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Sukuk Market Continues To Grow Despite Gloomy Global Market Conditions

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Sukuk Market Continues To Grow Despite Gloomy Global Market Conditions

After a slow start in 2008, the sukuk market is picking up again. Total issuance stood at about \$14 billion in the eight months to Aug. 31, 2008, down from about \$23 billion during the same period in 2007. This lower level of issuance was largely due to the deteriorated conditions on the global markets resulting in lower investor interest in buying the paper and the related widening of credit spreads. Although difficult to measure, this could have also been partly due to comments about the Sharia-compliance of some sukuk by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Some issuers may have reconsidered how they structure their sukuk, resulting in delays. Most sukuk were issued in markets where liquidity is still abundant and/or appetite for Sharia-compliant instruments is high--namely the countries of the Gulf Cooperation Council (GCC) and Malaysia.

Despite lower issuance versus last year, Standard & Poor's Ratings Services still expects that sukuk issuance will reach \$20 billion-\$25 billion in 2008 given the good pipeline. We continue to see a lot of appetite from issuers in a larger number of countries--Muslim and non-Muslim. Entities located in more than 15 countries, predominately non-Muslim, have expressed interest or announced their intention to issue sukuk. We therefore expect the sukuk market to continue globalizing.

More than 50% of sukuk issued in the first half of 2008 were "ijara" (lease financing), most probably as a direct consequence of the debate among some Sharia scholars regarding the Sharia compliance of most sukuk previously issued. To date, Standard & Poor's has rated about 30 sukuk (or sukuk programs), the bulk of which are ijara or "musharaka" (venture capital financing). (Please see our "Glossary Of Islamic Finance Terms," published Jan. 7, 2008, on RatingsDirect.) Credit spreads on sukuk have followed the same trend as for conventional bonds with a sharp widening in the past 12 months.

The U.S. dollar lost its position as the currency of choice for sukuk issuance in 2008, not only because of its weakness but also due to speculation about the depegging of some GCC currencies from the dollar. Corporates remained the main issuers, with financial institutions and sovereigns far behind. These corporates find that sukuk are an alternative funding source to financing their business or projects, and financial institutions are issuing sukuk to sustain strong lending growth with longer term funding sources, therefore curbing maturity mismatches.

Standard & Poor's role is to provide market participants with independent and objective opinions about the creditworthiness of issuers or issues--Sharia-compliant or conventional. Our ratings represent opinions about creditworthiness and don't address Sharia compliance.

Sukuk Market Closes In On \$100 Billion

Despite gloomy market conditions, sukuk issuance is rapidly approaching the symbolic \$100 billion mark. It is likely to surpass that sometime in 2009 (see chart 1). In other words, the sukuk market has already established itself as a niche in the international capital markets and is on its way to becoming more than that. After a very slow start in the first quarter of 2008, with less than \$3.0 billion issued, the sukuk market resumed rapid growth--but at a lower pace than in 2007. Standard & Poor's expects continued significant growth in the next 12 months.

Chart 1



Sukuk issuance is on a growth path for several reasons:

- On the demand side, cash-rich investors from the Middle East and Muslim Asia are showing a growing interest for products that comply with their religious beliefs.
- On the supply side, massive infrastructure projects in the Gulf require huge amounts of funding. Banks there are also scrambling to balance the rapid increase in real estate lending with more long-term funding. Outside of the Gulf, conventional borrowers are willing to diversify their funding sources and attract deep-pocketed investors from the Middle East, especially under current tightened market conditions.
- Regulators and governments in the Gulf and in Muslim Asia, especially in Malaysia, support the development of Islamic finance, including the sukuk market, for religious, political, and business reasons.

