DechertOnPoint

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A legal update from Dechert's Private Equity Group

Islamic Private Equity Funds

Introduction

Private equity is a well developed asset class in the Western world that has also enjoyed tremendous success in the Middle East in recent years and funds investing in a Shari'ah-compliant manner are increasingly looking beyond the Islamic world to explore global investment opportunities, gaining greater visibility across the world. This *DechertOnPoint* outlines what demands the managers of Islamic private equity funds, investing outside the Middle East region, have to deal with and what rules are to be observed to invest the collected money in an acceptable Shari'ah-compliant manner.

Private Equity: Concept and Development in the Western World

The private equity asset class covers the equity financing of companies predominantly not listed on stock exchanges. Today, it is an important financing source for start-up enterprises operating in the technology sector, as well as of traditional companies with growth potential or a lack of successors. As an alternative asset class, it can provide investors with extraordinary return rates but also implies higher risks than traditional investment products.

Private equity financing can be used in many stages of the life cycle of an enterprise, and is sub-categorized depending on the stage in question. Venture capital, as a sub-category of private equity, refers to the equity financing of young, innovative companies, often in the high-tech sector, with the potential for extraordinary future revenue growth. These companies have not reached the break-even and require capital to further develop and market their products. Private equity proper on the other hand, refers to growth capital financing at a later stage of the business life cycle, or the acquisition of entire businesses through any kind of buyout transaction. As buyout targets are usually mature and already generating considerable cash flows, investment amounts are significant and often require leverage. At this stage the investor provides further capital for business growth or add-on acquisitions or just fills the gap as successor to the former owner.

Supported by state aid programs and tax incentives, private equity had its origins in the US in the early 1950s. In particular, venture capital was one of the main backers of California's technology hub Silicon Valley, consisting of world leading technology enterprises and universities. The first sizeable buyout transactions also took place in the 1950s and lead to a buyout boom in the US in the 1980s, typified by the 1989 US$ 31 billion takeover of tobacco company RJR Nabisco by private equity firm Kohlberg Kravis Roberts (KKR)—the largest buyout then to date and for a long time after.

Since that time, private equity has established itself as an essential capital provider for enterprises all over the world, and private equity funds have reached tremendous volumes and become big economic players, especially in the West. Until 2008, many multi-billion buyout funds were closed and conducted the takeovers of US and European industry giants. In 2007, fund managers raised more than US$ 400 billion globally and invested more than US$ 600 billion in businesses all over the world.

As a consequence of the 2008 financial crisis, the industry is currently slowing down as it became more and more difficult to secure debt financing for new targets and exits routes are tighter in a shrinking market. Additionally, many portfolio companies are heavily leverage, while the required refinancing funds are barely available in a credit market dominated by banks whose prime aim is to reduce their risk exposure as much as possible. Moreover, due to high investment losses, lack of liquidity and a lower allocation of money to private equity, Western investors are reducing their commitments to new funds, or even reducing former commitments to existing funds.

Private equity funds surviving the financial crisis will face much lower return expectations of their investors—at least for the next two years. Being

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fortunate not having lost their investment in these troubled times investors will forget past IRR ratios of 30% and more and instead appreciate ratios ranging from upper one-digit to lower two-digit numbers.

Private Equity in the Middle East

Unlike in the Western world, private equity in the Middle East is still a young industry representing a new asset class for local investors. Other asset classes such as real estate or project financings (e.g., oil rigs) have traditionally been more prevalent in an economy primarily based on the exploitation of raw materials. This explains why until 2005 only US$ 4.7 billion was raised by private equity firms from Middle East investors, a comparatively very low amount.

But, with oil reserves declining across the region and hence an economic shift away from raw materials towards new technologies, tourism and the service industry, new capital sources are now being welcomed by entrepreneurs in Countries of the Gulf Cooperation Council (GCC). Further, the tremendous increase in wealth in oil rich countries has necessitated a higher allocation of liquidity into new asset classes, especially private equity as it stands for comparable return rates to those Middle East investors were used to from oil and other raw material investments. As stock exchanges and legal and regulatory systems based on Western role models have finally been established in most of the GCC countries, the industry today enjoys a favourable environment well suited to expansion.

