

# PRACTICALITY OF ANGEL INVESTMENT IN THE CONTEXT OF ISLAMIC FINANCE

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# ISLAMIC FINANCE

**Islamic finance** is a financial system that operates according to Islamic law (which is called shari'ah) and is, therefore, shari'ah-compliant.

**Shari'ah Compliance** refers to the decision to apply Islamic principles to financial transactions and economic activities, whether in global markets or in Islamic-based markets.

In 2015 total global Islamic Financial assets estimated to be around **USD 2 trillion**, and is expected to reach **USD 3.24 trillion** by 2020\*.

\*Source: Thomson Reuters', IFSB.

# CrowdFunding

**Crowdfunding** is the practice of funding a project or venture by raising money from a large number of people, typically via the internet.

The crowdfunding model is fuelled by three types of actors:

- the project initiator who proposes the idea and/or project to be funded;
- individuals or groups who support the idea;
- and a moderating organisation (the "platform") that brings the parties together to launch the idea.

With an estimated market value of **USD 34 billion** in 2015, crowdfunding has come a long way since its valuation of **USD 880 million** in 2010.

# How CrowdFunding Works?



1. So you've got an idea?



2. Create a project



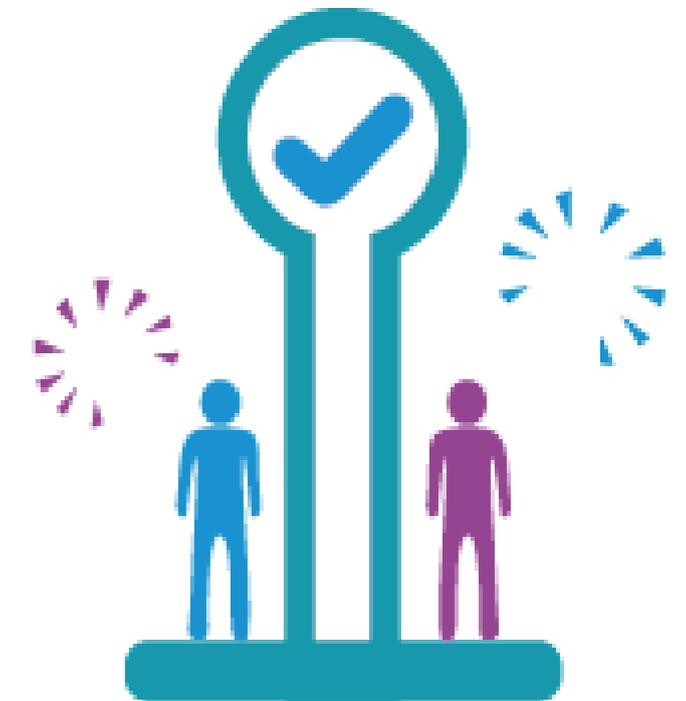
3. Tell your crowd



4. The crowd pledges cash in return for rewards



5. The crowd shares the project with friends



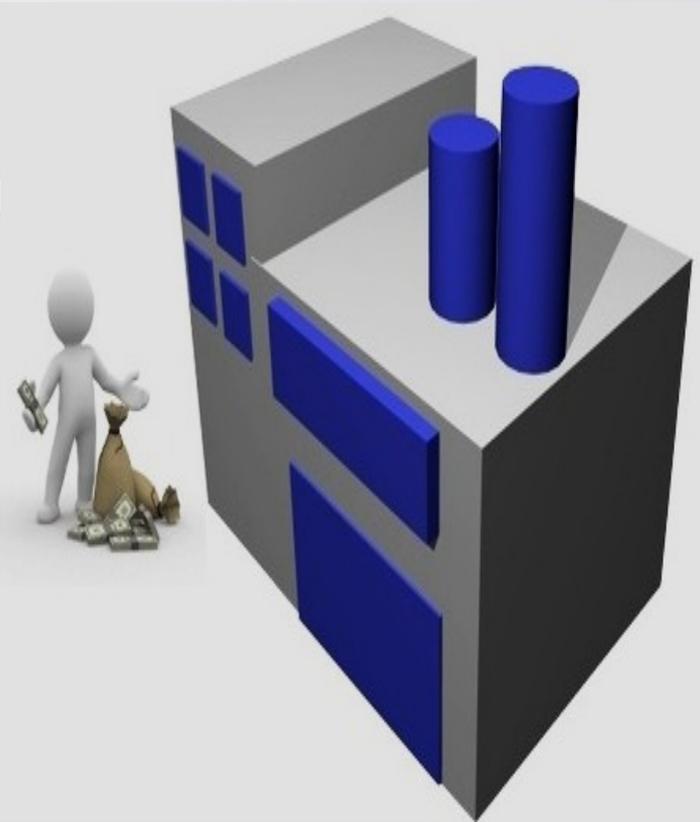
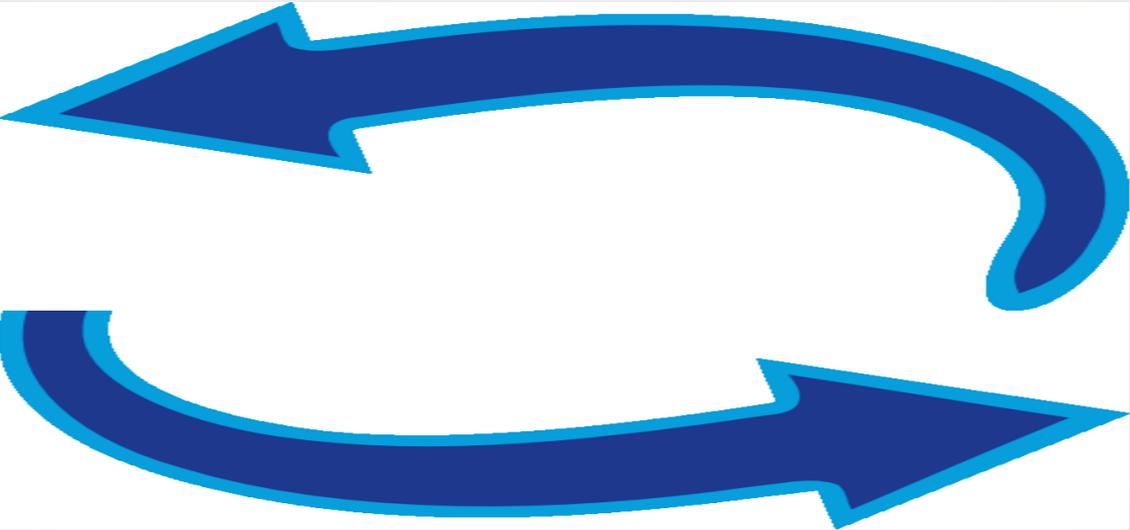
