Islamic Private Equity and Venture Capital

By Ahmad Lutfi Abdull Mutalip

In Islam, money is not a commodity and cannot be traded for profits. It is just a medium of exchange and it stores value. Money therefore must be invested in projects and ventures for the generation of activities for the benefit of mankind and in the process, for profit.

This is precisely why Islamic finance praises and encourages the application of finance in the financing of real economic activities. The returns should be earned by active involvement and participation in the business risks of investment and not the returns on lending or financing.

Islamic banks would apply the same criteria in evaluating projects to invest in, namely the entrepreneur’s ability and the project potential of the project. This is the reason why Murabahah (cost plus financing) as an Islamic transaction is considered less risky compared to Mudarabah (profit sharing) and Musharakah (partnership). A true form of Islamic financing or investment structure should have that element of sharing of profit and loss.

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Common Shariah based structures for Islamic private equity/venture capital

1. Mudarabah (profit sharing)
Mudarabah is one of the typical forms of Islamic private equity/venture capital (Islamic PE/VC). It is basically a contract made between two parties to finance a business venture. The parties are a Rab al maal (investor) who solely provides the capital and Mudarib (entrepreneur) who solely manages the project.

This is akin to a conventional PE/VC, where there exists a relationship between the capital provider and the entrepreneur. If the venture is profitable, the profit will be distributed based on a pre-agreed ratio. In the event of a business loss, it should be borne solely by the capital provider, to the extent of the capital contribution while the entrepreneur will lose his time and effort.

The key to a Mudarabah structure is the fact that the entrepreneur cannot be placed at risk to bear losses, unless proven negligent.

2. Musharakah
Musharakah is a partnership between two parties or more to finance a business venture whereby all parties contribute capital either in the form of cash or in kind. Profits are shared at a pre-agreed ratio while in the event of a loss, the loss shall be shared on the basis of capital contribution.

3. Wakalah
Wakalah is basically a contract where a party (principal) authorizes the other party or parties (agent) to act on his behalf, based on the agreed terms and conditions. Pursuant to the Wakalah contract, it confers the power and rights to the agent to act on behalf of the principal as long as the principal is alive.

Fundamental requirements for an Islamic PE/VC fund
There are two fundamental requirements for the establishment of an Islamic PE/VC fund, namely:

1. The appointment of a Shariah advisor to provide continuous guidance in ensuring that the investment contract and the instrument structure are in compliance with the Shariah at all times; and

2. The core activities of the investee companies must be Shariah compliant. Effectively, this means that the underlying assets and investments of the fund must be permissible.

Non permitted Shariah activities include:
(i) financial services based on interest (riba);
(ii) gaming/gambling (maysir);
(iv) manufacture or sale of non-halal products or related products;
(v) entertainment activities that are non-permissible according to Shariah;
(vi) manufacture of sale of tobacco based products or related products;
(vii) stockbroking or share trading in Shariah non-compliant securities; and
(viii) hotels and resorts with non-Shariah compliant activities.

Best practices
There are some best practices which are highly encouraged to be adopted by Islamic PE/VC fund companies, inter alia:

1. The Shariah advisor shall act with due care, skill and diligence:
   (a) to ensure that all aspects of the Islamic venture capital such as portfolio management, trade practices and operational matters comply with Shariah;
   (b) to provide Shariah expertise and guidance on matters relating to documentation, structuring and investment principles;
   (c) to review and scrutinize compliance report prepared by Shariah compliance officer or any investment transaction report; and
   (d) to provide a written opinion and periodic report.

2. Annual written disclosure and declaration
The Shariah advisor is expected, on an annual basis, to disclose and declare to the board of directors of the Islamic PE/VC fund company that the Islamic PE/VC fund company is managed according to Shariah principles.

3. Portfolio management
The Shariah advisor is also expected to endorse any investment decision and to ensure that the activities of the investee companies remain Shariah compliant right to the point of full divestment.

Source: Guidelines and best practices on Islamic venture capital issued by the Securities Commission of Malaysia.
Specific considerations in Islamic VC/PE fund companies

1. Structure
The documentation, financing and investment structure must be Shariah compliant in that:
(a) funds belonging to the Islamic PE/VC fund company must be invested in a structure which is Shariah compliant. Activities of the Islamic PE/VC fund company are based on tangible assets and are not speculative in nature (gharar).
(b) the constitution of the Islamic PE/VC fund company stipulates a prohibition on non-Shariah compliant activities.
(c) the activities of the directors and officers of the Islamic PE/VC fund company must be acceptable in nature and that their activities are conducted in a Shariah compliant manner.

2. Underlying Assets
The underlying assets and investments of the fund must be Shariah compliant. The Islamic PE/VC fund company funds must not invest in non-Shariah compliant counters or securities. The assets must also be of good quality and the risk and reward associated with such investment have been fully appraised.

3. Islamic VC/PE fund documentation
Legal documentation for the setting up of an Islamic PE/VC fund company and fund management company shall take into account the earlier points, inter alia, the appointment and powers of the Shariah advisor, the provision stipulating that the fund be invested in line with criteria as specified by the Shariah advisor, the provision specifying that the fund can only enter into transactions which are in compliance with Shariah principles and the provision for continuous audit to determine whether the assets are Shariah compliant.

4. Profits of fund
There must be an express provision and understanding between the parties involved that any profit of the Islamic PE/VC fund company shall be based on returns from investment of the fund, with no guaranteed profit return and there should also be a provision for reinvestment of profits into the Islamic PE/VC fund company.

Challenges faced by Islamic PE and VC
As the market and market players are more familiar with the banking industry, plus the fact that typical Islamic financing transactions lead to the creation of indebtedness (for instance sale and purchase, sale and lease back) compared to Islamic PE/VC the basis is profit and loss sharing and the sharing of risks, emphasis has been given towards the banking industry.

Until the market and market players are familiar with and are willing to venture into risk sharing, Islamic PE/VC will only be applicable to certain target groups like start up companies.

The establishment of legal and regulatory framework, or the appropriate guidelines to regulate the Islamic PE/VC industry are equally important to enable the industry to gain momentum in a particular jurisdiction and lend certainty on issues arising out of Musharakah, Mudarabah or Wakalah contracts.

The governments also need to play their role in supporting and backing the Islamic PE/VC industry in terms of incentives, tax exemptions, and such, to enable the industry to make way into the mainstream economy.

The creation of appropriate business structure or investment structure to make the Islamic PE/VC products better understood and accepted by market players is another important criterion to enable the rapid growth of the industry.

Shortage of well trained and high caliber individuals, advisors and management teams with expertise in investment strategies, legal documentation and who at the same time understand and appreciate the Shariah requirements are also real challenges to the Islamic PE/VC industry.

Another challenge worth noting is for market players in the Islamic PE/VC industry to innovate and develop new investment structures given the changing investment climate and circumstances without compromising the requirement of the Shariah.

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