As a consequence, fund raising in the Middle East, in particular over the past three years, has increased significantly. According to the 2008 annual report of the Gulf Venture Capital Association (GVCA) fund sponsors raised US$ 6.4 billion that year, double the amount raised in 2005. This represents a tremendous success for the industry in the region, with international private equity firms also successfully raising considerable sums. Firms such as KKR, Carlyle and Blackstone now offer special Middle Eastern funds and have established offices in Dubai, Abu Dhabi and elsewhere, both for investor relations and for making further investments on the ground.

Middle Eastern investors comprise high net worth individuals, single and multi-family owned businesses, local investment banks and sovereign wealth funds (SWFs). Whereas SWFs, which are said to be the wealthiest in the world, tend to invest their national capital and currency reserves on a deal by deal basis, other investors are increasingly committing funds to externally managed accounts. To achieve a well balanced fund allocation, commitments are made to both local and international funds investing in companies in the US, Europe and Asia. Thus, private equity funds from the Middle East are today prominent investors in the Western world.

In particular, SWFs from Abu Dhabi (e.g., ADIA, AD Invest), Kuwait (KIA) and Qatar (QIA) have gained recognition as major investors in US and UK financial institutions (such as Citigroup, Merrill Lynch and Barclays). Recently, in Europe, an investment by Abu Dhabi's International Petroleum Investment Company in German car producer Daimler amounting to almost US$ 2 billion has drawn the attention of financial newspapers for weeks. Local Middle Eastern private equity firms like Investment Dar, Investcorp and Gulf Finance House have also proven that they can act internationally on a par with their Western counterparts. Investments in British luxury car producer Aston Martin (backed by Investment Dar) and US luxury fashion retailer Saks Fifth Avenue (backed by Investcorp) are good examples of the international ambitions of such firms.

As the financial crisis has also affected Middle Eastern investors, especially those in the local real estate sector, and seen oil prices plunge, fund raising in the Middle East has become more difficult in recent months. Nevertheless, according to the World Islamic Banking Competitiveness Report 2008, there is still US$ 3.4 trillion in the region available for investment locally and overseas. But, as certain financial investors may be required—willingly or not—to support their domestic economies, they are increasingly demanding that overseas investments provide a link to the Middle East and North Africa Region (MENA), meaning a relationship where the target companies agree to the production or distribution of their products (also) in the MENA region. In summary, private equity investments by Middle Eastern investors remain strong, and funds focusing on healthcare, renewable energy, transport, power utilities and the construction sector are still attractive to them.

Investing in Islamic Private Equity Funds

The private equity investments of Middle Eastern investors, especially those of SWFs, are usually based on conventional principles developed in the Western world. But more and more investors are looking to comply with the principles of Shari'ah law

(i.e., Islamic law) when investing money both locally and abroad. Although the Islamic finance industry in the GCC region today only has an average market share of approximately 15%, experts predict an annual increase in Shari'ah-compliant financial products of 15 to 20%.

Consequently, private equity firms have rushed to accommodate the demand for Shari'ah-compliant investment opportunities for their Middle Eastern investors, and to make ethical investments available to believing Muslims. GCC country firms like Unicorn, Arcapita and Millenium Private Equity are certainly major players in this industry and others like Gulf Finance House and Rasmala will further grow and gain market share in the future. Further, fund managers from other parts of the world, like HSBC Amanah or UK house Prosperitus Capital are also successfully raining money from investors who stick to the tenets of Shari'ah law.

Because of the natural fit between providing risk capital to enterprises and Shari'ah law's profit and risk sharing principles, private equity has become well suited as an asset class to Islamic investors. Though the majority of such investors is still represented by Middle East high net worth individuals or local family offices also institutional investors like Islamic investment banks, takaful insurance companies or even state owned industry companies are more and more attracted by opportunities offered by this asset class.

However, as this *DechertOnPoint* will show, fund sponsors must be sensitive to the special needs of such investors, and avoid the pitfall of simply adopting the investment strategies and structures of conventional funds.

