$250

Seera
Investment Bank

The New Mainstream: Islamic Private Equity and Competitiveness

IN PARTNERSHIP WITH

Dow Jones Private Equity

About Seera Investment Bank & Dow Jones

Seera Investment Bank is a *Shari'a*-compliant private investment bank, licensed and regulated by the Central Bank of Bahrain, with an authorized share capital of US$2.5 billion and a paid-up capital of US$291 million.

Seera's shareholders include regional financial and commercial investors as well as several prominent GCC families. Founded in July 2006 as United International Bank, Seera recently adopted a more distinctive name which has been designed to better support the Bank in achieving the level of distinction that it seeks.

Seera's strategy has been to develop a diverse and balanced investment portfolio in established growth sectors, both in MENA and in the developed markets of Europe, North America and Asia.

Seera particularly seeks to invest in companies that dominate their niche, are market leaders, and have a global footprint. Its portfolio is selective yet diverse, and includes significant recent transactions in the aviation, energy and chemical sectors:

• Falak, an aviation investment fund established in May 2007 with a diversified portfolio of narrow-bodied and wide-bodied aircraft worth around US$400 million which are leased to major airlines in Europe, Asia and the GCC.

• Kosan Crisplant, a global leader in systems and solutions for filling and reconditioning liquefied petroleum gas cylinders, acquired in January 2008. This European company, which has been in business for over 50 years, is now launching a range of new products and services as well as investing in new operations with a view to consolidating its position and penetrating key growth markets including the Middle East.

• BWA Water Additives, the leading global provider of high-performance water treatment chemicals, acquired in September 2008. This UK company already sells its chemicals in over 85 countries and, with significant growth in demand forecast around the world, is now poised to expand into the Middle East and other new markets as well as undertaking significant investment in new products.

Seera has an experienced management team, a strong partner base and an increasingly attractive investment portfolio. These factors, allied to rigorous risk management, compliance and ethical standards, make it well placed to exploit opportunities globally.

About Dow Jones Private Equity

Dow Jones Private Equity (www.privateequity.dowjones.com), a unit of Dow Jones Financial Information Services, is the leading provider of finance and investment data to the private equity industry. Its reports, newsletters, directories and conferences deliver the insights private market professionals need on the latest trends, deals and the people behind them.

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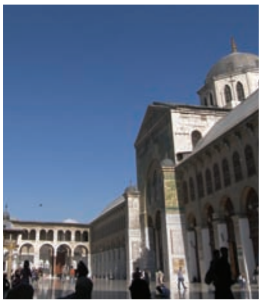
Methodology

The findings in this report are based on aggregate data from Dow Jones' unique research processes. The data was collected through interviews with leading figures in the private equity sector, industry analysis and secondary sources. The term 'private equity' in this report refers to investment in securities via a negotiated process. No statement herein is to be construed as a recommendation to buy or sell securities or to provide investment advice.

Table Of Contents



4 Foreword

5 Acknowledgements

6 Executive Summary

8 Part One: Growing

9 Part Two: Enabling

11 Part Three: Delivering

18 Part Four: Activating

22 Footnotes

The New Mainstream: Islamic Private Equity and Competitiveness

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DOWJONES

Seera
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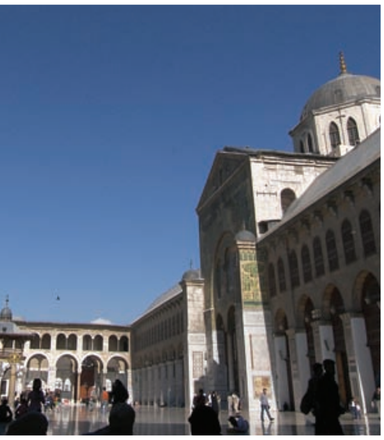
Foreword



The shareholders and Board of Directors of **Seera Investment Bank** are proud to announce the launch of the new brand at the 2008 Annual World Islamic Banking Conference in Bahrain. Founded in July 2006 as United International Bank (UIB), the new brand for Seera provides us with a strong asset which we believe will better support the Bank in achieving the level of distinction to which we aspire. Our long-term vision is to become not only one of the region's most prestigious investment banks, but also to attain greater recognition within international financial markets combining a modern, progressive approach with adherence to *Shari'a* investment principles and values. Our core strategy is to develop a diversified and balanced portfolio in established growth sectors which provides attractive risk adjusted returns and which is well suited for today's economic climate.

To mark this milestone occasion, **Seera Investment Bank**, in partnership with the world's leading provider of financial and business information **Dow Jones & Company**, is delighted to present the first in a series of groundbreaking thought-leadership reports on Islamic banking and investment. *Shari'a*-compliant investment has seen astonishing growth in recent years, and is now an increasingly important component of a rapidly-changing global financial system. Private equity represents an essential – and hitherto underdeveloped – application of Islamic economic principles, and the paper offers a pioneering demonstration of the competitiveness of this fresh and exciting sector. The paper also provides an essential analysis of the enabling factors behind the growth already achieved, and the key issues which remain to be addressed if it is to achieve its maximum potential.

We are proud to release this inaugural report, and firmly believe that, through the presentation of a new mainstream for private equity investment, it represents essential reading for investors, business owners and policy-makers across the MENA region and beyond. The paper offers a launch pad for an investment class which can create a future of competitiveness, stability and growth – a future in which **Seera Investment Bank** intends to play a key role.

Acknowledgements

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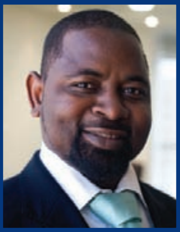

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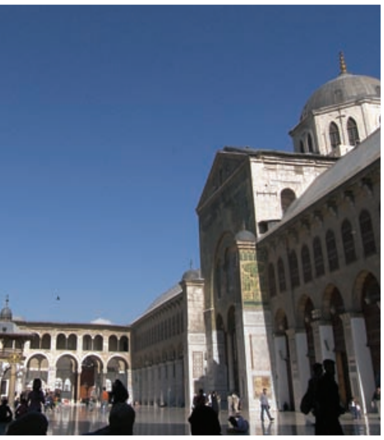
Executive Summary



Part One: Growing

Islamic finance seeks to reconstruct economics on the foundations governing wider Muslim society. The sector has seen remarkable growth in recent years, and the primary aim of this paper is to show that private equity based on *Shari'a* principles represents a competitive and credible alternative to the current mainstream, and has similar potential for growth as more established areas of Islamic finance.

Part Two: Enabling

There is an ongoing convergence of three enabling factors necessary for the benefits of Islamic private equity to be fully activated for the first time:

i.) Demand. There is a heightened awareness of, and interest in, *Shari'a*-compliant investments – from Muslim investors aspiring to lead an economic life as envisaged in Islam, and non-Muslim institutions looking to tap a growth market. In addition, both categories now see the capacity for returns comparable to conventional investments.

ii.) Means. Capital flows into the Muslim world, particularly the GCC, have assumed historic proportions. Hydrocarbon revenues are projected to top $8 trillion by 2030.

iii.) Support. Strong government and regulatory backing have resulted in the operating environment for Islamic finance becoming increasingly flexible and supportive.

