**KEY POINTS**

- The Sadara *sukuk* was issued as part of a multi-sourced financing which also included facilities made available by seven export credit agencies (ECAs), the Public Investment Fund (PIF), 26 mandated commercial bank lead arrangers and 11 mandated Islamic lead arrangers.
- If structured properly, capital markets liquidity can be accessed in a project financing for greenfield projects before the main term loan facilities are procured.
- The legal and intercreditor issues associated with issuing a *sukuk* or conventional capital markets issuance in the context of a multi-sourced project financing, need to be structured and documented appropriately to ensure the continued growth of this important potential source of funding.

Feature

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# Sadara project *sukuk*: heralding a new era?

This article examines the innovative use of Islamic bonds (*sukuk*) in the multi-sourced project financing secured by the Sadara Integrated Chemicals Project in the Kingdom of Saudi Arabia. Of the Sadara project's many unprecedented features, the *sukuk* issuance, which was structured as a limited recourse project *sukuk* (sized at the Saudi Riyal equivalent of US$2bn), paved the way for the main project financing, which, two months later, raised an additional approximately US$10.5bn.

## INTRODUCTION

As one of the largest project financings ever arranged in the international markets and the largest project financing ever in the Middle East, the issuance of the hugely successful US$2bn (equivalent) *sukuk* issuance in April 2013, followed two months later by the closing of the approximately US$10.5bn main project financing for Sadara Chemical Company's approximately US$19bn integrated chemicals complex, was always going to be headline news. With it, the Sadara financing has also heralded an era in which capital markets issuances can be expected to form an integral part of many project financings in years to come.

Undertaking a petrochemical project of this scale and complexity has few parallels, whether that be in terms of construction activity or ensuring the web of downstream and upstream operations remains functional and integrated. A project of this scale required stakeholders to distill its various components and to analyse its diverse revenue streams, all the while coming to grips with an ambitious finance plan and schedule. To add to this mix, the desire of the two sponsors, Saudi Aramco and The Dow Chemical Company, to issue a complex limited recourse project *sukuk* prior to the main financing being in place, was both unprecedented and ambitious. Hitherto, capital market issuances in the context of project financings, had only been undertaken after the term loan financings had long closed and, in many instances, only after physical completion of the relevant project because of a lack of appetite on the part of the investors to assume completion risk.

## SADARA INTEGRATED CHEMICALS PROJECT

The Sadara complex is located in Jubail Industrial City II in the Eastern Province of the Kingdom. Sadara has particular strategic importance to the Kingdom and its sponsors. When completed, the complex will be one of the world's largest integrated chemical facilities; the largest ever built in a single phase, and will comprise 26 fully-integrated manufacturing units. Certain of Sadara's complex contractual structures are illustrated in Figure 1: Sadara contractual arrangements (overleaf).

## THE FINANCING

In nurturing the Sadara concept through the global financial crisis, the sponsors sought to match the uniquely complex commercial contracting, technical and engineering project challenges with an unprecedentedly diverse multi-sourced project financing strategy.

The sponsors released their 400-page draft financing term sheet to the ECAs and PIF in August 2011. The creditors, assisted by their legal counsel and other advisors, progressed the due diligence process over the initial review period before term sheet negotiations between the sponsors and the ECAs/PIF were largely concluded by April 2012. The sponsors finalised a bridge financing with the Public Investment Fund, which signed in May 2012, shortly before the sponsors took the financing term sheet, largely agreed with the ECAs and PIF, to the commercial bank market on 28 May 2012.

## THE *SUKUK* ISSUANCE

### Rationale for the *sukuk*

At around the same time as the launch to the commercial bank market, the sponsors embarked on an ambitious plan to issue a limited recourse *sukuk*. The *sukuk* was the second-ever project finance *sukuk* to launch in the Kingdom, after the U$1bn SATORP issuance in 2011, and is the largest publicly listed *sukuk* to date. The *sukuk*, which was priced at 95bps over six-month SAIBOR and has a tenor of 15.75 years, was 2.6 times oversubscribed and was sized at SAR7.5bn (equivalent to US$2bn).

