

## PRIVATE EQUITY & VENTURE CAPITAL

### The new wave of emerging markets private equity and the case for the Middle East: play for today or here to stay

BY GUY RANAWAKE AND KOSTAS NIKOLOPOULOS

Only fifteen years ago, most mainstream finance professionals would have rejected the notion of establishing emerging markets private equity as a separate asset class. However, within this short period, we have not only seen its acceptance as a distinct asset class but have also observed a full boom and bust cycle, and are now witnessing a second upturn of unprecedented activity that has led to a quadrupling of emerging markets funds raised in 2005, compared to the money raised in 2003.

During the same period, within the Middle East, there has been a rapid increase in the number and size of funds. New entrants include Ithmar Capital, GCC Energy Fund, Shuaa Partners and the median fund size raised has grown from \$55m to \$150m. If the results through to the end of 2006 meet the EVCA's estimates, the Middle East will have raised a staggering \$17bn of committed new capital for investment both within and outside the region.

That being said, we should also note that the Middle East private equity market is growing from a relatively low base and even today represents a small percentage of total global funds under management. In the Middle East, investable net worth is estimated to be approximately \$2 trillion, of which only 0.25 percent has been invested in private equity (excluding venture capital and real estate), well below that of other regions, according to ABRAAJ Capital. In addition, many of the funds have an investment remit beyond pure private equity, spanning public equities, real estate and commodities.

#### Fundraising: the easy part?

There are several forces behind this growth in Middle Eastern private equity markets, divided between (i) supply-side factors impacting on the amount of funds available for all types of investment and (ii) demand-side factors impacting on the relative attraction of private equity compared to other asset classes.

On the supply-side, there has been a rapid increase in liquidity in the region driven by high oil prices. The rise in value of other asset classes such as public equity markets, real estate and commodities both globally and in the region over the period has further increased the size of funds to be invested (the denominator).

As a result, fund managers have needed to increase the value of funds invested in private equity (the numerator) in order to simply maintain the same percentage asset allocation in the investment portfolio. This argument is supported by some empirical evidence that suggests that asset allocations have not changed significantly over the period, i.e. that the expansion of private equity has been denominator- rather than numerator-led.

On the demand-side, investment managers have a wide range of conventional asset classes (public equity, bonds, cash) as well as alternative investments to select from (see *Figure 1*).

Private equity remains attractive relative to public equity markets due to the possibility of significantly higher long-term returns. Empirical evidence shows that private equity on average has outperformed public

equity benchmarks over a 10 year period by 4.3 percent in the US, while the top quartile managers have outperformed by a much wider margin of 31.6 percent, according to Thompson Financial/Venture Expert. However, it is too early to claim the same relationship in the Middle East.

In addition, there has been a shift in investment philosophy. "The people in the region think differently, nowadays, about their investments. It is not about investing in Eurodollar CDs and making a modest, relatively risk-free return, but about doing something productive for the region" says Roger Leeds, SAIS Professor and Chairman of the Emerging Markets Private Equity Association.

This argument has been reinforced by (i) outperformance of the region's public equity markets (and to a lesser extent real estate) relative to global markets despite recent corrections, (ii) the earlier collapse of NASDAQ in mid-March 2000, and (iii) some negative perception about investing in traditional target markets following 9/11.

Indeed, the very success of local IPO markets has meant that allocation of stock to funds has been severely scaled back in many cases. As a result, fund managers have been forced to invest at an earlier stage through private equity in order to position themselves favourably for future listings.

#### Management – the hard part?

The excitement generated by emerging markets private equity investments is not new. It was also present throughout Asia in the mid 1990s, but performance of first generation funds has proved disappointing.

Given the positive supply- and demand-based factors discussed above, it is clear that at the current time it is easier to raise new capital than to invest funds in the Middle East. The risk is that there will be too much money chasing too few opportunities. It is access to the right sort of deal ▶▶

Figure 1 – Alternative Investments



Source: European Private Equity and Venture Capital Association (EVCA)

flow, coupled with professional management, which will largely determine which funds will enjoy the target returns which have been promised to investors.

