



## The use of Islamic financing techniques in Project Finance Transactions

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Frankfurt am Main, 24. April 2012

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# Overview

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# Project Finance

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- Project finance is the long term financing of infrastructure and industrial projects (ports, roads, rail, stadiums, petrochemical plants)
- The financing is based upon the projected cash flows of the project rather than the balance sheets of the project sponsors
- Typically a project financing structure involves a number of equity investors, known as sponsors, as well as a syndicate of banks or other lending institutions that provide loans to the operation
- The loans are most commonly non-recourse loans, which are secured by the project assets and paid entirely from project cash flow, rather than from the general assets or creditworthiness of the project sponsors

# The Rise of Mega Project Financings

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- Increasing population throughout the Muslim world and demand in investment for infrastructure in Muslim populated countries
- The size and volume of energy, power, infrastructure and other projects in the Middle East (particularly the GCC) continues to grow
- Projects are becoming larger, and financings are now measured in billions of dollars instead of just hundreds of millions

# Case Study

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## ■ Saudi Kayan Petrochemicals Project

- World scale vertically integrated petrochemicals complex to be built in Saudi Arabia
- Petrochemicals Complex consists of numerous plants producing for export of products to markets in the region and the world
- Petrochemicals are used in the manufacture of adhesives, cosmetics, plastics, health care products, fragrances, food additives
- Project Costs: USD 10 billion
- Financing package: USD 6 billion
- At the time the largest Ijara lease facility: USD 1 billion

# Multi-sourced project financings

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- The rise of mega Projects has meant that Sponsors cannot rely on just one source of financing
- Financing needs to be sought from numerous sources:
  - Conventional financing
  - Export Credit Agencies
  - Multilateral Development Banks
  - Governmental financing institutions
  - Islamic financing

# The Rise of Islamic Project Finance

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- A growth in the wealth of a number of Islamic states has led to greater demand for opportunities to allow Muslims to invest in accordance with their personal beliefs and in accordance with the manner prescribed by the rules of Islam
- The rise of mega project financings means looking for all sources of liquidity and diversify funding techniques – international banks, which traditionally provide the majority of financing for such projects, may become constrained in their ability to provide finance due to their own specific risk-allocation ceilings in particular sectors and in particular geographies. Increasingly Islamic finance is the source of debt in a world troubled by the credit crunch (impacting US and European markets)
- Sponsors need to search for other sources of funding, including Islamic financing – this year Islamic finance is expected to make up 30% of project finance market in the GCC

# The Rise of Islamic Project Finance

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- Desire of companies in the Middle East region to demonstrate to their shareholders that their financings conform with the principles of Islam
- Islamic Project Finance market can be distinguished from the general Islamic banking and sukuk markets in that the Islamic tranches are usually integrated within a much wider multi-sourced financing arrangement
- Structuring and implementation of an Islamic tranche as part of a wider multi-sourced financing arrangement presents challenges for both project financiers and sponsors
- It requires Shari'a compliant financing solutions to be integrated in a way that adheres to traditional project finance principles – typically requires the Islamic lenders to assume a *pro rata* and *pari passu* position with the other senior lenders, whilst adhering to Shari'a principles



# The Rise of Islamic Project Finance

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- Conceptually Project Finance is an area conducive to Islamic finance
  - Remuneration of the Islamic financier is not based on the lapse of time but based on revenues (cashflow) generated by the Project.
  - The Lender will be an active partner in the Project and not a conventional creditor, therefore will take a commercial risk, which tends to resemble the philosophy of project financing.
  
- Project finance uses a variety of contractual and financial arrangements in order to fund specific projects in different sectors and environments, and involves a real, useful and beneficial asset – this seems entirely relevant to the principal of asset backing in Islamic law

# Incorporating an Islamic tranche

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- The relationship between Islamic banks and their customers is not the same as the conventional creditor and debt relationship – but rather one involved in sharing of financial risks and rewards
- Islamic finance is also principally asset based and in line with Shari'a principles of risk sharing, Islamic financiers bear some of the risks associated with ownership of the relevant assets. This is a classic method of avoiding Islamic speculation and *riba* concerns – conforming business practices to religious principles
- There is complexity in applying these principles to project finance
- Typically the Islamic financing tranche is structured in such a way that it mimics conventional financing – at least in terms of risk allocation

# Ijara lease arrangement

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- One of the preferred techniques for structuring a greenfields Islamic project financing is the use of an Ijara lease arrangement
- The project company will procure the assets on behalf of the Islamic financiers. A procurement contract acts as the funding instrument whereby payments made by the banks to the project company or the EPC contractor during the construction period – this occurs in the same manner as utilisations / drawdowns under a conventional project financing facility.
- The assets are then delivered to the Islamic financiers once completed
- An Ijara or lease arrangement is then effected in which the assets are leased to the project company. This enables the Islamic financiers to generate a return from the Project which replicates the economics of the arrangements typically associated with conventional project financing

