

SABIC Sukuk: The Debut Sukuk in Saudi Arabia

In the past two years there has been a surge in the number of high-profile Sukuk instruments issued in the GCC and South-East Asia, yet none had originated from the Kingdom of Saudi Arabia until the issuance of the SABIC Sukuk. This is despite the Kingdom having the largest domestic capital market of all of the GCC countries (in terms of market capitalization of its stock exchange) and, moreover, that it has been a pioneer in the establishment and development of Islamic banking and finance. It is a major member country of the Organization of the Islamic Conference (OIC) and the Islamic Development Bank (IDB) – to which it is the host country – it is home to the world's largest Islamic bank (in terms of assets) and, through private initiatives, was behind the establishment in the 1970s of two of the major international Islamic banking conglomerates.

The SABIC Sukuk was issued on the 29th July 2006, and anticipation accompanying the issue was considerable, as it was the first time that Saudi nationals and residents were able to invest in a local currency, fixed income instrument that had been vetted by the Shariah Supervisory Committee of a Saudi Arabian Bank (SABB Amanah). As would naturally occur with a first-time issuance, SABIC and its lead manager HSBC had set the platform for Sukuk issuance in the Saudi Arabian market. This involved preparing the offering documents to high international standards and addressing a number of issues, some of which are described in this brief case study.

SHARIAH AND STRUCTURING

The challenge in structuring the Sukuk was to obtain approval from a Saudi Arabian Shariah committee on a Sukuk structure – something that no previous Sukuk issued had achieved. A further challenge was that SABIC is a holding investment company with few tangible assets, aside from its equity investments in its affiliates.

Most Sukuk are based upon the Ijarah (leasing) template, with the purchase and pre-arranged resale of an asset to the obligor at a pre-agreed price. These Sukuk, and variations of this structure (including some of the Mudarabah or Musharakah Sukuk recently issued), may not be approved if vetted by a Shariah committee of a Saudi Arabian bank as the general consensus amongst these committees is that a purchase combined with a resale at a fixed price is not permissible. One of the concerns of the committees with this arrangement is that the ownership (and hence the purchase) is not true ownership (and hence a true purchase), as the terms of ownership completely restrict the owner's ability to sell the asset (or the Mudarabah/Musharakah investment) in the open market at a market price – the purchaser/owner is compelled to sell to the obligor at a pre-determined price. Another concern of Saudi banks' Shariah committees of the purchase and resale-

based structures is that the resale is at a pre-determined price and not at the prevailing market price. Please note that this is only our understanding of the concerns of these committees.

“The marketing services income represents a good proxy for SABIC corporate risk”

The unique structure that was tailor-made for SABIC is a Sukuk Istithmaar (Investment Sukuk). This Sukuk structure is not based upon the structure of any previous Sukuk, although an investment Sukuk is one of the main categories of Sukuk types included in the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Shariah Standards.

The Sukuk assets represent an investment, for 20 years, in limited rights and obligations of SABIC in certain marketing contracts that underpin the marketing services that SABIC provides to its manufacturing affiliates. SABIC itself is a holding company which has an equity stake in many affiliate companies that produce petrochemicals, steel and fertilizers (and other intermediate goods). In addition to being a holding company, managing and coordinating its investments, SABIC itself has a research and technology unit (holding over 200 registered patents) and a marketing business unit. Its marketing unit undertakes the service of marketing and selling the products of certain of its affiliates to companies located in Saudi Arabia and across the globe to over 100 countries. This marketing unit incurs certain costs (the costs of marketing and selling products to thousands of global customers) and receives fees in return for conducting these services. The scope of its marketing and selling activities are documented in marketing agreements signed between SABIC and its affiliates.

The marketing unit has an established history of providing exemplary service and earning significant net revenues for SABIC, as marketing fees earned are based upon sales levels achieved. As the SABIC group's own net income is based upon sales of the group, the marketing services income represents a good proxy for SABIC corporate risk.

The structure of the Sukuk entitles Sukuk holders, for 20 years, with a right in the defined net income from these marketing services subject to certain terms and conditions outlined in the Sukuk offering circular. The net income derived from this investment is paid quarterly to Sukuk holders, up to a specific amount (based on a benchmark linked to SIBOR) and surplus income is kept as a reserve. The reserve is used as a buffer protection to safeguard Sukuk holders in the

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SABIC Sukuk (continued...)

unlikely event that net income for any period unexpectedly falls below the specific amount.

In addition to acting as a buffer, money accruing to the reserve is used to pay, every 5 years throughout the 20-year life of the Sukuk, an extra amount equal to 10% of the face value of the Sukuk. Thus, by the end, an amount of 40% of the face value (as well as the quarterly return) would have been paid to Sukuk holders. Also, at the end of the Sukuk's life – whether 20-years or earlier if the Sukuk is purchased by SABIC before then – any remaining balance in the reserve is paid to SABIC as an incentive. The rationale for paying this is to provide SABIC with a strong incentive to continue providing the marketing services to a high and profitable standard.

