August 2014

PRIVATE EQUITY IN MENA

PRIVATE EQUITY AS AGENT OF VALUE: MYTH VS. REALITY

Authors: Faisal Al Meshal, Bilge Cakir, Vaibhav Gujral, Yusuf Hoballah, Gerard Zouein
(Harvard Business School, MBA Class of 2014)

Supervised by Josh Lerner,
the Jacob H. Schiff Professor of Investment Banking at Harvard Business School

Project Contributor: Growthgate Capital

Growthgate
CAPITAL

Table of Contents

Executive Summary 3
1. PE Value Creation: Myth vs. Reality 5
Overview of PE in the MENA Region 8
2. Stakeholders Perspectives on PE in the MENA Region 12
Challenges Exist, but PE Firms Have Addressed Them by Innovating 12
Opportunities Going Forward 14
3. Case: Growthgate Capital's Investment in Roots Group Arabia 17
Company Background 17
Roots Group's Search for a Partner 17
The Deal from Growthgate Capital's Perspective 18
A New Phase in Partnership with Growthgate Capital 19
Roots Group: the Path Forward 21
Conclusion 22
Appendix: Interview Guide Baseline 232
Appendix: Stakeholders Interviewed 243
Acknowledgements 254

Executive summary

Following a period of contraction and consolidation, the private equity (PE) industry in the MENA region is beginning to show signs of a recovery, both in terms of deal volume and size. The total number of investments increased from a low of 23 in 2009 to 48 in 2012 and 38 in 2013, with an increasing focus on non-cyclical sectors such as oil and gas services, healthcare, and education. However, with a large amount of "dry powder" in the hands of general partners (GPs), fundraising continues to be challenging. Part of PE's challenge has been the perception that PE investors focus excessively on short-term cash flows, and have a negative effect on job creation and the long-term health of the companies they fund.

In this white paper, we seek to debunk some of the myths surrounding PE, by reviewing how these firms have been able to add considerable value to portfolio companies and the broader economy. Drawing on evidence from a number of recent academic studies, in Part 1 of this paper we show how PE funds globally have improved performance of target companies by reducing constraints for companies in need of external capital, focusing on investments in innovation, increasing capital expenditures, and instilling better corporate governance and operational practices including productivity boost and surge in employment.

In Part 2 of this paper, we track the evolution of the PE asset class in the MENA region. Through extensive interviews with a cross-section of limited partners (LPs), GPs, advisors, and portfolio companies, we highlight some of the unique constraints faced by PE firms in the region: the existence of large family offices that compete for deals, the difficulty of sourcing proprietary deals, the lack of management talent, and the challenging regulatory environment. To overcome these challenges and succeed in the region, PE firms need to innovate in their funding model, market their expertise and capabilities more effectively, be creative in terms of deal sourcing, and most importantly focus on improving portfolio company operations and governance.

In Part 3, we review Growthgate Capital's investment in Roots Group Arabia, which we believe can serve as an effective template for how a PE firm can invest and create value in the region. With the help of Growthgate Capital, Roots Group Arabia has successfully transitioned from being a regional wholesale distribution company to a global, vertically integrated construction company. Through a minority investment model, Growthgate Capital has been able to add

considerable value in terms of financial expertise and advice, bringing in best-in-class corporate governance practices and sourcing management talent to scale the company.

We believe that long-term secular macroeconomic trends such as GDP growth and favorable demographics, coupled with company-level factors such as the need for patient external capital for growth, will drive the growth of PE in the MENA region. Evidence from PE investments globally and some early examples in the region show that PE firms have considerable ability to add value, provided they pursue the right investment model and engage with portfolio companies effectively.

1. PE Value Creation: Myth vs. Reality

PE is an alternative asset class that is illiquid and intended to be a long-term investment for buy and hold investors. The stability (or "stickiness") of PE capital is self-imposed by the charters of PE firms, as opposed to banks who are governed by strict capital adequacy and liquidity ratios. This form of long-term capital can be a very valuable asset for companies looking to grow.

A common criticism of PE funds is that they achieve high returns by levering their targets and cutting costs, eliminating jobs and destroying long-term growth opportunities in the process. However, several recent studies show that companies acquired by PE funds grow significantly more than comparable firms in terms of sales and capital employed, and often in employment. For instance, one comprehensive study using data from 3,200 deals in the United States reveals that on average, private equity buyouts raise firm productivity by over two percent in the two years after the buyout.[1] Another study of 527 European-based businesses owned by PE over 2005-2012, shows that employee numbers increased annually across the portfolio by 2% from entry to exit, while employment growth in comparable public companies over the same period is broadly similar at 2.2%. Across both good (2005-2007) and bad times (2008-2012), PE makes a net contribution to employment growth. The study also shows that PE increases not only employment but also labor productivity as it increased by over 7% a year from the time PE acquired companies in the sample to the point of exit.[2]

Another study, using data from 839 French deals over 1994-2004, shows that between the four years preceding the transaction, and the four subsequent years, employment, assets, and sales growth of PE targets are, respectively, 18%, 12%, and 12% higher than the non-PE backed firms.[3] These transactions were largely growth equity deals rather than the leveraged buyouts that dominate the U.S. sample, and those may be more representative of the PE transactions that dominate emerging market regions such as MENA.

