King & Spalding

# Client Alert

Real Estate

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# Alternative Financing Models for Real Estate and Infrastructure in Saudi Arabia

The launch of the Kingdom of Saudi Arabia's (the Kingdom) Vision 2030 Program preceded the announcement of numerous ground-breaking Mega and Giga-projects throughout the country. Eight years on, recent MEED data estimates that, to the end of 2023, the Kingdom had committed around USD 880bn towards projects like NEOM, Amaala, Al-Ula, King Salman Park, ROSHN, Diriyah Gate, Qiddiya and more in the drive to diversify its economy away from dependency on fossil fuel revenue. These projects, along with significant investments in key utility infrastructure, health and wellbeing facilities and housing, are part of the estimated USD 1.5 trillion pipeline of works that are rapidly changing the face of the Kingdom.

The new wave of Mega and Giga-projects is operating at enormous scale with tight programmes for delivery. This applies additional pressure on these projects on top of existing factors like budgetary constraints linked to lower oil prices, the limited availability of domestic contractors with sufficient capacity and limited liquidity in the Kingdom's domestic financial sector. As a result, to realise the visions of delivering these multi-billion dollar programmes on schedule, developers are beginning to employ alternative methods to fund and construct their projects by making use of third party finance and expertise, both within the Kingdom and internationally.

Vision 2030 also aims to reduce barriers to doing business in the Kingdom by modernising the legal system. In particular, the passage of the Private Sector Participation Law and Civil Transactions Regulation (which King & Spalding has considered in previous articles) has increased the viability and attractiveness of investing in new projects in the Kingdom. Coupled with the increased number of developers and procuring entities seeking investment from the private sector, these reforms have led to a surge in projects across the Saudi economy seeking investment from the private sector through alternative development models, with many of these models being seen for the first time in the Kingdom.

The purpose of this article is to provide a snapshot of the features of some of these alternative development models on which we are advising clients in the Kingdom, and to highlight some key considerations for investors and developers.

As these models become more prevalent, we expect to see the emergence of a new, Saudi-specific way of implementing them. There will be opportunities for well-advised parties to influence the development of this new way of contracting, although it is important to remember that there is no "one size fits all" approach.

Developers can utilise a combination of one or more models, and which one will be suitable for a particular project depends upon several key parameters. These include, amongst others, the:

- timing and programming of the project;
- type of asset being developed (e.g. Is there a revenue stream that can be monetized? Who will operate the asset once it is created?);
- location of the contractor/investor (i.e. domestic vs international), and the strength of their balance sheet;
- type of works being undertaken (e.g. large export value vs site clearance); and
- value of works and the ability to obtain financing for them on commercially acceptable terms and in a timely way.

These parameters should all be considered carefully when determining which model to employ. It is important to engage early with legal counsel to identify key issues based on a project's unique scale, subject matter and programme demands. Early engagement ensures a suitable development model is selected from the outset, which ultimately avoids the need for last-minute negotiations that cause delays and additional costs.

## SALE AND LEASEBACK / LEASE AND LEASEBACK

*The Model*

The owner of an asset sells that asset to an investor who then leases the asset back to the original owner for an agreed term ("**Sale and Leaseback**"). As a variation to this model, the owner of the asset could potentially lease the asset to the investor rather than selling the same, with the investor subleasing the asset back to the owner ("**Lease and Leaseback**").

In both a Sale and Leaseback and a Lease and Leaseback, the investor collects rent payments from the owner of the asset for an agreed term pursuant a lease. The lease is structured as a "triple net lease" such that the owner would maintain total control of the asset subject to the owner paying the investor the rent, the property taxes, building insurance and utilities.

*Uses*

A Sale and Leaseback and a Lease and Leaseback are financing arrangements that allow the original owner to unlock and access capital that would otherwise be tied up in the ownership of the asset. These models also offer the parties greater flexibility relative to conventional forms of borrowing as the parties can negotiate the terms of the financing independent of a traditional lending institution. In certain instances, these models allow off-balance sheet financing whereby the use of the asset would be recognized as an operating expense rather than a liability on the owner's balance sheet. As a result, by having fewer liabilities, the owner could become eligible to borrow from more lenders.

*Key Considerations*

- consider, as an asset owner, whether this model makes financial sense and whether the transaction is attractively priced relative to the asset owner's weighted average cost of capital (WACC).
- consider ownership and transfer issues under applicable laws, including the impact of such transfer from a tax perspective (RETT, VAT, withholding, etc.).
- consider what (if any) ongoing responsibilities the asset owner will assume as tenant with respect to the leased asset. Whilst the standard position is for the asset to be leased on a "triple net" basis, this may not necessarily apply in every case and the parties can carve-out certain obligations.
- consider in a "Lease and Leaseback" the types of securities, if any, that will be given by the asset owner to the investor.

