# Islamic private equity: what is new?

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The current paper analyzes similarities and differences between conventional and Islamic private equity (PE). Despite the financial subprime crisis and the lack of liquidities in financial markets, PE still play an important role in financing growing unlisted firms all over the world. However, conventional PE and Islamic PE display different features.

First, Islamic PE funds have less investments opportunities and cannot diversify their projects across activities and sectors mainly because of the *Shari'ah* compliance criterion. For instance, the PE funds is composed of the managers team, the *Shari'ah* supervision board SSB and the supervision compliance officer SCO. Second, the choice of PE partnerships depends on the target's performance, the Islamic scholars' school and the religiosity degree of the country where they operate, and the SSB policy. Third, they bear varied and different risks from their conventional counterparts. As a consequence, Islamic PE financing is expensive and still not very competitive. Fourth, to overcome and mitigate risks, conventional PE funds can issue convertible securities and abandon prematurely bad quality projects. In contrast, Islamic PE funds are actively involved in the project only in specific cases and cannot exit prematurely the target but can sell gradually their stocks to cover their equity. Finally, financial modes vary according to the degree of involvement of the PE fund in the project and the pre-agreed arrangements between the entrepreneur and the PE fund.

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## Introduction

Almost every one today has heard of the term private equity (PE) but only few people know that it is a well developed asset class in the Middle East and is used to finance Shari'ah compliant investments. Whether they are Islamic or not, PE partnerships are source of funding for a large range of unlisted firms.

The story of PE has its origins in the USA. In 1946, Georges Doriot, Ralph Fanders and Karl Compton decided to found the American Research and Development Corporation (ARDC). The ARDC's objective is to fund private investments of soldiers returning from the World War II. It is officially the first VC institution and was supported by State aid programs and tax incentives. Consequently, the number of PE investments and the volume of raised funds had increased significantly. Indeed, the amount of money raised by PE investors has sometimes exceeded capital issued through Initial Public Offering (IPO).

Over the past thirty years, PE projects have grown dramatically in the Western world. In 2007, funds managers raised more than US$ 400 billion and invested more than US$ 600 billion in enterprises all over the world (Gierath, 2010). After the financial subprime crisis, it became difficult to secure debt financing for new projects (like for example in France see figures 1 and 2). One explanation is the lack of liquidity in private markets due to the reluctance of institutional investors and the high investment losses. In addition, banks become more selective to reduce their risk exposure as much as possible. As a consequence, investors reduce their commitments to new projects and raise lower capital in project in which they were involved. Another explanation closely related to the investors' reluctance, exit routes become tighter in this unpredictable environment.

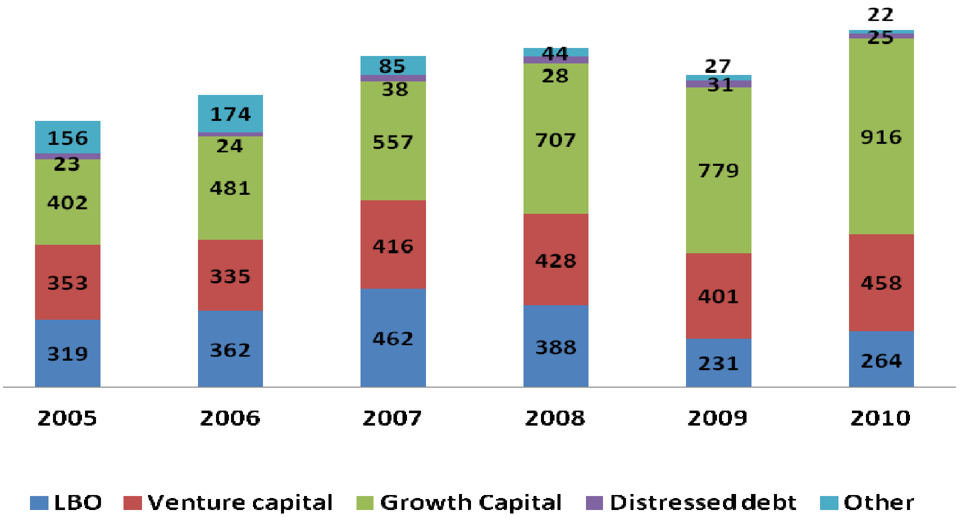


Fig 1: The number of PE projects (www.afic-data.com /Grant Thornton, March 2010)

