Special Report

Private Equity in the Middle East: Gathering Strength as New Opportunities Unfold

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Two major upheavals have rocked the Middle East and North Africa (MENA) region in recent years. The global financial crisis of 2009 slowed the rapid economic growth that the region had been enjoying, while the turmoil that has swept from Tunisia to Bahrain — the so-called Arab Spring — has shaken the political landscape. In this four-part special report, experts at Wharton and Amwal AlKhaleej, a leading Middle East-focused private equity firm, and other analysts, explore the outlook for private equity across MENA in light of these developments. While the financial crisis slowed the expansion of private equity deals, the improving economy will open up fresh opportunities for investment over the long term, particularly for firms with close ties to the region. In the short run, however, while the political situation remains uncertain, investors will likely favor more liquid assets.

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The Middle East and North Africa: A Region Gathering Strength

The Middle East and North Africa (MENA) region is generally rebounding from the surprisingly sharp tailspin that rocked the oil-rich area during the global 2009 recession. Boosted by rising oil prices, improving capital markets and gradual growth in lending, governments across the region are pursuing aggressive spending plans and actively courting international investments to spur job creation.

These gains point the way to a continued economic comeback for many MENA countries, yet some wounds have been slow to heal. The overall region has been experiencing a "two-speed recovery," says Fadi Arbid, chief executive officer of Amwal AlKhaleej, a leading Middle East-focused private equity and alternative investment firm and the first to be headquartered in Saudi Arabia. "On one hand, the real economy is growing nicely," says Arbid. "Oil prices are at a comfortable level for most Gulf governments, and public sector spending is booming. On the other hand, the capital markets and investor confidence are still struggling, albeit slowly regaining strength. We still haven't fully recovered. Investors are still very nervous and rattled. Overall, people are more optimistic now than they were a year ago, and we're finally seeing some investment flows, but nowhere near what we should be seeing, given the strong economic fundamentals."

At the same time, the economic impact of the political turmoil that has swept across the region from Libya to Bahrain remains highly uncertain. "I don't think it is possible to think through the future of the economies" in the wake of the turmoil, says Howard Pack, professor of business and public policy at Wharton. "One still has no idea if the political system [in Egypt and elsewhere] will be authoritarian, democratic, or something in between, and the range of economic policies they will follow may not be predictable from the political system. Think of Eastern Europe after 1989 — lots of things took a decade or more to settle down, and some still haven't."

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In this article, experts from Wharton, Amwal AlKhaleej and other regional analysts assess the outlook for the area and to what extent it was vulnerable to the global financial crisis.

Only Some Shelter from the Storm

The region initially looked sheltered from the credit crunch that enveloped the developed world in mid-2007. MENA countries appeared to be inoculated against the crisis by soaring oil prices, heavy government spending, domestic economic reforms and financial systems that were for the most part relatively disconnected from the global economy.

But the financial storm that pounded the world after Lehman Brothers imploded in September 2008 dispelled any hope that the hydrocarbon-rich MENA region would prove fully immune. "People probably underestimated the challenges coming out of this crisis," says N. Bulent Gultekin, professor of finance at Wharton and a former central bank governor of Turkey. "This has been a worldwide recession, and it's not easy to recover from something like that. But the Middle East region is essentially still okay. The oil producing countries still have a constant source of income, and the other [Middle East] countries have still been less affected than many others."

However, the recession damage was heavy. Oil prices plunged below the budgeted break-even points of most hydrocarbon exporters, and non-performing loans started to proliferate in certain countries in the region, weakening the outlook for the banking sector and causing lending to freeze. Equity markets, particularly those in more "internationalized" countries such as Egypt and the United Arab Emirates (UAE), fell significantly farther than counterparts in emerging and developed markets. The Saudi market also fell as sharply as those in Egypt and the UAE.

Despite their abundant hydrocarbon wealth, the Arab Gulf states — which along with Egypt remain the main economic drivers of the MENA region — were among the poorer performers in the immediate aftermath of the global financial crisis. The six main Gulf countries — Saudi Arabia, Bahrain, United Arab Emirates, Oman, Qatar and Kuwait — known collectively as the Gulf Cooperation Council (GCC), a loose regional bloc, saw economic growth slow from 7% in 2008 to just 0.4% in 2009, according to the International Monetary Fund (IMF). As recently as October 2008, when the global financial system was engulfed in post-Lehman panic, the IMF had forecast that the Gulf's economy would expand a brisk 6.6 % in 2009.

The MENA region as a whole suffered a similar setback. The IMF reports that real Gross Domestic Product (GDP) growth for the region fell from 5.0% in 2008 to 2.0% in 2009, compared with an average annual growth rate of nearly 6% between 2003 and 2007.

The psychological impact of the unexpectedly painful downturn has perhaps been even more pronounced than the headlined economic growth figures indicate, Wharton and Amwal AlKhaleej experts say. "Initially many thought the region would be isolated, secluded and sheltered from the financial crisis, so it was a big shock to many when it became apparent that we weren't," says Arbid.

Growth Picks Up Again

Now trends that battered the region during the downturn are reversing themselves. A resurgent Asia and worries over the region's political stability helped the price of oil recover to more than US$100 a barrel by February 2011, bolstering government budgets in the Gulf in particular. The price of benchmark Brent crude spiked above US$120 in April. Stock markets continue to recover but still face jitters over the political turmoil, while bank loans are becoming more available.

The long-term picture still is bright. The region's population remains exceptionally young, which could lead to a significant "demographic dividend" in the form of a rapidly growing and highly productive labor force if enough private sector jobs are created. And foreign investor confidence in the region picked up following a marked dip in foreign direct investments over the past two years. More generally, the latest GDP projections by the International Monetary Fund (IMF) released in April 2011 show annual economic growth rising from 3.8% in 2010 to 4.1% in 2012. While the recent wave of unrest will depress investments this year, the level is expected to resume rising once the political outlook becomes clearer.

