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PRIVATE EQUITY FUND INVESTING IN THE MIDDLE EAST AND NORTH AFRICA

2009

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ABSTRACT

1. Like other emerging private equity markets, the Middle East and North Africa (MENA) region[1] offers prospective investors some promising opportunities in some of the world's fastest growing countries. However, this is an immature private equity market, suitable only for international investors with an appetite for risk and the resources required to come to grips with the region's unique business environment, or for local investors whose inherent local knowledge forms a strong basis for the due diligence process.

2. Although not immune from the global economic downturn, the region is likely to grow by 2.5% in 2009 (versus 6.0% in 2008, according to IMF estimates from April 2009, the latest available). Longer-term growth will be propelled by a relatively young and booming population that requires extensive expansion of basic services like health care and education while also fueling demand for consumer goods.

3. The main intraregional distinction is between the energy-centric economies of the GCC and the poorer, but more diversified, economies of North Africa and the Levant. The global downturn has affected all three. A rebound in oil prices should enable the GCC to achieve higher growth rates, albeit less than those of recent years, and GCC countries are likely to postpone parts of the US$1.5 trillion budgeted for current and future infrastructure investments. Relatively low deficit thresholds based on oil prices around US$50/bbl, partially budgeted infrastructure expenditures, a record account surplus estimated at US$3 trillion, and fundamentally unmet demands for better public goods and services will support ongoing economic growth. One exception is Dubai, which does not have oil revenues but does have an overall debt to GDP ratio over 100% and is experiencing a real estate bust.

4. With over 10,000 privately held mid-size companies, the region is characterized by a high level of private corporate ownership. The landscape of local firms is fragmented in most sectors and along with a weak initial public offering market and a drop in public market valuations, this creates some attractive private equity investment opportunities. Legal, regulatory, and capital market reforms have facilitated the establishment and growth of private equity firms, and if the GCC countries succeed in creating a single-currency zone in the next few years that would further reduce costs and barriers to regional business development in all areas. However, foreign investors should also realize that politics and business are often closely intertwined in this region, where personal or familial relationships are so important, and develop local ties accordingly.

5. Private equity activity in the region has grown from a standing start over the past five years. According to the Emerging Markets Private Equity Association (EMPEA), "total capital raised for the region has more than tripled since 2005, with over $19 billion in cumulative funds raised [through May 2009]." Despite substantial domestic investment by local sovereign wealth funds, EMPEA anticipates that regional governments will continue to welcome foreign private equity investors to help realize their

[1] This region being defined as the Gulf Cooperation Council, also known as GCC (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates), the Levant (Jordan, Lebanon, Palestinian Territories), and North Africa (Algeria, Egypt, Libya, Morocco, Tunisia).

ambitious growth plans. Consequently, we have seen the launch of a few dozen MENA-focused funds, including newly founded local independent firms, captive bank-based funds, and larger and more experienced entrants from other markets. Most firms are regional, focusing on a group of related countries, and most engage in growth/minority investing due to the fact that few private companies offer majority stakes or full buyouts. As a result, buyouts in the region to date have been, for the most part, either public firms taken private or government privatizations. Private equity investment professionals are mainly nationals of the region who have been educated at western universities, typically with some work experience in western markets and/or local operations of western financial organizations.

6. Local fund-raising activity tripled in 2008, with 62 funds raising approximately US$16 billion. Fund sizes range from US$50 million to US$4 billion. Early capital came mainly from local investors; however, the proportion of capital from non-regional investors of all types is steadily increasing.

7. Competition for private equity deals is still relatively light compared to that in western private equity markets, and is likely to remain so as long as deal flow continues to outstrip manager capacity. The majority of investments to date have been in the GCC countries—home to the majority of private equity managers—and in Egypt. Investments are spread across basic materials, consumer goods and services, financial services, health care, oil & gas, transportation, and other sectors.

8. While a few high-profile exits in the past three years have delivered good returns, most investments are still relatively new and unrealized, therefore very few firms have as yet developed significant track records in comparison to those operating in more mature private equity markets.

9. Selecting the most promising local managers requires an understanding and appreciation of regional attributes. While such understanding is essential, our research shows that the leading independent MENA private equity managers are increasingly adopting the best practices of managers in mature private equity markets and consequently the small number of institutional-quality funds is growing. One distinctive MENA attribute is that business and social relationships are typically intertwined. Business in the region is inherently local and usually insulated from foreign competition. Strong local private equity managers can therefore derive competitive advantage from their local networks. On the other hand, foreign investors without local ties have thus far had limited success finding and competing for the best deals.

10. Managers that pursue defensible growth opportunities with an ability to control and support portfolio companies operationally and strategically, and that demonstrate pricing discipline, will likely emerge as strong regional players. Managers fund raising now are likely to benefit from attractive entry valuations, increasing opportunities to attract and retain international management talent, and the possibility to create value via organic growth and accretive pan-regional acquisitions.

SUMMARY

Introduction

The Middle East and North Africa (MENA) region is moving quickly to establish itself as an attractive segment of the global private equity market. Like other emerging private equity markets, the MENA region offers prospective investors some promising opportunities in some of the world's fastest growing countries. However, this is an immature private equity market, suitable only for international investors with an appetite for risk and the resources required to come to grips with the region's unique business environment, or for local investors whose inherent local knowledge forms a strong basis for the due diligence process. For those investors that are able to identify MENA funds well placed to ride the rising economic tide and able to exploit the compelling opportunities unveiled by market reforms, we see a clear opportunity to generate strong returns from one of the world's growth regions by accessing the best firms early in their development. This paper provides an overview of the MENA region, the macroeconomic and business landscape, and the landscape for private equity investing.

Defining the Region

For the purposes of this paper, the MENA region is defined as including the states of the Gulf Cooperation Council (GCC), which are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (UAE); the countries of the Levant, which are Jordan, Lebanon, and the Palestinian Territories; and the countries of North Africa, which are Algeria, Egypt, Libya, Morocco, and Tunisia.

However, the Emerging Markets Private Equity Association also includes Afghanistan, Iran, Iraq, Pakistan, Sudan, Syria, and Yemen, while some other definitions also include Djibouti, Israel, Malta, and/or Turkey.

Neighboring countries in the MENA region have common links based on history, language, religion, geography, and free-trade agreements, but operate their own legal and financial systems, and typically have differing social and cultural practices.

Gulf Cooperation Council (GCC)

Home to 40% of global oil reserves and 23% of global gas reserves, the economies of the GCC (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, UAE) are hydrocarbon based. The cost of extraction is cheaper here than in the other oil-rich parts of the world because the reserves are closer to the surface. In 2007, the combined GDP of these six countries was $804 billion, and the population 36.5 million (GDP per capita of about $22,000). In 2008, the combined GDP of the GCC countries was $1.1 trillion (GDP per capita of about $29,100).

North Africa

Libya and Algeria have hydrocarbon-driven economies, while those of Tunisia and Morocco are based on services and limited manufacturing. Egypt's economy spans hydrocarbon, services, agriculture, and manufacturing. The countries of North Africa have close ties to the GCC and to Europe, given their geography. In 2007, these five countries had a combined GDP of $446 billion, and a population of 155 million (GDP per capita of about $2,900), compared to a combined GDP in 2008 of $549 billion (GDP per capita of about $3,500).

The Levant

Although they have small economies, Jordan's and Lebanon's locations and ties with neighboring countries make the Levant a gateway to neighboring Iraq, whose oil reserves could make it an important economic power. These economies do not have oil revenues and rely mostly on services and tourism. The combined GDP of Jordan and Lebanon in 2007 was $42 billion, and their population 9.5 million (GDP per capita of about $4,400). In 2008 these two countries had a combined GDP of $49 billion (GDP per capita of about $5,100).

Macroeconomic and Business Landscape

The MENA region is characterized by a number of high-growth economies and generally young populations. Thanks to high oil revenues the countries of the GCC have generally larger GDPs and higher GDPs per capita than neighboring countries. The GDPs of countries in North Africa and the Levant generally show greater industrial diversity; manufacturing plays a large role there. The population of the greater MENA region is 85% as large as that of the European Union (EU) and 40% bigger than that of the United States (because the greater MENA region includes Iran and Turkey).

Gross Domestic Product

MENA economies vary widely in size, composition, and growth rates. Locations of oil reserves and population do not coincide, resulting in the wide disparities seen across the region (Exhibit 1). The GCC's greater wealth and significant oil reserves make these countries the primary growth engine of the MENA region. Consequently, the GCC's private equity funds dominate the larger region, aided also by GCC reserve fundamentals and generally higher levels of education and economic liberalization.

