By Mohammed khnifer

THE PRIVATE EQUITY CALAMITY

THE UNTOLD STORY OF THE PREMIUM COLLAPSE OF GULF FINANCE HOUSE

Gulf Finance House (GFH) is a Shari'ah compliant Islamic wholesale investment bank established in 1999 in Bahrain. The core business of GFH has been private equity, and most of this was in new real estate projects. During its first seven years of operations, GFH launched projects and investments with an aggregate final value exceeding $12 billion. Its diversified investment portfolio includes mega real estate developments such as the $1.3 billion Bahrain Financial Harbor, the $1.6 billion Energy City Qatar, and the $3.8 billion Legends in DubaiLand. When the global financial crisis hit in 2008, it also uncovered GFH's premium scheme, a lopsided fee structure that not only contributed to its meteoric rise but also to its near colossal collapse.

GFH was heavily involved in real estate-related Private Equity (P/E) deals and real estate-related infrastructure projects. The bank's operating activities generated a 2009 net loss of nearly $728 million of which $607 million was announced in the last quarter (Fitch, 2010). Compared to 2008, there was a decline of approximately 350% in the net income (net income in 2008 $292 million).

Perhaps GFH's end-of-year results can symbolize the property bust in the GCC region. For example, due to an impairment loss in 2009, the bank´s total assets fell from $3.49 billion in 2008 to $1.64 billion at the end of December 2009. As one would expect these massive asset impairment provisions affect the bank's ability to fulfil its commitments on current headline projects like Dubailand and at least three of their four Energy city projects (Qatar, Libya, Kazakhstan and India), if not all four.

The global financial crisis was fully evident by the end of 2007, and by the end of 2008 there were almost no investment sectors worldwide that had not experienced dramatic value declines. U.S. and European private equity firms openly stated in their year-end financial statements that assets declined anywhere from 15% to 25% or more. GFH hassened its demise though thanks to a combination of risk mismanagement and a private equity fee scheme known as the premium.

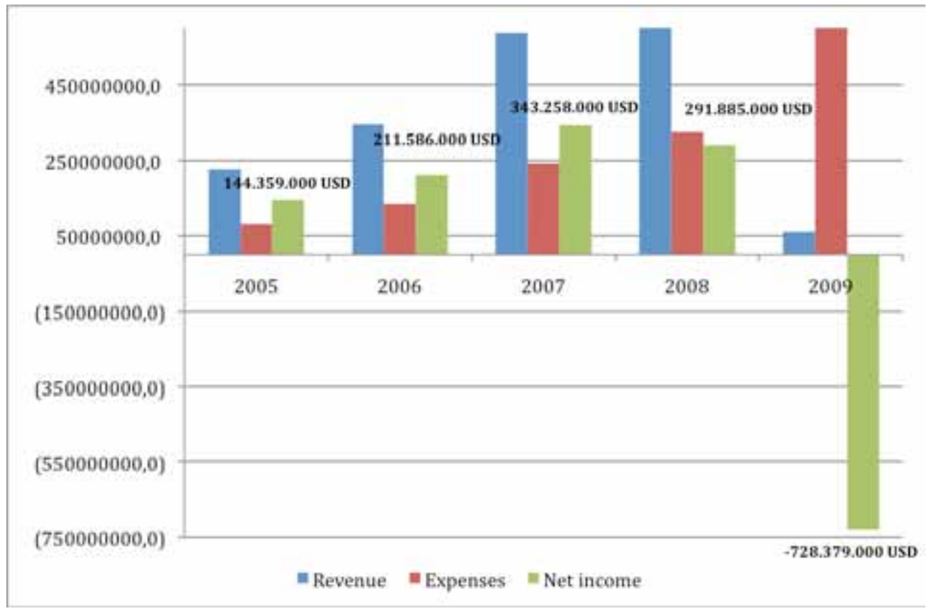
FAILURE OF RISK MANAGEMENT

By analysing the background of 2009 losses, we can deduce that a) GFH was in the middle of an unprecedented real estate valuation collapse and b) that GFH had a majority of nearly every aspect of its valuation and business model tied to real estate.

