



Islamic Private Equity

Omar Shaikh – IIR Frankfurt Nov 2008

28 November 2008

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Industry Overview

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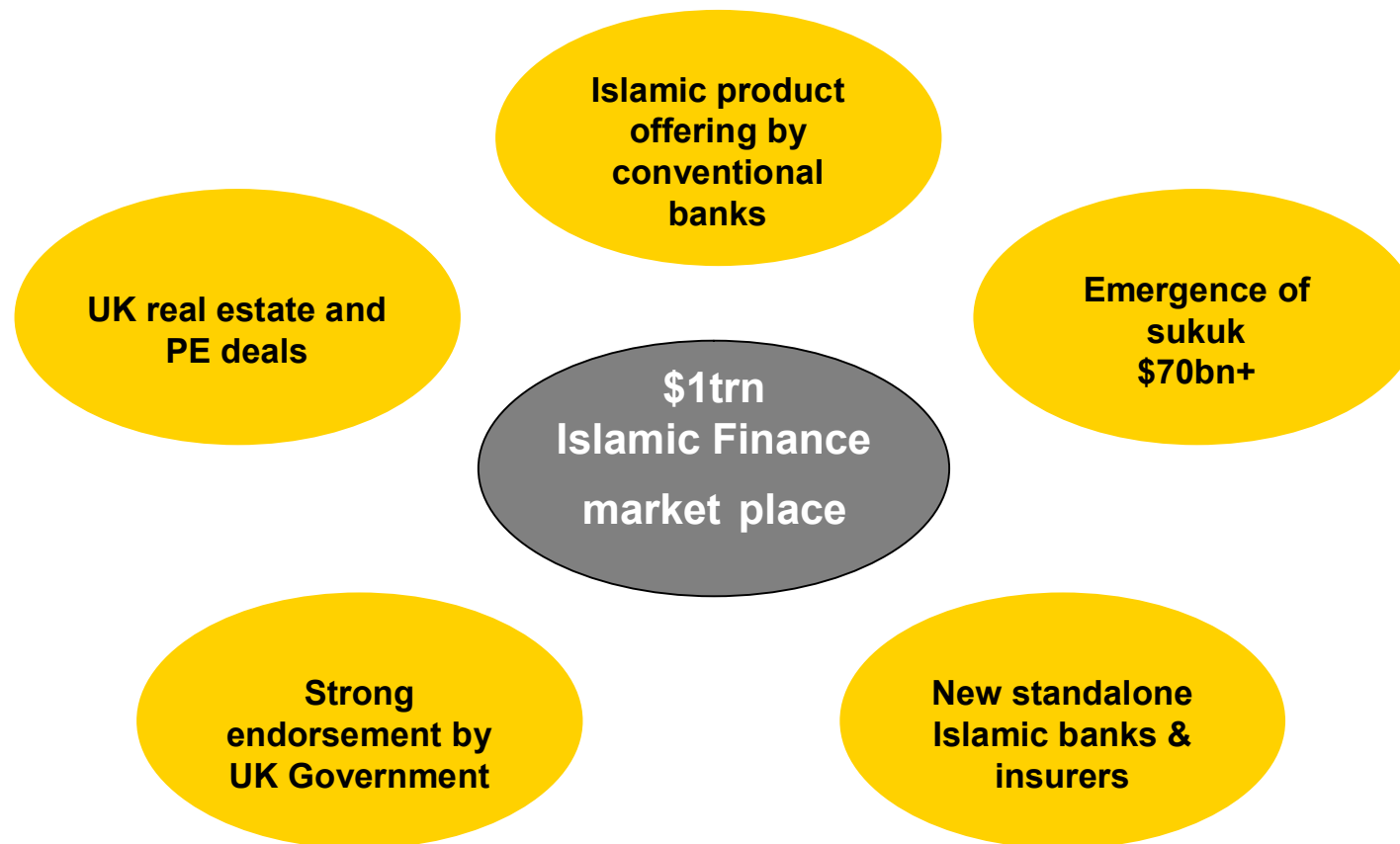
The Islamic Financial Services Market

“Broader than banking, wider than the Middle East”

- ▶ Islamic finance is a new industry in its infancy which has only come to the fore over the past five to seven years
- ▶ Industry worth circa \$1trillion (McKinsey) and growing between 15% – 20% pa (S&P)
- ▶ Islamic finance is a horizontal niche affecting a number of areas
- ▶ Driven by increasing demand and petro\$ liquidity a number of new Islamic banks and insurance companies are being established
- ▶ Traditional hubs are Malaysia and Bahrain with increasing involvement by other jurisdictions (Dubai, London, Pakistan, Brunei, etc)
- ▶ Fundamental structural differences in Islamic banking products with inherent additional challenge of Sharia compliance
- ▶ Estimated total takaful premiums of \$2bn in 2006 (against global insurance premiums of \$3.7trillion – WTR08)
- ▶ Predicted to be a \$10bn to \$15bn industry within 10 years

