MENA's sleeping giant

Saudi Arabia, the Gulf's biggest economy, is attracting the interest of private equity investors. But will the region's powerful family conglomerates turn out to be friend or foe? Marc Mullen reports.

The oil-rich Kingdom of Saudi Arabia is the largest and wealthiest country in the Arabian Peninsula, but MENA's regional powerhouse is something of an enigma to private equity investors. With a gross domestic product (GDP) of US$468bn in 2008, the Saudi economy has grown dramatically since the latest oil price boom started in 2003. GDP grew at an average of 5.0% between 2003 and 2007 according to the Economist Intelligence Unit (EIU).

By the end of 2007 rising oil exports, which account for some 90% of Saudi export revenue, had swelled government's coffers, taking the trade balance from deficit to a healthy surplus of US$151bn, according to the EIU. To put the real wealth of Saudi Arabia in perspective, its state-owned oil business Saudi Aramco has 300bn barrels of proven oil reserves. Exxon Mobil, with 20bn of proven reserves, is the most valuable public company in the world, worth US$406bn at the end of 2008. But with the world economy slowing and the oil price well below recent highs, what are the prospects for Saudi Arabia?

"People think because the oil price has dropped to 40 bucks a barrel we are in bad shape, but definitely not," says Fadi Arbid, executive vice president and country head for Saudi Arabia of private equity firm Amwal AlKhaleej, which is headquartered in the capital Riyadh (see profile, page 34). "The government budget is the most important metric you have for Saudi, more than the oil price. Why? Because it is a very government dependent economy, with 60-70% of the working population either directly or indirectly employed by the government. For 2009 they announced a government budget of US$125bn of spend – 15% higher than last year. At a US$40-oil barrel and expected output of eight million barrels of oil a day, they expect a fiscal deficit of 10%, which is just 3% of their total cash reserves, and represents 12% of the 2008 surplus. The spending will go on the right soft and hard infrastructure such as education and healthcare, desalination plants, etc. In the context of private equity this is the market to be in: you have the population, you have the growth, the companies, the size, the reforms and you have the government spending."

Indeed in February Amr Al-Dabbagh, governor of the Saudi Arabian General Investment Authority (SAGIA) announced it was ploughing ahead with US$400bn of infrastructure projects over the next five years, making use of its high foreign currency reserves and taking advantage of falling construction costs.

But despite its wealth, Saudi Arabia has remained something of an enigma to the world of private equity. Private equity investment accounts for 0.1% of GDP in Saudi Arabia, compared to 1.5% in Dubai. Apart from the fact that a huge part of Saudi GDP is oil-related, business there remains largely dominated by wealthy merchant families and the conglomerates they own. This is a large barrier to the development of a formal private equity industry but equally it presents its greatest opportunity.

Sometimes referred to as the Land of the Two Holy Mosques, Saudi has the holiest place in Islam, Mecca, and the second holiest, Medinah, and it is governed under a strict and conservative form of Sunni Islam. As a result it hasn't opened its arms to westerners wanting to bring some of their culture with them, in particular alcohol which is difficult to obtain legallly, and nor is it likely to.

As a result the country has been somewhat less enticing for expatriates, who proved the catalyst for the growth of private equity in its Gulf neighbours, such as Dubai and Abu Dhabi, and so the fledgling private equity community has remained just that. But whilst the other countries in the Gulf Cooperation Council (GCC) have been hit hard by the global crisis, private equity players in Saudi itself are sure its fiscal and investment conservatism has served it well and there are more deals to be done than there are GPs to do them.

"In the wider region there are over two-dozen private equity firms and investment houses based out of Dubai, Abu Dhabi, Bahrain and the Gulf, but there are just five or six active KSA-based firms, which definitely puts us in a strong position," says Hisham El-Farouki, vice-president of private equity at Siraj Capital, which has offices in both Riyadh and Jeddah. "At the same time, I think the Kingdom can support five times the number of private equity groups. Of the deals we have done, 100% have been proprietary; we have not been in a bidding situation, which is quite unique."

Siraj Capital is affiliated with the AlSulaiman group of companies, owned by a prominent Saudi merchant family. It is the co-sponsor with the Saudi Arabian General Investment Authority (SAGIA) of the US$270m Rahala Hospitality Company, which invests in the hospitality and tourism

Hussein Khalifa, MVision

sectors, mainly in Saudi Arabia. It has invested in partnerships with Holiday Inn and Marriott to roll out their Express and Courtyard brands across Saudi Arabia. It has also entered into a joint venture with Kempenski to develop Shaza, a five-star chain of Shariah-compliant hotels. Its US$50m Nawader fund invests in smaller private equity deals in the MENA region, and it has targeted worker residential developments in the UAE through its company Janayen Holdings.

