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Abstract

There is no doubt that the equity market plays a central role in the growth and the sustainability of an economy. Equity and capital markets allow companies to access increased levels of accessibility to capital. Besides the traditional models to access for corporate finance, new opportunities have appeared which offer interesting alternatives. The accumulated wealth from the Islamic community became accessible through new vehicles, built on the Islamic Shariah laws in as far as money and banking is concerned. The Islamic concepts of money and banking, emphasise the relationship between profit and risk as well as responsibilities of institutions and individuals.

Many of the guiding principles of corporate finance and banking would not be pegged on religious provisions and doctrines. The Western, conventional economic system holds opposing views to Islamic economics and a key question arises, could principles of Islamic finance feed into a Western economic system and be maintained on a sustainable basis?

Proponents and supporters of a Shariah compliant economic system argue that religion is meant to affect every other aspect of life and so would be the economic principles one stands for. As such, remaining committed and observing Islamic law in business and economic activities would be inevitable for all those who take pride in prophesying the Islamic faith. More recently, regulators in South Africa have taken a number of steps to promote Islamic finance in South Africa. The country has one of the more efficient and advanced financial systems, legal and tax frameworks as well as governance structures and regulations on the
continent. This gives South Africa a competitive edge and first mover advantage over other African countries in promoting and advancing the Islamic finance industry.

The main goal of this mini thesis is the study of what constitutes an Islamic Shariah compliant Private Equity Fund (IPEF). At a secondary and more basic level its viability is considered within a South African context. It also examines the key challenges and potential solutions for such a fund to exist in an economy based largely on Western principles, particularly with reference to the legal frameworks, interest treatment, taxation laws, regulatory and supervisory bodies as well as basic conceptual understandings. Of great attention to the researcher would be the differences between the conventional economic principles that guide equity and finance in South Africa and how Shariah compliance has affected the trade instruments. The author of this thesis has vast experience in the area of Private Equity and Islamic finance as it pertains to this field. In this work, the author builds on his own experience and critically reflects it against the dominant literature in the field. This work does not focus on the risk/return profile or provide any consideration as to the likely performance of such Islamic Private Equity Funds.

The work performed focused on each of the key stages within the conventional lifecycle of a private equity fund, beginning with the establishment of a fund, the management of a fund, key contractual and partnership agreements, screening, evaluation and due diligence of investments, ongoing monitoring and supervision, reporting and exits. The study then notes and identifies what changes or additional elements are required at each stage in order to adhere to Shariah compliance.
The study has identified the key gaps between a traditional private equity fund and one that conforms to the principles of Islamic finance. It further shows that the establishment of an Islamic Private Equity Fund can be achieved in South Africa but that further development of key regulatory structures may be required to make the integration more successful.

Introduction

Partnerships and profit sharing contractual arrangements conforming and adhering to the principles of Islam were commonly used to finance permissible and productive activities even prior to the teachings of the Prophet Muhammad (Iqbal & Molyneux, 2005). However, the Islamic finance system as we know it today only started to grow exponentially from around the 1980’s. The starting point of the first recognised and acknowledged financial company based on Shariah principles was the MitGhamr savings project set up in 1963 in Egypt. A number of scholars do however suggest that interest free commercial transactions existed in various parts of the Muslim world before then. To cater for a largely under banked Muslim population, financial services based on Shariah were set up in Malaysia during 1971 (Schoon, 2008). The earliest services offered were savings plans for the pilgrimage to Mecca while in 1975, the Islamic Development Bank (IDB) was established in Jeddah to raise funds for investment in projects and around the same time the Dubai Islamic Bank was founded in the United Arab Emirates, which was the first privately established Islamic bank.

Since then, the demand for Islamic financial products and services continued to rise and the awareness together with governments and their progressive policies that were supportive of these demands, saw the establishment of sophisticated financial institutions not just in the
Arab World and Southeast Asia, but also in the West. Amongst the factors driving the growth is the strong demand from Muslims in these countries, both immigrant and non-immigrant, the significant wealth created by oil revenues and the competitiveness and relative attractiveness of the Islamic financial products that have attracted many individual investors, Muslim and non-Muslim, as well as Sovereign Funds and businesses. A further contributing factor is the need for more ethical based products and risk sharing in light of the recent global financial crisis.

Currently there are about 1.6 billion Muslims, or 23% of the world’s population, making Islam the second largest religion in the world. Notwithstanding the rapid growth in Islamic finance and related products, it is estimated that less than 1% of global financial assets are Shariah compliant. The size of the Shariah compliant banking assets with commercial banks globally varies between US$1.3 trillion to US$1.7 trillion. An EY MENA region analysis estimates this value at US$1.5 trillion in 2012 and expects it to reach US$1.7 trillion in 2013. Standard and Poors and Kuwait Finance House Research (KFH) estimate for 2013 is at US$1.4 trillion “upwards” and according to both PWC and the Islamic Financial Services Report 2013, there estimate as at 2012 is US$1.3 trillion citing sources such as Deutsche, The

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4. EY World Islamic Banking Competitiveness Report 2013–14
Banker, Bloomberg and Central banks amongst others. Islamic Funds under management grew from US$29.2billion in 2004 to US$ 73.7billion by December 2013 and the number of funds has also increased from 645 in 2008 to 1053 in December 2013\(^5\). Even at the lower end of the estimated size of Shariah compliant assets, it is becoming apparent that Islamic investors, not just in the Gulf region but elsewhere in the world, are looking to alternative investments, as risk appetite increases and commensurate returns are sought.

The basic fundamentals underlying Islamic finance are about investing in the real economy with strict adherence with the tenets of Shariah (Islamic Law derived from the Holy Qur’an, the Sunnah or practice and behaviour of the Prophet Muhammad (PBUH), and independent interpretation of legal sources). Since the advent of Islam over 1400 years ago, it can be accepted that the underlying financial principles of an Islamic finance and economic system have remained unchanged. Islamic finance encourages the sharing of risks and rewards and Shariah compliant products and transactions adheres to a number of key and widely accepted principles that include; no investments or provision of finance for undertakings that are incompatible with Shariah law (haram), such as alcohol, gambling, traditional financial services, tobacco; the backing by a tangible asset, usufruct or services, so as to avoid speculation (gharar); exclusion of interest payments (riba); risk sharing amongst investors and limitations on sale of financial assets. These principles of Islamic finance have been


The necessity of this thesis is brought about by the major difference between the overall perception of business from a conventional approach to equity and that which is defined by the Quran and other sources of Shariah law. In Islam, investments are not just about the returns achieved, the objective of finance is to grow an economy by taking risk and building businesses based on real transactions and physical assets. The eradication of poverty, adequate distribution of income and socio economic justice are some of the primary goals of Islam and should be basic features of an Islamic economic system (Chapra, Towards a Just Monetary System, The Islamic Foundation, 1985). Further, the accumulation of wealth is allowed in Islam as long as the sources of wealth do no breach Islamic principles and extravagance and squandering is avoided (Shanmugam & Zaharin, 2009).

Private equity (PE) therefore in most respects appears to make for a good ethical fit. Private Equity and Venture Capital (VC) tenets are largely based on building and growing businesses in order to realise and maximise value. PE is often defined as partnerships specialising in VC and growth, LBO, mezzanine, distressed debt and other investments and typically the VC or LBO aspects represent the nucleus (Lerner, Hardymon, & Leamon, 2009). Growing businesses enables the growth in employment which in turn helps economies to expand.

Much has been said and documented about Islamic finance as a means of transforming the global economy and replacing what some perceive to be a flawed conventional system. Islamic financial systems, which emphasis is on the promoting of shared risks and rewards in
lending through Shariah approved partnerships, is still considered as being less efficient than conventional systems that put no limitations on debt. It has however been suggested that conventional banking can learn from the alternative systems offered by Islamic finance (Rogoff, 2011), but little has actually occurred to suggest that it has the ability to do so in any meaningful or competitive way. Islamic private equity could be one of the few asset classes that truly have the potential to do so and could play a role in nurturing and supporting the core of the global economy and providing further opportunity to invest in markets that facilitate such Shariah compliance.

The first part of this study provides an overview and the history of private equity, considers different definitions and also discusses some of dynamics of private equity in South Africa. Using the literature, a further overview is provided of the relevant building blocks of the private equity model, how private equity works, capital structures, management incentives and the different transaction characteristics over time.

The second part of the study provides an understanding of what is Islamic law, evolution of Islamic finance, the prohibitions within Islamic law, the challenges and objectives. We further study the key concepts of Shariah finance and the different contracts permitted and understand what are the key drivers of growth. This was achieved through a detailed study of academic literature and a review of books and journals as well as web based direct research on companies offering Islamic finance products and services, identified by the author.

The remaining three sections contemplate the creation of an Islamic Private Equity Fund and begins with a brief study of the South African landscape, the legal framework and challenges
that arise in conforming with Islamic law. This is achieved through a review of literature, legal concepts, authors own knowledge of private equity and a study of established industry bodies and authorities such as the Malaysian Securities Commission. Certain basic concepts of legal establishment and partnerships are discussed and parallels drawn between what is required from a Shariah perspective and the existing laws and frameworks. From section four onwards, the author uses his private equity experience, knowledge and understanding and critically reflects it when assessing the academic literature, both Islamic and conventional, as it relates to specific stages of the private equity cycle. The author notes the requirements from a Shariah perspective at each of the stages in private equity and offers, based on his experience, practical considerations for addressing and implementing these requirements. Section five ends with further practical considerations relating to insurance, legal advice and exits in private equity. The conclusion and findings are presented at the end.

Section One

This section provides a background to private equity, its history, components of private equity funds, related structures and the general evidence of the characteristics of the industry and its recent evolution.

1. What is Private Equity

According to the European Venture Capital Association\(^6\), Private equity refers to shareholder capital invested in private companies. This is distinct from publicly listed companies. Private equity funds are investment vehicles that invest primarily in companies which are not listed

on a public stock exchange. This type of private investment can be classified into two categories:

- venture capital: an investment to create a new company, or expand a smaller company that has undeveloped or developing revenues; and
- buyout: an acquisition or build-up of a significant position in a more mature company. A private equity firm’s acquisition or build-up of position in an investee company usually entails a change of control, with appointees of the firm sitting on the board or taking over certain key functions of the company. Leveraged buyout (LBO) refers to a buy out where a material portion of the investment is made using bank debt or borrowed money.

EVCA also suggests that “PE provides equity capital to enterprises not quoted on a stock market. PE can be used to develop new products and technologies, also called venture capital, to expand working capital, to make acquisitions, or to strengthen a company’s balance sheet. It can also resolve ownership and management issues. A succession in family owned companies, or the buy-out and buy-in of a business by experienced managers may be achieved by using PE funding”

Others observe that PE is more often associated with investments in established companies (Gompers & Lerner, 2001) and that fundamentally, Venture Capital (VC) activity is similar in many aspects (Sahlman, 1990). The terms PE and VC are typically used interchangeably, however, it is worth noting that the National Venture Capital Association of America (NVCA) disagree that VC is the same as PE. “Venture capital is not designed to maximize capital efficiency from mismanaged or undervalued public companies, nor is it designed to meet short-term liquidity needs, invest in public markets, securities or derivatives, take short
or long positions or be accessible through brokers. Venture capitalists do not encourage their companies to engage in financial engineering or use leveraged structures. Venture capital returns are achieved by building private companies from the ground up with the goal of bringing innovation to market and creating substantial economic value in technologies, businesses and industries”.

