



# Private Equity

## A Natural Fit for Islamic Investments

The \$400 billion Islamic finance industry has evolved over the last 15 years thanks to its size, magnitude and comprehensive financial system

In the financial world only numbers dictate consideration. Although the Islamic financial industry has existed for centuries, it has never attracted such paramount attention until recently when its size and magnitude could no longer be overlooked.

Currently, there are 300 Islamic financial institutions worldwide managing deposits estimated at USD 200 billion, with assets worth USD 265 billion and financial investments exceeding USD 400 billion. Islamic bonds are estimated at USD 30 Billion while Islamic Takaful premiums are estimated at USD 2 Billion.

The industry has come a long way in the past fifteen years and has evolved into a comprehensive financial system. Governed by Shari'a principles, to be in compliance with Islamic Law as revealed in the Quran and Sunnah, the industry continues to demand superior innovation

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skills and persistence to develop within these parameters and hold its current position in the financial world. Banks have always taken the lead in the Islamic financial industry investing depositors' funds through various forms of Islamic contracts such as Murabaha, Mudaraba, Istisnaa', Ijara, etc. During the 1980s the launch of the first Islamic investment fund initiated the debate among Islamic scholars regarding the Shari'a compliance of equity investments. The Islamic Fiqh Academy concluded the debate by ruling that shares in a company are an undivided portion of the company's assets and are thus considered Shari'a compliant. This was the real catalyst to the development of Islamic equity investment.

At the core of Shari'a principles, money should be directed towards the real economy, which is the production of ethically acceptable goods and services. Furthermore, Islamic investors are not allowed to purchase any financial instrument that has a guaranteed principal with a predetermined rate of return. This stipulates that returns should only be earned through active involvement and participation of the business risk in Shari'a compliant

investments. For these reasons, Islamic Private Equity as an asset class is a natural fit for Islamic investors. Accordingly, Islamic investors should apply the model of private equity firms whose strategy evolves around taking majority stakes in privately held companies engaged in the real economy. This enables them to effect changes and maintain control, which ensures the company's adherence to Shari'a principles on a continuous basis. Apart from contributing financial capital, these investors are actively involved in providing intellectual capital through management experience, strategic direction and expertise in key areas such as capital structuring, corporate governance and operational efficiencies. With a clear vision and an overall ability to work with and incentivize the management team to achieve the

company's objectives, Private Equity investors unlock the potential, create and realize value while sharing the performance risk of their investment decisions. As a result, Private Equity offers Islamic investors a better value proposition compared to other asset classes in terms of performance, diversification, long term returns, price stability and lucrative investment opportunities.

Governed by Shari'a principles, the parameters set for Islamic Private Equity investors cause an increase in research costs compared to their conventional counterparts. In addition to the specialized skill set needed to screen, evaluate, negotiate, execute, manage and create value, sourcing commercially viable deals that are Shari'a compliant and structuring them accordingly is a very exhaustive task. Furthermore, holding a majority control in companies to ensure their compliance to Shari'a principles on a continuous basis and maintaining a diversified portfolio become a challenge for Islamic investors with small amounts of capital to invest. To address these issues, the concept of creating Islamic Investment Funds was debated and then cleared by Shari'a

scholars in accordance with the definition and parameters set by the Accounting and Auditing Organization of the Islamic Financial Institutions as follows:

"Funds are investment vehicles, which are financially independent of the institutions that establish them. Funds take the form of equal participating shares/units, which represent the Shareholders'/unitholders' share of the assets, and entitlement to profits or losses. The funds are managed on the basis of mudaraba and agency contracts. Investment funds are permissible by Shari'a because funds are a form of collective investment that continues throughout their term, the rights and duties of participants are defined and restricted by the common interest, since they relate to third parties' rights...." The fund manager will own a particular class of shares in the fund that will enable it to participate in the management of the fund. The manager's remuneration will be a fixed fee arrangement under an agency contract (Wekala) by reference to the value of the fund itself, and by way of share of profits generated by the fund under a Mudaraba contract where the manager acts as the Mudarib and the Shareholders of the fund act as the Rab Al Mal. Furthermore, to ensure compliance with Shari'a principles, all activities of the fund will be pre-screened and monitored on a continuous basis throughout the life of the fund by an independent Shari'a Board.

The average annual returns of 34% over the past seven years delivered by the World Private Equity industry triggered the demand for Islamic Private Equity Funds especially with the creation of a Shari'a compliant fund structure. Between 1994 and 2001, 120 Islamic Equity Funds (including Private Equity) were launched and closed.

These Funds grew by an average rate of 25% per annum over the past seven years to stand at USD 3.3 Billion today. With the increasing awareness among Islamic investors of the value proposition of Islamic Private Equity compared to other Islamic asset classes, and with the continuous innovation and product development in the industry, it is safe to state that Islamic Private Equity is set to grow significantly in the near future. ■