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Islamic Private Equity Fund

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Introduction

To earn money is commendable for any Muslim. It enables one to support themselves, their family and loved ones. It also allows one to pay the zakah (welfare contribution) and sadakah (charity).

But there is also the obligation to use the money wisely and to spend it in a way which allows the whole community to benefit thereof. Together with the broad Islamic inheritance rules, the repartition of wealth is an important factor in Muslim society.

The sharing of profit and loss in business is another facet of that same mirror and one which the foundations of the Islamic economy and finance is built upon.

However, until recently, all the attention seemed to be focused on the development of the Sukuk market. This market was pressurised into developing into a fixed income stratagem that, whilst trying to attract investors, mimicked the conventional bond market to the extent possible, rather than going its own way.

After the first strong wave of the Sukuk market and in the full aftermath of the subprime crisis, the recent reminder by the AAIOIFI might cause some short-lived dips in the growth trend but will lead to further growth in a more apt direction.

There also is the proverb of “what you do not know you will not miss” or “ignorance is bliss”, as it were. The big amounts of money involved in the Sukuk issuances by nature always attract more attention and publicity than the strong and steady but silent growth of the Islamic financial institutions themselves. The Sukuk did help to give the industry, as a whole, a global brand and even enticed the conventional market to participate eagerly. Its overall value therefore must not be underestimated.

Besides these instruments, it is a wide known fact that the trade finance contracts (Murabaha, Ijara ...) form the main body of contemporary Islamic banking.

Strangely enough, the so-called “private equity” investments have been under-developed so far.

Venture Capital can briefly be described as capital that is made available for newly established to middle sized businesses that have a significant growth potential. Sometimes it is also accompanied by the contribution of additional human resources and networking aid made available by the investors (or their management team).

Mostly, the investment is designed to exit once the growth targets have been reached. The investors aim to generate a return, typically through an IPO or merger of the company. It is a full risk project where profit and loss is shared by both parties concerned during the growth phase and intended capital gains are reaped at the exit thereof. Both *mudaraba* and *musharaka* principles can be fully applied so there is therefore no better compliant way of investment possible.

Investment criteria

Any portfolio manager will confirm that it is advisable to spread the risk of failure of a Target Company over several investors and over a larger portfolio of investments.

It also makes sense to pool the investors in larger investment structures. The benefit thereof is that more money is available which in turn enables increased stakes in different Target Companies to be acquired (further spreading the risk). The pooling also allows special fund managers to be hired to manage the business professionally.

Investing money on the public stock exchange has its advantages. The concerned companies usually have had a reasonable life span, sufficient publicly available information, controlled governance, supervision by Capital Markets Board or Stock Exchange Regulators, financial track records and dividend policy.

Companies that are in their early or mid stages or even in their start up stage for that matter, lack all that and by consequence pose more risks to the investor. On the other hand, they also offer more growth prospects and profit returns.

As far as the Target Companies are concerned, Shari'ah imposes some restrictions to the ethical selection criteria to make sure that the investments stay halal (lawfull). In general activities are considered to be haram (unlawfull) when::

- A company produces/slaughters/sells/trades or distributes pork (or pork-related) products, blood.
- A company engages in pornography or obscenities in any form
- A company primarily engages in the entertainment business (films, videos, theatre, cinema etc.)
- A company is engaged in gambling, casino's, lotteries and related games and activities like bookmakers
- A company is active in non-compliant financial practices or insurance
- weapon industry, defence or anything akin in nature.
- A company produces/distils/sells/trades or distributes alcoholic beverages or related products
- A company produces/grows/sells/trades or distributes intoxicants or related products (drugs, tobacco)
- Other activities *ijtihad* the Shari'ah Adviser may deem as non-permissible

Immediately, it is clear that the available investment environment is considerable and nearing to unrestricted. Industries, services, retail, IT .. you name it and it can be done.

Most of the existing businesses however, are not yet aware of the ethical – financial restrictions related to *riba* and are entangled in interest based lending in different ways. The willing investor should avoid getting mixed up in such an undesirable environment.

In the present state of the economies, it is extremely difficult to find Target Companies that are completely “*interest free*” (loans) and not too “*liquid*” (cash and receivables). The Shari’ah scholars have accepted this reality and have allowed cooperation for the general benefit. Partial “contamination” of the Target Companies therefore does not pose any insurmountable hindrance to investment.

