

Islamic Finance *news*

Islamic Private Equity Fund

Paul WOUTERS



**British Swiss
Capital Partners**

**Bener Law Office
Istanbul-Turkey**

Introduction and basic observations

Private equity investment (partnership in non-listed companies) is a rational choice for any investor in the diversification of their investment portfolio.

Next to cash, stock, fixed income bonds and real estate, private equity is considered to be the fifth asset class in every contemporary strategy development for conventional asset allocation.

Islamic finance considers the pure lending of money against interest as haram or prohibited. Partnerships and asset based trade finance are the core of its principles.

The Muslim investor can neither lend money against interest nor trade in interest based debt instruments (i.e. conventional fixed income bonds). But the concepts of risk, and profit or loss sharing align the basics of the private equity markets with the Shari'ah ideals. There is an obvious window for cooperation and convergence between (conventional) private equity finance and the Islamic investor.

The direct involvement of Investors in target companies allows them to reducing any asymmetry of information (one of the typical dangers of publicly listed companies is insider trading) and to upgrade the internal corporate governance as much as possible. The higher risk profile – as compared to investment in listed instruments - is matched by prospects of a fairer share of the profits.

Hence, the present boom of the Islamic private equity market is not a coincidence.

Paul Wouters



Paul Wouters is a Belgian lawyer who has been a Turkish resident for some years now. Trained as a corporate and financial regulations practitioner in Europe, he focused on melting down differences in legal cultures that would benefit a large, international clientele.

Wouters is a member of the advisory board of Islamic Finance news (Malaysia) and publishes worldwide opinions and articles on the subject of Islamic finance and banking. He is partner at Bener Consulting (Istanbul-Turkey) and B-S-C-C Capital Partners (East Sussex – UK).

Paul Wouters can be reached at pwouters.law@gmail.com

Table of Contents

Understanding Islamic Private Equity Funds	1
Islamic Private Equity Fund	3
Investors	4
Management Team	5
Investment Strategy	6
Target Company	6
Haram activities	6
Financial ratios	7
Total debt	7
Total interest bearing securities and cash	7
Accounts receivable	7
Legal Challenges	9
Islamic Liquidity Management	10
Shariah Adviser and Shariah Compliance Officer	10
Shariah awareness	11
Coexistence with conventional finance	11
Case study: Coexistence of conventional and Islamic Investors	12
Conclusion	13

Used Abbreviations

DJIM	Dow Jones Islamic Markets Index
EVCA	European Venture Capital Association
FMV	Fair Market Value
GP	General Partner
IPEF	Islamic Private Equity Fund
IPO	Initial Public Offering
IRR	Internal Rate of Return
LP	Limited Partnership
PLS	Profit and Loss Sharing
ROI	Return on Investment
SSB	Shariah Supervisory Board
TraFiCo	Trade Finance Company – uses contracts such as the Ijarah or Murabahah
VC	Venture Capital

From the same author:

WOUTERS, Paul, Venture Capital “investment company” – SICAR Luxembourg, (2004)
 WOUTERS, Paul, The European Company SE (2004)
 WOUTERS, Paul, Finance Contracts – the Islamic approach (2005)
 WOUTERS, Paul, Compliance and Compliance Function (2006)
 WOUTERS, Paul, Mediation – Introduction – Belgian perspective in the EU (2006)
 WOUTERS, Paul, SPF Luxembourg – Société de Gestion de Patrimoine Familiale, Company for Family Wealth Management (2007)

Islamic Private Equity Funds

Understanding Islamic Private Equity Funds

When people talk about private equity, they are referring to shareholdings in companies that are not listed on a public stock exchange. Non-listed companies are not subject to the same level of government regulation and disclosure rules as listed ones. Since there also is no “daily market” where the stock is regularly traded, private equity is less liquid than publicly traded equity. And anyhow, those smaller companies have far less outstanding stocks to be traded or negotiated, leaving little room for sufficient volatility. Moreover, the transfer of private equity in such companies is mostly regulated by law, the articles of association or even stipulated in shareholders’ agreements.

Venture capital (VC) usually means capital that is made available to small and medium-sized enterprises with perceived exceptional growth potential. VC investments are generally classified as high risk with high return potential. The aim of the VC investor is to build substantial additional business value within a certain time frame (mostly four to six years) and then exit, typically through an initial public offering, merger or buyout strategy. A VC investment is typified by active ownership, extra capital injections, the implementation of aggressive but realistic business plans, additional managerial and technical expertise, and networking contacts/synergy offered by the investor to the target company. Effective governance and a disciplined approach are key to realizing the projected rapid but sustainable growth.

In Europe, private equity is to be understood as VC at any stage of the life cycle of the target company. In the US, however, VC typically refers to early-stage investments, while private equity is normally related to financial involvement in later stages (e.g. management buyout or buy-in).

Besides the so-called private equity, the following major asset classes could be available for Islamic funds:

- commodities and money markets;

- real estate;
- fixed income;
- trade finance contracts (Murabahah, Ijarah);
- equity listed on stock exchanges;
- mixed.

Private equity also can be aimed at middle-sized to large target companies and even listed companies (so-called “take privates”). Those deals, however, usually involve companies in the “out zone” (already too much debt financing because they’re at a later stage of their life cycle) for Islamic compliant private equity investment and, moreover, often thrive on big interest-based financial debt leverage. Generally, the following industries are within the scope of activities of private equity investors:

- technology
- telecommunications
- industrial products
- healthcare and pharmaceuticals
- services and retail
- leisure and media (sometimes regarded as unlawful — or allowed only under strict conditions — by Shariah scholars because of the possible sale of alcoholic products and the presence of reprehensible music and movie displays).