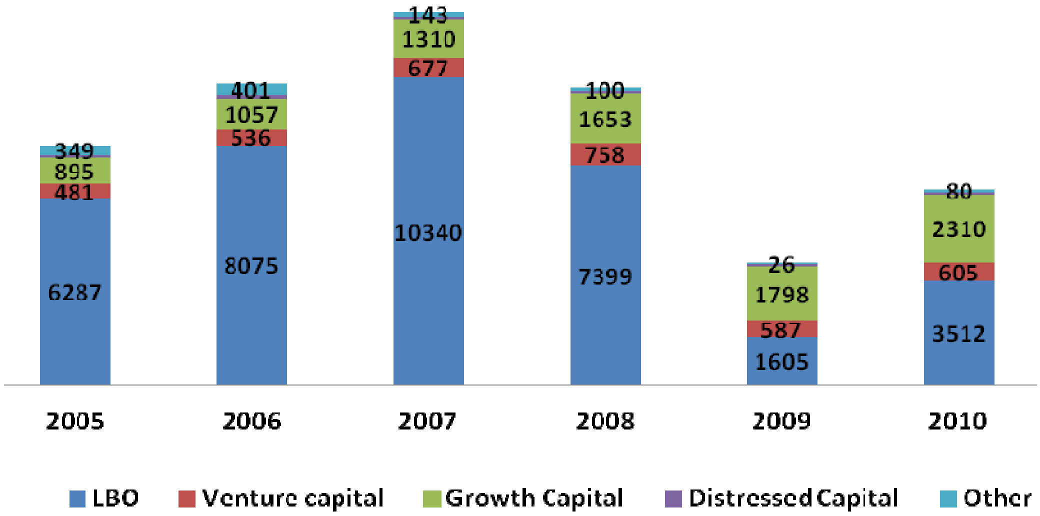


Fig 2: The size of PE projects (€ millions www.afic-data.com/ Grant Thornton, March 2010)

The PE industry enhances job creation and improves economic growth. It is based on partnerships in non-listed companies, for example, innovative or star-up firms, firms operating in the middle market, firms in financial distress and even public firms that want to go private through buyout acquisitions. Entrepreneurs are very often wealth-constrained and/or have no business experience to turn alone their projects. In addition, they cannot raise financing in the debt market or the public equity market because they do not have real guarantees and collateral. PE is a broad term that refers to funds that have been raised in the private markets. Despite the increase of funds issued in PE investments and its important role in corporate finance, only the venture capital VC and leveraged buyout LBO investments have received considerable attention in the academic literature. But in practice, PE is used in many stages of the cycle life of the enterprise.

Funds raised in PE partnerships are provided by professional intermediaries who invest in all the stages (creation, development, buyout, recession…) with the aim to exit quickly the target and maximize their gains. Their prime aim is to get their money back to invest it in a new deal.

One development worth noting here is the tremendous development of PE based on *Shari'ah* principles first in Muslim countries, particularly in the Middle East. Despite the fact that the first Islamic banks had been established in the 70s, the first Islamic PE funds appear only in the last decade. Islamic banks like for example *Arcapita Bank* and *Gulf Finance House* set up investment funds to take stakes in growing unlisted companies. Last years, they generate high yields in some business lines which were for a long time dedicated to conventional players.

In 2003, there are more than 300 Islamic financial institutions operating in 70 countries. The total amount of deposits is around US $ 120 billion while the amount of raised funds managed by Islamic PE funds varies between US $ 300 and US $ 800 billion. The Gulf Cooperation Council (GCC) countries[2] capture US $ 100 billion (see figures 3 and 4).

Nowadays, many conventional banks operate Islamic Windows in order to attract both Muslim and non-Muslim depositors, financiers and investors who became more and more cautious particularly after the financial subprime crisis. This shows the attractiveness and the increasing interest for Islamic PE industry. Many international financial centres have set up Islamic benchmarks, like for example the Dow Jones Islamic Market Index[3] in New York and the FTSE Global Islamic Index[4] in London.

In 2008, the number of Islamic projects in Kuwait has exceeded the number of their conventional counterparts; it increased by 300 percent compared to 2003. There are more than 130 *Shari'ah* compliant mutual funds operating in Malaysia -the centre of Islamic finance- and 120 in Saudi Arabia. In the UAE, the number of Islamic PE fund has almost quadrupled between 2005 and 2008: they increased from 15 to 63 (Seera investment Bank and Dow Jones, 2008).

[2] GCC consists of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

[3]The Dow Jones Islamic Market Index was the first benchmark of investment performance for the global universe of *Shari'ah* compliant equities. Since the launch of this global index in 1999, the DJIM index has expanded to provide a wide variety benchmarks tracking *Shari'ah*-compliant securities including indexes for specific countries, regions, industries and market capitalization ranges.

[4]The FTSE Global Islamic Index Series (GIIS) are equity benchmark indices designed to track the performance of leading publicly traded companies whose activities are consistent with Islamic *Shari'ah* law. In essence, it is an indicator of the performance of global stocks that are available to an Islamic investor.

