A renewed search for value as confidence begins to recover

February 2021
Our third TransAct Middle East report is published as COVID-19 vaccination programmes across the region are helping to restore investors’ confidence, after a year of unprecedented market disruption. There is a realistic prospect the Middle East M&A landscape will be easier to navigate by the end of 2021, as companies gain greater clarity about what their future business models may need to look like, after the rapid transformation forced on them during the pandemic.

Across the region, deal activity picked up slightly during the second half of 2020. This modest recovery was mainly driven by consolidation or public sector-led investment and monetisation, in contrast to North America and Europe, where private equity-led activity helped to fuel a surge in dealmaking. Looking ahead, the Middle East’s dealmaking landscape will continue to be shaped, like the rest of the world, by the pandemic’s ongoing impact, creating challenges as well as opportunities.

Importantly, investors are also now comfortable with virtual dealmaking, building on their rapid, imaginative response to the sudden shift to home-based working in the first wave of COVID-19.

In the short term, however, investors in the Middle East will continue to face significant pandemic-related challenges when seeking deals, with the region still being buffeted by the same worldwide headwinds discussed in our latest Global M&A Industry Trends report. They include uncertainty resulting from ongoing waves of COVID-19, unemployment and the resulting weaker demand for products and services, global trade tensions and regulatory pressures.

Against this transitional background, we anticipate that key industry sector leaders in the Middle East will continue to explore consolidation strategies that create shareholder value and strengthen their market positions. They will need to select targets carefully, with many potential deals on hold because of valuation and financing issues, and heightened uncertainty about business models. Buyers are looking harder at contingent considerations, with particular attention being paid to issues such as termination rights in sale and purchase agreements (SPA) and completion mechanics.

However, whilst it remains essential for deal makers to cautiously navigate the new normal, companies and investors should also view M&A as an opportunity to achieve their strategic objectives and it may be the best or fastest way to fill in gaps, for example, in technologies or resources.
We expect the following themes to drive Middle East dealmaking over the next one to two years, as confidence gradually returns and investors review their strategic capital allocation:

**Focus on value preservation:**
Consolidation of operations and divestment of non-core assets, in line with the global emphasis on repairing and reconfiguring businesses.

**Government-led recovery:**
Strategic public investment to stimulate economies, with accelerated privatisation programmes, especially in infrastructure and utilities.

**Technology:**
Further integration of new digital technologies into core sectors will be key.

**Opportunistic deals:**
Liquidity in the market will enable investors to acquire distressed assets in newer sectors, including tech-based start-ups, facilitating portfolio diversification.

**Localisation:**
Continuing supply-chain disruption, particularly in food and agricultural products, will intensify the focus on reducing dependence on imports.

**ESG focus:**
An increasing awareness of ESG, reflected in more dealmaking and investment decisions being considered through an ESG lens.
Overview of M&A activity

Worldwide, volumes for completed deals fell by 9% in 2020 compared with 2019, as the pandemic slowed or halted transactions, particularly during the first half of 2020. Despite this global decline, M&A activity in the Middle East increased marginally by 6% in 2020, with 235 deals completed in the region, compared with 221 in 2019.

The total volume of deals in the region

Source: Completed deals are based on Thomson Reuters data
1. Region refers to GCC, Egypt, Jordan and Lebanon
2. Where possible, we have excluded multiple deals reported in relation to the same transaction (e.g. multiple funding rounds for the same transaction).

More than half (117) of these deals were valued at less than $100m, based on the 136 deals with disclosed values, with six deals worth more than $1bn.

$10.1bn
The largest deal was by Abu Dhabi National Oil Company (ADNOC) for its 49% stake in its natural gas pipeline for $10.1bn to an investor group led by Global Infrastructure Partners (GIP).

$3bn
Indonesia’s PT Indofood’s $3bn acquisition of Pinehill Co, a manufacturer of instant noodles in the Middle East and Africa.

$2.7bn
The delisting of port operator DP World from NASDAQ’s Dubai exchange, which raised $2.7bn.

$5.5bn
ADNOC’s sale of 49% of its real-estate portfolio to a consortium led by Apollo Global Management for $5.5bn, with $2.7bn paid upfront in 2020.
By contrast, Saudi Arabia experienced a sharp fall in activity, with 25 deals completed in 2020, compared with 45 the previous year. This decline was partly due to a slowdown in the energy sector, following Saudi Aramco’s acquisition in 2019 of a 70% stake in Saudi Basic Industries Corp (SABIC) for $69.1bn and Aramco’s $631m buy-out of Shell’s stake in its refinery operations. In 2020, the only significant reported energy deal was the acquisition by the Saudi government’s Public Investment Fund (PIF) of an additional interest in ACWA Power. Meanwhile, healthcare and education witnessed only three deals in 2020, compared with 10 in 2019.

