CHAPTER 8

Islamic commercial real estate investment in the UK

8.1 Introduction

Commercial real estate has always been and remains a popular asset class for Shari'a compliant investors (Compliant Investors), either indirectly through a real estate fund or directly as a standalone investment. A key reason for this is that real estate is a relatively easy asset to due diligence and understand It can be easily managed and is able to be financed on a Shari'a compliant basis.

The demand for real estate assets in the UK from Compliant Investors has remained strong; in particular, the focus of Middle Eastern investors has been in London, although other parts of the UK have garnered interest provided sufficient returns can be made, typically around 8-10% IRR. More recently London has seen interest from some of the Malaysian pension funds, who are looking to diversify their real estate portfolios which have tended to be concentrated in Malaysian assets.

A Compliant Investor, like any other investor, maximises its returns by holding real estate assets in tax efficient structures and making use of leverage. Overseas investors typically hold UK real estate assets through holding companies domiciled in Jersey or Guernsey. If a real estate investment is not structured correctly, this can result in materially lower returns from the investment.

The biggest challenge facing a Compliant Investor looking to buy property in the UK is how to finance the purchase price, assuming the Compliant Investor wishes to leverage its equity in order to maximise returns which is quite common. Like any other purchaser of real estate, a Compliant Investor will typically put in some of its own money (equity) and look to a financial institution to provide the balance (financing).

The Compliant Investor has a problem in that it cannot go to a bank and take out an interest bearing loan. In the last 20-30 years various methods have been developed to provide Compliant Investors with access to financing that complies with the principles of the Shari'a. The financing techniques which are currently commonly used by Compliant Investors worldwide to finance the purchase of real estate include murabaha (cost plus) financing, ijara financing and, for real estate developments, istisna'a financing. Real estate is also commonly used to raise sukuk financing, e.g. the Nakheel and many sovereign sukuk. The UK Government made specific changes to the UK tax regime in 2009 to enable sale and lease back structures to be used to raise sukuk finance. To date such structures have not been used in the UK to raise sukuk finance.

A Compliant Investor wishing to invest in commercial real estate therefore has three primary issues to consider (i) are my tenants Shari'a compliant?, (ii) how do I structure by equity investment to ensure I maximise my return and (iii) (if applicable) how do I leverage my investment? It is the third issue where the paths of real estate investment and Islamic finance cross. The focus of this chapter will be on how Compliant Investors wishing to invest in UK commercial real estate structure their equity investment and use leverage to maximise returns.

8.2 Use of Shari'a compliant financing

8.2.1 Murabaha (cost plus) financing

The most common form of commercial real estate financing in the UK is murabaha financing.

Commercial real estate murabaha financing works as follows:

- The Compliant Investor requires funds to finance the purchase of UK commercial real estate.

- The Compliant Investor requests the bank for a murabaha facility up to the amount of the funds it needs (say £10 million) for the term of the financing period (say 5 years).

- Pursuant to the terms of the murabaha facility, the bank buys £10 million of freely tradable commodities with its own money from a broker (Broker 1) and turns around and immediately sells the commodities to the Compliant Investor for the cost of such commodities (£10 million) plus a profit rate (say 3 month LIBOR plus 2% In this example, we assume that the additional profit will be £62,500) with the cost and profit payable on a deferred payment basis. The murabaha price (the aggregate of the cost plus the profit) must be fixed at the outset of the transaction; therefore if the murabaha financing is bench marked to 3 month LIBOR, the deferred payment period will be three months At the end of this period, LIBOR will need to be fixed again and a new profit amount calculated., On this date, the cost (£10 million) and the profit (£62,500) will need to be paid by the Compliant Investor to the bank. Below, it is explained how the cash flows on the deferred payment date work to ensure that the Compliant Investor is not required to repay the whole of the cost price (£10 million) on the deferred payment date.

- The Compliant Investor immediately sells the commodities for cost (£10 million).

At the conclusion of the above transaction, the Compliant Investor has £10 million in cash and owes the bank a sum of £10,062,500 million payable in three months time. The Compliant Investor is then free to use the £10 million cash for, to finance the acquisition of UK commercial real estate. The profit charged by the bank is treated as a profit on the resale of a commodity and not interest. However, this type of transaction is not without its critics within the Islamic banking community, although despite this criticism, the method of murabaha financing remains a primary choice for many Compliant Investors who need capital to acquire UK commercial real estate, for the primary reason that it is easy and cost efficient to implement.