Part Three: Delivering

With these conditions in place, we offer four reasons, spanning the length of the investment cycle, why Islamic private equity should be considered as a key component of this new financial paradigm:

i.) There is a close symmetry between private equity and Islamic financial prescriptions. Both are of a participatory nature, result in income from asset-backed, entrepreneurial investment and involve equitable distribution of risks and rewards.

ii.) Neither Islamic private equity investors nor their investee companies can be reliant on debt trading. The Islamic requirement that financial and productive flows are correlated offers attractive levels of stability and resilience.

iii.) There is a growing pipeline of *Shari'a*-compliant deals available – and today's *Shari'a* investor has the advantage of ready liquidity to complete them. A genuine demand for Islamic investment solutions now encompasses all stages of the financial ecosystem, from limited partners to business owners. *Shari'a*-compliant private equity is also optimally positioned to support non-collateralized start-ups and often-conservative GCC family businesses.

iv.) *Shari'a*-compliant private equity investors can apply the same value addition instruments as conventional private equity investment to their investee companies, provided that these instruments do not violate the basic principles of *Shari'a*. Tools such as management support and global connectivity have long been shown to be essential in driving business growth, and the private equity emphasis on corporate governance is of particular importance in the GCC, where a culture of full business transparency continues to develop and grow. In fact, Islamic investors may well deliver even closer support, due to their need to ensure continued *Shari'a* compliance.

Part Four: Activating

In summary, private equity is readily amenable to use by *Shari'a*-compliant investors. There are minimal differences in many areas between Islamic private equity and its conventional form, and those which remain either represent sources of competitiveness (reduced leverage and improved corporate transparency) or do not necessarily constitute a disadvantage (deal flow). The similarities on the other hand, principal among them the support and creation of world-class businesses, are compelling. Complementary to the three enablers which have allowed the sector to begin its initial growth, there remain four key drivers which must be addressed if the benefits of *Shari'a*-compliant private equity are to be activated and supported:

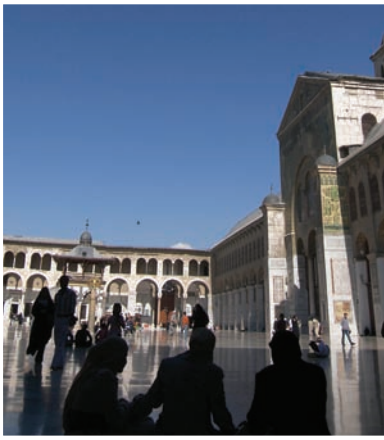
i.) Industry standardization. Standards improve transparency and facilitate the integration of Islamic finance into the global marketplace. They also streamline internal *Shari'a* screening, offer clarity of rights and obligations and reduce costs – a significant advance towards competitiveness with conventional investors.

ii.) Financial engineering. Modern private equity is a complex phenomenon and necessitates the development of creative instruments. Innovation will also be key in attracting wider interest critical for the long-term competitiveness and sustainability of Islamic investment, although this must not result in dilution of *Shari'a* authenticity.

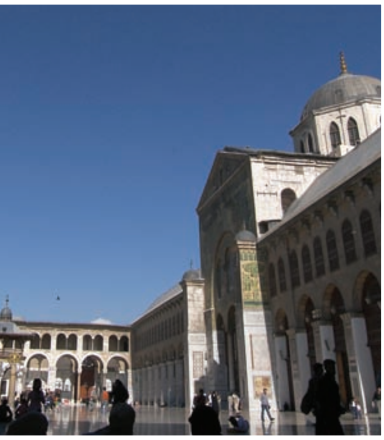
iii.) Market education. Islamic private equity must be demystified. Investors must develop track records and offer concrete examples of value addition - the issue is not only distinguishing Islamic and conventional investment, but meaningfully distinguishing value-adding Islamic private equity investments from those which do not add value.

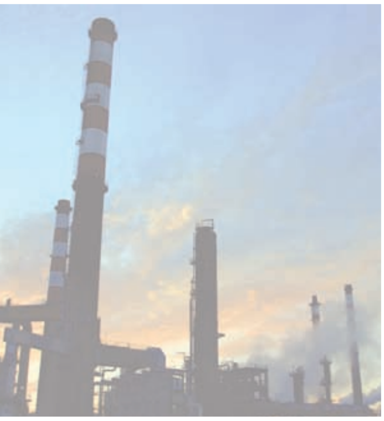
iv.) Human capital. There is a supply-demand mismatch for qualified professionals, with talent becoming highly monetized. Education and training need to be increased.

Islamic private equity is the right product for the right time, and delivers benefits throughout the investment cycle. Given that the financial teachings of Islam aim at equitable wealth distribution, with an essential concern for economic justice, the socio-economic impact of successful *Shari'a*-compliant investments could be immeasurable.



Part One: Growing





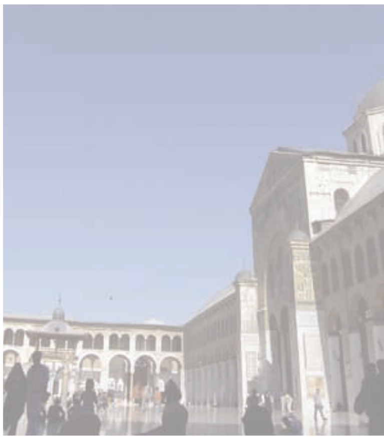
Islamic finance is defined as a financial service principally implemented in order to comply with the tenets of *Shari'a* – itself deriving from the Holy *Qur'an*, the *Sunnah* or practice and behaviour initiated by the Prophet Muhammad, and independent interpretation of legal sources[1]. The practical implications of this can be summarized in the following general principles, the majority of which are based largely on the simple morality and common sense which forms the basis of many of the world's great religions, including Islam[2]. In short, they are **i.)** the exclusion of *riba* from economic activity, a term which means excess, increase or addition – implying any excess compensation without due consideration – with the effect of eliminating the payment or receipt of interest[3]; **ii.)** the prohibition of investments in sectors inconsistent with the tenets of Islam, including, but not limited to, alcohol, tobacco, gambling, arms manufacturing, life insurance and pork production[4]; **iii.)** an emphasis on participation, whereby an investor and an entrepreneur share business risk in return for shares of rewards; **iv.)** the removal of uncertainty from contracts, which must instead provide full disclosure and refrain from asymmetrical information; and **v.)** a constant focus on materiality, with financial flows directly correlated to real productivity and assets. The final principle **vi.)** mandates justice in all financial activity, which should never lead to the exploitation of any party to the transaction. In short, Islamic finance seeks to reconstruct the financial sector on the foundations which govern wider Muslim society.

