



# THE ISLAMIC FUNDS & INVESTMENTS REPORT

## Islamic Funds & Investments Report 2007

ASSESSING THE POTENTIAL FOR GROWTH AND IDENTIFYING CRITICAL SUCCESS FACTORS



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INVESTMENTS REPORT**

ASSESSING THE POTENTIAL FOR GROWTH AND IDENTIFYING CRITICAL SUCCESS FACTORS

## *The Ernst & Young Islamic Funds & Investments Report 2007*

Dear Banking, Finance & Investment Executive,

Many experts are predicting a major boom in Islamic capital markets and investment funds. With the **Sukuk** market currently witnessing a spate of record-breaking deals, the Islamic **Private Equity** market set for a boom, and Islamic **Alternative Investments** attracting increasing interest; the stage is now set for the launch of the **1st Annual WIFCMC Ernst & Young Islamic Funds & Investments Report (IFIR)** to address this exciting and dynamic landscape.

Reflecting these challenges and opportunities, the inaugural Islamic Funds & Investments Report will focus on the spectrum of asset classes and drivers that will have the most significant impact on the industry. The objective of the IFIR is not to analyse the performance of investment funds, but rather to provide new insights into the market, pinpoint critical success factors and identify key trends that will shape the immediate future of the industry.

### *Anticipating Increasingly Complex Islamic Financial Markets*

- What deal flow can we expect to see emerging in the **Islamic Private Equity** space?
- How sustainable is the current appetite for **Islamic Real Estate** investments?
- Are Islamic **Alternative Investments** ready for a boom? And which asset classes are offering the greatest opportunity scope today?
- Where will the next **Sukuk Mega Deals** come from?

Our gratitude goes to leading audit and advisory firm, **Ernst & Young**, and their Islamic Financial Services Group led by Sameer Abdi, who have invested their considerable international talent and resources in leading the research project and in developing the insights contained in the Report.

We hope that you will find the contents of this Report useful in your own strategic planning activities and we wish you great success in your own quest for market-leading excellence in the Islamic Funds & Investments industry.

Yours sincerely,



**David McLean**  
Managing Director  
**The World Islamic Funds & Capital Markets Conference**  
A MEGA Brand

**Dear Investment Executive,**

On behalf of Ernst & Young, I would like to take this opportunity to introduce you to the **Ernst & Young Islamic Funds and Investments Report 2007**. This year's report is the pioneering edition of this unique research program that is aimed at identifying key trends in the Islamic funds industry and the implications of these for industry players. Accordingly, we are honored to be associated with the World Islamic Funds Conference in presenting our findings.

This year's report is a culmination of desk-based analysis and interviews with several leading players in the Islamic wealth management industry. The study begins by analyzing the impacts of macro-economic developments on investors' wealth before considering the demand segments' investment allocation trends. The report also discusses the potential growth for the industry, particularly the expansion in the different investment asset classes. Subsequently, certain supply side dynamics are analyzed before key success factors are drawn from the analysis for a new market entrant. A central theme that emanates from the report is the critical need for product development across asset classes to provide investment opportunities and support the growth of the Shari'a compliant wealth management industry.

These are exciting times for Islamic wealth management, a sector which is becoming ever more significant on the global stage. Market participants will need to take stock of their core competencies and enhance these to compete better with regional and multinational players.

I hope you find that this report is informative and assists you in formulating your own strategic initiatives in the pursuit of excellence.

Kind Regards,

**Sameer Abdi**  
Group Head, Islamic Financial Services  
Ernst & Young



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# Introduction

## Market Opportunities for Shari'a Compliant Investment Management will Allow Industry Players to Meet Their Objectives

These main business objectives

- Build assets under management (AuM)/client base;
- Do this in a profitable manner;
- Build a credible brand name

...will be acquired by these industry players ...

- Investment Bank
- Private Bank
- Asset Manager
- Focused Player

...to target the opportunities in the Shari'a compliant investment management industry.

- Economic growth;
- Increasing Affluence;
- Increasing Demand for Shari'a Compliant Investments/Products;
- Room for growth of funds industry;
- Lack of depth across asset classes/products
- Regulatory reforms/developments

Source: E&Y Analysis



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# Regional Investors



## Key Messages

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- Macro-economic growth in the region has been robust on the back of strong oil prices and diversification
- Growth has 'trickled down' to individual and institutional investor segments
- Investors' portfolio allocations indicate a need for diversified asset classes
- Current penetration levels of Islamic funds indicates room to grow

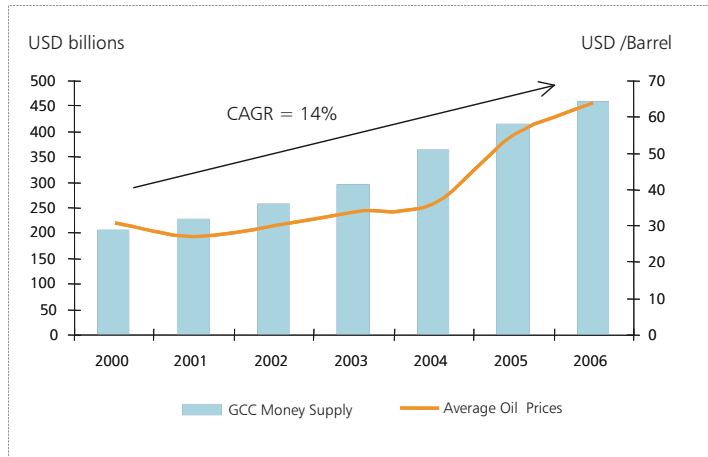
" Clients are looking for products that are new and innovative."

" There has been a move away from conservative portfolios."

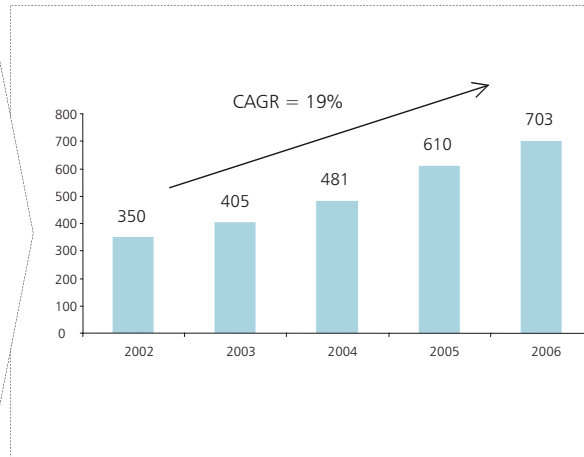
Head of Wealth Management - Islamic Bank (May, 2007)

## High Oil Prices Have Led to Economic Growth and Increased Liquidity

GCC Money Supply vs Oil Prices



GCC Nominal GDP (USD billions)

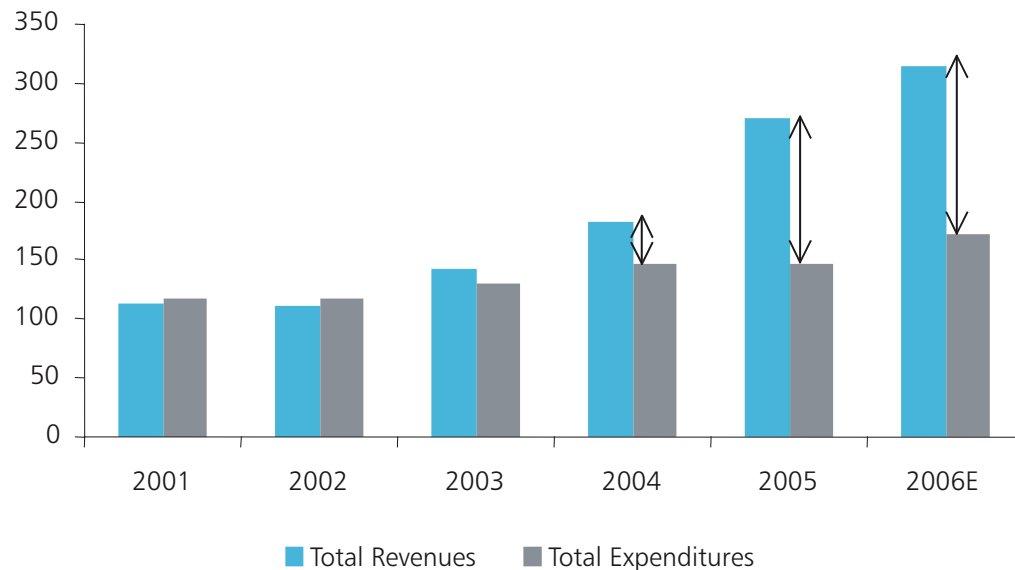


Source: Global Insight, OPEC Annual Report; GCC Central Banks; E&Y Analysis

## Which Has Allowed GCC Governments to Post Increased Budget Surpluses

Total Revenues of GCC Governments vs. Total Expenditures

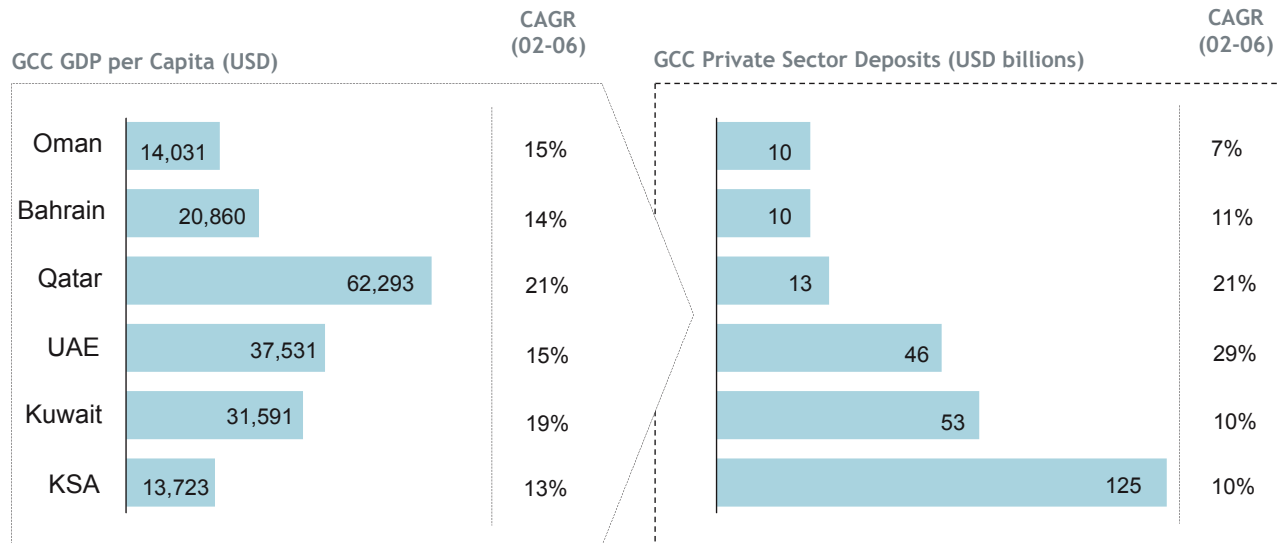
USD billions



- GCC economies are estimated to have posted a record budget surplus of USD 170 billion in 2005.
- Government spending has increased further with investments in infrastructure projects taking a high priority to stimulate sustainable long run economic growth.