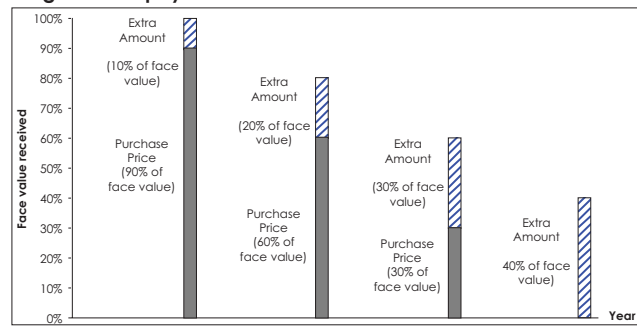
In addition to the 10% extra amount paid to Sukuk holders every five years, SABIC provides Sukuk holders with a purchase undertaking under which it undertakes (as direct SABIC credit risk), to purchase the Sukuk for a specific amount on each date. The purchase undertaking is both irrevocable and individual so that Sukuk holders may individually exercise their option (not needing a minimum level) requiring SABIC to purchase the Sukuk from them. The purchase price decreases over time, representing the remaining life of the Sukuk (as it is a 20-year financial instrument). The price decreases from 90% of the face value at the end of year 5 to 60% in year 10 and 30% in 15; at the end of year 20 the Sukuk has no value as its life has expired.

Therefore, if the Sukuk holders exercise their option for SABIC to purchase the Sukuk at the end of year 5, they will receive

an aggregate of 100% of the face value; 90% as a purchase price and a 10% extra amount. If Sukuk holders choose not to sell to SABIC at the end of the first five years (SABIC has no option to refuse, it is the right of Sukuk holders), the aggregate amount receivable declines to 80% in year 10, 60% in year 15 and just 40% in year 20.

Therefore, we expect that Sukuk holders would naturally elect to sell to SABIC at the end of year 5, thereby achieving a 100% return of the face value and earning a quarterly return reflective of SABIC risk during these 5 years. Although, importantly, SABIC does not have a call option to prepay the Sukuk and investors are not compelled to exercise their put option.

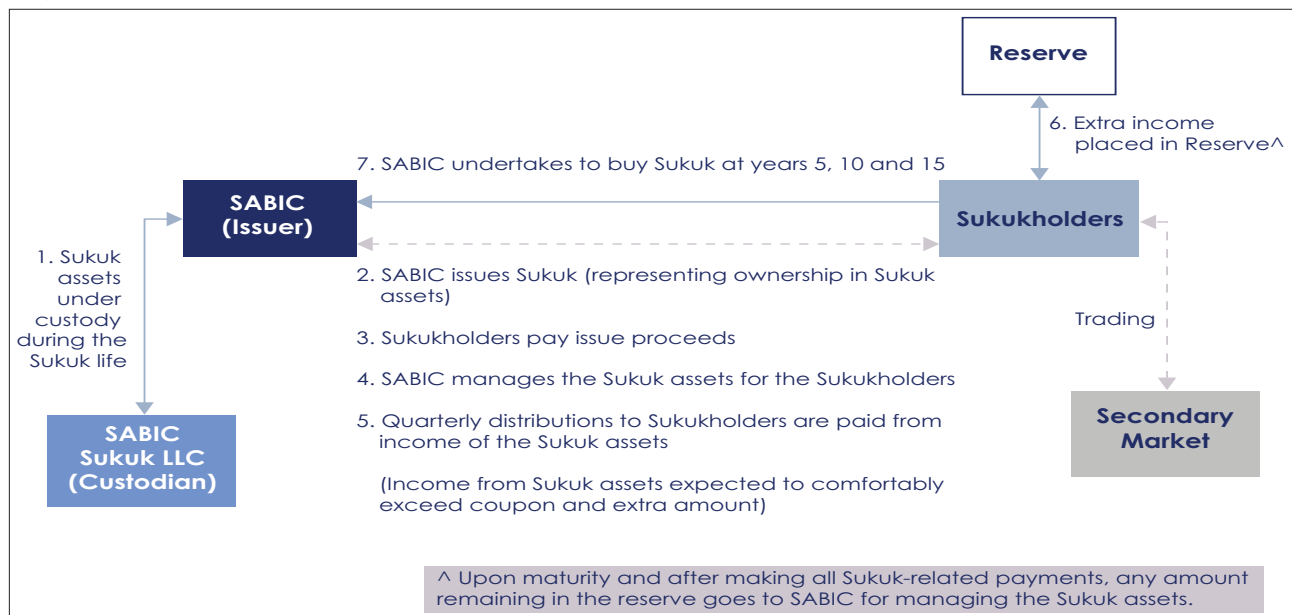
Diagram 2: Repayment Profile



DISTRIBUTION AND TRADING OF THE SUKUK

As one of the key objectives of the Sukuk was to develop the local capital markets, distribution of the Sukuk was limited to Saudi nationals or permanent residents of Saudi

