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Briefing note

Spring 2013

Introduction to Islamic project finance

Overview

The market for *Shari'a* compliant project finance in the Middle East has grown significantly over the past decade, with a number of landmark transactions being closed in the region. Whilst the last couple of years has seen some challenging times for raising both conventional and Islamic project finance, there is renewed optimism for 2013, with a strong pipeline of deals expected.

The origins of Islamic funding in project financing transactions can be traced back to the early 1990s, to the US$1.8 billion Hub River power project in Pakistan which involved a US$92 million Islamic tranche and where Clifford Chance acted for the financiers. Since then, there have been numerous Islamic project financings, mostly in the GCC, with size and frequency both continuing on an upward trend.

What distinguishes the Islamic project finance market from both the general Islamic banking and *sukuk* markets is that it is common to see Islamic tranches integrated within a much wider 'multi-sourced' financing arrangement. This typically involves the Islamic banks coming in alongside the conventional lenders, multinational development banks and export credit agencies. The structuring and implementation of an Islamic tranche as part of a wider multi-sourced financing arrangement is challenging for project financiers and sponsors alike. Integrating *Shari'a* compliant financing solutions - in a manner which adheres to traditional project financing principles - typically requires the Islamic banks to assume a pro rata and pari passu position with the other senior lenders, whilst adhering to *Shari'a* principles (outlined in our *"Introduction to Islamic Finance"* Client Briefing).

However, conventional funding is not always involved and 2006 saw the first wholly Islamically financed project financing, the US$526 million Al-Waha petrochemical project. More recently, Jabal Omar Development Company obtained SAR5 billion of Shar'a compliant funding for its mixed use project in the holy city of Makkah, Saudi Arabia.

Recent deals

Clifford Chance is proud to be at the forefront of the Islamic project finance industry and in 2012 our Middle East banking and projects team was awarded "Project Finance Team of the Year" at the IFLR Middle East Awards.

The team has won numerous other awards for its achievements in the Islamic finance industry, including Best Islamic Law Firm at the Triple A Islamic Finance Award 2012.

Islamic project finance transactions on which Clifford Chance has advised include:

- **Jabal Omar Development Company -** advising a syndicate of banks in Saudi Arabia including Al Rajhi Bank, Bank AlJazira, Bank Al Bilad, The National Commercial Bank, The Saudi British Bank and Saudi Hollandi Bank in relation to a SAR5 billion multi-tranche financing based on wakala and procurement structures with integrated forward lease (*ijara*) financing components for a mixed use hotel, retail and residential construction project in the holy city of Makkah, Saudi Arabia.
- **Acrylates complex -** advising the financiers on the US$1.4 billion financing of an integrated acrylates petrochemicals complex located at the Jubail Industrial City in the Kingdom of Saudi Arabia and related infrastructure, sponsored by National Industrialisation Company, Sahara Petrochemicals Company, The Dow Chemical Company and Evonik Industries AG and implemented through Saudi Acrylic Acid Company, Saudi Acrylic Monomers Company and Saudi Acrylic Polymers Company as Project

Key issues

companies. The multi-sourced US$1.4 billion financing combined an Islamic *ijara* facility, an Islamic *wakala* facility, a procurement facility, a facility to be provided by the Public Investment Fund of Saudi Arabia and a facility to be provided by the Saudi Industrial Development Fund.