# Ijara lease arrangement

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- A forward lease arrangement is also entered into during the construction of the assets which “advance” rental payments are made by the project company while the assets are still be constructed
- To the extent that the asset is never delivered to the Islamic financiers and therefore the project company does not have the benefit of the lease of the assets, then such “advance” rental payments are typically required to be refunded to the project company
- To avoid this outcome, if the assets are not delivered to the financiers, then the project company is required to pay liquidated damages under the procurement contract equal to the aggregate of the “advance” rental payments which the project company has paid

# Structural issues: Acceleration

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- In theory, Islamic financiers and conventional financiers may have very different rights. The Islamic financier may be the owner or lessor in possession, and the conventional financier may be a secured party. However, the parties would expect that the assets are available for the benefit of all financiers
- If there is an event of default, the Islamic financiers will have the benefit of a purchase undertaking which serves as a method of accelerating the payment of the Islamic tranche
- The exercise price of the purchase undertaking is typically the aggregate of all amounts outstanding under the Islamic tranche. As the amounts will be immediately due and payable, the Islamic financiers will have a claim on the security package available to the wider project financing

# Structural issues: Acceleration

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- The asset is not transferred until the Islamic debt has been satisfied in full
- It is important that the financiers party to the Islamic tranche are required to be party to an Intercreditor Agreement with the other Lenders to ensure that they do not have priority ahead of any conventional lender – all Lenders *pro rata* and *pari passu*
- Certain financial institutions do not typically sign English law contracts and therefore enter into a separate undertaking agreement with the Intercreditor Agent and undertake to comply with the provisions of the Intercreditor Agreement

# Structural issues: Owner liabilities

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- As owners of the assets, Islamic financiers have exposure to certain risks and liabilities:
  - third party liabilities, such as injury or death
  - environmental damage
  - operation and maintenance of the project assets
- Commonly the Islamic financiers will enter into a service agency agreement with the project company under which the project company will perform these responsibilities and will be liable for any loss or damage suffered by the Islamic financiers for failing to do so
- Total Loss – Sharia'h requires that lease arrangements be terminated with immediate effect – the purchase undertaking then becomes ineffective. Instead, the project company shall be appointed as service agent / provider to maintain insurance in respect of the full replacement value

# Transactional issues

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- Forming the Special Purpose Vehicle as the leasing company (Islamic Asset Custodian)
  - Typically one or two of the Islamic financiers will act as shareholders in the SPV
  - Mitigate some of the risks associated with Owner Liability
  - Overcome some foreign ownership restrictions
  - Analysis would need to be conducted in each case to determine whether corporate veil of SPV could be pierced, so that the shareholders (i.e. Islamic financiers) would be held liable. Shareholders would expect to be indemnified by other Islamic financiers in any case
  - Is there any additional legal risk resulting from the use of the SPV
  - Timing for incorporation



# Transactional issues

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## ■ Sharia'h Committee

- An Islamic financial institution will have a Sharia'h board or committee to which is referred certain transactions to ensure that they conform to Sharia'h principles
- The Sharia'h committee decides what is permissible (lala) or forbidden (haram)
- Sharia'h committee issues a fatwa (legal opinion) as a condition to entering into the transaction
- The opinion of different religious scholars may differ – there are four main “schools”
- Scholar input on the project financing - timing and structural issues
- One fatwa issued by lead bank or each bank to obtain its own fatwa

# Transactional issues

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## ■ Complexity of Documentation

- Document heavy and therefore more expensive eg. a procurement facility typically includes:
  - Investment agency agreement
  - Procurement agreement
  - Forward lease agreement
  - Service agency agreement
  - Purchase undertaking agreement
  - Sale undertaking agreement
- No standardised documentation - eg. such as LMA, although there is the Accounting and Auditing Organisation for Islamic Financial Institutions

# Transactional issues

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- Complexity of Documentation (cont'd)
  - A mechanism is required to establish the amount of the “investment” in the project by each Islamic financier – comparisons can then be made between loans and lease payments
  - The investment amount can be used in relation to agreeing scheduled payments, voting rights and allocation of funds if there is a shortfall on acceleration and termination of the financings
  - Common Terms Agreement and Intercreditor Agreement (parties)

# Transactional issues

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- Liberal vs. conservative Islamic tranches
  - Islamic financiers or conventional financiers with an Islamic “window”
  - Identifying the assets to be financed - undivided economic interest in the assets vs. specific assets
  - Pricing vs. liquidity
  - Ma’aden Aluminium Project

# Conclusion

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- Mega Project financing transactions are on the rise
- The demand for new sources of investment is increasing
- The importance of Islamic financing to fund Projects is expected to continue to grow
- Particular structural and transaction issues needs to be considered and addressed in any multi-sourced financing which incorporates an Islamic financing tranche

# The use of Islamic financing techniques in Project Finance Transactions

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GERMANY-1503735-v1