SECTOR REPORT

Co-ownership and Asset-based Finance *By Chris Cook*

"You don't know what you've got 'til it's gone",* sang Joni Mitchell in her song "Big Yellow Taxi" in 1970: 35 years on, the corollary might be *"You don't know what you've missed 'til it comes."

So it is that the arrival in the UK of a new corporate entity on 6 April 2001 - the UK "Limited Liability Partnership" (LLP) has demonstrated that the "Western" legal structures we take for granted may yet be overtaken.

The LLP allows the sharing of risk and reward in a radically simple way and provides us with new financial tools and techniques:

- the "Capital Partnership";
- the "Guarantee Society" or "Clearing Union";

which are not only entirely consistent with Islamic Values but arguably optimal, in that those enterprises which do not utilise them may be at a disadvantage to those which do.

In this article we will consider only the Capital Partnership.

Introducing the Capital Partnership

The new LLP came into effect in order to protect professional partnerships from the consequences of their own negligence. Confusingly, an LLP is *not* legally a partnership: it *is,* however - like a company - a corporate body with a continuing legal existence independent of its members and - as with a limited liability company - you cannot lose more than you invest.

Unlike a company there is no requirement for a Memorandum of Incorporation or Articles of Association or any of the body of legislation governing the relationship between investors and other stakeholders, and particularly the directors who act as their agents in managing the company.

The "LLP agreement" between members is totally flexible, and in fact need not even be in writing, since simple provisions based upon partnership law apply by way of default.

Students of Islamic finance will note that - when applied to taking ownership of productive assets in what I shall denote a "Capital Partnership"-the LLP is virtually indistinguishable from Musharakah.

Perhaps the first appearance of an embryonic Capital Partnership was a transaction in late 2002 in which the Hilton group entered into a 27 year revenue sharing agreement with a development finance consortium which invested US$636 million (£350 million) in an LLP vehicle which acquired 10 UK hotels from Hilton.

While this particular transaction involved a bank, and in its actual detailed terms could certainly not have been described as Islamically sound, in its *structure* it illustrated the potential for a new form of "co-ownership" through a Capital Partnership LLP with two members:

a) the "Capital Partner" or Investor;
b) the "Capital User";

who pays a "Capital Rental" consisting of an agreed revenue share for as long the Capital is used.

Let us take two reasonably high profile UK projects as examples of what is possible utilising this form of "asset-based" Finance.

The London Eye - 2005

The owner of the London Eye is a private UK Ltd Company with three shareholders which leases the land on which the Eye stands. The initial finance provided by one of the 3 shareholders was at 24% per annum and due to a combination of circumstances the servicing of accumulated debt - now at US$272.55 million (£150 million) - is impossible from gross revenues of US$81.75 million (£45 million) per annum so that the Eye is in asset/liability terms insolvent.

Refinancing with new debt has proven impossible due to conflicting interests between shareholders and a claim for a vastly increased rental by the landlord has complicated matters further.

However, asset-based financing is capable of "squaring the circle". A London Eye LLP would have two Members:

a) the Capital User / Operator - i.e. the existing company;
b) the Capital Partner/Investor;

and in return for Investment of US$272.55 million (£150 million) a Capital Rental of 3% initially is payable i.e. US$8.16 million (£4.5 million) per annum.

Now for the Alchemy. The Capital Rental constitutes 10% of the Eye's gross revenues. So the proposition for someone who invests US$273 (£150) is:

a) "Co-ownership" in a one millionth "equity share" in the Eye;
b) An initial rental "dividend" of US$8.18 (£4.50) and a future dividend consisting of one ten millionth of Eye revenues;

the "downside" is limited and at the very least income is likely to rise in line with inflation, and probably by much more.

London Eye Ltd would retain the balance of 86% of revenues (one of the shareholders is currently entitled to 4% already) and would become immensely profitable.

Finally, the current bitter dispute between the landlord and London Eye Ltd is more easily solved, since rather than agreeing a lease, the landlord could become an "investor"/ capital partner by investing the *value* of the land in the LLP and receiving a revenue share (at 4% this would give US$3.27 million (£1.8 million) initially) in return.

The London Olympic Village, 2012

The Capital Partners/Investors in London Olympic Village LLP would be pension funds who are invited to invest in building high quality and energy efficient homes to be used as the Olympic Village. Young members of these pension schemes will then be invited to occupy these properties after the Olympics are over by paying an inflation-linked rental set at an initial level sufficient to provide a reasonable Capital Rental.

The Investors therefore acquire a simple property-backed and inflation-linked rental stream perfectly suited to match their long-term liabilities.

The Occupiers enjoy "Co-ownership" through an *indefinite* right of occupation for as long as they pay the Capital Rental. If they choose they may transfer "equity shares" from savings made previously rather than pay in cash, since if an Occupier pays a rental ahead of

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the due date then he automatically becomes an Investor.

The Community would retain ownership of the Land and a Developer/Operator member would be introduced who obtains a reasonable reward in respect of the delivery and maintenance of a high quality and energy efficient Olympic Village.

The outcome is that that instead of the local tax-payer funding an Olympic "Legacy" the Legacy funds the Olympics.

Energy Partnerships - the Tidal Electric project

There is a brewery company in Germany that pays its dividends in beer. While this cannot be a candidate for Islamic financing for moral reasons, it demonstrates the potential for an intriguing variation of "Asset-based finance" i.e. a dividend in "Money's worth" rather than Central Bank-issued money.

An interesting and extremely credible project to generate electricity by the creation of a "tidal lagoon" in Swansea Bay projects an annual output of 186,000 megawatt/hours from some US$145.5 million (£80 million) investment perhaps half of which would be from public funds in the form of grants and the balance borrowed.

Using the Capital Partnership approach we could instead of borrowing pay a Capital rental/dividend to Investors in energy. An initial "Capital Rental" of 3% on US$72.75 million (£40 million) would equate to US$2.18 million (£1.2 million) which is equal to the value of about 12% of energy produced. Repayment of Capital over 40 years would equate to a further 10% of energy generated.

The balance of energy produced, after a revenue share to an operating partner, would accrue to the Community which would own the project in perpetuity.

So the proposition to an investor is a return of 3% and the return of Capital in the form of energy. The result is a simple but elegant forward energy purchase, which is an asset class growing in popularity currently served only by complex and illiquid "over the counter" derivatives.

Finally

> *"Behind it all is surely an idea so simple, so beautiful, that when we grasp it – in a decade, a century or a millennium – we will all say to each other, how could it have been otherwise? How could we have been so stupid for so long?" …..John A Wheeler*

This quote is the measure of the emerging "Capital Partnership" concept documented in this article and the asset-based financing which flows from it. This - it is submitted - constitutes a new paradigm for Islamic Finance.

Note: The author is a former Director of the International Petroleum Exchange (IPE) and a member of the Wimpole consortium.

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