PRIVATE EQUITY international

Ground Floor
Newspaper House
8-16 Great New Street
London EC4A 3BN
Tel: +44 (0)20 7906 1188
Fax: +44 (0)20 7583 8485

Middle Eastern equity

Private equity in the Middle East represents a compelling opportunity, but educating business owners, local and Western investors about this opportunity has been difficult. A small handful of Middle Eastern private equity firms are stepping up the effort in anticipation of major growth. *Simon Sheppard* presents the case for private capital in the cradle of trade.

It is important to remember that until the mid-1990s, when it was overtaken by Europe, the Middle East was second only to the US as the largest source of investment capital for international private equity funds. Middle Eastern governments have long been significant investors in private equity. And according to one estimate, there are more than a dozen family groups in the region who are able to make large commitments of $20m to $25m at a time to private equity funds.

Most of these commitments have been oriented towards the US. Increasingly, Middle Eastern investors are looking for exposure in Europe and Asia as well.

But, as a region, the Middle East itself has not drawn much capital for private equity activity, either from local sources or internationally. Now, a small handful of Western educated private equity professionals with local business acumen are setting up partnerships to target what they describe as compelling opportunities in the region.

"The Gulf states have a limited capacity to absorb capital"

The biggest private equity player in the Islamic world is the $1.5bn Bahrain-based Islamic Development Bank Infrastructure Fund. Managed by Emerging Markets Partnership (Bahrain), it is 60 per cent owned by Washington-based Emerging Markets Partnership and 40 per cent by Bahrain's Shamil Bank. The fund targets the power, telecommunications, transportation, energy, natural resources, petrochemicals, water and other infrastructure-related sectors in Muslim countries.

Naqvi: generational change at family groups

Investcorp is another major player in the region. Smaller, country-based funds throughout the Middle East include MECG in Lebanon; United Arab Emirates-based Shuaa Capital; and EFG Hermes Private Equity, which operates out of Egypt.

Generally, Western institutions have been slow to seek investment opportunities in Middle East.

Global banking group HSBC Holdings became the first major international institution to operate a fund in the region when, in March 2003, it closed HSBC Private Equity Middle East on $118m. HSBC had seeded the fund with $33m, and a further $85m was raised from regional institutional investors.

Local talent

Abraaj Capital, formerly known as Rasmala Private Equity, which bills itself as the only dedicated LBO fund manager in the Middle East, closed its debut fund on $150m at the end of June. The vehicle was largely raised from local >>

Crosland: region attractive for Western investors

high-net worth individuals. The Dubai-based firm's signature deal was the $65m leveraged buyout of Nasdaq-listed Aramex, a Middle Eastern freight and courier company, in early 2002. The deal was not only the first public-to-private deal on the Nasdaq of the year 2002, but also the first ever Nasdaq tender offer by a Middle Eastern buyout firm.

Arif Masood Naqvi, executive vice chairman and chief executive officer of Abraaj Capital, says his firm will invest opportunistically throughout the Middle East, as the region's private market is still too immature to afford investors the luxury of a specific sector focus.

However, signs of development in the region's private equity market are unmistakable. A recent trend to emerge is for Western-educated Arab entrepreneurs who have experience in Western public and private finance returning to the Middle East to launch Western-style investment vehicles.

One example is Amman, Jordan-based Foursan Technology Partners, a venture capital firm established in February 2000 to target emerging growth information technology startups in the Middle East and North Africa. The firm was founded by two Harvard-educated brothers, Leith and Nashat Masri. Leith Masri was previously with diversified financial firm Manara Investment Group and has worked at The Blackstone Group, the Boston Consulting Group, and the Bechtel Group, while his brother Nashat has worked for JP Morgan, where he was a vice president in the investment banking division.

Another pair of US-educated Arab entrepreneurs recently launched a fund targeted at $100m for investment in post-Saddam Iraq. The fund, which was founded two years ago by Yousef Al-Essa, a Harvard Business School graduate, and Mohamed Sarhan, a graduate from Duke School of Law, who previously practiced corporate law in New York with White & Case, will be managed by a firm named Amwal ("money" in Arabic).