The present growth of the sovereign wealth funds and an expanding market of “secondary buyouts” (private equity funds that take over companies already in the portfolio of other PEFs in order to propel them to a higher stage of their development), however, also will open markets for upscale and major Islamic compliant-gear transactions.

Most jurisdictions do not have specific guidelines for setting up and managing Islamic VC. Malaysia is an exception, and it is useful to direct the reader’s attention to the “Guidelines and Best Practices on Islamic Venture Capital” issued in May 2008 by the Securities Commission Malaysia (SC) in this regard. Other sources of information are the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrain and UAE-based Dubai Financial Services Authority.

In essence, Islamic finance strives to promote the real economy by means of:

- i. risk/profit- and loss-sharing (PLS) partnerships; and
- ii. asset-based trade finance contracts (Murabahah, Ijarah and Salam).

A broad generalization would be that for the Islamic economy, unlike assets, money is not a commodity that can be traded for profit. Money is merely an instrument to measure the value of things (e.g. one glass of soft drink = EUR1 = two candy bars) and a payment facilitator (instead of barter). Rather, money has to be exchanged against money at par value and on the spot.

The lending of money against interest (payment reflecting a perceived opportunity cost to the lender and an increment that is due because of the simple lapse of time) is *riba* and *haram* or prohibited. Islamic finance, therefore, will need to be asset-based instead of debt-based.

For a long time now, learned Shariah scholars have been pushing towards PLS partnership structures. These partnerships lead to: (i) shared investment of money and labor; and (ii) benefits and losses that are shared equitably.

The PLS mode of finance — and in general, all asset-based finance — provides the most appropriate instrument for the accomplishment of fairness in an efficient manner. By way of illustration, consider that a conventional bank or financier relies on the pure lending of money against interest with a secured and preferred status (debt-based finance). The goal is to isolate risk, if any, from the banker who in effect seeks not to share risk and profit. Actually, the banker does not want the outcome of the venture for the entrepreneur (big or small success or even failure) to affect his position at all (in any case, fixed return/profit and, if so needed, even a forced payback).

The PLS principle in Islamic finance generates efficiency through sharing risk and therefore, appears destined to play a more important role in private equity investment.

(Public) equity investment relates to investment in shares listed on public stock exchanges. Its shareholdings are generally in companies with considerable size and known performance records. Those companies also are subject to disclosure and

governance regulations of the jurisdiction in which they are traded. They are supervised by local capital markets regulators and stock exchange authorities. The reporting and transparency duties allow the investor to gain sufficient insight and make educated investment decisions. Depending on the volatility of the markets, it is relatively easy to invest or disinvest in that kind of stock.

Private equity investment, on the other hand, refers to shares of non-listed companies. These mostly young companies usually are still in the start-up or early phase of their existence. As they do not yet have a proven performance record and usually also lack sufficient assets, these companies have difficulty in getting access to public investment or even to much-desired bank loans. Most of the time, additional injection of capital is the only option available.

Another issue with this type of companies is that generally, their shares are not easily transferable. This may be due to legal barriers such as laws, articles of association or private shareholder agreements.

Furthermore, without an exchange listing, their shares are not available for easy trading. Investors therefore often find it difficult to exit their investment until a certain growth potential has been reached so other investors can be attracted. Private equity, by consequence, is marked by a higher risk profile and a longer time span of illiquidity. This last aspect is in line with the vision of many Shariah scholars.

More conservative scholars are relatively hesitant to condone the fast buying/selling of equity on stock markets as this comes close to gambling, in their opinion. This perspective explains at least in part why not all of Islamic jurisdictions have taken a binding positive stance yet towards the public equity markets. The slower turnaround, combined with PLS principles, is therefore appealing to many Shariah scholars.

There are basically three major groups of private equity investments:

- i. investment in organic growth
- ii. increasing the value of the core business (restructuring)
- iii. buy and build (growth by synergy between the target companies in a portfolio).

Special focus is given by investors to maximize any potential upside in those areas in order to optimize the value — and the profit — on exit. Such exit typically

takes place through an IPO, a sale, a merger or a buy-out. In most cases, an exit at mid-period may not be possible or can only be done at great cost. However, a considerable number of target companies fail to or at least do not reach the desired return on investment (ROI) on exit.

This explains the need to “pool” the money of several investors in a fund and then channel that money to several target companies. Such an approach will disperse the risk and spread the financial failure of one venture over the total investments held by the [Islamic] Private Investment Fund [I]PEF and ultimately, over all the individual investors.

As is the case with other asset classes, markets evolve in cycles. It is difficult to predict if they will move up or down over a longer investment period. Nevertheless, the overall annual return of investments through private equity funds between 1960 and 2000 was 19.6% (source: EVCA). Private equity statistically generates sufficient more return than investments on the stock exchange, provided there is a good strategy and sound management.

Islamic Private Equity Funds (IPEFs)

Basic remarks

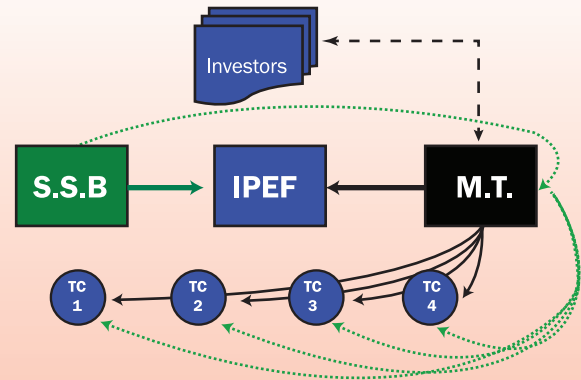
A fund allows the pooling of investors and results in a more substantial concentration of capital. This provides access to a more diverse range of investments than would be accessible to each investor individually.

