Herbert Smith

Islamic Finance techniques relevant to Projects; Case Studies; Utilization in Iran to PPP

Nadim Khan, Partner, Herbert Smith LLP
July 2010

Herbert Smith

Herbert Smith in association with
Gleiss Lutz and Stibbe

Contents

Understanding the Current Mood

Why is Islamic finance en vogue?

- Growth in the Middle East
- Large pool of liquid funds looking for investments that accord with religious beliefs
- Pressures on margins in traditional markets
- Islamic finance is a credible alternative – major deals closed in the past five years
- Socio-Political dimension
- Islamic economic theory fully supports financing in many industrial sectors where they add value and benefit to society
- Right deal, right place, right time …

Islamic finance in perspective

- 1.2 billion Muslims (20% of the global population)
- Islamic financial assets now estimated $800 billion - $1 trillion
- Liquid funds in Middle Eastern Islamic markets are estimated around $12 billion
- Market has been enjoying double digit growth year on year over most of this decade
- Interest in non-Muslim jurisdictions - up to 40% of GCC Sukuk issuances are subscribed for by non-Islamic investors in Asia and Europe

Islamic Project Finance structures and techniques: Ijara based techniques

The fundamental structures: leasing

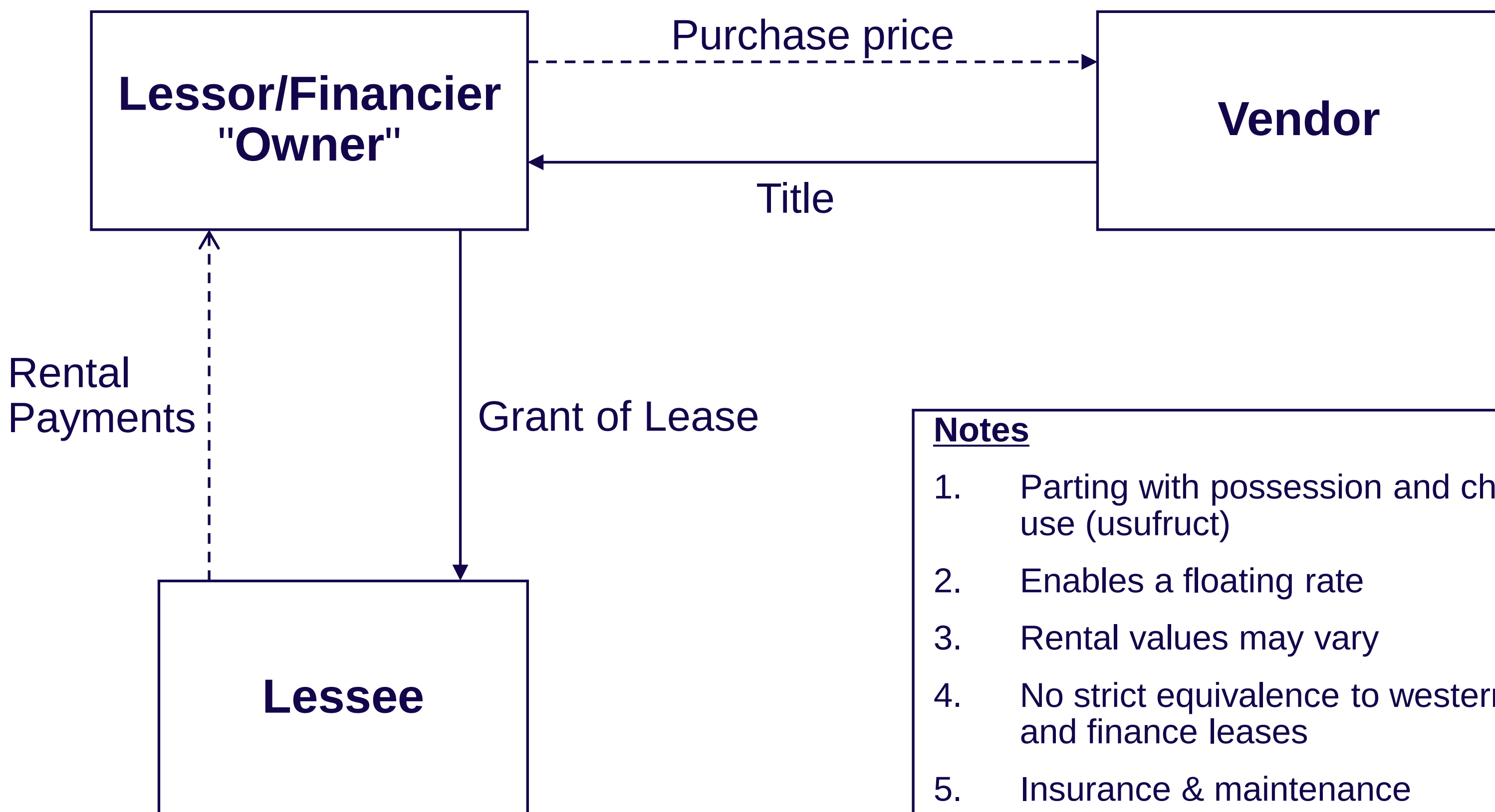
Ijara Leasing

- **The legal background** – *Shari'ah* recognises the principle of *usufruct* – that the owner of an asset may part with possession of that asset and charge a third party for use of that asset

- Leasing techniques have developed steadily since 2000

- **The modern imperatives** – there are two reasons why leasing is critical to the future development of Islamic finance:
  - **floating rate** – offers the ability to compete with conventional products on pricing and tenor
  - **asset based** – retaining a "ownership interest" in the asset allows the Islamic financier to participate in many deals that would not otherwise be capable of being financed

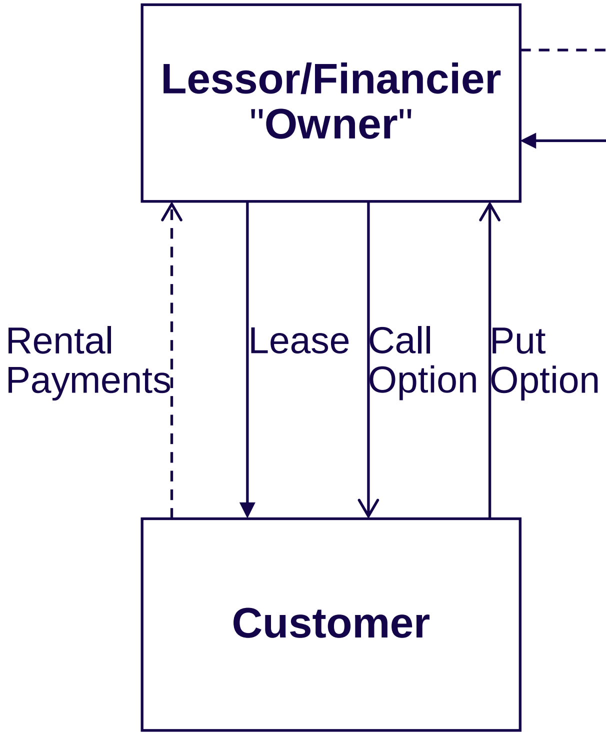
Ijara (operating lease)



Notes

1. Parting with possession and charging for use (usufruct)
2. Enables a floating rate
3. Rental values may vary
4. No strict equivalence to western operating and finance leases
5. Insurance & maintenance

