Built on shifting sands?

Kuwait's financial sector has been hit harder than most by the global downturn, while allegations of fraud have been levelled at Kuwaiti investment companies. Market players hope that these pressures lead to increased transparency over the longer term. By Patrick McCurry

It's been a difficult 12 months for one of the Gulf's richest states. Late in 2008, Kuwait's Gulf Bank announced a US$1bn loss linked to foreign exchange bets and in January the government took a minority stake to rescue the bank. Then in February 2009 the Kuwaiti government announced a US$5.4bn plan to prop up the banks, a move that followed accusations that it had been too slow to shore up confidence. Part of the reason for Kuwait's tardiness was said to be the authorities' difficulties in understanding the banks' books.

Equally worryingly, last December one of Kuwait's biggest financial players, Global Investment House (Global), defaulted on more than US$1bn of debt. Global, which had been an active private equity player, is in the process of rescheduling its debt. Finance firm Investment Dar, which owns half of UK car company Aston Martin, also defaulted on debt this year and has said it may sell some assets as well as borrow up to US$1bn to refinance loans.

But it is not just defaults that have cast a shadow over the country's financial sector but also claims of wrong doing. Kuwaiti investment house KAMCO and Bahrain investment bank United Gulf Bank have been forced to defend their behaviour in a controversy that surrounds a Kuwaiti financier who committed suicide in July 2009. The death followed accusations from the US Securities and Exchange Commission of stock trading fraud. The SEC alleges that KAMCO made profits from the trading, although KAMCO has denied this.

No checks and balances

Part of the reason for the problems affecting some Kuwaiti financial companies is a lack of the usual checks and balances common in the West, according to Hussein Khalifa, a partner at placement advisers MVision. An-

Hussein Khalifa, MVision

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other factor, he adds, is that groups such as Investment Dar tried to copy the approach of some Dubai houses in taking on too much leverage. "But the core businesses of the banks are sound," he says. "While there have been problems to do with liquidity and trading positions, the main parts of banks are profitable."

The government has used its sovereign wealth fund, the Kuwaiti Investment Fund (KIA) to try and tackle the problems, encouraging it to invest in the stock market and boost investor confidence.

Over-exposed

But in August ratings agency Moody's downgraded three Kuwaiti banks - Commercial Bank of Kuwait, Al Ahli Bank of Kuwait and Bank of Kuwait and the Middle East. It said this was due to the weakening credit conditions in the country and the poor performance of the stock exchange, despite a modest recovery in the second quarter. It is also concerned about the banks' exposure to bad loans and the real estate bust.

Part of the challenge for Kuwait is that it is a relatively small economy that is highly reliant on oil. The country has about 10% of world reserves and petroleum accounts for about half of its GDP. It has been trying to build up its finance sector and so investment banks and other financial companies now make up over half the country's quoted businesses. The economy is expected to contract by more than 1% in 2009, the worst of the GCC states.

The problems experienced by Global have had a significant impact on the local market. "There are relatively few private equity houses investing in Kuwait, and Global was the most experienced," says Khalifa. The firm began with late-stage pre-IPO finance but then evolved into a more traditional private equity approach. The default has led it to shut down its private equity operations for a while. The other main private equity house operating in the Kuwait market is NBK Capital, an investment bank and subsidiary of National Bank of Kuwait. Its most recent announced deal was a stake in an IT company in November 2008.

As well as a few local private equity houses, mainly divisions of Kuwaiti banks, there are some regional funds that occasionally invest in Kuwait. In January this year Dubai-based Millennium Private Equity invested US$25m in Kuwait Energy Company, one of the largest MIddle East-based independent exploration and production companies.

Mansour Al-Khuzam, managing director at investment house Khazaen, says that private equity houses are scaling back investments but that there will be activity in snapping up distressed assets at attractive prices. There will be more interest, he believes, in assets that have clear value rather than businesses without tangible assets or "exaggerated goodwill". Confidence is returning slowly to the market but is still lower than before the global instability caused by Lehman's collapse last autumn.

Some believe that the growth of the Kuwaiti private sector was unsustainable and that the credit crunch and global downturn have revealed important weaknesses. "Some companies have been operating with high-value short-term loans, which people turned a blind eye to in the good times but which now look ridiculous," says Al-Khuzam. "A lot of companies' business model was wrong."

When it comes to the banking sector Al-Khuzam says that a number of banks mismanaged their risk exposure to sectors such as real estate and are now more vulnerable as a result. On the other hand, he says, there have only been limited defaults so far and the country has a budget surplus. Given the fact that more than 90% of the population work for the public sector, the banks that stick to their main line of retail business have no real problem and, in fact, are making increased profits.

An investment banker based in Kuwait says that private equity in Kuwait has been seen as a quick money-making vehicle in which certain investment houses did not have to add much value other than perform some window dressing, then realising large profits through secondary sales, private placements or IPOs.

The lure of easy profits in a fast-moving regional market led to a significant number of investors and large corporates investing outside the sectors they were familiar with and are now stuck with businesses in sectors they don't really have an affinity with or have bought at such high multiples that they cannot exit from them. "The challenge for these investors is to add value to those businesses, by growing sales and reducing expenses, with a view to making it more attractive for a trade buyer," says the investment banker. "Tremendous opportunities exist for those investors that can selectively acquire discounted non-core holdings of others and growth them to a size where they become attractive buys for others."

