

# AFTER THE CRASH

*New market realities and the need to demonstrate the moral legitimacy of long term capital will see the growth of the Islamic private equity and venture capital markets in a post recession world.*

*Khalid Najibi explores the issues*

■ The global recession brought about by the collapse in credit supply saw many of the globally accepted models of investment disintegrate as the pillars of their construct, the ready supply of cheap financing and ever increasing asset valuations, disappeared almost overnight with the collapse of Lehman Brothers in September 2008. The investment market is now a very different environment to that of the past decade, where we witnessed the rise of huge private equity houses, capable of raising multi-billion amounts for funds and made personal fortunes for many. The fall out from the global financial collapse and the resultant collapse has seen much recrimination between financial industry leaders, regulators, governments and the public as we seek answers and search for accountability. It is evident that with the financial services industry and its wider influence under greater scrutiny than ever, its very morality, or perceived lack of morality, in the pursuit of profit at all cost has become a question of our time.

The radical change in the investment dynamics of the market and a clear question of the morality of the investment industry signify a clear turning point in the development of regional and global investment markets. Investments will necessarily be longer term, with higher levels of equity and lower returns compared to the frenzy of the recent past. Societies, particularly in developed markets, are now questioning the benefit and the licence of the wider investment industry, with extraordinary returns and profits made through cheap financing and high levels of leverage, with little of that economic return seemingly being reinvested into society. It is this new environment, new market realities, the moral case for investment institutions in society – in essence, earning the right to operate – that will provide new impetus to the already burgeoning Islamic private equity and venture capital industries.

Even before the full onset of the global downturn, the characteristics of Islamic private equity and venture capital ensured the sectors enjoyed increasing attention from regional and global investors. The growing demand for Islamic financial services in general, driven by the forecast 15-20 percent annual growth in Islamic finance, saw many investment firms offering new Islamic private equity and venture capital products to meet the market demand. There is already a close connection between the Islamic principles of investing and private equity. In private equity, the investor shares both the risks and the rewards, which replicates the basic principles of Islamic investment. The realities of the new investment markets in which we operate will see a growing demand for a far more partnership approach to private equity and venture capital investment as the levels of equity for investment increase and the market sees an increase in the merger of companies as a means of meeting the operational and strategic challenges of the economic

downturn. Islamic investment also tends to be made in largely infrastructure orientated projects, such as transport, energy, healthcare and education, as these sectors not only offer asset backed investment but also long term investment into societies, a key tenet of Islamic investment. It is not about the profit alone and never should be. Islamic investment should be made on the basis of partnership and for the wider benefit of our communities. Islamic private equity and venture capital also invests in an ethical manner, which sees it applying often relatively conservative financial structures to investments, offering realistic return levels to investors. With major private equity houses still suffering from their pre-crisis leverage levels, Islamic private equity and venture capital will undoubtedly appeal to more restrained market expectation about returns.

Given that there is a natural fit between providing risk capital to businesses and Islamic law's profit and risk sharing principles, Islamic private equity and venture capital have become increasingly attractive asset classes to Islamic investors. In a post-crisis market, a market that is far less exuberant, much more realistic and is searching for an ethically based approach to investment, they are products not only of the moment but also for many years to come.

The opportunity exists for Islamic private equity and venture capital to grow strongly and secure their future as increasingly standard asset classes. Comparatively, the sectors have coped well with the effects of the downturn. Although levels of investment and exits have dwindled over the past 18 months, the asset-backed nature and conservatively structured deals mean that the sectors are generally better placed than many of the highly leveraged, debt financed conventional investments made over the past five years. The downturn itself has seen a reduction in asset valuations across industries. This provides Islamic investors with the opportunity to make investments at the bottom, or at least near the bottom of the market, offering additional reason for investors to consider these sectors for long term value opportunities in a post downturn market.