Source: GCC Central Banks; E&Y Analysis

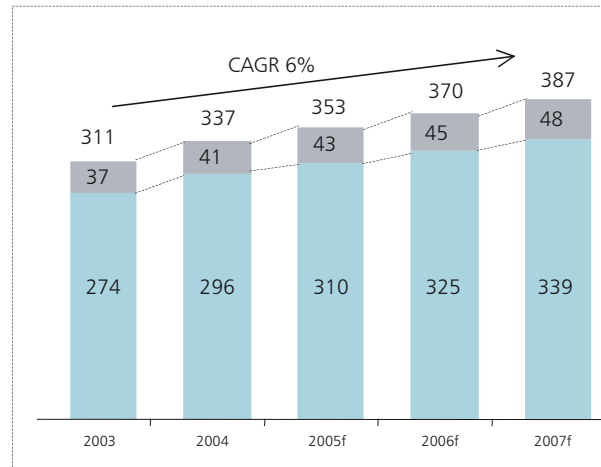
## Macroeconomic Wealth Has Also Trickled Down to Individuals



Source: GCC Central Banks; Global Insight; E&Y Analysis

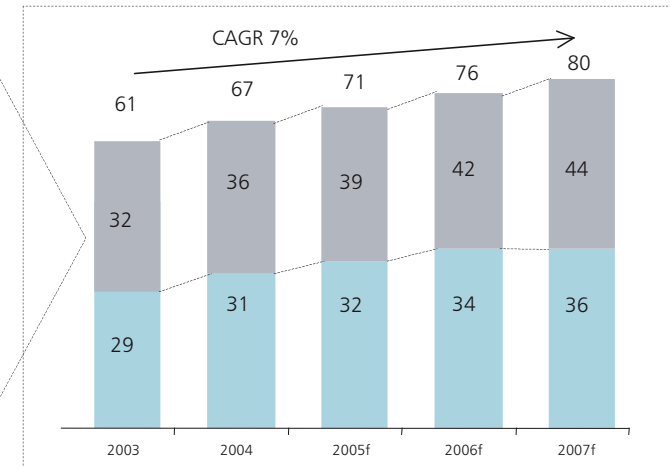
## Affluence in the GCC Has Experienced Significant Growth

Number of GCC Wealthy Individuals (thousands)



- Those individuals with aggregate liquid wealth of USD 300K+
- Those individuals with aggregate liquid wealth of USD 50K-300K

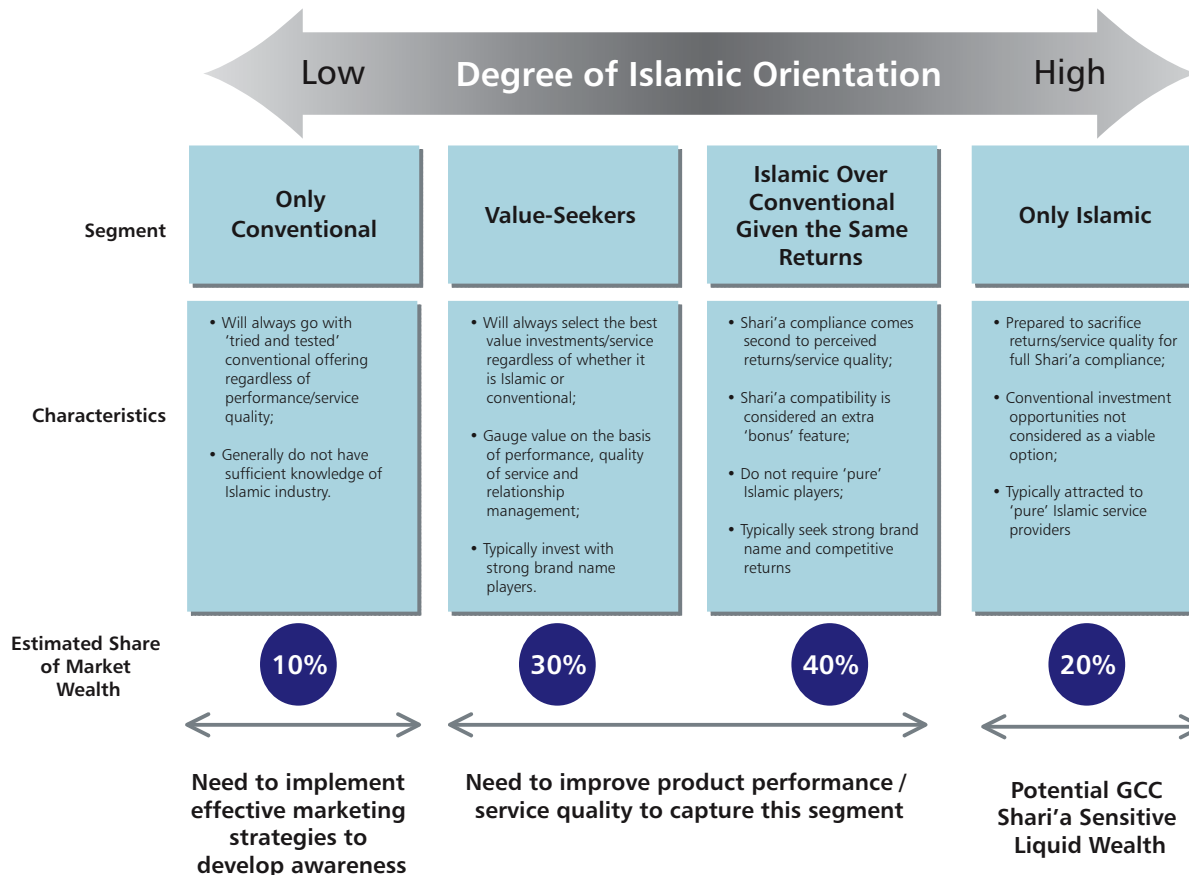
Liquid Assets of GCC Wealthy Individuals (USD billions)



- The number of affluent individuals (liquid assets in excess of USD 50k) has grown by a CAGR of 6% between 2003-2007
- This growth has been most impressive among high net worth individuals (liquid assets in excess of USD 300k) who have seen their proportion of liquid assets increase by a CAGR of 7.9% between 2003-2007
- Total liquid assets of affluents in the GCC is forecast to reach approximately USD80 billion in 2007

Source: Datamonitor; E&Y Analysis

## Potential Islamic Portion is Significant Although Islamic Players will Need to Proactively Target the 'Value-Seekers'



Source: E&Y Analysis

## There is a Strong Institutional Demand Segment in the GCC

### Major GCC Investment Authorities and 2005 Funds

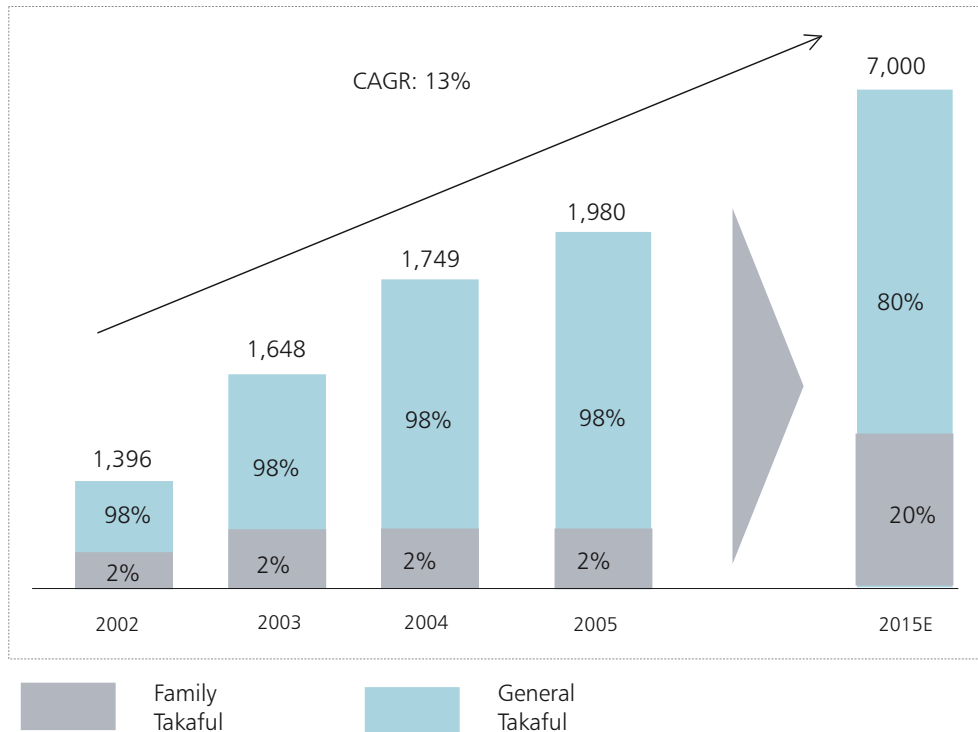
		Estimated Funds (US\$ bil )	Brief Description
<b>Kuwait</b>	Kuwait Investment Authority	>100	<ul style="list-style-type: none"> <li>• Invests long term and globally;</li> <li>• Targets equities, fixed income, treasury, private equity and real estate.</li> </ul>
<b>Saudi Arabia</b>	GOSI and Pension Funds	>250	<ul style="list-style-type: none"> <li>• Investment style relatively conservative</li> <li>• Emphasis on credit quality</li> <li>• Liquidity, diversity of portfolio and risk adjusted returns.</li> </ul>
<b>UAE</b>	Abu Dhabi Investment Authority	>250	<p>Asset allocation roughly split ;</p> <ul style="list-style-type: none"> <li>• 50% to 60% in equities;</li> <li>• 20% to 25% in fixed income;</li> <li>• 5% to 8% in real estate;</li> <li>• 5% to 10% in private equity;</li> <li>• 5% to 10% in alternatives.</li> </ul>

- The three largest investment authorities in the GCC hold investments greater than USD 500bn
- An accurate figure is however very difficult to verify due to confidentiality reasons

Source: Reuters News; Market Intelligence

## The Takaful Industry, In Particular, Presents a Growing Demand Segment for Islamic Investment Opportunities

Future Growth of Takaful Premiums (USD millions)



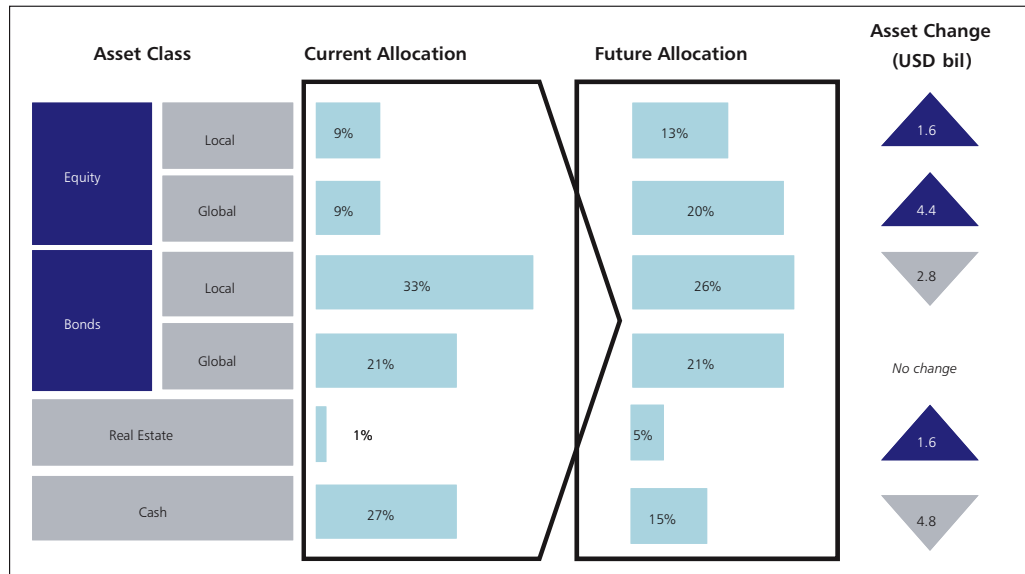
- Growth in the Takaful Industry has further contributed to the demand for Shari'a compliant investments;
- Industry growth is forecast to maintain approximately 13% to until 2015;
- In 2006, an estimated USD 3 billion in premiums were held globally, 36% of which was based in the Middle East.