Ijara wa Iktina – leasing with a purchase option (finance lease)



Notes

1. As for the *Ijara*
2. Call option granted in a separate contract
3. On exercising the call the Lessee can make a final payment to acquire title to the asset
4. Put option used on default termination

Finance lease or *Ijara wa Iktina*

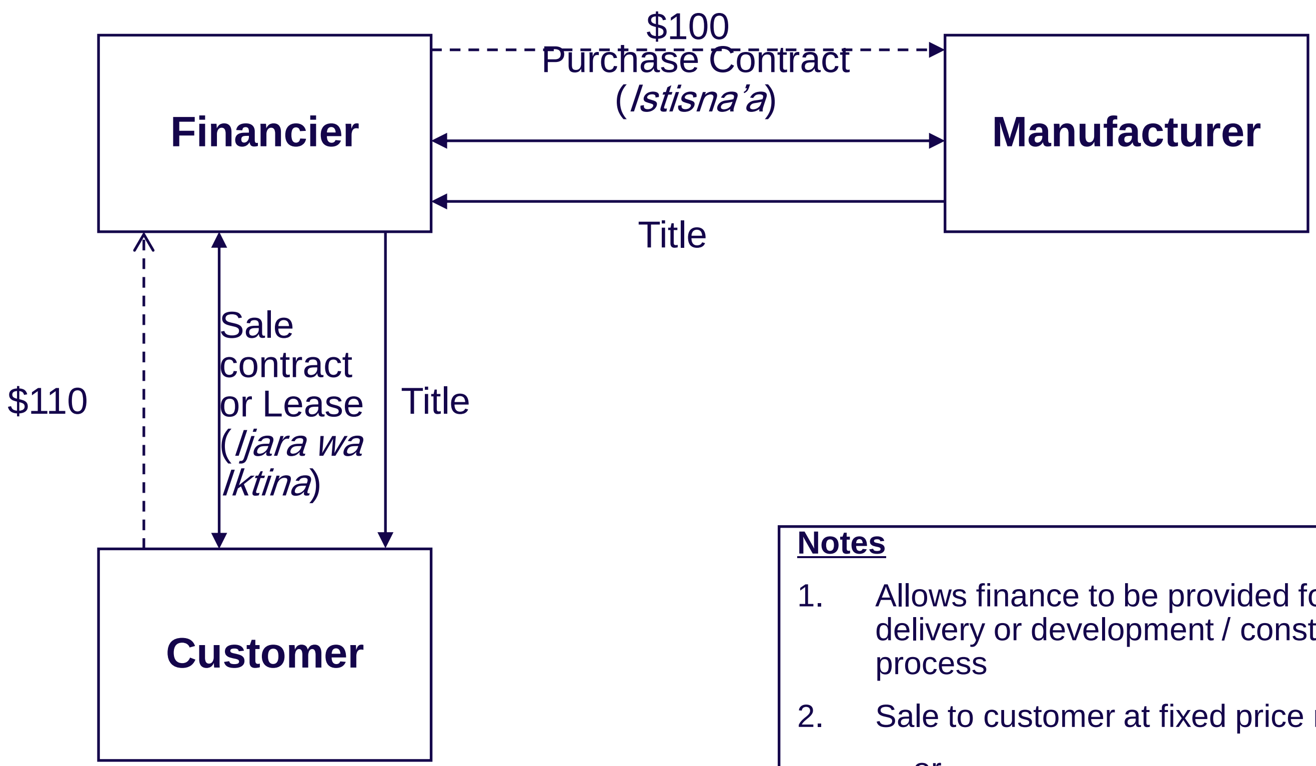
Some characteristics

- Lease of asset
- Capable of having long tenor
- Call option for project company
  - at end of lease
  - Through period of lease to effect “prepayments”

- Put option for Islamic investors
  - at end of lease
  - on Enforcement Event

Islamic Project Finance structures and techniques: The Istisna'a

Istisna'a (development financing)



Notes

1. Allows finance to be provided for pre-delivery or development / construction process
2. Sale to customer at fixed price mark up

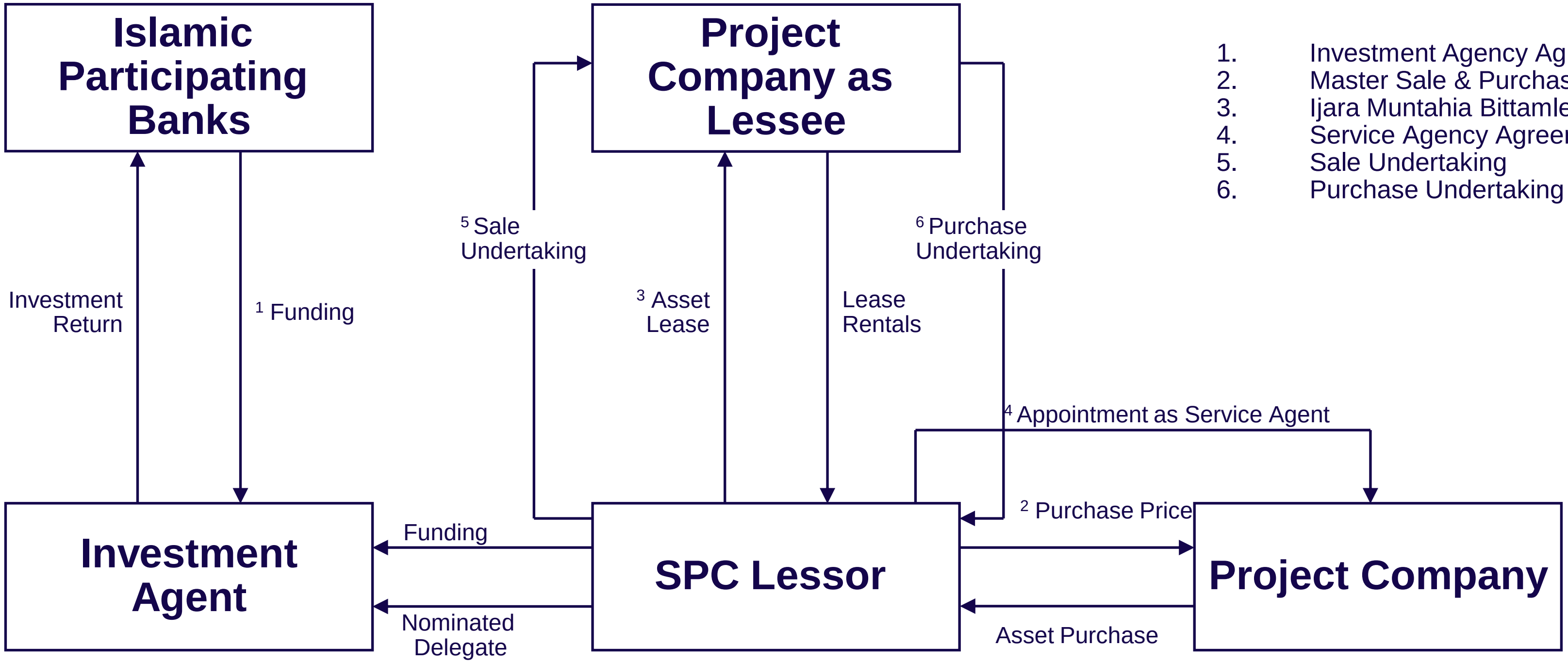
   or

3. Lease to customer for longer term financing (*Ijara wa Iktina*)

Practical application of lease based techniques

1. Financing to an existing plant

Ijara Muntahia Bittamleek (existing asset lease structure)



