



Malaysian Sukuk: A Superior Alternative to Traditional Bonds

PERSPECTIVE FROM FRANKLIN TEMPLETON INVESTMENTS



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EXECUTIVE SUMMARY

- For consecutive years, local-currency Sukuk have dominated the domestic fixed income space in Malaysia, where Sukuk issues have outnumbered those of conventional bonds.
- Generating steady long-term performance, Malaysian Sukuk, which are anchored by a stable investor base, also offer decent yields and low volatility as compared with other fixed income asset classes.
- Malaysian Sukuk continue to be the fixed income asset class of choice for many corporate and institutional investors in the country, owing to Malaysia's world-class Islamic finance infrastructure, an established Shariah legal framework, comprehensive capital market regulations and conducive tax policies.
- The launch of the world's first green Sukuk by Malaysia in 2017 also epitomises the country's leadership in the global Sukuk market when it comes to innovation as well as dedication towards sustainable and socially responsible investments.

An Asset Class of Choice

The world's first Sukuk inaugurated in Malaysia back in 1990, when Shell MDS (Malaysia) Sendirian Berhad launched a \$125 million issue in Malaysian ringgit (RM). Since then, the popularity of Sukuk, which are non-interest bearing, Shariah-compliant fixed income instruments, has gone from strength to strength, especially in Malaysia.

For years, Sukuk have seen high demand from Muslim investors as well as non-faith-based ones in Malaysia, where many regard this asset class as a superior alternative to traditional bonds.

The reasons are obvious: Malaysian Sukuk in general have turned in steady and decent long-term returns, exhibited lower volatility and generated higher yields relative to comparable fixed income securities.

Apart from their appealing risk-return profile, Sukuk also enjoy advantageous tax treatment in Malaysia, whose tax framework is conducive for both Sukuk issuers and investors.

In addition, Malaysia's comprehensive capital market regulations, policies and best-practice guidelines with regard to Sukuk have safeguarded investors' interest and instilled market confidence in these securities.

That's why investors in Malaysia, regardless of their faith, have continued to embrace Sukuk, owing to all the advantages they offer.

Outshining Conventional Bonds in Malaysia

Unsurprisingly, Sukuk have dominated the domestic fixed income space in Malaysia. For consecutive years, local-currency Sukuk issues in the country have continued to outnumber those of conventional bonds, especially in the investment-grade segment.

In the first half of 2017, for instance, Sukuk issuances by the Malaysian government and corporate entities amounted to RM79.01 billion, representing 53.3% of total bond issuances in the country, according to the International Islamic Financial Market's Sukuk Report 2018.

Similarly, in its 2018 Sukuk report, the Standing Committee for Economic and Commercial Cooperation of the Organisation of the Islamic Cooperation (COMCEC) noted that outstanding value of local-currency Malaysian Sukuk amounted to RM718.4 billion as at end-June 2017. That's significant higher than the RM534 billion outstanding value of conventional bonds during the same period.

According to COMCEC, outstanding Malaysian Sukuk have surpassed outstanding conventional bonds by more than half since 2014, and the numbers have been rising steadily as more quasi-government and corporate sectors are opting to issue Sukuk instead of common bonds.

Internationally, Malaysia is currently the largest Sukuk issuer in the world. As at end-June 2018, Malaysia accounted for 51.6% of the world's outstanding Sukuk, according to estimates of the Malaysia International Islamic Financial Centre (MIFC). The value of RM-based global Sukuk issuance from 2000 to 2018 year to date (as at September 30) also surpassed those of the US dollar-based and other currency-based Sukuk (see Illustration 1).

Supported by the country's world-class Islamic finance infrastructure, an established Shariah legal framework and a dynamic Islamic capital market, we believe that Malaysian Sukuk will remain a growing area of interest for many domestic as well as international investors, including Islamic financial institutions, corporate entities, pension funds, asset managers, family offices and high-net-worth individuals.

