Tadhamon Capital تضامن كابيتال

PRIVATE EQUITY IN THE MENA REGION

April 2011

OVERVIEW

The objective of this Research Note is to analyze Private Equity (PE) activity in the MENA region during 2005-2010 with a special emphasis on 2010. The note discusses fundraising and PE investments by geography, sector and size during 2005-2010. Studying the trend of the past 5 years and the key challenges in light of the global economic downturn, the note presents key conclusions for PE investments in 2011 and beyond in the MENA region.

- In 2010, Private Equity fundraising in the MENA further declined to reach close to the levels seen in 2004. During the year, General Partners (GPs) managed fundraisings worth USD448.1mn against USD1.07bn in 2009 according to Emerging Markets Private Equity Association (EMPEA).

- PE deals/transactions worth USD1.07bn were announced in the MENA region in 2010. This depicts an increase of approximately 67% over the USD0.64bn recorded in 2009, but a decline of 47% over the 2005–2009 average.

- Between 2005 and 2009, Egypt and the UAE attracted the largest number of PE deals. In 2010, maximum deals (number/value) were seen in the UAE. The two most active sectors during 2005–2009 were industrial manufacturing and financial services. Data for 2010 indicates that information technology is an area of growing interest.

- PE sector faces key challenges of raising capital, limited openness of family groups for PE investments, lack of experienced PE professionals and incentive structures in PE firms, and limited corporate governance and information transparency in investment targets.

- PE in the MENA region seems to be moving towards the traditional model of adding value to investee companies before exit rather than selling down shortly after closing the transaction to generate returns. There will be a continued focus on smaller deals and a growing trend of joint deals between PE institutions.

- In the last few months the region has gone through unprecedented political change and upheaval. Due to the resulting uncertainty, investment plans have either been deferred or delayed. Although North Africa is a region with investment potential, it will take some time in attracting PE investments. We might also now see capital increasingly being deployed outside the region.

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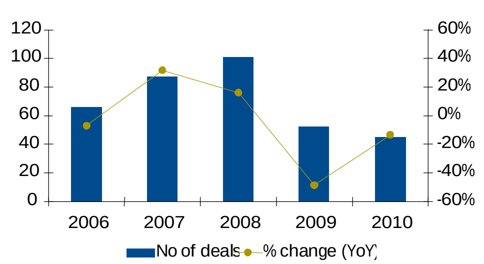
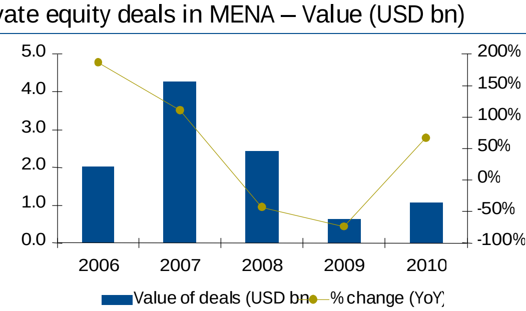
Private equity deals in MENA – Volume (Nos)



Source: Zawya Private Equity Monitor, Thomson ONE Banker

Private equity deals in MENA – Value (USD bn)



