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Private Equity and the MENA Region:
Best Post-acquisition Practices for Growth Capital

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The primary objective of a private equity firm is to increase the value of an investment, with the ultimate aim of realizing this increased value monetarily through a direct sale or listing. However, the best strategy to achieve this can differ significantly from market to market, and depends on a company's stage of development.

In Western, developed markets, public exchanges are deep and liquid, often with a broad spectrum of companies in various stages of development. And while regulatory regimes can vary, most are relatively sophisticated and conducive to private equity investments. Though there are many forms of private equity present in Western markets, the most common strategy was until recently leveraged or management buy-out – in which a firm acquires under-managed, or undervalued, public or private companies, potentially turns them around and uses financial leverage to enhance real returns. The financial crisis has derailed this model, and the Western industry has had to search for an alternative to the debt-centered model of recent years.

According to experts at Wharton and Amwal AlKhaleej, a major Middle East-focused private equity house and the first in Saudi Arabia, the *modus operandi* of the Middle East and North African (MENA) private equity industry is often very different, and partially sheltered from the questions being asked in the international industry, due to the relative newness of the industry there, and the level of development and the needs of the regional corporate world. Leverage plays a smaller role, relatively unsophisticated regional regulatory bodies make delisting difficult, and private sector companies in the region are largely owned and managed by families reluctant to relinquish control. While many private equity firms may profess to target buy-outs, in reality most private equity transactions take the form of growth capital rather than leveraged buyouts (LBOs). According to the Gulf Venture Capital Association, over the past two years only about a quarter of private equity transactions have been control investments, where a fund acquires a 50% or larger stake. As recently as 2006, only 7% of transactions were control investments.

Thus, in the MENA region the role of private equity is to accelerate the expansion of already promising companies, says Stephen Sammut, a senior fellow and private equity lecturer at Wharton. In the West, that role would more likely involve turning around underperformers or incrementally improving the operations of a highly leveraged business. "Family-owned businesses often need a very different sort of help compared to Western, listed companies. The private equity firm might be quite passive operationally (compared to Western practice), but still help family-owned companies grow regionally… advise on supply chains, supply financial expertise, and so on."

This affects the effective fund life, which is on average shorter in the MENA region. "Cleaning up a mess and completing turnarounds can take a lot longer than nudging a promising company in the right direction and accelerating its growth trajectory," says Fadi Arbid, executive vice president and country head of Saudi Arabia at Amwal AlKhaleej.

Experts at Wharton and Amwal say private equity strategies in the region must be tailored to recognize these clear differences when it comes to creating value in investee companies. They identify six key areas where regional firms have a role to play in adding value to portfolio companies: business networks, geographical expansion, professionalizing management, financial expertise, corporate governance and liquidity events. While these are important aspects of adding value in all private equity transactions, in the MENA region these are the pivotal aspects, the experts say.

Business Networks

One of the most important benefits regional private equity firms bring to companies is their extensive business networks, says Raffi Amit, a professor of management and entrepreneurship at Wharton. “A lot of regional private equity firms have got first-class connections with the regional business network, which can be quite tight-knit and difficult to penetrate by outsiders, even if they are from the same region,” he notes.

A link with a leading private equity firm can also have an indirect beneficial effect, Amit points out: “A private equity fund owning a stake in your company immediately adds enormous credibility, and indicates that someone has gone closely over it and found it worthwhile to invest in.”

While business connections are valuable in all markets, and a common culture and language across the region helps, experts say the MENA region’s business world is often centered around powerful, tight-knit and opaque merchant families. “Because it’s a very incestuous business world here, especially at the upper levels, it can help to bring business connections to mid-level companies, who otherwise would struggle to make these connections as outsiders,” says Noha Khattab, senior vice president of Amwal in Egypt. “Most of the mid-level up-and-coming companies aren’t owned by the really large family conglomerates, but strategic and corporate connections, or some sort of joint venture or association to some of these large conglomerates can really help.”