It also spreads the risk over more target companies and allows the services of specialized investment managers to be brought in.

The choice of jurisdiction and legal structure of the IPEF are important. Attention should be paid not only to the types of fund structures available in the host country of the IPEF, but also to the potential funds that may be marketed to investors in their home jurisdictions and type of investments they are allowed to venture into in the jurisdictions of the target companies. It is important to consider cross-jurisdictional issues between the investor, the IPEF and target company home markets (FDI regulations and so on).

The final decision on what legal vehicle to use for the IPEF will be influenced by, among other things, the

Basic IPEF fund structure



1. Shariah adviser (SA) or Shariah Supervisory Board (SSB) sets the Shariah statement of policy
2. Investors finance the IPEF
3. Management team (MT) identifies and acquires equity in the target companies (TC) on behalf of the IPEF
4. SA monitors the follow-up of statement of policy and overall compliancy
5. MT and Shariah compliance officer (SCO) monitor the TC for the IPEF – Shariah irregularities discovered in that reporting from the TC will be reported by the SCO to the SA
6. MT keeps the investors updated on the development of the TC
7. On decision of the IPEF, the MT ultimately executes the exit out of the TC through IPO/sale
8. The profits/losses of that exit flow back to the IPEF that distributes them to the investors

legal structures available in any specific jurisdiction (trusts, companies and funds), tax requirements and specific Shariah constraints.

As the basic structure of fund transactions is one of money flows – downstream from the investors to a fund, and then to the target company and then again upstream from the target company, over the fund to the investors – tax evasion and exchange regulations/treaties for the avoidance of double taxation and money laundering regulations will also be aspects of significant consideration.

The organization and function of the fund vehicle must be Shariah compliant. This means that the legal advisers will have to model some of the clauses and

mechanisms to meet the requirements of the Shariah in general and the principles of Mudarabah or Musharakah PLS partnerships and Wakalah in particular.

The structure can be open-ended (easy outflow of existing investors and additional inflow of new investors) or closed-end. It must be noted that open-ended structures are often avoided and, on the contrary, certain lock-in structures are sometimes perceived as more Shariah compliant.

Bearing these issues in mind, the most appropriate structure for an IPEF may vary from a standalone corporation (with general assembly of shareholders/investors and board of directors) and with an internal or external management team to a real fund/trust structure that holds the monies (and later, the equity), managed by an outside management team (either a company or real persons). This second structure may behave as a (sub)-contracting fund manager or as a general partner in an overall partnership structure.

The IPEF will invest in the underlying target companies and will, upon the exit thereof, incur losses or gain profits. The IPEF will then distribute net capital gains (or losses) back to the underlying investors.

Sufficient consideration should be given to the choice between a regulated (listed) or non-regulated (discreet) special purpose vehicle (SPV) as this might have a significant impact on the tax implications for any capital market regulatory issues.

Some scholars do not consider the type of vehicle used to be significant as long as its aspects do not contravene the basics of the Mudarabah and Musharakah PLS partnerships or other nominate contracts like the Wakalah. In this context, it may be observed that Malaysia allows the use of corporations.

Some conservative Shariah scholars however oppose to the use of western-style “companies”. They only accept the Mudarabah and Musharakah PLS partnerships or at least legal structures that emulate those very closely (frequently common-law style limited partnerships (LPs) where the same investors – mostly HN-WIs and institutional investors – may be grouped as limited partners), together with the use of other nominate contracts like the Wakalah.

After the initial fundraising, the promoter of the IPEF usually becomes the general partner (management team). They will identify the target companies, conduct

due diligence reviews, obtain the investor agreement and undertake the initial equity acquisition in the target company. The general partner is also responsible for managing the target companies and to ultimately conduct the exit strategy on behalf of the IPEF.

Any conventional financial institution (i.e. the bank) can set up such an IPEF, provided its local regulations do not require special licenses for the activity and the vehicles are properly isolated from conventional activities and managed in a compliant way.

Investors

Investors in private equity might be real or legal persons. They are typically high net worth individuals (HN-WIs), family trusts, corporations and institutions. They want to diversify their portfolios and achieve higher returns on investment for their medium-to-long-term financial commitment and the higher risk profile by:

- optimizing the innovative characteristics; and
- exploiting the strong growth potential of the target company.

(1) The origin or residence of certain underlying investors, combined with (2) the legal structure and home regulations of the IPEF structure that is withheld and (3) the regulations of the host countries of the target companies, may influence the range of possible investments available. The combination of those three aspects needs to be well balanced from the start.

For IPEFs, investor profiles indeed may be as important as company profiles. Some jurisdictions have a reputation of being tax havens (usually, they also have few or no money laundering compliance regulations). Investors resident in those jurisdictions are sometimes shunned by local regulators at the IPEF or target company level, even when the investors originating from such jurisdictions would only have a small portion in the IPEF.

Foreign investment restrictions, financial market regulations, disclosure requirements and so on might cause serious problems. The compliance requirements of a Luxembourg-based IPEF vis-à-vis those of US-, Gulf- and Malaysia-based investors might therefore cause several sets of regulatory hurdles in different jurisdictions at the same time.

The promoter of any type of investment fund – IPEFs included – generally prepares a memorandum and an

executive summary to introduce investors properly in the set-up of the envisaged fund. Usually, there will be a series of “closings” when the various investors confirm their commitment to the IPEF.

When the traditional “road show” undertaken by investment brokers can be considered a “public offering”, local capital markets regulations must be followed, permission obtained from the relevant authorities, and official memoranda drafted and approved.

As innovation evolves faster and faster, and sometimes in unpredictable directions, it becomes more and more difficult for the individual investor to single out a good investment, manage it properly, keep a competitive edge and then grab a good exit opportunity.

