GLOBAL EUROBOND SUKUKS

NOW THAT THEY ARE A STANDALONE ASSET CLASS IN THEIR OWN RIGHT, WHAT ARE THE ISSUES THAT REALLY MATTER?

Faisal Ali (CFA)
Senior Portfolio Manager, Azimut Group

OVERVIEW

The global Eurobond Sukuk market continues to expand at a healthy pace. This is partly because of the favourable dynamics of the market and partly because of the strong growth in key economies.

On one hand, issuers/borrowers are more easily able to finance their own expansion, at home and abroad and on the other, buyers/investors in sukuk instruments can benefit from the growth of particular countries with (predominantly) Muslim populations.

Crucially, most of the countries that dominate the issuance of sukuks are undergoing an economic transition that needs high levels of CAPEX spending. Much of this will have to be financed through debt instruments – such as conventional Eurobonds and Eurobond Sukuks.

Over the last 20 years, most of the risks associated with Eurobond Sukuks – in terms of economies and markets and legal/regulatory issues – have been ironed out. At Azimut, we are confident that the remaining regulatory issues will be addressed in the near future: this will also add to the appeal of the asset class.

Capital flows from the resource-rich countries of the Middle East and South East Asia to populous countries in South Asia and North Africa should increase. This will boost growth and, therefore, opportunities for investors in the latter.

Nevertheless, important aspects of the global Eurobond Sukuk market need to be borne in mind:

- What is their position in the context of the global fixed-income environment?
- What is the credit risk?
- What does this evolving asset class look like, and what is the best approach to investing in it?
- In which countries are social and economic developments driving the growth of the asset class?
- What other changes are happening to sukuks?
- What are the regulatory changes that could have a negative impact on global Eurobond Sukuks – and how likely are these changes to be affected?

GLOBAL EUROBOND SUKUKS IN CONTEXT

We strongly believe that global fixed income investors can enhance the risk/return profile of their portfolios by adding exposure to global Eurobond Sukuks.

Sukuks provide investors with means to get exposure to the economies of broader Islamic world which, in turn, offers attractive growth prospects over the medium term.

Further, sukuk issuers are based in a diverse group of economies that are at different stages of economic development. Currently, the majority of global Eurobond Sukuks are issued by oil producing Gulf Cooperation Council (GCC) countries that have some of the highest per-capita income in the world. In addition, these economies are benefitting from structural reforms undertaken to reduce dependence on their respective oil and gas sectors.

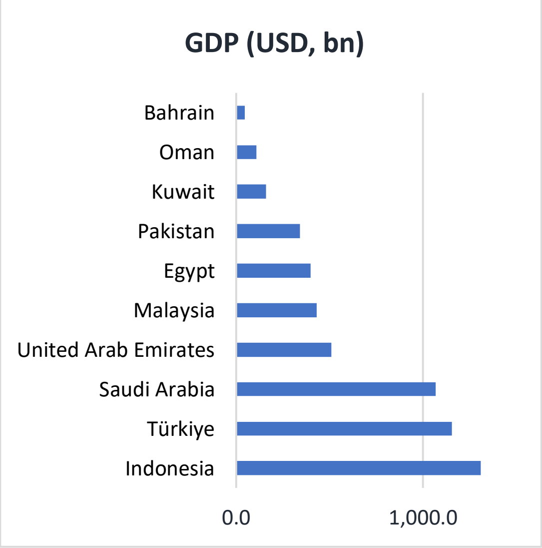
Meanwhile, the Islamic world also consists of developing and high population growth countries such as Egypt, Pakistan and Türkiye: Many of these economies have been adversely affected by Russia's invasion of Ukraine. Some details are shown in the charts below.

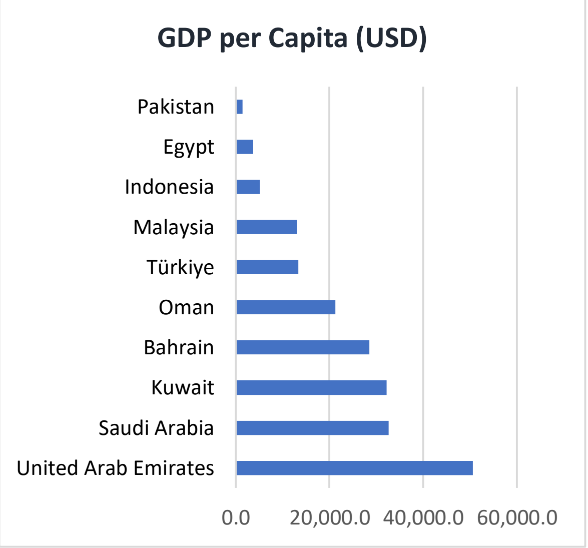
These two groups of economies are linked by financial flows – specifically remittances and investment from the GCC countries, with their large US dollar current account surpluses and reserves, to the others. A good example is the Ras Al Hekma megaproject in Egypt, which has been funded by investment from the United Arab Emirates (UAE). We expect that such flows will grow materially over time.

