ISLAMIC PROJECT FINANCE: A GROWING TREND

Islamic project finance has grown in significance and is now widely used to finance large, longer-term infrastructure and power generation projects, especially in the Middle East region with a main focus on the Gulf Cooperation Council (GCC) countries. The development of such capital-intensive projects on a larger scale began only in the earlier part of this century, fueled by high oil prices in some of the resource-rich GCC countries. In these countries, the need to build oil and gas extraction, transport and refining capacity pushed the demand for Islamic project finance. Islamic finance made up nearly 40% of the total project finance market in the GCC in 2015, compared to just over 12.5% in 2006. However, the first major project financing to involve Islamic finance was the Hub River Power Project in Pakistan. The Islamic and conventional co-financing involved a US$92 million istisna’ facility used for the manufacture of turbines for the project.¹

In developing countries such as Africa and Pakistan, growth of Islamic project finance was driven mainly by the increasing need for electricity and water desalination stations. Whereas in the Asian region, Islamic project finance served the financing needs of infrastructure development projects (mainly public infrastructure such as transportation, communication, sewage, water, electricity) that are both capital-intensive and long-term (20 to 30 years) in nature. In the MENA region, infrastructure demand has been increasing due to population growth, rapid urbanisation and economic expansion; with greater urgency coming from the political changes of the Arab Spring.² The World Bank estimates that the region will need between US$5 billion and US$100 billion of investment per year over the next 20 years to meet its development needs in providing good quality infrastructure in order to address the pressing challenges of accelerating growth, creating jobs and reducing poverty.³

A number of factors have contributed to the growth of Islamic project finance including: (i) capital-intensive nature of mega-projects undertaken in the Middle East and Asia; (ii) growth in dedicated Islamic finance institutions offering a full range of Shari’a-compliant products capable of utilising a project’s underlying tangible and intangible assets; (iii) increase in the liquidity

¹ GIFR, 2010
² OECD, 2014
³ World Bank, 2013
of the Islamic finance institutions allowing them to participate in projects with longer tenors; (iv) political and cultural desire in certain projects (especially mega-projects with national significance) to promote Islamic finance; and (v) broader consumer demand for Shari’a-compliant financial services and products.  

This niche segment of the Islamic financial industry has yet to develop its full potential to become a mainstream mode of financing despite the growing appetite for infrastructure investments in Muslim dominated countries. While large scale infrastructure development projects have been the domain of governments and multilateral institutions; the private sector has emerged as a major source of infrastructure financing in recent years. The surge in private project financing especially in infrastructure development as a result of a renewed government focus and a tremendous growing appetite for infrastructure investments has created major opportunities for Islamic banks and institutions. The Organisation of Economic Cooperation and Development (OECD) estimates that approximately US$71 trillion would be needed globally by 2030 for investments in road, rail, telecoms, electricity and water infrastructure. In the GCC region and emerging markets, approximately US$2 trillion and US$21 trillion, respectively would be required for infrastructure investments in the next decade.


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**WORLD’S LARGEST GAP**

<table>
<thead>
<tr>
<th>WATER SANITATION</th>
<th>ELECTRICITY</th>
<th>ROADS</th>
<th>INTERNET</th>
</tr>
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<tbody>
<tr>
<td>900 Million</td>
<td>800 Million</td>
<td>1-2 Billion</td>
<td>80% of Asia</td>
</tr>
</tbody>
</table>

Number of People without access to infrastructure in the Asia and Pacific region

Source: Infrastructure Journal, 2014
What is Islamic Project Financing?

There is a fundamental difference between “financing projects” and “project financing”. Financing projects with the support of existing balance sheet is relatively easy – because bankers rely on the strength and historical performance of borrowers. But project financing is a distinct asset-class, meant for projects having no existing balance sheet support and tend to be a non-recourse\(^5\) or limited recourse asset. The funding is done purely on the basis of future cash flows of the new projects being financed. This means analysing and evaluating in detail the project’s construction, operating and revenue risks and their allocation between investors, which typically entails much higher risks, to ensure that the project is financially and economically feasible. For these reasons, project finance requires sophisticated due diligence and structuring skills to ensure all the possible risks are clearly identified and appropriately boxed-in, upfront.