PE is also often defined as partnerships specialising in VC and growth, LBO, mezzanine, distressed debt and other investments and typically the VC or LBO aspects represent the nucleus (Lerner, Hardymon, & Leamon, 2009). Apart from just providing capital to develop and grow the business, investments by private equity funds have a number of other benefits. Private Equity funds have shown their positive impacts in terms of job creation, productivity and skills development. According to a SAVCA 2014 survey of 31 respondents, staff employed within and outside of South African owned PE businesses grew by around 40%.

Private equity fund managers play an important and an active role in managing their investments in the companies. Ultimately, the increase in value of their investments will benefit the manager from a return and monetary perspective. The same SAVCA survey noted that 70% of investee companies acknowledged better corporate governance as one of the most important contributions from their private equity partners; 64% indicated they received invaluable financial advice from their investors and 62% felt they gained insightful guidance on strategic matters. The investee companies surveyed also demonstrated rewarding growth in performance ratios such as revenue and profit.

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According to the Private Equity Growth Capital Council’s second annual public pension fund analysis, released in October 2013\(^8\), it found that private equity outperformed other asset classes over comparable periods, demonstrating the industry’s role in strengthening the retirement security for millions of Americans who rely on pension benefits. The report examined 146 U.S. public pension funds with assets greater than $1 billion, analysed the asset allocation of these funds, and compared the performance of their private equity investments to other asset classes.

2. A brief history of private equity

It was the establishment in 1946 of the American Research and Development Corporation (ARD), a publicly traded investment company that is considered to be the origins of a market for private equity investments (Fenn & Liang, 1998). However, private equity became more well known in North America during the junk bond market of the 1980s. It has been suggested that the first LBO of the 20th century was the Morgan backed acquisition of Carnegie Steel Company in 1901, forming United States Steel Corporation (Baker & Smith, 1998).

Due to various laws and Banking Acts established during the early 1900’s the LBO was seen more commonly during the second half of the 20th century. KKR, established by Henry Kravis and George Roberts who left the bank Bear Stearns, acquisition of RJR Nabisco in

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\(^8\) PEGCC Annual report 2013
1989 for US$31 billion was one of the largest LBO’s in history (Baker & Smith, 1998). The private equity sector began with less than US$1 billion in 1980 and reached a peak of more than $60 billion in 1988 (Kaplan and Stein, 1993). After a slow-down in the early 1990s, PE investments gained significant scale during the mega-buyout era between 2005 and 2007 (Kaplan & Strömberg, 2008). By 2013, PE invested over US$400 billion in over 2000 investments in the USA alone.

It has been suggested that that private equity markets are driven by liquid debt markets and the availability of cheap credit (Acharya, Franks, & Servaes, 2007). The onset of the junk bond market created a private equity wave in the 1980s (Cheffins & Armour, 2008). However, it was only after the development of the well-known syndicated debt markets of the early to mid-2000s that saw the flourishing in private equity during that period (Acharya, Franks, & Servaes, 2007). Of particular interest is the study of 153 LBOs completed in the United States and Europe between 1985 and 2007 (Axelson, Stromberg, & Weisbach, 2007) which concluded that private equity investments rise under favourable financing conditions i.e. if debt financing is cheap and readily available to private equity funds.

According to the Bain Global Private Equity report 2014, PE fund raising in 2013 was its best since the global financial crisis. In 2013, 902 PE funds attracted $461 billion in new capital worldwide, a 21% increase over 2012.

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9 PEGCC Annual report 2013

10 Global Private Equity Report 2014 | Bain & Company, Inc
3. **Overview of a Private Equity Fund**

Private equity funds are the vehicles formed to act as an intermediary between investors, the private equity fund manager and the companies that will be acquired by the manager. Private equity firms are constituted in the form of partnerships or limited liability companies (Kaplan & Strömberg, 2008). This is also the case in South Africa. The limited partnership itself is the fund vehicle that raises capital and conducts investments. There are companies such as KKR and Blackstone, amongst others, that are listed but who may still use the aforementioned partnership structures for specific funds when investing.

Private equity investments are made by these funds. These funds are usually closed end vehicles with a limited lifetime of ten to twelve years (Kaplan & Stromberg, 2009). In a closed end fund, investors cannot withdraw their funds until the fund is terminated. This is different to mutual funds that allow investors to withdraw funds at any point in time.

Private equity fund investors are made up of institutional investors such as pension funds, banks and often high net worth individuals (Fenn & Liang, 1998). These investors commit an amount of capital to the fund. The capital is then invested by the private equity fund manager during a period of typically the first five years after fund closing (which is the date on which no further commitments are accepted). Capital is then returned to the investor in the subsequent five to eight years (Kaplan & Stromberg, 2009).

Private equity managers are paid by the investors in the form of a management fee which is typically 2% of the total funds committed. The funds are committed on the basis that an agreed upon rate of return will be achieved, in principle. There is no real alignment between
the interests of the investors and the private equity manager from a financial investment perspective as the manager only invests about 1% in the partnership via a vehicle that serves as general partner (Fenn et al. 1998, Strömberg 2009). However, the fund manager is incentivised by way of carried interest. Carried interest typically consists of 20% of realised gains from investments (Kaplan & Stromberg, 2009) (Metrick & Yasuda, 2009). On average, this makes up one third of the of the average private equity fund manager’s compensation (Gilligan & Wright, 2008). The intention is that the management fee is meant to cover the costs of managing the fund and the carried interest is meant to serve as the primary source of income for the general partner. To earn this carried interest, the manager must ensure that all the initial capital that the investors (limited partners) contribute is returned along with the previously agreed upon rate of return.

A limited partnership agreement details the legal relationship between the partners, structures, fee arrangements and distributions. During the 1990s the fee structures were increasingly agreed on the basis of invested capital (Fenn & Liang, 1998). Investors have over time called for fees to be lowered with a preference to pay the manager based on actual delivery that reflects a work load that is value enhancing to an investment.

The selection process comprises all activities in which private equity firms engage to identify potential target companies. The time consuming screening and evaluation of investments often follows a structured and standardised approach (Kaplan and Strömberg 2001) in order to ensure a constant flow of high quality investment deals. Most private equity firms have a deal generation strategy that focuses on companies in a specific industry, size bracket, geographic region, stage of development and/or other characteristics depending on the
specialisations of the team members (Wright, 1998). A number of investments are made and achieved through an arranged and structured auction process that requires the submission of an indicative non-binding or binding offer by investors after initial information (information memorandum “IM”) about the company has been made available.

After an investment has been closed, private equity managers actively monitor the companies in which they have invested and often play an active and key role on their boards. The appointment of board representatives is a common one in order to ensure that the manager remains fully involved and abreast of all developments at the company and also to draw on the industry expertise, broad experience and wide networks to implement value creation plans. Typically 100 day plans are initiated immediately post the acquisition. Additional plans and strategies are adopted with the aim to increase the operational and financial performance of the portfolio companies (Kaplan & Stromberg, 2009). Finally, the exit strategy must be defined and executed in light of the timing and nature of the divestment either by way of an initial public offering (IPO), a full or partial private sale or a secondary buyout (Wright, 1998).

The universe of target companies for a private equity manager is broken down into LBO firms and venture capital firms, depending on the developmental stage of the companies in which they invest (Kaplan & Stromberg, 2009). For countries such as South Africa, such categorisation is also achievable given the mature nature of a number of companies but also due to the growing small and medium markets.
An evolving trend in private equity involves teaming up of private equity firms to invest jointly or co-invest in the same target company (Officer, 2010). This has often been the experience in South Africa during the mid-2000s when a number of de-listings occurred and local private equity funds had restrictions regarding the absolute and relative size of single investments, as well as a regional or industry focus that required additional expertise and capital to successfully manage such complex deals. In these instances, the fund that is laying out the most capital will be the lead investor, typically, although not in all cases. They will also lead the deal structuring and large parts of the due diligence process, while the input of the co-investors may vary as a function of the needs of the given investment (Fenn & Liang, 1998) (review of the top 20 deals in SA in the last decade, SAVCA website).

During 2013, global buyout deal making was up 22% in value, mainly due to two big public-to-private transactions, Dell and Heinz while the biggest PE-financed growth deal was Baring’s $1.5 billion acquisition of Giant Interactive Group, an online game developer and operator. Most deals completed in 2013 were small, early-stage investments (Bain Global PE Report 2014).

4. Private Equity in South Africa

South African companies have long invested in unlisted businesses\textsuperscript{11}. According to KPMG’s SAVCA 2000 PE Survey, “the success in terms of growth achieved by private equity funds in the United States and to a lesser extent in Europe resulted in the development of professional private equity firms in other parts of the world, including South Africa”. There is the

appreciation that private equity in South Africa has gone through tremendous changes. So far, South Africa has seen significant changes in as far as private equity is concerned as a result of increased buyouts since the 1980’s. This can also be partly attributed to the milestones made by private equity in the rest of the world. South Africa being the largest economy after Nigeria has so far been seen as the best frontiers in Africa from where private equity growth could be expanded.

The South African private equity industry is dominated by a number of independent fund managers who can point to their successful historical track records, although there are also a fair number of promising new players and fund managers affiliated with local banks and insurers. According to the latest SAVCA KPMG 2014 survey, South Africa’s private equity industry now has a total of R162.2 billion funds under management. This is a R23.4 billion (16.9%) increase from funds under management at 31 December 2012 of R138.8 billion. The industry has achieved a compound annual growth rate of 11.8% of total funds under management since 1999 when the survey began\(^\text{12}\).

According to the latest 2014 Riscura survey, South African private equity offers institutional investors the opportunity to invest in an asset class that has historically outperformed listed equity over the long term. It does, however, have a different nature from quoted equity and it is crucial that an institutional investor considers the appropriateness of private equity to its particular objectives\(^\text{13}\). Given the relatively attractive GDP growth achieved and forecast to


be achieved in a number of African countries, leading international Private equity funds such as Carlyle (US listed), KKR (US listed) and Abraaj (Middle East) have all raised large Africa funds in excess of US$600 million to capture this growth\textsuperscript{14}.

Private equity in South Africa and Africa is focused largely on growth and expansion, rather than just financial leverage and engineering, in order to unlock and realize value. The strong banking system in South Africa has played a leading role in facilitating local private equity LBO deals. There remains a continued focus on building South African businesses and capturing the dynamic economic and business growth across the continent. This growth requires capital and the appetite for financing is strong. Private equity is set to grow rapidly across Africa. Continent wide demand for capital should increase by 8 percent a year between now and 2018. South Africa will remain a magnet for funding\textsuperscript{15}.

Historically, private equity was an attractive alternative to large public companies who wanted to go private and thereby avoid the scrutiny of public investors and regulators. This trend has slowed in recent years largely as a result of increased delisting regulations as well as listed markets being at high and sometimes overvalued territory.

Based on a review of the Top 50 PE deals in South Africa using the SAVCA KPMG surveys, a trend has emerged in the South African private equity market with increasingly more activity in growth companies and less in LBO’s. This may also be due to increased legislation

\textsuperscript{14} \url{http://www.ey.com/Publication/vwLUAssets/EY_Private_equity_roundup_Africa/$FILE/PE%20roundup%20Africa%202014_FR0117.pdf}

\textsuperscript{15} \url{http://www.mckinsey.com/insights/africa/uncovering_hidden_investment_opportunities_in_africa}
around the deductibility of interest in such LBO’s which essentially reduce the returns achieved through gearing.

