Global Sukuk: GCC Makes up Ground on Malaysia, but faces Challenges in the Current Low Oil Price Environment

Executive Summary

With its first endeavors in Islamic Finance pre-dating the early 1980's, Malaysia has been pioneering and dominating the global Islamic fixed income market. The country had a competitive advantage due to its Islamic Capital Market infrastructure, especially in its legal and regulatory framework, due to a long history of strong support from the Malaysian government. Today the sukuk market in Malaysia is RM 608.5 billion.[1]

More recently, partly due to the rapid increase in oil prices in the first half the 2000s; the global sukuk market saw rapid growth in the Gulf Corporation Council ("GCC") countries, and most particularly in Dubai. Global sukuk issuances increased significantly in volume in the GCC area as many new large infrastructure projects there were partially funded through issuance of global sukuk. The success GCC countries in tapping vast reserves of liquidity through sukuk had a spillover effect for the global sukuk market pushing it into other financial centers around the world. Countries from the West (i.e. United Kingdom and Luxemburg) and East (Indonesia, Hong Kong and China) began or increased issuing sukuk in view that the excess liquidity in the GCC area could be invested in their markets. These countries are highly focused on attracting the Middle East funds and many have even adjusted their tax structures to suit the Shariah needs of the sukuk issuances.

However, from CIMB-Principal Islamic Asset Management's point of view, although the global sukuk space often exhibits low correlations with other markets and generally has maintained its value, there are certain market fundamentals that have put pressure on the securities. The largest correction in the global sukuk space came in 2008 where, in conjunction with the global financial crisis, Dubai had a particularly challenging debt problem. Since then, the market has been more mindful of sovereign debt levels of sukuk issuers, and given the increase in issuance over the years, concentration risk has been meaningfully reduced.

That said, the sukuk space is still dependant on certain variables, one of which is oil prices. Oil is the backbone of a large swath of the sukuk space. As we are witnessing a sharp repricing lower of oil, we begin to think about the short term and longer term outlook of the GCC sukuk market. Will it be able to weather this storm and remain sustainable? How far can spreads widen, and which sukuk in the near term are the best to hold? What is a reasonable repricing where issuer credit profiles are weakening and the buy side's liquidity is also being challenged?

[1] As of end December 2015, RAM Ratings: Malaysia Maintains Lead in Global Sukuk, 10 February 2016

Background

Malaysia has always been known as the leading issuer of sukuk in the world since the inception of Islamic finance in the 1980s. Sukuk issuances and particularly Ringgit denominated issuances have been dominating the global sukuk market with strong support coming from the Malaysian government, global-conglomerates and corporations.

In 1990, Shell Middle Distillate Synthesis (Malaysia) was the first company to issue Ringgit denominated sukuk. The RM125 million Shell Middle issuance was historical for being the pioneer of sukuk issuances in Malaysia. However, Malaysia's sukuk market initially was largely concentrated on public or government linked debt issuances, rather than the private debt market. It was over a decade later that the market began to take expand into the global investment market when in December 2001, Guthrie Malaysia issued a USD 150 million Sukuk Al Ijarah which offered a floating rate return and made it the world's first global corporate sukuk. [2]

Now, 15 years later, the outstanding value of Malaysian sukuk stands at RM608.5 billion accounting for approximately 54% of the total RM1.15 trillion of outstanding bonds and sukuk in the domestic Malaysia market[3]. At the same time outstanding global sukuk including all currencies stood at USD280.9 billion with Malaysia still dominating the sukuk space while maintaining its lead as sukuk issuer with more than 50% global sukuk issuances of all currencies originating from Malaysia.

However, there has been a meaningful increase of global sukuk issuances from other regions namely the GCC countries as well as other Asia Pacific countries. To date, 29% of global sukuk issuances were issued by GCC countries while 17% was issued by other Asia Pacific countries. Although Ringgit denominated sukuk has been dominating the global sukuk market, the USD denominated sukuk has been steadily progressing. As at end of December 2015, 39% of total global sukuk issued was in Malaysian Ringgit while 32% of total sukuk issuances is denominated in USD.[4]

Much of the sukuk issuance in the GCC area was a result of the funding requirements necessitated for massive infrastructure projects in the region undertaken by both the public and private sectors. There was a rapid acceleration of projects in the United Arab Emirates ("UAE") as well as in the Kingdom of Saudi Arabia ("KSA"). Big conglomerates issued sukuk to finance their capital expenditure needs related mainly to large government contracts (e.g.: DP World, Dubai Electricity and Water Authority, Aldar Properties and Jebel Ali Free Zone).