1. Investment Agency Agreement
2. Master Sale & Purchase Agreement
3. Ijara Muntahia Bittamleek
4. Service Agency Agreement
5. Sale Undertaking
6. Purchase Undertaking

Practical application of lease based techniques

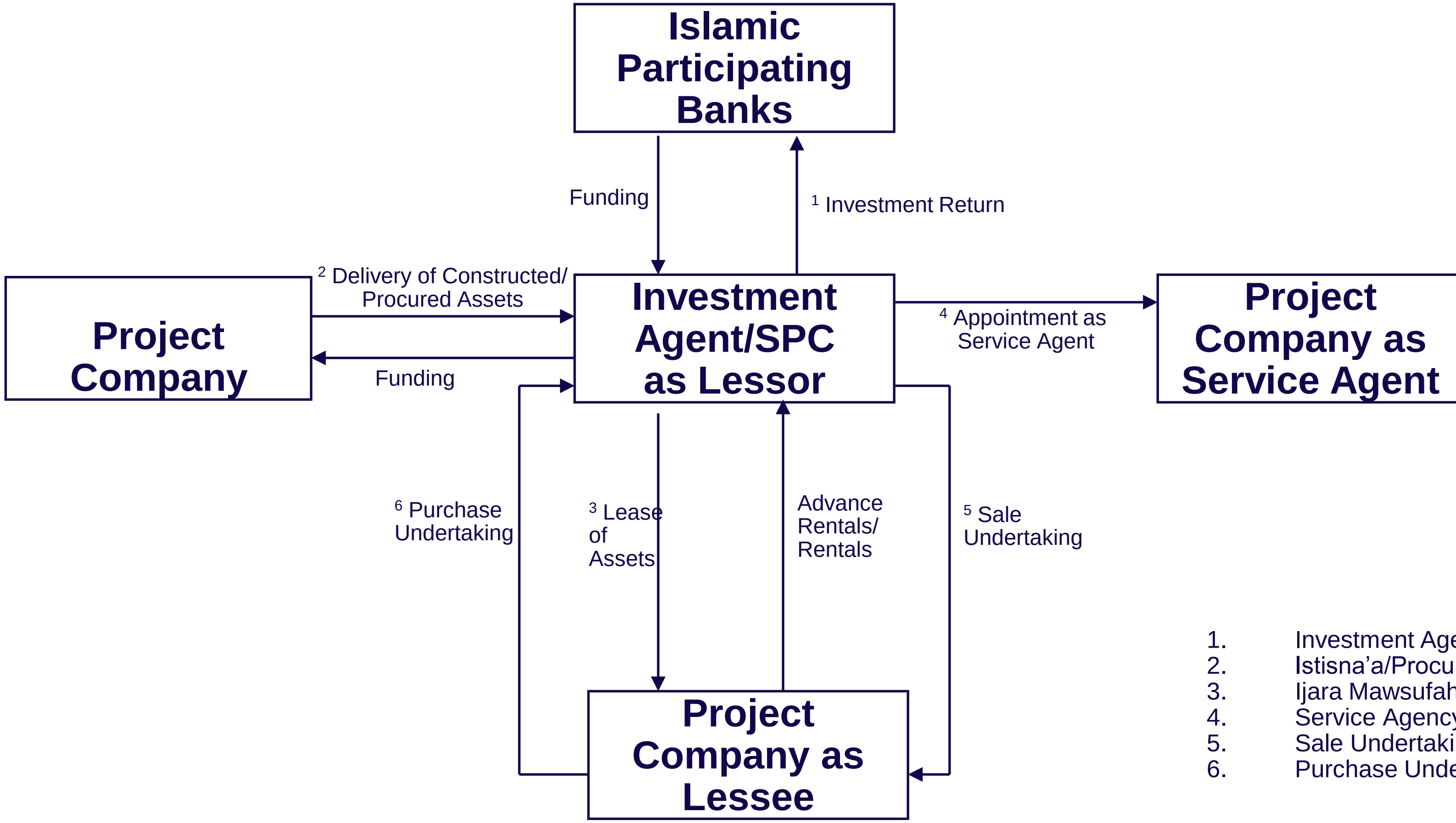
2. Financing to a greenfield project

Ijara Mawsufah Fi Al Dhimmah (forward lease)

Some characteristics

- staged payments by Islamic investors in return for delivery of asset at commercial operation
- prior to commercial operation – "initial rentals"
- after commercial operation – rentals
- capable of having long tenor
- call option for project company
  - at end of lease
  - through period of lease to effect "prepayments"

Ijara Mawsufah Fi Al Dhimmah (construction procurement financing lease structure)



1. Investment Agency Agreement
2. Istisna'a/Procurement Agreement
3. Ijara Mawsufah fi al Dhimmah
4. Service Agency Agreement
5. Sale Undertaking
6. Purchase Undertaking

Case studies: Islamic project finance in action

Case Study 1: TIFERT Project

Financing of a USD500M greenfield phosphoric acid plant in Tunisia

Tifert - background

Project

- Build, own, operate and maintain a 360,000 tons P205 / year phosphoric acid plant located in La Skhira in Tunisia
- Capital cost: USD 500M
- Financed by debt (65%) and equity (35%)

Sponsors

Tunisian Sponsors

- Compagnie des Phosphates de Gafsa (“**CPG**”), State-owned
- Groupe Chimique Tunisien (“**GCT**”), State-owned

Indian Sponsors

- Gujarat State Fertilizers & Chemicals (“**GSFC**”), listed on the Bombay stock exchange
- Coromandel Fertilizers Limited (“**CFL**”), member of the Murugappa Group (India)

