

The Anatomy of Private Equity Investments in the MENA Region

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Table of Contents

I.	Introduction	3
II.	Macroeconomic Landscape	3
A.	Economic Fundamentals	3
B.	Financial Markets and Corporate Characteristics	4
C.	Regulatory Characteristics and Restrictions.....	4
III.	Current Private Equity Activities.....	5
A.	Fundraising	5
B.	Who is raising capital?	6
C.	Investment Trends - Where are players looking to deploy capital?	7
D.	Deal Structures - Financial characteristics	9
E.	Adding Value - growing an investment and potential exits	10
IV.	How does the environment look moving forward	13
A.	Operational Environmental Trends.....	13
B.	Economical Environmental Trends	13
V.	Conclusion	17

I. Introduction¹

Private equity (“PE”) investors worldwide have been rattled by the consequences of the global financial crisis. This has certainly been true of the Middle East and North Africa (“MENA”) region, where a PE market of limited maturity has taken a significant hit in fundraising and seen its peculiar investment landscape change in different ways: from longer investment holding periods to government reforms that could pave the way for larger deal sizes in the long-term than the existing mid-cap market has to offer. Although the regulatory landscape remains somewhat restrictive, and government control over certain industries quite strict, the MENA PE market has historically thrived in the middle market space and is expected to continue to do so as it exits the recession.

II. Macroeconomic Landscape: A View Through 3 Lenses

A. Economic Fundamentals

The MENA region has shown a steady GDP growth between 2000 and 2010 with an annualized rate of 4.7%. Despite drastic decreases in growth in 2009 due to the global crisis, growth outlook is positive for the MENA region in 2010 at 4.3%, making it one of the highest growing regions in emerging markets. Going forward, regional economies will continue to have a high GDP growth of 5% annually on average during the next five years, according to the Economist Intelligence Unit estimates. Egypt, Saudi Arabia, and the UAE will be driving the growth of the region as the major economies with average growth rates of 5.8%, 3.8%, and 4.9%, respectively.

Oil and gas play a major role in the regional economy. According to the Oil and Gas Journal, the region has more than 60% of the world's oil reserves and 45% of the world's natural gas reserves (Oil and Gas Journal - January 2009). Oil and gas are major export items of regional economies, accounting for more than 65% of total exports and significantly contributing to budgetary revenues (Economist Intelligence Unit - Country Reports). Vast hydrocarbon revenue also serves as a driving force behind wealth accumulation in the region that is partly channeled into investments in other industries. Such wealth also stands behind major diversification efforts in the region, especially in GCC countries, as governments

¹ We thank the principals of Keystone, the General Manager of GrowthGate Capital Corporation (“GrowthGate”) which has provided research material, relevant data and valuable checks and cross-references on market and sector information, along extending its financial support for the efforts behind the preparation and publishing of this white paper. We thank the principals of many other private equity groups in the region for providing helpful information in interviews. All opinions are solely those of the authors.

are involved in major infrastructure projects while maintaining a low tax burden on other industries.

B. Financial Markets and Corporate Characteristics

Financial markets in the MENA region are relatively underdeveloped compared to other growing regions of the world. The region's capital markets structure consists of disproportionately high share of bank assets and low stock market capitalization and debt securities. According to the IMF Global Financial Stability Report, the MENA region lags behind the world in stock market capitalization and debt market, with only 12% and 3%, compared to 25% and 42% globally, respectively (International Monetary Fund, Global Financial Stability Report, 2004).

Historically, banking finance was the preferred choice of firms in MENA because of a family-owned business structure and underdeveloped capital markets. Reportedly, 40% of non-oil gross domestic product in the MENA is produced by family-owned businesses (Private Equity and the MENA Region - Best Post-acquisition Practices for Growth Capital, 2009). However, most of these companies cannot obtain adequate financing from banks that have stringent collateral requirements including personal guarantees and that prefer short-term lending.

Therefore, the share of the private sector loans is smaller than those in other emerging markets, with more than half of all credits in the MENA region having maturities of less than one year.

C. Regulatory Characteristics and Restrictions

The financial regulatory system in the region is developing rapidly. Many countries have changed their capital market laws and financial regulations in general to encourage foreign investment. However, some gaps in financial regulatory system limiting PE activities still exist. Regulations governing structures such as preferred shares, takeover regimes and squeeze-out clauses that protect minority investors are still absent in some countries. Since minority investors might not be able to protect their stake by taking shares with liquidity preferences or enhanced voting rights, these investors can only rely on the terms of the investment memorandum. In addition, restrictions on foreign ownership are present in certain countries, or in certain sectors, like in Saudi Arabia where local citizens are required to hold majority ownership in banking and insurance.

Saudi Arabia is one of the leading countries in the region in terms of regulatory reforms. According to World Bank's "Doing Business 2010" report, the country was ranked as ranked 13th worldwide for ease of doing business, improvement of two places from last year's report (Doing Business 2010 - World Bank report).