Some critics argue that PE firms focus unduly on short-term cash flow and as a result reduce capital expenditures. In reality, PE firms do not sacrifice long-term growth in exchange for short-

[1] Davis, Haltiwanger, Hanley Jarmin, Lerner, Miranda, 2014, "*Private Equity, Jobs, and Productivity"* (American Economic Review).
[2] Ernst & Young, 2013,"*Myths and challenges: How do private equity investors create value? A study of 2012 European exits*"
[3] Boucly, Sraer, Thesmar, 2011, "*Growth LBOs*" (Journal of Financial Economics)

term performance. PE-owned firms tend to focus more on investments in innovation, evidenced by higher patenting activity following the transaction.[4] In addition, value creation by PE funds is mainly due to their ability to relax credit constraints of targets, allowing companies to take advantage of unexploited growth opportunities by increasing capital expenditures. This has been illustrated in a study showing that growth in capital expenditures is 24% higher for buyouts relative to the control firms.[5] Another study shows that at the time of their acquisitions, the PE-backed companies also had lower average capital spending as a percentage of their sales (4.4% of sales) than the national average (5.3% of sales); within three years of their acquisitions, the private equity-backed firms increased their capital spending rates to 7.9% of their sales.[6] Additionally, post-buyout growth in size and capital expenditures is larger when the target industry is relatively more dependent on external finance.

Some point to returns generated by PE as simply the result of adding leverage to the businesses backed by PE. The study of 527 European-based businesses owned by PE over 2005-2012, shows that PE gross returns (i.e., before fees and charges) are more than leverage and market returns. For exits in the sample between 2005 and 2012, stock market returns (those from comparable public companies) account for 30%, leverage for less than 35%, while fundamental improvements to the additional business account for over 35% of outperformance. While there is some variation in these percentages from year to year, strategic and operational outperformance has always made up the largest proportion of returns generated by PE in each of the annual studies conducted by the same source. Even with the difficult economic conditions over the past few years, where measures such as profit growth have been harder to achieve, and absolute returns have declined, this still holds true.[7]

Other studies, using data from a sample of medium-sized manufacturing firms in Asia, Europe and the U.S., show that PE-owned companies are significantly better managed than government-owned, family-owned, and privately-owned companies. This is evidenced by more robust operations and management practices, such as the adoption of modern lean manufacturing,

---

[4] Lerner, Sorensen, Stromberg, 2011, "*Private Equity and Long Term Investment: The Case of Innovation*" (Journal of Finance)
[5] Boucly, Sraer, Thesmar, 2011, "*Growth LBOs*" (Journal of Financial Economics)
[6] Shapiro and Pham, 2009, "*The Impact of Private Equity Acquisitions and Operations On Capital Spending, Sales, Productivity, and Employment*"
[7] Ernst & Young,, 2013, "*Myths and challenges: How do private equity investors create value? A study of 2012 European exits*"

continuous improvement, comprehensive performance documentation processes, and stronger people management practices.[8]

Due to the relatively recent introduction of PE in MENA, there are limited studies on the impact of PE investment in the region. However, there is little evidence from PE in the MENA region that supports the claims of economic value destruction. PE in the MENA region before and after the global financial crisis has not:

- Relied on leverage whether excessive or moderate to conduct acquisitions;
- Caused massive lay-offs of workers or employees;
- Spurred considerable divestments or sell-offs by investee companies.

As a general observation, PE in MENA has proven to be a "sticky" form of investment, while investments in public equity proved feckless. Public fund managers massively cut their exposure to the region after two episodes: the global financial crisis which started in late 2008, and the Arab Spring which began in 2011. PE investments in MENA are long term, and often enhance the companies that they finance. As the industry matures, the true impact of PE involvement in the region will become clearer. But the evidence from other regions suggests that it is likely to play a positive role.

[8] Bloom, Sadun, Van Reenen, 2009, "*Do Private Equity Firms Have Better Management Practices?*"

Overview of PE in the MENA Region

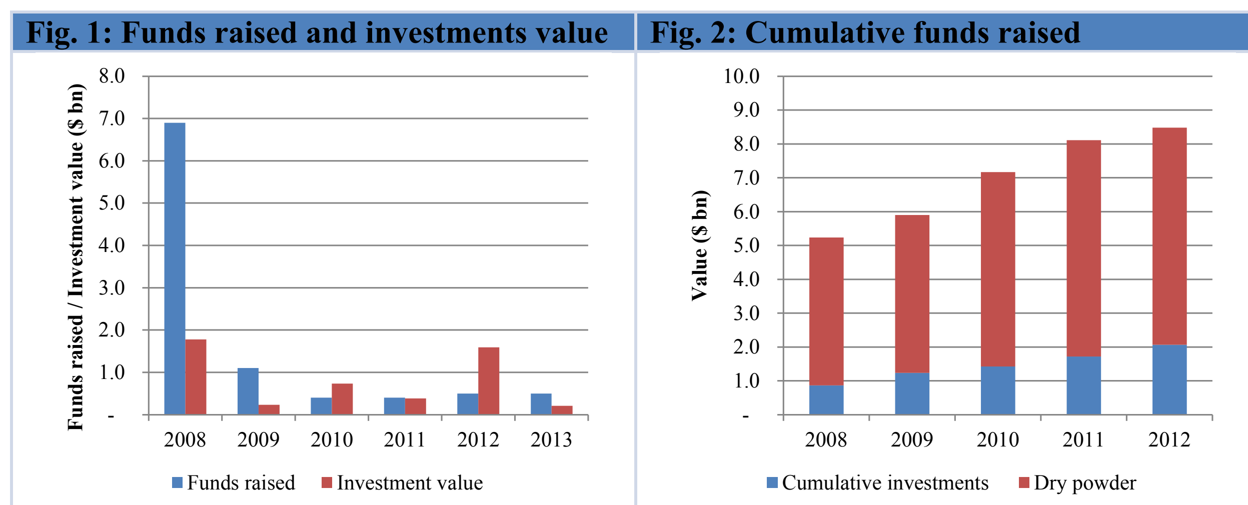
PE in the MENA region has struggled after the initial frenzy coinciding with the booming global economy of 2004-2008. While part of this decline can be attributed to the global economic recession, the industry also contends with some challenges that are unique to the region. In response to headwinds, several firms have amended their business models and there are signs that the industry can emerge stronger after a period of consolidation.

