

By Dr. M S S El Namaki

Opportunity or Threat?

Private Equity in the Middle East

While greed, if managed, could be conducive to a dynamic and progressive private equity industry, it could also turn into an ugly whirlwind that destroys the very foundations of the structure.

Private equity is in fashion, despite recent global capital market volatilities. The principle of opportunistic leveraged buyout of businesses and rapid and enhanced sell-out of restructured and presumably healthy companies has caught fire. The reach and depth are global in scale and intensity. A near \$136 billion of private equity and venture capital funds, or the equivalent of 0.31 percent of the world's gross domestic product (GDP), was invested globally in 2005. A record \$272 billion was raised, also globally, in the same year. Total global private equity investments over an 8-year period (1993 to 2005) amounted to \$935.06 billion and funds raised reached \$1,312.38 billion over the same period, according to the PricewaterhouseCoopers

Global Private Equity Report 2006.

Private equity performance in the Middle East is leading to a number of questions. Prime among those is the claim that private equity potential is not fully utilized and that opportunities exceed, by far, the demonstrated reach of the players. Firm portfolio composition and rationale are also raising questions.

The Players

Players in the Middle East are few and far between. Abraaj, the UAE operator, seem to be the undisputed leader. The Abraaj portfolio includes investments in retail, financial services and aircraft maintenance businesses. Exit decisions related to past acquisitions in insurance, financial services, logistics and waste water management.

By aligning owner and management interests and seeking higher productivity, (private equity) is fulfilling one of the basic premises of capitalist thinking.

Shuaa Asset Management is another player that was established in 2001 and claims near \$1 billion assets under management. The company's mission states that it aims to be "the leading Asset Manager by specializing in Arab and Regional Emerging Markets. We will build on our expertise and long track record to create value for our clients and shareholders through innovation, dedicated research and strategic development."

Global players are enticed by the area's capital clout as well. US-based Carlyle Group's Middle East and North Africa base, created in 2005, aims at investing in healthy, growing companies in the energy, financial services, healthcare, industrial, infrastructure, and technology and transportation industries. Sovereign wealth funds, quasi-private equity entities, are strong in Middle East countries, especially the Gulf states. They command massive resources and have strong capital clout. Abu Dhabi's Investment Authority, or "Mubadala," is the largest and Qatar Investment Authority is possibly the smallest and youngest (established in 2005). Mubadala was created in 1976 and is the largest sovereign fund on the globe, with a near \$875 billion in assets. Its investments are broad and scattered. It has bought a controlling stake in the Chrysler Building, an icon of the Manhattan skyline, and is planning to become one of the 10 biggest institutional investors in General Electric. Past Mubadala deals included a 5 percent stake in Ferrari, 7.5 percent equity in Carlyle Group and a 4.9 percent capital input in Citigroup. These moves highlight the growing self-confidence and ambitions of Abu Dhabi's sovereign investment vehicle and the efforts of the emirate to develop a balanced and diversified economic growth model.

