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Credit FAQ:

What Are The Prospects For Green Sukuk Issuance?

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Green sukuk has been attracting growing interest from Islamic and conventional investors, ever since Tadau Energy issued the first in Malaysia in July 2017. That green sukuk was followed by a handful of others by corporate issuers in the country, which raised funds largely to invest in solar power generation projects. Here, S&P Global Ratings addresses some of the questions we frequently receive about the prospects for green sukuk.

What Are Green Sukuk?

A green sukuk is a form of Islamic financial instrument where issuers use the proceeds to finance investments in renewable energy or other environmental assets such as solar parks, biogas plants, wind energy projects, as well as renewable transmission and infrastructure projects. Tadau Energy issued the first green sukuk in Malaysia in July 2017 for Malaysian ringgit 250 million ($58 million) to finance a solar project in the country. Following this debut, we have seen a handful of other sukuk, issued in Malaysia, in compliance with the country's Sustainable and Responsible Investment (SRI) Sukuk framework, and one in Indonesia, where the sovereign in March 2018 issued the largest green sukuk to date (see table 1).

Table 1

Green Sukuk Issuances To Date

Issuer	Country	Issue date	Currency	Funds raised (mil. $)	Use of Funds
Tadau Energy Sdn Bhd	Malaysia	Jul-17	MYR	58	Solar power project
Quantum Solar Park Semenanjung Sdn Bhd	Malaysia	Oct-17	MYR	236	Solar power project
PNB Merdeka Ventures Sdn Bhd	Malaysia	Dec-17	MYR	461	Real estate development in Kuala Lumpur complying with certain green building accreditations
Mudajaya Group Berhad (Sinar Kamiri Sdn Bhd)	Malaysia	Jan-18	MYR	63	Solar power project
Indonesia	Indonesia	Mar-18	USD	1,250	Various green projects
UiTM Solar Power Sdn Bhd	Malaysia	Apr-18	MYR	57	Solar power project

Source: Bloomberg.

What's In It For Issuers?

Green sukuk allow issuers to access not only the pool of conventional investors interested in green projects but also Islamic investors. Not only do conventional investors have interest, but many have revised their investment guidelines to incorporate socially responsible considerations. Issuers are also tempted by the significant shortfall of sukuk offerings compared with demand. The dearth in supply was put at $143 billion for 2017, according to an estimate by Thomson Reuters in its "Sukuk Perceptions & Forecast Study 2017." Tapping the green sukuk market can therefore be an opportunity for issuers to target a wider pool of investors and exploit potential excess demand to their advantage, which could take the form of higher appetite, lower pricing, or longer maturity.

What's In It For Investors?

Investors primarily seek green sukuk to meet investment guidelines:

- Islamic investors obviously meet their need to invest in instruments that are compliant with their beliefs. Islamic banks or takaful companies, for example, cannot invest in conventional products.
- Likewise, conventional investors committed to green meet their own investment objectives or guidelines.

Aside from these considerations, we believe investors benefit from additional transparency that green sukuk bring regarding the use of proceeds, because by definition sukuk's underlying assets have to be clearly identified from the outset.

What Are Your Projections For Green Sukuk Issuance?

At this stage, green sukuk issuance remains sporadic, though we are of the view that significant opportunities exist. Our rationale:

Energy demand is rising

The International Energy Agency estimates that energy demand will increase substantially over the next 20 years and significant investments are needed to cater to that increase, in its "Southeast Asia Energy Outlook 2017," published in October 2017. In Southeast Asia for example, the IEA forecasts that energy demand will grow by almost two-thirds by 2040. It also estimates the region's cumulative energy requirement until 2040 (in energy supply and efficiency) at an estimated $2.7 trillion in its main scenario. In another study, "International Energy Outlook 2017," published in September 2017, the IEA said it expects to see a 45% increase in energy demand in the Middle East between 2015 and 2040.

The energy mix is changing

A number of countries are targeting a higher contribution of clean energy to their energy mix. Some core Islamic finance countries have set ambitious targets. For example, the Association of Southeast Asian Nations (ASEAN) has an aspirational target to increase the relative weight of renewables in their energy mix to 23% by 2025. Similarly, many Gulf Cooperation Council (GCC) nations are also looking at investing in renewables. For example, Dubai is targeting a renewables mix of 75% by 2050, while Saudi Arabia expressed its intentions to build a gigantic $200 billion solar project, which once complete by 2030 is to have annual generation capacity of 200,000 MW.

