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Credit FAQ:

Project Finance Sukuk

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In the past 18 months, Standard & Poor's Ratings Services has assigned ratings to two project finance transactions that feature Islamic finance-compliant debt obligations or "sukuk." Islamic financing has potential to become an important means of financing such projects.

Frequently Asked Questions

What is Standard & Poor's experience of rating project finance sukuk?

So far, Standard & Poor's has rated two project finance sukuk transactions, both linked to industrial companies based in the United Arab Emirates (UAE):

- National Central Cooling Co. PJSC (Tabreed; BBB-/Stable/--); sukuk issued by Tabreed 06 Financing Corp., a special purpose entity (SPE).
- DP World Ltd. (A+/Stable/A-1); sukuk issued by DP World Sukuk Ltd., a wholly-owned SPE subsidiary.

The Tabreed senior secured sukuk issuance consisted of a $200 million seven-year istisna and ijara sukuk to fund the construction of district cooling plants in the UAE. The "ijara" nature of the sukuk refers to a sale-leaseback aspect of the transaction, while "istisna" refers to the "construction and delivery" aspect of the transaction.

DP World's 10-year $1.5 billion senior unsecured mudaraba sukuk were used to fund a trust that onlends proceeds of issuance to a mudareb (investment manager) who funds periodic payments to sukuk holders through returns made on investment assets. The "mudaraba" aspect of the transaction refers to the fact that periodic payments were funded from mudaraba (joint investment) assets.

Based on the categories described in our article "Standard & Poor's Approach to Rating Sukuk" (published Sept. 17, 2007, on RatingsDirect), both the Tabreed and DP World transactions would fall under the category of sukuk with full credit-enhancement mechanisms. Under this structure, sukuk receive an irrevocable third-party guarantee, usually by a parent or original owner of the underlying collateral. The ratings on this type of sukuk are largely dependent on the creditworthiness of the guarantor or the entity providing the credit enhancement mechanisms, as well as the ranking of the sukuk among other financial obligations of the guarantor. There are, however, some interesting differences in the broad analytical approach taken to rating the two transactions, which are described below.

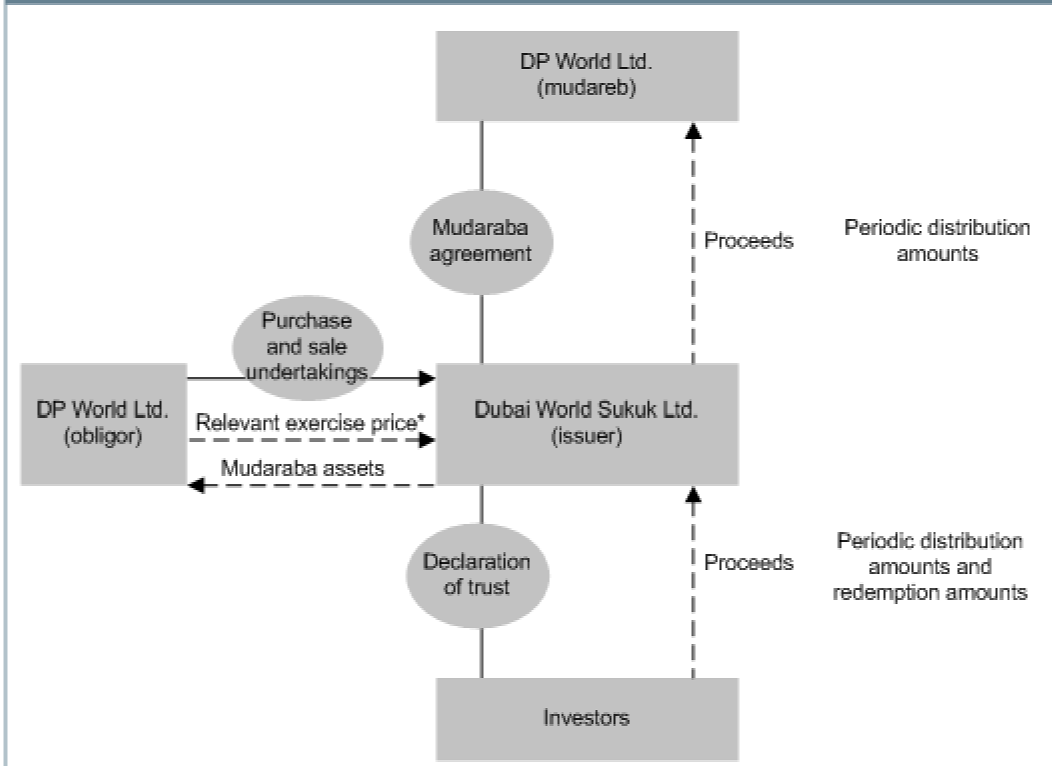
How does cash flow through the two project finance sukuk ratings and what are the credit risks?

