GCC Debt Capital Markets: issuance volumes surge as markets deepen

At the beginning of this year, there were concerns that 2014 would prove disappointing for Arab debt markets but, by mid-year, as issuers were closing their last deals before Ramadan, it was clear that such concerns had been misplaced.

Michael Grifferty, the President of the Gulf Bond and Sukuk Association describes the recent – and exciting – developments in regional debt capital markets and looks ahead to the challenges for the future.

Global market conditions in 2013 and the first part of 2014 provided Middle East corporates and Government-related entities with exceptional opportunities to fund or refinance themselves. Demand for sukuk from the Middle East has grown as part of a Middle East bond market for sovereign, sovereign-related and, increasingly, corporate issues, that is now well established.

Middle Eastern debt issuance surged in the first half to $22 billion, of which a remarkable $18 billion was transacted in the second quarter alone. If this trend continues, the volume of debt raised in 2014 could easily eclipse previous records.

The attraction of GCC bonds and sukuk is underpinned by extremely strong sovereign balance sheets and a demonstrated willingness by governments to support key issuers. At a macro-level, regional economies have shown consistent growth through several global economic cycles, are becoming stronger as a result of diversification, and are building strong trade and financial linkages with Asia.

Debt Capital Markets in the Gulf have changed greatly over the last few years and are unrecognisable when compared to those of a decade ago. Issuers are more knowledgeable and confident and they are willing and able to take advantage of new structures and market opportunities. Late 2013 and early 2014 saw opportunistic issuance in Australian Dollars, Malaysian Ringgit and Japanese Yen. Many of the sophisticated issuers – most notably financial institutions – have raised debt several times before and there has been a steady stream of new entrants.

Market depth is increasing with the emergence of new instruments, such as sukuk with longer-term or perpetual tenors, amortising sukuk, and sukuk with equity-like features.

Gulf banks such as National Bank of Abu Dhabi, Qatar National Bank, Emirates-NBD and First Gulf Bank are playing leading roles in arranging bond deals not only in the Gulf but also further afield, and are now starting to compete with the large international banks.

Sukuk issuance goes from strength to strength

For sukuk, the breakthrough occurred in 2012, when issuance of Shari'a-compliant instruments first surpassed issuance of conventional bonds. All expectations are that sukuk issuance will continue to grow as Middle East capital markets mature and the volume of global Islamic assets increases.

Demand for sukuk is underpinned by a steady increase in Islamic banks' deposits – and the resulting need for those banks to place excess liquidity – as well as new pockets of investor demand, including demand from conventional bond buyers.

The sukuk market has a good track record, with familiar and high-quality counterparties behind transactions. There is innovation in the way deals are structured and this is proving good both for issuers and for global investors who are becoming increasingly familiar and comfortable with the distinct features of sukuk. With a broader investor base, issuers have been able to extend tenors from five years – which until recently was the industry standard – to ten years or even more.

The success of sukuk issues has led to a narrowing of spreads with some sukuk being priced more aggressively than comparably rated conventional bonds. Growing consensus around issuing standards and a reduction in the time needed to bring issues to market is also contributing to greater investor demand.

Islamic banks have been among the most prolific issuers of sukuk in recent years. Financial issuers accounted for 54% of debt capital market activity in Q1 2014, much of it in sukuk format. Issues have included innovative structures such as hybrid Tier 1 perpetuals issued by Abu Dhabi Islamic Bank in late 2012 and by Al Hilal Bank in June 2014.

There are also signs that corporates that have not issued before will use sukuk when they come to market, particularly in Saudi Arabia where there is a wide range of companies with strong cash generation.

The Gulf is supplying the lion's share of sukuk issuance, but issuers in oil importing countries are also making a positive contribution. Jordan, Tunisia, Morocco and Egypt have either adopted or are in the process of adopting legislation to facilitate Islamic finance and several have given notice of plans to issue sukuk within the next 12 months. With sovereign issuers paving the way, corporates and project finance deals can easily follow.

Regulation and issuing standards are being upgraded

The GBSA has been helping regulators in several GCC countries to improve regulation of conventional bonds and sukuk, and to move closer to international standards. The UAE's Securities and Commodities Authority recently adopted new regulations, Saudi Arabia's Capital Market Authority is expected to release a new sukuk strategy soon, Oman has released new sukuk regulations and is thinking of revising regulations on conventional bonds, and Kuwait's Capital Market Authority is believed to be close to issuing enhanced regulations for its fixed income market.