In general project finance is defined as the financing of an economic unit in which the lenders look initially to the cash flows from operation of that economic unit for repayment of the project loan and to those cash flows and other assets comprising the economic unit as collateral for the loan.\(^6\) The economic unit is often referred to as a Special Project Vehicle (SPV), which is typically used as vehicle to finance a large project in order to insulate the sponsor companies from the project’s liabilities in the event of a project failure. As a SPV, the project company has no assets other than the project itself. By making the project its own economic unit via SPV, it is “off-balance sheet”\(^7\) from the vantage point of the sponsor companies.\(^8\)

Furthermore, project financing is often rendered complex due to the multiplicity of participants involved (both local and international parties) such as governments, investors, project companies, lenders, construction and operating companies, legal consultants and insurers. Hence, this becomes the source of multitude risk factors that require numerous agreements and documents to identify risks involved in the structure and to allocate them between the concerned parties. Due to these reasons, co-financing, as opposed to fully funded projects on a Shari’a-compliant basis, is a common structure within Islamic project finance. Co-financing is simply the blending of Islamic finance tranche with a conventional finance tranche, which offers the benefit of deepening the capital pool that would otherwise be limited with Islamic financing only.

Since Islamic finance encourages long-term, partnership based, profit- and loss-sharing investments, its potential for supporting infrastructure projects is substantial. As such infrastructure investment is suitable to be financed through an Islamic financing scheme so long as these projects do not contain any activities that are prohibited in Shari’a. Moreover, the ‘Profit and Loss’ sharing methodology, which characterises Islamic finance does not seem to be too different from the logic behind the operations of pure project financing. Project finance is a natural fit for Islamic finance since emphasis is on equity participation. Islamic finance instruments such as mudaraba, musharaka, ijara and istisna’ have inherent features of risk-sharing and asset-backing, thus making them suitable for infrastructure projects. Furthermore, the increased use of sukuk has opened up an important potential new source of funding for development projects, which require large capital outlays with long construction and amortisation periods.

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5. Non-recourse financing refers to the fact that the sponsor’s liability is restricted to the amount of capital invested.


7. “Off-balance sheet” means the SPV’s debt does not appear on the sponsoring companies’ balance sheets. This avoids any formal restrictions on additional borrowing that may be part of the sponsoring companies’ existing debt obligations.

ADVANTAGES OF PROJECT FINANCE

01 NON-RECOuRSE
- Loan repaid from project cashflows; assets are used as collateral.
- Lenders get comfort in terms of credit support from guarantees, warranties and other covenants from the sponsor, its affiliates and other third parties.

02 MAXIMISE LEVERAGE
Highly leveraged projects with c. 60 - 85% debt used to finance the costs of development and construction of the project.

03 OFF-BALANCESHEET TREATMENT
- Depends on the structure of the transaction.
- Can help the borrower manage its debt portfolio to ensure it can meet the covenants already in place with other lenders.

04 MAXIMISE TAX BENEFITS
Project can be structured to maximise tax benefits.

Islamic project finance is distinguishable from Islamic banking and sukuk in the sense that it is common to see Islamic tranches integrated within a much wider 'multi-sourced' financing arrangement within the Islamic project finance structures. What this entails is the involvement of Islamic banks alongside conventional lenders, multinational development banks and export credit agencies in the implementation of an Islamic tranche as part of a wider multi-sourced financing arrangement. In Islamic project finance, a transaction is structured around a SPV for the collection of financing, both by participating in risk capital (equity) as well as by means of other Shari’a-compliant forms of financing, either directly or through an intermediary funding company, also established for the purpose.

However, the means in which an Islamic project financing is structured will largely be determined by the nature of the project itself, whether it is a 'brownfield' or a 'greenfield'.

