

# Asia on the lookout for Islamic LBOs

**Leveraged buyouts have made their way into the world of Islamic finance at a time when conventional wisdom is weighed down with sub-prime woes. Scholarly opinions vary over whether these instruments are *shariah*-compliant, but modern interpretations are opening the door to private equity-style transactions by Middle East investors in particular. Asia is watching this space, too. Chris Wright reports.**

Headline writers had a field day last year when a consortium buying Aston Martin, every British spy's car of choice, pledged to finance the purchase through *shariah*-compliant means. "The name's Bond," said the *Financial Times*, the pick of the bunch. "Islamic bond."

Puns aside, the deal signalled the latest branch of conventional finance to make its way into the world of Islamic finance: leveraged buyouts (LBOs). They're chiefly a Middle Eastern phenomenon so far, but expect them to appear in Asia before long.

The Aston Martin deal involved the £479 million (US\$941.8 million) acquisition of the iconic British car company from Ford. The consortium was organised out of London by a British motor racing entrepreneur called Dave Richards, but the key financiers behind the deal were two Kuwaiti financial groups, Investment Dar and Adeem Investment.

Both invest only in accordance with Islamic principles. In all, 60% of the deal was financed through equity contributions, and the rest through a £225 million loan via German bank West LB, which the backers insisted be arranged Islamically. To do so they used a *murabaha* facility, which is a cost-plus financing. This structure, in which costs and profits are pre-agreed by all parties, is how many mortgages are arranged in the Islamic world. The deal was refinanced in February with a £225 million, eight-year syndicated loan, again on a *murabaha* basis.

To some, the appearance of "leveraged" and "Islamic" in the same sentence rings alarm bells. In fact, there's nothing in *shariah* (Islamic) law against leverage, except for an aversion towards excessive indebtedness. "*Shariah* does not have problems with leverage as long as it is achieved through Islamic debt," says Humayon Dar, managing director of Dar Al Istithmar in London, in a recent essay on the subject. "Leverage is not a *shariah* concern; rather it is an economic issue."

Such an attitude is one that potentially will bring about a raft of new *shariah*-compliant LBOs, opening the door to private-equity-style transactions conducted by Middle East-based investors across the world.



#### DRIVING FORCE

Adnan Al-Musallam, chairman of Investment Dar, one of two Kuwaiti financial groups to back the 2007 buyout of British car company Aston Martin.

#### FINANCING FRONTIERS

There are no hard and fast rules on how LBOs meet with Islamic law. Ultimately, any *shariah* transaction is arbitrated on by boards of scholars. Generally, however, the industry tends to require that the ratio of debt to market capital (some say to total assets) must be less than 33%. So really, it's an issue of what state the target company is in. In Aston Martin's case, this wasn't a problem: it didn't have any debt.

Where companies do have more than that level of leverage, or any conventional interest-bearing debt, scholars require the buyer to pay off that conventional debt within a set period of time for it to be considered compliant.

Far from being a breach of *shariah* principles, some argue that the buyout – with the target's cash flows being used to pay off the cost of the purchase – is closer to pure *shariah* than regular acquisition financing. "It ties in better with the requirements of *shariah*," says Arul Kandasamy, head of Islamic financing solutions at Barclays Capital in Dubai.

Like many people quoted in this article, he was speaking at the *Euromoney* Islamic Finance Summit in London last month. "In addition to the credit element of the risk you are taking, there is no additional recourse to a third party to provide credit support to the transaction. In the deal itself, the cash flows from it must be sufficient to repay the financing that's provided."

To his mind, the problem comes with trying to re-badge things to be something they're not. "In any transaction you will always have an equity piece, possibly a mezzanine piece, and the debt financing piece. What we as an industry need to do is call a spade a spade and say: yes, we are using an *ijara* [Islamic lease agreement] or a *mudaraba* or a *musharaka* [profit and loss sharing] structure, but that piece is a debt piece, not equity. There's a need for that piece and we will structure it in a compliant manner." He predicts that 2008 "will see a lot more non-recourse type financings, whether for acquisition or project finance or private equity".

