أموال الخليج
Amwal AlKhaleej
www.amwalalkhaleej.com

Amid Political Unrest, Private Equity Firms Navigate Challenges in the Middle East

June 2011

Produced by

Knowledge@Wharton

http://knowledge.wharton.upenn.edu

Amid Political Unrest, Private Equity Firms Navigate Challenges in the Middle East

The political unrest that began in Tunisia in December 2010 and spread throughout the Middle East and North Africa ("MENA") region has profoundly impacted both the political and economic landscape. Private equity investors have been left wondering if and when the frothy MENA business environment they had previously enjoyed might return and, in the meantime, how to best position their funds for an uncertain political future.

Despite the unrest, companies in the MENA region are currently doing quite well from an underlying business perspective, says Fadi Arbid, CEO of Amwal Alkhaleej, a Riyadh-based private equity firm that operates exclusively in the MENA region. "Sellers have decided to refocus on their own businesses," strengthening their operations and paying dividends to shareholders, he adds.

Strong oil prices — which hovered above $90 a barrel even after the announcement of the release of supplies through strategic reserves — are responsible for some of the positive performance. Media reports indicate that corporate earnings are growing across a variety of industries. For instance, the financial services sector has made a remarkable recovery as trends in underperforming loans and unrecoverable debt have reversed. In particular, banks are performing very well given sizable margins on loans, steeper financing rates and favorable pricing. Insurance companies are also thriving. The retail sector, especially businesses like supermarkets, has been doing well as it has benefited from the demographics of the relatively young populations of MENA countries. Lastly, the energy sector has also been encouraging given the continued volatility in oil prices.

According to Arbid, on a country-by-country basis the net result for the MENA region remains unclear. Businesses in Egypt, for example, are faring well, though any business that generates revenue from the state has been interrupted, as an increased level of caution and scrutiny has disrupted state-governed infrastructure investments. Another example is the UAE, where real estate valuations and tourism have tumbled since the political unrest began. However, the UAE may experience a positive benefit from the turmoil in Bahrain by recovering the Western ex-pats who had previously abandoned the UAE for Bahrain; their return is expected to help stabilize declining real estate prices. While the growth appears promising, investors should be sure to evaluate based on pre-turmoil metrics. Arbid notes, "The UAE is in growth mode again, but it is normal growth." Generally speaking, while public valuations are down, they are still up from the bottom.

Compressed Multiples

Despite earnings growth led by positive business momentum, valuations remain relatively low. For example, the Saudi index was at approximately 7,000 points before the political unrest in the Middle East but then it fell to a low of approximately 5,700 during the turmoil, before recovering to pre-political crisis levels. During that same period, earnings continued to grow, driven in part by strong oil prices. Because earnings growth persisted while valuations declined, the drop in valuations is almost entirely attributable to multiple compression, a phenomenon that occurs when a stock may be trading at a certain multiple, but its price stays low despite strong earnings. "People are still cautious," Arbid notes, as a reason for depressed valuations. "We were expecting a big recovery," he adds, referring to the political reforms and progress in Saudi Arabia, the UAE and potentially on a longer term Bahrain and Egypt. It may still be too early to judge the ramifications of the political crisis which began in January 2011.

Muted valuations have substantially slowed if not halted capital deployments, given conflicting perceptions of value held by buyers and sellers. Private and public enterprises have been faring well since the political turmoil began, giving rise to high expectations on the part of sellers. However, buyers have been conservative and cautious, giving rise to a valuation gap. Since the political crisis, which dates back to January 2011, no transactions have taken place. Arbid reckons that two to three private equity transactions have been completed since the economic crisis of 2008. To put this in perspective, before the economic crisis, one to two transactions were occurring on a monthly basis, Arbid explains. While public-market price-to-earnings multiples and price-to-earnings-to-growth ratios look very cheap, he says it doesn't matter because "there are no sellers" at these valuations. "It is a good buying opportunity but there is no transaction."

Further exacerbating the disconnect between buyers and sellers is the cautiousness of private equity investors, who have been waiting on the sidelines while the situation shakes out. Arbid observes that "a lot of opportunities came post-turmoil, but PE firms couldn't take advantage of it." A case in point is the emergence of yields of 40% to 60% from bonds backed by governments in the region. As a result, many investors in this region are maintaining high levels of liquidity.

All these factors have enabled a few private equity investors, who were less risk averse, to scoop up great companies at below-average prices. This makes a lot of sense, Arbid points out. "Risk premiums are more conceptual. If you are bullish on the mid- and long-term, people are quite positive."

