



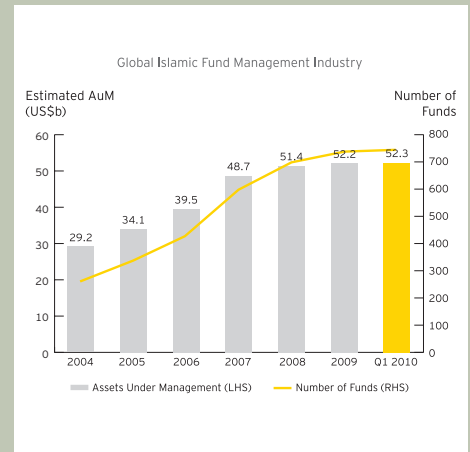
Farabi Zakaria
 Senior Manager
 Ernst & Young, Luxembourg
 farabi.zakaria@lu.ey.com
 Tel.: 00 352 42 124 8919

Zeeshan Ahmed
 Senior Manager
 Ernst & Young, Luxembourg
 zeeshan.ahmed@lu.ey.com
 Tel.: 00 352 42 124 8091

www.ey.com/Luxembourg

Islamic Private Equity – an emerging asset class for alternative investments

Many economic indicators such as government initiatives to attract Islamic investments, increasing demands for Islamic banks and insurance companies and structuring of Sharia compliant investment products, indicate that Islamic finance has reached a critical mass and changed from a “niche market” to a main component in the field of finance. The increased focus on Islamic finance during the current crisis is also due to the realisation that it is not exposed, due to binding principles of Sharia, to leverage and unnecessary uncertainty and due to the fact that most Islamic transactions are backed by tangible economic businesses / assets. According to the 2010 Ernst & Young Islamic Funds and Investment Report global Islamic Fund assets are approximately, USD 52 billion in 2009.



This awareness has given opportunity and encouragement to this emerging sector to expand from its existing network in the Middle East and North Africa (‘MENA’) and South East Asia. It has also resulted in more focus on investment products in the domain of asset management such as Sharia compliant private equity. Thus, an investment thesis, combining typical private equity parameters and Sharia requirements, has resulted in an emerging asset class for alternative investments. Both Muslims and non-Muslims are choosing these products either because they are in conformity with the principles enacted by Sharia or simply because they represent an alternative to other investments.

Basic principles:

The Sharia principles which govern Islamic finance are derived from a number of sources, the Quran, the Sunnah or Hadiths (examples and sayings of the Prophet Muhammad), Qiyas (analytical comparisons), Ijtihad (reasoning and logic applied by Islamic Scholars) and Ijmaa (consensus on issues requiring ijtehad).

The practical implications of Sharia can be summarized in the following general principles, the majority of which are based largely on simple morality and common sense which forms the basis of many of the world’s religions, including Islam. In short, they are;

- i) The prohibition of investments which are not consistent with the tenets of Islam such as alcohol, gambling and leisure related activities.
- ii) The prohibition of riba from economic transactions. Riba means excess compensation without due consideration.
- iii) The removal of uncertainties from contracts.
- iv) The mandate of justice in all economic activities, which should never lead to the exploitation of any party to the transaction.

Private Equity (‘PE’) is a natural fit:

Meeting the requirements of investors while ensuring Sharia compliance and remaining competitive with conventional fund offerings has been a significant and continuing challenge for Islamic fund managers. PE, however, (with some limitations) fits naturally to Sharia compliant investing due to its inherent profit and risk sharing aspects. Through PE, investors may participate in, and benefit from, the

value creation process of target companies as partners rather than as creditors. The use of the private equity model within a properly structured partnership is a true manifestation of Sharia business principles. Key parameters of the conventional PE model are comparable to Islamic finance concepts, as explained in the table below:

PE concepts	Islamic finance concepts	Natural fit
Value creation of target investment	Earnings and capital appreciation linked to economic activities	●
Risk and diversification of investments	Profit and loss sharing based on real business / asset risk	●
Equity investments	Permitted equity investments within Sharia parameters	●
Partnership - shares risk and rewards	Mudaraba / Musharaka - shares risk and rewards	●
Alignment of interest	Alignment of interest	●
Long term value	Long term value	●
All industries	Sharia compliant industries	●
All mode of financing	Permitted financing within Sharia parameters	●

The four main Sharia principles that are used to structure Islamic Finance are the Mudaraba, Musharakah, Murabaha and Ijarah. Among the four, the Mudaraba and Musharakah are widely used to structure Islamic PE. Mudaraba means the surrender of capital by investors to an entrepreneur (a Mudarib), for investment in a commercial enterprise. Significantly, the profit for the Mudaraba contract is agreed at the inception of the contract and the losses are only borne by the investors. In this context, the Mudaraba is similar to a conventional PE whereby the Mudarib is the General Partner ('GP') and the investors are Limited Partners ('LP'). On the other hand, Musharakah is a joint enterprise in which each partner (or parties) share both, the profit and loss. In this context, Musharakah provides an excellent alternative to the traditional interest based economy.

