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Resource

Sector in Brief:

Global Sukuk

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bfinance is an award-winning specialist consultant that provides investment implementation advice to pension funds and other institutional investors around the globe. Founded in 1999, the London-headquartered firm has conducted engagements for more than 540 clients in 45 countries and has 11 offices globally. Services include manager search and selection, fee analysis, performance monitoring, risk analytics and other portfolio solutions. With customised processes tailored to each individual client, the firm seeks to empower investors with the resources and information to take key decisions. The team is drawn from portfolio management, research, consultancy and academia, combining deep sector-specific expertise with global perspective.

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What's new?

The Global Sukuk market has evolved significantly in recent years, evidenced by the sharp increase in sukuk issuance, with overall issuance almost tripling from US$60 billion in 2015 to more than US$160 billion in 2023. The overall amount of sukuk outstanding last year was US$870 billion, reflecting a significant increase from the US$490 billion reported in 2019.

In recent years Saudi Arabia has ramped up its use of these instruments to fund its economic reform programme, Vision 2030. The overall market continues to be dominated by Malaysia and Saudi Arabia who combined have 70% of Global Sukuk issuance outstanding.

The local currency Sukuk market continues to be dominated by Malaysia, which issued over US$50 billion in 2023, as it has a large domestic investor base. However, the market has also seen the entry of more frontier countries issuing sukuks in local markets, including the likes of Nigeria, Pakistan and Egypt all issuing sovereign sukuks denominated in their local currency. This shows a broadening out of the Global Sukuk universe from a country perspective.

More recently, there has also been an increase in sustainable sukuk issuance from a low base, with over US$10 billion in sustainable linked sukuks being issued last year, with the UAE leading the way with 40% of issuance last year, driven by the UAE regulators exempting sustainable sukuk from registration fees.

This increased demand is reflected in the performance of the global sukuk market. Currently, sukuk demand is exceeding supply, making this investment vehicle highly resilient during market downturns because investors are opting to sell alternative assets while holding their sukuk exposures, and this strategy appears to be paying off. While perhaps not the most lucrative asset class, global sukuk continues to attract investors thanks to its shorter duration, higher quality and returns in-line with what investors would expect from traditional bonds, but with lower volatility risk.

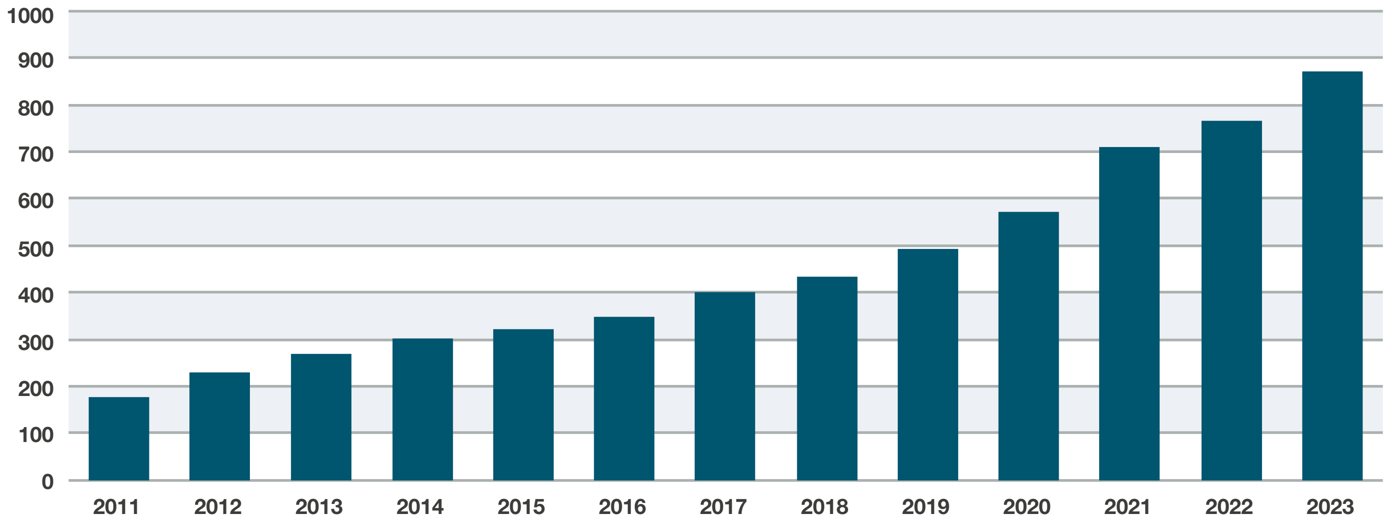
Facts & figures

> Market size has increased by **75%** in the past five years.