Key industry achievements

Transitioning from a niche into mainstream



Industry challenges

- Standardisation in contracts
- Consistency within shariah opinion
- Limited availability of assets
- Credibility challenge
- Lack of secondary markets
- Legal and fiscal frameworks under-developed in Western countries
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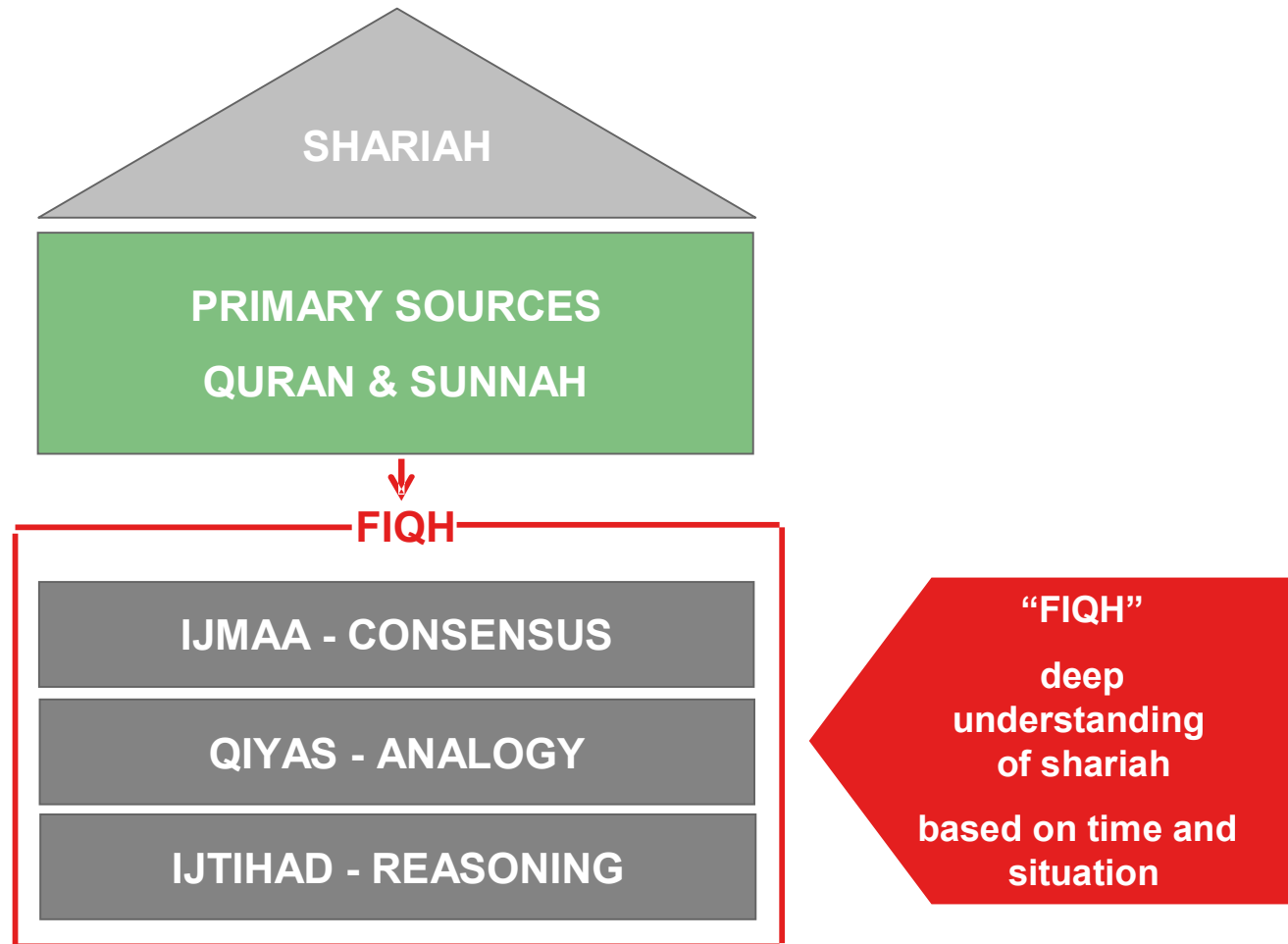


Basics of Islamic Finance

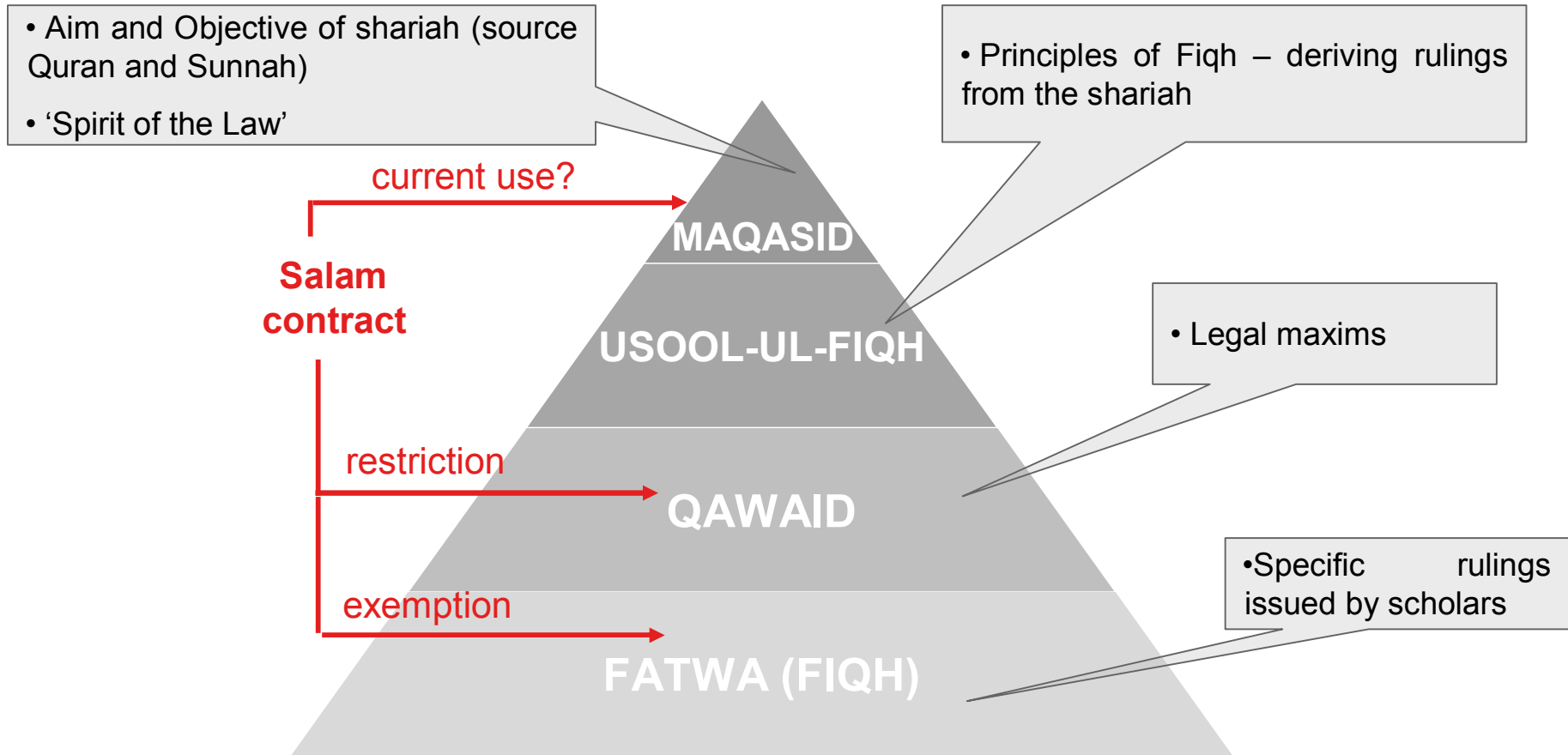
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Demystifying Shariah



Shariah and Islamic Finance



Source: Sheikh Haytham Tamim, Utrujj Foundation for Islamic studies

Lessons from the Prophet Shuaib (as)

- Speaker of the Ambiya (Q.s7v.85-93 & s.11v.84-95)
- Diseases of the people was cheating in business, tauwhid,
- Quran, s11.v85+, ‘..give full measure and weight..’
- Relevance is the business value set
- Concept of **baraqah (blessings)** and **tawakul (reliance)**
 - distinctive component
 - secret to success of Islamic understanding of finance and economics

Strong business ethics promoted by shariah
Moving towards shariah based v shariah compliant

Importance of equity participation

- 3rd world debt
- Sir Ronal Cohen – CSR link
 - Applying PE techniques to social entrepreneurship
 - Efficiency of private sector, incentives to do the right thing
- Rejuvenate confidence in the sector
 - Negative perceptions of being overly-engineered
 - Shariah based v compliant
- Preserving the distinctive values of Islamic finance
 - Moral ground
 - Spread of Islam
 - Alternative paradigm challenging capitalism

Private equity as modern day musharika – addressing the challenges of the Islamic finance industry ?