The issuance of a *sukuk*, as well as the procurement of *Istisna-ijara* and *Wakala-ijara* Islamic participant term facilities as part of the wider Sadara project financing, highlights the strategic desire of the Kingdom to promote the use of *shari'a*-compliant financings and affirm the Kingdom's status as a regional hub for *sukuk* issuances. The issuance also illustrates a significant step towards developing alternative funding sources in light of tightening bank lending (particularly in the project finance context where commercial banks are having to grapple with a combination of lower margins and longer tenors in the context of the bank capital adequacy rules being implemented under Basel III); a step which has certainly been welcomed by the sponsor and lending communities alike, who are now beginning to see capital market issuances (both Islamic and conventional) as a key financing source to plug the funding gap in the project finance market.

## What is a *sukuk*?

Although *sukuk* are often referred to as "Islamic bonds", they are more akin to Islamic trust certificates, representing an undivided beneficial ownership interest in an underlying asset where the return is based on the performance of that underlying asset. The key attributes of *sukuk* are that they are generally asset-based securities and any profit or benefit derived from the *sukuk* is linked to the performance of a real asset and the risks associated with ownership of that asset. *Sukuk* are therefore distinguishable from conventional bonds, which are bearer negotiable debt securities that pay the holder fixed or floating interest on a periodic basis during the term of the bond. *Sukuk* do share certain features with conventional bonds, such as being in certificated form, being freely transferrable on the secondary market if the *sukuk* is listed, paying a regular return, and being redeemable at maturity, but conventional bonds are also tradable debt which *shari'a* prohibits. Therefore, *sukuk* have to be linked to an underlying asset using, for example, an *ijara* or *musharaka* arrangement to generate revenues that mirror the coupon payments received under a conventional bond. The return generated is justified as the certificateholder has an ownership interest in the underlying asset as represented by the *sukuk* and is thus assuming ownership risks.

## Structure of the Sadara *sukuk*

The structure of the *sukuk* in Sadara is illustrated in Figure 2: Sadara *sukuk* structure (overleaf) and used a *musharaka* arrangement (essentially a *shari'a*-compliant partnership arrangement) between Sadara and a special purpose issuer. The issuer (as a senior creditor) contributed the proceeds of the *sukuk* issuance to the *musharaka*, which was applied by Sadara to procure certain project assets in accordance with a procurement agreement. Sadara contributed its rights in the land lease to the *musharaka*, which added to the complexity of the transaction from a *shari'a* and regulatory perspective. The project assets were then leased to Sadara by the *musharaka* under a forward lease agreement. Rental payments are paid by Sadara to the *musharaka*, and then on to the issuer (as a senior lender) for payment to the certificate-holders, in accordance with the terms of the certificates. These proceeds from the *sukuk* assets (which mainly comprise the issuer's contractual rights as a senior creditor under the finance documents, and which are, therefore, distinct to the real and intangible assets of the project company) are the sole source of payments on the certificates and so the *sukuk* is limited recourse to the issuer and is a form of asset based financing (ie, on a default, the certificate-holders would only be able to enforce their contractual rights under the *sukuk* documents against the issuer and direct the issuer to enforce its contractual rights against Sadara; the certificateholders could not compel the issuer or Sadara to sell specific project assets) and not asset-backed financing (ie, on a default, the certificateholders would be able to compel the issuer to sell the project assets). The completion risk was mitigated because the certificates benefit from the completion guarantees during the pre-completion period of the project. The existence of completion guarantees was essential to the successful marketing of the *sukuk* because of the unwillingness of investors to assume the construction risk in respect of such a complex project.

