

PRIVATE EQUITY

Shari'ah compliant private equity investment

BY CLAIRE SPENCER



The rising price of oil has accelerated the growth of Middle Eastern economies and showered local investors with capital. This competitive, highly liquid environment has fuelled demand for new investment opportunities. One outlet gaining greater traction is Shari'ah compliant private equity, which allows local investors to tap into an asset class capable of delivering significant returns, while observing their religious obligations.

Evidence of the rising demand is clear. "Almost daily, articles are published about the enormous wealth and liquidity of residents in the Gulf arising from the price of oil," says Trevor Norman, a director at Volaw Trust & Corporate Services Limited. "This wealth and liquidity creates demand for investment products with Muslim investors looking increasingly to invest in Shari'ah compliant products. Historically, real estate has been the major asset class for investors throughout the region, but increasingly, regional investors are recognising the need to diversify. It is argued that a properly constructed private equity fund is the ultimate manifestation of investment in accordance with Shari'ah principles."

Basic structure of a Shari'ah compliant fund

There are certain principles that make the private equity model conducive to Shari'ah

law. As Dr Walid Hegazy, head of Islamic finance at Freshfields Bruckhaus Deringer, explains, the concept of private equity reflects one of the main philosophical underpinnings of Islamic finance: risk sharing between the capital providers, fund managers and entrepreneurs. In Shari'ah terms, investors must participate equally, with no investor taking precedence over another. Of course, there are also significant departures from traditional private equity. "Certain compliance criteria need to be taken into account when structuring a Shari'ah-compliant fund," says Dr Hegazy. "Ultimately, the structure needs to include a Shari'ah advisory board whose role is to scrutinise and monitor the fund's investment from a Shari'ah perspective. The general partner is accountable both to the supervisory board and the limited partners in ensuring that Shari'ah compliance criteria are implemented in the fund's investment strategies."

As a fund raises and deploys its capital, it will be monitored by scholars or advisers who interpret Shari'ah principles and make appropriate recommendations based on the manager's activities. Their level of involvement will vary from fund to fund, ranging from direct influence to passive oversight. Mr Norman outlines a number of responsibilities that Shari'ah advisers typically undertake. "Shari'ah supervisory boards may study the fund's offer-

ing memorandum, constitutional documents and any major agreements controlling the relationship between the functionaries of the fund. They give general advice to the manager or investment adviser regarding compliance with Islamic Shari'ah, and determine suitable criteria for the selection of companies in whose securities the fund may invest. The fund may use instruments and techniques for hedging and efficient portfolio management, the board will advise on their compliance with the principles of Islamic Shari'ah. They will also advise on the separation of non-Shari'ah compliant profits of the fund and specify the charitable activities to which they will be directed. Finally, they may also prepare an annual Shari'ah audit and review concerning the fund's activities and issue a report to investors in the fund." Vitally, the role of these scholars is not to manage, but to advise.

Investment strategies and fund deployment

When it comes to distributing profits, the private equity fund needs to assess how its income has been generated and account for any sources that contravene Shari'ah law. Through a process known as 'income purification', managers will identify any underlying investments that have reached an unacceptable level of prohibitive activity – most commonly the earning of interest – and remove the proceeds from their overall profits. Once deducted, any non-compliant capital is donated to charitable institutions under the supervision of Shari'ah advisers.

Income purification has an obvious impact on investment strategies, as it will be analysed in the pre-deal stage. "The amount of non-compliant income in a portfolio company's profits tends to be minimal since one of the screening criteria for selecting companies is low or no non-compliant income," says Tariq Al-Rifai, vice president of UIB Capital Inc. "The cut off point seems to be 5 percent. For example, if a manufacturer generates more than 5 percent of its profits or revenues, depending on the fund's criteria, then the fund will not proceed with acquiring the company." But deducing how much income is attributable to interest can be highly complex, as precise sources may be hidden or buried in accounting processes. Consequently, ►►

some funds agree on a standard percentage to remove the fund's profits. Alternatively, they may notify limited partners of the amount of non-compliant income that has been revealed, and leave it to investors to dispose of whatever amount they see fit. But this should not be confused with the concept of 'zakah' which is a periodic levy that Muslims pay based on a calculation of their personal wealth.