Enactment of foreign investment law, establishment of Saudi Arabian General Investment Authority (“SAGIA”), privatizations of public companies in recent years also encouraged investments in the country. However, businesses still face difficulties, enforcement of contracts and labor issues within the regulatory system in the country.

Business arbitration forums and contract enforcement are still undeveloped in the region because of bureaucratic delays caused by local courts and conflicts between commercial laws and Islamic rules, which further decrease incentives for PE firms to gain majority stakes. According to “Doing Business in MENA 2010”, a survey conducted by the International Finance Corporation, there are 43 procedures on average needed to enforce the contract in the region (Doing Business in MENA 2010 - International Finance Corporation). This puts the MENA region as one of the most unattractive regions for dispute resolution among emerging markets.

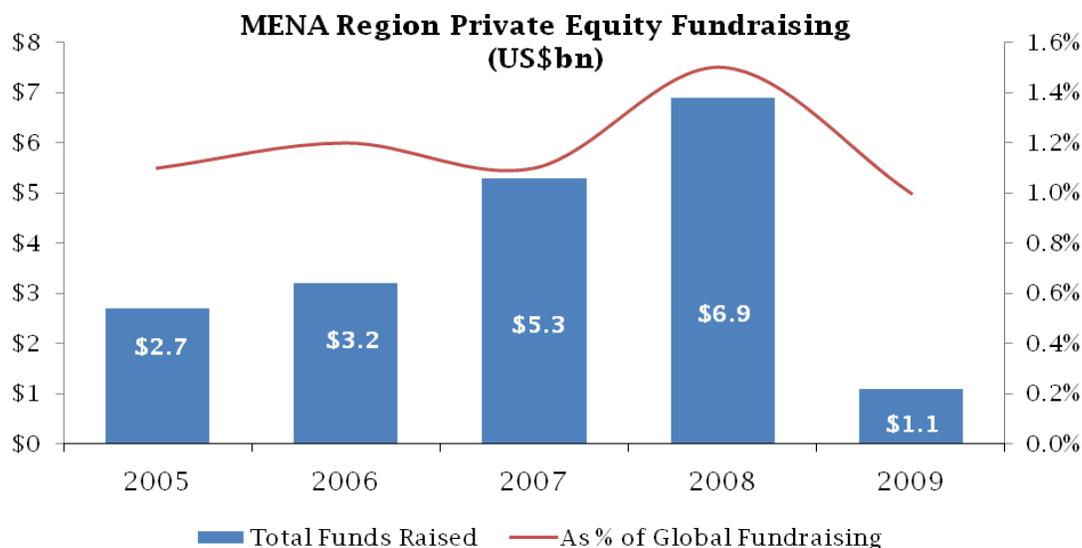
III. Current PE Activities

Given some of the characteristics of the MENA region mentioned above, particularly the rapidly growing economic indicators, lagging financial markets and regulatory systems, financial activities and numerous PE players have historically focused their efforts on mid-sized deals. The deal sizes listed in part C below reinforces the claim that PE firms operate in the mid-cap PE space. This trend is likely to continue in the short-to-medium term in the region. During 2009, activity in the region witnessed a significant decline as the impact of the global financial crisis began to spread to the MENA. The relative decline of oil prices and reduced foreign capital inflows forced local governments, especially in the GCC, to inject liquidity from accumulated reserves thus, stimulating domestic growth through public works and averting serious economic slowdown. The Saudi government has taken the lead in this approach, which has had positive ripple effects throughout the MENA region. However, continued private sector woes including, shocking headlines of troubled family conglomerates in Saudi Arabia and a struggling Dubai government have shaken investors’ confidence in the region.

A. Fundraising

Funds dedicated to the MENA region raised a total of US\$1.1bn in 2009, a significant drop from the fundraising efforts of 2008 which totaled US\$6.9bn. This was in the wider context of 66% and 65% declines in emerging and developed markets for fundraising (EMPEA - Insight MENA, 2010). But while 2009 can be seen as a challenging year for the global PE industry, the MENA region today may be able to offer attractive opportunities to players. Regional governments are responding to the financial crisis with heavy government spending which include the development of infrastructure projects. As governments start to spearhead these

developments such as roads, ports and power, they are actively looking for private partners. The region's family-run businesses are also looking to PE as expansion financing is becoming increasingly scarce (EMPEA - Insight MENA, 2010)



Source: Adapted from EMPEA data

B. Who is raising capital?

Many of the funds that were able to raise capital in the turmoil of 2009 were those that demonstrated a strong track record of investing in the MENA and surely funds that benefited from powerful relationships in the region. In fact, most deals are generated on a proprietary basis due to the intricate social network and the peculiarities of business communities (therefore, the role of intermediaries and especially investment banks is limited). The highlights of these fundraising efforts include:

- Abu Dhabi-based Gulf Capital achieved a final close with GC Equity Partners II in 2010 raising total commitments of US\$533mn
- Jordan-based Foursan Group held a first close of US\$100mn for its second fund, Foursan Capital Partners I in 2009, targeting total commitments of US\$200mn in 2010
- Egypt-based Citadel Capital completed a dry close on its US\$500mn MENA Joint Investment Fund in 2009
- US-based The Carlyle Group raised its first MENA fund, Carlyle MENA Partners, with equity commitments of US\$500mn in 2009
- GrowthGate Capital Corporation (“GrowthGate”), which raised US\$200mn by 2008, has recently launched its placement efforts for another capital raising of up to US\$100mn in 2010

It is worth noting that the Carlyle Group—two of whose three investments were made in Turkey—is not the only foreign player targeting investments in the region. US-based Kohlberg Kravis Roberts & Co. has launched a Dubai office in 2009, perceived by many in the region more as a liaison office with mega-investors (sovereign wealth funds, family offices). France-based BNP Paribas has announced its intent in mid-2009 to launch a private equity fund targeting commitments of US\$300mn focused on the GCC region (EMPEA - Insight MENA, 2010).

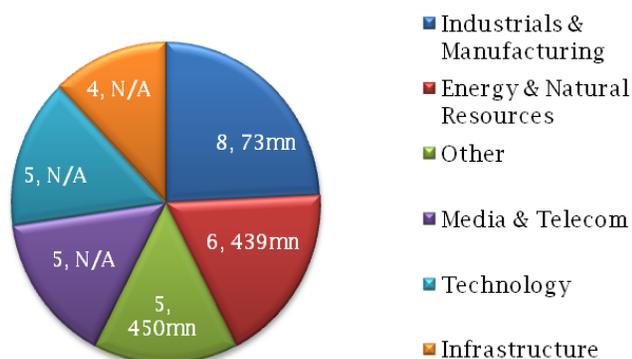
When it comes to sources of capital, historical trends have shown that fund managers rely primarily on local investors and governments (mainly sovereign wealth funds). But with the advent of the financial crisis, many of these players are currently constrained by liquidity. Moreover, the bankruptcy and receivership of two large local firms, Dar Investment and Global Investment House, has led to cautiousness by local investors. Funds have as a result been looking increasingly for alternative sources of funding. For instance, both Gulf Capital (Abu Dhabi) and Amwal AlKhaleej (Saudi Arabia) have retained foreign placement agents to raise capital from international investors.

C. Investment Trends - Where are players looking to deploy capital?

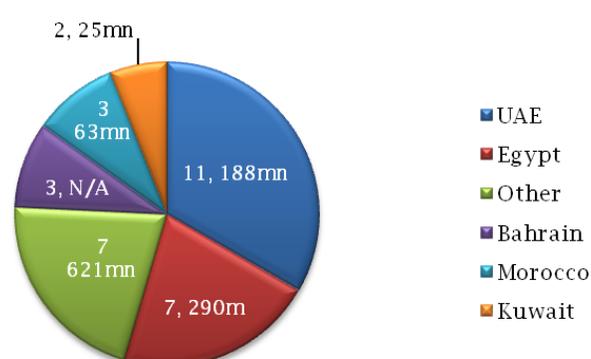
As a response to increasing government spending on infrastructure and healthcare (total expenditure has reached US\$550bn in 2009, according to EMPEA), several sector focused funds have formed. These include:

- TVM Capital MENA - healthcare growth capital fund, held a first close at US\$40mn in February 2010
- SHUAA Capital - SHUAA hospitality fund (US\$200mn)
- Abu Dhabi Investment House, Ithmaar Bank and Gulf Finance House - hospitality development fund (US\$300mn)

**MENA Region PE Investments by Sector,
2009 (No. of Investments, Value US\$)**



**MENA Region PE Activity by Country,
(No. of Investments, Value US\$)**



Fund Manager	Company	Market	Sector	Transaction Value (US\$)	Date	Equity Stake
Abraaj Capital	Mediaquest Corp.	UAE	Media & Telecom	N/A	Apr 09	N/A
The Carlyle Group	Medical Pack Saglik Hizmetleri	Turkey	Healthcare	N/A	Dec09	40%
DIC, HSBC, Waha Capital	United Power Co.	Oman	Power Gen. & Distribution	27mn	Jun09	33%
Investcorp, Eastgate Capital Group, The National Investor	L'Azurde Group	Saudi Arabia	Consumer	200mn	Mar09	70%
Investcorp	Gulf Cyro Group	Kuwait	Chemicals & Indust. Materials	N/A	Nov09	20%
Kingdom Zephyr Africa Mngt Co.	Mixta Africa SA	Morocco	Engineering & Construction	52mn	Mar09	21%
Société Générale Asset Mngt	Opalia Pharma SA	Tunisia	Pharma	3mn	Oct09	34%
Actis Capital LLC	Commercial International Bank	Egypt	Banking	244mn	Jul09	10%
Citadel Capital	Tanmeyah Microfinance Co.	Egypt	Financial Services	6mn	May09	51%
Citadel Capital	Nile Co. for Food Industries	Egypt	Food & Beverage	N/A	Jun09	100%
EFG Hermes PE	Omnia Investment Group	Egypt	Food Processing	N/A	Oct09	75%
GrowthGate	Rubicon Holding	Jordan	Animation & Edutainment	N/A	Oct09	30%
EFG Hermes PE	Ridgewood Egypt	Egypt	Utilities	N/A	Dec09	74%
Gulf Capital	TechnoScan AS	Egypt	Technology	N/A	Feb10	75%
GrowthGate	IrisGuard Inc.	Jordan	Biometrics	N/A	Feb10	30%