Demystifying Private Equity

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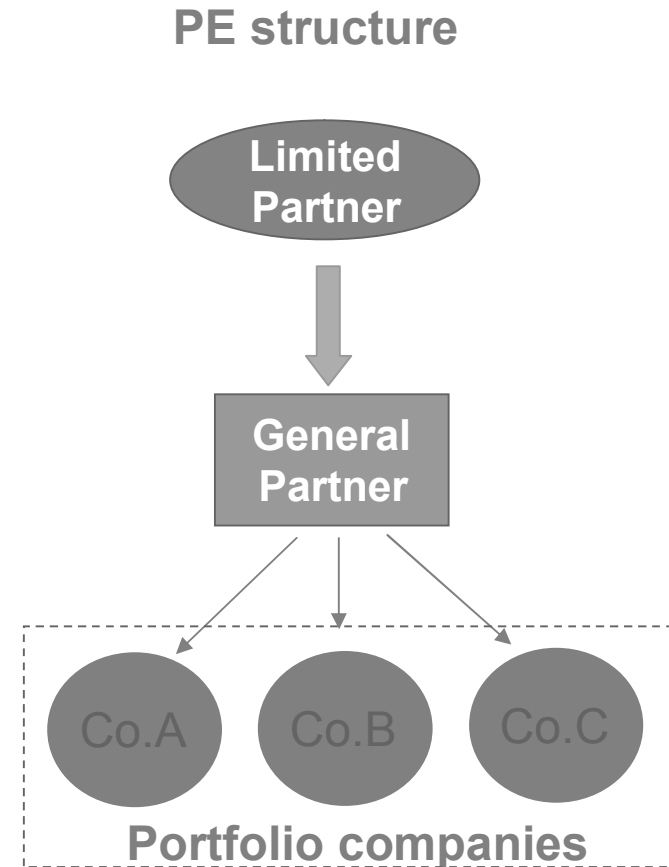
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Definition of Private Equity

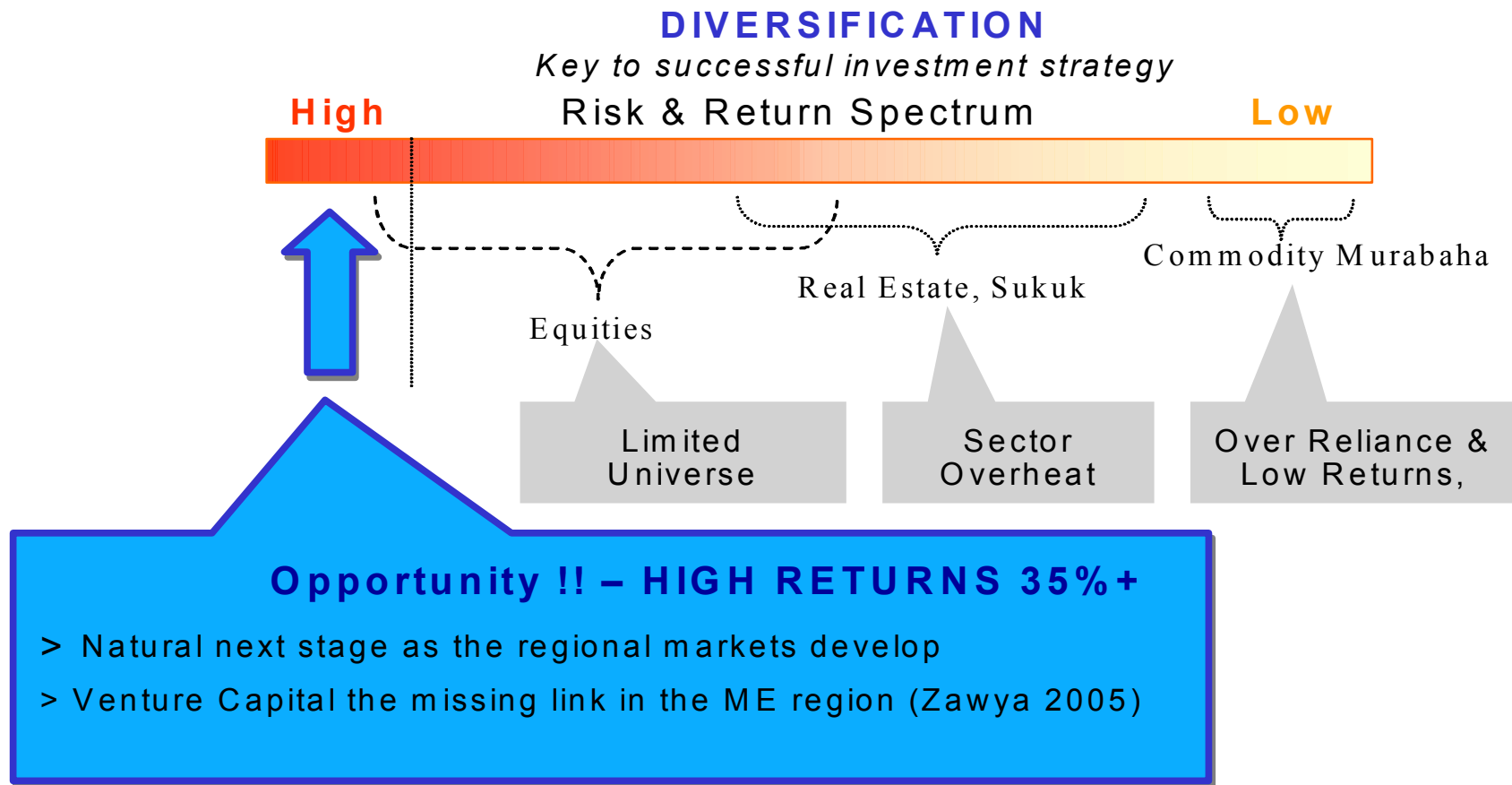
- ▶ The term Private Equity represents a diverse set of investors who take an equity stake in a private company. The success of PE has meant that there are a number of new players in the space (eg., Hedge Funds)
- ▶ Private equity is medium to long-term finance (usually 3-7 years), provided in return for an equity stake in potentially high growth unquoted companies
- ▶ In Europe the term “private equity” is synonymous with “venture capital” and is used to cover funding at all stages of a businesses life cycle
- ▶ In the USA “venture capital” refers only to investments in early stage and expanding companies whilst “private equity” covers more mature businesses; ie, management buy-outs and buy-ins

What is a PE fund?

