

# PE: Tough times ahead

The private equity (PE) industry in the Middle East and North Africa (MENA) region is something of an anomaly at this point, since there seems to be both doubt and optimism amidst the hope of finding opportunities in crisis. **Ritwika Chaudhuri** reports.

There are definitely reasons to be optimistic about the PE industry in the MENA region. After all, the Middle East and Asia are the only two regions in the world that the International Monetary Fund expects to grow positively this year, and PE growth depends on the growth of the real economy to some extent.

The regional PE industry, which has raised US\$19.6 billion in the MENA region since 2000, is yet to invest nearly US\$11 billion of that capital, according to the Gulf Venture Capital Association (GVCA). And arguably, now is a great time to invest, especially since the market is strapped for credit and valuations have dropped like a stone in cold water.

A report from KPMG states: "Given the capital overhang and lower valuation dynamics, the outlook seems to be positive for 2009 vintage funds."

Yet, MENA private equity majors are not overly excited about doing new deals right now. They say that their central

focus this year will be on creating value for their existing portfolios, rather than on acquisitions.

## A peek into the past

Private equity as an investment strategy and as a potential source of capital for growing companies has seen tremendous growth in the region during the last few years. Funds raised in 2008 increased to US\$6.4 billion from US\$5.8 billion in 2007 and US\$2.9 billion in 2005, which works out to be a compound annual growth rate of 30 per cent.

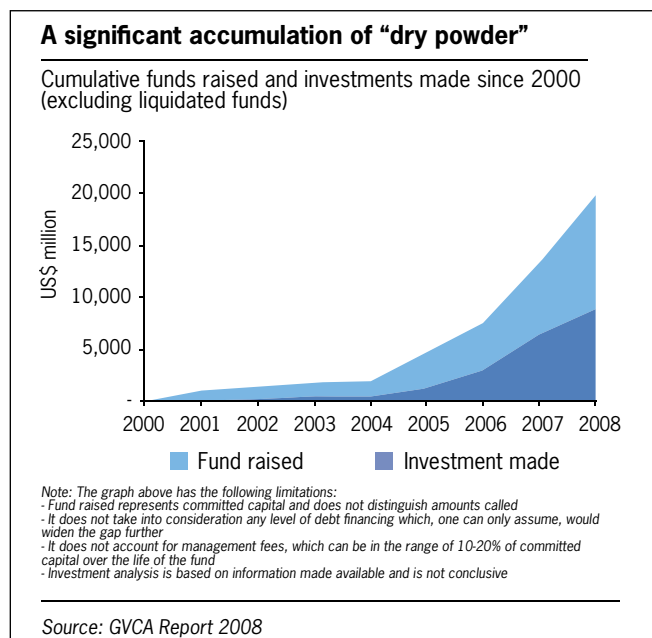
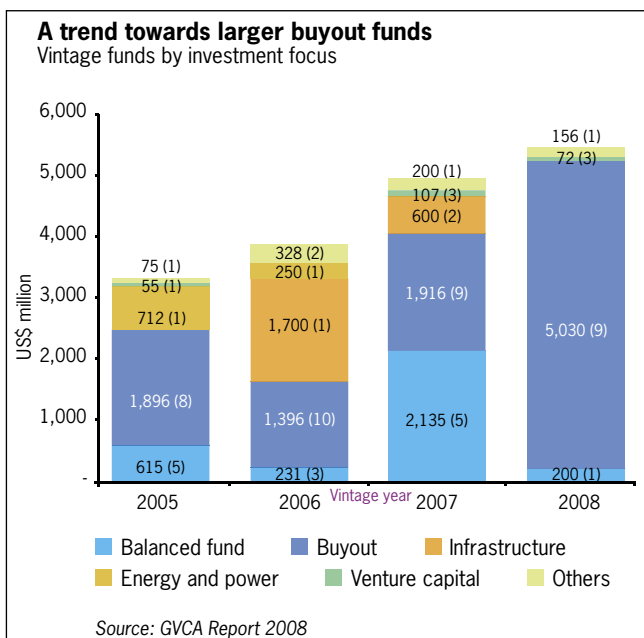
According to the GVCA, 76 per cent of the total US\$19.6 billion raised since 2005 has been raised in the past three years. The average size of funds also increased during this period, rising to US\$258 million in 2008 compared to US\$213 million in 2007 and US\$177 million in 2006.