The MENA PE industry is relatively young. In the late 1990s, some regional banks began acquiring businesses with their balance sheets and syndicating equity stakes to their networks of family offices. Some of the region's LPs were familiar with the concept of PE, having invested in Western PE funds since the 1980s, but many remained hesitant to invest on a "blind pool"[9] basis and lock up their capital, preferring the flexibility offered by deal-by-deal investing. At the peak of the cycle between 2002 and 2008, strong economic growth contributed to abundant liquidity and an appetite for new investment vehicles. Early PE successes attracted significant sums of capital to a host of new funds, some of which were able to raise funds with limited or nonexistent track records. The number of PE firms exploded to more than 50 in 2008.[10]

The global economic crisis in 2008 exposed several of these PE firms' excesses, leaving many of them unable to fully deploy the capital raised and others unable to sell the assets they had acquired at the peak of the market. Many LPs that suffered during this market downturn were investing in this asset class for the first time, and reacted by completely writing off investing with regional GPs. The remaining ones have heightened their standards for investing with regional GPs, resulting in a consolidation to 10–15 funds. LPs concede that some PE firms have sourced attractive deals and added value to portfolio company operations, but remained hesitant to invest in subsequent funds because of the recent downturn. This decline can be seen in the graph below (Fig. 1), which shows that minimal funds have been raised after 2008 and very few investments have materialized. In addition, cumulative funds under management have remained almost stagnant since 2008, with many predicting a decline once exits are complete and capital is

[9] "Blind pool": A fund that accepts capital from investors without specifying property assets. Investors contribute to the fund without knowing what will be purchased
[10] MENA Private Equity Association, 2013, "*2012 Annual Report*"

returned to investors. As a result of the aforementioned economic downturn, a significant amount of “dry powder” (un-deployed capital) remains (Fig. 2).



Source: Emerging Markets Private Equity Association; MENA Private Equity Association (2012 Annual Report).

Fig. 3: Top 10 investments (by value) in the MENA region in 2012

Fund name	Target company	Country	Sector
Greater than $100m			
Abraaj Private Equity Fund IV	Viking	Turkey	Oil & Gas Services
Abraaj Private Equity Fund IV & Kantar L.P.	Saham Finances	Morocco	Financial Services
Abraaj Private Equity Fund	Kuwait Energy Company	Kuwait	Oil & Gas
Less than $100m			
Gulf Capital Equity Partners II	Smart Energy Solutions	UAE	Power and Utilities
NBK Capital Equity Partners II	Bavet	Turkey	Healthcare
EuroMena Fund II	Sakson Petroleum Services	Egypt	Oil & Gas
Gulf Credit Opportunities Fund L.P. I	Sakr Energy Solutions	UAE	Industrial Manufacturing
TVM Healthcare MENA Fund I	Cambridge Medical and Rehabilitation Center	UAE	Healthcare
Gulf Credit Opportunities Fund L.P. I	Orion Group	Turkey	Services
EuroMena Fund II	Sakson Petroleum Services	Egypt	Oil & Gas

Source: MENA Private Equity Association (2012 Annual Report).

Equity represents a substantial portion (up to 100%) of PE deals capital structure in the MENA region. The low leverage limits the average investment size of PE. As result, PE spread their risk via a wider allocation of funds amongst several midcap investments. Leverage for PE investments in the region is constrained by several inherent and regulatory factors. First, commercial banks, the traditional lenders for businesses, have no policy to extend leverage at multiples of EBITDA as practiced by their foreign counterparts, unless physical collateral and personal guarantees of the buyers are pledged. Second, the market for mezzanine financing is at its infancy. Third, the issuance of bonds to finance acquisitions is not a familiar feature of the MENA financial markets. Fourth, the relatively low taxation, especially in the GCC nations,

does not provide sufficient fiscal incentives for leverage. Finally, the preponderance of PE deals being focused on strategic minorities tends to lessen the need for high levels of leverage.[11]

Historically, a significant portion of deals represents strategic minority stakes in family-owned businesses. This is the result of the region's economic structure where 85% of businesses are family owned and 40% of non-oil GDP is estimated to be produced by family-owned businesses. These family-run businesses are reluctant to relinquish control. Instead, they look at PE mainly as a source of expansion or acquisition financing. Hence, PE in the region seeks minority protection rights complemented by tailor-made contractual arrangements giving additional influence and control levers over key decisions including exit (e.g. timing and routes). In addition, a number of control opportunities are potentially emerging as many family businesses face the pressures of transitioning to third and subsequent generations of family control.[12]