Source: Adapted from EMPEA data

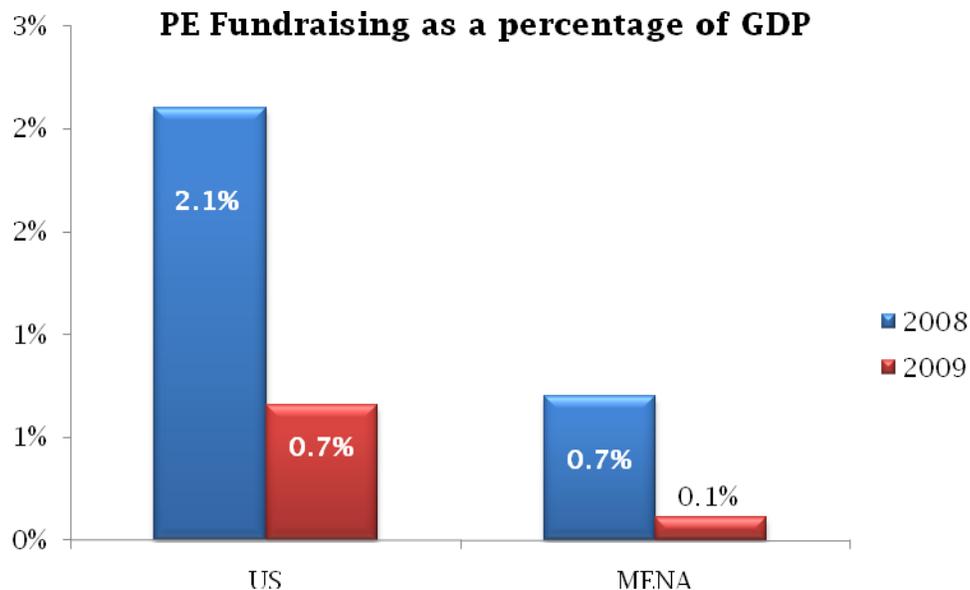
The previous table lists some of the recent PE transactions in the MENA region. With the exception of Egypt, a significant portion of deals represent strategic minority stakes. This has been a historical trend for deals in the region. (For instance, GrowthGate—which specializes in the middle-market PE sector—notes that all 6 deals completed by it between late 2007 and early 2010 have been for strategic minority stakes.) This phenomenon was attributed to few key factors by players in the region: principally, an inefficient market for talent, and structurally, the reluctance of family-run businesses to relinquish control in the first round of financing. When a company is acquired through a majority stake, there tends to be a management shuffling taking place within the target company. With a minority stake, the firm maintains existing management and helps steer the business in the right direction. As such, there are limited situations that involve a change in control.

While the majority of investments to date have represented “minority stakes in family owned enterprises, a number of control/buyout opportunities are likely to emerge as many local firms face the pressures of operating in difficult economic times as well as transitioning to third and subsequent generations of family control” notes EMPEA. Minority protection rights are sometimes complemented by contractual arrangements giving PE firms additional ‘influence’ and ‘control’ levers over key decisions including future exits (i.e., timing and routes).

D. Deal structures - financing characteristics

Equity investments represent a substantial portion of the capital structure of regional PE participations. The use of low leverage limits the size of the ‘ticket’ that a PE firm is willing to invest and forces it to spread its risk via a wider allocation of funds amongst several midcap investments. For some players in the MENA space, their deals include up to 100% equity financing. According to GrowthGate, leverage for PE investments in the region is constrained by several inherent and regulatory factors: “(i) commercial banks, the traditional lenders for businesses, have less skills and lesser will to extend leverage at multiples of EBITDA as seen by their foreign counterparts, unless physical collateral and personal guarantees of the buyers are pledged, (ii) the market for mezzanine financing is at its infancy with little if any inroads in the regional mergers & acquisitions sector, (iii) the issuance of bonds to finance acquisitions is not a familiar feature of the MENA financial markets, (iv) the relatively low taxation especially in the GCC does not provide sufficient fiscal incentives for debt-laden financial structures; and (v) finally, the preponderance of PE deals being focused on strategic minorities (as shown historically) tend to lessen the need for high levels of leverage.” (Extracts from interviews with the principals of Keystone, the General Manager of GrowthGate, 2010)

The region is still facing information limitations with regards to investments, which could partly explain limited debt financing. Approximately 10% to 30% of PE investments remain unannounced. The lack in transparency results from the region being in its early stages of PE development. The chart below displays PE fundraising as a percentage of GDP as evidence of this compared to mature markets such as the US.



