

Marmore First Take

Dana Gas's Sukuk

A trail of tribulations?

July, 2017

Highlights

Dana Gas recently declared that it had received legal advice on its USD 700mn sukuk, maturing in October 2017, were not shariah compliant and hence has become unlawful in the UAE. The company subsequently has stopped payments and proposed that creditors exchange the sukuk for new Islamic instruments offering profit distributions that could be less than half those of the existing one. This has raised concerns that the other sukuk issuers too could pursue similar path of breaching the obligations on the pretext of the instrument being non-shariah compliant. The current Dana Gas imbroglio can impede a growing sukuk market where issuances across core markets reached USD 40bn in 2016, up from about USD 32bn in 2015¹.

Dana Gas's sukuk- history of the issue

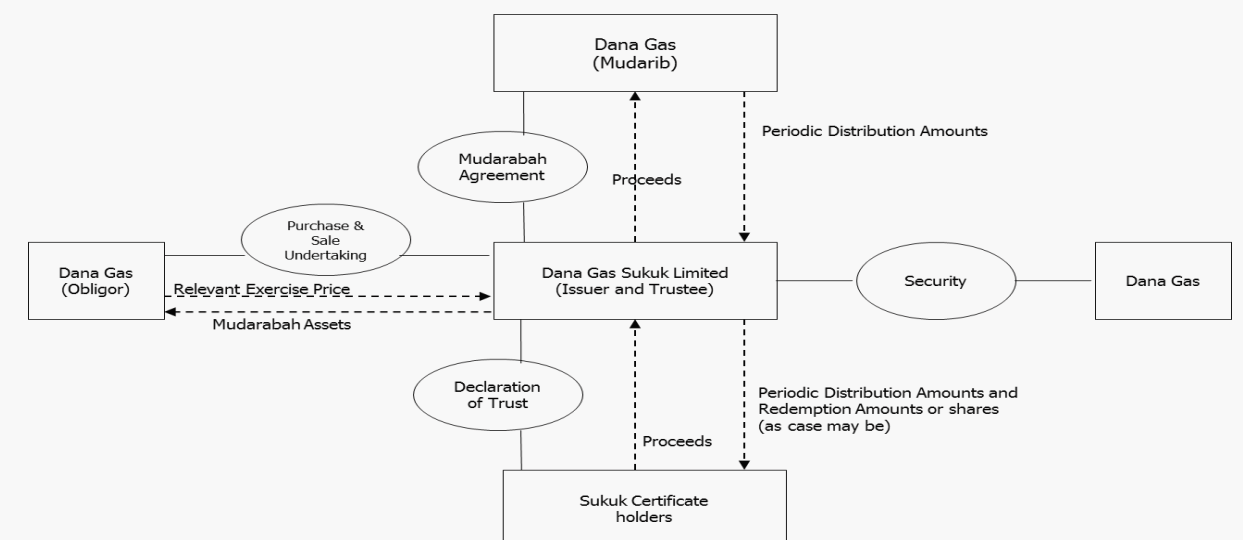
Dana Gas USD 1bn sukuk was first issued in 2007 with maturity in 2012. Though it went on to repurchase about USD 80mn in 2008 the company was unable to service the remaining USD 920mn at maturity in October 2012. Dana Gas became the first United Arab Emirates (UAE) company which failed to pay an Islamic bond on maturity. The company however managed to re-structure the sukuk by extending the time to maturity by another five years. Recently in May

Dana appointed advisors to identify solutions to repay the sukuk maturing in October this year. On June 13th the company made a sudden announcement declaring its own sukuk unlawful.

The structure

The sukuk was structured as a simple mudaraba contract. Under the mudaraba structure the originator enters into a mudaraba agreement with the investors (Trustee), pursuant to which it invests the mudaraba capital (i.e. proceeds) in certain assets and the Company as mudarib manages the assets, and makes periodic payments to the Trustee equal to the expected periodic income amount. The structure stipulates that the capital provider agrees to share the profits between themselves and the mudarib at a predetermined ratio. Upon maturity or on an event of default the mudarib would liquidate the mudaraba assets and repay the proceeds to the investors. Though the structure appears straight-forward and based on the profit and loss principles, several features are embedded to mimic fixed-income like issuances, where the profit component and principal amount to some extent is guaranteed.

Figure: Dana Gas Sukuk Structure



Source: Recreated from prospectus

Dana Gas Sukuk is an asset based instrument that involves full recourse to the originator, unlike an asset-backed instrument, where asset is the only object of recourse for the sukuk-holders. In an asset-based sukuk, there is no true sale of the underlying asset by the originator, and instead attaining real ownership of the asset, the sukuk investor only attains beneficial ownership. Therefore, the investors have to recourse either to the originator (via purchase undertaking) or the issuer (via guarantee).