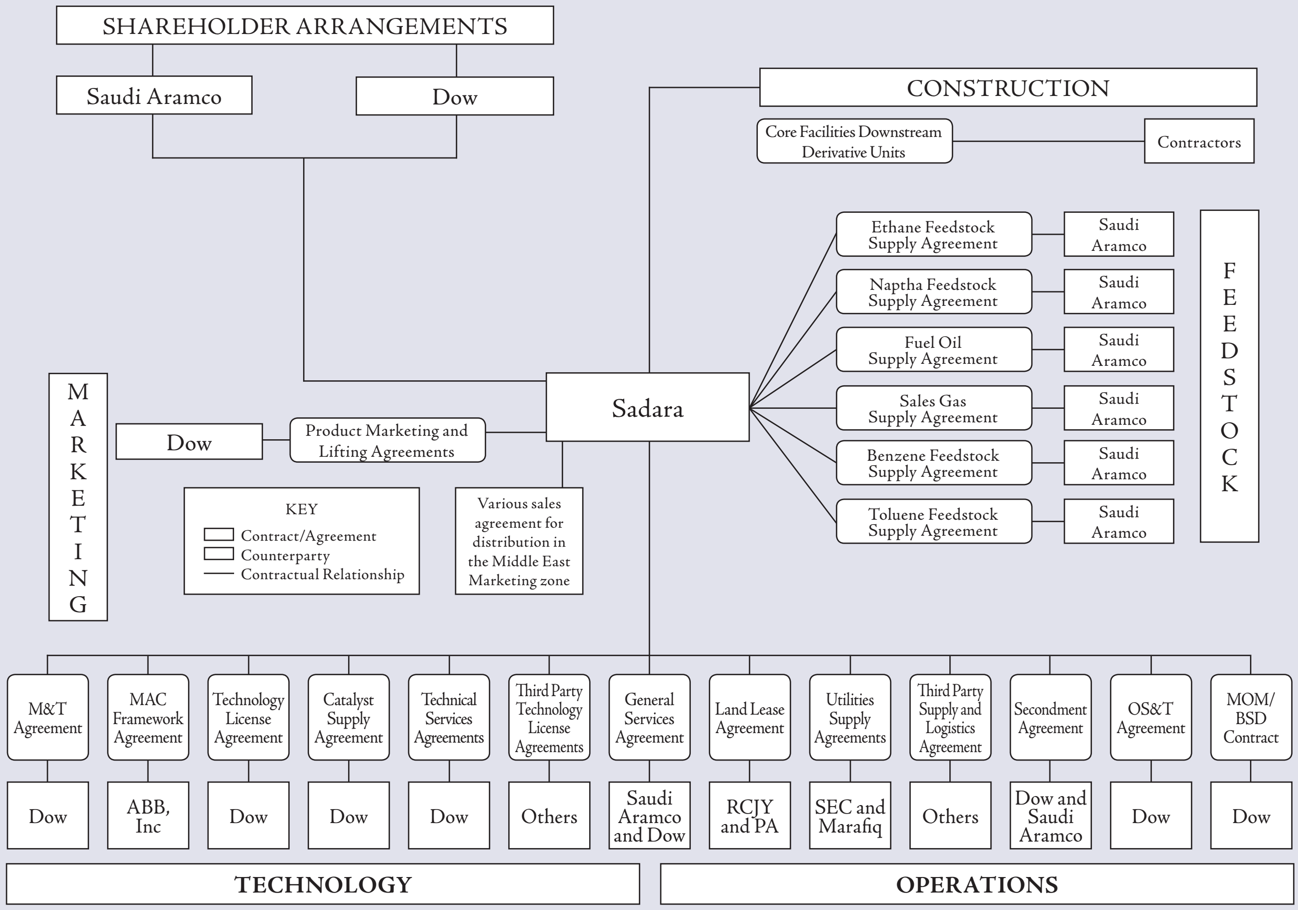
## The "split-closing" regime

The project financing had many unprecedented features, with one of the most notable being that the *sukuk* was closed on 2 April 2013, which was after the sponsors had received debt commitments from the commercial banks, but over two months before the rest of the initial senior debt was signed on 16 June 2013 and closed on 30 June 2013. Termed as a "split-closing", the sponsors were keen to ensure that once the other initial senior debt was ready to sign, the affirmative consent of the certificate-holders would not be required for the amendment and restatement of the finance documents (now reflecting the terms subsequently agreed between Sadara and the other senior creditors), mainly because of the inherent delays in procuring the relevant consent. A mechanism, which involved the delivery of a certificate by Sadara and the issuer was put in place so as to provide confirmation to the certificateholders prior to the second signing date that the proposed amendment to, or restatement of, the relevant finance documents on the second signing date would not affect certain key rights of the certificateholders. Aside to structuring and documenting this complex arrangement, adequate safeguards to protect the rights of the certificateholders had to be negotiated between the joint lead managers of the *sukuk* and the sponsors, including the following: requiring the redemption of the certificates at par if the rest of the initial senior debt had not been signed within a specified period from the *sukuk* being closed; preventing certain key intercreditor rights of the certificateholders from being amended; and restricting any amendments which would have an adverse commercial impact on the certificateholders.

