

Navigating Saudi Arabia's Private Equity Landscape

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Saudi Arabia has one of the strongest and most dynamic economies in the Gulf Co-operation Council (GCC). Long considered the sleeping giant of the Middle East, Saudi Arabia is now leading growth in the region, driven by solid demographic fundamentals, sound economic reforms and, of course, capital surpluses built on its hydrocarbon exports. With a young and growing population, an economy that generates about 50% of the region's GDP, and access to the world's largest proven oil reserves coupled with recent oil discoveries, the economic outlook for the Kingdom seems promising for years to come.

Real GDP is forecast to rise 2.6% in 2010, up from about 0.5% in 2009, and then ratchet up to 4.7% in 2011, according to estimates from the Saudi Arabian Monetary Authority (SAMA) and Credit Suisse. World Bank estimates place GDP growth for the country even higher – at 3% – for 2010 (4% in 2011).

Saudi Arabia also has the largest capital market in the GCC with a market cap over \$450 billion and is increasingly being recognized for improving its business practices. It is ranked as the number one country in the Middle East for the ease of doing business in the World Bank's *Ease of Doing Business 2010* survey and 13th overall (up from number 27 in 2007) out of some 178 countries, ahead of Germany, France, Sweden, South Africa and Turkey. The numbers reflect the substantial progress that Saudi Arabia has made towards opening its economy to foreign investors in recent years. And as it more closely embraces foreign companies and foreign competition, Saudi Arabia is also steadily diversifying into non-oil sectors, as is much of the rest of the GCC. Non-oil sector real GDP growth in the region ranged from 5.7% to 11% between 2004 and 2006, for example.

All of this points to a market that should be highly attractive to investors, particularly private equity (PE)

firms. Yet, few PE firms have succeeded in closing deals in Saudi Arabia, especially relative to the number of investment funds, says Ahmed Youssef, a principal with Booz & Co. And a look at the value of private equity activity as a percentage of GDP shows that Saudi Arabia remains in an early market stage. PE in 2007 made up just 0.12% of GDP in Saudi compared with 2% in the UK, 0.9% in India and 0.5% in China, according to Booz & Co.

So, why are there so few PE deals in Saudi Arabia, despite increasingly attractive fundamentals?

According to experts from Wharton and Amwal AlKhaleej, a leading Middle East-focused private equity firm and the first to be headquartered in Saudi Arabia, few PE firms appear to have mastered the Saudi market mainly because they fail to understand the unique business and cultural aspects of doing commerce in the country. They have not yet learned how to adapt to a specialized market with local intricacies that are different from other markets where they are used to operating.

Breaking into a 'Closed' Market

The uniqueness of Saudi Arabia causes outside investors to see it as "somewhat closed" and not very business friendly, says Wharton finance professor N. Bulent Gultekin. This is true despite Saudi's positive rankings in the *Ease of Doing Business* survey. Raphael (Raffi) Amit, a Wharton professor of management and entrepreneurship, says that the perceived lack of transparency in Saudi Arabia is even greater than in most Middle East countries. This perception is due to a confluence of factors, chief among them the lack of PE transactions, the absence of strong trade associations and in turn data and statistics, and more importantly the prevalence of family businesses that naturally refrain from sharing information.

One of the most notable differences that these firms confront in the Saudi market is the utter dominance of family-owned businesses, which make up about 95% of the corporate economy. That is true for most

of the Middle East, while “the Saudi Arabian private equity market is the hardest shell to crack – but has the greatest potential,” says Fadi Arbid, executive vice president and country head of Saudi Arabia at Amwal.

Musaab Al-Muhaidib, general manager of Al-Muhaidib Technical Supplies, a subsidiary of Al-Muhaidib Group, one of Amwal’s limited partners (LPs), agrees that various entry barriers make Saudi Arabia a big challenge for outsiders. “Absolutely, it will be very difficult for a PE company to crack Saudi Arabia,” he says. Al-Muhaidib is a family-owned business and one of the most prominent diversified conglomerates in the region, with more than 200 investments in its portfolios. Al-Muhaidib himself emphasizes the importance of understanding the “Saudi mindset,” and also the dynamics of the family business when doing business in Saudi.

On a very basic, interpersonal level, a PE team investigating a target company can demonstrate to the family owners its commitment to understanding family concerns by being humble, by using simple terms rather than business jargon, and by recognizing the importance of some subtle but culturally important cues, such as maintaining eye contact just below the gaze of the Saudi owner, Al-Muhaidib explains.