Growing demand for more energy that is clean or renewable means that ASEAN and GCC countries will need to attract substantial amounts of investment in renewable energy projects over the next several years. While banks traditionally have taken a leading lender role in these countries in such projects, we expect some of these deals to find their way to the capital markets as sukuk or bonds.

How Can Green Sukuk Grow And Prosper?

To prosper, the green sukuk market needs a regulatory push. This could take the form of tax breaks or additional funded or unfunded enhancement mechanisms (for example, guarantees or offtake agreements). An example of such government support is the Green Technology Financing Scheme (GTFS) launched by Malaysia in 2010. This leverages a 60% government guarantee and 2% annual rebate on interest and profits to reduce the cost of funding for eligible projects. Another example is the SRI Sukuk framework the Malaysian Securities Commission launched in 2014, which defines eligible SRI investments and introduces certain tax deductions.

The market would also benefit from greater standardization of legal documentation and Sharia interpretation, which would avoid issues that could disturb its growth trajectory.

Green Sukuk Or Green Bond: Is There A Difference In Credit Quality?

S&P Global Ratings rated the green sukuk issued by Indonesia in early 2018. The rating was at the same level as the issuer credit rating of Indonesia as the transaction fulfilled the five conditions or our sukuk criteria. Generally, we equalize the rating on a sukuk with that on its sponsor if the sukuk has, among others things, sufficient contractual obligations for the timely and full payment of principal and periodic distributions. Beyond credit quality, the tradability of the sukuk during the construction phase of the underlying asset is one of the main issues that weigh on investor appetite. This issue does not exist in conventional finance because green bonds can be traded even though the underlying asset is still being constructed. Because most green sukuk are dedicated to the financing of greenfield assets and Sharia prohibits trading when the underlying asset is still to be built, this issue is relevant. It was resolved in the Indonesian case by ensuring a sufficient mixture of existing assets and assets to be built to allow for tradability. Another route that the market has followed is to use financing from multilateral lending institutions during the construction phase and then package the assets in a sukuk transaction once they are built.

How Does S&P Global Ratings Rank Green Quality?

We rank green quality using our Green Evaluation tool, which we developed to help investors understand the environmental contribution of green financings (see "Green Evaluation Analytical Approach," published April 26, 2017). The Green Evaluation is different from a credit rating. It is an asset-level credential that assesses the relative environmental impact of a financing on a global basis. The assessment takes into account the net environmental benefits associated with the technology utilized over its full lifecycle relative to a local baseline and adjusted based on the sector's overall contribution to avoiding and coping with climate change, combined with our review of governance and transparency protocols. The overall score provides a benchmark of green quality that investors and issuers can use to understand not just whether a transaction is green or not, but how green it is relative to other financings globally. The final score is expressed on a scale of 1 to 100 and further broken into quartiles, where E1 (100-75) reflects the greatest positive environmental impact. The green evaluation tool can be equally applicable to conventional and Islamic finance structures.

Related Criteria And Research

Related Criteria

- Methodology For Rating Sukuk, Jan. 19, 2015

Related Research

S&P Global Ratings

- Credit FAQ: What's Behind The Rise In Green Covered Bond Issuance? June 26, 2018
- Credit FAQ: Why Gulf Cooperation Council Corporates' Sukuk Issuance Has Dried Up, July 16, 2018
- Why The Global Sukuk Market Is Stalling In 2018, June 19, 2018
- How Our Green Evaluations Align With The Green Bond Principles, April 16, 2018
- Shining Light On The Key Rating Assumptions For Our Solar Photovoltaic Project Portfolio, April 10, 2018
- A Look At Banks' Green Bond Issuance Through The Lens Of Our Green Evaluation Tool, March 2, 2018
- Green Evaluation Analytical Approach, April 26, 2017

Other

- Southeast Asia Energy Outlook 2017, October 2017, International Energy Agency
- International Energy Outlook 2017, September 2017, International Energy Agency

This report does not constitute a rating action.