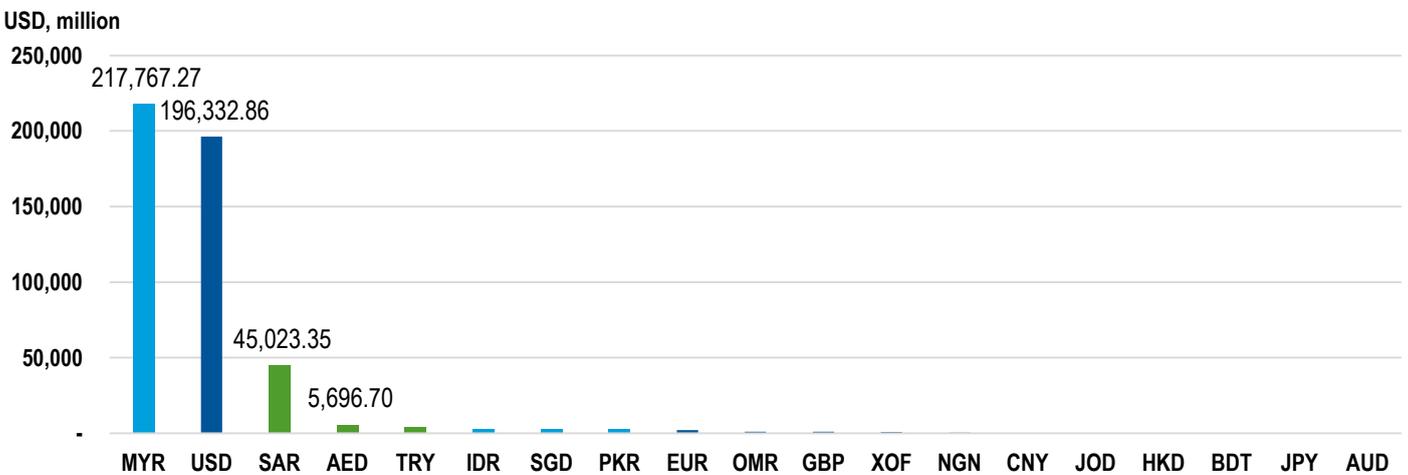
The Appeals and Risks of Malaysian Sukuk

The main draws of Malaysian Sukuk are their decent and stable returns, which give these securities a uniquely attractive risk-return profile.

As a fixed income asset class, Malaysian Sukuk, which include local corporate Sukuk, have consistently produced steadier and better returns over the past five years as compared with Malaysian government bonds (see Illustration 2 and 3).

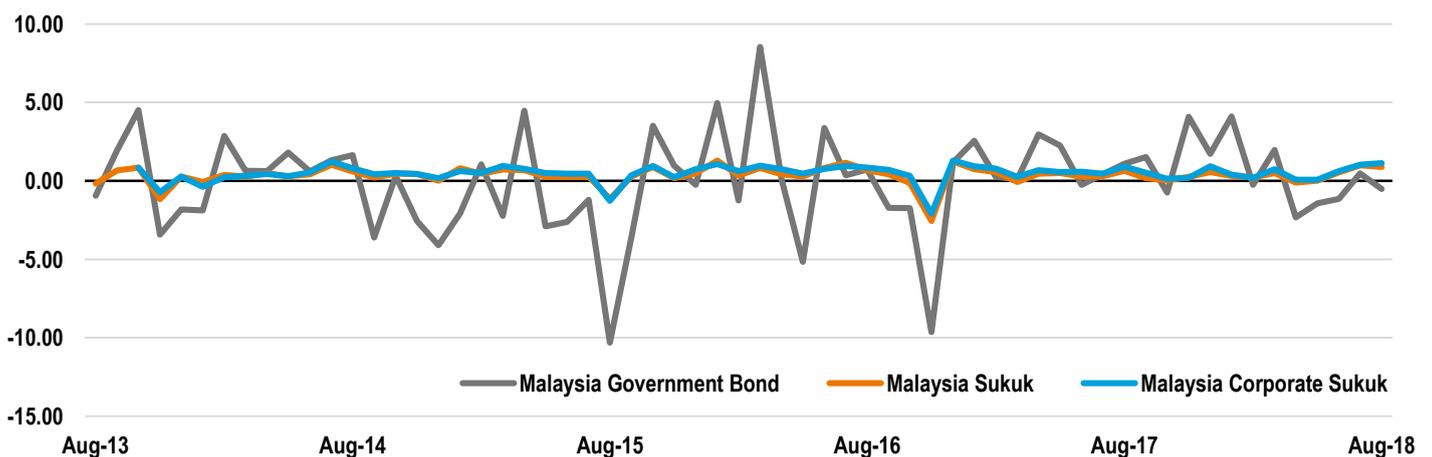
► **Illustration 1: Ringgit-Based Sukuk Issuance Dominates the Global Sukuk Investment Universe**

Global Sukuk Issuance (by Currency)
Year 2000 – 2018 (YTD) as of 30 September 2018



Source: Bloomberg as of 30 September 2018.