GFH faced four traditional risks: market risk, operational risk, liquidity risk and credit risk. Its absence of any meaningful diversification amplified some of those risks, but especially market and liquidity risks (Goeksenin, 2009). GFH also faced sector concentration risk. This risk is evident especially when looking at the bank's asset distribution. In 2009, 83,4 % of total assets were concentrated in the GCC countries, whereas 16.6% were in MENA, Asia, Europe and the United States (GFH Financial Statement, 2009).

NONSUSTAINABLE REVENUE

With the above being said, it is clear that GFH had a volatile earnings stream and was far from diversifying away from private equity investments in brand-new real estate projects that were years away from generating cash flow. This can be proven, by looking at the revenues and expenses over a period of 5 years (see graph 1).



Graph 1: Net Income, Revenue and Expenses from the GFH between 2005 and 2009 (Source: Gulf Finance House Annual Report 2005, 2006, 2008, 2009)

P/E STRUCTURE

Most of GFH's deals were private equity comprising never less than 70% of its revenue. In order to comprehend the fall of GFH, it is important to understand the basic mechanism of private equity, as well as the adaptation of private equity used by GFH.

According to International Finanical Services London, "Private equity is a broad term that refers to any type of equity investment in an asset in which the equity is not freely tradable on a public stock market. This also includes public companies that are delisted as part of the transaction."

The fund raising process begins when private equity houses establish a special-purpose vehicle (SPV, a "fund") then raise capital from institutional investors, such as pension funds, and high net worth individuals. These investors are collectively referred to as limited partners (LPs). The year in which the capital is raised and invested for a given transaction is known as that transaction's "vintage" year. Once set up, a fund is generally closed to new investment.

Once the value-adding process has finished and the private equity firm believes that it has increased the business' efficiencies—usually in 5 to 7 years—the GP seeks an exit to realise returns on the investments made by the LPs.

It is important to note that private equity is almost always totally illiquid as capital is usually locked up for the 5 to 7 year period, but it is not unusual for investments to be locked up for ten years until there is an exit. Sophisticated investors will seek private equity firms that have a solid track record (Baig, 2010). A private equity firm itself will also try to achieve diversification. It will spread its talent and resources among several funds in various industries, plus as is often the case it will branch into other lines of business to reduce total reliance solely on private equity

THE GFH PRIVATE EQUITY MODEL AND THE "PREMIUM"

Understanding the conventional Private Equity model helps us understand the modifications of this model used by GFH. In general, GFH pioneered in the GCC region the addition of a large upfront fee, a relatively large amount of money at the time GFH made its Private Equity invesment on behalf of LP investors.