As much as the sectors offer a potentially highly attractive model to investors, both in terms of structure and moral requirements of our new investment environment, both Islamic private equity and venture capital are still nascent industries, very much in their infancy. The industries are still only a small part of the overall Islamic finance growth opportunity. Industry estimates suggest that global conventional private equity market was worth around \$2trn in 2009. Official figures do not exist for the Islamic private equity industry but estimates suggest that only \$4bn of the entire \$20bn Gulf private equity sector is accounted for by Islamic private equity. Consider this figure against the global value of



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the entire Islamic finance industry, estimated at \$800bn, and we can see that Islamic private equity and venture capital is still a small player in the vast opportunity that the rapidly growing global Islamic financial market offers.

A number of challenges face the sectors; challenges that if not tackled will hold back the development of these important asset classes. The perception of these industries is hugely important to their development. Often they can be viewed as being a Muslim only product, complex and offering lower returns. The range of products compared to conventional products currently can sometimes be limited. In addition, fee structures can seem relatively expensive compared to conventional products due to investment screening requirements, complexity and higher research costs due to the lack of research material. Investment opportunities and acquisition finance options can sometimes be limited by the requirements of Islamic financing and the lack of uniformity in terms of accounting standards and the interpretation of Sharia'ah principles can add additional complexity to Islamic investment. Lastly, the number of qualified and experienced Islamic private equity and venture capital experts remains limited, holding back the development of the sectors. That being said, the industry has made significant progress over the past few years in overcoming some of these challenges. For example, fees and investment returns are now comparable with conventional products. In addition, investment products are managed in a Sharia'ah manner, which complement the product promise and offering of many conventional "ethical investments" which have been available in the West for many years.

Many of these challenges are not uncommon across many aspects of Islamic finance in general as it remains a relatively young sector in comparison to the range of products and services, regulatory environments and financing structures offered by conventional finance. However, within the Islamic private equity and venture capital markets, the achievements of institutions such as Capital Management House and other leading regional Islamic investment banks are pushing the development of the industry. Increasing innovation in terms of financing structures and screening procedures means that many more opportunities are available to Islamic investors than just a few years ago. An increasing number of highly trained and qualified financial experts are entering the Islamic investment market out of preference, keen to become part of what will continue to be a rapidly developing global market place. Accounting principles and Sharia'ah interpretation are becoming more standardized as the industry coalesces around the standards issued by the Accounting and Auditing Organisation for Islamic Financial Institutions. All of these continuing developments will

see the industries offering an increasing range of highly sophisticated, competitively positioned investment opportunities to Islamic investors over the coming years.

The aftermath of the economic downturn could well prove to be a defining moment in the growth of Islamic private equity and venture capital. Adjusted return expectations and a need to demonstrate the moral legitimacy of investment to society offer the sectors a golden opportunity to secure their future as long term asset allocation requirements for both Islamic and conventional investors. The Sharia'ah principles of Islamic private equity speak to our times, to the needs of the market. It offers investment in the real economy, as opposed to highly complex derivative instruments. Investing in the real economy not only offers potential returns for sponsor and investor but it also benefits society as a whole given the often infrastructure type investment typical of Islamic private equity. The GCC and wider Middle East region offers a massive infrastructure opportunity over at least the next 20 years. Companies such as Capital Management House are ideally placed to secure value from this market opportunity and we have made substantial progress and investment into important markets and sectors in the Middle East. Our Libya Fund, established to invest in the forecast development of this oil rich and strategically important gateway market, is already investing in the energy potential of Libya. Over time the fund will also invest in other important markets, such as healthcare, in which we are already making progress with potential investment plans. We are also investing in the energy needs of the region with investments such as our investment in the Al Dur power plant in Bahrain last year. Islamic investment is equity based and is made into stable companies, with these investments based on partnership models of agreed risk and return. Value is unlocked by Islamic private equity deals as the interests of all parties involved are aligned. Deals are also based on long term value propositions, rather than short term return horizons.

In the post recession world, the market, and society, is demanding that the investment industry provide a responsible form of investment. Islamic private equity and venture capital are both ideally suited to meet this demand and to create demonstrable economic value not only for investors but also for society. An important part of the Islamic investment market has come of age. ◇

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