Source: 2006 ARIG AIM Report; AME Info; E&Y Analysis



## GCC Social Insurance Funds' Investment Trends Indicates Demand for Diversified Investment Products

GOSI (Saudi Arabia) Current and Future Pension Fund Allocation (2005)\*



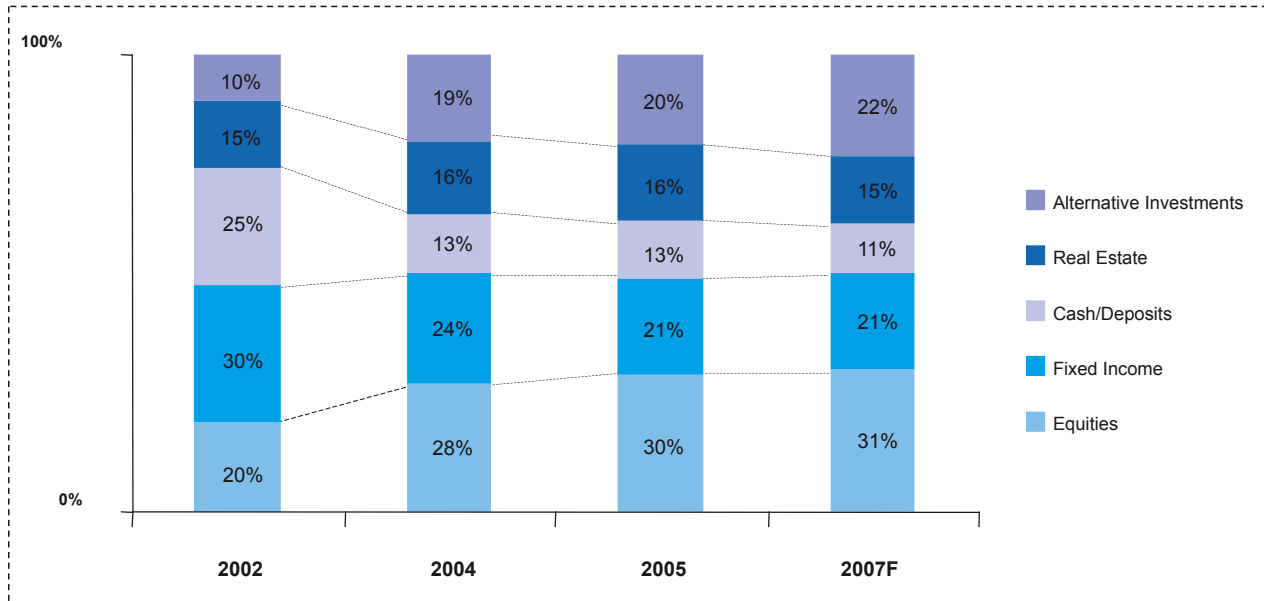
- A study conducted in 2005 analysed the planned future allocation of the GOSI pension fund in Saudi Arabia.
- It suggested a shift from fixed income and cash holdings to regional and global equities and real estate.

\* Indicative example

Source: GOSI Saudi Arabia

## Affluent and HNWI Investors Require a Diverse Range of Asset Classes with a Growing Appetite for Alternative Investments

HNWI Investments by Asset Class 2002-2007F

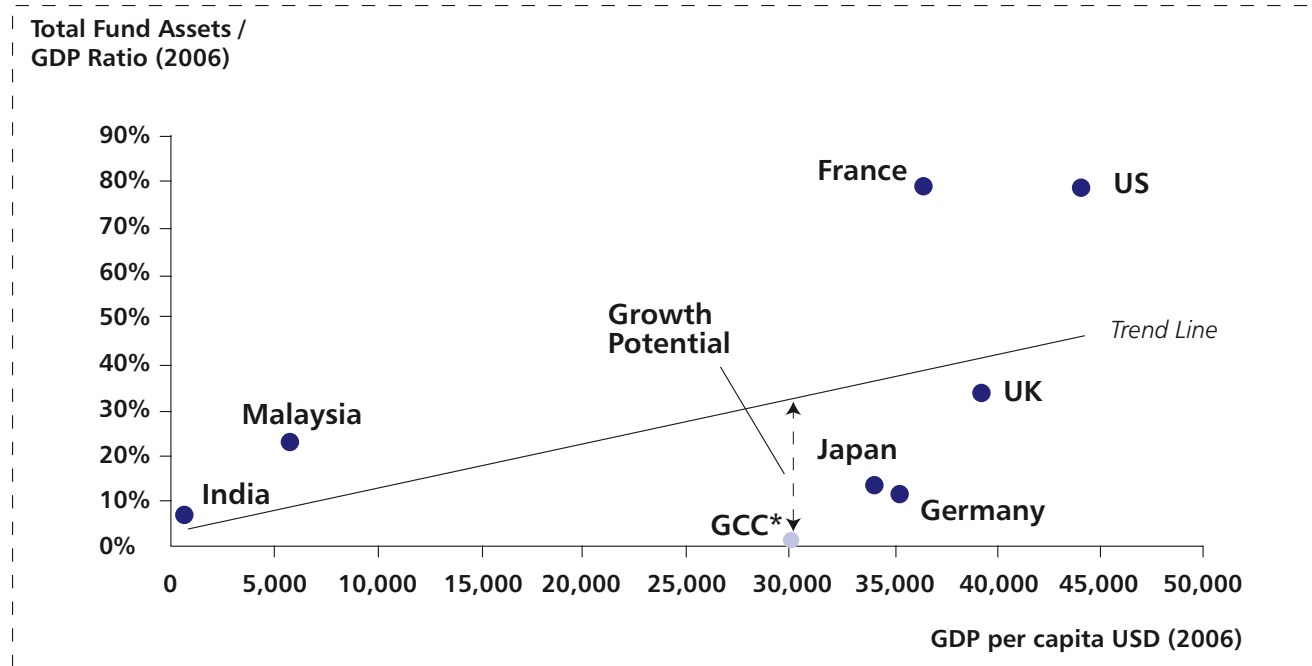


- Equity and fixed income assets account for 52% of HNWI's portfolio allocations
- Alternative investments as an investment asset class is expected to grow to 22% of HNWI portfolio allocations in 2007 from 10% in 2002.
- It is expected that investment portfolios of GCC affluent investors will increasingly resemble their counterparts in Europe and the US.

Source: CapGemini & Merrill Lynch

## And the Islamic Fund Industry in the Region Can Capture a Growth Potential to Meet This Demand

Penetration of Funds (2006)\*\*



\* GCC value reflects cumulative size of Islamic funds estimated from various sources

\*\* For the rest of the world, total assets held in mutual funds is used as a proxy for fund penetration

Source: GCC Stock Exchanges; Zawya; The Banker, Eurekahedge; Investment Company Institute; Global Insight; E&Y Analysis



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# Trends in Investment Asset Classes

## Key Messages

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- Regional equity capital markets are slowly on the path to recovery following corrections in 2006
- High concentrations of market capitalisation in regional exchanges indicates lack of depth in capital markets
- Islamic investors need investment opportunities in fixed income (sukuk) and across alternative asset classes to garner diversification benefits. Although, the volume of sukuk issues is expanding, there remains a need for deepening of the sukuk market
- Fund raising in real estate markets has grown. A significant portion of these funds have also been invested in the GCC which is expected to continue in the immediate term
- Private equity fund raising activity has been growing robustly on the back of strong investors' appetite and due to the industry's inherent compatibility with Shari'a
- The Islamic wealth management industry can also capture a share of the future growth in the hedge funds industry – although product structuring issues will need to be addressed

" We have to challenge the misconception that Islamic banks will provide little to investors while charging an arm and a leg."

" The issue with Islamic wealth managers is that they have to create new products"

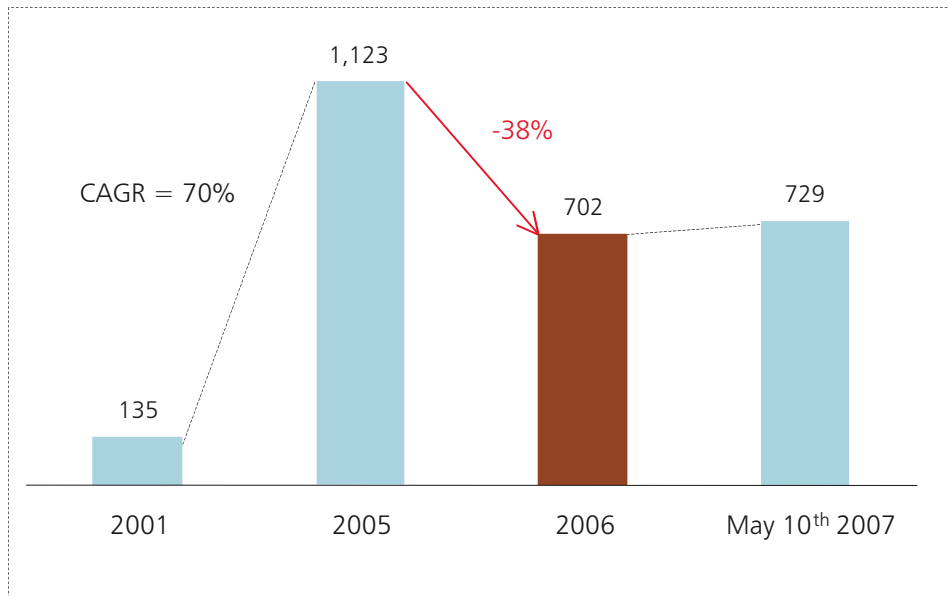
Head of Wealth Management - Islamic Bank  
(May, 2007)

" Sophisticated investors are demanding capital protected notes and convertible sukus."

Head of Private Banking – Multinational  
Conventional Bank (May, 2007)

## GCC Equity Capital Markets Are Slowly Recovering After the Corrections in 2006

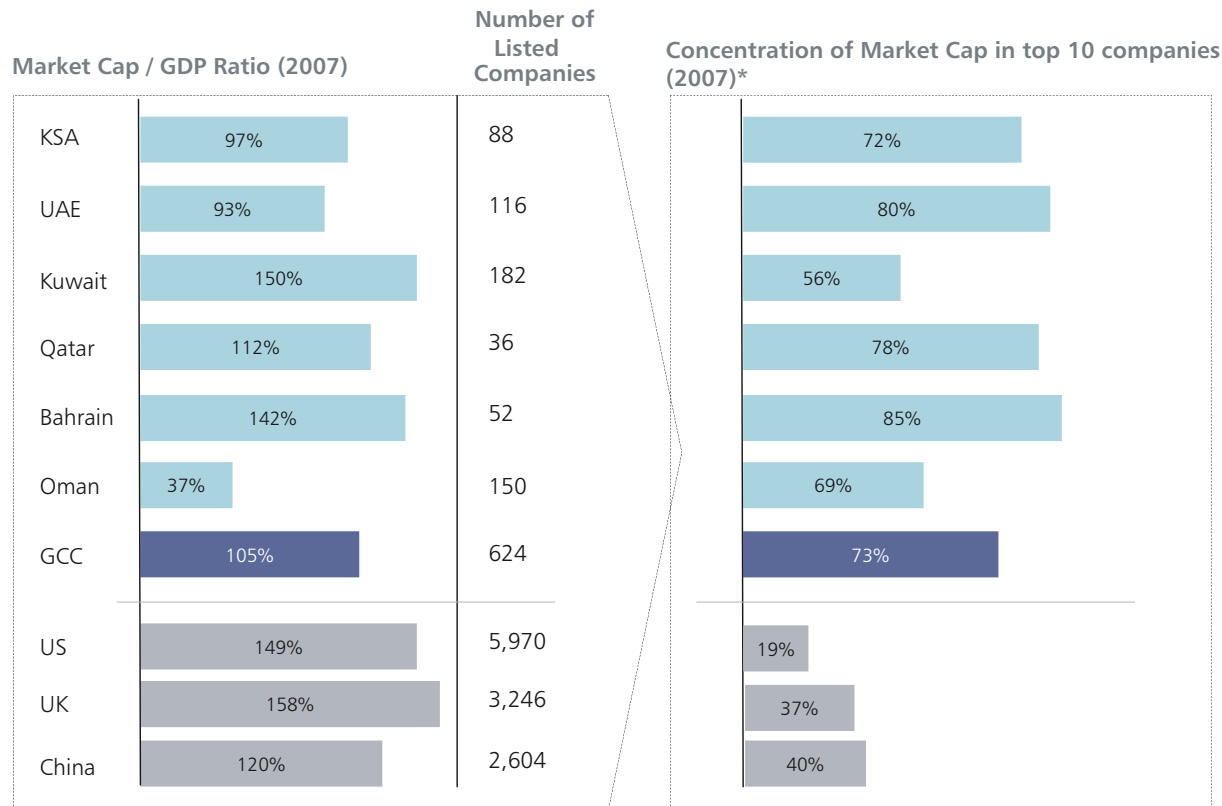
GCC Stock Market Capitalizations (USD billions)