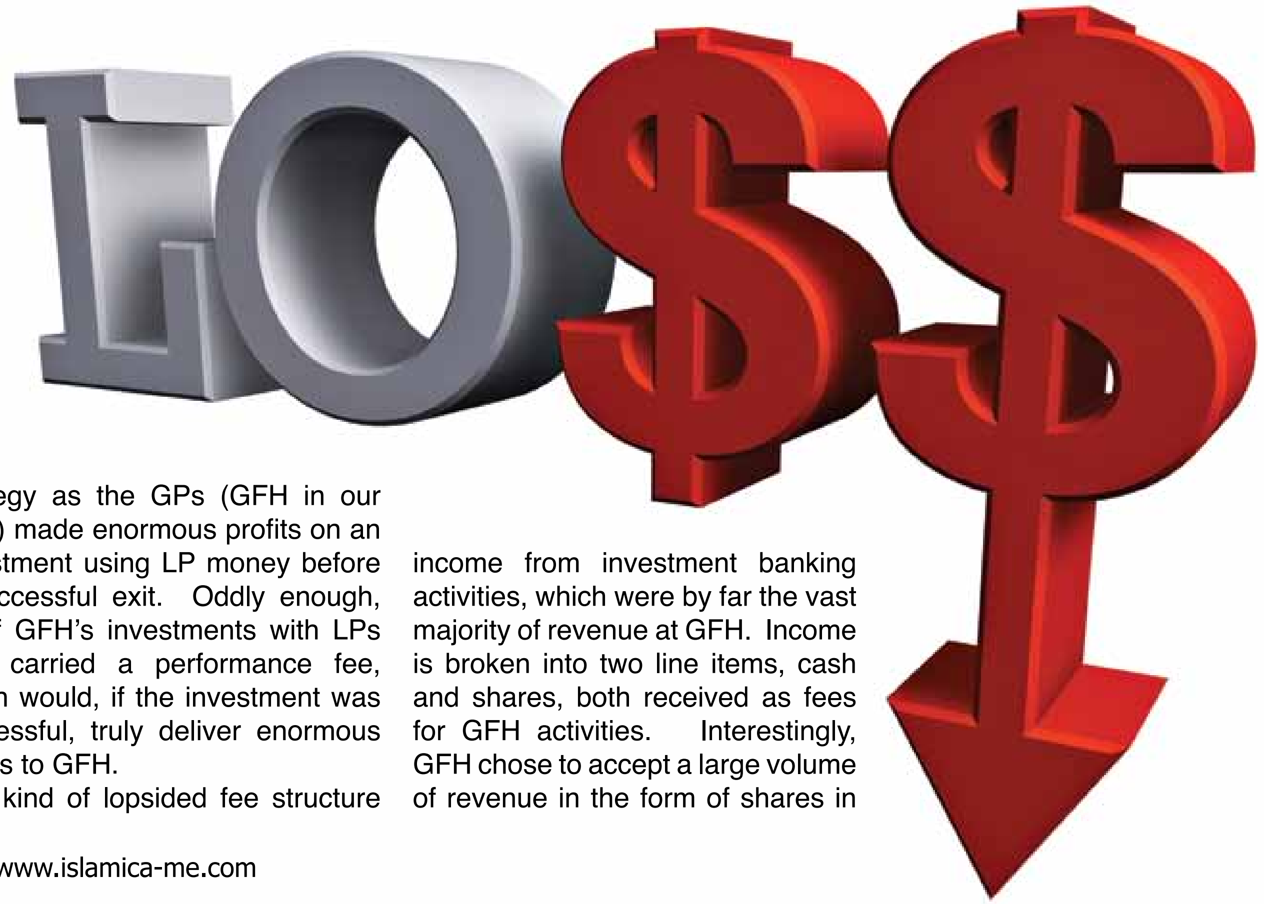
GFH would normally find a target investment, most often a greenfield real estate project but also companies or pools of real estate in Europe or North America. These were then taken under GFH's control, either through direct acquisition of the asset on GFH's balance sheet, or control of the project through an SPV created by GFH.

GFH would then create a fund offering memorandum and send its sales force out to meet LP investors. Happy with the investment prospectus, the investors would then transfer money to GFH. A new SPV created by GFH, or the previous SPV, would then transfer majority ownership of the asset to the LP investors.

GFH investment banking activity

	2005	2006	2007	2008	2009
Income from investment advisory services/investment banking services (the "premium")	129,023,000	93,326,000	355,709,000	323,191,000	48,980,000
Income from receiving shares in companies in which the bank invested, in lieu of cash	38,729,000	74,426,000	44,471,000	130,000,000	0
Placement, arrangement & management fees	27,280,000	20,337,000	13,421,000	33,233,000	2,580,000
Total income	$222,926,000	$246,811,000	$587,983,000	$617,586,000	$62,175,000
Investment banking income as % of total income	87%	76%	70%	79%	83%
Placement, arrangement & management fees as % of total income	12%	8%	2%	5%	4%

