ISLAMIC FINANCE: AN IDEAL MODEL FOR PRIVATE EQUITY AND VENTURE CAPITAL

As the Islamic financial industry continues to evolve and experience growth, it is also gaining sophistication in its appeal to demanding investors. As a prime example, Shariah-compliant Private Equity/Venture Capital (PE/VC) is an ideal model for Islamic finance as it represents the participatory modes of financing imbued with risk sharing concept. There is a very close relationship between conventional and Islamic PE/VC, in the sense that both offer a risk sharing concept rather than risk transfer. The equity-based structure and profit sharing nature, making it an ideal match for the Shariah-seeking investors.

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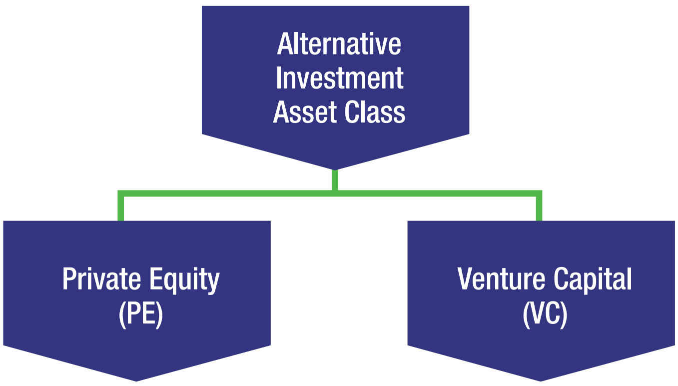
Islamic Private Equity and Venture Capital at a glance

As the Islamic financial industry continues to experience exponential growth, similar sentiment is also shared for the Shariah compliant investment asset class. This is particularly true as the market continues to evolve towards maturity and complexity alongside more sophisticated and demanding investors. For the year 2014, the global alternative investment asset class accounted for USD7 tln[1], whilst the Shariah compliant investment asset class managed by the top 50 fund firms was valued at USD8.5 bln, recording an increase of 43% from the previous year.[2]

Private Equity (PE) and Venture Capital (VC) have demonstrated the largest segment of alternative investment asset class. For the year 2014, it recorded a 12% increase as compared to the previous year, at a value of USD3.8 tln.[3] In term of capital raised, both PE and VC have managed to accumulate a total capital of USD495 bln in 2014 where the bulk of it (85%) was centralized in North America and Europe.[4] It is predicted that the PE/VC sector was on the verge of a new investment cycle, as investors' confidence were boosted on the back of improved global equity market performance.[5] This significant growth will positively affect the future of Shariah-compliant PE and VC.

Shariah-compliant PE/VC is an ideal model for Islamic finance as it represents the participatory modes of financing imbued with risk sharing concept. The risk sharing mechanism reflects the concept of fairness and justice in business dealing where the notion of profit and loss sharing is reflected in its ideal form.

Private Equity and Venture Capital: An Understanding



Source: ISRA

1 Preqin, The Global Alternative Report 2015
2 IFN, 2015
3 IFN, 2015
4 IFN, 2015
5 MENA Private Equity Survey by Deloitte, October 2013

PE refers to a medium to long term investment in a potentially-high growth unlisted companies by way of acquiring majority stakes with the expectation of profit maximization.[6] The very important feature in PE is that it represents the equity-based structure and profit sharing nature, making it an ideal match for the Shariah-seeking investors. There is no capital guarantee provided by PE companies, therefore the investors are exposed to financial loss of their capital. VC is a sub set of PE, usually involved in the start-up stage of the life cycle of venture. PE on the other hand involves in the investment activities in a more matured stage. This is particularly true in the case of US. However, the terms PE and VC in the case of Europe are synonymous and frequently used interchangeably.[7]

Conceptually, there is a very close relationship between conventional and Islamic PE/VC in the sense that both offer risk sharing concept rather than risk transfer. It forms an ideal concept of Islamic finance in which the concept of mutual benefit, equity and equality, and fairness in financial dealing are manifested. It provides the investors with the portfolio diversification, high performance, superior risk adjusted return and diverse investment opportunities. The common structure used for Shariah compliant PE/VC is musharakah, mudharabah and wakalah.