> Green sukuk issuance **more than doubled** in three years with companies and financials issuing 85% of this.

> **25+** active managers now offer Global Sukuk strategies.

FIGURE 1: SUKUK OUTSTANDING (US$ BILLION)



Source: S&P Global

What are Sukuks?

Sukuks are an Islamic financial instrument that allow issuers to borrow money without paying interest–also known as riba–which is against Islamic law. The instruments are structured in a way that leads to an issuer borrowing money to purchase an asset and then granting investors partial ownership of the asset, for which the issuers receive regular profit payments that the asset generates.

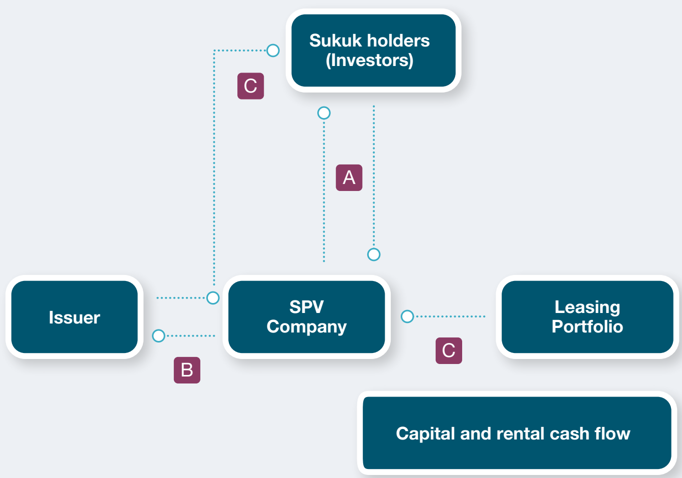
While there are various different types of sukuk, they can broadly be broken down into 'asset-backed' sukuk and 'asset-based' (Al-Ijarah) sukuk structures. The former are where the borrower transfers both legal and beneficial ownership over the asset to sukuk holders, meaning the sukuk holders have full recourse to the underlying assets and assume the risk that the underlying assets will generate lower revenues than anticipated, but do not have recourse to the issuer in this case. On the other hand, asset-based sukuks, which make up the vast majority of sukuks, are where the issuers only transfer beneficial ownership of the assets to sukuk holders and as such they enjoy the rights to the revenues or receivables generated by the asset, but do not have full ownership of the assets. Their beneficial ownership ends at the end of the sukuk term and on repayment of their principal by the borrower.

Riba explained

Riba, within Islamic banking, refers to charged interest. It has previously been dubbed usury, otherwise known as the charging of unreasonably high interest rates.

Under Shariah law, riba is forbidden for a number of reasons, but it is primarily intended to ensure a fair exchange. By making riba illegal, Sharia law creates opportunities and contexts in which people are encouraged to act charitably, reflective of Zakat, one of the five pillars of Islamic faith.

FIGURE 2: THE MECHANICS OF ASSET-BACKED AND ASSET-BASED (AL-IJARAH) SUKUK

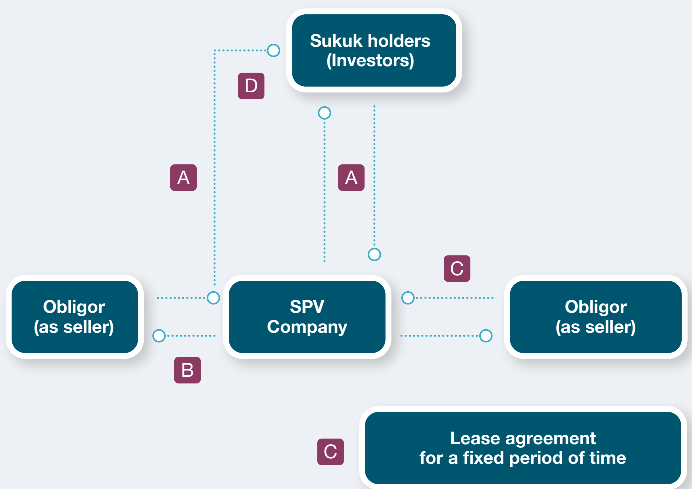


Asset-backed Sukuk process:

- **A** Investors buy-in by paying an issue price to a special purpose vehicle (SPV) company, who then issues certificates to the investors indicating the % they own in the SPV.
- **B** SPV buys a portfolio of assets that are already generating an income and in return receives the title deeds to the leasing portfolio.
- **C** The positive return from the leased assets are then paid to the SPV, which makes periodic payments to the investors.
- **D** The Investors are responsible for the insurance and maintenance of the portfolio as they are the legal owners. The rental payments provides the return and the final redemption of the sukuk is pre-agreed, making this type of sukuk more akin to debt and bonds.

Asset-based (Al-Ijarah) Sukuk process:

- **A** Holders subscribe by paying an issue price to a SPV company, which then issues certificates indicating the % they own in the SPV.
- **B** The SPV uses the funds raised to purchase the asset(s) from the seller and transfers legal ownership to the SPV.
- **C** The SPV, acting as a lessor, leases the asset back to the seller under an ijarah agreement and the seller pays rental to the SPV because the SPV is the legal owner of the asset.
- **D** The SPV then makes periodic distributions (both rental and capital) to the sukuk holders.



Source: bfinance

What are Sukuks? Continued

Sukuk versus bonds

Sukuks and bonds, while both investment vehicles that offer returns to investors, differ significantly in their underlying principles, structure, and how they generate returns. Bonds, on one hand, are based on interest (riba) payments, where investors lend money to the issuer in exchange for periodic interest payments and the return of the principal amount at maturity. Sukuks, however, are compliant with Islamic Sharia law, and instead of interest, investors receive a share of the profits generated by the underlying asset or project, representing partial ownership in the asset.

With traditional bonds, the bondholder is essentially a creditor to the issuer with no ownership in the underlying assets, working similarly to the likes of direct lending, observed in private markets. Returns are fixed and predetermined as interest payments, and the primary risk is related to the issuer's creditworthiness. Conversely, sukuk bondholders own a share of the underlying asset and are entitled to a proportionate share of the returns generated by that asset. The returns on sukuk are variable and depend on the performance of the underlying asset or project, sharing in the risk of its performance. If the asset does not perform as expected, the returns may be lower.

Funds raised through traditional bonds can be used for any purpose, including activities that might not be compliant with Islamic principles. In contrast, sukuk funds must be used for Sharia-compliant projects or assets, excluding businesses related to alcohol, gambling, pork, or other activities prohibited by Islamic law. Both investment types have various structures; traditional bonds include government, corporate, and municipal bonds, among others. Sukuk also have different structures, such as Ijarah (leasing), Musharakah (partnership), Murabaha (cost-plus financing), and Istisna (construction/production financing).

Regulatory and legal frameworks for traditional bonds are well-established in global financial markets and regulated by conventional financial authorities. Sukuks, however, require compliance with both conventional financial regulators and Sharia boards, adding a layer of complexity to their structuring. This dual regulation ensures adherence to Islamic finance principles, making sukuk a suitable investment for those who prioritise ethical or religious guidelines.

Sukuk issuance by country in 2023 (US$)

Malaysia	$65 billion
Saudi Arabia	$30 billion
Turkey	$15 billion
Indonesia	$12 billion
UAE	$10 billion
Kuwait	$10 billion

FIGURE 3: SUKUK VS BONDS

SIMILARITIES	KEY DIFFERENCES
Both offer investors payment streams.	Sukuk involves asset ownership, whereas bonds are debt obligations.
Bonds and sukuk are issued to investors and can be used to raise capital.	If the asset backing the sukuk appreciates in value, that increase in value can be reflected in the sukuk.
Both are considered low-risk options when compared to equities.	Assets that back sukuk are halal (permitted under Islamic law), whilst bonds are often riba (charged interest) and therefore forbidden under Sharia law.
Sukuk investors receive profit generated by the underlying asset on a periodic basis, whilst bond investors receive periodic interest payments.	Sukuk valuation is backed on the value of the assets backing the sukuk, while bond prices are typically determined by the overall credit quality of the issuer.