Private investments in private companies are generally illiquid investments. Private investors will generally only realise on their investment if there is a subsequent capitalisation, a sale or merger of the company or an IPO. The start of the new century saw the growth of a secondary market for private equity interests, including by way of securitisation. Private equity funds were created to specifically invest in private equity managers and/or buy mature assets from LP’s. The activity represented a shift in private equity: the secondary market grew from a niche sub-market in which sellers were distressed and had limited options to an active market with sufficient supply of assets and market participants.

In particular, private equity serves as an important source of funds for start-ups, private medium-size companies and public firms seeking buyout financing (Fenn & Liang, 1998). A review of the SAVCA KPMG 2014 report, the EVCA 2013 Performance benchmark study, Preqin Global PE report and the Bain Global PE 2014 report\textsuperscript{16} supports this comment. This is further evidenced from the growing capital supply that attracted new PE industry entrants, typically being specialized in early stage VC or late stage LBO financing and organized as limited partnerships as opposed to publicly traded closed-end funds (Lerner, Hardymon, & Leamon, 2009).

\textsuperscript{16} Global Private Equity Report 2014 | Bain & Company, Inc
So far, private equity has in the recent past been associated with increased economic growth and signs of an economy that would be sustained over a long period of time. As such, South Africa has been favoured as destination from where private equity can be enhanced as part of economic growth strategy. In 2013, 21.5% of PE funds raised by South African firms were from non South African sources and investment activity for independents only, as a % of GDP, was 0.13% (2012: 0.11%). This compares with the UK of 0.89% and the US of 1.02% (KPMG, SAVCA Survey 2014). With a country that reels from 25% of its population being unemployed, private equity could be a meaningful way out to reduce the pressure on demand for jobs.

Section Two

An understanding of Shariah law and the fundamental concepts of Islamic finance is required in determining what the requirements are for an establishment of a PE Fund that conforms to these laws. This section defines what Shariah law is, its applications and objectives and describes the various Islamic products and contracts permissible in Islam.

1. Islamic Law and the Shariah

Understanding how the Islamic Shariah laws apply to business would not be feasible without understanding the basic foundations of Islam and the Islamic faith. The tenets of the faith of Islam are what inform the behaviour of those practising this faith and so would it be for business and economic activities. The word Islam is a derivation from the word “salaam,” which means peace (Khir, Gupta, & Shanmugam, 2007). A Muslim is a person who believes in and follows Islam.
Shariah means literally “the Way.” Shariah is defined as the body of Islamic religious law as interpreted by Muslim jurists or Shariah scholars and forms the foundation of Islamic finance. “It is considered to be both divine and eternal because it represents the true words of Allah” (Al-Omar & Haq, 1996). Shariah is the constitutional law of Muslim Society (Rahman, 1979), aspects of which are used by some countries in their legal systems. Shariah is aimed at protecting religion, promoting life, posterity and family, the intellect, property and wealth (Abdullah, 2005). Islamic life, virtues and principles, economic and political are covered by Shariah and is meant to address not just Muslims, but humanity (Berghout, 2006). “Shariah is the entire worldview of Islam that consists of the body of Divine guidance, its structure and format and also constructs” (Abdul Rauf, 2002).

There are a number of scholars, who have studied Shariah and the provisions of the law as concerns Shariah. According to (Ramadan, 1970), there are primary and secondary sources of Shariah. The primary sources are i) the Quran (Holy Book of Islam), ii) the Sunnah or authentic traditions of Prophet Muhammad (PBUH), iii) Ijma’ (consensus of opinion of Muslim Jurists) and iv) Qyas (judgement upon juristic analogy). Whereas both primary and secondary sources to Shariah would apply in the lives and engagements of the faithful, the Quran is the sole important reference principle where dispute arises. The Quran is the elementary tool with which Shariah laws are derived. The secondary sources include i) Al-Istihsan which is the deviation on a certain issue, from the rule of a precedent to another rule for a more relevant legal reason that requires such deviation, ii) Al-Istislah, the judgement motivated by public interest to which neither the Quran nor the Sunnah explicitly refers and iii) Al-‘Urf, the custom and the usage of a particular society, both in speech and action. A
source of law in Islam is obtained through the agreement of the scholars of Islam on any religious matter (Kamali, 2000).

The principal objective of Shariah as explained in literature on Islamic finance is economic justice through equitable distribution of resources (Iqbal & Khan, 1998). The Shariah position regarding commercial transactions and contracts is that they are permissible unless there are clear restrictions against them, specifically transactions that involve riba (interest). A number of verses in the Qu’ran, Islam’s holy book, condemn riba. Riba is an Arabic word which means an increase in a loan that must be paid to the lender by the borrower, irrespective of how small or large the increase is (Siddiqi, 2004). Other Muslim scholars have interpreted riba to mean any fixed or guaranteed interest payment on cash advances or on deposits (Mahmood, 2004). It has been noted that riba contradicts the principles of risk and reward sharing which is aimed at creating balance between the lender and the borrower (Moore, 1997).

Riba is a constant issue when it comes to the discussion and consideration of Shariah law. The following has been translated from the Holy Quran and the Sunnah (Metwally, 2006);

> O Ye who believe! Fear Allah and give up what remains of your demand for usury, if Ye are indeed believers. If Ye do it not, take notice of war from Allah and His Apostle. But if Ye turn back, Ye shall have your capital sums: Deal not unjustly and Ye shall not be dealt with unjustly (2:278-279).
The Prophet has condemned both the receiver and the giver of usury. It is claimed that the prophet said: Sell not gold for gold except in equal quantity, nor sell silver for silver except in equal quantity, nor sell anything present, for that which is absent.

Whereas riba has in many times been seen as business on its own and one that promotes economic growth, it is the same principle that has been prohibited by the Sura Baqara, 2:275.3. This excerpt provides that usury should never be allowed and that anybody engaging in this behaviour “…will not stand except as stands one whom the Devil, by his touch hath driven to madness”. Such is the strong worded statement with respect to usury. According to others, riba is forbidden on the ground that it fosters the unjust acquisition of wealth at the expense of social justice, the equitable distribution of wealth and the wellbeing of the community (Choudhury, 2012).

Getting back to the secondary sources of Shariah (Ramadan, 1970), the words and submissions of the Prophet have also pointed to the prohibition of usury. The Prophet makes a submission that ‘Though usury may increase its effect indeed it turns towards decrease’. This statement has been the subject of contention in various circles with respect to motivations behind prohibition of usury. For many analysts and theologians, any move and or principle must be justified. In this case, Prophet Muhammed through this statement clearly indicates that the ethical principle of good over the bad would have its way. Islamic Shariah law therefore gives greater consideration for the overall impact of usury to the society and not to a single party alone. According to leading Islamic scholar, Allama Mahmud al-Hassan Taunki, Riba means excess or increase, and when, in a contract of barter more of one thing is demanded in exchange for exactly similar thing, it is called Riba.
From an economic perspective, this would have greater bearing given that it seeks to promote equity and ensure the society goes through sustainable growth. (Kuran, 2004) quotes the Islamic economist Afzalur Rahman as saying that interest “inculcates love for money and the desire to accumulate wealth for its own sake. Usury is, therefore though to make men selfish, miserly, narrow minded, and stonehearted”.

There are intense debates in the Muslim community about what constitutes forbidden practice and, therefore, the difficulty for practitioners of Islamic finance, lies in determining what riba actually is so that it may be avoided. Even though there are no verses in the Quran or prophetic sayings in the Sunna providing reasons for the forbidding of riba, some studies argue these may be inferred (Iqbal & Molyneux, 2005) (Siddiqi, 2004). There are also debates on the permissibility of futures, options and other derivative products. The traditionalists hold that futures involve the selling of things that one does not own (Kamali M. H., 2005). Since a central requirement of the Shariah is that one only sells what one actually owns, all futures are rendered impermissible. The focus for this paper does not consider these debates.

2. Islamic Finance: Objectives

The objective for Islamic finance providers or investors should be the provision of finance in conformance with Shariah. The key goals of such an Islamic finance system are as follows (Shanmugam & Zaharin, 2009):

- Shariah compliant financial products and services - the financial products and services must not be based on the payment or receipt of interest.
– Social and Economic development – participatory type financing based on mudarabah (profit sharing) and musyarakah (joint venture). The intention here is that investment returns to both the capital provider and the recipient and user of capital will reflect the success of such investment.

– Resource optimisation – the provision of capital must be made into investments and projects that have favourable risk return profiles. Projects are selected primarily on the basis of their anticipated profitability rather than the creditworthiness of the borrower (Al-Omar & Haq, 1996).

– Equitable distribution of resources – a key objective and principle of Islam and therefore in turn Islamic finance is to serve humanity and those less fortunate. This is achieved by promoting the equitable distribution of resources.

– Stability in money value – money is considered to be a store of wealth and as a means of exchange. Islam does not recognize money as a commodity that should be bought and sold at a profit (Ismail, 2005).

The Institute of Islamic Banking and Insurance outlines the following ten principles summarising the guidelines for an economy as enshrined in the Quran and Sunnah. This is a direct extract from their website:

1. Trusteeship

Humans are therefore accountable to God for the uses they make of these resources. The idea of trusteeship distinguishes the Islamic approach to economics from materialistic approaches
such as extreme capitalism and socialism. It introduces a moral and spiritual element into business life and has been made practicable by creating rules to govern individual behaviour and public policy.

“Believe in Allah and His Messenger and spend out of that in which He has made you successors. For those who have believed among you and spent, there will be a great reward.” (The Quran 57:7)

2. Care for Others

To attain fulfilment or happiness in life, one needs to interact with others. Individual happiness and collective interests therefore go hand in hand. It follows that Islam discourages indulgence in luxuries. The wealth and integrity of a society can only increase when there is equitable distribution of wealth to the needy.

3. Productive Effort as a Means of Serving God

Islam emphasises the duty of every individual to work for his living. Productive enterprise is looked upon as a means of serving God (2:195).

In the West, it is now considered enough merely to ‘enjoy life’, work being an unfortunate necessity. But in Islam, it is seen that working for a living gives man a sense of worthiness in his society. To support a family and contribute to others with any surplus enables one to take one's part in consultations on practical, social matters, so that all can benefit.

4. Application of the Shari'ah Rulings to Business

The aim of the Shari'ah rulings is to make the transfer of goods safe and easy and to facilitate economic transactions by eliminating vagueness or misunderstanding in all types of contracts. It prohibits the charging of interest on loans as a form of injustice. The goal is to
remove the causes of social tension or litigation and to promote a climate of peace and goodwill. Islam strongly recommends that the terms of financial agreements be put in writing.

5. Mutual Consultation

Men are free to make private economic decisions, but decisions concerning the public welfare must be based on consultation. The Qur'an describes Muslims as a people "whose rule (in all matters of common concern) is by consultation among themselves." (42:39). Mutual consultation avoids society or local communities coming under the rule of a dictator and makes sure that reasonable decisions acceptable to all are made.

6. Treating Wealth as a Means and not an End

Islam regards economic well-being as a means to peace, freedom from hunger and freedom from fear of others, except God. Beyond the satisfaction of basic needs, the ultimate objectives of earning and spending money are moral and spiritual. It is against Islamic rationality to hoard money (9:34, 35).