6. Hit your target and turn your idea into reality

# Angel Investing

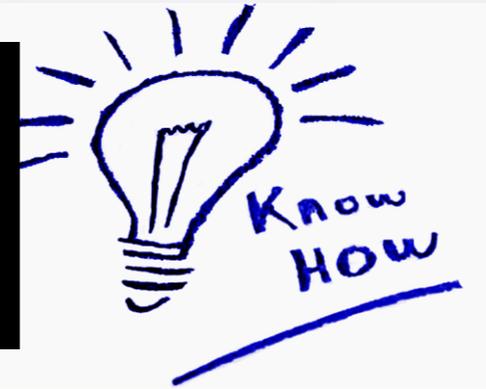
- **Angel investing** is equity finance
- An **Angel investor** makes use of their personal disposable finance and makes their own decision about making the investment. The investor would normally take shares in your business in return for providing equity finance. In so doing, they normally seek to not only provide your business with money to grow, but also bring their experience and know-how to help your company achieve success.
- **Angel Investors** seek to have a return on their investment over a period of 3-8 years. Angels can invest on their own or with a syndicate.
- **Angel investors** invest an average of \$20 billion each year globally



2. Obtains return on his investment over 3-8 years



1. The Angel invests his money and know-how in your business



# Why Angel Investment?

- Angel Investment can play a major role within the economy. At a microeconomic level, it accelerates the **growth of SMEs** through financing, sharing experience and skills and, ultimately, benefits from the professional network. In fact, Angel Investment contributes significantly to the increase of the **overall productivity of the economy**.
- Entrepreneurs are usually wealth-constrained and very often have no business experience. They have no real guarantees and no collateral to get credit financing. Angel investors provide financing and, in turn, they share the benefit as well as the control of the firms they are investing in.