Middle East sovereign wealth funds have very recently

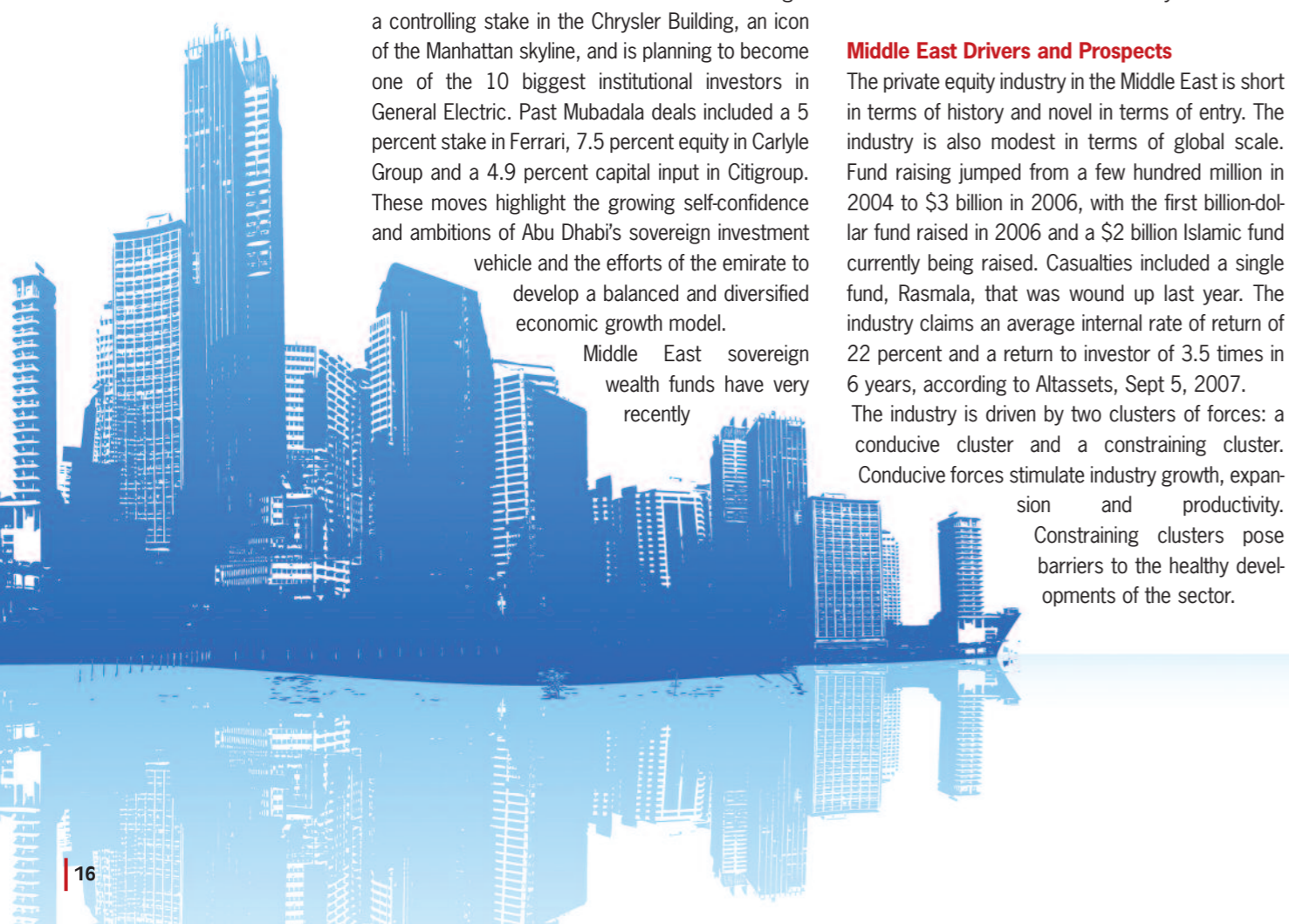


played a leading role in helping to recapitalize the faltering US banking industry, a risky endeavor in today's volatile capital markets. These investments are not really performing. Worse still, they are leading to the question of who owns what and for what purpose. Put differently, there are those in the United States who are wondering whether government ownership, especially if it is a Middle Eastern foreign government, of specific American assets is a good thing. There is the concern that this could jeopardize interests and undermine traditional capital-market fundamentals of the country.

Middle East Drivers and Prospects

The private equity industry in the Middle East is short in terms of history and novel in terms of entry. The industry is also modest in terms of global scale. Fund raising jumped from a few hundred million in 2004 to \$3 billion in 2006, with the first billion-dollar fund raised in 2006 and a \$2 billion Islamic fund currently being raised. Casualties included a single fund, Rasmala, that was wound up last year. The industry claims an average internal rate of return of 22 percent and a return to investor of 3.5 times in 6 years, according to Altassets, Sept 5, 2007.

The industry is driven by two clusters of forces: a conducive cluster and a constraining cluster. Conducive forces stimulate industry growth, expansion and productivity. Constraining clusters pose barriers to the healthy developments of the sector.