In this, private equity firms are often helped by their limited partners (LPs). In the West, LPs are usually passive high-net worth individuals, pension funds, endowments and other institutional investors, but MENA LPs are often wealthy locals, merchants and family offices – the wealth management arms of the region’s many sprawling family-owned business empires. Rather than taking the passive approach common to investors in the West, MENA LPs are sometimes tapped for their government and corporate connections, and in some cases, for their specific industry acumen. Although not all MENA private equity firms are equally active in capitalizing on their LP network, Amwal considers this a key value addition strategy. LPs can also supply a proprietary deal flow and a potential exit avenue, Wharton faculty and Amwal executives say, and according to a recent survey of emerging markets private equity players by Deloitte, 60% of MENA general partners expect the key source of deals to be proprietary.

A proprietary deal flow, sometimes through LP referrals, is invaluable in the MENA region, given the paucity of corporate information, and the rarity of auction processes and privatizations that are more common in developed markets.

A case in point is Amwal’s investment in Damas, a United Arab Emirates (UAE)-based jewelry and watch retailer. Amwal acquired in early 2005 a 23% stake for US$82.5 million. A key growth strategy for the company was expansion into Saudi Arabia, the largest Arab economy and a vital market for most ambitious Gulf companies. Two of Amwal’s Saudi founding partners and LPs set up a joint venture with Damas in Saudi Arabia. This helped increase net profit from AED92 million in 2004 to AED204 million in 2007, and helped Amwal achieve a gross internal rate of return of over 30% when it successfully exited this investment through an initial public offering (IPO) in July 2008.

“The LP network is a huge advantage in the Middle East… and is one of the main differences from passive investors in the West” notes Arbid. “The value addition in the Middle East doesn’t come from leverage, but from the connections and the additional expertise you can bring,” he adds. “An active and helpful LP network is key to this. We don't call them our investors, but our partners."

However, while an activist LP base can be an asset, it needs to be managed carefully, particularly when it comes to providing a proprietary deal flow through family office divestitures, introductions to promising companies or potential exit avenues, notes Sammut. "Other LPs should be asking if a deal is really at arm's length, and if the price is right. On a case-by-case basis, I'm sure they can get the mechanisms right, but it throws up major questions of conflict of interest." However, Amwal executives and others agree it is critical to strive to avoid conflicts of interest.

Geographic Expansion

As the Damas example shows, geographic expansion is an important factor in achieving growth for portfolio companies. Many companies in the MENA region may have reached a certain size in their home market, but further expansion often requires a leap into new markets – and that leads to new challenges, Sammut points out. "When a company begins to expand outside its home market, a different expertise set comes into play. Contractual relationships, business networks, and supply chain knowledge are all valuable to a company, but many will not have it outside their domestic market."

In the Middle East, the most lucrative potential market is Saudi Arabia. "Many Gulf companies that are based outside of Saudi Arabia aspire for a presence in the large and lucrative Saudi market," says Fawzi Jumean, Amwal's executive vice president and UAE country head.

A Saudi Arabian connection has proven very useful to Dubai Contracting Company (DCC), in which Amwal acquired a 49% stake in 2007. Though the contractor is still working its way through an existing order book in the UAE and Jordan, the DCC is eyeing growth in the Arab world's economic powerhouse. Amwal helped DCC secure a license and local joint venture partners to operate in Saudi Arabia, where strong government spending is helping to fuel a continuation of the construction boom. DCC reports it is now negotiating several lucrative contracts in the Kingdom.

Professionalizing Management

External introductions often are not enough, however. A lot of work may have to be done in training management to be more professional and in bringing in best practices to companies that are often parochially run, says Amit. "Many companies [that private equity firms] acquire might have a lot of potential, but will often not have been run professionally, but by a family. So there is often a lot of value to be added by refining processes, hiring outside professional management, updating technology -- even improving the marketing department."

This can be difficult in a region where the roles of senior management and owners often can overlap, Amwal executives caution. Furthermore, the corporate world is less developed in the MENA region than in the West, and suitable human resources aren't as readily available, says Karim Saada, executive vice president and country head of Egypt at Amwal. "Expertise and leadership skills are very scarce in the region, and you cannot just go to a human resources company and find the executives you need. We can go to global head-hunters for top executives, but it is still very difficult, as you cannot just import them easily and plug them into this fairly peculiar region." Regional and industry experience again become helpful. Amwal, for example, helped identify and recruit a seasoned president for Right Angle, an Amwal portfolio company in Dubai's outdoor media industry.