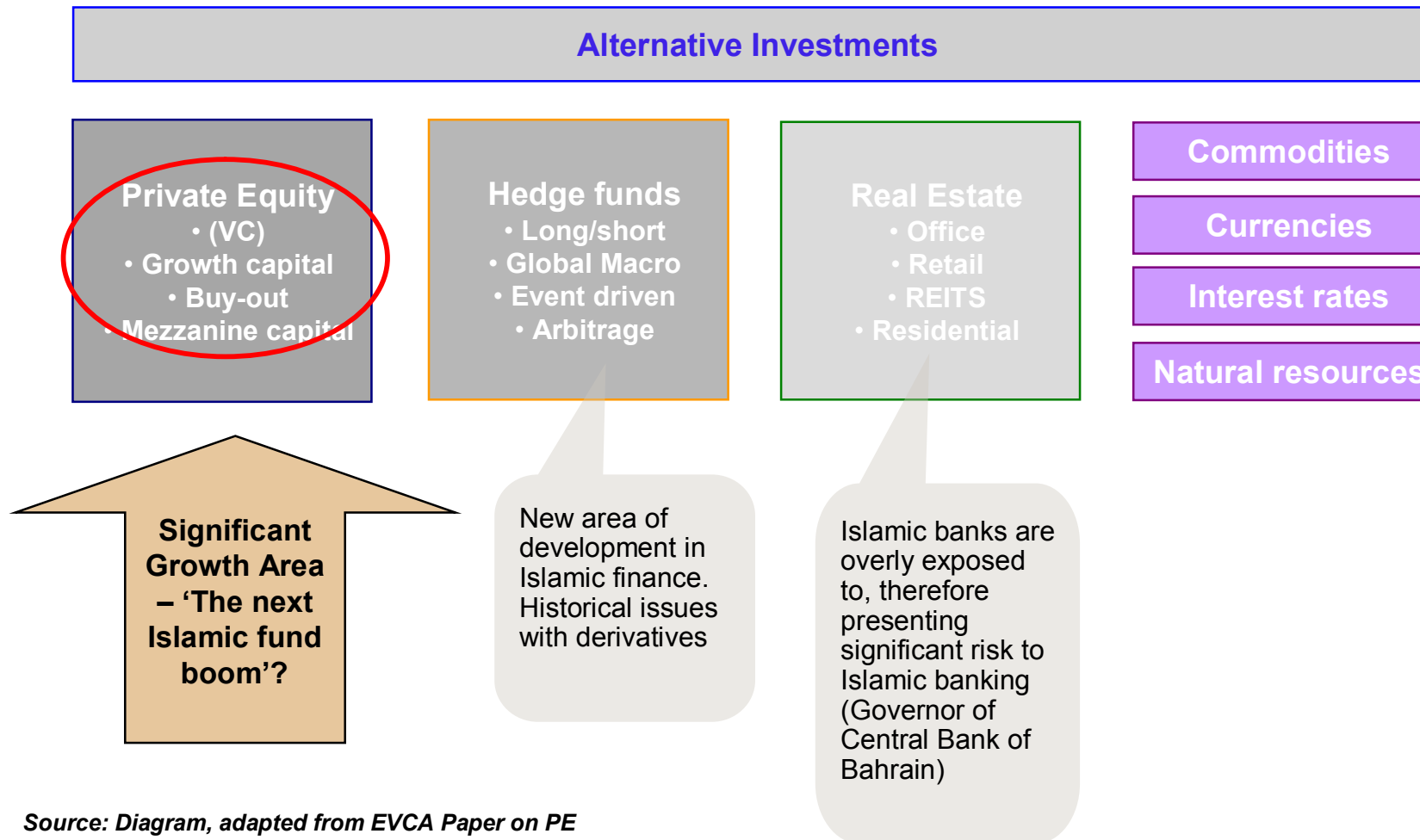
- ▶ A “Partnership” between a PE firm (“general partner”), and investors in the fund/s (“limited partners”) – eg: pension funds (c 25%), banks, insurance companies, governments
- ▶ Investors consent to an upfront commitment to provide funds:
 - ▶ for future equity investments
 - ▶ over a specified period of time (the life of the fund) usually 10 years
 - ▶ pay management fees over the life of the fund
- ▶ Funds are drawn down by the PE house as and when required
- ▶ Monies are returned at the end of the funds life together with any additional returns made



Private Equity – asset class within the risk spectrum



Private Equity – part of alternative investments asset class



Source: Diagram, adapted from EVCA Paper on PE



Deal Making Process

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Types of deals

Early stage

- ▶ Value is often in leading-edge product/ intellectual property
- ▶ Funding required to realise commercial potential
- ▶ Requires greater degree of VC (fund manager) involvement