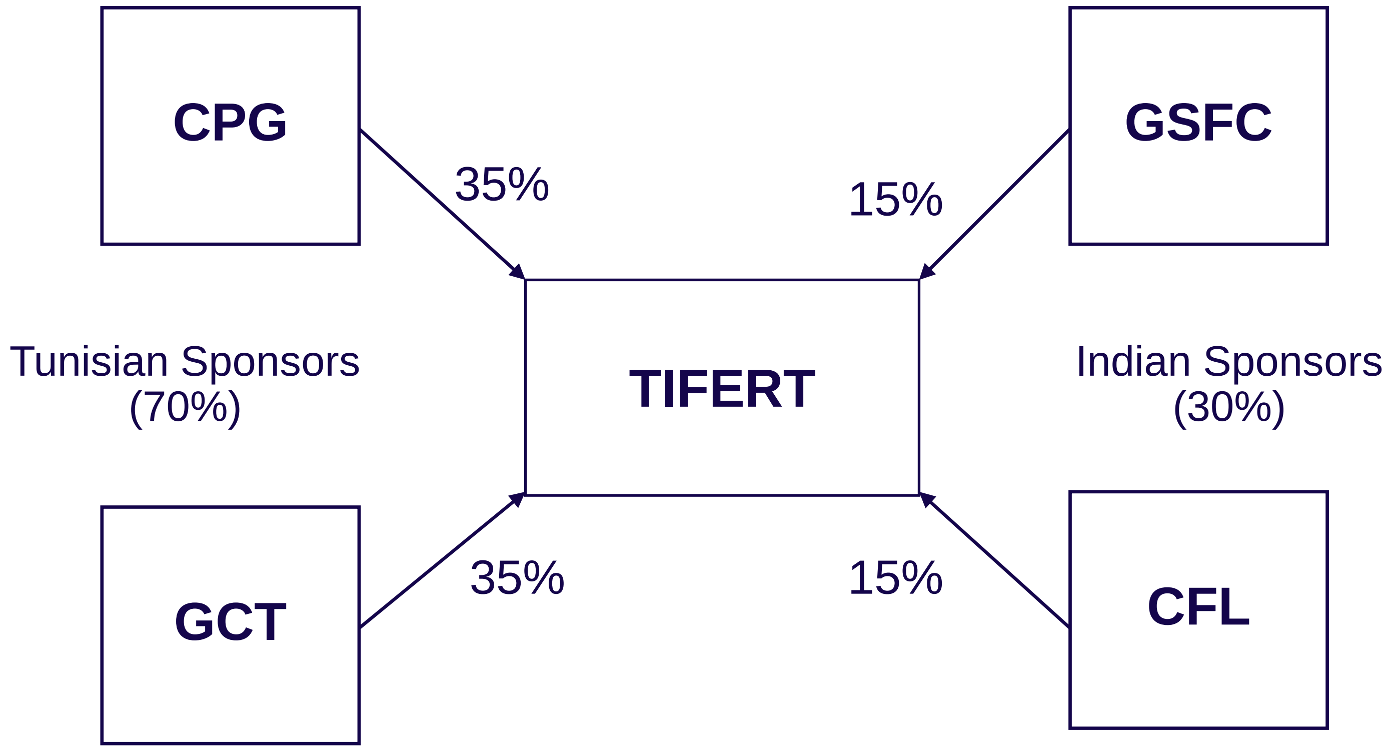
Co-lenders

Two multilateral development banks:

