IFIS 2026, Kuala Lumpur Aug 3rd- 6th

Islamic Finance & Investment School

STRATEGIC AVENUE CONSULTANCY

SUKUK

Source:Islamic Finance Review

ISSUING, PRICING & TRADING

Definition of Sukuk

- According to Securities Commission Malaysia (SC), sukuk refers to certificates of equal value which evidence undivided ownership or investment in the assets using Shariah principles and concepts endorsed by the Shariah Advisory Council Malaysia (SAC). A sukuk is an Islamic financial instrument structured based on Shariah principle with the intention of creating returns similar to those of a conventional bond.
- Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) described sukuk as securities of equal denomination representing individual ownership interests in a portfolio of eligible existing or future assets.
- A sukuk can be structured to offer a fixed return similar to the interest on a conventional bond. But unlike a bond holder, a sukuk holder is granted an ownership interest in the assets or business being financed, and the return is tied to the performance of the underlying assets.
- A bond is a fixed income instrument that represent a loan from the investor to the issuer (borrower) for an agreed period in exchange for regular interest payment. On the maturity date the issuer will fully repay the investor.

Definition of Sukuk cont.

- Malaysia’s flexible foreign exchange administration rules allow multilateral development banks, multilateral financial institutions, sovereigns, quasi-sovereigns and local or foreign multinational corporations to issue foreign currency denominated Sukuk in Malaysia.
- Sukuk issued by Malaysian government is called Government Investment Issue (GII) and it is used to raise funds from the domestic capital market to finance the Government’s development expenditure. GII is Islamic securities issued in compliance with Shariah requirements and is an alternative debt instrument for the Government. GII is issued under the Government Funding Act 1983 to enable the Government of Malaysia to raise funding in accordance with the Shariah principles. The terms and conditions of the GII are governed by, and construed in accordance with, the laws of Malaysia.
- Sukuk can be structured as Asset Based, Asset Backed or Investment Sukuk.
- Key investors are institutional and wholesale investors which include government link investment corporations, Islamic financial institutions, Takaful companies, fund and asset management companies and corporations. The retail sukuk market has also been developed to further diversify the investors based to further provide the breath and depth to the market.

Main Features Peculiar To Sukuk

- Structured using Shariah compliant principles & contracts such as Ijarah, Wakalah, Murabahah, Istisna etc;
- Represents proportionate ownership in the underlying assets;
- Proceed used for Shariah compliant activities only;
- Generate regular income to the holders in the form of profits (Wakalah) or rentals (Ijarah);
- Tradable or not tradable in the secondary mark

ISSUING

Modes of Issuance

- Tender
  - Involve issuance from government, central bank and corporations with strong credit rating.
  - Auction will be based on competitive tender.
  - For government securities and papers issued by BNM, the tender will involved Principal Dealers.
- Bought Deal
  - Lead Arranger/Lead Manger to subscribe the whole issuance.
  - Zero risk of undersubscription.
  - Certainty in pricing but will command higher premium.

Modes of Issuance cont.

- Underwriting
  - Lead Arranger/Lead Manager will primarily underwrite the unsubscribed portion.
  - Zero risk of undersubscription.
  - Certainty in pricing but will command higher premium
- Private Placement
  - Negotiation on tranche, size, pricing and tenure to be directly negotiated with identified key investors.
  - Issuer might not achieve targeted market pricing as premium may be required.
  - Pricing can be less transparent.

Modes of Issuance cont.

- Book Building
  - Strictly a price discovery process for the issuer within the indicated price guidance or lower.
  - Mass market placement for established stronger rated issuers.
  - Better blended yield.
  - Price transparency to all.
- Best Effort
  - Strictly a price discovery process for the issuer with no guarantee the full subscription.
  - Mass market placement for average rated issuers.
  - Issuer might not achieve targeted market pricing as premium may be required.