To diversify their economies, many GCC governments have funded development with a combination of local and foreign capital, both debt and equity. An overview of the GCC GDP breakdown is provided in Exhibit 2. GCC governments have also invested in foreign non-oil assets, predominantly via sovereign wealth fund (SWF) vehicles. Some byproducts of this diversification have been a stronger financial base and links with the world's major economies and financial markets.

GCC spending on infrastructure projects in the education, health care, housing, power, transportation, and water sectors has significantly increased since 2005. According to Global Insight, US$1.1 trillion was invested locally between 1993 and 2007, while US$3.3 trillion is expected to be invested between 2008 and 2017. Global consulting firm McKinsey & Co. reports that in 2007, the GCC spent an estimated US$175 billion, approximately 20% of total GDP, on infrastructure development, which benefits economic development generally and is expected to stimulate near-term growth in several target sectors:

- Hydrocarbon production, where MENA-based producers have significant cost advantages;
- Energy-intensive production industries such as aluminum, ethylene, and polyethylene;
- Telecommunications, with mobile phone and Internet use expanding rapidly;
- Financial services, which have grown at an average annual rate of 25% since 2002;
- Tourism, with both ancient and modern attractions based on weather, beaches, history, and culture; and
- Education and health care services, which lag significantly behind those of other developed regions.

The GCC countries seek to diversify their local economies to reduce the importance of oil exports and stimulate growth in a variety of other sectors. More diverse economies reduce the frequency and severity of business cycles, and also provide a range of opportunities for the private equity industry. Government leaders have published strategic development plans for each area (country, city, or emirate, as appropriate) based on local competitive advantages. The plans are designed to foster growth of complementary facilities and attractions to those of neighboring developments. For example, while Dubai is building itself into a financial services center and holiday resort, nearby Abu Dhabi is working to become a regional cultural and educational hub with local versions of the Guggenheim and Louvre museums as well as a variety of subsidiaries of leading western universities. The table below shows a few examples of major projects currently underway in the GCC.

Examples of Government Infrastructure Projects Underway in the GCC

Country	Project	Estimated Cost (US$ bn)
Saudi Arabia	King Abdullah Economic City	27
Saudi Arabia	Jebel Omar Complex	3
UAE	Dubai Waterfront	40
UAE	Business Bay	20
UAE	Burj Dubai	20
UAE	Al Raha Beach	15
UAE	Palm Deira	13
Kuwait	City of Silk	86
Kuwait	Khairan Residential City	27
Qatar	Lusail	5
Oman	Blue City	10
Bahrain	Financial Harbor	1

Sources: Global Investment House and Zawya Private Equity.

Dependence on Hydrocarbons

Hydrocarbon exports continue to be the primary economic force in GCC countries, with 2007 exports of US$380 billion accounting for approximately 50% of GDP. The GCC countries control some 40% of world oil and 20% of world natural gas reserves, yet use less than 10% of either.[1] Increased oil demand, primarily from China and India, has driven global hydrocarbon demand from 121 million barrels (bbls) per day in 2002 to 136 million in 2007. While the global recession is reducing world oil demand, long-term demand is likely to rise and result in large capital inflows to the GCC region.

Oil earnings enter GCC domestic economies primarily via public spending, with government budgets currently based on oil prices of $35 to $55 per bbl. Budget surpluses, after local investment costs, generally are saved and often invested in foreign assets so that spending and investment levels can theoretically be maintained during periods of lower oil prices. This approach accounts for an estimated $1.8 trillion to $2.0 trillion in foreign assets by the end of 2008 for the GCC.[2] Assessing the potential for GCC reserves to meet increased demand is difficult because critical data are not in the public domain; however, for discussion purposes, HSBC analysts estimate that Saudi Arabian–owned foreign securities represent 50% more than the total value of all outstanding commercial bank claims on the Saudi private sector, and that Abu Dhabi's single largest pool of assets alone would be enough to replace a decade's worth of foreign debt and equity inflows.[3]

Exhibit 3 shows oil revenues averaged over five years as compared to total government revenues and oil exports averaged over five years as compared to total export revenues for the GCC countries. Although oil prices will be highly correlated to stock market prices during a global economic contraction, this is not necessarily the case during different economic circumstances. For example, in 2006 MENA stock markets sold off sharply, while oil prices climbed—probably as a result of local inflation on the one hand and a weakening dollar and increasing demand on the other. In the four years since the inception of the MSCI Gulf Cooperation Council Countries Index in June 2005, the index has shown a 0.54 correlation to oil prices.

Demographics

Most MENA countries have a median age lower than the world average, and significantly lower than in OECD countries. With approximately 50% of the MENA population younger than 25 years, demographics remain a key growth driver, resulting in the following trends: (1) increasing demand for infrastructure such as education, energy, health care, housing, roads, and water; (2) increasing demand for jobs—unemployment rates are already causing some concern in Saudi Arabia; and (3) a new class of young consumers who control increasing wealth, are better educated, and marry and start families later.

[1] *BP Statistical Review of World Energy*, June 2008.
[2] Eckart Woertz, "Impact of US Financial Crisis on GCC Countries," Gulf Research Center, October 2008.
[3] Simon Williams, "Where Has All the Money Gone?," HSBC Global Research, November 17, 2008.

Local populations are heterogeneous as a result of inter- and intraregional migration. Foreign workers' share of the national labor force in MENA countries ranges from 50% in Saudi Arabia to 80% in Kuwait, underpinning the relevance of the foreign/migrant workforce in the region.

Private versus Public Corporate Ownership

The central element of business in the GCC region is the family, which has retained its traditional importance despite modernization in the region. An estimated 90% of all commercial activity and non-oil-related GDP in the region is controlled by family firms. These 5,000 firms hold combined assets of $500 billion and employ 70% of the workforce. Many of these firms are locally called "family conglomerates," which are generally collections of unrelated businesses. Their development was usually a result of entrepreneurially capturing a range of business opportunities in a given local area, as opposed to expanding a successful business across multiple cities or countries. This ownership profile has both positive and negative implications for private equity firms:

- Most markets are highly fragmented, offering a range of opportunities for consolidation or scaling.
- Family succession and management issues create regular opportunities for partnership or buyout.
- Proprietary deals are possible, and preferable, due to the premium families place on trust.
- But working with families requires
  - An in-depth understanding of the motives, growth plans, and aspirations of both buyers and sellers;
  - Building and maintaining good relationships with key family members; and
  - An ability to understand and manage a large and complex network of local contacts to create, vet, and develop investment opportunities.

Public stock markets are relatively new to the region and only represent a small fraction of total corporate ownership. As a result of the relative youth of these regional public markets, many companies and investors have, until very recently, only seen rising markets.[4] The UAE, for example, established formal stock markets in 2000, and has even more recently set up a purpose-built free-trade zone in Dubai called the Dubai International Finance Centre, complete with its own regulator, the Dubai Financial Services Authority. As a result of young and continuously rising local markets, companies and investors may have an overly enthusiastic attitude toward initial public offerings (IPOs), holding shares within private equity funds, and other uses of the local public markets. However, the current financial crisis is already having a healthy and instructive dampening effect on this attitude.

Private equity firms will benefit as company owners start to recognize new routes to liquidity and the need to be more strategically aggressive as globalization and market reforms combine to increase competition. Alongside the range of investment banks now in operation and the relatively new option to list shares publicly, the recent development of private equity funds presents sellers an option to either exit (which

[4] Note that the Egyptian stock markets, which started over a century ago and were reborn in the 1990s, have a more turbulent history, as does the Saudi market, which experienced a version of the dot-com bubble in 2006.

is still infrequent) or to take on a capital partner that can help with operational and strategic issues. To date, most private equity deals have been for minority positions because entrepreneurs/owners have not wanted to relinquish control, and/or they do not tend to trust private equity firms. However, this too is changing, particularly as the number of successful and high-profile deals increases.

Market Liberalization

In addition to the creation of public markets and financial regulatory bodies, in the last decade governments in the MENA region have instituted a range of legal and economic reforms in order to create a more entrepreneur-friendly environment, stimulate foreign direct investment, and spur economic growth.[5] The main themes include:

- **Privatization:** Numerous government-owned or government-regulated sectors are being opened up to private ownership and investment, including aviation, financial services, logistics, telecommunications, and utilities. The IPO of DP World and the planned flotation of Emirates Airlines are two noteworthy examples. This trend is expected to provide significant future deal flow to private equity firms.

- **Foreign Ownership:** GCC countries are allowing increased levels of foreign ownership of listed and unlisted companies, from a defined maximum percentage to full ownership, depending on certain sectors in each country. Many MENA countries have also reduced corporate tax policies to make them more equitable with local company treatments. Also, several GCC countries, like Kuwait, have set up a foreign investment capital office to facilitate foreign direct investment.