Diagram 1: Transaction Structure

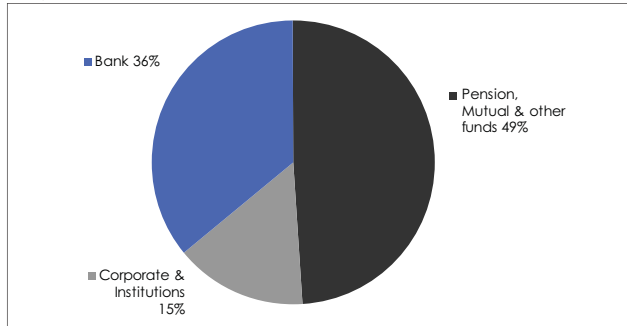


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SABIC Sukuk (continued...)

Arabia. Also, the offering documents were prepared according to international standards of disclosure. This restriction was possible as there was estimated to be a sufficient level of demand and liquidity in the local market. The Sukuk was the first capital market instrument in the Kingdom to be approved by the Capital Market Authority (CMA), which in turn was offered to the public on a book-building basis. This was an important achievement as SABIC aimed to attract new relationships outside of its extensive banking relationships – entities targeted included pension funds, insurance companies and mutual funds, corporates and institutions. Demand for the Sukuk was strong, with confirmed orders of over SR4.3 billion (US\$1.15 billion) raised in a relatively short period of time at a competitive price.

Diagram 3: Investor Type



As there was no precedent in the market, the trading mechanism for the Sukuk had to be formulated from scratch with the domestic stock market (Tadawul) and the mechanism was tested with other market-making banks before the launch to guarantee smooth trading in the secondary market. The system used was Tadawul's existing Equator platform where trades are matched electronically. Since the launch, trading in the secondary market has been active and has been increasing in volume.

CONCLUSION

The SABIC Sukuk is an important step in the development of the Sukuk as a viable Shariah compliant financial instrument. It has a firm basis in Islamic Shariah, being modelled on an investment in an existing business activity, yet achieves a credit risk profile familiar to sophisticated capital markets investors.

It is hoped that this Sukuk structure and this issuance will herald the further development of the Kingdom's capital markets, efficiently bringing together the vast capital resources that have blessed the Kingdom with efficient and profitable users of capital such as SABIC.

HSBC
Amanah

The authors Hissam Kamal and Sheikha Al Sudairy are from HSBC Amanah. The views expressed in this article are those of the authors and not of HSBC.

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TERMSHEET

Saudi Basic Industries Corporation

INSTRUMENT	Sukuk Istithmaar (Investment Sukuk)
ISSUER	Saudi Basic Industries Corporation (SABIC)
PRINCIPAL ACTIVITIES	Manufacturing of chemicals, fertilizers, plastics and metals.
BOARD OF DIRECTORS	Seven members – five of whom are representatives of the Government of Saudi Arabia: chairman - His Highness Prince Saud bin Thunayan Al-Saud; vice-chairman and chief executive officer - Mohamed H Al-Mady; deputy minister of planning - Ahmad I Al-Hakami; deputy minister for industrial affairs - Saleh E Al-Husseini; ministry of finance representative - Abdulmuhsin Ibn Abdulaziz Al-Faris; private sector representative - Mohammed S Abanumay; private sector representative - Abdullah M Al-Issa.
ISSUE SIZE	SR3 billion (US\$800 million)
DATE OF LISTING/ISSUE	29 th July 2006
MATURITY	First put option 15 th July 2011 (final expiry date, if not previously expired: 15 th July 2026).
COUPON	3-month SAR SIBOR + 40 bps.
PAYMENT SCHEDULE	Quarterly payments
AUTHORIZED PAID UP CAP	SR25 billion (US\$6.67 billion)
IDENTIFIED ASSETS	20-right limited rights and obligations in contracts underlying SABIC's marketing business.
LEAD ARRANGER AND SOLE BOOKRUNNER	HSBC Saudi Arabia
CO-MANAGERS	Banque Saudi Fransi, Gulf International Bank, National Commercial Bank, Saudi British Bank, SAMBA, Saudi Hollandi Bank.
LEGAL COUNSEL TO ISSUER	Baker & McKenzie Local counsel: Torki Al-Shubaiki in association with Baker & McKenzie
LEGAL COUNSEL TO LEAD ARRANGER	Clifford Chance Local counsel: Al-Jadaan Law Firm
UNDERWRITERS	HSBC Saudi Arabia, Banque Saudi Fransi, Gulf International Bank, National Commercial Bank, Saudi British Bank, SAMBA and Saudi Hollandi Bank
TRUSTEE	SABIC Sukuk
SHARIAH CO-ORDINATOR	SABB Amanah
FORM OF ISSUE	Dematerialized registered form
PURPOSE OF ISSUE	To finance part of SABIC's capex program and general corporate purposes.
RATINGS	Not rated (issuer rated A+)