Sukuk Markets

Primary Market

- A marketplace where securities are created and issued,
- Entail issuance and sale of newly issued securities in the form of equity or debt market instruments such as stock/shares, bond or sukuk.
- The funds raised are issued to the company as a form of direct investment and channeled to productive purposes.
- Pricing of primary market securities are fixed and agreed by the company (and depending on the type of instrument and structure) advised by the investment bank.

Primary Market cont

- Parties involved are the companies and investors.
- Securities issued are floated on the primary market before going to the secondary market. Hence it precedes the secondary market.
- There are different methods of raising capital in the primary market:
  - Stock & Shares - Initial Public Offering (IPO), Offer for Sale, Private Placement, Rights Issue;
  - Bond & Sukuk - Tender, Bought Deal, Underwriting & Book Building.

Secondary Market

- Sale and purchase of already issued securities in the primary market. The secondary market provides access and liquidity for investors can buy and sell the securities anytime.
- Securities are negotiated and transacted among investors and does not involve the issuer (the company issuing the securities).
- The proceed of fund does not represent direct investment to the company
- Pricing are based on demand and supply with the high volume of transactions led to the lower transaction cost.

Secondary Market cont.

- Dealings in the secondary market is either through a formal platform i.e. a stock exchange or direct dealing between the buyer and sellers (Over the Counter - OTC)
- Secondary market encourages new investment among investors. It also ensures the safety and fair trading for the protection of the investor's interest.
- Furthermore, the secondary market helps banks and other institutions fulfil their short term liquidity needs. It also facilitates the liquidity and marketability of existing shares.

Ratings: Rated & Unrated Sukuk

- Credit rating agency (CRA) is a third-party assessment about the creditworthiness of an individual or entity that seeks sovereign governments, state or provincial authorities and corporations that want to raise funding via bond or sukuk.
- Rated sukuk are sukuk that have been assessed for a fee by the CRA that issues a rating based on the ability to repay the debt as well as the likelihood of a bond’s default.
- Unrated Sukuk are sukuk which do not go through the assessment process and do not appear in benchmark indices.
- Decision for companies whether to opt for rating include:
    - Rating cost
    - Size of issuance
    - Complexity of structure
    - The need for visibility

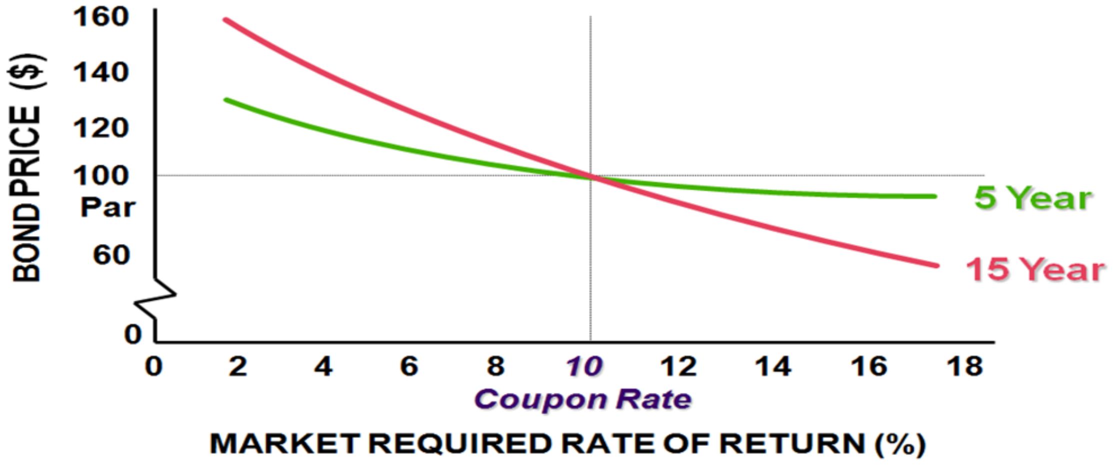
Ratings: Rated & Unrated Sukuk cont.

- Advantage of rating include:
  - Competitive pricing i.e. the higher the rating, the lower the expected yield
  - Draw buyer from a larger investors’ pool
  - Save potential investors time and effort to evaluate the issuer
  - Good for profiling the company especially for international investors.