# Developing Islamic Angel Investment Industry?

- Looking at the financing options in an Islamic Finance, you find that the emphasis is on profit sharing, and contracts which are also the characteristics of angel investment.
- Islamic Angel Investment provides an ideal financing system for promoting the growth and development of an Islamic financial system since it is a profit sharing arrangement. Especially, it is considered as the needed for the encouragement of entrepreneurship, wealth creation, employment generation and increase tax revenues

# Developing Islamic Angel Investment Industry?

- Angel Investment supports the growth of economic independence and development of a sustainable economic community and therefore should be explored fully by developing countries to grow their economies.
- The financing options that closely fit into Islamic Angel Investments are the **mudarabah** and the **musharakah**.
- **Mudarabah** and **Musharakah** is main partnership structure in Islamic Finance.

# Mudarabah Arrangement

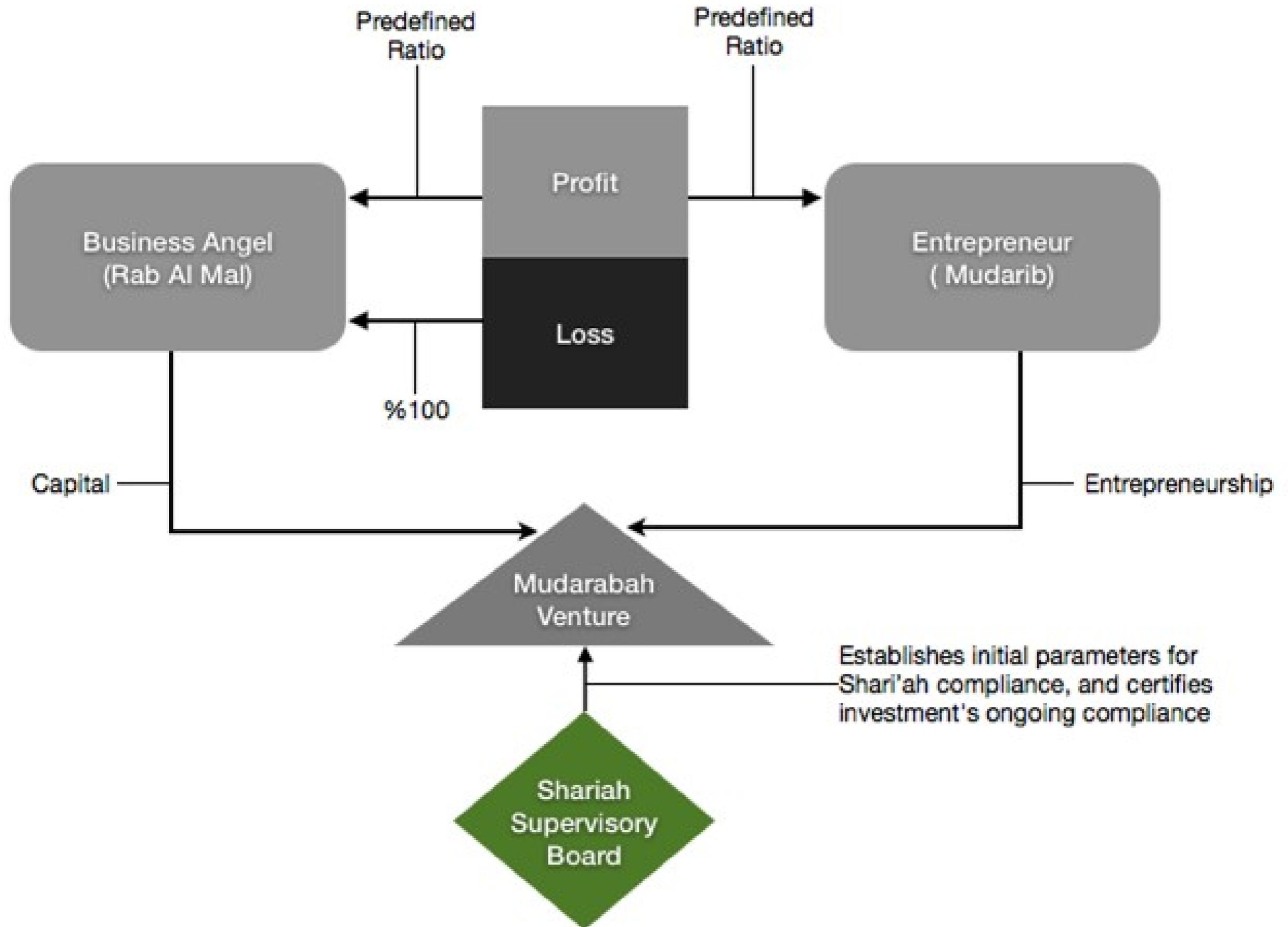
In a **Mudarabah** arrangement, contract is made between *Rab Al Mal* (Investor) or who solely provides the capital to undertake sharia-compliant business/project and *Mudarib* (Entrepreneur) who solely manage the business/project.