- GCC equity capital markets experienced significant corrections in 2006 following a period of robust growth;
- Stock markets lost an estimated 38% of total market capitalisations in 2006 (approximately USD 421 billion) due to speculative corporate valuations and sell-off pressures;
- Markets are slowly recovering in 2007, backed by strong economic fundamentals and growing business confidence in the future;

Source: Global Investment House, E&Y Analysis

## However, There Continues to Be a Lack of Depth in Regional Equity Capital Markets\*

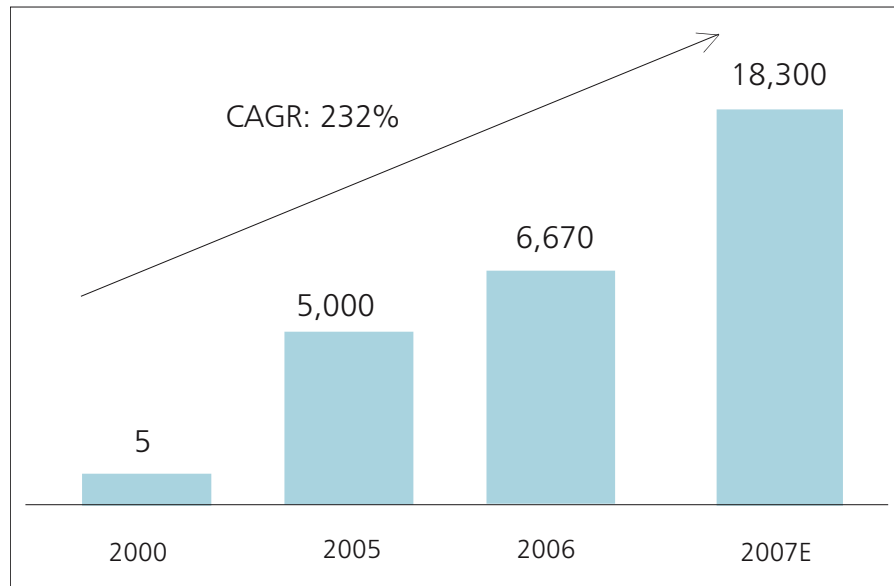


\* Details accurate as of May 1st 2007

Source: Global Investment House, GCC Stock Exchange Websites; International Federation of Stock Exchanges; Global Insight; E&Y Analysis

## Which is Driving the Demand for Investments in New Listings

Growth in IPO Capital Raised in GCC (USD million)



- Despite the corrections in the GCC equity markets, the outlook for public offerings is positive.
- In 2006, GCC stock markets witnessed 21 IPOs amounting to USD 6.67 billion.
- The average size of IPOs has also been on the rise, growing from USD 244 million in 2005 to USD 322 million in 2006.
- In 2007, more than USD 18.3 billion is expected to be raised through 63 IPOs.
- As of April 2007, eight IPOs have been offered - the same number offered during the same period last year which indicates a healthy appetite for new listings in the GCC as a whole.
- This may be due to a lack of existing public equity investment opportunities present for GCC investors due to high market capitalisation concentrations.

Source: Zawya IPO Monitor; E&Y Analysis



## However There Are Barriers to Investment

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### Capital Markets Still Recovering

Further to corrections in 2006, regional equity capital markets have been slow in recovering

### Lack of Capital Market Depth

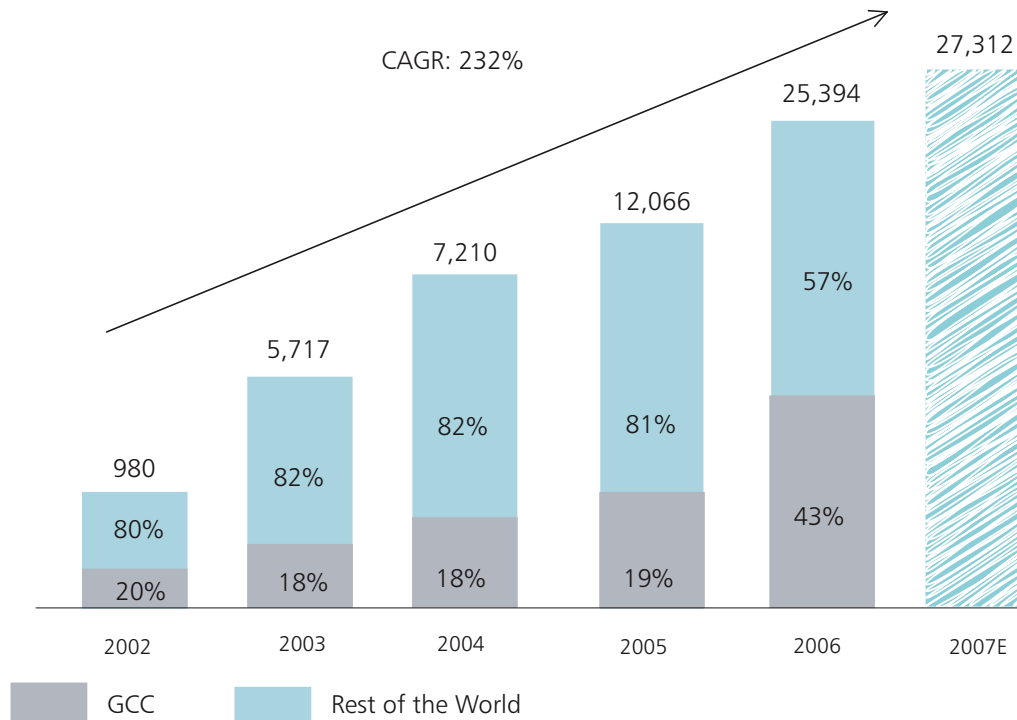
Due to relatively high concentrations of market capitalisations, there is a lack of depth in regional markets

The increase of public listings is expected to alleviate this in the medium to longer term



## Growth of Sukuk Presents Opportunities for Fixed Income Asset Class

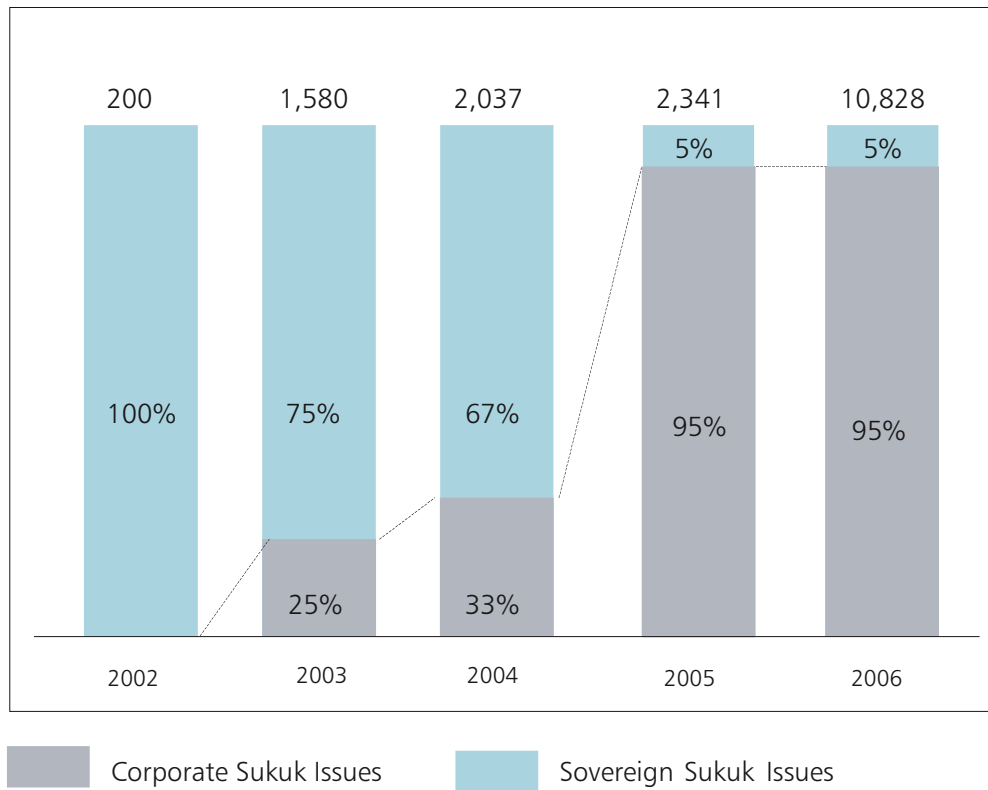
Global Sukuk Issues (USD millions)



Source: Zawya Sukuk Monitor; Islamic Financial Information Service; E&Y Analysis

## Especially Considering the Growth in Corporate Sukuk Issues

GCC Corporate Sukuk Issues (USD millions)



Source: Zawya Sukuk Monitor; Islamic Financial Information Service; E&Y Analysis

## However There Are Strong Barriers to Investment

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### High Minimum Subscription Levels

Retail investors are discouraged and unable to make investments in sukuk issues

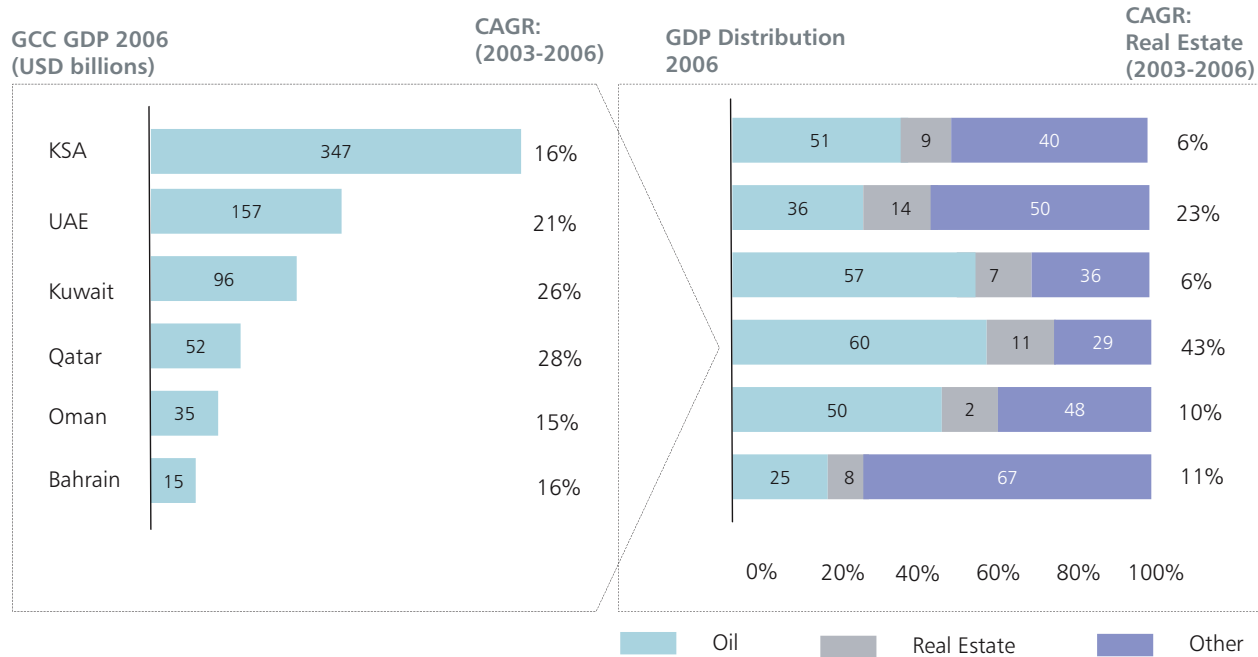
### Lack of Active Secondary Market

Investors display a tendency to buy issues and hold them to maturity due to lack of secondary market.

### Lack of Sukuk Funds

Islamic wealth managers have not tapped the opportunity to provide sukuk funds to meet the demand.

