

## Convergence of Venture Capital and Private Equity in Islamic Finance



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**Digg** Islamic finance is trending towards a convergence with private equity and venture because of the general ability of these forms of investments to provide the capital necessary for firms under the requirements of Sharia law. Islamic finance is theoretically based on the principles of Sharia law, which prohibits certain types of investing activity commonly found in non-Islamic capitalization transactions such as the use of debt instruments or use of preferred shares providing higher return than common shares. The venture capitalist or private equity provider must not only evaluate the financial merits of an investment opportunity, but must also structure the investment to remain compliant with Islamic financial requirements. Sharia law prohibits lending funds at interest for business investments. Because of this restriction, the venture capital and private equity approach supports economic growth with the provider of capital becoming a shareholder in the organization. The convergence of venture capital and private equity with Islamic finance is because of the attributes of the private equity financing approach that create inherent compatibilities with the principles of Islamic finance.

**submit** Under Sharia law, the provider of capital for a business venture is viewed as involved in a partnership with the operator of the business. Venture capital and private equity are very compatible with the fundamental principles of Islamic finance because the provider of capital holds an equity interest in the firm and becomes involved in its success or failure at a relatively early point in the company's life. Venture capital and private equity involve investments in companies providing real goods and services that have a beneficial influence on the economy. Both the company and the private equity provider share the same risks for profit and loss as the company grows. In addition, the private equity stake in a firm in most cases is sufficient to influence the firm's governance to ensure operations are conducted in an ethical manner. The private equity stake can also be sufficient to alter the capital structure of the firm to minimize or eliminate its debt related activities. At the same time, venture capital and private equity support economic growth by providing necessary capital for a firm's expansion compliant with the Sharia prohibition against the use of borrowed capital.

Investing under the principles of Sharia law imposes an obligation on the individual or organization making the investment to ensure the funding is used only for moral purposes. The business activities of the firm in which the investment is made cannot be immoral, and the business cannot conduct its operations in an immoral manner. Because of this requirement, the venture capitalist in Islamic finance not only has to determine whether the purpose of the business is moral, but also has to ensure the actions of management are moral. While this requirement does not impose an obligation on the investor to continuously monitor the activities of management, it does create a requirement to thoroughly investigate the activities of the business prior to making an investment. The requirement, however, does preclude investing in firms involved with alcohol production, defense, the production of pork products, gambling, or pornography as defined under Sharia interpretations.

Sharia law also requires the investor to share in both the risks and the rewards from an investment, envisioning the relationship between the supplier of capital and the operator of a business as a partnership. This amounts to a prohibition against lending funds to a firm without an equity stake because the lender may have a reduced risk because the loan claim would have a higher priority than an equity claim. Because of this requirement under Sharia law, all funding for businesses in Islamic finance take the form of either *mudabah* or *musharaka* financing. *Mudabah* financing can be viewed as a traditional venture capital arrangement in which the owner of a business provides the knowledge and expertise to operate the business while the financing organization provides the necessary capital. If the venture operates at a loss, the venture capitalist receives no return on investment or may experience a loss. In the event the business prospers, the venture capitalist profits according to pre-negotiated percentages. The *musharaka* arrangement can be characterized as a joint venture in which the business operator and the venture capitalists jointly supply capital, with profits and losses divided according to the capital contributions. In both approaches, the investor provides capital to a firm in exchange for a portion of ownership, with the right of control over the firm remaining vested with existing management. The provider of capital can subsequently sell the equity ownership for a profit or can continue to hold the equity stake in the firm and receive a portion of the profits. Both the lender and the business operators divide the profits of the venture according to an agreed ratio. Most private equity arrangements in Islamic financing involve the *mudabah* approach in which the firm's managers continue to control operations although the private equity investor will oversee operations through the corporate governance structure.

One of the private equity approaches sometimes used in Islamic finance for some industries is the use of capital leasing, which is compliant with Sharia requirements and is known as *murabaha*. For firms requiring large capital assets such as airlines or manufacturing firms requiring capital equipment, the private equity firm purchases the equipment and enters into a long-term lease with the user of the asset. The lessee pays a fee for the use of the asset enabling the private equity firm to obtain a significant return on investment. The lessee has use of the asset during the term of the lease, but title remains with the lessor. This approach enables the private equity firm to fund asset-intensive industries such as an airline while remaining compliant with Sharia law by retaining title to the asset leased by a company. While this approach, constructive ownership remains with the private equity firm, while the company can use the asset to produce value. This approach, however, often has fixed terms for the use of the leased asset and does not allow the lessor to participate in the growth of the firm using the asset. A variation of this type of capital lease is a situation occurs when the owner of the asset such as a building agrees to transfer title to the lessee after a fixed number of payments have been made. In practice, the payments are equivalent to the cost to the lessor of the purchase of the building plus an amount equivalent to interest. Title to the asset, however, remains with the lessor until the stipulated number of payments has been made. While some private equity firms engage in capital leasing for major assets such as aircraft or property, the majority of

the private equity firms provide capital through an ownership stake in target firms.