Higher risk than late stage but promises exceptional returns



Late stage

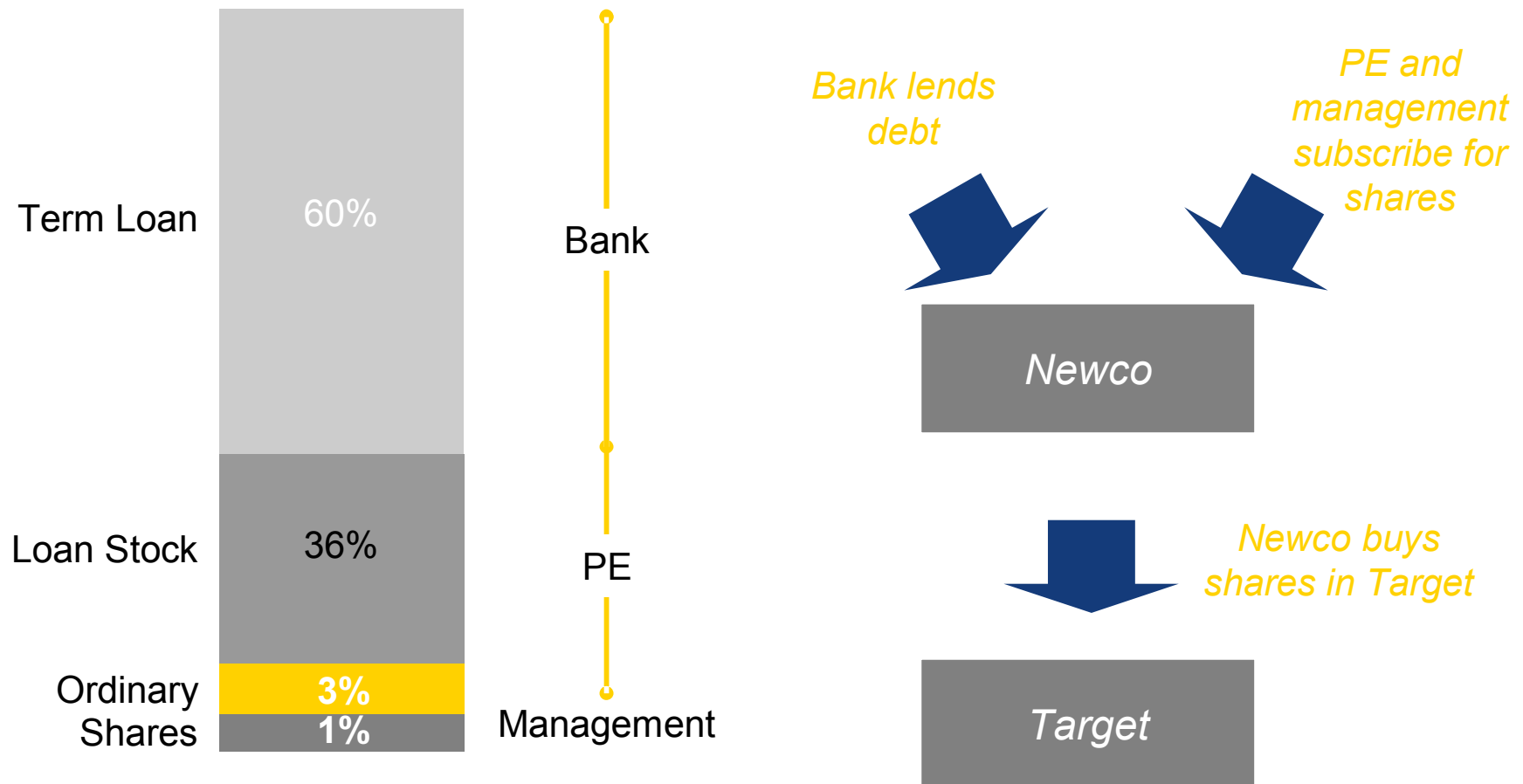
- ▶ Target existing family, private or publicly owned businesses
- ▶ Add value by:
 - ▶ Installing new management team
 - ▶ Promoting a more professional corporate culture
 - ▶ Merging with existing portfolio
 - ▶ Using as vehicle for further acquisitions
 - ▶ Cutting costs & improve efficiency

Goal is to build a company with large market share, valuable product and strong customer base



Deal structure & funding – an example

Structure of a typical MBO/MBI



Commercial considerations for a PE house

Typical commercial issues

Competitors:

- Who?
- Bigger / smaller?
- Fragmented / Global?
- Barriers to entry
- Substitute products
- Acquisition targets?

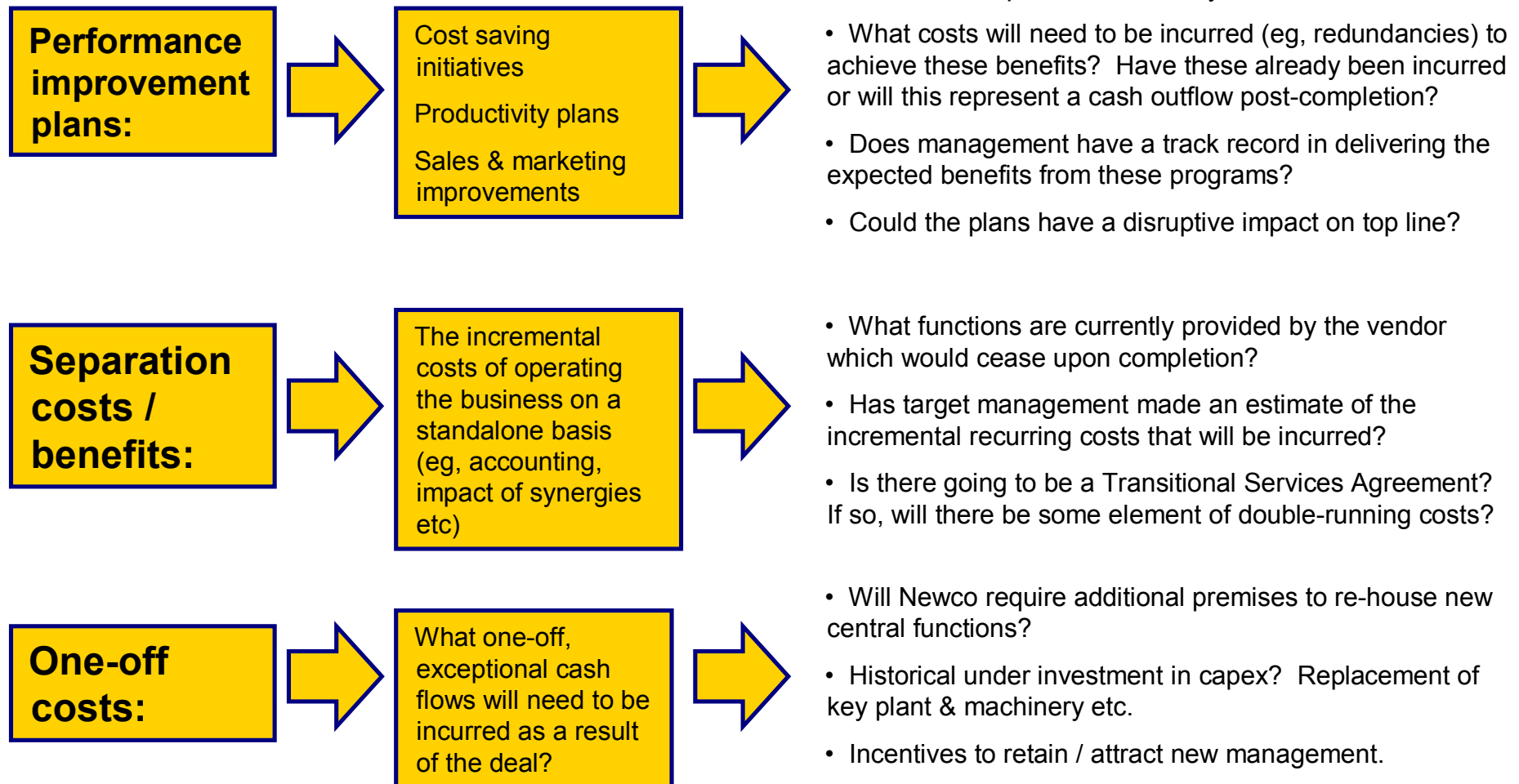
Markets:

- Brand reputation
- Market share
- Consolidation?
- New product development
- Territory expansion?
- Lifecycle?
- Technology requirements
- Key drivers

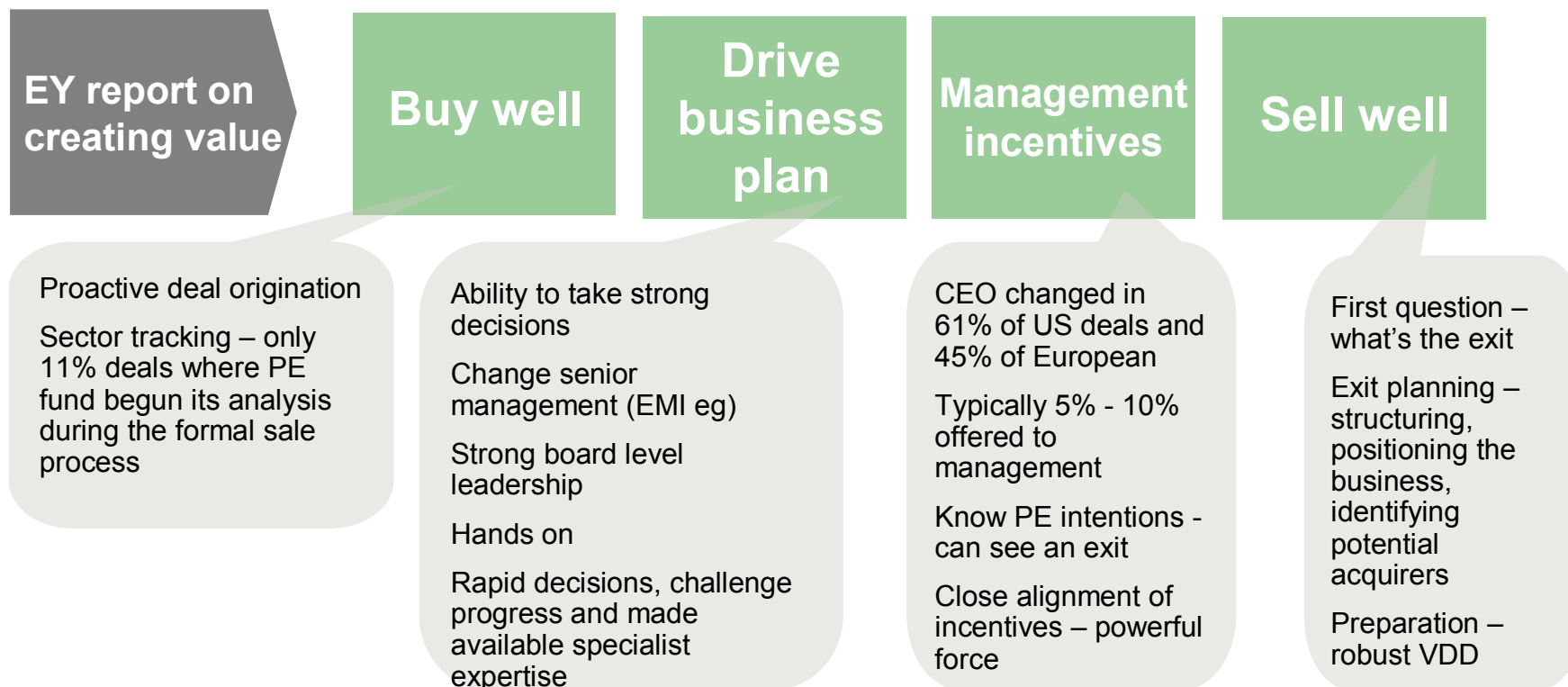
Customers:

- Who are they?
- Contracted? If so, for how long?
- Margin pressures?
- Dependence on major customers?
- Do you understand your customers' market?
- Customer churn versus competitors?

The following operational considerations are often fundamental in a PE transaction



Ernst & Young study on value creation



2007 exits study reinforce similar themes. Study provides perspectives on PE ability to provide active ownership, rapid organisational change and powerful incentives.

Available from www.ey.com

Current trends in Europe and US

- Reduction in large ticket deals (£1bn+)
- Move towards Eastern Europe assets
- Focus on portfolio
- Opportunity for P2P plays
- Buying discounted debt – opportunistic play on current banking sector turmoil
- PE as a sector – positive beneficiary as a result in excessive volatility in listed assets

Contemporary Issues

Credit crunch

- Consensus of much reduced LBO activity for the remainder of 2008, due to 'indigestion' in the banking market.
- Market participants view this as a short term dip in activity prior to returning to a more rational market in 2009.

There is long term belief in the PE model and long term economic fundamentals remain strong.

- In the short term, PE buy-side will be quiet in most markets. Exits to trade or IPO will continue
- PE clients' current focus on value creation within portfolio companies, selling in 'improvement' services and continuing to position for exits.
- Greater conservatism by banks should result in more due diligence.

Market perception

- ▶ Germany's 'locusts'
- ▶ Tax and cleaners
- ▶ Private equity becomes a public policy issue in UK, Europe and USA
- ▶ G8 concerns over SWF's – viewing certain ME PE funds as an extension of the SWF ?
- ▶ Walker report (Nov 07) guidelines apply to PE firms and portfolio companies
- ▶ Increased disclosure:
 - ▶ PE fund: annual review structure, history, UK management, portfolio companies, categorisation of LP's, etc
 - ▶ Portfolio company: identifying PE fund that owns, business review (s417 Co.Act 06), review of risk management

Current trends in Europe and US

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Private Equity in the Middle East

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The market size for Islamic finance

“Inclusive proposition with a captive value group”