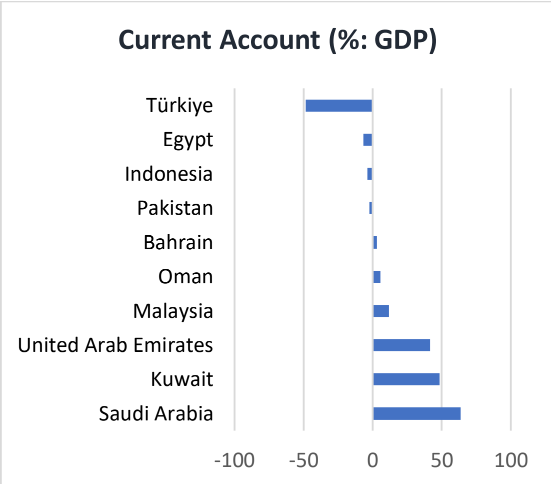
Notably, these investment flows expanded in 2022 in the aftermath of tighter financial conditions worldwide following the Russian invasion of Ukraine. Investment flows from the GCC countries were very helpful for Egypt, Pakistan and Türkiye - countries that were shut off from global markets due to liquidity withdrawal by global central banks.

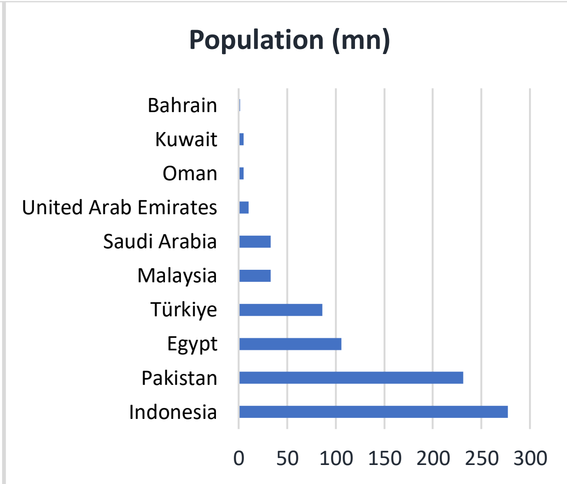
The involvement of the GCC countries reduces the perceived risk in the other countries in which they are investing. We have already seen positive ratings action in relation to Egypt following the announcement of the Ras Al Hekma mega-project, for instance.

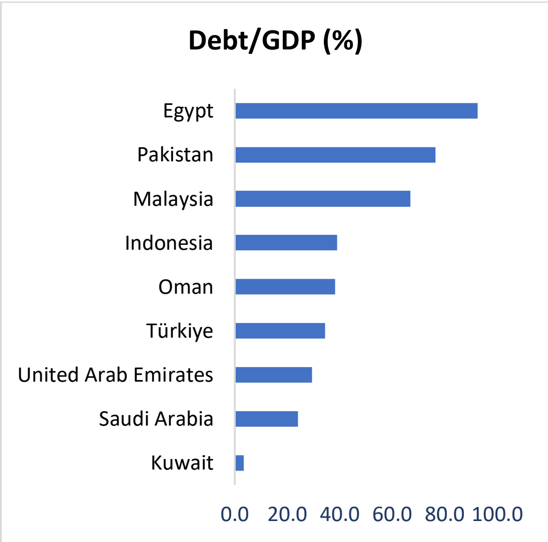
THE MAJORITY OF GLOBAL EUROBOND SUKUKS ARE ISSUED BY OIL PRODUCING GULF COOPERATION COUNCIL (GCC) COUNTRIES THAT HAVE SOME OF THE HIGHEST PER-CAPITA INCOME IN THE WORLD.

