

# Harvesting Strategies for Private Equity Investments in the MENA Region

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## **I. Executive Summary<sup>1</sup>**

The PE industry in the MENA region is still in its infancy. Substantial investments only began in 2005, and growth was cut short by the global economic downturn. One of the key difficulties that the industry currently faces is the availability of exit opportunities. Over the past few years, IPOs and trade sales have accounted for the vast majority of exits. Given that the public markets have yet to fully recover, most of the recent exit activity has taken the form of trade sales. Going forward, we believe that imminent exchange and regulatory reform has the potential to boost public market activity and re-introduce IPOs as a prominent exit channel. While rising political tensions may deter foreign investors from participating in the MENA growth story, the increasing professionalization of family businesses should lead to more trade sale exit opportunities. Secondary buyouts and management buyouts (“MBOs”), on the other hand, are not likely to capture a large share of exits in the near-term, although some growth is expected. Based on these trends, we believe that governments should take an active role in consolidating exchanges and introducing regulatory changes to attract more institutional and foreign investors. In addition, PE firms should focus more on operational change in portfolio companies and educate family businesses on the value that PE brings to the table.

## **II. Methodology**

We prepared this paper using a combination of quantitative and qualitative sources. The four main sources included databases, reports, articles and interviews. We obtained regional statistics and populated relevant charts using databases, such as Zawya PE Monitor and Capital IQ. We used reports mainly to understand the global PE landscape, while articles allowed us to identify specific regional case studies. Finally, we interviewed seven major regional PE players to understand the historical and prospective state of PE exits in the region. Throughout this paper, our definition of the MENA region included the Gulf Cooperation Council (“GCC”), Levant and North Africa. The geographic scope excluded Turkey and Israel given that those markets are more developed and are typically not covered by the PE firms that we interviewed.

Using the aforementioned sources, we developed a comprehensive summary of each exit channel in the MENA region and identified drivers of growth. We then

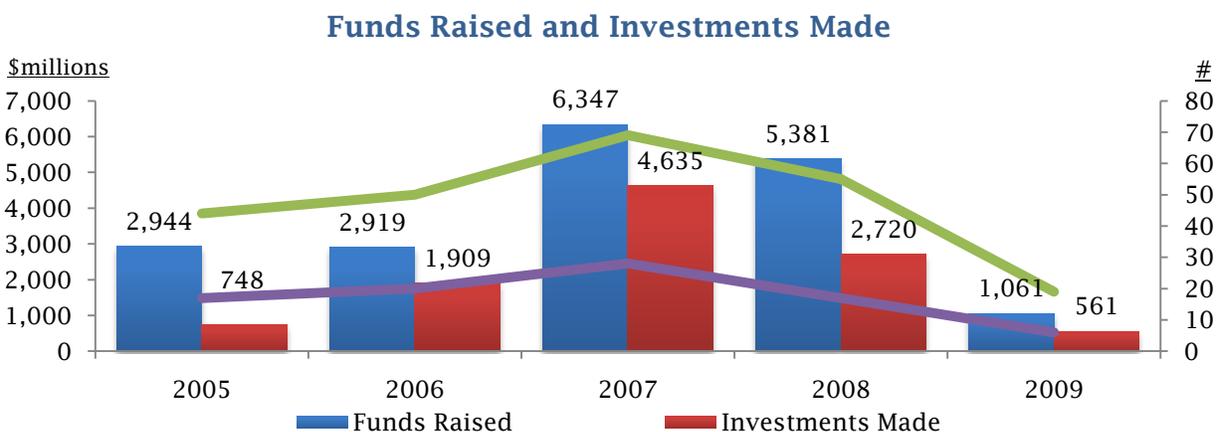
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<sup>1</sup> We thank the principals of Keystone, the General Manager of GrowthGate Capital Corporation (“GrowthGate”) which has provided research material, relevant data and valuable checks and cross-references on market and sector information, along extending its financial support for the efforts behind the preparation and publishing of this white paper. We thank the principals of many other private equity groups in the region for providing helpful information in interviews. All opinions are solely those of the authors.

used the drivers to frame the reasoning for the relative historical frequency of each exit channel. In the forward looking section, we identified three overarching themes that best capture our interviewees' perspectives. Lastly, in the recommendations section, we drafted a set of key actions that we think should be taken by PE stakeholders to benefit from future trends.

### III. Overview of PE in MENA

The nascent PE industry in the Middle East is only 10 - 15 years old. In fact, prior to 2005, none of the region's funds exceeded \$150 million in assets under management (the majority managed less than \$100 million). Since then, the industry has experienced rapid growth and decline, showing a high correlation with the overall state of the economy. In 2007, total investments reached a record high of \$4.6 billion, and subsequently experienced a sharp decline to only \$561 million in 2009. Fundraising activity also collapsed in parallel with the global economic recession. After hitting a record-high of \$6.3 billion in 2007, the total funds raised plummeted to only \$1.1 billion at the end of 2009 as investor risk appetite diminished, especially for alternative investments. (Please see exhibit below).



Source: GVCA Annual Report 2009: PE and Venture Capital in the Middle East, Zawya PE Monitor

A number of factors contributed to the growth of the industry and will remain essential for future growth. With the strength of oil prices since 2001, wealth in the region has increased exponentially, leading to an increase in regional investments both by sovereign wealth funds and large families. At the same time, regional governments have been developing investment-friendly environments. MENA states are becoming increasingly attractive to investors as they enhance their regulatory regimes and focus more on improving the business environment to attract foreign capital. Additionally, many governments began to appreciate the efficiencies and innovation that the private sector can bring, thereby embarking on major privatizations of sectors such as utilities and telecommunication.

Investor comfort with PE as an asset class has also been on the rise. Regional Limited Partners ("LPs") have shown an increased appetite for PE investments in

the MENA region. Traditionally, these investors preferred investing in safe instruments in developed economies (e.g. U.S. T-Bills). However, as LPs gained sophistication, and returns on traditional investments seemed low in comparison, investors started looking for alternative asset classes in their home countries.