Here is a look at key countries in the region:

Saudi Arabia Shows the Way

Saudi Arabia has led the way. It is the largest Arab economy — and, with some 28 million residents it has the largest population in the GCC (80% of which is indigenous). It is also the world's largest oil exporter. The government started to implement a five-year US$400 billion investment program in 2010, bringing public spending to a historic high of 39% of GDP, according to research by Barclays Capital. This boosted economic growth from a meager 0.6% in 2009 to 3.4% in 2010, according to the IMF. More recently, Saudi Arabia has announced an extra US$130 billion of spending to ward off any hints of unrest.

Saudi banks have largely shrugged off the financial crisis after having been shaken by the default of two major family-owned conglomerates and a rise in non-performing loans. Lending remains cautious but is recovering faster than in many other parts of the region and is buttressing economic growth

The country's Tadawul bourse is one of the better performing stock markets in the Middle East and has added almost a third to its total market capitalization over the past two years. The growing wealth has helped make Saudi consumers more confident about the future than are many of their neighbors.

Government programs further fuel this confidence. "The government is spending a lot of money on health care, housing, and education, — not the least of which are the expenditures announced by the King in March 2011— and we can see the emergence of a nascent middle class in Saudi Arabia, which creates a lot of opportunities," says Arbid. "Both health care and education are winning sectors in addition to many sectors that are consumer based."

Runaway Growth in Qatar

Next door to the east of Saudi Arabia, the small peninsula of Qatar (population of about a million) is benefiting from a long-standing investment drive in its liquefied natural gas industry and related infrastructure. This helped Qatar's economy grow at an estimated breakneck pace of 16% in 2010, up from 8.6% in 2009, according to the IMF. The country is now the wealthiest in the world per capita, and the government plans to continue to invest billions of dollars in domestic and international developments and assets. In particular, hosting the football World Cup in 2022 could mean between US$50 billion and US$100 billion of investments in infrastructure over the next decade, and will underpin economic growth for years to come. Any concerns over its domestic banks were swiftly obviated by a series of large government capital injections.

The UAE Strives to Restore Trust

The UAE, which borders Saudi Arabia and Qatar, was arguably the country hit hardest by the crisis, largely due to a severe property crash and debt restructurings in the commercial hub of Dubai. Abu Dhabi, the UAE capital, has kept spending on many of its ambitious economic diversification projects — incurring a projected US$57.5 billion budget deficit over the 2009-2010 period, according to government estimates—but many developments have slowed down.

While Dubai has managed to restructure the debts of Dubai World, a major state-owned conglomerate, several other government-linked entities are struggling to repay their loans and bonds, and talks with creditors are ongoing. Wharton and Amwal AlKhaleej experts say the government's handling of the debt restructuring has become more sure-footed — after some initial miscues regarding the emirate's debt crisis — but the reputational damage and the economic fall-out will take time to resolve.

"Trust takes years to build up, but can be quickly destroyed," says Raphael (Raffi) Amit, a Wharton professor of management and entrepreneurship. "The downturn has revealed a lot of problems in the Middle East, and the credibility of companies and institutions has been questioned across the region. The wounds are still open, which is apparent from the lack of investment flows into the region."

The lack of transparency in the UAE is a concern, and the reluctance of local banks to lend because of the overleverage in the system is hindering the prospects of a swift recovery, says Samer Sarraf, senior vice president at Amwal AlKhaleej. "Some progress has been made, but there is still a lot of uncertainty and volatility,' Sarraf says. "Banks have cut a lot of credit lines, which has caused a local credit crunch. There is still a lot of real estate supply coming onto an already oversupplied market which is holding back the recovery. Dubai is still going to be on a downwards trend for a couple of years, before it has got rid of all its excesses and can start a modest recovery." The recent events in Bahrain may accelerate this recovery with a new flow of population and capital finding its way to the UAE.

Still, Amwal and Wharton experts say that the positive long-term UAE story remains intact. The country's financial system remains one of the largest in the MENA region. Sectors such as trade, logistics, and tourism have held up relatively well and are on a full path to recovery, and Abu Dhabi's drive to diversify its economy into more value-added sectors such as petrochemicals, aluminum and other manufacturing industries makes good business sense. Key infrastructure projects such as nuclear power plants and a UAE-wide national railway system appear to be going ahead.

After falling by a negative 3.2% in 2009, real GDP growth in the UAE recovered to a positive 3.2% in 2010, according to the IMF, which in April 2011 projected growth for the year at 3.3%, rising to 3.8% in 2012. "Overall, the economic fundamentals of the UAE are still solid, once we've purged out all the excesses. Abu Dhabi still has plenty of oil reserves, and Dubai will remain the region's dominant business hub," says Sarraf.

Kuwait Plays Catch Up

Kuwait, near the northern tip of the Gulf, has long lagged its neighbors in developing and diversifying its statist economy, due to a political standoff between the country's fractious parliament and its royal family-dominated government. But Kuwait finally appears to be implementing an ambitious but long-delayed government investment program.

Thawing relations between the legislative and executive powers of Kuwait have allowed the passing of two key bills in the past year: a US$107 billion five-year development plan and a controversial privatization law, which could lead to more private-sector involvement in Kuwait's infamously state-dominated and bureaucratic economy. Kuwait's economy contracted 4.8 % in 2009, mostly due to the lower price of oil, which remains its dominant industry, but expanded an estimated 2.3 % in 2010 and is projected to grow 4.4 % in 2011, according to the IMF.

Egypt's Financial Clout

Egypt, whose Sinai Peninsula links North Africa and Asia, is the third-largest economy in the region after Saudi Arabia and the UAE, and the most populous Arab state. It enjoys a financial sector that is generally healthier than its Gulf counterparts. "The [financial] crisis has hurt everyone, but Egypt has suffered a lot less than most other countries," says Karim Saada, executive vice president and Egypt country head at Amwal AlKhaleej. "The banks are very conservative, the foreign exposure is minimal, and the average leverage ratios of Egyptian companies and individuals are very low—largely because interest rates are so high, so without subsidies and incentives it is very hard to take on a lot of debt."