- **Ma'aden Aluminium Company** - advising the Islamic financiers (in addition to the conventional financiers) on the project financing of a US$5.01 billion aluminium smelter plant, casthouse and related infrastructure forming part of what will be the largest fully integrated aluminium complex in the world, to be developed by Ma'aden Aluminium Company (a joint-venture between the Saudi Arabian Mining Company (Ma'aden) and Alcoa Inc). Awarded "Project Finance Deal of the Year" and "Saudi Arabian Deal of the Year" in the Islamic Finance News Awards 2010. Also awarded "Middle East Metals Deal of the Year" for 2010 by Project Finance Magazine and "PFI Middle Eastern Industrial Deal of the Year".
- **Ma'aden Rolling Company** - advising the Islamic financiers (in addition to the conventional financiers) on the project financing of a US$2.52 billion aluminium rolling mill and related infrastructure located at Ras Az Zawr in Saudi Arabia, to be developed by Ma'aden Rolling Company (a joint-venture between Ma'aden and Alcoa Inc).
- **Arabian Amines Company** - advising the project company and its shareholders, Huntsman Corporation and The Zamil Group, on the US$195.4 million financing of an ethyleneamines facility in the Kingdom of Saudi Arabia. This project financing was done on a purely Islamic basis. Awarded "Best Islamic Project Finance Deal" at The Asset Triple A Awards 2010.
- **Ma'aden Phosphate Company** - advising the Islamic financiers (in addition to the conventional financiers) in connection with the two Islamic tranches totalling US$1.8 billion as part of a US$5.5 billion project financing in the Kingdom of Saudi Arabia. This deal involved the largest Islamic financing to date in a project financing and was awarded "Project Finance Deal of the Year" at the IFLR Middle East Awards 2008.
- **Advanced Polypropylene Company** - advising the project company on the US$330 million Islamic refinancing of a private petrochemical project in the Kingdom of Saudi Arabia.
- **Saudi Polyolefins Company** - advising on the refinancing of a Saudi petrochemical project involving a US$400 million *ijara* and US$175 million murabaha financing.
- **Saudi Kayan Petrochemical Project** - advising the project company on the US$6 billion financing package for the development of a US$10 billion petrochemical complex (the world's largest) to be built in Jubail Industrial City, Kingdom of Saudi Arabia. This project financing included an *Istisna'a* / *ijara* tranche of approximately US$1.03 billion which, at the time of signing, was the largest ever *ijara* facility provided in a project financing. The financing package also included a US$644 million Islamic working capital facility.
- **Rabigh Refining and Petrochemical Company** – advising the Islamic financiers in connection with the US$600m Islamic tranche of a US$9.8 billion project financing in the Kingdom of Saudi Arabia. This deal was awarded "Project Finance Deal of the Year" for 2006 by IFLR.

Islamic structuring

The manner in which an Islamic project financing is structured will largely be determined by the nature of the project itself, particularly whether it is a 'brownfield' project or a 'greenfield' project. Islamic funding on brownfield projects is typically structured on the basis of a straightforward sale and leaseback (*ijara*) arrangement - the project company will often have assets in existence that it can sell to the Islamic banks, and which the project company can then lease back by paying a rental which replicates the economics of a project financing arrangement.

One of the preferred techniques for structuring a greenfield Islamic project financing is to combine the use of an *Istisna'a* arrangement (or a variation thereof) with an *ijara* arrangement. These structures are examined in greater detail below.

***Istisna'a* -** a traditional *Istisna'a* is, in essence, a sale contract whereby one party undertakes to manufacture a specific asset according to certain agreed specifications. The price of the asset and the date of delivery are specified at the outset. The liability of the purchaser to pay the price and the liability of the developer to deliver the assets are deferred to a future specified date or, in the case of payment, the instalment dates.

Although traditional *Istisna'a* contracts have been used successfully for infrastructure projects, they effectively require the financiers to enter into a construction contract directly with the contractor. This fundamentally changes the risk profile of a project financing for the financiers who, by entering into a direct contractual relationship with the contractor, would be taking an additional risk in the form of the credit and performance risk of the contractor itself. As a consequence, the use of the traditional *Istisna'a* has become extremely rare and the market has moved favourably towards the sub-contracting and procurement variants with a view to mitigating such risks.

Procurement - under a procurement arrangement (which essentially combines elements of *Istisna'a* and *Mudaraba*), the project company agrees with the financiers to procure the manufacture/construction and delivery of the project/assets being financed. The Islamic financiers will have a direct contractual relationship with the project company, pursuant to which it is recognised that the project company will be procuring the assets from the relevant EPC contractors. Where the procurement arrangement is only part of a wider (multi-tranche) financing (including, for example, a wakala facility), the financiers and the project company may not necessarily agree detailed specifications of the project/assets in the procurement agreement itself, opting instead to simply reference the underlying EPC contracts, specifications and overall percentage of the project assets to be funded by the procurement tranche. Procurement arrangements do, however, still require that the project company be under a strict obligation to deliver the project/assets to the financiers on time and to specification.