Requirements of Islamic Investors

Investors who seek to abide by the tenets of Shari'ah law must comply with certain principles when investing.

According to the said principles, money must be invested in businesses that offer ethically acceptable products or services, and returns must be earned through active participation in the relevant business risks. The investment strategies of Islamic funds must comply with these principles to be acceptable to Shari'ah investors. In particular, as certain *haram* (improper) industry sectors (e.g., the production or distribution of alcohol and pork-related products, arms, hotels, casinos, and even conventional banks) are prohibited, investment opportunities are tighter for Islamic funds. Further, because Shari'ah law bans any kind of interest based financing (*ribâ*), an Islamic fund may neither make use of conventional bank leverage when acquiring target companies, nor receive or pay interest of any kind.

Compliance with the above principles must be overseen by a Shari'ah board during the fund's entire lifetime. Usually an Islamic fund engages such a board from the start of its establishment and a legal opinion issued by the board stating the compliance of the fund's strategy with Islamic principles (*fatwa*) is part of the investment package the investors expect to receive before subscribing for shares in the fund.

Fund Model, Legal Form and Domicile

A private equity fund is usually a blind pool until it closes. Commitments by investors are made up front, enabling the fund manager to invest the collected money in target companies it identifies which comply with the fund's investment strategy. In principle, investors have no further say regarding investments by the fund and just provide the committed capital for the said investments after the fund manager has made a respective call.

This investment model is fairly new for Middle Eastern investors. In the past, they tended to favour a syndication model on a deal-by-deal basis, as some still do. Investing this way provided them with the opportunity to review each investment, understand the rationales behind it, as well as the likely benefits to be accrued. But as more and more investments are made out of the region, and investment decisions made by international or Western educated professionals, who trust in fund models developed in the West, investment in private equity funds is now common practice in the region.

Islamic private equity funds domiciled in the Middle East are still based on Shari'ah-compliant *musharaka* or *mudarabah* structures, while offshore funds are usually structured as limited partnerships (LP), whereby the general partner (GP) works as fund manager and investors subscribe for limited partner interest in the fund. Such GP/LP structures are in principle comparable to Islamic *mudarabah*-structures (a Shari'ah-compliant finance structure bundling investors and fund managers together) and thus are an eligible investment pool for Islamic investors. A given statutory limitation of the investor's liability for the fund's activities up to his entire commitment does not violate the Shari'ah principle of profit and risk sharing and enhances the attractiveness of these vehicles.

As private equity investors are looking for tax transparency when routing their international investments, fund domiciles providing no or low taxation are of major interest. Middle Eastern investors, who are, more than most, used to zero or low taxation in their home countries, tend to prefer international tax havens such as the Cayman Islands, the British Virgin Islands or the Channel Islands as fund domiciles. With respect to investments in Europe the attractive fund vehicles now provided by EU member Luxembourg (e.g., the Luxembourg SIF) are increasingly attractive as they combine tax transparent structures with light, but trustworthy, local regulation.

Shari'ah-compliant Flow of Funds

Private equity funds are usually financed by equity commitments from investors, and provide equity to portfolio companies. Returns are gained on equity stakes in underlying companies and are distributed as dividends to investors. Further, comparable to widely accepted *mudarabah*-structures, investors (*rab-al-mals*) usually assume all the losses of the fund, whereas the fund manager or GP (*mudarib*) does not. In principle, the above in and outflows of private equity funds comply with Shari'ah's profit and loss sharing principle.

However, attention has to be drawn to certain in and outflows of the fund to be compliant with Islamic law. In particular any kind of interest to be paid by the investor to the fund (e.g., as surplus for investors subscribing for interest after the first closing of the fund or, in case of investors who are in default with their capital commitments) is not permitted under Shari'ah law. In the case of an investor default, the fund manager or GP may claim reimbursement of costs incurred and for default penalties, provided the penalties, to be acceptable, are "purified" by donating them to eligible charities. Furthermore, as regards profit distributions, neither fixed nor any kind of guaranteed returns to the fund's investors are compliant with Shari'ah principles as they are classified as *ribâ*. However, Shari'ah law does not prohibit profit preferences such as preferred returns for investors in the form of agreed hurdle rates or typical fee structures of Islamic private equity funds which, like their conventional counterparts, provide management fees from 1.5-2.5% and carried interest payments to the fund manager ranging from 15-25% of the fund's profit after the full repayment of investors' capital, all provided that such payments do not imply guaranteed minimum returns for any of the fund manager, GP or the LPs.