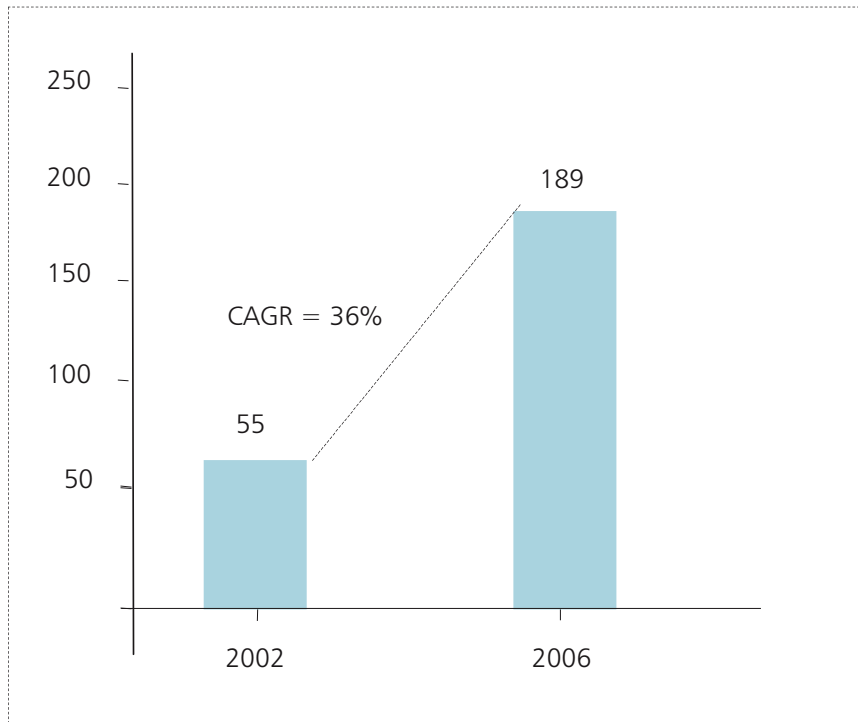
## Real Estate Sectors in the GCC Region Have Expanded



Source: GCC Central Banks; E&Y Analysis

## Resulting in Relatively Larger Average Real Estate Fund Sizes

Average Size of Islamic Real Estate Fund (USD millions)



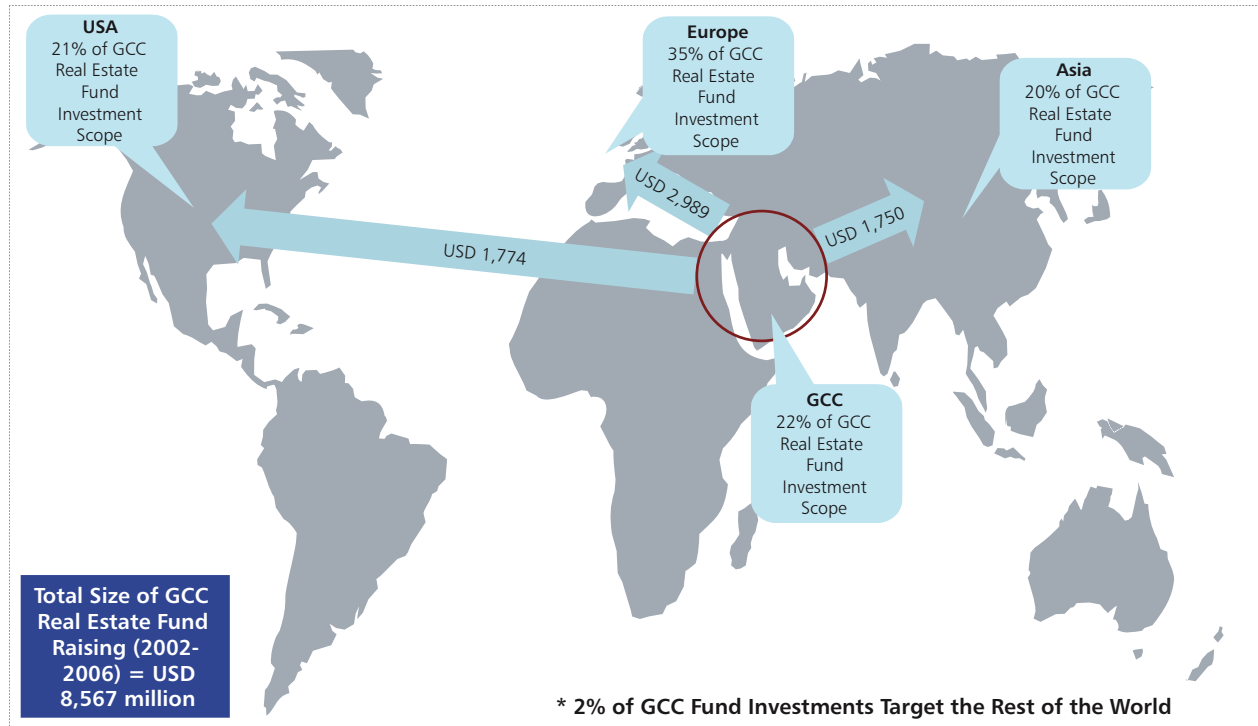
“Sophisticated real estate deals are relatively new in the GCC.”

Islamic Bank (May, 2007)

Source: Company Annual Reports, Zawya, Islamic Financial Information Service, E&Y Analysis

## And A Significant Portion of Real Estate Funds Are Being Invested In the Region

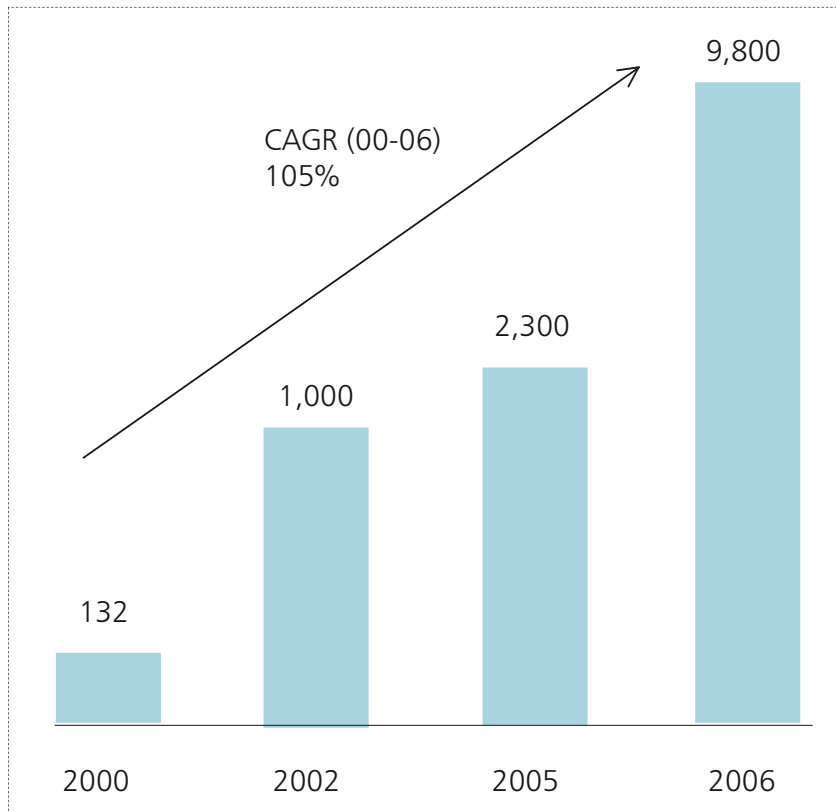
Size of GCC Real Estate Fund Investment Scope 2002-2006 (USD millions)



Source: Islamic Financial Information Service, E&Y Analysis

## GCC Investors Have Increasingly Sought Private Equity as An Asset Class

GCC Private Equity Funds Raised (USD millions)



“Privatization incentives are giving private equity traction.”

Head of Private Banking-  
Islamic Bank (May, 2007)

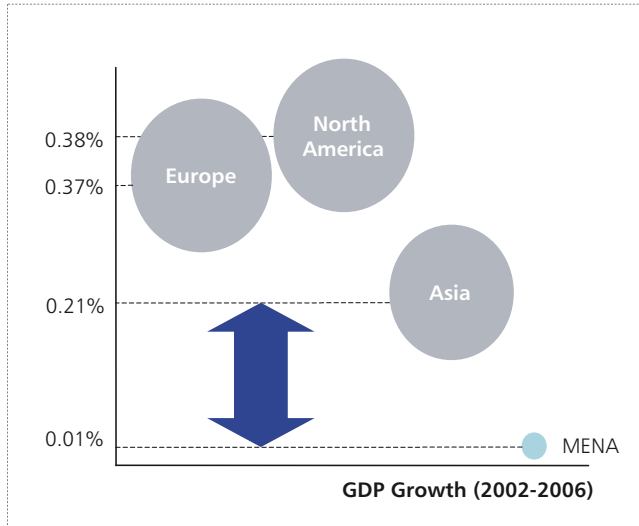
- Approximately USD 9.8 billion raised in the GCC region in 2006
- With the recent corrections in equity capital markets, private equity has become an attractive portfolio investment asset class
- Average fund size has increased to USD 284 million from USD 230 million in 2005

Source: Gulf Venture Capital Association, E&Y Analysis

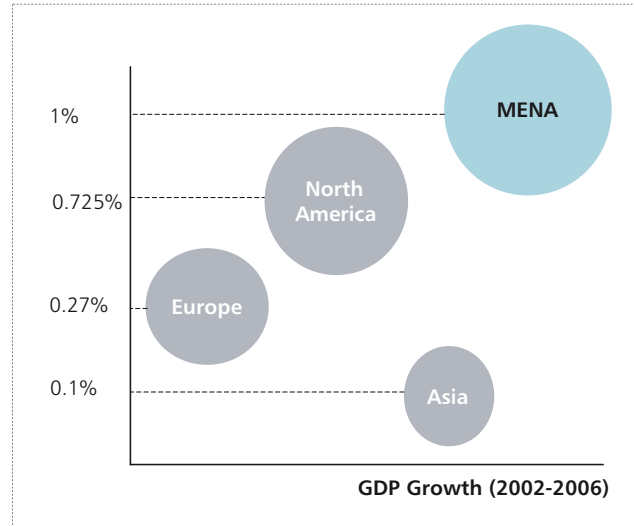


## Although PE Investments in the Region Have Been Limited, the MENA Region is Popular for Fund Raising Activity

PE Investments as % of GDP (2006)



PE Funds Raised as % of GDP (2006)

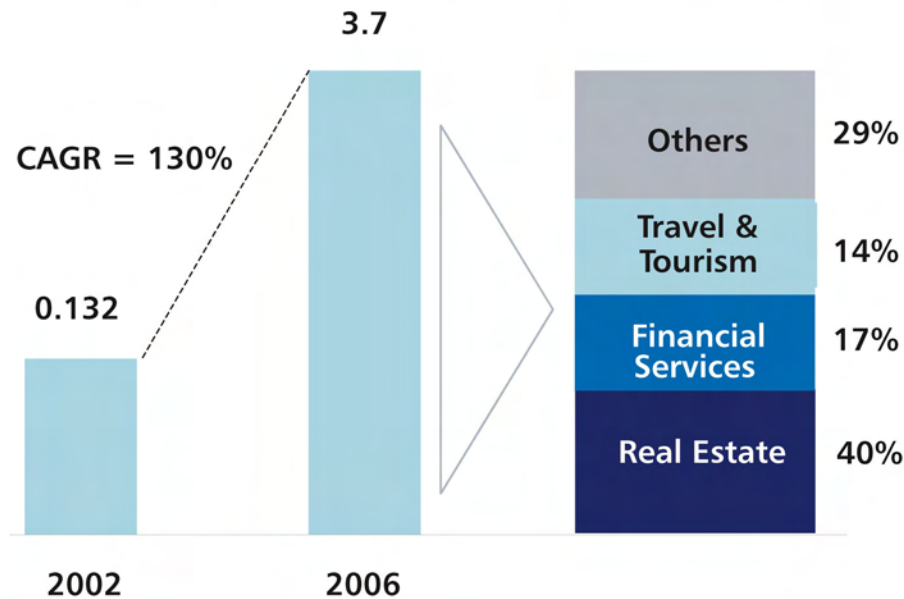


“GCC and North African investors love venture capital.”  
Head of Wealth Management- Islamic Bank (May, 2007)

Source: Global Insight, North American Venture Capital Association; European Private Equity and Venture Capital Association; Asian Venture Capital Journal; E&Y Analysis  
Size of circle denotes relative size of fund raising activity normalized for regional GDP.