"To date we have made six investments, but we have put the brakes on for the first half of this year," says El-Farouki. "That doesn't mean we are not still looking and we hope to look seriously at opportunities in the second half of the year, when valuations have come down. Historically even during the good times of the last couple of years we have been very fortunate in the valuations we have been able to negotiate. You are able to sell your proposition to the founders of businesses on the benefits you can add, give them the vision of being a market leader and a regional player."

With little competition and the right merchant names linked to their firms as limited partners, players in the fledgling Saudi market have a somewhat charmed existence. With proprietary deals brought through the networks of their LPs there is seldom any competition in the bidding process. This highlights the importance of relationships in the Kingdom to do business.

"In Saudi Arabia, relationships with LPs are a lot more active," says Hussein Khalifa, partner with placement agent MVision. "They have far bigger roles. A lot of people use their LPs as sounding boards and in local due diligence. It is also a good source of potential deals. All the good GPs have to be much more engaged with their investors. Groups like Abraaj went out their way to build up a wide range of LPs, so they have prominent investors from every country in the region where they do business. It is a wider GCC thing, but it is especially crucial to have in Saudi. If you are a foreigner doing a deal and they cannot associate you with someone they ask who you are."

Malaz Group is an early to mid-stage venture capital firm with a MENA focus. Based in Riyadh, it primarily invests in the information and communication technology, healthcare, and education sectors. Gulf International Bank, the regional investment bank, has offices in both Jeddah and Riyadh and has been active in Saudi.

Global players are looking at the Kingdom. In March, Bahrain-headquartered investment group Investcorp teamed up with the private equity arm of the National Commercial Bank of Saudi Arabia, Eastgate Capital, to take a controlling stake in L'Azurde, a Riyadh- and Cairo-based jewellery company. Abraaj Capital, the Dubai-based private equity firm, is active in Saudi Arabia. In 2007 its Abraaj's ABOF II fund bought Tadawi, the leading pharmacy business in Saudi Arabia, with a view to strengthening its position in the Kingdom as spending per head on healthcare increases as well as expanding its operations overseas.

For private equity to flourish there must be a range of exit options available for its investment. In 2003, the Saudi Capital Markets Authority brought about reforms, opening the door for family businesses to realise some value in their company by going public. The door of opportunity also opened for private equity players to establish relationships with merchant families, take stakes in their businesses and ready them for flotation. Between 1993 and 2003 there had been two IPOs in Saudi Arabia. After 2004 there was one a month, until the financial crisis hit.

In 2006, the stock market had a rollercoaster ride. Starting the year at 8,000 points, in the next six months it rocketed to 21,000 points, but by the end of the year it had plummeted back down to 7,000. This sapped confidence in the viability of IPOs as an exit route.

"You do have to look at the exit options and, just like everywhere else at the moment, it is tough in Saudi," says David Gibson-Moore, deputy CEO and head of wealth management at Gulf-based BMB Group. "Given that most of the private equity funds are relatively early stage, the exit issue is a problem that can still be postponed for a year. There have been a large number of IPOs taking place in Saudi Arabia in the last few years and there have been many privatisations, so the routes are established, but we have this more difficult situation in the capital markets like everywhere else."

David Gibson-Moore, BMB Group

The other exit option open to those private equity players willing to work in Saudi and base themselves there is that proprietary deals they have sourced can be tidied up, refocused and then sold on to a ready market of larger regional private equity players that do not have the links to the merchant families that are the source of these deals.

"The sort of transactions that are most common in Saudi Arabia are controlling minority stakes, which is very compatible with business culture in the region, and particularly in Saudi, because most of the businesses are owned by big families and conglomerates," says Jean Aboumrad, Middle East managing director for placement agent Triago. "It is not as easy as doing buyouts in the US and Europe. Private equity has to be much more accepting of what the families want in terms of the deal."

"I think what you will see is new consolidation platforms they have set up, and the eventual transfer of a lot of family owned businesses," says Khalifa. "It is a huge potential niche, because in many cases you find the next generation is not interested in running the business. Some may want to run the core, but not the rest and as a result you find a lot of family-owned orphans that they really need to get rid of."