While Egypt may have weathered the financial crisis better than most of its neighbors, the unprecedented wave of protests that toppled former President Hosni Mubarak in February brought the economy shuddering to a halt. The full financial and economic impact of Egypt's revolution remains difficult to gauge, but it is likely to be severe. The country's political future is uncertain and protests and strikes have continued. Foreign companies, which had poured billions of dollars into Egypt, have largely shelved investment plans until the outlook becomes clearer.

However, economists stress that Egypt's economic advantages — a large and youthful population, educated middle class, skilled labor and strategic location —will ensure that its long-term economic prospects remain relatively undimmed. They could even be enhanced if a democratic, transparent government free of the former regime's graft emerges.

Mixed Outlook for Full Recovery

The overall picture of the region thus remains mixed. Saudi Arabia is likely to experience one of the region's most robust recoveries, thanks to its large population, comprehensive reform program, and soaring oil revenue. Moreover, the ability of the region's governments to address traditional challenges — including underdeveloped regulatory architecture, poor corporate governance, perceived weak and arbitrary legal systems, and a dearth of highly skilled and educated workers — could translate into significant economic gains and potentially lucrative investment opportunities.

But across the region key challenges such as still-weak lending growth and political uncertainty remain. “It took three years for the U.S. to recover from the IT bubble bursting in 2000, and that’s in the U.S., where there’s a strong regulatory and institutional framework,” Wharton’s Amit says. “In most of the Middle East the regulations that control capital markets are weak, and that hinders investment. I think it will take at least two years for the region to [fully] recover from the crisis, notwithstanding any geopolitical developments, such as heightened tensions with Iran, which will really concern investors.”

Overcoming Barriers to Successful Private Equity Investments

Private equity investments are inherently complex. The issues related to sourcing, implementing, managing and exiting these investments are compounded in emerging economies, where capital markets are often shallow and underdeveloped, regulatory and legal frameworks can be patchy or haphazardly enforced, and company owners are often reluctant to sell. These aspects are even more pronounced in the frontier markets — those with less liquidity, and lower market capitalizations than more developed emerging economies — that characterize most of the Middle East and North Africa (MENA) region.

Nonetheless, private equity became an increasingly popular subset of the asset class in emerging and frontier markets over the past few years. The Emerging Market Private Equity Association estimates that the U.S. dollar amount raised by funds that specialized in developing markets rose from $6.6 billion in 2001 to $66.5 billion in 2008. That boosted the funds' share of all money raised for private equity investments from about 4% in 2001 to about 14% in 2008. MENA-focused funds alone raised almost $16 billion from 2005 to 2010.

> "Everyone is excited about the potential of the Middle East."
>
> –Chadi Hourani, partner, Hourani & Associates

For those interested in the region's private equity potential, it is essential to recognize the unique challenges that private equity firms face in the MENA region and to know how to cope with them. This article combines insights from Wharton and Amwal AlKhaleej, a leading Middle East-focused private equity and alternative investment firm and the first to be headquartered in Saudi Arabia, and from other industry experts about these barriers and the ways to navigate them.

"Everyone is excited about the potential of the Middle East," says Chadi Hourani, partner at Hourani & Associates, a regional law firm that has worked closely with Amwal AlKhaleej. Yet "there are so many interplaying factors in the Middle East that can complicate investments: family politics, government politics, economics and regulations. The key is knowing how to overcome them."

Find a Willing Seller

First of all, finding viable investments is often far trickier in the MENA region than in more developed markets. Apart from large, state-owned enterprises — which are only rarely privatized in the Gulf, usually through the initial public offering of a minority stake to nationals — the vast majority of companies in the MENA region are family-owned. These are predominantly wealthy, well-established merchant dynasties that are often reluctant to sell even minority stakes to private equity firms.

"You need to find a company owner that is willing to sell, which can prove difficult in some parts of the world where sentiment can come into play," says Stephen M. Sammut, a senior fellow and lecturer on entrepreneurship at Wharton. “Being predatory is normal and accepted in developed markets, but not so much in regions like the Middle East.”

The global financial crisis was widely expected to trigger a rash of distressed sales, but they have largely failed to materialize. “On one hand, after such a crisis you would have expected more distressed sales, but we haven’t really seen any,” says Bassam Yammine, co-chief executive of Credit Suisse Middle East. “Many family groups were affected in the wake of the crisis, but banks in the region normally enable them to hold on while they regroup.”

The region’s lack of transparency and generally weak corporate governance are further obstacles to finding deals. “You have a layer of companies that look like great investments, but they are just so haphazardly run, audited and structured that a private equity firm won’t touch them,” Hourani says. “There are actually very few that are of a quality that a private equity firm could contemplate an investment [in]. A lot of companies need more house cleaning than a private equity firm is willing to do, which limits the number of companies that are viable investments.”

Listed companies, which are at least somewhat transparent, are also difficult investment avenues. Apart from Egypt, which enjoys a regulatory architecture similar to that of the western world, there is little regulatory support for prospective buyers. This makes hostile takeover bids of listed companies almost impossible. Saudi Arabia has introduced some helpful regulations, but they remain untested. The rest of the Gulf lacks squeeze-out provisions that would allow buyers who take a substantial stake to gain control of a company.

Virtually all private equity firms thus set their sights on privately held companies. “There are no squeeze-out provisions, and it’s virtually impossible to take a company private in the strict western definition,” says Fadi Arbid, chief executive officer of Amwal AlKhaleej. “You can take sizeable ownership in public markets and try to take control, but even that can be complicated as each of your moves will be overly scrutinized by the regulator. You will need to create value while working around these hurdles, but this is a tedious task.”

MENA countries also typically have stringent foreign ownership limits. While Egypt has no such restrictions and has benefited from the resulting foreign direct investment windfall, many countries in the region cap the foreign ownership stake at 49% in most sectors. This is more of a challenge for international private equity firms, since most regional firms are locally incorporated and are not prevented from taking larger stakes. Nevertheless, minority investments are the rule across the region for both international and local firms.