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11. The Environmental Protection Agency (EPA) defines brownfield as "real property, the expansion, redevelopment, or reuse of which may be complicated by the presence or potential presence of a hazardous substance, pollutant, or contaminant".
12. A greenfield project is one which is not constrained by prior work. It is constructing on unused land where there is no need to remodel or demolish an existing structure.
KEY DIFFERENCES BETWEEN CORPORATE LENDING AND PROJECT FINANCE

**01**

**CORPORATE LENDING**

- Full recourse
- Lenders rely on established balance sheet and Cash Flows
- Credit analysis and rating
- Usually unsecured
- Limited covenants (financial, cross default and negative pledge)
- Relatively low fees and margins
- Short to medium term tenor

**VS**

**02**

**PROJECT FINANCE**

- Limited or non recourse
- Security over project assets including physical and accounts
- Detailed economic and financial analysis carried out by lenders with support of independent consultants
- Comprehensive covenant package (affirmative, negative)
- Usually relatively high fees and margins, although current trends favourable to borrowers
- Long term tenor

Innovative Structuring Solutions – Case Studies

Generally, two traditional sources of financing used in infrastructure financing are either equity financing (mudaraba, wakala, musharaka) or debt financing (murabaha, bai‘ mua’jjal, istisna’, salam, ijara). In addition to these forms of financing, some larger infrastructural pro-

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Projects are financed through issuance of sukuk. The most frequently used structures in Islamic project finance are the istisna’–ijara structure and wakala–ijara structure.

**Istisna’-Ijara Structure**

A typical istisna’-ijara structure is illustrated in the following example of the US$20 billion SADARA Chemicals venture between Saudi Aramco and Dow Chemicals of the US to build a giant petrochemical complex. In this venture, the National Commercial Bank (NCB) played a key role by committing US$350 million to the project. This project had an Islamic tranche of close to US$0.5 billion out of the total commercial debt of approximately US$4 billion. This facility is divided into two phases — the construction phase which is governed through a procurement agreement and the lease phase which is governed by a lease agreement to enable the lease of the assets (once constructed and delivered) to the lessee. Under the istisna’-ijara structure, the istisna’ agreement applies to the construction phase of a project, and an ijara contract for the operations phase.

During the construction phase, the Project Company undertakes an istisna’ contract to procure the construction, development and delivery of the assets with the asset custodian,
which in this case is the SPV. The Project Company simultaneously enters into a construction contract with the engineering, procurement and construction (EPC) contractor incorporating the terms and conditions of the istisna’ contract. In return, Islamic banks make phase payments to the Project Company based on milestones reached as per the agreed predetermined schedule. These transactions are akin to draws under conventional finance facility. Ownership of the assets is delivered to the Islamic financiers upon project completion pursuant to the istisna’ contract.

In the operations phase, following project completion, lease comes into effect. The ijara contract requires that the lessor (SPV) maintains legal and beneficial ownership of the asset
as well as bear responsibility for risks associated with asset ownership. Furthermore, the ijara contract also includes a promise from the Islamic financiers to transfer ownership of the leased asset to the borrower either at the end of the lease period or in stages during the term of the ijara. Once leasing commences, service arrangements become effective whereby the Islamic banks appoint the Project Company as its service agent in order to insure the assets, responsible for major maintenance and manage other ownership-related tasks. During this period, the Project Company makes rent payments as per the terms of the lease agreement. On payment of the final lease rental, the lessor (SPV) shall transfer the leased assets to the lessee (Project Company) in accordance with the terms of the sale undertaking.

Wakala-Ijara Structure

Another structure often implemented in project financings involving an Islamic tranche is the wakala-ijara structure, which was used in the first independent water and power project (IWPP) in Shuaibah, Saudi Arabia in 2005. Shuaibah was at that time the largest single financing for an individual power sector project. It was developed by a consortium led by Tenaga Malaysia and ACWA Power of Saudi Arabia (who are now undisputed leaders in the regional water and power business). The deal was guaranteed by Saudi Ministry of Finance.

The Islamic facilities in the Shuaibah IWPP is based on a wakala-ijara mawsufah fi al dhimmah structure, a hybrid structure based on ijara which entails financial institution leasing an asset to the customer. Since the project assets (power plant) do not exist as yet because they are still under construction, a forward lease (ijara mawsufah fi al dhimmah) is used. The forward lease will be executed at the same time as the wakala by the Islamic banks (in its capacity as the investment agent) and the Project Company. Under the principles of Shari’a, the lease is classified as a ‘forward lease’ because it takes effect in respect of an asset which is not yet owned by the lessor at the time of execution of the forward lease contract (i.e. the project assets are still under construction). The primary benefit of the forward lease structure is that the Islamic banks are able to receive payments of profit (advance rentals) during the period when the asset is under construction.

