Private Equity in the Middle East

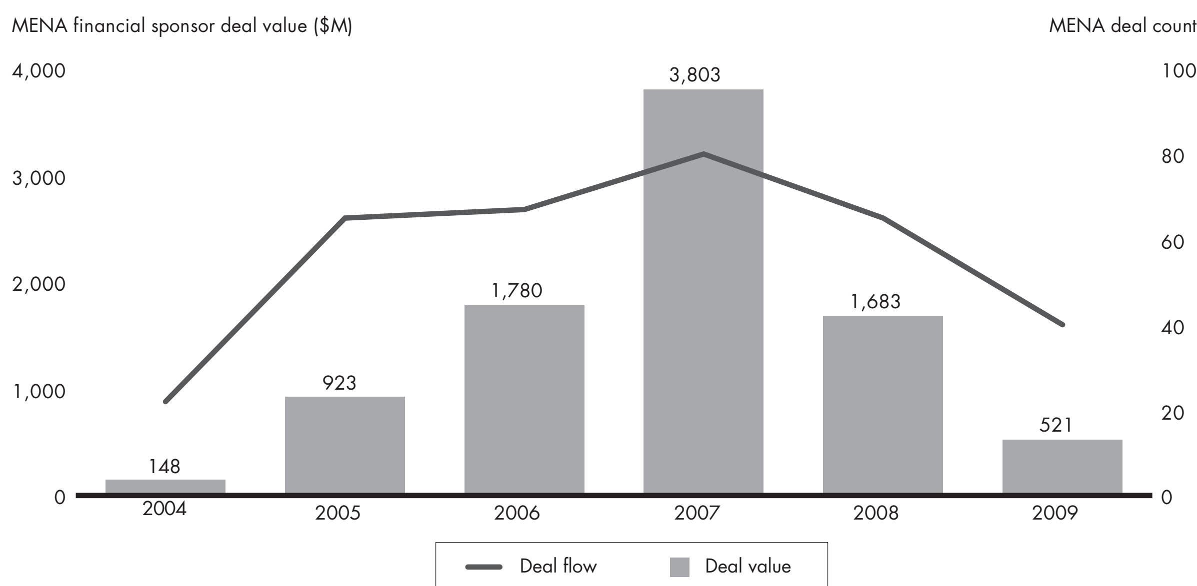
After a promising start, investment in the region has fallen off sharply. PE firms need to raise their game.

Private equity's expansion into fast-growing emerging markets helped redefine the business landscape of the past decade, and the Middle East and North Africa (MENA) rode this new wave of investor interest. Annual private equity (PE) investments in the region soared from just $148 million in 2004 to top out at $3.8 billion in 2007 before dropping steeply following the global recession, as they did nearly everywhere else.

Now, with economic growth reviving, conditions look promising for PE to pick up where it left off and deepen its presence in emerging markets. But bucking the global trend, the industry's momentum in the MENA region appears to have stalled. In 2009, total deal value was just $521 million, an 86 percent decline from its 2007 peak to its lowest level in five years (see Figure 1). Signs of inertia elsewhere in the deal pipeline suggest that new investment activity could remain subdued. One indicator is a lack of exits by PE firms from investments made across the region a few years ago. Last year, for example, PE firms arranged just six exits—a steep decline from the 17 exits valued at $2.9 billion in 2008.

A slump in new fundraising is another sign of PE's loss of momentum in the region. New capital commitments to the Middle East dropped from 10 percent of the total allocated to emerging markets in 2008 to just 5 percent, or $1.1 billion, in 2009. More recently, firms active in the region have struggled to meet their funding targets. For example, Dubai-based Abraaj Capital announced that it would reduce the planned size for its fourth buyout fund to $2 billion, half of the original goal. In March, weak investor appetite led Invest AD, an Abu Dhabi state-owned investment firm, and its partner UBS Global Asset Management, a division of the big Swiss banking company, to liquidate a $250 million fund targeting regional infrastructure investments. Examining a sample of 10 regional funds, Bain & Company found that, on average, they were able to close at only 55 percent of their original targeted size.

