أمــوال الخلـيـج
Amwal AlKhaleej
www.amwalalkhaleej.com

Private Equity in the MENA Region:
Is the Growth Model the Right Model?

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Private Equity in the MENA Region – is the Growth Model the Right Model?

Enthusiasm for the potential of private equity (PE) within the Middle East has historically been stronger than the deal flow. The number of funds based in the Middle East and North Africa (MENA) and mandated to invest regionally has risen. But many have struggled to deploy their capital.

However, as bank lending to companies requiring capital becomes increasingly conservative, PE firms say more companies are knocking on their doors looking for an investment partner. Thanks to the growth in the number of PE funds during the oil-fired, economic boom prior to the global downturn, and the inflow of international financial and legal specialists in the field, PE is no longer a novel idea in the region. Using their proprietary investor networks, some regional PE firms say they are hearing of more local opportunities, which can be found across sectors.

PE firms globally are now scaling down the size of their investments in the absence of once abundant credit, points out Wharton professor of management Raphael Amit. But local firms have consistently shown a preference for minority, including large minority, stakes in growth capital deals, even before tight credit markets. In 2008, 75% of investments made in the region were for stakes of less than 50%, according to the Gulf Venture Capital Association. The figure was the same for 2007, and in 2006, only 7% of the number of investments consisted of majority stakes. Some regional firms' strategy has consistently diverged from international players in that they have consciously opted for smaller stakes in expanding companies and have avoided leveraged buy-outs (LBOs).

Amit notes that minority stakes are not exceptional to the region. According to Emerging Markets Private Equity Association (EMEA) data, the growth and expansion of capital investments make up the bulk of emerging market PE investments. However, within MENA, minority-growth investments have been far more common than LBOs due to the structure of regional economies, the infancy of the private sector, nascent capital market regulatory frameworks, and the prevalence of family businesses, say industry participants. The funds that did undertake LBOs benefited from the availability of cheap debt, which in some cases simply subsidized expensive pricing. That era is now over.

Buying in, Not Buying out

"PE in the region is a growth capital model – a model of buying in rather than buying out," says Fadi Arbid, executive vice president and country head of Saudi Arabia at Amwal Alkhaleej, a major Middle East-focused private equity house that is the first in Saudi Arabia. "This is much more suitable for the region at this stage of market maturity. LBOs will come later when all value creation levers such as top line growth, margin improvements and operational efficiency are exhausted." Riyadh-based Amwal has offices in Dubai and Cairo, and invests across MENA.

The prospect of LBOs is curtailed by the structure of local economies, which dictates that PE is still focused on taking private companies public, rather than delisting any of the small number of public entities. The largest companies often remain government owned in the MENA region. Merger and acquisition activity to consolidate smaller, private enterprises is championed, but scarce. "Companies are state owned or family held. It is not possible to acquire control of these companies and it's not feasible to acquire control of companies on [regional] stock exchanges," says Wharton associate professor of finance Bulent Gultekin.

Legally, LBOs do not lend themselves to MENA's emerging markets. Stock exchanges are immature, and regulations governing structures typically found in LBO transactions, such as preferred shares, are entirely absent, as are takeover regimes and squeeze-out clauses, say lawyers. There are also caps on foreign ownership of floated shares in certain capital markets.

Substantial leverage is still a novelty in a region where most enterprises operate in heavily cash-orientated economies. Complex debt structuring is rare and was only made available when international investment banks well used to buy-out lending opened shop in the region. What is more, sharia-compliant businesses and Islamic investors are only permitted to use debt restrictively, point out PE players. Until the high profile troubles of Saudi Arabia's Saad Group and Ahmad Hamad Al-Ghosaibi & Brothers, few highly distressed companies had surfaced in the region.

An Economy with Promise

Regardless of the downturn, MENA is still underpinned by strong economic fundamentals, regional general partners (GPs) insist.

Arbid stresses that the pace of economic growth varies across the region, but Amwal identifies most opportunities in Saudi Arabia and Egypt. Crucially, both countries enjoy strong levels of population growth, government reform, oil surpluses (for Saudi Arabia) and established and growing private sector businesses, Arbid points out.

