Private Equity Funds

The Ideal Shari'ah Product?

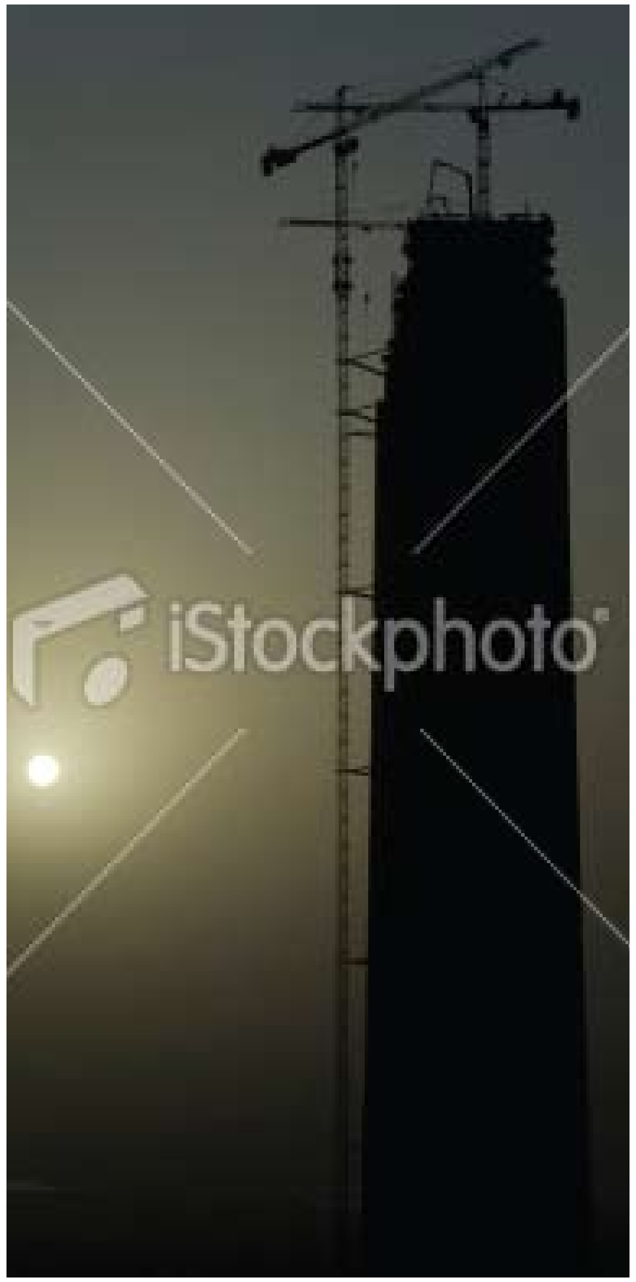
At first glance Private Equity vehicles seem tailormade for Islamic Finance however, as *Thomas Gierath* explains the reality is not so simple.

Shari'ah-compliant private equity funds represent a challenge for both fund managers and their advisors, as certain Islamic investors increasingly insist on compliance with the tenets of Islamic law. This affects both the fund structure and the management of the funds' assets, and requires new professional skills from all involved.

Flourishing market

The private equity industry has developed vigorously in the Middle East over the last few years and international and regional private equity funds have raised considerable funds in this region. According to the annual report of the Gulf Venture Capital Association for 2006, funds managed by regional private equity firms in 2006 equalled approximately $18 billion (of which almost three quarters were raised in 2006). And, the Ernst & Young Islamic Funds & Investments Report 2008 indicates that, at the end of the first quarter in 2008, there were more than 500 Shari'ah compliant funds in the world, of which 153 were established in 2007 alone. Bearing in mind that Gulf country investors are estimated to be able to tap free liquidity of approximately $2.3 trillion available for reinvestment in the coming years, most private equity fund sponsors have probably considered raising funds in this region.

One might be surprised to learn that of the amount raised, only $1.1 billion has been raised by Islamic funds. This is because Islamic finance (finance



in accordance with the principles of Shari'ah law) has only been in existence since the 1970s and not all regional investors adhere to Shari'ah principles when making investment decisions. But the Islamic finance industry has been growing annually by 15-20% since its inception, and more and more Middle Eastern investors are requiring Shari'ah-compliance, in addition to profitable investments.

An Attractive Asset Class - but with Strings Attached

At first glance, private equity seems an asset class tailor-made to suit the needs of Islamic investors as this asset class should, in principle, be compliant with the principles of Shari'ah. According to such principles, returns must be earned through active participation in the risks of the relevant business. Thus, equity financing is well known to Islamic investors who routinely use similar legal structures, e.g. the *musharakah*-structure (an Islamic kind of joint venture).