Total private equity investments (by value) in the MENA region have increased

by a CAGR of 48 per cent since 2005. Of the total investments made in the last decade, approximately 86 per cent were made in the last three years (2006-2008), with approximately 39 per cent made in 2007 and 27 per cent made in 2008.

The average size of investments, however, showed a decline after 2007. In 2008, the number of new funds decreased 22 per cent over the previous year, while the average size of investments decreased 31 per cent. The average size of investments, which went up to US\$64 million in 2007 from US\$48 million in 2006, declined in 2008 over the previous year to US\$50 million.

One of the most interesting aspects of capital-raising has been the failure of most PE funds to raise the amount they initially announced. According to the GVCA, regional PE funds were able to raise only 16 per cent of the amount they intended to raise in 2008, compared to 65 per cent in 2005. Roughly half of

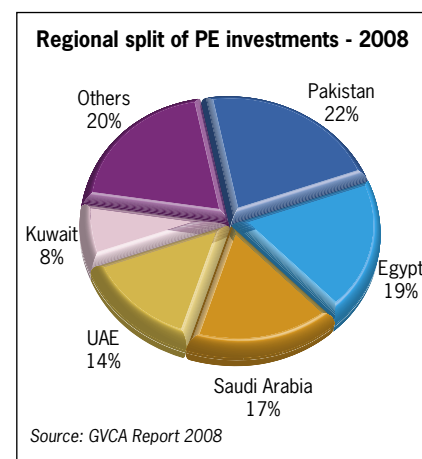
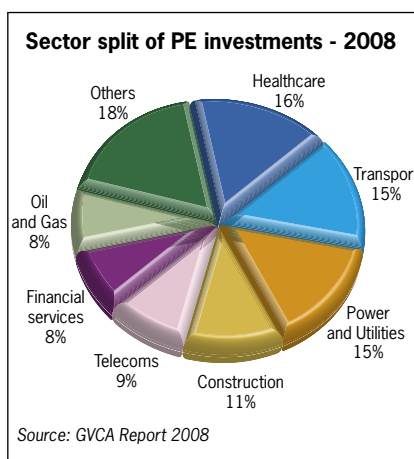


the funds announced in 2006 have not come to the market, and funds that were targeting a capitalisation of approximately US\$11.7 billion from 2006-2008 are yet to announce their closing.

Although the majority of MENA funds are focused mostly on opportunities across the GCC and North Africa, fund managers are increasingly looking at an expanded region, including South Asia, Southeast Asia and Turkey.

Investments over the last four years have focused primarily on Egypt, Saudi Arabia and the UAE. Egypt has accounted for 33 per cent of total investments since 2005, while Saudi Arabia has accounted for 15 per cent and the UAE has accounted for 14 per cent. In 2008, investments in Egypt accounted for 19 per cent of total investments, while investments in Saudi Arabia accounted for 17 per cent and investments in the UAE accounted for 14 per cent. The most dominant sectors for investment in 2008 were healthcare, transport, power and utilities.

Although 2008 saw one large exit of US\$2.5 billion, overall sales activity saw a declining trend. The number of exit transactions in 2008 dropped approximately 60 per cent compared to 2007. The year 2007 saw 17 exits, compared to only 11 in 2008.