In the case of the Shuaibah project finance, Islamic banks appoint the Project Company as the agent or wakil in procuring the assets from the EPC contractor with Islamic Facility Agent acting on their behalf. Hence, parties to the wakala agreement are the Project Company (as the wakil) and Islamic Facility Agent. During the construction period, upon drawdown request from the Project Company for construction payments to the EPC contractor as per the agreed phased payments, the Islamic banks shall make payments to the Islamic Facility Agent for onward disbursement to the Project Company. Upon construction of the power plant, it is leased out to the SPV. The SPV then repays the funds back to Islamic banks through a number of lease instalments over a long period of time. The repayment period more or less matches with the Power & Water Purchase Agreement (PWPA) that the SPV signed with a government utility, as an off taker of all the plant’s outputs.

The Shuaibah IWPP was followed by a number of fossil fuel based power projects funded with slightly variant structures. What changed significantly, however, was the increase in size of these Islamic tranches. For instance, if Shuaibah had only 9% of the total financing done on Islamic basis, this has increased in later deals where some of the large, multi-billion dollar power projects were done with 100% Islamic finance. Similarly, the value of Islamic tranches in project finance continues to increase in size.

Public Private Partnership based BOT Project Structure

For key infrastructure assets such as airports, seaports and railways; owning such strategic assets is not usually possible as governments do not pass on ownership to private entities – only operating rights are granted through concession agreements. Hence, the traditional Islamic finance structure (known as the 'procurement model' or Build-Operate-Transfer) is not suitable because it requires Islamic financiers to own the assets that are being constructed and then subsequently lease them to the project company. And having identifiable assets is a fundamental requirement for Islamic financing. Hence, concessions rights, which are intangible assets, do not qualify to be the subject matter of an ijara. For such strategic assets, it is necessary to create a new structure whereby the rights (i.e. intangible assets) granted to the
consortium under a Build-Transfer-Operate (BTO) structure rather than tangible or fixed assets underpin the financing structure.

An example of an Islamic project finance of a Public-Private-Partnership (PPP) based BTO project is the US$1.2 billion financing of the expansion of Madinah Airport in Saudi Arabia; comprising a commodity murabaha equity bridge facility, procurement facility (in several tranches) and working capital facility. This was the first international airport in the world where the entire financing was done on an Islamic basis. Since this was a BTO project, this meant that the only asset element really available to TIBAH Consortium16 (the SPV) are the concession rights under the BTO; which includes building, operating, maintaining, charging

16. TIBAH Consortium comprises of Al Rajhi Holding, Saudi Oger Ltd and TAV Airports Holding.
MADINA INTERNATIONAL AIRPORT ISLAMIC STRUCTURE
fees and collecting economic revenues. Hence, TIBAH Consortium, will be responsible for the management of the airport, including airside and landside operations. The General Authority of Civil Aviation (GACA) retains ownership of the airport infrastructure where actual completed building works and the rest of the airport structures and facilities including runways would remain the property of GACA.

Working closely with one of the main lenders to the project, NCB (in its capacity as Shar‘ia Structuring Advisor to the Project), came up with the solution where the concession agreement (through which the SPV generates cash and therefore pays lease rentals) was considered as the underlying asset. So in this structure, the SPV wore an additional hat of a “manager” of the airport. This is a kind of “genuine innovation” that the Islamic finance industry requires to take the game to the next level.

As a first step, TIBAH Consortium as the project company transfers certain rights contained under the BTO concession agreement to the financiers (lenders) and as a consideration, lenders assume the obligation of project company to construct the airport as required under BTO. A procurement agreement (istisna’) is entered between the Islamic Facility Agent and TIBAH Consortium, under which the principal of debt financing is disbursed based on agreed disbursement schedule. A management agreement is made and entered where TIBAH Consortium is designated as the manager of the project and thus, is the party who is responsible for implementing all the rights under the BTO. Under this agreement, the TIBAH Consortium pays a fixed share of profits to the financiers. Being a PPP scheme, the lenders had also a Direct Agreement with TIBAH Consortium (i.e. manager) and GACA (tendering authorities) in case of default of the project company.

