

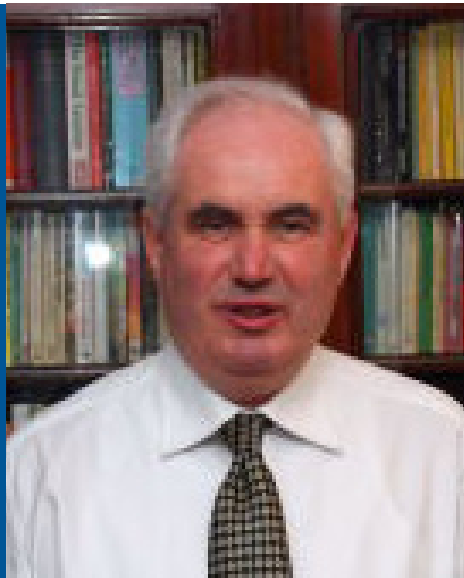
Shari'ah Compliant Private Equity Finance

It is only during the last decade that private equity has attracted the attention of Muslim investors, especially those located in the Gulf and Malaysia. Hitherto this asset class was relatively unknown in the Islamic World, as equity placements in family businesses were usually arranged informally, and seldom involved unknown outsiders. Shari'ah compliant funds have existed for over 20 years, but most invested in shares in public listed stock and not in unlisted companies.

Major private equity investors in the Gulf include the Gulf Finance House and Investment Dar of Kuwait, Investcorp of Bahrain, Shuaa Capital and Millennium Private Equity of Dubai and Corecap of Doha. Investment Dar and the Doha and Dubai based investment companies have Shari'ah boards, but Gulf Finance House and Investcorp do not, but both are becoming increasingly involved in Islamic finance. Investment Dar is perhaps the best known internationally as a result of its purchase of Aston Martin, the British based luxury sports car manufacturer. It has extensive interests in real estate, including ownership of Park Lane Properties of Leeds in the United Kingdom and Oqyana Real Estate of Dubai. With its working capital exceeding KD 500 million, (\$1.85 billion) Investment Dar is well positioned to undertake strategic private equity investments.

Prof. Rodney
Wilson

“This type of investment has a promising long term future.”



Private equity in the Middle East

The accounting firm KPMG carried out a survey of private equity and venture capital in the Middle East in 2006 and found that over \$18 billion was raised by closed end funds over the period from 1997 to 2006. There is anecdotal evidence to suggest that as a result of the major slump of equity markets in the Gulf in 2006, when Saudi Arabia's market lost 60 percent of its capitalisation, one investor response was to diversify into private equity as risk perceptions changed. The figure for private equity investment in the region today probably exceeds \$30 billion, but there are no reliable statistics. This figure includes all private equity and not only investment which is Shari'ah compliant. Eureka hedge covers 279 Middle Eastern private equity funds compared to 108 for Latin America, an indication of the scale of activity, although few of the 547 Islamic funds they cover are involved in private equity.

Screening criteria for private equity investment

Although the Dow Jones Islamic Market Index screening criteria are designed for listed companies, they can also be applied to private equity. Excluded sectors include alcohol, food products containing pork, casino and gambling operations and media companies whose output is unacceptable from an Islamic perspective, or indeed from any moral viewpoint. Activities such as tobacco manufacture are also excluded, as with Socially Responsible Investment, as smoking represents a form of slow suicide, which is prohibited in Islamic teaching.

Most companies are involved with interest based transactions with conventional banks, including those in which private equity investors aim to secure an ownership stake. To exclude such companies because Shari'ah prohibits interest would be to deny Muslim investors the possibility of involvement in equity investment. The issue is the extent of interest or riba, as investing in companies such as conventional banks that derive much of their income from interest is clearly unacceptable, as is investing in companies with high leveraging, a risky proposition in any case. The Dow Jones Islamic Market Indexes therefore apply a "one-third" criterion, excluding companies whose borrowings exceed one third of their market capitalisation or those where interest income exceeds one third of market capitalisation. The problem with private equity investments is that as they are not listed there is no capital market valuation, and therefore estimated asset values have to serve as an alternative, usually taken from the accounting statements.

Shari'ah compliant private equity companies can themselves be listed, as is the case with Investment Dar, one of the largest companies on the Kuwait market. Usually they will not take any conventional borrowings onto their books, but they can raise funds through Shari'ah compliant instruments and harness equity investment.

Shari'ah compliant venture capital

Venture capital is a sub-set of private equity investment usually involving seed capital or investment during the early stages of the business life cycle. In the Middle East venture capital is in its infancy, although the businesses located in Knowledge Village in Dubai demonstrate what can be achieved. Malaysia is the leading Muslim country for venture capital enterprises, many of which are located in the Multi-Media Super Corridor south of Kuala Lumpur and near its international airport. A recent survey of eighteen venture capital companies in Malaysia by Dr. Fara Farid, revealed that most were interested in or involved with musharaka, a form of joint venture

partnership financing based on profit and loss sharing. This would appear to be especially suited to private equity and venture capital financing, while at the same time resulting in a new asset class with distinctive risk and return characteristics.

Expect some of these ideas and concepts to be applied in the Gulf oil states. These are being transformed into entrepreneurial states with a focus on asset management. The sovereign wealth funds that are increasingly in the news were more interested in fixed rate instruments and listed equities in the past, but appetite for risk has grown as higher returns are sought. Private equity is even more appealing if the sovereign funds can demonstrate to their political masters that they are Shari'ah compliant. This type of investment has a promising long term future whatever happens to credit markets in the coming months.

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