In addition, the "split-closing" regime, together with the associated risks, also needed to be disclosed in the prospectus and the certificates to comply with the applicable disclosure rules.

The "split-closing" regime allowed the sponsors sufficient flexibility thereafter to continue negotiating the finance documents with the ECAs, PIF and the commercial

## FIGURE 1 – SADARA CONTRACTUAL ARRANGEMENTS




and Islamic banks and also to establish the size of their respective debt allocations once the sizing of the *sukuk* was known. The regime also meant that the signing of the rest of the initial senior debt would not be delayed by having to wait for a vote of the certificate-holders. No such vote was necessary and the main project financing closed on schedule. Foreseeing and legislating for these issues at the documentation stage was imperative to ensuring the "split-closing" was successful in achieving its purpose.

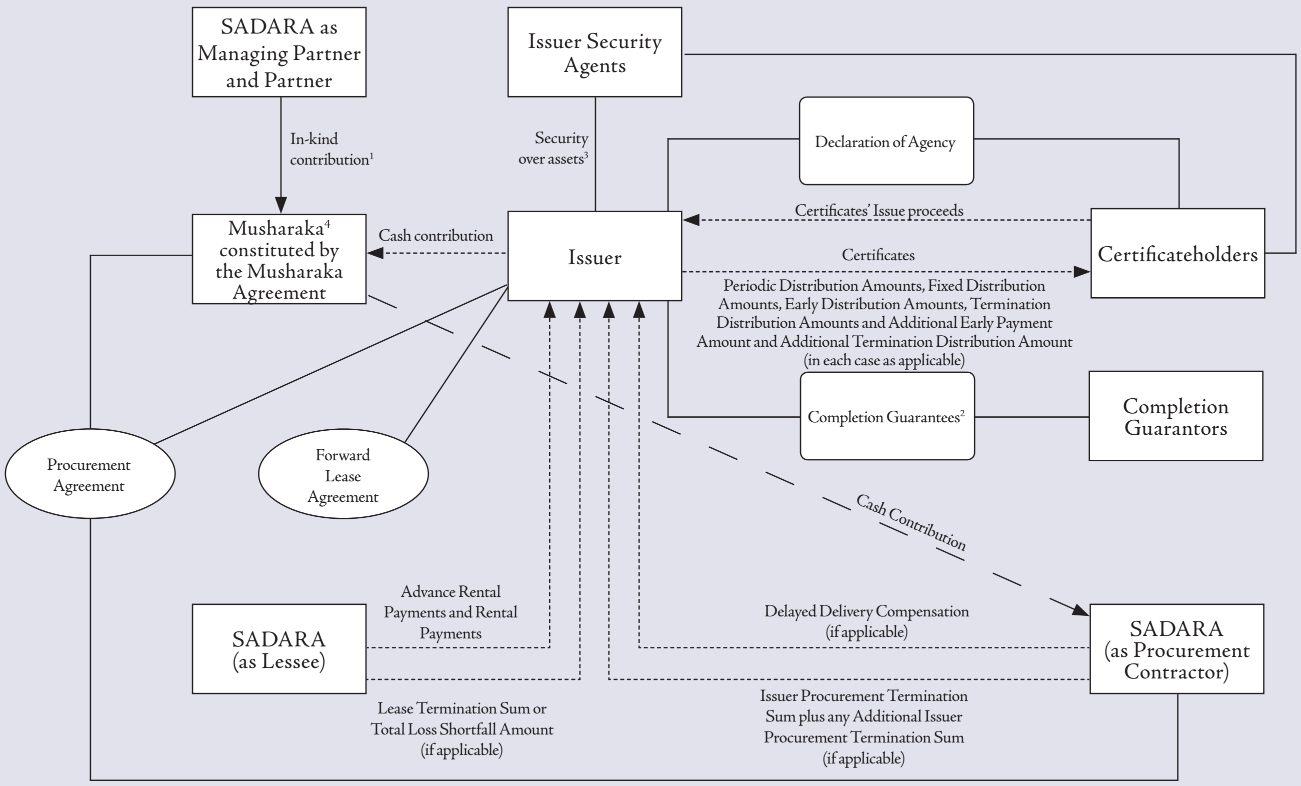
Although relative to the main financing, the *sukuk* was smaller in size, since the project *sukuk* was limited in recourse to Sadara's assets, the traditional suite of project financing documents (including the core finance documents, the security documents and the direct agreements) had to be put in place at the *sukuk* issuance date. This meant that the issuance and closing of the *sukuk* not only involved completing the traditional process associated with a capital market issuance (including signing the subscription agreement, signing the agreements equivalent to the indenture and undertaking the bring-down due diligence sessions), but also included signing the core finance documents and the security documents and then closing the project financing itself, which involved the satisfaction of in excess of 200 conditions precedent. Of course, achieving financial close as part of the *sukuk* was not the end of the story. The main financing also necessitated a second financial close with hundreds of additional conditions precedent required to be satisfied, as well as the amendment and restatement of certain of the core finance documents entered into as part of the *sukuk*, to reflect the terms subsequently agreed between the sponsors and the ECAs, PIF and the banks.