Project Sukuk Structure

Another innovation in the area of Islamic project finance was the Saudi Aramco Total Refining and Petrochemicals (SATORP) company project sukuk, which was the first public project sukuk. It was seen as a step forward in the diversification of the sources project financing in Saudi Arabia. The sukuk comprised an istisna’ for the construction phase and a forward lease transaction for the construction of the refinery assets with a musharaka contractual overlay. Following the success of the SATORP sukuk17, similar project finance sukuk structure was used to finance a greenfield project in Saudi Arabia – the SADARA Chemicals project in 2013, which is a joint venture between chemicals giant Dow and Saudi Aramco (national oil company in Saudi Arabia). Once completed, the SADARA chemical complex will consist some 30 full-size production plants producing both upstream and downstream products and will be the largest petrochemical facility ever built in one single phase.

Through its subsidiary SADARA Basic Services Company (SBSC), SADARA issued a US$2 billion sukuk. As part of the project financing, net proceeds of the sukuk issuance will be used for the financing and procuring of the construction and delivery of plants of the SADARA chemicals project. SADARA is appointed by the unincorporated musharaka as the procurer of the construction of the assets in return for the issue proceeds. Pursuant to the musharaka agreement, SADARA contributes all its rights and interests on the land which the project is constructed as its in-kind contribution to the musharaka. Musharaka then leases the SBSC’s (sukuk issuer) undivided interest in the sukuk asset to SADARA (as lessee) in return for periodic rental payments. Lease payments from SADARA to the SBSC will match the periodic distribution amounts due under the sukuk certificates. Under this project sukuk structure, the

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17. The SATORP sukuk was oversubscribed by 3.5 times.
sponsors (Dow and Saudi Aramco) will guarantee, up to the project completion, the obligations of SADARA (as procurer under the istisna') and lessee (under the forward lease).

**Risks Inherent to Islamic Project Finance**

As with any project finance, risk analysis and risk allocation between various project participants are essential elements in Islamic project finance. The manner in which risks are assessed and managed depends largely on several factors including parties involved in the project, location of the project as well as the nature of the project. Nonetheless, risks applicable to project finance vary from sector to sector and project to project. Apart from the typical project financing (see Box 10.1), there are additional risks associated with Shari’a-compliant project financing.
Risk to Islamic financiers as asset owners

As the legal owner of the project assets, Islamic financiers are exposed to third-party liabilities as well as other obligations imposed as owners of the assets including responsible for effecting the insurance and major maintenance of the asset. In a typical istisna’-ijara structure, the project company agrees to insure and maintain the assets on behalf of the Islamic facility agent under a service agency agreement. Hence, the borrower in its capacity as the service agent is liable for any loss or damage suffered by the Islamic financiers as a result of any failure to perform these obligations. However, as owners of the assets, Islamic financiers bear the risk of availability of insurance and any vitiation by the borrower of its obligations with respect to the project insurance policies. In the case that the asset sustains serious damage or incurs significant third-party liability, borrower indemnities to cover insurance shortfalls are of little value.18

Shari‘a risk due to different interpretation of Shari‘a rules

Islamic structures and practices not only differ from institution to institution but in some cases from one jurisdiction to another. Hence, Shari‘a risk arises due to non-standard practices in respect of different contracts in different jurisdictions.19 As a result, Islamic financing need to be structured to meet the requirements of each Shari‘a Committee of Islamic banks involved in the project. Lack of standardisation may also discourage investors and borrowers and this is especially true in large project financing that involves cross-border projects.

Risk of conflicting legal principles

The Shari‘a risk discussed above is further exacerbated with the absence of an internationally recognised Shari‘a courts that apply universally settled principles of fiqh.20 In many complex cross-border financing, English law is often chosen as the governing law. However, the issue of governing law takes on a new dimension of complexity in the event of a conflict between two sets of legal principles – which law should take precedence - English law or Shari‘a law. In the event that English law takes precedence, the related issue is whether the English judge is qualified to adjudicate on a dispute relating to Islamic contracts. However, if the Shari‘a law is applied, deciding which school of thought to adopt can greatly complicate the matter. Since Islamic project finance is still a niche market, lack of legal precedent regarding relevant dispute resolution mechanisms are holding back the sector’s growth. Since ownership and liability in these deal structures are quite different from that in conventional finance, it is yet to be seen how they will play out in the court systems. This increases the uncertainty when Islamic banks are considering entering already murky waters.

