

*Shari'ah* Compliant Private Equity Funds: what GPs need to know.

The forging of new relationships with Middle Eastern investors (beyond those with the region's merchant families and investment houses which have, for some time, been investors in the private equity asset class) has brought with it new and complex issues of culture, commerce and religion. In light of the compelling size of the pool of available Islamic capital estimated at between \$300-500 billion, private equity funds and their general partners (GPs) may be well advised to learn about accommodating the concerns of Islamic investors.

Private Equity Managers accustomed to fundraising in Asia, will probably not be surprised to find that it generally takes longer to secure firm commitments from Middle Eastern investors than from their European or U.S. counterparts. This is due, in part, to the greater emphasis that investors in the region place on personal contact and establishing trust in business dealings, as well as the need to educate certain investors to whom private equity is a relatively unfamiliar asset class.

Private equity managers commonly encounter the most difficult issues when seeking to admit Islamic investors into their funds. These investors conduct their commercial activities (as well as all other aspects of their lives) in accordance with the body of Islamic jurisprudence known as *Shari'ah* law. The *Shari'ah* prohibits, *inter alia*, the charging or paying of interest (*riba*), investment in certain forbidden (*haram*) industries (such as conventional financial services, armaments, cable-tv operators, gaming, alcohol (including hotels and restaurants that serve alcohol, unless such income is "purified"), contractual uncertainty (*gharar*) and the guarantee of a fixed return on investment

Not all Islamic investors require the same degree of compliance with *Shari'ah* law, and the extent of the modifications which a private equity manager will have to make to its fund documentation will depend on the degree of compliance necessitated by any given investor. However, in general, where a GP wishes to admit an Islamic investor into its fund, it will have to adopt a *Shari'ah* compliant investment policy, which will include some, if not all, of the following restrictions being incorporated into the fund documentation:

- no investment in *haram* industries;
- no investment in interest-bearing instruments such as convertible debt securities (although these may be restructured in a *Shari'ah* compliant manner);
- no participation in bridge financings;
- no investment in financial products such as options or futures (*i.e.*, no hedging), although

recent developments in the Islamic finance market have suggested that certain types of derivative contracts may be permissible; and

- no investment in companies which do not meet specific financial parameters in relation to debt to equity ratios, interest income and accounts receivable.

The use of interest-bearing debt at both the portfolio company level and at the level of any special purpose financing vehicle in the acquisition structure is of particular concern to Islamic investors, given the *Shari'ah* prohibition on *riba*.

At the portfolio company level, most Islamic investors take the view that they can only invest in a portfolio company if the interest-bearing debt to equity ratio of such portfolio company is no more than 33%, where equity, for these purposes, is deemed to be the enterprise value of the portfolio company. It is also worth pointing out that some *Shari'ah* scholars take the strict view that if an Islamic investor gains control of a portfolio company, it must undertake to repay all of such portfolio company's debt within three years of the acquisition. Portfolio company debt may, however, be restructured in a *Shari'ah* compliant manner and new debt may be incurred by relying on traditional Islamic financial products, although this may be more expensive and is only really feasible if Islamic investors control the company.

Investment in LBO funds is obviously problematic for Islamic investors, given the use of acquisition indebtedness in most typical buyout structures. It is, however, possible to structure around these difficulties and create "Islamic debt" (by utilising, among other techniques, a lease financing arrangement (*ijara wa iktina*) in respect of the assets of the portfolio company). Islamic debt has become more widely available over the last 5 years and more western banks are now familiar with these types of transactions. As a consequence, transactions are not as difficult or costly as they once were; however, there are still complex legal, tax and accounting issues that need to be grappled with on a jurisdiction-by-jurisdiction basis and this often leads to a somewhat lengthier transaction process.

Fund documentation may also require modification to prevent the manager from charging interest on monies due but unpaid in relation to investors' drawdown obligations and in relation to investing surplus cash in interest-bearing temporary investments. To the extent that a fund or a portfolio company conducts *Shari'ah* compliant activities, most Islamic investors will tolerate interest income provided that such income does not exceed 5% of the total income of the fund or portfolio company. In practice, such investors will "purify" this income by donating it to a charity.

In addition, for certain Islamic investors, there will also be a need to address issues in relation to the exercise by the fund of redemption rights and liquidation preferences attaching to preference shares, which may

not be acceptable in a form familiar to western investors.

Significantly, certain investors may insist also on the establishment of a *Shari'ah* Committee in relation to the fund, which would consist of Islamic scholars appointed by such investors and which would advise the GP in relation to *Shari'ah* compliance. Compliance is an ongoing obligation and the *Shari'ah* Committee will be responsible for conducting annual *Shari'ah* audits to ensure that the fund and portfolio companies continue to be operated in accordance with the *Shari'ah*. Where this is found not to be the case, purification of non-complying investments will be required.

A thorny issue in the negotiation process with certain Islamic investors is whether the *Shari'ah* Committee should have the power to prevent the GP from making investments that are not *Shari'ah* compliant. This raises fundamental issues for the GP as it relates to its control of the investment process and also may not be acceptable to other non-Islamic investors in the fund since such a restriction may lead the GP to forego making what would otherwise have been a profitable, albeit non- *Shari'ah* compliant, investment. One solution that we have used as a compromise in such

circumstances is to allow Islamic investors to opt out of investments which the *Shari'ah* Committee regards as being non-compliant.

Certain GPs have attempted to reconcile the inherent tension of having Islamic investors and their western counterparts as partners in the same fund by establishing a *Shari'ah* compliant parallel vehicle which invests in parallel with the main fund. This may work for certain investors and in certain circumstances but the more sophisticated Islamic investor is increasingly worried that the GP will devote its time and effort to the main fund, where the bulk of the capital usually is, rather than making the effort to find and execute investments that both the main fund and the *Shari'ah* compliant parallel vehicle may make together.

In summary, not all Islamic investors will have the same requirements and not all GPs will want to make concessions, particularly where Islamic investors do not represent a significant investor group. Yet, given the wealth and potential for growth in the region, many GPs are likely to be willing to at least make themselves familiar with the special concerns of Islamic investors in order to differentiate themselves and be able to avail themselves of Islamic capital.

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