- European Investment Bank
- Islamic Development Bank

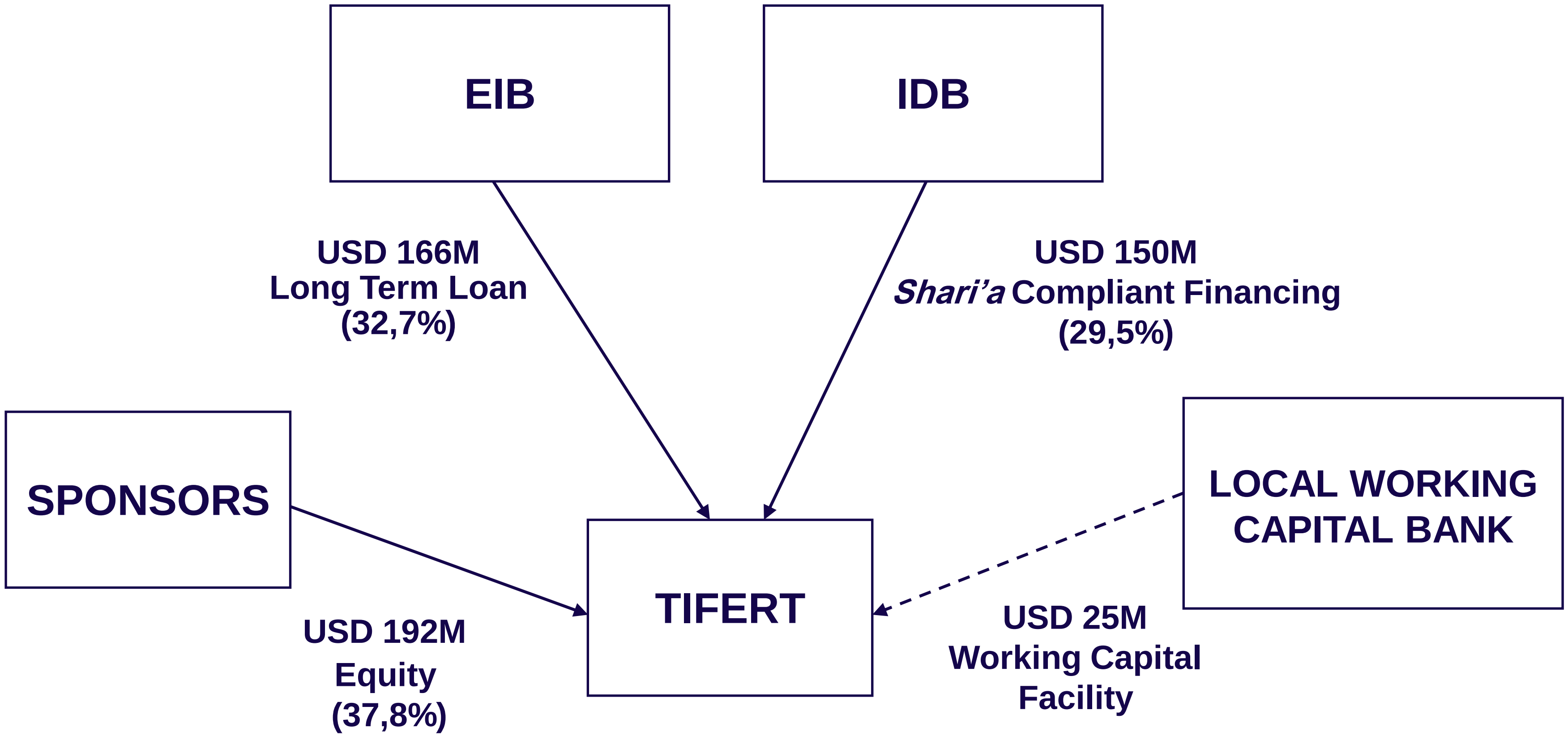
Tifert - background

Capital ownership structure of Tifert



Tifert - background

Financing of the project



Tifert - background

Islamic financing

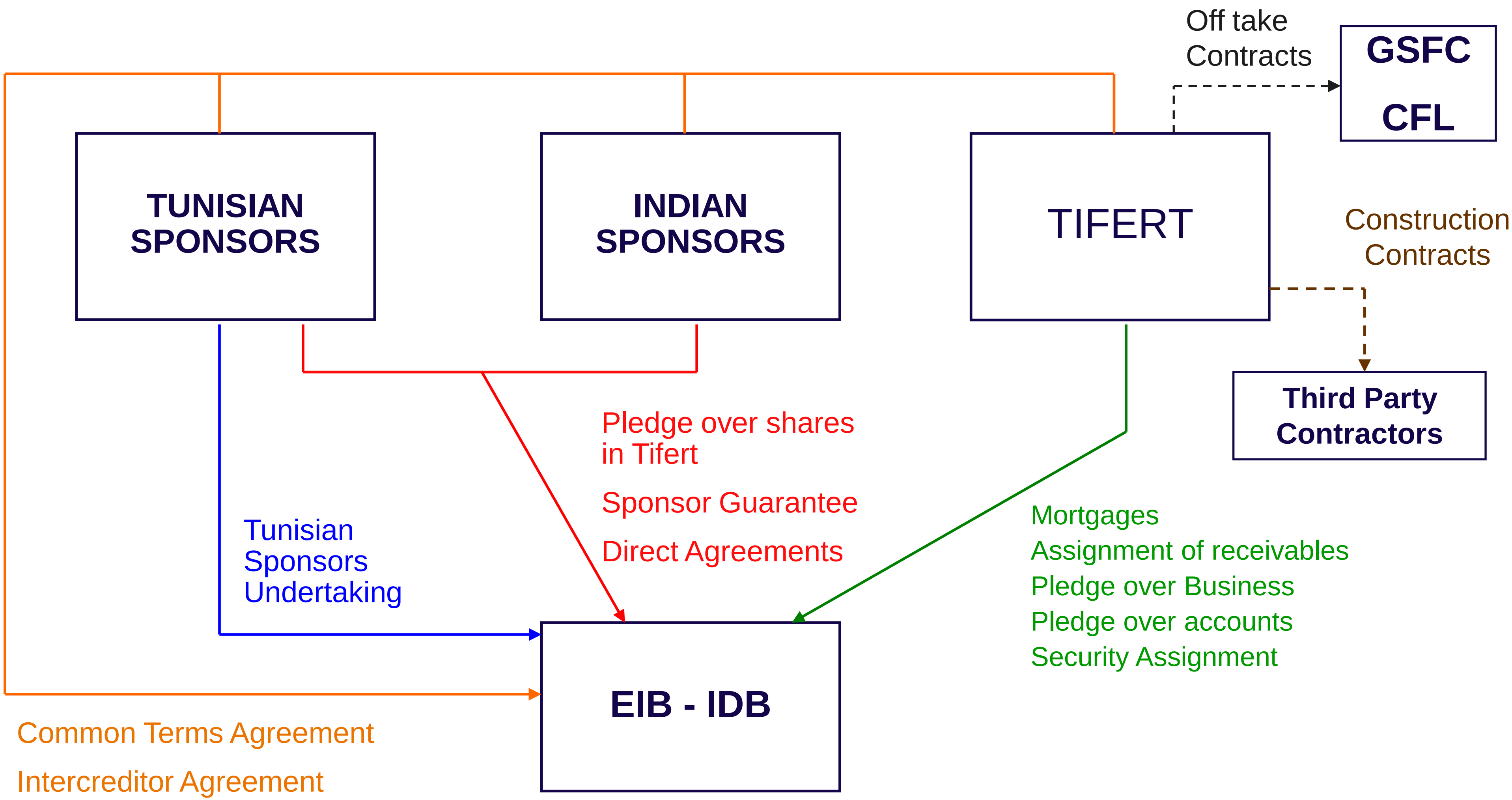
- IDB's tranche was **lease-based** (IDB being the owner of the Islamic Project Assets) whereas EIB acted as a **conventional project lender** with security over the Other Project Assets

- There was thus a need to reconcile within the same project:
  - an asset-based financing structure (IDB)
  - a conventional project financing structure (EIB)

- From a technical standpoint, this was made easier as the construction was split in five lots

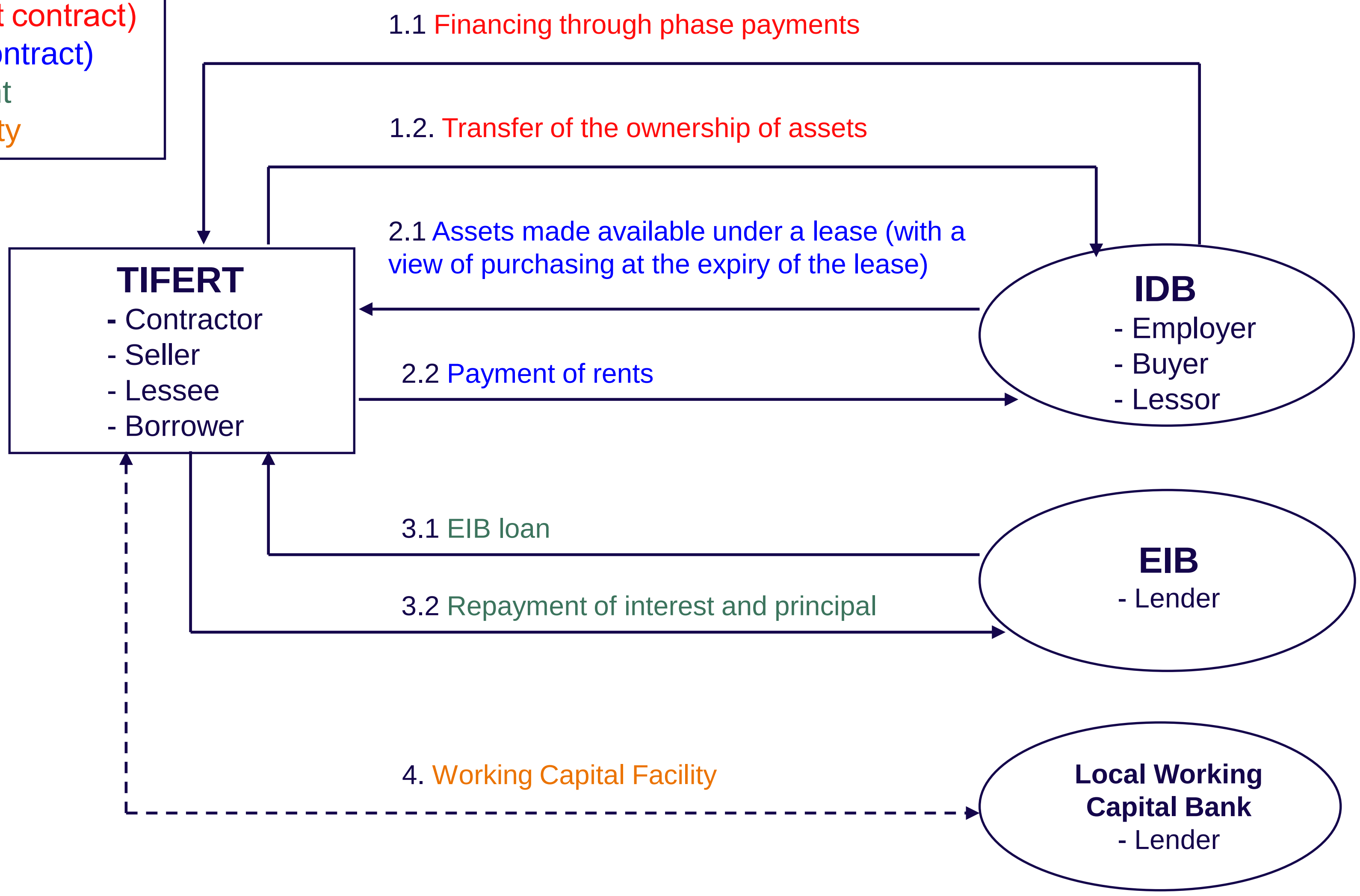
- Nevertheless, the Project from an economic standpoint is a single production unit: **the challenge was to create contractually, to the greatest extent possible, a single project financing instead of two financings of various project assets**

