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Islamic Project Finance

A Case Study of the Equate Petrochemical Company

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ABSTRACT

Kuwait Finance House underwrote, arranged, and syndicated the US$200 million Islamic lease finance facility, which was structured on a sale/lease basis, for Equate Petrochemical Company (Equate) in Shuaiba, Kuwait, a joint venture between the Petrochemical Industries Company (PIC), Kuwait, and Union Carbide Corporation, U.S.A. The Islamic facility was part of the total US$1200 million long-term financing that Equate raised through major international and regional banks. KFH negotiated with attorneys, finalized documentation (particularly those related to the Islamic tranche to ensure *sharīᶜa* compliance), and refinanced the facility to bring the pricing closer to market levels for similar projects regionally and globally. The success of this Islamic lease facility signals the debut of a new era of Islamic long-term financing in conjunction with conventional facilities.

I. INTRODUCTION

The Equate project is unique in the sense that, perhaps for the first time, an effort was made to combine Islamic financing with conventional financing. *Prima facie*, it may sound odd, even incongruous, if not blasphemous, that two modes of financing thus far considered irreconcilable both in concept and performance—one based on interest and the other on avoiding interest—are sought to be brought together. But the task is not altogether impossible provided that care is taken to clearly demarcate their respective roles and keep each part of the financing within its own bounds, with and under the benign guidance of learned scholars of the *sharīᶜa* on the one hand, and experts of conventional finance and law on the other.

Kuwait Finance House (KFH) underwrote and arranged the US$200 million Islamic lease finance facility for Equate Petrochemical Company, Kuwait (Equate), a joint venture between Petrochemical Industries Company, Kuwait (PIC) and Union Carbide Corporation, USA (UCC), toward Equate's petrochemical plant project. As an underwriter and arranger, KFH was actively involved at all stages of the entire financing process, including all negotiations with *sharīᶜa* experts and with lawyers in the successful finalization of documentation, particularly those related to the Islamic tranche, in order to ensure *sharīᶜa* compliance.

The Islamic facility was part of the total US$1200 million long-term financing which Equate raised through major international and regional banks. Subsequently, KFH was involved in the renegotiations of the pricing with Equate and other facility arrangers. As a result of this, the pricing was re-fixed in line with the market rates. The refinancing aimed at bringing the pricing closer to the market level for similar projects regionally and globally and as such received active support from all the underwriters. The changes became effective at the technical completion of the plant on 16 November 1997.

The total project financing package also provided for a working capital facility equivalent to US$150 million (approx. KD45 million), in addition to the US$1.2 billion long-term financing.

II. THE ISLAMIC FACILITY IN BRIEF

Islamic financing was designed to adhere to *sharīᶜa* requirements and was structured on sale/lease basis. This was the first time that Islamic financing had been arranged for a major project of such a large amount and unusually long tenor, and in complete unison with the conventional facility. It was also unique in being the first Islamic and largest "limited recourse" financing facility ever arranged in Kuwait or elsewhere.

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III. The Project: Technical Brief

The project involved the construction of a petrochemical plant (Equate plant) at Shuaiba, Kuwait, by major international contractors. It was hailed as Kuwait's most ambitious private sector downstream project. It was completed as per schedule. Right from inception and the start of production, the plant has been delivering superior operating performance and is also making timely rental payments (both the profit element and the amortization of lease amount). Equate has also been enjoying full support and continued cooperation of its sponsors and project lenders/lessor. The refinancing of 1997 enhanced the cost competitiveness of Equate's products. An independent project feasibility report rates Equate as one of the most competitive petrochemical plants in the world, both in product quality and cost structure.

