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Islamic issues to attract many followers

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Sukuk bonds – financing vehicles which comply with Sharia law – will be launched in London with much fanfare as early as this year. This month, Ed Balls, the City minister, said the UK would aim not only to issue the new bonds on wholesale financial markets, but also to use them as vehicles to allow Muslims in Britain to invest in National Savings products.

It is likely that Muslims will jump at the chance to invest in these bonds. But non-Muslims looking to diversify their assets may also be keen.

Analysts say returns on these sorts of Islamic issues tend to be on a par with mainstream corporate issues.

For example, a short-dated sukuk issued last February by Bahrain Leasing, backed by the government of Bahrain and set to mature in August, would offer a yield of 5.23 per cent, which would be slightly better than a comparable 5.17 per cent yield on a US government bond.

“Islamic debt in general is still slightly more attractively priced, but that gap is dwindling as more and more people access the market,” says Danie Marx, head of treasury and capital markets at the European Islamic Investment Bank.

Access to these bonds is restricted largely to wholesale investors as only licensed financial professionals will be allowed to invest directly. And the market for international sukuk issues – which stands at about $22bn globally excluding the vibrant Malaysian market – is tiny compared with mainstream corporate markets.

“The market is in its infancy. It remains largely illiquid,” says Marx. “But it is growing rapidly. Because of the glut of money in the Middle East, anyone who buys into a sukuk typically buys it and holds it. Demand for sukuk exceeds supply.”

In practice, sukuk bonds are more similar to variable-leases or profit-sharing agreements than to debt. This means most sukuks have underlying agreements for the use of assets.

“Under Islamic law, you can’t charge interest, but nothing says you can’t do variable-rate lease or profit sharing,” **says John Sandwick, manager of Sanad, a listed retail fund which invests in sukuks**.

When the managers of Saudi Aramco, the state-owned national oil company of Saudi Arabia, want to buy a new ship, for example, they do it via a sukuk. Aramco signs a lease with a trustee who has a special purpose holding company. The trustee buys the ship, and issues sukuk or enters into the equivalent of a lease arrangement with Aramco. “Aramco has to meet quarterly lease payments which are pegged to the cost of funds or London Interbank Offered Rate (Libor), the benchmark for interest rate lending,” explains Sandwick.

Sukuks can also be used to establish a new project, appoint an investment manager – who is paid a fixed fee – or finance a business activity through a partnership contract.

Sandwick predicts that big corporations such as Ford, the US carmaker, will one day look to sukuk for financing. “If you’re the treasurer of Ford Motor, you want diversified funding sources. You want to absorb the liquidity to finance your liabilities. You don’t want to rely on the New York bond market,” he says.

Sandwick saw a vacuum in the retail market a few years ago and spent half a million dollars to launch Sanad – in arabic this means credit note – his sukuk fund last year.

“Properly executed, these deals represent a mountain of assets with nice decent cash flow. At first, it was my Saudi clients who were most interested, but now I’m looking to buy sukuk bonds for my non-Muslim clients too,” he says.

Interest in the fund has been voracious and Sandwick says assets under management are likely to increase from $20m to as much as $100m by next month’s finish. The minimum purchase price for investing in a sukuk bond is $5m-$10m.

Analysts say sukuk deals are likely to become more necessary. “If you’re handling investments in infrastructure or real estate in the emirates, you have to be familiar with sukuk. It’s a growing requirement from Muslim participants to do the financing in a Sharia-compliant way,” says Marx of the European Islamic Investment Bank.

When competition heats up, UK retail investors will be offered more choices about ways to profit from these deals, analysts say.