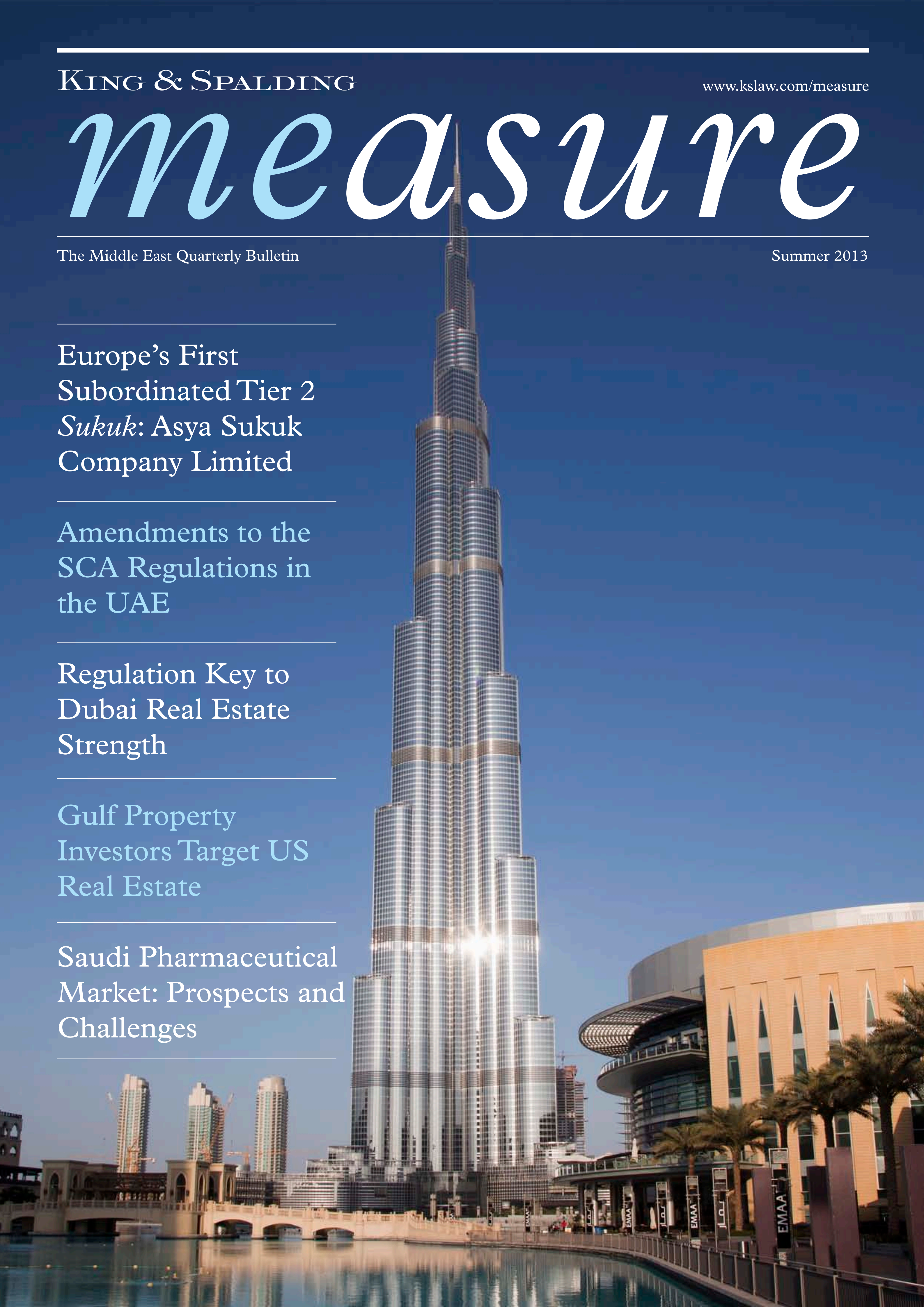

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The Middle East Quarterly Bulletin

Summer 2013

Europe's First Subordinated Tier 2 *Sukuk*: Asya Sukuk Company Limited

Amendments to the SCA Regulations in the UAE

Regulation Key to Dubai Real Estate Strength

Gulf Property Investors Target US Real Estate

Saudi Pharmaceutical Market: Prospects and Challenges

Foreword

Welcome to the Summer 2013 issue of *measure*, King & Spalding's Middle East and Islamic Finance newsletter. This issue is rich in news on emerging market trends and legal developments. A revival in real estate investments has been witnessed across the globe, and Middle East investors are playing a greater role. Our head of Middle East and Islamic Finance practice, Isam Salah, provides perspectives on the renewed focus of Gulf investors on US real estate and the Islamic Finance issues surrounding these investments. Following that, partner Stephen Kelly discusses the importance of regulation to a strong revival of the real estate market in Dubai.

Other interesting developments include an amendment to the UAE investment funds regulations that introduces a private placement exemption for the offering of foreign funds in the UAE. Our award-winning corporate and funds team recently presented a seminar on structuring and marketing investment funds in the GCC, citing innovative examples that we have introduced to our clients. We are setting new trends in the Middle East funds industry, offering our clients commercially practicable solutions to complex issues, such as obstacles to foreign investment and ownership in the GCC. Overwhelming response as well as the attendance of more than 100 clients indicate that this is an area that will continue to see rapid growth in the region.

Another new trend as witnessed by our Capital Markets team, led by partner Rizwan Kanji, is that of Islamic financial institutions accessing the securities markets through *Sukuk* as a source of capital raising. Finally, partner Nabil Issa and associate Sanjarbek Abdukhalilov discuss opportunities and challenges facing private investors into the Saudi pharmaceutical industry. With arguably the most experience in Middle East healthcare and pharmaceutical transactions, our Riyadh lawyers are at the forefront of these developments in the Kingdom.

As you may have seen from the firm's recent press release, I am also pleased to announce the team's continued growth with a number of new lawyers who have joined our Middle East offices during the past few weeks. We have bolstered our Real Estate practice with the addition of partner Stephen Kelly in Dubai and counsel Moustafa Said in Abu Dhabi, who bring significant regional and international experience in real estate, development, tourism and leisure. Their combined skill and in-depth industry knowledge further enhance our strong reputation for local and cross-border real estate matters stemming from the region. We continue to build up our global dispute resolution team with the addition of three new international arbitration and construction lawyers: partner Adrian Cole in Abu Dhabi, counsel Raza Mithani in Dubai, and associate John Packer in Abu Dhabi. Together, the three have worked as a team for a number of years advising on Middle East and international disputes. The specialty of Adrian and his team, arbitrations involving the construction, infrastructure and energy sectors, provides synergies with our energy and global transactions practices. We welcome them on board and look forward to introducing them to you at the earliest opportunity.