At the very outset the Equate Project was considered a priority project by the State of Kuwait and to this end, the Ministry of Oil and Kuwait Petroleum Corporation (KPC) and its subsidiaries, including the Petrochemical Industries Company (PIC), agreed to provide the project and the Company (Equate) with all appropriate support and assistance to facilitate successful construction and operation in accordance with the original plan. The plan was to construct and operate a 650,000 metric tons per year ethylene plant (by the USA's Brown & Root), a 450,000 metric tons per year polyethylene unit (by Italy's Snamprogetti) and a 340,000 metric tons per year monoethylene glycol facility (by Foster Wheeler Italiana) at Shuaiba Industrial Area, Kuwait. USA's Fluor Daniel served as Project Manager. The local Ahmadia Contracting & Trading Company carried out architectural services on the complex, including the construction of Equate's headquarters.

On the technical side, PIC has been able to utilize Union Carbide's licensed technology, and management and marketing skill. The participation of such a huge U.S. enterprise has also helped ensure the interest of private sector financiers.

IV. The Project: Financial Summary

The total project cost was estimated to be around US$2 billion with the non-debt portion coming from the partners' equity. PIC, Union Carbide, and Bubiyan Petrochemicals Company are providing US$730 million in equity and subordinated debt toward the project. A large quantity of Union Carbide's subordinated debt is in the form of technology licenses for the plant.

The debt portion of the project involved the US$1.2 billion package, comprising US$1 billion of conventional facilities and US$200 million of Islamic facilities. The award, to 11 Gulf institutions (including Kuwait Finance House) and three U.S. banks was especially sweet for the Arab banks since they managed to beat off a US$1 billion financing package led by the Export Import Bank of the USA (U.S. EXIMBANK) that would have covered almost all the cost of the financing. The group of Arab banks, led by the National Bank of Kuwait, was able to provide the long-term funding on a limited-recourse basis. If things went according to plan, the main recourse was the project itself. The Group included five main Kuwaiti banks, some of the major Persian Gulf based banks and international banks (among them Citibank, Chase, and J.P. Morgan) and Kuwait Finance House (KFH). KFH exclusively underwrote the entire US$200 million Islamic facility.

The whole project financing involved a complex web of agreements including an intercreditor agreement with the other participants, including both conventional banks as well as KFH.

The joint venture approach on a project of this scale is a new development in Kuwait.

V. Guarantees and Insurance Aspects

This groundbreaking limited-recourse facility reported strong demand and was oversubscribed by over 50 participating banks and financial institutions, despite the lack of credit agency guarantees. The sponsors—PIC, UCC, and Bubiyan—took out some investment insurance with the World Bank's Multilateral Investment Guarantee Agency and a political risk insurance facility underwritten by National Bank of Kuwait and Gulf Investment Corporation.

Both Union Carbide Corporation (UCC) and PIC, each on several basis with respect to 45% and 55% of the total facility respectively, guarantee the borrower/lessee's (Equate's) payment obligations in relation to all amounts falling due and payable under the term loan, the working capital facility and the Islamic lease facilities until released upon completion. ("Completion" includes mechanical completion, integrated reliability test, unit performance test, commercial completion test and financial completion). The sponsors' guarantee will remain in place for the entire period of the facilities, if completion is not achieved by September 30, 2000 at the latest.

VI. Some Details of the Islamic Facility

The Islamic lease facility provided by Kuwait Finance House is denominated in U.S. dollars and is comprised of two tranches:

1. **Tranche A:** US$100 million to be amortized *pro rata* with tranche A of the conventional term loan facility of US$400 million. Tenor 10.5 years. Repayments for ten years in 20 semi-annual equal installments starting June 1998 – final maturity December 2007.
2. **Tranche B:** US$100 million to be amortized *pro rata* with tranche B of the conventional term loan facility of US$600 million. Tenor 8.5 years. Repayments for 8 years in 16 semi-annual equal installments starting June 1998 – final maturity December 2005.

This Islamic lease facility signaled the debut of a new era; that of Islamic long-term financing in conjunction with conventional facilities. The leading role played by Kuwait Finance House in arranging, underwriting, syndicating, and also in subsequent re-pricing/refinancing, underwriting and limited syndication of the facility opened a window of opportunity to many potential project financing syndicates to gain access to the Islamic market.