## Important features of Mudarabah contract:

- The profit of the business/project is distributed among the Investor and Entrepreneur according to a specific pre-defined distribution ratio.
- Material losses are, if any are borne by Investor unless there is a proven negligence or a contractual breach by Entrepreneur.
- The Investor has no control over the business/project and no right to participate in the managerial decisions.

In practice, it used mostly to finance innovative **startup companies** and **SMEs**.

Figure 1. Angel Investment in Mudarabah Structure



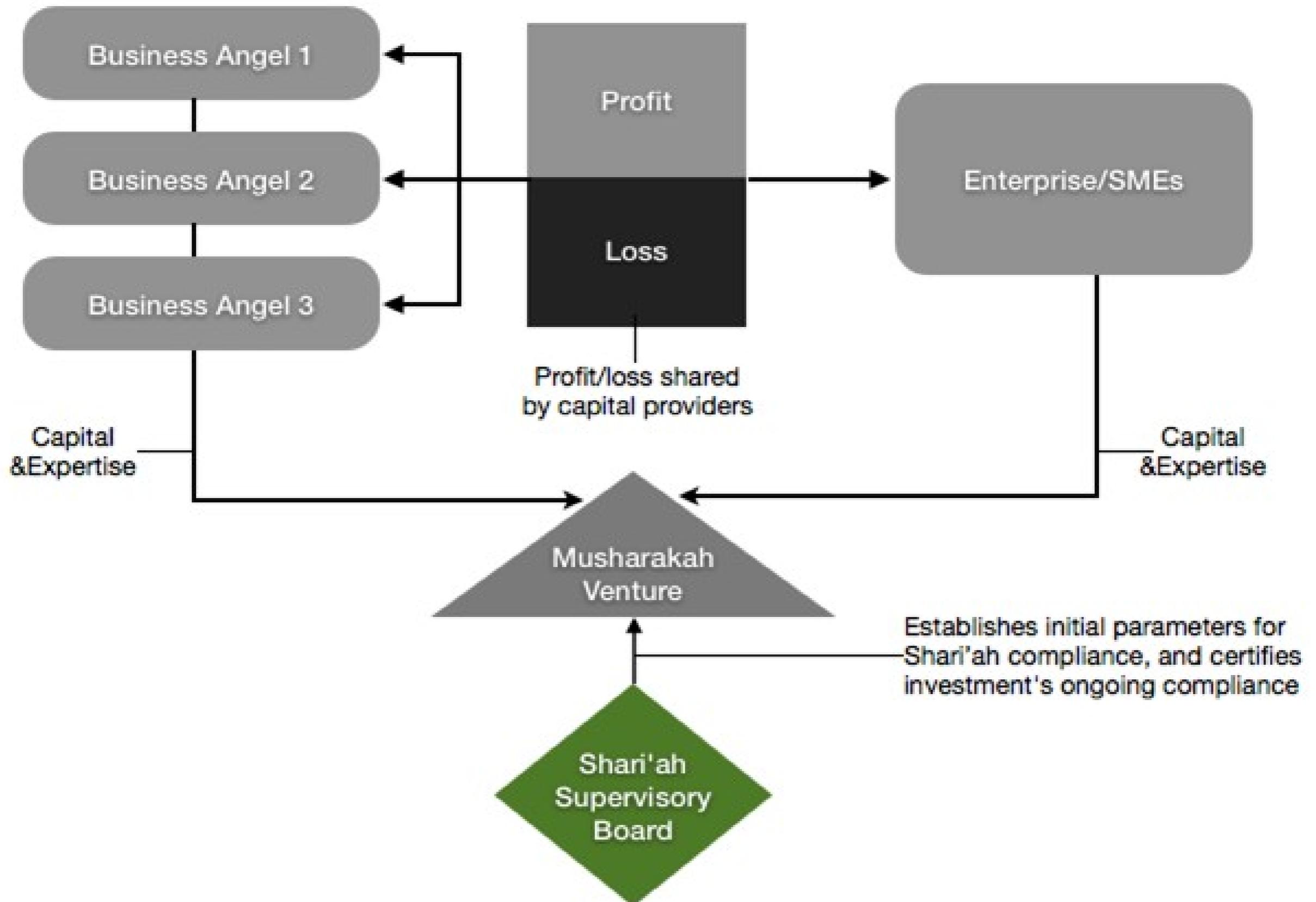
# Angel Investment in Mudarabah Structure