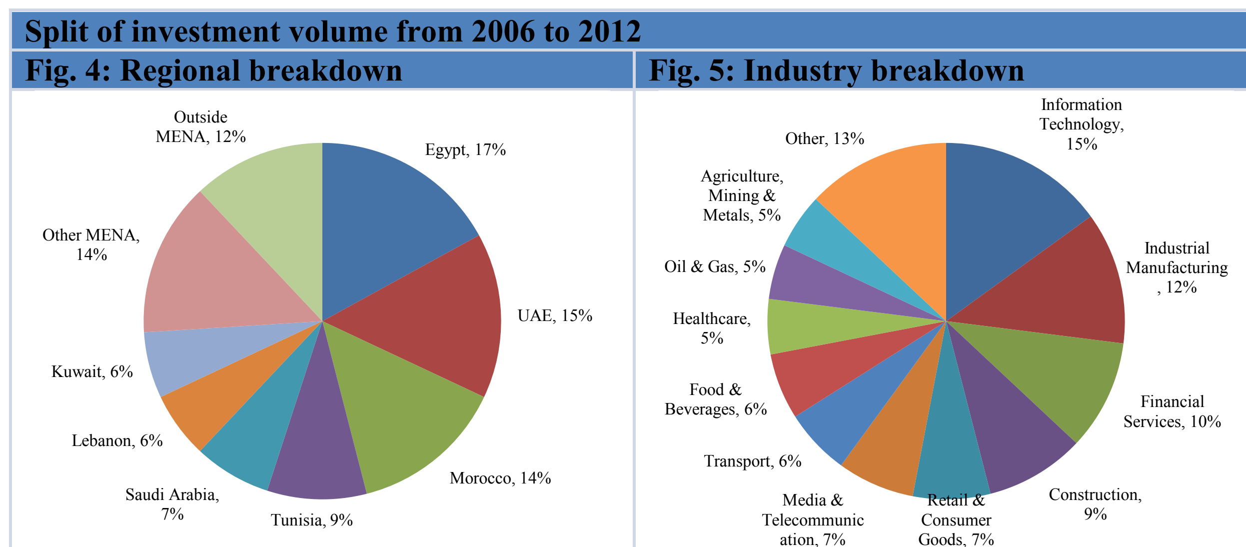
Across the MENA region, the average holding period for investments ranges from an aggressive two years (for a "buy and flip" investment) to five years (for a "buy and build" strategy). Currently, with the difficult conditions in the market, the average holding period is likely to increase to seven years as the number of transactions in the market drops and exit options become more complicated. Trade sales are expected to become more common in the MENA region, but IPOs remain a primary target. While most developed markets have liquid stock markets and advanced regulatory frameworks, the MENA region's capital markets are underdeveloped and lack the regulatory robustness that the West benefits from. In 2013, the market witnessed only five exits.

Although the impact of economic challenges has reduced the number of investments, particularly in the UAE, the GCC countries continue to be the focus of PE firms in the region. The rationales being a continuing increase in per capita income and purchasing power coupled with large demand for infrastructure and high government spending budgets. As Egypt turns back to economic stability, PE deal activity is likely to pick up due to the country's sizeable and growing population, educated middle class, and strategic location. In 2012, Turkey was the most

[11] Abillama, Bolurfrushan, and Mammadov, 2010, "*The Anatomy of Private Equity Investments in the MENA Region*"
[12] Abillama, Bolurfrushan, and Mammadov, 2010, "*The Anatomy of Private Equity Investments in the MENA Region*"

attractive country outside of the GCC region to attract PE investments due to large infrastructure expenditure and favorable demographics.[13]

Defensive sectors such as oil and gas services, healthcare, and education continued to dominate the PE market in MENA, accounting for almost 60% of investments in 2012. On the other hand, sectors such as real estate, construction, and financial services continued to see low deal activity, a trend that persists since the global financial crisis. However, more PE activity is expected going forward in major infrastructure projects as the governments look for public-private partnerships to overcome funding needs. Demographic-dependent sectors like healthcare, education, and fast-moving consumer goods are attractive in the MENA region, and especially in countries like Egypt and Saudi Arabia, due to increasing population and a growing middle class.[14]



Source: MENA Private Equity Association (2012 Annual Report).

[13] MENA Private Equity Association, 2013, "*2012 Annual Report*"
[14] Private Equity World, 2013, "*The insider's guide to private equity in the Middle East: 6 influential GPs share their outlook for private equity in 2013 and beyond*"

2. Stakeholders Perspectives on PE in the MENA Region

In order to understand the current situation, we conducted interviews with a cross-section of GPs, LPs, advisors and portfolio company executives across the region. The following summarizes some of the key findings.