Rash decisions on letting employees go can also backfire, warns Arbid. "The most difficult thing to replace down here are the managers. There aren't that many skilled and experienced managers in the region ready to be deployed, and if you try to buy out or intervene too closely in a company, you might advertently or inadvertently get rid of some of the longstanding relationships or very specialized knowledge, such as the understanding of the regulatory framework."

Still, private equity firms can supply some of this outside expertise themselves, due to their experience in managing other companies through growth periods, says Bulent Gultekin, professor of finance at Wharton. "They have been through the process many times before and have experience in lifting companies up to the next level. They can bring in managerial expertise, financial acumen, a big picture view and business alliances," he says. "It is difficult to overestimate how much value just an outside view can add to a company."

Amr Sharnouby, the chief executive officer of Amwal Alarabia in Egypt, the textiles investment arm of Arab Cotton Ginning Company in which Amwal controls a 20.6% stake, and is the largest shareholder, says that an "outside view" has been invaluable. "They clearly bring in a different way of managing a company. Businessmen often want more industrial detail, rather than the big picture. An overarching clear strategy has added a lot of value to the company. While we might know our industry inside-out, they can help on many management levels, coming up with conceptual, value-adding strategies."

Often, introducing even simple management techniques and practices common in the West but rare in the MENA region can be helpful and private equity houses can bring that to the table. Says Arbid: "Designing compensation plans, properly incentivizing management, and professional human resources policies may be the norm in many companies in the West, but not always here. Private equity firms strongly assist in that. We can help recruit the right people to the right positions, and put in place stock option or incentives programs, which aren't very common in the Arab world yet."

Financial Expertise

Corporate finance acumen is another important value-adding skill that private equity houses can bring to the table, Wharton professors say. While many Western firms may already have a well-staffed and knowledgeable financial department, many companies in the MENA region are unfamiliar with more sophisticated corporate finance practices common in developed markets.

"One shouldn't underestimate how valuable it is to bring in corporate finance expertise to some companies in the region. Many companies are poorly capitalized, often under-leveraged, poorly structured or streamlined financially," says Jumean. Corporate finance practices such as debt management, and hedging commodity prices and currency exposure, for example, are common in developed markets, but less so in the Middle East.

A common private equity strategy in emerging markets such as the MENA region is to buy a leading company and use it as a vehicle to consolidate a fragmented industry, a roll-up strategy, says Sammut. This is the strategy Amwal chose for its Arab Cotton Ginning Company investment. However, as he notes, "acquiring just one company can be arduous, but doing it with many, even smaller companies, and then integrating them, is challenging." Yet many MENA private equity houses have strong in-house corporate finance expertise acquired by employing former investment bankers, whose experience can prove valuable to companies in acquiring and pricing target companies of the portfolio business, Wharton faculty and Amwal executives point out.

Given the current difficult economic and financial conditions, perhaps the most "profound value-adding service at the moment … is help with [additional] fund-raising" and recapitalization says Amit. International banks are now willing to lend only to highly rated MENA governments and parastatals, and even before the crisis local banks preferred to lend to long-standing corporate clients or prominent family groups. This has cut off access to credit for a lot of mid-level MENA companies, but regional "private equity firms can certainly be good bridgeheads for debt finance deals," says Sammut.

Corporate Governance

Improving corporate governance and transparency of an investee company is a central part of best practice in Middle East private equity deals, according to Wharton faculty and Amwal executives. Accounting, auditing and reporting standards in most Western markets will be far more sophisticated than at most mid-level, family-controlled MENA companies. "Often, the main strategy is to exit onto the public markets, and even if it's a trade sale, the acquirer would probably be looking for well-governed, transparent companies," says Sammut.

Arab Cotton Ginning Company is already listed on the Egyptian stock exchange, and Sharnouby says that one of the first aspects Amwal addressed when it acquired a stake in the company was to improve corporate governance standards and make it more "investor friendly."

MENA stock markets, particularly those in the Gulf, are often dominated by retail investors rather than institutional investors, and corporate governance and transparency are not always as highly valued as in more developed markets. While Saada acknowledges that "corporate governance is a fairly new concept in the Middle East," he says that the slow but steady institutionalization of regional bourses and more attentive regulators make improvements in corporate governance increasingly important. "Many retail investors might not care that much about it, but institutional investors certainly do." Meanwhile, regional regulators and authorities are actively working on educating local investors on capital markets.