► **Illustration 2: Malaysian Sukuk Produce Steadier Returns Versus Malaysian Government Bonds**

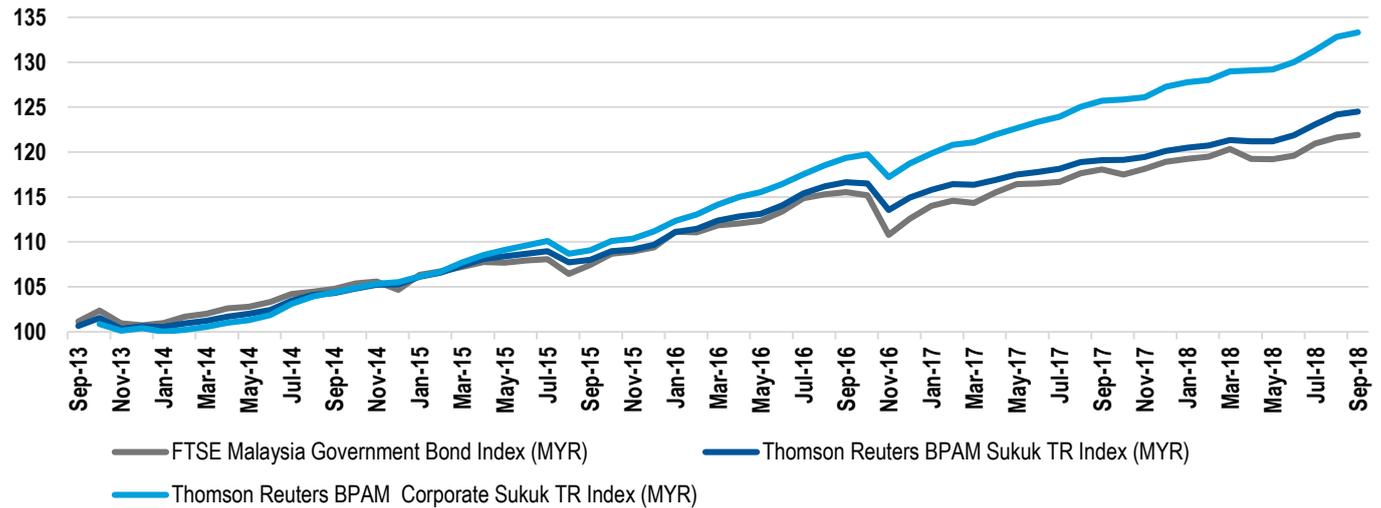


Source: Barclays POINT as of 31 August 2018, all indices are in MYR currency; Malaysia Sukuk are represented by BPAM-Thomson Reuters 3-7 Years Multisector Sukuk index; Malaysia Corporate Sukuk are represented by BPAM-Thomson Reuters Corporate Sukuk index; and Malaysia Government Bond is represented by FTSE World Government Bond Index – Malaysia. **Past performance is not an indicator or a guarantee of future performance.**

Illustration 3: Malaysian Sukuk Generate Stronger Performance Versus Malaysian Government Bonds

Sukuk & Bond Index 5-Year Cumulative Performance (rebased to 100)

30 September 2013 – 30 September 2018



Source: Barclays POINT as of 30 September 2018. All indices are in MYR currency. **Past performance is not an indicator or a guarantee of future performance.**

Malaysian Sukuk have also produced decent absolute returns over a 10-year period ended September 30, 2018. Over that decade-long period, the asset class, as measured by the Thomson Reuters BPAM 3-7 year Sukuk Index, turned in cumulative returns of 58.77%¹ or annualised gains of 4.73%¹ (both in RM terms).

Performance aside, Malaysian Sukuk have demonstrated to have lower volatility, as measured by annualised standard deviation, as compared with Malaysian government bonds for the period from end-September 2014 to end-September 2018 (see Illustration 4).