Figure 1: MENA private equity deals fell significantly in 2009, to below 2005 levels



Note: MENA includes Algeria, Bahrain, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Palestine, Qatar, Saudi Arabia, Sudan, Syria, Tunisia, UAE, Yemen and Turkey
Sources: Bain MENA deal database based on Zawya; Thomson Reuters; literature search

Bain's recent interviews with more than 25 limited partners (LPs) and family offices investing in PE in the region have found that they are becoming more sophisticated and selective about the fund investments they make—a phenomenon that is not confined only to the Middle East. Globally, investors are becoming much more discriminating about the funds in which they invest and fund managers with whom they work. They are also pushing back against the terms, conditions and fees PE firms try to impose. It is unlikely, for example, that "two-and-twenty" compensation arrangements, whereby PE firms collect a 2 percent fee on assets LPs invest and earn 20 percent carried interest on the fund's returns, will come back as the industry norm.

For Middle East-focused funds that are unable to demonstrate a consistent track record of success in the region, it is becoming increasingly difficult to attract international investors who have a plethora of attractive options in other high-growth emerging markets from which to choose. In a recent ranking of the most attractive markets for PE investment by the Emerging Markets Private Equity Association (EMPEA) and Coller Capital, the Middle East ranked only ninth out of the top ten, just ahead of Russia and the former Soviet republics (see Figure 2).

Figure 2: How limited partners rank the attractiveness of emerging markets for PE investment over the next 12 months

Emerging market	Overall ranking 2010
China	1
Brazil	2
India	3
Other Emerging Asia	4
Latin America (exluding Brazil)	5
Central and Eastern Europe (including Turkey)	6
South Africa	7
Africa (excluding South Africa)	8
Middle East	9
Russia/CIS	10

Source: EMPEA/Coller Capital *Emerging Markets Private Equity Survey*

Even without new funds to deploy, PE firms active across MENA have their hands full trying to put to work the money they have already raised. Capital committed by limited partners in previous years' fund-raising rounds has been accumulating and remains undeployed. Through the end of 2009, the cumulative capital raised since 2001 reached $20 billion, of which more than half has yet to be invested. Much of this "dry powder" has been idle for so long that many PE funds are now beyond their planned investment windows. Thus, unable to count on using capital gains from successful liquidations of earlier PE investments, anticipating depressed returns associated with more prolonged investment-holding periods, and facing their own liquidity constraints, investors may hold off on meeting future capital calls.

A scarcity of attractive investment opportunities will continue to be a major challenge for the region's PE market. Local economies are dominated by family businesses and government-owned enterprises that have long spurned PE acquirers—and in some cases, have become competitors to PE firms. Many privately held companies are reaching the third generation of family ownership and face major business succession issues at a time when regional growth is brisk. However, PE investors have struggled to gain traction with these potentially attractive targets, which have been reluctant to sell them significant stakes or cede management control. Most deals are for small, minority positions that do not allow PE owners to exert the kind of influence to add value to their portfolio companies as they commonly do in other markets. This dynamic is unlikely to change over the short run, since the global economic downturn has left many families dubious about financial assets and preferring to hold on to businesses that generate cash flow.

A second drag on dealmaking activity has been the slow pace of privatization of state-owned companies, a trend that investors expected to spark opportunities for PE acquirers. The increased sale of government-owned assets by the emirate of Dubai that many had hoped for has yet to materialize.

Finally, deep-pocketed government investment companies (GICs) and sovereign wealth funds (SWFs), including Mubadala Development Company, Emirates Investment Authority and Invest AD, have become potent new rivals to PE firms in the region. The big state-owned investment firms are beginning to target the same investments and buyout opportunities that have traditionally been the domain of PE firms. Their government connections, privileged access to potential deals, and longer time horizons will make them tough adversaries. This new challenge, on top of the other liabilities weighing on the industry in the region, is likely to jeopardize many firms' prospects for survival. Bain estimates that approximately one-third of PE firms will not bounce back from the downturn or successfully raise follow-on funds.