## NEW PROSPECTS

Those who make their living from structuring in the Islamic world are delighted with this new field. “I’m extremely happy with the development of the LBO market,” says Geert Bossuyt, head of structuring for the Middle East at Deutsche Bank, and the man behind the bank’s *shariah* product platform. “Personally I’m far more excited about developments in the LBO market than the *sukuk* [*shariah*-compliant bond] market.”

Usman Ahmed, the global head of Citi’s Islamic banking business in Dubai, thinks that several developments should drive LBO activity. “Firstly, a number of private equity firms that were formed in the Middle East a few years back have demonstrated a successful track record and sold some of their investments at handsome profits; they are seen as contenders in the international mergers and acquisitions scene. Then we have corporates who have become increasingly acquisitive as well, with global ambitions, who are looking to acquire assets outside of the region.

“So there is a real demand for financing structures that look beyond the obvious senior unsecured debt equivalent, and need to be able to push down some of the financing to the level of the assets for which they are being raised.”

But some observers display a sense of uneasiness about the direction that Islamic finance is taking when it embraces structures such as these.

Salah Jaidah, the chief executive officer of Qatar Islamic Bank, made a curious and unelaborated remark about Islamic LBOs during a panel discussion at the London conference. “It is not appreciated by a lot of scholars, especially ours, so it is a very sensitive area to explore for Islamic banking,” he said. “But I guess for the time being we’re going to take short cuts and take an advantage.”

He didn’t explain what those short cuts were. He had no doubt, though, of the likelihood of further deal flow from the Middle East. “Private equity funds are now on the move. A lot of companies are prepared to be sold, or to grow for further expansion in the region.”

Qudeer Latif, head of Islamic Finance (Middle East) for law firm Clifford Chance, recently advised on another landmark Islamic LBO, when Abraaj Capital, generally considered the leading home-grown private equity business in the Middle East, completed the US\$1.41 billion acquisition of Egyptian Fertilizers Company in the largest private equity transaction in the Middle East to date (see box).

He, too, expects plenty more out of the Middle East. “There’s a fundamental shift in the mentality from a few years ago,” he says. “Middle East investors are more willing to leverage themselves to acquire assets.” The high liquidity in the Gulf, con-

centration risks in portfolios, and a general hunger for overseas assets underpin the trend.

## LEGAL OBSTACLES

From a legal perspective, Latif outlines the issues that have to be thought about before considering carrying out a buyout on an Islamic basis.

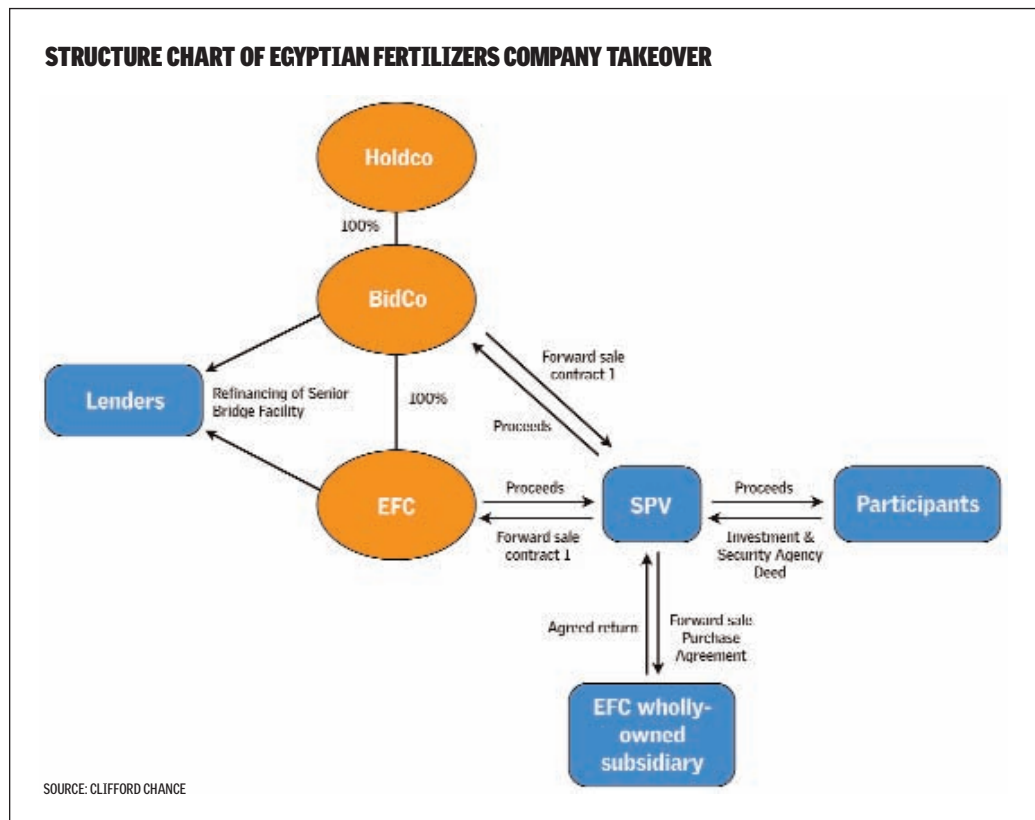
“Is the target a *shariah*-compliant target? Is it a *shariah*-compliant business? Clearly any acquisition of a brewery or a casino is not going to be financed by Islamic financiers.”