Source: Zawya Private Equity Monitor, Thomson ONE Banker

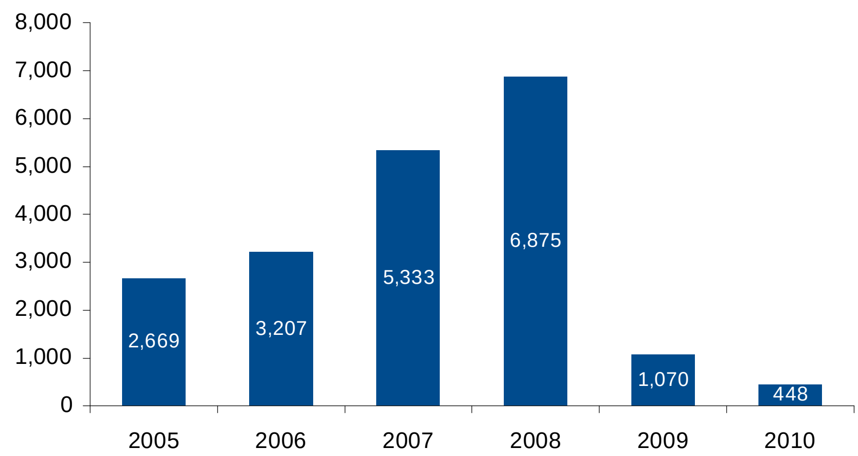
DEVELOPMENTS IN 2010

Fundraising activity

Private equity fundraising for MENA dropped below USD500mn-mark in 2010 - such level of fundraising was last seen in 2004. Data available from the Emerging Markets Private Equity Association (EMPEA) suggests that funds dedicated to the MENA region raised a total of USD448.1mn in 2010, depicting a decline of 58.1% YoY. Annual average fundraisings in 2005–2009 stood at USD3.83bn.

As per the latest annual report from the Gulf Venture Capital Association (GVCA), about 84% of the total funds raised in the last decade, were secured during 2005–2008. The report further suggests that the average fund size declined below the USD200mn level in 2009, reflecting a shift in trend towards smaller funds and increased risk-aversion of Limited Partners (LPs). Average fund size was USD227mn in 2007 and USD317mn in 2008.

Private equity fundraising for MENA – 2005 to 2010 (USD mn)



Source: Emerging Markets Private Equity Association (EMPEA)

Notable MENA-focused private equity funds closed in 2010 include:

- Abraaj-Riyada Enterprise Development Growth Capital Fund (Abraaj Capital),
- ARC Real Estate Income Fund (Al Rajhi Capital and Arcapita Bank), and
- DB Masdar Clean Tech Fund (Swicorp)

DEVELOPMENTS IN 2010

Value of deals/investments

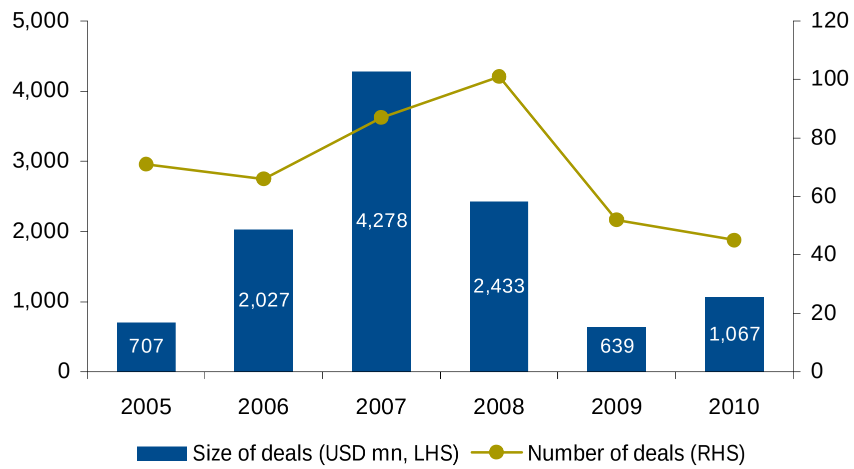
Private equity investments in MENA are exhibiting signs of a turnaround. At USD1.07bn, the total known investments in the region in 2010 rose more than 67% YoY from USD0.64bn in 2009. Private equity investments averaged USD2.02bn over 2005–2009.

Abraaj Capital and Ithmar Capital concluded the two largest PE transactions (worth USD544.5mn and USD272.0mn, respectively) in 2010. Average transaction size, however, has been small. At USD24mn in 2010, the average transaction size is still half of the levels achieved in 2007.

MENA-based PE firms predominantly focus on the capital growth model, taking a small or large minority stake. This trend can be attributed to the infancy of the private sector, nascent capital market regulations, and prevalence of family-owned businesses.

Majority (56%) of the PE investments in MENA since 2005 were less than USD20mn in size, while 36% were in the USD20mn–USD100mn range.