It follows that savings must be put to good use. One who cannot go into business himself can do so in partnership with others, or can supply funds on a profit-sharing basis. People can also borrow and lend, but it is forbidden for the lender to claim interest from the borrower as this is unjust (2:275). Islam prohibits gambling, cheating, exploitation, coercion, etc., but freedom to make financial arrangements is constrained only by these few prohibitions and by the Islamic tendency to treat money as a means to the good life.
Islam prohibits dishonesty, fraud and deception, coercive practices, gambling and usurious and injurious dealings. Hoarding, speculation and collusion among producers and traders against the interest of consumers, and such monopolies as are injurious to the socio-economic health of society are all ruled out. The basic principles regulating market operations in an Islamic state are:

a) A person should be free to buy, sell or dispose of his possessions and money within the framework of the Shari'ah.

b) There is no restriction on the percentage of profit which a trader may make. It is left to him and depends on the business environment and the nature of the goods. However, moderation, contentment and leniency must be taken into consideration.

c) The Shari'ah emphasises avoiding illicit acts detrimental to the wellbeing of society or the individual.

d) The State should not fix prices except where there are artificial factors in the market which may lead to excessive price increases or decreases or fraud. If there are such, the State should intervene to remove these factors.

7. Protection of Consumers

It is the states duty to ensure that all constituents of an economy are treated fairly and not exploited. There should be adequate rules and regulations in place to facilitate an efficient and functioning market.

8. Monopolies and Cartels
Industrialists in a free and competitive economy can form cartels and monopolies and exploit people and a firm law is needed to control them. No unjust, oppressive or cheating business can be allowed to continue in an Islamic economy.

9. Zakat or Zakah

Zakat is a levy on certain categories of wealth. It can be collected and distributed by the government and is obligatory only on Muslims. It is applicable to income and savings, agricultural harvests, commercial goods, gold and silver over certain amounts, some categories of livestock, excavated treasures, mined wealth, etc.

10. Qard Hasan

A Quranic term meaning an interest-free loan. This was introduced by the Prophet after entering Medina and was used primarily for productive economic purposes.

3. Shariah compliant contracts and methods of finance

Islamic finance operates under Islamic law constructed according to principles that are Shariah compliant. The contract is the basis of Islamic business and is a measure of a transaction’s validity. The Arabic term for contract is Aqad and refers to a contract between two parties on a specific matter, which is concluded upon after the offer by one party is accepted by the other in terms of the aqad (Billah, 2006). Applying English law or any other Western law where Islamic Shariah is not known, or even, applying some Muslim countries laws where Shariah law exist with common or civil laws exposes Islamic financial institutions not only to legal risks, but also to reputation risks. As most Muslim countries
have adopted either the common law or civil law framework, their legal systems do not have specific laws/statutes that support the unique features of Islamic financial products (Habib Ahmed, 2009).

Islamic finance is provided through Islamic financial products, which in general, refer to the financial instruments that help invest, save, borrow, acquire and obtain insurance. Islamic financial products may be described as a financial service or product implemented to comply with the main tenets of Shariah on interest, non-Islamic investments, and speculation (Gait & Worthington, 2007). These products are based on Islamic Laws and they differ from the conventional products in a number of ways (Iqbal & Khan, 1998).

Another interpretation is offered for contracts in Islamic Finance, ‘It means people are free to contract and to stipulate as they desire, but upon one sole condition: that their contracts do not involve anything prohibited in the Shariah, e.g. usury or similar prohibitions. Such contracts are sanctified and must be fulfilled; if, however, contracts involve prohibitions then they are void, or at least the prohibited element would not need to be fulfilled.’ (Abu Zahrah, 1996). It is further aptly noted that the principle of Islamic law related to commerce and transactions is permissibility (ibahah) which maintains that everything in economic affairs is permitted other than those explicitly forbidden by divine guidance (Kamali, 2000).

The traditional Islamic contracts that are frequently used in Islamic finance can be broadly classified into equity and debt. While equity instruments are partnership-based contracts of mudarabah and musharakah, debt-instruments arise from sale transactions. These fixed-
income debt instruments include murabahah, bai-muajjal, salaam, istisna and ijarah (Ahmed, 2014).

Wealth creation in Islam is promoted through the formation of partnership agreements. These agreements should determine the risk and reward sharing consistent with the principles of Islam and are governed by the following types of participation contracts (Usmani, 2002):

**Musharakah**

A partnership between two parties or more to finance a business venture where all parties contribute capital either in the form of cash or in kind. If the venture is profitable, the profit will be distributed based on a pre-agreed ratio. In the event of a loss, the loss shall be shared on the basis of capital contribution.

There are three common types of musharaka: commercial, decreasing participation (where ownership eventually reverts to the agent), and permanent participation. Commercial musharaka, which is the most common type, is generally used for a specific, short-term purpose, such as the purchase and sale of machinery or commodities. In addition, musharaka can be by way of contractual agreement (a shirikat-ul-aqd), or arise without a contractual agreement (shirikat-ul-milk).

According to Usmani (2002), “partners can agree, while entering into the contract of the Musharakah, on a condition that the liquidation or separation of the business shall not be effected unless all the partners or the majority of them wants to do so”. This may be justified in light of current situations where the continuity of a business is necessary for its success and
where such liquidation or separation by a single partner may cause damage or financial loss to the other partners.

**Mudarabah**

A contract or partnership made between two parties to finance a business venture. The parties are a rab-ul-mal (investor) who solely provides the capital and a mudharib (entrepreneur) who solely manages the investment/project. If the business 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.

**Difference between Musharakah and Mudarabah (Usmani D M2002, pp. 106-107)**

<table>
<thead>
<tr>
<th>Musharakah</th>
<th>Mudarabah</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 All partners invest.</td>
<td>Only Rab-ul-mal invests.</td>
</tr>
<tr>
<td>2 All partners participate in the management of the business and can work for it.</td>
<td>Rab-ul-mal has no right to participate in the management which is carried out by the Mudarib only</td>
</tr>
<tr>
<td>3 All partners share the loss to the extent of the ratio of their investment.</td>
<td>Only Rab-ul-mal suffers loss because the Mudarib does not invest anything. However this is subject to a condition that the Mudarib has worked with due diligence.</td>
</tr>
<tr>
<td>4 The liability of the partners is normally unlimited. If the liabilities of business exceed its assets and the business goes in liquidation, all the exceeding liabilities shall be borne pro rata by all</td>
<td>The liability of Rab-ul-mal is limited to his investment unless he has permitted the Mudarib to incur debts on his behalf.</td>
</tr>
</tbody>
</table>
partners. But if the partners agree that no partner shall incur any debt during the course of business, then the exceeding liabilities shall be borne by that partner alone who has incurred a debt on the business in violation of the aforesaid condition.

| 5 | As soon as the partners mix up their capital in a joint pool, all the assets become jointly owned by all of them according to the proportion of their respective investment. All partners benefit from the appreciation in the value of the assets even if profit has not accrued through sales. | The goods purchased by the Mudarib are solely owned by Rab-ul-mal and the Mudarib can earn his share in the profit only in case he sells the goods profitably. |

The above two contracts provide an alternative to conventional contracts which if implemented at a broader level are likely to result in fairer distribution of wealth in society with a potentially far reaching effect on the economy (Kahf & Khan, 1993).

Usufruct contracts govern the legal right to use and profit from property that belongs to another person. The key usufruct contracts in practice in Islamic banking are the following:

**Ijara – lease:**

A medium to long-term leasing structure in which the Islamic financier purchases the asset – generally equipment or real estate – and leases it back to the client for an agreed period of time and rental payment. The ijara differs little from the conventional lease. Maintenance and
insurance of the leased asset are the bank’s responsibility, whereas the lessee has to bear the running costs as well as any repair costs in the case of misuse (Gait and Worthington, 2007).

**Salam**

This is a financing transaction, where the provider of finance pays in advance for buying a specified asset/s, which the seller will provide to the buyer on a pre-agreed date. Money itself cannot be given in exchange for the advance payment of the price. The contracting parties should stipulate a future date for the supply of goods of specified quantity and quality.

Salam may be considered as a kind of debt, because the object of the Salam contract is the liability of the seller, up to the agreed future date, to deliver the object for which advanced payment of the price has already been made. The contract can cover almost everything, which is capable of being definitively described with regard to quantity, quality and workmanship. As such, salam contracts include agriculture and machinery and other goods that are manufactured over time.

Sales contracts are used extensively in Islamic banking and include (Usmani, 2002):

**Murabaha**

The word Murabaha is derived from the Arabic word ribh which means profit. A commonly used contract akin to a particular kind of sale, similar to cost plus financing. The financier (seller) expressly mentions the cost of the lawful commodity or goods being purchased, and sells it to another person by adding a profit thereon. Thus, Murabaha is not a loan given on interest, it is a sale of a commodity for cash/deferred price.

**Bai’ bithamanajil**
A sale of goods on a deferred-payment basis. The bank purchases an asset and sells it to the customer at cost plus a profit margin agreed to by both parties. The bank is not required to disclose the price and profit margin. Payments can be monthly, quarterly, or semi-annually.

**Bai’ salam**

An agreement whereby payment is made in advance for delivery of specified goods in the future. The underlying asset does not exist at the time of the sale. This type of contract is used in agricultural financing. Funds are advanced to farmers who deliver their harvested crops to the bank to sell in the market.

**Bai’ istisna contract (supplier contract)**

An agreement in which the price of an asset is paid in advance but the asset is manufactured or otherwise produced and delivered at a later date. This type of contract is typically used in the manufacturing and construction sectors. These types of contracts have been used by Islamic banks in the Gulf region to finance large operations, particularly in the construction sector and also in the industrial sector (Ahmad, 2010).

**Bai’ istijrar contract (also a type of supplier contract)**

An agreement between a purchaser and a supplier whereby the supplier agrees to deliver a specified product on a periodic schedule at an agreed upon price, rather than an agreed upon mode of payment by the purchaser.

**Bai’ inah contract (sale and buyback contract)**
Sale and buyback of an asset. The seller sells the asset on a cash basis, but the purchaser buys back the asset at a price higher than the cash price on a deferred basis. This type of contract is commonly used in Malaysia for cash financing and is also used for Islamic credit cards.

The supporting contracts used in Islamic financing include the following:

**Kafalah (guaranteed contract)**

A contract in which the contracting party or any third party guarantees the performance of the contract terms by the contracting party.

**Rahnu (collateralized financing)**

An arrangement whereby a valuable asset is placed as collateral for payment of an obligation. If the debtor fails to make the payments specified in the contract, the creditor can dispose of the asset to settle the debt. Any surplus after the settlement of the sale is returned to the owner of the asset.

**Hiwalah (remittance)**

Involves a transfer of funds/debt from the depositor’s/debtor’s account to the receiver’s/creditor’s account; a commission may be charged for the service. This contract is used for settling international accounts by book transfers. It obviates, to a large extent, the necessity of a physical transfer of cash. Examples are a bill of exchange and a promissory note.

**Wakalah**
A contract which gives the power and rights to another party or parties to act on his behalf, based on the agreed terms and conditions.

**Wadiah contract (safekeeping contract)**

Wadiah refers to a deposit of goods or funds with a person who is not the owner for safekeeping purposes. So far, this provision has raised controversy with respect to the overall impact it has in promoting business growth and expansion. As a matter of fact, business opportunities do exist to make profits. When such profits are not forthcoming, it becomes difficult for the proprietor or shareholders getting the motivation to carry on with the business. This type of contract is used for savings and current accounts in Islamic banks. Because wadiah is a trust, the depository institution (bank) becomes the guarantor of the funds, thus guaranteeing repayment of the entire amount of the deposit, or any part of it outstanding in the account of depositors, when demanded. The depositors are not entitled to any share of the profits earned on the funds deposited with the bank, but the bank may provide hibah (a monetary gift) to the depositors as a token of appreciation for keeping the money with the bank. Those opposed to this provision argue that competition would never be encouraged in as along as extrinsic motivation is not in place.