Current State of Islamic Project Finance

Islamic project finance has become a staple of Middle Eastern mega-projects in recent years. Huge public spending—funded by previously healthy oil revenues—backed these capital-intensive projects. Islamic finance institutions (IFIs) played an increasingly important part in this equation, as project sponsors looked to them as an additional source of liquidity. As IFIs grew, they were able to participate in project financings with long-term tenors and began offering a full range of Shari‘a-compliant products capable of utilising a project’s underlying tangible and intangible assets. Add to this the political and cultural desire in certain projects (especially mega-projects with national significance) to promote Islamic finance and the reasons for Islamic project finance’s remarkable growth become clear.

BOX 8.1:
TYPICAL PROJECT FINANCING RISKS

Construction risk: The construction risks refer to various individual risk factors that adversely affect the construction of a project within the time frame and costs projected and at the standards specified for the facility. Examples of construction risks are cost overruns, cost and scope of identified but unspecified work and variations, contractor default, increased financial costs, force majeure event etc. Construction risks increase with more complex schedules and technologies as well as when a difficult terrain and/or geographical location is involved.

Operational risk: Generally, operational risk is more broadly defined as any and all risks that may cause the project company financial distress during operation such as risks of the project failing to meet agreed upon performance standards and the inherent risks involved in running and maintaining the asset including the ability of the project to withstand volatility in revenue and costs without impacting the debt service.

Supply risk: Risks associated with four critical dimensions of supply - quality, quantity, access and availability of critical inputs for the duration of the project’s life.

Offtake risk: The off-take and sales risk is the risk that the project will fail to generate sufficient cash flow. Once the project is fully completed and operational, offtake risk becomes the most important risk that affect the long term creditworthiness of the project.

Repayment risk: This risk arises when the project company generates insufficient revenues (whether due to offtake risk or other cause), has obligations to third parties that take precedence over the payments to the lenders or is otherwise prevented from making the necessary payments to the lenders. This risk is non-recourse and solely dependent on cash flows after construction involving multiple risks and multiple parties.

Currency risk: There are two currency risks facing project companies, namely currency devaluations and currency inconvertibility. The first currency risk refers to exchange rate fluctuation, i.e. devaluation erodes the value of a contract or payment in the project company’s home currency, or the currency in which it must service its debt. The second risk is currency controls, i.e., the sovereign government limits the project company’s access to foreign exchange or curtails its ability to make foreign currency payments outside of the country.

Country and Political risk: These risks cover changes within the country’s economic, political and business landscape such as civil unrest, war, change of government, changes in national policies, laws and regulatory frameworks; imposition of exchange controls or other types of currency transfer limitations.

Environmental risk: This is the risk that a project will be disrupted by environmental issues or incidents during the course of implementation of the project but is generally within the control of the construction, and the operation and maintenance consortium. Over the years, environmental risk has increased due to the presence of strict legal liability in relation to such environmental incidents.
**Authorisations risk:** Risks associated with obtaining governmental approvals, permits or licenses to construct or operate the project such as environmental permits, drilling permits and permits to own property or operate the project in the case of foreign investors.

**Dispute resolution risk:** In international project finance transactions, parties must determine the law that should govern their transactions (to the extent they have a choice) and whether any disputes that arise under the documents will be resolved through arbitration or judicial means.

However, sustained downward pressure on oil prices is reversing this trend not only for Islamic project finance, but Islamic finance as a whole. Most of the world’s Islamic project financing is used in the major energy deals of the Middle East. After enjoying healthy oil prices of US$90-$120 per barrel for the first few years of the decade, prices began to nosedive in mid-2014. Oil prices fell to a 12-year low in January 2016 and look to continue their downward spiral. Indeed, Goldman Sachs has predicted that prices will sink to as low as US$20 per barrel. With no agreement among OPEC and non-OPEC states to cut or even freeze production, and the expectation that Iran will add as much as a further 1 million barrels per day to the supply glut now that sanctions have been removed, it is hard to argue otherwise.