Islamic banks have usually taken a cautious approach to non-recourse financing and generally tend to concentrate at first on deals within their domestic market to avoid cross-border risk. For them, the preferred technique for medium and long-term financing has been leasing. The Islamic facility utilized the product structure of a full payout (finance/capital) lease. The Islamic institutions participated by way of an Islamic sub-funding/sub-participating structure.

VII. Related Aspects

It is believed that some competing groups bidding for the financing, including some credit agencies (like the U.S. EXIMBANK, Germany's Hermes and Italy's SACE), had asked for terms that Kuwaiti authorities considered too rigorous, including a financial covenant from PIC parent company, Kuwait Petroleum Corporation and other guarantees from the Government of Kuwait, a sort of sovereign risk structure. The overall conditions attached to the loans in such proposals were thought to have been too stringent. Besides, some such groups wanted the Kuwaiti government to guarantee feedstock supplies to the complex as well as minimum output levels. With the selected loan package, the government has guaranteed feedstock supplies and has offered cheap power to the plant. The Union Carbide Corporation, which has a 45% stake in the project (state owned PIC 45% and Bubiyan Petrochemicals Co., a US$50 million public shareholding company establish in June 1995 own the remaining 10% stake) had offered to pick up output at market prices.

The deal, described as a surprise victory, demonstrated that Arab banks have the capability to arrange and fund big regional projects against stiff opposition and fierce competition. Moreover, the introduction of the Islamic element demonstrated the depth of virtually untapped financing resources in the region. Such blending of Islamic and conventional funding may become an important source for the future. The success of regional and international banks to negotiate such a complex arrangement in conjunction with Islamic banks has raised hopes that other large-scale private sector projects can be financed in a similar way. The success of local and regional banks in funding such a high profile project may well be the start of a new trend. These banks have proved that they can handle such a large and complex transaction by beating bids from other reputed funding sources. The Equate project will not only enable Kuwait to join the elite club of major petrochemical producers but will also have broken new ground for the traditionally state-dominated energy sector in Kuwait.

With this, project financing in the Middle East can be said to have come into a new limelight. Deals of this nature show that where governments are no longer willing or able to pick up the entire bill for development, banks can step in to take the risk, in some cases even without the security of guarantees from states or export credit agencies.

VIII. Certain Terms and Conditions of the Equate Lease

Under the Lease Agreement between KFH (the Lessor) and Equate (the Company, the Lessee), the Company has agreed to lease from the Lessor, and the Lessor has agreed to lease to the Company the Project Assets. (This is subject to the passing of title to such assets from the Company to the Lessor pursuant to a sale arrangement under the Sale Agreement between these two parties, and upon terms and conditions of the Lease Agreement). The

Lease period commenced on the date on which the Lessor acquired title to the Project Assets pursuant to the Sale Agreement and shall end on the final maturity date. The Company is entitled to replace any of the Lease Assets by way of renewal of obsolete or worn out items or by way of replacement of items that are damaged beyond repair for any reason. Title to such replacement item shall vest in the Lessor upon such replacement and such replacement item shall form part of the lease assets. The Lessor shall have no obligation to maintain the Lease Assets which obligation shall fall entirely on the Company pursuant to the covenants contained in the Common Terms Agreement. In consideration of the lease of the Lease Assets to the Company, the Company shall pay to the Lessor lease payments that will constitute periodic rental (profit element) and reimbursement element (periodic amortization of capital/principal) without any deduction of any nature whatsoever. Each of the Lease Assets (including any replacement part) shall remain the property of the Lessor at all times, from the commencement of its leasing until the ownership thereof is transferred to the Company upon full and final payment upon maturity, in case of sale to the Company by delivering a duly executed bill of sale and transferring of all of the Lessor's rights or under certain conditions by way of gift on "as is, where is" basis. No sub-lease is allowed. Under certain terms and conditions, the Lessor may require the Company to purchase all the Lease Assets from the Lessor for an agreed price. The Lessor shall be entitled with the approval of the Company to assign or transfer all or any of its rights, benefits, and obligations to any person who accedes to the Common Terms Agreement and the Security Trust Agreement.