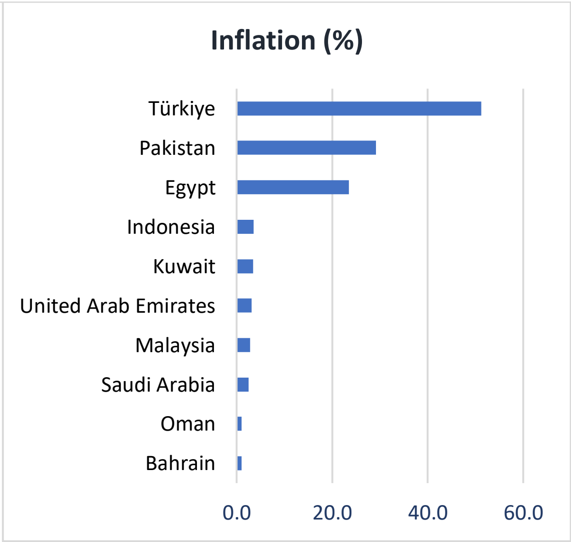












Source: IMF, 2023

The Backstory

It is worth bearing in mind how the Islamic finance sector, of which global Eurobond Sukuks are a part, has developed over the last 20 years or so.

The two oil shocks of the 1970s greatly expanded the resources of oil producing countries of the GCC region. This development spurred demand for a wider range of financial products directed towards GCC region-based investors - including those investors who only wanted to invest through instruments whose structures were compliant with Shari'a.

For an instrument to be classified as Shari'a-compliant, it must be assessed as such by a properly qualified Shari'a board, whose members will have deep understanding of both finance and Islamic jurisprudence. Over time, and with the growth of Islamic finance generally, certain types of instruments have established precedents and standards. These standards have made life easier for both borrowers/issuers and lenders/buyers of sukuks and other Shari'a-compliant instruments.

There are a variety of Shari'a-compliant instruments, most of which mimic conventional financial instruments. For instance, there are forms of insurance and reinsurance (takaful and retakaful), syndicated loans (murabaha), leasing (ijara), and equity participation (musharaka).

The main characteristic of the sukuk structure is, of course, a prohibition on payment of interest which is seen as usurious: further, financing and investment should be backed by assets. However, currently, there is a very limited market for asset-backed sukuks. Most sukuk structures ultimately have a risk and return profile similar to that of a conventional senior unsecured bond.

Rating agencies assign ratings to a sukuk based on the credit profile of the issuer backing the sukuk. For example, while the underlying assets backing different sukuks of the same issuer might differ, the sukuk holders are effectively exposed to the senior unsecured credit risk of the issuer – and this will be reflected in the rating.

The Emergence of a New Asset Class: but What is the Best Way to Invest in It?

The global Eurobond Sukuk market (i.e. with US dollar-denominated instruments issued in quantities of at least US$200 million and with a maturity of one year or more) came into existence in 2002 following a US$600 million five-year offering from the government of Malaysia.

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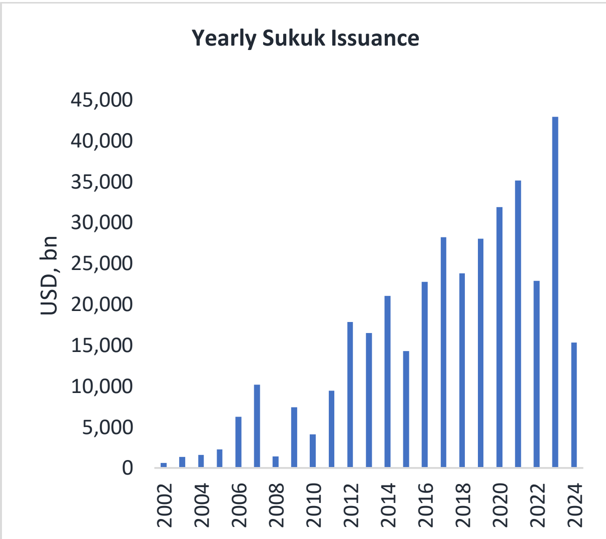
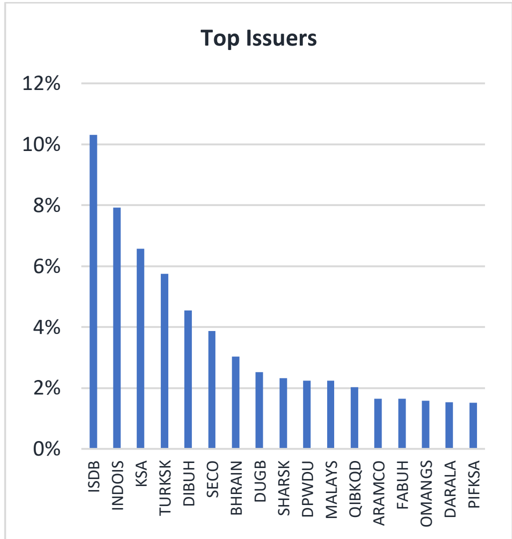
Since then, the asset class has grown rapidly: in both the GCC region and Malaysia, sukuks have become a part of the mainstream investment landscape. Borrowers utilise sukuk markets to access medium- to long-term financing. Islamic banks use sukuks as important tools for managing their assets and liabilities and recycling liquidity. Meanwhile, institutions use sukuk funds to fulfil their investment requirements.