**Sukuk: a sakk (plural: sukuk)**

Sukuk commonly refers to the Islamic equivalent of bonds. However, as opposed to conventional bonds, which merely confer ownership of a debt, sukuk grants the investor a share of an asset, along with the commensurate cash flows and risk. A sukuk is issued by an existing company, generally through the use of a special purpose vehicle which acts as agent (mudarib) to silent investors (rabb al-maal) for the purpose of financing a specific money-
making project, often separated from the company’s main activities. The profits of this separate activity are split on a fixed income basis. An example of a sukuk is a fixed income financing for a government project, whose revenues are then paid out to the sukuk holders as their participation in the profits. Such an arrangement is well in line with the provision of the Islamic Shariah as defined by Prophet Muhammad. From the Prophet, sustainable growth is the main objective of any Islamic faithful and so would be the grating of assets in case of an issuance of a bond.

In summary, the concepts of Shariah have been used as an integral part in an attempt to develop the Islamic ideal in social and economic terms. The contracts noted above are currently being used internationally by a number of Islamic institutions and continues to evolve.

4. **Drivers of growth in Islamic Finance**

Some of the key drivers of growth are listed below and these lend themselves to an opportunity set that could materialise in South Africa.
Shariah compliant finance, including private equity, seems set to become a mainstream segment of the global financial market. There are some key drivers of this move. According to Emerging Markets Private Equity Associations (EMPEA) 2014 industry statistics, private equity and venture capital fund managers raised US$45 billion and invested US$34 billion in emerging markets in 2014, corresponding to 16% and 26% increases, respectively, compared with 2013. The largest year-on-year gain was for Sub-Saharan Africa, where private equity fund managers raised more than US$4 billion in 2014, the highest amount recorded since

| Economic growth and liquidity | • Strengthened oil prices  
|                              | • Solid economic growth in the Gulf Cooperation Council (GCC)  
|                              | • Increased wealth being retained in the region as investment opportunities improve  
|                              | • Increased government spending and investment in infrastructure/development projects  |
| Investor appetite for Shari'a-compliant instruments | • Shari'a-compliant instruments becoming increasingly popular with investors  
|                                                      | • Testified to by rapid emergence of sukuk (Islamic bonds)  
|                                                      | • Increase in desire of family enterprises to tap liquidity in order to go public  |
| Privatization and foreign direct investment (FDI)    | • Increased GCC privatization initiatives accelerating project finance and structured finance activity  
|                                                      | • Strong and improving FDI potential in the region because of rising sovereign ratings and human development  |
| Regulatory changes                                    | • Improving regulatory infrastructure  
|                                                      | • Liberalization of country markets and increased investor friendliness  
|                                                      | • Increased foreign participation  |
| Diversification                                      | • Movement of GCC countries' investments into nonoil sectors  
|                                                      | • Investor funds diversifying regionally throughout the GCC and greater Middle East region  |
| Globalization                                        | • Islamic financial instruments increasingly accepted globally because of globalization  
|                                                      | • Foreign regulators (e.g., in United States, United Kingdom, European Union, Canada, and Singapore) accepting Islamic finance  
|                                                      | • Entry of global players in Islamic finance  |

EMPEA began tracking fundraising statistics in 2006, and well above the previous record of US$2.6 billion raised in 2006\textsuperscript{17}.

This bodes well for those IPEF’s and conventional funds which may have investors that require Shariah compliance. Following the financial crisis in 2008, some economies are beginning to recover and those in the Middle East and Asia still reflect relatively strong GDP growth. The economies that are reliant on oil revenues remain fragile and at risk given the volatile oil prices which are currently at pre-crisis levels. Fiscal and external imbalances remain significant with growth in the MENA region expected to pick up gradually to 3.5 percent in 2017\textsuperscript{18}. There are significant other risks emanating from the regional turmoil and political and security challenges remain.

Global Sovereign Wealth Funds (SWFs) currently controls an aggregate of approximately US$5.3 trillion in assets under management (AUM). Of this amount, the Gulf SWFs (most notably ADIA, currently the world’s second largest SWF behind the Norway Government Pension Fund) account for approximately 30% of global SWFs by AUM\textsuperscript{19}. These distressed periods are times when oil-rich SWFs have taken advantage of opportunities to acquire assets in the West. Governments in the West, including the South African government who is looking for capital from the Middle East, must adapt and demonstrate a deep understanding of what is driving the thinking of SWFs.

\textsuperscript{17}http://empea.org/research/data-and-statistics/full-year-2014-em-pe-industry-statistics
\textsuperscript{18}http://www.worldbank.org/content/dam/Worldbank/GEP/GEP2015a/pdfs/GEP2015a__chapter2__regionaloutlook_MENA.pdf
There is also an increasing development of Islamic finance products in the financial services sector, with a move away from murabaha and other controversial products to mudharaba and similar equity vehicles. There is also improved and growing regulatory infrastructure and support for Islamic finance in Western countries, as evidenced by the issuance of sukuks, more recently even in South Africa at US$500 million, which was considered a huge success.

The creation of these structures, regulatory environment and support for Islamic finance will increase the attractiveness for SWF’s and Private Equity investors who seek to diversify their interests, acquire solid assets, achieve attractive returns and do so by maintain adherence to Shariah principles. Private equity could become an ideal platform for such investors.

Section Three

This section contemplates the South African market from a macro-economic perspective, the South African legal system as well as challenges that arise in implementing Islamic laws in South Africa.

1. South Africa as an Investment Destination

Any reasonable investor will consider a number of factors when investing in Private Equity, including the macro-economic and related environment. The acquisition process for mid-cap targets tended to be less structured and less competitive, while the PE backed capital could add value by financing expansion, restructuring, or succession (Fenn & Liang, 1998).
South Africa is the second largest economy in Africa and is the 27th largest economy in the world\(^{20}\). According to the World Economic Forum, September 2013, South Africa was ranked as the 53rd most competitive country out of 148 surveyed in the 2013/14 World Economic Forum's Global Competitiveness Index, making it the second highest ranked country in Africa after Mauritius (45th). It took over Brazil to take second place among the Brazil, India and China (BRICS) economies, with China at 29 and Brazil dropping to 56th place (from 48). The main goal of the report is to evaluate countries' economic environment and their ability to achieve sustained levels of prosperity and growth.

According to the report, South Africa does well on measures of the quality of its institutions (41st), including intellectual property protection (18th), property rights (20th), and in the efficiency of the legal framework in challenging and settling disputes (13th and 12th, respectively). The high accountability of its private institutions (2nd) further supports the institutional framework. South Africa is rated first overall in terms of economic competitiveness out of 38 African countries, according to the Africa Competitiveness Report, which reviews the degree of competitiveness of Africa's economies. Rated as being on a par with innovative countries such as India and Brazil, South Africa is credited as having high-quality scientific research institutions, strong investment in research and development, and a significant level of collaboration between business and universities in research\(^{21}\).

It further offers developed world infrastructure and financial systems with the attractive investment profile associated with developing economies. The government’s National


\(^{21}\)http://www.southafrica.info/business/economy/globalsurveys.htm#competitiveness#ixzz3Qa8uqfR
Development Plan (NDP) combined with investment by the corporate sector and a growing middle class is expected to lead to accelerated GDP growth in South Africa. The NDP plans to increase employment from 13-million in 2010 to 24 million by 2030; ensure that all children have at least two years of pre-school education and that all children can read and write by grade 3; provide affordable access to healthcare; and ensure effective public transport\(^{22}\).

Because it has many of the characteristics of a developed market such as a strong services based economy, a relatively large domestic economy, strong financial institutions and regulations and a robust democracy, this positions the country uniquely in capturing investment. According to the IMF, South Africa is also the leading African destination for foreign direct investment (FDI) by number of FDI projects. According to the December 2014 IMF SA Country report, during 2013, South Africa received $8.2-billion in foreign direct investment (FDI), followed by Mozambique, which received $5.9-billion. Nigeria followed closely behind with $5.6-billion\(^{23}\).

According to the 2014 Standard and Poors Islamic Finance Outlook, Islamic bonds can give government’s access to a new investor class and help diversify sources of fiscal funding. Among potential sovereign sukuk sponsors in Africa, the highest rated is South Africa followed by Morocco, Tunisia and Senegal.


The above are all key elements that private equity managers may look for at a macro level. With the African landscape continually changing and strong infrastructure and economic growth being experienced in large parts of the continent, and with the large Muslim populous in Africa, the increasing number of middle-class populations, there will be growing demand for Shariah compliant and ethical products and services and measures undertaken by some of the governments to review and reform their respective banking laws to allow Islamic finance institutions to set up and thrive (Islamic Financial Services Industry Stability Report 2013).

2. Legislative challenges for an Islamic finance in South Africa

South African Law

“The Constitution is the supreme law of South Africa. Any law or conduct that is inconsistent with the constitution is invalid and the obligations it imposes must be fulfilled” (Moorcroft, 2009, pp. 1-2).

The basis of South African law is statutory law and Roman-Dutch common law influenced by English decisions and English common law. There are a number of legislative and regulatory rules that govern private equity activities. According to Bowman Gilfillan, a leading law firm in SA, private equity transactions must take cognisance of the Companies Act, 2008, as amended (the New Companies Act), which came into force on 1 May 2011; the King Report on Governance for South Africa (2009) and the King Code of Governance Principles (King III); the new Takeover Regulations, read with sections 117 to 127 of the New Companies Act (the Takeover Regime); the JSE Listings Requirements (the Listings Requirements), the Financial Advisory and Intermediary Services Act, 2002 (FAIS), and the Collective
Investment Schemes Control Act, 2002 (CISCA), as well as legislation regulating exchange controls, competition and antitrust activity\(^\text{24}\). In addition, the Income Tax Act (ITA) will apply to private equity transactions, and depending on the nature of the structure, where the structure is domiciled i.e. resident versus non-resident and the source of earnings, different aspects of the ITA such as dividend tax, Capital Gains Tax, s24O and s24J interest deductibility etc. will apply.

They further note that the New Companies Act is not applicable to limited liability partnerships or trusts established in South Africa, nor does it apply to foreign companies wishing to solicit investments from South African potential investors. The New Companies Act is relevant with respect to fund managers who are incorporated in South Africa, or with respect to offers to the public. We provide an overview of the relevant sections in the New Companies Act below.

The SA Constitution recognises Islamic banking. Moorcroft (2009) explains that a client enters into a Mudarabah contract with the bank. The client invests money with the bank and the bank in turn manages the funds for the client. The risk of loss lies with the investor, up to the limit of the investment. The bank is required to invest the funds with due diligence as well as in accordance with the Shariah. Due to the nature of Islamic banking transactions, they cannot be equated to deposits with conventional banks (Moorcroft, 2009, pp. 15-23).

The country’s previous finance minister emphasised the country’s aim of positioning South Africa as an Islamic finance hub. “The development of Islamic finance in South Africa is critical to the expansion of National Treasury’s strategy to position South Africa as a gateway into Africa. The treasury envisages South Africa being a central hub for Islamic product development and ensuring the rollout of such products into African markets,” he recently said. Muslims represent 1.5% or around 1 million of the population in South Africa, however, only 10%-15% of the Muslim population uses Islamic banking.