Building Trust

Business in Saudi Arabia is conducted in a “highly relational” way, Amwal senior vice president Tariq Al-Sudairy says, and PE firms from outside the country can often find the intricacies of these interactions hard to understand. “Personal relationships matter much more in this part of the world, where a deal is more likely to be closed in a social gathering rather than a boardroom.” Notes Youssef: “It is important to do relationship building with the owner and other stakeholders, and to know the relationship between family members. For example, if a son runs the business on behalf of the father, then it is actually the father who calls the shots.”

Al-Sudairy and Al-Muhaidib agree that trust matters most to a Saudi family, and that trust can take a long time to build. Al-Sudairy stresses the importance Saudi family-owned businesses place on knowing and trusting the negotiator across the table and, often, the value a family places on dealing directly with a person who is well acquainted with the local culture. Family background and one’s general network of business relationships matter. Thus, having a general partner with an indigenous, well respected team is critical for PE firms conducting deals in Saudi Arabia.

One reason for such heavy emphasis on trust is that Saudi commerce is based on Shariah law, which in part means there is no concept of precedent. Knowing that a prospective partner shares the same values offers family businesses reassurance. “A handshake and a gentlemanly word are important,” says Hani Halawani, Amwal senior vice president. “That may pose an obstacle for foreign firms, which are used to relying more on legal agreements.” Working with a firm that has deep knowledge of the culture, family and community ties can help bring down barriers, raise trust levels and minimize potential miscommunications.

Prior to establishing trust, PE firms looking to invest in the country should consider building a well rooted indigenous professional team on the ground to overcome the entry barriers, according to experts at Amwal and Wharton. By having a local team, PE firms are in a position to fully understand distinctive challenges of conducting business in the Kingdom. It is important, for example, for a PE firm to have a permanent office in Saudi – a local presence – in addition to having principals who speak the language and who understand the culture, Gultekin says. A PE firm needs to show presence and commitment. Flying into Riyadh for the work week and out again for the weekends doesn’t work, he adds. And PE firms also need a permanent presence in Saudi to win proprietary deals, according to Booz & Co’s Youssef. “A PE firm coming from outside Saudi or outside the region will find it difficult to penetrate the ‘inner sanctum.’ They

will miss out on evenings and weekends when deals actually happen.” In order to transact proprietary deals, all parties must be physically close to the source of capital and the network that brings in the deals.

Concerns of Family Businesses are Potential Opportunities of PE Firms

While PE firms face challenges in making their case in Saudi Arabia, family-owned businesses could benefit greatly by taking on outside partners, although the advantages are not yet well-understood by many Saudi families as the whole concept of PE participation is new. Al-Sudairy says “they still need convincing on the importance of PE.” And that is why, Youssef points out, PE firms must show the type of performance they can deliver and offer a performance benchmark.

“The issue is to convince local or homegrown companies to work with PE firms, not for capital per se, but to acquire business development skills,” Gultekin says. A PE firm can provide credibility regarding a company’s ethical and business standards, and help a company to grow and diversify its earnings base by providing access to strategic partners. Once people see the value that a PE firm contributes to a company, others will start to embrace the idea of bringing on board an external investor very quickly, he says. “This is known as the demonstration effect.”

Until then, however, family-business owners will continue to “fear losing control to a private investor,” Youssef says. “The perception is that a sale to a PE firm is a negative thing to do. Family firms have an emotional attachment. There is a belief that no one else can add value.” Others point out that many family-business owners think that getting involved with outside investors, or seeking to raise capital in equity markets, could send a wrong signal that a company is in trouble. Here, PE firms often can help provide the right expertise to present a more accurate – and positive – message of growth and improvement to the public.

In fact, these concerns are what make PE firms potentially highly attractive partners for family businesses. Saudi companies increasingly will need fresh financing to spur growth or to monetize existing investments, for example. Yet, bank financing can be problematic in a region where local equity financing is preferred over local debt due to conservative business mindsets. At the same time, Saudi businesses face a general tightening in bank loan requirements, making loans harder to secure. Both factors add weight to the attractiveness of private equity.

Outside partners can also help Saudi companies solve other important challenges, such as a general lack of succession planning, which has become increasingly important as many family businesses begin to hand off leadership to a new, third generation of owners. Other factors that might cause a company to consider external investors include a family’s desire to diversify or a need to buy out certain family members to resolve a family dispute, for example. By working with external investors, such as a PE team, family businesses can overcome these shortfalls and put their companies on a sounder footing, say Amwal experts.