Until this point the process was in line with industry standards. However, it appears GFH would charge a “premium“ to LP investors. Say, for example, GFH bought a mid-sized American company for $10 per share. It would then sell a majority of its position to the LP investors for $15 per share, making an immediate 50% profit on its investment. This extra bonus became commonly known as the “premium.“
The GFH model for charging the performance fee in advance became widely emulated throughout the GCC region, used by peer firms Arcapita, Addax, GBCorp, and many others. It seems to be a extremely profitable strategy as the GPs (GFH in our case) made enormous profits on an investment using LP money before a successful exit. Oddly enough, all of GFH’s investments with LPs also carried a performance fee, which would, if the investment was successful, truly deliver enormous profits to GFH.
This kind of lopsided fee structure was obscured in part because of the very favorable market conditions that existed during the boom years of late 2002 through 2007, when asset prices were inflating everywhere, but in particular in real estate. However, it would only take a modest crisis to expose the inequal application of GFH’s fees. With a recession and deflating asset values GFH would ultimately have to disclose substantial capital loss to its investors. And, that is precisely what has happened.
During the boom years, GFH launched a series of private equity and real estate projects. In the table above we can see the annual income from investment banking activities, which were by far the vast majority of revenue at GFH. Income is broken into two line items, cash and shares, both received as fees for GFH activities. Interestingly, GFH chose to accept a large volume of revenue in the form of shares in the SPVs it created.
But, GFH became highly exposed when the crisis hit. Its private equity business ground to a halt. Income from investment banking services collapsed, from a high of $453 million in 2008 to a low of $49 million just the next year. Clearly GFH was unable to sustain revenue in its core line of business. It was fully exposed to a single business line, private equity, and its revenue was dependent on LP investors continuing to accept the concept of the premium, which apparently they did not.



In a typical Private Equity deal the company does not commit its own money into the funds, investors do. GFH, following industry practice, placed little of its own money into any of the transactions it sponsored yet ended up holding significant minority positions in all of them via the premium. This strategy backfired when the various GFH SPVs collapsed in value.
GFH was once a household name in the Islamic Investment sphere but they also were a pioneer in developing a highly questionable Private Equity business model that hugely rewarded GFH before investments matured, in other words reversing the order of the success fee from the end to the beginning of a transaction. Everything changed when the credit crisis reached the Gulf‘s shores. For now, GFH is trying to stand up on its feet by implementing aggressive restructuring plans from within. We should also note that further provisions equal or exceeding last year‘s magnatudes are likely, which might mean the bank is on the brink of bankruptcy. But that remains to be seen in the coming months.

While cutting the operational cost intensifies & with staff of 45-60 people, can GFH manage these multi-billion mega projects?

- Mumbia Economic Development Zone (investment volume approximately $10 billion)
- Algiers Economic Development Zone ($3 billion) (Gulf Finance House, 2010)
- Energy Cities in Qatar, Libya, India and Kazakhstan (investment volume above $11.6 billion)
- Legends in Dubai Land ($3.8 billion) (Zawya, 2010)
- Tunis Financial Harbor ($3 billion)
- Bahrain Financial Harbor ($1.3 billion)

Mohammed Khnifer is regarded as part of a ‘second generation’ of Islamic banking practitioners who have a solid academic background in Islamic finance. He is a holder of an MSc. in Investment Banking & Islamic Finance from Reading University and is a Chartered Islamic Finance Professional (CIFP) from INCEIF. He is one of the most prolific and well-known journalist specializing in Islamic Finance today. For the past six years he has been in charge of the editorial content for the Islamic Banking section of Al Eqtisadiah (Kingdom of Saudi Arabia). By 2011, he is expected to earn his MBA in Islamic Banking & Finance after he won the Silver Scholarship Award from Bangor University.