Shari'ah Board

To be Shari'ah-compliant, an Islamic private equity fund must engage a Shari'ah board—a board consisting of at least three Shari'ah scholars that oversees the entire business of the fund regarding its compliance with Shari'ah principles. This is not only legally required, but is also in the best interest both for the GP and LPs so as to avoid any discussion about individual interpretations of Shari'ah law and any unintended termination right for investors because of an alleged lack of compliance with Shari'ah principles.

The Shari'ah board, provided from the outset by the fund, usually advises the fund manager or GP with regard to Shari'ah law principles affecting the fund's business and in particular the investments conducted by the fund. The board issues investment guidelines as regards industry sectors the fund may or may not invest in, eligible acquisition finance structures (including permitted debt finance) the fund may make use of, and permitted financial ratios of eligible target companies as well as any other compliance issues affecting the management of the investors' funds (e.g., permitted short liquidity management structures). As mentioned above a due diligence package handed over to potential investors usually contains a *fatwa* of the Shari'ah board stating the compliance of the intended fund activities with Shari'ah principles. Further, the board continuously oversees the activities of the fund manager or GP regarding their compliance with Islamic law. In particular, investments proposed by the fund manager or GP usually require the prior approval of the Shari'ah board which reviews them for Shari'ah compliance. And, it is general the practice that the board, as part of the required annual reporting package, issues a Shari'ah certificate confirming that the fund's activities continue to be compliant with Shari'ah principles.

Shari'ah scholars as members of the Shari'ah board, are in principle independent as regards their interpretation of Shari'ah law, and are not bound by decisions issued by Islamic courts. Interpretations by different scholars may differ strongly depending on which Islamic law school (e.g., Hanafi, Hanbali, Maliki or Shafi) the scholars are aligned with. Making use of this divergence the fund manager or GP should refrain from "*fatwa*-shopping", i.e., engaging Shari'ah scholars who support the fund's business by offering little limitations on managers. But as the above law schools each predominate in different regions of the Middle and Far East (e.g., the Hanbali school predominates in Saudi Arabia

and the Shafi in Malaysia and other parts of East Asia) it is best recommended to appoint Shari'ah scholars who are aligned with the school favoured in the same region as the fund's potential investors.

However, over the years more and more scholars have chosen to abide by the Shari'ah standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), an independent international organization domiciled in the Kingdom of Bahrain, and which completely dominates in Bahrain, the Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan and Syria. The acknowledgement of these standards has lead to a further international standardisation of Shari'ah principles and thus, investors in Shari'ah-compliant funds are increasingly benefiting from greater legal certainty when it comes to decision making by the funds' Shari'ah boards. Therefore, although Shari'ah boards' duties certainly conflict with the discretionary management of the fund by its manager, such a board can actually be a marketing benefit for the fund, boosting investor confidence by providing a degree of oversight which helps ensure proper management of the fund.

Governing Law of Fund Documentation

In principle, the relationship between a private equity fund and its investors is governed by the statutory law of the fund's domicile. However, limited partnership agreements, including those of conventional funds domiciled in jurisdictions such as the Cayman or Channel Islands, are usually governed by the national laws of the US or UK, based on relevant contractual governing clauses. As Shari'ah law is in principle not national but supranational, it cannot be agreed to as a fund's governing law. Similarly, the limited partnership agreements of Islamic funds should contain contractual governing clauses providing a specific national law (Western or Middle Eastern) as its governing law. It is also recommended one choose the relevant court in the country the law of which governs the fund's legal documentation.