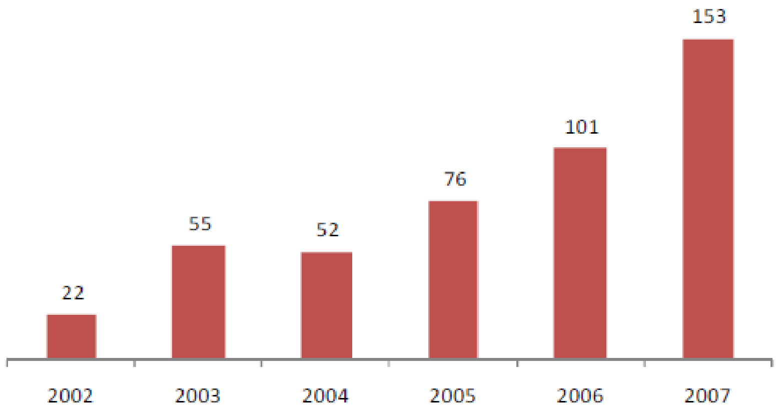


**Fig 3: The number of Islamic PE funds between 2002 and 2007** (Eurekahedge Islamic Funds Database, 2008)

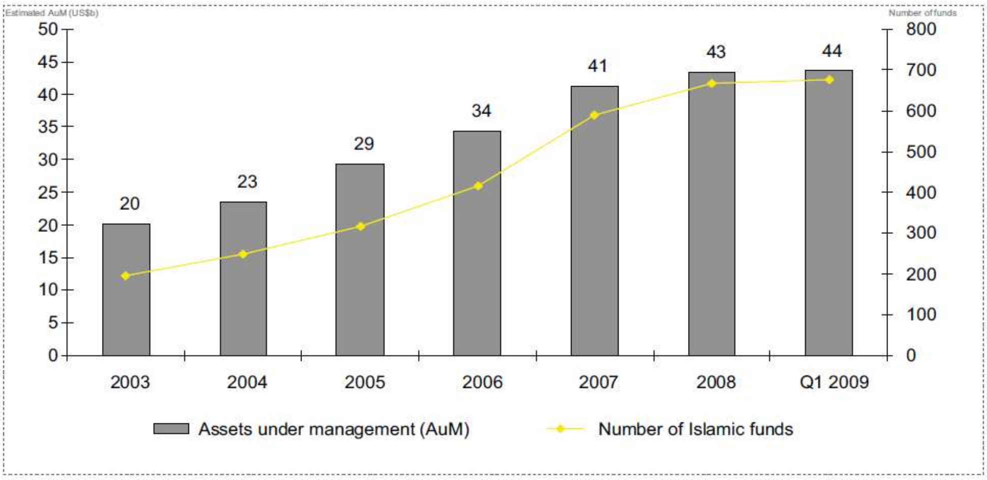


**Fig 4: Global Islamic Funds Industry (Ernst & Young, 2009)**

It is straightforward to see that there are some similarities between Islamic and conventional PE, like for example the active participation and the quick exit of the PE fund, and the close and active partnership. For instance, VC financing is too similar to some traditional methods of financing observed in medieval Islamic societies. Because of the lack of data, it is hard to pinpoint exactly the beginning of Islamic PE. In fact, there was partnership arrangements very similar to those practiced in conventional PE. But Islamic and conventional PE display also different features

## 1. Similarities between conventional PE and Islamic PE

PE funds SME and increases the productivity of the economy, in both Muslim and non Muslim countries whether it is *Shari'ah* compliant or not. Indeed, PE industry satisfies the specific needs of growing companies that cannot get credit financing and raise equity in public equity market. Unlike traditional financing methods, it provides not only funds but also skills and know-how to enable the firm to move to the next stage (for example, from the starting stage to the development stage). The entrepreneur/ PE fund partnership is based not only on sharing experience and skills but also on trust.

There are four common features in Islamic and conventional PE financing:

First, it is based on a close and active partnership. PE funds play a double role: they are financiers but also investors. They participate actively in all the tasks in the selected project. For instance, the entrepreneur benefits of their professional network and contacts. They help developing business plans, looking for new partners and taking decisions.

Second, the entrepreneur is very often wealth-constrained particularly in start-up firms and has no business experience/skills and no guarantees. Risk failure is therefore significantly high. As a consequence, PE funds are very selective: the initial review leads to the rejection of a large number of proposals. Only few projects are chosen after the second review. Business plans are scrutinized particularly in foreign countries because they present additional risks (like for example, exchange and legal risks). If the entrepreneur's proposal belongs to the surviving ones, the PE funds organize meetings and telephone discussions with the key staff of the target and sometimes with its customers, suppliers and creditors. PE partnership is value enhancing in the sense it decreases risks, creates a real dynamic and provides financial resources, varied skills and more effective governance.

Third, PE financed firms must show high potential for generating cash-flows during a fixed period (it varies between 2 and 8 years). The choice of the exit route is the last and important way to earn money for both partners. Dividends are very often distributed randomly particularly the first years. There are three main exit routes: IPO for the most successful projects, sale and buyback.

Finally, PE funds are financed by equity commitments from institutional investors, wealthy individuals and business families, retired managers, corporations and institutions. They are the limited partners LP. They delegate to the general partners GP (the PE investors or managers) the responsibilities of selecting, managing, conducting the exit strategy and liquidating the targets if necessary. The LP aim is to diversify their portfolios without facing the risks that would be faced if they invest directly in these firms. They provide capital to the GP in exchange for high returns.

## 2. Conventional versus Islamic Private Equity: what is different?

The tremendous development of Islamic PE is explained by several facts. First, many Muslims (particularly traditionally minded farmers and artisans) still refuse to deposit their savings in banks, particularly conventional ones. These savings are increasing dramatically and captured in the last years by Islamic PE funds. In addition, many non-Muslims investors and depositors become reluctant to the conventional banking system after the financial subprime crisis and show an interest for Islamic one as an alternative for conventional one.