This is important when that private equity portfolio becomes diversified over several target companies with a geographical spread. Specialized and reliable help from a good management team then becomes essential.

Management team

If a partnership structure has been chosen, then usually the general partner becomes the management team. It is possible, however, that (part of) this task is outsourced to outside fund managers.

The composition of the management team, which may consist of natural persons or a separate legal entity, is crucial to the success of the whole venture. The team should not be too broad and should be eager to make the business. The portfolio(s) that are managed should not be too wide and should be within the scope of the available capabilities and qualifications of the team.

Sufficient local introduction and experience are important for good management of the target companies. Indeed, the same line of business is performed in different ways, according to different regulations and business cultures in the various geographical locations of the investments. It is hardly “one size fits all”.

Experience has taught us that the past track record of a management team has little or no value in determining future performance. Markets and opportunities change constantly and one lucky shot might hide a consistent history of failure of a management team.

Furthermore, a team that follows the beaten track might venture into a mature and over-competitive market, destined to underperform or fail. An innovative approach in emerging markets has to be preferred, combined with a weathered management team.

Where the management team also is to run other (maybe even non-Shariah compliant) portfolios, it is necessary to verify whether or not the presented strategies are still compatible. Where there is a mix of Shariah compliant and conventional portfolios to be managed, it has to be determined whether or not the strategies could cause friction with the compliant project.

Sound and transparent reporting to investors during the lifespan of the IPEF is a must. Things often do not happen suddenly and timely intervention with additional funding can save many a mishap.

During the first stage, the management team has the crucial responsibility of identifying the target companies that meet the desired investment profile and that match the fixed return on investment (ROI) strategies. It has to make sound due diligence, to present the opportunity properly to the investors and then make the acquisition on behalf of the IPEF. Strong cash flow, profitability, ability to attract and keep high-profile clients, good governance and sound business strategies should prevail in choosing and managing the target companies.

During the second stage, in addition to new financial resources brought in by the IPEF, the management team could add value to the target companies through intellectual capital and synergy.

Where needed, it will be involved in:

- restructuring part or all of the business activities and strategies
- changing the CEO and/or CFO or adapting management structures
- optimizing cost structures
- general assistance and guidance to realize the set growth targets.

It could also be important to keep the in-house management of the target company to deal with the operational side of the business, but to disconnect them from the financial issues and shift those to the management team.

During the third stage, the management team will

negotiate and finalize the envisaged exit strategies. Depending on the IPEF structure, the general partner (management team) will take a profit share or management fee that may be dependent on a mixture of performance-based criteria and a fixed fee.

Any agreements between the IPEF and its managers are favored to be structured around the nominate Mudarabah and Musharakah concepts (may be combined by a Wakalah).

Investment strategy

A sufficiently diversified portfolio should target an attractive return with acceptable risk through carefully selected and monitored investments, taking the following criteria into consideration:

- Geographical distribution
- Business and industry sectors involved
- Currency risk
- Term of investment
- General risk profile
- Projected return

Attention should be paid to local regulatory restraints such as access to ownership of financial institutions, strategic industries and real estate acquisition by foreigners etc.

The strategy should be clearly defined and manageable by the management team, which should obviously not only have financial expertise but also specific business knowledge in the fields of activities of the target companies. Although diversity of industries in a portfolio certainly has merits, it has been proven that private equity investments are more likely to be successful when they are more focused.

The strategy will also be bound by the haram activities and financial ratios that the target company will face, as explained below.

Target company

Target companies will be identified through contacts within the IPEF network, soliciting by the target companies themselves and sector tracking. A thorough due diligence on financial and non-financial issues, projected ROI, synergy and timing will help single out any interesting investments.

Smaller companies with the potential for significant growth are high on the list of priorities. These types of enterprises have little interest leverage and there still is a considerable scope of negotiation room for structuring and asserting compliance.

Haram activities

Here is a non-exhaustive list of possible elimination criteria that would classify an investment opportunity as haram or unlawful. The definition of "haram" may vary and will be subject to fine tuning by the Shariah adviser or Shariah Supervisory Board (SSB) of the IPEF. They include companies that:

- produce/slaughter/sell/trade or distribute pork (or pork-related) products, blood
- engage in pornography or obscenity in any form
- primarily engage in the entertainment business (films, video, theater, cinema)
- engage in gambling, casinos, lotteries and related games and activities like bookmakers
- are active in non-compliant finance or insurance
- weapons industry, defense or related
- produce/distil/sell/trade or distribute alcoholic beverages or related products
- produce/grow/sell/trade or distribute intoxicants or related products (drugs, tobacco)
- engage in human cloning, trades/produces or products related to aborted human fetuses or other ethical border transgressions
- have bad employee records, environmental records.

For referral and comparison, below is a list of haram activities as stipulated in the Guidelines and Best Practices on Islamic Venture Capital from the SC. The IPEF should not engage in:

- financial services based on riba (interest);
- gambling and gaming;
- manufacture or sale of non-halal products or related products;
- conventional insurance;
- entertainment activities that are non-permissible according to the Shariah;
- manufacture or sale of tobacco-based products or related products;
- stockbroking of share trading in non-Shariah compliant securities;
- hotels and resorts;
- by ijthad, other activities the Shariah adviser may deem non-permissible.

The list of excluded activities may vary from time to time and from source to source. The reason is that some of those activities are not really haram but rather should be avoided or because they could lead to “problem” situations (for instance, the hotel business). They are either included or excluded following the decision of the Shariah adviser.

In any case, careful attention should be paid to all target companies that could derive partial income from such haram activities such as supermarket chains, airlines, hotels and restaurants that incidentally sell alcohol, cigarettes and so on.