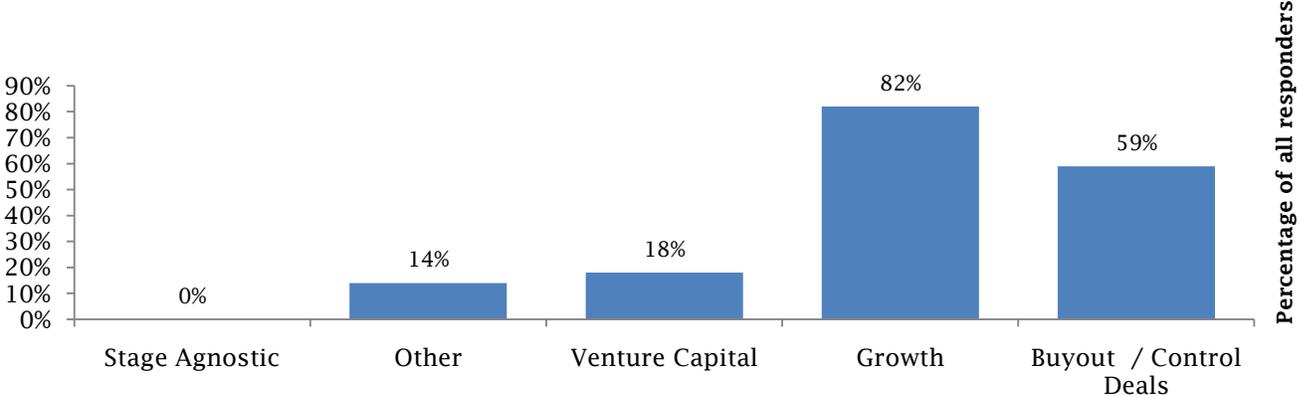
**Characterisitcs of the MENA PE Industry**

There are a number of characteristics that are unique to the PE industry in the MENA region. It is important for both observers and participants of the industry to understand these characteristics. One such characteristic is the strong role that LPs play in the PE ecosystem. In developed economies like the US and Western Europe, the role of LPs is typically limited to providing capital to the General Partners (“GPs”). In comparison, LPs in the MENA region usually provide their networks for both sourcing and exiting deals. In fact, it is fairly common to see LPs act as buyers or co-investors in some of the deals.

Another key characteristic is the importance of relationships. Strong networks and connections are a key requirement for doing business in the MENA region. This can be explained by the dominance of family-owned or controlled businesses, combined with cultural factors that emphasize personal connections. For these reasons, the importance of relationships is even more pivotal in the PE industry, explaining why international PE firms have largely limited their involvement in the region to fund raising activities.

Finally, most PE firms in the MENA region have historically focused on providing growth capital. This is because the venture capital industry is nascent and very few mature industry players exist in the region. Within the scope of growth investments, PE firms have typically invested in “low-hanging fruit” arbitrage opportunities, in which transactions were primarily “quick-flips” with little or no operational change. A recent survey asking GPs about their investment focus supports this claim. (Please see exhibit below).

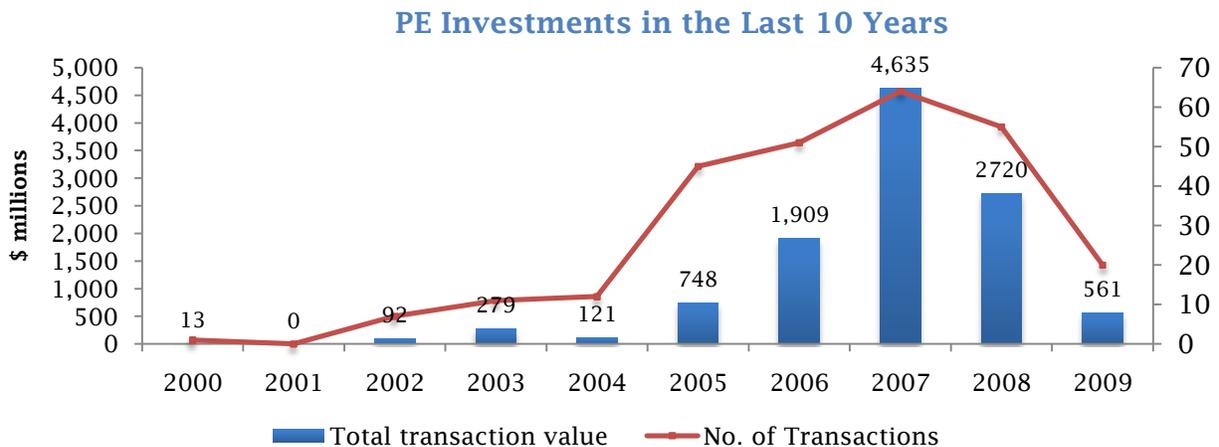
**GP Survey Questions: What investment stage(s) does your fund focus on?**



Source: 2010 INSEAD and Booz & Company Survey

## IV. Usual Exit Strategies

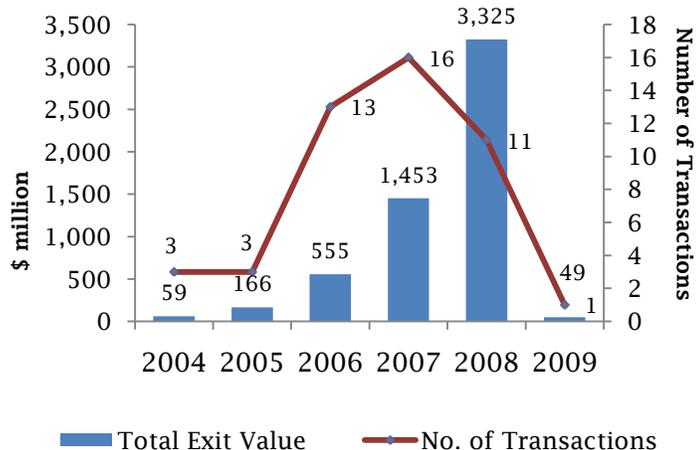
Since the MENA PE industry is still in its infancy, only a handful of portfolio company exits have been observed in recent years. As demonstrated below, deal activity in the region has only picked up since 2005. Deal volume peaked in 2007 at \$4.6 billion and troughed in 2009 at \$561 million. Assuming an average investment horizon of 4-6 years, we would expect the first “wave” of exits to appear around 2009-2011.



Source: GVCA Annual Report 2009: PE and Venture Capital in the Middle East, Zawya PE Monitor

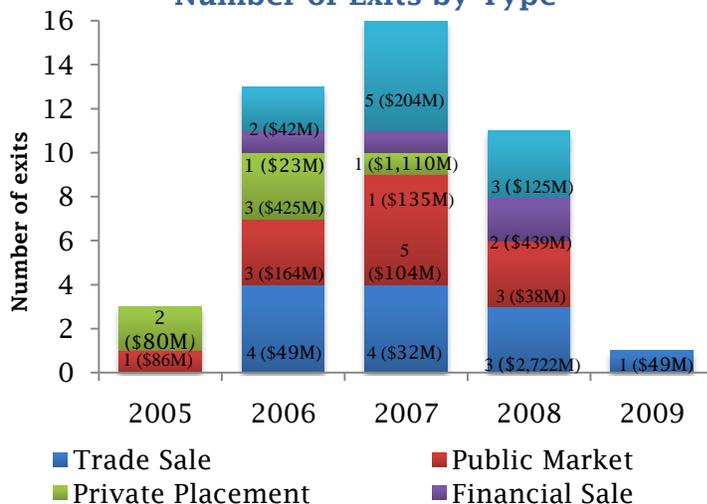
Actual results, however, differ somewhat from our initial expectations. Specifically, as per the graphs below, we notice that a large wave of exits were completed in 2007 and 2008. In fact, the \$5.3 billion of combined exits during 2006-2008 represents almost 51% of the capital deployed between 2004 and 2008. The data suggests that many of the exits over the past five years were quick-flips - companies that were sold only 1-3 years after the investment date. The prevalence of quick-flips was facilitated by an unprecedented flow of capital into the region. In a period of ever-rising stock prices, PE firms tried to find pre-IPO companies that they could quickly bring to market.<sup>1</sup> Returns were therefore primarily driven by multiples expansion. Operational changes, on the other hand, represented only a small driver of value creation. “Market immaturity is the main culprit behind the lack of active exits in the MENA region: a relatively young PE industry (less than 20 years), dearth of leverage (unavailability of acquisition finance), mostly illiquid stock markets (at the exception of Saudi), small scale sponsor-to-sponsor deals; and finally, no solid culture of M&A for regional corporate buyers”, a senior source at GrowthGate stated.