When did the confusion arise?

The issue of Shariah non-compliance is stemmed from the statement "About 85% of Gulf Islamic bonds do not really comply with Islamic law" issued by Mufti Taqi Usmani – Chairman, Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) Shariah Board in 2007. The concern raised by the shariah scholar was that most of the sukuk in the market back then, especially musharaka or mudaraba structures, were not in line with the principles of shariah. These structures provided the issuer with a purchase undertaking to buy back the underlying assets from the issuer at face value on the expiry date of the Sukuk or in the event of a default. These structures put the onus of the credit on the

credit worthiness of the provider of the purchase undertaking and not the assets underlying the sukuk.

However, AAOIFI issued statements permitting to undertake the purchase on the basis of the net value of assets, its market value, fair value or a price to be agreed, at the time of their actual purchase. And, also stipulated that sukuk manager can only guarantee to repay the capital to sukuk holders at face value in cases of negligence or breach of terms of contract.

In the case of Dana it is argued that its sukuk is unlawful "due to the evolution and continual development of Islamic financial instruments and their interpretation". However, the Dana Gas sukuk was restructured in 2012, by when all concerns relating to mudarabah structures were completely addressed. Assuming that the updated AAOIFI guidelines, where taken into consideration while restructuring the Dana Gas sukuk, the claim that sukuk isn't shariah complaint is rather obscure. Since there weren't any amendments to the issuance guidelines after the restructuring, the current claim of not-being shariah compliant holds good, only if the sukuk wasn't shariah compliant at the time of restructuring itself.

¹ Reuters

Does Dana have the cash reserves to pay back the sukuk by October 2017 or is it a repeat of 2012?

Dana has been struggling to recover hundreds of millions of dollars in overdue payments from Egypt and Iraqi Kurdistan. As of March, 2017, its receivables stood at USD 1bn. In May, Dana Gas received an initial payment of USD 50 million (Dh184 million) from the Egyptian government

as partial outstanding receivables. This payment represents 18% of Dana Gas Egypt's total overdue receivables of USD 283bn (Dh1.038 billion) as of the end of first quarter 2017. Taking into the overall consideration of the financial position of Dana Gas, it is evident that Dana Gas's liquidity wasn't sufficient enough to redeem the sukuk back in 2012 and the situation has only worsened now in 2017.

Table: Dana Gas Financial Overview (USD mn)

	Qtr ending Mar'12	Qtr ending Mar'17
Revenue	191	118
Net Profit	56	11
Cash	415	307
Receivables	541	1,040
Total-Debt	936	779