Where the profit element of a murabaha financing is benchmarked to LIBOR, on the deferred payment date:

(i) the bank will, assuming the financing is non amortising and the cost, equivalent to the principal under a conventional loan, will be paid in one sum at the end of the financing period, i.e. in 5 years time- acquire £10 million of freely tradable commodities but not pay Broker 1 immediately;

(ii) the bank will sell the commodities to the Compliant Investor for a price equal to the cost (£10 million) and a profit (3 month LIBOR plus 2%, assume for this example that will be £62,500) payable in three months time;

(iii) the Compliant Investor will sell the commodities to Broker 2 for £10 million but Broker 2 will not pay the Compliant Investor immediately;

(iv) Broker 2 will sell the commodities to Broker 1 but Broker 1 will not pay Broker 2 immediately;

(v) Broker 1 will instruct the bank to pay the £10 million owed to it by the bank to Broker 2 (in discharge of Broker 1's payment obligation to Broker 2);

(vi) Broker 2 will tell the bank to pay the £10 million owed to it to the Compliant Investor in discharge of the payment obligation Broker 2 owes to the Compliant Investor; and

(vii) the Compliant Investor will tell the bank to offset the £10 million owed to it against the obligation of the Compliant Investor to pay to the bank £10 million on the deferred payment date (being the cost price). Once the above procedure has been followed the cash that actually moves from the Compliant Investor to the bank is £62,500, being the profit. On the next deferred payment date the procedure is repeated until the final payment date when the cost (£10 million) will be paid by the Compliant Investor to the bank.

A Compliant Investor acquiring commercial real estate in the UK should be able to access murabaha financing from banks operating in the London market. The reasons for this are as follows:

- The purchase of the commodities by the bank, the sale of the commodities by the bank to the Compliant Investor and the on sale of the commodities by the Compliant Investor to obtain the cash is a tax neutral transaction for UK tax purposes.

- The profit element of the transaction is accounted for and taxed in the same manner as interest on a loan (the UK Government has introduced legislation (the Alternative Finance Arrangements) to provide tax neutrality for murabaha financing).

- A bank does not need any special licence or permission to buy and sell the commodities under a murabaha transaction nor does it need to set aside any regulatory capital as part of the commodities' trade itself.

- It is possible to adjust the profit and the deferred payment obligations to replicate the economics of a loan (e.g. the bank can provide the financing on a 3 month LIBOR basis).

- The bank is able to take security from the Compliant Investor to secure the payment obligations under the murabaha facility.

There are many Compliant Investors who wish to invest in UK commercial real estate but at present are being shut out by the unwillingness of UK banks (with the exception of one or two of the Islamic banks in London) to provide murabaha financing. Given that murabaha financing is tax and regulatory neutral, banks can structure the financing to ensure that the obligations under the murabaha financing are fully secured and provide them with the same economic return had they advanced a loan. There is thus no reason for UK banks to turn away Compliant Investors who are requesting murabaha financing. London proclaims itself as a centre of Islamic finance suggesting that at least banks in London should be able to provide Compliant Investors with access to murabaha financing. The reluctance of UK banks to provide murabaha financing is something that the UK Islamic Finance Secretariat (UKIFS) is proposing to look into in 2012. UKIFS (part of TheCityUK) brings together government and industry to jointly promote the UK as a global gateway for Islamic finance. UKIFS has set up a commercial real estate group whose objectives, inter alia, will be to free up the provision of murabaha financing by UK banks.

The lack of murabaha financing offered by UK banks has required Compliant Investors and their advisors to come up with alternative financing structures. For a Compliant Investor the most cost efficient structure is to enter into a murabaha facility directly with an Islamic bank. Islamic banks in the Middle East and Malaysia as well as one or two of the Islamic banks in London provide such facilities direct to their customers for the purpose of financing commercial real estate acquisitions.

An alternative structure that has been used by Compliant Investors to finance the purchase of UK commercial real estate is:

(i) the bank makes a loan to a special purpose vehicle (SPV) which is typically owned by a charitable trust and run by a corporate services company;

(ii) the SPV then enters into a murabaha facility with the Compliant Investor purchasing the commodities to be on-sold to the Compliant Investor with the loan proceeds from the bank;

(iii) the Compliant Investor uses the funds from the murabaha facility and its own equity to acquire UK commercial real estate;

(iv) the Compliant Investor grants a mortgage over the real estate to the SPV to secure its obligations under the murabaha facility; and

(v) the SPV assigns its rights under the mortgage to the bank to secure its obligations under the loan agreement.

The loan agreement and the murabaha facility contain substantially similar representations, warranties and covenants. For example the payment obligations under the murabaha facility will mirror the payment obligations under the loan agreement. Provided the Compliant Investor fulfils its payment obligations under the murabaha facility, the SPV will have sufficient funds to meet its payment obligations under the loan agreement. If the Compliant Investor fails to meet payment obligations under the murabaha facility, the SPV will not be able to meet its payment obligations under the loan agreement. The bank will then exercise its rights under the mortgage assignment and step into the shoes of the SPV. The SPV will then enforce its rights under the mortgage and will sell the property with the proceeds used to discharge the obligations under the murabaha facility and ultimately the loan agreement.

The use of SPVs adds a layer of complication and cost and is not the first preference of a Compliant Investor who would prefer a murabaha facility direct from a bank. The use of an SPV can also result in tax complications for the reason that tax neutrality depends on one of the parties to a murabaha transaction being a "financial institution" (as defined in UK tax legislation). It is therefore necessary to ensure that either the SPV or the Compliant Investor is a "financial institution" or the result could be that the transaction is not taxed efficiently.