## OTHER FEATURES OF NOTE

### Intercreditor issues

Given the scale and the range of the financing facilities, intercreditor issues were of particular focus and were a matter of detailed negotiation once the finance plan became settled. In light of the particularly large ECA commitment, it was considered important to recognise the voice of the ECAs, which led to the incorporation of a voting concept requiring an ECA majority (ie, a simple majority of the ECAs, which simple majority must, because of its large commitment, generally include US Ex-Im) in favour of a range of qualified majority decisions, which generally incorporate matters that would customarily be super-majority or all lender decisions.

**FIGURE 2 – SADARA *SUKUK* STRUCTURE**



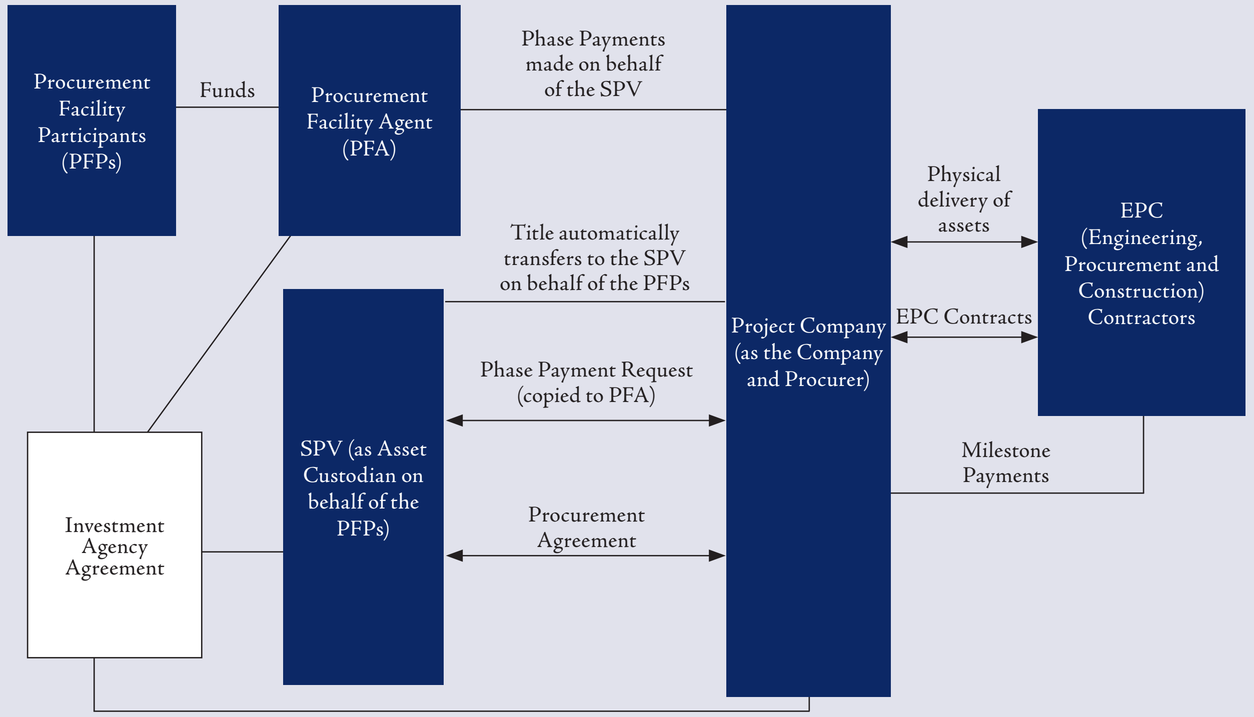

The intercreditor treatment of the *sukuk*, which facility was generally treated as being *pari passu* with the other senior debt for the reasons described further below, provided additional complexity as was the sponsors' desire to pre-structure the flexibility for issuance of additional *sukuk* and conventional bonds in the future. Unlike most capital market issuances issued pursuant to r 144A and/or reg S of the US Securities Act 1933, the certificate-holders benefitted from a broader range of voting rights than bondholders would ordinarily benefit from. The rights afforded to the certificateholders recognised their interest in participating in important decisions. This interest had to be balanced with the overarching aim of ensuring that the decision-making process for the project financing continued to function in an effective and efficient manner.

## *Pari passu* status of the *sukuk* facility

Based on precedent bank-bond financings, it was initially envisaged that the certificateholders would benefit from similar rights to bondholders in those precedents, particularly with respect to the intercreditor arrangements (including the ability to vote on specified waivers and the ability to initiate and then vote to take enforcement action in respect of particular events of default) and receiving the benefit of incurrence covenants only. However, due to the discreet class of investors in the Kingdom who purchase securities of this type on a "buy and hold" basis, to ensure the *sukuk* could be marketed successfully, the *sukuk* was largely afforded *pari passu* status with the other senior debt, which meant that the certificate-holders (through the issuer): (i) benefitted from the maintenance covenants, as well as the incurrence covenants that bondholders would normally benefit from in a typical r 144A or reg S issuance; (ii) had the right to early redemption of the certificates upon a mandatory redemption of any of the senior debt; and (iii) would share in the project financing security on a *pari passu* basis with the other secured creditors.