Jawad I. Ali
Managing Partner – Middle East Offices and Deputy Practice Group Leader – Middle East & Islamic Finance Practice Group

Volume 3: Issue 6
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Upcoming Events and Our Practice

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Courtesy of Getty Images; Burj Khalifa skyscraper in Dubai, United Arab Emirates. Currently the tallest man-made structure ever built.

Europe's First Subordinated Tier 2 *Sukuk*: Asya Sukuk Company Limited

Around the end of the year 2012, Abu Dhabi Islamic Bank's US$1 billion Tier 1 hybrid perpetual *sukuk* was overwhelmingly welcomed by the market.

This was recently followed by a similar US$1 billion Tier 1 hybrid perpetual *sukuk* issuance by Dubai Islamic Bank indicating that Islamic financial institutions are now accessing the securities market as a source of capital raising in order to maintain their capital ratios.

On 28 March 2013, Asya Katilim Bankasi A.Ş. (Bank Asya) issued the first Tier 2 subordinated *sukuk* out of Europe and the Middle East, further illustrating the expanding use by Islamic financial institutions of *sukuk* to manage capital ratios. This pioneering issuance came with its challenges, particularly from a Turkish regulatory and laws perspective.

Sukuk in Turkey – The Story

In 2010, Kuveyt Türk Katilim Bankasi A.Ş. (Kuveyt Türk) issued the first *sukuk* out of Turkey, a US$100 million debut issuance which listed on the London Stock Exchange. This issuance was based on numerous exemptions as at the time there was a lack of legislative infrastructure to facilitate *sukuk* issuances.

This successful issuance prompted a proactive approach by the Capital Markets Board of Turkey (CMB) to issue a communiqué dated April 2011 (the CMB Communiqué) which provided for the establishment of an asset leasing company (ALC), akin to an on-shore SPV. It also provided that such companies would be able to issue and sell "Rental Certificates" (*sukuk*) utilising the lease (*ijara*) based structures. Any other structure would

require CMB review and approval. The omnibus bill 2011, Law number 6111 dated 13 February 2011 provided for the various tax and levy exemptions applicable to the ALC and payments related to the *sukuk*. The changes in Turkish laws and regulations prompted the second issuance by Kuveyt Türk through KT *Sukuk* Varlik Kiralama A.Ş., an ALC incorporated in Turkey pursuant to the CMB Communiqué. This was the first issuance pursuant to the changes in Turkish laws and regulations.

The issuances having been pioneered by a participation bank and the launch of the Republic of Turkey's first sovereign *sukuk* in September 2012 signaled a milestone and a benchmark for further issuances from Turkey.

The First Subordinated *Sukuk*

On the back of growing investor demand and a need to improve capital adequacy ratios, Bank Asya, the largest Turkish participation bank, issued US$250 million Fixed Rate Resettable Subordinated Tier 2 Certificates due 2023 (the *Sukuk*) listed on the Irish Stock Exchange. This is Bank Asya's debut issuance in the international debt market, and the certificates were issued through Asya Sukuk Company Limited, a Cayman Islands incorporated special purpose vehicle (the Issuer). The certificates are the first-of-its-kind subordinated Tier 2 *Shari'ah*-compliant *sukuk* for capital adequacy purposes in Europe and the Middle East.

The *Sukuk* Structure

The issuance involves a hybrid *ijara-murabaha* structure with approximately 51% of the issue proceeds contributing to the purchase of an initial portfolio of non-real estate *ijara* assets and receivables from certificates (*sukuk*) from Bank Asya. The remaining 49% comprises a commodity *murabaha* between Bank Asya and the Issuer. A couple of key challenges were first required to be overcome.

> ... the launch of the Republic of Turkey's first sovereign *sukuk* in September 2012 signaled a milestone and a benchmark for further issuances from Turkey.

The Challenges

The key challenge was reconciling the subordination requirements for Tier 2 treatment and the amended laws in Turkey in relation to *sukuk*. Under current Turkish legislation, Article 61(4) of the new Capital Market Law No. 6362, which came into force on 30 December 2012 provides that:

> in case: (i) the issuer cannot fulfill its undertakings arising from the lease certificates [i.e., *sukuk*] when they fall due; (ii) the management or the audit of the issuer is transferred to a public institution; (iii) the operation permit of the issuer is revoked; or (iv) the issuer is bankrupt, <u>the proceeds gained through the assets under the portfolio of the issuer are to be primarily used for the payments to lease certificate holders</u>. In such a case, the Capital Markets Board is entitled to take any precautions in order to ensure the protection of rights of the lease certificate holders.

The Banking Regulatory and Supervisory Authority (BRSA) has taken a strict interpretation of the above clause (which applies to all *sukuk* regardless of rank). The BRSA's view is that the above provision, particularly the provision underlined, provides that *sukuk* holders may have recourse to an issuer's assets. Such an interpretation, which mandates recourse to the issuer's assets, goes against the intended nature of subordination to all senior obligations for Tier 2 capital treatment. The BRSA, with its engaging and proactive approach, appreciates that this inadvertent contradiction needs to be rectified.

As the scope of Article 61(4) covered only ALCs, the issue posed by Article 61(4) was avoided through the use of an offshore Cayman Islands special purpose vehicle. Although this overcame the inadvertent contradiction in Turkish law, it raised the potential withholding tax liability on Bank Asya.

All payments by Bank Asya to the Issuer will be subject to withholding tax pursuant to Article 30.1(c) of the Corporation Tax Law, Law No. 5520 (the Corporation Tax Law), which requires a withholding tax at a rate of 15%, to be withheld from all payments of interest and fees on loans obtained by borrowers resident in Turkey from non-resident persons. The Council of Ministers' Decree No. 2009/14593 (the Decree) issued pursuant to Article 30 of the Corporation Tax Law, however, reduces the Turkish withholding tax rate applicable on payments of interest on loans to 1% if such loans are (i) obtained by banks and qualify as Tier 2 capital pursuant to Law No. 5411; or (ii) obtained by banks or entities through securitisations that take place outside Turkey and are structured on a cash flow or an asset portfolio.

