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The Region's Leading Advisor on Family Business

October 8, 2013

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Despite the uncertainty in the Middle East and North Africa (MENA) following a spate of socio-political unrest, the announced private equity deals value in the region rose by 42% to USD 44.8 billion in 2012 from USD 31.6 billion in 2011.

Deal volume, on the other hand, slipped by 4%, but the market saw activities spread across the MENA region. Majority of the transactions in 2012, however, took place in the GCC - particularly UAE, Qatar and Saudi Arabia. Even though private equity investments in the MENA have been relatively diversified, these core markets (along with pre-Arab Spring Egypt) have accounted for over 50% of the activities since 2005.

In retrospect, while the 42% increase may be impressive, it could also reflect an improvement in valuation gap among buyers and sellers. Valuation gaps in the region are very common, especially considering that 70% of local businesses are family-owned and tend to be extremely emotional in fixing a price on the fruit of their hard-earned labor

THE FAMILY BUSINESS OPPORTUNITY

Over the last decade, family-owned businesses have been one of the areas offering growth opportunities in the region However, both deal origination and execution in this field have experienced some stumbling blocks.

Family businesses remain a difficult field for deal originators due to the unwillingness of families to sell their shares to outsiders, especially financial institutions such as private equity groups or foreign investors. As a result, most PE transactions in the Gulf are not complete buyouts or change-of-control transactions, but rather acquisitions of minority interests - what is referred to as "growth capital".

While PE managers are keener on family businesses, the latter face unique challenges that heavily impact the execution of an imminent acquisition. To cut a long story short, the complex interaction between the family, the ownership and the business augments the risk factors surrounding the transaction. That also dictates the kind of elaborate hedging needed to be exercised by investment committees - but certainly not the hard-pressed hedging.

PE HEDGING THEIR BETS

As a result, PE investors are addressing the challenges through a rigid system of checks and balances.

First they marry defensive sectors that ensure better returns, then they increase their knowledge of the target through comprehensive due diligence done by neutral third parties. In addition, they safeguard their interests and exit options by putting in place the right structures and contractual protections. While the first two practices are fairly reasonable, the third is recognized as "colonization" when it comes to contractual protections.

SECTORS ON THE INVESTMENT RADAR

As general partners aim to provide lucrative returns to their limited partners, they opt to target those family businesses that are engaged in defensive sectors, which cater to the very basic needs of the population. These include, but not limited to, healthcare, fast-moving consumer goods (FMCG), education, energy and infrastructure.

Healthcare has recently been a popular sector for investment, supported by increased demand and spending power for services and facilities. Another key sector that continues to be rewarding is oil and gas. While most of the upstream is dominated by national oil companies such as Saudi Aramco, PE managers believe there is a large opportunity in acquiring businesses that provide the underlying services supporting those state-owned firms.

EMPHASIS ON RIGOROUS DUE DILIGENCE

Deficits in corporate governance, along with the opacity associated with inconsistent financial reporting, make it extremely difficult for PE to have a complete picture of the family business target they are buying into.

Unfortunately, local cultures dictate accounting principles that obscure the true financial state of the business, which makes it doubly harder to reach an informed valuation of the business. To mitigate such risks, PE managers throw the ball at a team of qualified experts to fully assess the risks associated with the target company, before celebrating the marriage.

CHOOSING THE RIGHT STRUCTURE & JURISDICTION

Although resisted from local partners, PE managers ideally try to structure their deals with family businesses offshore - in jurisdictions where the enforcement of their rights will not be contested. In case the target is a goldmine and the family principle insists on staying onshore, PE managers consider structuring their investments in a way that take advantage of foreign investment laws and sophisticated on-shore legal structures -

joint stock companies for instance - if feasible, in an attempt to increase their overall level of protection.
As another safety pre-caution, PE investors choose a neutral law, ideally the English law, as the governing law of their investment agreement and shareholders' arrangements, except where it is compulsory to apply local law.

MICRO-LEGAL ARRANGEMENTS

There is a growing trend among PE managers to put a greater emphasis on the contractual terms set out in the purchase or investment agreement. During the "happy-go-lucky" times and certainly before the global financial crisis, contractual terms tended to be more seller friendly due to the high level of competition between buyers to acquire a limited number of attractive assets.

While the current landscape remains competitive, it is riper for consolidation and many PE players have channeled their attention towards the maintenance of their existing portfolios. With more dormant funds on the market, active PE managers now expect to receive a full set of representations and warranties from the sellers, along with drags on exits, participation preferences, forced realization and veto on a continuously evolving.

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IN A NUTSHELL

While MENA continues to be compelling economic region with vast growth opportunities, PE managers should stand in the shoes of family principles and speak their language if they wish to strike deals.
Despite the witnessed improvement in valuation gaps, deal volume will continue to drop beyond 4% with the current PE practices, bearing in mind that the number of family businesses prepared to marry new partners at the logical price and terms is constantly growing.