Shariah Equities Proprietary Screening Norms: A Comprehensive Guide

Introduction

Shariah-compliant investing is a vital aspect of ethical finance, ensuring that financial activities adhere to Islamic principles. It avoids elements such as riba (interest), excessive debt, and involvement in prohibited businesses. At Shariah Equities, we have developed proprietary norms grounded in rigorous research and tailored to the Indian financial landscape. These norms aim to provide Muslim investors with ethical and viable investment opportunities.

This document outlines our norms in detail, providing insights into their development, rationale, and application.

---

1. Debt-to-Total Assets (D/TA)

Threshold:

≤ 27%

Definition:

The Debt-to-Total Assets ratio measures the proportion of a company's assets financed through debt. This ratio reflects the company's reliance on borrowed funds.

Rationale:

Islamic principles discourage excessive debt, particularly interest-bearing debt, as it leads to undue financial risk and dependence on non-compliant financing. A stringent threshold ensures that investments align with ethical values.

Why 27%?

Our proprietary research analyzed financial data from 2019 to 2024 across various sectors. The median Debt-to-Total Assets ratio consistently ranged between 27% and 30%. Setting the threshold at 27% achieves:

- **Conservatism:** Ensures compliance with Islamic guidelines.
- **Inclusivity:** Retains companies with sound financial structures while excluding those excessively leveraged.

Practical Example:

A company with total assets of ₹1,000 crore and debt of ₹260 crore or less meets this criterion. Companies exceeding this threshold are excluded to ensure ethical investment.

---

2. Interest Income-to-Total Income (II/TI)

Threshold:

≤ 3%

Definition:

This ratio calculates the proportion of a company's income derived from interest-bearing activities. It identifies the company's reliance on non-compliant sources of income.

Rationale:

Islamic principles prohibit riba (interest). Limiting income from interest ensures the company's operations align with Shariah. The 3% threshold reflects a balance between practicality and strict adherence to ethical standards.

Why 3%?

Our analysis of historical data revealed:

- Most compliant companies generate minimal income from interest-bearing activities.
- A 3% cap filters out companies heavily reliant on interest income while retaining those with incidental or negligible exposure.

Practical Example:

A company earning ₹1,000 crore in total income must ensure interest income does not exceed ₹30 crore to qualify as compliant.

---

3. Cash Plus Interest-Bearing Securities-to-Total Assets (C+IBS/TA)

Threshold:

≤ 30%

Definition:

This ratio assesses the proportion of a company's assets held in cash and interest-bearing securities. It reflects the company's liquidity management and compliance with ethical asset utilization.

Rationale:

Excessive liquidity in interest-bearing instruments can lead to significant reliance on non-compliant income sources. Limiting this ratio ensures that companies utilize their assets productively and align with Shariah principles.

Why 30%?

Through extensive research, we determined that a 30% threshold:

- Includes companies with responsible liquidity practices.
- Excludes those excessively reliant on interest-bearing instruments.

Practical Example:

A company with total assets of ₹1,000 crore can hold up to ₹300 crore in cash and interest-bearing securities combined to remain compliant.

Rationale for Using Total Assets (TA)

Our norms prioritize **Total Assets** over other metrics like Market Capitalization due to its:

- **Stability:** Total Assets are less volatile compared to market cap, offering a consistent basis for evaluation.
- **Relevance:** Reflects the company's operational resources rather than investor sentiment.
- **Alignment:** Better suited for assessing compliance with ethical and operational guidelines.

Development of Proprietary Norms

Research Methodology:

1. **Data Collection:**
   - Financial data spanning five years (2019-2024) from a comprehensive database.
   - Analysis of key sectors including IT, Pharmaceuticals, FMCG, Energy, and Real Estate.
2. **Analysis:**
   - Statistical evaluation of financial ratios across industries.
   - Identification of sector-specific trends and anomalies.
3. **Benchmarking:**
   - Comparison with global practices while ensuring alignment with Indian market dynamics.

Challenges Addressed:

- Balancing inclusivity with strict adherence to Shariah principles.
- Accounting for sectoral nuances without compromising on ethical standards.

Application and Implementation

Screening Process:

1. Collect financial data of target companies.
2. Apply the three norms sequentially to filter out non-compliant entities.
3. Validate results through periodic audits and updates.

Investor Benefits:

- **Ethical Assurance:** Confidence in compliance with Islamic principles.
- **Transparency:** Clear and consistent criteria for evaluating investments.
- **Inclusivity:** A balanced framework that retains high-quality investment options.

Conclusion

Shariah Equities' proprietary norms represent a robust and ethical framework for Shariah-compliant investing. By emphasizing debt management, income purity, and ethical liquidity practices, these norms enable investors to participate in financial markets confidently while adhering to Islamic values.

For further information or inquiries, please contact the Shariah Equities team.