Intangibles: the next frontier of the Islamic Economy

by Shehram Khattak, Jonathan Lawrence and Ronnie Yearwood | 20 December, 2015

The Islamic Economy is, to a greater or lesser extent, reliant on its emerging growth companies, essentially small to medium-sized enterprises (SMEs), which are widely recognised as engines of economic growth and key contributors to the sustainable gross domestic product of all countries. SMEs looking for seed money are the traditional targets for VCs. Typically such SMEs have a limited operating history, are too small to raise capital in the public markets or secure a bank loan and may benefit from additional management guidance.

An International Finance Corporation study released in 2014, carried out across nine countries in the Middle East and North Africa, revealed that approximately 35 percent of SMEs do not use conventional banking because they seek Shariah-compliant products. The study further found a potential market gap of up to $13.2 billion for SME Islamic financing in the relevant region with a corresponding depository potential of $9.71 billion to $15.05 billion. In Saudi Arabia, up to 90 percent of SMEs are specifically looking for Shariah-compliant financial services.

In today’s technology- and service-based economy, value is increasingly tied up in the intangible assets of SMEs and larger companies, too. This is especially the case in the technology, media and telecoms (TMT) sector. However, and perhaps this is a sign that the sector is still in its nascent stages, it is difficult to place a value on the TMT sector within the Islamic Economy.

A recent report by Thomson Reuters on the Digital Islamic Economy estimated the global digital economy at $1.9 trillion in 2014, with Muslims contributing $107 billion to that value. Thomson Reuters valued the Islamic Economy’s ”Media and Recreational” sector at $185 billion.

Muslim consumer value in the global digital economy is projected to grow at 17 percent compound annual growth rate to $277 billion in 2020 and the Media and Recreational sector is projected to grow to $301 billion in 2019.

CHALLENGES

This raises the question that “If there are so many opportunities, what is the challenge?”.

Unfortunately there is no single challenge but a myriad of interconnected and critically circular ones.
Rights and remedies (the legal infrastructure) associated with intangibles are unclear in some Islamic jurisdictions, deterring companies from utilising such asset classes or entering the market in the first place. This means that the market may not mature due to systemic problems such as liquidity, risk allocation and pricing.

This confusion means there is a lack of Shariah-compliant funding to the companies that are present in this area. Without sufficient demand, financial institutions are not incentivised to explore more “exotic” structures and, therefore, do not engage with Shariah scholars, meaning the potential development of a legal consensus on intangibles is hampered. This takes us, full circle, to the need to clarify remedies in relation to issues surrounding intangible assets.

VALUING INTANGIBLES

We see two main challenges that must be dealt with first: (1) a lack of clarity; and (2) a lack of funding.

Although the West has developed sophisticated intangible asset valuation techniques, certain matters remain unresolved.

For example, under U.S. accounting standards, all U.S. companies have been required to report the values of all their acquired intangible assets on their balance sheets; however, research shows that many leading companies are failing to comply with this requirement.

The primary reason is that it is inherently difficult to value intangibles. Even if you try to value an intangible asset based on the cost of an exact replica; or estimate its value by reference to the market; or by reference to its projected apportioned cash flows, there are inherent further valuation issues - for example, the problem of liquidity means there may not be a market; it may be difficult to disassociate the intangible asset from the main business and, thus, difficult to apportion value. Additionally, the industry-specific nature of intangibles tends to mean subject matter experts are required to assess the asset properly.

Consequently, intangibles are often of indeterminate resale value and, before taking security over such assets, lenders tend to take a conservative view and robustly explore their rights and enforcement issues.

SHARIAH CONSIDERATIONS

The familiar Shariah restrictions apply to intangibles in that the subject matter must conform to Shariah, title must be clearly transferred and the product or asset must adhere to the usual prohibitions. However, there are additional issues: gharar (speculation), maysir (gambling, or games of chance), and concealing knowledge.
The issues with gharar (speculation) are twofold. First, the parties must know the precise value of the product, and secondly, the parties must know what the exact product is.

This poses a challenge, for example, in the sale of a confidential recipe. It is difficult to value, and the subject matter is the recipe itself, which, if disclosed, would have no value and, therefore, might deter the potential licensee from concluding the contract.

Shariah prohibits acquiring money without labour (considered to be maysir), as in gambling or income through interest. Some forms of intellectual property creation could yield enormous revenues for the creator (through, for example, royalties generating income years after the creator created his or her work). In some instances traditional measures of time and physical effort can give little indication of creative output, value and application for use in a product or service. The purpose behind this prohibition is that, as a matter of principle, the reward earned should be proportional to the effort expended.

Concealing knowledge is the third consideration. A saying of Prophet Muhammad (PBUH) clearly expresses the prohibition of concealing knowledge - “the one who conceals knowledge would appear on the day of resurrection as reined in a bridle of fire”.

This hadith is sometimes used against the concept of copyright. It was clearly established, at the time of the Prophet, that authors (especially poets) had rights over their work. As with the case of maysir the principle underlying this prohibition is that knowledge should be freely dispersed. This principle is then limited by commercial reality (with the aim that the ensuing tension means a middle ground is reached in good faith).

**USE OF INTANGIBLES IN ISLAMIC ECONOMY**

There are instances where the structural difficulties have been overcome. For example, there have been several sukuk issued using phone airtime as the underlying assets. (Examples include Axiata’s in 2012 and Ooredoo’s in 2013.) This shift to an intangible asset represents a step away from the normal (tangible) asset classes on which sukuk are generally formulated, such as real estate.

Issuances such as these demonstrate that a Shariah-compliant structure can meet the requirements and standards that the market would expect from a conventional bond issuance by a European corporate, for example, those relating to title, security, tax, accounting and regulation. Such a transaction proves that Shariah is flexible and can adapt to a complex intangible as it would to land, commodities or other more tangible asset classes.
Therefore, further market education is needed to align expectations and bring confidence to the sector.

**FUNDING GAP**

Given the opportunities tied up in intangible assets in the Islamic Economy, it would be expected that the traditional guardians of finance — banks — would be happy to meet Shariah requirements and therefore there should be no funding gap.

However, intellectual property, although enormously valuable to the borrower, may be of little value to a bank, and further, the prohibition on interest and asymmetric risk allocation and the high compliance costs associated with Shariah structuring means that banks are not particularly incentivised to engage with this sector or asset class.

**OPPORTUNITIES FOR VCs**

VCs, however, are designed to target this gap. A key difference between regular financial intermediation (financing through banks or bonds) and venture capital is the sharing of risk between the investor and the firm. This sharing of risk as opposed to risk transfer is more attuned with Shariah concepts than with a traditional financial institution’s risk appetite.

It is also noteworthy that VCs have been closely associated with technology. The digital revolution was to some measure financed by VCs. There is, therefore, some evidence that VCs play an important role in bringing new technologies to the market.

Further, VCs provide two ingredients that are in short supply in the Shariah-compliant SME/TMT sector: capital; and professional management skills (with regard to, for example, organisational management, headhunting, marketing, networking, certification and reputation). By filling this gap VCs can provide an impetus to growth in the Islamic Economy as it relates to SMEs.

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