The Egyptian Investment Ministry has reduced its GDP growth targets but still expects Egyptian GDP growth to be in the 3.5%-4% range for fiscal year 2009-2010. Riyadh-based Jadwa Investment expects Saudi Arabia's economic recovery to begin in the fourth quarter of 2009, driven by government spending, and leading to real GDP growth of around 4% in 2010.

Amwal is sector agnostic, but Arbid identifies retail, leisure, education and health care as rich in opportunities. In Saudi Arabia, for example, Amwal's portfolio includes a 52.5% stake in Rowad Schools; a 20% stake in Gulf Insulation Group, a regional manufacturer of insulation materials; a 12% stake in Zohoor Al-Reef, the cosmetics retailer; and a 60% stake in Sports Club Company, the largest gym chain in Riyadh. In Egypt it holds various percentage stakes in an auto finance company, a textile firm, real estate assets and a polypropylene complex.

According to Amwal executive vice president Mazen Al-Jubeir, "If you can find a company in a growth market with proven capabilities, the investor can benefit from the growth of the market and the support of existing shareholders without the complexity and risk of a full buyout. A full-scale takeover model often over complicates and sometimes undermines what should be a straightforward investment case."

With last year's oil price of $150 per barrel, liquidity trickled across the region from Saudi Arabia to Morocco. While the oil price has dropped, it remains above $50 a barrel and governments, thanks to their large capital reserves, should be able to weather even an extended bout of low oil prices with little difficulty. Oil is still going to be a source of wealth, Gultekin points out. "The rise of PE companies is explained by companies looking to take advantage of the potential of the region. Most companies are in the growth stage and PE brings capital and management to owners. It is not well-established companies being sold, but early stage investments where PE can grow [a business] and eventually make a profit," Gultekin says. The success of PE firms hinges on the supply of companies and the availability of finance, he adds.

Family Ownership, a Key Driver

The prevalence of minority stake investments is explained by a key feature of the MENA enterprise landscape. The vast majority of Middle East private businesses lie in the hands of family owners. In the Gulf, according to Booz & Company, families represent the second largest group of shareholders after governments; family businesses contribute to about 40% of non-oil GDP and about 50% of private sector employees work for a family business.

Owners, although they might be seeking help from PE investors, remain extremely reluctant to sell out entirely or cede control. PE investors take minority stakes because frequently, it is only these size stakes on offer, they say.

"For family businesses, it would be surprising if they turned over majority control to outsiders, particularly if [these outsiders] are US, French or Swiss funds. It's comparable to the number of private firms in the US that won't go public," says Wharton professor of business and public policy Howard Pack.

Owners also form the core management team, and management is where the value of family run companies reside, GPs point out. Owner-managers come with contacts, relationships and intimate knowledge of the business, and are not easily interchangeable. A buyout is often not advantageous to PE investors, who maintain that the continued presence of the main shareholder is intrinsic to the success of the investment. PE firms see the owner-managers' vested interest in the business diminishing commensurate with their size of shareholding.

Growth capital, minority stake investments are an investment in management, industry experts agree. Both Gultekin and Arbid characterize a minority stake investment as a partnership. "You are buying into a successful person, not replacing them or overhauling their business," says Arbid. "You buy in at the stage the owner knows there should be some change. They want a third party referee to do some cleanup. The owner has been running the firm from one pocket to the other and wants liquidity."

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Bet on the Jockey – or the Horse?

Arbid uses a jockey and horse analogy to outline Amwal's approach, in which the jockey is the manager and the horse is the company. He says that some PE firms have bet on the horse on the basis of the macroeconomic environment, while others have focused on both the horse and equally importantly, the jockey, to push the company to success. Amwal in this metaphor is the trainer, guiding both to accelerate growth and get the horse to the finish line quicker, Arbid says.

Amwal's preference is to go into a company where the leading shareholder has built it up, knows the company inside out and is still passionate about it, Al-Jubeir says. "Our focus is on investing in established, profitable, proven companies which are seeking additional capital to grow or where one of the significant shareholders needs liquidity. But the business is fundamentally healthy, well managed and growing," he says.

