VOL. XXIII, NO. 1 Originally published in AbanaReview, Fall 2006

ABANAREVIEW

جمعية المصرفيين العرب في شمال أمريكا Arab Bankers Association of North America

INDUSTRY DEVELOPMENTS

The Coming Shift in Middle East Private Equity

By Tarek Younes

As private equity managers, we have been gratified to see many of the developments of the last two to three years.

Several factors have combined to cause a boom in regional private equity: increased allocations to PE as an asset class worldwide; capital inflows to the Middle East; and the increasing attention of international managers and LPs. New private equity funds have been raised and established international PE managers have raised dedicated funds for the Middle East. Investors face a rapidly changing situation and GPs face increased competition. The next three to five years will prove to be a major turning point for Middle East private equity as these funds are invested and we start to see the first exits.

Foreign-sourced private equity investment, in the form of principal investment by U.S. and European private equity firms with a significant commitment to the region, represents a significant vote of confidence in the region's market infrastructure and growth potential. Foreign ownership can mean accelerated information transfer, the imposition of world-class corporate governance and operational standards, and greater international cooperation. Foreign private equity investors, however, face challenges in the Middle East that they have not had to face elsewhere. These include lack of transparency; competition from extraordinarily large pools of local capital; and resistance to both foreign ownership and loss of control. An international PE firm large enough to have a Middle East allocation may be shocked to find that it lacks credibility with local target companies.

WHAT DOES "PRIVATE EQUITY" MEAN IN THE MIDDLE EAST?

The meaning of "private equity" varies across markets. When we at the Concord Group use the term, we mean direct investment, generally by professional managers representing individual and institutional capital, to provide expansion capital to growing local or regional companies. The GPs/managers then undertake strategic review, set goals, and mobilize resources to bring operational and financial improvements to the portfolio companies. The exits are sales to strategic or financial buyers, to the public, or to secondary PE funds.

There are a few key differences between U.S./European private equity and private equity in the Middle East. The financial engineering and aggressive use of debt financing often seen overseas are less common in the region. Debt capital has traditionally been prohibitively expensive and many markets are not set up to accommodate exotic securities. Note: In defining private equity, we do not find the "public/private" distinction particularly useful. In Egypt, for example, the government offered tax breaks to companies that listed on the stock exchange, to encourage information disclosure in the early days of privatization. This means that a company could be both privately held and publicly listed. (The "public/private" distinction is increasingly blurred in the U.S. as well, where the recent IPOs of private equity managers have created public private equity funds, which themselves often invest in public companies.)

> No matter how favorable the investment climate, investors will stand or fall based on their choice of a local partner.

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THE COMING SHIFT IN MIDDLE EAST PRIVATE EQUITY

The investment policies of most funds in the region have been distinguished to date by their geographic scope. As the private equity market develops, we expect to see more sector-specific funds and fewer generalist funds. Either way, the inflow of private equity capital means longer investment horizons, more rigorous standards of corporate governance, and increased operational expectations for target companies.

Private equity equals direct investment by professional managers to promote local and regional growth.

NO MORE QUICK FLIPS

In the very recent past, the booming local stock markets provided a ready-made exit strategy for regional funds. In a period of ever-rising stock prices, PE firms tried to find pre-IPO companies that they could bring to market quickly. The challenge was to find companies that were just mature enough to IPO, but were not mature enough to access the capital markets on their own. Managers were able to achieve returns through multiple expansion, having performed only minor operational changes to the target company. While they certainly earned their fees, they were performing a service more akin to late-stage venture capital investment than private equity.

Recent market corrections and regulatory changes have cooled the IPO market, but this is good news for private equity LPs.

- Private equity managers will increasingly be forced to demonstrate real financial and operational improvements in their portfolio companies.
- Purely financial investors will seek quicker gains elsewhere.
- PE fund investment horizons will lengthen to more realistic levels.
- Acquisition prices will fall as target company owners have fewer alternative sources of capital. Competitive bidding by private equity firms may eventually cancel this effect.

With that exit route closed, general partners that are capable of attracting, and negotiating with, international strategic investors will be more likely to achieve exits.

THE IMPORTANCE OF THE LOCAL PARTNER

No matter how favorable the investment climate may be, international private equity investors will stand or fall based on their choice of local partner. The last five years have shown international institutions that they cannot hope to run private equity funds in remote markets without a strong presence on the ground. For most international fund managers—and all co-investors and club deal participants—that means a local manager that is skilled, experienced, and well-informed. Every aspect of private equity investing, from sourcing deals, to dealing with company management, to dealing with local governmental and regulatory authorities, requires specific regional and country expertise.

As discussed above, more of the obvious acquisition candidates went directly to the public markets for expansion capital. This means that GPs will have to dig deeper to find attractive investments, or work past salability barriers such as reluctant family ownership, lack of transparency, and government regulation. Ideally, a local partner would be a known quantity to Middle East corporate owners and government regulators: an acceptable buyer for privatizations and spinoffs. In addition, the local GP must have the credibility in the local market to identify and attract top managerial talent; as well as work with the portfolio company on all levels, from boards of directors and special committees to marketing departments.

Perhaps the most significant function of the local GP is the ongoing monitoring of the acquired company. The scarcity of management talent and information asymmetries make this function even more important than in developed markets. More particularly, since most of these emerging markets are still developing their legal and regulatory frameworks to international standards, there are no substitutes for close, active management by local partners.

Successful private equity investment in the Middle East for foreign institutions requires a division of labor and complementary skills. Foreign PE firms face three crucial decisions: 1) the most difficult decision, the initial allocation to the region; 2) the choice of local partner; and 3) the investment decision. They then provide capital, knowledge of international standards, and the introduction of international buyers. The regional and local partner's task is more complex. It must bring its credibility and skills to bear in convincing reluctant target companies of the value of private equity investment, and then fully manage all aspects of the investment as a true partner to the foreign firm. ■