The low volatility of Malaysian Sukuk is partly due to their stable investor base. The Malaysian Sukuk market is

anchored by long-term focused institutional investors, many of which have strong capital positions, long investment horizon and limited Shariah-compliant investment options.

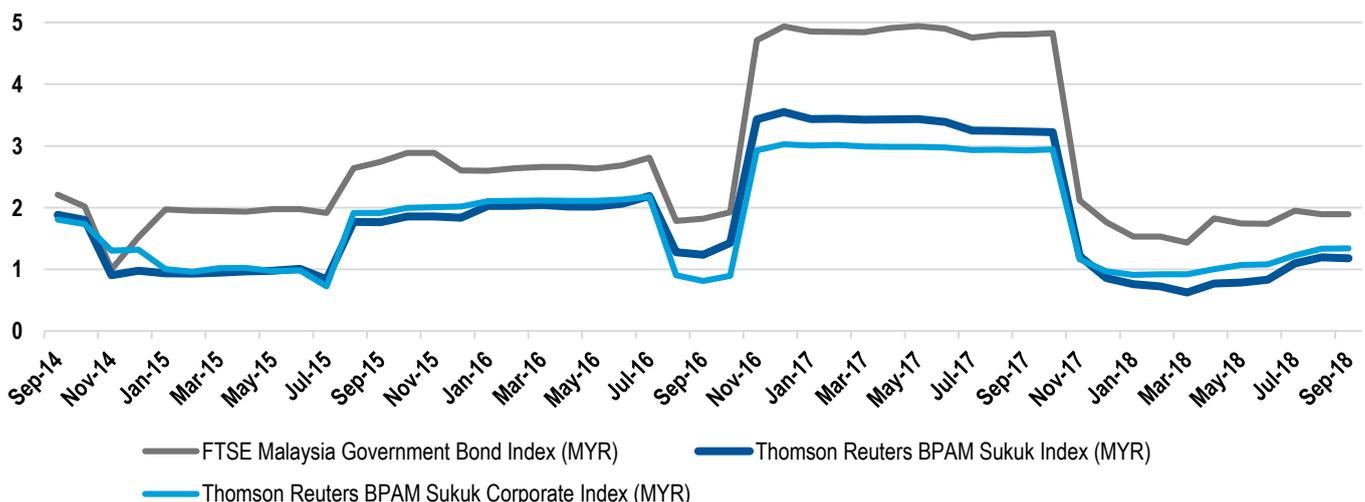
These institutional investors create stability for the Malaysian Sukuk market, even during periods of high market volatility. Conventional global bonds, on the other hand, are more susceptible to the short-term flows of international investors, who have the tendency to shift in and out of asset classes as the perceived market environment changes.

Adding to their appeal, Malaysian Sukuk have historically offered superior yields as compared with Malaysian fixed deposits and other fixed income investments, such as Malaysian government bonds (see Illustration 5).