Private equity investments in MENA – 2005 to 2010 (USD mn)



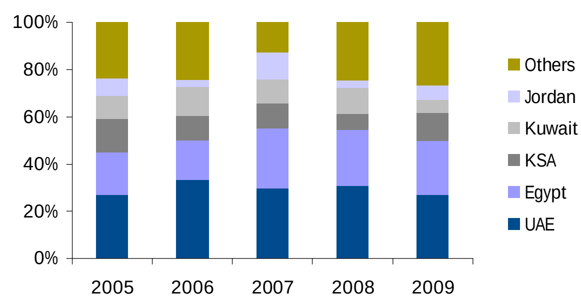
Source: Zawya Private Equity Monitor, Thomson ONE Banker

DEVELOPMENTS IN 2010

Investment by geography

Between 2005 and 2009, Egypt and the UAE attracted the largest share of all private equity deals. Egypt received USD4.23bn (41.9%), while the UAE attracted USD2.54bn (25.2%) of PE investments (based on deal value reported). However, in terms of number of deals, the UAE with 112 transactions stands above Egypt that recorded 82 deals. Key private equity deals concluded in Egypt and the UAE over 2005–2009 include Abraaj Capital's USD1,900mn investment in Egyptian Fertilizers Company; Actis Capital's USD244mn investment in Commercial International Bank; DIFC's USD817mn investment in Dubai Pearl Project; and ADCB Macquarie Infrastructure Fund's USD188mn investment in ZonesCorp.

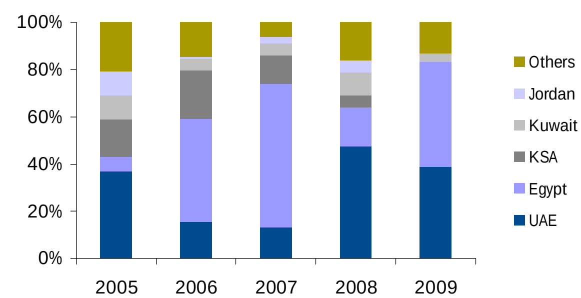
No of private equity deals by country – 2005-09 (No's)



Source: Zawya Private Equity Monitor, Thomson ONE Banker

Note: Others include countries like Algeria, Bahrain, Iraq, Lebanon, Libya, Morocco, Oman, Qatar, Syria, Tunisia and Yemen

Value of private equity deals by country – 2005-09 (USD mn)

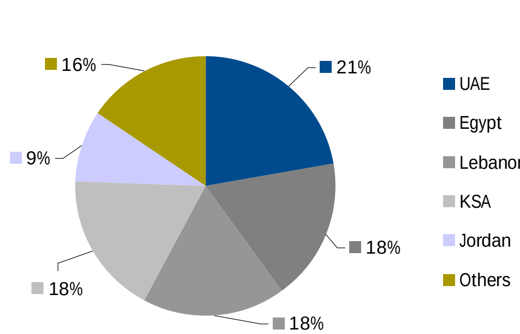


Source: Zawya Private Equity Monitor, Thomson ONE Banker

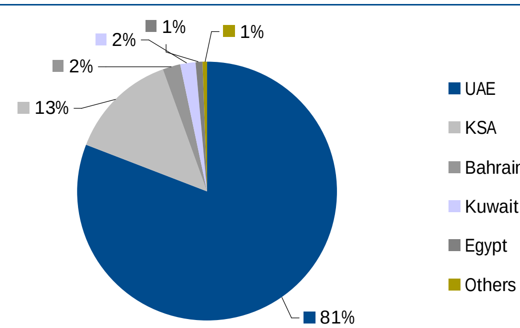
Note: Others include countries like Algeria, Bahrain, Iraq, Lebanon, Libya, Morocco, Oman, Qatar, Syria, Tunisia and Yemen

During 2010, the UAE accounted for approximately 81% (USD863.5mn) of all private equity investments in the MENA region. Even in terms of number of deals, the country was by far the favorite destination. Other countries recording large private equity activities were Saudi Arabia, Egypt and Lebanon. Some of the notable deals included Abraaj Capital's USD545mn investment in Network International, a payment solutions provider; Ithmar Capital's USD272mn investment in Al Noor Medical Company, a healthcare operator; ARC Real Estate Income Fund's USD80mn investment in a logistics and distribution center in Riyadh; Actis Capital's undisclosed investment in Mediterranean Smart Cards Company; and Intel Capital's undisclosed investment in VoIP service provider, Nymgo.

