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Negotiating Private Equity and M&A Deals in the Middle East

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After a number of ebullient years of activity until late 2007, the Middle Eastern private equity industry is facing new challenges as fund-raising is getting tougher and investors across the board have become more demanding. In addition to all the negative news from the global economic environment, the Middle East North Africa (MENA) region is muddled in its own economic and social issues, including the protests and political unrests in several of its states. This has resulted in trade disruptions, as well as a slowdown in a number of key sectors including the investment activity within the MENA region. This has lead to a deterioration of the region’s economic growth and has negatively impacted investors’ returns across the board. Furthermore, questionable deals concluded during the boom years leading up to the global financial crisis have also deeply affected the industry. In particular, Bahrain's $7.4 billion private equity firm, Arcapita, filed for Chapter 11 bankruptcy protection in the United States in March 2012 after it was threatened with legal action if it did not pay its creditors. The private equity subsidiary of Egypt's EFG Hermes, was, in May 2012, charged with corrupt stock exchange dealings dating back to 2007 over the sale of the state-owned Al Watany Bank.

The past few years have been a period of correction and change in the mindset of the Private Equity industry in the region. The years of frenetic deal making (often times hastily documented and executed) have now been replaced by more introspection and a more careful consideration of deal structures and deal terms by those investors who are still in business. Those investors who are interested to enter the market at this juncture may benefit from lower valuations across the board and may potentially extract more favourable deal terms. We believe that by using the right financial and legal tools to mitigate the risks associated with emerging market investing, investors should be able to overcome some of the challenges and risks inherent to investing in emerging economies such as the Middle East.

Challenges associated with Middle East PE deals

The MENA region is a challenging market for PE players when it comes to deal origination and deal execution. Over the last decade, one of the most opportunistic areas in the region has been the family-owned businesses. Interestingly, such businesses also remain a difficult area for deal originators due to the unwillingness of the families to sell their shares to outsiders, especially if such outsiders are financial institutions such as private equity houses or foreign investors. As a result, most PE transactions in the Gulf Cooperation Council (GCC) countries (Saudi Arabia, the United Arab Emirates, Kuwait, Bahrain, Oman and Qatar) are not complete buyouts or change-of-control transactions but rather acquisitions of minority interests. This is compounded by the fact that in most jurisdictions in the GCC, foreign investors may not own the majority of the shares in a private company (with lower thresholds in certain regulated industries).

As a result, it is not uncommon for the historic majority shareholders to take advantage of their dominant position in the enterprise to disenfranchise foreign or financial investors. It is therefore essential for PE investors to increase their knowledge of the target through diligence and protect their interests and exit options by putting in place the right structures and contractual protections.

Increased emphasis on due diligence

Deficiencies in corporate governance, distortions associated with inconsistent financial reporting (particularly where local accounting rules tend to obscure the true financial state of the enterprise), as well as country-specific sources of operational risk make it extremely difficult for investors, especially those who are foreign, to have a complete picture of the target they are buying into. It is therefore essential for investors to assemble a team of experts (whether it be lawyers familiar with the target country legal system in conjunction with an international law firm, accountants or industry specialists) to fully assess the risks associated with the target company they are considering acquiring. Ensuring the careful screening of target company sponsors and other stakeholders to avoid politically-exposed persons is also prudent.

Picking the right structure

Ideally investors should try to structure the deal offshore in those jurisdictions where the enforcement of their rights will not be contested by the local partner. This is unfortunately not always possible to bring the shareholding arrangement outside the country and will most likely be resisted by the local partner. In any event, foreign investors should consider structuring their investments to take advantage of international investment treaties which may increase their overall level of protection or improve their tax situation.

Bilateral Investment Treaties (BITs)

BITs grant investors a number of rights and remedies to enforce those rights. The substantive investors' rights commonly found in BITs include: (1) guaranteed payment of adequate compensation in the event an investment is expropriated; (2) prohibition of the host country enacting currency controls to prevent the free flow of capital; (3) prohibition of discrimination against the investor in favor of the host country's citizens or other foreigners; (4) fair and equal treatment by the host country; (5) provision of full protection and security of the investment by the host country; (6) a guarantee by the host country that the investor will not be treated less favorably than the minimum standard required by customary international law; and (7) an agreement of the host country to honor all commitments made to the investor. Foreign investors investing in MENA should consider channeling their investments through BIT jurisdictions (such as the Netherlands, for example). Most MENA countries, including the United Arab Emirates, are parties to BITs with OECD jurisdictions.