However, main characteristics of this asset class are in conflict with Shari'ah law. First, leveraging investments, used by buy-out funds, and the receipt or payment of interest (*ribâ*) is incompatible with the principles of Islamic law and one of the key reasons why many Western private equity sponsors have so far been cautious in extending their marketing activities to the Middle East. Furthermore, Islamic money must be invested in businesses that offer ethically acceptable products or services. Thus, the fund may not invest into certain *haram* (improper) industry sectors (e.g., the production or distribution of alcohol and pork-related products, or arms, hotels, casinos, or conventional banks) which limits the investment opportunities for private equity funds. The existence of a remarkable number of Shari'ah-compliant private equity funds shows, however, that the above obstacles can be circumvented for both investors and fund sponsors.

Structuring Issues

When setting up a private equity fund for Islamic investors, the fund sponsor should consider the following requirements that impact on the structure, financing, and investments made by the fund:

Legal structure and domicile of the fund

Islamic investors have become increasingly familiar with the conventional GP/LP structure of western private equity funds as this reflects the classic Islamic *mudarabah* investment structure (a Shari'ah-compliant finance structure bundling investor and managing partner together). Fund domiciliation in Gulf countries, such as Bahrain and the United Arab Emirates, has become more popular due to the possibility of Western-owned management companies and the provision of international accounting standards, as well as favourable tax regimes for fund managers. With attractive tax regimes offered to foreign investors, on- and off-shore funds domiciled in, for example, the Cayman Islands, the Channel Islands or Luxembourg, also have proved attractive to Middle Eastern investors.

Investment constraints and observance by Shari'ah board

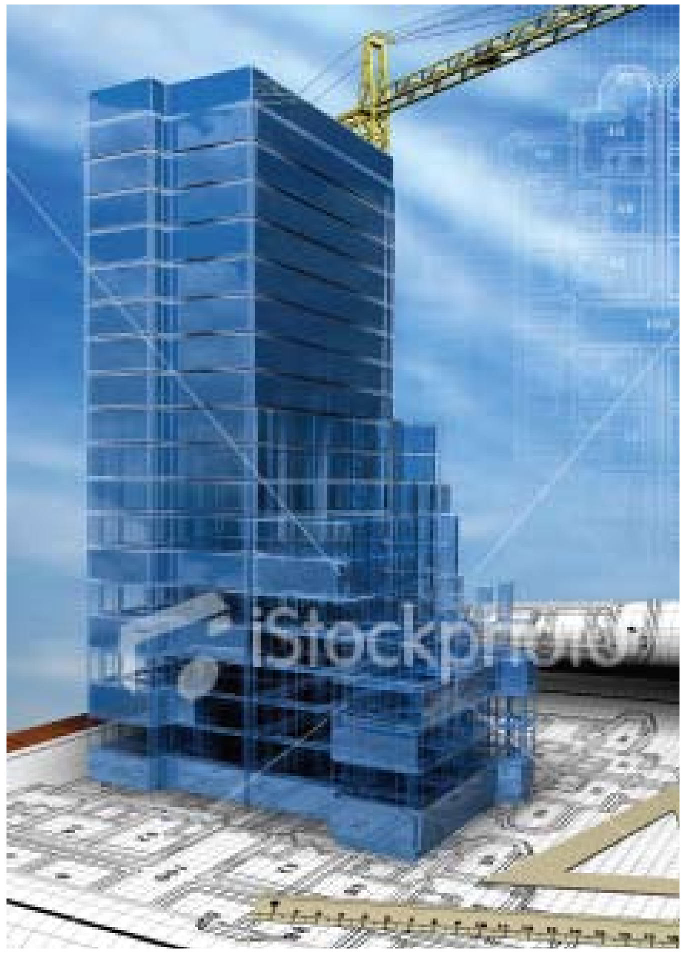
Increasingly, to ensure that investments of the fund are not made in *haram* industries, Islamic investors require their general partners to provide Shari'ah-compliant investment guidelines to be incorporated in the fund's documentation (i.e., the Limited Partnership Agreement and the Private Placement Memorandum). The extent of such guidelines will depend on the strictness of the Shari'ah scholars advising the investors of the fund. Such guidelines limit the discretionary management of a fund, thus limiting what has traditionally been one of the key advantages of the private equity asset class. However, technology-focused funds, which usually invest in *halal* (permitted) businesses, tend not to be limited by such guidelines.