No of private equity deals by country – 2010 (No's)



Value of private equity deals by country – 2010 (USD mn)



DEVELOPMENTS IN 2010

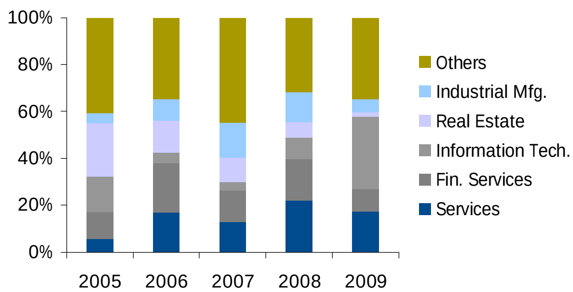
Investment by sector

The two most active sectors in terms of private equity capital raising/number of deals during 2005–2009 were:

(1) Industrial manufacturing – A total of 38 deals totaling USD2,357mn were reported during 2005–09 in this sector. PE deal activity reached its peak in 2007, primarily due to the USD1,900mn investment by Abraaj Capital in Egyptian Fertilizers Company and Intaj Capital's USD100m investment in Lebanon-based Uniceramic.

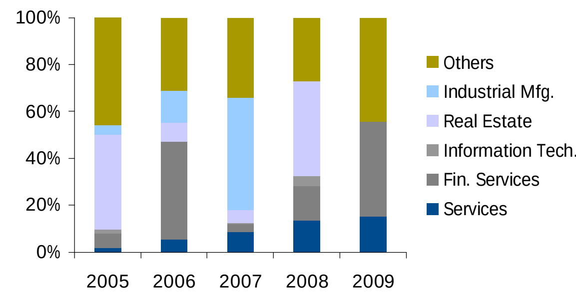
(2) Financial Services – As many as 57 deals worth USD1,638mn were reported during 2005–09; most transactions were executed between 2006 and 2008. Abraaj Capital's USD501mn investment in EFG-Hermes; Swicorp's USD64mn investment in Amlak and Unicorn Investment Bank's acquisition of Bahrain Financing Company were the prominent transactions.

No of private equity deals by sector – 2005-09 (No's)



Source: Zawya Private Equity Monitor, Thomson ONE Banker

Value of private equity deals by sector – 2005-09 (USD mn)



Source: Zawya Private Equity Monitor, Thomson ONE Banker

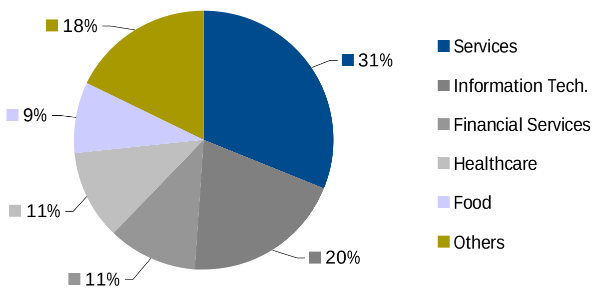
A large number of private equity deals (nine deals totaling USD568mn) were recorded in the Information Technology sector in 2010. The biggest transaction – Abraaj Capital's USD545mn investment in Dubai-based Network International contributed more than 95% to the total deal value of the Information Technology sector. Actis Capital's investment in Mediterranean Smart Cards Company was unreported. Three of the nine deals in the sector involved Lebanon-based companies.

The services sector is the mainstay of the Lebanese economy, accounting for nearly 60% of the country's GDP. According to the World Bank, Lebanon receives massive overseas financial transfers and capital inflows–net foreign inflows of services, capital, income and remittances contributed 60% to the country's GDP in 2009.

Yet, basic industries like healthcare, education, and retail continue to attract private equity interest. As many as five deals worth USD284mn were reported in the Healthcare sector in 2010.