8.2.2 Ijara financing

An alternative to murabaha financing is ijara financing. Commercial real estate ijara financing works as follows:

- The Compliant Investor requires funds to finance the purchase of UK commercial real estate.

- The Compliant Investor requests that the bank provide it with an ijara facility up to the amount of funds it needs (say £10 million).

- The bank buys the property using the £10 million it will provide in the form of financing. Equity from the Compliant Investor will be paid over to the bank by the Compliant Investor in a tax efficient manner e.g. a refundable deposit. The bank then leases the property to the Compliant Investor. The rent payable by the Compliant Investor to the bank will be set at a rate which provides the bank with a return (e.g. LIBOR plus 2%) and the repayment of the financing amount (i.e. £10 million). Similar to the murabaha financing it is possible to structure the rental payments to provide the bank with the same economic returns had it advanced a loan, to enable LIBOR to be re-set on a periodic basis with rental periods tracking the re-set dates of LIBOR. The bank will remain the owner of the property until the last rental payment is made and is therefore fully secured.

The terms of the ijara lease provide that the Compliant Investor leases the whole of the property subject to the occupational leases. The Compliant Investor becomes the landlord and tenants pay rent to the Compliant Investor. The Compliant Investor uses the rental income to service its payment obligations under the ijara lease. Careful consideration needs to be given to the Compliant Investor granting new leases to occupational tenants. The ijara lease will have a term equal to the financing term (say 5 years). The Compliant Investor cannot grant a lease for a term that is longer than its own lease. Therefore, any lease granted by the Compliant Investor needs to be drafted in such a way that it does not fall away in the event that the ijara lease terminates (for example if the Compliant Investor fails to meet its obligations under the ijara lease).

The tax issues which arise with ijara financing are more complicated than murabaha financing. Specifically, Stamp

Duty Land Tax (SDLT) is payable on the transfer of the property to the bank and on the lease of the property by the bank to the Compliant Investor in an amount equal to the NPV of the lease payments over the financing term, if the bank is not a "financial institution" as defined in the UK tax regime. The Compliant Investor may therefore be paying SDLT twice (once on the purchase and second on the lease) in the event that one of the parties to the ijara lease is not a "financial institution". There are ways to mitigate the double taxation; however the tax structuring can sometimes be as costly as paying the tax itself.

It is very unlikely that a Compliant Investor will get a UK bank to provide it with ijara financing for commercial real estate, for the simple reason that banks do not like owning real estate). In the UK therefore alternative structures have been used by Compliant Investors to access ijara financing, similar to the structures used to access murabaha financing.

Instead of the bank making an ijara financing facility available to the Compliant Investor, the bank makes a loan to a SPV and the SPV buys the property with the loan proceeds and the equity payment from the Compliant Investor. The SPV then leases the property to the Compliant Investor. The Compliant Investor uses the rent it receives from the tenants to satisfy its obligations under the ijara lease and the SPV uses the rental payments from the Compliant Investor to satisfy its obligations to the bank.

The SPV grants a mortgage to the bank to secure its obligations under the loan agreement and the ijara lease is subject to the mortgage (i.e. ijara lease falls away if mortgage is enforced). Provided the Compliant Investor continues to meet its obligations under the ijara lease, the SPV will always have sufficient funds to meet its obligations to the bank and therefore the mortgage will not need to be enforced (i.e. whether the mortgage is enforced is within the hands of the Compliant Investor).

In the period 2003-2008 the use of SPV structures for murabaha and ijara financing in the UK was not uncommon. Since 2008 banks have become less willing to finance such SPV structures due to the fact banks have less money to lend and when they do lend they would prefer to do a plain vanilla real estate loan.

8.3 Structuring the Equity

If a real estate fund or real estate investor acquires UK Commercial real estate, it will typically set up an SPV to acquire the property. The SPV will be 100% owned by the fund or the investor (as the case may be). Where this is the case it is not unusual to capitalise the SPV (being the equity for the transaction) with equity and shareholder loans, which bear interest. Due to the fact that the fund/investor will be making an interest bearing loan to itself (i.e. making a loan to a 100% owned subsidiary), the generally held view is that the payment of a return is compliant with Shari'a principles. The fund/investor is simply structuring its equity investment in a tax efficient manner. The only requirement is that the fund/investor holds and continues to hold 100% of the SPV.

8.4 Conclusion

The UK remains a popular jurisdiction to invest in commercial real estate. Compliant Investors from the Middle East in particular like UK commercial real estate. Similar to other investors, Compliant Investors look to leverage their equity. It is becoming more difficult for Compliant Investors to access Shari'a compliant financing to acquire UK Commercial real estate. This lack of liquidity is something UKIFS is planning to investigate in 2012 with a view to address the lack of liquidity and whether any measures can be taken to alleviate the problem.