## The Most Popular Sectors in MENA during 2006 were Real Estate, Financial Services and Travel and Tourism

Investments Made by MENA Based Private Equity Firms (USD Billions)



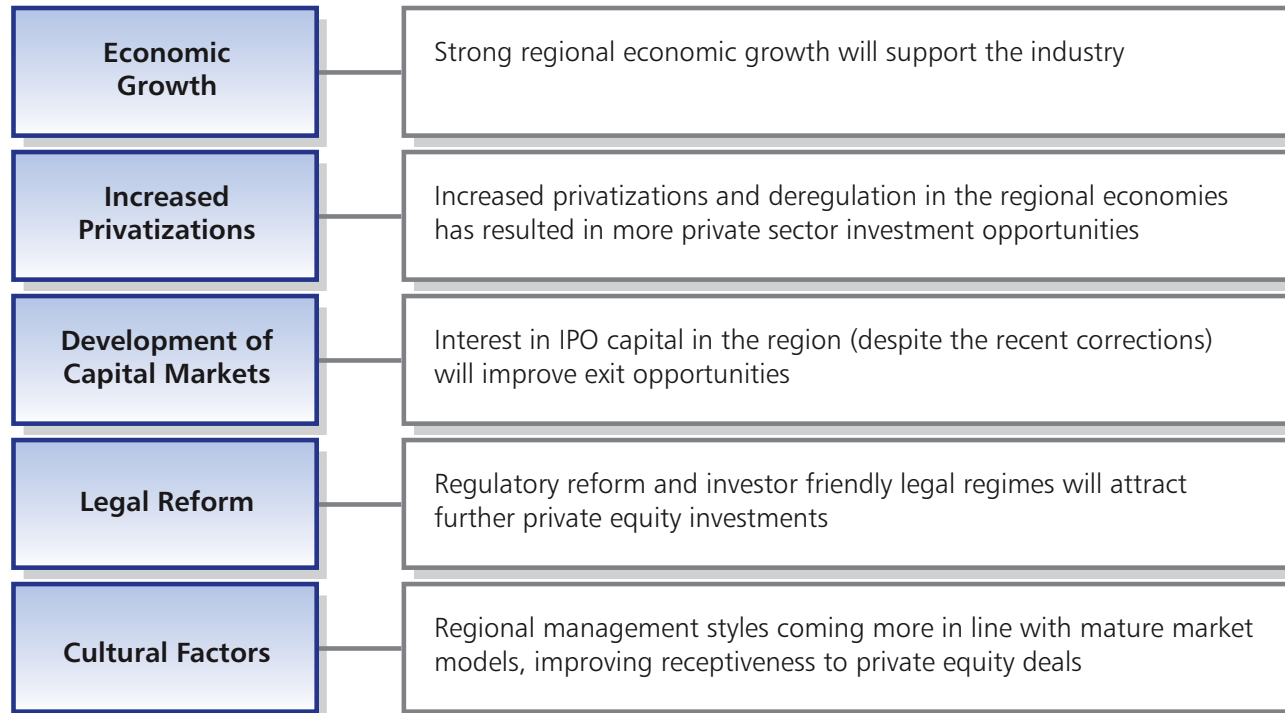
In 2006, an estimated US\$ 3.7 billion of private equity investments were made by MENA private equity firms

The most popular sectors for investments were real estate, financial services and travel & tourism

Indicates focused investment strategies for private equity

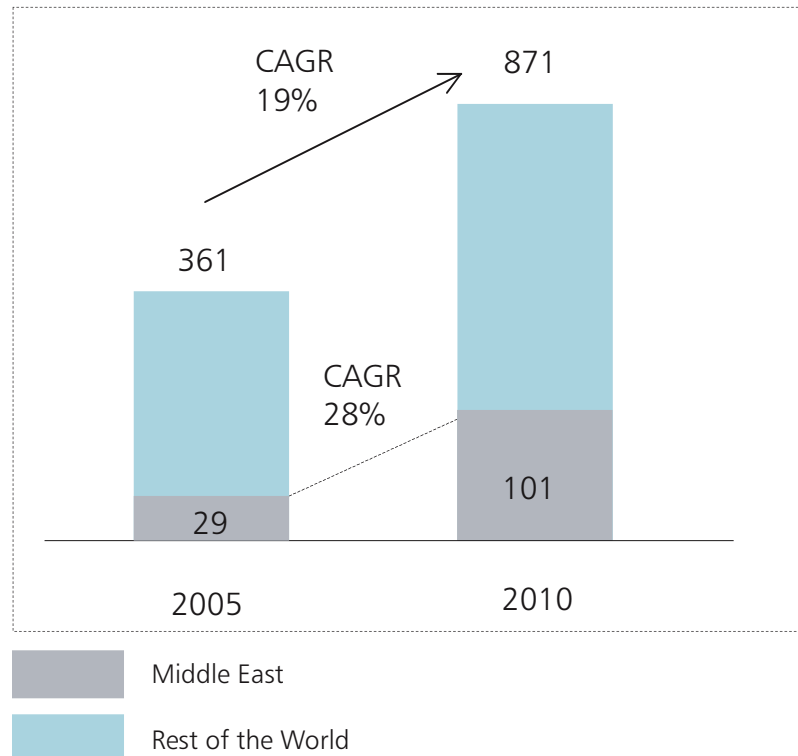
The most popular destination of private equity investments have been the US with over 50% of investments made between 1998-2006

## **Moving Forward, The Private Equity Industry will Grow Due to Strengthening Drivers**



## Institutional Hedge Fund Inflows from the Middle East Are Expected to Display Robust Growth Due to Investor Demand

Global Institutional Hedge Fund Inflows (USD Billions)



Source: Bank of New York; E&Y Analysis

Today, total institutional investors account for approximately 30% of total hedge fund assets and an estimated 40% of inflows.

By 2010, institutional investors are expected to account for 40% of total assets and approximately 65% of inflows.

Currently, Middle Eastern institutional investments represent 8% of global institutional investments.

By 2010, total Middle Eastern institutional investments are expected to reach USD 101 billion.

“People are always interested with derivatives.”

“There is a certain fascination with the unknown.”

Head of Wealth Management- Islamic Bank (May, 2007)



# Supply Landscape of Funds

## Key Messages

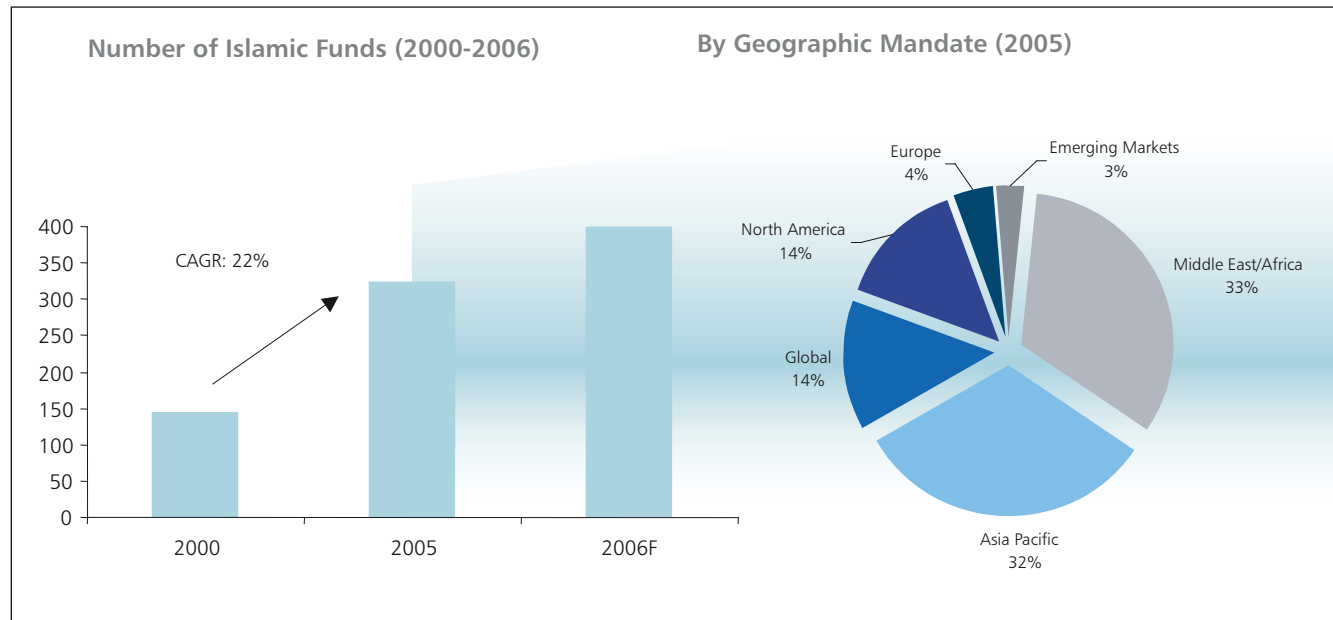
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- The number of Islamic funds available on the market has expanded. However, most of them are relatively small.
- Approximately 50% of the total number of funds each have less than USD 50 million of assets under management
- There exist strong gaps in the supply of funds. A significant portion of Islamic funds is concentrated in equity investments whereas there are prevalent gaps across other asset classes including sector specific funds, fixed income and hedge funds

“ There is a need to create depth in service provision.”

Head of Private Banking - Islamic Bank  
(May, 2007)

## The Universe of Islamic Funds Has Grown

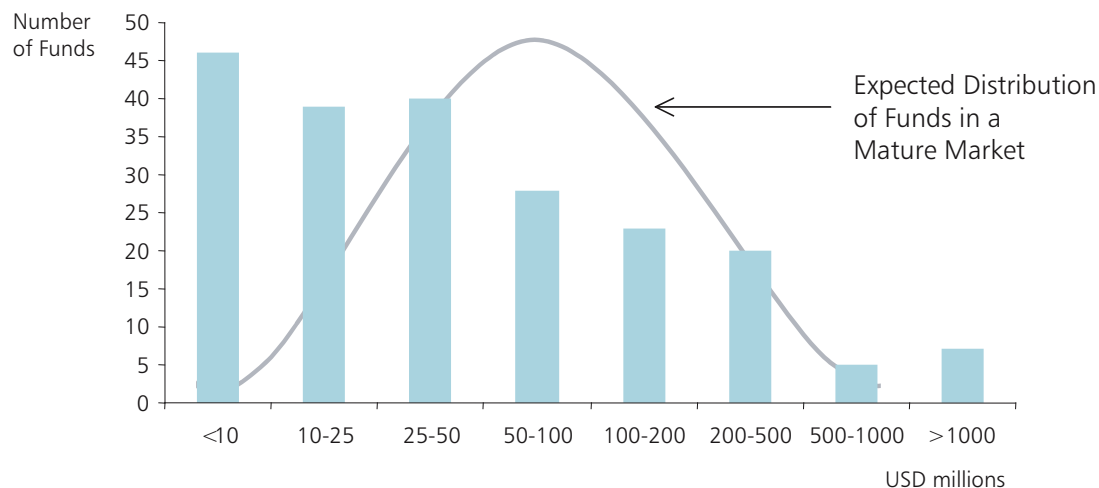


- The universe of Islamic funds has grown by an approximate CAGR of 22% between 2000-2005;
- The total number of funds is forecasted to have reached 400 by 2006;
- Geographical mandates in 2005 were dominated by the Middle East / Africa and Asia Pacific regions, accounting for 33% and 32% respectively;
- North American and global mandates together accounted for approximately 28%.