Forces at work in Middle East private equity

Competition
- Low level of competition for deals from small PEs, banks and family conglomerates
- Most players are generalists
- Danger from 'top tier' global PE firm partnering with local player

Investment
- Overseas investors view market ashigh risk
- Local investors often have low understanding of PE structures
- Large American / European institutional investors have been allocated to regions for diversification

Market
- Low exposure to PE results in few 'push' deals and reluctance of target company management to work with fund
- Huge opportunity in market
- No dominant players

Deal flow
- Sporadic and relationship-based opportunities
- Few intermediaries to create transfer of opportunities
- Cultural reluctance to sell business
- High number of undervalued assets captive in conglomerates

Financial performance
- Market volatility makes timing of deals key
- Exchange rate impacts performance for foreign investors
- Large variability in success rates

Source: McKinsey & Company / Abraaj Capital

Abraaj Capital's Naqvi says he welcomes the entry of new rivals into the market: increased competition boosts the overall size of the market, creating more investment opportunity and expanding the range of exit options. Besides, he adds, how can a firm characterise itself as generating top-quartile returns unless there are at least three other firms operating in a given market?

Early days for musharaka

These private equity initiatives, while welcome, still only draw a small percentage of Islamic capital. "If you look at where most of the money from the Gulf is in terms of choice of investment vehicle, about 80 per cent to 85 per cent is in murabaha [commerce], then it's leasing, then commodities, then mudaraba, which is the mutual funds, then very little left in musharaka, which is venture capital," an analyst says.

Indeed, while the buying and selling of commodities is a practice that goes back to the dawn of time in the Middle Eastern region, the buying and selling of companies for financial gain is still a rather novel concept. "The Middle Eastern investor, as a rule of thumb, is a proprietary owner," says Mounir Guen, the founder of London-based private equity placement agent MVision. "They enjoy owning physical assets, whether they're factories, industrial sites or real estate."

Statistics presented in a recent McKinsey & Co. report bear out this cultural observation. From 1996 to 2001, there were 266 mergers and acquisitions in the Middle East. This comes to 0.11 deals per every US$1bn in annual GDP. In Western Europe, the equivalent ratio is 1.02, according to the report.

The comparative lack of liquidity in the deal market stems in part from religion, which, according to Islam's shari'ah law, favors income-producing assets over income-producing cash and other forbidden forms of liquid securities (see *Shari'ah compliant* on p.42).

Luckily for the shari'ah-observant investor, the private equity partnership is about the most illiquid form of security available. It gives investors equity stakes in private companies and usually only yield profits when those companies are sold. But convincing local investors that this Western asset class can be applied to the Middle East has been a slow education process.

Occidental reluctance

If drawing Middle Eastern capital to private equity funds is taking time, then convincing Western institutions to invest in funds targeting the region has been even more difficult. Many of these investors do not perceive the region as being a fertile area for private investment. "These are relatively small markets in economies that are very much government controlled, the result of which is that ownership is governed very strictly," says MVision's Guen, who has spent time raising capital in the region. "The Gulf states have a limited capacity to absorb capital."

> "The market will grow rapidly, despite issues of transparency and due diligence"

The recent McKinsey & Co. report on the Middle East noted the lack of public market exit options. There is no domestic equivalent to the Nasdaq, the report said, and "there are no capital markets in the region with significant depth and liquidity." In addition, "leaving aside the local markets, few companies from the region can have any realistic expectation of achieving a flotation on a market in Europe or North America and such a listing might not achieve their aims since being such a small player in such a big market is unlikely to create any interest, analytical coverage or liquidity in the stock (which is likely to hinder the longer-term development of such a company)."