***Less investment opportunities***

Islamic PE finance only *Sahri'ah* compliant projects to make a *halal*[4] profit. This means that Islamic PE funds have lower investment opportunities than the conventional one as many investments are not in accordance with the *Shari'ah* principles (*haram* investments) and are financed by interest-bearing instruments (see figure 5). However, there is no exhaustive list of *halal* investments: it depends on the Islamic scholars' school (*Malikite*, *Hanafite*, *Chafiite* and *Hanbalite*) and the degree of religiosity of the country. It varies also from one *Shari'ah* committee to another.

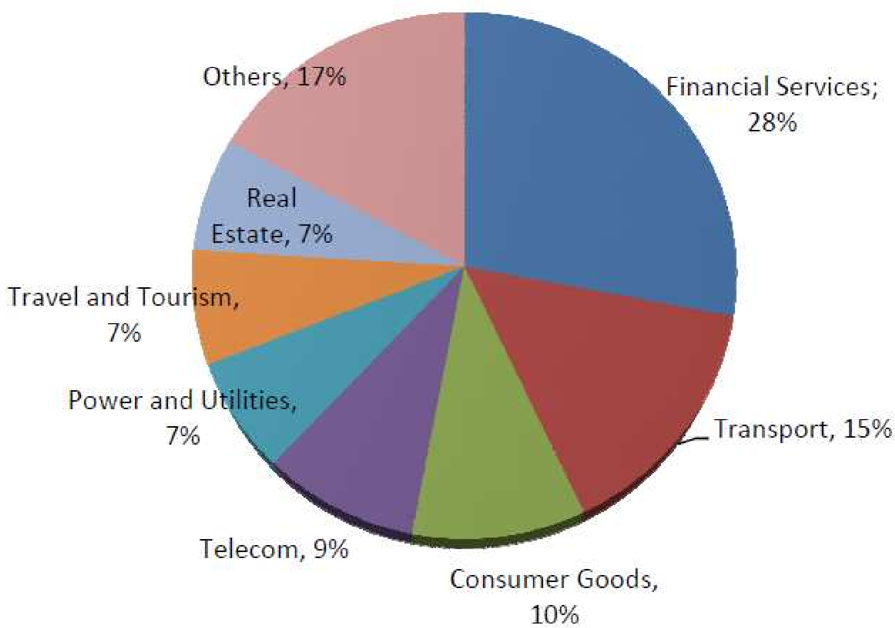


**Fig n 5 - Sector Focus of IPE 1997-2006 (Zawya/KPMG, 2006)**

[4] A *halal* project is a project that is in accordance with the precepts of Islamic rules.

In practice, all the investments related to pork products, blood, any activity related to intoxicant products, pornography or obscenity in any form, gambling, casinos, lotteries, trading on human cloning and human fetuses are strictly prohibited in Islamic finance. Some conventional projects based on interest, speculation and insurance cannot get Islamic PE financing. In practice some other activities should be avoided as they lead to confused situations, eg hotel industry. It depends on the financial criteria retained by Islamic scholars. If the target companies satisfy some ratios, they become *Shari'ah* compliant (see table 1). For instance, despite the fact that interests are prohibited, Islamic PE funds can raise financing in leveraged investments only if the total interest-based debt divided by assets is less than 33 percent. They can also finance conventional targets if the rate of non permissible income is less than 5 percent.

| | Debt ratio (%) | Receivables ratio | Cash + Interest-bearing ratio | Non-permissible income/total income |
|---|---|---|---|---|
| DJIM[1] | 33 | 33% | 33% | ≤ 5% |
| FTSE[2] | 33 | 50% | 33% | ≤ 5% |
| S&P[3] | 33 | 49% | 33% | ≤ 5% |
| MSCI[4] | 33 | 70% | 33% | ≤ 5% |
| Parsoli[5] | 33 | 45% | 33% | ≤ 10% |
| HK Islamic Index[6] | 33 | 49% | 33% | ≤ 5% |

[1] Trailing 12 months average market capitalization
[2] Total assets
[3] Market value equity
[4] Total assets
[5] Trlng 12 Mth Av Market Cap
[6] Trlng 12 Mth Av Market Cap

[1] Guide to DJIM Indexes November 2007
[2] Ground Rules for the Management of FTSE Shariah Global Equity Index Series Version 1.2 March 2008
[3] S&P Shariah Indices Index Methodology June 2007
[4] Morgan Stanley MSCI Islamic Index Series Methodology April 2007
[5] Parsoli Islamic Equity Index PIE
[6] Hong Kong Islamic Index

**Table n 1- Financials screening ratios (Wouters, 2008)**

In addition to the high potential for growth, the low leverage and the religious criteria, target companies must contribute to the economic development of the region in which they are set up. They must be directed towards a social objective. It is inserted into the local community bearing some responsibility for its prosperity. Islamic PE promotes and consolidates social development through the almsgiving (zakat)[5] and the creation of funds employed in charitable works.

