

Growth of Private Equity Funds using Islamic Finance

By Hamid Yunis

Introduction

The rapid development in the use of Islamic finance over the last few years is partly due to the enormous wealth and accordingly liquidity amongst investors in Islamic countries, who want to structure their investments in a Shariah compliant manner. As a consequence, product developers are tasked with the responsibility of creating new and innovative channels to attract these funds.

One of the things that we have seen developing, given our work at the centre of the Islamic finance industry, is the increase in the establishment of private equity and venture capital funds structured to attract Islamic investors. Indeed, it has been argued, and we agree, that the use of private equity and venture capital within a properly constructed partnership is a true manifestation of Shariah business principles.

Muamalat and Ibadah

What has given comfort to these product developers, not only for this type of product but generally, is the Shariah principle of Muamalat, which is clearly defined in Islamic jurisprudence. The principle relates to human dealings and indeed contracts, and also deals with issues regarding human relations. It simply states that everything is permitted unless prohibited. As such, private equity and venture capital are perfectly acceptable modes of conducting one's business dealings and indeed in structuring finance and investment, provided they meet certain Islamic guidelines.

This principle – which literally translates into “dealings” – should not be confused with the Shariah principal of Ibadah, which literally translates into “worship.” The latter principle states that everything is prohibited unless permitted and this relates to issues of worship and not dealings.

Fundamental requirements

As a background, private equity and venture capital funds must adhere to the following fundamental requirements:

1. **Underlying asset:** the underlying or ultimate asset, which is the subject of the investment, is acceptable and halal.
2. **Structure:** the proposed structure itself is acceptable from a Shariah compliant viewpoint.

Underlying asset

The ultimate or underlying asset must be halal. For instance, in a real estate investment fund, the following will need to be taken into account:

1. The occupiers of the real estate must conduct Shariah compliant business or something which is not inherently haram. Various rules have developed over the last few years as to what proportion of income from a real estate asset can be haraam and will not “taint” the underlying investment.
2. It does not contain any element (subject to paragraph 1 above) of haram activities such as pornography, gambling or the sale of alcohol or pork products.

Structure

Additionally, the proposed contract, financing and instrument structure itself has to be Shariah compliant.

1. Funds must be invested in a vehicle that has been structured in a Shariah compliant manner. This, in particular, takes into account the basis upon which the activities of the vehicle are based on tangible assets and are not speculative in nature (gharar).
2. The constitution of the vehicle provides for a prohibition on haram activities.
3. The activities of the directors and officers are acceptable in nature and it is possible to ensure that their activities are conducted in a Shariah compliant manner.

Practical example

Turning now to a means of structuring these requirements, it may be helpful to consider a practical example relating to the use of such funds. A typical scenario would provide for the following:

1. a product developer creates a proposed vehicle, which is interested in attracting Islamic equity investors, for the purposes of investing in real estate;
2. in general, private equity and venture capital funds are structured as limited partnerships. The same holds true in developing countries, except where regulations mean it makes more sense for the vehicle to be structured as a corporation or for another type of vehicle;
3. the limited partnership would have general and limited partners, with the latter likely to be the Islamic investors. Additionally, the general partner in a limited partnership is responsible for the raising of funds, choosing investments, monitoring transactions and exiting investments where appropriate. In return, they are paid a management fee plus a share of the profits, which can be structured in a variety of different manners;

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4. at the outset, consideration will need to be given as to whether the vehicle should be set up as a regulated investment scheme or indeed through the subscription by way of equity in a discrete vehicle. (Please see comments below on legislative requirements for financial services);
5. a prospectus/information memorandum would then normally be prepared which would contain the following details:
 - a. **Fund summary:** this will provide a summary of the basic aspects of the fund, including a description of the vehicle to be used, the investment objectives, the relevant characteristics and a statement of compliance with Shariah principles. It will also refer to the method of management and details of the other stakeholders involved.
 - b. **Market opportunity:** this will provide an analysis of both the macro and micro market in which the investment is to take place and the opportunities available.
 - c. **Investment approach:** this will outline the investment approach and again underline the Shariah aspect of the fund. It will also look at the investment policy and strategy, the method by which the fund managers will manage the fund, possibly in different locations, and indeed how financing will be obtained to leverage the assets being used. This again will provide a statement of compliance with Shariah principles.
 - d. **Management:** this will give brief details of the managers involved in the fund and in particular their curriculum vitae.
 - e. **Summary of principal terms:** the summary of principal terms summarize some other aspects referred to elsewhere in the prospectus. These will include the following:
 - i. fund objectives;
 - ii. fund contract structure (in general terms);
 - iii. the investment criteria, including reference to currency, the type of interest being sold to investors, the term of the fund, the size of the fund and also details of the minimum commitments and subscription arrangements; and
 - iv. reference to the choice and role of a Shariah compliance committee or scholar.

There will also be an analysis in this section of other aspects, such as fees and expenses to be payable, when distributions can be made and, of course, again a statement underlining Shariah compliance.

- f. **Legal and tax considerations:** this will be an extremely important section. It will provide details of the contractual structure of the proposed vehicle and underlying investments. Additionally, warnings and guidelines will be given in respect of tax considerations in the different types of investor jurisdiction that might be relevant. There will also typically be a section dealing with risk factors such as:
 - i. general business considerations relating to the relevant countries for investment;
 - ii. that there is an unspecified pool that requires an investment in the fund with no certainty of return or IRR;
 - iii. lack of liquidity, not only in the investments themselves, but perhaps in the interest;
 - iv. Shariah requirements on structure and leverage and Shariah opinions;
 - v. management risks;
 - vi. currency exposure;
 - vii. asset risks such as real property risks; and
 - viii. country and market considerations including legal and regulatory factors;

6. the prospectus/information memorandum would then be issued to either the market generally (taking into account any specific financial services/market/jurisdictional rules relating to the sale or advertisement of investments in vehicles to the public) or to a group of sophisticated investors who are known to the fund developers and therefore allow country specific exemptions to be obtained;
7. the fund would then attract equity investments, usually through a series of multiple closings; and
8. the fund would invest in a Shariah compliant manner using a variety of financing and ownership, development and investment techniques. Typically these are based upon structures such as a Murabahah, Musharakah (diminishing or otherwise) or Ijarah.

Consideration would also need to be given at the time of the fund's development to the investors' views in relation to appropriate exit strategies.

We made reference earlier to the appointment of a Shariah committee or scholar. An effective early appointment can be extremely helpful in providing guidance throughout the process to the fund developers and indeed to other advisors. It also reinforces Shariah compliance and provides confidence to potential Islamic investors.

Conclusion

Private equity and venture capital funds using Shariah compliant techniques is becoming a thriving industry, not only for Islamic investors, but also because it helps fund the market generally. Indeed, the use of conventional instruments, adapted to comply with Shariah guidelines, allows the Islamic finance industry to develop and innovation is welcomed. The combination of different techniques such as the use of Sukuk on a corporate basis is an example of this.

Our view is that Islamic institutions and indeed major investors are realizing the potential of this industry and are more willing to take a leading role in private equity and venture capital deals.

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