Pricing & Trading

Relationship Between Sukuk Price & Sukuk Yield

- Sukuk price has an inversed relationship to Yield



- 1. The higher the yield, the lower the price and vice versa
- 2. The longer the tenor, the steeper the curve and thus the greater change in price movement.

Sukuk Key Principles

Key Principle No 1 : Sukuk Price Moves Inversely with Market Yield

- The holder of a 10% coupon sukuk would make a capital loss in the event the market rate rise (sukuk price decline) and will show profit if market rate fell i.e. sukuk price increase.
- The sukuk contains a streams of cash flow (coupons) which remain fixed throughout the entire life of sukuk. As market rate changes, the value of the sukuk must be adjusted up or down to reflect current market prices.
- Given this logic, a sukuk trading the same market rate with the coupon will results the price trading at par.

Key Principle No 1 : Sukuk Price Moves Inversely with Market Yield cont.

- 5-Year Sukuk With 10% Coupon

Market Yield	Sukuk Price
5%	121.88
8%	108.11
10%	100.00
15%	82.84

Key Principle No 2 : The Longer the Sukuk Term to Maturity, the Greater Impact on Sukuk Prices

- While it is true that sukuk prices and market rates move inversely to one another, the impact in the changes are not the same.
- The longer a sukuk term to maturity, the more sensitive to the change in market rate
- The longer term to maturity means the more coupon payments required hence the sukuk is more vulnerable to the changes in market rate.

Key Principle No 2 : The Longer the Sukuk Term to Maturity, the Greater Impact on Sukuk Prices cont,

5-Year Sukuk With 10% Coupon

Term to Maturity	Yield	Sukuk Price	Yield	Sukuk Price	% Change
1 Year	8.75	101.17	9.75	100.23	0.93%
3 Year	8.75	103.24	9.75	100.64	2.52%
7 Year	8.75	106.44	9.75	101.25	4.88%
10 Year	8.75	108.22	9.75	101.57	6.15%

Key Principle No 3 : <u>The Higher the Sukuk Coupon, the Less Impact on the Sukuk Prices</u>

- While it is true that sukuk sensitivities to changes in market rates increases with its term to maturity, it is not true two sukuks with identical term to maturity will be equally affected by a change in market rate.
- The shift in sukuk prices will be influenced by the nominal coupon as shown in the table above.
- The implication is for sukuk investors with low coupon will have higher volatility

Key Principle No 3 : The Higher the Sukuk Coupon, the Less Impact on the Sukuk Prices cont.

10 Year Sukuk

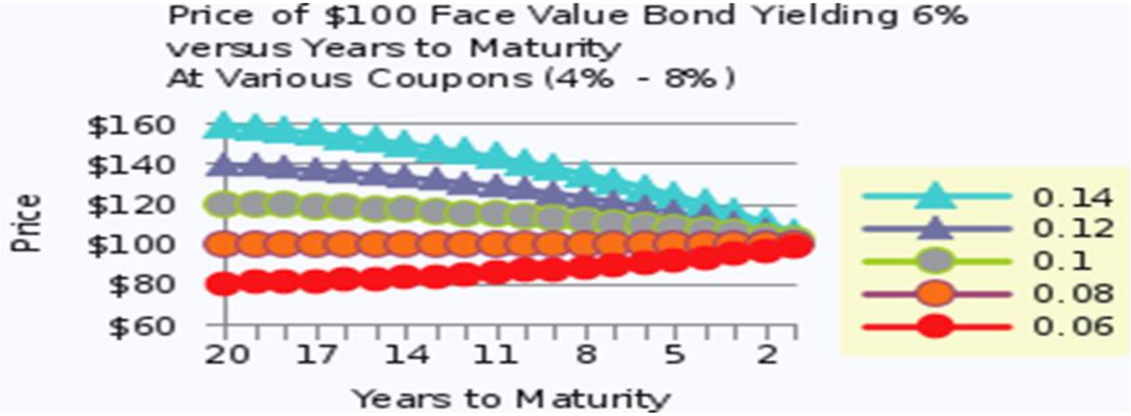
Coupon Rate	Yield	Sukuk Price	Yield	Sukuk Price	% Change
5%	8.75	75.34	9.75	70.09	6.67%
8%	8.75	95.07	9.75	88.98	6.41%
12%	8.75	121.37	9.75	114.17	5.93%
15%	8.75	141.09	9.75	133.06	5.69%