Egypt registered 93 deals in 2020, compared with 58 in 2019, with most of the disclosed values at less than $100m. Real estate (especially property management) and construction were the most important M&A sectors, accounting for 19 deals, largely driven by opportunistic buyers seeking returns on investments in equities after share prices slumped during the first wave of COVID-19, which coincided with falling oil prices.

The UAE remained the most important focus of M&A activity, with 79 completed deals in 2020, six more than the previous year. However, a number of these transactions were smaller-scale deals valued at less than $100m. Strikingly, the UAE registered 21 venture capital (VC) deals, confirming its status as the main focus for the recent influx of VC funding into the region.
Despite the challenging conditions during the year, there are early indications that several M&A trends that preceded the pandemic have been reinforced by COVID-19, while market disruption has also opened up new areas for dealmakers to explore.

Over the next one to two years, key themes to watch in the wake of COVID-19 will include:

**Privatisation:**

Governments will need to address the infrastructure funding gap and help stimulate economies with public-private partnerships (PPPs).

**The role of sovereign investors:**

Sovereign wealth funds (SWFs) and governments will be critical drivers of M&A activity.

**Localisation:**

Supply-chain disruptions and their impact on businesses have increased the focus on finding local solutions to reduce dependence on imports.

**Digitalisation and new technologies:**

Activity will remain strong, reinforced by the lockdown shift to remote working, with opportunities in sectors ranging from e-commerce to cyber security.

**Public-sector consolidation:**

The consolidation and reorganisation trend for some public-sector entities will continue as a means to reduce costs and optimise operations.

**Restructurings:**

Restructuring activity will increase once COVID-19 support measures end, affecting deal activity and valuations.
In the Middle East, as globally, we are already seeing an increase in activity in key COVID-19-linked sectors such as consumer markets, healthcare and technology. Given the continuing market volatility, it is taking longer for many deals to close. However, the early signs in 2021 are that dealmakers’ confidence is starting to return in the Middle East; for example, initial public offerings (IPOs) have begun to pick up in Saudi Arabia.

Going forward, we expect a range of sectors from pharmaceutical manufacturing to transport to benefit from targeted state investment and support as part of national economic stimulus programmes. We also anticipate further consolidation in sectors hit hardest by COVID-19, including retail, hospitality, real estate and construction.

Meanwhile, the pandemic has prompted many family-owned companies to review their investment strategies in order to generate more value from their core assets, and to reassess their governance structures with regard to how they manage their portfolios in future.

We expect some family-owned businesses and conglomerates will seek to divest non-core assets to reallocate capital to other parts of the group and raise cash for long-term strategic investments.

Overall, Middle East dealmakers, like their global counterparts, will focus on portfolio rationalisation to preserve and create value in difficult market conditions.
Dealmaking significantly slowed in 2019 and 2020, with no significant completed deals announced in 2020. Nonetheless, the sector’s long-term fundamentals remain strong for dealmakers, while the disruption caused by COVID-19 has opened up strategic expansion opportunities.

M&A activity is likely to be supported, with several UAE corporates including Emirates Healthcare Group and NMC Health seeking capital injections. Meanwhile, investors continue to be attracted by the ongoing privatisation of Saudi Arabia’s healthcare sector and its development of world-class medical facilities.

Other specialist segments that are likely to be active in the coming years include long-term and preventative care, and mental health and wellbeing.

In the UAE and Saudi Arabia, the Middle East’s leading education markets, the COVID-19 upheaval has also created promising terrain for investors. In particular, some education providers are assessing whether merging with a local player could add shareholder value, given spare market capacity and resulting price pressures.

We see potential opportunities in educational technology (EduTech), vocational training, content creation and school management services.

Saudi Arabia and the UAE’s kindergarten to 12th grade (K-12) and higher education sectors are likely to remain the region’s most active acquisition markets, especially because these countries’ regulatory environments favour private capital.

The key ingredient will be a return of investor confidence, following a relatively quiet year in 2020. More recently, COVID-19 has forced operators to review portfolios, close underperforming schools and raise short-term cash. Yet as with healthcare, this continuing upheaval presents opportunities for sharp-eyed dealmakers. Emerging post-COVID-19 themes in education include the sale of non-core assets and mergers to improve efficiency. We also note the recent surge in sale and leaseback deals as investors seek alternative sources of liquidity.
Consumer Markets

Throughout the Middle East, COVID-19 has accelerated the sector’s long-overdue modernisation. During the lockdowns, consumer businesses whose survival was suddenly at stake seized the moment to address challenges such as inadequate digitalisation, inefficient supply chains, bloated organisations and surplus stores.

Above all, the pandemic has underlined the need for retailers to develop e-commerce channels and implement digital technologies for contactless delivery, payment options and other services to improve operational efficiency and provide better customer experience.