Source: EurekaHedge, EY analysis

## However, The Distribution of Islamic Funds is Skewed Towards Smaller Sizes

Distribution of Islamic Funds by Size (USD million)

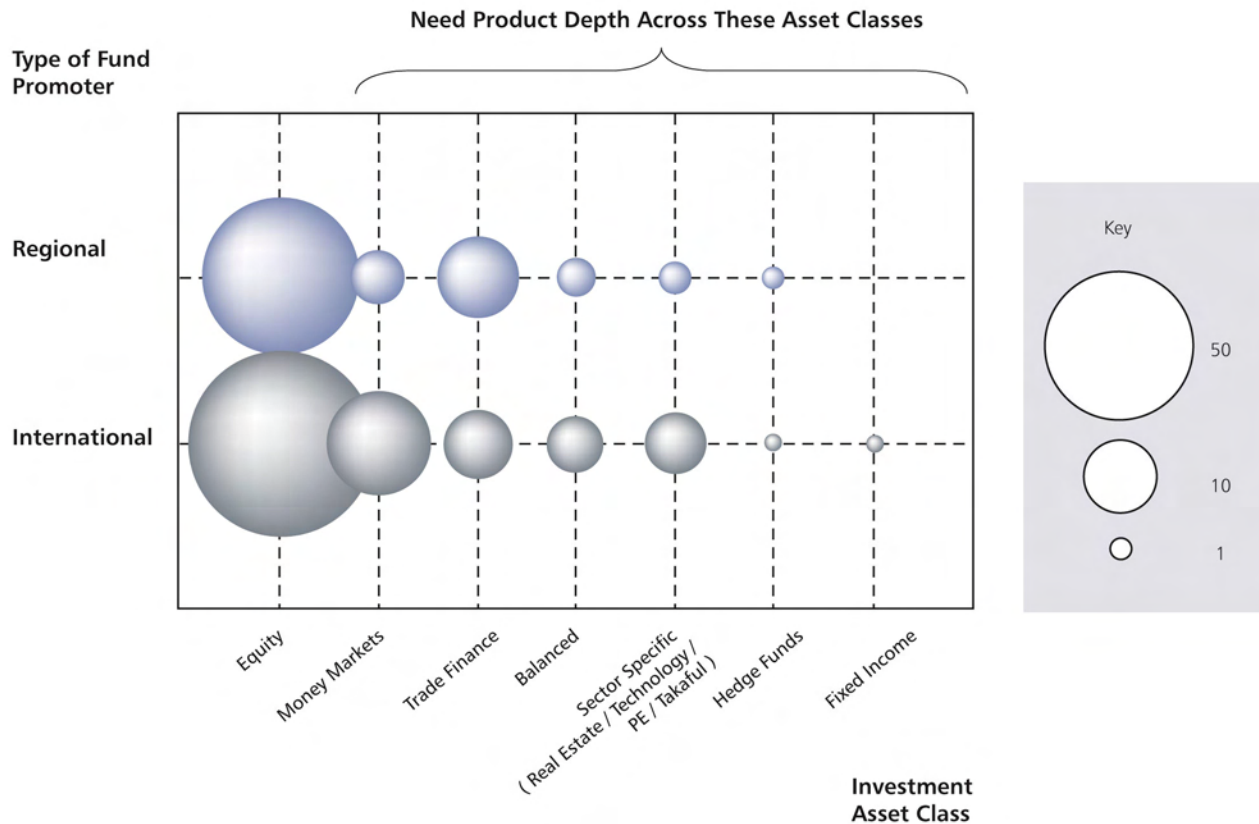


- The distribution of Islamic funds remains skewed towards smaller fund sizes
- This trend reflects the historically regional focus of Islamic funds and capacity constraints of smaller markets
- Future trends may see the increased influence of intermediation products, including fund of funds structures, resulting in a shift towards a “normal distribution” of fund sizes

Source: EurekaHedge, EY analysis



## And the Supply of Islamic Funds is Concentrated on Equities with Substantial Gaps Across Other Asset Classes



Source: GCC Stock Exchanges; Zawya; The Banker; E&Y Analysis



# Implications for a New Islamic Wealth Manager

## Key Messages

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- The supply landscape of institutions indicates that Islamic players are providing, at best, moderate depth of offerings in terms of range of services, value added advisory, and asset classes
- The Islamic wealth management industry needs to develop holistic business models that leverage intricate client relationships and implement efficient operational frameworks
- The critical success factors for a new entrant include product development expertise to fill the perceived supply gaps, client relationship management, operational efficiency, competitiveness with established and multinational players, effective marketing and distribution networks as well as retention of high quality human resources

“The competitive landscape is getting congested”

Head of Private Banking- Multinational Conventional Bank (May, 2007)

“The availability of quality people is the single largest challenge the industry faces today.”

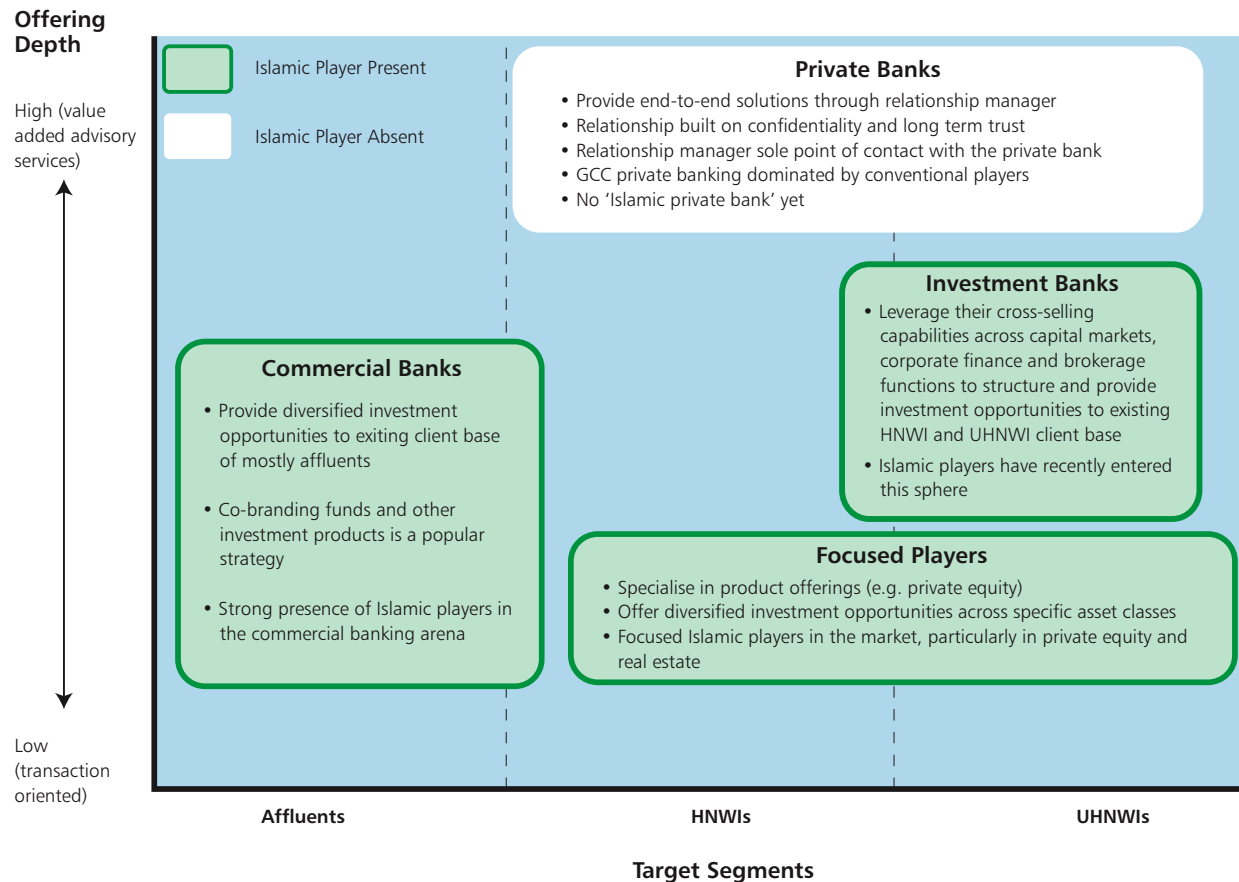
Islamic Bank (May, 2007)

“Islamic wealth management has now become an international game.”

“International players are leveraging their experiences to enter the market.”

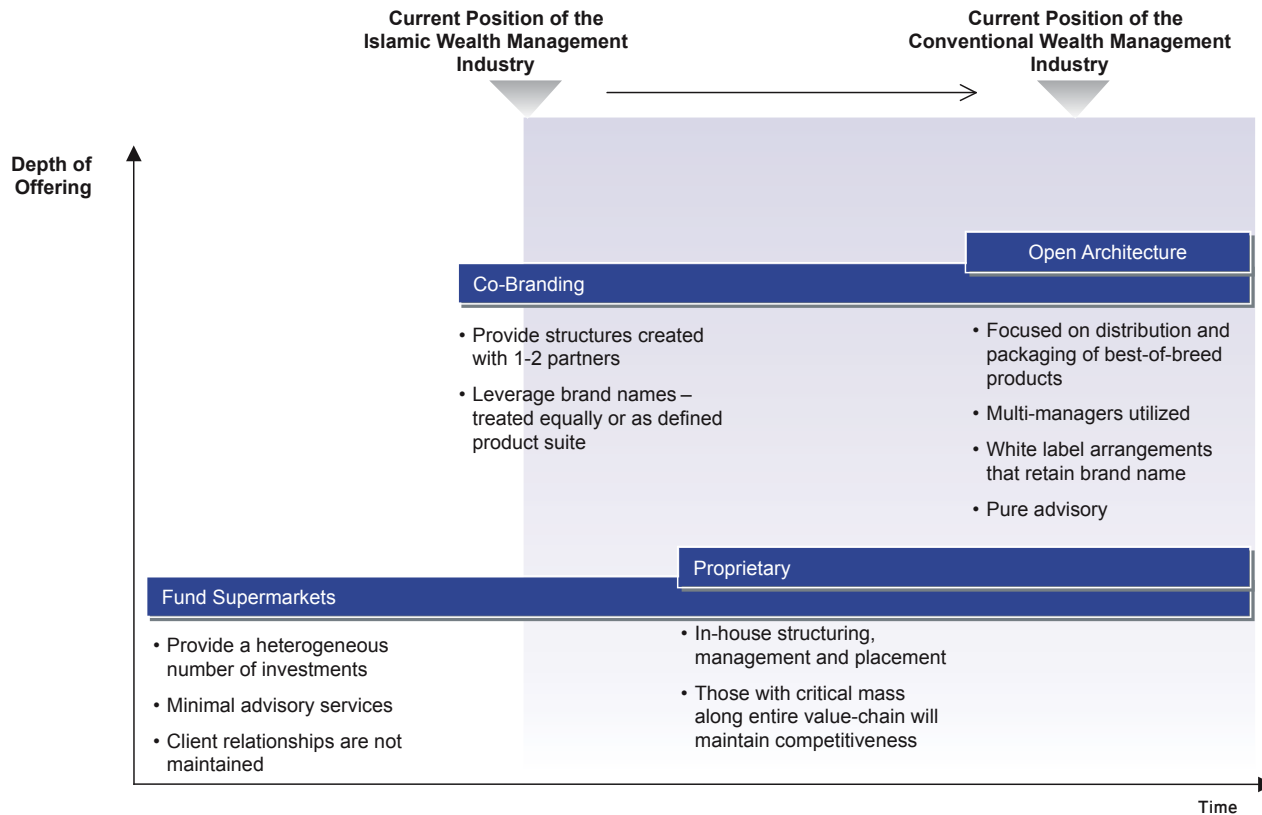
Head of Private Banking- Islamic Bank (May, 2007)