The use of an *Istisna'a* or a procurement arrangement raises a number of issues which require detailed consideration:

- title to the assets will be transferred (directly or indirectly) to the financiers upon delivery - this is typically stated to occur only at project completion, with partial delivery of assets not permitted. The financiers will then be responsible for all rights and obligations associated with ownership, for example, the obligation to effect insurance and the risk associated with loss, environmental liability and third party claims;
- neither of these products provides a return to the financiers - it is therefore necessary to combine its use with that of another product (typically *ijara* - see below);
- where the project company fails to deliver the assets (either by the agreed delivery date or at all), or the assets are damaged or destroyed prior to delivery or the project company is otherwise in breach of its obligations, the remedies available to the financiers need to be carefully considered; and
- the interaction of the 'financing structure' (pursuant to which the financiers agree to provide financing and 'pay' for the costs of construction of the assets of the project) and the traditional construction arrangements may give rise to EPC warranty issues, tax and/or accounting concerns.

It will also be necessary to carefully evaluate each of the issues identified above within the framework of applicable laws in the relevant jurisdiction(s).

***Wakala* –** although less common than Istisna'a and procurement structures, we have also seen wakala structures used on a number of project financing transactions. Although several features are similar to Istisna'a and procurement structures, the risk profile is greater as a wakala arrangement involves the appointment of the project company as *wakeel* or agent of the financiers to enter into the EPC contracts on their behalf for the relevant project. Importantly, the assets being financed under the wakala arrangement must be expressly identified and must be predominantly financed by the 'wakala participants'.

Whilst the above structures describe how payments are made to the project company during the construction period, it is also important to look at the mechanism through which repayments to the project financiers are made.

The role of ijara in Islamic project finance

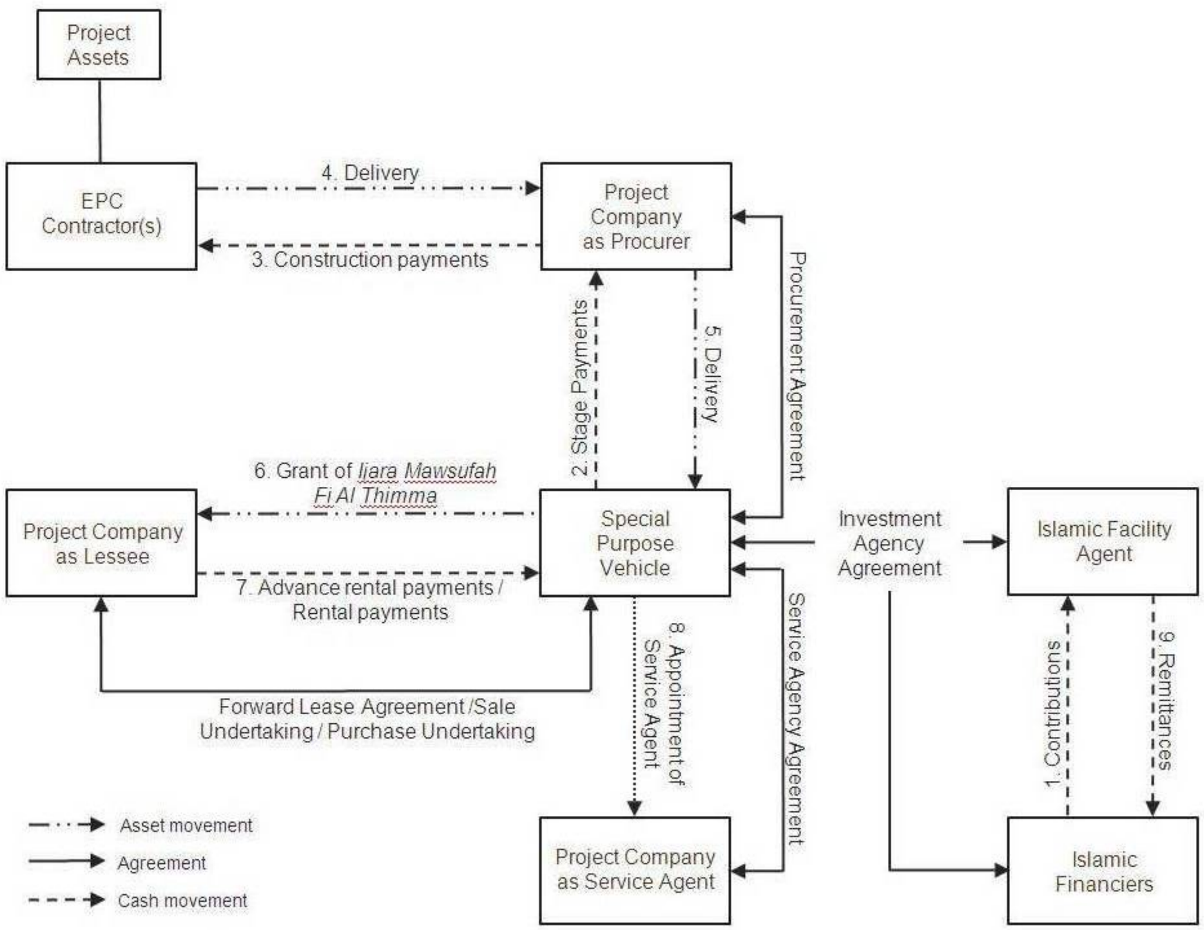
An ijara is the Islamic equivalent of a lease and a hybrid between an operational lease and financing/capital lease. It offers the certainty of regular payments throughout the life of the financing with the flexibility of tailoring payment instalments in a manner that allows for financiers to achieve a profit margin structure comparable to that of conventional financiers.