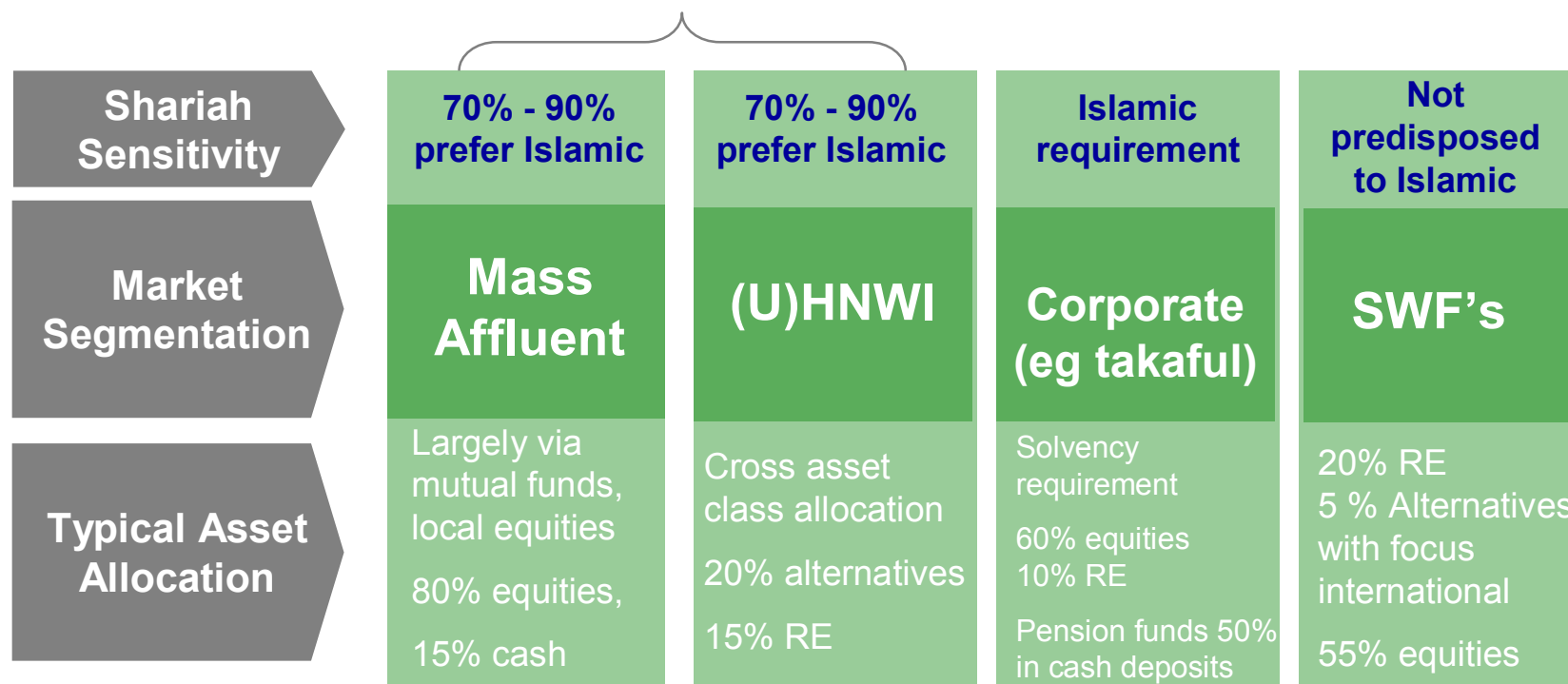
- Increased awareness
- Western players offering Islamic finance products & services
- Increased number of enablers
- More Islamic banks present
- More innovative products
- Competitive pricing

Potential target for Financial Institutions offering Islamic Financial Services

Ernst & Young Islamic Funds and Investment report 2008

- Total number of PE funds raised in 2006 - 16, 2007 = 22
- Total value of PE funds raised in 2006 - \$2,800m, 2007 = c\$6,100m