For investments in publicly listed companies, it is more or less generally accepted that any haram income of a non-compliant target company that does not exceed 5% (some scholars even go as high as 15%) of overall gross income is considered marginal or incidental.

The target company is therefore still acceptable, provided sufficient cleansing according to the guidelines set forth by the Shariah adviser is undertaken. It is likely that the adviser will allow the same leniency towards the private equity investments.

Note that by respecting this threshold, the company does not become compliant but only still is acceptable for investment.

Therefore, it is recommended that the company strives for 100% compliant activity—otherwise, undesired business developments in the haram activity may cause problems and the cleansing exercise could affect the profitability of the IPEF overall. Since the IPEF will mostly focus on relatively immature target companies, such selection should be possible.

Financial ratios

It is extremely difficult to find target companies that are completely “interest free”. Most Shariah scholars have recognized and accepted this, and allow cooperation for the general benefit of all.

Though some scholars still insist on prompt pay-off of all outstanding riba-based debt, the general accepted standard is that a partial contamination of a target company does not pose an insurmountable hindrance to investment.

Following the methodology set out in 1987 by leading Islamic finance scholars Justice (Rtd) Muhammad

Taqi Usmani (Pakistan), Prof Saleh Tuğ (Turkey) and Sheikh Mohammad Al-Tayyed Al Najar (Egypt), Dow Jones developed the Dow Jones Islamic Market Index in 1999. Since then, similar templates have been developed and widely accepted in the Islamic finance community. The criteria governing these types of investments in equity of listed companies may be outlined as follows:

- **Total debt**

Excludes investments when total interest-based debt divided by 12-month average market capitalization exceeds (or is equal to) 33%.

- **Total interest-bearing securities and cash**

Excludes investments when total cash and interest-bearing securities divided by 12-month average market capitalization exceeds (or is equal to) 33%.

- **Accounts receivable**

Excludes investments in target companies if accounts receivable divided by total assets is greater than (or equal to) 33%.

In short, companies will be excluded when they are too much exposed to interest-based lending or when the liquidity or debt ratios are too high and would boil down to actual trading of cash or debt (both problematic for the Shariah and, therefore, to be avoided). As the Prophet Muhammad said: “One third is big or abundant.” As we will see later, sometimes a “majority” rule (50% or even more) is applied by certain parties.

As mentioned earlier, any haram income from unlawful activities and interest also has to be contained at low rates, usually a 5% maximum is acceptable (and then this income has to be cleansed). Note that by respecting these thresholds, the company does not become compliant but only still is acceptable for investment and free trading of its equity.

The follow-up and application of these guidelines may be difficult. The financial needs of the target company may fluctuate quickly and local markets often do not offer sufficient compliant “interest-free” financing products.

It also is important to note that the DJIM approach (market capitalization as a benchmark) may be an easy tracker and results in easily verifiable figures but has the downside of making the actual threshold float. The consequence, indeed, is that market

Financial screening ratios (simplified)

	Debt ratio (%)	Receivables ratio	Cash + Interest-bearing ratio	Non-permissible income/total income
DJIM ¹	33	33%	33%	≤ 5%
FTSE ²	33	50%	33%	≤ 5%
S&P ³	33	49%	33%	≤ 5%
MSCI ⁴	33	70%	33%	≤ 5%
Parsoli ⁵	33	45%	33%	≤ 10%
HK Islamic Index ⁶	33	49%	33%	≤ 5%

¹ Trailing 12 months average market capitalization

² Total assets

³ Market value equity

⁴ Total assets

⁵ Trng 12 Mth Av Market Cap

⁶ Trng 12 Mth Av Market Cap

¹ Guide to DJIM Indexes November 2007

² Ground Rules for the Management of FTSE Shariah Global Equity Index Series Version 1.2 March 2008

³ S&P Shariah Indices Index Methodology June 2007

⁴ Morgan Stanley MSCI Islamic Index Series Methodology April 2007

⁵ Parsoli Islamic Equity Index PIE

⁶ Hong Kong Islamic Index

fluctuations can suddenly affect a target company’s eligibility. Higher share prices result in higher upwards leniency toward the level of allowed interest-based financing and a sudden drop in share prices may suddenly force a company into the “out” (haram) zone.

In general, since IPEFs will target unlisted companies, the FTSE screening ratios that are based on total asset values appear to be a sound tool. The Shariah adviser sets out rules and may decide on delays for compliancy before or after an acquisition is made. The parameters set forth above weigh more heavily than one might appreciate at first glance. Any impure income – also UNDER the 5% threshold – will have to be cleansed.

This process of purification entails distribution of said “haram” profits to charity. Since such distributions have a negative influence on the overall profitability of the investment, it is best to keep them to the minimum.

The Shariah screening criteria from AAOIFI, as set forth in Standard No 21 on Financial Papers (May 2006), follow the regular haram business activity screening (be it that the articles of association of the company may not contain reference to any excluded activity – even if the company is not actually engaged in that activity). Two out of three of the included financial screens use the market capitalization as a basis, the one-third rule of thumb reigns as does the 5% threshold rule (with cleansing duty). Companies that are fully liquid or debt can only be traded at par value, just to name the most important characteristics.

Together with FTSE Group and Yasaar, the Shariah Advisory Council (SAC) of the SC developed two screening methodologies: the FTSE Bursa Malaysia Hijrah Shariah Index, which follows the international FTSE standards; and the FTSE Bursa Malaysia EMAS Shariah Index, which caters more for the local markets and uses different benchmarks – 5% revenues max (clearly unlawful activities: riba from interest-based companies such as banks, gambling, liquor and pork), 10% revenues max for items that are difficult to avoid in present market conditions (interests from fixed income deposits, tobacco-related activities), and a 25% benchmark (non-permissible profits from otherwise permissible business activities including share trading and stockbroking, hotel, resorts that may be serving alcoholic drinks to non-Muslims and so on). The ratio for accounts receivable is not withheld mainly because of the different stance taken by the local authorities to the sale of debt (Bai Dayn).