The traditional *ijara* involves the lease of an existing physical asset and is typically used, in the form of a sale and leaseback arrangement, for the purposes of financing brownfield projects. For the purposes of greenfield projects, and in order to enable the financiers to receive a return during the construction period, certain scholars have permitted the use of a forward lease arrangement (known as *ijara Mawsufah Fi Al Thima* or *ijara Fil Thimma*), whereby 'advance' rental payments are made prior to project completion and 'actual' rental payments commence from project completion. The strict proviso attached by the scholars to the use of forward lease structures is that, if delivery of the asset to be leased never occurs (and therefore the lessee never has the benefit of that asset), the lessor (i.e. the financiers) must refund all advance rental payments that have been made to it by the lessee (i.e. the project company). This obviously presents an unsatisfactory scenario for the financiers and increases the importance of clear remedies under other parts of an Islamic project finance structure (see commentary above regarding *Istisna'a* or procurement arrangements).

Ijara combined with Istisna'a or procurement - the *ijara* is typically combined with the *Istisna'a* or procurement arrangement, such that:

- an *Istisna'a* or procurement contract acts as the funding instrument whereby payments are made by the financiers to the project company or to EPC contractors (at the order of the project company) during the construction period - this occurs in the same manner as utilisations / drawdowns would be effected in a conventional project financing and is often subject to exactly the same kind of conditions and milestones;
- an *ijara* or *ijara Mawsufah Fi Al Thima* enables the financiers to generate a return from the project which replicates the economics of the arrangements typically associated with conventional project financing. Whilst the forward lease arrangement is normally entered into at the same time as the *Istisna'a* or the procurement contract (i.e. at a time when there is no physical asset in existence and its construction is being commissioned), actual leasing itself does not commence until the asset has been delivered;
- once the assets have been delivered and leasing has commenced, service arrangements become effective whereby the financiers appoint the project company as its service agent in order to (among other things) insure the assets, to be responsible for major maintenance and manage other ownership-related tasks; and
- any purchase and sale undertaking arrangements (documenting termination and prepayment rights) also become effective once the assets have been delivered.