*Source: Adapted from Bloomberg, AMEInfo (2008), and World Bank
 Note: MENA data includes GCC, Egypt and Jordan only*

E. Adding Value – growing an investment and potential exits

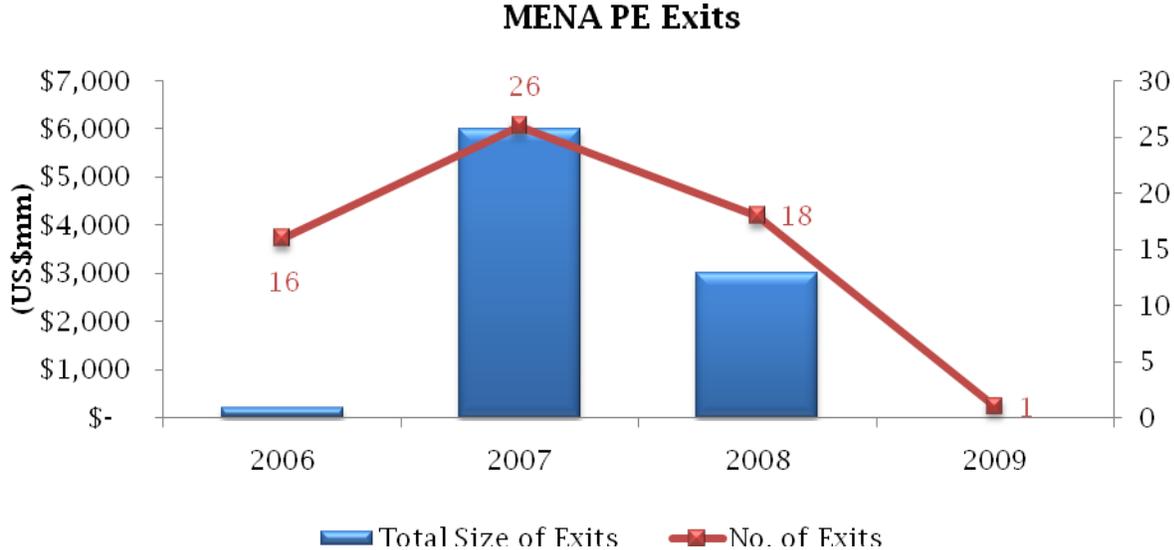
There are two main ways that PE players add value to their portfolio companies:

1. Operational improvements and efficiencies: this generally involves PE players deploying staff with operational expertise into target companies to streamline operations
2. Strategic planning and capital optimization: this approach is less demanding in terms of manpower requirements and involves developing a coherent sustainable strategy (e.g. market entry strategy in Saudi Arabia), helping the company optimize its capital structure in addition to establishing a solid corporate governance

Looking at investments and holdings across the MENA region, the average holding period for investments seems to range from an aggressive two years (for a “buy and flip” investment) to 3 to 5 years (for a “buy and build” deal). Currently, with

the difficult conditions in the market, the average holding period is likely to increase to 7 years as the number of transactions in the market drops and exit options become more complicated.

Upon exit, there are a number of options for the PE firms to consider. Trade sales are expected to become more common in the MENA region, but IPOs remain a primary target. While most developed markets have liquid stock markets and advanced regulatory frameworks, the MENA region’s capital markets are underdeveloped and lack the regulatory robustness that the West benefits from.



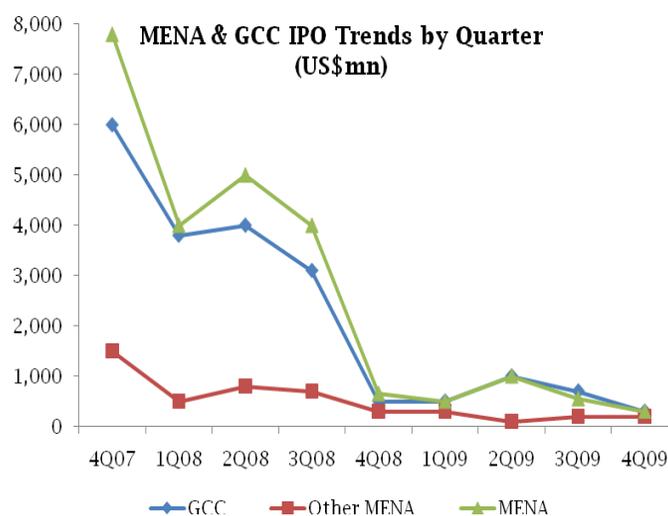
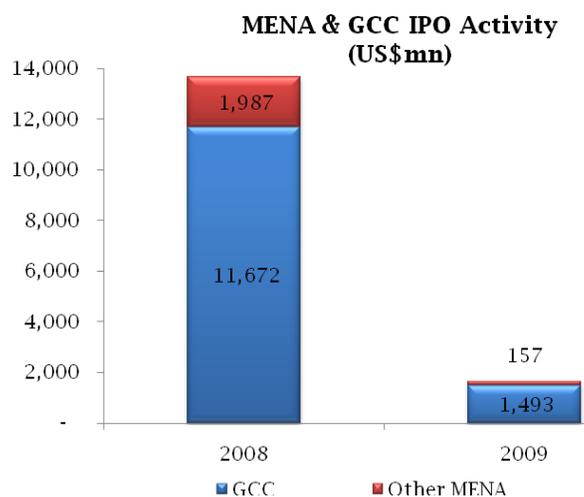
Source: Adapted from Zawya PE Monitor