DP World.

Cash flow movement: Investors pay the issue price for the sukuk and Dubai World Sukuk Ltd. (in its capacity as rab el-maal, or provider of capital) applies the proceeds as the capital of the mudaraba, pursuant to a mudaraba agreement entered into between the issuer and DP World Ltd. (the latter acting in its capacity as the mudareb). The mudareb, in turn, invests the capital of the mudaraba in DP World Ltd.'s business activities in accordance with an agreed Sharia-compliant investment plan prepared by the mudareb designed to generate "profits," which will be used to service the certificates. If insufficient profit is generated, then DP World Ltd. (in its capacity as mudareb) will be required to provide Sharia-compliant funding to meet the payments in full.

The basis of repayment is the profit generated by the mudaraba (or joint investment trust). If the mudaraba does not generate enough profit then DP World Ltd. has to provide funds to meet the shortfall in returns generated by the mudaraba. For this reason, credit risk is linked not only to the mudaraba but also to DP World Ltd.

Chart 1
DP World Ltd. Transaction Structure

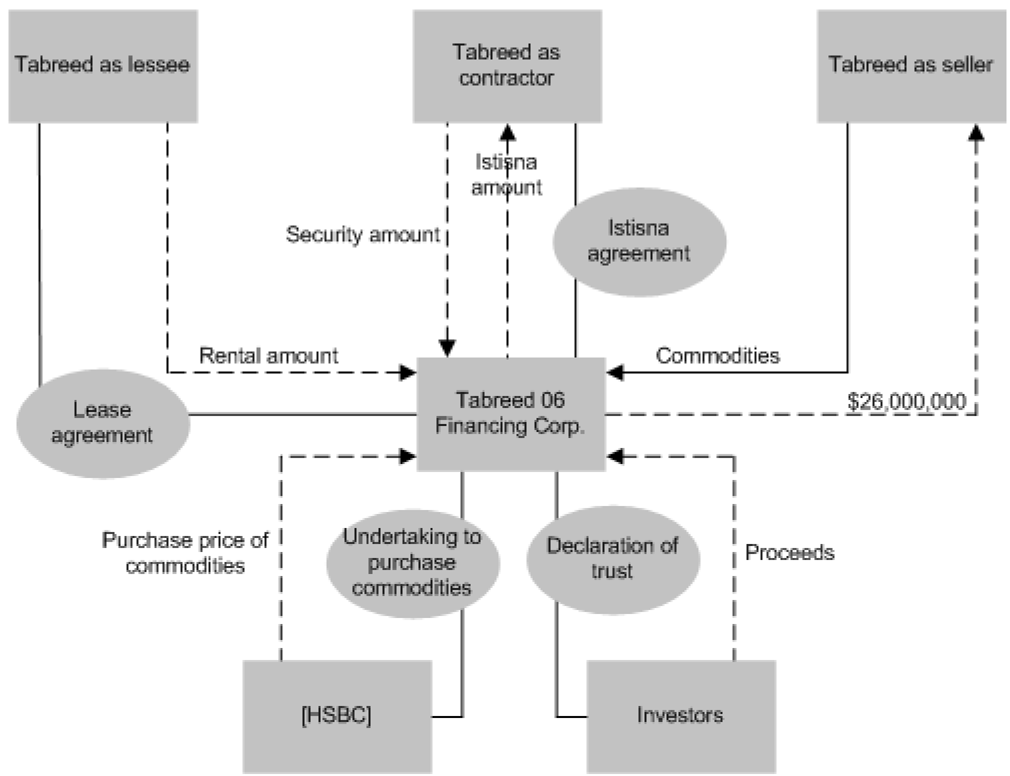


*Relevant exercise price will be equal to the amount required to redeem the certificates on the relevant redemption date.

Tabreed.

Cash flow movement: Investors pay the issue price for the ijara sukuk and Tabreed 06 Financing Corp. invests the proceeds to purchase certain district cooling plants from Tabreed which are then leased back to Tabreed under the ijara sale and leaseback structure. The lease payment is calculated with reference to a certain margin over LIBOR that allows for servicing of the certificates. As shown in chart 2, the proceeds from the istisna sukuk are paid in installments to Tabreed (in its capacity as contractor) as well as to authorized investments in financial institutions and for the purchase of commodities from Tabreed. Tabreed (in its capacity as contractor) is paid in installments of US$40 million on financial close, followed by US$26 million on the date of the first debt service payment. The remaining proceeds are temporarily invested in financial institutions and commodities in order to generate some return on these funds until the exercise date. On the exercise date (which coincides with completion of construction of the plants), the issuer buys the plants from Tabreed--using moneys previously held in commodities and financial institutions. Following the sale, Tabreed (as lessee) undertakes to enter into a lease with the issuer for the plants that have just been delivered. The lease payments are calculated to allow for servicing of certificates.