Key Principle No 4 : <u>Final Yield to Maturity Depend on the Prevailing Market Rate When Reinvesting the Coupons</u>

- The sukuk holder may be wrong to conclude that the sukuk acquired and held to maturity will be exactly equal to the yield they originally purchased the sukuk.
- The actual return or yield will depend on the rate which an investor is able to re-invest the coupon payment which he receive during the life of the sukuk.
- The downward market trend might lead to lower reinvestment proceed hence lower overall yield as compared to the initial YTM.
- An upward market trend might led to higher reinvestment proceed and will lead to higher overall yield as compared to the initial YTM.
- A zero coupon sukuk with nothing to reinvest will mean that the initial YTM will be equal to the realized yield on maturity.

Pricing Of Sukuk

- **Premium, Par or Discount?**



- 1. Premium : Coupon Rate > YTM
- 2. Par : Coupon Rate = YTM
- 3. Discount : Coupon Rate < YTM
- Conclusion: All issues goes back to par on maturity.

Yields

- **Definition**

  Yield refers to the annual return on an investment. The yield on a sukuk is based on both the purchase price of the sukuk and the coupon or profit payments received.

- **Measure of Yield**

  1. Current Yield

  Annual income (profit or dividends) divided by the current price of the security. This measure looks at the current price of a sukuk instead of its face value and represents the return an investor would expect if he or she purchased the sukuk and held it for a year.

$$CY = \frac{\text{Annual Dollar Profit Paid}}{\text{Market Price}} * 100$$

$$\text{Adjusted CY} = \frac{\text{Annual Dollar Profit Paid}}{\text{Market Price}} * 100 + \frac{(100 - \text{Market Price})}{\text{Years to Maturity}}$$

$$\text{CY for Zero Coupon} = \left(\frac{\text{Future Value}}{\text{Purchase Price}}\right)^{\frac{1}{n}} - 1$$

- ## Measure of Yield

  2. Yield to Maturity (YTM)

  Yield to maturity reflects the total return an investor receives by holding the sukuk until it matures. YTM is considered a long-term sukuk yield expressed as an annual rate. The calculation of YTM takes into account the current market price, par value, coupon profit rate and time to maturity. It is also assumed that all coupons are reinvested at the same rate. Sometimes this is simply referred to as "yield" for short.

$$\text{Approximation to YTM} = \frac{C + \frac{F - P}{T}}{\frac{F+P}{2}}$$

Where C = Annual amount paid in profit
F = Nominal value of Sukuk
P = Selling price of the sukuk
T = Number of years to maturity

else must do trial and error using the normal formula given below

$$\text{Sukuk Price} = \text{Cash flow} * \frac{1 - \left(\frac{1}{(1 + YTM)^n}\right)}{YTM} + \text{Maturity Value} * \left(\frac{1}{(1 + YTM)^n}\right)$$

- ## Measure of Yield

  3. Yield to Call

  Yield to call is calculated the same way as yield to maturity, but assumes that a sukuk will be called, or repurchased by the issuer before its maturity date, and that the investor will be paid face value on the call date.