Saudi Arabia’s Tadawul Capital Market is the deepest and most liquid in the MENA region, with the most advanced regulatory environment including strict penalties for insider trading and material fines for market manipulation. But this market is not free of constraints for PE firms planning to exit via an IPO. Limitations include the need to determine the offering price in consultation with the Capital Markets Authority (the levels are typically set within a 20% to 30% discount to prevailing average P/Ex), the restriction to list only Saudi companies (with no cross-listings permitted), the ability for Saudi investors alone to participate in the IPOs and trade on the secondary market, and the imposition of a 20% capital gains tax on any non-Saudi founding shareholder (usually the PE firm) who intends to sell at the time of the IPO. GrowthGate which is pursuing an exit for one of its portfolio companies via an IPO on the Tadawul, currently planned for Q4 2010, confirms the prevailing view that “the Saudi market is the MENA’s most significant in terms of liquidity and capitalization, and thus, in terms of exits for PE firms. Due to these comparative advantages, Saudi’s regulatory environment will ultimately move

towards gradual flexibility, including allowing foreign investors to participate in IPOs and reducing capital gains taxes, in order to further solidify Tadawul's position as the preeminent regional capital market, a claim many others have boldly made but most have failed to live up to, in the past few years." (Extracts from interviews with the principals of Keystone, the General Manager of GrowthGate).

Companies in the UAE have to list at least 55% of their shares through primary issuances, implying that a PE firm cannot exit its investment upon IPO - although exceptions are made for businesses that are wholly family-owned, which can IPO 30% of their shares. Additionally, original shareholders have a two-year lock-up period. The offshore NASDAQ Dubai is modeled on Western exchanges, and a six month lockup. However, investors prefer the older, more established bourses.

In 2009, the market witnessed only one exit: the Reliance Petroleum Limited which was previously acquired by Global Opportunistic fund II. In 2008, when conditions were somewhat more favorable: the 18 exits that took place were valued at US\$2.96billion, including the US\$2.5billion transaction of the Egyptian Fertilizers Company sold to Orascom Construction Industries. Given economic conditions over the last 18 months, most PE players will find it challenging to exit their investments in the current climate. With public markets depressed, IPO activity was weak during 2009 (see charts below) and therefore not the dominant exit route. As a result, most firms are therefore looking into trade sales as previously mentioned.



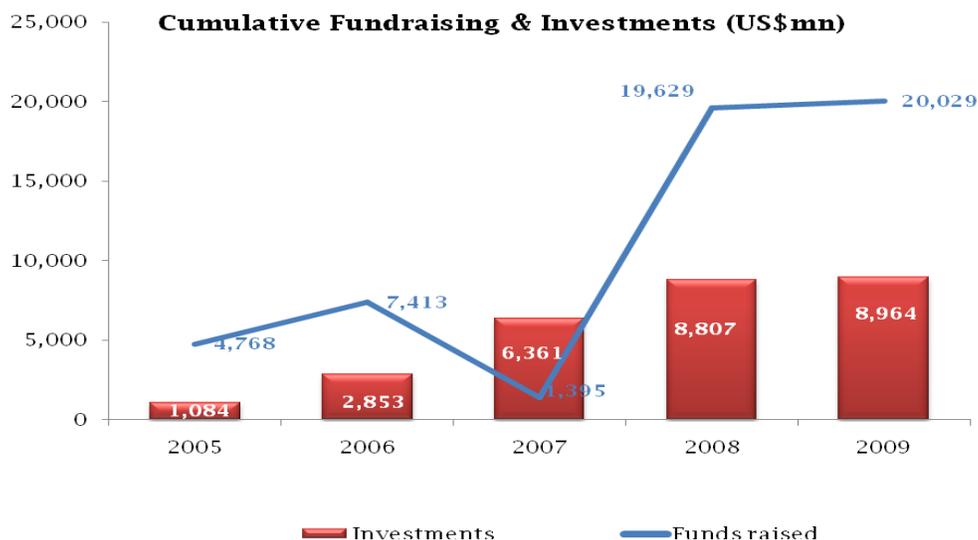
IV. How does the environment look moving forward?