In so far as the principles set out by a Shari'ah board are deemed to prevail over the applicable national law, according to a decision by the English Court of Appeal, it is recommended that the limited partnership agreements provide a detailed description of the governing principles and of the legal consequences of violation. Otherwise, simply based on a general reference to Shari'ah law, an investor in an Islamic fund might not be able to successfully claim non-compliance of a fund's activities with Shari'ah law before the relevant court. Hence, the use of detailed written investment guidelines based on Shari'ah principles issued and interpreted by the Shari'ah board should be part of the legal documentation of any Islamic private equity fund.

Acquisition of Target Companies

Managers of Islamic private equity funds have to meet enhanced demands when it comes to investing in target companies in a Shari'ah-compliant manner. This has an impact not only on the selection of permitted portfolio companies but also on dealing with Shari'ah-compliant acquisition finance structures. Furthermore, as Islamic private equity funds do not only invest money in the Middle East but also in European or Asian target companies and as not all of these funds provide teams in each destination they invest in, it is advisable to have advisors on the ground providing sophisticated advice with regard to local peculiarities that might affect a fund's investments.

Selection of Permitted Portfolio Companies

Being Shari'ah-compliant limits the investment opportunities of a private equity fund as investments in *haram* businesses or companies with non-Shari'ah-compliant financial ratios are not permitted. As a Shari'ah board will only approve an intended investment if it is in compliance with the investment guidelines it has issued, the selection of eligible portfolio companies requires enhanced legal and financial due diligence for Shari'ah compliance purposes before one can present a proposed transaction to the Shari'ah board.

As set out above, investments in business sectors such as the production or distribution of pork or pork-related products, alcohol, the operation of casinos, trading in arms, or in pornography, or other ethically improper forms of entertainment is unlawful according to Shari'ah law and is usually prohibited by the fund's investment guidelines. This certainly limits the investment opportunities of Islamic funds as compared to their conventional counterparts. However, the number of companies listed in the Dow Jones Islamic Market Indices (DJIMI) and the S&P Shari'ah Indices (indices which only list public companies with Shari'ah-compliant businesses and financial ratios), shows that there remain plenty of investment opportunities out there which are acceptable for Islamic funds. Further, bearing in mind that the S&P 500 Shari'ah Index has lost only 9% over the last five years in comparison to 27% on the regular S&P 500 Index, a focus on Shari'ah-compliant targets might even be attractive from an economical perspective.

In cases where due diligence discloses that the core business of a target company is Shari'ah-compliant but those of additional business units are not (e.g., a hotel chain whose in-hotel bars serve alcohol), more and more Shari'ah boards are nonetheless allowing investment (especially if the target company is domiciled outside the Islamic world) provided that the income that infringes Shari'ah principles does not exceed 5% to 20% of the entire target's income. In such cases, the Shari'ah board will usually require the relevant returns from such unlawful portfolio activities be donated to charity. To avoid pitfalls, it is advisable to consult with the Shari'ah board ideally before a fund is launched if it follows such "core-business" approach, or if it requires a target company be fully Shari'ah-compliant. Any thresholds regarding unlawful but accepted income rates of portfolio companies should be outlined in the fund's investment guidelines.

Eligible target companies for Islamic funds must not only run Shari'ah-compliant businesses but also provide Shari'ah-compliant financial ratios. Shari'ah law, in principle, prohibits investments in over-leveraged companies and in conventional financial institutions, i.e., companies operating a conventional lending or interest based depository business. Following a *fatwa* issued by a renowned scholar in 1998 (known as the "Dow Jones *fatwa*") the criteria set out by the methodology of the DJIMI regarding acceptable financial ratios of companies listed in the index today are widely accepted by Shari'ah boards. According to these criteria the target's total debt, its cash and interest-bearing securities as well as its accounts receivables must be less than 33% of its average market capitalisation. Furthermore, many Shari'ah boards today accept interest income not exceeding a threshold of 5% of the entire company's income. If a target company does not comply with these ratios at the time the fund invests in them, some scholars will allow a grace period of between one to three years after the fund's initial investment during which a Shari'ah-compliant refinancing of the company must be completed.

The above limitations must not only be met when a fund invests in a target company but over the entire period during which the fund is a shareholder in the target company. It is therefore advisable for a fund to acquire controlling stakes in target companies thus providing it with a controlling influence over a target's day-to-day business, or at least to request veto-rights for the fund in the company's shareholders agreement in case of intended changes in the target's business affecting the above-mentioned Shari'ah principles.

