

Emad A. Zikry, President and Chief Executive Officer

An Overview of Sukuk and its Application In Global Fixed Income Markets

Sukuk, commonly known as Islamic bonds, are a recent entry to the world of finance. (Sukuk were used extensively in the Middle Ages, but not in the form by which they are now known in modern finance) The first issuance occurred in 1990, when a subsidiary of Shell in Malaysia raised \$30mm. Sukuk are one segment of the fast growing Islamic financial sector that started to take root in the late 1970s. Assets in Islamic finance stood at approximately \$1.8 trillion at the end of 2013. Given the vast potential for this segment of global finance, investors may be rewarded for keeping an eye on the development of the Sukuk market as opportunities materialize. GE Capital issued the first Islamic bond by a western industrial company in 2009, highlighting the growing acceptance of Sukuk as an emerging, but potentially important arena for global corporations. In this paper, we will review the most relevant principles of Shari'ah that govern the issuance of Sukuk, note the particular structures used to address these principles, and provide an overview of the current market and its growing significance for investors.

Principles of Islamic Finance

Although Islamic Finance in general and Sukuk in particular are a somewhat recent phenomenon, the principles underlying them have been in existence for over 1,500 years. The most relevant principles to Sukuk within Shari'ah involve the forbiddance of interest, the necessity of identifiable assets being traded, and the prohibition of uncertainty as pertains to contractual terms (not markets).

Prohibition of "Riba" or Interest:

- Shari'ah considers money to be a measuring tool for value and not an "asset" itself, therefore it requires that one should not be able to receive income from money alone
- The generation of money from money is forbidden

Requirement that finance used only for specific or identifiable assets:

- Trading in indebtedness is prohibited as is the issuance of conventional bonds, which represent interest based funding for non specific general corporate purposes
- All returns and cash flows must be directly linked to assets purchased
- Requirement of "tangibility" of assets excludes derivative products

Prohibition of “Gharar” or Uncertainty:

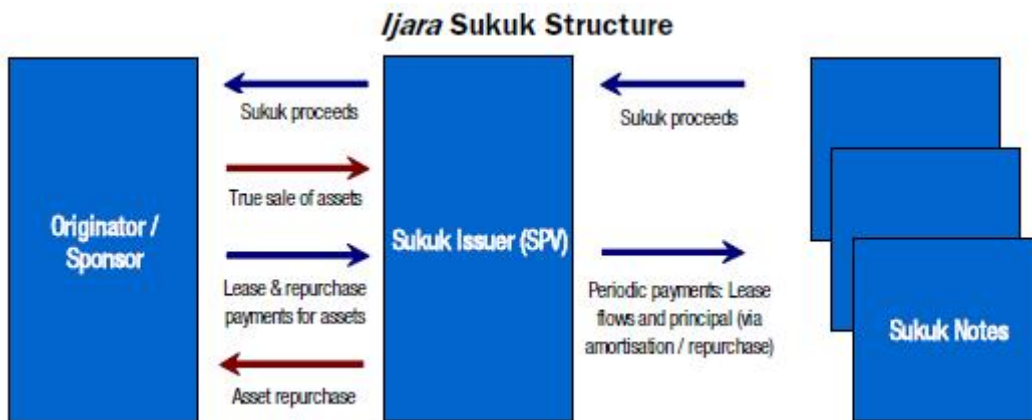
- Uncertainty in contractual terms or uncertainty in the existence of an underlying asset is not allowed.
- Application of the latter creates an issue when considering the use of derivatives, which play a large role in the liquidity of global bond markets. (Derivatives may also be seen as a tool for gambling (*Maysir*), which violates the principle that profits must be earned.)

A number of structures have been created in order to address these principles and make Sukuk suitable for investors. Below we will highlight the two most popular.

Sukuk Structures

Ijara Sukuk (Sale and Leaseback)

- Borrower/Originator sells assets to the Sukuk Special Purpose Vehicle (SPV)
- Investor/Lender purchases shares in the Sukuk SPV and leases assets back to originator.
- The borrower makes regular lease payments to investor, and agrees to buy back assets from investors at a specified time.