The growth of the sukuk market does not only emanate from selected countries in the GCC region. Countries like Oman and Qatar have begun to develop their domestic financial market, mostly in the Islamic capital market space. Other non-oil producer such as Bahrain and Dubai are also trying to get a fair share of Islamic Finance market by developing their Islamic capital markets to support the massive growth in the GCC nations' economy. (Oman, Qatar, Bahrain and Dubai (UAE) are all in the GCC)

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[2] Sukuk Market and Its Recent Developments, Prof. Azmi Omar, Islamic Research and Training Institute
[3] As of end of December 2015, RAM Ratings: Malaysia Maintains Lead in Global Sukuk, 10 February 2016
[4] RAM Ratings: Malaysia Maintains Lead in Global Sukuk, 10 February 2016

However, the recent drop in oil price is profoundly impacting the economies in the GCC area as well as Malaysia. Oil is the backbone of many of the GCC economies. Governments are no longer experiencing budget surpluses and some are looking to austerity measures. Large government infrastructure projects have been delayed or even cancelled. Large corporations have had government contracts cancelled and are struggling to have new projects in their order book. Banks in the region are also experiencing tighter liquidity as sovereign funds and oil related companies started depositing less and even withdrawing deposits from the financial institutions.

The combination of the events above have eventually halted past years' rapid growth in the global sukuk market as companies are now having lesser funding requirements for working capital, and governments are constrained by higher costs in issuing sukuk. At the same time international rating agencies have reviewed their credit outlooks unfavorably which in turn resulted in a recent strings of sovereign credit rating and outlook downgrades in the GCC area. Similarly, potential sukuk issuers outside the GCC are also struggling to raise funds in the GCC area due to the tighter liquidity on the buy side of the market which has translated into higher yield premium.

Recent Development and Outlook of the Oil Prices

The global sukuk market has been shaken by the relentless and sustained fall in oil prices. Moody's has lowered its Brent oil target to USD43/bbl in 2016 and USD48/bbl in 2017 from previous assumption of USD53/bbl and USD60/bbl respectively, compounding market concerns over prolonged oversupply (particularly, with the lifting of Iranian sanctions) and weakening of Chinese demand with no sign of a pickup in global growth.[5]

At the centre of the turmoil over the collapse of oil prices, which have plummeted by more than 50% since September 2015, there has been a shift in the oil supply paradigm that has added to market volatility. Saudi Arabia, backed by other GCC countries and the undisputed leader of the Organization of the Petroleum Exporting Countries ("OPEC"), has been described as the "swing producer" of oil for many years due to its immense production capacity which can be used to raise or lower global output and control oil prices. However, the role came into question at the OPEC December 2015 meeting in Vienna when Saudi Arabia seemed to effectively resign from that role (at least temporarily) and OPEC handed over the responsibility for oil pricing to global markets.

At that meeting, OPEC set aside its output target of 30 million barrels a day and while adding net energy importer Indonesia as the group's 13th member. OPEC's decision to lift its daily output cap was a strong message to a global oil market accustomed to seeing OPEC step in and cut production to boost the oil price when necessary. The publicly stated rationale for their actions is that given global oil drilling advancements OPEC would lose market share permanently to new competition if OPEC continued to reduce its production in its historical role of swing producer. The new competition is coming from not only American shale oil producers but also from Canadian oil sands and new supplies from Russia, the Arctic, Brazil, Central Asia, Africa and growing volumes of offshore oil around the world. Less publicly

[5] Moody's Investors Services, "Moody's Sharply Lowers Oil Price Assumptions on Threat of Prolonged Oversupply",15 December 2015

stated but generally understood is that as a secondary benefit (if not primary) OPEC also would not be giving up market share to Iraq whose output is increasing, and they would be preventing Iran from obtaining a windfall which would have come had Iran's sanctions been lifted in a world with $100 oil.