Islamic PE/VC: Regional Hotspots

In key Islamic finance jurisdictions such as Malaysia, Indonesia, MENA and the GCC region, the growth for Shariah compliant PE/VC is encouraging. In Malaysia, the robust Islamic finance infrastructure facilitates the growth of Shariah-compliant PE/VC in the country. The Malaysian Venture Capital Association (MVCA) was established in 1995 to promote the venture capital industry. Malaysian Exchange of Securities Dealing Automated Quotation (MESDAQ) was also launched in 1997 as the platform for ICT companies to raise equity capital and for exit investment mechanism.[8] In 2008, Malaysia introduced Guidelines and Best Practices on Islamic Venture Capital which underlies the core requirements for establishing Islamic venture capital cooperation.[9] In addition to that, dedicated Shariah advisers that are appointed in the respective Islamic PE and VC companies has to ensure the beginning-to-end Shariah-compliant of the whole business operations. A number of tax incentives have also been granted by the Malaysian regulators to promote the development of overall PE/VC. For example, a five year tax exemption is provided to VC companies that invest at least 30% of their funds in start-up, early stage financing or seed capital.[10] The special purpose vehicle (SPV) which is established for Islamic financing is also exempted from income tax.[11]

Chronological Development of Venture Capital and Private Equity in Malaysia

YEAR	DEVELOPMENT
1984	The establishment of Malaysian Venture Capital Berhad as the first venture capital in Malaysia
1992	The Malaysian Technology Development Corporation (MTDC) was set up in March 1992 to channel venture/risky capital to SMEs and in high tech sector in Malaysia
1995	The Malaysian Venture Capital Association (MVCA) was established
1997	Malaysian Exchange of Securities Dealing Automated Quotation (MESDAQ) was launched

6 ISRA & SC, 2015
7 ISRA & SC, 2015
8 SC, 1997
9 SC, 2008
10 The 2009 Budget Bill
11 The 2007 Budget Bill

2008	First Islamic Venture Capital was established by Malaysia Venture Capital Management (MAVCAP) based on the concept of musharakah worth total RM35 mln (USD8.28 mln) The introduction of Guidelines and Best Practices on Islamic Venture Capital
2009	A five year tax exemption for VC companies was granted under Budget Bill 2009
2012	A total number of 59 venture capital funds/companies, including Shariah compliant VC, have been registered under MVCA
2015	Guidelines on the Registration of PE/VC corporation and management corporation was introduced on 9 March 2015 RHB Islamic Bank signed a collaboration agreement with VC solution providers Malaysian Technology Development Corporation. The bank acts as the custodian of RM150 mln (USD40.37 mln) fund entrusted by the government via Unit Peneraju Agenda Bumiputera. The government expected to raise at least RM300 mln (USD80.74 mln) Inspire, a Japanese investment company, established an Islamic PE fund with the Permodalan Nasional, a Malaysian sovereign wealth fund, jointly with Japanese regional banks

Source: Adopted from various sources

Moving to Indonesia, Pertamina's Pension Fund and IDB have jointly agreed to establish Islamic joint venture PE firm which aims to support the funding of various infrastructures and other projects in Indonesia.[12] The IDB has committed to a total paid-up capital worth around USD100 to USD200 mln in the first year with the contribution from two other investors from the United Arab Emirates and Bahrain.[13]

Elsewhere in the MENA region, Shariah compliant PE/VC has also witnessed an encouraging sign. In 2012, the MENA Private Equity Association was launched at the Dubai Financial Centre (DFC). The association serves as a platform to promote more investments in the areas of PE/VC within the region. The association comprised of 25 members who include the largest PE/VC fund managers in the MENA region and in total manage over USD18 bln in assets.[14] In North Africa and Sub-Saharan, in particular, there are more than 20 PE companies available in 2014.[15] In 2014, the region saw a 13% y-o-y rise in mergers and acquisitions to USD50.7 bln.[16] In the GCC region, the improved confidence in the GCC economy has also led to a surge in private equity and sovereign wealth fund investments. Out of the total 442 deals, private equity investors comprised of 66 deals altogether, valued at USD4 bln.[17] In addition, the Saudi Arabia's biggest brokerage house, Aljazira Capital is also exploring the PE arena as its investment strategy so as to further diversify its income stream.[18]

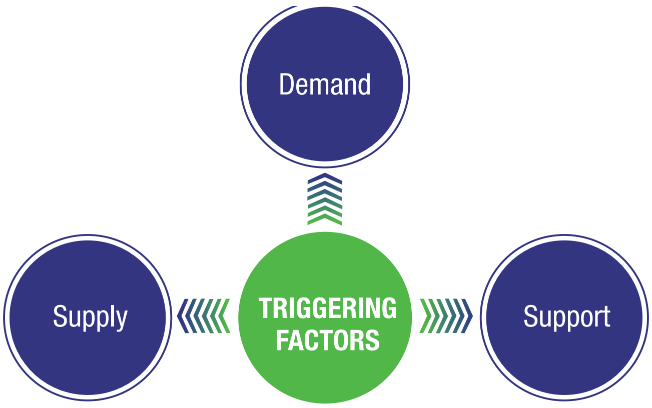
In non-key Islamic finance jurisdictions such as Europe and US, these continents are also showing interest towards Islamic PE/VC. In Europe, Luxembourg is an emerging platform for Islamic PE. Historically, PE was established in Luxembourg in 1980s with the structure of participating companies. A survey conducted by the European Private Equity and Venture Capital (2006) ranked Luxembourg as the second most favourable jurisdiction in Europe for the development of the PE industry.[19] Moving to the United States, Guidance Financial Group, an international Islamic financial services company in US structured Asia's first Islamic buyout fund. In September 2003, it announced the successful closing of ASIA's first Islamic PE fund where it also served as a Shariah advisor to the fund.[20]