Further, to be Shari'ahhhh-compliant, a fund has to establish a Shari'ah board with advisory and oversight responsibilities. Usually such a board will consist of three recognised Shari'ah scholars appointed by the fund's investors. The board generally advises the general partner with regard to Shari'ah law principles affecting the business of the fund and seeks to ensure that the fund's investment activities are in accordance with the investment guidelines of the fund. By issuing legal opinions (*fatwa*) regarding the Shari'ah-compliance of the fund and of its investments, the board continuously oversees the fund managers. Furthermore, proposed investments usually require the prior approval of the Shari'ah board. In the event that investments already made by the fund cease to be Shari'ah compliant, the board may want to instruct the general partner to divest. These constraints certainly conflict with the discretionary management of private equity funds in the West. Nevertheless, provided that the general partner and the Shari'ah board can cooperate efficiently, such 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.

Financing of the fund

Typically, private equity funds are financed by equity contributions provided by the investors. But Western-based funds also provide for leveraging possibilities at the fund level, in particular in cases of bridge financings when draw downs can not be served within a given period of time, or at the beginning of an investment period due to an initial lack of investors' funds. Such interim debt financing might conflict with Shari'ah law and the general partner should consult with the Shari'ah board regarding the level of strictness the board intends to apply. For example, more liberal Shari'ah boards might allow a fund a leverage of up to 33% of the fund's assets within a given period of time.

Furthermore, the payment and receipt of interest is forbidden under Shari'ah law. This affects not only any leveraging possibilities, but also penalties for investors who may be in default with respect to capital draw downs. Finally, it can also impact the fund's free liquidity management. Shari'ah-compliant funds in general should refrain from interest payments, and income that contains unlawful interest should be "purified", i.e. donated to charities. However, the general partner should always seek the input of the Shari'ah board regarding the type and amount of income to be purified.



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Asset Management

Shari'ah-compliant status for a fund requires adherence to the principles of Shari'ah law, not only at the fund level, but also with regard to the management of its assets. This has an impact not only on the selection of permitted target companies but also on acquisition and financing structures, and requires the general partner to possess expert knowledge of both Shari'ah-compliant and profitable financing instruments.

As mentioned above, leverage of investments is by its very nature in conflict with Shari'ah investment principles. However, some Shari'ah boards accept leverage to a degree, limited either by amount or repayment period. To avoid such limitations, or where a Shari'ah board is not as permissive about conventional leverage, debt may be structured in a manner compliant with Shari'ah law by using sophisticated financing structures tailor-made for Islamic investors. Such structures include classic Islamic financing structures such as the *muharabah* (sale structure with deferred payments), *musharakah* (Islamic joint venture) and *Ijara* (structure with leasing components). Also, Western banks now offer Islamic debt instruments and the prices for such instruments are lower than previously was the case. However, the complexity of such instruments on the legal and tax side requires the involvement of Islamic finance experts and may lead to slightly more detailed investment procedures.

When intending to make an investment, the general partner should consult the Shari'ah board as early as possible with regard to the Shari'ah-compliance of the proposed investment. In cases where the Shari'ah board does not consent to an investment due to its incompatibility with Shari'ah law, but the general partner wishes to make the investment, the fund documentation may provide special opt-out provisions for investors. According to these procedures, such investors can be excused from committing to that particular *haram* investment made by the fund. While such provisions help ensure management's discretion, they must be drafted precisely so as not to offer an excuse for investors regarding investments they don't favour for other reasons. The same principles should be followed in case a fund's investment becomes incompatible with Shari'ah law at a later stage.

Parallel Fund Structures

The above constraints show that funds dedicated to Islamic investors require a different fund structure than for conventional private equity funds. In addition, non-Islamic investors may not want to be bound by limitations not required for their investment in the fund. Thus, in case the private equity sponsor intends to raise money from both Islamic and non-Islamic investors, it may be advisable to set up two vehicles in parallel. To give confidence that the general partner will also take care with the sourcing and executing of Shari'ah-compliant investments, a co-investment agreement, usually a three-party agreement between the two funds and the general partner, can be entered into governing the terms and conditions of the joint investments of both funds.

Conclusion

Private equity is an interesting asset class for Islamic investors. Due to its natural fit with the Shari'ah law principle of risk sharing, as well as attractive return rates and the immense free liquidity available in Middle Eastern markets, we are likely to see an increasing number of both regional and Western funds dedicated to this type of investor. The challenge will be to further develop structures that are open and attractive to both Islamic and non-Islamic investors. This will expand the universe of investment opportunities available to Shari'ah compliant fund-of-funds, potentially opening up private equity investment opportunities to a broader range of Islamic investors.

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