We continue to believe that long-term growth of the sukuk market won't be stunted by the debate among some Sharia scholars about the Sharia compliance of most sukuk previously issued. However, we've noticed a shift toward the ijara structure in the first half of 2008 and away from musharaka, which was prevalent in 2007. The debate about Sharia compliance is likely to introduce more standardization and encourage innovation in the structuring of sukuk. We should see the development of sukuk that are backed by cash-flow-generating assets and that don't benefit from "credit enhancements" or third-party guarantees. Real estate, for example, could back sukuk, given the explosive growth of this sector in the Gulf. For instance, we have assigned credit ratings to the United Arab Emirates dirham (AED) 4.0 billion sukuk al-mudaraba al-muqayyada certificates issued by Sun Finance Ltd. (See our report, "Presale: Sun Finance Ltd.," published July 21, 2008). This transaction involves a plot sales receivables financing

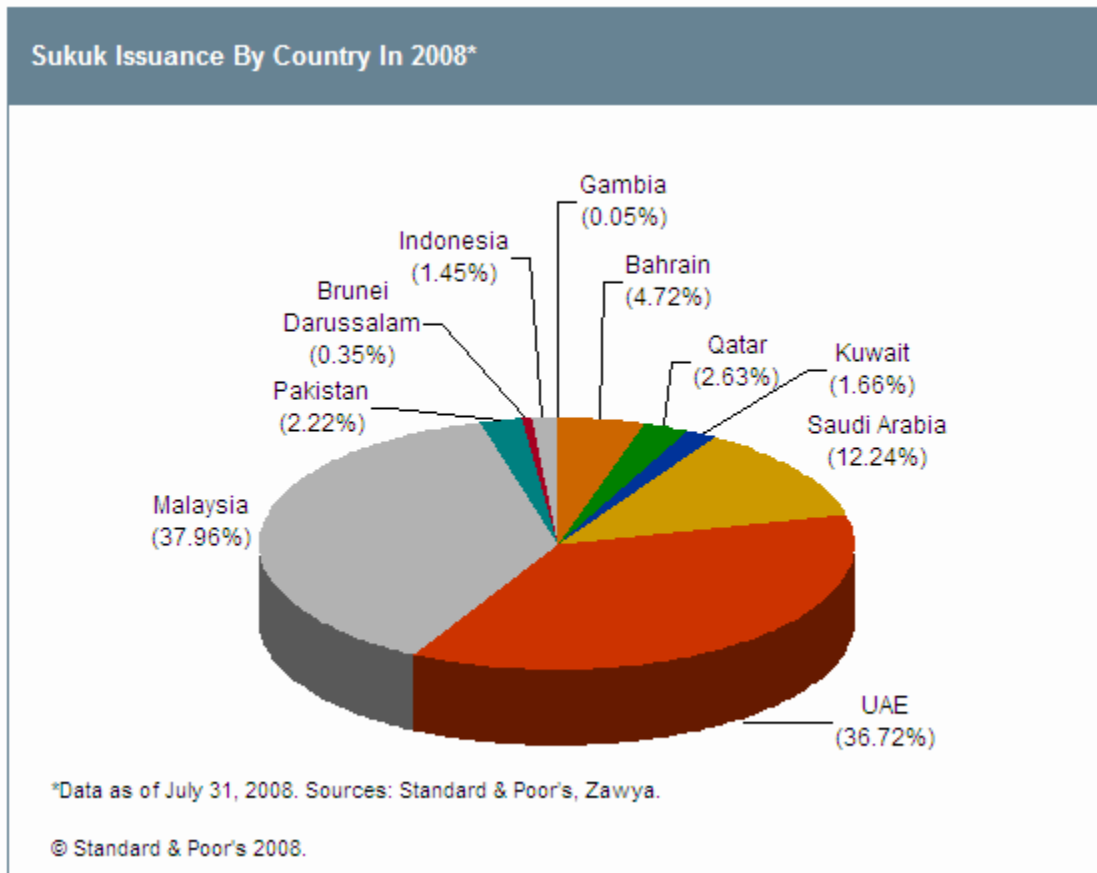
company under which Sun Finance receives its cash flows from a property company, Sorouh Abu Dhabi Real Estate LLC (SADRE), domiciled in Abu Dhabi.