... the Capital Markets Board is entitled to take any precautions in order to ensure the protection of rights of the lease certificate holders.

It has further been confirmed in a tax ruling of the Ministry of Finance that for the purposes of the Corporation Tax Law and the Decree, the Turkish withholding tax rate applicable to all payments made under such loans is 1%. Therefore, to overcome the subordination point, Bank Asya's cost of borrowing increased on the basis of such withholding tax.

The CMB Communiqué provides pre-approval for the incorporation of an ALC for the purposes of issuance of an *ijara*-based *sukuk*. Any other structure requires CMB review and approval. As the Issuer is incorporated in the Cayman Islands, the CMB has taken the view that it falls outside its remit and therefore its review and approval is not required.

Conclusion

This is indeed a landmark transaction with a wide distribution of 52% being placed in Europe, 35% in the Middle East and 13% in Asia and one that has required the proactive engagement of the regulatory authorities in Turkey to facilitate its successful issuance. Whilst it was a learning process to identify and overcome the hurdles, particularly the contradiction between requirements for subordination relating to Tier 2 treatment and Article 61(4) of the new Capital Market Law No. 6362, it is essential that steps are taken to address these and therefore facilitate further such *Shari'ah*-compliant capital raising issuances out of Turkey. |

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Pavandeep Gill is a debt capital markets associate at King & Spalding based in Dubai. He assisted in advising Bank Asya on its Fixed Rate Resettable Subordinated Tier 2 Certificates due 2023 and was part of the team that advised the joint lead managers on the Republic of Turkey's debut sovereign *sukuk* issuance. He can be contacted at pgill@kslaw.com or +971 4 377 9948.

Amendments to the SCA Regulations in the UAE

On March 13, 2013, the UAE Securities & Commodities Authority (the SCA) issued amendments (2013 Amendments) to the investment funds regulations which govern the establishment, management and promotion of local funds, and the promotion of foreign funds in the UAE.

Background

The UAE investment funds regulations (the SCA Regulations) came into force on August 27, 2012, heralding a new era of regulation for the UAE investment funds industry. While the introduction of the SCA Regulations strengthened the legal and regulatory framework in the UAE funds industry, unlike other sophisticated jurisdictions, there were no exemptions granted to investment funds being offered on a private-placement basis to sophisticated investors, such as financial institutions and high-net-worth individuals.

Prior to the 2013 Amendments, the SCA Regulations provided that all foreign funds that are offered on a public or private basis to investors in the UAE must obtain the approval of the SCA and must be offered by a local promoter licensed by the UAE Central Bank or the SCA or, in certain circumstances, by a representative office of a foreign company in the UAE. This ultimately resulted in an increase of cost, and time, in placing foreign funds within the UAE.

Amendments to the SCA Regulations

The 2013 Amendments have relaxed the rules on the offering of foreign funds to investors in the UAE. Under an amendment to Article 2 of the SCA Regulations, foreign funds that are privately placed only with the following categories of investors in the UAE are exempt from the SCA Regulations:

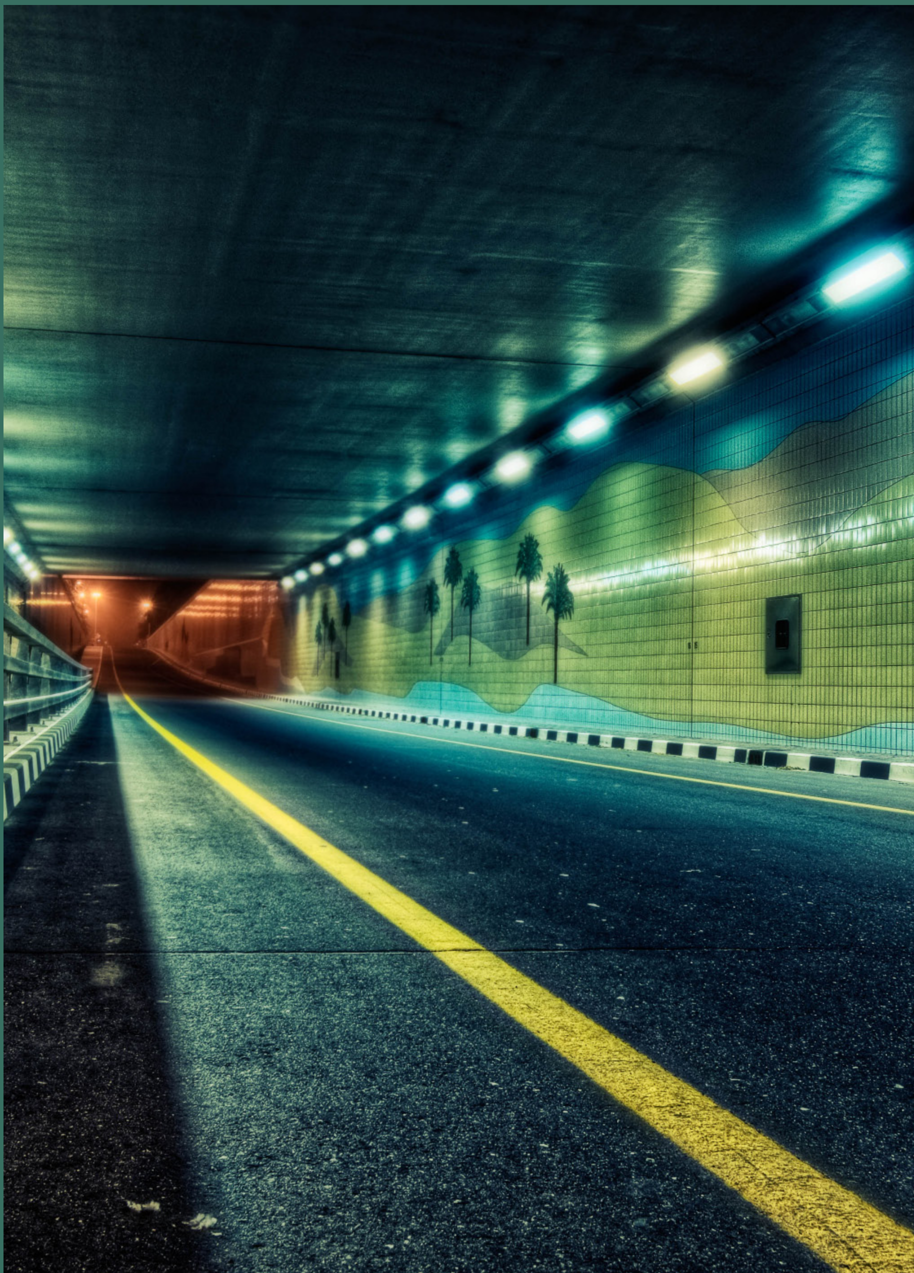
(i) investment portfolios owned by federal or local governmental agencies;

(ii) institutions or entities whose purpose is to invest in securities, provided that such institutions are acquiring the fund interests for their own account; and

(iii) investment managers with discretionary management authority.