- **Currency:** Many MENA countries have stable currencies that are either largely (in the case of Kuwait) or entirely (in the case of the other five GCC members) pegged to the U.S. dollar. In recent years, this has resulted in double-digit inflation rates, since U.S. monetary policy (which a pegged currency regime imports) was too easy for such a rapidly growing region. It remains to be seen whether the plan to establish a currency union in 2010 will be consummated and/or whether the GCC countries (collectively or individually) will reconsider their currency peg.

- **Labor Markets:** Most countries have set up formalized education and training programs, ramping up education at all levels in anticipation of the growing number of students, and in recognition of local solutions being more effective and efficient than sending many students overseas. Various measures to encourage expatriates to relocate are also in place and older laws that stand in the way of free labor markets are being repealed, such as Qatar's automatic employment of all graduates. Private equity managers described the difficulty of sourcing management talent locally, but also noted that the combination of returning nationals and the region's growing attractiveness to foreign talent is helping the issue.

[5] For a good overview of key structural reforms in the GCC see Ugo Fasano and Zubair Iqbal, "GCC Countries: From Oil Dependence to Diversification," International Monetary Fund, 2003.

Impact of the Global Financial and Economic Crisis

While GCC governments have the savings and the determination to withstand the global financial crisis by tapping into their reserves, an oil price persistently below $55/bbl would negatively impact the region's growth rate as it would likely lead to a postponement of those infrastructure projects that local governments have not yet included in their budgets.

So far only a few GCC banks have announced any exposure to U.S. subprime assets, representing about $2.7 billion in total, according to the Gulf Research Center. This is partially the result of local banks' conservative/restrictive investment criteria. The bigger problem for GCC banks and debtors lies in the increased costs of funding amid maturity mismatches and credit exposure to local consumer, project, and real estate financing. Events like the withdrawal of almost US$60 billion of international speculative money and massively negative real interest rates, which do not provide an incentive to save, have further exacerbated the liquidity situation for some GCC banks (mainly in Dubai). However, local governments and central banks have demonstrated an ability and willingness to swiftly support local banks and other companies with deteriorating liquidity positions by injecting sufficient liquidity into the banking system.

Local private equity deals are less affected by the local credit squeeze given the relative lack of leverage traditionally used in local growth investments. However, local infrastructure and real estate investors will likely face significantly higher (re)financing costs that could erode overall investment returns in light of the tighter local credit markets. As an example, credit default spreads for corporate bonds in the GCC have increased from around 145 basis points (bps) a year ago to over 500 bps.[6] The main reason behind this distressed pricing level is the deterioration of Dubai-related credit, which represents a large part of the GCC bond market and faces US$30 billion of refinancing obligations in 2009. International banks' increasing reluctance to extend their commitments as they face liquidity constraints is leading to postponements, modifications, and withdrawals of loans. According to Reuters, the Middle East borrowed 16.5% less in third quarter 2008 than a year earlier ($91 billion versus $109 billion in third quarter 2007), a trend that is likely to continue in the fourth quarter.

The effects of an anticipated global recession on the GCC countries will not be confined to the financial sector, but will also affect the real economy if global demand for crude oil and derivative products remains weak. The decrease in oil prices below US$55/bbl over late 2008 and into spring 2009 presented a fiscal challenge for most GCC countries, which generally run budget surpluses at oil prices above that level. While GCC governments benefit from large cash reserves and can command government-backed companies and SWFs to support their local infrastructure investment and diversification programs in the short and medium term, they will seek, through OPEC, to engineer drastic production cuts to raise oil prices back US$80/bbl.

[6] Eckart Woertz, "Impact of US Financial Crisis on GCC Countries," Gulf Research Center, October 2008.

Given that most MENA-based private equity transactions do not rely on leverage, private equity investments are likely to be less affected than similar transactions in the United States or Europe. However, managers will likely have to contemplate longer holding periods for existing portfolio companies given the recent valuation decline and generally expected lower growth profiles. On the other hand, the current environment presents an opportunity to acquire companies at attractive entry valuation levels in what is still expected to be a growth environment.

Potential Impact of a Common Currency in the GCC

At the formation of the GCC nearly 30 years ago, a number of goals for the harmonization of regulatory and policy frameworks were set out. The EU has provided a model and example for many of these goals, including the development of a common currency. Officials in the UAE and Saudi Arabia continue to call for the establishment of the currency in 2010 as planned, and in time it is hoped a GCC currency might be used more widely in the MENA region. Such expansion would logically require some years of successful operation following the currency's introduction.

It is widely believed that a single currency is integral to the success of the GCC common market as it would bring a number of economic benefits such as lower exchange, accounting, and transaction costs; elimination of exchange risks; stronger integration and deepening of financial and money markets; and in time, a common monetary policy with more disciplined fiscal policies in member countries. These factors are expected to increase interregional saving, investing, and trade. As most internal trade is non-oil-related, increases will contribute to the development of non-oil sectors and help diversify regional economies. As the currency of an economic bloc with a GDP of $388 billion, this would be the world's third largest currency after the euro and the U.S. dollar, and in time could serve as the reserve currency of choice for Islamic and Arab central banks.

The introduction of a common currency would result in a loss of independence in individual member countries' monetary and exchange rate policies, which would not be of much significance as they have already been coordinating policies, and their relative exchange rates have remained steady for a prolonged period, since all are more or less pegged to the U.S. dollar.[7] The new currency would probably also be linked to the U.S. dollar at first, but a partial or full float might be considered at some point in the future. All is not smooth sailing, however, as such thorny issues as the location of the region's central bank remain in dispute among participating countries.

[7] Four out of six GCC currencies are formally pegged to the U.S. dollar—the Omani *riyal* since 1970s, the Qatari *riyal* since mid-2001, and the Bahraini *dinar* and the UAE *dirham* since early 2002. The Qatari *riyal*, Bahraini *dinar*, and UAE *dirham* were previously pegged formally to the special drawing right (SDR), but in effect they have maintained a fixed relationship with the U.S. dollar since around 1980 (other than a slight change in 1997 in the case of the UAE *dirham*). The Saudi *riyal*, though pegged to the SDR, has been virtually fixed to the dollar since June 1986. The Kuwaiti *dinar* is linked to a special basket of currencies, but since the U.S. dollar was assigned a very large weight in this basket, the exchange rate of the Kuwaiti *dinar* vis-à-vis the dollar has remained broadly stable over time.

Private Equity in the Region

Evolution

As noted above, the vast majority of equity in the region is privately held in family companies and thus not in the fund format prominent in western countries. Large MENA-based investors have a long history of investing in private equity funds globally, with some very high-profile SWF investors, such as the Abu Dhabi and Kuwait investment authorities, leading the way. In contrast, private equity funds operating within the region are still a new phenomenon, most having started in the past four years.

While independent private equity firms are emerging to capture the opportunities presented by the expanding and changing market conditions, a wider range of local investment firms—presented below in order of accessibility to outside investors—also actively pursue local investments.

- **Family-based firms:** Funds from family-based firms are not accessible to most investors. However, some family investment firms have evolved into multifamily firms, sometimes employing a general partner (GP) / limited partner (LP) structure, and in the cases of Amwal al Khaleej and Ithmar, changed again into fully independent firms. As the predominant unit of business in the region, families provide deal flow as well as development and exit opportunities. Any fund operating in the region will require a measure of family connection; however, prospective investors must be careful to analyze and determine the level of independence and GP/LP alignment that is possible within this context.

- **Government-sponsored firms:** These funds are not typically available to outside investors, having started from a variety of government-inspired initiatives to stimulate specific economic sectors—for example, the newly started Saudi Telecom Venture Fund—or to further diversify a large pool of capital, as in the case of the Abu Dhabi Investment Company's (recently renamed AD Invest) ADIC MENA Partners fund. When accessible, these funds may look attractive to local investors, who may also receive political pressure to invest in them, but they should be checked carefully for all the regular strategic and structural elements required of a successful private fund.

- **Bank-based firms:** Regional banks have offered project-based direct investment opportunities for many years, and, like the rest of the industry, have only relatively recently started to offer private investment products in a fund format. Banks such as EFG Hermes, GIH, Investcorp, and TNI offer clients access to private equity deals as an offshoot of their investment banking and/or wealth management groups. Banks can bring large established networks as well as process and investment discipline to the market, although the regular pitfalls of such large institutions exist for these funds.

- **Independent firms:** Some firms began as independent firms outside of family, bank, or government sponsorship, such as Gulf Capital and Citadel, and others have evolved into this form. Although there are clear investment and decision advantages to investing in a fund with an independent firm,

simply being an independent organization may not be enough in this highly interconnected region. Investors must gauge the level of true autonomy each firm has in decision making and, in operational terms, from its main stakeholders.