Financial institutions seeking to optimize their funding profiles might find these kinds of deals attractive. Indeed, the rapid growth of real estate finance has widened maturity mismatches on the balance sheets of GCC banks. The regional environment therefore seems increasingly fertile for the emergence of securitization--Islamic and conventional. As the region becomes more familiar with securitization techniques, the sukuk market is set to benefit from a wave of opportunities and innovation.

The Club Of Sukuk Issuers Is Widening

The sukuk market is attracting issuers from a larger number of countries than ever before (see chart 2). This trend is set to continue. In the first half of 2008, the Republic of Gambia entered the league of countries issuing sukuk through a series of deals (very small in absolute terms) by its central bank. Entities in more than 15 countries, predominately non-Muslim, have expressed interest or announced their intention to issue sukuk. In the U.K., the Treasury launched a consultation in November 2007 to seek views on the potential for the government to become an issuer of Islamic financial instruments denominated in British pound sterling. Several Asian countries, including Indonesia, are currently launching their sukuk or reviewing their options to do so. Therefore, Standard & Poor's expects the market to continue globalizing.

Chart 2



Issuers from the UAE and Malaysia continue to be the locomotives of sukuk issuance. In the first half of 2008, issuers from these two countries accounted for three-quarters of total sukuk issuance. We expect them to continue to be the giants in the market, thanks to their authorities' support for the development of Islamic finance and the UAE's status as a regional gateway to global investors. Since Jan. 1, 2008, the four largest sukuk were issued by SABIC (Saudi Basic Industries Corp., A+/Stable/A-1), Aldar Properties PJSC (A-/Stable/A-2), Nakheel Properties (not rated), and DEWA (Dubai Electricity and Water Authority; not rated), for a cumulative \$4.2 billion.

The Tadamun sukuk program of the Islamic Development Bank (ISDB; AAA/Stable/A-1+), launched in July 2008, was the first sukuk transaction by this multilateral lending institution, based in Saudi Arabia, issued through a special-purpose vehicle (SPV) with a transaction infrastructure entirely located in Malaysia. We have assigned an 'AAA' rating to the ISDB transaction (on a par with the 'AAA' rating of the offshore fundraiser), after analyzing the transaction structure and, in particular, the incentives for the bank to consider the performance of the sukuk certificates that Tadamun issues as equally important as its own obligations and the exposure to Malaysian sovereign risk. This is the first sukuk that we have rated higher than the rating on the sovereign of the country where the issuer is located.

Malaysia Continues To Be Asia's Islamic Finance Hub

Malaysia remains Asia's regional hub for Islamic finance. Its well-established Islamic banking system, strong regulatory framework, and government support have made the country a leading market for sukuk issuance. Sukuk issuance from Malaysia remained strong in the first half of 2008, with structures denominated in Malaysian ringgit (MYR) representing more than one-third of total issuance.

In 2006, the ruling government and regulatory bodies established the Malaysian International Islamic Finance Centre (MIFC), with the aim of promoting the country as a leader in this field. One of the MIFC's key objectives has been to liberalize the domestic Islamic finance industry by issuing new licenses to offshore Islamic banks and takaful companies, to globally integrate the country's domestic industry. The government also introduced incentives to attract issuers and investors alike, including various tax exemptions for Islamic banks, brokerages, takaful companies, and offshore sukuk investors; and the removal of ownership restrictions on Islamic funds. Malaysia continues to be among the global leaders in innovative sukuk structuring. The MYR2.7 billion exchangeable musharaka sukuk that the government's state investment arm issued was the world's first-ever sukuk with convertibility features. In 2007, the world's largest sukuk transaction to date (\$4.8 billion) was issued in Malaysia by Binariang GSM. Malaysia is also one of the world's leading markets for Islamic securitization. This involves structuring sukuk backed by payment streams from a wide variety of assets, from lease payments on plantation assets to trade contract payments or Islamic residential mortgages.