This outlook has put many energy projects in the Middle East at risk. According to Wood Mackenzie, the world’s big energy groups have already shelved US$200 billion in new projects. Shell has announced a US$15 billion cut in capital spending over the next three years, while BP cut capital expenditure by US$4-6 billion in 2015. Similarly, Statoil returned three licences for exploration off the coast of Greenland. As a sign of troubled times ahead, in November 2015 Standard & Poor’s downgraded a slew of Saudi banks and placed others on negative outlook. These banks include National Commercial Bank, Al Rajhi Bank, Samba Financial Group, and Riyad Bank—all key players in the Islamic project finance market.

According to Dealogic, global project finance volume stood at US$422 billion in 2015, the lowest total since 2013 (US$437 billion). Oil and gas deal volume dropped to US$82 billion in 2015, down 31% year-on-year (US$118.6 billion) and the lowest volume since 2011 (US$73.6 billion). But it wasn’t all bad news. The petrochemical sector saw—for reasons which will explored below—the largest year-on-year increase with a volume of US$18.7 billion in 2015, more than double the US$8.8 billion recorded in 2014 and the highest volume since 2013 (US$26.8 billion). This increase was driven by the US$8.1 billion Rabigh 2 petrochemical project in Saudi Arabia—the third largest project closed globally in 2015.

Overall, EMEA project finance accounted for 37% of the total market, up four percentage points from 2014 and the highest share since 2013 (41%). Not surprisingly, refinancing volume also had a significant increase. It reached US$134.5 billion in 2015, up 63% on US$82.5 billion in 2014 and the highest yearly volume on record, surpassing the previous record set in 2013 (US$130.9 billion). In 2015, 343 deals were completed, up from 203 deals in 2014 and the highest activity on record, ahead of the 225 deals placed in 2013.
### STATE OF ISLAMIC PROJECT FINANCE

![Graph showing project finance and refinancing volumes](source: Deologic)

<table>
<thead>
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<th>Year</th>
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<th>Refinancing (Volume)</th>
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<td>2015</td>
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### What Does the Future Hold for Islamic Project Finance?

Depressed oil prices mean it won’t be business as usual for Islamic project finance in 2016. To prosper it must change its strategy—focus on expansions and sukuk—and enter new sectors in post-sanctions Iran.

#### Project Expansions

Expansion financings in the oil and gas sector may emerge as the best bet for new investments in the face of the on-going oil price slump. Capital and cash flow constraints of industry players are reshaping the investment landscape in 2016. Investors are increasingly wary of greenfield projects that may well pass the bankability test for financiers but don’t meet profitability targets for sponsors. In such an environment, cash is hard to come by so maximizing returns from existing assets will be the name of the game.

One such expansion was the US$8 billion financing of an existing, world-scale petroleum refining and petrochemicals complex in Rabigh, Saudi Arabia which reached financial close in March 2015. Upon completion, the Rabigh 2 project’s combined facilities—constructed in two
Phases at a total cost of US$18 billion—will form one of the largest refining and petrochemical complexes ever built.

Moreover, expansions allow a project stakeholders to leverage a base project with established revenues, positive performance history and longevity of investor commitment. This provides a real opportunity to investors with money still to spend. Moreover, and contrary to some commentary, the confluence of low oil-based feedstock prices and a healthier consumer pocket (leading to greater product demand) makes this a sweet spot for those market participants that can continue to invest in downstream activities.

Petrochemical projects can be the winners in an oil price decline given alleviated pressure on margins, which can, in turn, be used by upstream oil operators to offset a decline in refining earnings. Combine, therefore, both the advantages of expansion financings and the upside of investing in the downstream value chain in the current climate and petrochemical expansions can be one of the remaining pockets of activity in an otherwise quieting sector.

This can create opportunity for Islamic project finance as petrochemical projects and Islamic project finance often go hand-in-hand in the Middle East. By way of example, the Rabigh 2 petrochemical project had three Islamic finance tranches: a US dollar denominated procurement facility, a Saudi riyal denominated procurement facility, and a Saudi riyal denominated wakala facility. The SADARA petrochemical project that achieved financial close in 2013 had the same three Islamic finance tranches in addition to a Saudi riyal denominated sukuk worth US$2 billion. This was similar to the SATORP Refinery and Petrochemical Project that closed in 2011.