The 2002 deal in which the Rasmala Buyout Fund took Aramex International off the Nasdaq for $65 million is widely regarded as a benchmark and model transaction for the industry, having captured the attention of the investment community for its size, structure, and exit to the Dubai Financial Market (one of the three stock markets in the UAE). However, institutional private equity in a fund format started in earnest in 2004, when a variety of regional firms were founded, and international firms started to consider deals in the region. Since then fund raising has increased each year through 2007, with data through June 30, 2008, showing the possibility of a decline from what will likely prove record 2007 levels (Exhibit 4). From 2005 to 2007, the number of funds raising capital doubled, and then tripled in 2008 to 62. While such data are always imperfect and the various providers disagree on absolute figures, it is clear that in the past four years both the number and value of funds raised has increased significantly.

Limited Partners and Other Sources of Capital

In the early years of the MENA private equity industry firms sourced most of their capital from investors based in the region. Today, however, most private equity firms are having success diversifying their LP bases outside the region. Regional investors range from the sophisticated SWFs that have been investing internationally for many years, to banks and other institutions looking to broaden their capital markets exposure, to corporate family entities. Many family institutions are private equity investors in their own right, but through their direct holdings rather than through a GP/LP structure. For these groups investment in private equity partnerships can be attractive for a variety of reasons, including diversifying their holdings into new sectors and geographies, broadening sourcing and exit networks, and providing a source of co-investment opportunities.

Attracting non-MENA investors is important to regional firms as the strongest market signal of their developmental maturity, not only in the areas of investment strategy, team development, and track record, but also in achieving world-class governance and alignment of interest with investors. Regional firms have taken a variety of approaches to reach these goals, for example by limiting individual investment sizes so that no one LP may become a dominant force; by limiting the percentage of regional capital in a given fund, through careful selection of investment committee and advisory boards; and by investing significant amounts of their own capital alongside that of LPs. Interest from significant external investors can be seen in public and private markets alike, such as with EFG Hermes' launch of its MENA Opportunities Fund with an affiliate of Harvard University in 2007, Gulf Capital's inclusion of Credit Suisse Alternative Investments as a cornerstone in its second partnership in 2008, and the ADIC-UBS joint venture Infrastructure Fund. As with any private equity investment, investors should consider the governance structures, networks of stakeholder relationships, and other factors affecting the alignment of interests between investors and GPs of such firms.

Fund Landscape

Exhibit 5 shows the landscape of the major funds in the MENA region. With a target size of $4 billion, Abraaj Capital is trying to raise the largest and most geographically diverse fund, covering the entire MENA region and South Asia, which includes India and Pakistan. Mirroring the higher degree of market activity and the relative sophistication of the local markets, most funds focus on the GCC countries. A few local firms focus elsewhere, but include a subset of GCC countries, such as Citadel and EFG Hermes, whose primary focus is Egypt.

Strategy

As in the early days of all private equity markets, MENA-based firms target a wide range of opportunities and market imperfections. Their strategies are opportunistic in nature. Most firms look to take advantage of the best deals that come in through their networks, as opposed to proactively mapping and pursuing a particular geography or sector as one would expect in more mature markets. This reflects the immaturity of the local market and the relative lack of strong competition for deals. As markets mature, firms will likely specialize more along the lines of western firms, choosing those geographies, sectors, and situations that they are best equipped to exploit.

In the meantime, external/international investors have a choice to invest with the very few firms that profess (and stick to) a more focused western-style strategy, or to investigate the majority of firms where widely drawn and less restricted strategies are the norm. As always, manager selection is paramount. In the absence of track records, it remains essential to understand the organization, the history of the individuals who make up the firm, and the major stakeholders.

So far, most private equity deals are for minority positions in established companies. Some control positions and buyouts have been done, often as a result of privatizations or green field projects. As entrepreneurs, families, and local banks become more familiar and comfortable with private equity firms as buyers, we expect to see more classic control buyout deals. Leverage usually plays a minor role given the high growth component of the deals, and the inability to easily obtain cash flow–based credit, which is still regarded as a novelty in the region. Most managers we met in late 2008 were confident of being able to raise the levels of debt they require from local banks, although this situation will likely worsen somewhat as the full effects of the global financial crisis are felt. Recent declines of local stock markets of between 30% and 60% have led to a dramatic correction of company valuations which, in turn, have translated into generally more realistic/attractive price negotiations in private equity deals.

In contrast to private equity, there is little venture capital in the region, which we believe is a function of relatively weak local higher education systems, lack of true local innovation activity, and relatively heterogeneous markets that are not easily scalable. In time, many of the universities and research parks now being developed may stimulate local innovation and make the case for venture investing more compelling in the longer term.

Team Composition

Because business in the MENA region is so relationship oriented, an effective team has to consist of MENA nationals who speak Arabic and are well integrated into their target investment area. These investment professionals should have corporate finance education and experience, which usually comes from a western education and work experience in one or more international firms or organizations. The ideal firm consists of partners with backgrounds in private equity, but few people have both the requisite local knowledge and the private equity experience. Firms have balanced these issues in a variety of ways: some have partnered with western private equity firms, some have hired expatriates to complement local talent, some are using local investors with experience in fund investing as advisors, and most have commissioned studies to analyze the gaps between their firms' and the industry's best practices. Because the MENA market is still emerging in this way, investors should carefully review the mix of skills and experience embodied by the partner group, and supplemented by advisory groups.

Investing and Exits to Date

Total private equity fund investments in the MENA region have increased at a compound annual growth rate of 107% since 1998. Of the total investments in the last decade, 92% were carried out from 2005 onwards, with 54% in 2007. In 2007, Egypt emerged as a preferred destination for investment in the MENA region, with $2.3 billion being invested since 1997. This distinction, however, was mostly because of two large deals of more than $500 million each, carried out in 2006 and 2007 by Abraaj Capital, which represent 82% of all Egyptian investments. Otherwise, private equity funds have been most active in the UAE and Saudi markets (Exhibit 6). About 66% of private equity investments in the last decade were less than $20 million in size, with about 28% more falling in the $21 million to $100 million range. Only 11 of total 184 private equity investments during the past decade have been over the $100 million mark. In 2007, however, the $1 billion threshold was broken (Abraaj's EFC deal, a secondary buyout) and two other deals crossed the $500 million mark.

Since 1997, exits have mostly been in the oil & gas sector, which has seen exits worth $393 million, followed by transport ($166 million) and telecommunications and information technology ($158 million). Most exits in the region have been via IPOs or sales to co-investors or to corporate investors, with only a few notable exits to the secondary private equity market. Firms have broadened their exit scope to include listings on other markets, or a trade sale to international strategic buyers, as larger target companies become increasingly attractive for international corporations.

Most portfolio companies are still unrealized. Exits over the next couple years will therefore be instructive on many levels, not only for gauging the health of the MENA economies versus the West, but also for challenging the discipline and skills of private equity firms.

Competition

Competition for private equity deals in the MENA region is currently moderate compared to that in mature markets. Managers report some intermediation, but the relationship-based nature of business means that sellers still place a premium on who is buying the business, what they plan to do with it, how large a stake will be taken, and whether the buyer will be a trusted business partner. Certain high-profile deals, however, do attract more aggressive bidding—for example, government privatizations. At this developmental stage of the private equity market, competition for individual deals and certain localized deal flow is more likely to come from local investors of other types, such as family conglomerates, than from other private equity firms.

Region-Specific Considerations

The Enhanced Role of Stakeholder Networks

To invest successfully in MENA-based private equity, investors must understand the fusion of business and social interactions in the region. With a relatively small population, and an even smaller ruling class, many business leaders are also social leaders and/or governmental officials. It is therefore likely that those people in a position to be fund stakeholders (partners, LPs, advisory board members, portfolio company executives, etc.) may also be in a position to influence the businesses or the environment in which they operate. This dynamic gives rise to situations where, for example, a fund LP may also be interested in a portfolio company, either as a current shareholder, or with a desire to buy it from, or sell it to, the fund. Similarly, stakeholders may be in a position to influence relevant legislation, may operate in collaborative or competitive businesses, may have family connections in or near particular companies, or play other influential roles.

Western LPs are not accustomed to such extremely interlinked relationships and many will have an instant, negative reaction to the inherent potential for conflicts of interest. However, aside from being a prerequisite to doing business, these personal network connections have equal power to drive positive results. For example, regional LPs are an excellent source of deal flow; they engender valuable credibility and trust in local markets; they are a viable exit route for all types and sizes of company; and they can help with local legislation, provide market intelligence, and access to key people, contracts, and other key resources.