Financing structure



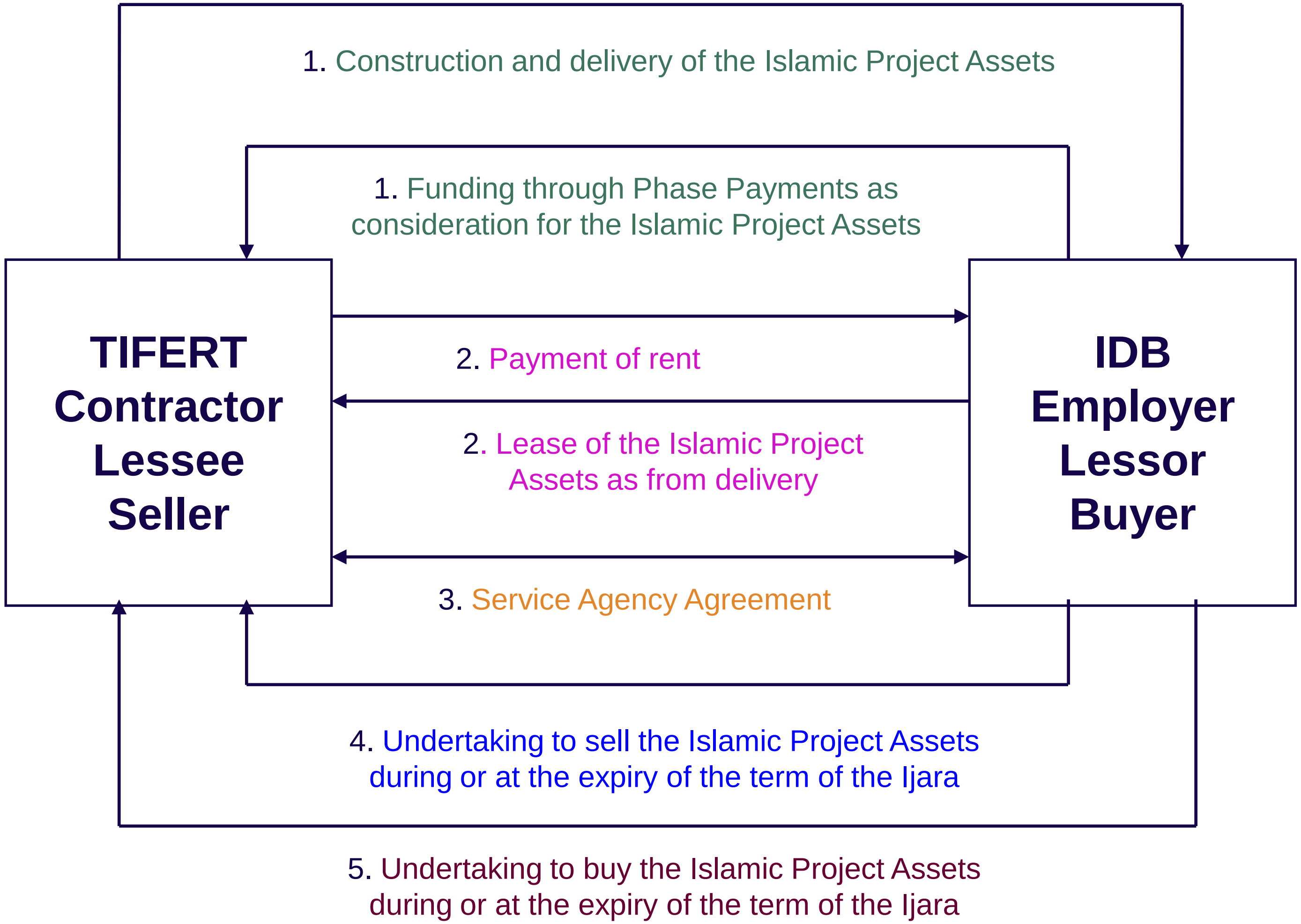
Tifert – financing agreements

1. Istisna'a (procurement contract)
2. Ijara (forward lease contract)
3. EIB Facility Agreement
4. Working Capital Facility



Tifert – Islamic tranche

1. Istisna'a (Procurement contract)
2. Ijara (Forward Lease)
3. Service Agency Agreement
4. Sale Undertaking
5. Purchase Undertaking



Tifert – Islamic tranche

The purchase undertaking

- **Obligation** for Tifert to purchase the Islamic Project Assets from IDB:
  - upon the occurrence of a termination event – replicating events of default and mandatory prepayments events in conventional loans
  - if the Ijara is held to be invalid or unenforceable
  - Upon the expiry of the term of the Ijara

The sale undertaking

- **Right** for Tifert to make incremental payments towards the future purchase of the Islamic Project Assets during the lease – replicating voluntary pre-payment in loans
- **Obligation** for IDB to transfer the Islamic Project Assets to Tifert upon payment of the final lease or incremental payment – provided no other sums are due by Tifert to IDB