Set out below is a diagrammatical overview of how a combination of the procurement and *ijara Mawsufah Fi Al Thima* structure would typically work:



Structural considerations

Special Purpose Vehicle (SPV)

Although the use of a special purpose vehicle may help overcome issues preventing foreign ownership (in jurisdictions where such restrictions apply), it is questionable whether it would provide any significant mitigation to the asset risk which the financiers assume. Although the direct asset risk to the financiers is one step removed, analysis would need to be undertaken in each particular case and in the context of the relevant jurisdictions, as to whether the corporate veil of the special purpose vehicle could be pierced and therefore whether the shareholders (which are likely to be some of the financial institutions participating in the Islamic facility) of the special purpose vehicle could be held liable. In any case, the shareholders of the special purpose vehicle, particularly if they are any of the financial institutions participating in the Islamic financing, will expect to be indemnified by the wider bank group for their liabilities as shareholders.

In addition to the overall perceived benefit, the use of a special purpose vehicle does raise a number of structuring issues, mainly related to the impact of the intervening special purpose vehicle on the contractual relationships between the financiers and the project company. In the context of the structures described above, the special purpose vehicle will hold title to the leased assets and will be the project company/lessee's contractual counterparty under the Istisna'a or procurement contract and the forward lease agreement. As with conventionally structured finance transactions, a careful assessment of the consequences of the involvement of the special purpose vehicle is necessary, in each case, in order to ensure that no incremental 'legal risk' is added as a result of the addition of the special purpose vehicle.

These uncertainties can be even greater in the case that regulatory requirements or tax concerns require that the special purpose vehicle be incorporated in a jurisdiction identical to that of the project company and/or physical location of the leased assets. In such cases, the relevant jurisdiction may not be the most advantageous for setting up the special purpose vehicle for example, the costs of maintaining the corporate existence of the vehicle may be greater, and it may be more difficult to ensure the bankruptcy remoteness of the vehicle.

Acceleration

In a default scenario due to an event of default of the lessee or otherwise, the financiers will typically have the benefit of a purchase undertaking from the project company which serves as a method of accelerating payment on an *ijara*-based Islamic tranche. The financiers may exercise their rights under the purchase undertaking and require the project company to purchase the leased assets for an exercise price (typically equal to the aggregate of all amounts outstanding under the Islamic tranche). The actual transfer of title to the assets will often not take place until the exercise price has been paid to the financiers and the Islamic debt satisfied in full. However, by exercising the purchase undertaking the financiers will have a claim against the project company for an amount that is immediately due and payable and will thus have a claim in the proceeds of any security package available on the wider project financing.

Total Loss

Where the project financing relies upon an *ijara*-based component, one area of concern is the impact that a total loss of the underlying project/assets (that is if the project/assets are destroyed, damaged beyond repair or otherwise completely lost) will have on the leasing arrangements. *Shari'a* requires that the lease arrangements be terminated with immediate effect upon the occurrence of a total loss and that any purchase undertaking in respect of those assets becomes ineffective as a result. In order to mitigate this risk, the financiers typically appoint the project company as their service agent / service provider and require it, in such capacity, to maintain insurances in respect of the full replacement value of the project/assets. Upon the occurrence of a total loss, the project company (as service agent or service provider) will be under an obligation, within a given timeframe, to provide the financiers with the proceeds of the insurance. In the event that the proceeds are less than the full replacement value of the assets, the project company will have failed to comply with its strict insurance obligations (as service agent or service provider) and will be liable to indemnify the financiers for any shortfall.

Third Party and Environmental Liabilities

It is a common concern amongst financiers that they manage to mitigate and/or avoid the risks of third party or environmental liabilities that could arise during the construction or operation periods of a project. Unfortunately, this is not easy to achieve where the financiers have an ownership interest in some, or all, of the project assets. Whilst it is typical for the project company to provide indemnities in favour of the Islamic financiers, this alone is often not enough to make the financiers comfortable with the risk they are assuming and additional protection is sometimes sought through specific insurances or the use of a special purpose vehicle (considered above). This becomes a difficult but important issue to be resolved on multi-sourced financings - in order to ensure that the Islamic financiers are in the same position as the conventional financiers.

Pari Passu and Pro Rata

On multi-sourced financings it is particularly important that all financiers, Islamic and conventional, are treated equally to the extent possible. This typically involves the Islamic and conventional tranches being co-ordinated in a manner whereby all utilisations (other than under a wakala tranche) and prepayments are addressed *pro rata* across the facilities and that all payment obligations in respect of the facilities rank *pari passu* at all times. Such principles are fundamental to project financing structures and usually require careful structural consideration on any Islamic tranche.