In the light of macroeconomic fundamentals and historical PE activity in the region, we believe the changes in operational and economic environments will be shaping PE investments as moving forward.

A. Operational Environmental Trends

Regional governments are involved in most large cap players, large LBOs are increasingly rare. We foresee that the government will continue to 'control' the economy and will have a heavy hand in its development. Therefore, all funds have to work around this powerful player and will consequently lose out on potential large scale opportunities. Nonetheless, due to the fact that 75% of businesses are family-owned, most PE deals will be with private, family-run companies. The vast majority of these players are mid-market. Therefore, mid-market PE will be crucial and the main model going forward in the region. Furthermore, as we can see in the chart below, there is an accumulated reserve of over US\$35bn of undeployed capital in the region that has already been raised.

Additionally, there will be a trend towards regional sovereign wealth funds increasing the share of investments into regional PE funds (as opposed to international investors) at least in the short-term due to certain mandates they have, more knowledge about the region, attractiveness of investments and lack of 'middle east fear' that resides in many international investment houses. The graph below further shows the vast pool of capital at regional sovereign wealth funds' disposal.



Source: Adapted from GVCA and Zawya PE Monitor

The table below has estimates of the size of the sovereign wealth funds in the region:

Sovereign Wealth Funds in the Middle East

Fund Name	AUM (US\$bn)
Abu Dhabi Investment Council (UAE-Abu Dhabi)	627.0
SAMA Foreign Holdings (Saudi Arabia)	431.0
Kuwait Investment Authority (Kuwait)	202.8
Qatar Investment Authority (Qatar)	65.0
Brunei Investment Agency (Brunei)	30.0
Investment Corp. of Dubai (UAE-Dubai)	19.6
Mubadala Development Co. (UAE-Abu Dhabi)	14.7
Mumtalakat Holding Co.	14.0
International petroleum investment Co. (UAE-Abu Dhabi)	14.0
State General Reserve Fund (Oman)	8.2
Public Investment Fund (Saudi Arabia)	5.3
RAK Investment Authority (UAE-Ras Al Khaimah)	1.2

Source: Adapted from SWF Institute

There are three ways to capitalize on this trend:

1) Inter-generational transfers

Only 30% of family businesses survive until the 2nd generation and only 5% survive until the 3rd generation. This implies an increasing trend of 2nd and 3rd generation family businesses looking for exits or strategic partners.

2) Divestures

According to Booz & Co, 90% of the regions family businesses are involved in three or more business segments since in past decades, this diversification was easily accomplished by strong growth, access to capital and limited competition. With current market conditions, owners are being forced to rethink and streamline their businesses. PE funds can benefit from this by acquiring business segments and merging them for synergies.

3) Economic downturn

Most businesses were not focused on their cost or capital structures during a sharp growth. This has led to financial distress and short-term cash strap for some businesses opening the door for opportunities in working capital investments.

While the above outlines operational trends that will lead to PE opportunities, it is also necessary to analyze which sectors will require a focus PE capital to benefit from current trends.

B. Economical Environmental Trends

The undercurrent that most sector-specific opportunities we found share is their benefit from the enormous infrastructure investments regional governments are making. EMPEA expects US\$400bn of infrastructure spending over the next three years in the Middle East, mostly in Saudi Arabia, UAE (Abu Dhabi) & Qatar. While this 'crowds out' private capital from being deployed in the large cap projects - it simultaneously creates opportunities in key sectors below. There are major funds that are focusing on capitalizing this trend but we still believe this opportunity is underserved. Examples of funds already focused in this area are Abraaj Capital's US\$2bn Growth & Infrastructure fund, and EFG-Hermes's Gulf Housing Solutions Fund.

Delving deeper into these opportunities:

- a. **Opportunity in transportation-related industries.** According to Gulf Venture Capital Association (GVCA), the transportation sector has attracted 15% of PE investments made in 2008 (US\$1.2bn). With the advent of Dubai World Central & Dubai Logistics Corridor - this will be all the more relevant.
- b. **Opportunity in electricity subsector.** GCC current installed power capacity is 75,000MW which is expected to grow by 44% to surpass 1,609 megawatt hours by 2013. An annual growth of 9.5% in demand will require additional 55,000MW of incremental power by 2015 and this magnitude of the additional capacity shall need funding of about US\$50bn. While Saudi Arabia is the main driver of this demand, Abu Dhabi's demand for electricity grew at 11% last year as opposed to 8% the prior year.
- c. **Opportunity in healthcare-related sector.** Demographics have a large part to play in this sector. There is a significant aging population who has a much higher prevalence of affluent lifestyle diseases and significant increases in per capita healthcare spending. The current private sector has a low penetration of only 25% but governments (specifically the UAE and Saudi Arabia) are planning to invest in the healthcare infrastructure through regulatory means by introducing mandatory medical insurance for expatriates and private sector employees. We can see from the graph

below that healthcare expenditure accounts for 75% of total expenditure with the majority related to the government. There have been various reports of the market size of this opportunity, but an interesting estimation is by Alpen Capital which expects a 9% annualized growth rate until 2020 to a US\$55bn market size. Another study by GVCA concluded that 44% of PE firms in the region plan to invest in the GCC's healthcare sector.