Global Investment House (GIH) developed the Global GCC Islamic Index for equity listed on the GCC stock exchanges (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE). It holds the companies of which the articles of association mention that the company is fully compliant.

The final screening criteria that will be withheld by the Shariah scholar will be a mix of the abovementioned generally accepted standards used to track larger numbers of listed stocks and maybe his personal opinion based on larger consensus. The final criteria comprise a mix of the abovementioned “generally

accepted standards” and a personal opinion based on consensus.

It is common practice during the life cycle of an investment by an IPEF for the target company to calculate the internal rate of return (IRR) based on fair market value (FMV). This valuation calculation is used to determine the share price. Standard rules (such as the International Private Equity and Venture Capital Valuation Guidelines) may be applied to this calculation, subject to the approval of the Shariah adviser to the IPEF.

Legal challenges

Besides the haram categories and financial ratios explained above, there are important restraints in the form and contents of the legal documentation related to the compliant project. These must be compliant with the Shariah.

Anyone who has worked in a Shariah compliant environment knows that combining conventional regulations with the provisions of the Shariah is, in general, possible. There are, however, certain restrictions of public order at some of the local host jurisdictions that may cause legal headaches or undesired tax results.

The fundamentals of the Shariah will govern all aspects of the IPEF’s business practices. For instance, the financial relations between the investors must be compliant. The new legal environment will have to be tailored to the fundamental principles of the Mudarabah of Musharakah PLS.

While Shariah principles require that any loss is borne by the participants in proportion to their invested capital, profit can be shared at levels agreed earlier, stipulated in equitable financial agreements.

For instance, preferred stock — in so far as for instance giving the holder the right of:

- i. a preference payout before the common stock at liquidation (this would eliminate the equal sharing of the risks and the losses)
- ii. a periodically guaranteed fixed return on investment (this would lead to *riba* and could lead to the exclusion of loss sharing) are prohibited. Furthermore, any cascade of equity classes with different subordination is not acceptable.

In general, guaranteed liquidation/exit pricing (in a

way securing profit and excluding the risk of sharing a loss) is also contrary to the Shariah. Sometimes, parties wrongly want to negotiate beforehand a guaranteed minimum price at exit (initial investment or even a multiple thereof). Evaluation of fair market value and company performance are to be preferred.

On the other hand, unequal preference to profits might be construed within limits when attached to common stock, as long as there is no guaranteed minimum return. Also, certain convertible and exchangeable structures have been approved.

Certain vesting techniques might be used. This roughly means that some stocks only accrue value for the entrepreneur (or key employees) after agreed periods have elapsed or benchmarks reached.

Such stock helps to retain investor/employee interest in the business or it simply places a time frame on value creation before the actual transfer. Certain lock-in agreements also have been approved.

Contractual restrictions and insertion of any such criteria into the target company’s by-laws are suggested to ensure compliance.

Indeed, good covenants with the management team and the target company (reporting, board meetings, financial follow-up and so on) are necessary to ensure that the venture is being managed according to plan and to the agreed guidelines.

Where the IPEF has influence on the target company, restraints will also have to be transposed to that underlying level, to avoid friction or incompatibility with the other shareholders or existing contracts.

At the setting up of an IPEF structure, it must be recalled that Islamic finance is based on a set of religious beliefs. It is therefore important to remember that though various investors may commit themselves to using an IPEF, their personal perspectives on the Shariah may prevent them from participating in certain concrete investment proposals. To address this situation, well-balanced “opt-out clauses” will be an inherent part of the commitments.

Also after the investment, differences of opinion may arise concerning the application and the “exit” position of the IPEF. Conciliation and remedy clauses will be key to resolving such issues and should be taken into consideration at the setting up of the structure.

Islamic liquidity management

A substantial part of the available cash will stay liquid for some time. At the early stage of the IPEF, this will be the case simply because no investments have been made yet and all funds are still in cash. That liquidity will then slowly be replaced by equity (shareholdings) as the IPEF starts investing in the target companies.

When the investments have been done, probably a floating 20% or so of the funds will be held liquid, to be at hand for any additional financial intervention in one of the target companies. These funds may not be deposited in interest-bearing bank accounts for obvious riba-related reasons. It may, however, be invested through Islamic compliant means, for instance, in available Shariah compliant liquidity management products or compliant stock, commodity Murabahah and other contracts as long as they are approved by the Shariah adviser. Short-term trade finance contracts may also be envisaged either by the IPEF or a special SPV, either to the target companies or to third parties, provided local business and company laws and regulations and tax rulings allow this in a profitable way.

Shariah adviser and compliance officer

The Shariah adviser or the Shariah Supervisory Board (SSB) will assume responsibility for the Shariah compliancy of the IPEF, and eventually the target companies and management team.

First of all, the overall quality and independence of the Shariah adviser or SSB are important. The composition of the SBB or the choice of Shariah adviser must be such that their decisions support rather than contradict the Shariah position of the individual compliant investors. A clear statement of the investment policy criteria with respect to Shariah compliance, rules for refusal/acceptance of investments, cleansing procedures and the level of monitoring by the SSB (through the Shariah compliance officer) of the portfolio should also be given special attention.

Here is a summary of the standing guidelines of the SC. It is advisable to appoint at least one Shariah adviser who will:

- Ensure that all aspects of the business are in accordance with the Shariah (including portfolio management, trading practices, operational matters, administrative matters, and so on).
- Provide Shariah expertise on documentation, structuring, investment instruments and ensure compliance with the general Shariah principles and the standards, regulations and resolutions of the regulator.
- Scrutinize any compliance report or any investment transaction report prepared by the Shariah 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 IPEF.