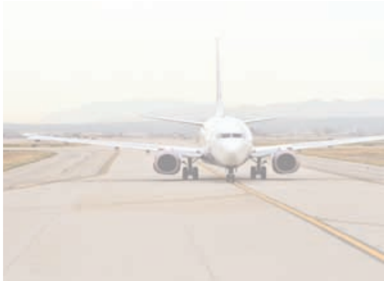
There are now more than 300 Islamic financial institutions operating across 70 countries, with deposits exceeding $120 billion[5] and estimated funds under management ranging anywhere from $300 billion to $800 billion[6]. Around $100 billion of these are adjudged to be in the Gulf Cooperation Council (GCC) – a six-nation economic bloc comprising Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates - region alone[7], with the local Islamic banking sector projected to grow by 60% in the coming years[8]. One development worth noting here is the increasing number of multinational banks, including HSBC and Deutsche Bank, now offering Islamic facilities[9] – evidence of the long-term attractiveness of the industry[10]. Other components of the Islamic finance universe are seeing similar growth – May 2008 saw both the number of Islamic investment companies in Kuwait exceed their conventional counterparts for the first time, jumping 300% from 2003[11], and the number of Islamic funds worldwide predicted to double to over 1,000 by 2010[12]. Saudi Arabia is today home to 120 *Shari'a*-compliant mutual funds and Malaysia 134 funds[13], with non-Muslim investors also beginning to show interest in this sector[14]. Stellar growth in the *Sukuk*, or Islamic bond market, has seen the GCC corporate bond issuance industry valued at around $17 billion at the end of June 2008, compared with $14.5 billion at the end of June 2007 – a 17% increase – with the overall *Sukuk* market now worth $80 billion[15]. Saudi Arabian Mining Company (Maaden) and Saudi Basic Industries Corporation (Sabic) have also completed the world's first $2 billion-plus *Shari'a*-compliant project finance transaction – the largest Islamic project finance deal ever done by a factor of almost 50%[16]. Huge growth is predicted in Islamic equity funds in the near future[17], with the first retail *Shari'a*-compliant, capital-protected equity product recently launched in the United Kingdom[18], an Islamic stock exchange planned for Bahrain[19], and Islamic securities now accounting for 42% of outstanding private debt securities and 25% of outstanding bonds in Malaysia[20].

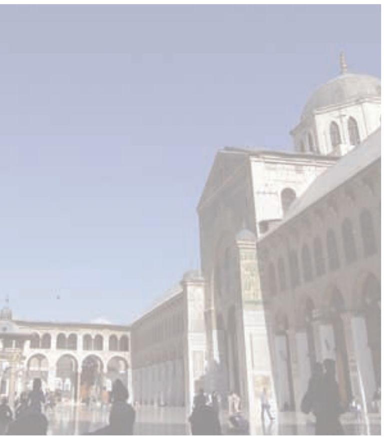
Favourable evidence is beginning to accumulate that Islamic finance accords not only with the needs of faith, but the demands of the global market. Taking just one component of the broad survey above, publicly-traded *Shari'a*-compliant equities have not only been shown to be more in accordance with the requirements of Islam, but also to be largely competitive with their conventional counterparts. The most established series of indices, namely the Dow Jones Islamic Indexes launched in 1999, offer similar risk-reward and diversification benefits to standard indices[21], with investors not paying any discernible extra costs for compliance[22]. In fact, the three months to July 2008, marked by considerable instability across most world stock indices, saw the Standard & Poors Global Shariah Index series return 3.61% against a fall in the equivalent international index of 1.49%[23]. Islamic private equity, on the other hand, has yet to see such rapid progress. As a result, the primary aim of this paper is to show that not only does the sector have similar potential for growth as the other areas within Islamic finance noted above, but that it is a competitive and credible way of doing private equity investment. However, before discussing the specific benefits that *Shari'a*-compliant private equity can offer, there is a further issue which must first be covered. It is of absolute importance to highlight that the present moment is, in fact, witnessing an ongoing, unique convergence of three enabling factors necessary for these benefits to be fully activated.

i.) The first enabler is also the most straightforward – demand. Without question, there is a heightened awareness of, and interest in, *Shari'a* investments – both from Muslim investors increasingly aspiring to lead an economic life as envisaged in Islam[24] and non-Muslim institutions looking to tap a growing market. In addition, both categories of investor now see the sector as offering the potential for returns at least comparable, and possibly superior, to conventional investments, and this has pushed demand still higher. Mohammed Arbouna explains that: "People now are more likely to want their businesses and investments to be in compliance with their beliefs. In Bahrain alone, we have seen seven Islamic banks established in the past year. Most of them are investment banks, and these would not be here if demand was not here too. They would not risk their time, effort and money"; and Amr Elimam adds: "People are becoming more aware of *Shari'a*-compliant investment. Once they recognize that the option is available, they then gravitate towards it. It is becoming increasingly mainstream both in the region and outside". Shahzad Iqbal summarizes the situation as follows: "Investors have become more focused on returns. They are much more cautious in where they invest their funds and have started to ask very focused questions. Not only do they, quite understandably, expect returns to be competitive with those offered by the conventional counterparts, but they also want to know what the underlying assets the funds are being invested in. In my view, *Shari'a*-compliant private equity investments provide answers to both."

ii.) The second enabler is equally simple – means. Recent years have seen capital flows into the Middle East, and particularly the GCC, assume historic proportions. Much of this liquidity has originated in hydrocarbon revenues, with the four GCC countries holding Organization of the Petroleum Exporting Countries (OPEC) membership enjoying reserves of around 480 billion barrels of



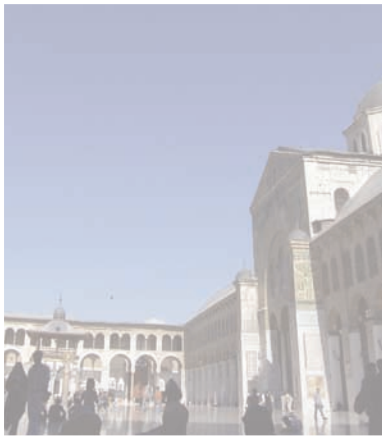




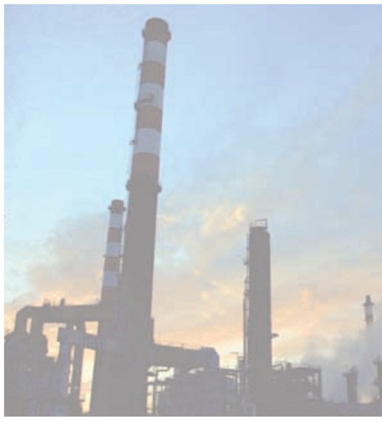
crude oil and over 40 trillion cubic meters of natural gas[25] – Saudi Arabia alone is considered to account for 25% of the world's crude reserves[26]. Combined with broadly consistent global demand, which is predicted to be 50% higher in 2030 than at present[27], total GCC hydrocarbon revenues are projected to exceed $600 billion in 2008[28], with an average price of $50 a barrel sufficient to bring in $4 trillion by 2020 and $8 trillion by 2030[29]. These cash flows will feed into GCC current account balances (CABs) which can only be described as already remarkable – the United Arab Emirates is now sitting on a CAB of $31.57 billion, Kuwait $52.73 billion and Saudi Arabia $95.30 billion[30]. Repatriation of capital to the region by local investors looking for opportunities in increasingly attractive markets has also played a highly significant role. Although there is little solid data on the size of funds available for investment, it is estimated that 300,000 Middle Eastern individuals – half of which are Saudis – share wealth worth at least $1.1 trillion[31]. The combination of this liquidity with the burgeoning awareness and demand noted above that it be invested responsibly creates a real and immediate need for properly Islamic investment products.