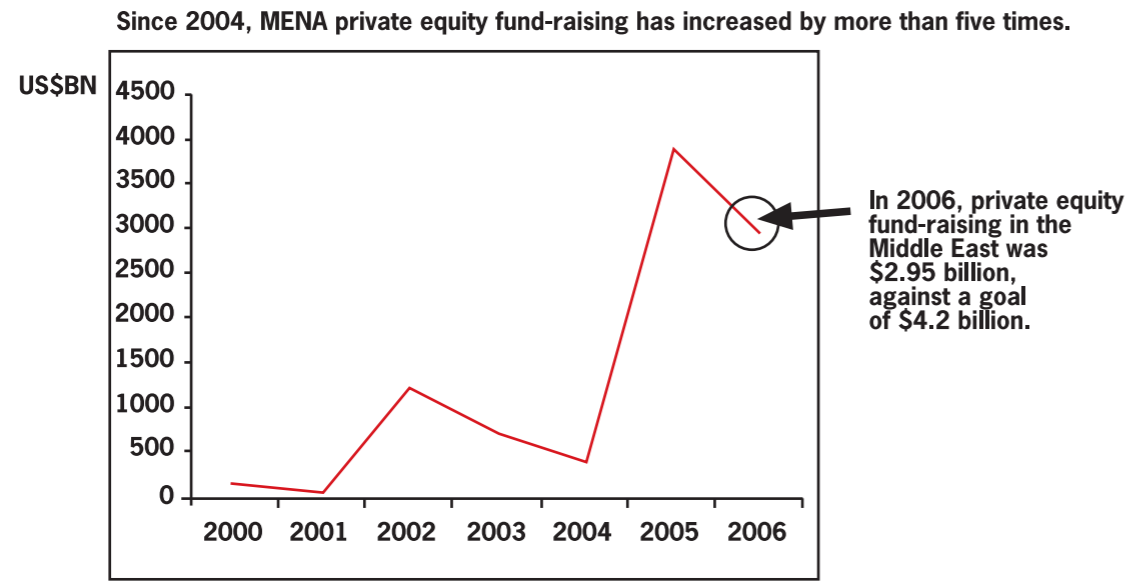


Conductive Forces

1. Capital market, fund generation and fund flow. Increasing levels of available capital will undoubtedly stimulate industry growth and progression. The following chart shows private equity fund raising between 2000 and 2006, and one can only speculate that with oil prices rising at the recently witnessed pace, larger volumes and greater access are on the horizon.

Private equity performance in the Middle East is leading to a number of questions. Prime among those is the claim that private equity potential is not fully utilized and that opportunities exceed, by far, the demonstrated reach of the players.

Figure 1: Private equity fund-raising in MENA 2000-2006



Source: Zawaya PE Monitor, June 2006, EMPA Private Equity 2006 Fundraising Review, March 2007

It is estimated that the private equity industry in the Middle East had, in 2007, a near \$15.3 billion under management.

There is also the issue of growth in neighboring markets such as India and even faraway markets such as China. Both markets provide ample opportunities for Middle Eastern private equity capital to enter and grow

2. Target acquisitions. There are four types of "lucrative" acquisitions in the Middle East, and together they represent substantial potential.

- Ill-managed businesses or businesses that do not conform to common standards of management or performance. These are commonly observed, especially in the small and medium industry sector, and could provide a target.

- Family businesses provide the backbone of the business sector, especially in GCC countries. Their attraction lies in conservative management culture and entrenched management approach.

- To-be-privatized companies feature across the entire Middle East, although sizable ones are more likely to be identified in Egypt, Saudi Arabia and Syria.

- Fragmented industries. There is a high measure of fragmentation among industries in the Middle East and opportunities for consolidation are numerous.

3. Macro economic climate. Oil price climbs, combined with stimulatory economic growth policies, have led to an average GDP growth of 9.4 percent and 7.1 percent (at constant prices, IFM data) in the UAE in 2006 and 2007, respectively. Even traditionally slow growers such as Egypt have shown a growth of 6.8 percent and 7.4 percent in the same period (at constant prices, IFM data). Projections for the coming years reflect the same positive outlook.