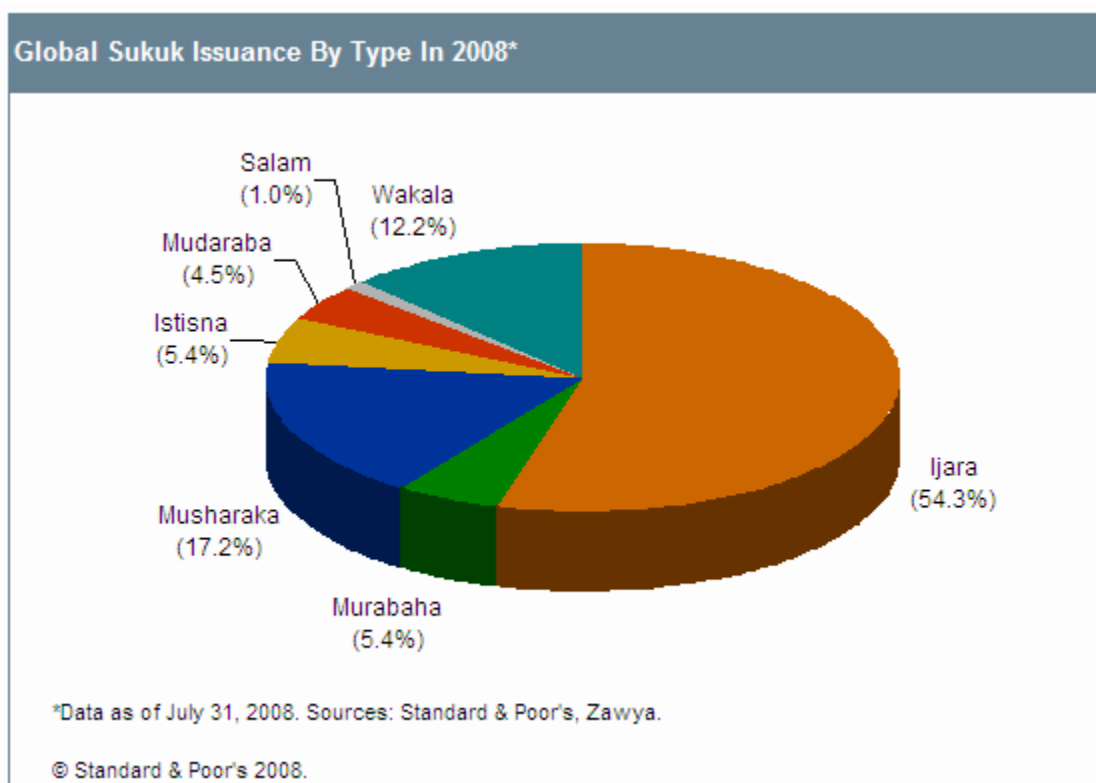
An increasing number of Asian corporates are looking to tap this market with the hope of lowering funding costs and obtaining much needed funding and liquidity in an otherwise difficult environment. They are doing this in conjunction with a plethora of international financial institutions, led by Malaysian banks, promoting the sukuk market to the rest of Asia. Asian sovereign governments are also starting to focus on this market. The debut Indonesian-rupiah-denominated (IDR) 4.7 trillion sukuk that the Indonesian government raised in late August might be the catalyst for other Asian sovereigns to follow suit, which could lead to the popularity of Islamic finance in the region. For instance, Pakistan recently announced that it will sell its first domestic sukuk before year-end with an auction target of Pakistan rupee (PKR) 15 billion to PKR20 billion.

The region's international financial centers--Singapore and Hong Kong--are also working to facilitate sukuk issuance. Potential issuers from the non-Islamic Asian markets of Singapore, Hong Kong, Taiwan, and Korea have been studying the market and have started discussions with arrangers. In August 2008, City Developments Ltd., Singapore's second-largest developer, mandated a bank to arrange a Singapore dollar S\$1.0 billion unsecured multicurrency Islamic medium-term note program. Cambridge Industrial Trust (CIT), a real estate investment trust (REIT) listed in Singapore, announced in July 2007 that it intends to become the first publicly listed Sharia-compliant industrial REIT and appointed HSBC to arrange a Sharia-compliant debt facility to refinance its existing borrowings.