In fact, all private equity funds operating in the MENA region need intimate links to their relevant community leaders. But for outside investors it is a question of balance—without the right personal networks firms cannot operate at all, and in an area where auctions are scarce, will not even see deal flow. On the other hand, with too few links, or links that are too strong, the alignment of manager and LP interests can suffer. It is therefore important when evaluating a MENA private equity firm to carefully consider its network of stakeholders and their potential influence, for gain or loss, on investment management and the fair treatment of all LPs. Similarly, it is incumbent on GPs to implement good governance practices, which some are

building already through their advisory boards, the involvement of large non-MENA LPs, and insistence on a diversified LP base.

Regulatory Environments: Different, and Rapidly Changing

Regulatory reforms across the region are showing good progress toward creating a free market environment. The main reform trends are described in the "Market Liberalization" section above. However, some "local" impediments for private equity firms remain, including stock market restrictions.[8] While firms do have a choice of exchanges in various countries for their company listings, ownership restrictions in local economies can affect the people, incentives, and attractiveness of deals. Legal "work-arounds" for the more common ownership restrictions exist, but these introduce their own potential issues. For example, firms typically deal with foreign ownership restrictions by owning the maximum portion of a company allowed by law, and then assigning ownership for the rest of their stake to a "local partner." The local partner is typically an individual who has the right nationality to own the asset, and he or she reassigns the "economic rights" of that asset to the fund. (Of course, the local partner should also be a trusted one—often the partner is an LP, advisory board member, or affiliated with the fund or partners in some way.) Many funds operate in this fashion and it is important for investors to understand who local partners are, their incentives and compensation, and what measures private equity firms take to ensure their assets are safe both economically and from a governance and control perspective.

The Term "Infrastructure" Is Used Broadly

In the MENA region, the term infrastructure is used more broadly than in western markets, which is particularly relevant when evaluating MENA funds or in speaking with MENA investors. Middle Eastern infrastructure funds, or the infrastructure allocations of more diverse funds, consider investments in energy, public-private partnerships, transportation, utilities, as well as social infrastructure and services such as education and health care. These funds are likely to target the typical long-term and green field projects that characterize infrastructure funds elsewhere, as well as operating companies that may not own any physical assets and would more closely resemble private equity fund targets.

Return expectations for local infrastructure funds are often in line with those for buyout funds, in part because MENA infrastructure funds are not synonymous with hard assets or lower risk/return profiles. It is therefore important to look at a given firm's particular strategy to understand exactly what they propose to invest in rather than assume a western-style infrastructure classification. Unlike other markets, there are many government-sponsored projects in process; as a result, some regional funds may, for example, have preferential terms alongside a government investor, or may have exclusive access to certain deal flow. These types of funds may be attractive to a private equity program that would not include infrastructure funds elsewhere.

[8] For example, some define a high minimum amount of a company's equity that must be offered in an IPO, and some have central regulators that set all IPO prices.

Portfolio Construction

At this time, the main strategy differentiators between MENA funds are geographic and sector focus, and, to a lesser extent, deal size. Because there is little to no venture investing and there are few opportunities to buy controlling stakes in companies, most firms engage in minority, and when possible control, investing. Most are also sector agnostic, following similar demographic and economic-driven themes, except for those with a hard assets focus like infrastructure or real estate funds. For reasons highlighted above there is not a great deal of competition among firms yet, nor is there a great deal of co-investing or portfolio overlap.

Subject to the regular best practices of manager selection, a portfolio approach that selects MENA fund investments with different geographical competencies/coverage, and different fund/deal sizes would be appropriate. Larger funds will tend to expose a portfolio to privatization and government-related opportunities, whereas smaller funds will capture more of the traditional family and entrepreneurial deals. A selection of GCC-focused funds could be complemented with some more local funds, for example those focusing on North Africa or the Levant.

Conclusion

Without sufficient time and resources to study and understand the region and specific managers' strategies, investors may wish to wait until the local private equity market further matures before considering future commitments with the firms that emerge as the winners in each strategy and geography.

From essentially a standing start some five years ago, the MENA private equity market is moving quickly to establish itself as an attractive segment of the global private equity market. However, like other emerging private equity markets, it requires time to mature and it will be some years before investors will be able to analyze meaningful track records that include a variety of exits managed by stable teams through multiple fund cycles. Such comforts of mature markets are not yet available in these early days of the MENA industry and this, coupled with a dramatically different business culture and quickly changing market environment, may lead many international investors to conclude that such investments are a bridge too far. However, those with a larger appetite for risk and the resources necessary to come to grips with the market should be able to identify MENA funds well placed to ride the rising economic tide and able to exploit the compelling opportunities unveiled by market reforms. In short, we see a clear opportunity to generate strong returns from one of the world's growth regions by accessing the best firms early in their development.

Investing in the near term will be most suitable for the higher-risk or emerging markets portion of an international portfolio, or for local LPs whose inherent local knowledge forms a strong basis for the due diligence process. Both international and local investors can now choose from a variety of potentially attractive funds to suit regional mandates or missions, and these investments can act to diversify both portfolios of local direct investments or of international fund investments. In the global financial and economic turmoil of 2008, MENA market returns were highly correlated with those of other emerging

markets—but this was true of virtually all equity and credit investments worldwide. In less stressful circumstances, the MENA economies and markets have tended to be uncorrelated with those of developed markets, providing investors with valuable diversification benefits.

Positives

- Strong macroeconomic growth compared to that of the mature markets of the United States and Europe
  - Volume and quality of deal flow continue to offset strong fund-raising pace
  - Attractive entry valuations and maturing exit markets show potential for good returns, while lack of intermediaries keeps deals proprietary and prices low
  - Massive and stable government spending gives rise to a range of direct and indirect opportunities
- Rapidly improving regulatory environment
  - Regulatory reforms are being enacted quickly
  - Ownership, labor, and other restrictions are being removed
  - Large privatization movement underway, which has historically been a significant source of private equity returns in mature markets
- High level of fragmentation in every sector, creating many opportunities
  - Family conglomerates of unrelated businesses are ripe for consolidation and privatization of large industries is ongoing
  - Large opportunity to build successful local businesses into "regional heroes"
  - Several key sectors suffer from historic underinvestment (e.g., health care, education, consumer)
- Small but growing set of promising managers
  - Partners are mainly MENA nationals with the same western education of those in the United States and Europe
  - Desire and effort to emulate the "best practices" of the western private equity industry
  - Access to all managers is still good, signaling the importance of building relationships now

Issues

- Macro economy and capital markets still evolving
  - Macro environment still strongly correlated with hydrocarbon prices; exit markets still maturing
  - Despite progress with regulatory and structural reforms, many impediments still exist
  - Nascent corporate governance practices increase risks for investors
- Lack of experienced managers
  - Broad lack of strategic focus, albeit partly as a response to large opportunity set
  - Investment pace too fast, product proliferation and geographical spread already starting
  - Many funds yet to adopt trusted GP/LP structure
- Private equity is new to the region
  - Private equity managers not yet widely known or trusted by wider business community
  - Many corporate owners do not want to sell the company or give up control
  - Highly interconnected business culture can lead to conflicts of interest