Source: bfinance

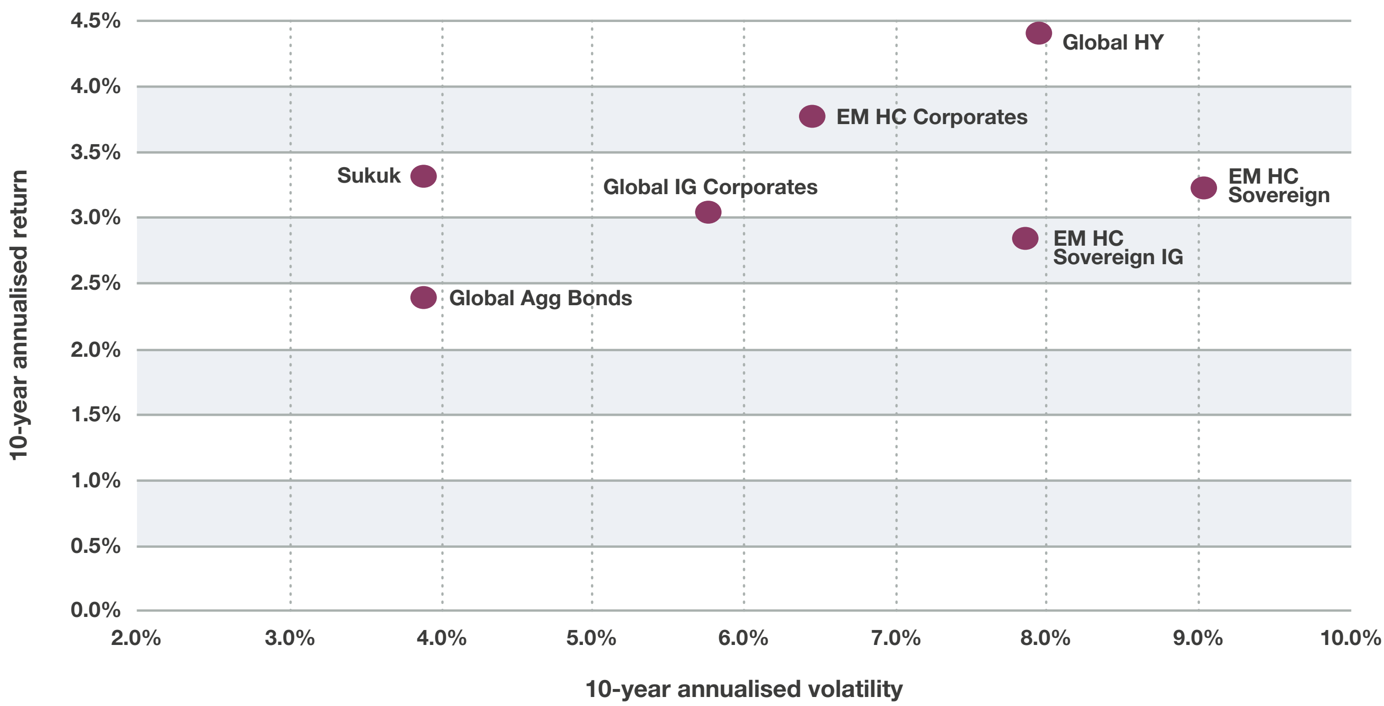
Assessing Sukuk performance

Recent years have not been too kind to fixed income investors due to high inflation, caused by Covid-related supply side issues, and the resulting fiscal and monetary policies implemented to combat these trials. These challenges prompted central banks to engage in meaningful interest rate hikes to stem inflation, which sent bond prices tumbling at a rapid rate. This was particularly true in 2022 (in which bond markets had their worst year in a generation) but also into the first three quarters of 2023. Whilst in 2024, central banks have maintained these higher interest rates, despite a general consensus from investors that we could see several interest rate cuts over the year, as they expected inflation to cool. This has resulted in weaker returns for investment grade bonds over the past two years.

The Global Sukuk market, however, has been an area of relative strength during this period, as it has held up significantly better than other parts of the investment grade global fixed income universe. Relative to global investment grade bonds, the Global Sukuk market benefits from a shorter duration with an index average (Dow Jones Global Sukuk Index) of four years, compared to more than six and a half years for the Bloomberg Global Aggregate Bond Index, for example.