PE needs to raise its game in MENA

The types of deals available in the region are unlikely to change anytime soon. Investments will mostly continue to be for minority stakes that restrict the ability of PE firms to manage their portfolio companies. Successful PE firms will be ones that can clearly define their investment "sweet spot" and differentiate themselves strategically from their competitors. They will also need to concentrate on four key areas:

Sharpen their sector focus. Most PE firms in the MENA region position themselves as opportunistic investors of growth capital or as buyout generalists across a broad set of sectors and geographies. Even though many claim they enjoy privileged access to deals, this positioning suggests that they offer little that sets them apart from their rivals or equips them to add value to the companies with which they negotiate.

Effective specialization in such growth sectors as healthcare, education, logistics, and oil and gas will be an increasing source of competitive advantage for sustaining strong deal flow. These industries boast increasing consumer demand and attractive profit margins, and they have proven to be resilient through the downturn. PE firms will need to build deal teams with geographic and industry specialization in order to demonstrate convincingly how they can add value to portfolio companies. Given the large amount of idle PE capital looking to land attractive deals, bringing capabilities to the table beyond being a financial partner will be a key factor separating winners from laggards. Some firms are already beginning to organize investments based on sector themes.

Broaden the investment landscape. PE firms can significantly expand their deal flow by looking beyond conventional buyouts and growth-capital investments to consider a wider range of opportunities, including infrastructure, real estate, mezzanine lending and other debt financing. Given the region's large, unmet needs for transportation, electric power, and water and waste treatment, infrastructure projects alone represent vast, untapped potential for PE investors.

Penetrating the infrastructure deal flow—and zeroing in on the relatively small number of deals that are open to PE investors—will require them to develop distinctive competencies for arranging deals and expertise in financing and managing large projects. But the opportunity for those that can do so will be large. Bain & Company estimates the value of infrastructure deals open to PE investors to reach between $6 billion and $10 billion annually—more than double what we estimate more conventional PE investments in growth capital, buyouts and venture capital will be (see Figure 3).

Some PE firms are widening their deal options by targeting companies earlier in the development cycle. To the extent that their involvement complements economic development initiatives in the region, they may find willing investors and partners in the public sector. Abraaj Capital recently added to its dealmaking arsenal by acquiring Riyada Ventures, a Jordanian venture capital firm, to create Riyada Enterprise Development (RED), a new investment platform focused on small and medium-sized enterprises. Seeded with $50 million of Abraaj capital, RED has already attracted government co-investors. Abraaj teamed up with the Palestine Investment Fund to launch a RED-managed fund that will target Palestinian companies. More recently, the Overseas Private Investment Corporation, a US government agency, announced it would commit $455 million to fund five technology-focused MENA funds. Up to $150

Figure 3: Tapping new opportunities could lift annual PE investments to US$10 billion to $15 billion

Source: Bain analysis

million of this total will go to RED, which Abraaj anticipates could ultimately grow to have $1 billion under management.

Enhance due diligence and smarter ownership. PE firms need to hone their due diligence processes—disciplines that are especially important in the MENA region, where a high proportion of potential target companies are small, private and lacking in transparency. Once they close on a deal, PE firms need to work actively with management at their portfolio companies to identify two or three high-priority initiatives that create value.

Lay the path for exits. PE leaders begin weighing how they will exit each investment well before the time comes to sell by continuously evaluating market conditions for initial public offerings (IPOs) and identifying potential strategic acquirers. Developing a sound exit strategy is particularly important for foreign PE firms operating in markets like Saudi Arabia, where IPOs are restricted to local investors, the secondary market is thin, and taxes on capital gains can be onerous.

Despite recent headwinds, the MENA region's vast wealth, entrepreneurial talent and solid growth offers much that should continue to attract PE interest. But it will take greater focus and resourcefulness on the part of PE firms to convert those appealing attributes into winning returns.

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