### PE Exits in the Last 6 years



Source: GVCA Annual Report 2009: PE and Venture Capital in the Middle East, Zawya PE Monitor

### Number of Exits by Type



Source: GVCA Annual Report 2009: PE and Venture Capital in the Middle East, Zawya PE Monitor

A brief look at representative transactions confirms this view: many of the decade’s largest deals were characterized by a relatively short hold period. Abraaj Capital’s \$480 million sale of National Air Services represented a one-year hold (’07-’08). Similarly, Amwal AlKhaleej’s \$270 million sale of Dubai Contracting Co. also represented a one-year hold (’07-’08). Finally, Citadel Capital’s \$1.4 billion sale of Egyptian Fertilizers Co. represented a two-year hold (’05-’07).

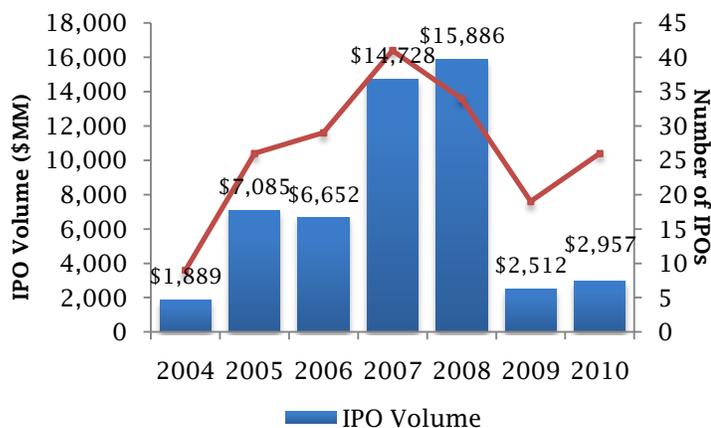
Trade sales and IPOs were the most common exit paths over the past 5 years. According to Zawya’s PE Monitor, twelve trade sales and twelve PE-sponsored IPOs were executed during the 2005-2009 period. Although equally common, trades sales eclipsed IPOs by value. The twelve trade sales represent \$2.8 billion of deal value compared to only \$392 million for the twelve IPOs. Meanwhile, exits through secondary sales and MBOs were sporadic. Four secondary sales and no MBOs were completed during the same period. “Exit routes are not “either or” ready options, but rather tailor-made to the nature of the underlying business and suited to the intent of the founders-sellers. Some businesses are prone for an IPO (especially mature ones with the capacity of paying regular dividends) while others have a longer growth trajectory and would be more fitting to sophisticated corporate buyers who can benefit from complementarity and can better exploit economic synergies”, said a senior source at GrowthGate.

Since a majority of the businesses in the MENA region are family-owned, most of the historical PE investments represent minority stakes. In fact, traditional buyouts with outright control are few and far between. Most of the PE funds that we surveyed have sought minority protections (including veto rights, drags/tags, and transfer restrictions) in their prior investments. The fact remains, however, that these funds are constrained by the exit decision of their majority co-investor. PE

firms mitigate this concern by agreeing on an exit schedule with the founders prior to investing, and jointly determining a harvesting strategy by year three of the investment.

## A. IPOs

**Historical MENA IPO Volume ('04 - '10)**



Source: Capital IQ. Data excludes Turkey and Israel.

**Average IPO Size ('04 - '10)**



Source: Capital IQ. Data excludes Turkey and Israel.

After record capital-raising activity during 2004-2008, MENA IPOs plummeted in the fourth quarter of 2008. Volumes remained depressed in 2009 and 2010 as risk appetite dried up for frontier emerging markets. In fact, the \$2.5 billion of new listings in 2009 represents only 16-17% of the IPO volume at the peak of the market. In addition to a decrease in the number and aggregate volume of IPOs, the average capital-raise was also much smaller. In 2010, the average IPO raised \$115 million compared to \$360m-\$470m at the peak of the market. Importantly, the average capital-raise in 2010 was smaller than in any period over the past seven years.

IPO volumes showed a slight improvement in 2010 after declining to a 5-year low in 2009. During this time, the number of new listings increased from 19 to 26 in the MENA region, while aggregate volume increased from \$2.5 billion to \$3 billion. Activity in the GCC markets remained low, however, with only four IPOs (aggregate value \$1.2 billion) completed in the second half of 2010. These deals included two state-controlled entities (Nawras Telecom in Oman and ALBA in Bahrain) and one family business (Al Khodari & Sons in Saudi Arabia). In both 2008 and 2009, the GCC exchanges hosted 92-93% of all MENA IPOs by value. In 2010, this figure dropped to 71%.

Importantly, PE-backed IPOs remain a modest slice of the overall IPO market and have declined in parallel with it. Three PE-sponsored IPOs were completed in 2006, five in 2007, and three in 2008. These transactions represented 2.5%, 0.7%, and 0.2% of aggregate MENA IPO volumes in 2006, 2007, and 2008 respectively. There were no PE-backed IPOs in either 2009 or 2010.

Most of the region's PE-sponsored IPOs have listed in Dubai - whether on the DFM or Nasdaq Dubai - including Arabtec Holding Co., Aramex Co., Damas International Ltd., and Depa Ltd. Although most of the portfolio companies were listed on MENA exchanges, one company (Petrofac Ltd.) was listed on the London Stock Exchange. The Petrofac IPO, sponsored by Shuaa Capital, was 12 times oversubscribed and represented the first MENA PE-sponsored IPO in a developed market. Surprisingly, there have been no PE-sponsored IPOs in the attractive Saudi market, as few financial sponsors have succeeded in closing deals in Saudi Arabia.