Egypt is introducing a Corporate Governance code, for example, that listed companies must comply with, says Khattab -- a significant milestone in a region that has often lagged behind even other emerging markets when it comes to transparency and corporate governance best practice.

Liquidity Events

Liquidity events, the final stage in a private equity investment life cycle, are important drivers of value creation for general partners and company owners in developed and MENA markets, but Amwal executives and Wharton faculty highlight some key differences.

Trade sales are expected to become more common in the MENA region, but IPOs remain "the first exit thesis," says Jumean. While most Western markets have deep and liquid stock markets, and sophisticated regulatory frameworks, the MENA region's capital markets are not only less developed but the regulatory architecture can vary greatly from market to market, too. "As a shareholder, you need to choose the right market to list in. The domestic market isn't always the best one. In some markets you get a better price for certain companies and industries, and sometimes it pays to list in a growth market rather than in a company's home market," says Arbid.

There is a multitude of bourses to choose from in the Middle East, from the Casablanca stock exchange in Morocco to the Muscat Securities Market in Oman. The UAE has three exchanges -- two onshore and the offshore NASDAQ Dubai -- and even Syria has recently established a nascent stock market. Only impoverished and conflict-ridden Yemen has yet to form a formal stock exchange.

But across the region, the regulatory framework is often onerous and mostly skewed towards favoring retail investors rather than companies listing shares. For example, Saudi Arabia's Tadawul, the largest stock market in the MENA region, has a six-month lock-up period for original shareholders, and the Capital Markets Authority (CMA), which must approve all share sales, typically stipulates a price that is about 20%-30% below the price set through a book building process, says Arbid. "The regulator says that retail investors don't have the expertise to judge whether a pricing is correct, and whether he should invest, so the CMA wants to protect the retail investors, who make up the vast majority of the market."

In the UAE, the Emirates Securities and Commodities Authority regulates both the Dubai Financial Market and the Abu Dhabi Stock Exchange, and also has strict requirements. Companies have to list at least 55% of their shares through primary, rather than secondary, issuances, which means that a private equity firm cannot exit its investment upon IPO – although exceptions are made for businesses that are wholly family-owned, which can IPO 30% of their shares. Additionally, original shareholders have a two-year lock-up period. The offshore NASDAQ Dubai is modeled on Western exchanges, and allows secondary share listings and has a six month lockup, but lacks the liquidity of its onshore peers due to the absence of retail investors – who prefer the older, more established bourses.

However, lock-up periods aren't as onerous as they might initially appear, Amwal executives note. Due to the pricing mechanism, most shares rise on listing, and the markets with longer lock-up periods still allow private equity firms to book mark-to-market profits, even though they cannot be immediately realized.

Across the world, private equity firms are reassessing their management strategies in light of the seismic economic and financial shifts of the past year, Wharton faculty say. Leverage, if available at all, will not be available as cheaply as in recent years, preventing firms from augmenting mediocre real returns, and even modest growth plans will in many cases prove harder to implement than before the crisis struck. "The world is changing and we're living through a financial revolution," says Amit. "The debt aspect is a very profound industry change. This completely changes the kind and size of transactions that private equity can do."

Some MENA private equity firms are largely sheltered from these challenges, in part due to the relative immaturity of the regional industry, the differences in the financing and post-acquisition strategies, and the limited use of leverage in the region. Expect best practices in the growth capital deals most common in the MENA region in the foreseeable future to continue to be more oriented around growth potential. These practices include drastically improving corporate governance strategies, tapping into the growth potential across the region – particularly the population centers of Egypt and Saudi Arabia – introducing successful international management strategies and sophisticated corporate finance techniques, and plugging companies into the close-knit regional business elite.

With an estimated $22 billion already held by PE firms throughout the area, watch for growth in PE investments to increase as long-term prospects grow locally and the world economy improves. Also watch for shifting oil prices to sometimes uncover buying opportunities and at other times drive the growth potential of target companies. What's clear, as Wharton professors and Amwal executives have explained above, is that investors who want to participate in the MENA private equity industry should understand the strategy disparities in order create more successful investment plans. •

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