Shari'ah-compliant Acquisition Finance

The objective of private equity funds is to provide equity as risk capital to portfolio companies. In this regard, private equity investments fit perfectly with Shari'ah law's profit and risk sharing principles. However conventional private equity firms, in particular buyout firms, have built their financial success primarily by using interest-based bank leverage to increase returns on investments when exiting from a portfolio company. Unfortunately, conventional leverage instruments such as secured and unsecured debt violate Shari'ah principles. First, a hierarchy of instruments with preferential treatment of one type of instrument over others violates the principle that profits and losses should be shared equally by all, and that capital providers must rank *pari passu*. Secondly, bank leverage usually contains unlawful *ribâ* as it is almost invariably interest bearing. Islamic private equity funds may therefore not make use of conventional acquisition leverage.

Leveraging in a Shari'ah-compliant manner can be achieved however by using Islamic debt finance. There are several Shari'ah-compliant structures available which can provide a comparable economic outcome to conventional leverage. In the Islamic world, asset finance instruments like *murabaha*-finance or lease finance instruments like *ijara*-finance are widely offered by Islamic banks. As the cash flow of both structures is backed by the underlying assets all payments to the bank, i.e., the surplus for the bank in the *murabaha*-concept or lease payments of *ijara*-concept are accepted by the Shari'ah.

Islamic acquisition finance is also increasingly on offer from banks in the Western world. One of the leading Western countries for Islamic finance is the UK, which now has several government licensed Islamic banks operating and offering a full range of Shari'ah-compliant products. In addition several other banks in the UK, continental Europe and the US provide Islamic debt finance in the form of an Islamic window, i.e., a business unit that offers certain Shari'ah-compliant products. As Islamic banks must also offer competitive products to survive in Western markets, the price for Islamic debt today is lower than it was previously.

Many Shari'ah boards, at least when it comes to overseas investments, have accepted finance structures which are based on Islamic contracts, and which can even include conventional debt mechanisms. One of these is the so called leveraged *ijara*-structure. In this structure, an Islamic fund

does not acquire a target itself; instead an acquisition vehicle owned by a trustee acquires all assets of said target and draws down conventional leverage. The acquired assets then are leased to the fund by way of an *ijara*-lease agreement, which sub-leases the assets back to the portfolio company. Lease payments from the company are partly forwarded to the acquisition vehicle for repayment of debt to the bank, with excess amounts representing the fund's returns. The structure includes put and call options for both regular and early termination of the structure. More and more conventional banks are offering debt based on this structure and thus, many Islamic funds can successfully make use of leverage finance in the Western world at prices comparable to pure conventional debt. It should be noted that not all Shari'ah scholars support this particular finance structure and, the more "pure" Islamic leverage is on offer in the Western world, the lesser the acceptance of such structures will be in the future.

The above financial structures should be carefully implemented and may vary slightly from country to country. In particular, it must be determined to what extent the local jurisdiction can provide civil law instruments ensuring a proper and reliable acquisition and finance structure for both, fund and the banks. Further, the structure must be overseen from a tax perspective to avoid pitfalls which can significantly reduce the after tax return rate on a fund's investment. Following the lead of the UK, many Western countries are currently reviewing their tax laws to avoid disadvantaging Islamic investors by using the above Shari'ah-compliant financial structures (and thus making themselves more attractive to Islamic funds). Consequently, experienced advisors on the ground with expertise in Islamic finance are needed to help funds make successful investments abroad.

Achieving Shari'ah Board Approval

Each investment by an Islamic private equity fund must be legitimised by the prior approval of the fund's Shari'ah board which will be granted in the form of a *fatwa*. A *fatwa* may only be issued on the basis of a board meeting taken place in this regard. As the number of renowned scholars qualified for such mandate is limited to only around fifty worldwide, and as these scholars sit on up to thirty boards each, board meetings must be prepared well in advance to avoid pitfalls and unnecessary delays in the investment process.