### The focus in 2009

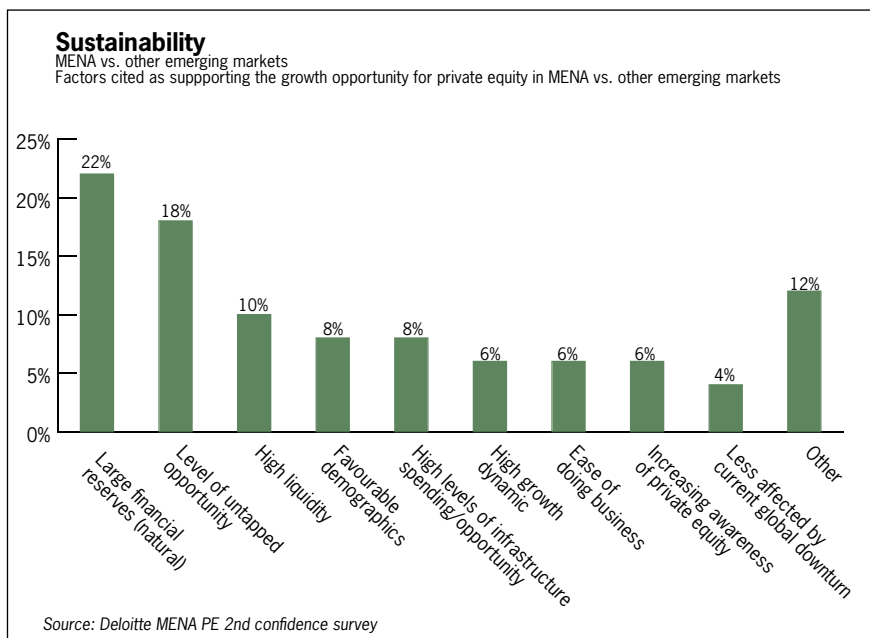
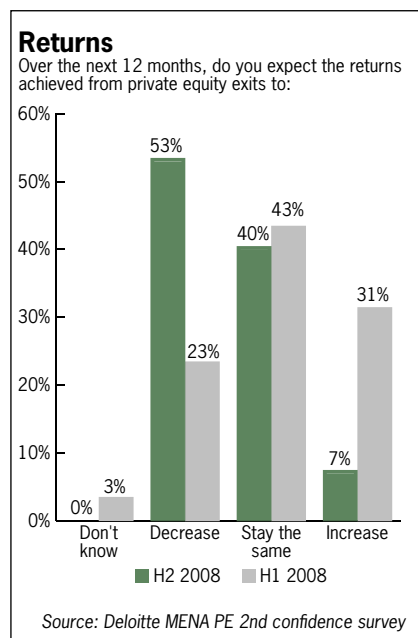
The year 2009 has brought a lot of worry for investors across all asset classes, and private equity has been no exception. Although some expect the industry to be hit by some distress selling in the secondary market, nothing has been registered or reported so far. At the moment, industry participants do not seem overly concerned about the subdued market conditions in 2009. The mood has, however, discernibly changed to one of long-term views, compared to 2007 when assets were quickly changing hands.

Carlos Perry, COO of the Emerging Markets Private Equity Association,

concedes that there is a slowdown in the pace of activity in the industry. He notes, however, that in the long term, private equity will be critical for reigniting economic growth across the developing economies of Asia, Latin America, the Middle East and emerging Europe.

"It's also important to battle the notion that PE is only about attractive returns to investors, as PE is a major driver behind the growth of entire industries and economies," Perry adds.

Arif Naqvi, CEO of Abraaj Capital, the region's industry leader, cautions the industry against thinking short term. He says that more efforts should be made to protect investors' money, rather than



## Key themes for the MENA PE industry in 2009-2010

- Accumulated capital and high liquidity in the industry as a whole
- Fundraising more difficult for smaller players
- Consolidation within players
- Reduced interest in the region from global players
- Crisis may not induce a significant decline in valuation or increase in deal flows
- Sectors like healthcare, education, infrastructure, food and agriculture with regional comparative advantage to be the main focus for 2009
- Possibility of opening new frontiers like the privatisation of mega public companies, public to private transactions or takeover of core family conglomerate
- Control buyout models gaining control
- Returns will average up because most of the investments will be made post-crisis
- Move towards trade sales and away from IPOs
- Concentrate with the existing portfolio companies and endeavor towards value creation
- More involvement of LPs in the management of the companies and increased cooperation within economic agents like government, regulators and LPs
- Focus on regional funds rather than on country-specific funds and little possibility of international investment by regional players
- Tendency towards picking up majority shares rather than minority shares by the PE players to ensure greater control with the company
- Sovereign wealth funds looking inward and starting direct investments
- Measures to ensure greater corporate governance, better disclosure and transparency and enhanced code of conduct

worrying about higher dividends. He also urges the industry to help enterprises with strategic planning in growing talents.