Challenges Exist, but PE Firms Have Addressed them by Innovating

Large family offices: The existence of large family offices poses a unique challenge to PE managers in the MENA region. With extensive networks and the ability to realize synergies with existing businesses, family offices are often aggressive and well-funded competitors for PE funds, despite being a logical and attractive source for fundraising. Even in cases where they are not competing directly for assets, several family offices question the benefits of investing in regional PE managers. Family offices want to diversify their holdings away from the region (since the majority of their income is generated by local businesses), prefer to have flexible investment structures, and can access similar deal flow on their own. Some PE firms have overcome these reservations by developing and promoting unique advantages: operating expertise, industry knowledge, and access to deals that are in unfamiliar countries or too large to be digestible by individual family offices. But many family offices claim that GPs have not demonstrated these value creation capabilities consistently enough to be credible. Other ways in which some firms have overcome these challenges include deal-by-deal fund raising and co-investments, which are more aligned to family office preferences.

Deal sourcing: PE firms also face reluctance to sell and low tolerance for debt among business owners. Families that have operated a business for several generations may be emotionally attached to the business and enjoy the regular stream of income, and therefore are not necessarily looking for a liquidity event. While averse to the sale of majority stakes, some business owners have embraced minority equity sales in certain situations. Although this limits investors' ability to lever and control the business, many investors have pursued a minority investment model. By negotiating negative control rights and certain provisions in shareholder agreements, PE firms are able to positively influence the performance of target businesses while ensuring that the existing owners are incentivized to improve the business.

Government and regulatory environment: Political instability, as heightened by the events of the Arab Spring, poses a significant risk to investors in the region. Also, the opacity of the business and regulatory environment also poses some challenges. Labor laws are restrictive, minority shareholder rights are difficult to enforce, and business practices are not always transparent. For example, bankruptcy regimes are not well-developed, often posing personal recourse risk for management. Furthermore, access to debt financing is typically limited to companies able to pledge hard assets, significantly limiting the use of acquisition financing, a key value creation tool for PE in developed economies. This environment makes it more difficult for PE firms to deploy capital effectively. Finally, many industries are restricted and inaccessible to private investors such as oil and gas and utilities, reducing the potential diversity of investments. There are signs, however, that the regulatory regime is improving, with many countries displaying progress on metrics such as ease of doing business indices and developing restructuring laws.

Management pool: Another concern cited by PE firms is the lack of a strong management pool in the region. In more developed markets, PE firms generally add value by bringing talented managers to the businesses they acquire. Without a stock of managers trained in professional organizations to draw on, PE professionals have to dedicate a significant amount of their time to the portfolio companies.

Due to the unfavorable regulatory environment and dearth of management talent, many GPs are forced to avoid investing in situations that require significant turnaround or overhaul of operations. Although this forces many PE managers to increase their involvement beyond the typical call of duty, this also reinforces the perception of many LPs, specifically family offices, that these types of investments can be made directly, and do not require expensive PE funds to accomplish.

Exit options: Finally, PE firms have limited exit options for their investments. There have been few secondary PE buyouts and strategic buyers have shown limited interest in acquiring PE portfolio companies. However, the IPO markets have recently re-opened, especially in the Gulf region, and foreign strategic buyers are showing increased interest in the MENA region.

Although the PE firms who raised funds during the peak of the market have realized some exits, most of the capital is still un-deployed, and many industry observers are eagerly waiting to see if these PE firms can crystallize their returns before the expiration of the term of their respective investment vehicles. Still, PE exits have picked up from the trough of the market more recently (that is, between the third quarter of 2013 and the present time), leading to a somewhat positive outlook for the future.

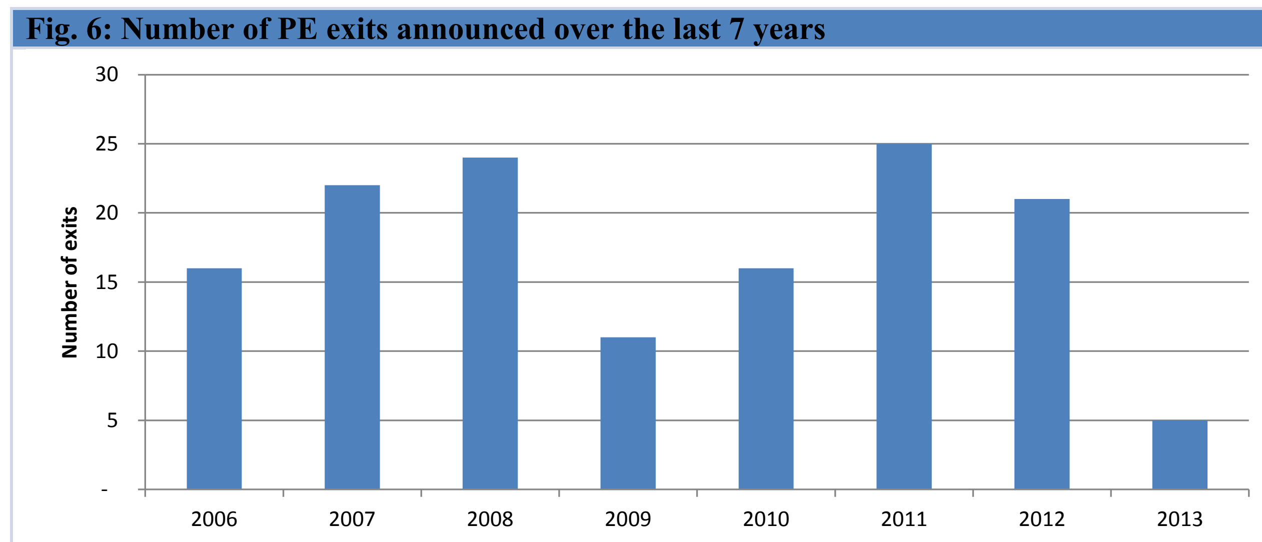


Fig. 6: Number of PE exits announced over the last 7 years

Source: MENA Private Equity Association (2012 Annual Report); Emerging Markets Private Equity Association.