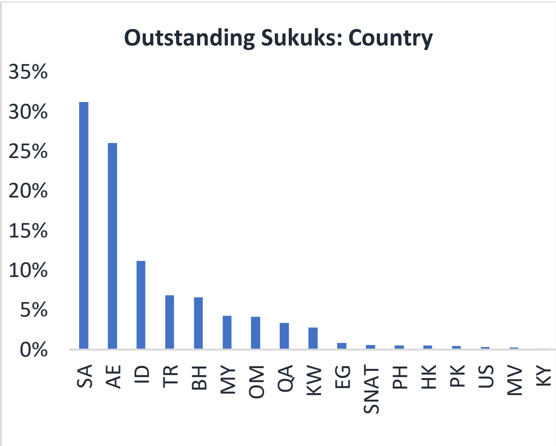
All this is reflected in the hard numbers. The total value of tradeable sukuks issued since 2002 stood at approximately US$365 billion in March 2023. Trends in issuance are shown in one of the two charts below. Excluding supra-national agencies, the Indonesian government has been the largest single issuer in the sukuk market with a share of approximately 7.9 per cent. The Indonesian government has been followed by its counterparts in Saudi Arabia and Türkiye, with respective shares of 6.6 per cent and 5.7 per cent - as is shown in the other of the two charts for Yearly Sukuk Issuances and Top Issuers.

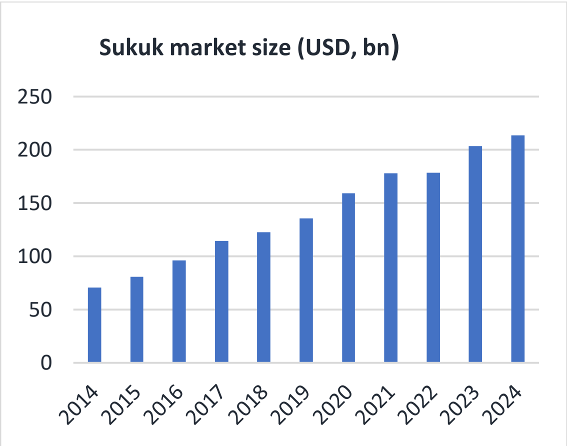
> **MOST SUKUK STRUCTURES ULTIMATELY HAVE A RISK AND RETURN PROFILE SIMILAR TO THAT OF A CONVENTIONAL SENIOR UNSECURED BOND.**





Source: Bloomberg, Azimut estimates

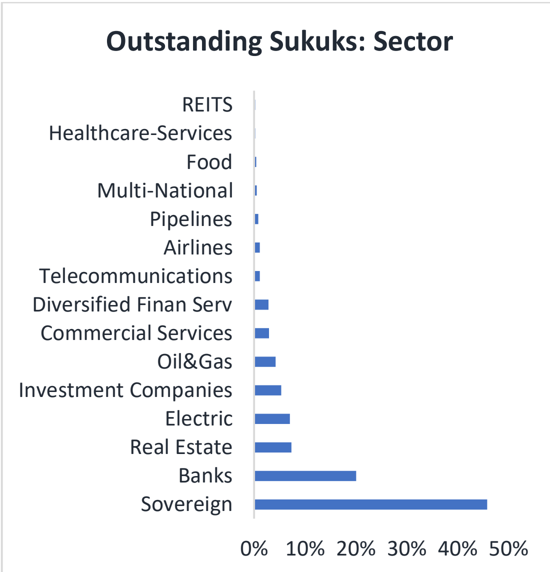




Source: Bloomberg, Azimut estimates

Today, US dollar denominated Eurobond Sukuks outstanding amount of over US$200 billion. It includes public and private sector issuers across a number of countries. Sovereign issuers now account for nearly half of the investment universe (c. 46 per cent) followed by banks at 20 per cent. In terms of the countries where Eurobond Sukuks have been issued, Saudi Arabia has the largest share at 31 per cent followed by UAE at 26 per cent and Indonesia at 11 Per cent. The GCC region as a whole accounts for 74 per cent of the total. Around 63 per cent of outstanding Eurobond Sukuks are rated as investment grade, while 25 per cent are assessed as High Yield and 11 per cent are non-rated. Details are shown in the charts on next page.

