A new source of funding

WITH THE ISSUE OF THE FIRST EVER UK SUKUK, BY TECH COMPANY IIT, THERE IS NO REASON WHY OTHER UK COMPANIES CANNOT ALSO USE ISLAMIC BONDS FOR CORPORATE FUNDING, AS **FARMIDA BI** EXPLAINS.

A new alternative source of funding for companies has recently been tapped in the UK. In August this year Gateshead-based technology development company International Innovative Technologies (IIT) made the first ever issuance of Islamic bonds (sukuk) in the UK. It is hoped that the $10m sukuk fundraising will be the first of many in the UK.

Sukuk are Shariah-compliant investment instruments that have seen steady global growth in recent years. The first half of 2010 saw worldwide sukuk issuance topping $13.7bn, nearly double the amount recorded in the first half of 2009. They provide a way for financial institutions and other entities to invest in companies without breaching the principles and rules of Shariah. Under Shariah principles, investment in certain sectors and businesses, including those related to alcohol, tobacco, pork, pornography and weapons, and investments paying interest, is prohibited.

London has emerged as the most advanced Islamic finance centre in Europe but as yet, for various reasons, sukuk are still to get off the ground in this country. The IIT deal therefore represents a notable development for the Islamic finance industry in the UK, potentially opening the door to other UK firms raising finance through sukuk.

It is also expected to pave the way for the launch of the first sovereign sukuk by the UK government in the next year or so. As well as representing IIT on its sukuk, Norton Rose was also instructed by HM Treasury to act on its proposed inaugural sukuk, which for "value for money" reasons was put on hold and is still under review.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defines sukuk as "certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity". A number of structures can be used to generate the revenue paid to sukuk-holders; they are generally categorised as either asset-based or asset-backed structures. In asset-based structures sukuk-holders rely for repayment on the company seeking to raise finance, in the same way as a conventional corporate bond issue. In asset-backed structures, sukuk-holders rely on the assets of the sukuk for security.

Although small in amount, the IIT issuance is an important development for sukuk in Europe. It is also significant because it shows that sukuk can be used for small, equity-like transactions, as well as for jumbo-sized financing, such as the $3.5bn sukuk issued by Dubai Ports to partially fund the acquisition of P&O.

A number of reasons have been cited to explain why there have been no UK corporate sukuk prior to this, including the fact that the legislative and regulatory framework in the UK did not provide an efficient environment for sukuk issuances. In recent years, however, the UK government has pursued a policy of creating a level playing field for Shariah-compliant financing as part of a broader scheme to promote London as the key Western hub for Islamic finance.

Since 2003, a series of Finance Acts have removed some of the tax barriers that made Islamic products less tax-efficient than other conventional finance products. The UK government also passed a number of further measures in the Finance Act 2009, including relief from stamp duty land tax in connection with the issue of alternative finance investment bonds (a definition which includes sukuk) and relief from capital gains tax on transfers of land to and from sukuk issuance vehicles.

Most recently in February of this year, the Financial Services and Markets Act 2000 Order 2010 was introduced to remove any further barriers and uncertainty in the regulation of alternative finance investment bonds. The order explicitly exempts them from collective investment scheme regulations, which should, according to the Treasury, reduce compliance and legal costs for such instruments.

Given the legislative changes and the fact that a UK corporate has now raised finance through sukuk, there could be a spate of sukuk issuances in the UK, even in the absence of the long awaited benchmark issue by the UK government. As a result of the current economic climate, which has resulted in some UK companies struggling to gain access to conventional forms of finance, sukuk can offer a viable (and now proven) alternative form of financing for domestic companies. It is one of the ways in which cash-rich investors required to comply with Shariah financing principles can invest in small, medium or larger companies in the UK. Many Islamic investors are looking at potential investments in different sectors but particularly in the high-tech sector.

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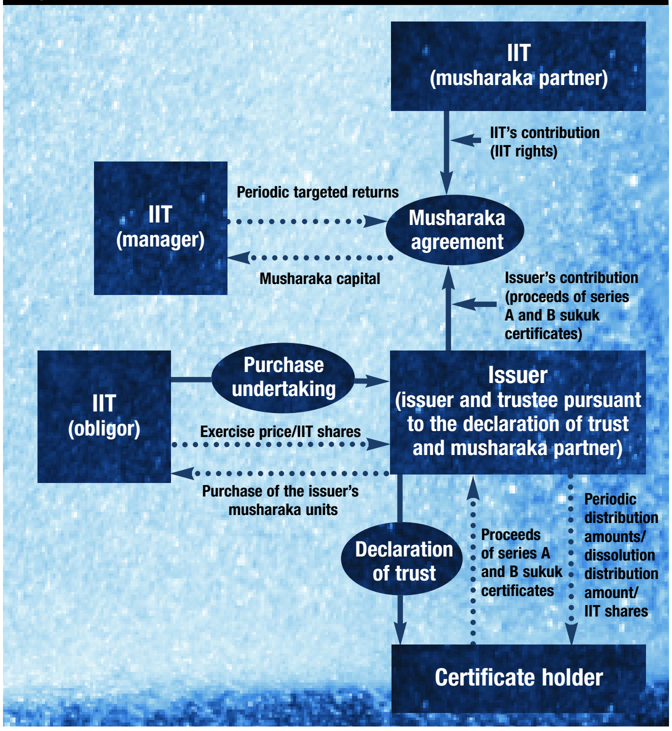
The IIT sukuk used the musharaka structure, also known as profit and loss sharing, to allow the sukuk investor an option to take a stake in IIT. The sukuk, which were issued in two tranches of series A and series B trust certificates, pay 10% a year and will expire in 2014.

In a musharaka, parties contribute capital to a venture, with profits to be shared in an agreed ratio, and losses generally divided in line with capital contributions. In the IIT deal, IIT and the sukuk issuer, a Cayman Islands-based special purpose company, entered into a joint venture. The issuer contributed the proceeds of the sukuk and IIT contributed intellectual property rights and benefits under patents pending for technologies relating to coal-fired power stations. Each of the parties acquired an equal undivided beneficial entitlement to the assets of the musharaka in the form of units, comprising the parties' contributions and all assets acquired, developed and constructed from or through the application of the contributed capital.

IIT was appointed to manage the musharaka under a management agreement in accordance with a business plan. The sukuk issuer acts as trustee under a declaration of trust and also as agent under a declaration of agency for and on behalf of the sukuk holder.

Figure: Structure of IIT musharaka and sukuk



The revenues from the musharaka are shared between the parties in accordance with an agreed revenue share percentage, and the losses are shared according to each party's ownership percentage of the musharaka.

As part of the deal, the sukuk holder has the option, should specified default events occur, to convert its sukuk into shares of IIT.

In the case of specified termination events, the transaction administrator may instruct a licensed liquidator to dissolve the musharaka and distribute the realised proceeds to the partners in the musharaka in accordance with the ownership of units at the time of the termination event.

The proceeds of the sukuk were used by IIT to fund capital expenditure and for general corporate purposes.

Although sukuk issuances have declined in recent years, reflecting the capital markets in general, the global sukuk market hit $46.65bn at its peak in 2007. The Islamic capital markets are expected to revive quickly once confidence returns to the markets generally.

While sukuk issuers have traditionally been based in the Gulf Co-operation Council countries and South East Asia, there is no reason why, given that a UK corporate has now set the precedent, other UK companies cannot use sukuk as a method of financing.

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