AFRICA. THE NEXT FRONTIER FOR ISLAMIC FINANCE

In the search for new markets and prospects, Africa remains a region with relatively untapped potential. Africa currently accounts for more than 2% of global Islamic banking assets and 0.5% of sukuk outstanding. However, as a driving force of the African economy is a population more than 1 billion, increasingly urbanised people, the need for more foreign investment shows huge potential. It has been estimated that the need for infrastructure financing alone amounts to USD93bln per year with the financing gap for these plans being around USD31bln per year. Investment financing, including for projects related to the commodity sector and the growing halal industry, has seen both government and corporate sectors exploring Islamic finance as a source of funding.

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Africa as the next frontier for Islamic finance

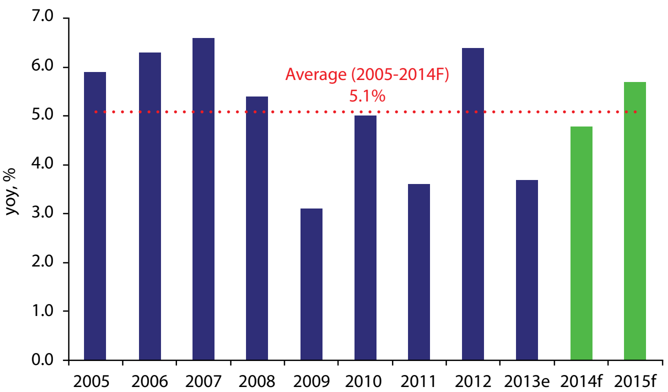
In the search for new markets and prospects, Africa remains a region with relatively untapped potential. The continent is home to more than 1 billion people[1], and an important source of several key commodities. Africa has benefited from a decade of solid economic expansion - since 2005, GDP growth rates have averaged around 5% - which has led to increasing urbanisation and more foreign investment.

Looking ahead, economic growth of the region will be supported by Africa's increasing ties to the global economy, through both trade and financial channels. The region is an important producer of many commodities such as oil, copper, coal, aluminium, timber and cocoa; these remain important sources of economic activity and foreign investment. Africa is expected to benefit further from greater access to international capital. In 2013, total foreign capital flows into Africa amounted to USD56.6bln, up from USD51.7bln in 2012[2].

A key driving force for the African economy is the rise of the urban African consumer. Today, more than 40% of the African population live in urban areas, and this figure is set to increase to 54% by 2050[3]. In the near future, a large consumer base is expected to attract more sustainable sources of investment, in addition to commodities-based investment.

[1] African Development Bank (AfDB) and United Nations
[2] International Monetary Fund (IMF)
[3] United Nations Department of Economic and Social Affairs (UN DESA)

Africa Real GDP Growth (2005-2015F)



Source: African Development Bank (AfDB), KFHR

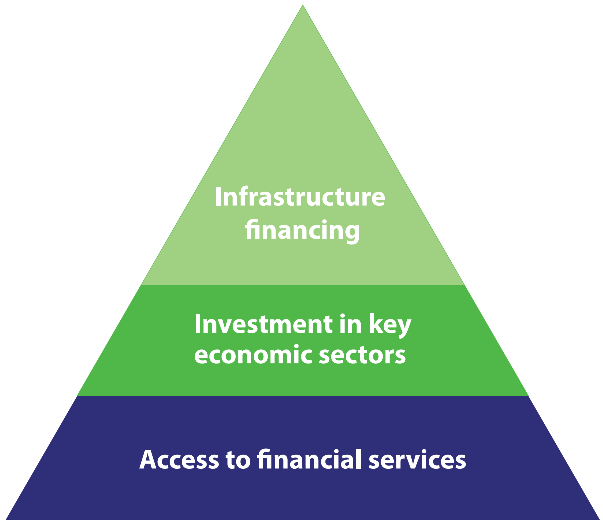
Africa's GDP growth was estimated at 4.8% in 2014, a stronger growth rate compared to 3.7% in 2013[4]. This year, growth is expected to accelerate to 5.7%[5], moving closer to pre-global financial crisis rates. Growth performances varied across sub-regions and countries. Foreign direct investment increased, and was mainly from the UK, US, Italy, and France; while increasingly benefitting from emerging economies' investments, namely the BRICs (Brazil, Russia, India, China). The share of investment from BRICs increased from 8% in 2009 to 12% in 2012[6].