These enhanced rights enjoyed by certificate-holders gave rise to the concern among some of the other creditors that the project's decision-making process could be adversely affected due to the inherent difficulties of obtaining decisions from bondholders. This concern was mitigated by incorporating a general "snooze-you-lose" provision (which has the effect of disregarding the facility of a creditor who fails to respond within the requisite timeframe, from the denominator for the purpose of calculating whether the required threshold for a decision had been reached) which gave some certainty to Sadara and the other creditors that a decision would be reached by the end of the specified period. Furthermore, because certificate-holders in the Kingdom, generally, take large participations in capital market issuances and "buy and hold" certificates until maturity, it was accepted that the decision-making process at the *sukuk* facility level was likely

FIGURE 3 - ISTISNA-IJARA FACILITY – CONSTRUCTION PERIOD




to be more streamlined than if there was a large class of certificateholders with smaller participations in the *sukuk* who consistently traded out.

## Legal and regulatory issues in the Kingdom

### *Legal regime in the Kingdom*

The *sukuk* was issued by a Saudi Arabian incorporated issuer and the *sukuk* itself was listed on the Saudi Stock Exchange (*Tadawul*). In the context of structuring and documenting any *sukuk* and any related main financing, it is imperative to appreciate the significance of the Kingdom's status as an Islamic monarchy where *shari'a* (Islamic law) is a primary source of law. This body of law is comprised of a collection of principles derived from the principal sources of Islam including the *Holy Qur'an* and the *Sunnah* (the sayings and recorded actions of the Holy Prophet Muhammad (Peace be upon Him and His Family)). One such *shari'a* principle, which is relevant in the financing context, is the prohibition on levying and/or receiving interest, which could render the underlying contract as void.

In addition to *shari'a* principles, the Kingdom's laws consist of legislation in the form of Royal Decrees, Royal Orders, Resolutions of the Council of Ministers, and Ministerial Resolutions and Circulars. This legislation is subject to *shari'a* and Saudi courts will apply and interpret such legislation in accordance with *shari'a*.

The Kingdom's judicial system comprises courts (including the General Courts and the Board of Grievances (the Saudi courts) and judicial committees (including the Banking Disputes Committee (formerly the Committee for the Settlement of Banking Disputes or the SAMA Committee) (the BDC) and the Commission for the Settlement of Negotiable Instruments Disputes (the NID Committee)). The BDC hears banking disputes and the NID Committee is tasked with enforcement of promissory notes. Since the establishment of enforcement judges in early 2013, the task of uncontested enforcement of promissory notes falls under their jurisdiction.