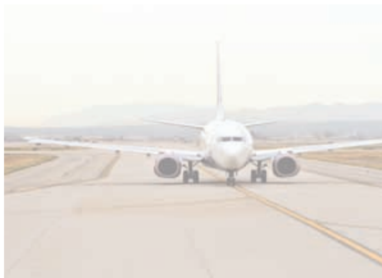
iii.) Rounding off the list of enablers is a dramatic change in official attitudes. The operating environment for Islamic finance is becoming increasingly flexible and supportive, both in the Islamic world and elsewhere. The United Kingdom, for example, has come a long way from a Bank of England declaration in the mid-1980s that it could not license Islamic financial institutions[32] to a government statement of intent in 2006 to become a global centre for the industry[33]. Similar positions have been, or are in the process of being, adopted by governments and regulators the world over – one significant recent example from the Gulf region being the planned establishment of a higher *Shari'a* council in the United Arab Emirates to supervise and encourage the development of the local Islamic finance sector[34]. As Mohammed Arbouna highlights: "Compared to when Islamic banks first started operating, the regulatory authorities have become much more supportive. Central banks are more aggressive in supporting the Islamic financial sector – for example, the Central Bank of Bahrain now has a special unit for Islamic banks. This awareness and support was not there before". Raed Sarhan concurs: "The regulatory balance has definitely improved, and there are now clear expectations for both investors and governing bodies. Ten years ago, these processes were less defined, whereas today there are specific rules and regulations"; as does Amr Elimam: "We now have proven structures and a regulatory environment where *Shari'a*-compliant investment is well established. Such an environment validates *Shari'a* compliance as mainstream". So mainstream, in fact, that GCC governments are now themselves taking stakes in Islamic financial companies[35], with the Dubai government and the emirate's ruler holding a combined 50% of Noor Islamic Bank, launched in 2006[36], and Abu Dhabi seeing the opening of Al Hilal Bank, fully owned by the government's Abu Dhabi Investment Council arm[37]. All of the above are key developments – not only are markets becoming increasingly supportive, but progressive regulatory systems facilitate the application of internationally-recognized standards and offer an appropriate level of oversight to maintain *Shari'a* authenticity. Government involvement in the sector also lends it some crucial credibility. As a result of all these remarkable changes, it is now drastically easier for investors – and their partners – to ensure and demonstrate that their operations are truly Islamic.

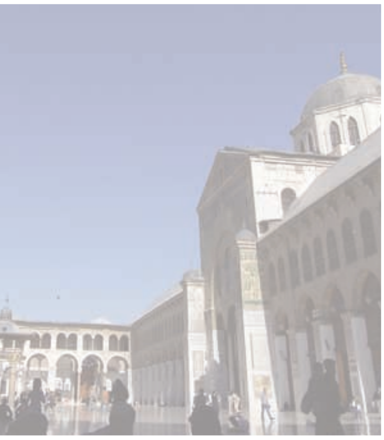
Demand, means and support are therefore the three key enabling factors behind the Islamic finance breakthrough. The conditions are now in place. However, there are numerous remaining *Shari'a* investment outlets that have yet to be fully exploited[38]. We strongly believe that private equity is just such an outlet, and will now set out four reasons, spanning the length of the investment cycle, why it should be considered as a potentially key component of the Islamic financial system.

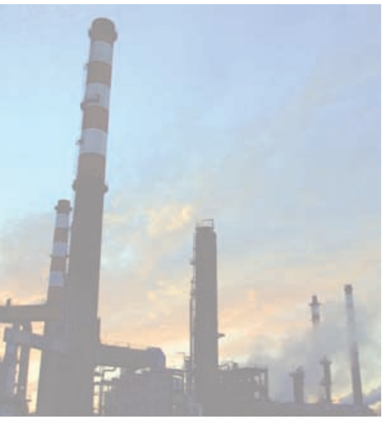


i.) Firstly, there is a close symmetry between private equity in its purest form and Islamic financial prescriptions. The principal intersection between the two is their participatory nature – rather than merely extending a debt facility, private equity investors, as the name suggests, take an active equity stake in businesses and seek to share the ultimate financial rewards, usually through a public market listing or trade sale mechanism, of the success of these businesses. Shahzad Iqbal underlines that: "Private equity is very close to what *Shari'a* allows you to do. Structuring a compliant deal is relatively straightforward, and it is also easy for investors to understand"; and as Amr Elimam explains: "One of the most positive aspects of *Shari'a*-compliant investment is its focus on value creation. There is an emphasis on the tangible economy, and it is less supportive of complex structures and financial instruments which in themselves do not necessarily drive value creation. Private equity and *Shari'a* compliance go hand-in-hand because in both cases there is a closeness to the economy. Things are produced and services are provided". In addition, investors also have the option of using a range of specifically Islamic models. There are four principal examples of the latter, namely *mudarabah* (a partnership between an investor and entrepreneur with profits shared per an agreed ratio, and losses borne by the investor), *musharakah* (similar, except with room for capital contributions from both parties, and with losses shared between both parties in proportion to the capital held by each), *murabahah* (purchase and resale of an asset or commodity at a mark-up) and *ijarah* (a leasing agreement)[39]. All of these are readily adaptable for use by private equity players as a means of leverage for a transaction, or as financing for an investee company seeking to strengthen working capital. Finally, Islamic contracts offer solutions to private equity deals, allowing extensive flexibility for all parties and a virtually open-ended menu of possible contractual forms – provided that the fundamentals of *Shari'a* compliance are respected[40]. Islamic management contracts provide a general framework of responsibilities and liabilities, and each party has a defined role, within which they can exercise considerable freedom of action[41]. As Raed Sarhan summarizes: "The structure leading to the end product can assume various forms, as long as this end product meets both the needs of the client and the *Shari'a* requirements. We always look at what the client wants and structure the transaction accordingly." There is, in short, a clear structural compatibility between Islamic finance and private equity, with the basic principles of both already broadly in line with each other.