Furthermore, with the Saudi economy liberalizing and opening up to foreign investors, family businesses are spinning off and divesting non-core assets to concentrate on mainstreaming their operations, which provides PE firms with an attractive new pool of investment opportunities.

Many Saudi families also have conservative capital structures and require help in strategic guidance. PE firms with strong seasoned professionals can help family businesses optimize their capital structure and provide strategic guidance and support to unlock hidden values within the company.

Creating Flexible Models

Arbid says that to win the trust of a family and be able to partner with them, it is critical that PE firms maintain a flexible approach. “A firm needs to have a

certain model that caters to family-owned businesses and addresses their concerns.” For example, going down the buyout route, as PE firms often do in mature markets, does not often work well in Saudi Arabia. If a PE firm buys a significant majority of a company, then it risks losing the management team’s commitment because the original owners are also the managers. In Saudi Arabia, families need to retain a significant ownership percentage to ensure commitment and dedication to the business. Amwal experts say they find projects workable when they are able to gain a significant minority, which might be in the range of 20% to 40%.

“A buyout model that looks to replace management is very difficult,” Al-Sudairy says, adding that what is required instead is to strengthen management and introduce good corporate governance mechanisms, including the right incentives to motivate management.

If a PE firm does decide to go the buyout route, meaning it buys a majority stake and then runs the firm, it is left with the task of finding a new management team. “It is very difficult to do this in Saudi – talent is very scarce, and where do you find the experience?” Al-Sudairy asks. The basic talent “you actually need is already there, with the founding managers and shareholders.”

PE firms can also better align their interests with those of the selling family than other financial or strategic investors, according to Amwal experts. A family business could require a pre-emption rights clause, for instance, to allow them to buy back the external investor’s stake in the company if there were a desire to reverse the investment arrangement.

At the same time, Saudi Arabia’s judicial process can be onerous and lengthy, and can present delays and roadblocks when enforcing such things as put options. Therefore, PE firms have to focus on conducting extensive due diligence through their local LP network and banking relations to verify a family’s ethics and reputation. Also, by having a strong local LP base, the

potential for tarnishing a family reputation serves as a stronger deterrent than any legal agreements.

PE Firms Can Still Add Value

A 2008 survey covering corporate governance practices in the Middle East and North Africa (MENA) bears out the concerns that some investors might have doing business in the region, according to a recent article in Knowledge@Wharton titled, “Time for Transparency: What Will It Take to Improve Corporate Governance in the Middle East?” From the PE perspective, certainly, the perceived state of corporate governance in many Middle East businesses presents an opportunity for PE firms to help create value by introducing global best practices and financial reporting. Debt payment defaults by two large family-owned conglomerates in Saudi Arabia in the summer of 2009 highlight the transparency vacuum that PE firms could fill.

As Saudi and other businesses in the Middle East expand and become more sophisticated, serious concerns over governance will prompt searches for better solutions. Tapping into local, private equity expertise could provide the help needed to build a sounder oversight structure. According to Arbid, Amwal has helped family-owned businesses upgrade their corporate governance practices through various initiatives, including: creating a functioning board, a family board, and board committees (e.g., executive and audit committees); developing an organizational structure, reporting lines, and job descriptions; separating the chairman and CEO functions; clarifying voting rights, and enhancing financial controls and internal reporting systems.

Al-Muhaidib also thinks it is important that a PE firm understand the role family members should play in the business post acquisition – they should retain the central role. Amwal agrees with Al-Muhaidib that the managerial skills of family members are one of the cornerstones of investment decisions. Says Arbid: “In a growth model, we buy into businesses where,

typically, family members run operations. We then complement our partners' operational expertise with our contribution to governance, business development, corporate finance skill set, and strategic insight. PE can play a bigger role on the board, helping to give strategic direction and know-how," he says.

The Emerging Saudi PE Market

Private equity remains a nascent industry in Saudi Arabia and, at least numerically, a little behind the rest of the GCC. But it is gradually developing, and Saudi inevitably will become the best market for PE deals in the region, says Halawani. Saudi Arabia has the largest economy in the region, a young and growing population, a liquid and well-functioning capital market, and a constantly improving legal, labor and commercial environment, all of which suggest a rise to prominence. Eventually, major international PE firms will do deals in Saudi. But in the meantime, the handful of regional PE firms with indigenous teams on the ground, an understanding of the business and legal culture, and a focus on the right PE opportunities will likely remain the dominant players in the Saudi PE market.

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