Illustration 4: Malaysian Sukuk Exhibit Lower Volatility

Sukuk & Bond Index Annualised Standard Deviation

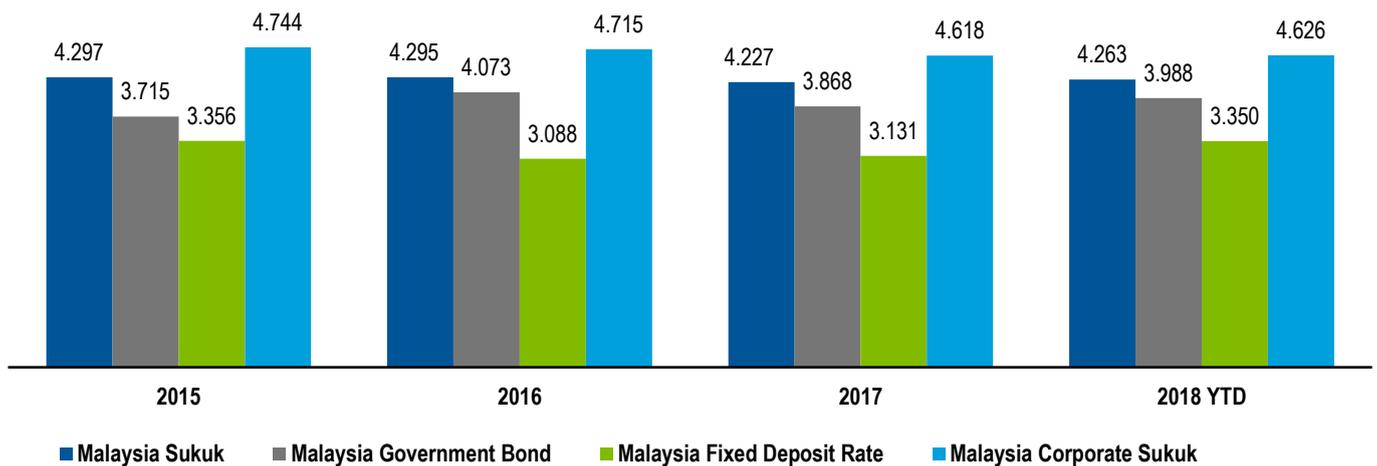
30 September 2014 – 30 September 2018



Source: Barclays POINT as of 30 September 2018. All indices are in MYR currency. **Past performance is not an indicator or a guarantee of future performance.**

Illustration 5: Malaysian Sukuk—A High-Yielding Asset Class

Yield to Maturity (%)
2015 – YTD 2018



Source: Barclays POINT as of 30 September 2018, all indices are in MYR currency.

Malaysia Sukuk Index is represented by Thomson Reuters BPAM Sukuk index, Malaysia Corporate Sukuk is represented by Thomson Reuters BPAM Corporate Sukuk index, Malaysia Government Bond Index is represented by FTSE Malaysia Government Bond Index, and Malaysia Fixed Deposit Rate is represented by Malaysia 12M Islamic Murabaha Deposit Rate

Nonetheless, like all fixed income securities, Sukuk aren't without risks. To be sure, Sukuk, which pay a fixed rate to investors, are subject to the same interest rate risk that impacts conventional bonds. A surge in market rates inevitably causes a drop in Sukuk values, negatively impacting their rate of return. The impact of interest rate risk varies with the maturity of the Sukuk; the longer the maturity, the higher the risk.

Sukuk are also exposed to credit risk, which is the probability of an issuer defaulting on its payment obligation or delaying in settlements. Asset redemption risk—the chance that the underlying assets could not be fully redeemed when Sukuk originators buy them back from certificate holders—is another risk that Sukuk are subject to.

Malaysia's Islamic Finance Advantage

To augment their marketability and attractiveness as a fixed income asset class, Malaysian Sukuk are backed by strong Islamic finance regulations and guidelines, sound supervisory structure and established legal framework in Malaysia, which offers legal recourse and the necessary protection to Sukuk investors.

Besides being the largest issuer of Sukuk globally, Malaysia is widely recognised as the most developed Islamic financial market in the world, as measured by the Thomson Reuters's Islamic Finance Development Indicator, which ranked the country as number one for the fifth consecutive year from 2013-2017.

According to Moody's in a March 2018 report on Islamic finance, Malaysia has a deep domestic market that supports local-currency Sukuk issuances. That's why Malaysian Sukuk tend to be well-subscribed by institutional investors of the country's established insurance, pension and asset management industries. The credit-rating agency expects Sukuk issuance amongst Malaysia's Islamic financial institutions to grow between 10% and 13% year-on-year in 2018.

Malaysia's tax policies have also been conducive to the issuance of Sukuk in the country. Currently, Sukuk issuers in Malaysia enjoy a tax deduction on issuance cost² as well as stamp duty exemption². Likewise, Malaysian Sukuk investors receive a tax exemption on income received². The country's tax-neutral framework and tax deductions for Sukuk issuance expenses further enhance the competitive advantage of these Shariah-compliant fixed income securities versus conventional bonds.

All in all, Malaysia's reliable regulatory framework and tax-friendly regime towards Sukuk have certainly led to a vibrant marketplace for these Shariah-compliant fixed income securities. Indeed, outstanding value of Sukuk issued in Malaysia had enjoyed an average annual growth rate of 13% over the last decade (as at end-June 2017), as compared with 4% for conventional bonds, according to the 2018 Sukuk report by COMCEC.