Meanwhile, Middle East governments are encouraging localisation to reduce dependence on imports and exposure to vulnerable international supply chains.

All these factors are likely to drive M&A activity over the coming years, with a focus on value-creation opportunities in the following areas: digital, where e-commerce channels will be a strong theme; agricultural, where food security and commodities sourcing will feature; retail, where we expect further consolidation in food and beverages (F&B), as companies renegotiate lease contracts and scale back operations to preserve shareholder value and in some cases ensure their own survival; and fast-moving consumer goods (FMCG), where manufacturers and distributors will seek joint-venture deals and product diversification.

Energy, Utilities and Resources (EUR)

As a continuation of the theme noticed in 2019, the largest deals in the EUR sector in 2020 were ADNOC’s divestment of a stake in its gas pipeline assets and the sale of a stake in its real-estate portfolio. Going forward, we expect the NOCs to continue with their strategy of monetising their asset portfolio through sell down of stakes or structured finance solutions to unlock cash and optimise their balance sheets. For instance, there is currently a process underway for sale of a stake by Saudi Aramco in its pipeline assets.

Clearly there is a strong appetite for such assets from international infrastructure investors and for NOCs, and this asset monetisation play is a key enabler of further investment required to expand their value chains. We expect to see NOCs aggressively seeking to internationalise trading, marketing, distribution and retailing capabilities as well as further investments in downstream chemicals and power to build long-term natural hedges.

Additionally, in the wake of COVID-19 there seems to be increased emphasis from NOCs on localised supply chains and further digitalisation to improve operational efficiencies. This could involve certain strategic acquisitions and investments as well as potential consolidation play within the oil field services sector.
Going forward, we expect consolidation as well as privatisation activity to accelerate across the power and utility sector as governments across the region see this as an opportunity to generate necessary funding to balance fiscal deficits, drive efficiencies and/or bring in international operators to optimise operations.

Also, there currently seems to be a strong activity within the district cooling (DC) space with real-estate developers and property managers divesting non-core DC assets to raise funds and manage cashflows. There appears to be a strong appetite for these infrastructure assets from both local and international investors, which seems to be driving an increase in valuation multiples.

Given the ongoing focus on the ESG agenda, we also anticipate a further pivot towards solar, wind and other renewable energy sources, led by the UAE and Saudi Arabia.

Within the power and utility sector, the landmark deal in 2020 was the merger of Abu Dhabi National Energy Company (Taqa) with Abu Dhabi Power Corporation (ADPower), creating one of the largest utility companies in the Europe, Middle East and Africa (EMEA) region.

Financial Services

The largest announced deal in 2020 was the merger of National Commercial Bank (NCB) with Samba Financial Group in KSA. Once completed, the NCB-Samba tie-up would create the Gulf region’s third largest lender by assets. Over the next two years, Middle East banks and financial services companies will prioritise cost-cutting, liquidity and solvency, in line with their global peers.

Insurers have been particularly exposed by COVID-19’s impact on their balance sheets. The sector is relatively fragmented across the region and mergers are being explored by market leaders to eliminate duplicated costs and create cross-selling opportunities. Meanwhile, Tier-2 banks will drive further regional banking consolidation.

A more positive theme will be continuing M&A activity in the payments sector, which has benefited from the COVID-19 boost to online shopping.

Western Union’s $200m acquisition of a 15% stake in Saudi Telecom’s payments arm is a prime example of Saudi Arabia’s move towards a more integrated and developed payments platform.

We expect payments and the broader fintech sector to continue to attract investor interest.
In recent years, most TMT deals have been investments by VC or family offices in tech start-ups. Going forward, we expect there will be an increase in M&A activity in the wake of COVID-19, which has reinforced the need for digital transformation across most sectors in the Middle East. This heightened sense of urgency is in line with the results from a recent PwC report: 76% of business leaders worldwide say they plan to allocate more resources to digital transformation, while 53% indicate they will allocate more to M&A activity, including acquiring digital assets, to achieve their key strategic priorities.

In the Middle East, businesses will need to think strategically about joint ventures and acquisitions to meet their digital transformation objectives and revise their operating models.

COVID-19 has also acted as a catalyst for trends we expect to see accelerate, such as the shift to remote working. We anticipate continued investment in digital infrastructure and software as a service (SaaS), as more organisations adopt cloud technology. In addition, technology investment is central to the transformation visions of governments across the region in areas such as giga projects to build smart cities. Lastly, local developments such as the resumption of relations between Qatar and certain nations through the Al-Ula Accord, and Israel’s peace deals with the UAE and Bahrain will bring new investment opportunities. Israel in particular presents potential technology investment opportunities for companies in these countries, as well as bringing new technology to the region.
Dealmakers need to be aware of the following issues when planning and executing transactions in volatile market conditions:

### Key consideraitons

#### Valuations

1. **Pricing deals will continue to be more complex than prior to COVID-19.** Globally, stock-market rebounds, fuelled by increased confidence because of vaccination programmes, are raising expectations about performance and growth and increasing valuation multiples. Yet dealmakers will need to assess the sustainability of business models and the extent to which markets will return to pre-COVID-19 levels.

