Islamic Real Estate Venture Capital in India

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Introduction

Venture capital is a form of finance which is very close to the essential ethos and underlying spirit of Islamic Finance. The well-known and oft-quoted contracts of mudarabah, musharakah and wakalah are essentially different formats of venture finance. Yet Islamic venture finance in the modern sense has been slow to take root. The reason for this is the timorousness of practitioners of Islamic finance to embrace equity based transactions rather than the debt (Islamic?) based transactions. Thus we find Islamic venture capital making a formal entry in the Middle East only in the first decade of the twenty first century and Malaysia, the supposed vanguard of Islamic finance globally, really waking upto it only towards the end of the same decade.

In venture capital, as in so many other sectors of Islamic finance, India has lagged even more. Thus we find that the first Sebi-registered venture capital fund took off only in 2009. Though Secura India Real Estate Fund remains the only home-gown Islamic real estate venture capital fund, some venture finance funding transactions had been made in the Indian market by reputed Arab Islamic finance players such as Kuwait Finance House, Saudi Economic Development Company and Gulf Finance House earlier.

Post 9/11, with Arab and Islamic funds seeking new destinations and the Indian economy finally growing at an alluring rate, we had a golden opportunity to attract Islamic finance (including the newly developing venture finance segment of the industry). One would have wanted to believe that the developments in the Islamic venture finance space in India noted above were a consequence of proactive government measures taken in the backdrop of these developments. But unfortunately this has not been the case. The funding that has come is not as a result of official government policy but rather in spite of it. Despite repeated efforts from different quarters to impress on various governments and the central bank and recommendations of various committees, official policy continues to ignore the potential of Islamic finance to contribute to the development of the country.

In no field is this official apathy leading to a greater loss of opportunity than in the field of infrastructure and real estate development. These are segments which Islamic venture finance investors understand and can relate to. Unlike venture capital investors from developed countries, who look for opportunities in technology related fields, substantial quantums of Islamic venture capital investment can be attracted in these two areas. Arab funds are comfortable with construction and real estate development investment projects. On the other hand, South-East Asian investors and venture capital funds, including large sovereign funds such as Temasek and Maple Tree are prepared to look at not just funding opportunities but also at hands-on participation in development activities and Malaysian companies are also bidding for infrastructure projects in India. Hong Leong Bank has an Islamic investment arm which can look at Islamic venture capital opportunities.

Conventional and Islamic Venture Capital

Islamic venture capital operates on certain principles which need to be clearly understood. These lead to differences in the way Islamic venture capital operates from the manner conventional venture capital does. The main difference of course is in the treatment of debt. But other major issues are also the attitude to allocation of loss and consequently the limitations in structuring the waterfall distribution of profits. Apart from these, another issue is that of the areas which can be funded by Islamic venture finance. Sectors which are taboo in Islam cannot receive Islamic funding. Then it is also essential that an Islamic funding agency avoid structured transactions involving derivatives and futures.

Islamic Venture Capital in Real Estate

We shall discuss in this paper some of the issues involved in Islamic venture capital funding in real estate development.

Minimizing the Funding Requirements

Real estate development projects necessitate deployment of large resources. Typically, a large proportion of these are raised from banks, other lending institutions and venture capital funds. Loans from banks and institutions are interest-based and therefore ruled out for projects structured on Islamic basis. Hence the first priority for such projects is to minimize the project funding requirements.

Two strategies that are often employed for this are:

i. Entering into a Joint Development Agreement with the landowner instead of purchasing the land outright, and
ii. Effecting pre-sales of part of the project.

The Joint Development Agreement involves a joint venture contract between the landowner and the developer whereby the landowner contributes his land and the developer agrees to build the project at his cost from his own resources. Specific proportions (portions on obtaining sanctions) of the completed project are earmarked for the two partners as the payoffs for their respective contributions. Generally, it is considered that this is a form of musharaka or mudaraba and therefore a valid Islamic transaction. A little reflection however will reveal that it is neither, but a kind of barter transaction.

If the project involves a residential development, generally the developer (but theoretically, also the landowner) can sell (Islamically, agree to sell) parts of his allocation and collect periodical instalments towards the same from the buyers. If the asset class is not residential but commercial, then generation of such cashflows during the period of construction of the project are more difficult, as interim financing of the purchase for the buyer, may not be easily available.

Treatment of Debt

It is commonly understood that Islamic finance does not accept debt in the capital structure of an enterprise. While this is essentially correct, some structuring is possible in special situations. But first one needs to understand the important role that debt can play in a real estate development project.

It is obvious that since debt acts as a shield against tax, it is in the interest of both, the developer and the investor, that the SPV take on debt and consequently, both partners reduce the equity investment and the tax outgo, and thereby also enhance their return on investment. However debt is not Shariah-compliant. This is a generic problem of Islamic finance in environments that do not recognize Islamic finance.

Secondly, a characteristic of real estate venture capital financing which makes debt attractive is that real estate projects are often self-liquidating. Hence it is convenient and easy to pay off the debt as sales are realized. Equity is less flexible in this context and could require a more cumbersome exit.