## DESIN, BUILD, FINANCE, OPERATE (DBFO) / BUILD, OPERATE, TRANSFER (BOT)

*The Model*

The exact structure of DBFO/BOT projects will differ from project to project. Under a concession-based model, at a high level, a procuring entity with the requisite legal authority grants a concession right to an SPV to construct and operate an asset for a set term in return for the payment by the SPV of a fee. The SPV is responsible for construction and operation costs, and entering into contracts with the construction and O&M contractors, suppliers and end users of the development. The SPV is paid during the operation period of the asset and transfers its interest in the asset back to the procuring authority at the conclusion of that term. In the utilities sector, an interesting alternative model involves the procuring entity entering into a utilities concession agreement with the SPV under which the SPV is entitled to receive tariff payments from end users. A hybrid model sees bulk tariff payments from the procuring authority and the balance from end users. This is often seen in district cooling, but also captive co-located utilises for mega and gigaprojects (desalinated and irrigation water, waste management, solar & wind, and BESS). Formal models which have regulation and guidance through Government's treasury or other departments include PPPs (e.g Saudi Arabia, Abu Dhabi, Dubai and many others internationally).

*Uses*

DBFO/BOT models allow procuring entities to deliver complex infrastructure with little or no up-front capital outlay and to benefit from technical expertise of experienced contractors. These models are proven structures that are increasingly commonly used to deliver such utilities assets and other infrastructure (hotels, housing/accommodation, schools, universities, airport infrastructure, healthcare clinics and hospitals). Risk and responsibility for the operation of the facility is largely transferred to the SPV, although procuring entities can retain a level of control over how their assets must be operated through careful drafting of the DBFO/BOT agreement, among other ways.

*Key Considerations:*

- consider how the procuring entity will fund payments to the SPV (i.e. through end-user payments, direct payments from the procuring entity, etc.), which is often dictated by the type of asset being developed and the existence of a clear and reliable revenue stream;
- consider whether the SPV will be required to transfer its interests in the constructed asset at the end of the term in an agreed condition (e.g. the "T" in the BOT model) whether it is required to remove the asset and ensure the

land on which it is constructed is returned to the same condition as at the start of the term, or whether the procuring entity allows the SPV to continue to use the asset or remove it and relocate (BOO);

- consider how key risks are to be allocated between the procuring entity and the SPV (e.g. demand risk, construction/operating risks, cost increases and overruns, non-payment by end-users, force majeure events etc. and termination payments); and
- given the complexity of these transactions and the time it takes to put in place their contractual structures, parties should be mindful of the typically higher transaction and financing costs associated with these models.

## JOINT VENTURES (JV)

*The Model*

A developer and an investment partner hold assets jointly though a JV entity. The developer typically provides land and assets as its investment contribution into the JV, with the investment partner providing capital for the development of the project. If required, the JV can raise further debt secured against the assets of the JV (transferred from the developer) or guarantees from its shareholders. The JV will then enter into contracts with the investor and/or third party contractors for the development and management of the asset. Over the course of its existence the JV will be responsible for repaying any raised debt and paying dividends to each of its shareholders.

*Uses*

JVs introduce a flexible investment vehicle to a project ownership structure that can be used to share the costs (and benefits) of a development project, or to monetize developed assets and revenue streams through the sale of a stake in the holding entity. By sharing ownership of the assets in this way, a JV structure can reduce the capital cost to the developer to deliver a project and provide more flexible access to additional sources of financing (through investors). Establishing a JV as a limited liability company (the typical approach) can also limit the potential liability of both the developer and investors. If the developer retains a majority interest in the JV, this structure allows them to retain a high degree of control over how the assets are operated without having responsibility or risk for their daily operation. Control can also be achieved through the structuring of concession or lease rights to the JV.

*Key Considerations:*

- consider whether the JV is to be set up as a “true” (50/50) partnership between the developer and investor, or with one party as a minority shareholder;
- consider what the contribution of each party to the JV will be (i.e. land, assets and capital), their responsibilities following incorporation and how the JV will be funded;
- consider how valuable the JV assets/project will be, which can often be influenced by concession or lease terms, and consequently how attractive the investment will be to investors (and their financiers) to maximise monetization/financing;
- consider how the parties may exit the JV (i.e. whether there is a minimum time for the parties to remain involved, whether specific events would trigger an entitlement for an early exit, what restrictions on transfers by investors may be required etc.);
- consider how key risks are to be allocated between the developer and its investment partner; and

- ensure that the management processes for the JV are agreed (e.g. board composition, voting rights, any reserved matters for the benefit of minority shareholders, deadlock procedures and day to day management).