Tax treaties

Most of the jurisdictions in the GCC currently have no or fairly limited taxes on corporate profits, capital gains or dividends. Accordingly, tax planning is generally not a key driver in most cases. Most North African jurisdictions have some degree of taxes on dividend distributions and corporate profits. Accordingly, investors should consider structuring their investments through tax treaty jurisdictions (such as the Netherlands or Luxembourg) as part of a careful tax planning.

Contractual arrangements

Purchase agreements. A greater emphasis is being put on the contractual terms set out in the purchase or investment agreement. During the boom times, the warranty claims regime in private equity deals tended to be more seller friendly due to the high level of competition between buyers to acquire a limited number of attractive assets, especially in the Middle East. Sophisticated buyers now expect to receive a full set of representations and warranties from the sellers with longer claim periods extending in excess of 18 months with caps moving back to the full purchase price (instead of a fraction thereof prior to the financial crisis).

While still fairly uncommon in the MENA region, buyers have recently successfully managed to include deferred compensation mechanisms in order to bridge the valuation gap between the seller's expectations of high returns and the buyer's desire to pay a fair price. Such earn-out mechanisms are generally based on the target's earnings performance over a period of time following the closing of the transaction. Investors should also consider investing in tranches over time rather than disbursing their investment capital in one lump sum. It is not uncommon for the price of subsequent investment tranches to be locked in through preagreed terms in a call option with the sellers.

Completion accounts rather than locked-box mechanism are also back in favor. The locked-box mechanism is more seller friendly as it gives upfront certainty about the price. Completion accounts are more buyer friendly, allowing the buyer to adjust the purchase price for fluctuations in working capital or sometime the full balance sheet.

Another notable trend is the inclusion of material adverse change (MAC) as a condition to closing. These MAC provisions are generally broadly drafted and could potentially include economic and political disruptions affecting the target's markets therefore shifting the post-signing completion risk on the sellers. Such clauses are obviously heavily negotiated, especially in this period of instability affecting the Middle East and the increased potential for an armed conflict with nations such as Iran.

Finally, it should be noted that some of the tools available to sophisticated investors in mature markets (such as preference shares) are not available in most Middle Eastern jurisdictions due to the limitations of the legal system (unless that is, the investors can bring the structuring of the deal to a sophisticated offshore jurisdiction where the shareholding structure may be more flexible). It is also understood that such hybrid instruments contradict the principles of Islamic jurisprudence (*Shari'ah*) and therefore may not be acceptable to all local partners emanating from the Middle East.

Shareholders' Agreement. As indicated above, most PE transactions in the GCC are not complete buyouts or change-in-control transactions but rather acquisitions of minority stakes due to restrictions of foreign ownership and the reluctance of sellers to relinquish control to outsiders. Accordingly, it is of crucial importance for investors to negotiate a full suite of contractual rights with the target's existing shareholders. Such rights should typically include the following:

- *Reserved matters / negative control rights.* A well drafted shareholders' agreement should contain requirements that certain key decisions are approved by a qualified majority (typically more than 75% of the shareholders' vote). Such decisions typically include capital increases, issuance of debt instruments, capital expenditures, acquisitions or dispositions of significant assets, approval of budgets and business plans, payment of dividends, filing for bankruptcy, hiring and firing of key employees and statutory auditors. It should be noted that in a number of GCC jurisdictions, including the United Arab Emirates, minority investors benefit from the ability under applicable corporate laws to block certain key decisions (such as a capital increases,...). It is therefore important that the percentage of ownership acquired be sufficient to block all key decisions (typically 25% in most GCC jurisdictions).
- *Board rights.* Typically shareholders' agreement will give investors the ability to appoint a number of board members. Such rights may be tied to the percentage of shareholding maintained by the investor in the target companies.
- *Information rights.* Investors should agree with the majority shareholders that at a minimum they will receive periodic financial information about the target and have full access to the company's books and records.
- *Anti-dilution*. In the GCC, existing shareholders have a statutory pre-emption right on new issuancesof shares and a statutory right of first refusal if another member wants to transfer its shares to an unrelated party. Furthermore, in most GCC jurisdictions, a transfer or issuance of shares in a private company requires that all of the existing shareholders appear in person (or through proxy) in front of a notary public to execute amended and restated articles of association. In practice, an investor can therefore exercise a pocket veto by refusing to appear in front of the notary. Such rights should be supplemented by contractual protections in the shareholders' agreement.

