RESEARCH PAPER | Commerce | Volume : 4 | Issue : 1 | Jan 2014 | ISSN - 2249-555X

AN EMPIRICAL STUDY ON ISLAMIC PRIVATE EQUITY (IPE)

KEYWORDS: Gulf region, Islamic Private Equity, liquidity, Shari'ah.

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ABSTRACT *The Islamic private equity (IPE) industry is a very young one and traces its roots back less than a decade. The lack of liquidity in the West, the recent oil boom, the opportunities in the Gulf region and the rapid rise of credit demand are among the reasons that lead to the development of IPE. Despite the fact that it is more restrictive than conventional private equity, it has shown a persistent performance in the recent crisis. However, the Western practice of IPE had some violation to Shari'ah. This paper discusses various issues related with IPE e.g. genesis, growth and development, way of functioning and list of business activities not covered by IPE.*

01.Introduction:

A venture capital or private equity (VC/PE) is a collective investment scheme or reserve capital used for making investments in various equities (and to a lesser extent debt) securities according to one of the investment strategies associated with private equity firm (Lerner, 1999). VC/ PE activity started in 1946 when General Doriot, a French born and a Harvard educated businessman, established the American Research and Development Corporation (ARDC). It grew in Silicon Valley in the 1970s. Intel and Microsoft are amongst the most famous projects financed through VC (PWC, 2012). Over the past thirty years, VC/PE projects have grown dramatically all over the world. In 2011, fund managers raised more than US$ 800 billion and invested more than US$ 1200 billion in enterprises all over the world (Jain et al, 2012). After the financial subprime crisis, private equity becomes one of the major sources to secure debt financing for a new project.

One development worth noting here is the incredible growth of private equity based on *Shari'ah* principles in the Middle East. Despite the fact that the first Islamic bank had been established in the 70s, the first Islamic private equity (IPE) funds appear only in the last decade. To meet the growing demand of Muslims and recently non-Muslims in both Muslim and non-Muslims countries, the Islamic finance industry has grown appreciably over recent years not only in terms of the volume of the entire industry but also in terms of the development and the design of innovative and sophisticated products which are *Shari'ah* compliant. In 2012, there are more than 350 Islamic financial institutions operating in 90 countries. The gross amount of deposits is around US$ 350 billion while the funds managed by Islamic PE funds vary between US$ 500 and US$ 1200 billion. It was noticed that US$ 300 billion are invested in the Gulf Cooperation Council (GCC) countries (e-Newsletter, MVCA, 2013).

Nowadays, many conventional banks run Islamic Windows in order to attract both Muslim and non Muslim clients who are more and more alert particularly after the financial subprime crisis. This shows the attractiveness and the increasing interest for Islamic PE industry. Many international financial centres have set up Islamic benchmarks, like for example the Dow Jones Islamic market Index in New York and the FTSE Global Islamic Index in London. There are more than 150 *Shari'ah* compliant mutual funds operating in Malaysia and 130 in Saudi Arabia. In the UAE, the number of Islamic PE fund has increased from 15 to 93 during the period 2005 to 2012 (e-Newsletter, MVCA, 2013).

02.Genesis of Islamic Private Equity:

Early Arab traders were lead the way of flowing private capital into profit-and-loss sharing ventures, with the Prophet Muhammad (570-632 AD) himself becoming a great exemplar. The Prophet's companions, most notably Abdur-Rahman ibn 'Awf (580-652 AD), were heavily involved in the equity financing of trade caravans and became the equivalent of today's private equity tycoons. Since then, Muslims have continued to take leading role in profit-and-loss sharing while Islamic finance firms have started in following Islamic private equity principles to a global scale. Recently, such firms have financed everything from *Shari'ah* -compliant hotels (e.g., Shuaa Capital in Saudi Arabia), self-storage units and industrial plazas (Conundrum Capital in Canada), fried chicken and coffee franchises (Arcapita in USA) to infrastructure projects (Islamic Development Bank).

Fundamentally, Islamic private equity is based on broader Islamic commercial principles requiring that transactions be based upon, and stay true to, certain legally-recognized instruments and structures. In the private-equity context, the two major instruments are *mudaraba* (limited partnership) and *musharaka* (general partnership). Importantly, Islamic private equity or venture capital funds are very similar to their conventional counterparts, with the exception of some strict qualitative and quantitative screening.

03.Growth and Development of Islamic private equity:

In an institutional form, modern Islamic VC/ PE could be traced back to the *mudaraba* companies established in Pakistan in 1984 (Hasan et al., 2011, Sethi 2008). The idea of setting up *mudaraba* companies was materialized in 1979 when the then President of Pakistan Zia-ul-Haq established the Council of Islamic Ideology (Herein after CII). Injazat Capital Limited gets the honour of being the first fund set up for Islamic VC / PE investment. It mainly stresses on MBO, ILBO and multi-stage investments. Injazat Capital was initiated the operation by the Islamic corporation for the development of the private sector and Gulf Finance House in partnership with Dubai Islamic Bank, Saudi Economic Development Company and Iran Foreign Investment Corporation.