A year ago, Amwal took a 20% stake in Gulf Insulation Group (GIG), a holding company of stakes held by family business Amnest group in pre-insulated pipe and rockwool factories in Saudi Arabia, Jordan and the United Arab Emirates. The new group already has significant market share in Saudi Arabia and ambitious growth plans to set up in Qatar and Egypt. Taking on a PE investor was a strategic decision, says GIG chief executive officer Suleiman Al-Hedaithy. "Amwal opened our eyes to new ventures in similar industries," he says. "They have introduced us to other investors and we think more globally. When you have an investor, it helps you build up relationships."

Amwal typically pursues minority stakes in portfolio businesses of 20% to 49%. A 20% stake is large enough to justify investor expectation that their voice will be heard through representation on the board, board committees or executive committees, Al-Jubeir says. It is also big enough that they would obtain rights to influence significant decisions related to matters such as budgets and capital expenditures, he says.

Arbid stresses that Amwal obtains strict contractual commitments from the other shareholders to protect its minority rights. The division of ownership and control can vary. In some deals, Amwal has taken majority ownership but exerted only the level of control that it normally does in minority-control arrangements. That gives investors more comfort, and Amwal calls such cases "circumstantial majorities." In one instance, Amwal purchased a majority stake from a company owned by three brothers — two of whom had been passive investors – and kept the active member of the family in the key management position. In another case Amwal bought a car leasing and finance company in Egypt from a commercial bank and retained the company's management team while continuing to work with the bank that sold the business.

Conservative Banks Mean More Openings for PE

That PE investors can offer target companies a route to fresh capital is more crucial now, when lenders are becoming more selective, GPs say. "Sellers dealing with a healthy business can be discriminating regarding capital, but banks in the region are conservative, and companies can run into a ceiling regarding borrowing. Some companies have to go down the equity route; for those that choose to [do so], selling some equity brings the prospect of value enhancement," Al-Jubeir says.

From a PE investor's standpoint, taking a minority stake has positive implications for price. MENA family business owners are notoriously ambitious about their asset values. But lawyers point out that buying a minority stake is a relatively cheap way for a PE firm to buy into the lifecycle of an expanding company. "In the case of a minority stake sale, price or valuation is less important [to the owner] than value," says Arbid. "The owner is looking for maximum price if he's selling out a majority or the entire business. When you are offering to grow a company, the price doesn't matter so much, the value you bring in to his company matters much more."

However, Gultekin cautions that the influx of financial talent back home to the region, and the repatriation of funds post 9/11, has created intense competition for PE deals and the risk of under-analyzing and overpaying.

Beyond capital, a PE investor can assist in institutionalizing management practices and corporate discipline, which are generally weak across the region. Pack points out that the lack of transparency related to even the disclosure of critical performance measures poses a deterrent to potential investors.

PE investors can also help prepare a company for a future public listing, which industry experts and lawyers agree can take a lot of work and an attitude shift on behalf of MENA owners. "When we go into the investment, we make clear that this is what are looking for, that this is our exit route and what the implications for the company are," Al-Jubeir says. "This is a business they have built and are not in a hurry to sell. When we sell, they have to be prepared to run a public company. Listing is a transformative moment when governance changes again. That's one of the legacies of our investment," Al-Jubeir said.

GIG is preparing for an initial public offering (IPO) next year, Suleiman says. "This is part of the deal. We are doing our homework. We've made changes on the operational side. When [Amwal] came in, we looked to streamline our operations and we organized our companies much better. We are starting to think more strategically and more formally, and to change management. Family owned businesses can't operate the same way if they want to IPO," he says. Among changes to its business processes, GIG has introduced new board committees, group-level financing, internal audit systems and a new IT system.

Local PE investors say the presence of a PE fund can boost a company's international credibility, which can help it attract international managerial talent. And a PE firm with exposure to other portfolio companies across geographies can offer a local company access to new markets and the benefits of their experience there, they say.

Companies feeling the heat of stiffer competition from sector rivals are most keen to take on a PE investor, say PE experts. These companies are looking for help to execute balance sheet restructuring, cost cutting, better pricing, and to consolidate their market position through acquisition, GPs say. In some cases, PE investors also offer a solution to family shareholders seeking to exit their stake.