The three categories taken together could provide fertile ground for the private equity industry in the Middle East in the medium and longer terms.

Constraining Clusters

1. Business culture. Business cultures in most Arab countries diverge from the typically open culture of North America or some European countries. Some evidence is provided in Geert Hofstede's book "Culture's Consequences: Comparing Values, Behaviors, Institutions and Organizations Across Nations." The High Power Distance coefficient (PDI) (80) and equally high Uncertainty Avoidance (UAI) (68) coefficient are predominant and induce a closed business culture. Closed cultures are generally not conducive to the risk-taking spirit of private equity.

2. Track record. Track records of private equity operators are scarce, if not non-existent, and even the oldest practitioner, HSBC, can only trace its history back to 2001. This track record is crucial to an assessment of industry participation and industry expansion.

3. Management talent. A shortage of skilled investment professionals and legislation governing foreign ownership are regarded as critical in the evolution of the private equity industry in the Middle East.

4. Exit market. Exit volumes are expected to increase as fund portfolios reach maturity, with counter acquisitions and IPOs perceived as the most likely exit routes. A few initiatives are being undertaken to expand and enhance the exit market. However, trade sales will remain the preferred exit route. Questions remain with regards to the scale and scope of the exit market.

5. Competition. Home-grown private equity firms will, very likely, be at the forefront of the Middle Eastern market. Non-national sovereign wealth funds and internationally backed private equity firms will pose a threat, however.

The Role of Risk

One can view this question in terms of two variables. The first is the measure of risk involved and the derived risk attitude of the private equity player. And the second is the extent to which the concept could magnify the less than positive dimensions of capitalist thinking.

Let us start with the risk attitude issue.

Private equity is a risk-laden process and the risk attitude of the player is a key force. It is my contention that this risk attitude is closely associated with two variables: the level of leverage involved in the transaction and the scope and span of the

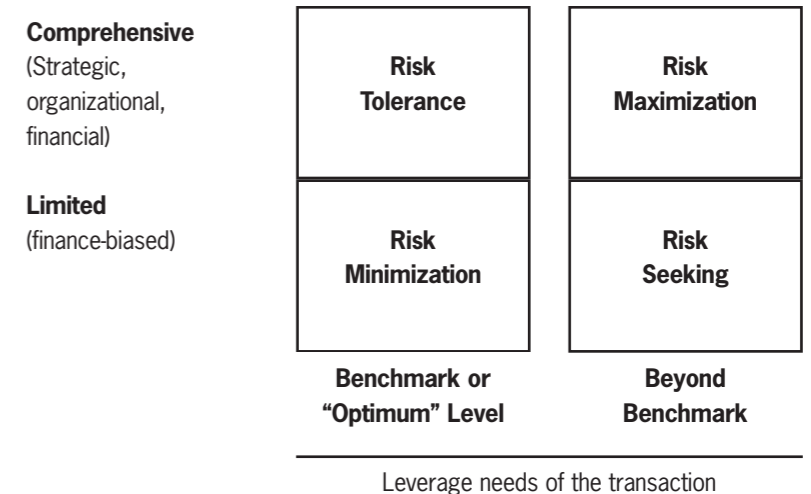
restructuring process of the acquired or to-be-acquired business. Leverage could be "benchmark-compatible" or "optimum" or "above benchmark" or "beyond the optimum." An "optimum" or "benchmark-compatible" level of leverage is, largely, a function of the future earnings, the rate of return on total assets and the cost of leverage as well as the accepted standards within the industry. To the extent that future earnings are high enough to provide an industry-accepted rate of return, cover the costs of debt incurred in the process of acquisition and allow a "windfall" return to investors, the level is "optimum."