Tailor-made Agreements

Once a potential investment has been found, private equity firms must structure the investment carefully. Private equity firms often seek additional safety through customized investment agreements, says Samer Sarraf, senior vice president at Amwal AlKhaleej, since the legal environment in many of the MENA countries remains underdeveloped. “In private companies, it can actually be easier to protect your shareholder rights through tailored legal agreements that deal with almost all eventualities,” notes Sarraf.

Yet even carefully worded documentation is no guarantee if the relationship between a minority and majority shareholder ruptures. For example, many firms insert put options as mechanisms to ensure exits if a listing or trade sale proves difficult. Such options give the firms the right to sell acquired securities at a specified price. But enforcement can be challenging in some Gulf jurisdictions, where courts are often unfamiliar with complex financial and legal structures and can be more inspired by sharia — or Islamic law — than by western commercial codes. “Time will tell if these structures are acceptable and durable,” says Hourani.

Remaining Hurdles

Many MENA countries have in recent years overhauled their bureaucracies, commercial laws and regulations to make themselves more business-friendly. While this has earned them relatively high positions in the World Bank’s ease of doing business rankings, the region nonetheless remains a difficult environment in which to operate.

This is particularly true in Saudi Arabia, the largest MENA economy. The government has tasked the Saudi Arabian General Investment Authority to encourage foreign businesses to set up in the kingdom, and has helped make Saudi Arabia the world's 11th easiest country to do business in, according to the World Bank's 2011 "Doing Business" report. However, experts say the reality is often very different. "There is still a lot of red tape," says Amwal's Arbid. "For example, in theory it is supposed to take just a few days to set up a new company with foreign ownership, but in practice it does take much longer than one would like."

The Value of a "Godfather"

Yet, well-connected local private equity firms are often well-placed to surmount such obstacles. "Private equity is a very social and local industry, particularly in emerging markets like the Middle East," says N. Bulent Gultekin, a professor of finance at Wharton and a former central bank governor of Turkey. "You really have to be a local firm" with a team of locals on the ground "and be socially integrated into the corporate fabric of the country." Most local private equity firms have influential board members and MENA limited partners that are usually well-connected merchant families. These partners are often far more active than investors in western markets, and frequently lend a hand in sourcing deals, advising on investments and even on exits. "Having a 'godfather' – a professional, respectable family — on the board or involved in some way, always helps to open doors," agrees Arbid. "A lot of companies we look at don't necessarily need money, but connections — people who can make introductions and open doors and markets."

Many PE investee companies need support at the management level as well. However, the ability to recruit capable and effective management is complicated by two factors, according to executives at Amwal. First, since most of these companies are family owned, ownership and management are often intertwined, which makes introducing a new management team to take over from the family owner a sensitive topic. Second, and this is particularly true in Saudi Arabia, managerial talent is scarce in the region, therefore making the identification of a new management team with sector expertise, local knowledge, a proven track record and the right skill set a major challenge for PE firms.

Bumpy Exits

Finally, exits are often not as smooth as in developed markets. The MENA region has a plethora of stock markets — the United Arab Emirates (UAE) alone has three bourses. But initial public offerings, the primary exit strategy, can be difficult for private-equity players. "Retail investors dominate the market, and protecting them is the paramount guiding principle of the regulators, which it should be," says Arbid. "But that means the capital markets aren't always as conducive to private equity as we'd like."

IPO exits are particularly complicated in the UAE, according to Sarraf: "Nasdaq Dubai [the emirate's international exchange] is fine, but the liquidity is low, and on the Abu Dhabi Stock Exchange and the Dubai Financial Market the flotation rules aren't conducive to private equity," Sarraf says. "Only primary listings are allowed, so you can't exit via a secondary listing, and there is a two-year lock-up period for existing shareholders" before they can sell or redeem their shares."

Moreover, he adds, "IPOs are priced at par, rather than through a book-building process" that takes bids to determine the price of an offer before it goes on sale. "This means that investors can't cash out immediately, can't get the price they want, and companies that list have bloated, inefficient cash piles on their balance sheet while the lock-up period is in effect. Reforms of the capital markets regulations are needed, but have been slow."

Pledges of Reform

Countries across the MENA region have pledged to reform their capital-market regulations and there have been some positive developments. Saudi Arabia's Capital Markets Authority has revamped its listing rules, which now include an element of book building, though pricing is often set low by the regulator to protect retail investors. Kuwait has recently established its first ever Capital Markets Authority, and Oman has recently seen its first book-building IPO, for Nawras, the country's second-largest telecommunications company. Yet overall regulatory reform has been slow and piecemeal in the region, and staffing and enforcement of existing rules can be patchy. "All the regulators are pretty young, and have not been able to keep up with developments or don't have the resources or expertise to do so," says Hourani.

One clear exception is Egypt. Although Egypt's economy and stock market have been rattled by the revolution that ousted former president Hosni Mubarak in February, the country's regulatory architecture remains one of the most developed in the MENA region. Egypt's stock market is arguably the best-regulated in the region, and the newly formed Financial Supervisory Authority (FSA) has set out to tighten regulation of listed companies and financial intermediaries even further.

Publicized reforms include tighter regulation of insider trading and financial disclosure, with penalties ranging from hefty fines and imprisonment to suspension from doing business. In 2009, some of Egypt's largest financial intermediaries were suspended for up to a month at a time.

Reversals of trades have also become common practice. This has caused investors to sustain heavy losses over and above penalties levied for insider trading. The FSA is also tackling reporting requirements, and Egypt has started implementing — albeit gradually — a corporate governance code.

Beefing up regulations and corporate governance should be a priority for the region, say experts at Wharton. "Improving the regulatory frameworks would help investor confidence. It can and should be done as soon as possible," says Raphael (Raffi) Amit, a Wharton professor of management and entrepreneurship. "One of the region's main weaknesses is the laxer regulations and corporate governance. Tightening up those aspects would help a lot."

Investor Activity Picks Up...But...