### Key MENA Exchanges

Region	Saudi Arabia	Qatar	Kuwait	Egypt	UAE	UAE	Bahrain	Lebanon
Region	GCC	GCC	GCC	North Africa	GCC	GCC	GCC	Levant
Market	Saudi Stock Exchange	Qatar Exchange	Kuwait Stock Exchange	Egyptian Exchange	Abu Dhabi Sec. Exchange	Dubai Financial Market	Bahrain Stock Exchange	Beirut Stock Exchange
Year Established	1954	1995	1962	1903	2000	2000	1989	1995
Market cap. (\$billion) - 2010	\$353.4	\$123.6	\$119.5	\$84.1	\$80.2	\$54.2	\$20.1	\$12.7
# of listings	144	44	215	212	66	61	49	11
Liquidity (2010 turnover)	57.3%	14.9%	37.2%	42.9%	23.8%	35.0%	8.1%	14.8%
<b><u>Admission Requirements:</u></b>								
Yrs of business activity	3	N/A	2-3	1-3	2	2	3	2
Paid in capital	\$26.7m	\$2.8m	\$10-35m	N/A	\$5.5m	\$10.9m	\$10m	\$5.2m
# of shareholders (millions)	200	100	50	2-150	2	100	100	50

Source: Exchange websites, Grant Thornton Capital Markets Guide

Note: Represents a sample of key MENA exchanges, sorted by 12/31/2010 market capitalization.

Companies looking to list in the MENA region have a multitude of exchanges to choose from. The GCC states and Egypt host the region's top bourses. Saudi Arabia boasts the largest and most liquid exchange, with 144 listed companies valued at \$353 billion. On the other end of the spectrum, Lebanon, Palestine and Syria host the region's smallest exchanges. The Beirut Stock Exchange, for example, has only 11 listed companies with a combined \$13 billion market capitalization.

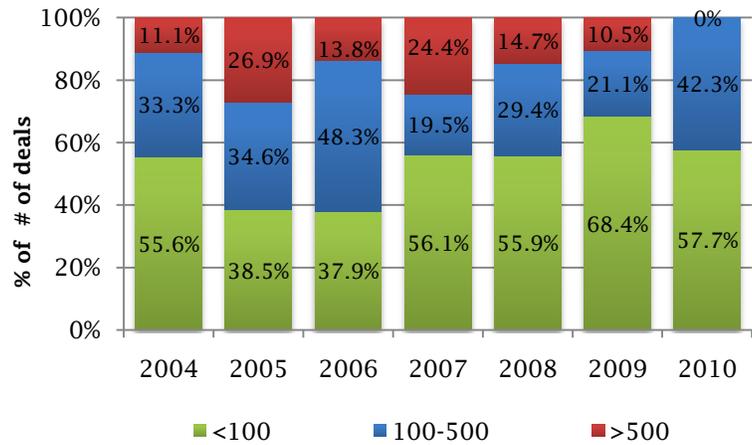
The GCC bourses have historically received a disproportionate share of all MENA listings. Between 2005 and 2010, the six GCC states represented 87% of IPO activity. While new listings in Kuwait, Qatar and the UAE have historically come in waves, only the Saudi market has maintained consistent IPO activity over the past 5 years. During 2006-2010, the Saudi market hosted 30-45% of all MENA IPOs. Egypt, like the other GCC states, has shown sporadic IPO activity in the past.

The MENA IPO market has been dominated by small-to-mid capitalization deals. Of the 184 IPOs executed during 2004-2010, 155 were less than \$500 million in value. During this period, 52% of the deals executed were small cap (<\$100 million), 32% were mid cap (\$100-\$500 million), and 16% were large cap (>\$500 million). Investor receptivity to smaller-sized transactions is good news for regional PE funds, which predominantly focus on middle market growth equity transactions.

In fact, all the PE-sponsored IPOs that have been executed to date were sub-\$500 million transactions. Indeed, all the IPOs mentioned earlier (Arabtec Holding Co., Aramex Co., Damas International Ltd., and Depa Ltd.) were sub-\$300 million.

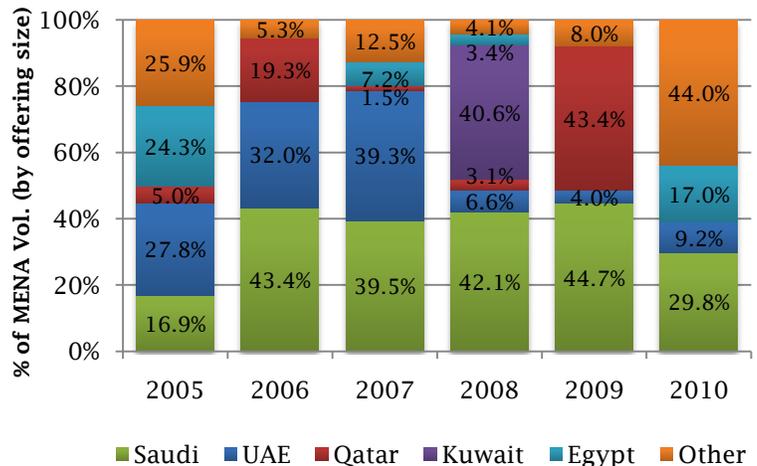
Although there has generally been only a handful of >\$500 million transactions each year, these deals tend to be huge. Examples include the \$950 million Vodafone Qatar IPO in 2009, the \$2.5 billion Saudi Arabian Mining Co. IPO in 2008,

**MENA IPO Composition by Size ('04 - '10)**



Source: Capital IQ. Data excludes Turkey and Israel.

**MENA IPO Composition by Location ('05 - '10)**

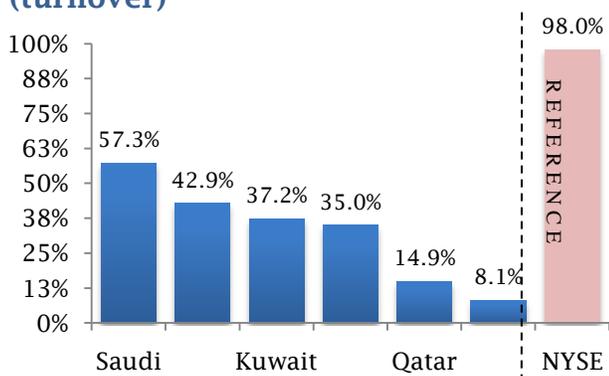


Source: Capital IQ. Data excludes Turkey and Israel.

and the \$4.2 billion DP World IPO in 2007. These deals represented the majority of IPO activity by value in the year that they were listed.

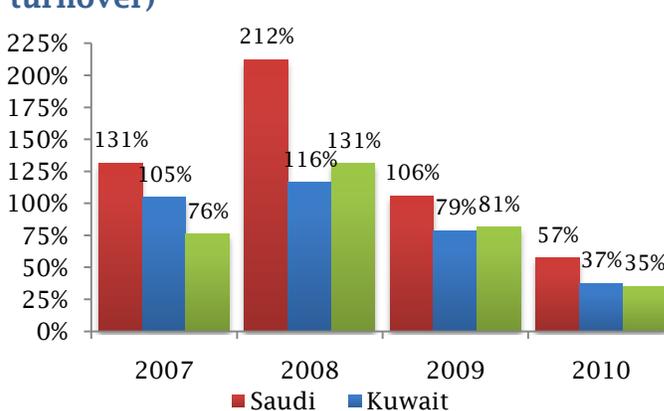
Our conversations with the region’s leading PE firms reveal that market liquidity is the primary factor shaping their decision to IPO. Liquidity, which we define as annual traded value as a percentage of market capitalization, has varied significantly in the past, both across markets and over time:

**Liquidity at Multi-year Lows in 2010 (turnover)**



Source: Exchange websites.