Then there are the financial ratios of the target, as discussed above. “One of the other things to think about is use of proceeds,” he adds. “Clearly the facility on the financing will be used to pay the acquisition price, but they’re issues as to whether you can use the Islamic facility to refinance existing debt, and can you use it to repay the costs and expenses associated with the acquisition?”

The answer to that question appears to depend on which Islamic structure is being used, and probably also on the views of the advising *shariah* scholars.

Other areas apply equally to a conventional or an Islamic LBO: the structural subordination between mezzanine and senior debt, with the inter-creditor issues that follow; upstream security and guarantees, with the target usually providing security for the indebtedness that the bidder incurred for the acquisition; and covenant packages in the event of a default.

One of the advantages the Islamic world has on the last point is that it isn’t trying to clear up the wreckage of covenant-lite packages that were common in conventional finance ahead of the United States sub-prime crisis. “In the Islamic LBOs that came to market last year there was a standard acquisition financing and a standard LBO covenant package,” Latif says. “Covenant-lite was never entertained.” Consequently the Islamic world is one of



the few places on earth where anyone is talking positively about leveraged finance.

### TECHNICAL TRICKS

There are some tricky technical matters that come up when trying to conduct LBOs Islamically.

Anything in the *shariah* world has to be backed by physical assets: money can't just turn into more money for its own sake without some link to the physical world. This means the financier will own the asset for a certain period of time, which is not always the case in a conventional LBO, where assets tend to go directly to special purpose vehicles.

"The financiers need to think about the issues that arise from that ownership," says Latif. "Are they going to be liable for any third-party liabilities which arise as a result of being the owner of that asset? Are they going to be liable for paying taxes as a result of that asset?"

Bossuyt argues that because LBOs raise such issues at a local level, they can be a useful force to prompt change in regulation. "The fact that there is this underlying asset that needs to move creates all sorts of legal and tax issues that every first Islamic LBO in a country needs to face," he says. "One of the good aspects about LBOs is that it creates a better discussion with the

authorities about what needs to be done in specific countries to make sure Islamic finance can grow there. At least then you have concrete transactions to discuss the issues we have."

Several different Islamic structures lend themselves to LBOs. Aston Martin, for example, used the commodity *murabaha* approach, which is more usually used as a short-term inter-bank deposit instrument. The sale and *ijara* approach, a lease-to-own method also common in Islamic mortgages, could also apply. And the Abraaj/EFC transaction used another system called *bai salam* (see box below).

What has not been seen yet, however, is the use of *sukuk*. "I suspect as soon as the markets open up we will see the high-yield subordinated *sukuk*," says Latif. "In the conventional space, most acquisitions are effected by senior debt and high-yield debt. The high-yield debt is normally done in the capital markets. Going forward, we'll see the development of the high-yield *sukuk* market."