Local private equity firms can do little about the broader macroeconomic picture in the MENA region, which has been more challenging than expected. The recent surge of political turmoil across much of the Arab world has also wrong-footed many investors and could dampen economic growth as companies shelve investments.

However, expansive government spending has buttressed growth rates in many countries and the region's economy is still expanding at a faster rate than developed markets. This has enabled the profits of listed companies in the region to start to recover from the depths of the trough in 2008 to 2009. Companies representing about 90% of the Gulf's overall stock market capitalization reported profits of $43.1 billion in 2010, for example, a 25% gain over the year-ago period, according to research by Markaz, a Kuwaiti investment house. What is more, signs now point to growing investor activity in the region. Trade sales in which private equity firms sell their stake to other companies are picking up, and demand for IPOs, which had been dormant during the financial crisis, appears to be recovering gradually. "I expect to see more and more trade sales and initial public offerings over the next few years as conditions improve," says Credit Suisse's Yammine. "We are also going to see more cross-border synergy-driven acquisitions."

Nevertheless, Amwal executives caution that the investment landscape has been changing over time. For example, factors which prior to 2008 enticed investors to focus on private equity, such as the remarkable growth of regional capital markets, have, in the aftermath of the financial crisis, given way to new realities. These include the following: a large pool of capital chasing limited number of deals; limited exit avenues; a fading of the presumed entry/exit multiple arbitrage; and, more recently, the political instability that has engulfed the region, and which is leading investors to favor more liquid asset classes over private equity until the region's political and economic outlook improve.

Targets of Opportunity: The Region's Top Investment Sectors

In a region that stretches from Morocco to Kuwait and covers terrain from mountains to desert, the range of economic activity in the Middle East and North Africa (MENA) is as varied as the geography. The rich diversity of economies provides numerous sectors primed for private equity (PE) investment. "In terms of sectors, each country has its own sweet spot," says Fadi Arbid, chief executive officer of Amwal AlKhaleej, a leading Middle East-focused private equity and alternative investment firm and the first to be headquartered in Saudi Arabia.

> "Most funds are opportunistic. They look at a deal to see if it makes sense and then proceed."
>
> –Bassam Yammine, managing director and co-chief executive officer, Credit Suisse

Investors are now scrutinizing each sector in the wake of the global economic downturn that swept through the region in 2009, and the Arab political unrest that erupted in 2011. Funds are focused on markets where economic growth is driven by solid fundamentals and sectors that are resistant to the fluctuations in the global economic cycle. "The sectors are defensive and less speculative," notes N. Bulent Gultekin, professor of finance at Wharton and a former central bank governor of Turkey. "There are the same shifts in the U.S. as well."

Targeted MENA sectors include health care, education and consumer-related businesses that offer growth or turnaround potential. Funds polled by Deloitte's MENA Private Equity Confidence Survey 2010 cited the following as the most likely to see deals over the next 12 months:

- pharmaceuticals, biotech and health care (17% of respondents chose this)
- power, oil and gas and mining (13%)
- infrastructure and education (tied at 12%).

The choices are wide throughout the region. The United Arab Emirates (UAE) offers offshore oil and gas opportunities, for example. Qatar and Kuwait have seen PE investment in real estate. Algeria's key sectors are oil, gas and housing, while tourism-related businesses such as hotels, spas and transportation are attractive in Morocco. Lebanon and Jordan host opportunities in banking, pharmaceuticals, medical laboratories and technology-related business. Iraq has the potential for infrastructure investment.

Still Sector Agnostic

With so much to choose from, at least theoretically, many funds view themselves as "sector agnostic" and scan the investment horizon for the most promising values. "We are opportunity driven," says Amwal senior vice president Hani Halawani. "We are sensitive to value expectations, which is why we don't pursue a lot of the opportunities that we see." However, he notes, most of the opportunities that Amwal identifies come from sectors such as education and health care that the firm is actively monitoring.

"We have not seen so much of a sector focus so far," says Bassam Yammine, managing director and co-chief executive officer of Credit Suisse in the Middle East. "Most funds are opportunistic. They look at a deal to see if it makes sense and then proceed." Firms tend to be more country-focused, Yammine says.

But investors throughout the region may increase their focus on individual sectors as industries consolidate, he adds. Such a sector-oriented approach could also help firms identify opportunities that lie beyond industries that are already congested with investors.

However, Amwal's executives tend to disagree with an outlook that favors specialization for PE funds today. Given the current business environment of deal scarcity and capital abundance, many of the general partners that launched specialized or sector-focused funds six years ago have reversed direction and broaden their mandate to become more opportunistic. Very few, if any, industries in the region warrant a specialized fund. "Funds have struggled to be asset-class specific — private equity or otherwise — let alone to be sector- or geography-dedicated," says Halawani.

Government-dominated industries are another factor that investors must contend with. This is particularly true for major infrastructure projects such as road and transport schemes that largely exclude private partners. "The need is big [for infrastructure projects] and the funding needs are significant. Infrastructure could be an area where PE could invest substantially," says Yammine. "But that requires a consortium, which you don't see much of in the region.

Private equity deals appear most attractive in countries where growth is viewed as assured, most notably in Saudi Arabia and Egypt, the region's first and third largest economies. Both countries have diverse economies, domestic industrial bases, government spending programs and large and growing populations that include an expanding middle class. "Although limited, most PE transactions that have closed during the past 12 months or so have been in either Saudi or Egypt," says Chadi Hourani, partner at Hourani & Associates, a regional law firm that has worked closely with Amwal AlKhaleej. "What PE needs is volume and mass, and those two economies provide that."

As a reflection of the potential seen in these markets, Egypt and Saudi Arabia are home to the likes of Amwal, The Carlyle Group and Axis. "First funds do a deal [in a market] and then they open an office to do more deals," says Maged Ezzeldeen, a partner at PricewaterhouseCoopers in Cairo. "The investment community is small, and they tend to follow the big players and look at the same sectors."

Here is a look at key investment sectors in Egypt and Saudi Arabia.