Foreign funds may still be offered on a private placement basis to investors in the UAE who do not fall within the above categories, provided that such private placements are approved by the SCA and are made by a local promoter licensed by the Central Bank or the SCA. The minimum subscription amount would need to be AED 500,000 per investor or AED 1 million per investor for a fund established in

> The 2013 Amendments have relaxed the rules on the offering of foreign funds to investors in the UAE.



a “free-zone” outside of the UAE (e.g., the Cayman Islands). The SCA Regulations, as amended, also allow a representative office or branch of a foreign company to act as a local promoter provided that any promotion in the UAE is made on a private placement basis to institutions only and subject to a minimum subscription amount of AED 10 million per investor. The SCA Regulations do not appear to prohibit the promotion of foreign funds to UAE investors where such promotion occurs entirely outside of the UAE. Furthermore, the offering of foreign funds to UAE investors on a reverse-solicitation basis (i.e., where the investor initiates the offer) is unlikely to be caught by the SCA Regulations.

Conclusion

The 2013 Amendments signal the SCA’s recognition of certain qualified investors who possess the necessary sophistication and experience to make well informed assessments of investments. This new private-placement exemption will have a substantial positive impact on the marketing and promotion of foreign funds in the UAE and will be seen by many as a significant move towards promoting the growth of the UAE funds industry.

The 2013 Amendments came into force upon publication in the UAE Official Gazette on 28 April 2013. |

Phillip Sacks is a senior associate in King & Spalding’s Dubai office. Phillip regularly advises fund sponsors and managers on the structuring and establishment of investment funds of all types, including private equity, venture capital, real estate, infrastructure, credit and hedge funds. He can be contacted at psacks@kslaw.com or +971 4 377 9916.

James Stull recently relocated to King & Spalding’s Dubai office after spending three years in the firm’s New York office. James is an associate who regularly advises fund sponsors and managers on structuring and establishing investment funds with a Middle Eastern focus. He can be contacted at jstull@kslaw.com or +971 4 377 9929.

Real Estate

Regulation Key to Dubai Real Estate Strength

As the real estate market in the Emirate of Dubai enters into its next phase of sustainable growth, it is an opportune time to reflect on past practices and how the regulators have responded to protect investors and better regulate market practices.

Although the incredible pace of development in the Emirate initially resulted in a gap between the sophistication of development and the level of supporting legislation, the regulators have worked hard to close this gap and provide greater certainty to the market.

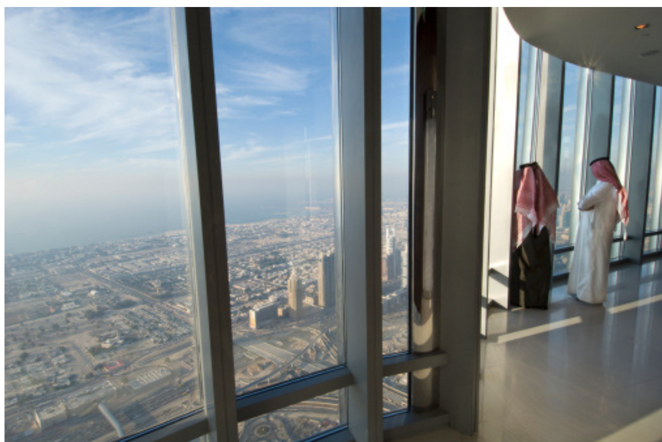
After a relatively soft few years, it is clear from the recent well-published release of a number of projects that demand for quality real estate product has returned and investors are once again willing to invest in the future of the Dubai real estate market.

Although there are many reasons for this return of sentiment, including the significant contribution from the aviation and hospitality sectors, one factor that continues to set Dubai apart in the region is the strength of its real estate legislation and its unwavering commitment to better regulating the real estate market.

The Land Department, and in particular its Real Estate Regulatory Agency division (commonly referred to as RERA), has worked tirelessly to improve industry practices, and to better educate and provide guidance to developers and consumers alike. Wearing their many hats, the Land Department and RERA have introduced greater transparency and accountability into the real estate industry, providing a stronger platform for the future of the real estate market in Dubai.

It is now up to the developers and consumers to embrace the initiatives promoted by the Land Department and RERA to give full effect to this regulatory advantage.

Most importantly, developers and investors need to ensure that lessons are learned and past mistakes are not repeated. For those new to the Emirate or not familiar with its real estate market over the past



decade, at its best, Dubai was leading the world with the pace and sophistication of development, with such incredible achievements as Burj Khalifa, Palm Jumeirah and Dubai Marina. At its worst, however, Dubai became a real estate trading floor for many where the trading of real estate was akin to the trading of commodities, often with little or no concern for the value of the underlying assets.

Fortunately for the market, those days appear to be behind us, and investors now are (or at least should be) far more concerned with what product they will be receiving and what the net yield from the asset will be after service charges and the like have been paid.

To enable investors to properly assess opportunities, and to ensure that the market remains focused on value and not speculation, developers need to embrace the concept of full and frank disclosure as promoted by the regulators, and consumers need to reward developers who do so (and not support others who do not).

Many of the disputes that have arisen in the market have resulted from the developers' failure to adequately disclose the nature of their projects and the product being sold (although to be fair, even if developers had done so, many consumers did not even bother to read their sale and purchase agreements).

Thankfully, gone are the days of developers rushing to market with little more than a glossy brochure and an idea about what they were planning to construct on a plot they were still to own. The ability of a developer to go to market to sell "off plan" has been greatly curbed by the regulator generally requiring significant investment in the land and construction before the developer will be able to release the project.