What really matters is this: Bearing in mind the absolute size of the market, the diversity of issuing countries, the varied profile of issuers and the ratings spectrum, global Eurobond Sukuks can and should be seen as a standalone asset class in their own right.



Outstanding Sukuks: Rating Distribution

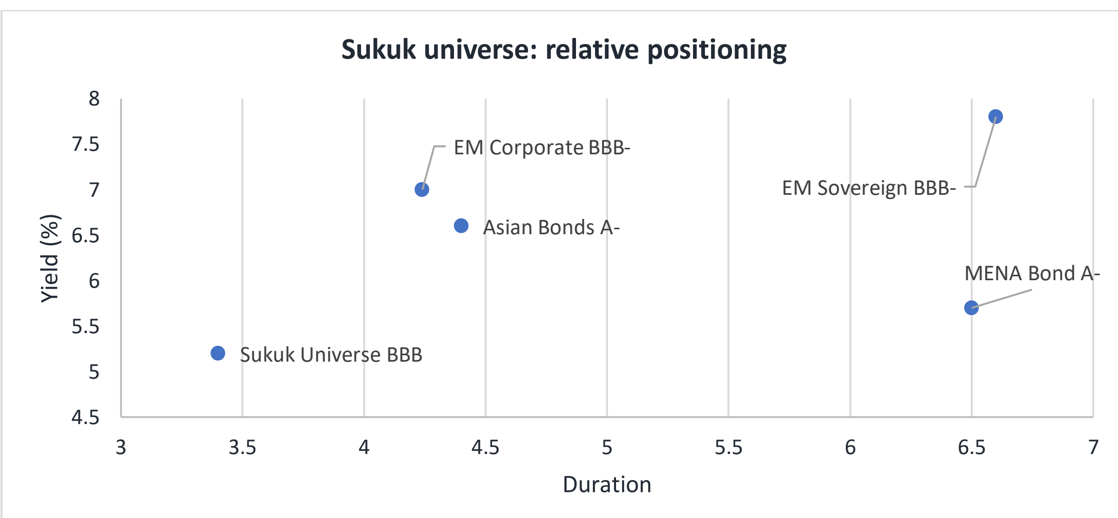
Rating	%
AAA	0.0%
AA+	0.0%
AA	0.0%
AA-	2.1%
A+	19.0%
A	8.6%
A-	10.8%
Summary A (bucket)	**40.4%**
BBB+	2.5%
BBB	17.1%
BBB-	3.3%
Summary BBB (bucket)	**22.8%**
BB+	8.7%
BB	0.7%
BB-	0.9%
Summary BB (bucket)	**10.3%**
B+	7.2%
B	0.3%
B-	6.6%
CCC+	1.2%
CC	0.0%
C	0.0%
D	0.0%
Summary B or lower (bucket)	**15.3%**
N/R	11.2%

Source: Bloomberg, Azimut estimates

The profile of the global Eurobond Sukuks resembles that of a regional emerging market debt (EMD) asset class: the crucial difference is that the sukuk investors get exposure to countries that comprise the core of the Muslim world. And as with any EMD strategy, country and security selection is a critical driver of investment returns. The global Eurobond Sukuk universe includes over 80 issuers across 16 countries and 14 sectors.

Therefore, we believe that an active approach to global Eurobond Sukuks is the right one, as the asset class is under-researched and provides a diversity of instruments.