- According to the Figure 1; Entrepreneur is willing to execute a Shari'ah compliant Business venture on a Mudarabah basis and enters into Mudarabah Agreement with the Business Angel.
- Profits from Business venture are distributed according to pre-defined ratio between the two Mudarabah parties. If the business makes a loss, Business Angel bears the loss, unless Entrepreneur has been negligent.
- Usually in Mudarabah based investment, Business Angel provides capital only and Entrepreneur provides his skill and effort and will be responsible for the management of the business. On the other hand, Business Angel has an absolute right to access information and to monitor investment activities.
- Mudarabah based Angel Investment is most suitable for innovative start-up companies.

# Musharakah Arrangement

- in **Musharakah** arrangement, all the parties must contribute to financing of a shari'ah-compliant business/project and actively involved in the management. Losses are shared between them according to the financial contribution of each one.

Figure 2. Angel Investment in Musharakah Structure



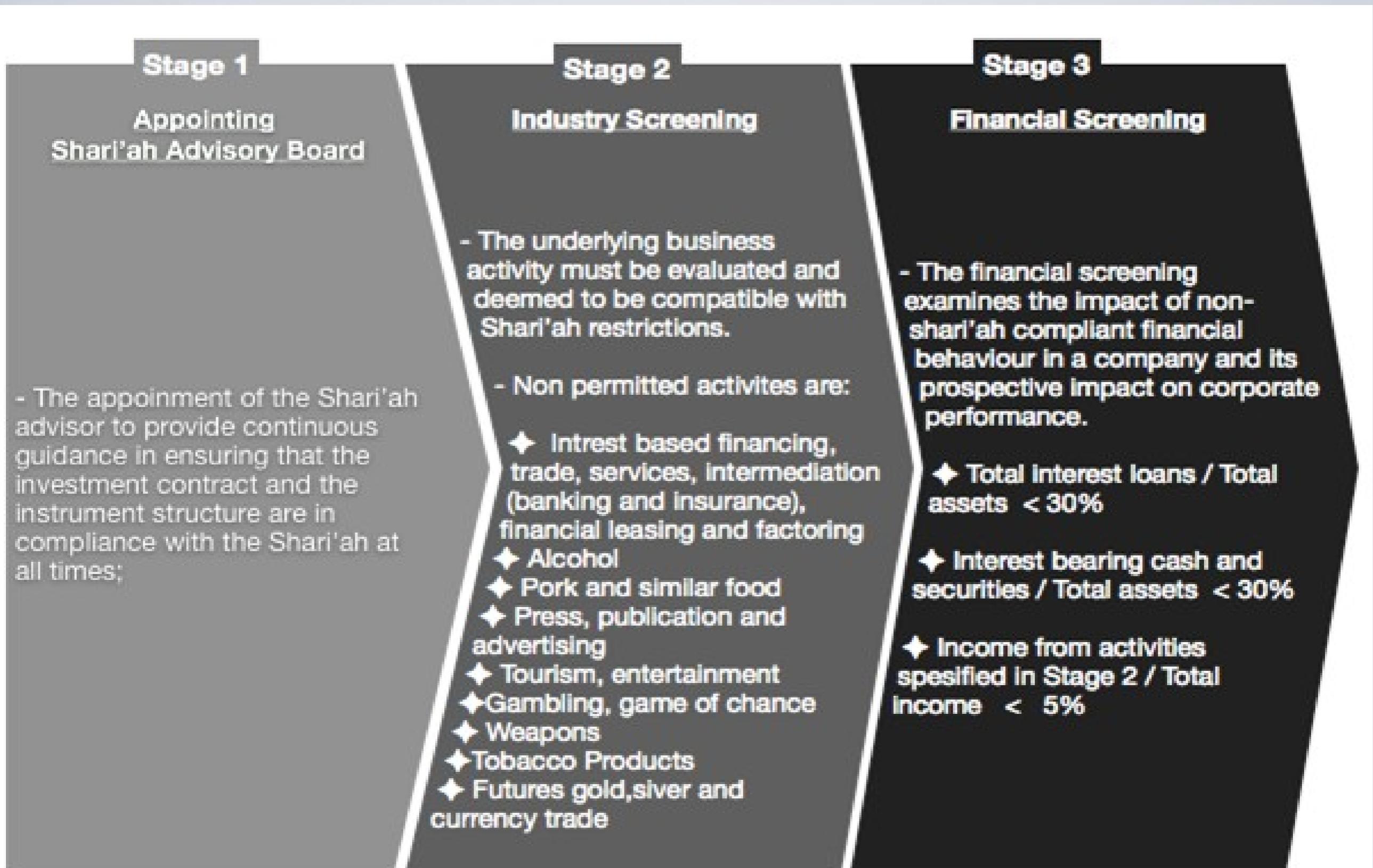
# Angel Investment in Musharakah Structure

- Figure 2. illustrates that, three Business Angel and one Enterprise/SME are willing to execute Shari'ah compliant business venture on a Musharakah basis and enters into Musharakah Agreement. All the parties provide capital/expertise to the business venture and have a right to participate in the management of the business.
- Profits are distributed according to a pre-defined ratio agreed between all the parties in the Musharakah agreement.
- Losses (if any) are born by all parties according to their capital contribution.
- Please note that in the figure 2, it is assumed that Enterprise/SMEs will contribute both Capital and expertise. However, Enterprise/SMEs can only contribute his expertise as in Muadarabah structure as well. In this case profits will be shared among all the parties, losses (if any) are born by Business Angels according to their capital contribution.

