Private equity's challenge in the Middle East

INSEAD and Booz & Company have issued a report titled Private Equity in the Middle East: A Rising Contender in Emerging Markets. The report examines how the industry has evolved over the years as well as its current challenges and outlook.

Private equity players in the Middle East face a major challenge. With an estimated US$11 billion in un-invested funds raised before the global financial crisis in 2008, PE firms in the region are under mounting pressure to find and make meaningful investments.

At the height of the PE industry in the region between 2005 and 2007, there were about 70 transactions a year, with an average size of US$30 million. Using this yardstick, it would take more than five years to invest these funds.

As PE investment firms have to invest their existing funds before they can raise additional capital, there are some concerns that deals may be done "at almost any price" despite weak investment opportunities, according to a new report based on a joint survey of PE investment firms and investors by INSEAD and management consultancy Booz & Company. However, the same report highlights that the industry has drawn important lessons from the crisis and most private equity firms or general partners (GPs) are expected to exercise stronger investment prudence and proper due diligence. This may explain the recent focus on SME investment by some top companies.

Furthermore, the actual amount of "actionable" investable funds could be less than the estimated US$11 billion because as the report states, it appears that some investors affected by the recent crisis may not be able to honour their investment commitments.

Growth in the PE industry has surged in the Middle East since 2005, buoyed by strong regional economic growth, the fast-developing financial and banking sectors, and government support for the development of regulatory frameworks. In 2006, PE activity in the region peaked at nearly US$40 billion in total funds and 23 funds posting their first closing. But the onset of the global economic downturn stalled the industry's growth, resulting in total funds of just US$3 billion and 12 funds posting their first closing in 2008.

Happily, economic growth in the region is expected to rebound this year, with estimated aggregate real growth of 5.1 per cent in the six-nation Gulf Cooperation Council (GCC). (It should be noted though that this regional average masks important country differences). Notwithstanding the brighter economic outlook, the dominance of family-owned companies in the Middle East creates a challenging environment for less connected PE firms in the region.

According to British bank Barclays, family-owned firms represent about 40 per cent of the region's non-oil GDP and around half of private sector employment. They manage 75 per cent of the private sector economy and hire 70 per cent of the labour in the GCC. That contributes to a "disjointed information environment" in which investors are forced to source for information through business and social networks, even as "trusted networks, relationships and connections" are key to doing business in the Middle East. Furthermore, family-owned businesses generally lack formal holding company structures with control exercised entity by entity, while the regional regulatory environment is still maturing to developed nations' standards.

In the Middle East, high net worth individuals tend to be active PE investors, and support the sourcing for proprietary deals by tapping into their networks. But because such deals are often privately brokered and sourced through trusted networks, due diligence may sometimes be less rigorous than that for public deals. As such, questions may arise about deal valuations.

From a monetary standpoint, many currencies in the ME region are pegged or managed, constituting a "persistent Achilles heel", because this reduces the range of monetary policy options to manage issues such as inflation, which has been particularly problematic in the Middle East in recent years. Inflation in the region averaged at 8.3 per cent between 2003 and 2008. (Again, there were important country differences which are masked by this regional average figure).

In terms of regulatory reforms, the focus in the region has shifted towards issues of transparency, corporate governance and capital markets development. Banks are also reviewing and tightening their lending practices following a spate of high-profile and high-volume defaults. Historically, the banks have tended towards name-based lending rather than collateral and cash flow-based lending, despite a lack of corporate transparency.

Though Egypt has been the traditional focus of PE investments in the region, with about 40 per cent of the market, investors are broadening their attention to other budding regional markets such as Saudi Arabia. Despite its economic and cultural conservatism, investors view the kingdom as a compelling investment destination, attracted by its large economy, its sizeable and young population, and the government's commitment to economic diversification. Indeed, some international PE firms are opening offices in Saudi Arabia, drawn in part by the projected expenditure of US$144 billion in Riyadh's latest budget.

PE investment firms are also starting to specialise in sectors including healthcare, infrastructure, energy and agriculture. Industry players expect the healthcare sector, including biotech and pharmaceuticals, to yield the most substantial investment opportunities in the near term.

The INSEAD-Booz report adds that the healthcare sector in the Middle East has been "characterised by underinvestment for several decades, and countries like Kuwait have not built a new hospital in over 20 years."

"Given that spending on healthcare in the GCC region is expected to increase fourfold from $15bn in 2008 to $60bn in 2025, and given also that the cost of providing ongoing healthcare services is largely carried by the state, there is substantial scope for PE to take advantages of opportunities in the healthcare sector."

The report concludes that for PE firms to succeed in the region, they need to adopt basic fundamental strategies which include finding advantages in specialisation, identifying sustainable investment ideas, providing more operational support to their portfolio companies, reducing their risks and gaining the trust of the best possible investment partners.

These strategies, says the report, "will work and remain important in good times and bad".

This article was written by Kevin Tan based on the INSEAD and Booz study. For a copy of the full report, please click here.