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Middle East Megatrends in Mergers & Acquisitions

Animal Spirits Returning

After several years of subdued deal flow, merger and acquisition activity in the Middle East and Africa appears to be on the cusp of a significant increase.

Compelling case

The attraction for investors in the region continues to be compelling. Economic growth in the Gulf Cooperation Council (GCC) is set to average about 4.5 percent in 2014 and 2015, according to the IMF, and the population is largely young and continuing to grow rapidly. Over half of the population of the GCC is under thirty. At the same time investors have capital to deploy and are looking for growth assets, while many business owners in the region are also starting to look at attracting investors to fund further growth.

"There has been expectations that M&A activity will increase for a few years now, but it was only really in early 2014 that we have seen a change in the landscape" said Christopher Hawley, Managing Director at Rothschild, speaking at the Megatrends in Mergers & Acquisitions conference in Dubai.

The total value of M&A deals in the third three months to the end of September rose for the fourth consecutive quarter, according to data from Zephyr. Even so, most of the deals in the Middle East region are relatively small in size, typically below 5 per cent of the number of deals being over $500m, according to Tom Emmet, Managing Director and Regional Head of M&A MENAP at Standard Chartered Bank. This masks overall activity levels which have risen strongly since the beginning of 2014.

A good place for M&A

The region is increasingly becoming an easier place to do business, an easier place for foreign direct investment, and a more attractive destination to invest. Cass Business School ranked the UAE 19th on a 2013 list of the most attractive countries for M&A activity in the world, rising 8 places over the previous five years.

Barriers remain to increase levels

Despite this positive backdrop, several obstacles continue to limit activity, both regulatory and cultural. A sentimental attachment to companies that have grown up from within family groups, at time unclear application of existing regulation and the lack of a dedicated rulebook for takeovers will all need to progress to help to drive continued growth in M&A activity.

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Sectors in focus - Capitalising on demographics

Popular sectors

The sectors that are attracting the most interest from private equity investors, both within and from outside the Middle East, are those that benefit from the region's demographic make-up, notably education, healthcare, and consumer and retail. The energy industry is also attractive given the rich supply of natural resources in the region, although this can be more difficult for private investors to get direct access to because state-owned entities tend to dominate this area. Instead, private investors attempt to access the sector via proxy investing in services companies to the oil and gas industry.

Sovereign wealth fund focus

The sovereign wealth funds of the region will also continue to make a variety of investments as part of their mandate to redeploy excess government resources in a way that will provide income for future generations. While these deals have historically been large and occasionally headline grabbing, they are becoming more strategic in nature and are naturally pre-disposed to being out of region.

Less likely sector

Some sectors are ripe for consolidation but unlikely to experience it: banking and telecoms sectors in the region would benefit from the economies of scale that come from creating region-wide champions. However, opportunities for this are limited because governments are often major shareholders in these ventures, and have historically been less willing to let them be acquired by another government, or to sell them off to the private sector.

Cultural Limitations - Selling the family silver

Emotional attachment

Many of the region's largest and most successful businesses are family companies that have been nurtured over the past 30-40 years. They are often still majority owned by the founding family. The emotional attachment that many founders feel towards these businesses has historically limited perhaps how likely they are to sell off significant stakes.

"There is a cultural issue embedded within us that says if I build something then it is mine, and to sell it is like selling one of our children," said Dr. Ahmed Bin Hassan Al Sheikh, Board Member of Dubai Economic Council.

As time passes and the business is handed down to the next generation the chances of selling increases. "The first generation will definitely not sell, the second generation will think about if there are good bucks in it, but the third generation will probably sign immediately," said Al Sheikh.

Ceding control

Many families are also unwilling to cede control of their businesses to another investor, limiting a partner to holding a minority stake. For a lot of investors that is less attractive at first.

Inevitably as time passes more of these family businesses will become receptive to merging with other companies or being acquired, particularly as many battle with corporate governance, succession issues and seek economies of scale. Over the next five years this transition from first generation company founders to second and third generation shareholders, who maybe are more interested in shareholders returns than the harder task of day-to-day managing of a business, will gather pace and should allow more deal-making to occur.

There are signs that this is already beginning to happen as valuation expectations are becoming more realistic. Coupled with the good availability of finance for acquisitions now, this is creating an environment where buyers and sellers are more able to agree to a deal that works for both parties.

Regulatory obstacles - Exit strategies

The Outlook in summary

Application of regulation

Regulators in the Middle East have been making progress in developing the regulatory framework, but there are still several regulatory obstacles which prevent more M&A activity from taking place in the region. One of the biggest is the lack of depth in current regulations which creates a degree of uncertainty in how they will be applied. Because the regulatory framework is still relatively young, and there is not much precedent in how they should work in practice, it is possible to get several different interpretations of them. As more work is done to expand the rulebooks it will give greater clarity for investors on how the process of the more complicated M&A situations might work in practice.

Use of shares

One of the other limitations in the current regulatory framework is the lack of rules governing the use of shares as an acquisition currency. “Once you enable the use of equity capital to acquire a company a lot of things start to flow from that. Those frameworks need to be in place to encourage business and economic decisions to be made,” said Tom Emmet Managing Director and Regional Head of M&A MENAP, Standard Chartered Bank.

Rules that prevent companies from listing existing shares also make it difficult for private equity investors to exit their investments through a sale on the stock market. Rules that force companies to list a minimum of 55 percent also deter some companies from going public as it would require them to cede a majority stake in the business. As a result several Gulf private equity investors have turned overseas to bourses like the London Stock Exchange, for example, to exit their investments through an IPO. These deals have been a great success for the companies involved. Abu Dhabi based Gulf Capital said it made a gross gain of $600m from exiting its investment in Gulf Marine Services through an IPO in London.

Foreign ownerships limits of 51 percent will continue to be of concern to some investors, as will the restrictions on equity awards.

Public stock markets

Regional stock markets boomed over the last 18 months and so far in 2014 have been some of the best performing in the world. This is helping to encourage more firms to look at the public markets as a way of raising money or exiting investments and the pipeline of new listings on local bourses now that equity valuations are much higher.

Attracting FDI

Governments of the Middle East are under intense social pressure to create more jobs to satisfy the aspirations of their young and increasingly well-educated populations. Studies have shown that foreign direct investment creates jobs, as does encouraging entrepreneurs. Developing a regulatory and cultural framework that supports M&A can form a key and important part of attracting FDI into the regional economy that would play a part in achieving broader ambitions of the state.

Proving attractive

The region's economic growth, proximity to attractive markets in Africa, and positive demographic trends are encouraging more international investors to look for opportunities here, particularly in the face of weaker growth in Europe and the US. Those investors are starting to find business owners more receptive to bringing in new sources of capital for expansion or to help professionalising their management and corporate governance.

Challenges not insurmountable

There are challenges to doing deals in the region, but recent activity has shown that they are not insurmountable and that there are great opportunities available. The outlook is very positive and the potential gains for governments, investors and the broader economy will increasingly drive further deal flow in the Middle East.

"The macro factors in the region are very compelling and when it comes to running a model to determine if an investment is going to grow between 8-12 percent p.a, that is still very different from growth of 0-3 percent you might get in Europe or the US, so the returns are available in this region. The flip side is that it is probably harder work to get them."

Richard Rollinshaw
Middle East Private Equity Leader

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