Saudi Arabia

The Saudis boast the region's strongest economy and Amwal is the leading Saudi-based fund. "Following the collapse of the global and regional markets, investors have realized that not only does Saudi Arabia exist, but it is the only legitimate and self-sufficient economy in the region," says Hourani. "Its current local population has basic education, infrastructure and health care needs. It's not about building for tomorrow, it's about today. It's not about building housing and cities to lure people in the future. Those houses are desperately needed to satisfy today's demands. It is the same with education, health care and infrastructure." And even if the economy takes a downturn, he notes, the population still needs roads, housing, schools and desalination plants.

Saudi Arabia has also proven relatively insulated from the surge of political discontent that has swept the Arab world. Moreover, Riyadh plans to spend US$130 billion on housing, infrastructure and other projects over the next few years to ward off unrest and further boost the economy.

Investors have taken notice. "There's been a surge of interest in Saudi during the past 12-18 months," says Hourani, "significantly more so than during the regional boom" that preceded the 2009 recession. "Businesses are now in the process of shifting the excess capacity left from the golden days in the region — based in the UAE and to a lesser extent other GCC [Gulf Cooperation Council] countries — to the kingdom."

Saudi Arabia's need for more economic development provides targets of opportunity. "In Saudi, for example, high quality health care services are hard to come by," notes Hourani. "For a population that is nearing 30 million people, there's the possibility to develop this and other sectors en masse across the country. The country is still quite underdeveloped relative to the neighboring economies, and that is what is so enticing."

Also topping the investment list are post-high school and adult education, English language teaching and information technology. In addition, opportunities exist in construction-related industries such as building materials and cement, and in industries where growth is driven by rising consumer spending such as the retail, food and beverage, and leisure and entertainment sectors.

In the consumer space, Amwal has a minority stake in cosmetics retailer Zohour Al-Reef (a local version of the Body Shop store), which in 2010 opened its 100th store in the region, up from 56 stores in 2007, the year of Amwal's investment. Amwal also has a majority stake in a local chain of gyms under the Body Masters brand name, which is now among the largest gym chain in Saudi and has opened locations in other cities in Saudi Arabia since Amwal's investment in 2008.

Amwal's significant minority stake in Gulf Insulation Group is an example of an investment in construction-related business. And realizing the tremendous opportunities in education, Amwal acquired a controlling stake in Rowad Schools, one of the leading K-12 schools in the Saudi capital, and then used the company as a platform to conduct add-on acquisitions. Between the acquisition in 2008 and 2010, the number of students grew from about 5,400 to over 13,000.

The kingdom displays a mixed attitude toward foreign investment. It is one of the most open in the Gulf, on the one hand, allowing up to 100% foreign ownership in sectors that include information technology, contracting and real estate development. And the Saudi Arabian Investment Authority continues to shorten the list of sectors from which foreigners are excluded.

On the other hand, the key growth markets of health care, education and some wholesale and retail segments are restricted to Saudi and GCC investors, which the kingdom and other GCC markets view as local players. Foreign investors — unlike local partners — are also subject to a 20% corporate income tax on profits.

Policies are similarly mixed with regard to the kingdom's crucial energy sector. Investment in oil and gas services and downstream industries like refining is permitted, but oil and gas exploration and production remain strictly off-limits to all private investors. "From a national perspective, there are strategic interests that governments are more comfortable controlling, and Saudi Arabia is perhaps the most guarded," says Stephen M. Sammut, a senior fellow and private equity lecturer at Wharton. He compares the situation to China, where the growth of the private sector also is relatively new. In China, however, there is "a huge landscape of state-owned enterprises (SOEs), or those that existed originally as SOEs, which have been taken 100% private or spun off."

Egypt

Egypt, the most populous Arab country, has been rattled by the widespread unrest that toppled former president Hosni Mubarak in February. But the Egyptian economy remains highly diversified, and the breadth of opportunities available to investors is far wider than in Saudi Arabia. Attractive Egyptian sectors include food and natural gas production, packaging, real estate, housing and telecommunications. Also beckoning investors are textiles, petrochemicals and other related downstream industries. "It's anything that works on the basis of mass," says Ezzeldeen. "Anything related to the population is a good investment, and that has proven to be the case even in the bad times."

Foreign ownership laws are significantly less restrictive in Egypt than in Saudi Arabia. Foreigners can own 100% stakes in the banking and insurance sectors, brokerages and asset managers and manufacturing companies. There are no restrictions on management or repatriation of profits. Off-limit sectors include aviation, commercial importing and commercial agencies that help foreigners penetrate the Egyptian market. "Egypt has been opening up to foreign investors for the past 20 years," says Mohammed Ghannam, partner at Helmy, Hamza & Partners in Cairo.

Whatever government finally emerges in Egypt will likely continue to encourage outside investment, given the country's reliance on that source of capital rather than oil receipts, which fund Saudi Arabia's huge projects.

Egypt has revised its tax regime in its effort to court investors. New provisions include an exemption from the capital gains tax when companies are listed and sold on exchanges which should grab the attention of PE firms considering an exit. Ghannam expects initial public offerings to come back into favor as partners seek higher valuations.

The low cost of skilled labor and energy remains a key attraction for new investors. A case in point is Amwal's investment in Arab Cotton Ginning. Working through Amwal Al Arabia, one of its subsidiaries, Amwal is in talks with European textiles manufacturers who seek to relocate their facilities to Egypt to take advantage of Egypt's abundant cotton, low energy costs and cheap yet skilled labor. These factors contrast with the rising labor and energy costs in Europe that are leading to the extinction of the European textiles industry. Amwal also has an investment in Cairo-based Egyptian Polypropylene Company, which benefits from a readily available feedstock (natural gas) and a production complex in Port Said at the doorstep to Europe, all leading to a low-cost competitive end product.

Also inviting is Egypt's fertile land, which makes agriculture a major contributor to the country's economy. Agriculture accounted for 13.6% of Egypt's GDP in 2009, according to *The Economist*, while manufacturing accounted for 16.2%.