As a consequence, many firms choose at least one board member who works closely with the fund manager and is available for day-to-day communication. This board member is then consulted very early in the process with regard to Shari'ah compliance issues, and in cases of material non-compliance of an intended investment, this may help find ways around said non-compliance issues either before or shortly after the fund steps in. Thus, this board member can help to ensure a successful decision of the board and usually supports the GP preparing the investment presentation to the board.

Board approval not only consists of the specific approval itself, but also of the conditions and potential restructuring measures required for an investment to be Shari'ah-compliant, as well as any grace period the board decides during which Shari'ah compliance of a target company must be achieved. In case of required restructurings (e.g., a Shari'ah-compliant refinancing) it is recommended that the board agrees on eligible structures from a Shari'ah perspective. Based on these, the fund manager may execute a later restructuring of the target, but should nonetheless request again formal Shari'ah board approval before the restructuring is closed.

To avoid breaching letters of intent ("LOI") with sellers, it is preferable to include the approval of the fund's Shari'ah board as an additional condition precedent to signing of the share purchase agreement. As most of the private equity funds provide investment committees also requiring prior approval of a transaction such clauses in LOIs are common practice in international buyout transactions.

Local and Cultural Challenges

Investing outside the Middle East region may represent a challenge for Islamic funds due to local peculiarities and different cultures on the ground. Local protectionist regimes might be in place requiring the fund to request approval from the local authorities prior to acquiring target companies operating in certain industries. This holds true for certain relevant energy, infrastructure or media companies in some Western countries. Other countries, such as Germany, generally allow local authorities to review and prohibit certain foreign investors from acquiring more than a specified stake in local enterprises (e.g., in Germany more than 25% of voting rights in German companies). Avoiding delays and pitfalls regarding investor notification periods is vital and, if possible, clearance certificates should be applied for.

As many funds do not have professional investment advisors or managers in every jurisdiction they

invest in, a hands on approach when managing local portfolio companies is often hard to achieve simply due to distance-related difficulties, especially in the case of overseas investments. As Islamic funds also require understanding of their specific investment needs and their consequences for portfolio companies, the management of the target company needs to be educated regarding at least the basic principles of Islamic finance that affect their business. Finally, sellers as well as local customers and works councils have to be prepared that a new owner may be an Islamic investor. This should be conducted carefully to avoid unsubstantiated fears and to provide a climate which ensures confidence and economic success for both the investor and the people on the ground.

Conclusion

Private equity funds are a no longer new but still very attractive asset class for Shari'ah-compliant investors. The tremendous success of private equity in the Middle East in recent years has shown that this asset class, which can provide return rates comparable to those Middle Eastern investors are used to from investments in commodities, is increasingly accepted in the region, with investors allocating increasing amounts of their liquidity to it. This enhanced liquidity going forward, coupled with the lower investment losses of Middle Eastern investors in private equity funds, mean that they may come in time to rival or even surpass Western investors in the post-credit crunch world.

Islamic private equity funds are already well known and respected in the Western world and will gain market share in the future. Given the global success of Islamic finance, many private equity sponsors will continue launching Shari'ah-compliant funds over the coming years. This will help the industry to develop the beneficial legal and tax environments for Islamic funds in target destinations which is required to successfully offer more acceptable investments to Islamic investors all over the world.

The global success of the industry will however depend on the continued attractiveness of Islamic funds to conventional Western investors to reach critical mass. The current financial crisis has perhaps shown that ethically orientated finance products, such as Islamic finance offers, may represent, at least to some extent, safer investments for investors, and could be a way to avoid the current instabilities of the financial market. In this regard a recent positive statement by Pope Benedict XVI regarding the ethical dimension of Islamic finance products may also see interest in similar products increase in the West. Any further standardisation of Islamic financial products and consistent Shari'ah interpretation will certainly do so.

This update was authored by Thomas Peter Gierath (+49 89 21 21 63 17; thomas.gierath@dechert.com), based upon Chapter 22 "Islamic Private Equity Funds" in the 2010 CPI Yearbook *Investing in the GCC Markets – New Opportunities in a Changing Landscape*.

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