potential risks and market fluctuations.

Utilizing Credit Ratings for Informed Sukuk Investments

Credit ratings play a vital role in assisting investors to make well-informed decisions when considering Sukuk investments. These ratings provide an independent assessment of the creditworthiness of the Sukuk issuer and the associated risks. They offer valuable insights into the issuer's ability to meet its financial obligations and the level of risk associated with the investment.

Investors can use credit ratings as a guide to evaluate the relative safety and potential returns of different Sukuk offerings. Higher-rated Sukuk typically carry lower credit risk and may be more attractive to risk averse investors, while lower-rated Sukuk might offer higher potential returns but come with increased risk.

Major ratings agencies such as Moody's, Fitch and S&P are prominent in evaluating Sukuk issuers. Bloomberg also provides composite ratings for many Sukuk issues.

| Bloomberg Composite/ Fitch/ S&P Credit Rating | Moody's Credit Rating | Description | Implication for Investors |
|---|--------------------------|--|---------------------------------|
| AAA | Aaa | Highest credit quality | Very low risk of default |
| AA+ | Aa1 | Very high credit quality | Low risk of default |
| AA | Aa2 | Very high credit quality | Low risk of default |
| AA- | Aa3 | Very high credit quality | Low risk of default |
| A+ | A1 | High credit quality | Moderate-low risk of default |
| A | A2 | High credit quality | Moderate-low risk of default |
| A- | A3 | High credit quality | Moderate-low risk of default |
| BBB+ | Baa1 | Good credit quality | Moderate risk of default |
| BBB | Baa2 | Good credit quality | Moderate risk of default |
| BBB- | Baa3 | Good credit quality | Moderate risk of default |
| BB+ | Ba1 | Speculative or non-investment grade | Elevated risk of default |
| BB | Ba2 | Speculative or non-investment grade | Elevated risk of default |
| BB- | Ba3 | Speculative or non-investment grade | Elevated risk of default |
| B+ | B1 | Highly speculative or non-investment grade | High risk of default |
| B | B2 | Highly speculative or non-investment grade | High risk of default |
| B- | B3 | Highly speculative or non-investment grade | High risk of default |
| CCC+ | Caa1 | Substantial risk of default | Very high risk of default |
| CCC | Caa2 | Substantial risk of default | Very high risk of default |
| CCC- | Caa3 | Substantial risk of default | Very high risk of default |
| CC | - | Highly vulnerable to default | Extreme risk of default |
| C | Ca | Near or in default | Very high likelihood of default |
| D | C | Default | Defaulted on payments |

Note that the above table provides a simplified overview, credit ratings might vary slightly depending on the rating agency. It's important to understand the specific rating agency's definitions and methodologies when interpreting credit ratings.

History and Evolution

The modern form of Sukuk gained prominence in the 20th century. Originating from Islamic finance principles, Sukuk have rapidly evolved to cater to the global financial landscape while adhering to Sharia compliance.

Early Years of the 20th Century: The modern Sukuk market began to take shape, primarily in Islamic nations, focusing on sovereign issuances and supporting local infrastructure projects.

The first decade of the 21st century: The Sukuk market expanded internationally, with sovereign and corporate issuers tapping into the potential of Islamic finance.

Post-Global Financial Crisis: The resilience of Sukuk during the financial crisis further strengthened their appeal. Sukuk issuances extended beyond the traditional markets, including Europe and Asia.

Recent Years: The Sukuk market continues to flourish, with diverse issuances ranging from green and sustainable Sukuk to social impact Sukuk. Governments and corporations alike utilize Sukuk to fund development projects and expand their financing options.

Geographical Spread: Islamic finance hubs such as the UAE, Saudi Arabia, Malaysia and Bahrain play vital roles in the Sukuk market, with sovereigns, corporations, and financial institutions issuing Sukuk to fund infrastructure, development projects, and diversify their funding sources.