A number of “rules of thumb” have been developed and are largely accepted in order to help discern which investment targets are acceptable and those which should be avoided. We give here an example of the FTSE Shari’ah Global Equity Index Series guidelines which can be roughly be summarized as follows :

Total debt

Excludes investments when total debt on total assets exceeds (or is equal to) 33%.

Total interest bearing securities and cash

Excludes investments when total cash and interest bearing securities on total assets exceeds (or is equal to) 33%.

Accounts receivable

Excludes investments in Target Companies if account receivables on total assets are greater than (or equal to) 50 %.

Threshold haram income

Any *haram* income of a non-compliant Target Company that does not exceed 5 % of overall gross income is considered marginal or accidental. The Target Company will still be acceptable, provided that sufficient *cleansing* is made according to the guidelines set forth by the Shari’ah Adviser (isolated and given to charity).

These guidelines are sound and safe. They basically exclude companies that are too exposed to credit and lending (and interest based debt), which is what makes them prone to problems or even failure anyway. When most Islamic portfolios yield better results than their likely structured conventional opponents, then application of the Guidelines above already during the preliminary stages may be one of the reasons for the smaller rate of failures.

Investment structures

Of course, the nominative contracts such as the *mudaraba* and *musharaka* partnerships can be used to structure such consortia of investors.

But more contemporary limited partnerships, trusts, funds or corporate structures also have been accepted to be compliant. South East Asian scholars in general tend to be more lenient in this respect than some of their Gulf based counterparts.

The choice of the precise structure will depend on the legal vehicles that are available in the jurisdictions involved, tax and FDI regulations and Shari'ah restraints.

Shari'ah Adviser and legal assistance

The use of experienced legal council on both Shari'ah and conventional consulting of course is beyond question. It facilitates the communication between the Shari'ah Adviser, the Investors, the Management Team and the Target Company and its initial shareholders.

In order to assure full compliance to the Shari'ah, it is compulsory to involve a Shari'ah Adviser. Since that adviser cannot be available all the time, he/she should be assisted on a daily basis by the function of the Shari'ah Compliance Officer whenever possible.

The Shari'ah Adviser will:

- check that all aspects of the business are in accordance with the Shari'ah (including portfolio management, trading practices, operational matters, administrative matters, etc.).
- provide Shari'ah expertise on documentation, structuring, investment instruments and ensure compliance with the general Shari'ah principles and the standards, regulations and resolutions of the regulator.
- scrutinize any compliance report or any investment transaction report prepared by the Shari'ah Compliance Officer.
- provide written opinions of compliance from time to time or when needed and at least annually to the Board of Directors of the private equity fund.

Legal challenges

Besides tax implications in jurisdictions that are not apposite to receiving Islamic structuring, focus is streamed into aligning contracts, partnership structures and conventional regulations with the Islamic principles.

Moreover, in most cases, the expectations of lawyers and consultants involved – and possibly the other conventional investors or even the Target Company - do not fit the Shari'ah framework. The conventional mindset indeed is directed to minimizing risk (and sometimes even excluding) and optimizing profit on interest based basis.

Just to give a brief of a few topics:

- Preferential and not fully subordinated shares/debt for instance is commonly used in conventional structuring. This would entail that some shareholders bear less risk or at least the risk of loss is not equally distributed between the shareholders. In this sense, preferred stock – giving the holder the right of pay out of investment before the common stock - is prohibited.
- Guaranteed liquidation pricing (in a way excluding the risk of sharing a loss) is also contrary to Shari'ah.

- Guaranteed return on investment (say dividend of x % per annum) is also unlawful for the same reasons.
- On the other hand, preference to profits might be construed within limits when attached to common stock. Also, convertible and exchangeable structures have been approved.
- Vesting techniques can be used. This means that some stock only accrues for the entrepreneur (or key employees) after agreed periods have elapsed or benchmarks have been reached.
- Lock-in agreements also have been approved.
- It also is advisable to draft good covenants and where possible insert Shari'ah protection clauses in articles of association and so forth.

It is advised to consult properly trained professionals before and during any negotiations so mindsets and expectations can be changed or breaking points can be discovered at early stages.

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