EXHIBITS

Exhibit 1

GDP OF MENA COUNTRIES

2007

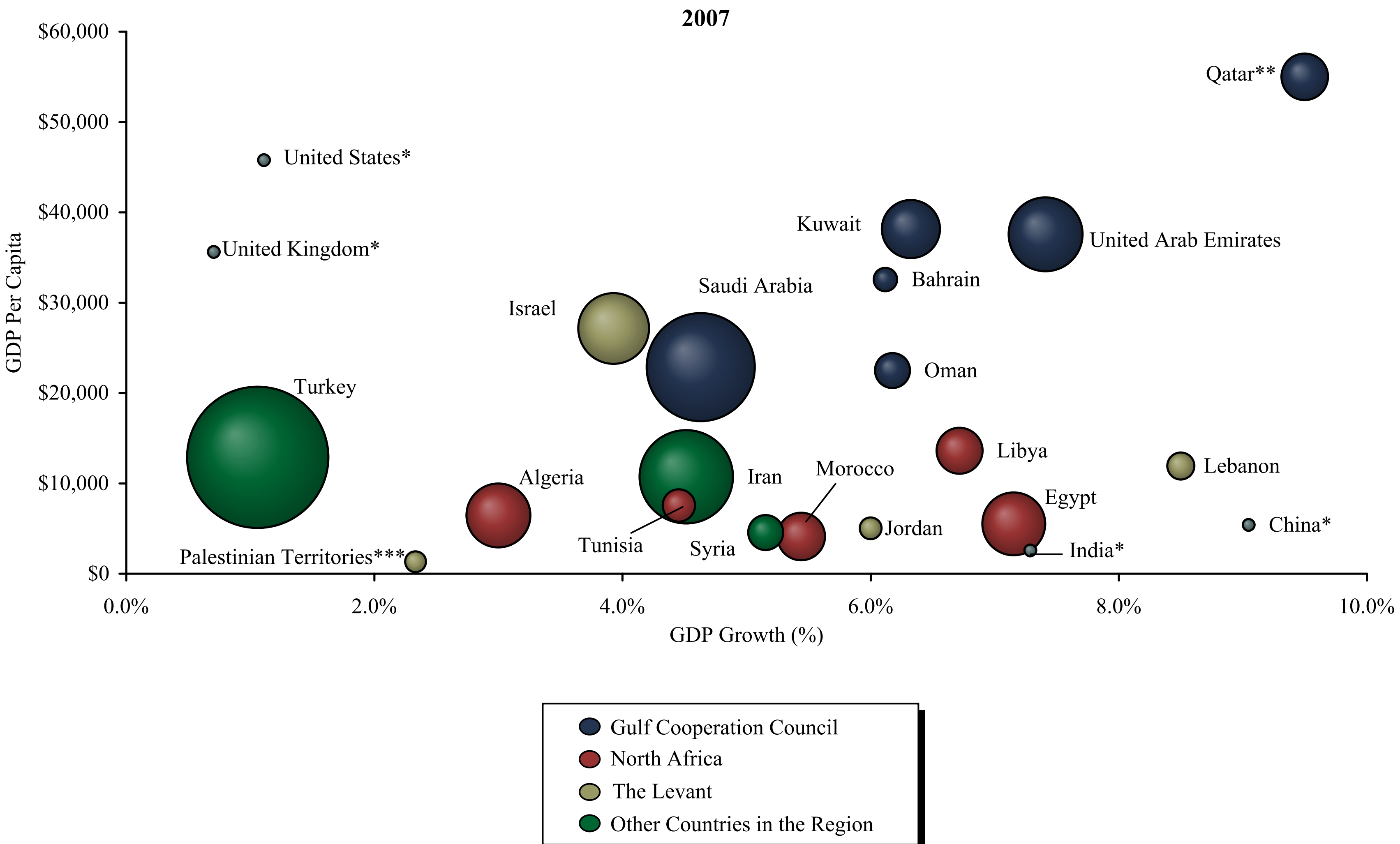
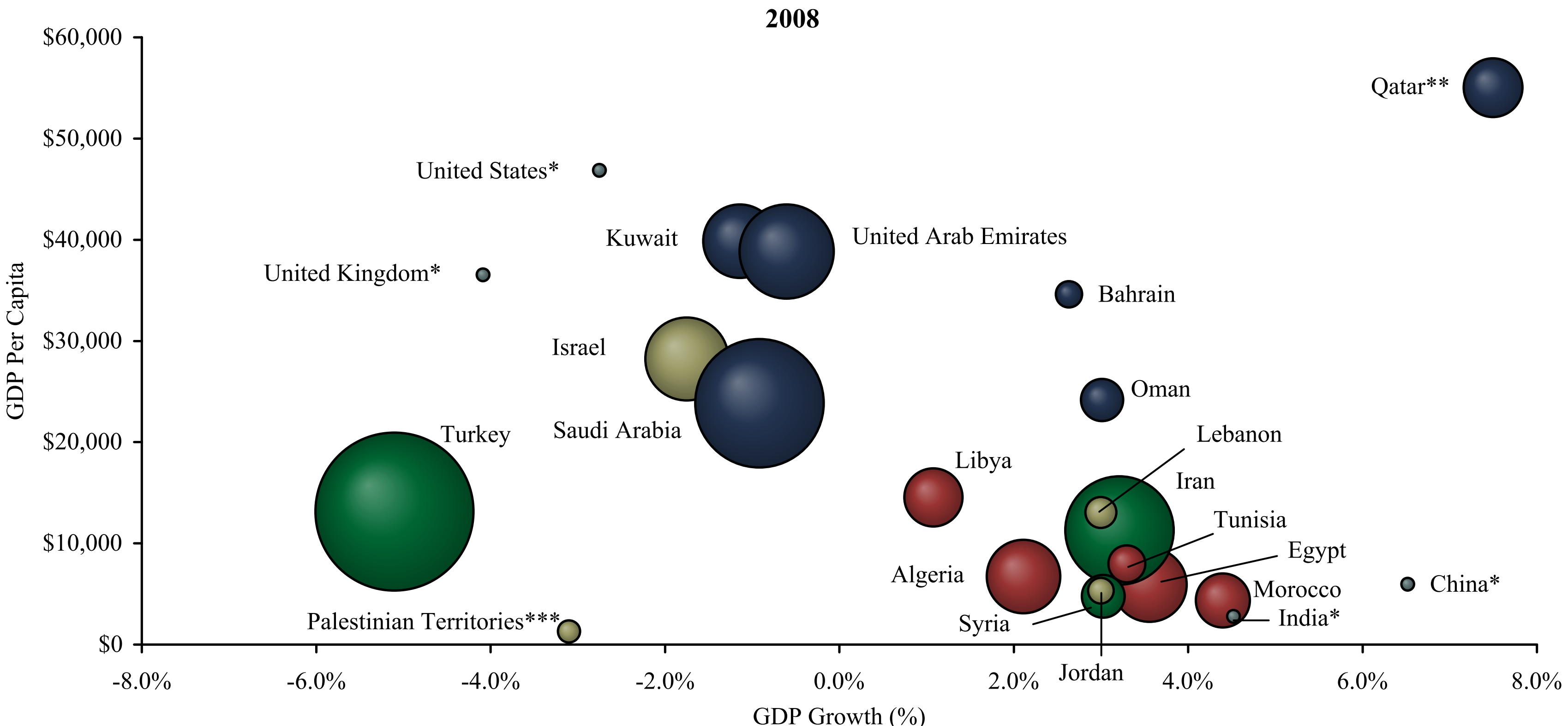


Exhibit 1 (continued)

GDP OF MENA COUNTRIES

2008

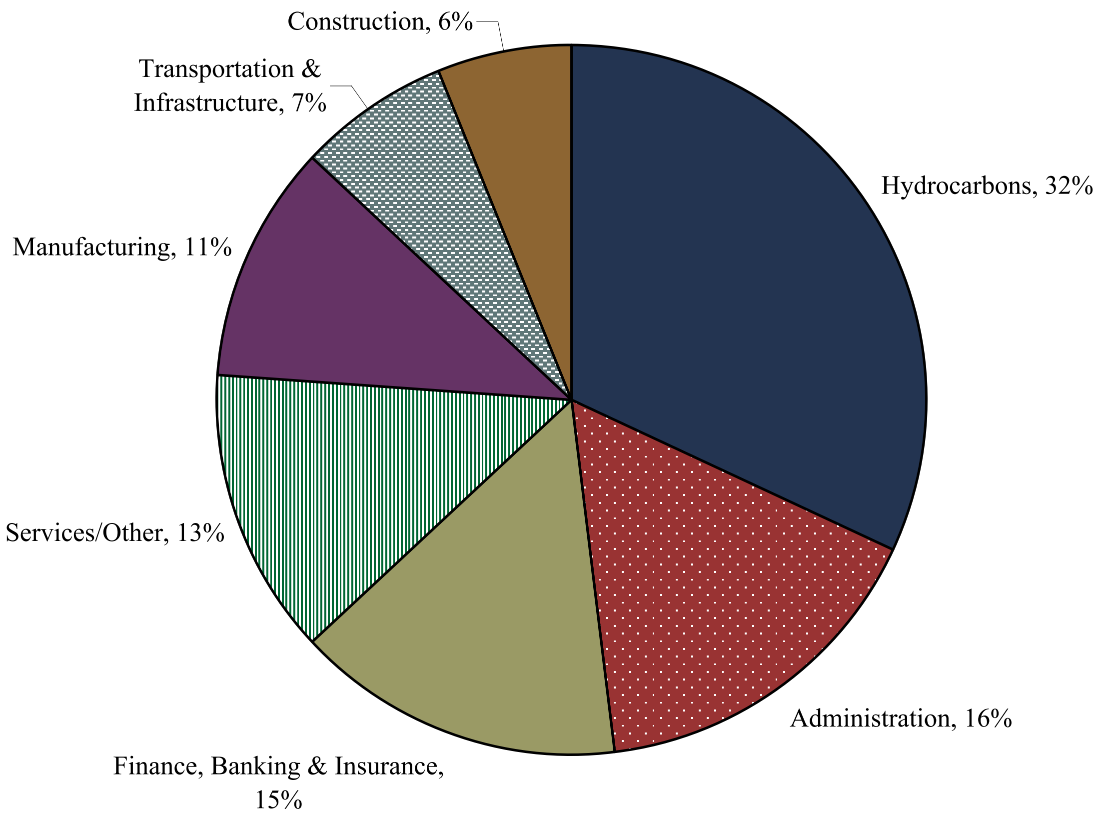


Sources: International Monetary Fund and Palestinian Central Bureau of Statistics.