**MENA Liquidity Dries Up.. ('07-'10 turnover)**

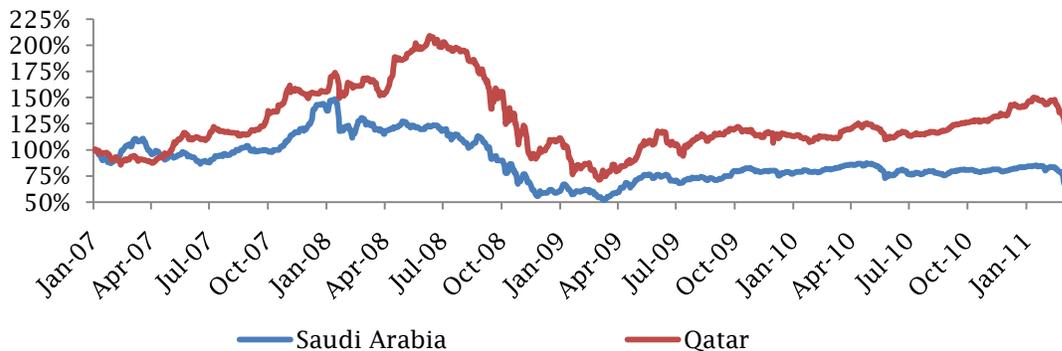


Source: Exchange websites.

Liquidity across MENA markets peaked in 2008, at which point some of the region’s leading exchanges surpassed the 100% turnover mark. In fact, the Saudi market reached a whopping 212% turnover ratio in 2008, comparing favorably to the NYSE’s 138% turnover during the same time period. Record capital flows were driven by surging oil prices and an increasing risk appetite among the local and international investor community. Liquidity decreased significantly in late 2008 and has been on a downward trend ever since. The exchange turnover ratios in 2010 for Saudi, Kuwait, and Dubai were off around 70-75% from 2008 levels. In comparison, the NYSE’s turnover ratio declined only 29% between 2008 and 2010.

One possible reason for this drop in liquidity is that retail investors (the primary market participants) remain busy repairing their personal balance sheets in response to the recent economic crisis. Another explanation may be the complete halt of bank lending for stock purchases, an activity that became common practice when banks were flush with liquidity and willingly lending to retail investors in 2006-2008. The plummeting stock markets in 2008-2009 (please see exhibit below), however, forced these banks to make hefty provisions for impaired stock loans. Many banks have since discontinued these loans from their service offering.

### Historical Indexed Price Performance (2007-3/2011)



Source: Capital IQ.

As a result, by 2010 all MENA bourses experienced liquidity levels drastically below those of developed markets. Saudi Arabia's 57% turnover ratio pales in comparison with the NYSE's 98%. In addition to the region's low liquidity relative to developed markets, turnover ratios also vary considerably across the MENA. Saudi Arabia, Egypt and Kuwait have historically stood apart from their peers in having the region's highest liquidity levels. At the other end are Lebanon, Syria, Palestine and Bahrain, which all have sub-10% turnover ratios; many stocks often experience multiple months without a single share changing hands.

The relative lack of institutional investor presence remains one of the defining characteristics of the GCC stock exchanges. Retail investors still typically account for 90% or more of trading on the region's exchanges.<sup>2</sup> The prevalence of retail investors can also partly explain the relative dearth of PE-sponsored IPOs historically. Specifically, across the region the regulatory framework is often onerous and mostly skewed towards favoring retail investors rather than companies listing shares.<sup>3</sup>

An example, as described by Amwal AlKhaleej, is Saudi Arabia's six-month lock-up period for original shareholders. In addition, the country's regulator (the Capital Markets Authority) typically stipulates an IPO price that is about 20%-30% below the price set through a book building process to "protect retail investors".<sup>3</sup> Another example is the strict requirements imposed by the UAE regulator, the Emirates Securities and Commodities Authority. Here, companies have to list at least 55% of their shares through primary, rather than secondary, issuances, which prevents PE firms from exiting their investments upon IPO.<sup>3</sup> Additionally, original shareholders are subject to a two-year lock-up period.<sup>3</sup>

Based on our conversations with the region's PE players, we have found these regulatory concerns to be of secondary importance. The funds are only interested in them insofar as they would increase market liquidity, facilitating new PE-sponsored IPOs.

## **B. Trade Sales**

A trade sale, also known as a sale to a strategic buyer, is typically defined as the sale of a portfolio company to another corporate entity (as opposed to a sale to a financial sponsor). The strategic buyer is often a competitor, but can also be a supplier, customer or a conglomerate seeking diversification. Owners pursuing a trade sale often seek full liquidity and expect to obtain a premium valuation due to the synergies that often exist with the ultimate acquirer. As the data demonstrates, trade sales have been one of the most preferred exit channels for the majority of the MENA PE firms. Between 2004 and 2009, 45 out of the 60 PE exits were trade sales.

Based on our discussions with leading PE firms in the region, trade sale exits usually lead to better terms and higher valuations, translating into greater returns. Recent exit data supports this view. Looking at all exits between 2006 and 2010 with published returns reveals that the average IRR was 112% for trade sales in comparison to 95% for IPOs. Trade sales in the MENA region can be divided into two categories: regional and international buyers. According to a Managing Director of a major MENA PE firm, "Selling to strategics tends to be easier as there are fewer restrictions, such as warranties. Furthermore, regional strategics tend to have a greater understanding of the market and the region, therefore resulting in a quick due diligence process."

Regional strategics are usually driven by either the desire to diversify their portfolio or to strengthen their market penetration. For example, OCIC, a leading construction and fertilizer company based in Egypt, bought Egyptian Fertilizer Co. ("EFC") from a consortium led by Abraaj Capital. OCIC's purchase decision was based on the desire to consolidate the fertilizer industry and become among the world's top five producers of nitrogen-based fertilizers and ammonia. Regional buyers are also interested in expanding their businesses in the region. For instance, the Savola Group, a leading food company based in Saudi Arabia, bought NBK Capital's stake in Yudum Food, a leading food company in Turkey, to expand their operations into the Turkish market. Post-transaction, regional buyers often bring their own management team and are therefore less concerned about the strength of the acquired team.

International buyers are mainly driven by the desire to expand their operations globally, and view the MENA region as an emerging market with strong macro-economic fundamentals. They have typically focused on markets with a clear demographic growth story driven by a rising middle class, such as the retail, healthcare, and education sectors. A case in point is Yahoo's purchase of Abraaj Capital's stake in Maktoob, a leading internet service provider known for developing the first Arabic e-mail network.