This has lessened the pain of the sharp rise in rates we have seen over the past two years. It also means that, if the global economy is transitioning away from a long-term deflationary environment, to one where inflation will be both higher and more volatile, a lower duration asset class could be a more suitable product for certain fixed income investors. The overall Global Sukuk market is relatively high quality, with the Dow Jones Sukuk Index having an average quality of A compared to A- for the Barclays Global Corporate Bond Index.

FIGURE 4: SUKUK 10-YEAR PERFORMANCE



Source: bfinance

The primary global sukuk index (Dow Jones Global Sukuk) possesses a higher rating than that of the main emerging market sovereign hard currency benchmark, the JPM EMBI Global Diversified Index, with the former bringing an average quality of A compared to the latter's BB+. And when assessing the realised risk and return metrics over the past decade, one can see that, despite EM debt having significantly lower quality, the overall returns of the two asset types has been remarkably similar at 3.3% per annum versus 3.2% per annum.

However, EM hard currency sovereign debt has seen more than twice the volatility than the Global Sukuk market has seen, at 3.9% per annum compared to 9% per annum. If we were to focus only on the investment grade names in the universe, we see EM Hard Currency Sovereign IG debt returning less than similar quality global sukuks (2.8% per annum compared to 3.3% per annum) and with twice the volatility (7.9% as opposed to 3.9%).

Assessing Sukuk performance Continued

INDEX	JP EMBI GD	JPM EMBI GD IG	BLOOMBERG GLOBAL CORP	BLOOMBERG GLOBAL AGG	DJ SUKUK
Credit Quality	BB+	A-	A-	AA	A
Modified Duration	6.7	7.7	6.0	6.6	4.4
YTM	7.9	5.7	5.0	3.9	5.3
Max Drawdown (10yrs)	-26%	-26%	-18%	-14%	-11%

Data as of 30th June 2024

One of the major reasons for the defensive nature of the Global Sukuk market is that it has a larger base of buy and hold investors compared to other fixed income assets, as the demand for them is currently exceeding their supply. This means that during periods of market turbulence, in particular, sukuk investors are less likely to sell their holdings, preferring to sell other assets, which results in sukuk pricing resilience and therefore displaying lower realised volatility. In recent years, sukuk bonds have also benefitted from a lower duration, so their drawdown figures in 2022 were significantly lower than most other fixed income asset classes.

When comparing to other asset classes, the returns also appear highly attractive from a risk-return standpoint. Taking a closer look at figure 4, which plots the annualised ten-year return versus the 10-year volatility of each of the major fixed income sub-asset classes, we can see that the return of sukuks has been above all bar EM hard currency corporates and global high yield. However, the realised volatility of the asset class has been low, similar to that of Global Aggregate bonds (a proxy for all developed market investment grade bonds) and significantly less than all other forms of emerging market debt and nearly 2% lower than global corporate bonds. This leads to the Global Sukuk asset class having the highest Sharpe ratio compared to other fixed income asset classes, over the past decade.

Manager selection considerations

The universe of active managers in the Global Sukuk space is small but growing, with over 25 managers offering Global Sukuk mandates. They also offer a diverse range of ways in which an investor can access the market. Some managers focus on the MENA region, with a heavy focus on corporate exposure that runs with a spread premium. Others, however, focus on emerging market sovereign issuers, including those in local denominated debt that offer a higher yield. There are managers that blend the two approaches and have more of a barbell structure with a high level of higher quality sovereign issuance alongside a similar level of lower quality high yield corporate or emerging market sovereign issuance.

Whilst the manager universe is relatively small, it has been a relatively bountiful area for active management in recent years, with 60% of managers listed on eVestment outperforming the benchmark over three years and 69% outperforming over the past two years, net of fees. However over longer periods this falls to just 33% outperforming over five and seven years.

Assessing active management data reveals the importance of selecting the right manager, as the dispersion of relative returns has been rather significant, with the difference between the first and third quartile being 125, 125 and 76 basis points, annualised over two, three and five years, respectively. On a three-year and five-year net of fee basis, the top quartile of the peer group has added 103 and 41 basis points, respectively.

The ability for certain managers to deliver significant levels of outperformance can be attributed to the fact that they are taking additional credit risk by overweighting lower quality credits compared to the benchmark. Using data from eVestments, as of the first quarter of 2024, we can see that the average manager in the space has 36% in BBBs compared to 29% in the benchmark, and just under 15% in high yield sukuks compared to 5% for the Dow Jones Global Sukuk index.