Regarding attractive opportunities for the industry this year, Naqvi says that defensive sectors that are resilient to a slowdown, such as education, healthcare, social infrastructure, low-cost carriers and pharmaceuticals, should be the focus of PE investing. Yield-driven opportunities also exist in the real estate sector, while another target is the small and medium enterprise segment. This segment is the region's engine of growth, notes Naqvi.

Stephen Murray, managing director of Citadel Capital's institutional fundraising,

adds that certain industries that have competitive advantages in the region, such as cement, fertiliser, oil and gas, food processing, agriculture and power distribution, will be also be on PE funds' radar screens in 2009.

### Returns

One thing that has differentiated PE investing in the MENA region from that in the developed markets has been the high rates of return. Some investments have had an IRR of as high as 1000 per cent. But returns are going to be under pressure in the current environment, according to a number of experts.

A survey from Deloitte Corporate Finance last November on MENA PE reported that 53 per cent of respondents were of the view that returns on PE exits from existing portfolios would decrease in the next 12 months. Their argument was that markets would become more efficient with the maturing of the industry and that returns would go down. The lack of leverage and delayed exits would add to the negativity, they said.

On the other hand, 40 per cent of those surveyed felt that returns would remain at the same level, while seven per cent thought that returns would go up.

The GVCA annual report on the PE industry says that returns will average up in the near future, as it expects a number of investments to be made during the crisis or post-crisis. Since most funds have made only a few investments and it is assumed that many of their pre-crisis investments were made above average valuations, it is most likely that PE funds will be able to offset their overvalued investments if they invest wisely in 2009 and 2010, argues the report.

Private equity funds, which focus on improving the performance of their portfolio companies, can still achieve their targeted returns despite the current global economic slowdown, according to Dr. Jochen Duelli, head of Bain & Company's Middle East PE practice.

"Good returns can be achieved through portfolio value creation," he says. "In the current environment, it is no longer enough to simply rely on rising valuations and dynamic economic growth."

### Challenges

The Deloitte survey results show that although the MENA region is considered an attractive emerging PE destination because of the availability of surplus liquidity and a degree of untapped opportunity, there are many barriers to its development, such as inconsistent regulations and issues with governance, company laws and foreign direct investment.

"There is a lot of misperception about the emerging market in general. There is concern about volatility of the market and corporate governance," says Perry.



Arif Naqvi



Carlos Perry



Jochen Duelli

There are other challenges, too. Fundraising has become difficult, with even the best funds achieving just 55 per cent of their targets in the past six months. With many companies preferring to wait for the first signs of recovery before investing, the number of reported deals executed by PE funds in the GCC has plunged over 60 per cent in the past three months. In addition, exit opportunities have all but dried up. GCC stock markets have plummeted more than 60 per cent over the past 12 months, damaging the attractiveness of IPOs.

Forty-five per cent of respondents to a recent GVCA survey said that the number of deals would increase this year, while 44 per cent said there would be a decrease. The almost equal ratio between those who believe deals will increase and those who think numbers will go down is an indication of how unsure market participants are about what to expect this year.

The Deloitte survey also suggests that the industry is expecting competition for deals to increase during the year, although there is concern that this increase could be offset by rising levels of caution. It is also expected that investments will largely depend on the quality of assets.

"There are still some good assets around. Abraaj has a lot of capital available with it, and hence the capacity to invest. But it is time to work with empathetic understanding, as the days of excessive valuation are gone," says Naqvi.