In an important move, the disclosure regime introduced by the Land Department under the Jointly Owned Property Law (Law No. 27 of 2007) also now requires developers to clearly disclose the nature of the project and the unit being sold, including a description of such things as, what are the common areas and facilities that will be provided and the expected service charges. If the developer fails to appropriately disclose these material matters, the developer is now exposed to claims from investors who are detrimentally affected.

Gone also are the days when developers could simply adopt whatever methodologies they chose to determine the area of the properties being sold. Many disputes have arisen due to different area methodologies being adopted by developers (some more questionable than others).

To put an end to this, the Land Department has issued surveying directions that now mandate how properties are to be measured, and these areas (together with a prescribed form of draft unit plan) must be included in the "disclosure statement" that must accompany the sale and purchase agreement provided to investors so they may compare "apples with apples" when deciding on where to invest.

Developers now must also turn their minds to how developments are going to be subdivided and operated, and this must be clearly disclosed in the sale and disclosure documentation. This is extremely important in the more complex mixed-use and hotel developments, where it is not always clear exactly how this will occur or what investors are buying into when deciding to invest in these projects.

Too often in the past, these issues have not been considered or appropriately addressed in the sale documentation, leading to discord following handover. It is no longer acceptable for developers to put this issue aside to be dealt with later. The subdivisional and operational structure of the project must now be clearly disclosed at the time of sale, including providing a copy of the draft plans and governance documents that are intended to be registered with the Land Department following completion of construction. These governance documents set out the rights and obligations of the owners and occupiers (and the developer if it is to have an ongoing role) and are key to investors understanding their future rights and obligations as owners.

These are only some of the improvements to the industry that have been introduced by the Land Department and RERA. Another notable example of effective regulation is RERA's campaign

to regulate service charges and the manner in which services are delivered to buildings and communities by both developers and third-party service providers. It is fair to say that prior to RERA's involvement, service charges were largely out of control, with many owners paying extremely high service charges with little transparency and accountability from the service providers. RERA has worked extremely hard to bring service charges back under control, accessing and approving service charges for buildings and communities across the Emirate and has significantly reduced end-user costs and ensured that investors receive better value for their money.

A change in culture is needed whereby developers appreciate that full and frank disclosure not only benefits the investors but protects developers against future claims and bad publicity.

For these initiatives to take full effect, it is now up to developers to take the lead by promoting principles of best practice and for investors to keep developers honest by being more diligent when purchasing property.

For the disclosure regime to be successful and the industry to continue to evolve, it is not enough for developers to simply go through the motions. A change in culture is needed whereby developers appreciate that full and frank disclosure not only benefits the investors but protects developers against future claims and bad publicity. Likewise, consumers need to invest time in reading and understanding the disclosure documentation provided by developers to ensure that they know what they are purchasing.

And yes, lawyers have a role and need to step up to assist in this process. It is fair to say that many of the sale and purchase agreements previously prepared by lawyers were inadequate and were not appropriately tailored to the individual projects. Often the same form of agreement was used despite significant differences in the projects. Further improvement in this area is needed in order to support the market as it strives for improved transparency and better industry practices.

An area of the market that RERA has not as yet sought to formally regulate is the practice commonly referred to as "flipping" where a person enters into an off-plan sale and purchase agreement with the sole intention of selling the property to another party prior to handover without ever intending to own the property. This practice was widespread during the "boom years" and, when the financial crisis arose in 2008, was a significant contributor to the market's decline. Many speculators were caught without the financial ability to complete their agreements leaving both themselves and the developers exposed.

With most developers having experienced the impact of purchasers not completing their sale and purchase agreements, we trust that developers are now more wary of selling to speculators and are putting in place policies that seek to limit this practice. Practices such as not selling multiple units to the same purchaser without financial due diligence being undertaken to ensure that the purchaser can complete, and not allowing purchasers to on-sell until a reasonable percentage of the purchase price has been paid, are two common ways a developer may limit its exposure.

For the next stage of development to be sustainable, developers and investors alike need to learn from the past and adopt a more responsible approach going forward. As in all real estate markets, there may be areas where greater regulation is needed in the future to support the Dubai market. However, regulation alone cannot take the market to the next level. It is up to all parties to play their parts to support this process by investing time and energy in improving market practices. |

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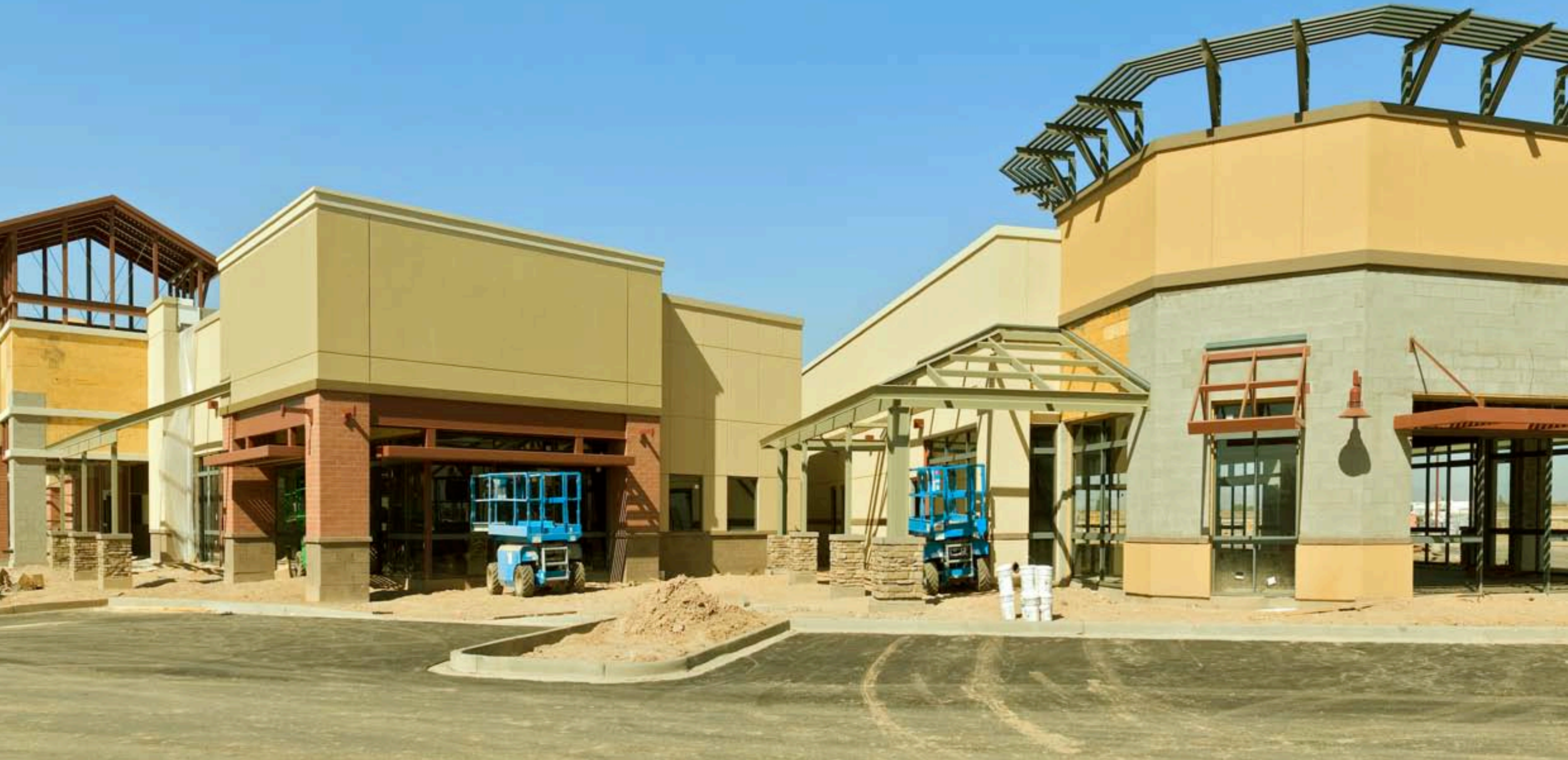
Gulf Property Investors Target US Real Estate