Enhancing growth in Africa: Islamic finance propositions

While structural demographic and economic prospects for Africa are bright, several key enablers need to be in place to support sustainable growth. The most notable issue for Africa is the need for infrastructure, in particular electricity, water, roads and information and communications technology (ICT). It has been estimated that these infrastructure spending needs (which include operation and maintenance costs), amount to USD93bln per year[7].

The financing gap for these plans is around USD31bln per year, even after capturing efficiency gains. For this purpose, African governments have started exploring Islamic finance as a means to fund government spending plans. In particular, several African nations have recently tapped the global sukuk market for sovereign funding. Additionally, there is great potential for Islamic finance in investment financing, including for projects related to the commodity sector and the growing halal industry, for both government and corporate sectors.

Key Islamic Finance Propositions for Africa



Source: KFHR

To translate the overall strong GDP growth into a better standard of living for households, and in support of a more inclusive and sustainable growth agenda, financial inclusion will be an increasingly important goal for the region. Broadly, financial inclusion refers to initiatives that make formal financial services available,

[4] AfDB estimates

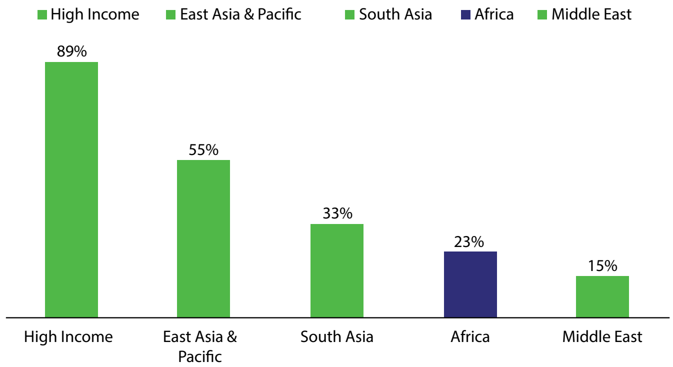
[5] AfDB estimates. Key assumptions include a continued recovery in the global economy, amid an improvement in geopolitical tensions in Africa.

[6] AfDB (2014 publication)

[7] AfDB, the Economic Commission for Africa (ECA), the African Union Commission (AUC) and the United Nations Development Programme (UNDP)

accessible and affordable to all segments of the population. Based on account ownership statistics, Africa ranks unfavourably compared to other regions. East Asia Pacific and South Asia recorded account ownership rates of 55% and 33% respectively, while Africa's statistic stands at 23%. As such, the region holds significant potential for the financial sector, and in particular the Islamic finance sector, to tap the underbanked market, especially in predominantly Muslim countries such as Nigeria and Djibouti. On the other hand, countries with majority non-Muslim populations have also benefitted Islamic finance presence in recent years, most notably South Africa and Kenya. These countries, which remain underserved by the financial sector, have taken concrete steps to support the development Islamic finance as a means to encourage the population to engage in formal financial services.

Account Penetration by Region (% share of adults with bank account, 2012)



Source: World Bank, AfDB, KFHR

Infrastructure funding

To date, the global sukuk market has witnessed issuances by Nigeria, Sudan, South Africa and Senegal. Amongst the sovereign issuers, Nigeria was the first African state to issue sukuk in October 2013. The state of Osun issued NGN10bln (USD62mln) sukuk to fund school and road-building projects. The new elementary schools built with the funds would provide space for 900 students per school, while the middle schools would cater to 1,000 students per school[8]. Earlier in the year, the Securities and Exchange Commission of Nigeria (SECN) had amended regulations to allow Nigerian companies to issue sukuk, in a bid to attract Shariah-compliant funds.