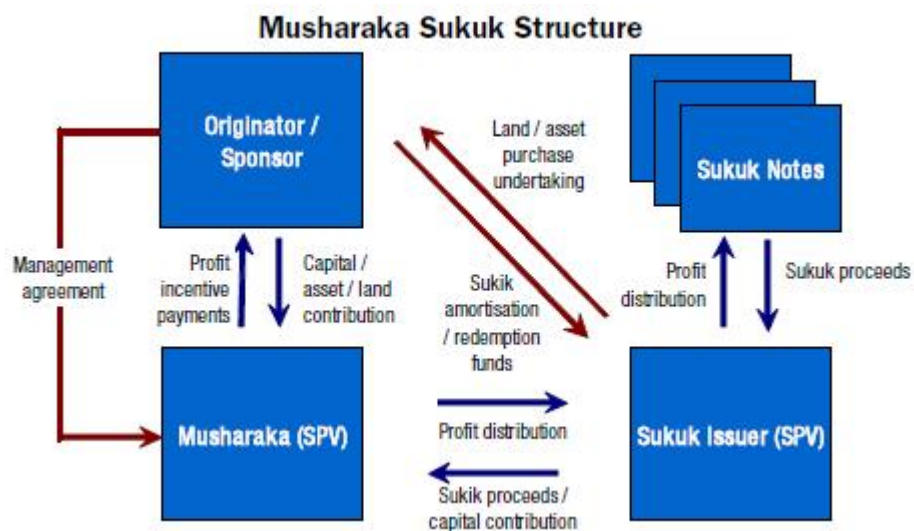


Source: Shari’ah and Sukuk: A Moody’s Primer

Ijara Sukuk are generally used to represent ownership in well defined existing and known assets tied up to a lease contract. This structure provides identifiable assets, certainty in contractual terms, and substitutes lease payments for interest. Thus it meets Shari’ah compliance. The structure in itself is fairly basic, but Sukuk based on this model can take many different forms. Payments can be bullet or amortizing and fixed or variable. Assets can be anything tangible (land, airplanes, cars, buildings, etc), but depending on whether it is a true sale or a purchase undertaking, the risks taken will reflect either the assets or the originator respectively. The number of variations require careful analysis on an issue by issue basis.

Mushkara Sukuk (Joint Venture)

- Originator/Borrower contributes specific assets and management skills to the Musharaka Sukuk SPV
- Investor/Lender contributes capital to the Sukuk Issuer SPV
- The Sukuk Issuer SPV contributes capital (from the investor/lender) to the Musharaka Sukuk for the originator to invest in accordance with a predefined business plan.
- A profit rate is usually specified based on a share of the income/profit generated.



'Source: Shari'ah and Sukuk: A Moody's Primer

The Musharaka Sukuk are used mostly to establish a new project or develop an existing one. Similar to the Ijara Sukuk, the Musharaka Sukuk addresses Shari'ah compliance, and can accommodate many variations with just a basic structure in place.

In both Ijara and Musharaka Sukuk, the most common form of repayment of principal is in the form of a “purchase undertaking”. This is an agreement by the originator to buy back the assets contributed at a specified time. Thus the critical analysis needs to be done on this agreement and the credit worthiness of the originator/borrower as opposed to the underlying assets.

Current Market

A number of supranational organizations have been making efforts to standardize and regulate Sukuk, such as the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB). They bring

transparency to the accounting standards for these financial instruments and ensure that proper disclosure of financial risks is captured for the investing public. The Islamic Development Bank (IDB), a prominent issuer of Sukuk established in 1975, helps to promote standards and procedures in the Islamic financials sector as well as a sponsoring member of the AAOFI.

As transparency has improved and progress made toward a consensus on Shari'ah compliant structures, the market in Sukuk continues to take large strides toward global market acceptance.

The growth of this market prompted Citigroup and Dow Jones to launch an index based on the dollar-denominated Sukuk in April 2006. Bahrain plans to launch a bourse dedicated to Shari'ah compliant securities. The Bahrain Financial Exchange is scheduled to open in October 2010 and will start trading Islamic debt next year. The creation of this market will provide liquidity for Sukuk in the secondary market. And as mentioned earlier, this market is not strictly the domain of Asian and Middle Eastern issuers such as the Government of Qatar, Emirates Airline, or Petronas. In addition to the actual issuance by GE and the German Federal State of Saxony-Anhalt, both France and the UK have discussed entering the market at various times.

Practical Applications

Below are the Bloomberg description pages for two GE Capital securities. We chose these examples due to the fact they were issued in close proximity of one another, and that the one on the left is issued as Sukuk, and the one on the right, is a more conventional global bond.