Healthcare Expenditures 2000-2007

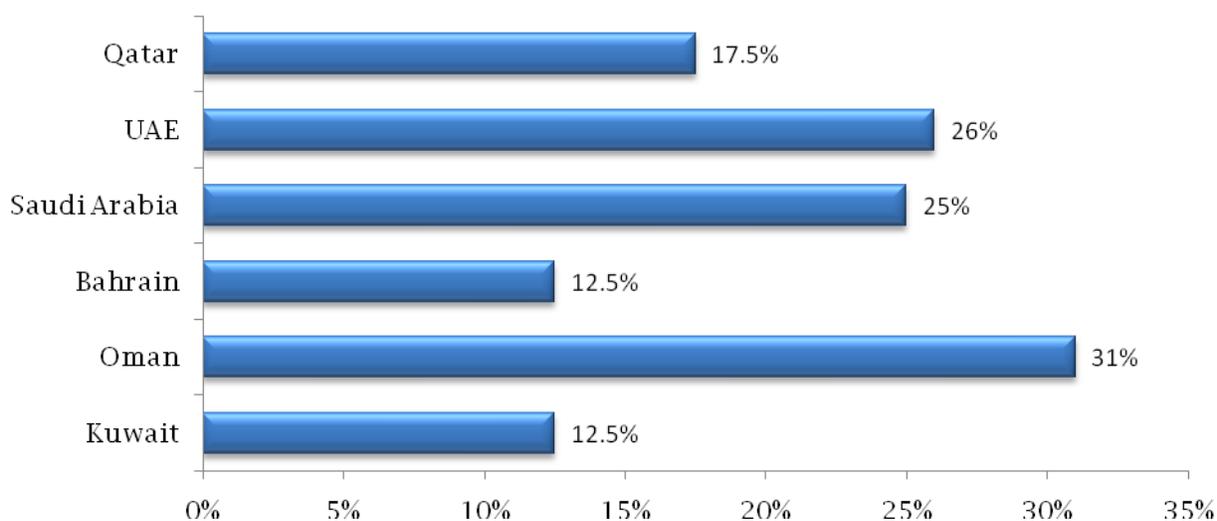


Source: Adapted from the World Health Organization

d. **Opportunity in education-related sector.** The second largest government expenditure is in the field of education. This has become a key priority for regional governments, as mentioned by Sheikh Mohammed in his 2020 vision address. This investment has come in the form of educational cities in Qatar and bringing prestigious international universities to the region. With the establishment of the Mohammed Bin Rashid Foundation and education campus plans in Abu Dhabi, it is easy to see its growing importance in the region. Demographics also play a role in this sector, there is an increasing young population coupled with an increase in the average standard of living. There will be a big increase in private educational facilities (only 3% of current market in Saudi Arabia). Several PE houses are already investing in private schools (NBK

Capital in Al Maaref private school in UAE for US\$7mn and Global Capital Management in PJSC in Kuwait for US\$11mn).

Share of Education Expenditure Out of Total Gvt Expenditure



Source: Adapted from UNESCO Institute of Statistics

In MENA: Marketing is more geared towards the seller than the investors

Our conversations with several regional funds made it clear that the largest obstacle they face is not attracting investor money but convincing sellers to enter into a deal. This is quite the paradigm shift from the institutionalized Western PE model. The main reason is due to many of the aforementioned regional themes.

Firstly, most opportunities present themselves in the context of family businesses in the mid-market realm. Secondly, these businesses are not always focused on large growth potential since the vast majority is private and do not have the pressure of the market. Thirdly, there is not a burning need for capital infusions. Therefore, the onus falls on the PE player to prove (and show evidence of) a clear value proposition that they can provide besides financing. Due to the mid-market, private nature of these deals, the vast majority of which are minority interest positions (also because of management issues mentioned above) and are viewed by the families as strategic partnerships. Thus, track records and proof of adding value to past businesses is a must in the region as opposed to merely maximizing financing gains for the funds' investors by buying and flipping.

V. Conclusion

To conclude, middle-market opportunities appear to be more attractive in the Middle East than the rest of the world due to heavy government involvement. Despite the continuing reduction in petrodollar exports from the region to the West, there are internal hurdles and limits to how much capital can be invested within the region due to the aforementioned mid-market nature. However, there are a number of structural initiatives currently taking place that signal a long-term proliferation in larger-cap investment opportunities.