Antoine Drean, chairman and CEO of Triago, a secondary advisor to the PE community, also believes that there are good opportunities in the market because valuations are low. Perry and Duelli agree.

"It is now time to take opportunity with limited risk and the possibility of having sufficient returns if the market returns. Now the entry pricing is at a better level, and there are chances of getting better control of the company," adds Murray.

We will also see activity in the distress and restructuring market this year, according to Drean. But some experts

## Global PE to see losses this year

Antoine Drean, chairman and CEO of Triago, which specialises in fundraising and is a secondary advisor to the PE community, tells **MONEYworks** that 2009 will be a tough year for the global PE industry.



Antoine Drean

### **You are of the opinion that the PE industry is going back to the basics. Can you explain how and why you think so?**

From 2006 until the third quarter of 2008, the PE industry was driven by speculative deal-making and an abundance of credit facilities. Players were buying high and selling higher; deals had significant leverage and there was hardly any holding period. The universal principle in any industry of buying low and selling high was almost missing. Fund managers were less bothered about where they were investing, while over-performance pressed LPs to invest more. Risk was often misperceived or misunderstood and the due diligence process was less thorough.

But PE is all about sourcing, due diligence, value creation and exit. In the PE industry, a team of managers with specific skills (typically operational, financial and managerial) invests in non-listed firms, taking majority shareholdings and improving the management, enhancing the value, doing what is necessary to make the company grow and selling it when it is time to have a decent market value.

In the typical 10-year life cycle of a PE firm, while the investing period is two to three years, the consolidation period is another three to four years and the remaining years are for divesting.

With the world reeling under a severe financial crisis, credit drying up, valuation going down and uncertainty prevailing everywhere, the industry is now going back to the basics. I believe fund managers will again start doing their due diligence before investing, as there will be fewer auctions and less competition in the PE marketplace.

### **What is your expectation regarding fresh fundraising and new investments with the already available capital in 2009?**

Although I believe PE as an investment strategy and as an asset class is here to stay, some analysts predict that the industry faces real challenges this year. According to a paper from the Boston Consultancy Group and business school IESE in December 2008, 50 per cent of PE-backed companies will default on their debt, 30 per cent of GPs will survive and PE will generate a loss of US\$1 trillion globally.

But there is hope, as by the end of 2008, PE represented only three per cent of the assets under management worldwide. Most institutional investors either want to maintain their allocation to PE or increase it.

Of course, 2009 is not a good year for fundraising, but if somebody can raise funds at this time, it will be worth doing the exercise, since interest is low and valuations are lower. Conditions are set for a good buy, but one needs to be cautious about what is worth buying. The fact that investors and fund managers have less money means they will be cautious while investing. There will also be a tendency to do good deals based on certain basic principles like sound business models, good management, solid perspectives and sound balance sheets.

In today's perspective, as far as investment is concerned, strategy is more important than the sector. If you are buying a business that everybody else wants to buy, then the price will be quite high. But if you are planning to buy a business that nobody is interested in, it might give you better value in the future, even if it is not interesting today. Companies with high entry barriers that still have a good business model are worth considering. In a bad environment, growth capital, growth mezzanine, turnaround, small and mid-sized buyouts and joint ventures with strategic buyers on mergers are better strategies. Also, distress and restructuring will be the flavour of 2009.

### **What sort of return do you expect in today's market?**

Usually, people want a 15 per cent net return from their PE portfolios. Today, two-thirds of these people will not put in any money because they do not have money. But the rest will expect 15 per cent. I suppose the expectation is still the same.

caution that distress does not always mean there is hidden value.

As these are still early days, most of the drama in the PE industry is yet to unfold. And when it does, it will be interesting to see how the market adjusts to some of the new realities. One thing is for certain:

by the time the region stabilises, the nascent PE industry will undergo some major changes. And those changes could be the demise of some of the weaker players, while some of the larger ones could be challenged to live up to their reputations.

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