Recent surveys of global property investors reveal a clear preference for real estate investments in the United States over the coming 12 months.

Increasing Global Interest in US Real Estate

According to a November 2012 survey conducted by Colliers International, major institutional and private investors representing a cross section of international property investors have indicated that the most desirable region for increased global real estate investment over the coming year is the United States, followed by Asia and Western Europe, in particular London, Paris and major cities in Germany.

Several other trends emerged from this survey: The volume of investment will continue to grow in 2013, and core investment opportunities will become increasingly difficult to find in key locations. Investors will continue to pursue investment opportunities in cities that are believed to be safe markets, such as London, Paris, New York, Munich and Frankfurt, with London and New York consistently identified as key investment areas. And while a stable income stream and maintenance of value continue to be important investment criteria, investors are likely to accept a greater level of risk in 2013.

In another survey, nearly 200 members of the Association of Foreign Investors in Real Estate (AFIRE), the United States again came out on top. Survey respondents ranked the United States as being the most stable and secure real estate market and as providing the best opportunity for capital appreciation. Nearly 40% of the respondents said they were more optimistic now than they were

one year ago about the US real estate market. An increase in portfolio size is expected by 81% of the respondents, with New York, Washington, D.C., Houston, San Francisco and Boston being the top cities. The leading property type for investment is multifamily, followed by industrial, retail, office and hotel properties.

Gulf Investors Renew Focus on US

Gulf investors have not let this trend pass them by. Gulf institutions that were active property investors in the United States prior to the 2009-2010 financial crisis have returned, and Gulf institutions that are new to the US have made an appearance. After a two-year hiatus in new investments, Gulf investment into the US property markets appeared to resume in late 2010; the pace quickened in 2011 and 2012, and the trend seems to be continuing into 2013 and beyond.

Several factors underlie this renewed focus on the United States. First, as indicated in the Colliers and AFIRE surveys, the United States is perceived to be the leading safe haven for property investments, an especially important consideration for Gulf investors that have seen the Arab Spring sweep across their region. While London continues to be a favorite destination for Gulf investors, economic uncertainty in the eurozone and exchange rate risk have dampened their enthusiasm for European property investments. Finally, Gulf investors perceive the US property market to have recovered from the financial crisis and to be poised for capital appreciation.

Shari'ah-Compliant Investment Trend

Apart from sovereign wealth funds that typically do not operate on a *Shari'ah*-compliant basis, most Gulf investment in US real estate during the past several years has been made in compliance with *Shari'ah* principles applicable to investment and finance. The continuing trend of Gulf institutions toward structuring their property investments in the United States on a *Shari'ah*-compliant basis is attributable to steadily increasing demand from their clients (with whom these investments will be placed) for *Shari'ah*-compliant investment products. In addition, financing structures developed for use in the United States have been tested and have received wide acceptance from the US legal community and financial institutions. These structures satisfy underwriting, regulatory and legal concerns, while allowing Gulf investors to obtain the same tax benefits derived from property investment that are available to conventional investors.

Shari'ah Issues with Tenants

The primary concerns of an investor operating on a *Shari'ah*-compliant basis are the use of the property and the structure of the financing. Gulf investors operating on a *Shari'ah*-compliant basis will not invest in properties with tenants that are engaged in prohibited activities or industries, such as conventional lending or insurance activities; the production or sale of alcoholic beverages, pork products or tobacco; or the production or distribution of pornographic materials.

Determining whether a tenant violates *Shari'ah* considerations is usually uncomplicated, but some tenants operating in a gray area require greater scrutiny, often with the participation of the *Shari'ah* advisors to the investor. For example, while conventional banks are generally not considered acceptable tenants, investors operating on a *Shari'ah*-compliant basis can undertake a more in-depth examination of the activities of a bank at a property to determine *Shari'ah* compliance. Renting space to a bank branch that is engaged in making conventional loans would not be acceptable, but renting offices to the human resources department of a bank might be acceptable from a *Shari'ah* perspective. Moreover, tenants engaged in limited noncompliant activities may also be acceptable, such as a supermarket that devotes a small portion of its shelf space (typically less than 5%)

Gulf institutions that were active property investors in the United States prior to the 2009-2010 financial crisis have returned, and Gulf institutions that are new to the US have made an appearance.

to beer and wine. Note that these considerations generally do not apply to the private activities of a tenant, such as an apartment dweller having an alcoholic drink in his residence.

As a result of these considerations, the property types favored by *Shari'ah*-compliant investors are multifamily, student accommodation, distribution/industrial, single-tenant commercial and office properties, government-leased properties, medical office buildings, and senior living facilities. Multitenant retail and office properties are not as popular because of issues concerning the activities of both current and future tenants.