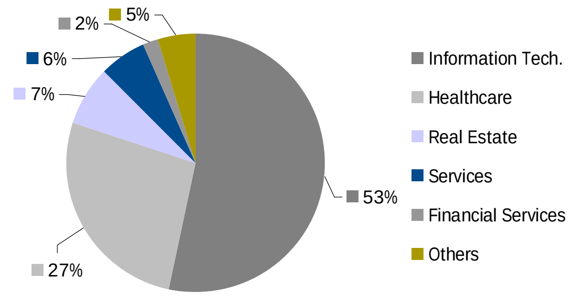
DEVELOPMENTS IN 2010

No of private equity deals by sector – 2010 (No's)



Source: Zawya Private Equity Monitor, Thomson ONE Banker

Value of private equity deals by sector – 2010 (USD mn)

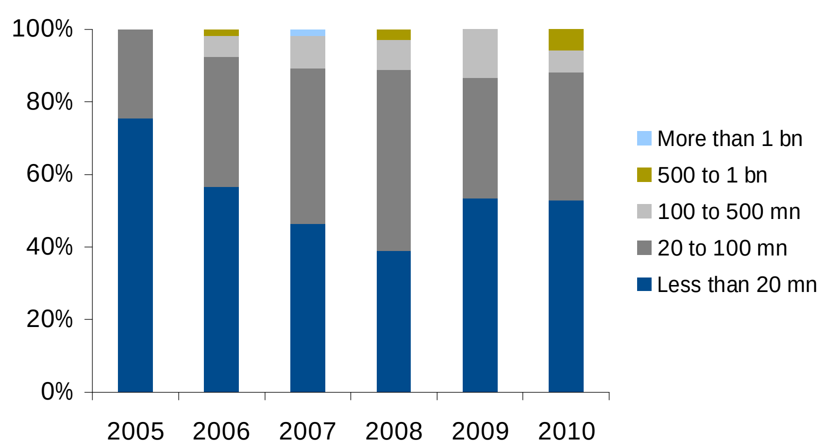


Source: Zawya Private Equity Monitor, Thomson ONE Banker

Investments by deal size

Private equity firms in the MENA region usually seek a minority stake. Based on our findings, as much as 56% of all PE investments in MENA since 2005 were less than USD20mn in size. Deals worth USD20mn or less accounted for 75% of all deals (excluding unreported transactions) in 2005. This share fell below 50% in the boom period of 2007–2008, but recouped to 53% in 2009. However, the number of deals between USD20mn–USD100mn has increased. In terms of the overall share, such deals comprised of 30–35% of all deals in the last two years. In 2005, deals sized between USD20mn–USD100mn accounted for just about 25% of overall deals.

Size of private equity deals in MENA – 2005 to 2010



Source: Zawya Private Equity Monitor, Thomson ONE Banker

CHALLENGES FOR MENA PRIVATE EQUITY INDUSTRY

Smaller funds/institutions struggle to raise money

Private equity firms in MENA have a substantial amount of dry powder (uncalled capital/uncommitted capital), led by extensive fundraising over 2006–08. Of the estimated USD21.8bn fundraising between 2001 and 2010, nearly USD11.7bn has been invested. However the dry powder in the MENA region is concentrated in selected large funds. Institutions which had undertaken the majority of the PE investments during 2005-2009 are struggling to raise capital and execute investments.

Limited openness by family groups

Most businesses in the MENA region are either family or government-owned. The former often treat their businesses as prized assets that need to stay within the family, moving from one generation to the next. These family-owned business enterprises in the region are not yet receptive to PE investors. Even if they accept the funding from a PE firm, most of them offer minority ownership and are highly reluctant to share management control. Thus PE investors are unable to extend the benefits of active management to an investee company.

In addition, the standard protective rights for PE investors in the West are also not offered making robust PE investments an even more challenging endeavor. While reluctance to share the management control is a constraint with the funding to the family owned businesses, government-owned institutions rarely seek private equity investors.

Small average deal size

As stakes sought are usually minor, the average size of private equity investments in the MENA region is small. Based on our findings, as much as 56% of all PE investments in the MENA region since 2005 were less than USD20mn in size. Average deal size in MENA reached a high of USD49mn in 2007 – about one-fourteenth of the average global deal size of USD700mn during the same year.

