SHARED RISK & REWARD

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Reading List

Disclosure Statement in Support of the Joint Plan of Reorganization under Chapter 11 (PDF)

Chapter 11 Joint Plan of Reorganization under Chapter 11 (PDF)

All of the documents filed by Arcapita Bank with the Court (link)

EIIB sells1$15m of Arcapita's syndicated murabaha for $8.1 m (link)

Bankruptcy for Bankers (PDF)

Blog Posts This Week

Indonesia's largest bank plans IPO for Islamic window

Saudi Sukuk Markets potentially opening

The development of sukuk investment options for retail investors

Dubai wants to be trading center for sukuk

Malaysia's new Islamic finance law: Incremental changes solidify a strong Shari'ah governance system

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Arcapita files a reorganization plan

Arcapita is setting a lot of 'firsts' in 2012 and 2013, not all of them good for Arcapita's shareholders and creditors, but all of which should be good for the Islamic finance industry, since they provide some certainty about how the bankruptcy of an Islamic private equity company can proceed. The latest 'first' was Arcapita becoming the first Islamic financial institution to file a reorganization plan in a Chapter 11 bankruptcy proceeding in the United States. Before moving into a description of what the reorganization plan means for the industry as a whole, I'll cover the basics of the plan itself.

First off, the plan would allow Arcapita to leave bankruptcy, but would then be involved only in exiting existing investments, not making new ones. The plan refinances the $100 million in secured debt held by Standard Chartered Bank into a 3-year murabaha facility with 8.75% coupon and places it at the top of the capital structure (behind the administrative expense claims). Additionally, Arcapita will receive $185 million in an Exit Facility, also a senior secured murabaha, with an unspecified lender, with profit of LIBOR plus 8% (and a LIBOR floor of 2%) due in 3 years. The exit facility will be used to repay the debtor-in-possession (DIP) financing, as well as to provide working capital.

Behind these secured murabaha are the company's remaining creditors who will see the bulk of their recovery come through coupon payments and redemption of a $550 million perpetual mudaraba with 12% coupon and a call date 6 years after the plan is approved. KPMG estimated that Arcapita's investments upon expected exit will return $1.3 billion to creditors (including administrative expenses from the bankruptcy and the secured creditors). With $3.2 billion in liabilities, most unsecured creditors will realize a loss, but different creditors will fare substantially differently.

After the secured murabaha are repaid, the first payments will be to the sukuk holders who include the $1.1 billion syndicated murabaha (which Arcapita failed to refinance and which forced the bankruptcy) and the unsecured creditors of Arcapita's Cayman-domiciled investment holding company AIHL. These creditors are expected—based on a KPMG estimate of the exit proceeds and allowable claims—to recover roughly 60% of their claims. Creditors of Arcapita Bank, on the other hand, face near total loss according to the KPMG estimates that show a recovery rate of just 6%.

The unsecured creditors of Arcapita Bank—including the Central Bank of Bahrain which provided a $250 million murabaha to Arcapita in 2009—end up with some of the new Class A preference shares (with liquidation preference of $790 million, but which are subordinated to the sukuk and secured murabaha) and most of the new ordinary shares of Arcapita, which will require significantly higher exit proceeds to have value.

The sukuk structure is relatively new because of the special situation that led to its issuance. It has no fixed maturity (since there is no definitive timeline for when sufficient exits to cover administrative expenses, secured creditors and the sukuk principal) but has a call date in 6 years (and will be callable on that date and every quarterly periodic distribution date after that point. The periodic distributions will accrue from the issue date, but will not be paid until the secured murabaha are fully repaid. If there is not excess cash (i.e. cash not needed for operations) the sukuk coupon is not paid, although in the future, excess cash is used to pay accrued but unpaid periodic distributions. Arcapita will "will explore reasonable options to facilitate off-market trading of the Certificates including enhanced financial reporting or, if practicable, listing the securities on a public exchange."

While the structure of the sukuk is known, and is included in the plan, the Class A preference share structure is not. The terms were decided upon: the Class A shares will be subordinated to the sukuk but senior to the new ordinary shares, and will be redeemed for $790 million (a number estimated based on full redemption of the sukuk within 3 years, which is odd since the sukuk is not callable until 6 years after the issue date). Preference shares are not commonly used in Islamic finance and the structure was, as a result, not determined within the plan documents. Instead, Arcapita and its creditors will work out the details to ensure Shari'ah-compliance so long as "no such modifications shall materially impair the economic rights conferred by such New Arcapita Class A Shares".

One note in the plan, which refers to concepts which I am not familiar with, states that "the New Arcapita Class A Shares [will] be analyzed using the 'self-lending' or 'preferred return' exception to the prohibition on the payment of interest."

If the Preference Shares are redeemed, any remaining funds are available to the new ordinary shareholders (mostly the Arcapita Bank creditors) and holders of various warrants. However, based on the recovery rates for the different creditors, it is unlikely that there will be much value for the Class A shares after the sukuk is repaid, let alone for the ordinary shareholders. They represent possible upside above the exit valuation estimates prepared by KPMG.

There are still aspects of the Arcapita bankruptcy yet to unfold. It is not clear that—despite developing the plan in concert with the creditors committee—that it will be approved by creditors, although Arcapita has left the option of a cram down to force approval. There may also be questions raised about $31 million in "value transfers" from Arcapita to relatives of the firm's insiders two days before the bankruptcy filing. This piece of data was announced in an amendment to the financial documents that was filed two days before Arcapita filed its reorganization plan. The transfers were originally listed as being (undated) transfers to employees, and include several transfers for more than $1 million (the largest was $14 million).

As for the implications for the Islamic finance industry, the bankruptcy process should be seen as a positive development because the terms of the DIP financing, the exit financing and the securities given to creditors (with the possible exception of the preference shares) are all designed to be Shari'ah-compliant. In the future, there should be greater certainty for creditors of companies that issued sukuk that the resolution can be accomplished in a Shari'ah-compliant way within a secular legal system. The caveat for this optimism is that the resolution of Arcapita was done through the US Chapter 11 bankruptcy process, which is not available to most Islamic financial institutions (Arcapita held many of its assets within the US and had an office in Atlanta, Georgia, and was able to use the Chapter 11 process).

Until next week,
Blake Goud

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