In Malaysia, the appointment of such a Shariah adviser is also regulatory to the management team (if this fits into a different management corporation). The guidelines do not exclude that this could be the same person for the IPEF and the outside management company.

CIMB Muamalat Fund I

Founded in 2002, it was the first Asia-based IPEF. As a parallel fund to the conventional Navis Asia Fund III, it was designed to co-invest in Shariah compliant investments.

Though investments are made at the Navis Asia Fund III investment committee level, they are subject to investment guidelines as set forth by the IPEF's Shariah Supervisory Board.

As the IPEF only holds a minority stake, those guidelines are realistically flexible, though fully compliant with the Shariah standards.

Funds are channeled into Limited Partnerships (LP) – structured around Musharakah and Wakalah contracts – that invest in the underlying target companies through share sale agreements or subscription at capital raise.

For both the IPEF and the management team, Malaysia also advocates appointing a Shariah compliance officer who will do the following on a daily basis:

- ensure full compliance of the activities;
- report any non-compliance to the Shariah adviser;

- assist the Shariah adviser in certifying that the business is compliant;
- maintain the compliance records.

In general, the appointment of a Shariah compliance officer to the board of the IPEF and the management team is advisable.

Shariah awareness

There is an absence of uniformity in the way that Shariah principles are applied in different regions and over time. This is not a downside. Differences challenge and spur innovation.

At present, there is not only a shortage of qualified professionals (lawyers, bankers, scholars, academics and so on) who are well versed in both the Shariah and conventional standards, but also a lack of Shariah awareness among entrepreneurs and managers.

In order to obtain full compliance, it is not only necessary that the Shariah adviser monitors the IPEF and the target company. The management team, which will be the link between the investors and the target company, should not fully depend on the Shariah compliance officer but provide and raise awareness among its members and keep close contact with the target company and the SSB.

Besides sufficient business/financial compliancy, standardized Shariah compliancy checks should be incorporated into basic systems to ensure follow-up. Certainly, at the level of the (maybe conventional) target company, inadvertent, qualified breaches of the Shariah could cause substantial damage to reputation.

Coexistence with conventional finance

When simple equity stakes are acquired through purchase of shareholdings from public companies on the stock exchanges, the influence of investors on the daily compliance of the target company is close to non-existent. Investors basically have to live with the majority vote.

With private equity injections, however, the case is different. Private equity financing can place the same

investors directly in a position to influence the target company. A controlling stake in a target company will allow the implementation of fully compliant policies.

Besides compliance with the abovementioned financial ratios, in general, the Shariah advisers tend to advise full transition to Shariah compliant structures (repayment of conventional debt) within three years following an acquisition. This time frame is usually given so it would not disrupt the going concern.

Highly leveraged companies should be restructured to meet acceptable levels of Islamic debt at the earliest possible time. This may be done using compliant finance structures such as Ijarah wa iktina etc.

The use of a trade finance company (TraFiCo) or the guarantee of sufficient compliant funding from an Islamic financial institution could conventional investors and the target companies to “go all the way” and commit to the compliant project.

Regulatory, tax and accounting issues have to be dealt with on a jurisdiction-by-jurisdiction basis, and this can sometimes lead to costly and lengthier transaction periods.

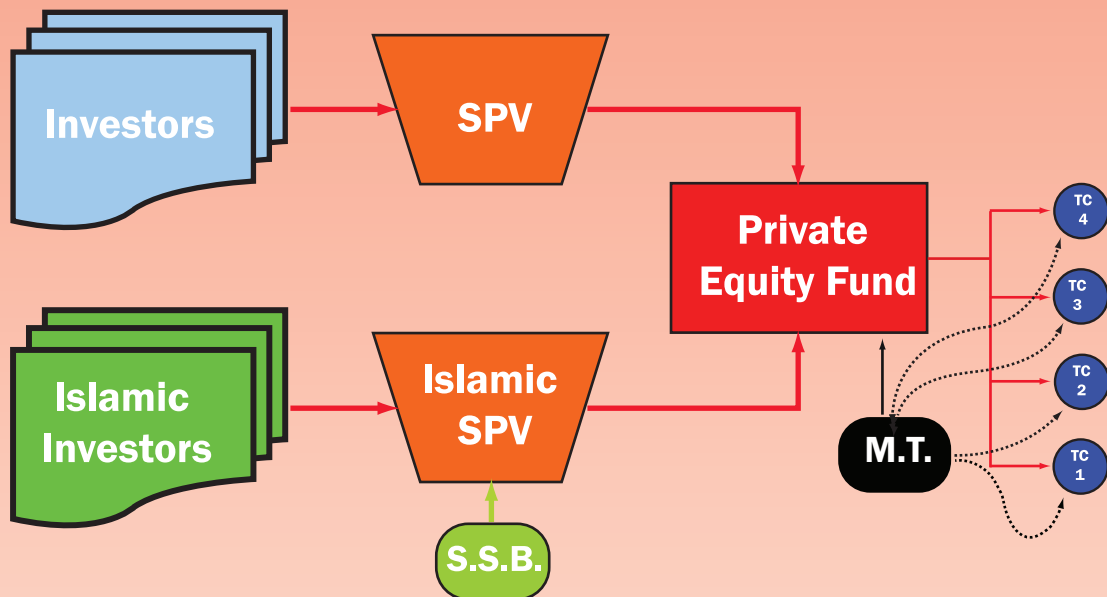
If the Islamic finance instrument is not well known to target companies, it will be necessary for management to be educated in order to fully understand the different compliant financing tools available. Rather than financing needs not being met, the variety of options available may surprise those new to the field. Confidence in the possibilities should be built.