Case Study

In September 2008, Seera acquired BWA Water Additives (BWA), a leading global water treatment solution provider. Headquartered in Manchester, BWA operates laboratories in the United Kingdom and the United States of America. The transaction, a leveraged buyout, saw Seera raise funding under a senior *murabahah* facilities agreement entered into with the Royal Bank of Scotland and HSBC Bank, and through a mezzanine *murabahah* agreement with the Royal Bank of Scotland Equity Fund. As Mohammed Arbouna explains: "The structure was based on an irrevocable restricted agency contract, whereby the financiers appointed us to act on their behalf to buy and sell a commodity to BWA. BWA can then sell that commodity to the market in order to get the cash it needs to finance growth". There were also a number of additional issues to be addressed from a *Shari'a* perspective, as Mohammed Arbouna continues: "Within this structure, there were further things which needed to be looked at – for example, we had to ensure that we dealt properly with delay payments, pre-payments, break-costs, floating and fixed profit concepts, alternative tax structures, existing hedges and the issue of preferred shares to the management". Once these processes were successfully completed, a structure was rapidly put into operation which complied both with the needs of *Shari'a* and the financing and growth requirements of the company.

ii.) Leverage plays a central role in many conventional private equity transactions, and Islamic private equity – given certain provisos – can make similar use of this vital resource. For example, a *murabahah* structure can allow a deal to be leveraged without incurring the use of interest – a fundamental prohibition of *Shari'a*-compliant finance. Islamic structures also have the advantage of discouraging excessive reliance on debt trading, whether by equity investors or their investee companies. At the time of writing, the ongoing tightness of global debt markets means that there has probably never been greater awareness than at present of the perils of over-leverage. Instead, the Islamic private equity requirement that transactions are accompanied by an underlying productive activity, and that financial flows are correlated with assets, appears to offer significantly more attractive levels of stability and resilience. Moreover, *Shari'a* screening processes offer an extra layer of protection and corporate governance, as Amr Elimam explains: "The amount of knowledge required in a *Shari'a*-compliant structure and the processes required to develop an adequate level of understanding about the transaction enable Islamic investors to reduce their exposure to riskier investments". The intrinsically Islamic principles of equity- and asset-based investments – and the depth of knowledge gained in closing a successful deal – thus provide, to a certain degree, an in-built check and balance[42], meaning that *Shari'a*-compliant private equity investors are now a considerable distance ahead of a highly significant curve – whilst still being able to leverage deals to an extent comparable to their conventional counterparts.

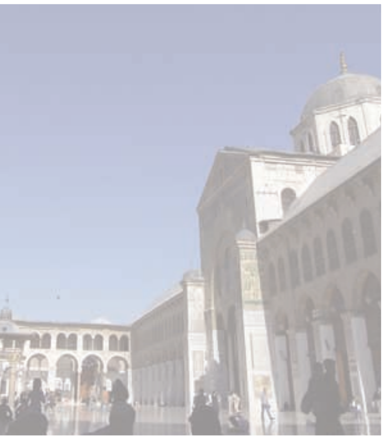
Case Study

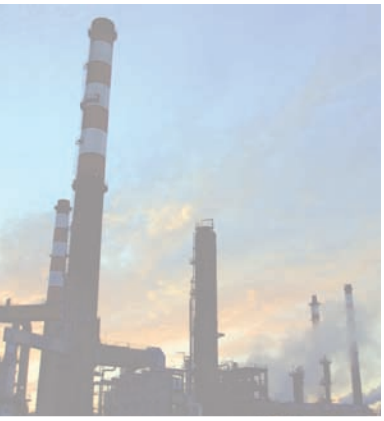
BWA has been successfully operating and growing in developed Western markets for over 35 years. As a consequence, at the point of acquisition by Seera the company held several interest-based loans. Given the incompatibility of such a situation with the tenets of *Shari'a*, action was required. Mohammed Arbouna recalls that: "Existing interest-based loans were one of the principal issues with which we had to deal. We had to restructure these in order to conform to the requirements of *Shari'a*". This keen focus on compliant company debt structures was extended across the entire scope of their operations – a process which delivered immediately positive results. Mohammed Arbouna explains how: "The capital of the business has now become more protected. We will not allow the company to leverage themselves *ad infinitum* and continue creating debts". As a result, extra financial stability and resilience are now firmly embedded within the corporate structure of BWA.

iii.) At this point, there is a common objection to taking an Islamic approach to private equity which must be addressed. One persistent refrain amongst investors, particularly in the Gulf region, is the difficulty of accessing deal flow commensurate with fund sizes. The prevailing wisdom is that the remarkable private equity fundraising activity in the Middle East and North Africa (MENA) region in recent years – total funds raised in 2007 totalled $6 billion, up from $2.4 billion in 2005[43] – exceeds the number of investments actually available. This conclusion is perhaps supported by the fact that whilst the number of deals has remained relatively consistent over the previous three years, the amount invested has increased dramatically. There were 56 deals completed in 2005, 50 in 2006 and 62 in 2007 – however, the total amount invested rose from $600 million in 2005 to $1,800 million in 2006 and $3,500 million in 2007, on average doubling each year[44]. This issue appears even more relevant to firms seeking to invest along *Shari'a*-compliant lines, as the pool of potential investee companies is generally supposed to be smaller than that available to investors operating without such restrictions. As a result, the deal flow pipeline is even more constricted.

However, it would be incorrect to conclude that there are insufficient opportunities available for *Shari'a*-compliant private equity investors. As already noted, the growth of interest in Islamic investment encompasses all stages of the financial ecosystem, from limited partners to business owners. There is now a genuine demand for Islamic solutions, and this has seen a new and ever-expanding deal pipeline emerge – to which *Shari'a*-compliant investors can expect privileged access. One particularly relevant example of this phenomenon to the GCC is family businesses. As Raed Sarhan points out: "Family businesses in the Middle East are becoming more professional. Because the owners of these businesses are predominantly Muslims, they are open to *Shari'a*-compliant solutions. Therefore, we will see a growing number of family businesses in the GCC and MENA regions converting and expanding their activities through *Shari'a*-compliant private equity". Such businesses are central in the GCC economic landscape, being estimated to control over 90% of GCC commercial activity, to hold combined assets of more than $500 billion and to employ 70% of the workforce[45]. As a rule, they are also traditional and conservative in outlook. Given that these businesses are increasingly looking to compete in changing markets and make the step up to the next level of corporate development, they can therefore be expected to be amenable to private equity investment which can deliver this whilst respecting their cultural priorities. The deal flow question also fails to take start-up businesses into consideration – and Islamic private equity is ideally positioned to sup-

Part Three: Delivering





port these. Early-stage companies are often not in a position to access debt markets, as they have little, if any, collateral against which to seek financing. Instead, equity participation from an investor experienced in delivering rapid growth and critical mass is a significantly more attractive option. In summary, growing demand for *Shari'a*-compliant investments, the economic dominance of family businesses in the GCC and early-stage opportunities are creating strong possibilities for Islamic investors. As Shahzad Iqbal concludes: "Despite the fact that Islamic finance could potentially have issues with restrictive deal flow, there are numerous opportunities available. And although there is competition for these deals, liquidity is helpful in overcoming this obstacle because it enables you to complete the transaction in a fast and efficient manner – especially if you are competing with a buyer from Europe or the United States in the current economic climate".