Abraaj's Naqvi says exit opportunities exist for those that understand the Middle Eastern market. He lists a litany of deals that he and his partners completed under their previous incarnation as Cupola Group – deals he says resulted in highly profitable exits through sales to regional companies. In one case, Cupola acquired Bahrain Maritime and Mercantile for $23.6m and later floated it on the Bahrain Stock Exchange in a $30.9m IPO.

Naqvi points out that a number of crossroads have been reached in the Middle East that private equity investors will find attractive – the many large family groups in the region, which control much of the private sector activity, are now undergoing generational change. As this happens, these groups will want to adopt more corporate structures, and private equity may be seen as a "pure" form of partnership capital, but nevertheless one that will help family businesses compete against international companies and against each other.

In addition, while economic reform has been gradual, Naqvi expects large, state-owned conglomerates to represent a "mid-term" opportunity for deals. >>

David Crosland, the president of Atlanta-based Crescent Capital, a shari'ah-compliant private equity fund that invests the capital of the First Islamic Investment Bank, describes the Middle East as "a very formative market. I think it will grow rapidly, but given how immature the market is, there are issues of transparency and due diligence. The size of the transactions are typically on the small side. And in the event of finding a transaction of proper size, the concern would be the exit opportunities - the public markets are underdeveloped."

Despite these impediments, Crosland expects private equity in the Middle East "inexorably will become an increasingly attractive market for Western investors."

The few private equity pioneers that have set up shop in the region are hoping to have established reputations when both investors and business owners wake up to the need for private capital in the Middle East.

Shari'ah compliant

With bank loans, bonds and other interest-related forms of finance off-limits to many Middle Eastern investing institutions, equity investments, including private equity, are the focus of activity. But Western private equity professionals seeking access to the vast capital reserves of the Middle East must first understand how shari'ah applies to the asset class. *Simon Sheppard* examines a distinctly Islamic form of compliance.

Since the beginning of history, the Middle East has always been in the headlines. But for investors, the real significance of the region lies not just in the ongoing drama of geopolitics but in the underlying capital reserves that, if fully utilised, could reshape the way the global private equity investment community procures its funding.

For many Western groups, a stumbling block to accessing Middle Eastern capital has been the fact that Islamic finance is constrained by a unique set of guidelines. These guidelines are established by scholars who make rulings according to the principles of the shari'ah – an organic law common to all Muslims. Shari'ah imposes an explicit moral framework which channels capital away from investments considered haram (sinful).

Shari'ah is derived from a number of overlapping sources: the Quran; the Sunna/Hadiths (examples and sayings of the Prophet Muhammad); qiyas (analytical comparison); ijtehad (reasoning and logic applied by scholars); and ijmaa (a consensus on issues requiring ijtehad).

According to shari'ah, investments in companies that manufacture haram products like alcohol, tobacco or pork products are forbidden. As such, the entertainment industry – hotels, casinos, cinema, music and pornography – is off-limits. Shari'ah investment principals also frown on companies tied to weapons, human cloning, abusive animal testing and abortion.

No making money from money

Most significantly, shari'ah investment principles forbid backing endeavors that depend heavily on riba – the paying or charging of interest. This includes insurance companies and any interest-based banks or financial associations. Bonds and many other fixed-income products are also ruled out, as are preferred shares, which pay guaranteed dividends. However, many investors are not absolutist in their approach to shari'ah compliance, allowing for leeway when assessing whether a certain investment is appropriate.

For example, the Dow Jones Islamic Market Index was launched in 1999 to represent companies that follow shari'ah investment guidelines to a reasonable degree. The FTSE has established a similar index agency.

Dow Jones' Islamic Market Index excludes companies if their ratio of total debt against total assets is equal to or greater than .33; if the ratio of accounts receivables against total assets is equal to or greater than .45; or if the sum of non-operating interest income plus other "impure" income divided by revenues accounts for 5 per cent or more of total income.

Determining whether a company is shari'ah compliant takes some digging. A company that does not generate excessive riba income and is relatively debt free may appear to present an attractive investment opportunity. But it may also employ interest rate swaps, currency swaps, trade the commodities market, and be heavily involved in internal financing of customer receivables, all activities which are considered haram.