Challenge for managers and administrators:

Managers and administrators in a Sharia compliant environment are challenged to increase efficiency through standardized internal processes in line with leading private equity practices and, in parallel, to deliver highly customized services in conformity with the specific requirements of Sharia laws and regulations. The balance between the two can only be achieved through a well trained and competent back office team with sufficient knowledge and experience in Sharia compliant private equity structures. The fundamental duty of managers and administrators is to ensure Sharia compliance both in the design of their product (commercial design) and in the conduct of their business (industry and financial screening of target investing entities). On the other hand, managers and administrators are also responsible for governance, risk

management, accounting, investor reporting and NAV calculation in accordance with guidelines of The Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI). AAOIFI is the autonomous self-regulated body responsible for the formulation and issuance of accounting, auditing, ethical governance and Sharia standards for Islamic financial institutions. These expectations require a robust operating platform where managers, administrators and Sharia boards can work together in order to meet the needs of investors.

Governance structure:

To be Sharia compliant, an Islamic PE must appoint a Sharia Board that consists of at least three Sharia scholars. The principal role of Sharia Board is to oversee the entire business of the fund regarding the fund's compliance with Sharia principles. This is not only legally required, but also in the best interest for both the GP and LP to avoid any discussion on individual interpretation on Sharia law.

The Sharia Board is normally provided from the outset of the fund and advise the GP with regard to Sharia principles affecting the fund business and mainly on the investments made by the fund. The Board issues guidelines on investments with regard to the industry sector, eligible acquisition finance structures (which include certain ratio of permitted debt financing), permitted financial ratios of eligible target companies as well as any other compliance issues that affect the management of the investors' funds. In general, investments proposed by fund managers or GP require the approval of the Board. The Sharia Board is required to issue annually a Sharia certificate that confirms the fund's activities are compliant with Sharia principles.

What Luxembourg can offer?

One of the most pressing issues that fund managers face when routing their international investment is the domiciliation of the fund. Domicile that provides low or zero taxation will always be the main criteria that fund managers will choose.

Luxembourg's role as the leading European centre for PE was first established in the late 1980s with the introduction of the financial participation companies or Soparfis. The Soparfi offers PE fund managers suitable intermediary vehicles for cross border acquisition. PE fund managers from Europe, America and Asia use the Soparfi for tax optimisation due to numerous double tax treaties concluded by Luxembourg. As of January 2011, Luxembourg has concluded more than 60 treaties. The establishment of the risk capital investment company (the 'SICAR') in 2004, as a lightly regulated vehicle designed specifically to attract PE buyout and venture capital business, has given a major boost to the Luxembourg PE industry. A SICAR is subject to the normal Corporate Income Tax rate of 28.80%. However, income generated from investments is exempt from tax.

In February 2007, the Specialised Investment Fund (the 'SIF') vehicle was introduced to further attract alternative investment to Luxembourg. As with the SICAR, the SIF is aimed at alternative investment products with a light regulatory regime, exercised, by the Luxembourg Financial Sector Supervisory Authority (CSSF). 244 SICARs and 1,196 SIFs are currently registered with the CSSF demonstrating the success of these vehicles which have been chosen by many of the top PE houses, as well by other smaller PE players. Islamic PE can be set up using any of the above mentioned vehicles.

Apart from being a leading European centre for PE, Islamic Finance also has been one of the driving forces of the development of the financial services industry. As early in 1983, Luxembourg became the first non-Muslim country to domicile a Sharia compliant insurance company (Takaful). The Luxembourg Stock Exchange

('LuxSE') plays a leading role in the Sukuk market with the first entrance in 2002. Currently, there are approximately 15 Sukuks admitted and traded on the LuxSE. Other recent initiatives, such as in 2010, tax circulars clarifying the use of Islamic financing instrument prove the growing interest of Luxembourg for Islamic finance.

- 1978 Luxembourg became the first country in Europe to organize the seminar on Islamic Banking System.
- 1980 Luxembourg became the first non-Muslim country to domicile the first Shariah Compliant Insurance Company in Europe.
- 2007 The Luxembourg Stock Exchange (« LuxSE ») became the first stock exchange in Europe to enter the Sukuk Market. In 2009, the LuxSE admitted to trading a Sukuk issued from Petronas, the state-owned oil and gas company of Malaysia.
- 2008 The Government of Luxembourg set up a Task Force, charged with identifying obstacles to the development of Islamic Finance and ways to support its growth. Working groups were subsequently set up by the Association of Luxembourg Fund Industry (« ALFI ») and by Luxembourg For Finance (« LFF »), the agency for development for financial centre.
- 2009 The Luxembourg Central Bank is the first European Central Bank to be accepted as an Associate Member of the Islamic Financial Service Board (« IFSB »).
- 2010 As of January 2010, the Luxembourg tax authority issued a circular that clarifies the tax treatment of various Islamic financing arrangement and issues. The circular deals with the tax treatment of Murabaha and Sukuk but also describe other instruments such as the Musyarakah, Mudaraba, Ijarah and Istisna.