Shari'ah-Compliant Financing

Banks in the United States do not provide *Shari'ah*-compliant financing directly on a commercial basis because of regulatory restrictions. (Several banks and financing companies in the United States provide *Shari'ah*-compliant finance at the retail level, primarily home mortgage financing.) Banks in the United States do, however, provide conventional funding to ownership structures that in turn provide *Shari'ah*-compliant financing to companies owned by Gulf investors.

Income-producing property in the United States is generally financed on a *Shari'ah*-compliant basis using a master lease *ijara* financing structure. In this structure, the property is held by an independent (typically) Delaware entity owned and operated by a corporate services company. This borrower entity obtains conventional mortgage financing from a bank or insurance company and in turn master leases the property to a (typically) Delaware entity owned by the Gulf investors. This master lessee operates the property and acts as landlord in relation to the existing tenants of the property. The master lease needs to be drafted with the proper allocation of rights and responsibilities to comply with *Shari'ah* principles applicable to leasing arrangements, and at the same time it must satisfy US tax and accounting requirements so that it is treated as a finance or capital lease. Rent paid by tenants is used by the master lessee to pay its rent obligations to the borrower, and the borrower uses those rent payments to satisfy its debt service obligations to its lender. The obligations of the master lessee to the borrower are secured by an assignment of leases and rents and a security interest in any other assets of the master lessee, and the borrower secures its debt obligations to the lender with a mortgage on the property, an assignment of leases and rents (which would include its master lease with the master lessee), and a collateral assignment of the security it receives from the master lessee. The lender providing the mortgage financing ultimately receives the same security package as in a conventional mortgage financing, although a portion of this collateral flows to the lender through the *Shari'ah* structure.

... the property types favored by *Shari'ah*-compliant investors are multifamily, student accommodation, distribution/industrial, single-tenant commercial and office properties, government-leased properties, medical office buildings and senior living facilities.

This structure works best for the *Shari'ah*-compliant financing of income-producing properties and has been accepted by a broad range of lending institutions – major national banks and regional banks, financial institutions that intend to securitize their mortgage loan or transfer the loan to Freddie Mac or Fannie Mae, insurance companies, and lenders that will have the repayment of the financing insured by the US government. Nevertheless, the structure does present a few issues that should be anticipated by the Gulf investor.

Financing Issues

Mortgage financing in the United States is on a limited recourse basis, meaning that the lender

will look only to the property for repayment of the financing. Most mortgage financings, however, provide that recourse will not be limited to the property in certain situations, such as fraud, diversion of rental income, environmental problems and filing for bankruptcy. Most lenders will require that a creditworthy party other than the borrower provide a guaranty of the losses arising from those events and, depending on the event, a guaranty of the entire mortgage loan. *Shari'ah*-compliant investors are generally unwilling to sign documentation directly with a conventional lender, thereby making the issuance of a guaranty problematic. If the Gulf investor is undertaking its investment in a joint venture with a local property company, that property company could provide the required guaranty. But if the Gulf investor is proceeding on its own, either it will need to make clear to prospective lenders at the outset that a guaranty will not be provided, which may result in a lower loan-to-value (LTV) ratio or, (if possible) it should create a guarantor with a net worth sufficient for the lender.

If the property is leased to a single tenant, the lender will require a subordination, non-disturbance and attornment agreement (SNDA) with the tenant for assurance that, in the event of a foreclosure, the tenant will recognize the purchaser in the foreclosure sale (which could be the lender) as its landlord, and in return the new owner of the property will abide by the tenant's lease as long as the tenant is not in default. The SNDA can be slightly more complicated in a *Shari'ah*-compliant transaction because the master lessee (which is intended to operate on a *Shari'ah*-compliant basis) should not enter into any direct agreement with the lender. On occasion this has necessitated two SNDAs — one between the tenant and the lender and a second between the tenant and the master lessee (the tenant's direct landlord). These issues and other related issues can usually be resolved in a manner that addresses each party's concerns, including the *Shari'ah* concerns of the Gulf investor.

Conclusion

The pace of foreign and Gulf investment in US real estate continues to pick up, and *Shari'ah*-compliant investors have been a significant part of the capital flow coming from the Gulf into the United States. Over the past two years, investments have focused on multifamily, student accommodation, industrial/distribution facilities, single-tenant commercial and office properties, and senior living facilities. Mortgage financing is readily available at historically low rates, and *Shari'ah*-compliant financing structures have become widely accepted by the legal community and financial institutions. All signs point to a continuation of this trend, with the main investment-limiting factor being the stiff competition for attractive properties. |

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Saudi Pharmaceutical Market: Prospects and Challenges

Recently, there has been a growing appetite for private investment in the Saudi pharmaceutical market, particularly from the Gulf-based private equity groups.

The Saudi pharmaceutical market is the largest in the region and forecast to grow by 4.7% annually to reach $4.7 billion by 2016, equivalent to over $140 per capita.[1] It is estimated that the government purchases around 35% of pharmaceutical products and the rest are bought by the private sector.

Saudi Arabia relies heavily on imports of pharmaceutical products (up to 85% of total sales), mainly from Europe, to satisfy growing local demand, which is driven by insufficient domestic drug production and lack of local R&D capabilities. Saudi Arabia has the largest manufacturing segment in the Gulf, but most local production is exported. Domestic production accounts for about 15% of the overall supply in the market.[2] The market is dominated by SPIMACO, Tamer Group and Tabuk Pharmaceutical Manufacturing.

It is estimated that there are about 4,000 retail pharmacies. Local pharmacies are increasingly becoming one-stop shops offering medicines, personal hygiene and beauty products, infant care and nutrition products. It is the retail segment of the pharmaceutical market that is attracting a lot of interest from private investors who are keen to tap into the growing success of local pharmacy chains.

The Saudi pharmaceutical industry is regulated by the Ministry of Health and the Saudi Food and Drug Authority (SFDA). The National Unified Procurement Company for Medical Supplies is the sole supplier of medicines and medical appliances to Saudi government institutions. There is an established framework for licensing and regulating the manufacturing, distribution and sale of pharmaceutical products.[3] The SFDA sets retail prices for all imported medicines.