Discussions with leading PE firms in the region reveal that international strategies are also interested in oil & gas service businesses, as they see a long-term play in

the industry especially in light of current commodity prices. International buyers are typically involved in large transactions (targeting companies with EBITDA higher than \$50 million).

Family businesses continue to be the dominant players in the MENA region. More than 80% of businesses in the Middle East are family-run or owned, with family businesses controlling over 90% of commercial activity in the region, as opposed to 65% to 80% in other parts of the world. <sup>4</sup> The big question is whether family business will be buyers or sellers of PE-backed companies. Our conversations with leading PE firms show that there is currently no consensus in the market; convincing arguments can be found on both sides of the spectrum. On the one hand, as most family businesses transition to third-generation owners and start to professionalize management, they are likely to divest non-core assets, especially those that are unprofitable. Divested businesses can be great opportunities for well-connected PE firms that can buy such assets on favorable terms. On the other hand, many successful family businesses remain flush with cash, and will be looking to acquire assets that reinforce their core strengths. This implies that family businesses may become a greater source of competition to PE funds in the future.

### **C. Secondary Buyouts**

A secondary buyout, also known as a sponsor-to-sponsor transaction, is typically defined as the sale of a portfolio company by one PE firm to another.

Globally, secondary sales represented a significant portion of exits in the years leading up to 2007. Their share of total exits declined noticeably in 2008 and 2009 but recovered in 2010. <sup>5</sup>One interpretation of the declining share of secondary sales during the economic crisis of 2008 is that plummeting asset prices and the paucity of credit drove PE firms to be much more selective in their investments. In addition, seller expectations took time to adjust to the new realities of the market. As a result, the demand for secondary sales dried up, leaving trade sales as the dominant exit channel.

In the MENA region, however, secondary sales have been a relatively uncommon type of exit. A few secondary sale transactions have taken place, but based on discussions with PE firms in the region, they have largely been relationship-driven minority investments. One example of a secondary deal in the region is the sale of Abraaj Capital's stake in EFG-Hermes to Dubai Financial Group ("DFG") in 2007. Abraaj Capital made a 118% return on the transaction.<sup>6</sup>

One reason why secondary sales have been so scarce is the lack of quality deals. First, the MENA region has not amassed a sufficient track record of PE deals that have completed their life cycles. Given the nascent nature of the industry, few deals have reached the exit stage, and those that have, coincided with the onslaught of the global economic crisis. As a result, PE buyers never had a robust

menu of secondary investments to choose from. Secondly, as mentioned earlier, most deals in the region have been quick-flips and not operational in nature. This implies that once the circumstantial value has been extracted, little upside is left for buyers with a similar mentality to benefit from such deals.

Another reason that prompts sellers to shy away from deals involving secondary sales is that PE firms tend to demand lower prices. Since they are sophisticated deal negotiators and rarely capture IPO or synergy premiums, such firms tend to ask for prices that are less attractive than those offered through IPO exits or trade sales. Furthermore, PE firms often require substantial reps and warranties, making the process more complex for sellers and precluding them from a clean exit, free of lingering commitments or lock-ups.

Thirdly, the decision to sell to another PE firm might be problematic when the seller has less than majority control in the company. For instance, when GrowthGate explored the sale of one of its portfolio companies to another sponsor, the majority investor insinuated that it would exercise its right of first refusal and buy back GrowthGate's shares. The founders preferred not to engage in a "pass-the-parcel" deal in which the company is shopped around to financial investors.

In addition, the composition and profile of buyers in the MENA region does not lend itself to secondary sales. Large global PE players, who often possess the resources, know-how, and specialization to pursue sponsor-to-sponsor transactions, have been primarily using the region as a fundraising base. On the other hand, local PE players, given the developing nature of the industry, sought to keep value for themselves. Because regional PE firms lack sector specialization, they cannot add value to investments that have already been "nursed" by other generalist funds.

Finally, cultural barriers on the demand side certainly present a strong obstacle in the face of secondary sale exits. Buying from competitors is still viewed as taboo in the region, and "not the right way to build a franchise," according to one PE fund manager. Nascent players prefer to build a track record of "real" deals before they consider venturing into the space of sponsor-to-sponsor sales.

#### **D. MBOs**

MBOs refer to transactions in which a company's existing managers acquire a large part or all of a target company. Typically, the purpose of a management buyout is to either save jobs or to maximize management's financial benefit. In a PE context, MBOs may represent a form of exit in which employees of the portfolio company gather the requisite financing and buy out the LPs in an MBO transaction.

On a global scale, MBOs have historically represented a small share of exits. Predictably, in the MENA region, management buyouts have been virtually non-existent. Although some MBO-type transactions have taken place, they are not

“Western-style” MBOs. Rather, the transactions largely involve family management seeking to increase their existing share of the company.

One key reason for the absence of MBOs in the region is the lack of management sophistication. More specifically, management is often confined to the execution of tasks and typically does not decide the fate of the enterprise. MBOs require the management team to be aligned, committed and capable. In addition, the fact that no regional precedent has been set for this type of transaction makes it difficult for the management of a company to take the first step in that direction.

A second reason driving the lack MBO exits is that, generally, creditors are unwilling to back management in such transactions. Banks are typically not prepared to extend LBO funds, since credit in the MENA region behaves differently than in Western markets. Acquisition and leveraged financing are relatively uncommon, and the situation is exacerbated by the lack of seller financing. Emerging PE firms are focused on establishing a track record, so transactions where the proceeds are paid over time are undesirable, since LP lock-ups become more restrictive.

Furthermore, for cultural reasons, job security in the Middle East tends to be relatively high. There is little fear of job losses that would prompt managers to acquire the business in an attempt to ensure job stability. This eliminates one of the key reasons that make MBOs desirable in Western markets. Furthermore, the concept of incentive-based compensation is less prevalent in the MENA region. A bias towards fixed salaries often precludes management from resorting to MBOs as a viable alternative to capture additional upside.

Lastly, ownership in the MENA region is typically concentrated in the hands of one or two shareholders (usually founders and family members) that do not want to relinquish control. This makes it relatively difficult for management teams to build a substantial stake in the company and eventually buy them out. Given the asymmetric nature of information between owners and managers, the former are also likely to be suspicious of any movement on the part of the latter to manipulate the share price of the company downwards prior to any such transaction.

It is noteworthy to mention, however, that the MENA region is host to a very particular related genre of transaction that we refer to as “sibling buyouts”. Many of the second generation members within family businesses often disagree on the direction of the company. In such cases, the exit of one family member would be facilitated by a debt-financed share repurchase, instead of putting the stake up for sale to a third party. Larger sibling buyout transactions may be candidates for future PE investments.

## **V. Analyzing the Way Forward**

Based on our research and discussions with leading PE firms in the region, we have identified several key drivers that will likely impact the MENA PE industry.