As things stand now, however, the negative impact of OPEC's moves on oil prices certainly may be much more than some of the member's had anticipated. Countries like Venezuela did not go into this price war with a healthy economy, and has made noise about prices since shortly after the OPEC meeting of November 2014. In the meantime, with their large holdings of foreign reserves, Saudi Arabia and the Persian Gulf emirates can afford to wait longer, which seems to be the current plan. Around the world, oil companies and sovereign nations are seen cutting budgets, paring costs, slowing down projects and deferring or cancelling new ones. Saudi Arabia points to these developments as evidence their refusal to reduce production is having an impact, or perhaps will eventually, on global oil supply. At the same time the Kingdom is suggesting that lower oil prices will stimulate economic growth and demand for oil.

With this ongoing war, where the missiles of choice are oil prices, the immediate outlook for oil prices remains bleak. Goldman Sachs has said prices as low as USD20 per barrel might be necessary to push enough production out of business and allow the market to rebalance itself.[6] Other oil experts believe there will be a modest recovery in oil in the next 12-18 months, but no signs of returning to a market above $70. Adding to oil's woes, floods across the Midwestern United States were threatening refineries and pipelines from Illinois to Louisiana, potentially swelling the glut of US domestic crude oil at a time when stockpiles were already at record highs. A mild winter so far in the Northern Hemisphere due to the El Niño weather phenomenon has also slashed demand for heating oil and U.S. heating oil prices fell 40% for a second year in a row.[7]

The Impact of Declining Oil Prices to the Global Sukuk Market

As declining oil prices will surely strain future budgets for petrodollar driven sovereigns, governments across the GCC region will be reviewing their funding options for pre-planned infrastructure projects, but there are limited options with such a drastic and persistent drop in oil. To be sure, lower projected revenues and revised budgets have already resulted in several sovereign downgrades over the past months and negative revisions to credit outlooks.

In April, Moody's Investors Service downgraded Bahrain's long-term government issuer rating to Baa3 from Baa2. With the downgrade, Moody's specified that the decision to downgrade the rating was predominantly based on the expected deterioration in the government's finances as a result of the oil price shock. The decision to maintain the negative rating outlook on Bahrain reflects the uncertainty regarding the Bahraini government's response to the fiscal challenges posed by a prolonged period of lower oil prices.[8] A cut of one more notch will drop Bahrain to below investment grade, commonly referred to as 'junk' status. In October, Standard & Poor's Ratings Services ("S&P") lowered its

[6] Bloomberg Business, How Low Can Oil Go? Goldman says $20 a Barrel is a Possibility, Ben Sharples, 11 September 2015

[7] The Star, Oil Ends 2015 Down 35%; Long, Painful Hangover Seen, 1 January 2016

[8] Moody's Investors Service, Moody's Downgrades Bahrain's Rating to Baa3, Maintains Negative Outlook, 16 April 2015

unsolicited long- and short-term foreign- and local-currency sovereign credit ratings on the Kingdom of Saudi Arabia to 'A+/A-1' from 'AA-/A-1+' with its outlook remaining negative. The kingdom has run fiscal surpluses - at times substantial - over the 10 years to 2013 (averaging 13% of GDP). However, the sheer size of the shift in 2015 to a deficit of 16% of GDP from a deficit of 1.5% of GDP in 2014 and a surplus of 7% of GDP in 2013, combined with a high reliance on hydrocarbon revenues (80% of total government revenues) and inflexible current expenditures, point to vulnerabilities in Saudi Arabia's public finances.[9] In November, Standard & Poor's ("S&P") downgraded Oman's foreign currency credit rating from A- to BBB+ with outlook remained negative. S&P said it projects a sharp increase in Oman's general government and current account deficits over 2015-2018 period, and expects that trend growth in real per capita GDP will remain materially below that of its peers.[10]

Issuing sovereigns will now have to take a step back and reassess their funding costs amid the rising yields in the global sukuk market. Issuers will also need to carefully reach out to the market and gauge the interest in potential issuances to ensure that the intended tenor and amount required could be met at an affordable price. Investors will certainly be more cautious with their global sukuk investment strategies which are already driving higher yield premiums, particularly from oil related entities.

Maneuvering Sukuk Investments through Low Oil Price

As mentioned above, the global sukuk market going forward will grow on the back of potentially lower supply pipeline and an upward trend in the yields. However, this will prove to be a challenge as under normal circumstances as these two scenarios have an indirect relationship with each other. Sukuk investors need to carefully lock their targeted yields based on the limited supply of sukuk in 2016. Investors could potentially optimize investment opportunities amid higher yield pickup despite possible decline in sukuk issuances in 2016. The key questions for global sukuk investors in 2016 are the investment entry points and which issuance to select in order to maximize potential yields with limited global sukuk issuances available.