The smaller deal size presents a significant challenge as PE funds/institutions need to execute and manage a larger number of deals for the deployment of a smaller pool of capital as compared to their western counterparts.

Lack of expereinced PE professionals and appropriate incentive structures

Private equity professionals in MENA are comparatively new, and in many cases lack appropriate skill-sets. According to a Bain & Company report, PE firms need to improve 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 lack transparency. Furthermore, there is also a dearth of industry expertise within the PE firms as most organizations rely on finance professionals who are more experienced in structuring transactions rather than managing companies in the post-acquisition phase.

Lack of appropriate incentive structures similar to those practiced in the West have also not been formalized by most PE institutions. Though the concept of carry programs has been introduced, the payout of incentives is still undertaken on a discretionary basis. This leads to PE managers having short-term views of PE investments which was very evident during the 2005-2009 period. Most of the PE investments during this period were undertaken with a view to selling-down in a very short timeframe rather than adding value to the investee companies.

PE institutions need to align, formalize and execute the incentive structures for the managers along the traditional PE models.

CHALLENGES FOR MENA PRIVATE EQUITY INDUSTRY

Unrealistic expectations of limited partners (LPs)

The boom period of 2005-2008 saw many PE firms in the region generating returns through sell-downs and structuring to generate fees upfront. The primary sectors for such investments, real estate and financial services, have suffered due to the recent global economic crisis and the sell-down model has limited viability in the current environment. LPs expectations for the timeframe of returns are yet to be aligned to the current market conditions and longer timeframe for profitable exits for PE investments.

Lack of corporate governance/transparency

It has been argued that MENA-based companies score poorly in terms of levels of disclosure. Issues such as filing of annual reports on time or/and in English as well as absence of an investor relations officer or a strong independent board to protect minority shareholders' rights continue to arise year after year. In addition, Boards are generally composed of key investors and/or shareholders, rather than individuals with the necessary vision and experience to grow and develop the business.

The private equity industry has shown recovery in 2010, with investments in the MENA region rising about 67% to USD1.07bn as against USD0.64bn in 2009. However fundraising activity remains subdued. After falling steeply in 2009, PE fundraisings in the MENA fell 58.1% YoY to USD0.45bn in 2010. Yet, resurgence in funds deployment can be termed healthy as it reflects the turnaround in the industry which had been trying to recover from the global financial crisis.

Move towards traditional PE deals

As mentioned previously, majority of the PE institutions in the MENA region simply focused on investments which could be sold down to generate up-front revenues. Investing in companies and adding value through professional expertise has received limited attention. However, as the PE space continues to evolve in the region, we expect the focus to shift towards the PE players identifying assets where they can add considerable value post-acquisition through their expertise and reaping the benefits of the growth upon a profitable exit. Skilled PE professionals who understand the operational dynamics of their sectors are likely to see more demand for their expertise.

Focus on defensive sectors

Sectors such as real estate and financial services have been the focus areas for the PE funds during 2005-2009. However, these two sectors were the worst hit by the global financial crisis, losing their sheen from the PE investment perspective. We believe this has brought renewed focus on defensive sectors such as healthcare, food (production, processing and retail), education and light manufacturing. The food sector has recently seen considerable interest from PE institutions both from procuring food security and the increase in prices. Education and healthcare sectors are still in the early stages of development in many of the MENA countries, but they hold significant growth potential.

Continued focus on small deals

As mentioned earlier, the average deal size has been declining since 2005. We expect this trend to continue in 2011 as well. Over 50% of all private equity investments in the MENA region since 2005 were less than USD20mn in size. While the average investment size was approximately USD10mn in 2005, it peaked at USD49mn in 2007. However, the global financial meltdown seems to have reduced the appetite for large deals among the PE players, as seen, by the average deal size of USD12mn in 2009. While 2010 saw a slight increase in the average deal size (USD23mn), we expect the trend of small sized investments to continue for the foreseeable future.