Opportunities Going Forward

As PE participants look to the future, they have several opportunities to reshape the existing business model and put the industry on a more solid footing. While the industry is still reeling from the latest cyclical downturn, the industry's consolidation could help restore confidence in the PE business model as talent and capital flock to the top performers that have established reputable track records.

Funding: While the deal-by-deal and co-investment models are preferred by LPs for their flexibility and transparency, the "blind pool" model is much more efficient from the GPs' perspective. LPs have cited that trustworthiness, competence, and access to deal flow are their key criteria for investing with GPs on a "blind pool" basis. PE firms must address LPs concerns in these areas in order to improve their ability to raise funds:

- Several LPs have complained that certain PE teams are staffed by consultants or bankers that lack investing experience. PE firms should instead focus on building stable teams of professionals that have several years of experience investing together with credible track records, preferably in the region;
- LPs have expressed a preference to invest with teams that have some industry expertise and are able to implement value-added processes;
- PE firms should do a better job of marketing their ability to source quality deals inaccessible by others and to improve the operations of portfolio companies through best practices;
- PE firms could target industries that have been categorized as development priorities by regional governments and provide an ideal platform for sovereign entities and funds to deploy capital in support of these development initiatives;
- International investors are interested in gaining exposure to the region; however, they typically prefer to invest with global GPs due to existing relationships. Bulge-bracket PE firms have struggled regionally after underestimating the complexities of doing business in the MENA region. Therefore, overseas capital is a jackpot that potentially can be won by a regional player that develops a unique value proposition, establishes a strong regional track record, and successfully markets itself internationally.

Deal geographies and types: Competition for majority buyouts in the Gulf region and Turkey is high, especially in non-cyclical sectors such as healthcare and education in Saudi Arabia and growth sectors such as food. Given the accessibility of these opportunities to family offices, PE firms can differentiate themselves by focusing on assets that are less accessible to GCC-based family offices:

- Growth-oriented minority stakes and mezzanine financing, where significant resources must be committed to professionalize the business;
- Complex transactions that family offices cannot handle by themselves due to technical expertise required or large size;
- North Africa and Levant buyouts, due to their limited accessibility for many Gulf investors, in addition to serving as a diversification tool for GCC-based capital.

Portfolio operations: The ability to add value to portfolio companies is a critical success factor for PE firms. Several interviewees acknowledged that some PE firms have been successful at implementing incentive structures, improving corporate governance and facilitating regional expansion. By emphasizing these capabilities and a cooperative approach, PE firms can access minority stakes in businesses that might otherwise be reluctant to sell. Through these partnerships, the business owners hope to maximize the value of the company in line with a prospective exit within four to five years, ideally through an IPO.

Nonetheless it is important for PE firms and the majority owners to agree upfront on the PE firm's scope and level of involvement, in addition to a clear end goal and timeline. Clear processes for dispute resolution and rights should be agreed in shareholders' agreements in order to avoid the conflicts that are inherent in minority investments. As more success stories emerge from this model, business owners will become more receptive to bringing in PE sponsors to enhance their businesses. This type of deal continues to grow in popularity due to the regional constraints discussed above. GPs have a unique opportunity to establish a strong presence in the market by successfully participating in minority deals and establishing a strong track record in this field. This positioning gains in importance as family businesses reach the third generation of ownership in which a form of liquidity event is sought. Growthgate Capital's investment in Roots Group Arabia is an early example of how a PE firm can engage with a portfolio company to add value through a minority investment model.

3. Case: Growthgate Capital's Investment in Roots Group Arabia

Company Background

Roots Group Arabia was established in 1982 and launched its operations as a building materials wholesale supplier to the construction industry in Saudi Arabia. By the end of 2007, Roots Group Arabia developed a sprawling network of offices spanning across the Middle and Far East. The Group's main operating market was Saudi Arabia, while also present in the UAE, Egypt, Lebanon, Syria, Malaysia, and China.

Between 2001 and 2007, the Group expanded its operations beyond its core of wholesale distribution. In order to support its business, the Group acquired equity stakes in three manufacturing facilities. In addition, the Group added 15 retail outlets, mainly in the Gulf region, to become one of the first regional integrated suppliers of construction and building materials. The outlets were serviced by a team of around 150 dedicated sales representatives and marketing executives. During this period, the Group's performance was very strong, with sales growing on average at 17% a year (or growing 2.5 times over that period). Sales were mainly derived from wholesale distribution (57% of 2007 sales), followed by manufacturing (27%), services (11%) and retail distribution (5%).

The management had plans to grow the business further by:

- Expanding the retail network to reach 45 outlets, covering every major city in the region;
- Acquiring new entities, especially in the manufacturing segment, to boost capacity;
- Extending operations to new countries and regions;
- Developing a new build & design division.