Case Study

Seera created and closed the deal with BWA in a highly efficient manner. Shahzad Iqbal provides some background: "Of course, any company in which we invest has to meet some basic *Shari'a* compliance criteria – that's always our starting point. We also focus globally, on companies with diverse revenue sources, and there has to be some value addition which we can offer. BWA – and many companies besides – ticked all of these boxes". He continues: "We continually work on relationships as a source of deals. This particular company was introduced to us by one of our advisors. We then looked at the business, and they were looking for someone who could give them value in a region where they see great opportunities". Once a decision was made, the deal was swiftly completed, as Shahzad Iqbal concludes: "The Islamic financial sector has grown rapidly. Liquidity is available and the preference is now moving towards *Shari'a* compliance. This means that what we offer as a *Shari'a* private equity investor – and this is very important for any company right now – is the ability to close out a deal quickly".

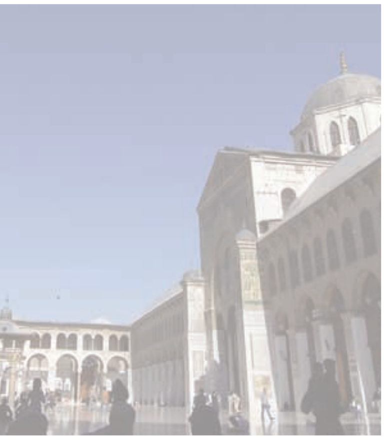
iv.) Once a deal has been reached, Islamic private equity can then bring the standard tools of the industry to bear upon their investee companies. The close correspondence between private equity and Islamic finance means that the widely-acknowledged value addition instruments of conventional private equity investment are also readily applicable to Islamic transactions. Private equity value creation tends to be activist in nature – as opposed to debt schemes, which have the advantage of requiring monitoring solely of whether returns meet the rates set. The observed general dominance of debt contracts is, therefore, due in large part to their cost-reducing characteristics[46]. Without a fixed rate of return, and fully dependent instead on business growth to the point of successful exit, private equity is faced with the need for active involvement across all areas of an investee business – and additional costs and resource pressures as a result.

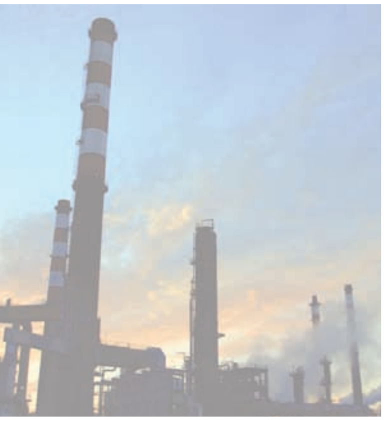
However, this additional expense pays off. Unlike a debt contract, private equity involvement with a business enables management support, the delivery of regional and global connectivity with access to an international matrix of partnerships and synergies, and robust analyses of optimal business efficiencies. All these active tools which private equity brings to the table are essential in driving growth and enabling companies to compete on a regional or global level – as has been proven the world over. For example, private equity-backed companies in the United Kingdom have been shown to create jobs and revenues at a markedly higher rate than other businesses, with employee numbers increasing by an average of 9% per annum compared to 1% and 2% for FTSE 100 and FTSE Mid-250 companies respectively, sales rising at 9% per annum compared with 7% and 5%, and exports growing by 6% per annum in contrast to a national growth rate of just 2%[47]. This value continues to accrue even after exit, with private equity-backed initial public offerings (IPOs) on the London Stock Exchange outperforming other IPOs by more than 9% one year after listing[48].

Private equity investment also has a positive impact on corporate governance. This is an essential point, as sustainable business growth can, in fact, only be achieved by maintaining high standards of regulatory compliance and transparency, with the absence or underdevelopment of standardized, internationally-credible compliance procedures exacting a heavy toll on operational efficiency and partner relationships. In fact, two in three institutional investors in the Gulf believe that poor governance has a direct negative effect on business performance[49]. The prospects of a successful exit are also closely correlated with the levels of company governance, with both potential trade sale partners and public listing regulations requiring optimal transparency.

Private equity investors thus have a strong vested interest in nurturing world-class governance levels in their portfolio companies – and *Shari'a*-compliant investors are no different. In fact, as Amr Elimam notes: "*Shari'a* compliance is based on principles of fairness, which can have a real impact on corporate governance. It can certainly influence better accounting standards, improved contract structuring and more transparency". The importance of such progress to the GCC and MENA regions should not be understated, as despite continuing reforms, the Middle East at present could still benefit from increased business transparency. The situation stems in large part from the economic dominance of family-owned businesses noted in the previous section. These businesses have traditionally been run in an unstructured, top-down manner, with decision-making processes often informal and lacking in any wider scrutiny or transparency[50], and this should be viewed a matter of some concern, given that good governance has been shown, in the long term, to function as a key macro-economic stabilizer[51]. As the relationship between Islamic private equity investors and family businesses evolves and becomes ever deeper, the hope is that this serves to promote and catalyze an improved culture of business transparency across the region.

In short, it is private equity investor activism which creates value. This is as true for *Shari'a*-compliant private equity houses as for any other. However, these investors may well be even more active than their conventional counterparts. Not only must Islamic investors ensure that their investee companies respond to the needs of their markets, they also need to ensure the continued compliance of these businesses with the demands of *Shari'a*. The work of *Shari'a* boards therefore does not conclude with the successful consummation of a transaction, but represents an ongoing process of monitoring. The successful use of *Shari'a*-compliant private equity instruments depends on specification of management rights, claims and responsibilities on the one hand, and measurement of performance – and compliance – through a system of control and compensation on the other[52]. The more effective the





methods of monitoring developed by the industry, the more competitive the Islamic financial system becomes[53], and these methods will become increasingly cost- and time-effective as the market becomes more commoditized. The results could be invaluable – in paying even closer attention to their businesses than other private equity firms, Islamic private equity investors are in a natural position to give maximum value, support and guidance. When this close attention is combined with the standard benefits of private equity investment already noted, the case in favour of Islamic private equity continues to strengthen.

Case Study

BWA can expect to benefit greatly from its partnership with Seera. The company offers a portfolio of products in three high-growth sectors, namely water desalination, industrial water treatment processes, and secondary oil recovery, and already has customers in over 85 countries. For BWA, the Middle East represents a particularly attractive new market for expansion, and the connectivity and experience of Seera will be vital in exploiting this opportunity. Shahzad Iqbal explains: "We know the region. That was an essential point for BWA. There are numerous potential contracts in this part of the world, and this is something which we have immediately begun working on. We can provide direct growth assistance in this manner". This relationship will, moreover, be even closer due to the *Shari'a*-compliant nature of the investment – as Mohammed Arbouna outlines: "We have an ongoing input into the investment. We need to make sure that we continue to partner with a company with no outstanding *Shari'a* issues. So our role from now on is to make sure that all our requirements which we put into the contract are addressed. Our role does not finish with the investment but involves ongoing monitoring and assistance". Particularly close working relationships will thus be forged between an expanding company and an experienced, value-adding private equity investor – and it is these relationships that will drive the growth and the future of BWA.

