A CONCEPTUAL FRAMEWORK FOR THE APPLICATION OF ISLAMIC PRIVATE EQUITY IN INTERNATIONAL SHIPPING

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Abstract

This paper aims to assess the application of Islamic private equity in order to develop Islamic finance and investment in international shipping. Shipping is a strong growth industry with about 85% of the global trade carried by the international shipping industry. The problem is that shipping is a highly capital intensive industry, and currently 75% of ship lending has been conducted by European banks and financed on a conventional basis. The post-financial crisis, shipowners, ship lenders and shipyards have all been exposed to the impact of over-levered balance sheets and debt finance. Our conceptual framework discusses how Islamic finance and investment institutions can participate at the retail and institutional levels involving private equity. Our study suggests that Islamic private equity should appeal to retail and institutional investors to promote and develop international shipping from Malaysia, in line with government policies on shipping and Islamic finance.

Keywords: Islamic finance, private equity, international shipping

1.0 Introduction

In terms of domestic government policy, the Malaysian government has already extended support to the development of the shipping industry through tax incentives to Malaysian flag vessels, including offshore ownership by international investors via Labuan, and also financially in the form of a RM 1.3 Bn Shipping Fund launched in 1992 and another RM 1.0 Bn in 2000 (Khalid, 2008)[1]. In addition, Global Maritime Ventures (GMV) was established in 1994 with RM 0.5 Bn of the RM 1.3 Bn in 1992 to provide venture capital funds to local shipping companies. Apart from Pacific Carriers Ltd's (PCL) joint venture with GMV through Malaysian Bulk Carriers (MBC), and also MISC's inherent relationship with Petronas on LNG carriers, generally, local shipping companies are not active in international shipping. There is also a financing constraint; notwithstanding the size of financing required, local banks are able, but unwilling to finance international shipping, perhaps due to their lack of knowledge concerning the international shipping market and perceived high risks and low returns, and hence, choose instead to finance smaller, less risky and typically off-shore local maritime assets often backed by Petronas charters.

However, why should international shipping be of interest to Malaysian investors, financiers and consumers, and specifically, Islamic financial institutions and institutional investors? In essence, globalization and sustainable growth cannot occur without the development of international shipping. With population, trade and financing data culled from Clarksons Research Studies, the global population has increased to 7.3 Bn and over 50% is now urbanized. Asian infrastructure is experiencing significant investment, especially within ASEAN. To underpin industrial growth, economies require electricity and steel, which at the very least stimulates the demand for coal, iron ore and oil, which in turn impact the derived demand for seaborne trade. In fact, 85% of global trade is seaborne, and given that global GDP is increasing by on average at least 3.0% per annum, shipping is clearly a growth industry. Shipping has been, and will

[1] Nazery Khalid, "Shopping For Ships: Ship Financing in Malaysia". Maritime Institute of Malaysia (MIMA), (Paper presented at *Ship Finance Asia 2008*, Singapore, 27-28 May, 2008).

remain, a capital-intensive business; however, 75% of ship lending has been conducted by European banks and financed on a conventional basis.[2] As conventional bank lending has contracted particularly in the aftermath of the global financial crisis 2007/2008, the shipping industry must source alternative capital. High asset cost makes shipping a natural destination for institutional and asset-backed capital investment and financing.

Hence, this paper attempts to encourage the international development of Islamic finance, involving the Islamic financial institutions (IFIs) as well as retail, HNWI and institutional investors, to provide a real alternative to conventional finance in promoting and developing international shipping from Malaysia. Shipping returns often outperform other financial and real asset investment alternatives.[3] Shipping involves income and capital appreciation and is internationally regarded as a tax-free investment, whether the shipping company is domiciled on-shore or off-shore. For example, shipping income for on-shore Malaysian shipping companies is deemed tax exempt[4] and equally for off-shore Labuan registered shipping companies.[5] While ships vary by sector, carrying capacity, demand fundamentals, yard of build and maintenance record, they enjoy a degree of homogeneity among specific vessel sizes, allowing for price transparency within size categories. Shipping is a well-organized, regulated and transparent industry that more recently has affected the economics of the shipping market, and provides significant entrepreneurial opportunities[6]. A shipping company with