Because of the complications involved in assessing the appropriateness of an investment, all Islamic fund managers must abide by the guidance of boards of shari'ah advisors. While these funds avoid haram investments, they often struggle to maintain a balanced, diversified portfolio.

Shari'ah investment strictures put many Middle Eastern investors in a unique situation – their portfolios may not include most forms of fixed-income investments, i.e. securities that are staple ingredients in the bulk of the world's institutional investment portfolio.

Venture versus buyout

Private equity, with some exceptions, lends itself nicely to shari'ah compliant investing. Through private equity, particularly through early stage investing, institutions may participate in, and benefit from, the growth of companies as partners rather than as creditors.

One analyst says venture capital investment allows for greater clarity in decision making and more control over the agenda set by any portfolio company: "You are investing in a company at the early stage of development, and the balance sheet has not been 'infected' with bonds and bank loans. From a shari'ah point of view, that is the most pure form of investment."

A venture capital fund can have its own shari'ah board to establish screens, firstly, on what investment can be made, and secondly, the type of securities that can be used to finance companies. For example, convertible or preferred stock options are common in venture capital funds, but are not acceptable in an Islamic context, because they bear interest.

> Through private equity, institutions may participate in the growth of companies as partners rather than creditors

From a shari'ah compliance standpoint, private equity becomes less "pure" as it moves into more mature businesses because at these later stages of development, bank loans are more common source of funding.

Here is where private equity is the subject of some debate among shari'ah scholars. Buyout transactions and recapitalisations obviously involve debt securities. But even a leveraged buyout, if structured properly, can be embraced by Islamic investors. Some investors view coupon-paying securities as allowable so long as their structure cannot be viewed as a straight loan. For example, a company that securitises its cash flow and sells the right to a receive a portion of that flow would not, according to some analysts, be against the rules. "Conceptually, it can work," says one.

A bright future?

These are, of course, gray areas. The line between a loan that pays interest and a security that channels cash flow is thin. According to shari'ah, making money from money is not permissible. A straight loan treats money as a commodity in its own right, rather than as a measure of value that has no human utility. A securitised cash flow, on the other hand, lays claim to the sale of underlying commodities or services. Therefore, the receiver of the cash flow is actually receiving his or her coupon based on the buying and selling of real commodities rather than as a fee for the "rental" of an intrinsically valueless currency.

Loans are allowed under shari'ah under three circumstances: the lender does not intend to be repaid in full; the lender is simply parking money with the borrower for safekeeping and does not expect interest; or the lender is advancing money to the borrower with the expectation of sharing in profits or losses.

From a fixed income viewpoint, the third circumstance sounds most similar to an unsecured, coupon-bearing note – the buyer may share in a pre-determined cash flow so long the issuer performs at a certain level. Otherwise, both the note-holder and the issuer experience loss.

However, securitisation does create an imbalance between the issuer and the holder, where fixed payments continue independent of the underlying performance of the assets, with the exception of a serious deterioration of the business. Shari'ah frowns on any form of imbalance in business relationship.

It is easy to see why many Islamic investors prefer early stage venture capital, where "pure" equity investing so clearly allows for equal partnership in the capital structure.

The Web site of the Al Rajhi Banking & Investment Corp., the Saudi financial institution, has a comprehensive overview of Islamic banking and investment principals that includes a nice summary of the principal of profit and loss. It reads almost like a primer on the private equity industry: "The basic and foremost characteristic of Islamic financing is that, instead of a fixed rate of interest, it is based on profit and loss sharing. Islam encourages Muslims to invest their money and to become partners in business instead of becoming creditors. This encourages entrepreneurship. In turn, entrepreneurs compete to become the agents for the suppliers of financial capital who, in turn, will closely scrutinise projects and management teams. The objective is that high-risk investments provide a stimulus to the economy and encourage entrepreneurs to maximise their efforts."

Well argued, and evidence that private equity and Islam may have a bright future together. ◆