To the extent possible under the confines of local law such protections should also be reflected in the charter of the target company (which may not be always be possible due to the lack of flexibility of corporate laws in the MENA region).

Exit rights. Market risk in emerging markets most commonly takes the form of illiquidity risk, which hampers effective investment exits. This is most obvious in countries that lack breadth and depth to their financial systems (for example, by not having well-developed stock and commodity exchanges and a functioning debt market, along with inadequacies in the financial rules and institutional infrastructure needed to afford the exchanges efficacy). Accordingly, even more so than in mature jurisdictions, it is crucially important for PE investors to negotiate upfront exit rights. It is unlikely that initial public offerings will be a viable exit alternative in most jurisdictions (with the notable exceptions of the United Arab Emirates and, to a lesser extent, Saudi Arabia which have well developed stock exchanges such as Nasdaq Dubai). Investors should therefore rely on trade sale exits, which for the most part were able to generate acceptable returns until recently.

Governing law and dispute resolution

To mitigate the risks associated with the uncertainties of local law, most sophisticated PE investors choose a neutral substantive law (typically English law) as the governing law of their investment agreement and shareholders' arrangements, except where it is compulsory to apply local law (for example, where the underlying investment relates to governmental concessions or the investment contract is entered with a government-owned entity). It should be noted though that a choice of law other than the host country may not always be enforceable.

Also, the dispute resolution mechanism and the choice of venue for the resolutions of conflicts is of crucial importance. Traditionally in the Middle East, in the event of a dispute, stakeholders would avoid litigation and generally try to work out an amicable settlement without any third party meditation. The mentalities are fast changing and more so than ever before investors are relying on the judicial enforcement of their rights. Quite symptomatic of this trend is the US $10 billion law suit initiated before the London Court of International Arbitration (LCIA) by Royal Bank of Scotland, Germany's Commerzbank and South Africa's Standard Bank in connection with the restructuring of Dubai Group debts. Dubai Group is an arm of Dubai Holding, owned by the ruling family of Dubai, which owns a diversified portfolio of assets, including a significant stake in the London Stock Exchange.

It should be noted that the 1958 New York Convention on the recognition and enforcement of foreign arbitral awards has been signed by the majority of the states in the region. A dispute can always be submitted to the exclusive jurisdiction of an arbitral tribunal of the choice of the parties in order to avoid dealing with unfamiliar local judicial procedures. It is wise, therefore, to opt for an arbitral tribunal as the dispute resolution forum, with exclusive jurisdiction. Arbitration conducted under the auspices of the local chambers of commerce can be used along with the international arbitration procedures of organizations such as the International Chamber of Commerce (ICC) or the LCIA.

Over the past few years, Dubai has emerged as an excellent regional center for dispute resolution with the DIFC LCIA Arbitration Center (a tie up between the Dubai International Financial Center (DIFC) and LCIA) and the DIFC Courts. In October 2011, Dubai allowed regional and foreign firms to file disputes with the DIFC Courts. The expanded jurisdiction for the DIFC Courts gives greater choice to firms as they seek swift and effective resolution to commercial disputes. Also, to the extent that enforcement of DIFC judgment may be needed in Dubai, decisions rendered by the DIFC courts are automatically enforceable in Dubai without any power of review by the Dubai courts (except on very limited grounds). The DIFC courts are an English-language based, common law court system with an international bench of judges who are experienced in handling complex commercial disputes.


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