Chart 2
Tabreed 06 Financing Corp. Transaction Structure



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The basis of repayment under both the ijara and istisna sukuk are the lease payments made by Tabreed to the issuer. If there is shortfall between the lease payments and the level of debt service required to service the notes, then Tabreed may be required to meet this shortfall through the exercise of the purchase undertaking by the issuer which forces Tabreed to redeem the full value of the notes. For this reason, credit risk is essentially linked to the corporate credit quality of Tabreed.

What is the Islamic nature of the financing structures presented?

There are various principles within Sharia (Islamic law) that determine the structure of the above project finance sukuk. Key among these is the philosophical interpretation of the meaning of money and the importance of linking funding to tangible assets. Under Sharia, money is used to measure the value of assets and has no value of its own, so using it should not include a charge or interest. Further, money should only be used in relation to tangible assets, and as such unsecured corporate debt is forbidden. Under Sharia, all financial products should include concepts of profit and loss sharing, with risk shared between the capital provider and the business.

In the project sukuk discussed, it is possible to see compliance with these key Sharia principles: In both the Tabreed sukuk and the DP World sukuk, for instance, repayment of the notes is achieved through lease payments from Tabreed to the issuer and through profits generated by the mudaraba. There is no interest expense, as such, linked to either transaction even though the actual amounts repaid in both cases are designed to meet debt service payments.

Both the Tabreed and DP World sukuk structures involve funding that is asset based. In the case of Tabreed, the assets are the district cooling plants, with DP World they are the mudaraba assets.

The principal of profit and loss sharing between provider of capital and the business itself is most evident in the DP World mudaraba, where proceeds from the debt issuance are invested by the issuer who also happens to be a joint venture partner with the business (the mudareb) under the mudaraba agreement. Profits from the mudaraba are used to repay the notes issued by the provider of capital (the rab el-maal) in its capacity as issuer.

Standard & Poor's does not opine on Sharia compliance when rating sukuk financing.

What is Standard & Poor's analytical approach for project finance sukuk?

We have a three-pronged approach to sukuk financing. First, we determine the extent of any credit enhancement (such as an irrevocable purchase undertaking), and the nature of any collateral security. Second, we analyze the source of repayment of the sukuk (periodic distributions versus rental payments). Lastly, we determine the extent of any government support.

Both the DP World and Tabreed transactions featured unconditional purchase undertakings from parent entities of the issuer. In each case, the purchase undertaking provides that, in the event of insolvency of the issuer or payment shortfall, the parent shall promptly pay all amounts due under the sukuk. In rating the Tabreed sukuk, such purchase undertaking was the basis of our rating. We viewed this payment undertaking as the functional equivalent of a parent guarantee allowing the sukuk to be rated at least pari passu with the senior unsecured corporate obligations of the parent. (We explain later in this report why the sukuk was considered pari passu with secured obligations of Tabreed.)

The DP World purchase undertaking resembled that used in the Tabreed transaction. While such similarity, all other things being equal, would have allowed us to rate the DP World sukuk pari passu with the senior unsecured corporate obligations of the parent providing the purchase undertaking, the issuance was structured through a mudaraba (joint investment) vehicle. Given that the cash flows used to service the debt are ultimately derived from an investment generating a profit, we determined that the mudaraba sukuk has equity-like, loss-absorbing features that could potentially weaken the flow of debt service to the rated sukuk. This is in contrast to the Tabreed (ijara and istisna sukuk) where cash flows are ultimately derived from long-term contractual lease payments originating from specific assets, which renders the sukuk more debt-like in nature. Were this feature the only structural feature of the DP World Sukuk Ltd. transaction, we would likely have viewed the sukuk as ranking below the senior unsecured debt of DP World Ltd. Ultimately, however, the transaction was rated on the basis of implicit government support for the transaction. We considered that the implicit government support for DP World Ltd.'s business extended to an implicit support for this sukuk financing. We in effect viewed the purchase undertaking as itself benefiting from implicit government support, which meant that the rating on the sukuk could be equalized with the rating on DP World Ltd., irrespective of the equity-like features of the sukuk financing.

How does collateral security feature in rated project finance sukuk?