Meanwhile, the upheaval that ousted former president Hosni Mubarak in February could ultimately benefit investors, says Wharton's Gultekin. Egypt "is not going to change that much economically," he says. While most investors "may sit tight and see what's happening, those who take a longer view should be able to do well." This is particularly true for local companies "that may be able to assess the risk much better than outsiders. Like everywhere else, changes provide opportunities."

Overall, PE firms are starting to take an operational as well as a financial approach to investments in the region. The Deloitte MENA Private Equity Confidence Survey 2010 found that respondents were evenly split at 47% each between those who expected to become more operationally involved and those who did not, with 6% unsure. This may reflect the preponderance of minority stake investments, in which PE funds mainly provide financial support. But should more PE money flows into the region's varied sectors, targeted industries may increasingly turn to the firms for operational help as well.

All in the Family: The Key to Investment Is Dealing with Family Owners

Business is largely a family affair throughout the Middle East and North Africa (MENA) region. Operating successfully in this environment requires private equity (PE) firms to master the art of making family owners comfortable with selling a stake in their enterprises and working with new partners.

"This is how you get the deals," says Fadi Arbid, CEO of Amwal AlKhaleej, a leading Middle East-focused private equity and alternative investment firm and the first to be headquartered in Saudi Arabia. "The families come directly to the fund or its local LPs (limited partners) rather than through an investment bank." It also is common for limited partners to come forward with proposed transactions, he says.

> "In the Middle East, PE derives from Middle East sources."
>
> –Stephen M. Sammut, senior fellow and lecturer on entrepreneurship, Wharton Entrepreneurial Programs

Making deals is far easier for locally based firms with established contacts and limited partners who are known and respected by attractive deal prospects. Deals are often proprietary — made directly between firms and companies without intermediaries — and based on knowledge and contacts within the market, says Hani Ashkar, partner at PricewaterhouseCoopers in Riyadh, the Saudi Arabian capital. "If you are not based in the kingdom, it is difficult to get early sight on deals."

This reliance on family and personal ties is typical of emerging markets in contrast to more developed ones. "In Europe and the U.S., most deals are intermediated by investment banks," says Stephen M. Sammut, a senior fellow and lecturer on entrepreneurship at Wharton Entrepreneurial Programs. "In many emerging markets, however, there is still proprietary deal flow, and funds are fewer in number and particular to a country," he says. "In the Middle East, PE derives from Middle East sources." That stands in contrast with some other emerging markets. In India, for example, most PE investments are sourced from outside the region.

Structuring the Deal

The diamonds in the rough that PE firms hunt for are family businesses that have yet to reach their full potential and are looking for help to unlock value. A typical PE play in Saudi Arabia might be to find a family business that wants to expand and provide it with the capital, financial expertise and cross-border contacts to do so.

Well-connected firms can approach deals from several directions. Another strategy is to find a family conglomerate and sell off an underperforming business and work with the owner to extract value from the remaining assets. Still another way is to pick out three or four companies and bolt them together to create economies of scale or perform a value chain integration, whether vertical or horizontal.

PE firms can bring expertise to even the most well-established companies, says Amwal senior vice president Hani Halawani. Firms can tap into their international networks and introduce acquired companies to new markets and prospective acquisitions of their own, for example. That was the case when Amwal used its local knowledge and business network to help Damas, its United Arab Emirates (UAE)-based jewelry company, expand into the Saudi market.

Amwal was set up in Riyadh in 2004 by a group of regional investors who have helped the firm build its pipeline in the initial stages. Amwal now has offices in Dubai and Cairo and has positioned itself as an experienced regional alternative assets investor with an indigenous team and a proven track record.

The home-grown Middle East PE industry is still young, having emerged only in the last 10 years and the vast majority of funds were established in just the last five years. More generally, the Middle East saw less than 2% of emerging-market PE investments in 2001, according to a survey by Booz & Co. and INSEAD. By 2008, the Middle East share of such investments had jumped to 10%.

That rapid growth slowed sharply during the 2009 global recession. Middle East PE funds raised just US$1.1 billion in 2009, marking an 80% drop from the US$5.4 billion that had flowed into funds in 2008. But despite the recent rounds of turmoil in the Arab world, the region could now be poised for a comeback for alternative investments including PE as investors see growth in emerging markets. "If you put aside the volatility, the trend is in favor of emerging markets and is not likely to reverse abruptly," says Wharton's Sammut.

Deals Remain Scarce

Deals themselves remain scarce, however. "The region doesn't suffer from lack of capital," notes N. Bulent Gultekin, a professor of finance at Wharton and a former central bank governor of Turkey. "It is a structural issue that companies are not usually for sale."

This is true despite the fact that bank lending virtually dried up during the recession, forcing family-owned companies to look elsewhere for funds. But instead of taking in partners, the companies turned to friends and family to meet short-term cash needs.

The lack of bank financing has thus failed to produce a slew of PE investment opportunities. In 2009, "there were few deals and very few distressed deals if any," says Amwal CEO Arbid. "The market thought that after the crisis we would see a lot of turn-around transactions, but we haven't seen it. Businesses need finance but valuations are not what they [the business owners] want them to be," he adds. "It's not the case that family businesses are keener now to talk to a PE investor. If, as a fund, you want to take a controlling stake, you need to overpay."

Indeed, the gap between seller and buyer price expectations that widened at the outset of the recession persists. Business owners have been slow to adjust to new market realities and PE firms remain wary of a further dip in asset values. "The biggest issue has been the disconnect in valuations," says Bassam Yammine, managing director and co-chief executive officer of Credit Suisse in the Middle East. "Sellers need to be realistic and realize that the valuations achieved at the peak of the market will not come back anytime soon," he says. "It's also surprising that you don't see more distressed [sales]. Most businesses are family-owned and there is sentimental value. It is going to take a few PE successes to change their minds."

Families with succession issues could give PE firms a friendlier welcome. This appears increasingly likely as a wave of generational changeovers gets under way in the region, making family businesses more open to help from investors.