Free money?

One of the main problems in the Kuwaiti investment system was the use of wakala financing. Wakala is similar to power of attorney and is an Islamic financial contract in which an investor gives an investment house cash for it to invest at its own discretion. The investment house receives a commission and obtains a pseudo loan with few restrictions and short-term maturities. The liquidity generated by this mechanism contributed to inflation of asset values.

The relatively under-developed bankruptcy laws and creditor protection in Kuwait meant that a lot of the private equity investment was carried out under wakala principles that gave investors had very little security. Lines of credit were granted from and to different individuals and families but without a clear investment focus. A lot of the assets were acquired using high leverage and now these IOUs are beginning to be called in, says the investment banker. "It hasn't fully sunk in yet, but by next year a lot of these people will be realising that the money they granted to others isn't coming back, at least in cash form." But Shari'a law calls for mercy towards those in debt who are not able to repay. "People are going to have to work together to get through this problem," he says.

Linked to this is the fact that the local banks are holding a lot of questionable loans. While the banks may seem to be doing well their balance sheets are a lot worse than they look because there has not been a revaluation of assets backing the loans. If those loans were revised downwards some of the banks would have to make serious provisions in 2010. So instead of calling in loans, banks are rescheduling them to avoid wider problems caused by defaults and further deterioration in asset value.

Western losses

And it is not just the banks that have suffered. The KIA has also taken a battering in some of its recent investments, but has said won't sell stakes in overseas financial institutions like Citigroup and Merrill Lynch. The KIA invested a total of US$5bn into the two companies in January 2008 to help them deal with losses sustained following the credit crunch. The KIA lost US$31bn between March and December last year, although there is likely to have been some recovery this year.

Burned by its experience in the West, the KIA is now increasingly developing links with China and the Far East and is looking to invest in countries such as Vietnam and Islamic markets like Malaysia. India is also an increasingly important destination for investment. Other Kuwaiti LPs have also, traditionally, invested overseas and in MENA, notably Egypt and North Africa.

At some point regulators may have to intervene and buy assets or help the banks further with their balance sheets, says the investment banker, but it will take three to five years before some of the private equity portfolio companies are healthy again.

Over the longer term, for Kuwait to develop a more robust economy that is less dependent on the oil price, the private sector will have to play a bigger role. Its reliance on the public sector is also not sustainable. "The private sector, and that includes private equity, needs to become more active and to roll up its sleeves and add value to small and medium-sized businesses," says the investment banker. "If that happens then the lessons learned from the current crisis will have been worth it."

After a slow period, Kuwait's private equity activity may yet pick up, says Eisa Al-Weggian of the Muthanna Investment Company

Eisa Al-Weggian, Muthanna

Muthanna Investment Company (MIC) is a Kuwait-based Islamic investment company that offers services in areas such as corporate finance, asset management, private equity and equity research.

MIC has made a number of investments, as part of its expansion strategy, in both Kuwait and elsewhere in the GCC region. The most recent is the acquisition of Kuwait-based International Markets Brokerage House, now called Muthanna Financial Brokerage Company. Others include a stake in an Omani investment company and a Bahrain real estate project.

Eisa Al-Weggian, senior VP, corporate finance, says: "After the global financial crisis there was very little private equity investment in Kuwait but small bits of M&A have begun to emerge and we think it's a good time to invest, as valuations are much lower. This is one of the reasons why we're acquiring a brokerage house in Kuwait."

But Al-Weggian says that one of the difficulties in acquiring companies in Kuwait is the lack of transparency. "You have to be careful because many businesses have loans or debts that are not contained in the main accounts and so you have to do thorough due diligence."

He adds that he expects investment activity to begin to recover in the final quarter of 2009, boosted by activity in sectors such as industrials, real estate and consolidation among financial and investment businesses.

MIC has teamed up with credit information company Dun & Bradstreet South Asia Middle East to survey business optimism in Kuwait. Its business optimism index for the third quarter 2009, carried out in the summer, found that sentiment was improving thanks to a recovery in oil prices and the government's decision to inject US$5.2bn in an economic stimulus package.

The survey also found that expectations were helped by parliamentary elections in May, which many hope will lead to the implementation of long-awaited projects, and by the Kuwaiti Central Bank's precautionary measures, such as two consecutive cuts in the discount rate. Just over 30% of the companies surveyed said they expected to increase investment in business expansion.

Going forward, Al-Weggian says it is very important that the Kuwaiti government takes more of a lead, by producing a longer-term vision and business plan for the country. The government is supposed to produce a five-year business plan covering government spending and a strategy for the economy, education, and healthcare. But this will be the first time it has produced such a plan since the 1980s. "It would help the private sector a lot if it had a clearer idea of the government's plans," he says.

CV

Eisa Al Weggian is a senior vice president in the corporate finance division at MIC. Before this he worked at Kuwait Investments Projects Company (Kipco), beginning as a senior officer in corporate finance and ending as head of direct investment. He is a board member of several Kuwaiti and overseas companies, including Muthanna Financial Brokerage Company, Icarus Medical Industries Company and Kuwait Resorts Company, which is listed on the Kuwait Stock Exchange.

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