But what are private equity investors to do until the long-term arrives? One option may be branching out into other, more opportunistic asset classes as well as exploring different routes of exit. Arbid explains: "The reason why we went to private equity is because the environment and market conditions were prone to PE; I am not sure this is still the case now." In the past, Amwal AlKhaleej had done opportunistic deals such as pre-IPO and greenfield transactions. "There was buoyancy of the investment world; our region was booming." Due to their unique access, firms such as Amwal Alkhaleej were able to enjoy success, driven in part by multiple expansion and earnings growth. According to Arbid, "Exit opportunities were there — IPOs were coming online. You had an exit route that was put in place. It is much harder now."

Exit Strategies

Many investors now wonder what kind of exit strategies firms are deploying now that the IPO market has dried up and other PE firms are gun-shy about investing. Today's alternative to the IPO exit may be the strategic buyer. Arbid believes that strategic buyers are now more strongly in play than before in helping PE firms exit deals. "Strategic buyers can have a very different view on risk," he notes.

Arbid sees new opportunities in the mezzanine space and in public equities and believes that private equity firms in the MENA region may revert to an opportunistic style of investing. In his view, dedicated private equity-only, sector-focused firms in the region are unlikely to emerge. "No asset class is deep enough for specifically differentiated funds," he points out. "There's not enough depth in PE, let alone a sector, to warrant a proper fund."

What does that mean for private equity funds today? "Many people question this model," Arbid notes, and he cites other global PE funds that have left the industry to pursue other forms of investing, such as hedge fund opportunities. "It's a question I'm asking myself. I'm not sure everyone is asking that question. You can't say you are just going into opportunistic investing, but PE firms are not going to see a lot of opportunities that justify their existence."

As a result of the dearth of deals, as well as general unease with the region, fundraising in this environment has been challenging. As Arbid observes, "Fund raising is dry. Even the deployment is dry." He further notes that achieving high exits and generating acceptable returns is particularly difficult in the Saudi and Egyptian markets. "Despite fantastic growth, multiples are not very helpful," he adds.

Political and social unrest in the region is a positive indicator for the most opportunistic investors. The public perception of political risk in the MENA region may present an arbitrage opportunity for private equity firms with capital to deploy. The pace of political and legal reforms favorable to private and foreign investors may accelerate as a result of the turbulence that captivated the world. The broader effects of the progressive developments will be top-down as wealth flows throughout the economy, according to Arbid. Widespread prosperity will fuel the emerging middle class and lift those at the bottom of the pyramid and enable increased access to health care and education, among other services. As Arbid notes, "Wealth distribution is changing in Saudi Arabia but these macroeconomic trends do take a long time to develop."

Since the situation in the Arab world is in such a flux, how can investors determine what is fleeting and what constitutes the new normal? While much of the political analysis in the region speaks to the short-term implications versus the long-term, it is unclear how these terms translate into timeframes that could be used in decision making. As Arbid sees it, characterization of the short- and long-term is heavily influenced by the specific country or region in which one is operating. For example, in Egypt, as much has occurred in terms of the extent of initiatives and political reforms over the past five years as has been the case over the past 50 years. Shifts and changes are happening much faster now than in the past. From 1995 to 2005, just a handful IPOs took place in Saudi Arabia. In contrast, from 2006 to 2007, IPOs were launched more than once a month on average. "It seems the long run is getting shorter and converging upon the near term at a faster clip than ever before," Arbid believes.

However, to keep things in perspective, he recalls, "Private equity is a six to eight year bet. That's long term enough." Indeed, it can be arduous for private equity investors to be overly tactical in developing their portfolios, given the cyclical nature of the industry. For most firms, the investment cycle is contingent upon when fund raising actually took place, which is why firms are focused on exits rather than deal flow. Due to the need to exit investments before their funds' life expires, many firms are looking for ways to exit despite the less than favorable environment.

So will private equity re-emerge in the MENA region? The answer, says Arbid, depends on the success of the exits of today's funds, most of which were raised and deployed between 2004 and 2007. "The moment of truth for these funds to raise capital again is when they exit," Arbid says. "They have to demonstrate to the outside world that they are able to generate returns." This situation, of course, is not unique to private equity firms in the MENA region. Arbid's advice to private equity firms and investors considering business opportunities in the Arab world is simple: "Work on your exit," he says. "It's not going to happen when you want it."

This article was produced by Knowledge@Wharton, the online business journal of The Wharton School of the University of Pennsylvania. The project was sponsored by Amwal AlKhaleej, a leading private equity firm founded in Riyadh with offices in Dubai and Cairo which focuses on investments in the Middle East and North Africa regions.

www.amwalalkhaleej.com