Ijara Is Taking The Lead

Ijara structures have taken the lead in the first half of 2008, accounting for more than 50% of total sukuk issuance. This is probably a direct consequence of the recent debate regarding the Sharia compliance of some other structures. There are 14 ways to structure sukuk according to the AAOIFI. In the first half of 2008, issuers used seven structures: ijara, musharaka, wakala, murabaha, istisna, mudaraba, and salam (see chart 3).

Chart 3

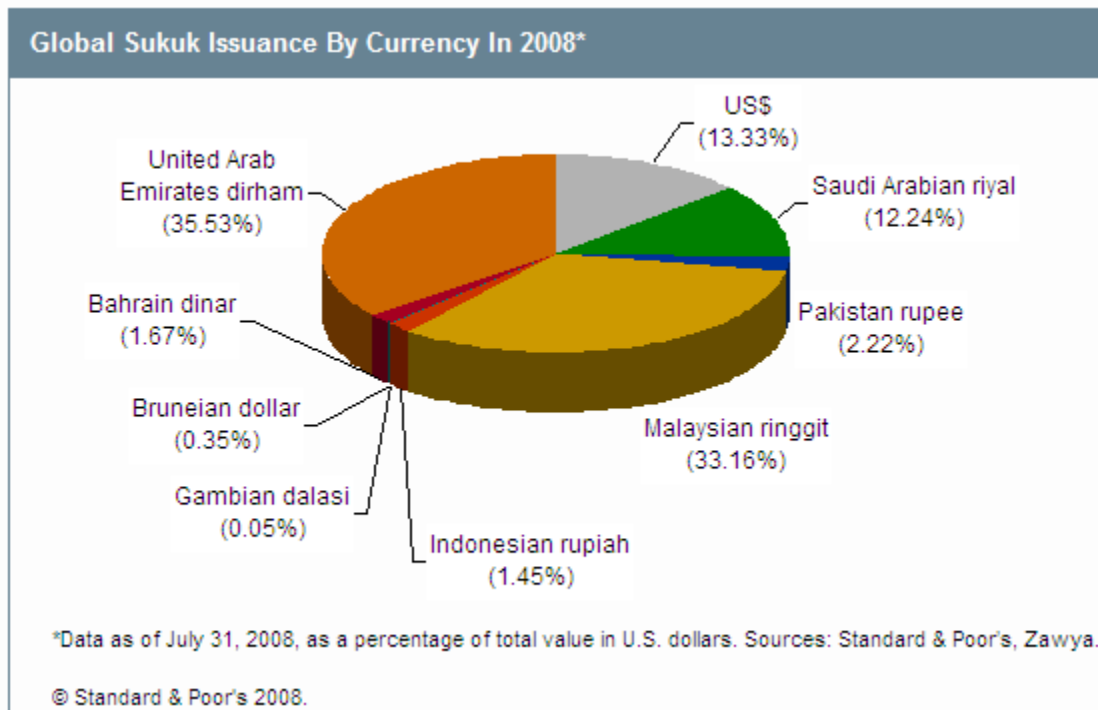


U.S. Dollar Lost Its Place As The Currency Of Choice For Sukuk Issuance

The U.S. dollar lost its place as the currency of choice for sukuk issuance in 2008. Less than 15% of the value of sukuk issued were denominated in U.S. dollars in the first half of 2008 (see chart 4). This is partly due to its

weakness compared with other major currencies but also the result of speculation about a change in the foreign exchange policy of some GCC countries. After the start of the global credit and liquidity crisis, sukuk issuers deserted global markets and concentrated on their domestic markets where liquidity was available and the appetite for Sharia-compliant instruments strong. Issuance denominated in Malaysian ringgit and UAE dirham represented almost 70% of sukuk issuance in the first half of 2008. Issuers are set to continue to use these currencies in the foreseeable future, especially if asset-backed sukuk takes off, with underlying assets generating cash flows in local currencies. However, once market conditions return to normal and uncertainties about GCC countries' foreign exchange policies are removed, we expect issuance in the dollar to resume--mainly because issuers are financing infrastructure projects in the Gulf where most costs are denominated in foreign currencies--usually the dollar.