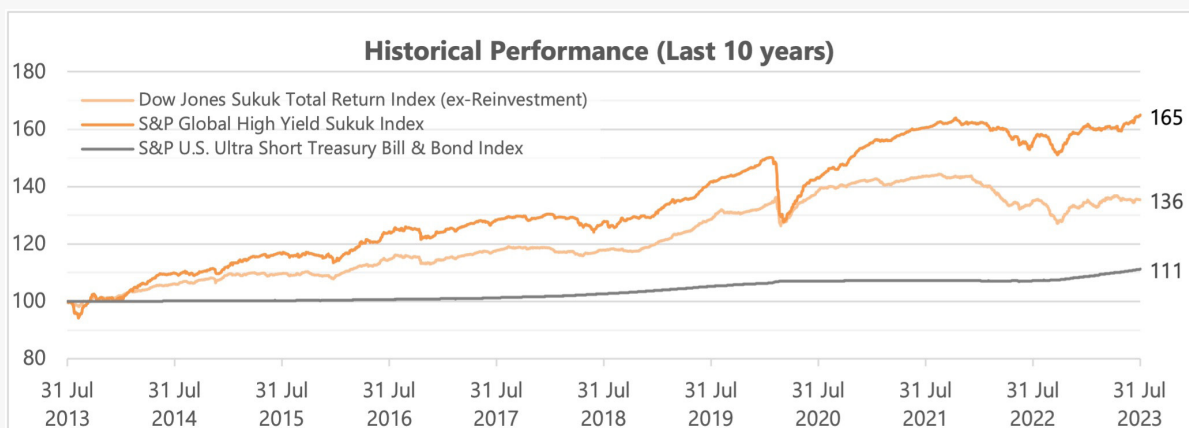
Beyond traditional Islamic finance centers, countries like Indonesia, Turkey, and non-Muslim-majority nations in Europe have embraced Sukuk, underscoring their appeal and market accessibility.

Sectoral Diversification: Sukuk are used to finance a wide array of sectors, including infrastructure, real estate, energy, and transportation, contributing to economic growth and development.

Innovation: Financial innovation has led to the creation of diverse Sukuk structures, catering to the evolving demands of investors and issuers.

The Global Sukuk Market: The Sukuk market has witnessed remarkable growth since its inception, reflecting the increasing demand for ethical investment options and Sharia-compliant financial instruments. Over the years, the market has diversified in terms of issuers, sectors, and geographic regions.

In the second quarter of 2023, global Sukuk outstanding volumes expanded by 10% year-over-year and crossed USD 800 billion. (Source: Fitch)



Source: SPGlobal.com

Major Types of Sukuk

1. Ijarah Sukuk

Backed by tangible assets, these represent ownership in leased properties, generating rental income.

Investors who buy ijarah Sukuk are essentially leasing the assets to the issuer. The issuer then makes rental payments to the sukuk holders over a period of time, in accordance with a pre-agreed lease schedule.

2. Mudarabah Sukuk

Mudarabah Sukuk reflect profit-sharing contracts, where investors who buy the Sukuk (Sukuk holders) become investors in the project and share in the profits and losses.

The Sukuk are essentially certificates of investment and investors share in the profits and losses of the project.

3. Musharaka Sukuk

Musharaka Sukuk are used to mobilize funds for establishing or developing a project or financing a business activity.

The Sukuk represents partnership in the project/business activity and investors share pre-agreed percentages in the profits. As for loss, it will be divided as per the percentage of contribution into the capital amount.

4. Wakala Sukuk

Managed by a trustee, Wakala Sukuk involve investor funds in various ventures (Wakala Portfolio), with profits shared based on agreed terms.

Based on the concept of Wakala, or agency. In Wakala Sukuk, the Sukuk holders appoint an agent to manage the Wakala Portfolio on their behalf. The Sukuk represent certificates of ownership of common shares from the Wakala Portfolio in which, Sukuk holders own the Wakala Portfolio and receive payments in accordance with a pre-agreed profit-sharing arrangement.

5. Manafa'a Sukuk

Based on the concept of manafa'a, or usufruct. In a Manafa'a Sukuk transaction, the investors grants issuer the right to use their usufruct right for a specified period of time. Investors who buy Manafa'a Sukuk receive payments from the issuer in accordance with a pre-agreed payment amounts.

6. Istisna'a Sukuk

Istisna'a Sukuk are generally used to finance the manufacture of an asset. In an Istisna'a Sukuk transaction, the Sukuk holders contracts with a manufacturer to produce an asset. The Sukuk represent certificates of ownership in the asset and investors receive payments from the sale of the said asset as per the agreement.

Summary of features - major types of Sukuk:

| | Ijarah | Mudarabah | Musharaka | Wakala | Manafa'a | Istisna'a |
|-------------------------------------|----------------|----------------|----------------|-------------------------|-----------------|--------------------------------|
| Basis | Lease | Partnership | Partnership | Agency | Usufruct | Manufacturing |
| Investor role (Sukuk Holder) | Lessor | Investor | Partner | Owner | Lessor | Mustasni' |
| Return Basis | Lease schedule | Actual profits | Actual profits | Wakala Portfolio Profit | Usufruct Rental | Sale of the manufactured asset |
| Loss sharing | No | Yes | Yes | No | No | No |

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