Based on the above, CIMB-Principal Islamic is recommending investors to adopt the following elements in their sukuk investing in 2016, "Defensive, Duration, and Diversification". We recommend investors to manage on the defensive, be less aggressive on the credit risk and opt for relatively safer credit. High quality investment grade sovereign sukuk should be the top pick for investors in this environment. In spite of our expectation of low interest rates for longer, for the short term we recommend investors to adapt an active portfolio management by rebalancing their portfolios throughout the year with a focus on short-dated issuances to manage volatility until oil prices bottom and turn up, and to realize capital gains when the opportunity arises. Finally, diversification has always been an effective investment strategy to ensure that risk exposures are well spread across the investment universe. In this case, investors should diversify their sectoral concentration and to gradually reduce exposure in oil related issuances when possible by investing in sukuk issued from issuers that come from industries that stand to gain benefit from the lower oil price such as airlines, shipping and processed food manufacturers.

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[9] Standard & Poor's Rating Services, Ratings On Saudi Arabia Lowered To 'A+/A-1'; Outlook Remains Negative, 30 October 2015

[10] Standard & Poor's Rating Services, The Sultanate of Oman Long-Term Rating Lowered to 'BBB+'; Outlook Negative; Short-Term Rating Affirmed at 'A-2', 20 November 2015

Global Sukuk Market Outlook for 2016

The outlook for global sukuk issuances in 2016 will remain constructive due to underlying credit fundamentals and the need to access capital markets to bring budget gaps. At the same time, issuance is supported by the projected trajectory of US Federal Reserve rates normalization to be flatter, where rates are expected to increase in a gradual manner. The downside risks to sukuk issuances in 2016 are such factors as a further decline in oil and commodity prices as well as exacerbated geopolitical concerns. Furthermore, the decision of Bank Negara Malaysia ("BNM") to cut sukuk issuances and switch to other liquidity management instruments because BNM sukuk were not reaching their targeted investors could also be one of the reasons for a reduction in sukuk issuances in 2016. This could give the opportunity to issuers such as IILM and IDB to increase their issuances and provide the industry with liquidity and further contribute to the development of the Islamic yield curve.

Sovereign issuers, and to a lesser extent banks, are expected to dominate the sukuk market in 2016. A number of governments in the GCC region have announced that they would adhere to their capex plans in spite of the expected reduction in their revenues. Other countries in the GCC have been following the path of fiscal consolidation due to sharp declines in oil revenues. Saudi authorities are currently reviewing their capital spending plans, with the expectation that a number of planned projects will be delayed or downsized. Meanwhile, the UAE has cut its subsidy on fuel[11], a move that could save billions of dirhams, and also there have been talks of introduction of Value Added Tax ("VAT") on goods. Countries like Bahrain and Kuwait are planning to privatize many government run companies. Elsewhere in the GCC, spending cuts loom in fiscal year 2016, together with further targeted cuts to corporate fuel subsidies and rises in corporate taxes.

While we have observed higher sovereign and government related entity issuances in Malaysia, we have not quite seen a similar trend in GCC countries other than some initial moves by Saudi Arabia. The governments in the GCC have enjoyed several years of high oil prices and are using their reserves to continue their investment programs in spite of budget shortfalls. Meanwhile, the list of sovereigns willing to enter the sukuk market continues to lengthen, although few have yet to do so. Tunisia, Nigeria, Korea, Egypt, Mexico, Kazakhstan, Kenya, Philippines, and Thailand are among those that have announced issuance plans in the past, but have yet to actually issue any sukuk. While it is likely that not all these sovereigns will eventually tap the market, there is a clear interest in doing so among an increasing number of governments. However, these issuances should be expected anytime soon as we believe some time may elapse between these expressions of interest and actual sukuk issuance as governments weigh the potential political and legal hurdles and the costs of issuance against the benefits and potential demand.

[11]Bloomberg Business, U.A.E. Removes Fuel Subsidy as Oil Drop Hurts Arab Economies, Claudia Carpenter and Sarmad Khan, 22 July 2015