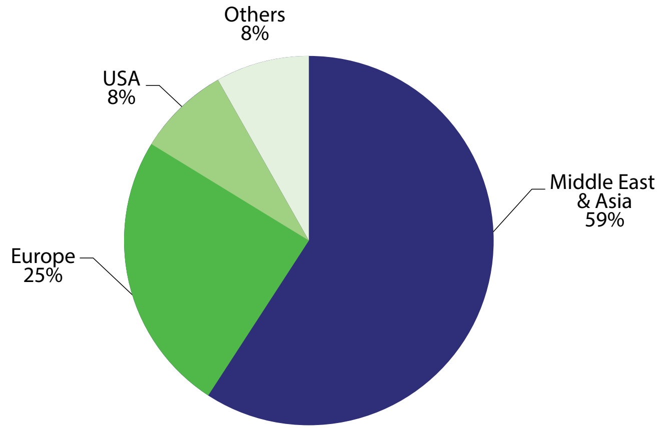
The governments of South Africa and Senegal issued their debut sukuk in 3Q2014. The Senegalese government issued an XOF100bln (USD200.5mln) sukuk in July 2014, to finance its budgeted spending for the year. The Ijarah sukuk utilised three government buildings as underlying assets. The government of South Africa also issued an Ijarah sukuk valued at USD500mln, which was oversubscribed by more than four times[9] and had benefitted from strong demand especially from Middle Eastern and Asian investors.

Landmark Sovereign Sukuk Issuances from Africa in 2014

Issuer	Structure	Currency	Issue date	Issue Size (USD mln)	Tenor (Years)
Government of Senegal	Ijarah	XOF	18 Jul	200.5	4
Government of South Africa	Ijarah	USD	24 Sep	500	5.75

Source: Bloomberg, IFIS, Zawya, KFHR

South Africa Sukuk: Investors by Region



Source: National Treasury of the Republic of South Africa, KFHR

[8] IFIS
[9] IFIS

Investment financing

In addition to sovereign issuers, several corporations have also tapped the sukuk market, namely in Sudan. A cement company had issued a USD130mln Musharakah sukuk in 2007, as part of a package to finance the construction of a new cement plant. With a total cost of USD200mln, the company's advisors recommended a Shariah-compliant debt structure to improve the company's chances of borrowing from investors who preferred Shariah-compliant instruments. The sukuk was fully-subscribed by several major GCC companies, including financial institutions.

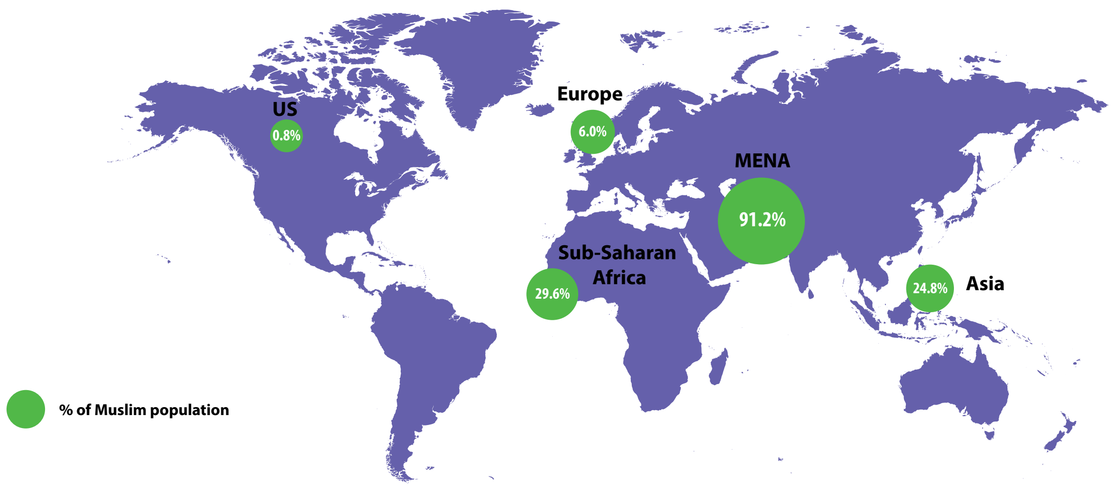
Corporate sukuk remain as a relatively untapped instrument in Africa. In part, this reflects a wider global trend where sovereign and government-related entities dominate the sukuk market, due to their bigger funding needs. Nevertheless, it is likely that the favourable economic prospects amid the recent launches of benchmark sovereign sukuk in Africa will create more opportunities for corporate issuers. There is notable potential in the commodities and halal sectors in Africa.

While Africa is a major producer of both agricultural and mining commodities, much of its potential remains untapped. Today, the region accounts for 10% of the world's oil reserves, 40% of gold, and 80-90% of chromium and platinum metals[10].