3. Institutional and Legal Framework

In order to facilitate an efficient and sustainable Islamic Finance market, it requires a specific institutional and legal framework. The main focus of Islamic financial industry has been to provide Shariah compliant structures of conventional financial products (Dar, 2007). The technology and institutional arrangements allow the use of financial and legal engineering to develop Islamic products that replicate conventional financial products at low costs (ElGamal, 2008). From an economic perspective, the objective of Islamic banks is to structure products that have similar risk-return features of conventional products. From a legal perspective, this is done by using several legitimate Islamic contracts to produce outcomes that replicate conventional products.

Currently in South Africa, institutional and legal frameworks are designed for conventional frameworks and are not geared to cater for the specific needs of Islamic finance. This is changing to cater for the increased use of Islamic Banking in South Africa, local regulators

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25http://www.indexmundi.com/south_africa/demographics_profile.html
having already taken various measures to develop and promote the Islamic finance industry including amending tax laws to create an equitable and level playing field for Islamic finance. Proposed tax amendments were issued in May 2010. Section 24JA of the ITA, first introduced in the draft Taxation Laws Amendment Bill, 2010, set out the proposed legislation for Islamic financial products. This section provided parity of tax treatment between Islamic finance products versus conventional banking products. Section 24JA of the ITA sets out the tax consequences of diminishing musharaka, mudaraba, murabaha and sukuk.

It is noted that conventional laws “contain provisions that narrow the scope of activities of Islamic finance and banking within conventional limits” (Iqbal & Khan, 1998). The costs involved in establishing such frameworks may be unjustifiably high in the South African context alone and further consideration of this may be required if it provides SA with a platform to export these services and products.

A further consideration raised is where Islamic financial institutions operate under Western legal systems with no supporting Islamic law and regulations. In these environments, provision of Islamic financial products would fall under existing banking laws. Islamic banks and other financial institutions can be established under non-Islamic legal frameworks. United Kingdom has successfully introduced Islamic banking with proactive support of the regulatory authority without introducing any specific Islamic banking law (Ainley, Mashayekhi, Rahman, & Ravalia, 2007).

Due to the nature of an IPEF, and the agreements that give rise to the partnership that governs the fund, based on the above, the lack of legislation is not considered to be a hindrance in the
creation of such a fund. Partnership agreements with the general partner can be negotiated to include the relevant Shariah requirements as discussed herein.

Section Four

In this section, we discuss several topics around the establishment of an IPEF as well as what is necessary for achieving best practices in Islamic corporate governance as highlighted by Nafis and Shanmugam (2007). To ensure the Islamic finance conforms with Shariah compliance, each institution providing such Islamic products or services should have a Shariah Supervisory Board (Delorenzo, 2000) (Abdallah, 1994).

1. An Islamic compliant Private equity fund

The conformance to Shariah rests with the judgement and rulings of Islamic scholars. In Malaysia, one of the most innovative providers of financial products, the body of Islamic scholars is the Malaysia Securities Commission Shari’a Advisory Council (SAC). The rest of the world remains quite fragmented in this regard.

According to the Malaysian Securities Commission, two fundamental requirements for the establishment of an Islamic venture capital fund are necessary:

- the appointment of a Shariah adviser who provides initial and continuing guidance on documentation and advice on whether the proposed investment structures are Shariah compliant; and

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The activities of the private equity and venture companies must be Shariah compliant.

Non-permitted Shariah activities include:

- financial services based on riba (interest);
- gambling/gaming;
- manufacture or sale of non-halal products or related products;
- entertainment activities that are non-permissible according to Shariah;
- manufacture or sale of tobacco-based products or related products;
- stockbroking or share trading in Shariah non-compliant securities;
- hotels and resorts;
- Weapons-related; and
- Other activities as advised by Shariah advisory board.

On the financial side, the general rules are that Shariah based investments are as follows:

- Leverage compliance:
  - Debt / total assets ≤ 33%

- Cash compliance:
  - Accounts & trade receivables / total assets ≤ 33%
  - (Cash + Near Cash Items) / total assets ≤ 49%

- Revenue share from non-compliant activities:
  - (Non-permissible income other than interest income) / total revenue < 5%

The acceptable conventional debt ratio is based on the Prophetic hadith that ‘a third is a lot’. However, this Prophetic guideline related to the size of charitable donations that testators could bequeath through their estate. Most Islamic banks, investment and asset management...
companies and equity funds have their own rules for assessing Shariah compliance for companies in which they consider investing in. These organizations do not make public their screening and selection criteria. There are however leading organisations such as Dow Jones Islamic Market index (listed at various stock exchanges) as well as screening criteria used by Meezan in Pakistan in addition to the Malaysian one noted above.

The Dow Jones Islamic Market™ Index Shariah Supervisory Board was established to advise the company on the methodology for screening securities for inclusion in the Dow Jones Islamic Market™. This screen is almost identical the one listed above with the exception of the financial ratio screens where cash and interest-bearing securities divided by trailing 24-month average market capitalization must be less than or equal to 33%.

With regard to impure income, the idea is that core activities should not violate the Shariah at all and peripheral activities should not render the investment non-compliant. In order to facilitate the development of Islamic equity investments and capital markets, scholars have declared that some impure income is acceptable. For example, if fund managers decide to invest in a retailer and some of the revenues come from sale of alcohol, the managers simply have to ensure that those sales do not cross the 5% threshold.

The key challenge for any investor in Islamic finance is to find companies that are completely interest free. The confirmation of Shariah compliance by Shariah Supervisory Board (SSBs) provides comfort and confidence to those religiously inclined people who deal with the banks both as providers and users of funds (Kahf, 2004). Most Shariah scholars have recognized and accepted this, and allow cooperation for the general benefit of all. The general accepted
standard is that a partial contamination of a target company does not pose an insurmountable hindrance to investment.

There is also further portfolio review and purification required. Equities invested are subject to quarterly review to ensure continued Shariah compliance. Those that fail must be divested. There are laws pertaining to flow of money and identification of sources and recipients of cash in South Africa through the Financial Intelligence Centre Act (FICA) that requires due process to be followed when making such distributions. Such transparency is important but also provides adequate comfort to investors and portfolio companies as to the recipients of cash.

2. Governance

There will always be the need for regulation and supervision despite the legal framework and legislation governing companies. Shariah being the backbone of Islamic finance instils the confidence of the shareholders and public that all practices and activities conform to Shariah at all times. This entails the creation of a Shariah Supervisory Board. The establishment of such boards creates an additional cost to IPEF’s and no detailed work has yet been undertaken to analyse the cost effects to the overall returns of such funds.

A SSB that must be established needs to be an independent body of specialised jurists in fiqh al-muamalat (Islamic commercial jurisprudence). However, the SSB may include a member other than those specialised in fiqh al-muamalat, but who should be an expert in the field of Islamic financial institutions and with the duty of directing, reviewing and supervising the
activities of the Islamic financial institution in order to ensure that they are in compliance with Islamic Shariah rules and principles. The fatwa and rulings of the Shariah Supervisory Board shall be binding on the relevant Islamic financial entity.\textsuperscript{27}

The role of a SSB is to provide an opinion for compliance of the institution to Shariah (Alexakis & Tsikouras, 2009). Until recently, Islamic finance and banking problems occurred as a result of a lack of standardised accounting and auditing rules. Historically, uncertainty in accounting principles involved revenue recognition, disclosures of accounting information and valuation etc. To address some of the issues and concerns, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) was created to provide a set of global standards and best practice. AAOIFI is now the international organization responsible for development and issuance of standards on accounting, auditing, ethics, governance, and Shariah. It has issued a total of 68 standards covering the whole range of Islamic finance practices that are accepted globally. The standards are used in all the leading jurisdictions that offer Islamic finance. The Accounting and auditing organization for Islamic Financial Institutions stated that the SSB and the financial auditor of an Islamic Bank should report such compliance to Sharia (AAOIFI, 2004). They should further undertake investigations that include a review of agreements, rules of association, contracts, financial reporting and other reports.

According to Iqbal & Molyneux (2005), the rapid growth of Islamic banking has meant that the industry has not been able to “produce enough experts needed to support this growth”.

\textsuperscript{27}http://www.nzibo.com/IB2/04_01.pdf

53
Some Islamic funds have established their own dedicated Shariah board and Audit Department or unit to support the Shariah Supervisory Board. The main responsibility would be the assistance by the board on Shariah rulings, monitoring and supervising ongoing investments. This is further supported by concerns that a major impediment to SSB’s is that the pool of skilled supervisors adequately trained in finance and Shariah knowledge must be increased (Khir, Gupta, & Shanmugam, 2007). The shortage of sufficiently qualified Shariah scholars means that in countries where it is allowed, scholars often serve concurrently on the Shariah supervisory boards of a number of firms.

The quantity and quality of Shariah boards have come into question of late. The number of members and the advice dispensed by them has been diverse, as have been the acceptable accounting treatments. For example, five ways of accounting for Murabaha have made more difficult the comparability of one institution or product with another (O'Sullivan, 1996).

In South Africa, although Islamic banking is recognised, there is no uniform body in the country that deals with the regulation and supervision of Islamic banking. Islamic banks are thus supervised and regulated by the same bodies and rules which regulate conventional banks. Some of the major banks in SA such as ABSA, FNB, Nedbank and STD Bank all offer some form of Islamic Banking and finance as well as Islamic compliant investments. There are also currently around 11 asset management companies offering various Shariah compliant investment products. Each of these companies utilise the services of an established Shariah Supervisory board that is either a part of or conforms to international best practice (company website information on Shariah advisory boards).

A more detailed analysis of the functions of the SSB is provided further below.
3. Understanding the requirements for a private equity fund structure

South Africa has a strong and established private equity industry. The industry caters for different fund types that vary depending on investment stage, size and sector specialisation. The South African private equity industry includes significant on-balance sheet investment by insurance companies, banks, investment holding companies and government agencies (Authors perspective).

For purposes of this paper, it is assumed that all requirements for Partnership and trusts iro adherence to South African and related laws have been complied with including those related to the Collective Investment Schemes Control Act, 2002 (‘CISCA’), Financial Advisory and Intermediary Services Act, 2002 (‘FAIS’) and South African Income Tax and exchange control Acts, where applicable. Private equity funds in South Africa are not subject to specific regulations and there is no government agency that exercises regulatory oversight specifically over such funds.

As noted section one, PE funds are typically formed through limited partnerships. When investors invest in a particular fund, they have limited recourse to their investment (Lerner, Hardymon, & Leamon, 2009) (Lerner & Wongsunwai, 2007). To address the potential conflicts of interest between the private equity fund and its investors, the limited partnership agreement is the mechanism to manage this. Specific and individual investor requirements that include various factors relating to management of the fund, fees payable and other
clauses are contractual elements that must be included and agreed upon in the limited partnership agreement (Sahlman, 1990).

Typically, the private equity fund would appoint a fund manager (general partner) in terms of a written mandate to manage the day-to-day affairs of the fund and to identify and execute investments and disinvestments. According to ENS web review of PE funds in South Africa, Investors in a South African private equity fund usually expect contractual provisions dealing with the following matters, among others:

- minimum investment requirement for the fund manager, adviser or associate;
- time periods for the making of investments and disinvestments by the fund;
- investor default; guidelines, requirements and prohibitions relating to investments;
- the composition and functions of the investor advisory board;
- reporting requirements;
- key personnel assurances;
- conflicts of interest;
- co-investments;
- fees of the adviser or fund manager; and
- termination of the fund.

The most important issue for any Islamic institution is that the activities of the company are Shariah compliant meaning that the underlying assets and investments of the fund must be permissible. If all Shariah compliant issues from a contractual perspective are adequately addressed in the agreement and the investment structure also meets the Shariah requirement,
the role of the Shariah advisor would be the screening of the investments that meet the Shariah requirements. In this process, the consideration of Maqasid al-Shariah, as a tool to sort out the projects to be selected, is crucial. (Dusuki & Abdullah, 2009).