Sharia law regarding financial matters has supported the development of both venture capitalism and private equity funds in Islamic nations because both investment approaches emphasize ownership stakes in the investment, sharing the risk, and exiting the equity position at a future time with profit contingent on the success of the venture. The venture capital approach is the traditional method for raising capital in Islamic nations, with the venture capitalist providing the seed or startup capital necessary for a firm but not adopting a management role. The private equity approach is used for the second stage of funding for a business after it is established, and is intended to take a long term perspective in which the investor becomes involved with a firm early in its growth and prospers along with the firm over the long term. Because of the increased inflow of wealth into many of the Islamic nations involved with oil production, the private equity firms and funds that have emerged over the past several years are one of the primary vehicles for investing in accordance with Islamic principles. An additional factor supporting the growth of private equity in Islamic nations is the traditional reliance on smaller family owned firms, which require additional capitalization and restructuring to expand operations. Banks in Islamic nations are also becoming involved in private equity financing, considering private equity funds as an opportunity to increase revenues from management fees while providing investors with professional management of the fund.

Because relatively few firms are fully compliant with the Sharia requirements to avoid issuing or using debt, the general approach taken by Islamic jurists in determining the criteria for investing in a firm is to use the rule of necessity. Under this rule, the use of debt should be minimal and only if it is necessary. As a result, a venture capital or private equity investment in a firm is permissible under Sharia law if its accounts receivable are less than 45% of its assets, interest income constitutes only a small portion of its income, and whose debt to moving average of market capitalization is less than 33%. In general, Islamic private equity firms use these criteria as an initial screen to identify firms eligible for investment, and are therefore able to take positions in firms outside of Islamic nations. In some cases, an Islamic private equity fund will also take a position in a firm contingent on the restructuring of debt and receivables to fall within the specified criteria. The restructuring may take the form of leased-based buy-outs of secured loans, which restructures the debt obligation to a lease obligation. The use of the criteria enables Islamic private equity firms to acquire positions in a variety of firms in non-Islamic nations while remaining compliant with Sharia law. As a result, the larger Islamic venture capital and private equity firms have globalized their operations, with major investments in Europe, North America and Asia.

One of the difficulties faced by a venture capitalist in Islamic finance is liquidity of the investment at the time for exiting the investment. While it is possible for smaller firms in Islamic nations to grow to the point where they have an initial public offering of stock to support liquidity and to raise additional capital, many firms in the region remain privately held. As a result, the venture capitalist with stakes in a few firms may not be able to find a buyer for the equity stake. The problem of liquidity may be even greater if the firm has not prospered and the value of the equity position has decreased. Islamic private equity funds provide some solution to the liquidity problem by creating a relatively large market for the purchase of equity positions in firms. To some degree, the private equity approach reduces the difficulties faced by the venture capitalist desiring to exit a position after a firm has developed, with the possibility a private equity fund will purchase the equity stake from the venture capitalist. In addition, many private equity investments have a very long-term horizon, intending to hold the ownership stake for an indefinite period.

The private equity funds following Sharia principles invest only in firms who agree to follow Sharia law, which eliminates firms borrowing funds for operations, and firms engaged in morally questionable practices. Because the amount of private equity funds available for investment is so large, some funds have adopted the approach of purchasing majority positions in firms with the intention of altering the practices of the firm to achieve compliance with Sharia requirements. In cases where the firm is not already compliant with Sharia law, the private equity placement should obtain a majority interest in the firm to bring it into compliance. An example of this type of approach is Qatar-based Corecap, which has assets of \$150 million to invest specifically in the information and telecommunication sector. After acquiring a majority stake in firms, the fund intends to alter the capital structures and practices of firms to ensure they are compliant with Sharia law and principles. In practice, this will require the gradual change to the capital structure of target firms by divesting debt and if necessary replacing the debt with equity capital. It may also require some changes to the types of products and services offered by the firms.

Despite the trend towards convergence between private equity and Islamic finance, private equity firms face several challenges to sustaining growth over the long term. Because of the need to select only Sharia compliant investments, the screening and research costs may be relatively high because it involves very close scrutiny of the firm and its practices. Obtaining adequate and trustworthy information about firms eligible for private equity investments under Sharia law is difficult in some developing nations because of the lack of transparency in financial reporting. Another type of challenge occurs in the use of private equity to support a merger or acquisitions between a Sharia compliant firm and a non-Sharia complaint firm. The merger or acquisition may be permissible only if there is a reasonable expectation the combined business entity will be Sharia compliant. 4There is also a lack of uniform accounting standards and interpretation as to whether the firm meets the Sharia requirements. Each private equity fund should establish a Sharia board to ensure a contemplated investment is compliant, but may have difficulty with finding a sufficient number of Sharia scholars with the necessary financial expertise.

The main opportunities for the use of private equity in the Islamic financing system is the possibility of generating greater gains over the long term for investors because of direct participation in the growth of the firm. The private equity approach has advantages for the investor because it can provide a very high return on investment if the firm prospers. Because the private investment firms become directly involved in the governance of firms, they can ensure management behaves in an ethical and

responsible manner to increase the value of the firm over the long term. In many Islamic nations such as Saudi Arabia, there is also a growing demand for capital supplied by investors to help transform smaller family-owned enterprises into multinational firms capable of competing in global markets. As a result, there are an increasing number of opportunities for investment in the Middle East in Sharia-compliant firms. At the same time, there the amount of capital controlled by venture capital and private equity funds in Islamic nations has increased substantially, leading to a global search for opportunities meeting the Sharia investment criteria. In the future, the venture capital and private equity approach is likely to become the primary component of Islamic finance.

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