On the other hand, the scope and scale of restructuring has something to do with the coverage, intensity and depth of restructuring. For restructuring to be comprehensive, it has to have a strategic, financial and organizational dimension. Financial restructuring alone, as was practiced in the early days of leveraged buyout, would very likely not suffice. Financial restructuring backed by a strategic restructuring and a change in the organizational parameters of the acquired business could be described as complete and purposeful. So the distinction here is between what we may call "limited" or "modest" restructuring, i.e., restructuring that is finance-biased, and "comprehensive" or "all-inclusive" restructuring, or restructuring that extends over the entire arena, i.e., finance, strategy and organization.

The following diagram provides an illustration.

Figure 2: Strategic positions within the private equity industry

Restructuring needs of acquired business



Turning to private equity and the practice of capitalism, let us start by stating that capitalism today – at least as Wall Street sees it – is a very different, and worse, business than years ago.



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The above diagram illustrates four strategic positions:

- Risk seeking, where leverage is beyond benchmark level and restructuring needs are limited.
- Risk tolerance, where leverage is placed at benchmark levels and restructuring is comprehensive.
- Risk maximizing, where comprehensive restructuring needs are combined with excessive leverage.
- And finally, risk minimizing, where leverage is limited and restructuring is modest.

The question now is where the Middle Eastern players are positioned today and where are they likely to be in the foreseeable future.

It is my contention that Middle East private equity practice, so far, has swayed between risk minimization and risk tolerance. Acquired businesses such as Aramex or Jordan Aircraft Maintenance, for example, required average levels of restructuring and were acquired within reasonable levels of leverage. This is commendable, given the realities of the area and the culture. And these are, of course, a few cases that do not represent or provide a board conclusion applicable to the industry in the region as a whole. Future competition and entry into the fray of aggressive global players such as Carlyle will, more likely than not, bring about more risk seeking and risk maximizing behavior. Those players are known for their aggressive leverage and fundamental restructuring practices. Acquisition and turnaround of family firms belongs, more likely than not, to the risk maximization category than any of the others. The same would apply to the privatization of state enterprises such as those in the textile sector of Egypt or the telecommunication sector of Syria, for example.

Turning to private equity and the practice of capitalism, let us start by stating that capitalism today – at least as Wall Street sees it – is a very different, and worse, business than years ago. "Greed," which has always been a core value of modern-day capitalism, has assumed a more pronounced role than ever. It has become a prime driving force in the search of excessive gains and exceptional opportunities. Enron in the United States and Ahold in the Netherlands provide ample evidence.

While greed, if managed, could be conducive to a dynamic and progressive private equity industry, it could also turn into an ugly whirlwind that destroys the very foundations of the structure. In the US, the pendulum has swayed to the danger zone. Witness several recent acquisitions such as Freescale and Neiman Marcus. The Freescale takeover was based on massive leverage at a time when the firm's market was contracting, and the result was a staggering debt burden, collapsing revenues and a serious management walkout. Neiman Marcus' story is more or less identical.

Private equity in the Middle East could sway in either direction and it will all depend on the impact of the new entrants and the accommodation of the industry's foreign culture.

A Question of Greed

Private equity is the process of leveraged buyout of opportunity businesses and rapid and enhanced sell-out of restructured and presumably better performing companies. It is a growth industry that is changing the very fundamentals of capitalism. By aligning owner and management interests and seeking higher productivity, it is fulfilling one of the basic premises of capitalist thinking. The industry is led by key players in the US that combine the powerful and the endowed.

Are Middle East private equity operations an opportunity or a threat? There is evidence supporting both notions. A combination of abundant funds, numerous acquisition targets, government support and the very scale of the economies of the area underline a robust growth and dominant position. On the other hand, the industry faces structural constraints. Prime among those is a closed business culture, a family-dominant business sector, hesitant government policies and scarce management talent. Where will that take the industry is a question mark. The sheer power of capital, combined with volatilities in the international market, may tip the balance in favor of the conducive forces.

However, the issue goes far beyond this straightforward analysis. The core is the extent to which capitalist greed, an inherent element in capitalism, could prove to be a boon or a hindrance within the private equity industry in the Middle East. Greed has led to grim consequences in the present-day US. And private equity in the Middle East could follow the same path if foreign new entrants and foreign industry culture takes hold. |