According to ENS, leading law firm in South Africa and Africa, the main vehicle that houses South African private equity funds investing in South Africa are limited liability partnerships (called \textit{en commandite} partnerships) and trust structures (called \textit{bewind} trusts). The main reasons for the use of these entities to house funds are the following:

- they permit the income and capital gains of the fund to be taxed in the hands of investors according to the tax profile of each investor;
- they provide investors with limited liability, so that an investor will not have liability exceeding its contractual commitment to the fund;
- they are not subject to cumbersome regulatory oversight and can be established with relative ease; they allow the day-to-day affairs of the fund and all operational matters to be outsourced, which permits the fund manager a high degree of autonomy; and
- they permit the use of the types of contractual terms and organisational practices that are commonly used internationally.

\textit{Limited liability partnership}

- An \textit{en commandite} partnership is established by contract. The contract between the parties should expressly reflect the intention of establishing an \textit{en commandite} partnership and should expressly identify the general or disclosed partner. An \textit{en commandite} partnership is carried on by one or some of the partners, called the general or managing partner (GP), to which every partner whose name is not disclosed, called a commanditarien partner or partner \textit{en commandite}, contributes
a fixed sum of money on condition that he or she receives a certain share of the profit, if there is any, but that in the event of loss he or she is liable to his or her co-partners to the extent of the fixed amount of his or her agreed capital contribution only.

The general partner of the en commandite partnership has unlimited liability toward creditors of the partnership in circumstances where the partnership’s assets are insufficient to settle relevant debts. The en commandite partnership usually terminates by agreement between all the partners or in accordance with the terms of the partnership agreement, which may, for example, provide that the general partner may terminate the partnership on notice to the other partners. All commercial aspects of the partnership, such as profit share arrangements, permitted expenses, investment restrictions and so forth, are usually contained in the partnership agreement. The terms of the partnership agreement are not publicly available. En commandite partnership agreements usually provide for the removal and replacement of the general partner.

These structures noted above, when read in conjunction with Shariah requirements, will accordingly be able to facilitate Shariah compliant contracts and agreements. Within the South African context, the Memorandum of Incorporation and Articles of Association or Fund LP Agreements should set out sufficient terms that note the specific requirements and adherence from a Shariah compliant perspective. This is especially important when there are other conventional investors and partners who need to be fully aware of these requirements. These terms include the following and encapsulate the key Shariah principles as described in this document and the relevant contracts and agreements that are permissible:

- Nature of and structure of the fund in adherence to Shariah guidelines.
- All the Islamic partner’s capital contributions, books of account, recordkeeping shall be segregated from those of the fund.

- All of the Islamic partner’s returns from the fund will not be commingled, at any point, with those of any other entity.

- Pre-transaction screening, assessments of investee companies and ongoing audits of all investments by the Islamic partner will be subject to supervision by its Shariah advisory board, which shall be fully functional prior to commencement of the fund.

- For further clarity: prior to responding to any calls for a drawdown from the fund, the Islamic partner shall consult with its Shariah advisory board to evaluate the potential investment in light of Shariah principles. The Islamic partner shall be entitled to exercise an opt-out clause contained in the LP agreement and refrain from participating in any transaction that the Shariah board deems to be haram (not permissible).

To conform to Shariah law, the conflicts can similarly be addressed in the LP agreement. Based on literature review and the Shariah contracts cited and described in the earlier sections, Shariah allows for different investment structures for private equity funds. As defined herein, it can be inferred that in a PE investment, a mudharaba arrangement would be where a fund manager acts as the worker (mudarib) and get individuals or institutional investors as rabb ul-maal i.e. silent investors.

Similarly, in a PE investment, a musharaka agreement would be one where the fund manager and the investors both share managerial and investment responsibilities; and a wakala
contract where the fund manager acts as an agent for the investors, with discretionary authority governed by the terms of the contract.

When setting up the Islamic PE Fund structure, it must be noted that Islamic finance is based on a set of religious beliefs. Even though various investors may commit themselves to using the structure, some of their personal views on the Shariah may prevent them from participating in certain concrete investment proposals. To address this situation, well documented legally balanced “opt-out clauses” must be an inherent part of the commitments (Wouters, 2008). According to Wouters, after the investment, differences of opinion may arise concerning the application and the exit position of the Fund. To resolve such issues, remedy clauses will be required and due consideration of this should be given at the initial stages of setting up of the structure.

The fund as a structure described above, enables the manager to spread risk across a portfolio of companies while at the same time maintains the ability to exert influence and control over those companies. This is very different to a publicly held investment where the individual investor generally has very little or no influence on the company invested in. This makes private equity funds ideal for Shariah based investments and the principle of profit and loss sharing. Private equity investing encourages working closely between, investor, fund manager and investee company.
4. Management of the fund and supervisory functions

A critical requirement in any private equity fund is a strong management team. In addition, according to the Malaysian Securities Commission, a fundamental requirement for the establishment of an Islamic venture capital is the appointment of a Shariah adviser who provides initial and continuing guidance on documentation and advice on whether the proposed investment structures are Shariah compliant.
Any Islamic Private equity fund (IPEF) in SA will have to be created on the basis as mentioned above and may the form of an *en commandite* partnership or similar. An important decision made when investing into a private equity fund is the core competency, track record, breadth and expertise of the manager and investment professionals managing the fund. From a Shariah perspective, it is paramount to have the core skills of a Chief Executive Officer, Chief Financial Officer, Chief Legal and Compliance officer augmented by strong and experienced team members including analysts, associates and investment principals.

Based on research and findings in central and eastern Europe (Farag, Witt, & Wright, 2004) and here in South African (De Venter & Mlambo, 2009), it is evident that the management team are an important decision criterion when investing in a fund. According to (Pintado, Lema, & Pérez, 2007), the "characteristics of the entrepreneur, manager background, and management team experience were consistently more important evaluation criteria than market and product characteristics."

5. **Functions of the SSB and other Shariah requirements**

To ensure compliance to Shariah, it would be essential and a pre-requisite to have a legal and compliance officer who is familiar with Shariah based investment structures and has the capacity to integrate the stringent requirements of both traditional private equity and Islamic adherence. The fund should also retain a full-time Shariah advisor and assurance board for their funds, although given the cost controls in the industry and long tenors, it may be more feasible to outsource advisory and assurance services.
An individual or a corporation may be appointed as an independent Shariah adviser, who is approved and registered by the relevant authorities within South Africa or applicable jurisdictions to act as such. The agreed criteria for such a person or corporation includes amongst others that the person is of good standing and character and possesses the necessary qualifications and expertise, particularly in fiqh muamalah and Islamic jurisprudence, and has experience and/or exposure in Islamic finance. Where the independent Shariah adviser is a corporation it must engage at least one Shariah expert who meets the criterion noted above. “Shariah board functions as a customer advocate representing the religious interest of the investor” (Delorenzo, 2000).

According to a survey by the Khaleej Times (2008)28, the number of Shariah scholars is very low. It is also widely criticised that these scholars are earning large salaries and are serving not only more than one shariah boards but also providing the advisory services to direct competitors. To deal with this issue in Malaysia in 2005, scholars were restricted giving services to more than one board or committee.

The profiles of investors into private equity funds vary and can be individuals, pension funds, family offices, academic endowments amongst others. The key criteria for all investors will almost always be the financial returns and risk tolerance. Adherence to Shariah should therefore be formally documented into a Shariah policy statement that is available for all investors to review. This statement should contain the ‘rules’ of the Shariah compliance not

28 Khaleej Times., (2008), Islamic Banks Enjoys Double Digit Growth
just for the fund but also as a term of investment or even post-investment for portfolio companies.

This would occur where the manager requires that the investee company conforms to a Shariah compliant funding structure which if required can be achieved by using Islamic debt (by way of murabaha or sukuk) to pay down existing debt. Companies may also be required to amend their articles of incorporation to include provisions along with a commitment to comply with all qualitative and quantitative guidelines laid down by the fund’s Shariah advisory board. This would mean that any non-compliance of the guidelines would become a breach of the company’s constitution. This is an area that has not yet been tested in Western jurisdictions; however, these requirements could also be included in a Shareholder Agreement regulated between key shareholders but should always conform and remain subject to the provisions and requirements of the South African Companies Act.

Shariah audits will need to be performed at various stages of the fund life, pre-inception, during fund raising, pre-investment, post investment and at each income cleansing stage. This is particularly important given the often complex nature of the companies invested in and the broader laws within which they operate. These companies, which could often be multinationals, have strict operating platforms, banking systems, credit lines, deposit accounts, short and long term debt and investments all of which require strict supervision for conformance to the Shariah requirement.

Conformance to Shariah will require that the private equity fund managers monitor and implement guidelines at each of the investee companies to maintain such compliance. The
fund representatives on the board of directors of such companies will need to implement Shariah guidelines at the company level and monitor this on an ongoing basis at a board level. This requires a subtle balance between the fund manager, the investee company and the environment within which the company operates. All the factors and issues that create risks that must be duly considered and carefully managed by all parties.

The holding of cash is also an issue from a Shariah context, however, private equity funds typically return all cash, in the form of dividends to investors as and when these occur. Shariah principles of investing cash reserves must be adhered to where such cash reserves are held.

**Section Five**

This section contemplates the additional requirements that are placed on Islamic finance organisations. Due considerations are given to any specific compliance for an IPEF compared to conventional funds at various stages of the fund life.

1. **The Investment Process, Due Diligence and Screening requirements**

So far, increased uptake of Shariah compliance policy in South Africa and by extension the growth of compliant companies has raised many questions with regard to process and due diligence. According to Muhammad Iqbal (2008), Shariah compliance would involve many other elements and procedures that can be seen as bring right with the Quran and the submissions made by Prophet Muhammad as part of the secondary source to Shariah laws. The same sentiments are upheld by (Rashidah & Faisal, 2013) in the study dubbed
"Challenges and Solutions in Islamic Microfinance". In this study, the researchers did contend that not many companies would be well placed to meet all the conditions as provided by the various forms of compliance and the principles that govern the sources of Shariah laws. As such, identification of companies as being compliant in South Africa and many other companies seeking to expand business through Shariah compliance and setting up of funds under this scheme would face the same challenges. Target companies will largely be identified through contacts, networks, research, auction processes, soliciting by the target companies themselves and sector tracking. A thorough due diligence on financial and non-financial issues, projected returns, synergistic benefits, exit timing and strong management will help identify investments.

Due diligence in Islamic private equity investing is very similar to that of conventional investments. In an article published in International Journal of Islamic and Middle Eastern Finance and Management, (Zubair, 2008) makes a submission that such similarity is the reason as to why Shariah compliance has been given a benefit of doubt by even those who have criticised it. As matter of fact, the resemblance or similarity in due diligence process in as far as compliance on both Shariah and conventional models makes it possible for government regulation and monitoring such business and at the same time makes it easy for analysis of the best markets in as far as investment in ventures that comply to Shariah laws are concerned. Preliminary due diligence is performed to determine whether a particular investment is economically viable and will ultimately deliver returns that the LP’s require. Work performed here must be focused on the financial, tax and legal related issues of the business, its operations, history and commercial viability in the future.
As noted, according to the Malaysian Securities Commission, two fundamental requirements for the establishment of an Islamic venture capital fund are necessary being the appointment of a Shariah adviser and that the activities of the target companies must be Shariah compliant and not include; financial services based on riba (interest); gambling/gaming; manufacture or sale of non-halal products or related products; entertainment activities that are non-permissible according to Shariah; manufacture or sale of tobacco-based products or related products; stockbroking or share trading in Shariah non-compliant securities etc.