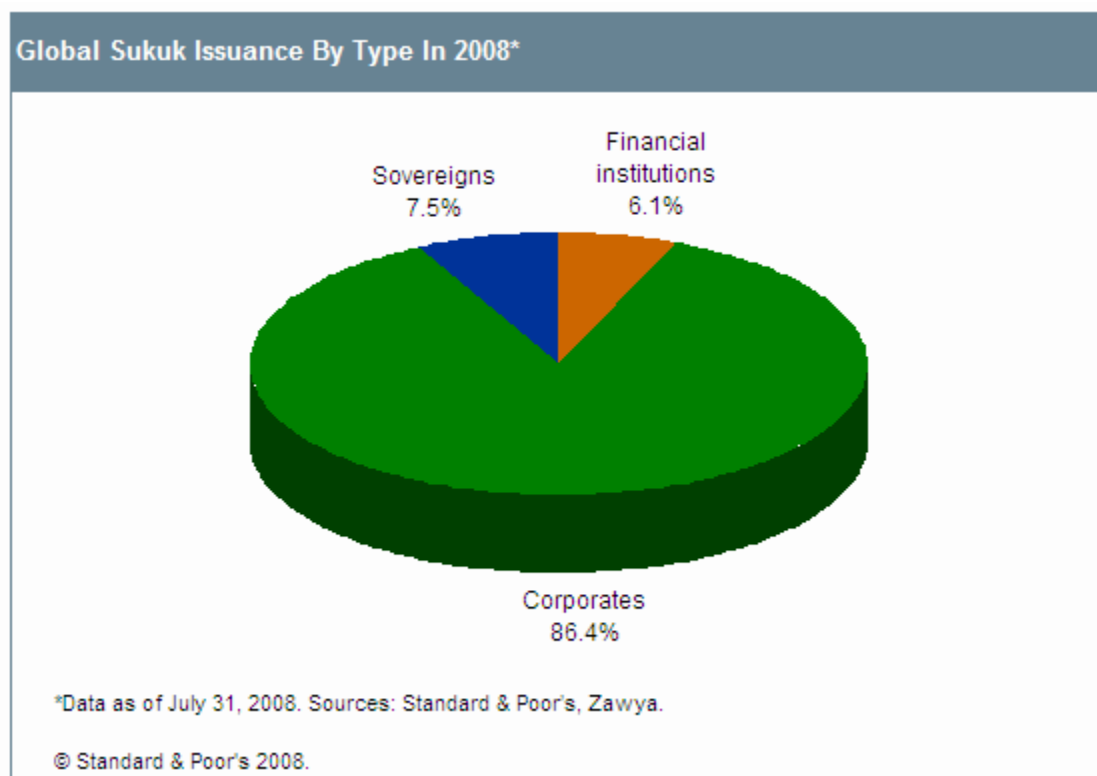
Chart 4



Corporates Continue To Power Growth Of The Market

Corporates continue to fuel sukuk growth (see chart 5). In the first half of 2008, corporates accounted for more than 85% of sukuk issuance. Standard & Poor's believes that corporates will continue to dominate, finding sukuk to be an alternative way to boost growth amid a very supportive economic environment and some restrictions on bank financing due to single-name lending limits. Financial institutions will also continue to play an important role, owing to their need to lengthen the maturity profile of their funding sources as the duration of their loans widens. Finally, as already stated, Standard & Poor's expects some sovereigns to issue their first sukuk in the near future. Some of these countries are looking at sukuk as a way to diversify their funding sources, attract deep-pocketed investors, and show their commitment to Islamic finance.