When compliant investors — through an IPEF — do not have a majority stake in a target company, they should pay special attention to the reduction and enforceability of a strong shareholders’ agreement. Such an agreement should guarantee Shariah compliance at all times. They should also reiterate the Shariah principles at the general assembly of the target companies at any time that’s convenient.

Having said this, one can envision the intervention of a local Islamic financial institution to assist the target company if possible through a facility framework agreement in refinancing Shariah compliant financial products where needed. Exposure to such products enhances the awareness of the target company to the Shariah, and provided that local regulatory and tax regulations are favorable, it would be possible to set up an assisting TraFiCo.

Case study: Coexistence of conventional and Islamic investors

Simplified scheme of a private equity fund with a conventional SPV and an Islamic SPV as limited partners



1. Conventional investors commit funds to an SPV in a friendly environment for ultimate investment in the private equity fund (PEF) as limited partners
2. Islamic investors commit funds to an Islamic SPV located in a friendly environment for ultimate investment in the PEF as limited partners but subject to Shariah screening by the Shariah Supervisory Board (SSB)
3. The management team (MT) is the general partner of the PEF
 - i. The MT identifies the target companies (TC)
 - ii. The MT presents the offers to the limited partners in the PEF
 - iii. The MT calls the funds at the limited partners in the PEF
 - iv. The conventional SPV transfers the funds to the PEF
 - v. The Islamic SPV transfers the funds to the PEF subject to Shariah approval
 - vi. The MT closes the deals and acquires the equity stakes in the TC for the PEF
 - vii. The MT manages the investment on behalf of the PEF as general partner
 - viii. The MT assists the exit of the TC and profit/loss is distributed through the PEF to the two SPVs and subsequently to the ultimate investors.
- 4 Reporting duties by the MT to all levels guarantees compliance with the investment policy and the Shariah.

A graphic of this case study

A basic scheme for cooperation between Islamic and conventional investors in a private equity fund (PEF) can be drafted now. The PEF has been made attractive to Shariah compliant investors through a focus on investments in specific halal sectors. Cash management has been restricted in a compliant and socially

responsible way. The PEF furthermore is located in a tax-friendly capital gains environment and targets emerging markets in carefully chosen geographical regions. The compliant investors opted to locate their SPV offshore (Bahamas). At the level of the Islamic SPV, there is full compliance and a Shariah compli-

ance officer has been included. The jurisdiction of the PEF was chosen so that its regulators and tax- and money laundering supervisors would not be too weary of the offshore Bahamas funding by the compliant underlying SPV.

The conventional investors in this case are all European and living in “tax-unfriendly” jurisdictions. They have opted, however, to locate their SPV in a European but tax-friendly jurisdiction. Their personal tax authorities do not like the offshore structuring in the Bahamas very much and the application of international treaties for the avoidance of double taxation has been optimized.

At the levels below the SPV (PEF and target companies), sufficient reporting systems have been installed to allow the Shariah compliance officer and the Shariah adviser of the Islamic SPV to ascertain that the investment strategy meets the Shariah standards as agreed.

The compliant investors have a Shariah screening opt-out clause in place (prior to investment) and a conciliation clause (after investment) to prevent their investments from inadvertently being mixed up in any target company with unacceptable haram activity.

The PEF, the management team and even the conventional investors are happy and confident that the ethical approach injected into the project by the compliant investors will be matched by them without too many difficulties.

It will be obvious from this scheme that other constellations may be agreed upon, depending on the situations, the parties involved and the financial weight of the overall project.

For example, an additional TraFiCo or Islamic bank could assist on the level of the target company to arrange for additional financing. Liquidity surpluses at the level of the target company, the PEF and the Islamic SPV could be handled through compliant short-term investments (compliant stock, Islamic money markets, TraFiCo, Islamic bank investment accounts and programs).

Conclusion

Private equity investment is to be encouraged. Investment in stock exchanges in so-called (public) equity is a good basic for portfolio diversification. However, it benefits companies that are already big and the money goes from one investor to the other; it is not directly

invested for economical growth.

Private equity investment confirms a social commitment to the real economy in the real, tangible sense of the word. The money will help creative entrepreneurs develop optimal business. It is a direct cooperation between money and labor on a fair and equitable foundation. And that is exactly what the Islamic economy and partnerships stand for.

Investors, however, do not necessarily have the time and knowledge (business lines, financial structuring, and cultural or legal know-how) to enter those markets in the different geographical locations and to manage the ventures closely. This certainly is the case when the investments need to be diversified into several target companies to spread risk.

There are ongoing complaints on the lack of PLS partnership funding at commercial/retail Islamic banks. Islamic banks indeed mostly stick to equity-based finance contracts, such as Murabahah and Ijarah. These complaints are without merit, since this kind of equity venturing simply is not (and will never be) their line of business. The products they want to finance most of the time are not suitable for partnership funding at all.

IPEFs, on the contrary, are perfect carriers for PLS purposes. One may use the traditional Mudarabah or Musharakah PLS partnership. However, venturing/investing outside of the Islamic world *sensu stricto* will lead to the use of different, but still Shariah compliant, vehicles.

This will likely also lead to permissible cooperation with conventional financiers. There is hardly a better way available to make the conventional business world aware of the Islamic ethical standards and to learn to respect them in a positive and inviting way.

The information contained in this document is provided for general information purposes only. It is intended to highlight issues and not meant to be comprehensive nor to address the circumstances of any particular individual or entity. Data and figures can be subject to changes and are for illustration only. Every situation is different and needs specific counseling. Professional (legal) advice should be sought before taking (or refraining from) any decision or action as a result of the contents of this article.