The Central Bank of Qatar has been issuing both conventional and Islamic instruments to its banks in increasing amounts and longer tenors.

Local and regional exchanges believe that they can add transparency and liquidity to fixed income markets in the region. GBSA member NASDAQ-Dubai is launching a sukuk trading platform that links to Euroclear, and bourses such as Saudi Tadawul, the Dubai Financial Market and the Abu Dhabi and Qatar exchanges list sukuk and are looking to improve trade execution.

Supporting infrastructural development and reconstruction

Bonds and sukuk have huge potential to support the social and physical infrastructure needs across the Middle East. The MENA region needs to invest about $100 billion annually on core infrastructure. Countries in transition or that are emerging from conflict will require massive infrastructure development or reconstruction, at the same time as they finance budget deficits. Both oil importers and exporters need to finance energy projects, including those involving renewables. Creating an asset class of 'Green Sukuk' – comparable to conventional climate-certified bonds – is already being considered as a way to channel ethical investment in the region.

It is already clear that European banks – who have historically been key funders of infrastructure projects – will not be able to meet all of the region's needs. Regional banks, although growing, face a more restrictive credit environment under the Basel III standards. The result will be increasingly difficult and costly access

The Gulf Bond and Sukuk Association

The Gulf Bond and Sukuk Association (GBSA) is the independent industry organisation that represents the fixed income business in the Gulf region. It is committed to growing and deepening the market in support of national development strategies. Effectively, it is a private organization with a public purpose. The Association consists of 57 market-leading and highly committed firms that are active as issuers, traders, investors, arrangers, ratings agencies and service providers. GBSA members are involved in virtually every notable transaction from the region.

The GBSA speaks for the industry, advocates its positions and strengthens the region's voice in the global arena. As a focal point for the bond and sukuk community, the Association helps to develop bond-related legislation and regulation, provides input to regulators and central banks, advises governments as issuers, sets market practices and conventions and raises awareness among the public about investing. It acts through its national chapters in the Gulf states and through standing committees (Regulatory Affairs, Government Issuance, Investor Relations, Investment Management) and working groups on Islamic Finance, Project Finance and Basel III. The GBSA enhances its effect by working closely with Arab Monetary Fund, Islamic Development Bank, IMF and EBRD by contributing to reforms not only in the GCC but in the larger Middle East region.

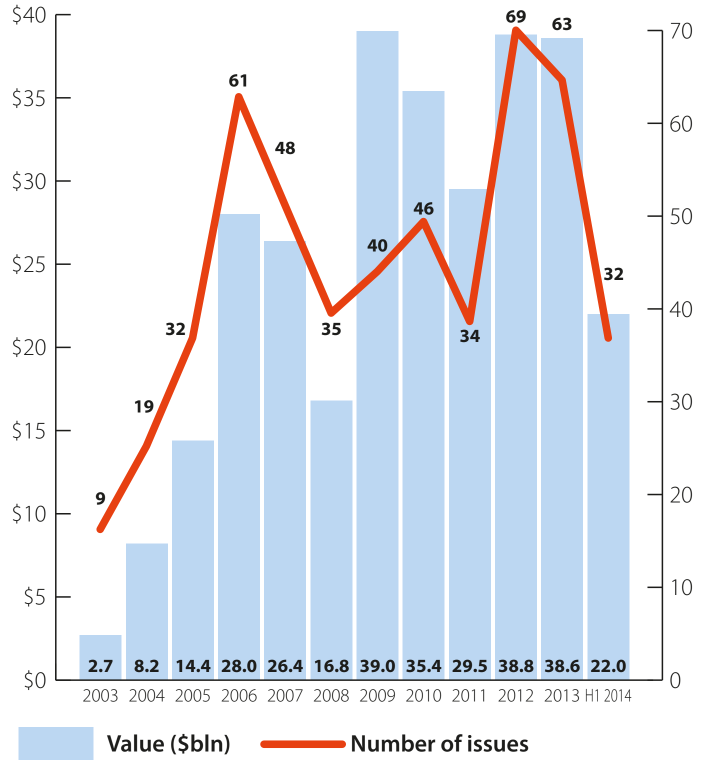
Direction is provided by a regional Steering Committee of 15 senior professionals, this year presided over by Stuart Anderson, MD and Regional Head of Standard & Poor's. The National Chapters and Committees are chaired by leaders in their respective fields. The GBSA team consists of an executive as well as legal, research and communications professionals.