In Malaysia, the first Malaysian VC/PE firm was established in 1984 through setting up Malaysian Venture Investment (MVI) with approximately 13.8 million fund through the Singapore based South East Asian Venture Investment (SEAVI). Since 1990's several government-sponsored VC/PE firms began to start their operations namely- Malaysian Technology Development Corporation (MTDC), Navis Capital and Perbadanan Usahawan National Bhd (PUNB) etc. In 1995, the Malaysian Venture Capital Association (MVCA) was established for providing a platform for venture capital industry participants to articulate their views and provide input to policy makers on issues relevant to the development of the VC/PE industry (Securities commission of Malaysia, 2004).

Volume : 4 | Issue : 1 | Jan 2014 | ISSN - 2249-555X

In 2003, Kuwait's Global Investment House appears to have been one of the first institutions to explore Islamic private equity through the launch of a Kuwaiti dinar denominated Private Equity Fund where the investments were channelled into little-known unlisted Kuwaiti companies. Also in Kuwait during the same year, Kuwait Finance House's launched $100m New Zealand- Australia Private Equity Fund. Venture Capital (VC) Bank is the first dedicated Islamic VC/PE investment bank under the license and regulation of the Bahrain Monetary Agency (BMA). Other noteworthy examples of Islamic private equity include the following:

- ✓ In January 2007 the Enmaa (Dubai Growth Fund) from 3i Capital Group was launched. This $100m fund was intended to invest in public and private equity securities primarily in the Middle East and beyond.
- ✓ In April 2007 Khaleej Finance and Investment of Bahrain launched its $200m Indian Private Equity Fund with the aim of investing 50/50 in private equity and real estate in India.
- ✓ Millennium Private Equity and Global of Kuwait launched the $500 m Global DIB Millennium Islamic Buyout Fund in 2008 as a true private equity fund focused on companies located in the GCC, Turkey, Egypt, Jordan, Lebanon, Tunisia, and Morocco.
- ✓ Arcapita, the Islamic investment bank from Bahrain, successfully exited its private equity investment in US-fast food firm Church's Chicken in mid-2009.

04.Operation of an IPE fund:

Usually a PE firm is structured as a partnership with two key components:

- ✓ The General Partners (GP); the management team responsible for the selection and management of the target company and, ultimately, the exit strategy.
- ✓ The Limited Partners (LP); the providers of the capital. They provide funding and allow the GP to draw down funds as required for investments that meet an agreed profile.

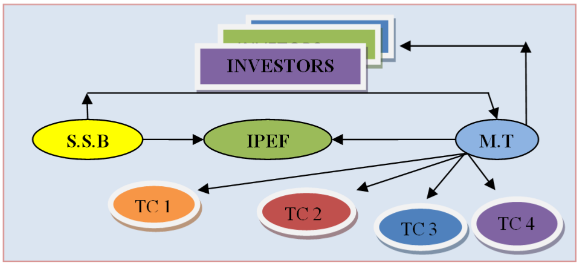
However, IPE appears more restrictive than conventional PE. In fact, there are many investments which are regarded as *haram* investments (literally not in accordance with *Shari'ah* principles). In contrast with conventional PE fund, in addition to the LP and GP, the IPE fund seek for the approval of Islamic authorities before making any investment decision (figure: 1). In fact, it function in the following manner:

i. The *Shari'ah* committee also called the *Shari'ah* Supervision Board (SSB) sets the *Shari'ah* policy of the fund. It recruits a *Shari'ah* Compliance Officer (SCO) to supervise target companies.
ii. Investors raise funds for a fixed period of time to finance the selected IPE fund (IPEF).
iii. The management team (MT) of the selected fund invests only in the more profitable target companies.
iv. The SSB checks whether the project is *Shari'ah* compliant or not and that it is in accordance with their policy.
v. MT and SCO control target firms and report any irregularities to the SSB.
vi. MT has to disclose at regular intervals information about the progress of target companies to investors.
vii. The IPE fund exits the target company at a fixed date and shares the profit and losses with the entrepreneur.

05.Essential criteria of a business under IPE principle:

There are many activities in which an IPE fund cannot raise capital but there is no exhaustive list of them.

Figure 1: An outline of the function of an IPE fund



Source: Wouters, P. 'Islamic Private Equity Funds', Islamic Finance News, October, 2008.

This list varies from one country to another, from one region to another and even from one *Shari'ah* committee to another. However, the following businesess are not approved by *Shari'ah* principle:

- ✓ Any transaction related to pork products and blood;
- ✓ Drugs, tobacco, alcohol and in general any activity related to intoxicant products;
- ✓ Pornography or obscenity in any form;
- ✓ Gambling, casinos, lotteries;
- ✓ Any activity related to the arms' industry;
- ✓ Some non-compliant financial activities based on interest, speculation and insurance;
- ✓ Trading on human cloning, human foetuses.

However, An IPE fund prefers companies with high potential growth. This type of company is *Shari'ah*-compliant, low leverage (their debt level must be very low or zero, making it favourable for Islamic Investment), economically viable and capable of providing financial returns better than other asset classes. In addition to financial and religious criteria, target companies must also satisfy economic conditions, even though these may not be prerequisites of *Shari'ah*.

06.Conclusion:

Islamic private equity, if practiced correctly would have substantial benefits on the economy of a country e.g. this will able the countries to diversify their economy, support the innovative youth and increase the wealth and prosperity of the country. Lack of *Shari'ah* based healthy infrastructure or model is creating barrier in the development of IPE. This is the need of the hour to build an Islamic model while avoiding all problems encountered in each and all stages of IPE Investment such as seed capital, start up phase, expansion & development and IPO so that a better *Shari'ah* compliant model can be established.

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