Despite a steady stream of new issues over the years, demand for Malaysian Sukuk continues to outstrip supply. The mismatch between demand and supply certainly reflects the huge appetite from investors for credible Shariah-compliant fixed income securities, beyond the realm of traditional Islamic asset classes, such as equity and real estate.

Mainstream investors, seeking to diversify their traditional bond portfolios, are also allocating more assets to Malaysian Sukuk, which can help to improve overall risk-adjusted returns and reduce volatility in their portfolios.

Taking the Lead in Going Green

Besides launching the world's first Sukuk in 1990 as well as the original global corporate Sukuk in 2001, Malaysia also rolled out the world's first green Sukuk last year. Green Sukuk are essentially Shariah-compliant renewable energy financing instruments.

The inaugural issuance of the planet's only green Sukuk by Tadau Energy Sdn Bhd back in July 2017 epitomises Malaysia's leadership in the global Sukuk market when it comes to innovation. The launch also showcases the

country's dedication towards green, sustainable and socially responsible investments (SRI).

To be sure, the RM250 million green Sukuk issuance by Tadau Energy Sdn Bhd to finance a large-scale solar project in Sabah was the result of close collaboration involving the Securities Commission Malaysia, Bank Negara Malaysia and the World Bank Group, all of which are keen to facilitate the growth of innovative SRI financial instruments to aid the financing needs of green infrastructural projects.

Subsequently, more green Sukuk were rolled out by Malaysian corporate entities in recent quarters. For instance, in October 2017, Quantum Solar Park Malaysia Sdn Bhd issued its green Sukuk worth RM1 billion to finance the building of three large-scale solar photovoltaic plants in Kedah, Melaka and Terengganu. Thereafter, two more green Sukuk were issued by PNB Merdeka Ventures Sdn Bhd in December 2017 and Mudajaya Group Berhad (Sinar Kamiri) in January 2018.

Without a doubt, green Sukuk are a growing segment within the global Sukuk space. The growth corresponds with the rising trend of green bonds and social impact bonds that have been in demand with global institutional investors, pension funds and sovereign wealth funds in recent years. To a certain extent, green Sukuk and green bonds address the global needs for sustainable and responsible financing on the back of an unprecedented demand for clean energy, water, transport, urban development and infrastructure.

The ability to finance green projects in a Shariah-compliant manner via green Sukuk enables Islamic finance to play a meaningful role in the area of sustainable, environmentally-friendly and responsible funding. And Malaysia is at the forefront of this development, providing the necessary regulatory framework, infrastructure and tax incentives to grow the nascent green Sukuk segment.

Healthy Growth, Stable Rate Supportive of Malaysian Corporate Sukuk

Of late, more fixed income investors are concerned about higher interest rates, rising inflation and higher volatility in the global bond markets. Investors, however, can take comfort that Malaysian Sukuk are domiciled in a country that is generally regarded as a “defensive market” in the Asian region due to its relative economic stability and low market volatility.