Project Sukuk

The istisna’-ijara and wakala-ijara structures will continue to dominate the Islamic project finance market as they are well suited to project finance. They allow IFIs to combine the phased payments of the construction price with rental payments matching the cash flows of the conventional financiers—achieving the same exposures, margins, and tenors. Project sukuk is a recent addition to Islamic project finance instruments. Making its debut on SATORP in 2011 and reappearing on SADARA in 2013, it is set to become a permanent presence in the Islamic project finance scene, particularly in Saudi Arabia. Sukuk is a low cost funding alternative and taps into the strong appetite to fund in local currency, such as the Saudi riyal.

As a sign of market sentiment, it is often seen that large-scale projects, such as Rabigh 2, seek to pre-structure the sukuk option in the documentation as replacement financing at a deal’s outset. Strong demand from regional and domestic investors, lower cost of issuance compared to conventional bonds, attractive pricing, increased standardisation and political commitment to develop the region’s capital markets have all contributed to the growth of project sukuk. In some ways, project sukuk can be advantageous for project companies and sponsors as it offers better pricing and longer tenors than those currently available in the Islamic commercial bank market. Also, sukukholders are typically afforded less oversight compared with the active management of projects by investment agents acting on behalf of Islamic commercial banks.

Iran Opening

Iran has been put on the map for international finance in a big way since it reached Implementation Day of its historic nuclear deal with the P5+1\(^{21}\) in January 2016. Given Iran’s enor-
mous energy resources and infrastructure needs, project finance participants are particularly interested. With its entirely Shari’a-compliant banking system and the world’s largest pool of Islamic banking assets—40% of global assets by S&P’s calculation—Iran can be a game changer for both Islamic finance and project finance.

With investment needs estimated at US$1 trillion, it appears to be a great opening at a time when other doors are shutting. Now that Iran has received relief from certain nuclear-related sanctions, it intends to pursue long-term joint ventures with partners who will transfer technology and employ the country’s well-educated youth. Project finance, in general, and Islamic project finance, in particular, are likely to emerge as the investment vehicles of choice to drive the economic transformation of the post-sanctions Iran.

The opportunity is undeniable. According to BP, Iran holds the world’s largest gas reserves and fourth largest oil reserves. Iranian oil and gas production coming back online could spell continued downward pressure on global energy prices and consequently continued slowdown of oil and gas projects. As one of the world’s lowest cost producers capable of churning out a barrel at a cost of US$5-10, Iran will likely attract oil companies even if (or especially because) prices remain low. Iran has stated that it will seek to increase its production to pre-sanctions levels of 4 million barrels a day. To this end, it is seeking to attract US$185 billion by 2020. To achieve this, Iran has scrapped its unpopular “buyback” contracts in favour of the Iran Petroleum Contract (IPC).

A teaser of the IPC was unveiled in Tehran at the end of November 2015 along with 40 fields ready for investment by international oil companies (IOCs), but the full details are yet to emerge. What we know so far is that the IPC will not be a production sharing agreement—as that would bump up against Iran’s constitutional ban on foreign ownership of its oil and gas resources—but its terms will need to be competitive in the global arena to attract investors in today’s low price environment. In addition to upstream opportunities, Iran has invited investment in petrochemical, power, and pipeline projects.

Iran is already a net exporter of power and a global top ten petrochemical producer. With double-digit growth in the past five years, Iran will benefit from any expansions in the petrochemical sector. In terms of mining, Iran ranks 10th in the world for mineral variety and 15th for mineral quantity. Iran’s 37 billion tons of proven reserves and 57 billion tons of potential reserves are estimated to be worth US$700 billion. Given Iran’s previous isolation, investment opportunities are abundant across various sectors—not just natural resources. Aviation, rail, power, and upgrading existing facilities and infrastructure are all candidates for Islamic project finance in 2016.

References


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capacity to manufacture a nuclear weapon in exchange for relief from certain economic sanctions and the ability to pursue a civilian nuclear energy program. The P5+1 is composed of the five permanent members (P5) of the UN Security Council (the U.S., China, Russia, France and the United Kingdom) and Germany.

22. The Iran Petroleum Contract (IPC) is set to replace the traditional buyback scheme, which was first introduced in the 1990s in an attempt to bridge the gap between the country’s need to attract foreign oil and gas investors, and a ban on private and foreign private ownership of natural resources.


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