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Seera depicts the philosophy of our business and objectives, it aligns well with our policy of selecting investments that, over time and with leadership, will deliver returns of measurable benefit to our clients.

Our brand provides us with a strong asset which we believe will better support us, both in our business activities and in achieving the level of distinction we aspire to.

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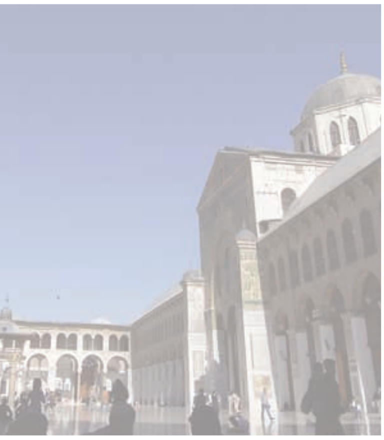
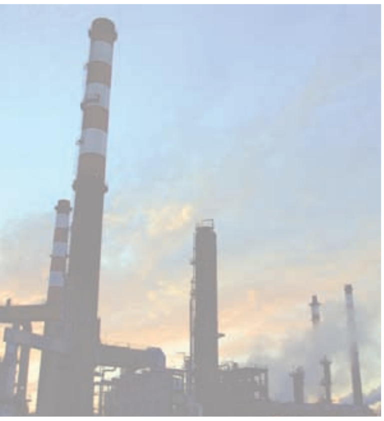
Part Four: Activating

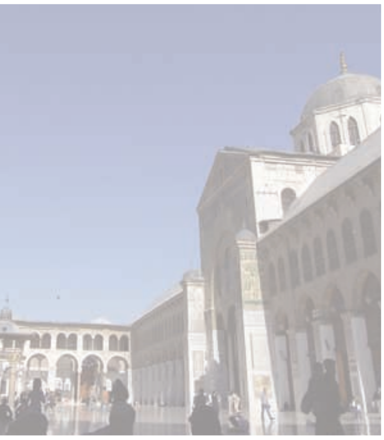


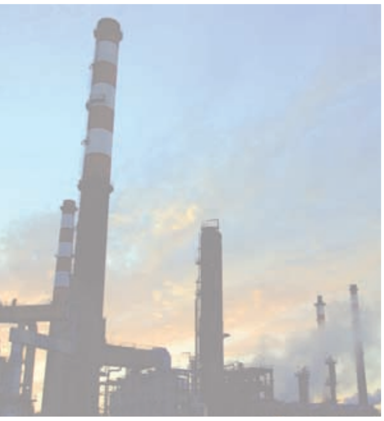


In summary, private equity is readily amenable to use by *Shari'a*-compliant investors. From an operational perspective, there are minimal differences between Islamic private equity and its conventional form, and those which remain either represent sources of competitiveness (reduced leverage and improved corporate transparency) or do not necessarily constitute a disadvantage (deal flow). The similarities on the other hand, principal among them the support and creation of world-class businesses, are compelling. However, these factors are not sufficient in themselves to grow the industry. There remain at least four key drivers which must be properly addressed if *Shari'a*-compliant private equity is to be sustainable and take its rightful place in the Islamic financial system. These should be considered as complementary to the three enabling factors discussed earlier which have allowed the sector to begin its initial growth.

i.) The first of these is industry standardization. It is clear that because of the differences between conventional and Islamic finance there must be special regulatory arrangements. Exactly what these should be, however, and how any agreed standards should be applied, is still the subject of debate[54]. At present, the majority of Islamic private equity institutions operate their own *Shari'a* advisory boards to assess the probity of transactions, and although this system usually functions smoothly, there may be room for some refinements. Amr Elimam queries the practicality of a situation in which: "Even if a board of one institution approves a specific kind of deal structure as *Shari'a*-compliant, the board of another institution still has to re-examine that same structure for a similar deal. Moving towards improved standardization and consistency would be a positive development. It will improve the competitiveness of the industry, because as structures become known, deals can move through the system in a more efficient manner". Shahzad Iqbal suggests that: "There needs to be a central *Shari'a* board whose *fatwahs* have industry-wide credibility and are available to everybody. That would be very useful. The non-competitiveness will fade away, and documentation and structuring will become more standardized"; and Raed Sarhan is positive on this front: "It takes time. There are scholars who have different views, and some of them accept things that others do not. It is sensitive because it is a matter of faith. That said, products are gradually coming closer together. The Islamic world is creating forums, meeting in conferences and generally making efforts". Real progress has certainly been made, as can be seen from the formation and work of bodies such as the Accounting & Auditing Organisation for Islamic Financial Institutions (AAOIFI), founded in 1990 and headquartered in Bahrain[55], and the Islamic Financial Services Board (IFSB) inaugurated in Kuala Lumpur in 2002[56], and this must be continued and deepened. Shahzad Iqbal again: "The AAOIFI regulations have improved credibility and created a level playing field for Islamic institutions. It represents an important regulatory starting point, and Bahrain has been very proactive in supporting AAOFI by making it mandatory for the banks to report in its terms. Standards themselves are of no use unless the regulators push implementation". Such organizations have a key role to play in the establishment of consistent and credible industry-wide standards, and the promotion of tightened and supportive policy[57] – both essential for continued growth. There may also be a requirement for improved standardization in respect to the eligibility and qualification of *Shari'a* advisors, and expanded mechanisms for central monitoring of *Shari'a* compliance. Islamic institutions should pay the same price for non-compliance as they would for financial mismanagement[58]. Mohammed Arbouna develops this point: "We need more support in terms of *Shari'a* compliance, with some kind of rules and regulations in place that pressurize institutions to remain in line with their license. If you are given an Islamic license, you have to ensure that you do business in that way. The central banks have a role not only in licensing institutions, but in ensuring that they do business in accordance with that license". Standards improve transparency and facilitate the full integration of Islamic investment into the global marketplace. They also streamline internal *Shari'a* screening processes for investors and offer clarity of rights and obligations to all parties in a transaction, whilst simultaneously measuring and mitigating risks. Costs will be reduced as a result, which represents a significant advance towards competitiveness with conventional investors. A guiding principle must be the creation of a level playing field for Islamic investors – and also a reverse level playing field for conventional investors looking to engage with Islamic models. The latter should be subject to the same standards and regulations as their Islamic counterparts for their investments to be credible[59]. If Islamic investment is to become truly globalized, the need to develop and promote standards is therefore a pressing one, although the final word on the subject goes to Mohammed Arbouna: "Standardization is an important question. However, there is a key distinction to be drawn. Many of the basic issues can certainly be standardized. But absolute standardization is not possible, because each transaction is unique and there are always specific elements which require review by a *Shari'a* board. Furthermore, you cannot completely standardize practices and structures across different cultures and legal systems, as institutions cannot operate in isolation from these. A typical example is accounting standards – although there are international accounting standards, some countries also have specific local standards. The same thing applies to *Shari'a* standardization".