Islamic investors will therefore have additional requirements and the investment will be diligenced further to ensure compliance with Islamic legal requirements. The Shariah principles are primarily focused on the interest bearing borrowings, the nature and features of securities issued by the potential investee company as well as guarantees. Another key area focus is the Social and Responsible investing principles of the target company, an area that is also gaining increased focus in traditional private equity as well as listed equity investments.

Whilst a Shariah compliant investment will ensure that the non permitted sectors such as alcohol, gambling, weapons manufacturing, pork and financial services are adequately checked, some of these can be invested in indirectly for example, acquiring a vehicle and tracking device manufacturer that may also supply components of weapon manufacturing. In these examples, further work may have to be performed to determine if income from these sources falls under 5%, thereby meeting the general Shariah requirements or if such income is qualitatively impermissible.
After the initial screening, due diligence on the economic feasibility of the Islamic private equity transaction will be on the same basis as conventional transactions. When conducting legal due diligence in Islamic private equity transactions, investors and their legal and accounting advisers have to attend to legal, financial, tax and insurance related issues in exactly the same manner as conventional private equity transactions. However, proposed Islamic transactions have another layer of supervision, primarily driven by qualitative and quantitative parameters derived from the Shariah. Principle among these is the focus on conventional interest-bearing debt.

The existence of preference shares also raises Shariah concerns, both because they represent a flow of fixed income and take priority over other share classes in the case of liquidation, insolvency or bankruptcy of the corporation. The Shariah advisor and the manager will have to address other aspects such as customer contracts to ensure that no interest is payable as a term of financing as well as consider supplier arrangements to ensure that these terms conform to Shariah.

While some measure of flexibility is clearly necessary, given the prevalence of interest in contemporary commercial arrangements, the manager will consult with Shariah advisers and make a final judgment on how to deal with the issues raised.

Finally, there are issues that arise with actual closing of the transaction, especially if there are multiple steps to the closing. The solution would be to ensure that the funds managed within Shariah confines and use of the murabaha products can be made.
2. Insurance in private equity transactions

When an Islamic private equity fund buys an equity stake in an existing business, they may either convert conventional insurance policies into equivalent takaful products or dispense with insurance cover altogether (Azhar, 2010). In many instances, takaful products are not available for important issues, even in the Muslim world. If general takaful products are available, they may be unavailable for certain issues that are at stake in an Islamic transaction.

On certain issues in South Africa, insurance is mandatory, especially in the case of motor vehicle accident coverage, key personnel insurance or life insurance. Where takaful is not available, Islamic scholars have stated that, for mandatory coverage, individuals should avail themselves of cooperative insurance products and, only if cooperative insurance is also unavailable, to purchase conventional coverage. Islamic private equity firms will also be interested in maintaining existing levels of commercial insurance, like business interruption insurance and personal injury liability insurance (Schoon, 2008). While these types of insurance are not necessarily mandated by law, they are often required under commercial lease agreements. Even without such a requirement, the private equity investor may be keen on contingency planning in the case of prolonged business interruption.

The major challenge to growth of Shariah compliant equity in South Africa and which can be extended in the Middle East and many other countries lies with risk. Investors would always seek to invest in businesses with an assurance that the risks of failure would indeed be relatively low. (Fauziah, Rashidah, & Normah, 2011) have provided perhaps the best
exposition on how this plays around. In their empirical study on Risk Management Tools Practiced in Islamic and Conventional Banks, the research has made conclusions to the effect that the risk of business failure with regard to investment in Islamic finance sector and the provision of funds under Shariah law is higher than in the conventional model. The slowed process in decision-making makes it difficult for efficient actions. The manager and investor will under each specific case have to engage with Shariah advisers and examine each insurance issue to determine if takaful coverage is available, or, in the alternative, other insurance models are available for mandatory insurance, or, whether other contingency plans can be made that would avert the need for insurance cover at all (Lewis, 2010).

3. **Legal advice in investee countries**

Private equity investors will also have to ensure their legal advisers are alive to the nuances of a particular legal jurisdiction, especially when they are contemplating a transaction in a foreign parochial legal regime, where there may be potential conflicts of interest between the executive, legislative and judicial branches. (Sy, Kunzel, Mills, & Jobst, 2007) have indicated that the slow growth of Shariah compliant markets has been as a result of the uncertainties with respect to Shariah compliance to the legal jurisdiction. South Africa was a country that had been modelled in the conventional economic model that gave room for the extremes of capitalism. As such, concerns were raised with regard to how the jurisprudence in the African economic giant would impact the industry or markets.

**Summary**
It is apparent that South Africa has managed to develop an environment that is conducive for Shariah compliant funds and banks. This is through enactment of laws that gives recognition to the core tenets of the Islamic Shariah laws as they apply to business and business operations. So far, there have been serious reforms in the South African market in as far as compliance to Shariah laws is concerned given that the country inched closer to such deals when its top banking regulator, South African Reserve Bank, went ahead in giving licenses to the first Shariah compliant bank in the country; Al Baraka in 1989. Rodney, (2008) notes that the apartheid regime did not provide much support for Shariah compliance and that it only allowed Al Baraka for political reasons. However, the ascendancy of President Nelson Mandela and the return to democracy in the country brought with it the political will, one that opened room for legislations that are friendly to Islamic Shariah laws and businesses that comply with these laws.

4. Exits

Exits in private equity are achieved either through a further private sale to financial and/or strategic trade buyers or through an IPO. Private equity investments are amongst the most illiquid forms of investments and therefore typically only deliver returns and cash when the investee companies are sold. Speculative and daily trading is frowned upon by Shariah as this is akin to maysir (gambling). As noted herein, private equity funds have investment terms of 8-10 years, some longer with an average investment for each company around 5-7 years (Azhar, 2010). With the Shariah prohibition against preference shares and other similar fixed income returns, the Manager has to consider the exit options carefully and determine what the most appropriate exit within a reasonable timeline is.
The impact of exit strategy in private equities in South Africa cannot be ignored. According to (Jaffer, 2009), such equities are a reason as to why the markets for Shariah compliance in difference have been expanded. In his research titled; ‘The global reach of Islamic banking and takaful’, Jaffer takes the position that Al-Baraka and many other institutions that have devoted their operations to strict Islamic laws are but a reason as to why there is an expansion in the Shariah business space. The study further provides that country as big as South Africa with minority Muslims would never have made it in expansion of private equity fund without the strategic exit strategies adopted by players in the market. Increased cases of exists within the industry are take an as a step forward towards sensitisation on the equity funds that comply with Shariah laws and so is the investment in this category.

Exits within the private equity sector have generally been within the aforementioned timeframes and historically have been achieved through a trade sale or IPO. However, with the significant amount of private equity money raised for investments in Africa, there’s been an increase in the secondary buyout market where other private equity funds are acquiring investments directly from private equity funds. (Lewis, 2010) provided a very comprehensive analysis of the challenges facing the exits with respect to Shariah compliance and business in Africa and beyond. In the study dubbed; “Accentuating the Positive: Governance of Islamic Investment Funds” the growth in private equity funds in South Africa and other fast growing economies in the region can be attributed to the mutual cooperation between different equity funds in the markets. The Al Baraka success case can indeed be a good reference point in as far as such achievement is concerned. It is only through such collaborations that milestones
are made in appreciation of the intrinsic motivations behind Shariah compliance in equity funds management.

5. Returns to investors

The aim of this mini thesis is not to examine or analyse the returns that may be achievable in South Africa or if Islamic private equity returns are better than conventional returns. It is noteworthy that in a study by Girard and Hassan, Islamic indices were considered more “growth and small-cap oriented than value and large cap oriented, if compared to conventional indices”. A reason provided for the high proportion of growth stocks may lie in the exclusion of traditional value sectors like chemical, energy and basic industries. The authors, after controlling for market risk, size, book-to-market, momentum, local and global factors, found that the difference in return between Islamic and conventional funds remains insignificant—i.e. as none of the alphas are significantly different from zero, and one cannot distinguish between the two (Girard & Hassan, 2005).

Conclusion

This note is not intended to assess the value proposition for private equity as this can be considered by reviewing and evaluating other materials. Private equity is certainly an attractive asset class for both investors and owners of companies looking to sell their
business. However, the mini thesis has provided sufficient evidence that a private equity fund in compliance with Islamic principles can be achieved. It further shows that South Africa is a country on positive end of the uptake for religious based financing and banking and so is the case for consideration of the Shariah laws and Shariah compliant organisations in the country.

This trend can be attributed to increased awareness of and compliance with Shariah laws by those businesses currently applying them, and confidence in the ability to comply with the various elements that defines Shariah laws as it applies to finance and equity. As such, increased uptake of Shariah compliant policies and development of financial institutions and agencies that are built on Shariah laws have served to lure more investors that were sceptical on the viability of such strategy of growth.

Private equity is now an established sector in South Africa with a number of established players in the market and as noted herein several international private equity funds such as Carlyle and Abraaj have recently opened offices in South Africa. With the rise of Islamic finance products within South Africa and further establishment of regulation in this regard, South Africa is well placed to attract Islamic finance in various forms including private equity. By creating and providing the platform in South Africa, Middle East SWF’s who hold a Shariah investment mandate and established Shariah compliant funds, will begin investing here especially given the attractive opportunities and returns that can be achieved (Masood, Ghulam, & Noryati, 2011)

Islamic institutions themselves have to diversify into untapped markets and explore growth opportunities in markets where excess capital could be better deployed to provide returns
Unavailable in more developed markets. Private equity is not often mentioned in the Islamic finance literature, perhaps because of current market size of private equity within the context of the wider Islamic finance industry. If Islamic finance is to take a leading role in the post-crisis financial world, it must increase its commitment to private equity and venture capital and develop a variety of funds and secondary market strategies. (Chapra, 1985), notes the call for justice for both finance & business organisations and the consumer have always resulted in reduction in the prospects of profit for these players. As opposed to investors who are much inclined into the extremes of capitalism and the promotion of the bourgeoisie-proletariat dominant style in business, Shariah laws would shade more ground to have the ordinary consumers getting a reprieve for the inhibitive charges.

This note has highlighted the specific issues and concerns that must be addressed in forming a Shariah compliant fund and the special sensitivities of Islamic investors due to guidelines and prohibitions set out in the Qur’an and Prophetic traditions. The challenges of meeting the financial screening and debt requirements are onerous but can be achieved into something Islamic investors would find palatable. According to Muhammad Iqbal (2008), Shariah laws pose the challenges of standardisation in world where globalisation entails proper analysis of the markets based on the conventional platforms and or criteria. In the article, "Islamic World's Development Policy Responses to the Challenges of Financial Globalization", he further notes that people require more integration than disintegration and that Shariah laws in business are seen as a form of disintegration from the mainstream operation policies and procedures in finance and equity (Azhar, 2010).
The literature reviewed and considerations observed and provided herein, demonstrate that an Islamic Private Equity Fund can be constituted in South African, which in itself is already embracing Islamic banking. This could become an interesting alternative for Private equity investors seeking an Islamic Fund and regional diversification while still potentially meeting all Shariah requirements. There are a number of challenges including both qualitative but also quantitative ones. Islamic finance principles provide adequate alternatives to overcome some of these challenges.

**References**