Islamic PE funds invest mainly in real estate and infrastructure sectors, eg *AlAhli Global Real Estate Fund* (funded by The *National Commercial Bank* - NCB) and *Al Qasr GCC Real Estate & Const. Equity Fund* (financed by *Saudi Fransi Caam* - Banque *Saudi Fransi* BSFR). Some other funds are exclusively devoted to VC funding in technology, media and telecommunication. For instance, *Injazat Technology Fund* is the first Islamic VC fund operating in the MENA region: it raised US $ 50 million in 2001 in Dubai.

***Different financing methods***

Conventional PE financing is based on four types of partnerships according to the life cycle of the enterprise. The financial capital structure varies according to the target:

1. Young and innovative firms developing innovative technologies, often in the high-tech sector, usually are financed through *venture capital*. In early-stage investments, entrepreneurs are wealth-constrained and very often the current proposal are their first one. VC fund accepts to finance only enterprises with the potential for extraordinary future revenue growth. These firms need capital to develop and market their products, and are in the research and development stage. Their objective is to

[5] Zakat institutionalizes the systematic giving of certain percentage (≃2.5%) of one's wealth each year to benefit the poor. It does not include charitable gifts given out of individual generosity and is not a replacement for taxes, but is seen as a form of compulsory worship, purification and redistribution. As it necessitates a regular reassessment of net wealth, Zakat is thought to help concentrate the mind in encouraging compliance with Shari'ah in all financial dealings (Alam, 2004).

increase quickly to reach the commercialization stage (Fenn et al., 1995). Because they cannot get financing in debt and public markets. The VC funds raise very often all the equity capital to finance the entrepreneur's project in exchange for benefit and control shares.

2. More established and mature firms, undertaking very costly investments, are financed by *Growth Capital*. They must be fast growing firms. Their objective is to develop their activities like for example establishing new subsidiaries in other regions or countries.
3. LBO acquisitions are commonly used when listed firms have subsidiaries to consolidate before going public. It solves difficult transmission of family firms to their heirs or employees, particularly in France. These firms must generate important cash-flows to cover the debt's payments. As investment amounts are considerable, LBO projects are significantly leveraged: the amount of debt represents more than 75 percent of the financial structure of capital (Jensen, 1986, 1991, Kaplan and Stromberg, 2010).
4. Firms in financial distress or those updating their technologies and replacing their equipments could be financed through PE partnerships.

In Islamic PE, financing is based on the *Profit and Loss Sharing* PLS principle: it implies that the entrepreneur and the Islamic PE fund share benefits and losses. There are three financing modes in Islamic PE:

1. *Mudarabah* scheme (profit sharing): it is very close to VC financing is used to finance innovative SMEs and start-ups. The Islamic PE raises financing and the entrepreneur brings skills and know-how to the project. Unlike conventional PE, the entrepreneur has all the control rights: the fund cannot participate actively to the

management of the target. However, the entrepreneur must report information to the PE fund at least every three months. The latter is considered as an alert partner. If the project is successful, the profit will be distributed according to a pre-agreed ratio. Otherwise, losses are borne solely by the capital provider and the entrepreneur losses time and energy. This could have the effect of incentivizing excess risk taking by the entrepreneur.

2. In *Musharakah* financing, all parties must contribute jointly to the funding of the target and are actively involved in the project. Profits and losses are shared between them according to their financial contribution or on pre-agreed ratios. Unlike *Mudarabah*, Islamic PE fund is a member of the directors' board. *Musharaka* principle looks like non-venture private equity (LBO, growth capital,..) in conventional PE.
3. It is also possible to authorize one party to confer the power and rights to act on behalf of the other one, based on agreed terms and conditions. This is the *Wakalah* financing. It enables PE funds to transfer some of the financial operations to the other partner. In such case, they receive the same return less fee that would be paid if they do all the business without relying on the entrepreneur's expertise. The idea is to take advantages of the information possessed by the entrepreneur. However, this contract creates agency problems because *Wakala* leads to a disconnection between the capital provider and the managers of the target.

Notice that in Islamic PE, a share of the available cash (about 20%) must stay liquid at the starting of the project (on average during the first two years). The capital raised by the fund will be invested gradually like in stage financing in conventional PE. This money is used to finance short term needs of the target.

### *Varied and different risks*

Islamic and conventional PE fund are exposed to significant and negative fluctuations of prices and therefore to the market risk, as well as default and liquidity risks and adverse selection problems of targets. However, to overcome these risks, they have different techniques. In conventional PE, future contracts decrease this risk. But they very often lead to speculation which is prohibited in Islamic transactions. In the same sense, Islamic PE does not allow forward sale of goods we do not own at the date t=0. Thus, futures contracts such as options and futures commonly used in conventional PE are not suited for Islamic one. But we find different variation of these contracts. Despite the fact that these products are largely inspired by conventional ones, they do not offer the same guarantees particularly in terms of mitigating risks. The objective of these products is to protect both parties by sharing profits and losses between the entrepreneur and the PE fund.