In addition, 60% of the world's uncultivated arable land is located in parts of Africa. The potential to increase commodity production has attracted investments from major economies as well as global food conglomerates[11]. There is potential for Islamic finance to play a role in investment financing, especially in countries which intend to diversify sources of funding. In Malaysia and Singapore, key commodity producers in food and palm oil have tapped the sukuk market regularly, including cross-border issuances. In particular, several Singapore-listed companies issued ringgit-denominated sukuk in Malaysia over the past few years, in light of competitive funding costs and a ready pool of investors seeking Shariah-compliant investment avenues.

Similarly, the halal industry, encompassing food, travel and lifestyle products has great potential in Africa. Sub Saharan Africa has a large share of Muslim population at 29.6%, comparable to 24.8% in Asia. Today, amongst the top five Muslim food markets is located in Egypt, with a total market value of USD88bln[12]. As the African consumer benefits from the region's growing wealth, it is likely that demand for halal products will increase. Importantly, halal producers may prefer Islamic finance to ensure end-to-end Shariah-compliance of the business.

Share of Muslim Population by Region (2014E)



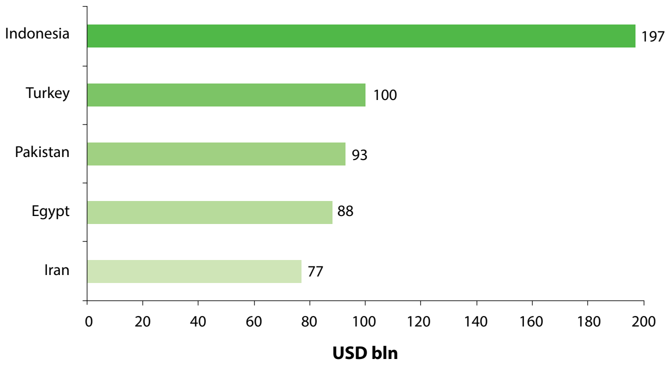
Source: KFH Research, Pew Research (2011), World Bank (2013)

[10] "Lions on the move: The progress and potential of African economies", McKinsey Global Institute (June 2010)

[11] "Commodities: Destination Africa", Financial Times (November 2013)

[12] Thomson Reuters (2013)

Top Muslim Food Consumption Markets



Source: Thomson Reuter 2013

In 2012 and 2013, several Saudi Arabian food producers had issued sukuk to finance capital investment and other general purposes. The Savola Group, a multinational food manufacturer, issued a SAR1.5bln (USD399.2mln) investment sukuk which was oversubscribed by almost three times. In addition, Al Marai, the world's largest vertically integrated dairy company issued three sukuk between 2012 and 2013 to fund its capex plans, including a perpetual sukuk valued at SAR1.7bln (USD453.2mln).

Financial inclusion

Islamic banking has made notable progress in some parts of Africa, spurred by demand from both Muslim and non-Muslim populations. In some countries, the set-up of Islamic banks are encouraged, to widen access to finance especially for the Muslim population; such as in Nigeria and Djibouti. According to a Gallup poll in 2011, 22.8% of Muslim Djiboutians who do not have account have cited religious reasons – one of the highest amongst the countries in the poll. Nigeria now has one full-fledged Islamic bank, which serves a Muslim-dominated population of 173.6mln, suggesting potential for more Islamic banks to set-up. Meanwhile, both South Africa and Kenya have welcomed Islamic banks, and products have been marketed towards non-Muslims. In Egypt, which was one of the pioneers of Islamic finance, there are only three full-fledged Islamic banks serving the population.

Of importance, the growing potential of Islamic finance in Africa has attracted the attention of international Islamic banking players. Bahrain's Al Baraka Bank, for example, has expanded operations to Egypt, Tunisia, Morocco, and Libya[13]. In Tunisia, for example, there are 10 branches, with 15 more planned by end 2015. The bank's entry into Morocco was made possibly by a new Islamic banking law, which is expected to support the further development of Islamic finance in the country; the bill will allow for local and foreign banking institutions to set up Islamic banking branches in Morocco[14]. In 2014, Dubai Islamic Bank announced plans to open an Islamic bank in Nairobi, Kenya, citing the demand potential and regulatory support as key factors[15].

In other developments, Burkina Faso's Coris Bank International (CBI) has announced its decision to launch a Shariah-compliant window in 2015[16], paving the way for it to become the pioneering financial institution in the West African republic to offer Islamic banking services.