### **Capital Market and Regulatory Reforms**

As equity market liquidity hits multi-year lows across the MENA region, talk about much-needed market reforms has resurfaced. Key stakeholders have proposed everything from equity market consolidation to changes in rules and regulations. These stakeholders include capital market regulators, securities dealers, financial sponsors, international development experts, and leading institutional/retail investors. A number of ongoing capital market developments have the potential to shape future PE exit activity, including:

#### **A. Consolidation of Regional Exchanges**

In late 2009, the Dubai Financial Market (“DFM”) announced that it was acquiring Dubai’s second bourse, the Nasdaq Dubai, for \$121 million. DFM believed that the deal would help broaden its asset classes for investors as it looked to solve its liquidity problems.<sup>7</sup> A successful integration would add 14 new companies to the 65 DFM-listed entities. Market participants had been speculating about such a transaction for years, viewing the presence of two bourses within the same city as unnecessary.

The transaction should significantly increase market liquidity by introducing new shareholders to the historically less-liquid Nasdaq Dubai. In fact, the integration of back-end operations will introduce more than 500,000 new investors to the struggling bourse, an approximately 20,000-fold increase for the exchange. Additionally, securities brokers believe that a reduction in their overhead will translate into lower commissions for their clients.<sup>8</sup>

The Dubai transaction is viewed as the first step towards further equity market exchange consolidation in the region. Even after this merger, the UAE continues to operate two exchanges - the DFM and the Abu Dhabi Securities Exchange (“ADX”), while the other Gulf countries each operate their own single country exchanges. Tom Healy, CEO of the ADX, recently expressed his views on regional exchange consolidation, saying: “You will see in this region a common capital market and securities market after the Gulf common currency”.<sup>9</sup>

The fact that all the MENA exchanges have their own proprietary systems (from trading platforms, to settlement and clearing) makes it very difficult for companies to cross-list their shares. This stands in clear contrast to the highly interconnected and well-integrated European bourses, where the logistical back-end of moving shares from one market to another works very well. Absent an exchange consolidation or complete systems standardization, the ability of PE funds to cross-list their portfolio companies within the region will remain limited.

## **B. Integration of Regional Exchanges**

As an alternative to a consolidation of regional exchanges (and the resulting disappearance of local bourses), some market participants have been instead advocating an integration of regional exchanges. In an early 2010 meeting of the Ministerial Committee of GCC Regulators Boards in Riyadh, for example, the UAE floated an initiative ‘aimed at integrating the securities markets of all members of the GCC.’<sup>10</sup> The initiative was proposed by the UAE minister of the economy, Sultan bin Saeed Al Mansouri, who is also chairman of the UAE regulatory authority, the Emirates Securities and Commodities Authority (“ESCA”).<sup>10</sup>

An integration of the GCC exchanges would primarily entail aligning the policies and regulations under which the region’s bourses operate. Each bourse would remain independent and continue to be regulated by local authorities, but rules and regulations would be standardized across all bourses. Such an initiative would presumably represent an interim step towards an ultimate region-wide consolidation as described above.

Although talks of a GCC monetary union have stagnated, the renewed commitment to strengthening GCC ties in light of the region’s ongoing political turmoil may serve as the catalyst to revisit the common currency and exchange integration talks. In fact, in late March 2011, the executive president of Oman’s Capital Markets Authority said: “The GCC bourses are trying to bring in uniformity in rules and regulations. There is going to be a meeting in Abu Dhabi sometime in April to discuss these issues”.<sup>11</sup>

## **C. Attracting a Broader Investor Base**

Since its founding in 1954 and until mid-2008, the Saudi Stock Exchange had been inaccessible to international investors. Starting in August 2008, however, the country’s Capital Markets Authority allowed indirect foreign ownership through total return swap contracts, also known as participatory notes. Investors in the p-notes do not receive voting rights and are exposed to counter-party risk (swaps are sold through licensed brokers only),<sup>12</sup> potentially reducing their appeal to foreign institutional investors. In January 2011, Reuters reported that Saudi Arabia’s stock market committee was moving closer to allowing foreign investors direct market access. It referenced a December 2010 meeting, in which bourse officials asked representatives from regional banks and brokerages to check capabilities for handling foreign accounts.<sup>13</sup>

Qatar and the UAE have also been seriously contemplating market reforms in order to secure MSCI’s “emerging markets” status. The countries, currently classified as “frontier markets”, were reviewed for reclassification in the past, but have to-date failed to secure a change of status. An “emerging markets” classification would increase foreign interest in the region’s equity markets, and potentially increase

liquidity due to a subsequent inclusion in the MSCI EM index. Relaxing foreign ownership rules remains a key requirement for reclassification.

In June 2010, both Qatar and the UAE failed to achieve a change in classification and were placed in the MSCI's markets under review list for reconsideration in 2011. Kuwait, however, has not been up for reconsideration since 2008 as it "still exhibits significant shortcomings in terms of market accessibility". MSCI stated that international investors have expressed serious concerns about the disclosure and enforcement of market regulations in Kuwait.<sup>14</sup>

To achieve a change in status, both Qatar and the UAE have been rumored to be contemplating significant changes, including a reduction in foreign ownership constraints and allowing short-selling. In addition, the exchanges are working towards segregating custody and trading accounts, and implementing a delivery versus payment mechanism ("DVP"). In fact, ESCA approved the DVP mechanism for both the Dubai Financial Market and Abu Dhabi Securities exchange in April 2011.<sup>15</sup>

The implications of the aforementioned capital markets reforms on PE exits cannot be overstated. The introduction of such reforms, whether in concert or separately, has the potential to significantly increase institutional investor participation and, in turn, increase liquidity in the region's markets. Rising liquidity will serve to reopen the PE IPO window, which has been more-or-less shut since 2008. Foreign investors longing for exposure to the region will likely be attracted to the shares of best-in-class operators that PE funds have brought to market.

#### **D. Rising Geopolitical Tensions**

The rising political unrest across the Middle East has several effects on the PE industry as well as exit strategies. In our view, increased political risks will most likely affect trade sale exits to international strategic buyers. Historically, international buyers have been very careful when investing in the MENA region and the current environment will increase their worries and curb their appetite to invest in the region. Conversely, in our opinion, regional buyers will remain interested in good portfolio companies that PE firms plan to exit. Regional buyers' better understanding of the geopolitical risks, less skewed by common misperceptions, enables them to accurately assess risk-reward trade-offs.

Another effect of geopolitical instability is the potential rise of middle class disposable income. As many governments in the MENA region, especially in the GCC, are trying to preempt any political unrest, they have made economic concessions in the form of government hand-outs or direct investments. One such example is Saudi Arabia's distribution of \$37 billion in total benefits to its population. Oil-producing countries are also expected to experience increased surplus as oil prices remain high due to increased regional tensions. This should prompt additional direct investments (e.g. infrastructure), creating more jobs and

subsequently increasing middle class disposable income. In our opinion, rising disposable income, especially among the middle class, will very likely increase liquidity in the public markets as retail investors place their surplus savings in public equities. Although this phenomenon will likely take some time to play out, it should ultimately enhance the IPO market as a viable exit route for PE in the coming years.