## FUND MODEL

*The Model*

A developer establishes a fund and transfers the land to be developed into it. A fund manager is appointed to administer the day-to-day operation of the fund, and capital is raised from lenders to fund the development using the land (and, potentially, expected returns from the assets) as collateral. The land is leased to another developer with whom the fund also contracts to develop the site, manage facilities and interface with tenants/end-users.

*Uses*

Setting up a fund allows a developer to defer capital expenditure on the development of an asset, and transfer the risk and responsibility for day-to-day operations and maintenance to a third party. Developers receive returns from the fund once the asset is operational, while the partner developer receives payment from the fund under its master development/facilities management agreements. If desirable, development partners can also be invited to contribute capital towards the establishment of a fund and share in the dividends.

*Key Considerations:*

- consider whether to involve third party investors in the establishment of the fund, and whether they should be given a separate class of shareholding;
- while financial lenders are comfortable with using fund structures, they will require the involvement of third party fund managers who will bring increased cost; and
- ensure the downstream developer's rights to deal with the asset are clearly defined (i.e. is the sale of any part of the asset, such as residential units, permitted?).

## CONTRACTOR FINANCING

*The Model*

A developer engages a contractor for the construction of a project. The contractor is also required to finance the cost of constructing the asset whether by cash-flowing the project from its own balance sheet or by securing lending against its entitlement to be paid the under the construction contract. Payments are made to the contractor at the completion of the project (or agreed milestones).

*Uses*

This model defers a developer's obligations to pay for the construction of an asset until it is completed. It can be used to incentivise a contractor to complete a project and is occasionally volunteered by contractors to make their bid more appealing to developers.

*Key Considerations*

- consider when payments will be made to the contractor (i.e. upon completion of set milestones or full payment on completion);
- ensure that the contractor's financing costs are factored into the overall contract price;

- contractors may behave less collaboratively to attempt to claim increased entitlements to be paid additional costs;
- ensure that a contractor has a sufficient balance sheet/credit history to be able to finance the project; and
- be aware that the terms of construction contracts will likely need to be disclosed to any of the contractor's lenders.

## EXPORT CREDIT AGENCY (ECA) FINANCING

*The Model*

ECAs are government agencies, quasi-government agencies or even private financial institutions. The objective of an ECA is to promote exports from its home country by offering financing linked to a supply of goods or services. To do this, an ECA can either provide direct loans to developers, or provide insurance/guarantees to commercial lenders to guarantee the repayment of amounts borrowed by a developer, to purchase the relevant goods/services.

*Uses*

ECA financing is often used by developers to overcome a lack of supply of products and services in their home country. Obtaining financing from an ECA allows developers to spread their capital costs and insulates providers of goods/services (and lenders) from the political and credit risks of the developer failing to make payments. Obtaining ECA cover provides security of payments for lenders and suppliers, and makes it easier for developers to obtain financing for their purchases.

*Key Considerations:*

- the time (often 9-12 months) and cost required to obtain ECA financing should be taken into account when assessing the suitability of a project for ECA cover;
- consider what, if any, portion of a contract's subject matter is eligible for ECA finance; and
- ensure underlying project documents enable the developer to comply with the requirements of the relevant ECA (which are typically more stringent than the requirements of commercial lenders).

## CONCLUSION

Increased adoption of alternative development models in the Kingdom will create opportunities for developers and investors to work together to deliver Vision 2030 Projects. King & Spalding has a wealth of experience in negotiating and implementing these structures (and more) both in the Kingdom and around the world. We would welcome any inquiries from entities seeking to utilise a particular development model. Our team of experts is well placed to assist with selecting a suitable model, navigating the potential pitfalls associated with different options and to help guide a project to completion.

## ABOUT KING & SPALDING

Celebrating more than 130 years of service, King & Spalding is an international law firm that represents a broad array of clients, including half of the Fortune Global 100, with 1,300 lawyers in 24 offices in the United States, Europe, the Middle East and Asia. The firm has handled matters in over 160 countries on six continents and is consistently recognized for the results it obtains, uncompromising commitment to quality, and dedication to understanding the business and culture of its clients.



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