* China, India, the United Kingdom, and the United States are shown for comparison of growth and per capita measures, but their sizes ($4.4, $1.2, $2.7, and $14.3 trillion, respectively, in 2008) are not shown in order to maintain a scale that is instructive regarding the MENA economies. By comparison, the UAE and Saudi Arabia have GDP sizes of $0.3 and $0.5 trillion, respectively, in 2008.
** For scaling purposes, Qatar's GDP growth and GDP per capita have been scaled down. Qatar's 2008 GDP per capita and GDP growth figures are $85,868 and 18.0%, respectively. For 2007, the figures are $85,199 GDP per capita and 16.4% GDP growth.
*** For scaling purposes, Palestinian Territiories' GDP level has been magnified. The actual GDP figure for both 2007 and 2008 is $1.1 billion.

Exhibit 2

GULF COOPERATION COUNCIL COUNTRIES: REAL GDP BY SECTOR



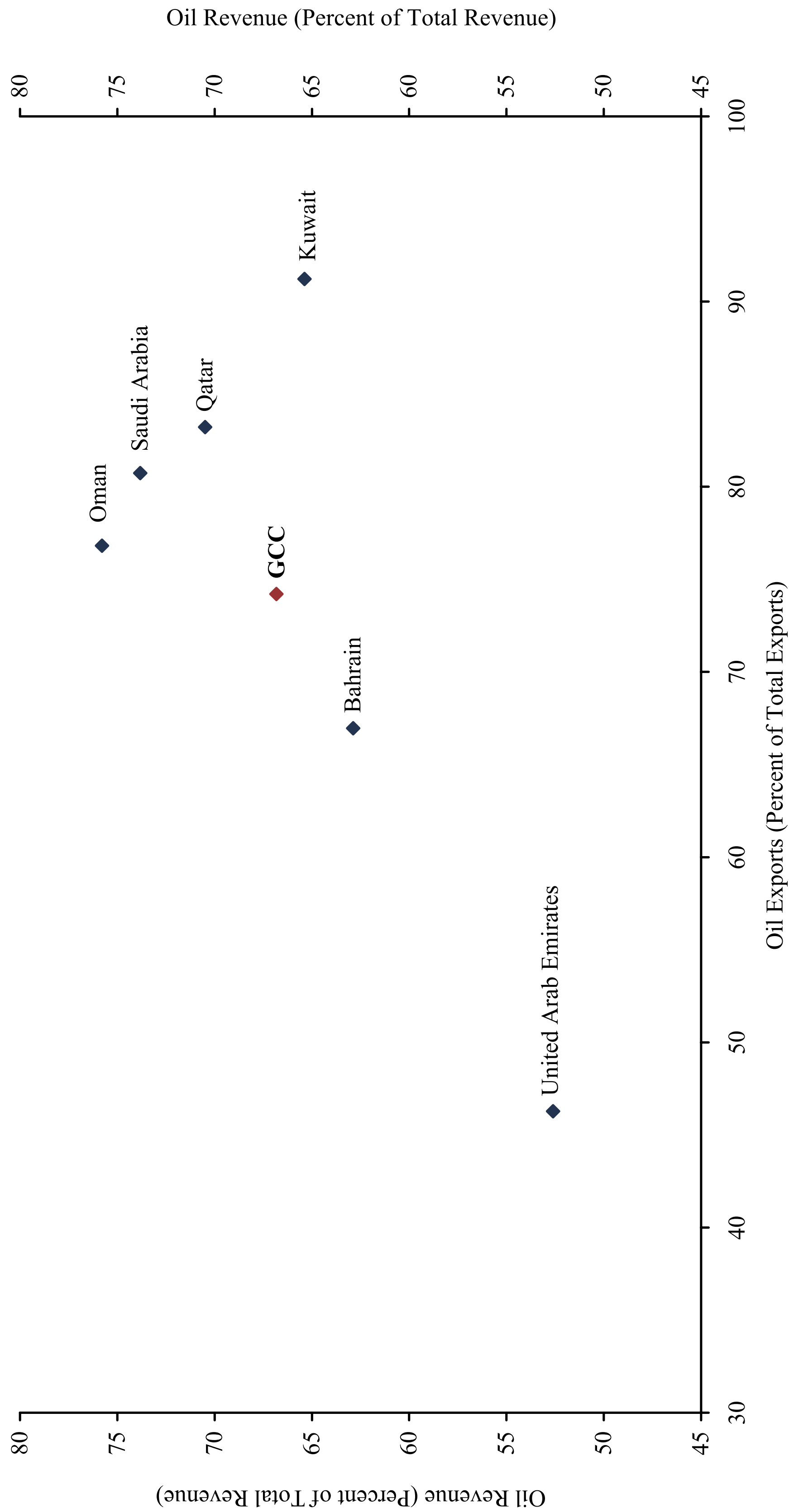
Source: HSBC.

Note: Data are as of December 31, 2006.

Exhibit 3

GULF COOPERATION COUNCIL COUNTRIES: OIL DEPENDENCY

Average from 1998–2002



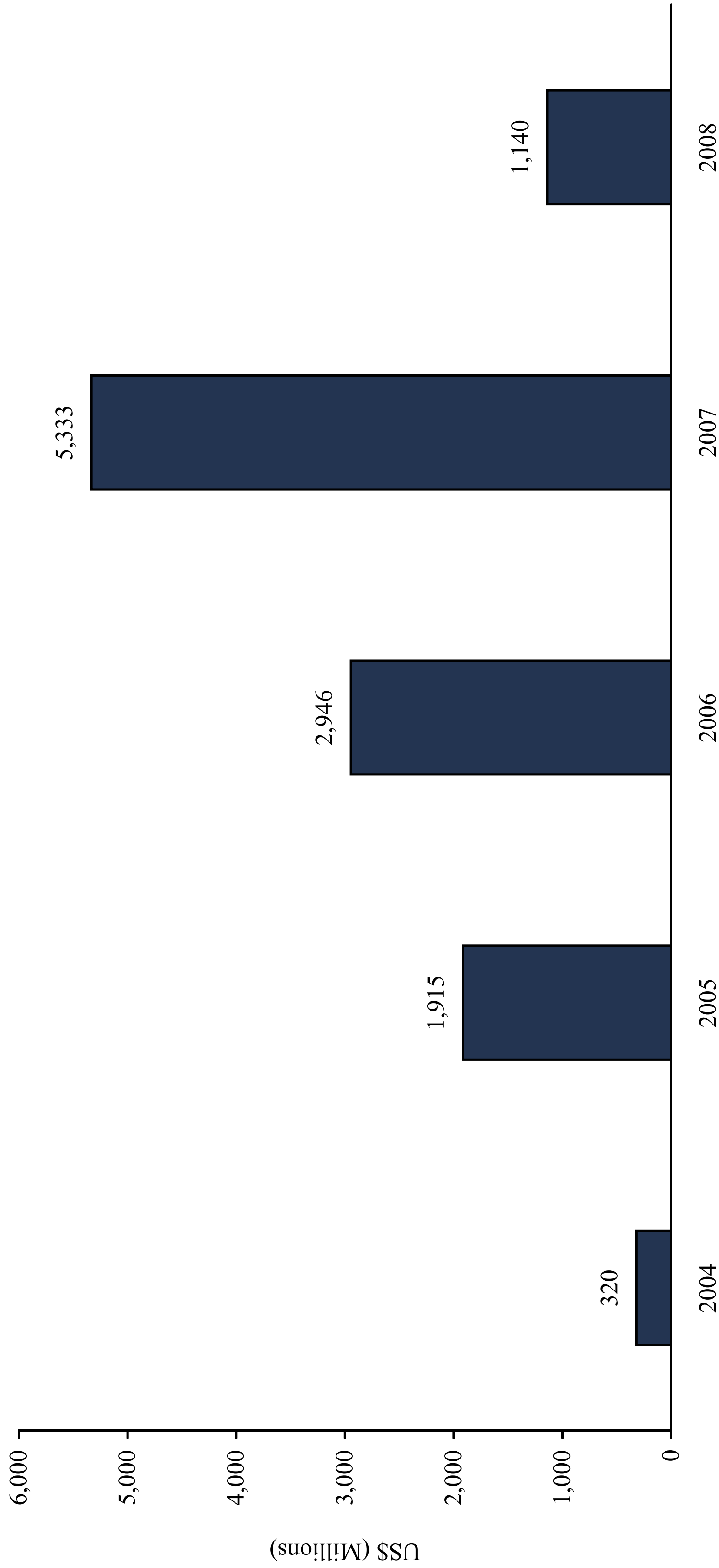
Source: International Monetary Fund.