Call Value replaces the Maturity Value

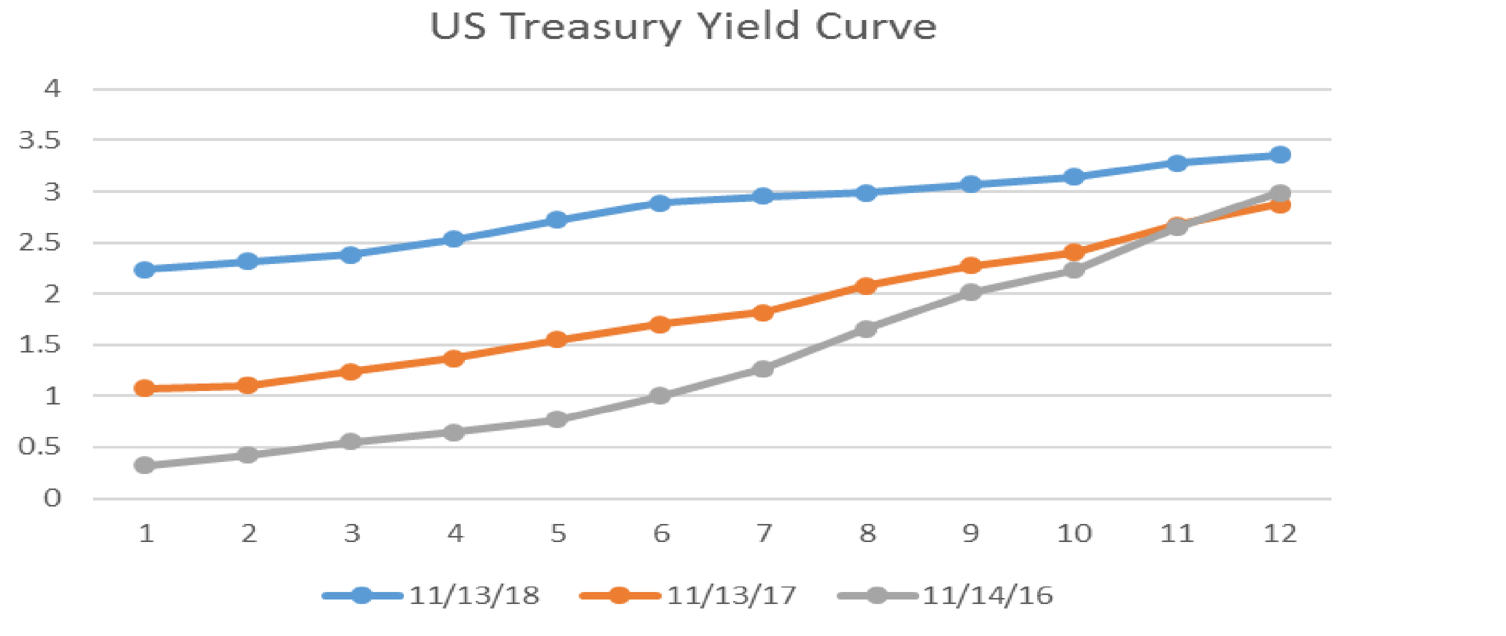
$$\text{Sukuk Price} = \text{Cash flow} * \frac{1 - \left[\frac{1}{(1+YTM)^n}\right]}{YTM} + \text{Maturity Value} * \left[\frac{1}{(1+YTM)^n}\right]$$

Time until call date replaces time to maturity

Sukuk Valuation & Pricing

- **Yield Curve aka Term Structure of Profit Rates**

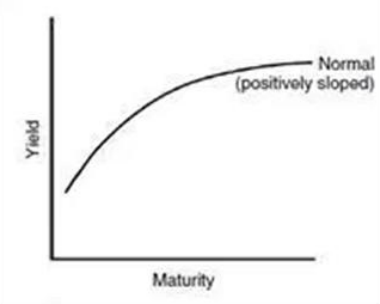
  The yield curve is a line graph that plots the relationship between yields to maturity and time to maturity for bonds of the same asset class and credit quality. The plotted line begins with the spot interest rate, which is the rate for the shortest maturity, and extends out in time, typically to 30 years.