IX. Islamic Lease Financing

Islamic leasing transactions are more or less similar to conventional ones, except few differences arising mainly from the standpoint that:

1. Ownership of asset rests with the lessor (Islamic investor) during the entire period of lease.
2. Major maintenance and major repair responsibility rests with the owner, not lessee. The owner can, however, separately contract out the above to anyone, including the lessee.
3. Total loss risk is to the owner, not the lessee. The owner can, however, separately insure the same, or separately contract out the insurance responsibility.

X. Rulings on *Sharīᶜa* Issues

Kuwait Finance House (KFH) underwrote the US$200 million Islamic Tranche out of a total US$1.2 billion Equate financing in unison and *pari-passu* with the other commercial banks. The banks were involved in providing senior debt of US$1 billion under conventional terms, while KFH participated under a lease (*ijāra*) transaction, which involved the signing of two exclusive Agreements with the Lessee: one a Purchase Agreement and the other a Lease Agreement. As KFH was a party to various other agreements with Equate in which other conventional banks were also parties and signatories, a number of *sharīᶜa* questions arose. The entire project and *modus operandi* was explained at length to the *Sharīᶜa* Board, which discussed each and every perceived problem and issue in depth and their ruling was obtained prior to participation. The following important issues deserve mention.

1. Kuwait Finance House could be a signatory to documentation along with the other conventional banks, where certain non-Islamic provisions are included as long as KFH does not receive benefits from the non-Islamic clauses.
2. The rental income of the Islamic Lease transaction could be computed by reference to LIBOR. The use of LIBOR as a benchmark to compute the rent would only serve as a mechanism to compute KFH's lease rental/profit element on the Lease transaction and would not amount to charging any usury (*ribā*), interest, or equivalent.
3. As one of the many parties providing the project term facilities (and as a consequence of being a signatory to the Intercreditor and Security Trust Agreements), KFH could assign the lease assets to a common security trustee to hold the property on trust and to be jointly shared *pro-rata* with the conventional participants, i.e. the other commercial banks. In case of default, KFH would be entitled to receive its share of Project Assets of the Company on a *pari passu* basis. In other words, KFH was allowed to have its security interest in the leased assets to become part of the general security pool, which both conventional banks and Islamic financiers would share *pari passu*. However, there was an overriding condition that assets initially the subject of Islamic lease, even after being assigned to the common Security Trustee, would only cover the Principal due to conventional banks and not their interest portion.