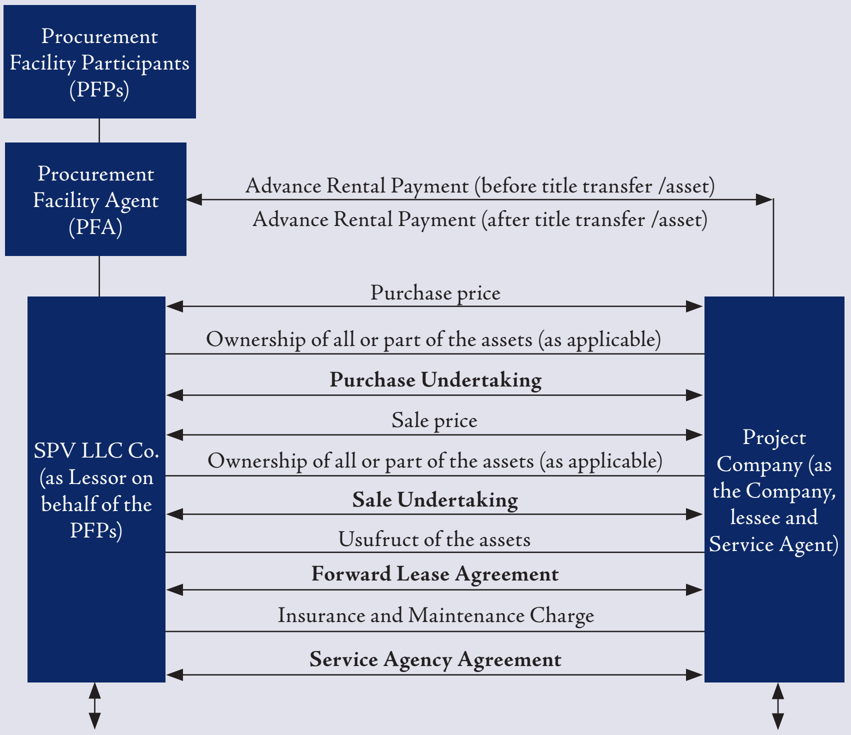
### *Mitigating steps*

It is generally acknowledged that if a dispute arises in respect of a finance document, which provides for the payment of interest, a Saudi court is likely to rule that such obligation to pay interest is unenforceable and could render the agreement to pay or receive interest as being void. Moreover, if a banking dispute is brought to the Saudi courts, they are likely to decline jurisdiction in favour of the BDC, which is tasked with mediating banking disputes in the Kingdom.

To mitigate this risk, lenders customarily seek to further mitigate related concerns in the manner described below. These mitigating steps are consistent with those taken on other multi-sourced financings in the Kingdom and go towards reducing the risk that the *shari'a* principle prohibiting the levying and/or payment of interest (applicable through the laws of the Kingdom) could limit a lender's ability to collect future interest payments from Sadara under the finance documents.

- The core finance documents are governed by English (or New York) law

**FIGURE 4 – *ISTISNA-IJARA* FACILITY – OPERATIONS PERIOD**




and disputes thereunder would (subject to conflict of law rules) be subject to the jurisdiction of English courts (as the case may be). The approach of the English courts has been to apply the ordinary principles of English law and avoid ruling or commenting on the compliance of an agreement with *shari'a*.[1] An English court would not, therefore, avoid enforcement for *shari'a* considerations if the relevant finance document is valid as a matter of English law.

- While judgments of English courts are not currently enforceable in the Kingdom and although most of the tangible assets of a Saudi project company are likely to be located in the Kingdom, customarily the project accounts structure would ensure that most of the project's revenues are deposited in the offshore project accounts. Therefore, there may not be a need to enforce an English court's judgment in the Kingdom. Lenders may also have the option to refer a matter to arbitration.
- Foreign arbitral awards can be enforced in the Kingdom under the New York Convention, but, due to various opt-outs in effect in the Kingdom, it is not uncommon for the enforcement of a foreign award to amount essentially to a re-arbitration in the Kingdom. A new arbitration law has, however, come into effect in the Kingdom, which provides that: (a) arbitration can take place outside of the Kingdom; (b) the parties may decide which arbitration rules to apply (they no longer have to use the Saudi rules); and (c) a foreign arbitral award can be enforced in the Kingdom under the new law. An important caveat is that this arbitration law is new and untested.
- While the security documents usually include onshore security documents, governed by the law of the Kingdom, the lenders often place greater reliance on the security interests created under the offshore security documents, which are usually governed by English law and subject to the jurisdiction of the English courts.
- It is also customary practice that with each drawdown of the senior debt, promissory notes are issued by the project company for the principal amount of such drawdown, and on or before the commencement of each interest period, promissory notes are issued in respect of the interest that will accrue during such period. The use of promissory notes ensures that the NID Committee, rather than the Saudi Courts, have jurisdiction over disputes relating to the promissory notes. The NID Committee would not, generally, consider whether the underlying finance documents provide for the payment of interest and would simply consider the amounts due under the relevant promissory note.