Because they cannot invest in many prohibited projects, diversification among sectors and activities is not always possible. Thus, Islamic PE funds face higher risks than their conventional counterparts. For instance, the entrepreneur bears lower risks than in interest based financing system and does not provide collateral and guarantees: damages and losses as well as benefits are shared between the two parties. As a consequence, Islamic PE funds are more selective than conventional one.

They are also exposed to a different structure of risks because of the high number of agreements that should be written in each stage of the transaction. This takes time and need the involvement of many contractors (the bank, the fund, *Shari'ah* board, the entrepreneur, the vendor,...) to ensure transparency. In addition, regulation varies significantly from one country to another. We should notice that there is no unified disclosure code. This poses new legal risk particularly for Islamic PE operating in conventional systems or conventional PE operating in Islamic countries. This explains to some extent why the average financing cost in Islamic banks is higher than in conventional ones (Chong and Liu, 2009; Baele et al, 2010).

Unlike conventional PE funds, Islamic ones cannot leave the project before the exit date even if it appears that the target is not profitable. They face therefore significantly higher risks than their conventional counterparts. In such case, they can choose *diminishing Musharaka* financing which looks like standard *Musharaka* one but it allows them to sell gradually their shares to the entrepreneur: the money invested is therefore recovered before the exit date.

Finally, as explained before, Islamic PE projects have social responsibilities as they have a social objective and are inserted into the local community. So they face varied and different operational risks than their conventional counterparts.

### *Different structure of PE fund*

In each Islamic PE fund, there is a *Shari'ah* committee called the *Shari'ah* Supervision Board SSB to define and set the *Shari'ah* policy of the fund. It consists of three scholars who are expert in Islamic Jurisprudence (*Fiqh el Muamalat*) and the financial law.

SSB interprets the *Qur'an*, the *Sunna*[6] and the *Hadith*[7] (the sources of Islamic laws) and relies on *Ijma'*[8], *Qiyas*[9] and *Ijtihad*[10] when the previous sources do not provide clear answers

[6] It is the second source of Islam faith, refers to the Prophet's acts and words which are related to his practice of faith. It explains and transmits the Qur'an.

on the compliance of some projects. The intuition is to facilitate future development and implementation of the Islamic judicial system (Pervez, 1990). It checks the compliance of the projects selected by the GP. Some scholars argue that SSB and GP should be independent to avoid conflicts of interests. New elements could transform the project into *harem* one, e.g. R&D activities that could be used in weapon industry. As consequence, Malaysia recommends the appointment of *Shari'ah Compliance Officer* SCO to supervise the financed targets and report irregularities to the SSB. Furthermore, SCO provides *Shari'ah* expertise on documentation, structuring deals and investment instruments (see fig 6).

***Financial Capital structure***

*Fund model LP/GP*

In conventional PE, GP may have an opportunistic behavior at the expense of LP, like for example exercising little monitoring, or charging excessive expenses, taking very risky decisions or keeping very profitable projects for themselves. This leads to agency conflicts between LP and GP. One solution is to fix finite lives for their partnerships: GP cannot keep the entrepreneur's project for a longer period than the LP money. Another solution is to link the GP remuneration to their portfolios' performance. LP have some degree of oversight over the partnerships they raise capital in. Furthermore, most partnerships have an advisory board consisting of the largest LP to solve interest conflicts that could appear between GP

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[7] They refer to tradition or stories of the Prophet. In contrast with the Sunna which was practiced, the Hadith are records of what was practiced. They have become a controversy between Islamic groups since there are a number of interpretations of them.

[8] It is the consensus of the Islamic community called umma, by which democracy makes its impact on the conduct of Islamic policy.

[9] It is a deductive analogy by which a jurist applies to a new case a ruling made previously in similar cases.

[10] It is independent judgment provided by scholars of Islamic laws for which clear principles and procedures are stipulated in the Qu'ran and Sunna.

and LP. Despite the fact that LP do not have an active role in management, they can vote to remove a GP or even to end the partnership before its termination. To protect LP interests, some agreements place restrictions through covenants, on PE partnerships and on some activities of GP.