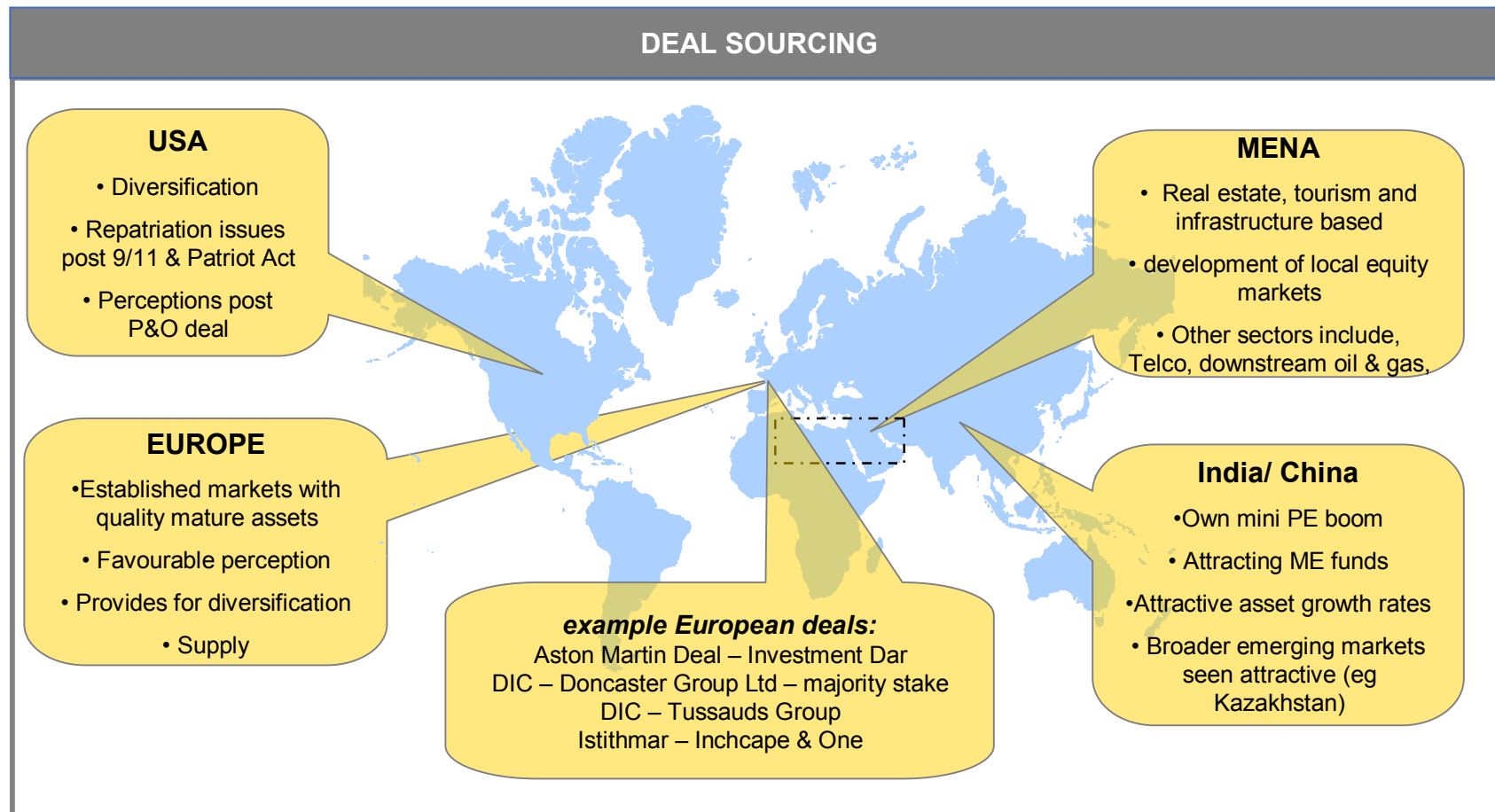
Country dependant



Major Drivers of Market Activity – *The Rise of Desert Capitalism*

- ▶ Sell down model – GP/LP structure now beginning to emerge
 - ▶ GP makes their return upfront but manage the funds acting on behalf shareholders
 - ▶ allows greater choice/control for the investor group
 - ▶ reflects nature of landscape being composed of multiple family groups and HNWI's
- ▶ Petro\$ influence - rise of the petro\$ presents a liquidity challenge
 - ▶ Limited universe of regional assets
- ▶ Volatile local markets – IPO as an exit route (most regional IPO's significantly oversubscribed)
- ▶ Importance of diversification (geography and asset class)
- ▶ Engaging in PE – having the right team of experience professionals
- ▶ Alternative approaches
 - ▶ buy into the GP (ADIA 7.5% stake in Carlyle for \$1.35bn), natural LP source
 - ▶ fund of fund approaches
- ▶ Regional PE
 - ▶ Carlyle group setting up their offices in the region – seen as the 4th major centre for PE
 - ▶ understanding the family influence over large domestic companies.
 - ▶ succession planning within family companies (numerous grand children), divestiture of non-core business, expanding business and benefits of partnering with PE fund

Current PE deal sourcing trends





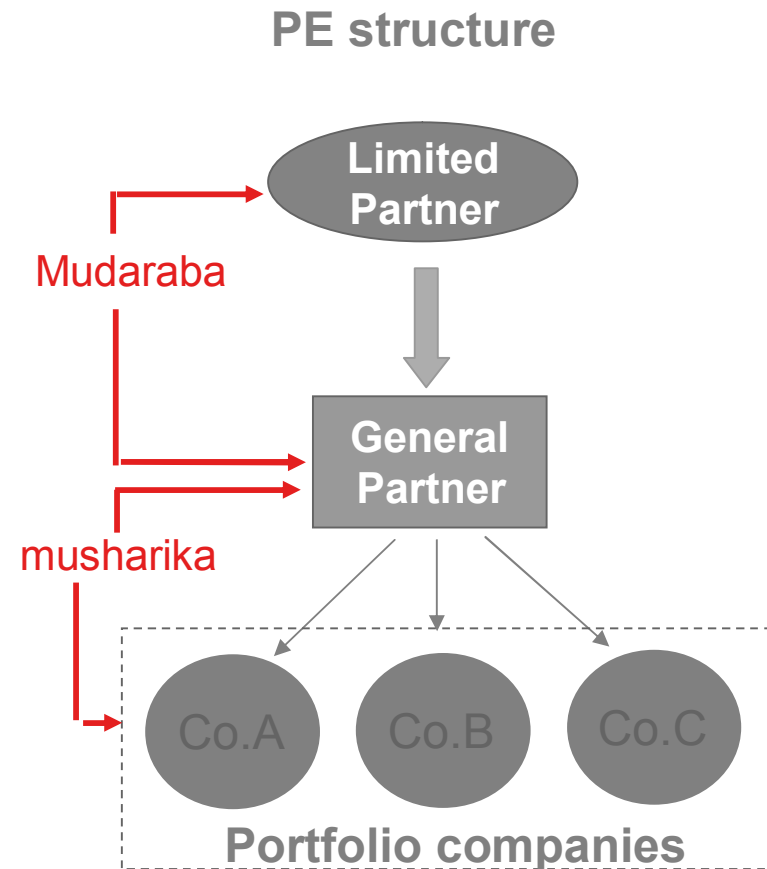
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Key issues in Islamic private equity

- ▶ **Prohibited industries** - gambling, pork, FS, etc
- ▶ Expect to use Islamic funding throughout where possible. Short term concessions maybe given
- ▶ Middle man theory/approach – validity?
- ▶ Leverage parameters applying to listed stocks:
 - ▶ Conventional debt (all types and quasi-debt) to market cap (or total assets) not to exceed 30%
 - ▶ Ratio of Non-operating gross interest income (plus any incidental income from non-permissible means) to revenue must be below 5%
 - ▶ Ratio of cash plus interest bearing securities to total assets not to exceed 30%
 - ▶ Ratio of liquid assets (cash + trade receivables) to total assets not exceed 45%
- ▶ **Instrument types** (convertibles, preferred shares) – limited market precedence, however increasing innovation in this area. Recent Mezz fund (Qatar MIP II)
- ▶ **Purification** – all income from non-permissible sources to be donated quarterly



Shariah compliant PE - market players and key trends

- ▶ Aston Martin deal in the UK
- ▶ In-sourcing opportunities
- ▶ Arcapita (FIIB) in 1997 – focus on US & European assets (Nov 04 acquisition of South Staffordshire Water)
- ▶ Number of new market entrants:
 - ▶ Unicorn, Gulf Finance House (GFH), Kuwait Finance House (KFH), Venture Capital Bank,
 - ▶ RHT Partners (AED750m Education deal in Dubai) – bringing in a new dimension
- ▶ Banks setting up their PE funds – NBD Sana, Al Salaam bank, et al
- ▶ Millennium Finance (DIB) - \$1bn family of funds launched in 2006 focusing on TMT and energy
- ▶ Islamic structures are beginning to emerge for majority of conventional products (mezz, pref shares, etc)

Conclusion

- ▶ Growing asset class
- ▶ Provides a real musharika based solution – opportunity to tap into the distinctive basis of Islamic finance and provide a solution that leads the global market place
- ▶ Conventional PE proves that within a short period of a time a new asset class can be borne – providing inspirational value to the IF sector
- ▶ Significant opportunity for conventional PE funds to tap into ME liquidity by structuring sharia compliant conduits
- ▶ Community level mid-market PE targeted at the SME sector is an area of need in the UK Muslim community

Thank you

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