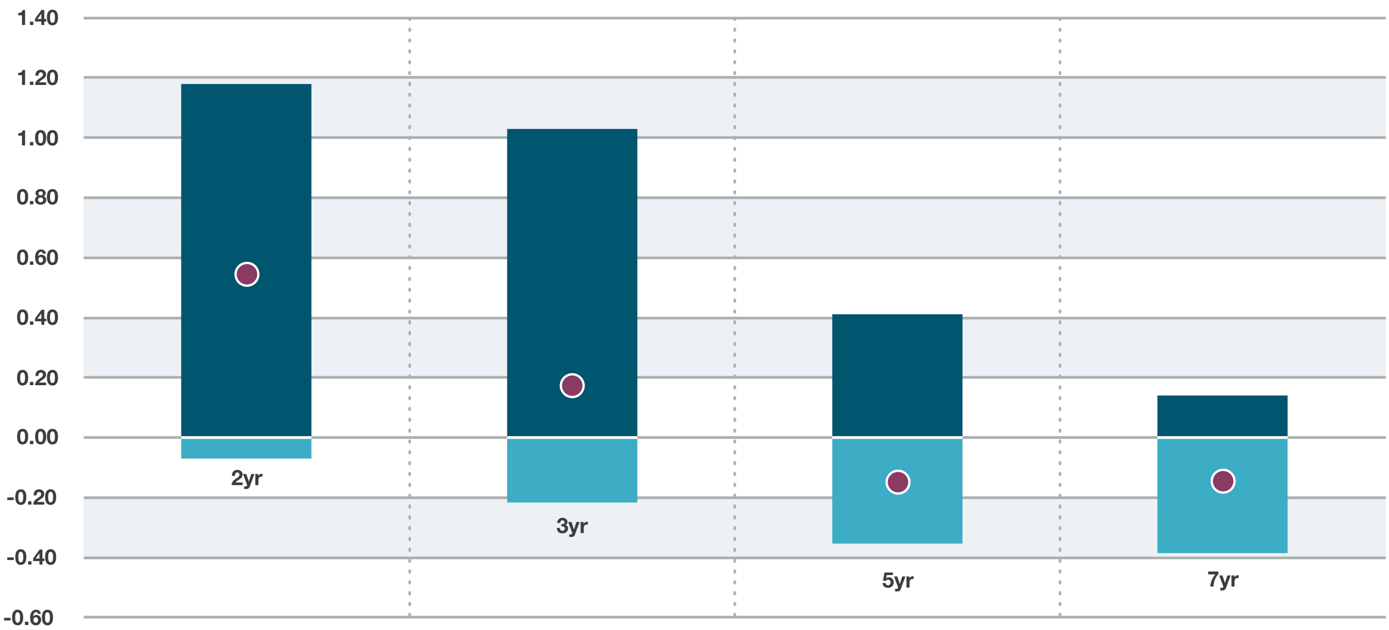
Manager selection considerations Continued

Those investors seeking outperformance could also take another approach, by allocating to local currency sukuks and maintaining active currency exposure relative to the US dollar, but only if managers believe there is a likelihood that the currency will appreciate relative to the dollar. As of the end of March 2024, based on eVestment data, just over half of managers had active currency exposure via local currency denominated sukuks and/or outright active currency positions.

As we mentioned above, the Global Sukuk market—while evolving rapidly and offering investors what appears to be a relatively safe fixed income option—is still small in comparison to mainstream bond markets. This in and of itself presents numerous challenges for investors: performance data is limited and, while promising, does not provide investors with a broader insight into how this asset type might withstand longer market downturns.

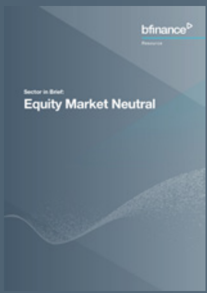
Overall, the Global Sukuk market is one for investors to keep their eye on, certainly while the broader geopolitical landscape remains uncertain and traditional fixed income markets struggle to keep pace. However, one should be aware of the challenges associated with this market and carefully assess all Global Sukuk managers before delving deeper into this small but growing asset class.

FIGURE 5: MEDIAN ACTIVE MANAGER RETURN AND 25TH TO 75TH PERCENTILE RANGE OVER VARIOUS TIME PERIODS



Source: bfinance

Related reading:



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