[12] IFN, 2015
[13] The Jakarta Post, 6 April 2015
[14] IFN, 2014
[15] PWC, 2014
[16] IFN, 2014
[17] IFN, Volume 11 Issue 9, 2014
[18] IFN, 2015
[19] PWC, 2011
[20] GVCA and KPMG, 2008

Islamic PE/VC: Way Forward

In general, the future of Islamic PE/VC across jurisdictions is determined by a number of triggering factors, namely demand, supply, and support:

Triggering Factors for the Future of Shariah Compliant PE/VC



Adapted from Seera Investment Bank, 2008, ISRA, 2015

1. Demand

There is a growing interest and awareness towards Shariah-compliant alternative investment asset class across jurisdictions both from Muslim investors and non-Muslim investors. The encouraging growth of the global Muslim population is undeniably a positive indicator for the future of Islamic PE/VC. There are rising facts in the behavioural literature that faith and ethnicity may influence financial literacy and financial decisions.[21] In 2009, the global Muslim population was approximately 21% of the global population, making them the second largest religious segment in the world. What's more, their numbers are growing at a rapid pace. The size of the Muslim middle class continues to expand, which represents a relatively untapped market for Shariah-compliant PE/VC. It is projected that the number of Muslims in the world will double from 1.1 bln in 1990 to 2.2 bln in 2030.[22]

2. Supply

The conventional PE/VC has seen remarkable growth in size globally over the years. This will positively affect the future of Islamic PE/VC given the very close relationship in nature between Islamic PE/VC and its conventional counterpart. In addition, the South Asian region potentially offers a significant number of untapped market areas for Islamic PE/VC. The area for Islamic PE/VC include food and water security, healthcare, energy, mining, utilities, chemical sector and information technology.[23] In 2014, the sector demonstrated the successful funding of the largest PE fund since 2011, namely Gulf Capital of Abu Dhabi which closed its largest fund together with GE Equity Partners Fund III worth total of USD750mln. Although this is not a dedicated Islamic PE company, the closing is a positive sign for the development of Islamic PE/VC in the region.[24] In addition to that, there are encouraging signs for Islamic VC to grow with the rise of crowd equity funding which is substantially compatible with Islamic value preposition of building and supporting local communities.[25]

[21] Gerrans et al. 2009 and Khan 2010
[22] Pew Forum on the Religion and Public Life, The Future of the Muslim Global Population (2011)
[23] IFN, 2015
[24] IFN, 2015
[25] IFN, 2015

3. Support

There is an increasing government awareness to support the development of Islamic finance in general and PE/VC in particular across the jurisdictions via strong regulatory backing to create the level playing field for the sector to grow. Malaysia for example provides some tax incentives for the establishment of PE/VC. The country also provides the specific guideline and framework for establishing Islamic venture capital cooperation via the introduction of Guidelines and Best Practices on Islamic Venture Capital in 2008. On the other hand, Luxembourg also provides various tax incentives for PE industry and offers continued innovation for setting up of the PE fund, such as risk capital investment companies (SICAR - société d'investissement à capital risque) and specialized investment funds (SIFs).

Even though both the Islamic PE and the conventional PE are a lot closer in features than most other asset classes, the future of Islamic PE and VC is promising given the natural progression and evolution of the Islamic financial industry. While the early stage of Islamic finance was dominated by deposit and saving products, the Islamic finance products and services over the last decade have evolved to become more sophisticated in structures, comprising a wide variety of sukuk models, derivative products, Islamic structured products, Islamic exchange traded funds (i-ETF), and Islamic PE/VC. It is clear that there is a need for diversified Shariah-compliant products and investment asset classes with various features and instruments. Moreover following the several years of capital constraint and investors' conservative attitude due to the recent financial crisis, the PE sector has also in the last year seen a new boom. Finally, along with the need to have exposure to this type of asset class in Islamic finance, it is perhaps an opportune momentum for Islamic PE/VC to flourish as it actually represents the ideal model of Islamic finance.