DES		Corp DES	
SECURITY DESCRIPTION		SECURITY DESCRIPTION	
GE CAPITAL GE 3 3/4 11/26/14 NOT PRICED Page 1/1		GEN ELEC CAP CRP GE 3 3/4 11/14/14 101.7320/101.9380 (3.32/3.27) MSG1 Page 1/1	
ISSUER INFORMATION	IDENTIFIERS	ISSUER INFORMATION	IDENTIFIERS
Name GE CAPITAL SUKUK LTD	Common 046963385	Name GENERAL ELEC CAP CORP	Common 046718224
Type Special Purpose Entity	ISIN XS0469633852	Type Diversified Finan Serv	ISIN US36962G4G62
Market of Issue Euro-Dollar	BB Number E10152518	Market of Issue Global	CUSIP 36962G4G6
SECURITY INFORMATION	RATINGS	SECURITY INFORMATION	RATINGS
Country BM	Currency USD	Country US	Currency USD
Collateral Type Company Guarnt	S&P Aa2	Collateral Type Sr Unsecured	S&P Aa2
Calc Typ()STREET CONVENTION	Fitch AA+	Calc Typ()STREET CONVENTION	S&P AA+
Maturity 11/26/2014 Series	Composite AA	Maturity 11/14/2014 Series A	Composite AA
NORMAL	ISSUE SIZE	NORMAL	ISSUE SIZE
Return 3 3/4 Fixed	Amt Issued/Outstanding	Coupon 3 3/4 Fixed	Amt Issued/Outstanding
S/A ISMA-30/360	USD 500,000.00 (M)	S/A ISMA-30/360	USD 1,500,000.00 (M)
Announcement Dt 10/15/09	USD 500,000.00 (M)	Announcement Dt 11/10/09	USD 1,500,000.00 (M)
Int. Accrual Dt 11/27/09	Min Piece/Increment	Int. Accrual Dt 11/16/09	Min Piece/Increment
1st Settle Date 11/27/09	100,000.00/ 1,000.00	1st Settle Date 11/16/09	1,000.00/ 1,000.00
1st Return Date 5/26/10	Par Amount 1,000.00	1st Coupon Date 5/14/10	Par Amount 1,000.00
Iss Pr 99.645	BOOK RUNNER/EXCHANGE	Iss Pr 99.60400	BOOK RUNNER/EXCHANGE
SPR @ ISS 175.00 vs T 2 3/8 10/14	JOINT LEADS	SPR @ ISS 155.00 vs T 2 3/8 10/14	JOINT LEADS
NO PROSPECTUS	Multiple	HAVE PROSPECTUS DIC	Multiple
SUKUK AL IJARAH	66) Send as Attachment	ISSUED FROM GHTN PROG SERIES A.	66) Send as Attachment
<small>Australia 61 2 9777 0600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000 Japan 81 3 3301 6900 Singapore 65 6212 1000 U.S. 1 212 310 2000</small>		<small>Australia 61 2 9777 0600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000 Japan 81 3 3301 6900 Singapore 65 6212 1000 U.S. 1 212 310 2000</small>	

GE Capital issued \$500mm International Sukuk in November 2009, which marked a turning point for Islamic securities. It shows a major corporation's willingness to issue specific bond structures to cater to international investor appetite, specifically the Islamic

funds of the Middle East and certain parts of Asia. The deal priced on issuance at 175 basis points over similar maturity treasuries at a price of 99.64, yielding 3.95%.

As a comparison, GE Capital also issued a \$1,500mm senior unsecured credit global bond at approximately the same time. This bond has a similar maturity, but a spread of 155 basis points over similar maturity treasuries at a dollar price of 99.61, yielding 3.84%. The premium for the Sukuk bond issued 9 days later than the senior unsecured GE credit was 20 bps. Both bonds were priced using the same 5 year Treasury benchmark. Aris Kekedjian, President and CEO, GE Capital Middle East & Asia Ltd explained the rationale for paying the additional 20bp for entry into this market as thus:

"We continually strive to diversify our funding base. The Sukuk platform helps complement and solidify GE's growing presence in the region and allows us to attract incremental liquidity from Islamic investors. We are proud to announce our secondary listing on the NASDAQ Dubai and look to continue supporting the region in our ongoing efforts."

However, what GE was willing to pay in additional coupon (or, lease payments, as these were based on aircraft leasing obligations) for entry into this market, could represent an opportunity for investors. Both of the above securities involve taking GE risk with a maturity of 5 years, but the Sukuk pays the investor an 1/8 more in coupon. There are two primary reasons investors are being paid more to own the Sukuk. One, although the Sukuk market is growing, it is still small compared to the rest of the global bond market. And two, the relatively untested legal status of its somewhat esoteric nature. The fact that GE Capital paid relatively little to issue in this market suggests that there are investors already comfortable with these risks as they pursue avenues to diversify their portfolios. With growing issuance and a number of institutions governing the market, some of the opacities surrounding these exotic structures will decrease. Examining the risk and rewards of these securitizations could give Western investors an advantage in diversifying their pool of income generating assets and increase their allocation to more stable cash flows.

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Emad is the Managing Partner and Chief Executive Officer of Vanderbilt Avenue Asset Management LLC. Vanderbilt's client base includes Multi-national Corporations, Public Funds, Foundations/Endowments, and Taft Hartley accounts.

Previously, Emad was Chairman of Institutional Business at Pioneer Investments. Pioneer investments has more than \$300 Billion in assets under management. The parent of Pioneer, UniCredit S.p.A., is the largest bank in Italy and the second largest bank in Europe. Pioneer had purchased Vanderbilt Capital Advisors, of which Emad was the founder and Chief Executive Officer.

Emad has had numerous articles published in professional and academic journals such as The Journal of Forecasting, The American Economist and The Journal of Fixed Income. He is a Board member of The National Investment Company. Emad was a member of the Board of Advisors of the Pacific Institute, The Advisory Committee of Fulcrum Global Partners, The Chief Executive Officers Club and formerly a board member of The Foreign Policy Association. He also served on the Board of Directors of the University of Albany Foundation, NextGen Healthcare Inc., The Park Avenue Bank, AA Bank and The New Providence Fund and Associates LP.

Emad is an FINRA Arbitrator. He is also a member of the National Association for Business Economists and The Economic Club of New York. Emad served as an adjunct professor at the University of Kansas and St. John's University.

Emad holds a Bachelor of Science from the University of Albany, and a M.A. and Ph.D. in Economics from the University of Kansas.