Both the DP World and Tabreed transactions featured collateral security. In the Tabreed transaction, we considered the security sufficiently adequate to allow the issuance to be rated equal to Tabreed's existing secured obligations. By contrast, the rating for the DP World transaction reflected the essentially unsecured nature of the structure.

For corporate entities that have a high level of secured debt on balance sheet, our corporate credit rating factors in the presence of such secured debt. Standard & Poor's criteria state that for any corporate entity that has a level of secured debt to assets above 20%, any unsecured debt would be rated one notch below the corporate credit rating.

Likewise had Tabreed's ratio of secured debt to assets been more than 20%, any unsecured debt would have been rated one notch below the counterparty credit rating. At the time when the Tabreed sukuk was rated, Tabreed's ratio of secured debt to assets was below 20%, so the issue of structural subordination of unsecured debt was not relevant. In any event, analysis of the Tabreed sukuk security features led to the Tabreed sukuk being considered secured. For this reason, were Tabreed's ratio to go above 20% in the future, we would not need to review existing ratings on Tabreed's sukuk as a result of structural subordination. Nevertheless, analysis of whether a sukuk (benefiting from a purchase undertaking from the parent) is secured or unsecured can therefore influence the final rating due to the possibility of structural subordination relative to the parent's corporate credit rating.

Tabreed sukuk security features.
In this transaction, the following security is provided by the issuer: The issuer acts as trustee in respect of the trust assets for the benefit of the noteholders. The trust assets include investments in plants linked to the istisna agreement, the commodities and authorized investments, any plants delivered, the rights under the transaction documents and all proceeds held to the credit of the transaction account (this account is where payment from the lessee is collected on each periodic payment date).

Tabreed's istisna sukuk benefits in theory from ownership of the district cooling plants built once they have been delivered to the issuer. In practice, however, Tabreed's cooling plants are fixed to the land on which they are constructed. Title to the applicable land includes title to the cooling plants which have no separate rights of ownership. As the land is owned by the Abu Dhabi government, Tabreed ultimately only has contractual rights over the cooling plants and not legal title. Legal title over the cooling plants is therefore likely only theoretical and not capable in practice of truly being assigned to the noteholders. Having said this, machinery and equipment relating to the constructed plants is legally owned by Tabreed and can be transferred to the noteholders as part of the trust assets, although the value of such assets is likely to be well below any market value assigned to the cooling plants. The key reason we considered the Tabreed sukuk financing to be secured is that enough features were present in the structure to render the financing comparable with other existing Tabreed secured financings. These features included: 1) A negative pledge over plants delivered to the issuer and leased by Tabreed; and 2) A cash waterfall structure where revenues derived from the leases were directly sent to a transaction account which in turn is assigned to the noteholders. These two features meant that that the designated cooling plants delivered to the issuer could not be comingled into Tabreed's business or used to meet other Tabreed unsecured obligations while the sukuk was outstanding.

DP World sukuk security features.
In this transaction, the key security provided by the issuer (DP World Sukuk Ltd.) is the declaration of a trust for the benefit of the certificateholders over its ownership interest under Sharia in the mudaraba assets. The trust to the benefit of the certificateholders also includes all the issuer's rights, benefits, and entitlements under the transaction documents including proceeds standing to the credit of the transaction account. The transaction account is where payments from the mudareb are made.

DP World's sukuk benefits in theory from an ownership interest under Sharia in the mudaraba assets. However, under English law, which governs the mudaraba agreement, neither the issuer nor the trustee has any ownership interest in the mudaraba assets.

In practice, any rights that the issuer has over assets in the mudaraba are likely limited to its rights under the purchase undertaking to force the obligor (DP World Ltd.) to purchase the notes at an exercise price commensurate with the value of the capital raised and invested in the mudaraba agreement. It is important to note that the performance and ownership of the mudareb assets (the Port Terminal 2 at Jebel Ali) brought into the mudaraba remain very much in the hands of the mudareb. The issuer as well as noteholders therefore have no claim over the tangible assets included in the mudaraba agreement.

While the mudareb acknowledges the need to generate a return from the mudaraba that is sufficient to meet debt service on the sukuk, it does not in any way provide a guarantee that it will do so. This is in contrast with the Tabreed (istisna and ijara sukuk) where long-term lease contracts are entered into, providing a stable revenue stream for the repayment of the notes.

Furthermore, under the mudaraba, the mudareb is allowed to commingle its own assets with assets under the mudaraba, making unclear the precise source and quality of assets that is being used to generate a profit.