Innovative Structures

Despite the obvious popularity, and suitability, of the *ijara* to Islamic project financings, a key concern with its use is that, upon an insolvency of the project company, the courts in certain GCC jurisdictions (such as Saudi Arabia) may find that either (i) the lease arrangement is a 'disguised' loan agreement and therefore not compliant with *Shari'a* or that (ii) the fixed lease rental payments are in excess of the market rate for similar assets and thus order the rental payments to be reduced or refunded accordingly.

These risks have, on some transactions, prompted financiers to look at alternative ways of restructuring the basis of their compensation through *ijara* arrangements which are combined with purchase and/or sale arrangements. For example, under a co-ownership structure it is possible throughout the term of the *ijara* for the financiers to sell incremental units of their ownership interest in the leased assets to the project company. As, and when, portions are sold to the project company the financiers will continue to lease to the project company a decreasing share of the leased assets, with payment streams under the lease and the purchase undertaking being structured accordingly.

Tax Considerations

It should be noted that transfers of title to assets, first from the contractor to the financiers (or special purpose vehicle) and then (upon repayment of the facilities) from the financiers to the project company, may have tax implications which need to be carefully examined on a jurisdiction-by-jurisdiction basis. Additionally, thought will also need to be given to whether the lease payments themselves would be subject to withholding tax and indeed whether the lease payments should be accounted for as a debt financing arrangement or otherwise both for the project company (in terms of amortisation of the leased assets and for tax deductibility of the lease payments) and for the financiers (in terms of accounting for rental payments).

Outlook

There are a number of additional issues to consider when looking at *Shari'a* compliant project financing. The demand remains strong, however, driven by the large liquidity of Islamic financiers and a greater appetite to fund projects (particularly in the GCC region) in a *Shari'a* compliant manner where possible.

The size of some projects will necessitate multi-sourced funding, though there is increasingly a shift to projects that are funded without any conventional funding.

To help mitigate some of the additional risks associated with *Shari'a* compliant project financing, *Shari'a* scholars have become increasingly amenable to *Shari'a* compliant hedging arrangements. As the Islamic structured products market continues to mature and novel *Shari'a* compliant hedging instruments are further developed, it is expected that Islamic financiers on project financings will look increasingly towards such products as potential solutions to some of these issues.

Whilst *takaful* (*Shari'a* compliant insurance) products have been available in the market for some time, they tend to be more expensive and more restrictive (in terms of pricing and the range of risks covered) than the equivalent conventional insurance products. As such, certain scholars have allowed entities to obtain conventional insurance in relation to project financings. We do, however, expect a greater emphasis to be placed on obtaining *takaful* for project financings as the *takaful* market develops and reaches a stage where it is competitive with conventional insurance products (both in terms of pricing and the range of risks covered).

As the size and volume of energy, power, infrastructure and other projects in the Middle East (particularly the GCC) continues to grow, there is a concern that international banks, which provide the majority of financing for such projects, may be constrained in their ability to provide finance due to their own specific risk-allocation ceilings. To address this concern, and to diversify the funding techniques used in project financings, it is likely that the market will look towards alternative means of raising capital. A key cornerstone of the Islamic finance industry has been the development and growth of the *sukuk* market - a market which now has global reach and appeal to both Muslim and non-Muslim investors. Whilst the use of *sukuk* in project financings has been fairly limited to date (e.g. the US$1 billion project *sukuk* issuance by SATORP), it is expected that an increasing number of projects will look to raise capital, in whole or in part, through the capital markets in the form of a *sukuk* issuance. The use of a *sukuk* structure, or a combination of one or more *sukuk* structures, is well suited to project financings - particularly brownfield project financings where, as discussed earlier in this briefing, there is usually a pool of assets available for Islamic structuring purposes. The growing international demand for *sukuk*, coupled with an investor base which, in comparison to banks, is much less restricted in both number and limits on the amounts which can be invested, makes the use of *sukuk* an ideal alternative to bank debt. As such, we expect that project companies will increasingly use *sukuk* to diversify their project cost and sources of funding going forward.

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