Overall, these encouraging developments point to a continued gradual expansion of Islamic banking in Africa, which would ultimately improve access to finance for the population, especially for a sub-segment of the populace that abstains from formal financial services due to Shariah-compliance reasons.

Challenges for the future growth in Islamic finance include the overall safety and stability of the region – concerns on political crises and civil strife[17] need to be managed in order to support investor

13 "Bahrain's Al Baraka Islamic bank sees new scope to expand", Reuters (February 2014)
14 "Moroccan parliament approves Islamic finance legislation", Reuters (November 2014)
15 "Dubai Islamic Bank Eyes Expansion Into African Markets", Ventures (March 2014)
16 "Burkina Faso set to welcome first institution offering Islamic financial services next year", Islamic Finance News (October 2014)

confidence. In terms of acceptance of Shariah-compliant financial services, the growth of Islamic finance in predominantly non-Muslim nations of South Africa and Kenya, while encouraging, may not reflect easy acceptance in the less-developed parts of the region. The awareness on the value propositions of Islamic finance particularly from the consumer point of view, given the retail banking potential in this region, is thus critical. An important part of this process is the level of understanding and capability of the financial regulators to regulate and spur the development of this alternative financial segment in their respective jurisdictions. Legislations and supervisory frameworks specific to Islamic finance need to be in place to support the viability of Islamic financial products and the stability of the Islamic financial system in Africa. To date, several jurisdictions have made headways in terms of drafting and approving laws specific to Islamic finance, such as Sudan[18], Morocco[19] and Kenya[20]. Meanwhile, many jurisdictions do not have specific laws on Islamic finance, instead allowing for product approvals on an ad hoc basis.

Conclusion

Today, Africa accounts for more than 2% of global Islamic banking assets (1H2014) and 0.5% of sukuk outstanding (2014)[21] . In the banking industry, Africa has attracted investments from international Islamic banks due to its strong potential in retail banking. Meanwhile, recent debut sukuk issuances by African governments were part of a funding diversification strategy.

Apart from industry-based developments, Africa has witnesses developments relating to multilateral bodies' involvement in Islamic finance, for example financing provided by the Islamic Development Bank (IDB). Broadly, the IDB supports infrastructure development as well as private sector expansion, in part by providing Shariah-compliant funds. The multilateral institution also provides technical support for these aims. The IDB Islamic financing facility has been utilised by more than 10 African nations, including Morocco, Senegal, Burkina Faso, Uganda, Niger, Cote d'Ivoire, Mozambique, Gambia, Egypt and Tunisia[22].

The expansion of Islamic finance in Africa has led to increased representation in the Islamic Financial Services Board (IFSB), by both financial institutions and regulatory authorities. As of December 2014, African countries with a presence in the IFSB include Egypt, Sudan, Nigeria, Morocco, Djibouti, Senegal, Libya and Kenya[23]. In May 2014, the IFSB Summit was held in Mauritius, nascent Islamic finance jurisdiction. Prior to this, IFSB also held a seminar entitled "The Role of Islamic Finance in the Development of Africa" in September 2012.

In the area of enhancing market development, the AfDB inked a Memorandum of Understanding (MoU) with the International Islamic Liquidity Management Corporation (IILM) in 2013 to promote liquidity management, which would support the development of sukuk market in the region. At present, the Central Bank of Gambia is a fairly active issuer of short-term Salam sukuk for liquidity management. Meanwhile, measures to support the human capital aspect of Islamic finance have been nascent. In February 2014, the Kenya School of Monetary Studies (KSMS) - a training institution run by the Central Bank of Kenya (CBK) - has introduced a course in Islamic banking.

Going forward, Africa is expected to attract more Islamic finance players, in light of its robust economic prospects and rising consumer base. Islamic banking is likely to benefit from the expected rise in retail demand. Meanwhile, sukuk issuances by both infrastructure and corporates may pick up, to support the region's infrastructure and business investment needs.

17 "Lions on the move: The progress and potential of African economies", McKinsey Global Institute (June 2010)
18 Sudan's financial system is fully Shariah-compliant (Source: IFSB Islamic Financial Services Stability Report, 2013)
19 "Moroccan parliament approves Islamic finance legislation", Reuters (November 2014)
20 "Kenya's market overhaul eyes Islamic finance framework", Reuters (March 2014)
21 KFHR
22 IFIS
23 IFSB website