Joint deal-making

Joint or club deals are likely to increase in the region. This will primarily be driven by two factors – (1) Shortage of capital/investable money and, (2) Lack of expertise. Several small PE firms in the region, having invested most of the funds raised previously, are still finding it hard to raise large sums. Hence, investing in a large transaction could encourage many of them to consider joint-deals. In addition, lack of human capital makes it difficult for the firms to have GPs who have expertise in different sectors. This could also be a driving factor for joint-deals, in our view.

Political Uncertainty

In a region known for its stability, political uncertainty and risk have over the last few months become key considerations. Whereas Egypt may have passed the abyss and positive developments are emerging on the political front, Libya, Syria and Yemen continue to confront issues of leadership and political change. As a result of this uncertainty, investors not already committed to funds or transactions will tend to hold back and those already committed may even try and renegotiate their commitments. PE funds and investors may also hold back on deploying new capital, until things start to look a bit clearer. Although we will see diminished activity across the region, we believe that the trends identified above will however still apply going forward.

OTHERS

Appendix 1: About Tadhamon Capital

Tadhamon Capital BSC (c) (Tadhamon) is a Shariah compliant investment company established in the Kingdom of Bahrain. Tadhamon's objective is to manage assets and deliver superior returns in Private Equity, Asset Management and Real Estate.

Private Equity at Tadhamon Capital (PE) is focused on value creation through active collaboration with management in the post-acquisition phase. Tadhamon aims to provide support to its portfolio companies to achieve growth and operational excellence through active involvement at the Board and management levels. PE will acquire controlling ownership in the investee companies with the objective of enhancing value-creation, guiding and defining financial and operational strategy and managing the exit processes. Minority ownership opportunities will also be considered, however, with strong minority protection and rights. Generally, PE will not invest in greenfield projects or companies.

PE has a defined selection criteria and each investment will have one or more of the characteristics set forth below:

- Leading companies within their markets or segments
- Clear growth potential and significant market opportunity
- Strong and established management team
- Identified value-add from partnership with Tadhamon
- Profitable history
- Clear exit opportunities

PE will target investment opportunities in the MENA region, with a specific focus on GCC countries, and a wider focus on Malaysia, Indonesia, India, Pakistan, Sri Lanka and Singapore. On an opportunistic basis, PE will also consider potential investments in other geographic regions.

PE focuses mainly on investment opportunities in the following sectors, but will also evaluate potential investments in other sectors on an opportunistic basis.

- Consumer and Retail
- Food and Agribusiness
- Logistics
- Services

Since inception PE has invested over USD40mn in key transactions. It is currently reviewing a number of opportunities in its target sectors and is also working on a private equity fund initiative.

OTHERS

Appendix 2: Research methodology

We commenced this study by extracting data related to private equity deals in MENA from Zawya Private Equity Monitor and Thomson ONE Banker. The data was then filtered for:

- MENA, in this report, refers to Algeria, Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Qatar, Saudi Arabia, Syria, Tunisia, the UAE and Yemen.

- Deals involving government agencies, particularly Sovereign Wealth Funds (SWFs), were excluded.

- All companies involved in the private equity transactions were segregated under 12 sectors: Construction, Consumer Goods, Financial Services, Food, Healthcare, Industrial Manufacturing, Information Technology, Oil and Gas, Real Estate, Services, transport, and Others.

- Investment in MENA based companies by all funds (MENA based and funds based outside of MENA) were considered for the purpose of analysis.

- "Value of the transactions" refers to the disclosed value of the transactions. Transaction values were not disclosed in many cases.

Emerging Markets Private Equity Association, Gulf Venture Capital Association, and Zawya Private Equity Monitor were the main sources for compilation of private equity fundraising related data.

OTHERS

References

- The Wharton School of the University of Pennsylvania
- Emerging Markets Private Equity Association (EMPEA)
- Dubai International Financial Centre (DIFC)
- Gulf Venture Capital Association (GVCA)
- The Boston Consulting Group
- Global Investment House
- Harvard Business School
- Deloitte & Touche
- Booz & Company
- Bain & Company
- Ernst & Young
- PEI Research
- World Bank
- INSEAD
- Zawya
- KPMG
- Preqin