

BASIC NOTIONS on ISLAMIC PRIVATE EQUITY FUND (IPEF)

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To earn money is commendable for any Muslim. It enables one to support oneself, family and loved ones. It also allows one to pay the zakat (welfare contribution) and sadaqah (charity). However, there is also the obligation to use the money wisely and 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 upon 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 pressured into developing into a fixed income strategy that, whilst trying to attract investors, mimicked the conventional bond market as much as 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 Accounting and Auditing Organization for Islamic Finance Institutions (AAIOIFI) may cause some short-lived dips in the growth trend but will lead to further growth in a more apt direction. There also is the saying, “what you do not know you will not miss” or “ignorance is bliss.”

The large amounts of money involved in the Sukuk issuances by nature always attract more attention and publicity than the strong and steady but quiet 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 such as Murabahah and Ijarah 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 significant growth potential. Sometimes this is also accompanied by the contribution of additional human resources and networking aid made

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available by the investors (or their management teams).

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 (initial public offer) or merger of the company. It is a full risk project where profit and loss is shared by both the parties concerned during the growth phase and intended capital gains are reaped at the exit. Both Mudarabah and Musharakah 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 among several investors and over a larger portfolio of investments. It also makes sense to pool the investors in larger investment structures. The benefit 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 stock exchanges has its advantages. The companies concerned usually have had a reasonable life span, sufficient publicly available information, controlled governance, supervision by capital markets 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 hence pose more risks to the investor. On the other hand, they also offer better growth prospects and profit returns.

As far as the target companies are concerned, Shariah imposes some restrictions on the ethical selection criteria to make sure that the investments remain halal (lawful). In general, activities are considered to be haram (unlawful) when a company:

- Produces/slaughters/sells/trades or distributes pork (or pork-related) products and blood.
- Engages in pornography or obscenities in any form.
- Primarily engages in the entertainment business (films, videos, theatre, cinema etc).
- Is engaged in gambling, casinos, lotteries and related games and activities like being bookmakers.
- Is active in non-compliant financial practices or insurance.
- Is involved in the arms industry, defense and the like.
- Produces/distils/sells/trades or distributes alcoholic beverages or related products.
- Produces/grows/sells/trades or distributes intoxicants or related products (drugs, tobacco etc).
- Other activities the Shariah adviser may deem as non-permissible.

Immediately, it is clear that the available investment environment is considerable and almost unrestricted. Industries, services, retail, information technology — name it and it can be done. Most of the existing businesses, however, are not yet aware of the ethical-financial restrictions related to interest (riba) and are entangled in interest based lending in different ways. The willing

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investor should avoid getting into such an undesirable environment.

In the present economic circumstances, it is extremely difficult to find target companies that are completely “interest free” (in terms of loans) and not too “liquid” (cash and receivables). The Shariah 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. Here are some roughly summarized examples of the FTSE Shariah Global Equity Index Series’ guidelines:

- Exclude investments when total debt over total assets exceeds (or is equal to) 33%.
- Exclude investments when total cash and interest bearing securities on total assets exceeds (or is equal to) 33%.
- Exclude investments in target companies if account receivables on total assets are greater than (or equal to) 50%.
- 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 — isolated and given to charity — is made according to the guidelines set by the Shariah Adviser.

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 the application of such guidelines even from 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 Mudarabah and Musharakah 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. Southeast 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 foreign direct investment regulations and Shariah restraints.

Shariah Adviser and legal assistance

The use of experienced legal counsel on both Shariah and conventional consulting of course is beyond question. It facilitates the communication between the Shariah adviser, the investors, the management team and the target company and its initial shareholders. In order to assure full compliance with the Shariah, it is compulsory to involve a Shariah adviser. Since that adviser cannot be available all the time, he/she should be assisted on a daily basis by the function of the Shariah Compliance Officer whenever possible.

The Shariah Adviser will:

- check that all aspects of the business are in accordance with the Shariah (including

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- portfolio management, trading practices, operational matters, administrative matters, etc).
- provide Shariah expertise on documentation, structuring and investment instruments as well as 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 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 the lawyers and consultants involved — and possibly the other conventional investors or even the target company — do not fit the Shariah framework. The conventional mindset indeed is directed to minimizing risk (and sometimes even excluding) and optimizing profit on an interest-based basis.

Briefly, on a few topics:

- Preferential and not fully subordinated shares/debts, for instance, are 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 among 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 Shariah.
- Guaranteed return on investment (say, dividend of x% per annum) is also unlawful for the same reasons.
- On the other hand, preference to profits may 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 stocks only accrue 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 Shariah protection clauses in articles of association and so forth.
- It is advised to consult properly trained professionals before and during any negotiations so that mindsets and expectations can be changed or breaking points can be discovered at early stages.

This article is a short introduction to an in-depth study by the author. The full report titled: 'Understanding Islamic Private Equity' . A copy of the report can be obtained at www.islamicfinancenews.com or at the author pwouters.law@gmail.com

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