“Exits are entries in reverse in the PE industry especially as far as trade sales are concerned. We believe that the M&A activity will pick up in Q4 2011 and in the quarters to follow. On the one hand, exits are a must for some PE firms to prove their harvesting capacity to their LPs and realize tangible returns after a long period of fund raising and gestation. On the other hand, having stood on the sidelines during the critical period of 2009-2010, PE firms with massive dry powder are under pressure to deploy their capital or face the wrath of investors who are paying idle management fees. As for IPOs, the resilient Saudi market offers hope for PE firms, whilst the UAE stock market is exhibiting signs of recovery that could usher an era for renewed floatations”, asserted a senior source at GrowthGate.

#### **E. Professionalization of Family Businesses**

A third theme that is likely to impact PE exits in the MENA region is the trend towards the professionalization of family businesses. Studies have shown that up to 80% of family businesses fail to make it through to the third generation.<sup>16</sup> Given that most family firms in the region are less than 60 years old, they have likely entered or will soon enter the third generation. This transition comes with the challenge of maintaining control over the businesses. As the number of family shareholders increases, ownership becomes less concentrated and the complexity of decision-making rises exponentially.<sup>16</sup> Consequently, many families will look to partially or completely sell their interests, leading to a professionalization of the businesses.

In addition to the argument of third-generation transition, we believe that other factors are also likely to engender professionalization. The global recession, coupled with a liquidity squeeze and a scarcity of credit, will likely expedite the sale of struggling family businesses to third-parties. This trend will be amplified by increased competition from regional and global firms. With the external landscape evolving at an unprecedented pace, the once family-driven economy will begin to witness a fundamental shift, albeit gradually, towards professionalization. This can have several implications on PE exit channels.

First, regional companies are likely to adopt a policy of consolidating their core businesses and divesting their non-core businesses. According to a Booz & Co. survey, 48% of family-owned companies are involved in five or more sectors. Many of these firms, for sentimental reasons, hold on to assets generating returns below the cost of capital.<sup>17</sup> As firms witness a wave of professionalization, such

businesses are likely to be divested. With increased access to global capital markets, more professional owners are expected to acquire companies to consolidate core sectors. This acquisition spree represents an opportunity for trade sale exits.

Second, as firms become more professionalized, the region may begin to see some instances of MBO transactions. With shifting internal firm dynamics, professional management teams detached from family owners may be put in place, paving the way for a management-led coalition to buy-out family owners. Needless to say, the prevalence of such transactions is highly contingent upon the availability of buyout financing in the region.

Lastly, and provided that capital market activity picks up, the professionalization of firms in the Middle East may lead to a sudden increase in public listings as families look to sell their businesses and capture an IPO premium. Holding the availability of equity capital constant, one potential effect is the crowding out of the IPO market. With limited retail capital chasing an increased supply of listings, PE firms may find it more difficult to exit via IPO, unless institutional involvement increases.

## VI. Recommendations

### A. Relaxing Foreign Ownership Constraints

As discussed earlier, the MENA markets in general, and the GCC bourses in particular, have historically placed significant constraints on foreign investor ownership and participation. This is true even in the narrow GCC context as local investors from neighboring GCC countries also face ownership constraints outside of their home markets. As a result, the impact of foreign investors on the MENA capital markets has to date been fairly marginal.<sup>18</sup>

#### Foreign Investment Ceiling for Listed Stocks in the GCC Markets

Market	Foreign Investment Ceiling
Bahrain	49% in general; 10% for a single entity; some banks & insurance companies are 100% open to foreign ownership; 100% in general for GCC nationals
Kuwait	49% in general
Oman	Up to 70% with some restrictions at company level; restrictions may differ for GCC nationals 25% in general
Qatar	25% in general
Saudi Arabia	25% for GCC nationals, other foreign investors may access market via mutual funds managed by Saudi banks
UAE	49% in general, different restrictions may apply to individual companies; 100% for GCC nationals with company's approval

*Source: Hazem Marashdeh and Min Shrestha, "Stock Market Integration in GCC Countries", International Research Journal of Finance and Economics. S&P Global Stock Markets Factbook, 2008.*

In addition to this lack of meaningful foreign presence, there is also a general absence of institutional participation in the MENA markets. This is due largely to the uneven development of parts of the financial sector as well as the relatively young age of the regional stock exchanges.<sup>18</sup> The arrival of foreign investors, and in particular foreign institutions, can serve to increase market liquidity and help soak up new issues, including PE-backed IPOs.

Well-developed and liquid capital markets provide domestic financing of public and private investments and ultimately drive increased economic growth. At the macro level, liquid capital markets are essential for the efficiency of capital allocation in modern economies and lead to low costs of capital for issuers. Research shows that liquidity is by far the most important decision-making criterion for investors and is regarded as the central quality characteristic in securities markets.<sup>19</sup> By relaxing the constraints on foreign ownership, MENA regulators would help alleviate some of the illiquidity problems that have plagued the region's exchanges for some time now. In fact, evidence from other countries suggests that over time, foreign institutions can play an important role in accelerating the move toward less retail-driven markets.<sup>19</sup>

#### **B. Capital Market Consolidation**

Also discussed above were some of the benefits of regional exchange consolidation. Although a complete integration of trading, settlement, clearing and custody functions will prove both costly and time consuming, a pan-GCC exchange should prove to be a huge catalyst for market liquidity and, in turn, IPO activity. An integration of policies and regulations followed by a complete consolidation of local exchanges will reduce some of the information and transaction costs that regional investors currently face in trying to reconcile the different registration, disclosure, and corporate governance policies of each exchange.

#### **C. Operational Capabilities and Sector Specialization**

As discussed in earlier sections, the PE industry in the MENA region has been dominated by quick-flips based mainly on multiples expansion with little or no change in the portfolio company's business operations. In our discussions with the MENA leading regional PE firms, we found that the majority of firms share the opinion that quick-flips are becoming harder to find. Firms that survived the financial crisis are starting to realize the importance of building in-house operational capabilities that can enhance the portfolio company's bottom line. In our view, focusing on the fundamentals, building specialized operational expertise in select number of sectors, and getting more involved in the management of portfolio companies are necessary factors to continue capturing value from PE investments.

#### **D. Educating Family Business Owners**

Increasing family business awareness of the value of PE is another key step towards creating investment and exit opportunities. By developing a deeper

appreciation of the value that PE funds can add, family businesses will be more willing to acquire portfolio companies or divest non-core assets. As such, PE funds, either individually or as a group, should organize joint workshops and forums to disseminate knowledge of the industry to family businesses. In addition, PE firms should author publications on how portfolio companies can add synergistic value to existing business across various economic sectors.

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