To get a foot in the door, funds have typically had to acquiesce to an owner-manager's unwillingness to give up control. Nearly three quarters of all PE deals in the region in 2008 were for stakes of 49% or less, according to the Gulf Venture Capital Association (GVCA).

Keeping the business founder on board with his networks and industry knowledge can bring substantial benefits, especially in markets that are powered by contacts and reputation, and that have a shortage of managerial talent. Family participation continues to be needed after the entry of the PE firm, "since in many cases management and ownership are intertwined," says Amwal's Halawani.

This marks another contrast between emerging markets like the Middle East and more developed economies. "It remains the preference of many of these families [in emerging countries] to maintain total control," says Wharton's Sammut. "Generally, we don't see the same in the West. By now, you would have thought that there would be a trend [among families] to be more comfortable selling their positions, but that doesn't seem to have happened."

However, a minority stake is not necessarily a passive position, says Arbid, who notes that funds can still be deeply involved in creating value. Among other things, they can identify new markets, optimize the company's capital structure, advise on mergers and acquisitions and act as a conduit to bring in state-of-the-art management talent.

Tale of Two Markets

Egypt and Saudi Arabia, the two markets with the most investment potential, take different approaches to dealing with PE investors — and Egypt is seen as the far easier place to do business. PE funds and advisers generally agree that taking a small and passive minority stake can be particularly risky in Saudi Arabia, and the downside can outweigh the advantages. The days of acquiring modest positions, riding rising asset prices and flipping the investment to generate impressive returns are clearly over. Investors point out that Saudi Arabian corporate law remains under development and offers little protection for minority stakeholders. "If you only have a minority stake, then the extent of the change you can instigate is limited," says Ashkar of PricewaterhouseCoopers.

This makes choosing a good local partner crucial. PE firms conduct careful reputational checks and legal due diligence prior to buying a stake in a Saudi company, and often insist on representation on the boards and executive and audit committees of their portfolio companies. In addition, a firm with its own sources of business intelligence can provide comfort to limited partners that may be jittery about the investment environment.

PE firms are now starting to adopt new strategies for Saudi investments. "The traditional model of minority interest hasn't allowed investors to drive up value in their portfolio companies," says Ashkar. "The recent trend over the past 18 months is for a majority stake," he notes, "or at least the ability to have the final say on the key strategic and operational decisions." Yet garnering a majority interest is easier said than done. Evidence still shows very few, if any, majority PE deals reaching completion, according to Amwal experts. Even the Carlyle Group, which typically specializes in majority buy-outs, had to adjust to the region's preferences and closed a minority deal in Saudi Arabia after the financial crisis in 2010.

Egypt's corporate legal environment is based on English law and is seen as more predictable than Saudi Arabia's. "In Egypt, there is a long history of legal interpretation and the courts are more developed," says Amwal's Halawani. "A legal document is much more enforceable." It's also easier to make larger investments in Egypt, he says, and target companies are more educated about the benefits of taking on a PE investor.

Credit is also easier to obtain in Egypt since its banks are among the most familiar in the region with PE deals and have a history of financing them. By contrast, "non-recourse acquisition financing is almost impossible in Saudi unless there is a large sponsor," says Halawani, referring to loans that are repaid from the cash flow of a project. In Egypt, "leverage is not impossible. Banks know how to do it and there are more exotic transactions. You see PE deals in Egypt include LBOs [leveraged buyouts], takeovers, management buyouts, minority investments and private placements. And that's a feature of a more mature PE market."

Leveraged financing has been far less prevalent in the region as a whole than in the United States and Europe. "As a consequence, the [global financial] downturn has had a much more profound impact in the United States" than in the Middle East, says Wharton's Sammut, because the nature of the deals is different. "In the Gulf, local money has been an important source of capital and will continue to be so."

Investors that have used debt to finance PE deals have usually been international funds that have borrowed from outside the region. While local financing was easier before the global credit crunch, banks with liquidity have begun to participate in more PE transactions, says Yammine of Credit Suisse, and several mezzanine funds are starting up in the region. Mezzanine financing, a hybrid of equity and debt, gives lenders the right to an ownership stake if the debt is not repaid on time.

This Way to the Exit

Few PE firms have cashed out of Middle East investments to date, since deals are still relatively young in the region. Of the 218 investments made by regional PE funds since 2004, only 14 had reached exit — defined broadly to include selling shares to other companies — by 2009, according to GVCA. The financial crisis has halted any significant divestments since then.

The lack of exits is also tied to the fact that there have been relatively few PE deals in the region to begin with because of the length of time it can take to consummate a transaction. Buyers and sellers may take 12 to 18 months to work out details that include negotiating the price, completing due diligence and complying with any conditions, says Ashkar. "Investors walk away from a lot of deals," he says. "It takes a long time and that limits the number of investments a year."

For example, "Saudi Arabia is quite new in PE and there simply have not been that many completed PE deals in the kingdom," notes Ashkar. "So in terms of exits, there has only been a small handful. They tend to be trade sales [to other companies] or sales to other PE funds, with a small number of IPO exits being prepared."

Many firms also acquired their stakes at the peak of the market and are reluctant to sell at current prices. "It's not so profitable to divest," says Credit Suisse's Yammine. "There have been a couple of strategic sales and more players will try to consolidate. The PE preference these days will be to do a trade sale rather than an IPO."

In surveying investment and exit strategies across the region, Amwal's Halawani says the difficulty of operating in Saudi Arabia, the single largest market, actually provides a compelling reason to do business in that country. "The number of alternative investment firms there is small and the number of opportunities is great," says Halawani, pointing out advantages. "It is an under-exploited market and there is still room for alternative investment players especially those who do not restrict themselves to a specific asset class or a single model. There is government spending in a number of sectors, which is generating employment and opportunities, and the kingdom is reforming rapidly," he adds. "The landscape is starting from a low level of development and offers many investment opportunities. It's rich soil and there is a lot of money that wants to be deployed."

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Special Report

Private Equity in the Middle East: Gathering Strength as New Opportunities Unfold

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