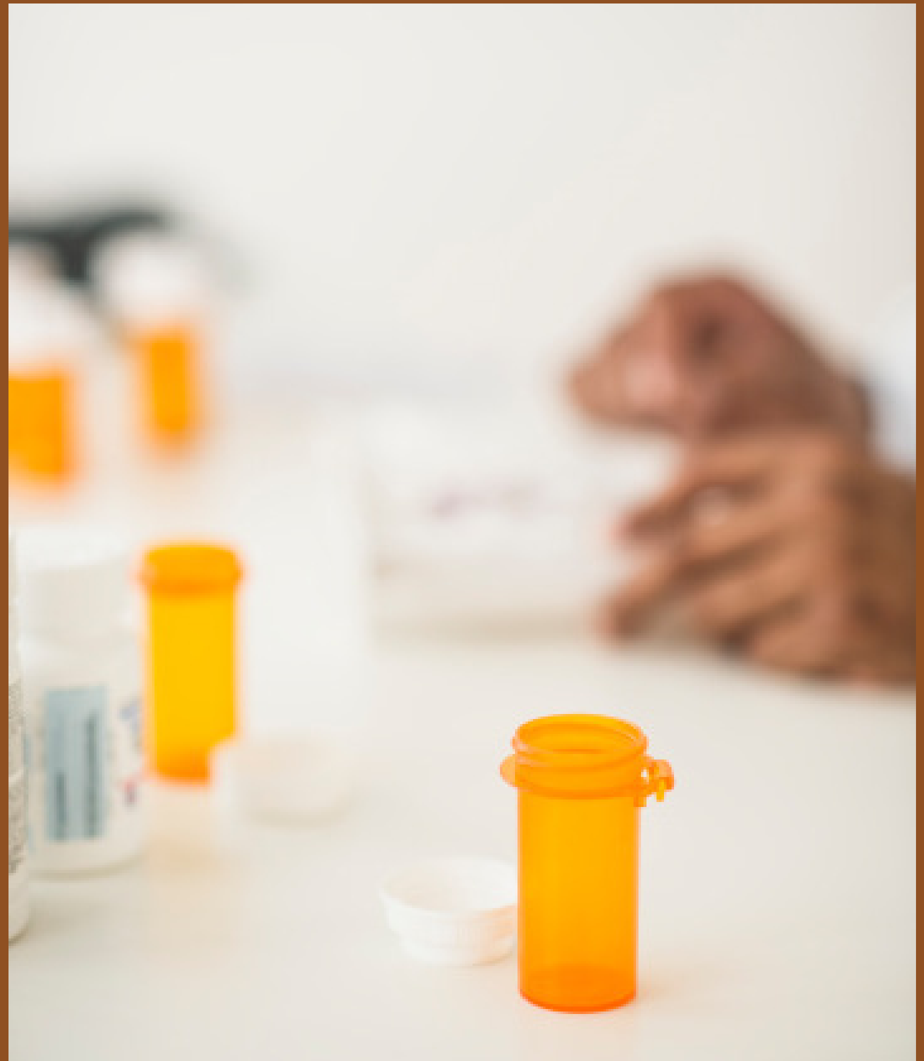
Local ownership restrictions are applied to the pharmaceutical sector that in fact limit structuring options available for investors. For example, only Saudi nationals or 100% Saudi-owned companies can own a pharmacy. The owner of a pharmacy or one of its co-owners must be a licensed Saudi pharmacist. The manager of the pharmacy must also be a licensed Saudi pharmacist. There is a limit on the number of pharmacies that a Saudi pharmacist or an entity owned by Saudi pharmacists may own. If the owner(s) is/are a licensed Saudi pharmacist(s), then the pharmacy entity may own up to 30 pharmacies. If, however, a nonpharmacist (e.g., a Saudi company) is one of the owners, then the pharmacy entity can only own up to five pharmacies. In contrast, GCC nationals or 100% GCC-owned companies may own a warehouse for wholesale trading in pharmaceutical

[1] The Economist Intelligence Unit – Saudi Arabia: Healthcare and Pharmaceuticals Report, August 2012
[2] Alpen Capital – GCC Pharmaceutical Industry, March 2013
[3] Law on Pharmaceutical Facilities and Products (Royal Decree M/31 dated 1/6/1425H) and the Implementing Regulations (Ministerial Decision No. 103542/1/12 dated 4/8/2004G)

... ownership restrictions are seen as the most significant challenges when it comes to designing a workable and legally enforceable structure for investing in a Saudi pharmacy company.

products, but the pharmacist operating such warehouse must be a Saudi national.

The above-mentioned ownership restrictions are seen as the most significant challenges when it comes to designing a workable and legally enforceable structure for investing in a Saudi pharmacy company. Having said that, it is possible to structure an acquisition or a joint venture without the target company losing the ability to own 30 pharmacies, which is essential if the target is a pharmacy chain with multiple pharmacy companies. We have advised a number of Middle Eastern investors on structuring their investments in Saudi pharmacy chains. Most local pharmacies operate as sole proprietorships owned by a Saudi pharmacist. Therefore, any acquisition or joint venture will require the conversion of the sole proprietorship into a limited liability company. Apart from the equity element, the investment structure will involve a matrix of contractual documentation based on *Shari'ah*-compliant financing, control of the products sold, and various sale and leaseback arrangements. |



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endnotes

Upcoming Events

Doing Deals in and with Emerging Markets: BRICs and Beyond
11 July 2013
New York City
Presenter: Benjamin Newland

IFN Turkey Forum
3 September 2013
Presenters: Jawad Ali and Rizwan Kanji

IFN Saudi Arabia Forum
18-19 November 2013
Presenters: Jawad Ali and Rizwan Kanji

About our Middle East Practice

With more than 25 lawyers in the Middle East, King & Spalding offers extensive experience in Islamic finance, construction, energy, real estate, private equity and international arbitration in the Middle East, North Africa and Asia. The firm has long been considered a leader in Islamic finance, having pioneered many of the *Shari'ah*-compliant financial products that exist today. Our energy practice is known worldwide for its oil and gas work, particularly in the area of liquefied natural gas, and also has a strong base in electric power, petrochemicals and renewable energy. Our corporate lawyers have advised on some of the most complex and high-profile private equity investments and M&A transactions in the MENA region and are consistently recognized in *Chambers Global* and *The Legal 500*. In the 2013 edition of the *Chambers Global* guide, King & Spalding was consistently ranked among the top law firms practicing in the Middle East.

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