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Solar Sukuk Lights the Way to Alternative Funding Sources: Australia, Indonesia and Malaysia Working Together

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SGI-Mitabu, a joint venture of two Australian solar companies, The Solar Guys International and Mitabu Australia, has revived its plans to fund its Indonesian 250 megawatt solar project with Islamic compliant funding. The solar project will require up to AUD550 million of financing. Commencing in July 2015, the first phase of the project will be funded through an offer of AUD150 million of sukuk (a type of Islamic investment instrument, similar to a bond).

SGI-Mitabu will offer its sukuk in Labuan, Malaysia. Labuan is an island off the coast of Borneo, which was designated as an International Offshore Financial Centre in 1990, making it Malaysia’s financial hub. Labuan is an established location for companies in the region seeking to access alternative sources of capital because of the ability to raise funds in several currencies and its well developed regulatory regime for Islamic finance. The regime addresses the potential double taxation associated with the transfer of the underlying asset, which is often involved in an Islamic finance transaction.

While nearby Malaysia has become a major hub for raising and trading sukuk outside the Middle East, Australia has yet to implement the recommendations identified in a report in 2010 to facilitate Islamic finance (such as the issue of sukuk) in Australia. This means that Australian companies who want to use Islamic financing techniques must either seek advance rulings from the Australian Taxation Office for their particular transaction or look abroad.

SGI-Mitabu’s sukuk issue is set to be the first Islamic finance offering by an Australian corporate and could provide a useful example of alternative sources of capital to other companies.

What is a sukuk?

A sukuk is a type of asset based financing structure, similar to a bond, but which is compliant with Islamic principles. Such principles do not permit the collection of interest, and therefore, traditional Western bonds are not acceptable to investors who wish to apply Islamic principles. A sukuk is used as an Islamic compliant mechanism for distributing cash flows to investors. The sukuk certificate issued to investors represents a partial ownership in the underlying asset which enables the sukuk holders to charge rent or receive profits generated from the underlying asset.

The most appropriate manner in which the underlying asset returns cash flows back to investors will depend on the nature of the underlying asset and may also vary at different stages of the lifecycle of that asset.

The reported structure of the SGI-Mitabu sukuk demonstrates the variety of forms that a sukuk may take over the life of a project:

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- Construction phase - *Istisna Sukuk*

  An istisna sukuk distributes cash flow like a fixed price manufacturing contract for goods. In this case, the sukuk certificate holders are in a position similar to the purchaser of goods that will, after payment, be manufactured and delivered on a stipulated date. On its own, an istisna sukuk does not generate returns for the certificate holders during construction. However, depending on the length of the construction period, this type of arrangement may be combined with a forward leasing arrangement to generate returns during construction. In this regard, solar panel projects, such as SGI-Mitabu's Indonesian project, have an advantage due to their rapid installation phase. This means that income streams can start within a few months without utilising forward leasing arrangements.

- First 20 years from completion - *Ijara Sukuk*

  An ijara sukuk distributes cash flow like a lease agreement would. Under an ijara sukuk a sukuk certificate entitles the sukuk holders to a proportionate share of the returns generated by the underlying asset by way of a lease back to the issuer company. Generally, under an ijara sukuk, the lease payments will match the periodic payments due to the sukuk holders under the certificates.

- 20 years onwards - *Musharaka Sukuk*

  A musharaka sukuk distributes cash flow like a limited partnership. In this case, the sukuk certificate entitles the holder to returns from the underlying enterprise that are distributed between the issuer and certificate holders in accordance with a profit sharing ratio. The ratio is normally based on the initial capital contribution of each partner.

Which projects are suitable for sukuk funding?

The sukuk mechanism is most suited to fundraising on income producing assets as this enables the assets to be sold during the life of the transaction. If an asset were not income producing, the originator would have to be prepared to lock up the investment for the life of the sukuk.

When considering whether Islamic financing is suitable for a project, the nature of the business activity also has to be considered to determine whether it is eligible for investment. This is because certain industries do not comply with Islamic principles of business (such as alcohol, gambling and pork).

There is no restriction on the location of a project that is funded via a sukuk under Islamic investment principals. However, a sukuk fundraising needs to be offered in an Islamic finance friendly tax jurisdiction (due to the transfers of title of the underlying asset that are normally involved).

Generally sukuk can be purchased by domestic or foreign investors to the country of issue. In this case, the entire issue by SGI-Mitabu is expected to be placed with Malaysian investors.

There are a number of regulatory barriers to the development of an Australian Islamic finance industry. These issues were identified in a 2010 report by the Australian Board of Taxation and are still yet to be implemented by the Australian government. In particular, the Australian regulatory environment is not presently considered "sukuk friendly" from a tax perspective. While in some cases it may be possible to obtain advanced rulings from the Australian Taxation Office for certain Islamic financing techniques, Australian companies wishing to access Islamic financing may also wish to consider looking

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overseas, particularly to Labuan, Malaysia which has become a regional hub in which funds can be raised in Australian dollars, avoiding the swap costs associated with raising funds abroad.

A sukuk offering is suitable for fundraising by way of a public offering or a private placement. Further, in the case of ijara or musharaka sukuk, these can also be listed and traded on a stock exchange.

Conclusion

Accessing the sukuk market may be advantageous for companies seeking to raise funds as demand for Islamic-compliant investments like sukuk tends to outstrip supply.

Companies seeking alternative sources of funding, particularly those that are active in Indonesia, Malaysia and the Gulf States, may wish to consider whether a form of Islamic finance would be suitable for their next project – even if they have to look outside their own jurisdiction to make it happen.

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