## Islamic Wealth Management Players Typically Supply Moderate Product Depth Offerings



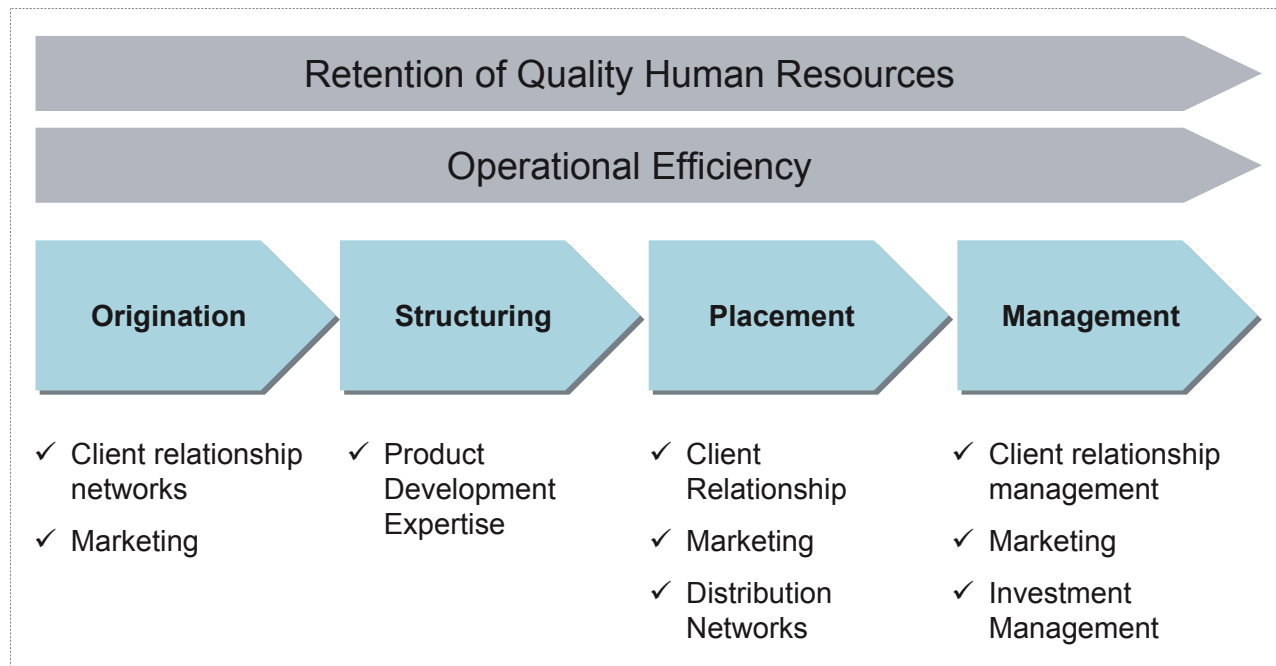
Source: Matrix adapted from David Maude; E&Y Analysis

## Players Should Pursue a Holistic Approach That Appeals to Clients and Embraces Efficiency



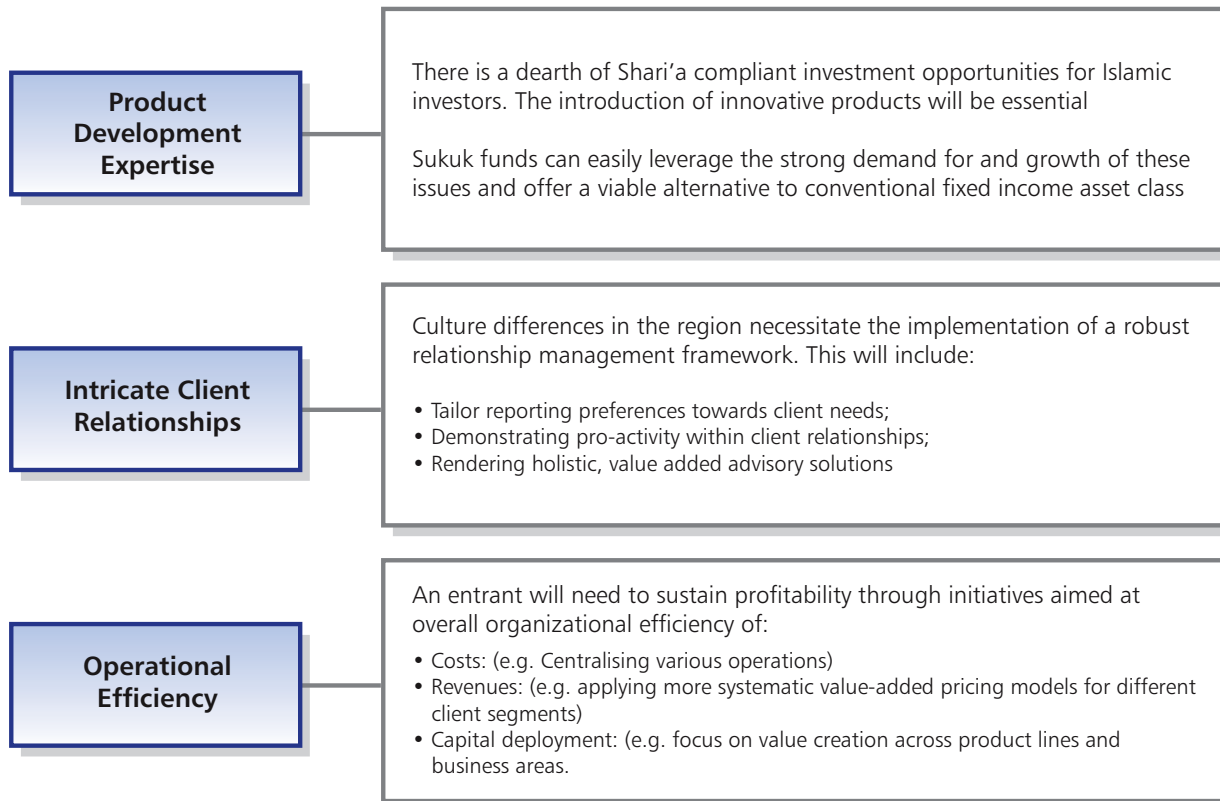
Source: E&Y Analysis

## The Value Chain for Investment Management Provides Focus Points for A New Entrant

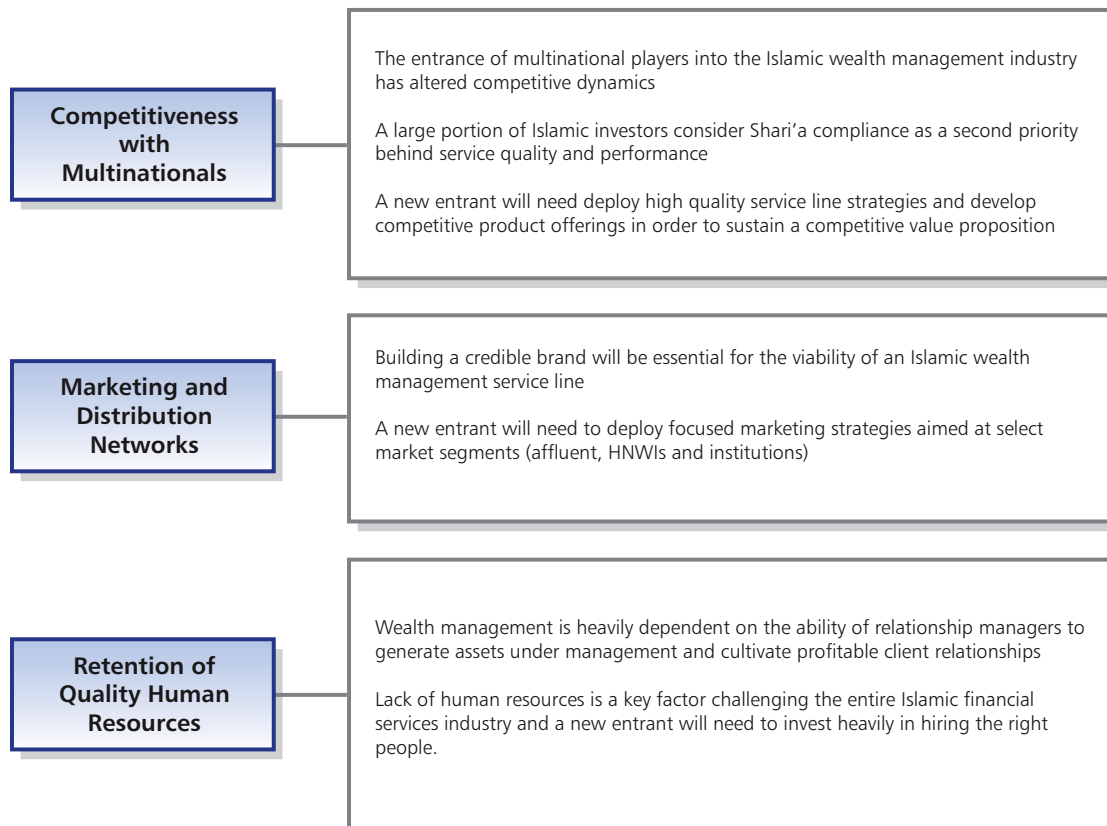


## And Certain Critical Success Factors to be Addressed

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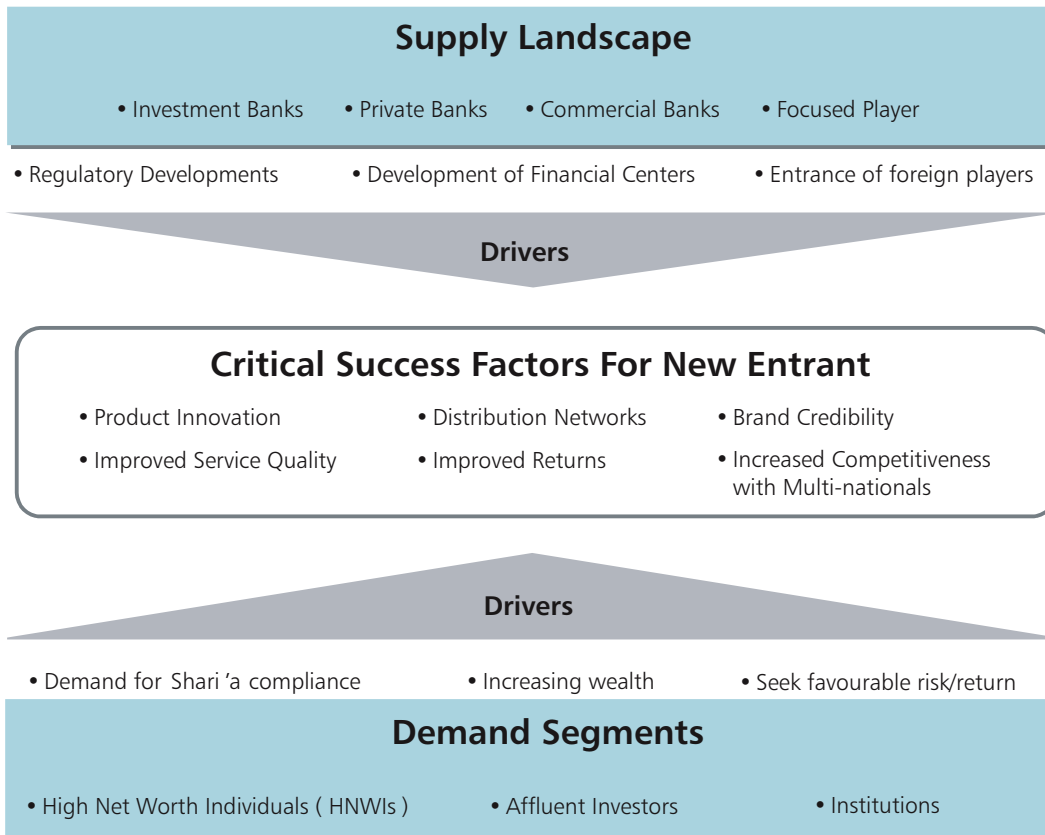


## And Certain Critical Success Factors to be Addressed





## To Develop the Competitiveness of Islamic Wealth Management



## Ernst & Young's Team



**Sameer Abdi**  
Executive Manager



**Ali Tariq**  
Senior Consultant



**Mark Stanley**  
Consultant



**Hasan Malik**  
Senior Consultant



**Karl Atiyeh**  
Senior Consultant

 **ERNST & YOUNG**  
*Quality In Everything We Do*



IFR is a MEGA Brand



Achieving Business Results for the Islamic Finance Industry Since 1993

**MEGA Brands. MEGA Clients. Market Leaders.**