Some Shariah authorities allow debt in the capital structure of the SPV to the extent of 30% or 33%. However this is debatable, as there is no Shariah justification for such a relaxation in the venture capital context (except as a stopgap to enable retirement of an existing debt over a fixed time period). The ruling appears to have been imported from the case of investment in shares listed on a stock exchange, which context is entirely different and has its own merits (though even in that case, there is no scriptural basis - in the Qur'an or Sunnah - for the relaxation).

There is however a special structuring possible under which debt (even interest-based debt), can be fully Shariah compliant. This is in the situation where the proportion of debt to equity contributed to the venture by all partners is identical, even if the absolute amounts vary. It can be shown by a simple calculation that in such a situation,

a. all partners earn the same overall percentage return on their total investment (debt + equity),
b. every partner gets the same percentage of the total profit as he would have, had all of them contributed their total investment (debt + equity) wholly as equity,
c. as the (identical) proportion of debt to equity of the partners, or the (nominal) percentage of interest paid on the debt increases, or both increase, the proportion of total tax paid by the SPV as a proportion of the profit before interest and tax, decreases,
d. as the (identical) proportion of debt to equity of the partners, or the (nominal) percentage of interest paid on the debt increases, or both increase, the proportion of the total earnings of all partners (on debt as well as equity) as a proportion of the profit before interest and tax, increases.

Treatment of Loss

A fundamental rule of Islamic finance is that the proportion of profit to be shared among partners can be negotiated between the partners but the share of loss is to be borne in the proportion of capital contribution. In contrast, in conventional venture capital, the venture capital investor

i. tends to invest his capital in a format which gives him a preferential right to distribution of profits,
ii. generally
    a. either has to bear the loss in the ratio of his equity, or
    b. gets a senior claim in the event of liquidation.

Obviously the Islamic system is more fair and balanced, though conventional venture capital investors would tend to argue that the entrepreneur needs to insulate their risk to an extent as it is he who

i. has to be finally responsible for his project,
ii. has a larger impact on its success, and probably
iii. has also been assured a "promote" or "carry" (i.e. is effectively entitled to a larger than proportional rate of return on his equity than the venture investors) in the event of profits

exceeding the expected ("hurdle") rate of return.

It needs to be noted that in the case of a VC fund, at the level of the fund, effectively the entrepreneur is replaced by the General Partners and the investors by the Limited Partners.

Waterfall Distribution

In a typical real estate investment, there is initially an investment phase when the cashflows of the project and therefore those of the developer and investor, are both negative, i.e., they need to infuse funds into the project. After a certain point, as the project starts to fructify, the cashflows become positive and the project starts generating excess cash. In a conventional venture capital investment arrangement, the venture capital investor may stipulate (in the extreme case) that when the cashflows turn positive, the allocation of the cashflow should be:

i. first, fully to the investor, till he has recovered his investment,
ii. second, fully to the investor, till he has received his target IRR on his investment,
iii. third, fully to the developer, till he has recovered his investment,
iv. fourth, to the developer, till he has recovered his share of return upto the target ("hurdle")
IRR,
v. fifth, to both investor and developer simultaneously, in the stipulated sharing ratio.

The fifth stage can itself be divided further too, into various stages, each extending upto a higher hurdle rate with the sharing ratio changing progressively, in favour of the developer.

The implication of this kind of allocation of the cashflows is that if the cashflow stream dries up at a certain point, then all subsequent allocation stages are lost to the participants. Hence, although the developer does not have a fixed debt and debt-servicing burden, he can expect to recover his investment only after the investor has recovered his entire investment as well as his projected minimum return on investment. Of course if the cashflow is not sufficient to even give the investor his investment, then he will also lose some of his investment; but then the developer will be in a real sorry state.

Since the return on investment is stipulated in terms of IRR and not a fixed percentage return on the investment, the later the amount of the investment is returned (and the return on it @ the minimum IRR paid), the higher is the absolute amount the investor needs to be paid. This is another disadvantage to the developer. In effect he has to pay not just a specific rate of return, but in a way a compound rate of return.

Evidently such an allocation of cashflows is completely un-Islamic. Whatever the stipulation regarding sharing of profit may be, the liability for the loss, if any, has to be proportionate to the capital contribution. Since the extent of cashflows can never be accurately predicted, at least the return of investment has in any event to be simultaneous and proportionate to both parties. Only thereafter, the sharing of profit could be as per agreement, which could also stipulate priority to one party over the other. Some Shariah scholars require that in this phase too, the allocation should not be fully in favour of one to the exclusion of the other completely, though the distribution could be done in several phases with differing sharing ratios for the different phases, as initially agreed.

Conclusion

In view of the enormous amounts of investment required for the country to bridge the gap between the requirement for meeting our transport and communication infrastructure and national housing (not to mention the IT, healthcare, hospitality, retail and commercial) infrastructure needs and the investment we can domestically generate, it is important for us to access venture capital investment from all sources. In this regard, we have Islamic finance venture capital, a major avenue waiting to be accessed and we need to ensure that we do not lose the opportunity.