4. The documentation allowed dealing with the issue of delayed payment without making it a contractual calculation. Logically, if payment is not duly made on time the credit standing deteriorates and hence a higher spread may be charged on subsequent facility period to compensate for the implied higher risk. Any loss of profit to KFH as a result of late/delayed payment could be dealt with by building that loss (lost profit) into the subsequent Lease payment, i.e. any delay in payment of previous lease rentals may be considered in calculation of the next lease payments along with the new LIBOR rate for computation of profit. This allowed us to address *sharīʿa* concerns by not charging compensation in relation to time, while addressing the business concern not to reward default.
5. There should be no purchase/lease transaction without the involvement of an underlying asset.
6. All prepayments should be shared *pro-rata* by conventional and Islamic investors.
7. Participants were allowed to assign their rights and obligations because the facility was backed by assets.
8. The *sharīʿa* links the lessor's entitlement to lease payment to his responsibility to secure the ability of the asset to yield utility at all times for the lessee.
9. In case of destruction or a total loss of the lease property, the lessee should not be obligated to make lease payments or purchase the leased assets at book value. In such circumstances, insurance claim proceeds could be the main source of repayment or compensation. In other words, there should be no lease payment to be made by the Lessee in case of total destruction, which would entail the termination of the Lease Agreement itself.
10. The Lease Agreement is only one part of the finance documents which together clearly mention that all assets of Equate are to be comprehensively insured with the insurance policies to be assigned in favor of the Security Trustee on behalf of the participating financiers. This was considered *sharīʿa*-compliant.
11. Lease payments could be allowed to vary at intervals coinciding with the lease repayment dates to take care of changing LIBOR rates and the prevailing market rates and circumstances. The Lease Agreement allowed these changes so that there was no real separation between principal and profit elements. Instead a more appropriate description of the mechanism to revise the rentals at agreed dates would be that each rental payment consisted of a total amount, comprised a fixed amount plus a variable element. The Lessee was to pay rental on the basis of such mechanism.
12. In case of delay in commencement of the Project operations in the beginning, Equate was to be allowed to delay payments by six months, without increasing the total period of financing. Consequently, the last payment was to consist or comprise of two payments. If on technical/business grounds such a thing is permissible, this would be acceptable to the *sharīʿa* and as such it should not be considered a *sharīʿa* issue at all.
13. The *sharīʿa* does not allow taking of a commitment fee. However, a role was recognized and we were allowed to negotiate management fees with the Sponsors on the basis that compensation of Islamic financing is promised to be not less or more than the conventional financing on *pro-rata* basis. Equate agreed to pay all KFH's fee in the form of management fees, irrespective of how they were calculated. We were allowed to accept the same without going into conventional type of calculations applicable in case of conventional commitment fee. (In fact, any deviation from standard conventional method of calculation was to be considered a blessing in disguise instead of a cause for dispute.). Equate made a very clear arrangement with us through a "Fee Letter" arrangement that any income available to KFH or Islamic financiers would always be paid in Islamically acceptable modes i.e. either as profit or management fee (a lump sum amount) and for that no standard/conventional method of calculation would apply. KFH was fully aware of ways and means of calculating the commitment fee on unutilized balances and never tried to deviate from the *sharīʿa* by giving commitment fee a different name, as we knew that would not have changed its nature and that substance is always required to prevail over form specially in *sharīʿa*-related issues. In the particular circumstances it was found acceptable to agree to take management fees as a lump sum amount.
14. Up-front Fee could be similar to conventional financing using the same methodology.
15. Each disbursement should be either less than or equal to the book value of assets submitted for the purchase/leaseback transaction. Each disbursement under purchase/leaseback is to be *pro-rata* to the proportion of Islamic financing to the total financing i.e. 200/1200 = 1/6th

The following issues were also ruled upon:

1. Lease Assets could include work in progress. The Lease value could be different from the value of underlying asset i.e. the lease could be based on invoices generated by the lessee instead of the actual cost of the assets to the lessee.
2. KFH could accept insurance on security from a conventional insurance company.
3. Transfer of the leased assets to the lessee at the end of lease term could be carried out by way of a gift.
4. KFH could accept insurance as Lease Assets identifiable pieces of plant and equipment from all over the Project and not necessarily only from one particular/distinct/discreet unit of the Project. In other words, we could accept insurance benefits of a *pro-rata* value, and the insurance could be of any identifiable pieces of plant/equipment from all over the project.

XI. CONCLUSION

It is shown here that there exist the possibility and advantages to combining the conventional and Islamic systems of finance to the mutual benefit of both, as also to the national economy. This can be done without violating the principles of the *sharīʿa*—though it might seem—to some of "traditionalists" that, *prima facie*, the two systems cannot operate together in a single transaction. The two systems are not irreconcilable if acted upon within proper bounds. This will be evident from the fact that the arrangement made in the case of Equate has received the blessings and approval of eminent *sharīʿa* scholars on the one hand, and of the mainstream financiers and distinguished legal experts on the other.