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[2] Clarksons, *Shipping Intelligence Network* database, Clarksons Research Services, London, accessed August 21, 2016, https://sin.clarksons.net/

[3] J. P. Morgan, "Maritime Investing: An Income Opportunity", *Insights and Research*, J. P. Morgan (Jan., 2015), accessed August 21,2016 https://am. jpmorgan.com/ nl/institutional/library/maritime-investing

[4] LHDN. Income Tax Act 1967, Section 54A: Exemption of Shipping Profits, accessed August 21, 2016 http://www.kpmg.com.my/kpmg/ publications/ tax/22/a0053s0054a.htm

[5] LBTA, Labuan International Business Centre, Malaysian International Ship Registry (MISR) and Labuan Business Activity Tax Act (LBTA) 1990, accessed August 21, 2016 https://www.labuanibfc.com/areas-of-business/134-360/financial-services/malaysia-international-ship-registry-misr.html

[6] Martin Stopford, *Maritime Economics*, 3e, (London: Routledge, 2009), pp. 329, 655.

USD 1.0 Bn in assets could be run by a ship-owner with 2 managers and 20-30 staff (less, if technical ship-management is sub-contracted). Most businesses employing this level of capital would require thousands of employees and a large management structure. Ship-owners generally prefer equity or debt financing that matches their operating income, which is typically denominated in USD; nonetheless multi-currency options are possible.

The structure of this paper includes an introduction to international shipping and ship-finance in this section. Section Two reviews the literature on Malaysian bank exposure to ship-finance, Section Three assesses the structure of private equity funds, and Section Four focuses on Islamic finance and the *mudharabah* contract. Section Five discusses the structure of Islamic private equity funds; Section Six analyzes the participation of IFIs, including retail and institutional investors, and Section Seven provides some concluding remarks.

2.0 Malaysian Bank Exposure to Ship-Finance

In terms of the literature, conventional ship finance involves a risk free transaction, where “the bank lends and the borrower secures the repayment of the loan by mortgaging his ship to the bank. Invariably there will be other security”[7], the Maritime Institute of Malaysia (MIMA) argued, that Malaysian financial institutions need to enhance their understanding of shipping to assess risk and thus price transactions better, and in particular alter the high risk / low return perception of shipping. In this regard, Islamic finance has emerged as a mainstream source of alternative finance for international ship-owners, and this research analyzes the pricing of risk and returns, investment appraisal and valuation, within the structure of Islamic finance that should appeal to institutional investors and ship-owners alike. Malaysian banks, including IFIs, have very limited exposure to shipping and largely involves the off-shore oil and gas market, which includes smaller product and chemical tankers, as well as the off-shore supply vessel (OSV) market, and all of this is now exposed to international competition under the auspices

[7] Stephenson Harwood (Ed), *Shipping Finance*, 3e, (London: Euromoney, 2006), 1.

of the Trans-Pacific Partnership Agreement (TPPA) signed in 2016. Conventional shipping banks dominate ship financing with a market share of 75%.[8] Each of these shipping banks has dedicated transportation teams that inherently possess extensive industry knowledge of international shipping. They have similar risk, liquidity and capital requirements, but the fault line is the lack of knowledge and understanding by Malaysian banks and their asset management companies. This lack of exposure in a highly capital-intensive industry is reflected in bank activity (figure 1) conducted by ABN-AMRO. As of 2015, there are no Malaysian banks identified in ship finance syndicates led by global shipping banks, which were supported by local institutions,[9] Hence, the need to look at different investment and financing structures, such as private equity, that would facilitate the development of Islamic finance and international shipping from Malaysia.

Figure 1: Active Global Syndicates of Shipping Banks by Region

Source: Biesbroeck (2015)

3.0 The Structure of Private Equity Funds

Furthermore, Hamzah articulates that the three main capital market asset classes comprise equities (stocks), fixed income (bonds, sukuk),

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[8] Clarksons, *Shipping Intelligence Network,* (2016).

[9] Gust Biesbroeck, "Ship Finance Update", ABN-AMRO, *28th Annual Marine Money Week*, New York (16 Jun. 2015), accessed August 21, 2016 https://www.marinemoney.com/forums/MMWeek15/presentations2015Tuesday