We believe that idiosyncratic opportunities can be best identified by managers who are 'close to the ground' and who can combine top-down macro analysis with fundamental bottom-up research. We think by using this traditional approach to



Source: Bloomberg, Azimut estimates

GCC: key data and comparison (IMF 2023)						
Gulf Cooperation Council	Avg. 2000-2020	2021	2022	2023	2024 F	2025 F
Real GDP (percent change, year-over-year)	3.8	3.8	7.8	0.5	2.7	4.6
Current Account Balance	12.1	8.9	16.1	9	7.4	6.9
Overall Fiscal Balance	5.4	0.7	7.9	3.7	3.2	3.3
Inflation (percent change, year-over-year)	2.2	2.2	3.3	2.5	2.3	2
Emerging market and middle-income countries1						
Real GDP (percent change, year-over-year)	4	3.7	5.1	3.1	2.9	4.1
Current Account Balance	–4.0	–4.8	–4.7	–2.8	–4.3	–3.4
Overall Fiscal Balance	–5.9	–6.6	–5.7	–5.4	–8.9	–8.1
Inflation (percent change, year-over-year)	7.1	7	11.1	22.6	25.6	19.8

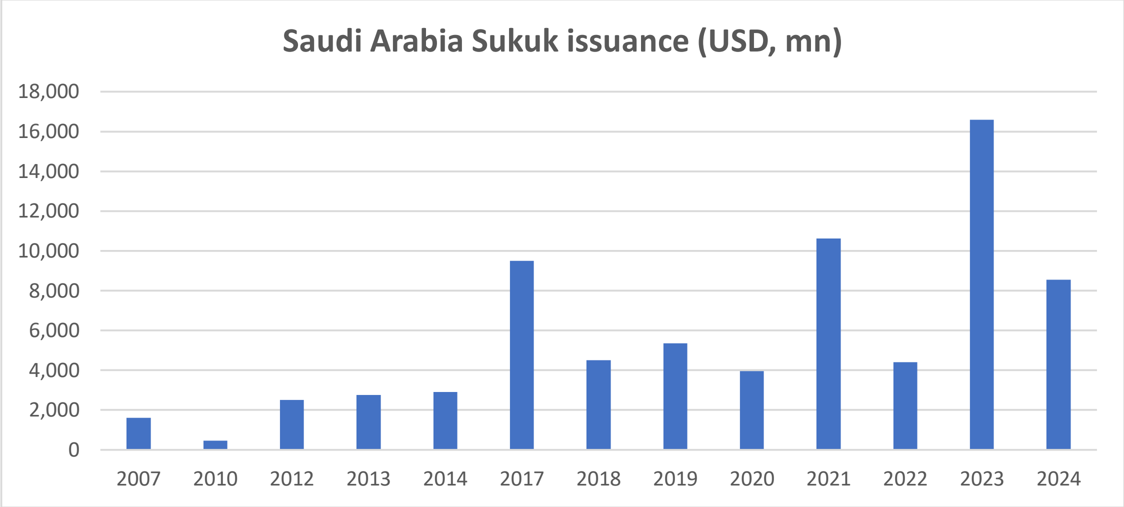
EMD investing, managers can generate alpha by identifying each country's position in the credit cycle and analysing macro-economic dynamics that impact the local industrial sector. Further details are shown in the charts below.

By taking a global approach to investing in Eurobond Sukuks, traditional fixed income investors can also diversify portfolio risk. Economic momentum in the GCC region since the end of the COVID pandemic has been much greater than other parts of the world while inflation in the GCC region has been stable unlike in most developed economies. The growth opportunities should persist in spite of the slowing in the global economy.

In our view, by investing in Eurobond Sukuks, one can lend to entities that are benefitting from elevated oil prices, economic reforms, expanding middle classes and favourable demographic trends. Sukuk funds typically have lower duration but higher credit quality than comparable and conventional EMD portfolios.

Saudi Arabia will Continue to Drive the Growth of the Market

2023 proved to be a record year for Eurobond Sukuk issuance, when borrowers tapped the market for approximately US$43 billion. Over the ten-year period ending in 2023, sukuk issuance volume has grown at a compound annual growth rate (CAGR) of over 7 Per cent.



Source: Bloomberg, Azimut estimates

Activity so far in 2024 indicates that this should be another record year: issuance in Q124 amounts to 35 per cent of the total for 2023.

A major driver of growth of the asset class in the recent past has been issuance by Saudi based entities. In the three-year period ending in 2020, issuance from Saudi Arabia amounted to US$13.8 billion. In comparison, in the three-year period ending in 2023, issuance amount stood at US$31.6 billion which represents a 129 per cent increase. Details are shown in the chart below. In relative terms, issuance from Saudi Arabia accounted for approximately 19 per cent of global sukuk issuance (excluding that of supranational organisations) in the 2018-2020 period. For the 2020-2023 period, the comparable figure was 36 per cent; in Q124, 57 per cent.