# Shari'ah Compliance Process of Angel Investment

- Figure 3. shows that how the shari'ah compliance process works in Mudarabah and Musharakah types of investment structure.
- In the first stage Shari'ah Advisory Board is appointed to provide continuous guidance in ensuring that the investment structure is in compliance with the Shariah
- In Stage 2 Industry Screening is applied. That is the underlying Business activity must be evaluated and deemed to be compatible with shari'ah restrictions.
- In the last Stage financial screening is used to examine the impact of non-shari'ah compliant financial behavior in a company and its prospective impact on corporate performance
- Industry and Financial Screening criteria In Figure 3. are adopted from Participation Index which is structured by BIZIM SECURITIES, INC. Participation Index aims to measure price return performance of tradable securities according to working principles of Participation Banking in Turkey. However these criteria can be redefined by Shari'ah Advisory Board if needed

Figure 3. Shari'ah Compliance Process



# Conclusion

- Angel Investment is a lucrative industry not only for investors but also for the overall advancement and development of economic and innovative commercial activity. Despite the fact that some financial instruments used in conventional angel investment structures are not shari'ah compliant, there are alternative structures that can be used by Islamic Angel Investors as discussed above.
- In conclusion, I believe there is a big opportunity for a Business Angels who wish to invest in shari'ah compliant manner, to create niche market that specifically targets Muslim entrepreneurs in Turkey.

# Thank You

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