2. **There will be a greater need to consider the impact of different scenarios on business cash flows, with continued emphasis on market multiples for benchmarking purposes.**

3. **Private equity and financial investors will need to reconcile different valuation approaches to assess whether they will be able to realise “normal” pre-COVID-19 gains.**

#### Value Creation

1. **The combination of the drop in demand triggered by COVID-19 and the oil price shock is driving consolidations in negatively impacted sectors where businesses in the region face large financial and operational cuts.**

2. **Consolidation by companies to achieve economies of scale will enable them to lower costs, respond more effectively to market pressures and benefit from greater capital efficiencies where there are common shareholdings.** For some companies, joining forces may be a way to stay solvent.

3. **Much of the deal value will come from synergies, increasing the need when the deal is signed for a clear, detailed understanding of how these will generate future value.**

4. **More than ever, there is a need to have a plan for creating value as a core part of deal strategy rather than as an afterthought.**
Pricing Mechanisms

01
There is increased risk for buyers between the “locked box” date for concluding transactions and formal completion of the deal.

02
As a result, there is a growing trend for buyers to avoid “locked box” transactions, which use a fixed price based on the value of a company on a specific date prior to signature. Instead, more buyers are submitting bids based on cash, debt and working capital estimates that assume continued market disruptions.

03
Targets with predictable revenues and profits, which could be candidates for a “locked box” transaction, will still present challenges for buyers in areas such as gap period profits.

Pricing Adjustments

01
Working out the normal level of working capital will become increasingly difficult as historical performance will include a full year of “exceptional” performance impacted by COVID-19.

02
Buyers need to consider carefully the treatment of grants provided by governments as part of rescue packages and whether waiver clauses mean this state support should be included as debt.

Accounting Structuring

01
Accounting impairments triggered by the impact of COVID-19 may create structural issues around distributable reserves and the creation of dividend traps for which structuring options and mechanisms need to be carefully considered.

02
In response to IFRS 16, which effectively brought most leases on to the balance sheet as liabilities, alternative structures have recently emerged to continue to enable cash monetisation of operating and core assets.

03
Merger transactions can help optimise balance-sheet positions where relevant structuring opportunities exist; for example, through uplifting net assets and equity, crystallisation of balance-sheet value and optimising distributable reserves.
The tax implications of debt restructuring and recapitalisation need to be carefully considered to prevent triggering unintended cash tax costs on, for example, the discount element.

Remote working can affect the transfer pricing of transactions within a group, impact the ability of a business to meet substance requirements, and expose the business to foreign tax obligations.

A longer-term investment horizon puts additional importance on the need to have robust and durable tax structures and strategies that are ‘future proof’.

Digital transformation and operating model and supply chain changes can have material VAT, customs and other tax implications, which can drive or cancel out any cost savings and efficiencies.

With proper planning, businesses may be able to ease cash pressures by deferring expenses and accelerating income to offset losses, or the reverse to decrease cash taxes. This and other tax and transfer pricing planning can enhance value in an M&A transaction, including value attributed to existing losses.

Fiscal reform activity in the Middle East will continue, and governments in the region are expected to introduce new taxes and ramp up audit activity to finance COVID-19 relief funding. This needs to be reflected in the tax due diligence effort and valuation of M&A transactions.
Looking forward, most sectors in the Middle East will see some level of consolidation in 2021, with the major players using their capital strength to gain market share through distressed or strategic acquisitions that will create shareholder value. We also expect to see an increase in restructurings in the region.

Overall, dealmakers will need to navigate the Middle East’s investment landscape in the coming months with an eye for emerging or re-emerging opportunities, following the macro-economic shock delivered by COVID-19. For example, investors see expansion opportunities in healthcare and education beyond the main markets of the UAE and Saudi Arabia. Meanwhile, agriculture and food manufacturing and processing continue to attract interest, given the defensive nature of these sectors; technology transactions are still buoyant, with the UAE experiencing the highest levels of activity; and we expect consolidation of financial services with the focus on fintech and payments.

All of this activity is being fuelled by the knowledge that vaccines at last offer an eventual route out of the pandemic. The immediate road ahead presents challenges for Middle East governments, companies and investors in the region, but it is clear that deals cannot be put on hold for the next one to two years while confidence gradually returns to markets. After a year of unprecedented difficulties, Middle East dealmakers can look forward to 2021 with hope tempered by caution.
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