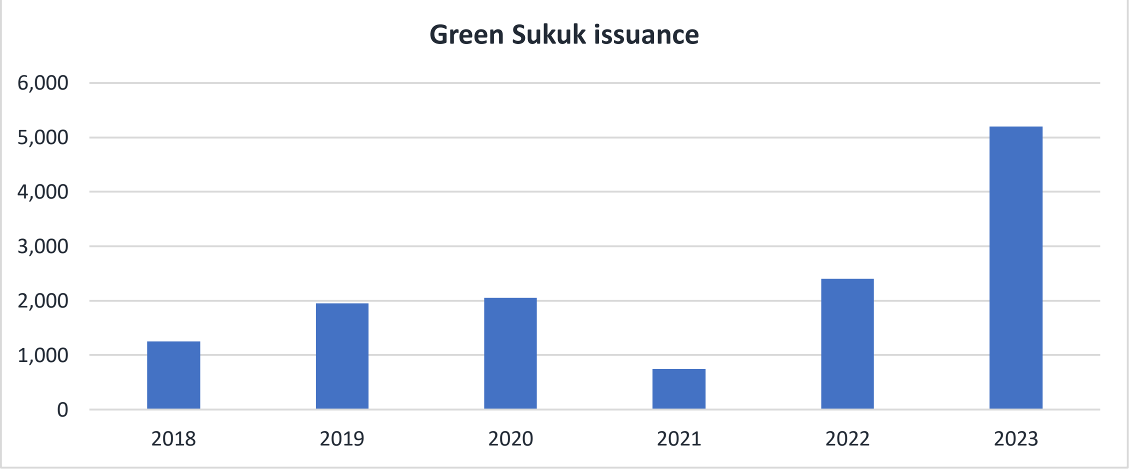
We associate these numbers with the extraordinary transformation of the Saudi economy and society. A massive drive for economic diversification away from oil and gas (through the promotion of tourism, entertainment etc.) has been accompanied by changes to improve the ease of doing business and social reform – bringing women into the labour force.

We believe that the global Eurobond Sukuk market will be an important source of funding for infrastructure spending. This is because the tenor of borrowing is much longer than what can be secured from local banks.

In addition, the Saudi government also aims to maintain liquidity in the local financial system which in turn increases its reliance on offshore markets. Meanwhile, the Saudi economy comprises approximately 50 per cent of the GDP of the entire GCC region, but with the caveat that Saudi infrastructure significantly lags behind that which is available in other GCC countries in terms of quality. Accordingly, we expect a further significant increase in the supply of global Eurobond Sukuks by Saudi issuers as they finance investment in new infrastructure.

If trends continue as we expect, Saudi issuers' share of the outstanding sukuk market should rise from the current level of around 30 per cent to over 50 per cent over the next five years or so. We anticipate that global investors will buy Eurobond Sukuks from Saudi issuers for two reasons. First, Saudi bonds are generally underpriced relative to their ratings. Second, the credit fundamentals of Saudi issuers are likely to improve.

Issuers in the UAE will likely continue to play a major role in sukuk markets. Particular sectors such as tourism, hospitality and transportation are growing at double-digit rates. Policies to promote immigration by High Net Worth Individuals should also ensure that economic growth remains well above the long-term trend. As is the case in Saudi Arabia, it makes sense for issuers to find the finance that they need for investment in the global Eurobond Sukuk market.



Source: Bloomberg, Azimut estimates

How Sukuks are Changing: Greener, with Fewer Physical Assets and from New Issuers

In the last couple of years, the sukuk market has seen the issuance of green/sustainable Sukuks. Volumes have increased in 2023, albeit from a low base – as the chart below shows. Currently, sukuk issuers are concentrated in oil-producing countries. In line with global commitments, these countries are implementing strategies to reduce the carbon footprints of their economies. Accordingly, we expect the use of green/sustainable Sukuk to finance projects that help with green transition.

In keeping with early trends, we think that UAE entities in particular will expand their green issuance programmes. This is not only related to COP28, which recently concluded in the country, but also because UAE regulators exempted sustainable Sukuks from registration fees in 2023.