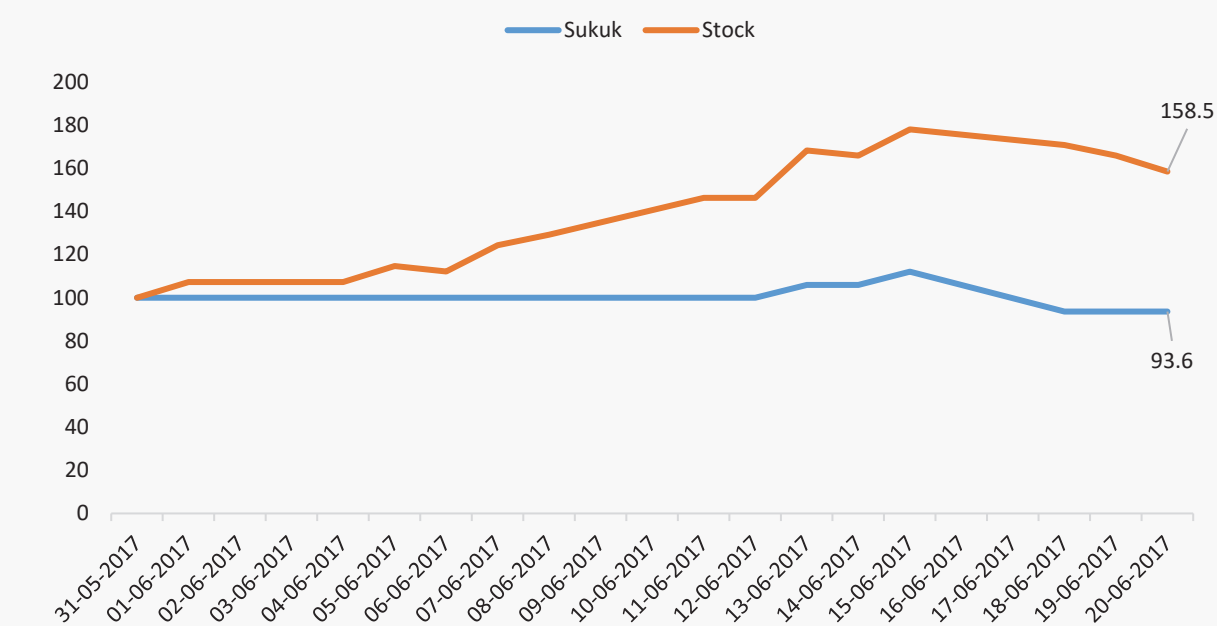
Source: Reuters

How have the investors taken the news?

The restructuring news received opposite response from sukuk and shareholders. While Dana Gas's shares moved higher by 8% post the news on

expectation of a large savings in interest cost, the sukuk was dumped by holders and it lost over 13%. Dana Gas is likely to face trouble to tap the debt market going forward if this issue is not resolved amicably.

Figure: Dana Gas Sukuk and Stock Price (Rebased to 100)



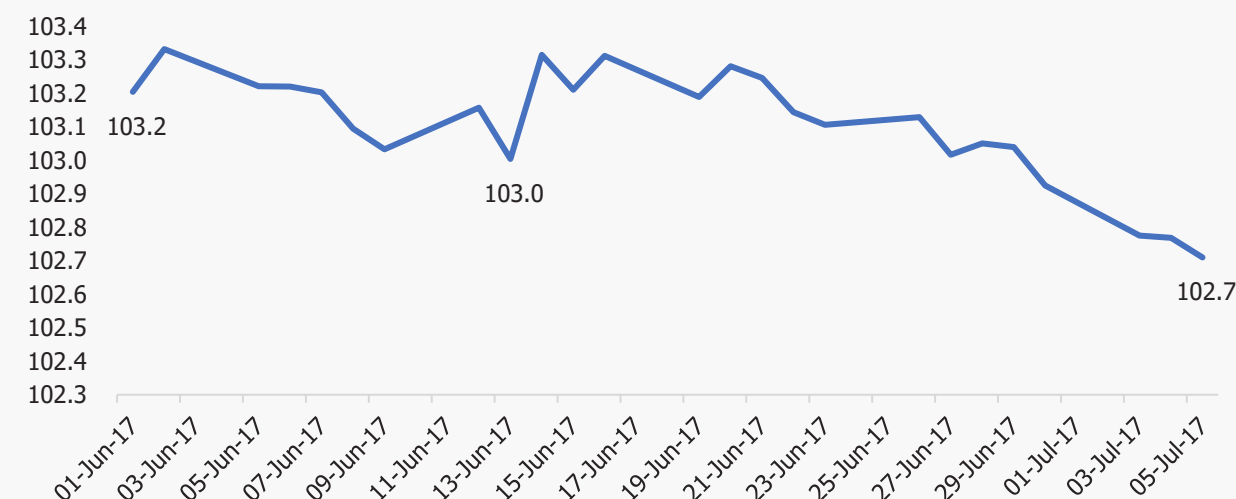
Source: Reuters

Conclusion

Back in 2009, Investment Dar, a Kuwait based Investment company appealed that it's transaction with the Lebanon based BLOM Bank SAL breached the shariah principles because Dar was accepting interest based deposits. However, the court set aside that argument and viewed the transaction on its contractual terms. Similarly, Shamil Bank Bahrain v.s. Beximco; and East Cameron v.s. Sukuk Holders cases brought by the issuers were rejected by the courts.

Dana Gas is governed by UK Laws as well as UAE Laws. However if we base our argument on precedence, the court should ideally consider the intent of the parties concerned when they entered into the contract rather than at the changes in Sharia interpretations after the transactions have been entered into. The marginal movement in the Dow Jones sukuk index also implies that the market is disregarding the claim by Dana Gas, as it did with three previous issues, which were also rejected by the courts.

Figure: Dana Gas Sukuk and Stock Price (Rebased to 100)



Source: Reuters

Incidents like these affect the market confidence and if shariah risk can lead to a write-down then investors are more likely to demand higher compensation. Moreover, investors might demand obtaining rulings from multiple shariah bodies. Investors can also push the burden of compliance

on the issuer-i.e that they guarantee that it is complaint, and if it is not, then they commit to pay interest plus damage at full future value. One solution to address this concern would be to establish a regulated central shariah board to ensure transparency and build confidence around

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