

No big deal(s)?

by Soren Billing on Thursday, 15 October 2009

Private equity firms in the Middle East are low on leverage and high on cash, with around \$11bn of unspent capital in their coffers. But a lack of deals in the region has the industry bracing for a wave of consolidation and closures.

The term flipper has become synonymous with Dubai's real estate market and the type of speculative investor who bought properties that were sold on before they were even built. As property valuations came tumbling down so did that business model.

In private equity, a different type of flipper is currently feeling the squeeze. When private equity began to take off in the Middle East in 2005 there was no shortage of players who wanted to take a bet on the ever-rising stock markets. Spotting a private company that was likely to go public and then taking a minority stake in it was usually enough to get the return investors were looking for.

But with the IPO market all but disappearing, many are wondering what will happen to the region's numerous private equity houses. A recent study by Abu Dhabi-based Gulf Capital puts the number at 126.

Zulfi Hydari, managing director of private equity at HBG Holdings in Dubai does not believe the number can be sustained, and predicts it will fall by between 70 and 80 percent.

"The situation we have now is nothing short of a crisis," he says.

Many companies set up shop based on a "fundamental disconnect between what could be raised and what could be invested", he claims.

Another obstacle: the corporate governance issues people thought would be ironed out largely remain, and are likely to do so, Hydari adds.

The number of deals closed by MENA funds in the first 9 months fell by 65 percent to 12 from 34 in the same period a year ago, while the value of total announced investments during the period dropped 75 percent to \$359m, the Gulf Capital study shows. Saudi Arabia, the UAE and Egypt accounted for 67 percent of the number of deals.

Investments were mostly in traditionally defensive sectors such as education, healthcare, utilities, telecommunications and food. Oil and gas attracted two of the 12 investments.

The Middle East slowdown compares with a global drop of 74 percent in deal volume to a four-year low of \$180bn, according to data provider Dealogic. US firms closed deals worth \$62bn in the first half of 2009, down 85 percent from \$400bn in the corresponding period last year.

In the West, the private equity industry ground to a halt as credit markets seized up amid the global financial crisis, cutting off the financing that was vital to their highly leveraged acquisitions. A Western firm would typically contribute 10 to 20 percent of the acquisition cost and fund the rest with corporate debt from banks.

For Middle Eastern firms, who were never leveraged to start with, funding is not an issue. According to Gulf Capital, \$11 to \$13bn of the total assets under management by the end of 2008 are still not invested. That means around 55 to 65 percent of the total \$21bn that has been raised by the industry to date remains uninvested.

However, all that dry powder isn't necessarily good news for the sector. Time is running out for many firms, who usually have around four to five years to deploy the capital raised, before it is returned to their limited partners, who may or may not choose to roll over into new funds. With much of that money raised in 2005, there will be growing competition for the right deals in the year ahead.

Despite a growing consensus that the worst of the economic crisis is over, opinions vary on what the future holds for the industry in the region.

Mustafa Abdel Wadood, managing director of Abraaj Capital, the Middle East's biggest private equity firm, is generally optimistic on the economy and the number of deals that will materialise. "Even if we're not out of the crisis, the worst is behind us in terms of a freefall," he says.

Business confidence in the region bottomed out in February and the government spending trend is positive, he says. Low corporate leverage and a modest ratio of retail loans to GDP also make it an attractive market; the latter is "almost non-existent" in Saudi Arabia, he points out.

More importantly, governments are beginning to see that privatisation can lead to efficiency gains, in addition to cutting costs at a time when balance sheets are stretched by higher government spending and lower oil revenues.

Abraaj is currently looking at investments in Saudi Arabia, Egypt and Turkey. Sectors of particular interest include specialised financial services, logistics and "things that benefit from consumer spending as people come out of a tough cycle", Abdel Wadood says.

"You could argue tourism, you could argue that a lot of sectors are actually very cyclical in their nature and react very positively to coming out of a cycle."

Ammar AlKhudairy, chief executive and managing director of Saudi-based Amwal Alkhaleej, sees Egypt emerging as a low-cost manufacturing hub for neighbouring Europe as companies try to circumvent labour laws and stricter environmental regulations in the European Union.

Dubai will have fully recovered from the crisis three years from now, he predicts, adding that a 50 percent drop in real estate prices compares with an 80 percent slide in Singapore in the wake of the 1997 Asian Financial Crisis. "Dubai will be back on top. It has certain features that are unique," AlKhudairy says.

Tight debt markets and volatile stock performances are expected to prompt more businesses that were previously reluctant to talk to private equity to do so, as funding remains hard to come by. The IPO route remains closed and the banks are reluctant to lend.

However, Hydari of HBG Holdings argues that asset prices have yet to come down and that the challenges facing the industry will prove insurmountable for most players.

"I don't see any sign of valuations coming down," he says. "There is a perception among vendors that an excess capital is chasing investments, which is bringing up prices."