SHARI'A STANDARD 62 COULD MEANINGFULLY ALTER THE GLOBAL SUKUK LANDSCAPE. .. THE PROVISION REQUIRES THAT THE OWNERSHIP AND THE RISKS RELATED TO THE UNDERLYING ASSETS BE TRANSFERRED TO SUKUK HOLDERS

We also expect to see more issuance from non-traditional, asset-light businesses. In our view, Oman Tel's issuance in 2023 has provided a good example. Oman Tel's issue was backed by its provision of broadband services rather than physical assets that usually underpin sukuk financings. In contrast, most sukuk issues incorporate physical assets into the structure, such as real estate or commodity financing, with the payments matched with underlying sukuk distribution.

Given the necessity of transferring physical assets, primary issuers in sukuk markets have been sovereigns, banks and real estate companies. Lacking physical assets, asset-light businesses have found it much harder to utilize sukuk financing. The Oman Tel Sukuk structure overcomes the need for incorporating physical assets by using revenues generated by the company's broadband services as the basis for the underlying sukuk. The provision of these services to customers should generate the required funds to finance distributions to sukuk holders. Funds for periodic distribution will be transferred from a reserve account should broadband service revenues fall short.

Importantly, Oman Tel's Sukuk structure has been approved by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) – an important institution that evaluates sukuk structures. Compliance with AAOIFI standards results in acceptance by a wide investment base. For instance, UAE-based Islamic banks only invest in AAOIFI-compliant sukuks.

We also expect increased issuance from borrowers based outside Islamic countries. For example, the government of the Philippines raised US$1 billion through a sukuk that was 4.9 times oversubscribed. Other non-traditional sovereigns that have issued sukuks are the governments of the UK, South Africa and the Hong Kong Special Administrative Region of China. Islamic investors have also invested in sukuks issued by global companies. United States-based Air Lease Corp issued its debut sukuk in March 2023. Air Lease used some of its leased aircrafts as underlying assets. Other global companies that have issued sukuks include GE and Goldman Sachs.

In general, borrowers can lower borrowing costs by issuing sukuks since sukuks tend to trade a lower yield compared to a conventional bond issued by the same entity. The reason for this anomaly is that Islamic investors have limited investment options compared to conventional investors. Companies can also diversify their funding base by issuing sukuks.

To Watch: Shari’a Standard 62

In late 2023, AAOIFI released its initial comment on Shari’a Standard 62 on sukuks, with a deadline for industry feedback of March 31, 2024. If adopted in its current form, Shari’a Standard 62 could meaningfully alter the global sukuk landscape. Among other recommendations, the provision requires that the ownership and the risks related to the underlying assets be transferred to sukuk holders. Conventional emerging markets fixed-income investors are likely to shy away from investing in sukuks issued under the proposed structure because payment obligations will become dependent on the performance of underlying assets which are usually illiquid and thus hard to value.

The new Standard could also impact issuer options since pricing dynamics under the proposed standard will be completely different. These instruments will likely have significantly lower liquidity and a very different investor base. Another result of Shari'a Standard 62 would be market fragmentation, since many countries do not require compliance with AAOIFI standards. Ultimately, we expect AAOIFI-compliant countries such as the UAE to force AAOIFI to adopt a more pragmatic approach than that which is proposed currently.

Due to its legal and financial landscape, the UAE has a competitive advantage over regional and Asian rivals in garnering fees generated from the Islamic finance market. We expect the UAE to take proactive steps to ensure that this competitive advantage is maintained: which in turn will require some flexibility in implementing stricter AAOIFI guidelines. UAE Islamic banks also have no other option other than to rely on sukuk markets for longer-term funding and we expect their requirements to further influence the policies of the Central Bank of the UAE.

Further, we also expect to see strong growth in Islamic bank deposits which should influence increased demand for sukuk assets. It is also important to note that in the past, regulators have proposed restrictive guidelines which have then been altered pragmatically - keeping in mind the requirements of borrowers and lenders.

AUTHOR BIO

Faisal Ali (CFA), Senior Portfolio Manager

Faisal is a Senior Portfolio Manager for global sukuk strategies at Azimut. Prior to joining Azimut in 2019, Faisal worked as Head of Fixed Income at Mashreq Capital. Before that, he was based in London where he worked as an emerging markets and fixed income portfolio manager for Barings Asset Management and Credit Suisse. Faisal is a CFA Charterholder and holds an MBA in Finance from University of North Carolina and a BA in Economics from University of Texas.

Azimut Group, founded in 1989 and listed on the Milan stock exchange since 2004, is one of Europe’s leading independent asset managers. Azimut manages and advises total assets of around USD 100bn across public and private markets, with investment capabilities in 18 countries.