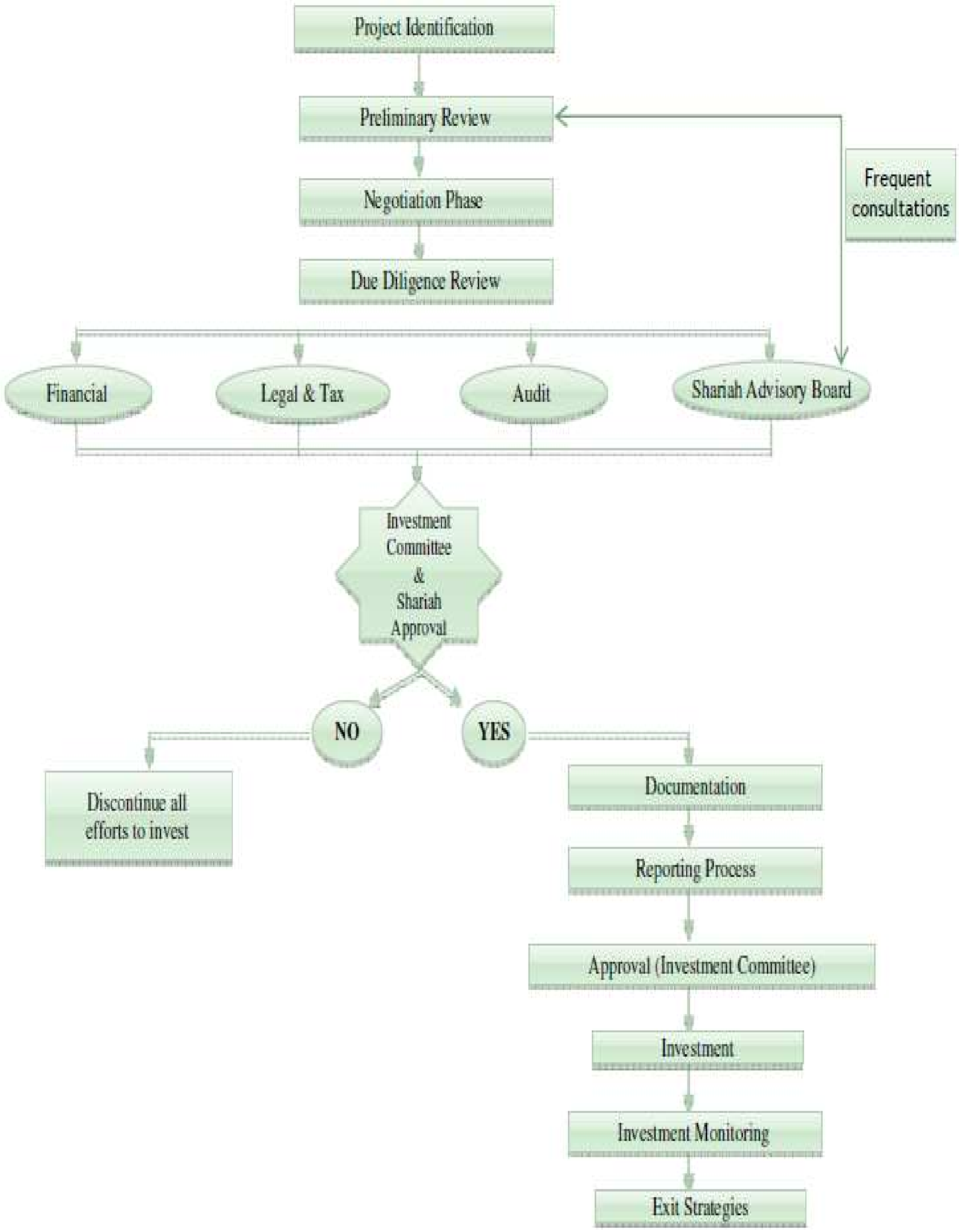


**Fig n 6- Investment process in Islamic PE** ($2^{sd}$ Islamic Venture Capital & Private Equity conference, 2009).

It becomes also necessary to adopt *Claw-back* provisions to preserve the LP right to recover their capital and management fees. Without such provision, losses on some investment may lead to a negative LP return.

LP choose GP according to their reputation and past experience. However, LP objective is to minimize fund-raising cost. They usually turn first to the GP that had invested in their past partnerships or stable investors offering the lowest fund-raising expenses with long-term PE commitment.

GP remuneration consists of:

- Management fees which most often range between 1.5 and 2.5 percent of the committed capital. This rate remains at a fixed level during the project life (Sahlman, 1990; Gompers and Lerner, 1994 and Fenn et al., 1995).
- Carried interest that is the GP share of partnership's profit. It is most often set at 20 percent of the target's net return (Gompers and Lerner, 1994).

In Islamic PE, partnerships are financed usually by equity commitments from investors. Returns are given by equity stakes in the underlying targets. Then, the PE managers distribute dividends to investors. In principle, the capital provider assumes all the losses of PE partnerships while the managers do not. Islamic PE funds domiciled in the Middle East are structured like in *Musharaka* or *Mudarabah* financing while out of this region, they are usually structured as limited partnerships very similar to *Mudarabah* structures. Accordingly, neither fixed nor any kind of guaranteed returns are allowed. However, *Shari'ah* allows profit preferences for LP such as a pre-agreed fee structure. Usually, after the repayment of investors' capital, GP are paid management fees (between 1.5 and 2.5 percent of the raised equity) and carried interest (between 15 and 20 percent) like their conventional counterparts. Unlike conventional PE, there is no guarantees for a minimum returns for both parties. In case of LP default, GP may, under specific conditions, claim the reimbursement of incurred costs and penalties.

*Financial structure of the target*

Conventional PE partnerships are very often financed through a mixture of debt and equity, particularly to fund LBO targets. The financial capital structure varies according to the project's performance, the financial contribution of each party and the guarantees they can offer to the bank.

Conventional PE is based on effective control and active monitoring. PE fund issues common and convertible securities[11] in exchange for shares of benefit and control. If the entrepreneur takes very risky decisions to enjoy perks (official car, travelling fees, improving their image/market reputation…) or the project does not perform as well as it was expected in business plan, the PE fund converts securities into common stocks to diminish the entrepreneur's control. Convertible securities and monitoring are a mean to decrease agency costs.