GBSA provides its members with a window on relevant events, regulations and trends within the members' countries and in other countries as well as high-value networking and speaking opportunities that are reserved for members. Members have access to the GBSA professional staff for advice and referrals, and the GBSA takes a pro-active role in identifying and facilitating opportunities for its members.

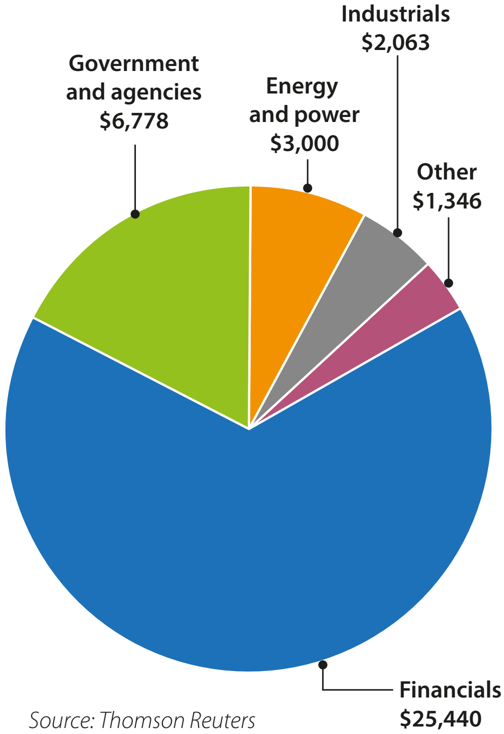
The GBSA has become an effective platform for the industry, giving direction to policy in the individual GCC states, across the GCC and beyond. The GBSA's advice and input is respected by and sought out by regulators, central banks and governments. The Association has affected the direction of securities legislation, companies' laws, investment management regulation and government issuance policies. Though the GBSA's focus remains on the Gulf, it has extended its involvement further afield, notably to Egypt and Turkey.

The GBSA holds specialised round-tables where members can discuss technical issues related to fixed-income issuance and investment.

Middle Eastern Debt Capital Markets: Annual



Middle Eastern Debt Capital Markets: Most Active Sectors (US$ mil)



Source: Thomson Reuters

to European credit and a reduction in bank credit from the Gulf itself.

For the first time in years, a true project bond was issued in 2013, when the Ruwais power project came to market.

An expert panel at a joint event the GBSA held with the European Bank for Reconstruction and Development at the Bank's headquarters in London, November 2013

Improving corporate governance

Gulf corporates have long been criticised for their lack of transparency and corporate governance shortcomings. Family companies continue to avoid capital markets and seek other means of financing so as to avoid the disclosure requirements of public issues.

But bond markets do have a role to play. A few years ago, issuers paid little attention to their investors after a deal had closed, but there is now a better appreciation of the importance of performing well in the secondary market. Some issuers have aligned their investor relations standards with guidelines issued by the GBSA.

More liquidity and price transparency is needed

Issuance in the primary market – both conventional and Islamic – is now big enough to justify expectations that a strong secondary market should develop. Nevertheless, both liquidity and price transparency need to be strengthened and there is a need for better indices to serve the investor community. Addressing these issues would be an important factor in drawing global investors to the regional market. It is something that the GBSA is working on with its partners.

We at the GBSA expect that the introduction of new products will continue to shape the market in late 2014 and beyond. The trend towards a greater variety of issuers should continue as smaller companies become more familiar with the market and the requirements for accessing it.

The single most important action needed to underpin the growth of debt capital markets is the development of yield curves in local currency government debt. More fundamentally, there is a need for a regional vision for the region's debt capital markets backed by organised official commitment starting with the organs of the Gulf Cooperation Council itself and involving national governments, central banks, capital market regulators, as well as the fixed income industry. ■