

## The "new entrepreneurs" of the Middle East must face up to the crisis or fail

Private equity firms need to rethink their business models in order for the industry to have a bright future



It's telling that there hasn't been a single bad news story about any major private equity firm in the Middle East since the start of the financial crisis, except of course the news coming out of a few publicly listed

investment groups such as Investcorp or high profile sovereign backed entities like Istithmar. Investcorp described the recent trading period as the most challenging since the firm was founded in 1982, yet no other privately held firm has come out with any bad news about staffing, portfolio, access to credit, fundraising or deal pipeline. Instead most industry commentators have painted a picture of 'opportunities abound' with falling valuations, \$13 billion of dry powder and solid portfolio performance.

Whilst I agree there will be opportunities, first there must be a lot of pain. One of the most candid admissions came from David Rubenstein, the co-founder of Carlyle Group, when he said at the recent SuperReturn Middle East private equity conference that PE firms helped inflate the credit bubble by buying companies at high prices whilst relying on cheap debt. "We contributed to the problem. We tended to invest near the bubble peak at very high multiples." Surprisingly no such admission is forthcoming from private equity leaders in the Middle East.

Nevertheless the industry is in crisis, and when it is over, you can expect 70+% of the region's 120 firms to have disappeared. Why? Well the key metric to look at is not the \$13 billion in dry powder but the 12 deals worth \$359 million that private equity firms announced in the first 9 months of 2009, down over 75% from 2008.

Even at its peak the regional private equity market was worth only \$2 - \$3 billion per annum so you still can't logically make a case for so many firms. However, the impact of consolidation will be positive for those who survive as the byproduct will be better access to investors and improved deal flow.

However, even survivors will need to rethink their business models, most likely opting for increased specialization, smaller funds, greater emphasis on earlier stage investing, improved economics for investors and more operationally focused teams.

In addition, one of the most important factors for most firms to consider when repositioning themselves will be their relationships with family businesses, who in most cases are also clients or investors. In the Middle East these family groups constitute more than 70% of the regional economy and control hundreds of billions of dollars in corporate assets. They are the most sophisticated and proven entrepreneurs in the region with adequate investment capital, deep operational know how and privileged market access.

It is therefore ironic that these family groups have inadvertently funded one of the biggest entrepreneurial experiments the region has ever seen: the establishment of the regional private equity firm. This new breed of entrepreneur claimed unique insight into matters of corporate governance, succession planning and unlocking financial value from conglomerates, which were all pressing issues for family groups. In reality many PE groups were, knowingly or unknowingly, evolving into cleverly disguised competitors of their investors rather than value adding partners.

It is highly unlikely that family businesses will continue to bankroll PE firms without forcing them to transform into effective partners. The alternative will be to seek new capital from other institutional sources.

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The commentary above might indicate pessimism about the future of private equity in the Middle East. On the contrary, despite the difficulties, it is my view that private equity has a very bright future for those who adapt and will play an increasingly pivotal role in the development of the private sector. Based on our internal estimates we think it likely that private equity will grow into at least a \$7 - \$10 billion p.a. industry by 2016 which bodes well for those who are willing to persevere through the crisis.

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