As explained before, Islamic PE fund can raise capital equity in leveraged investments under the condition that the total interest-based debt divided by assets is less than 33 percent. Notice that in Islamic PE, a share of the available cash (about 20%) must stay liquid at the starting of the project (during the first two years). The capital raised in Islamic PE partnerships is invested gradually: it is too similar to the stage financing in conventional PE but without the option of prematurely termination. One explanation is the use of this money to finance urgent and short term needs of the target.

[11] It issues common stocks, convertible preferred stocks, and subordinated and convertible debt.

### *Exit vehicles*

To end up the PE partnership and repay all parties, a contractual agreement is signed at the starting of the project: It specifies the partnership life and the exit route strategy. LP avoid payment with illiquid securities but sometimes it is unavoidable because they have neither the target control nor liquidity (the project is completed). PE project may end up with an IPO for the most successful projects (called high-flyers) or a trade sale or a buyback. The worst ones -called *living-dead* projects- are abandoned very quickly (most often before the end of the first year). The abandon shows the ability of PE managers to filter good projects from bad ones. This is no longer true in Islamic PE: investors cannot abandon the project even if there is misevaluation problem of the target's quality. In fact, they must hold their shares for a fixed period of time (5 years in average) whatever happens. As an alternative, they can sign *diminishing Musharaka contract* to recover the raised capital without waiting for the exit date.

## 3. Challenges facing Islamic Private Equity

Whether they are domiciled or operate in the Middle East or out of this region, PE funds are very often composed of Western educated professionals and financiers who are interested in Islamic PE models but they trust West models. They look for conventional solutions or instruments and make them Islamic to solve complicated problems. Sometimes, they are subject to much debate and contested by scholars.

In recent years, many institutions and universities, like for example in France and the UK, propose academic and professional training with high standards in Islamic finance to meet the increasing demand of banks, PE institutions and lawyers.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) set up some international *Shari'ah* standards to increase legal certainty when SSB scholars have to take decisions regarding the compliance of projects. These efforts are still not enough to provide clear answers, specifically for PE funds exploring overseas opportunities and conventional ones practicing Islamic Windows.

There are many risks coming from the complexities of PLS methods and the different rules enforced by Islamic rules. For instance, PLS financing may lead to moral hazard problem which can be avoided by the use of non-PLS methods, like for example leasing contracts (see Aggarawal and Youssed, 2000).[12]

In addition, PLS financing does not help Islamic PE actors to be as competitive as the conventional ones, particularly when they operate in a conventional environment: they bear high risks. For instance, Islamic PE funds domiciled in the Middle East are more based on Islamic rules while those offshore deviate from traditional *Shari'ah* principles because they cannot pay investment account holders regardless their performance. They adopt therefore practices very close to the conventional ones to attract local investors and entrepreneurs.

Like in Islamic banking system, financial and regulation institutions must call for reforms to help Islamic PE better cope with the conventional one. Some studies (see among others Errico and Farahbakhsh, 1998 and Khan and Ahmad, 2001) argue that a greater emphasis should be placed for operational risk and information disclosure.

[12] Many studies (see among others Chong and Liu, 2009; Dar and Presley, 2000; Beale et al., 2010) provide evidence that PLS methods are marginally practiced in Bangladesh, Egypt, Indonesia, Iran, Malaysia, Pakistan, Philippines and Sudan. We should notice that some of these countries have a financial banking system that is fully Islamic. Bank Indonesia (2009) reports that PLS financing is widely practiced in Indonesia compared to the other countries despite the fact that it represents only 35.7 percent in financing Indonesian Islamic banks. One explanation is that PLS methods increase the risk of deposit withdrawal.

Another point worth noting is the importance of transparent and low taxation. Islamic PE funds benefit from a null or low taxation in their home countries -which is *Shari'ah* compliant. As a consequence, they prefer raising funds in countries like for example *Cayman Islands* and the *British Virgin Islands*. In EU, some countries (Luxembourg) reform their regulation system to provide attractive taxation for these funds.

In many Western countries, Islamic PE funds need the approval of the local authorities to finance targets in energy, infrastructure and media sectors. In some other countries, they cannot acquire more than a fixed stake in local enterprises. Western investors, financiers and entrepreneurs are very often not well informed about Islamic PE and its specific features so they are reluctant and doubtful-while PE partnerships are based on trust.

Finally, these funds face a significant legal and exchange risks in their overseas investments. They do not have experts in every jurisdiction which makes the termination of their deals a hard task simply because of the distance or the cultural barriers.

## CONCLUSION

At a first sight, differences between conventional and Islamic PE may look great. Despite its young age, Islamic PE is also a source of funding for a large number of unlisted and growing companies in the Middle East.

In the last ten years, there is an increasing interest for Islamic PE but it is still not very mature and face many difficulties to gain greater visibility all over the world. The Islamic rules enforced by the *Shari'ah*, the lack of liquidity in financial markets subject to crisis and the reluctance of Western investors, financiers and entrepreneurs outside the Middle East are among the factors that could explain the difficulties in implementing Islamic PE.

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