Roots Group's Search for a Partner

With its ambitious growth plans, Roots Group Arabia was looking for a partner that could:

- Provide patient capital to grow the business. Banks in the region were reluctant to provide financing for local companies to grow. Management's initial conversations indicated that PE funds would potentially be a good source for this patient capital;
- Help the group in its acquisition strategy;

- Assist with the creation of an optimal corporate structure to support growth and prepare the company for a public offering.

The Group considered several potential partners during the process and ultimately decided to partner with Growthgate Capital because of the PE firm's belief in the company's vision. In addition, Growthgate Capital's experience with "buy and build" models equipped them to provide deal sourcing and due diligence expertise that a typical corporate player in the region lacks. Finally, Growthgate Capital's management team had experience in implementing best practices in corporate governance, instilling financial discipline, and preparing companies for IPOs.

The Deal from Growthgate Capital's Perspective

"Investing in Roots Group Arabia has been both challenging and rewarding. Challenging because we had to surmount negative perceptions of any tangible value-add that a PE firm can bring onboard beyond the initial injection of capital. Rewarding, because as soon as signs of such value-add became apparent, working in unison with management for the greater benefit of all shareholders became the rule" - GP of Growthgate Capital

Growthgate Capital viewed the Roots Group Arabia transaction to be strongly aligned with its "3M" investment philosophy, or Model, Management, and Markets (see text box).

Growthgate Capital's 3M assessment of Roots Group Arabia

Model

- Leading supplier of building materials with established manufacturing capabilities;
- Significant growth potential given the scalable and diversifiable business model;
- Company had close ties and relationships with key regional construction players.

Management

- Well-rounded management team with on average 30 years of experience that was receptive to a private equity investment;
- Ready to handle the increased scrutiny and the steep growth trajectory that comes along with such a private equity investment;
- Strong desire and capacity to pursue a path to a public listing.

Markets

- Fast growing regional construction sector driven by government spending provides steady and sustainable demand for building materials over the short to medium term:
    - Governments increasing spending on infrastructure to diversify economy from oil;
    - Projects value planned or underway in GCC estimated to be $2,677 billion in 2009.[1]
- Saudi Arabia is the largest economy in the GCC:
    - Saudi Arabia accounts for ~55% of the GCC's GDP and ~60% of its population;
    - Saudi Arabia, with a current population of 25 million growing at 2.5% per annum is set to double its population in the next 25 years. In order to provide housing for this growing population, they will have to build 1.5 million new houses by 2015;
    - The country is spending more than $80 billion in the development of industrial and economic cities with the goal of diversifying its economy from the oil sector;
    - Projects value planned or underway in Saudi Arabia was estimated at $578 billion in 2009.[1]

A New Phase in Partnership with Growthgate Capital

Recognizing Roots Group Arabia's strong market positioning and ambitious growth plans, Growthgate Capital invested in the firm in 2008 by acquiring a minority stake. The Roots Group Arabia management saw Growthgate Capital's role as being primarily focused on enabling and facilitating acquisitions, institutionalizing the board of directors, and providing financial advice and expertise. With Growthgate Capital's help, Roots Group Arabia transitioned successfully from being a manufacturer and supplier of building materials to a vertically integrated construction conglomerate with capabilities extending from manufacturing to design and building.

Following the investment in 2008, Roots Group Arabia's growth accelerated considerably, with revenues growing seven times from 2007 to 2013. The company now services over 18,000 clients, compared to 7,300 in 2007, and its presence extends from the Middle East to Europe, Africa, China, and Southeast Asia. The growth was accompanied with a formalization of the

company's governance and corporate structure. There were several ways in which the partnership with Growthgate Capital was beneficial for Roots Group Arabia:

1. Supercharging acquisitions and global partnerships

Growthgate Capital leveraged its "buy and build" expertise and worked closely with the Roots Group Arabia management to identify and acquire a number of companies. Growthgate Capital tapped into its relationships and networks in the region to identify suitable acquisition targets and partners. It also helped Roots Group Arabia with conducting operational and financial due diligence on the companies and effectively structuring the transactions.

Through acquisitions, the company substantially enhanced its manufacturing, sourcing, and design capabilities through acquisitions such as Top Factory in Saudi (a manufacturer of woodwork cabinets, furniture and fixtures), Mimar Offshore UK and Levant (interior design and procurement), Gandolphe (interior design), Saudi United Waterproofing and a minority stake in Ideal Standard MENA (global manufacturer of sanitary ware). In addition, valuable partnerships have been structured with Sipes, MEVA, SAKR and CASE. Through these acquisitions and partnerships, Roots Group Arabia has been able to establish itself as an integrated player in the construction sector.

2. Institutionalizing the board of directors and corporate governance

Growthgate Capital brought its expertise in terms of corporate governance practices to strengthen the company's board and operating practices and to improve financial discipline. In 2007, the Roots Group Board consisted of four executive directors, including the CEO, without any independent directors. In 2010, with Growthgate Capital's help, the size of the Board was increased to ten members, with four independent directors added following an extensive external search. Independent directors provide expertise on corporate control (risk management, internal audit, IT) and ensure financial discipline. Additionally, independent directors were brought on to evaluate the performance and sustainability of the company without any conflict of interest.

In addition to board expansion, several key committees such as the Audit and Remuneration Committees were formed in 2011 to govern the company's activities effectively. These changes

were done partly to comply with Saudi Arabian regulations for public listing, which require a company to establish Audit, Remuneration, Compliance and Executive Board Committees. According to CEO Ousama Fansa, these committees are "extremely active and involved".