ii.) The second area of focus must be financial engineering and creativity. Modern private equity is a complex phenomenon with a wide range of applications, and necessitates the development of creative instruments to deal with this. As Shahzad Iqbal notes: "Financial engineering is very important, because it allows you to do better deals through efficient structuring. Small deals do not change anything. If you want to do significant transactions, you need to bring in complex instruments that require innovative financial engineering. The industry needs innovative thinking in order to compete. A transaction may become unviable or uncompetitive if not structured to take advantage of all tax efficiencies while complying with *Shari'a* – this requires very careful analysis and financial engineering". Raed Sarhan concurs with this point: "The *murabahah* and the *ijarah* have come fairly easily because there are precedents. Buying, selling, trading, leasing – these were all there 1,000 years ago. Beyond these, investors have mainly taken conventional products and converted them to *Shari'a*-compliance. However, today's world requires more innovation, and the Islamic world is lagging behind. Financiers need to be more innovative and create their own products, rather than simply copying conventional investors". Innovation will also be a key driver in attracting the wider interest which will be critical for the long-term competitiveness and sustainability of Islamic private equity[60]. Islamic finance, as a whole, should be considered as a system which is still evolving, and many of its concepts are still at an early stage[61]. However, the pace of development must be sufficient to ensure an adequate supply of investments to satisfy the growing appetite for this kind of finance and cater to the varying risk-return profiles of different investors[62]. Again, progress is being made – for example, a number of recent project finance deals in the Gulf region have fused the concept of *ijarah* with *istisnaa*, which provides a means of financing a project while it is being built[63]. Such developments are to be encouraged, although it is





imperative that the pressure to innovate does not result in any dilution of *Shari'a* authenticity. This will be particularly important in manufacturing deals with family-owned businesses, which as already noted are often highly traditional in outlook.

iii.) Thirdly, there is a real need for market awareness and education. This is the case even against the background of rising demand for *Shari'a*-compliant investments already noted. Islamic private equity must be fully demystified and clarified, and this will enable misconceptions to be identified, levels of understanding to be raised and the sector legitimized as a viable alternative[64]. Such a process must embrace the whole private equity ecosystem, from limited partners to entrepreneurs. In addressing both, there is a requirement to appeal to the intelligence as well as the beliefs of potential partners[65], and make convincing arguments as to the advantages and relevance of Islamic investment products. Much can be learned from the growth of ethical banking in Europe and the United States, which has had great success in communicating a distinctive moral approach to finance and engaging with a pool of ethically-aware clients who prioritize social responsibilities as well as personal material gain[66]. Investment partners have a key role in creating a virtuous circle, whereby their participation in successful transactions serves as a progressive example and endorsement of the Islamic approach, and itself creates further interest and deals. This can essentially be reduced to a question of track records, and Islamic private equity investors offering concrete examples of their value addition. The issue is not only distinguishing Islamic and conventional investment, but meaningfully distinguishing value-adding Islamic private equity investments from those which do not add value. Amr Elimam believes that: "The industry will have to earn its credibility over time. This must take place firstly in terms of corporate governance, which must be demonstrably true both to *Shari'a* and generally accepted principles. Secondly, through competitiveness, and showing that the returns are there and that the risks taken are consistent with the broader marketplace". For a sector both relatively youthful and rapidly-growing, this is certainly a challenge – but also a necessity.

iv.) The final driver to consider is human capital. Talent pools are struggling to keep pace with the expansion of the Islamic finance industry in recent years, with an increasing supply-demand mismatch in the numbers of qualified professionals. Within the GCC, the *Shari'a* banking industry alone is projected to require up to 30,000 additional staff within the next decade[67], and estimates of the number of religious scholars worldwide with sufficient financial expertise converge on less than 100 – of which 12 in particular are heavily relied upon[68]. Raed Sarhan states that: "There is a real dearth of scholars. You need to find a certain kind of expertise – for example, a very good understanding of the English language is absolutely required. Most of the documentation is in English, and is based on English law, and we have to be aware of that fact"; a point expanded upon by Mohammed Arbouna: "Human capital is one of the most important issues facing the industry. Today we have a number of Islamic banks staffed mainly by professionals trained in the conventional way of doing business, and who have only a general awareness of *Shari'a* issues. To resolve this we have to create structures that promote knowledge and ensure a more solid background". The problem is further compounded by the growing presence of international financial institutions in the Islamic space. Given such a context, talent has become highly monetized and investors, at present, have to contend with relatively high personnel turnover. Shahzad Iqbal explains that: "New banks are being licensed all the time, and at the same time there are limited numbers of qualified, experienced people available in the region"; although Raed Sarhan strikes a positive note: "Demand is high, and hiring is tough. There needs to be much more training. However, I sincerely believe that professionals from different backgrounds – even from conventional banks – can adapt and successfully go through the process of training. It may not be as tough a learning curve as it may seem". That said, resolving this issue still represents a considerable challenge, as Islamic investment professionals require highly specialized knowledge of both *Shari'a* and financial markets. A pressing need exists for increased education and training – a responsibility which must be assumed by universities, colleges and financial institutions working together to identify and address the needs of the market[69], and which combines rigorous economic study with a thorough grounding in Islamic jurisprudence and commercial theory[70].

These four issues are, to a certain extent, interdependent – for example, the lack of personnel has, without question, constrained product development. All must be resolved in a progressive and proactive manner if Islamic private equity investment is to take its place in the new financial mainstream. Beyond its ability to deliver many of the long-established benefits of standard private equity investors, the specific advantages of the sector must be activated and supported. That the industry has such advantages, and the potential to stand shoulder-to-shoulder with its conventional counterparts, should hopefully have become abundantly clear. Islamic private equity is, in many ways, the right product for the right time and can deliver unique benefits throughout the investment cycle. As the industry continues to expand, investors can also be expected to become progressively more specialized and sophisticated – and in doing so, increasingly able to deliver proprietary value to their chosen sectors.

In the long term, the socio-economic benefits of these investments could be immeasurable. The private equity creation and support of strong, dynamic businesses able to play a decisive role in the region and beyond – a highly positive achievement in itself – is even more significant when achieved from a *Shari'a*-compliant perspective. Islamic finance is essentially about real transactions and growth strategies which have embedded within them the concept of fairness[71], and the financial teachings of Islam, along with the investment systems derived from them, ultimately aim at equitable wealth distribution, with an essential concern for economic justice. If, through the efforts of Islamic private equity investors and others, such an environment can be developed, a significant step will have been taken towards the achievement of a truly competitive, morally-centred economy – both in the Middle East and the wider world.

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