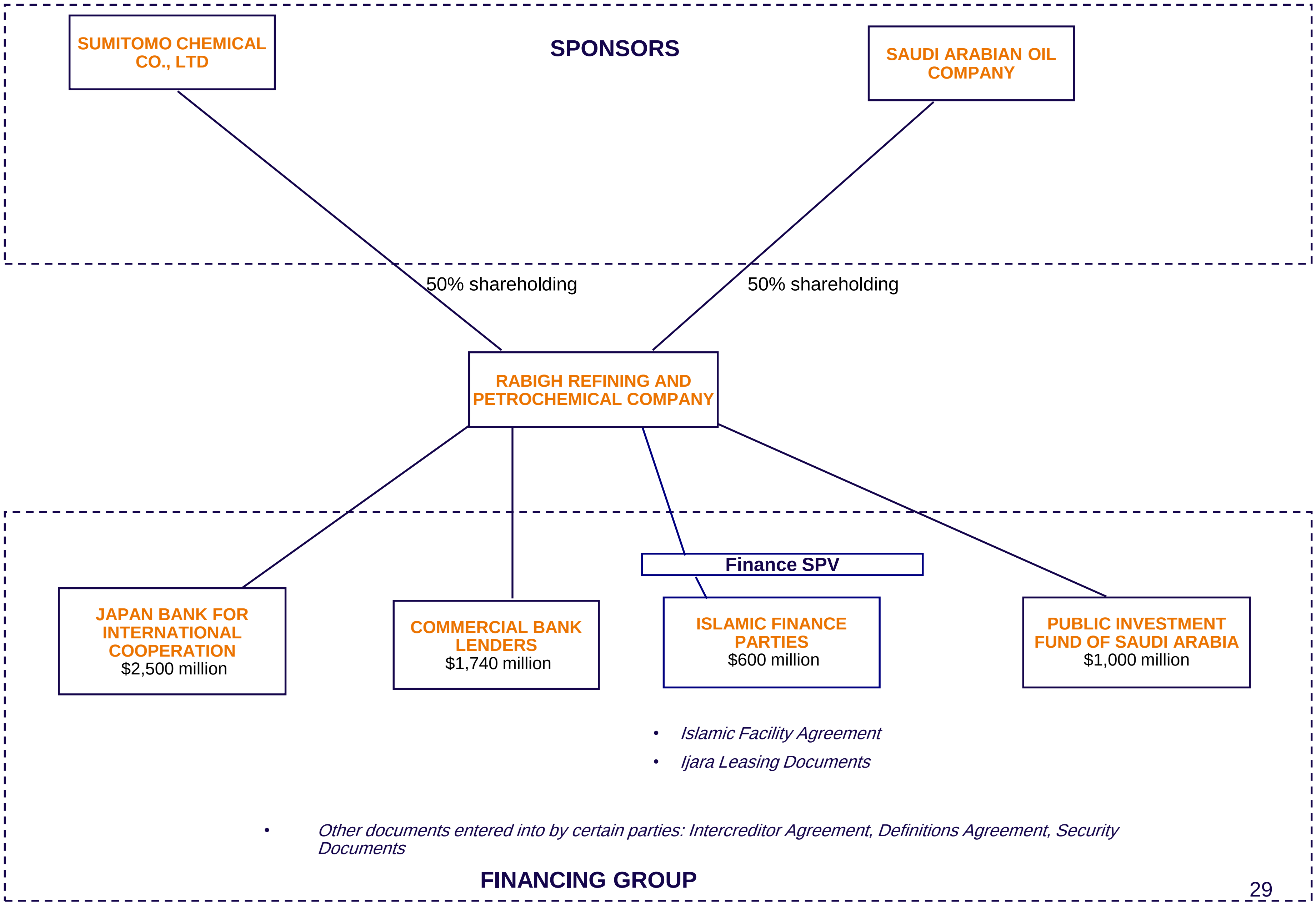
Tifert – Islamic tranche

The service agency agreement

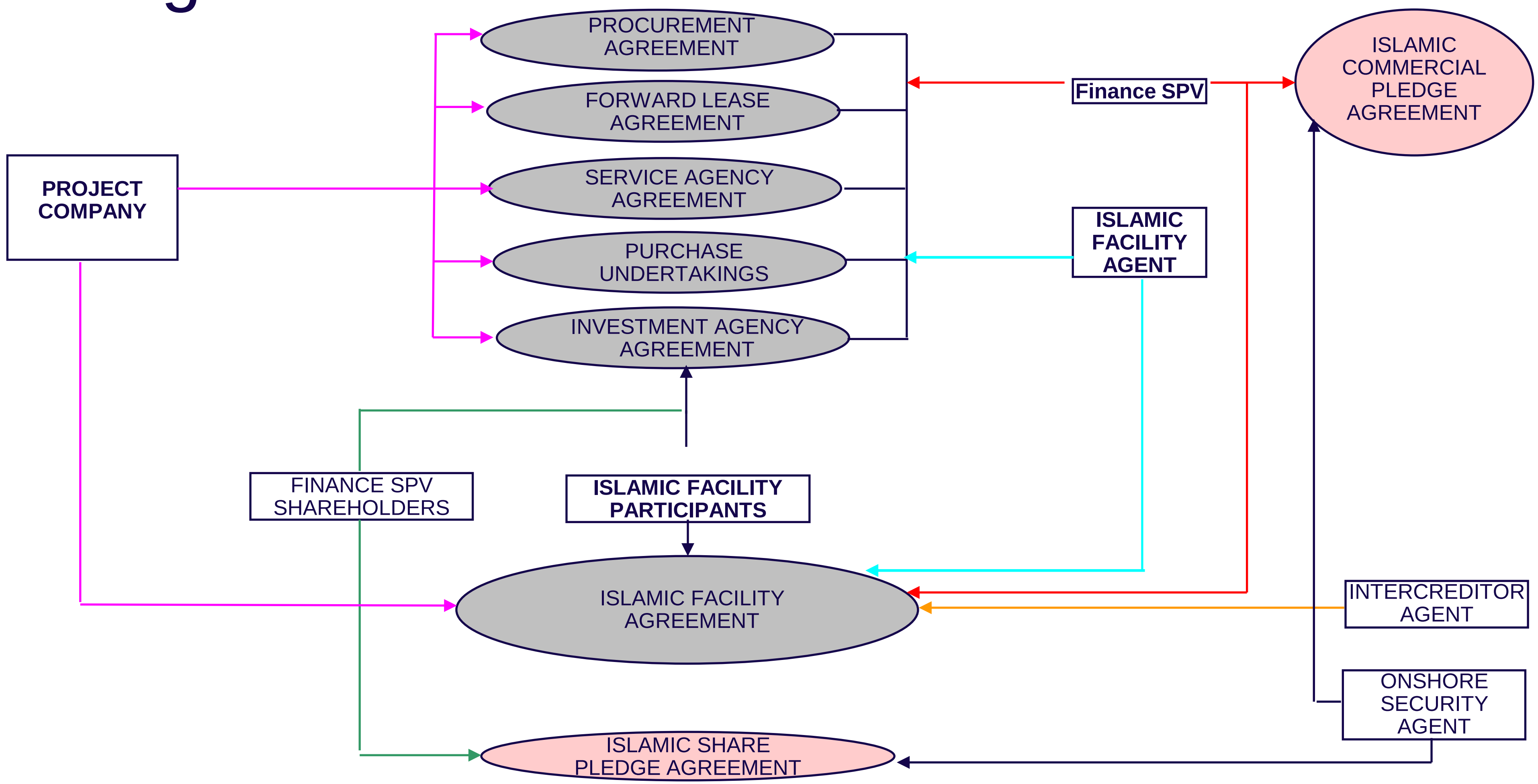
- As owner of the Islamic Project Assets, IDB was exposed to unusual risks for a bank (tax, insurance, maintenance, etc)
- Risks neutralised through the Service Agency Agreement
- Under the terms of this agreement, Tifert is appointed as IDB's agent for:
  - Maintenance of the assets
  - Insurance
  - Replacement of assets in case of damage/destruction (so far as not covered by insurance)
  - Payment of ownership taxes

Case Study 2: Rabigh: US9.8 billion integrated refining and petrochemical complex with a captive power station

Structure of the Rabigh Financing



Structure of the Islamic tranche of the Rabigh financing



Rabigh – Islamic tranche

Procurement Agreement

- Procurement of the *Ijara* assets and transfer of title to Finance SPV
- Payment of Phase Payment by Finance SPV

Forward Lease Agreement

- Lease of *Ijara* assets by the Project Company
- Payment of Lease Payments and Advance Amount Payments by the Project Company
- Project Company responsible for maintenance and insurance
- Mechanism to deal with ownership of *Ijara* assets at end of lease
- Mechanism fro circumstances where *Ijara* assets totally destroyed before the end of the lease

Rabigh – Islamic tranche

Service Agency Agreement

- Project Company appointed as agent by Finance SPV to carry out major maintenance, arrange insurance, assert claims under manufacturer warranties, settle ownership taxes

Purchase Undertakings

- The Project Company agrees to purchase Ijara assets by paying the Termination Payment under the Forward Lease Agreement or to receive Ijara assets as a gift at end of lease
- The Project Company agrees to pay liquidated damages equal to the Termination Payment if the Forward Lease Agreement is held to be invalid or unenforceable

Rabigh - Islamic tranche

Investment Agency Agreement

- Sets out agency relationship of Finance SPV for Islamic Facility Participants
- Contains LMA provisions e.g. participation procedures, sharing Contains provisions to deal with Article 180 event, including the Project Company indemnity
- Restrictions on transfers by Islamic Facility Participants

Islamic Share Pledge and Islamic Commercial Pledge

- Secures obligations of Finance SPV, Islamic Facility Participants and Islamic Facility Agent under all Islamic Finance Documents and Intercreditor Agreement and obligations of the Project Company under main Finance Documents
- Secured parties under main security package are the beneficiaries