Shari'ah compliance has a huge impact on where a fund can deploy its capital. General partners must screen potential investments to avoid businesses and products which are prohibited under Islamic law. "These are most notably conventional banking and financial institutions whose main income is generated from interest-based activities, gambling facilities and casinos, and businesses involved in the production or distribution of pork and alcohol," says Dr Hegazy. In Shari'ah terms, the company must be 'halal' – that is, it should not contain any 'haram' (disallowed) elements. The criteria for screening investments have been codified by the Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI) under Shari'ah Standard 21, by adoption of the principles laid out by the Dow Jones Islamic Index. Indices with similar systems include the FTSE Islamic Index and the S&P Islamic Index.

How a fund structures its deals is also dictated by religious compliance. Under Shari'ah law, sharing risk is achieved by prohibiting interest, or 'riba'. This means that deals must be equity-based. "Financing on an interest-free basis means such deals are either financed by 100 percent equity or by using a combination of equity and another debt-like equity such as hire purchase ('ijāra wa-iqtina') or mark-up sale ('murabaha') financing. In addition, the fund must perform financial screening of the fund's investment to exclude companies that

derive part of their income from issuing interest-bearing securities or carry interest-bearing debts. However, most Shari'ah advisers tend to tolerate a leverage ratio of 33 percent or less for companies located in non-Muslim countries because it is extremely difficult to find companies that are completely debt free in such countries," says Dr Hegazy.

The trouble is that although Shari'ah principles preclude any conventional debt subject to interest, many early stage private companies are often highly geared. As Mr Norman points out, this can cause major difficulties should a manager wish to invest in a company with leverage. "In fact, it may not be possible unless the target company refinances itself with Shari'ah compliant debt, adding costs to the overall transaction," he says. "In some circumstances, such as where the debt is convertible and does not bear a fixed rate of return, some scholars have accepted such debt as quasi-capital. But each case has to be looked at on its own merits, and will normally require a ruling from the fund's scholars." Leveraging deals on a Shari'ah compliant basis is therefore the most challenging issue facing these private equity investors, according to Mr Al-Rifai. "Debt structures that have been developed over 10 years ago for private equity transactions are not ideal these days, and Shari'ah scholars are becoming reluctant to approve them," he says. As the asset class grows, alternative instruments and structures will need to be devised to facilitate new investments and promote flexibility.

Transporting the model to western markets

Whether this particular type of fund structure will gain a stronger foothold in western markets remains to be seen. Activity in this area is only modest at present. "The amount of money deployed in western markets on a Shari'ah-

compliant basis is negligible compared to the overall size of the private equity markets," asserts Mr Al-Rifai. "Islamic private equity structures are extremely favourable to target company owners and managers because they are fair and more equitable than conventional structures. Islamic investors can only invest in common stock, no preferred stock or warrants, which bode well with business owners. However, very few in western markets know of these advantages and little money is being deployed in western markets seeking Shari'ah compliant investments." Yet investors will seek opportunities wherever returns are high, and general partners in western markets may react to a niche area where they can raise huge sums from Middle Eastern limited partners with specialist requirements. Also, nothing prevents western investors from participating in Shari'ah compliant funds, and recent sukuk offerings (Islamic secured loan notes) have been taken up by non-Islamic investors. Due to the increasing interest, many western investment banks have appointed Chief Shari'ah Officers as they develop products to service this market.

The Shari'ah compliant private equity model offers new possibilities to many investors, in a financing environment where other options are contracting quickly. Oil prices continue to ascend, and with consumption and supply trends expected to propel them further, Middle Eastern investors will only grow richer. Private equity allows these individuals to diversify their exposures and expand their portfolios. In response, Shari'ah scholars are working hard to develop new, compliant structures of debt and equity. What is currently a niche financing structure on the world stage could gain a stronger foothold in western markets, as Middle Eastern investments continue to grow in stature. ■



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