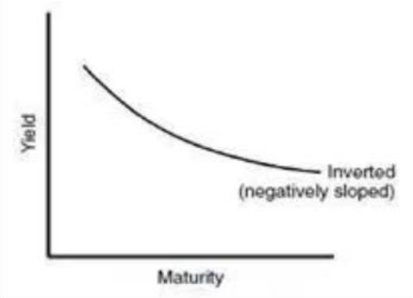
- **Yield Curve aka Term Structure of Profit Rates**

Shapes of a yield curve

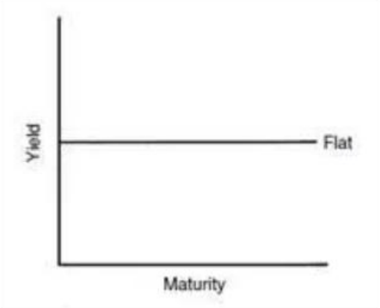
Positive YC



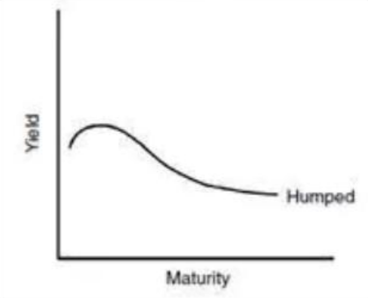
Negative YC



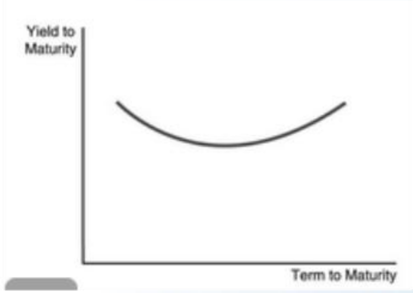
Flat



Humped



Bowled

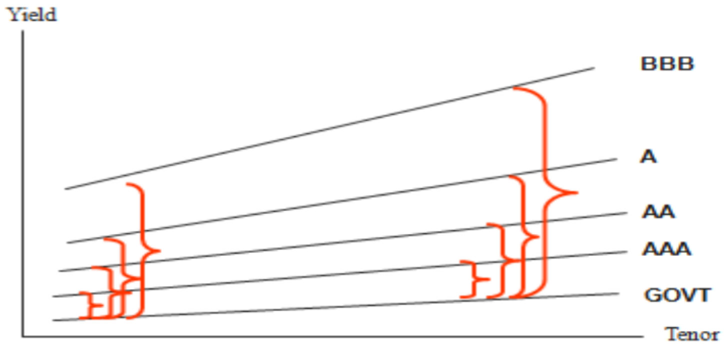


- **What discount rate should we use to value a sukuk?**

  For Government sukuks → use Risk-free rate

  For Non-Government sukuks → use Risk-free rate + risk premium*

* Risk premium is to compensate for greater credit risk, liquidity risk, political risk, etc.



Indicative Rating Mapping

International Rating Agencies			Malaysian Rating Agencies	
S&P	Moody's	Fitch	RAM	MARC
Investment Grade				
AAA	Aaa	AAA		
AA+	Aa1	AA+		
AA	Aa2	AA		
AA-	Aa3	AA-		
A+	A1	A+		
A	A2	A	Investment Grade	
A-	A3	A-	AAA	AAA
BBB+	Baa1	BBB+	AA1	AA+
BBB	Baa2	BBB	AA2	AA
BBB-	Baa3	BBB-	AA3	AA-
Speculative Grade			A1	A+
BB+	Ba1	BB+	A2	A
BB	Ba2	BB	A3	A-
BB-	Ba3	BB-	BBB1	BBB+
	B1	B	BBB2	BBB
	B2		BBB3	BBB-
	B3		Speculative Grade	

Speculative Grade	
BB1	BB+
BB2	BB
BB3	BB-
B1	B+
B2	B
B3	B-
C1	
C2	C
C3	
D	D

A note of appreciation & acknowledgment to IFRAC (Islamic Finance Research & Coaching) for the secondary source of information used in this presentation.

Website: www.ifrac.com.my

Thank You
Jazakallah Khair

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