

# Fund raising by Sharia compliant companies through Common Stock vs Sukuk

Islam Abaza

i.abaza@tamimi.com

Sharia compliant companies raise capital from a number of sources such as common stocks, Sukuk and funds. Different securities are expected to generate different returns. Fund raising by a company in a Sharia compliant environment may take different forms such as borrowing, issuance of shares or issuance of Sukuk.

As a general rule, Sharia law allows investment in common stocks (company shares) as long as those companies do not engage in 'Haram' activities such as lending, gambling or the production of alcohol, tobacco, weaponry or pornography. Investment in companies may be through participation in initial public offerings, rights issue or by direct investment (private equity). Islamic scholars have made some concessions on permissible companies, as most use debt either to address liquidity shortages (they borrow) or to invest excess cash (interest-bearing instruments). One set of filters excludes companies that hold interest-bearing debt, receive interest or other impure income or trade debts for more than their face values. A further distillation of the aforementioned screens would exclude companies whose debt/total asset ratio equals or exceeds 33%; companies with "impure plus non-operating interest income" revenue equal to or greater than 5% or companies whose accounts receivable/total assets equal or exceed 45% or more.

Sukuk refer to certificates or financial securities that represent a proportional or undivided interest in an asset or pool of assets and the claim embodied in Sukuk is not simply claim to a cash flow but an ownership claim. This differentiates Sukuk from conventional bonds as the latter proceed over interest bearing securities, whereas Sukuk are basically investment certificates consisting of ownership claims in a pool of assets. The aim is to sell the assets and recover its value from subscription, in which case the holders of the certificates become owners of the assets. Sukuk may be divided into two types: Sukuk that yield pre-determined returns and Sukuk based on profit and loss sharing. Sukuk al-ijarah is a prime example of certificates that yield pre-determined returns.

Having stated the above, a variety of factors may impact a company's decision as to which capital raising strategies to execute and when. The choices often have to be made and evaluated by a company before deciding on the most suitable method of fund raising. For example; a company, ABC Corporation, intends to raise Sharia compliant capital to build a power plant in Kuwait. Some of the considerations as to which of the two methods to raise capital is suitable for ABC Corporation are examined below.

The raising of capital through common stocks is done either through an initial public offering, if ABC Corporation is not a publically listed company, or through a secondary offering. This method has a number of advantages to ABC Corporation represented by features which appeal to investors, hence, will enhance the attractiveness of potential for subscription by the investors. Some of the factors are listed below:

(i) common stock has the potential for delivering very large gains as compared to Sukuk. Annual returns-on-investment (ROI) of over 100% have been experienced;

(ii) the potential loss from stock purchased with cash is limited to the total amount of the initial investment. This is considerably better than that of some leveraged transactions, where the maximum loss can well exceed the total of the funds invested;

(iii) stocks offer limited legal liability. Passive stockholders (those who take no active part in the running of the company) are protected against any liability stemming from the company's actions beyond their financial investment in the company;

(iv) most stocks are very liquid; in other words, they can be bought and sold quickly at a fair price;

(v) although past performance is not a guarantee of future performance, stocks have historically offered very high returns in relation to other investments.

In other words, stocks offer two ways for the investors to benefit, by capital gains and dividends. Each share of stock represents partial ownership in a company. If the company becomes more valuable, so will the ownership interest represented by each share of stock. This appreciation of the stock's value is known as a capital gain. In addition, if the company earns more profits than it needs to support its maintenance and growth, it may elect to distribute the excess to its owners, the shareholders, which are the dividends.

However, while there are numerous advantages to investors making investments on common stocks appealing, common stocks, like all investments, have some distinct disadvantages which make it not appealing to investors, hence, reducing the attractiveness of the stock to investors to participate, including:

(i) since common stock represents ownership of a business, investors are the last to get paid, like all other owners. A company must first pay its employees, suppliers, creditors, maintain its facilities and pay its taxes. Any money left over can then be distributed among its investors;

(ii) while shareholders are company owners, they do not enjoy all of the rights and privileges that the owners of privately held companies do. For example, they cannot normally walk in and demand to review in detail the company's books;

(iii) investors in a company may not know all that there is to know about the company. This limited information can sometimes cause investment decision-making to be difficult;

(iv) stock prices tend to be volatile. Prices can be erratic, rising and declining quickly. Such declines often cause investors to panic and sell, which actually only serves to lock in their losses; and

(v) stock values can sometimes change for no apparent reason, which can be quite frustrating for the investor who is trying to anticipate the stock's behavior based on the actual performance of the company.

On the other hand, ABC Corporation may want to consider Sukuk as a means of fund raising due to the following features of Sukuk issuance:

(i) able to mitigate liquidity of illiquid assets and untapped assets;

(ii) reduce the cost of funding, in addition, having the cost of funding linked to market rates is attractive in uncertain times;

(iii) decrease funding risks by diversifying the sources of funds;

(iv) takes assets of the balance sheet without the loss of use;

(v) ability to attract more investors since investors are able to make their investment decisions almost independently of the credit standing of the issuer and instead, focus on the degree of protection provided by the SPV to meet the investment target.

However, the disadvantages of ABC Corporation issuing Sukuk are as follows:

(i) including the widening of credit spreads, which make it less cost-effective if ABC Corporation has ratings

below 'AA' to issue the Sukuk;

(ii) the costs of structuring and issuing Sukuk remain high relative to conventional bank loans and bond issuance. Legal and accounting fees contribute to this higher cost structure, as does uncertainty regarding the perceived risk associated with these instruments. Moreover, the lack of standard structures, perceived differences in approach to sharia compliance and a relatively illiquid secondary market may, in our view, discourage investors' appetite for Sukuk;

(iii) investors' interest in Sukuk has been dampened by increased market risks, as for example, the requirement to mark-to-market (usually at a loss) the bonds which are within the investors' portfolio;

(iv) there is a lot of controversy surrounding the structure of the Sukuk. Some companies want to avoid the controversy as they are not keen on disguising the features of conventional bonds and making them appear as Sukuk. However, if ABC Corporation wants a bond that is truly asset-backed, maybe it will then issue Sukuk; and

(v) investors are often faced with the risk that there will be no assurance that a secondary market for Sukuk will develop, or if a secondary market does develop, that it will provide the Sukukholders with liquidity of investment or that it will continue for the life of the Sukuk. The market value of the Sukuk may fluctuate, consequently, any sale of Sukuk by Sukukholders in any secondary market that may develop, could be at a discount from the original purchase price of such Sukuk and accordingly, an investor in the Sukuk must be prepared to hold the Sukuk until the Sukuk has been redeemed, or all amounts then due have been paid in full.

Considering the above factors, the primary selection as to whether ABC Corporation should issue common stock or Sukuk lie in the fact that companies which want to grow through expansion or acquisition often issue stock rather than Sukuk, because Sukuk essentially raises a debt obligation and money has to be paid back. There is a limit as to how many Sukuk can be issued before the burden of repayment of principal and profit on a company's debt becomes too great and further offerings become impractical. By offering common stock instead, a company will raise money from the public without taking on more debt. However, if a company such as ABC Corporation which plans to undertake specific project financing may consider issuing Sukuk if it has specific revenue generating assets which can be offered as the underlying assets for the Sukuk. In such a case, only the specific assets will be affected and not the entire assets and revenue of a company. In the case of ABC Corporation, the power plant project can be structured in such a way so as to contribute as the underlying asset for the Sukuk (eg through istisna' or ijara for the land plot where the power plant is to be constructed) without affecting its other assets.