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SME funding: Risk takers move to fill gap left by play-safe lenders

By Simeon Kerr

When Tarig El-Sheikh lost his investment banking job in 2008, he co-founded a bespoke tailoring service making suits and shirts in Dubai, predominantly for US customers. Knot Standard has over the past few years raised $2m, a third of which came from the Middle East and north Africa (Mena) region. “We did a sales process, selling shares in the company,” he says. “In the Mena, there are traditional venture capitalists, investment networks and angel groups banding together.”

Mr Sheikh’s venture is a success story in what is a mixed – and potentially risky – environment for regional entrepreneurs seeking start-up and growth funding.

Some small consultancies, whom he describes as “unscrupulous investors”, are trying to force entrepreneurs to take expensive capital by discounting valuations of emerging businesses, or charging exorbitant advisory fees. “We came across equity loan sharks. With the good comes the bad,” he says. “It’s a little like the Wild West here.”

Investors and entrepreneurs agree that the market for early-stage equity financing for businesses is at its embryonic stage but they are happy to see it maturing.

From technology entrepreneurs in Jordan to wealthy family groups in Saudi Arabia, angel investors and venture-capital funds are backing fledgling businesses that are shunned by banks, while being too small to attract private equity.

Crowd investing is seen as having new potential for seed capital. Eureeca, a Dubai-based online crowd-investing platform, allows small companies to exchange equity for cash from investors, who as part of the three-month money-raising process can interact with the entrepreneurs to ask questions online.

After finding "overwhelming demand" of more than 400 funding proposals during its beta phase, the website was launched this month with two groups seeking investors online. "There is great pent-up demand because of the SME funding debacle," says Christopher Thomas, co-founder of Eureeca, which hopes to list 100 companies seeking equity financing over the next year.

Fadi Ghandour, the founder of Aramex, a regional logistics company, is one of the region's best known early-stage investors. His $20m fund, run alongside his business partner, Arif Naqvi, chief executive of Abraaj, a private equity firm, has invested in 65 companies, mainly technology groups.

Mr Ghandour is raising a $50m-$70m fund for those seeking the $1m-$3m they may need as "follow-on funding".

There is a real gap in the market, argues Salam Saadeh, founder and chief executive of Active M, a venture capital investment and advisory group.

Middle East start-ups usually rely on "friends and family" for their first $500,000. They can struggle to raise the next level of funding.

Governments have an important role to play, says Ms Saadeh. Lessons can be learnt from Jordanian experience in fostering an environment for technology entrepreneurs. Jordan encouraged start-up funding by investing via privately managed funds.

"Jordan has patient money," she says. "Not just investing in buildings, but investing directly to give confidence to the sector." The Jordanian technology ecosystem is the most developed in the Arab world, propelling the sector from 4 per cent of gross domestic product to 30 per cent.

Oasis 500, a state-backed incubator project, has helped drive the entrepreneurial culture and, combined with active investment from government officials and telecoms companies, helped ingrain it.

In the Gulf, where government backing is reserved for nationals, Ms Sadeh says it is at a much earlier stage and the private sector should lead the way in developing expatriate start-ups. “The UAE could play a big role as Dubai is a melting pot of different cultures,” she says.

High-profile entrepreneurial exits boost confidence further, such as the business information provider Zawya’s sale to Thomson Reuters last year and Maktoob’s sale to Yahoo in 2009. This year, expatriate-owned deals website Cobone.com was acquired by an overseas fund.

GrowthGate Capital, which has geared itself towards “middle market” investments of between $50m and $250m, has sold one business and expects to complete two more sales this year. “We also are planning to raise capital, in due time, to capture the real opportunities at hand,” says Karim Saoud, founding partner.

Abraaj, the Middle East’s biggest private equity firm, has homed in on the SME segment since acquiring Aureos, a global private equity group investing in SMEs in Asia, Africa and Latin America.

Abraaj is looking at investments of between $2.5m and $100m, says Ahmed Badreldin, who oversees the company’s Mena investments. “The smaller the company, the more hand-holding one needs to do,” he says. “It is more heavy lifting but for more reward.”