The quality and quantity of management resources at both the portfolio/investee company level, and the investment/fund management level, will determine whether a fund is a top quartile player or just an average player. The challenge is to find the fund management team which combines the necessary mix of region-specific expertise, demonstrable private equity transaction experience (not just as an adviser but also as a principal), and desired sector focus.

#### Investing: sourcing the deals

At first glance, the Middle East should be a fertile ground for private equity. The area does not enjoy a well developed banking system (although this is changing) and its middle market companies have limited access to global capital markets. Hence, private equity should be able to play an important role in providing external financing to early stage projects as well as leading middle market companies.

The drive to introduce private capital into traditional state-dominated sectors should create privatisation opportunities for private equity funds as should the existence of well-established family-owned companies looking to cash-out some or all of their investments. In addition, the rapid growth in infrastructure requirements should also provide opportunities despite the fact that this sector has not been traditional territory for private equity funds due to the risk of cost overruns and their long payback periods relative to fund life.

The success of the funds' investment strategy should be assisted by the fact that the new generation of Middle Eastern funds all have a local presence (see Figure 2) and are mainly trying to source deals within their region.

This is in contrast to the previous business cycle when most emerging market funds were 'clones' of US funds and were usually run out of the US or Europe, with limited if any presence on the ground. This local presence and the knowledge of the idiosyncrasies of each market are one of the very few effective ways to overcome the typical problems involved in

investing in emerging markets such as asymmetric information between the buyer and the seller and poor corporate governance.

Middle Eastern funds have also focused on specific sectors, such as energy, real estate and tourism. However, it should be noted that many of the funds or investment houses are investing beyond the traditional private equity sector and take a more opportunistic approach when it comes to allocating funds (such as public equities, real estate and commodities).

The new funds are also getting larger which should allow them to invest in larger projects both within and outside the region. This is supported by recent announcements of \$1bn-plus funds which would mean that Middle Eastern funds would "have the capital and the clout to compete with KKR, The Carlyle Group and Blackstone", as said by Hanah Taher, the chairman of Gulf One who is currently raising a \$10bn buy out fund. However, at least to date, there has been limited competition from the mega-funds although this may be changing with the announcement of the opening of local offices of international players, such as Babcock & Brown.

An interesting new entrant is First Energy, which is being established in Doha by some strong founding partners, including Esam Janahi, which will initiate and invest in energy projects and companies globally with a view of long term capital appreciation. The investment company will be capitalised at \$2.5bn.

#### Exit options in emerging markets

The ultimate success of the investment strategies of the new funds will be judged by exit strategies and performance. The regional funds are expected to consider all the main exit strategies when seeking the best terms for realising their investments, namely public markets, trade sales and financial sales each of which have their own advantages and disadvantages.

The attraction of an IPO exit strategy has been boosted by the current valuations of publicly traded stocks both in the region and globally, despite some recent cooling off. Regional equity markets are now significantly more liquid and deeper than in 2002, thus creating a viable exit mechanism.

However, trade sales driven by strategic considerations continue to play the dominant role despite the buoyancy of the public markets. The regional stock markets, even after their recent growth, are still relatively young and volatile as are some local investors, as shown by recent disturbances in Kuwait following a stock market correction. In addition, some companies may prove less 'listable' than others, thus favouring trade and financial investors over public markets.

Finally, fund managers need to consider all options in order to maximise price tension, particularly given that exit may be several years away when stock market conditions could be very different to the ones we see today.

#### Conclusion

The recent flurry of announcements of new Middle East funds and the rapid rise in public equity markets have generated an enormous amount of interest in the region – despite being still a relatively small part of the global economy. It is clear that fund raisers are experiencing extremely benign conditions as a result of both increased liquidity and attractive returns seen in the region. However, securing attractive deal flow at the right prices with professional management will be the key to determining which funds will be able to deliver the returns promised to expectant investors. ■