*Sukuk* issuances (as well as *Istisna-ijara* and *Wakala-ijara* facilities) are not immune from the principle prohibiting the levying and/or payment of interest. *Sukuk* documents, when construed in their totality, or individually, may cause a Saudi court to reach the conclusion that the features thereof, which purport to make them consistent with *shari'a* principles applicable to a financing transaction, should be disregarded and that accordingly, the transaction should be re-characterised as a conventional financing transaction (that is, one which is not in compliance with *shari'a* principles). One element which might lead a Saudi court to consider a payment obligation to be a payment of interest or an amount in the nature of interest could be the use of SAIBOR as a reference rate in the calculation of that payment or amount.

## SADARA'S ECA, COMMERCIAL BANK AND ISLAMIC PARTICIPANT FINANCING

The negotiation of the finance documents for the main financing continued apace even whilst the *sukuk* was being negotiated. To ensure the marketing of the *sukuk* was not adversely affected, it was necessary to ensure that the rights of the certificate-holders were aligned with other providers of the initial senior debt.

*Biog box*

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The commercial structure for the main financing included a number of features of note, not least the diverse sources of funds. ECA-direct loans were granted by US Ex-Im (of the US), FIEM (of Spain) and K-Exim (of Korea), in addition to a direct loan being provided by PIF. COFACE (of France), Euler-Hermes (of Germany), K-Exim and K-sure (both of Korea) and UK Export Finance (through the Export Credits Guarantee Department) agreed to provide ECA risk policies to cover commercial bank tranches in dollars and, in some cases, Saudi riyals, and the commercial banks provided uncovered loans in the same currencies, including a letter of credit facility in the Saudi riyal facility.

In addition to the conventional debt facilities, the sponsors arranged both *Istisna-ijara* and *Wakala-ijara* facilities with 11 mandated Islamic lead arrangers, which facilities[2] were made available as part of the main project financing ultimately signed and closed in June 2013. Figure 3: *Istisna-ijara* facility – construction period (see p 169) and Figure 4: *Istisna-ijara* facility – operations period (opposite) illustrate the typical structure adopted for an *Istisna-ijara* facility during both the construction period and the operations period.

As can be identified from Figure 3 and Figure 4, during the construction phase, the procurement agreement documents the construction financing for certain assets up to the value of the financing to be provided under that facility. Upon a phase payment request from the project company (for an amount equivalent to the EPC milestone payments payable by the project company to the EPC contractor pursuant to the EPC contract), the procurement facility participants provide the required funding to the procurement facility agent who disburses the same to the project company. During the construction period, the project company makes advanced rental payments to the procurement facility agent which mirrors the interest payable by the project company to the financiers under the conventional facilities. Upon construction of the assets, on or before the scheduled commercial operation date, the operations period begins and the forward lease agreement becomes effective to lease the usage of those assets to the project company. The project company pays lease payments during the course of the lease and units of the procurement facility participants' ownership interest in the assets are transferred to the project company during the course of the lease.

## PROJECT *SUKUK* – FUTURE

The Sadara *sukuk* issuance has certainly been welcomed by both sponsors and lenders alike. It represents a significant step forward in helping to bridge the funding gap which has dogged the project finance market since the recent financial crisis and which has been exacerbated for commercial banks by the implementation of Basel III. Sadara has shown that, if structured properly, capital market investors have appetite to provide funding to greenfield projects even before the other senior debt has been procured. Perhaps the next evolution in the project finance market might be an ECA covered project bond or *sukuk*? ■

1 See *Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd* [2003] 2 All ER (Comm) 849.

2 See "Islamic Project Finance" Dewar, J (Ed.), *International Project Finance – Law and Practice*, (Oxford: Oxford University Press, 2011).