Finally, it is unclear how the mudareb will use the assets in the mudaraba to generate a profit. Unlike the ijara and istisna Tabreed sukuk where lease contracts are part of the transaction documentation, under the mudaraba, it is somewhat unclear what the source of profit will be. Ultimately, there is much more of a reliance on the corporate credit quality of DP World Ltd. (as obligor) to meet sukuk obligations than the structure itself to provide for a regular revenue stream for debt service. For this reason, we deem the DP World sukuk to be unsecured and, as discussed above, to have some equity-like features rather than being a pure unsecured debt-like instrument.

What links Standard & Poor's project finance criteria with the approach it takes to rating project finance sukuk?

Standard & Poor's defines a project finance transaction as being a cross between a structured, asset-backed financing and a corporate financing. A project finance transaction is typically characterized as nonrecourse financing of a single asset or portfolio of assets where the lenders can look only to those specific assets to generate the cash flow needed to service its fixed obligations, chief of which are interest payments and repayment of principal. Lender's security and collateral is usually solely the project's contracts and physical assets. Lenders typically do not have access to the project's owner, and often, through the project's legal structure, project lenders are shielded from a project owner's financial troubles.

Neither the Tabreed nor the DP World transaction fully complies with this model. While Tabreed holds title to certain assets and transaction accounts and pledges them to a trustee or collateral agent, and has a cash flow waterfall structure and a negative pledge over the assets (as does DP World), neither structure fully complies with the criteria described above. Accordingly, the sukuks are not rated on the basis of such criteria.

Legal title over the assets being financed is not effectively available for either of the sukuk financings we have rated and as such lenders' security is weaker than we would expect for standard project financings. Furthermore, there is no distinct separation between the project owner's financial troubles and the project itself under the sukuk financings described here. The reliance on purchase undertakings on the obligor and the obligor's corporate credit rating means that the sukuk discussed have strong corporate features necessitating more of a corporate approach than a pure project finance approach to the analysis, even though they are structured as asset-based transactions in line with Sharia principles. Under both sukuk, full bankruptcy remoteness is yet to be tested. The contracts generating the source of repayment are also linked to the obligor, meaning that all risks go back to the obligor's corporate risk with no diversification of counterparty risk as typically seen with project financings.

In addition, while we look to the economic feasibility of a project, the approach taken to the sukuk ratings so far has relied more on the economic fundamentals of the obligor. None of the sukuk financing documentation included financial ratio covenants linked to the financing itself. The Tabreed sukuk for instance, only contained financial covenants linked to the corporate performance of the obligor, Tabreed (minimum EBITDA to debt service of 1x, and total debt to total equity of more than 2.76x).

Thus far, we have rated sukuk on the basis of either a purchase undertaking provided by a rated parent or implicit government support. In one case, the sukuk rating is based on a corporate credit analysis of the parent, in the other, a sovereign analysis of the government, rather than upon full dependency on the project.

In the commentary "Standard & Poor's Approach To Rating Sukuk," we discuss other categories of sukuk, sukuk with partial credit enhancements and sukuk with full credit enhancement, as possible future categories of sukuk. In each case, we will likely analyze the nature of the asset being financed, the counterparties involved, the level of credit enhancement, the credit quality of the cash flow dedicated to debt service, and financial performance parameters. We will also analyze transaction documentation and the existence of any security pledged as collateral for the transaction.

What is the potential for project finance sukuk to achieve investment-grade ratings?

As with any other transaction, a sukuk rating would ultimately depend on the fundamental economics of the transaction as well as the ability of the transaction structure to permit the full and timely payment of scheduled debt service on the rated obligation. The Tabreed and DP World sukuk achieved investment-grade ratings more for their structural features (enhancement and sovereign support) than economic fundamentals of the underlying transaction. More specifically, sukuk supported by an appropriately-worded purchase undertaking from an investment-grade counterparty (effectively allowing for credit substitution of the counterparty rating) may, all other considerations being equal, allow for an investment-grade sukuk.

For sukuk not supported by a purchase undertaking, the likelihood of attaining an investment-grade rating will depend largely on the economic fundamentals of the transaction. Given the lack of experience in enforcing creditors' rights in jurisdictions where many sukuk financings are based, there may be challenges that would need be addressed for such financings to reach investment grade.

What is the growth potential for project finance sukuk?

Project sukuk appears to be growing in popularity not only in the Middle East, but also in the West. Several large companies, such as Qatar Petroleum, have announced their willingness to explore this type of asset funding as a means to diversify their funding base. We expect the issuance of project finance sukuk to continue growing, although there are challenges that may first have to be addressed, including Sharia compliance, enforceability of security in local courts, and subordination features of debt instruments.

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