### NON-ISLAMIC APPEAL

One curious facet of deals like these is that the people drawn to them are not necessarily Islamic investors. "This is pure Islamic finance: venture capital," says Hussein Hassan, director and global head of Islamic structuring for the global markets division of Deutsche Bank, who arranged the Abraaj/EFG deal. "We would have expected that Islamic banks would be jumping up and down to get into this deal. But of more than two dozen investors who came into the deal, there were only two Islamic institutions."

It is understood that in a US\$1.4 billion transaction, less than US\$50 million came from Islamic institutions. Why is this? "A couple of reasons," says Hassan. "Most Islamic banks obviously need fixed income types of returns, and private equity doesn't provide that." Also, this deal involved an Egyptian asset; "banks don't always have lines to do this in Egypt."

But it raises an important question. "The question for people who want to finance leveraged buyouts in an Islamic manner is, 'Is there any point?' We talk a lot about Islamic finance, and the need to encourage more risk participation and risk-sharing contracts. The reality is that Islamic banks are not able to participate in risk-sharing structures such as these."

But if more and more institutions do as Investment Dar has done and decide that they will only finance buyouts through Islamic methods, the weight of liquidity in the Middle East is going to support this industry for a good while yet.

But what about Asia? There is already some evidence of Asian investor support to these transactions: 5% of investors in the Aston Martin deal were from Asia, without that part of the world being particularly targeted. "I don't see any reason why either of these structures [Aston Martin or Abraaj] couldn't be successfully sold into the Asian markets," says Latif.

David Testa, chief executive officer of newly formed Islamic finance group Gatehouse Capital, and at WestLB at the time of the Aston Martin deal, adds: "There's huge and growing interest radiating out of Malaysia... it's going to have a very healthy future in Asia."

That's from the investment perspective. Asian companies, and Malaysians in particular, are also very likely to be targets of Middle Eastern buyout bids. An Investment Dar executive vice-president told media in Kuala Lumpur in December that 10% to 12% of the group's US\$4 billion in assets would go towards Asia.

And then, finally, there's the prospect of Malaysian buyers wanting to finance their own buyouts Islamically. Watch this space. ▲

## LANDMARK LBO

In June, Abraaj Capital completed the Middle East's largest private equity acquisition: the US\$1.41 billion purchase of 100% of Egyptian Fertilizers Company (EFC).

Abraaj made the acquisition through two of its funds, the Infrastructure and Growth Capital Fund and Abraaj Buyout Fund II. Several prominent co-investors joined it in the deal, among them Dubai Capital Group and the Saudi Arabia-based Rashed Al Rashed & Sons Group. Deutsche Bank and law firm Clifford Chance were among the advisers, and many of the challenges they faced were unique to Egypt. Chief among them was the fact that Egyptian takeover requirements only gave a very limited period of time to complete the deal.

Consequently – and this may prove increasingly common in Islamic leveraged buyouts (LBOs) – the bidder and advisers got special dispensation from their *shariah* committee to finance the deal conventionally, with a commitment to refinance it again Islamically after the acquisition went through. The scholars agreed. Another problem is that the *ijara* structure, which would have been the obvious way to do the deal, was not possible under Egyptian law.

The structure they came up with instead is called *bai salam*. This is a forward sale agreement, and is one of the few exceptions in Islamic financing where the delivery of an asset can be delayed to a future date. The financier pays on day one; they get the asset on some specified date in the future.

This proved a handy arrangement for EFC, a manufacturer of urea. It involved a forward sale contract in which the purchase price for the urea is made on day one, with the urea then obliged to be delivered on specified dates in the future. Once that urea is delivered it is sold for an amount equal to the amortisation amount and when that cash comes in, it is used to repay the debt.

There was also a mezzanine piece using the *musharaka* method (*musharaka* means partnership, and a sharing of risk and reward; capital between investors is put together, with profits shared on a pre-agreed ratio, and losses must be proportionate to the amount invested). This too was used to refinance the conventional bridge financing. ▲