Issues and Solutions

Intercreditor arrangements

- Usual intercreditor terms dealing with *pro rata* drawdown and prepayment, drawstops, ranking, termination, voting, payment distributions, etc.
- Islamic investors' proprietary interests (put option)
- No interest to Islamic investors (payment cascade)
- Insurance
- Security – either:
  - granted by Islamic investors over assets and shared; or
  - granted by SPV and title transfer subject to this security

Identifying and Resolving the Issues

- Governing Law
- Security over the Islamic Assets
- Islamic tranche’s proprietal interest in the Islamically financed Assets – the role of the purchase undertaking
- Illegality
- Late Delivery / Non Delivery under the Istisna’a/Procurement Agreement
- Effecting Prepayments
- The approach to Total Loss
- Claiming Default Interest

Utilization in Iran

Utilizing Islamic Financing Techniques in Iran

- Islamic structuring only
- The opportunity
- Identifying the issues
  - Ownership of immoveable assets and/or land
    - Consent
    - Moveable asset selection
    - Local subsidiary/delegate
    - Non-ownership interest
  - Non-recoverability of loss of profit and consequential damages
    - Impact on Istisna'a termination sums and/or purchase undertakings
    - L.D.s recognised
  - Tax
    - Transfer of ownership
    - Lease payments/withholding

Conclusions

- Islamic finance is tried and tested (though developing)
- *Shari'ah* principles mean Islamic investors face different risks – more awareness of these
- Islamic institutions are now competing aggressively
- Increasing trend in many regions for sponsors to consider Islamic finance
- Understanding of issues becoming increasingly critical in advising or participating in Islamically financed deals

Alliance offices

Abu Dhabi
Herbert Smith LLP
Suite 302, 3rd Floor
Al Bateen Towers C2 Building
Al Bateen
PO Box 106178
Abu Dhabi UAE
T: +971 2 412 1700
F: +971 2 412 1701

Amsterdam
Stibbe
Stibbetoren
Strawinskylaan 2001
PO Box 75640
1070 AP Amsterdam
T: +31 20 546 06 06
F: +31 20 546 01 23

Bangkok
Herbert Smith (Thailand) Ltd
1403 Abdulrahim Place
990 Rama IV Road
Bangkok 10500
T: +66 2657 3888
F: +66 2636 0657

Beijing
Herbert Smith LLP
28th Floor Office Tower
Beijing Yintai Centre
2 Jianguomenwai Avenue
Chaoyang District
Beijing PRC 100022
T: +86 10 6535 5000
F: +86 10 6535 5055

Berlin
Gleiss Lutz
Friedrichstrasse 71
10117 Berlin
T: +49 30 800 979-0
F: +49 30 800 979-979

Brussels
Herbert Smith LLP
Central Plaza
Rue de Loxum 25
1000 Brussels
T: +32 2 511 7450
F: +32 2 511 7772

Gleiss Lutz
Central Plaza
Rue de Loxum 25
1000 Brussels
T: +32 2 551 1020
F: +32 2 551 1039

Stibbe
Central Plaza
Rue de Loxum 25
1000 Brussels
T: +32 2 533 5211
F: +32 2 533 5212

Budapest
Bán, S. Szabó & Partners
Gleiss Lutz
associated firm
József nádor tér 5-6
1051 Budapest
T: +36 1 266-3522
F: +36 1 266-3523

Dubai
Herbert Smith LLP
Dubai International Financial Centre
Gate Village 7, Level 4
PO Box 506631
Dubai UAE
T: +971 4 428 6300
F: +971 4 365 3171

Düsseldorf
Gleiss Lutz
Bleichstrasse 8-10
40211 Düsseldorf
T: +49 211 54061-0
F: +49 211 54061-111

Frankfurt
Gleiss Lutz
Mendelssohnstrasse 87
60325 Frankfurt/Main
T: +49 69 95514-0
F: +49 69 95514-198

Hong Kong
Herbert Smith
23rd Floor, Gloucester Tower
15 Queen's Road Central
Hong Kong
T: +852 2845 6639
F: +852 2845 9099

Jakarta
Hiswara Bunjamin and Tandjung
Herbert Smith LLP
associated firm
23rd Floor, Gedung BRI II
Jl. Jend. Sudirman Kav. 44-46
Jakarta, 10210
T: +62 21 574 4010
F: +62 21 574 4670

London
Herbert Smith LLP
Exchange House
Primrose Street
London EC2A 2HS
T: +44 20 7374 8000
F: +44 20 7374 0888

Stibbe
Exchange House
Primrose Street
London EC2A 2ST
T: +44 20 7466 6300
F: +44 20 7466 6311

Madrid
Herbert Smith Spain LLP
Paseo de la Castellana 66
28046 Madrid
T: +34 91 423 4000
F: +34 91 423 4001

Moscow
Herbert Smith CIS LLP
10 Ulitsa Nikolskaya
Moscow 109012
T: +7 495 363 6500
F: +7 495 363 6501

Munich
Gleiss Lutz
Karl-Scharnagl-Ring 6
80539 Munich
T: +49 89 21667-0
F: +49 89 21667-111

New York
Stibbe
489 Fifth Avenue, 32nd floor
New York, NY 10017
T: +1 212 972 4000
F: +1 212 972 4929

Paris
Herbert Smith LLP
66, Avenue Marceau
75008 Paris
T: +33 1 53 57 70 70
F: +33 1 53 57 70 80

Prague
Kubánek & Nedelka v.o.s.
Gleiss Lutz
associated firm
nám. Republiky 1a
110 00 Prague 1
T: +420 225 996-500
F: +420 225 996-555

Saudi Arabia
Al-Ghazzawi Professional Association
Herbert Smith LLP
associated firm
Jeddah Commercial Centre, 3rd Floor, Al Maady Street
Corniche Al Hamra
P.O. Box 7346
Jeddah 21462
T: +966 2 6531576
F: +966 2 6532612

Saudi Arabia (continued)
Al-Ghazzawi Professional Association
Herbert Smith LLP
associated firm
Arabian Business Center
Prince Muhammad Street
PO Box 381
Dammam 31411
T: +966 3 8331611
F: +966 3 8331981

Al-Ghazzawi Professional Association
Herbert Smith LLP
associated firm
King Faisal Foundation
North Tower, 4th Floor
K. Fahd Road
PO Box 9029
Riyadh 11413
T: +966 1 4632374
F: +966 1 4627566

Shanghai
Herbert Smith LLP
38th Floor, Bund Center
222 Yan An Road East
Shanghai 200002
T: +86 21 2322 2000
F: +86 21 2322 2322

Singapore
Herbert Smith LLP
50 Raffles Place
#24-01 Singapore Land Tower
Singapore 048623
T: +65 6868 8000
F: +65 6868 8001

Stuttgart
Gleiss Lutz
Maybachstrasse 6
70469 Stuttgart
T: +49 711 8997-0
F: +49 711 855096

Tokyo
Herbert Smith
41st Floor, Midtown Tower
9-7-1 Akasaka, Minato-ku
Tokyo 107-6241
T: +81 3 5412 5412
F: +81 3 5412 5413

Warsaw
Pietrzak Siekierzynski Bogen Sp. k.
Gleiss Lutz
associated firm
ul. Złota 59
00-120 Warsaw
T: +48 22 22242-00
F: +48 22 22242-99

www.herbertsmith.com
www.gleisslutz.com
www.stibbe.com