Chart 5



Standard & Poor's Role In The Market For Sukuk

Our role is to provide market participants with independent and objective opinions about the creditworthiness of issuers and issues--including those involving sukuk. We don't comment on the Sharia compliance of a particular issue or issuer. Our ratings don't constitute a recommendation to sell, buy, or hold a particular security--whether it is Sharia-compliant or not. Instead, our ratings help investors to make informed decisions and issuers to access debt markets and benchmark their creditworthiness against peers'.

Appendix 1

Sukuk That Standard & Poor's Rates

Originator	Date of rating	Issue amount (mil. \$)	Long-term foreign currency rating
Central Bank of Bahrain Sukuk	Various	665	A
DIB Sukuk Co. Ltd.	Feb. 15, 2007	750	A
DP World Sukuk Ltd. (Obligor: DP World)	June 27, 2007	1,500	A+
Dubai Sukuk Center Ltd. (Guarantor: DIFC Investment LLC)	May 25, 2007	1,250	A+
East Cameron Gas Co. Sukuk	July 31, 2006	166	CCC+
EIB Sukuk Company Ltd. Programme (Guarantor: Emirates Bank International)	May 15, 2007	1,000	A
GFH Sukuk Ltd. (Obligor: Gulf Finance House)	June 26, 2007	1,000	BBB-

Sukuk That Standard & Poor's Rates(cont.)				
Gold Sukuk dmcc (Guarantor: Dubai Multi Commodities Centre Authority)	April 11, 2005	200		A
Golden Belt 1 B.S.C.	April 18, 2007	650		BBB+
Islamic Development Bank	May 20, 2005	1,000		AAA
Ithmaar Sukuk Ltd. (Guarantor: Shamil Bank of Bahrain)	June 20, 2007	TBD		BBB-
JAFZ Sukuk Ltd	Nov. 8, 2007	AED7.5 billion		A+
Loehmann's Capital Corp. (Guarantor: Loehmann's Holdings Inc.)	Sept. 22, 2004	110		CCC+
Malaysia Global Sukuk Inc.	June 10, 2002	600		A-
MBB Sukuk Inc. (Obligor: Malayan Banking Bhd.)	April 11, 2007	300		BBB+
Pakistan International Sukuk Co.	Dec. 23, 2004	600		B
Qatar Global Sukuk QSC (Obligor: Qatar (State of))	Sept. 10, 2003	700		AA-
RAK Capital (Emirates of Ras Al Khaimah)	May 06, 2008	2,000		A
Sarawak Corporate Sukuk Inc.	Nov. 30, 2004	350		A-
Saudi Basic Industries Corp. (Sukuk I, II, III)	May 06, 2008	SAR16 billion		A+
Sharjah Islamic Bank Sukuk	Sept. 12, 2006	255		BBB
Solidarity Trust Services Ltd. (Guarantor: Islamic Development Bank)	Aug. 11, 2003	400		AAA
Stichting Sachsen-Anhalt Trust	July 9, 2004	130		AA-
Sun Finance Ltd. (Class A, B, C) (Sponsor: Sorouh Real Estate PJSC)	July 21, 2008	AED4.0 billion		Class A: A Class B: BBB+ Class C: BBB-
Sukuk Funding (No. 2) (Obligor: Aldar Properties PJSC)	May 22, 2008	AED3.75 billion		A-
Tabreed 06 Financing Corp.	June 15, 2006	200		BBB-
Tadamon Services Berhad (Obligor: Islamic Development Bank)	July 17, 2008	MYR1 billion		AAA

Data as of Sept. 9, 2008. TBD--To be determined. AED--United Arab Emirates dirham. SAR--Saudi Arabian riyal. MYR--Malaysian ringgit.

Appendix 2

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