3. Strengthening management and information systems

Finally, Growthgate Capital worked closely with the company's leadership to strengthen the management team and operations. To more effectively manage the company's expansion of operations, the executive team was expanded from five to 35 members. The management team also became more diverse in terms of backgrounds and nationalities across the region (from Saudi Arabia, Lebanon, Jordan, Syria, etc.). Growthgate Capital helped with identifying, screening and onboarding some of the key candidates.

To enhance operational efficiency, dashboards, and reporting, systems have been created for the management and board, reporting key financial and operating metrics in product and region-level reports. The dashboards have enabled management to be more responsive and proactive based on real-time information.

Roots Group: the Path Forward

"In 2007 we were a Saudi Arabian company. By 2010, we became a regional company. We are now on the path to becoming an international company" - Ousama Fansa, CEO, Roots Group Arabia

As a result of the steps that have been taken following Growthgate Capital's investment, Roots Group Arabia has now solidified its position in the construction sector in the region and is well poised for further growth. The company plans to become a leading global player with $2 billion in revenues by 2017 through a combination of organic growth and acquisitions.

The partnership with Growthgate Capital has generated considerable value for both parties. From Roots Group Arabia's perspective, the company is now better positioned to achieve its long-term vision. The institutionalization of governance structures and management have made it easier for the company to access capital through more traditional channels such as commercial banks and

potentially through a public offering. From Growthgate Capital's perspective, the deal has generated considerable value. The company has already returned considerable cash and according to professionally commissioned estimates, the valuation has grown by about five times over a period of six years.

Conclusion

As we have shown in this paper, PE firms have the ability to add significant value to businesses globally and in the MENA region. According to Roots Group Arabia's CEO Ousama Fansa, *"many companies in the region have the right vision but don't have the cash and expertise to execute on that vision. Banks tend to be less risk tolerant in the region (which constrains growth)."* The example of Growthgate Capital's investment in Roots Group Arabia illustrates how a PE firm can provide access to much needed capital to businesses in the Middle East that have bold aspirations and help them in their journey toward becoming regional and global companies.

Our analysis in the first section of this paper suggests that many of the beliefs surrounding the impact of PE firms, such as job destruction and an excessive focus on short-term profitability, do not hold. Firms that receive investment from PE funds do not experience significant contraction in net employment; tend to have greater investments in capital expenditures, and a greater ability to innovate. The firms also improve their corporate governance and management practices, making it easier for them to access capital markets.

While the PE landscape in the region has been challenging, LPs have now consolidated their bets on 10-15 PE firms that have demonstrated an ability to generate superior returns. PE firms that continue to innovate in terms of their funding model and deal sourcing and build portfolio operation capabilities are likely to continue doing well. More success stories, such as Roots Group Arabia, emerging from the region will make business owners more receptive to PE investments. As the evidence shows, through such investments, businesses in the region are likely to grow faster, and become more efficient and competitive on an international stage.

Appendix: Interview Guide Baseline

The following list served as a guide for the topics we sought to discuss with interviewees:

PE Investing Rationale

- Why do stakeholders invest in PE, and how much do they allocate to the asset class?
- What return thresholds are sought and over what period?
- What metrics are used to assess returns?
- What is the reputation of PE with LPs? How do returns compare with expectations?

Fundraising

- What is the framework for choosing a General Partner?
- What are the main challenges to raise funds in the region? What fundraising structure works best (deal-by-deal or funds)?

Deal Sourcing

- Key sources of private equity deals
- How involved are LPs in supporting the GPs in their activities?
- How willing are private owners in the MENA region to sell?
- What framework do private owners use to assess incoming bids from acquirers?

Financing

- What financing options are available to GPs in the region? How successful have these been?
- What are the challenges of financing M&A activity in the region?

Portfolio Company Involvement

- Have GPs added value to portfolio companies? What changes do they make in the acquired companies?
- How involved are GPs in the management of portfolio companies?
- How do portfolio companies rate the overall experience of being acquired by a PE fund?

Exits

- What exit options do GPs currently have? What are the main challenges to a successful exit?

The Future of Private Equity

- Where do stakeholders think the industry will be in the next 5 – 10 years?

- What industries and countries do LPs and GPs focus on? Where would they like to focus?
- What are the main risks associated with private equity that are specific to the MENA region?

Appendix: Stakeholders Interviewed

- David Abraham – The Carlyle Group
- Faisal AlHamad – NBK Capital
- Ammar AlKhudhairy – Amwal AlKhaleej
- Meshari AlNajdi – Kuwait Fund for Arabic Economic Development
- Omar AlOmar – Automak
- Rakan AlTouq – AlTouq Group
- Vivake Bhalla
- George Boueiz – Olayan Group
- Ousama Fansa – Roots Group Arabia
- Baris Gen – IFC
- Lokendra Jain – Saudi Aramco/ PIF/ SABIC Sovereign Investment Holding
- Serhan Nadir – Bain and Company
- May Nasrallah – Denovo
- Marc Nassim – AR Investment Partners

Acknowledgements

The authors express their special thanks to the MENA Private Equity Association for providing valuable research and background information to complete the report and to Ousama Fansa, CEO of Roots Group Arabia, for providing insightful information on Growthgate Capital's investment in Roots Group Arabia.