Note: Total government revenue includes investment income, and total exports includes re-exports.

Exhibit 4

MENA REGION: PRIVATE EQUITY FUNDS RAISED

2004–08

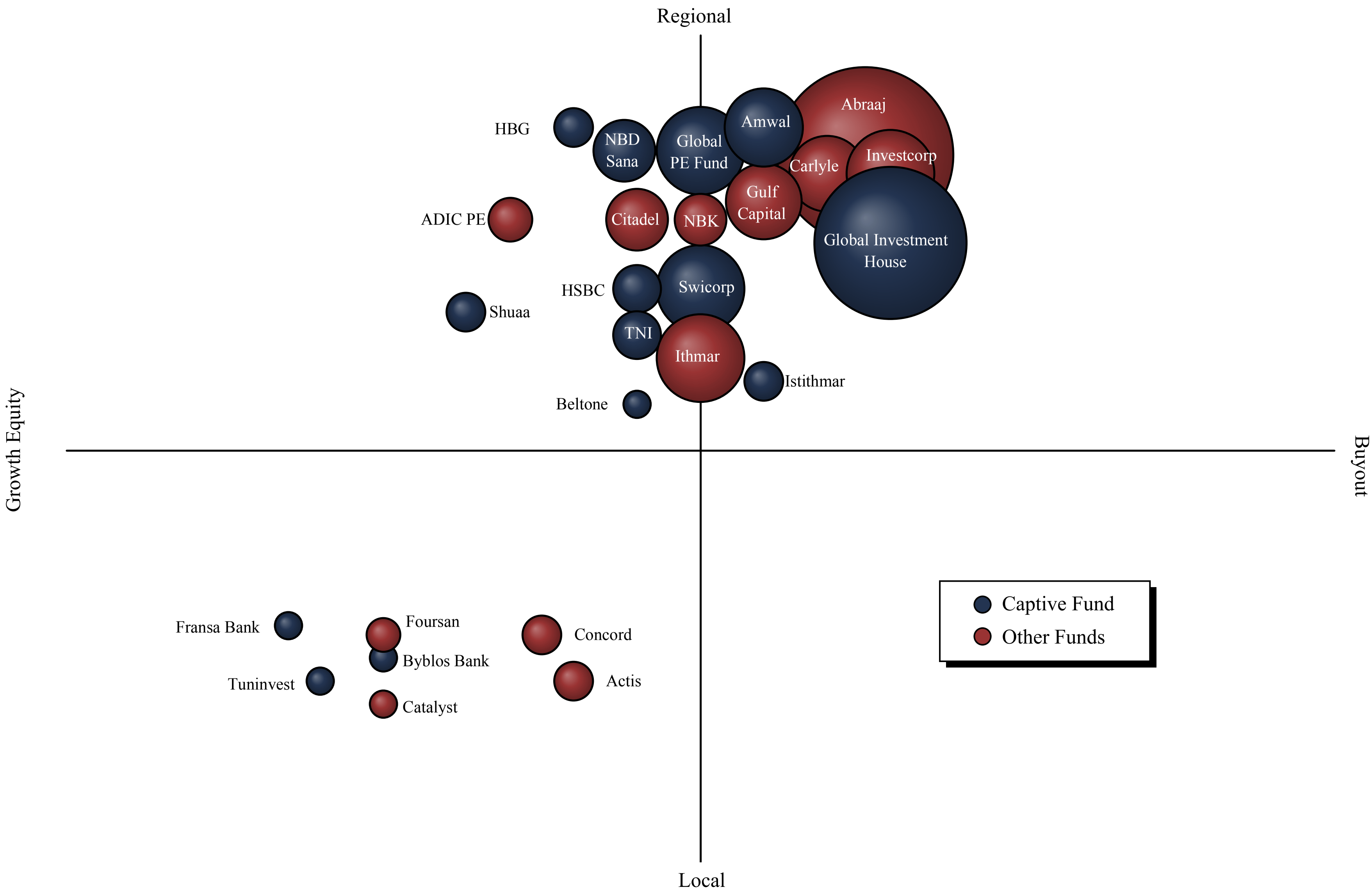


Source: Emerging Markets Private Equity Association.

Note: Data for 2008 are through June 30.

Exhibit 5

MENA REGION: PRIVATE EQUITY LANDSCAPE



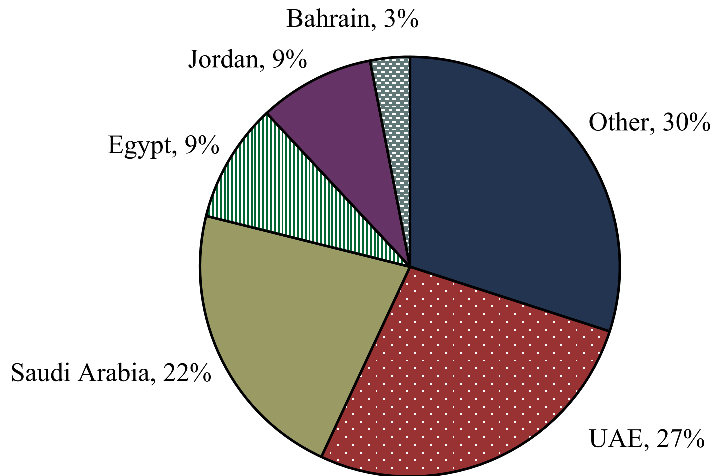
Source: Cambridge Associates LLC.

Notes: Manager positions on the chart are based on Cambridge Associates' qualitative analysis. The size of the "bubble" corresponds to the size of the most recent fund raised by that manager; i.e., the larger the fund, the larger the bubble and vice versa.

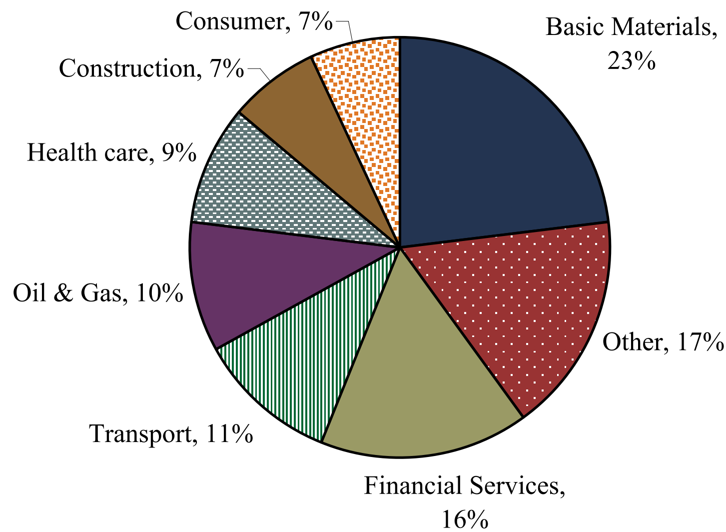
Exhibit 6

MENA REGION: PRIVATE EQUITY INVESTMENTS

By Geography



By Sector



Sources: Gulf Venture Capital Association and KPMG, *Private Equity & Venture Capital in the Middle East 2007 Annual Report,* using data from Zawya Private Equity Monitor.

Notes: These charts exclude two investments of over $500 million each that were both made in Egypt. Including these investments, private equity investments in Egypt were 37% of investments in the region.

Appendix

MENA MARKETS SUMMARY ASSESSMENT

Appendix

MENA MARKETS SUMMARY ASSESSMENT

Value Drivers Informing Investment Thesis	UAE	Saudi Arabia	Egypt	Levant	Kuwait/ Bahrain	Other
Overall Macroeconomic Environment	Good	Good	Fair	Fair	Good	Fair
Real Estate Supply and Demand Imbalance	Good	Good	Good	Good	Good	Fair
Legal, Regulatory, and Tax Environment	Good	Good	Fair	Fair	Good	Fair
Level of GP Talent, Experience, and Length of Track Record	Good	Fair	Good	Fair	Fair	Fair
Experienced/Available Company Management Talent	Excellent	Fair	Fair	Good	Good	Fair
Alignment of GP/LP Interests	Depends	Depends	Depends	Depends	Depends	Depends
Capital Raised, Investment Pace, and Capital Overhang	Good	Good	Good	Good	Fair	Fair
Competitive Environment for Deals	Excellent	Excellent	Excellent	Good	Good	Good
Quality and Quantity of Deal Flow, Sector Diversity	Good	Good	Good	Fair	Fair	Fair
Relative Entry Multiples and Valuations	Good	Excellent	Good	Good	Good	Good
Local Exit Market, both IPO and M&A	Good	Good	Fair	Fair	Good	Good
LP Access to Quality Managers	Good	Good	Good	Good	Good	Good