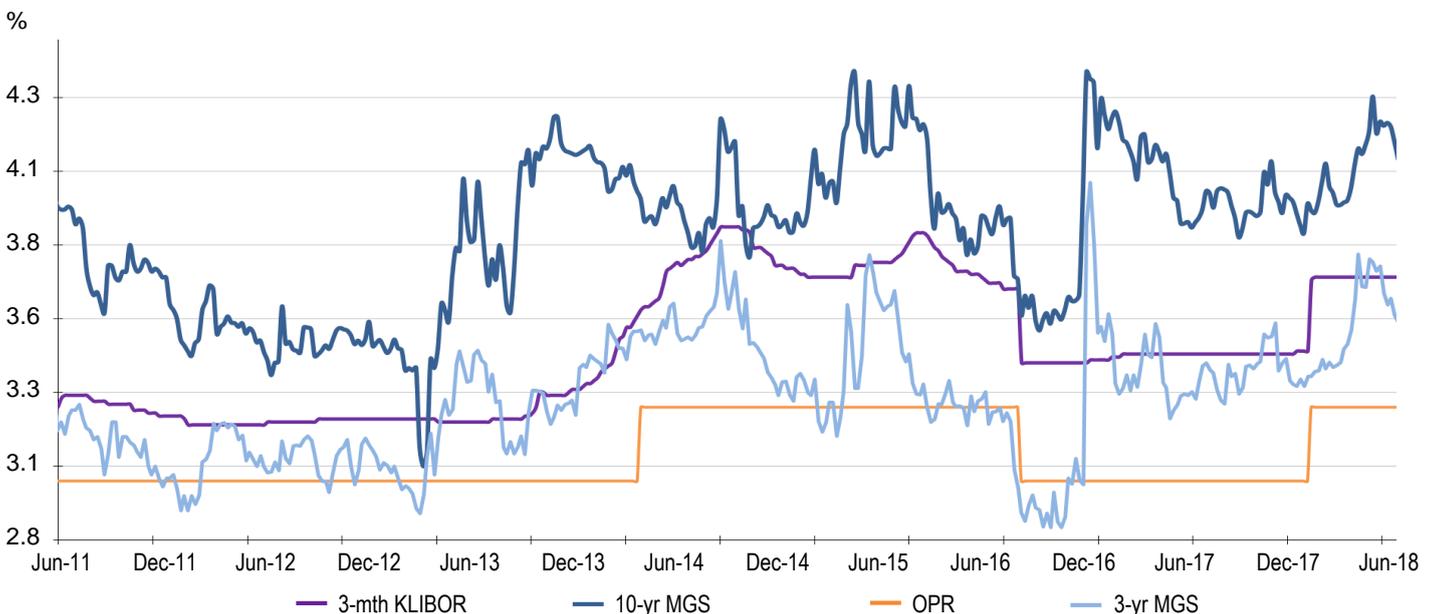
Malaysia's economic growth is expected to be healthy over the next few years. Despite a recent downward revision by the Malaysian government, real GDP growth for Malaysia in 2018-2020 is still projected to be around the healthy range of 4.5% to 5.5%, with growth supported by sustained domestic demand, particularly from private sector expenditure.

Despite more rate hikes expected from the US Federal Reserve in the coming quarters, Bank Negara Malaysia (BNM) is likely to keep overnight policy rate (OPR) unchanged at 3.25% in the near term (see Illustration 6). This is partly because US rate increases have already been priced in the market and any hikes are expected to be gradual.

With a stable OPR and decent economic growth, we continue to favour corporate Sukuk, which generally offer a higher yield pickup versus Malaysia Government Securities (MGS). We reckon that Malaysian corporate Sukuk are at a sweet spot at the moment, where corporate fundamentals remain strong while default rates stay low. We are currently neutral on duration and remain bullish on select corporate Sukuk, which have attractive yields and are likely to benefit from the recovering economic cycle.

To sum up, we believe that Malaysian Sukuk will continue to be an appealing fixed income asset class for corporate and institutional investors, given their low volatility, decent yields, attractive risk-return profile, and stable investor base.

► Illustration 6: Overnight Policy Rate Unchanged; MGS Curve Remain Flat



Source: Franklin Templeton GSC internal research, Bloomberg as at 13 July 2018

Franklin Templeton's Sukuk Expertise

Franklin Templeton Investments is one of the first to invest in the Sukuk asset class and is currently one of the largest independent investment managers in Sukuk. With a physical presence in Kuala Lumpur, Franklin Templeton Investments is geographically close to the majority of Sukuk issuing entities and has an investment process that was designed with the Sukuk universe in mind. We are able to take advantage of our global footprint, resources and expertise in combination with local understanding and insight.

The Franklin Malaysia Fixed Income & Sukuk investment team, which is part of the Franklin Global Sukuk investment team, has been involved in managing global Sukuk mandates since April 2011 and Malaysian (domestic) Sukuk mandates since November 2012. The investment team has been building the Malaysian Sukuk database since 2010, and is actively investing in Malaysian Sukuk for the global Sukuk mandates.

The Franklin Malaysia Fixed Income & Sukuk investment team is guided by a specific investment philosophy based on the core belief that a portfolio of diversified, actively managed positions has the potential to generate the most attractive returns over a full market cycle. The Malaysia Sukuk investment process uses a mix of bottom up, top down and quantitative approaches. The process and structure—designed with the Sukuk universe in mind—are well suited to deal with the research requirements, challenges and opportunities the Sukuk market presents.

1. Source: Franklin Templeton Investments, as of Sept 30, 2018
2. Source: Malaysia International Islamic Financial Centre, as of Sept 30, 2018

IMPORTANT INFORMATION

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