"We look for investment partners to help them with their skills in a few particular areas, including thinking through their capital structure and financing. That's quick value-add. In strategic areas, [PE investment] brings an investor who has experience across more industry sectors and markets to a company that has focused on a specific market or geography for a long time," Al-Jubeir said.

Risks for PE Investors

However, minority investments carry inherent risks for PE firms. Under such a growth capital model, where the balance of shares is held by the founders, the minority investor is inevitably exposed to risks associated with control and dependency on the family, PE experts agree. That is why the structure of the transaction is radically different to an LBO.

In other jurisdictions, investors might protect their stake by taking shares with liquidity preferences or enhanced voting rights, says Amit. These functions do not apply in MENA, where investors rely on the terms of the investment memorandum, he says. "If the target needs money and when money is tight, the company becomes flexible [about terms]. When cash is available and you have multiple investors, the target can play one against the other. But there's less competition for transactions now," he notes.

Key to a solid arrangement are the following, PE experts say: agreement on transparency, access to information, board/committee seats, adherence to an established consensus decision-making format, the use of vetoes and agreed exit routes. Business decisions are enshrined in legal documentation, which can mean that negotiation of the term sheet, the purchase and sale agreement, and the shareholder agreement is a prolonged process.

These agreements can include such protections as a put option in favor of the PE investor if the majority owner reneges on a key commitment, such as exit strategy, notes Arbid. But he cautions that put options are not enforceable in all jurisdictions, so investors must rely on a "reputational deterrent" that can become equally important in coaxing an owner to honor his commitments.

Issues will arise if the seller and investor have different expectations, most crucially over investor participation, concedes Al-Jubeir. Such miscommunication must be eliminated from the beginning, he says. "If the seller is motivated and wants to grow his business and wants to bring in a partner who respects that, and they want to add value, they know they have to give up a degree of control and decision making that now involves other parties. If the seller has a clear picture of why they are doing it and what they will get out of it, the transaction is straight forward. If you are upfront and have frank discussions around expectations of corporate governance, then any divergence [between owner and investor] is clear pretty quickly," Al-Jubeir says.

Giving each shareholder a voice is critical to mitigate the potential for disagreements, he says. "You have to be careful to draft agreements in a way that every investor's voice is heard. You draft a legal document that you hope will never be used; but the process allows everyone to get into the details and flush out how decisions will be made," Al-Jubeir says.

The Personal Relationship Factor

But more important than the legal documents supporting investor rights is the PE firm's relationship with the other shareholders, PE experts stress. Here local LPs are useful in giving insights on the reputation and credibility of the owners of potential targets.

"Most important is who you invest with," Al-Jubeir says. PE investors need to know who the shareholders are going to be. Typically, the lead shareholder will still be around after the investment, so the investor has to be confident that this is the person you can work with to maximize value. "You have to be confident of their management competence, reputation and integrity. And there's a strong element of personal chemistry," Al-Jubeir notes, adding that If the relationship between shareholders is healthy, formal rights are put aside in favor of consultation.

In turn, Gultekin points out that the reputation of the PE firm is also key. "There is only so much you can do with legal structures. Trust and reputation are important elements. It's a big region but there are a limited number of players, and the flow of information is efficient. This gives local PE firms an edge," he says.

Brakes on the growth of PE investment in the region remain. Despite the additional credibility and capital that some companies recognize that they gain from PE investor confidence in their business, other owners remain embarrassed by the implication they need external assistance and cash. Some prefer to lean on family members and other established sources for funds. Others lack the entrepreneurial drive to sell. And still others are in such dire need of organizational restructuring and improved corporate governance that they fail to meet funds' investment criteria.

However, one expected limitation on PE investment — that of foreign ownership — does not seem to apply. PE investors agree that a transaction can be structured around foreign ownership caps, which vary between MENA markets. Furthermore, if a typical minority stake is taken in a private company, the common 49% foreign-ownership ceiling is not touched.

For now, growth capital investments involving smaller stakes appear to be the optimal path within the regional PE landscape. However, this will likely change as the region matures, requiring local PE firms to adjust their value proposition, skill set, and offering to the portfolio companies. This all occurs against a backdrop in which a new strength in local economies will likely continue to drive investor interest in the region, which is now projected to grow faster than most others, while remaining insulated against periods of low oil prices.

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