Private Equity and Venture Capital in Emerging Markets: A Case Study of Egypt and the MENA Region

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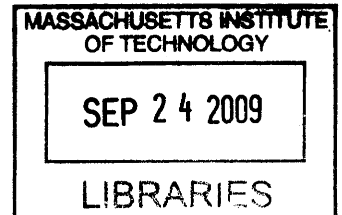

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ABSTRACT

Private equity and venture capital investments in emerging markets grew significantly over the past five years (2003-2008), both in absolute and relative terms. In this study, we examine the industry's role in emerging markets, in terms of key actors, business processes, and impact on portfolio companies. We use a case study of private equity and venture capital in Egypt, and the Middle East and North Africa region. We focus on two key questions: (i) *Why did private equity activities grow so much and so fast in Egypt?;* (ii) *What is the impact of private equity firms on their portfolio companies? And what are the broader economic development implications for the country?*

In addition to a number of global and macroeconomic trends that created a positive environment for private equity investments, we identify two key factors behind the industry's success in Egypt: first, the industry is dominated by local firms that rely on a mix of local knowledge and expatriate expertise, and have developed key competencies that provided them with a strong competitive advantage and enabled their growth. Second, these firms, while adopting global best practices in the industry, have adapted their business model and practices to the local market needs.

In terms of their impact, we found that in most transactions, private equity firms acted as a catalyst for *initiating, consolidating, professionalizing, growing and globalizing* their portfolio companies, and in doing so, they increased their competitiveness and expanded their operations in regional and global markets. Based on these findings, we argue that private equity firms in emerging markets are providing a new type of *"financial entrepreneurship"* that is increasingly playing a positive role in economic development.

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GLOSSARY OF ACRONYMS AND TECHNICAL TERMS

BOT	Build-Own-Transfer
FDI	Foreign Direct Investments
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GoE	Government of Egypt
GP	General Partner (typically, the fund manager in a private equity fund)
IRR	Internal Rate of Return
ITIDA	Information Technology Industry Development Agency (Egypt)
JV	Joint Venture
LBO	Leveraged Buyout
LE	Livre Égyptienne (Egyptian Pound)
LP	Limited Partner (typically, the investors in a private equity fund)
MBO	Management Buyout
MCIT	Ministry of Communications and Information Technology (Egypt)
MENA	Middle East and North Africa region
PE	Private Equity
PPP	Public-Private Partnerships
PPP	Purchasing Power Parity
SAE	Société Anonyme Égyptienne (Egyptian Joint Stock Company)
SEC	United States Securities and Exchange Commission
SME	Small and Medium Enterprises
SOE	State-Owned Enterprise
SPV	Special Purpose Vehicle
VC	Venture Capital

CHAPTER 1: INTRODUCTION

1.1 Overview

Over the past five years, private equity and venture capital investments have grown exponentially, both globally and in emerging markets. Morgan Stanley estimates that in 2007, more than 2,700 private equity funds were active globally. These funds executed around 25% of the global mergers and acquisitions transactions and 33% of the initial public offerings (IPO's) (Jensen 2007). The Emerging Markets Private Equity Association (EMPEA) estimates that globally, private equity funds raised $445 billion in 2008, more than three times the 2004 figure of $141.7 billion. Lerner and Gurung (2008) estimate the total value of companies[1] acquired by private equity globally in leveraged buyout transactions conducted between 2001 and 2007 to be more than $2.7 trillion.

In emerging markets, EMPEA (2009) estimates that in 2008, $66.5 billion were raised by more than 210 private equity funds focusing on emerging markets, compared to $6.5 billion in 2004. Private equity firms and funds are becoming increasingly important actors in these countries: they act as a source of finance for new enterprises or provide growth capital for existing ones; they act as

[1] The total value of a company acquired by private equity, sometimes referred to the enterprise value, includes both equity and debt (Lerner and Gurung 2008).

owners and managers of portfolio companies[2]; and they act as employers, both for management and labor.

This incredible growth trajectory clearly begs an important question: *Why did the private equity activities grow so much and so fast in emerging markets over this time period?* Analysts (e.g., Lerner and Leamon 2008, Lerner and Gurung 2008, Jensen 1989) provide three types of explanations for this puzzle. The first explanation focuses on changes in the global investment environment. This includes global trends such as the increase in global liquidity, the globalization of the investment banking and asset management industries, and the decline in growth and investment opportunities in developed markets. The second explanation focuses on the increasing opportunities in emerging markets. Many emerging economies enjoy high levels of economic growth, stable macroeconomic environments, and increasingly open and friendly investment climates. These favorable conditions, both on the supply and demand side, support the increase in global private equity investments (as well as other types of global investments such as FDI). The third explanation goes beyond these environmental conditions to examine the private equity investment model itself. We argue that private equity is particularly well-suited for these types of markets, and that it is in fact surfacing as a highly effective model for investing in emerging markets for institutional investors and high-net-worth individuals. In his paper, "The Eclipse of the Public Corporation," Jensen (1989) argues that the private equity leveraged buyout model is a new and powerful model for general management because it provides an efficient capital structure, strong corporate governance, concentrated and

[2] We use the term "portfolio companies" to refer to companies that receive private equity investments, and are hence part of the *portfolio* of companies owned (fully or partially) by the private equity firm or fund.

engaged investors, and strong management incentives (Stromberg 2008). While his argument was and remains controversial for many reasons, private equity transactions continue to grow, both in developed and emerging markets.

As more of the global economic growth shifts towards emerging markets, institutional investors are seeking more exposure to these countries, and more capital flows are seeking attractive investments within these countries. However, the vehicles for these investments are limited. Capital markets in many emerging economies are not broad or deep enough, may not have the liquidity to support these inflows, and can quickly become overvalued due to speculative demands. Private equity provides an alternative vehicle for these large investors. Private equity managers seek opportunities that are not publicly traded yet; they provide strong governance and accountability to their investors; they maintain an efficient capital structure; and they can structure their funds to maintain investors' tax privileges. For the same reasons, private equity is also an attractive investment vehicle for the local or regional high-net-worth individuals and family investors who need to diversify beyond their core business and want to maintain their investments locally or within the region, a growing pattern in the Middle East.

There is an extensive body of literature covering private equity in developed countries, especially in the United States and the United Kingdom, where the industry has been historically most active. This literature provides a theoretical and empirical understanding of private equity in terms of its business model, governance, and financial performance. It also provides an assessment of private equity firms' impact on portfolio companies in terms of labor, wages and employment, productivity, and innovation, with the premise that ownership of

companies by private equity funds affects their behavior and performance. In contrast, there is a very limited body of theoretical or empirical literature covering private equity in emerging markets, primarily due to the industry's short history, as well as its data limitations.

In this research, we provide a case study of the private equity industry in Egypt, a prime example of an emerging economy with a strong and fast-growing private equity industry. As of mid-2008, more than 36 private equity funds were investing primarily in Egypt, with more than $6.4 billion in committed capital. Additionally, 35 regional and global funds were investing in Egypt along with other countries in the region. These funds executed more than 78 private equity transactions in Egypt during the five year period between 2003/2004 and 2007/2008.

In our research, we focus on two key questions, using Egypt as a case study. Our first research question is: ***Why did private equity activities grow so much and so fast in Egypt?*** Moving beyond the macroeconomic and environmental factors, we examine the key actors, focusing on the firms and their founders and partners. We also analyze the private equity business model and practices throughout the end-to-end investment cycle, and how they adapt to the conditions of operating in an emerging market. Our second research question is: ***What is the impact of private equity firms on their portfolio companies? And what are the broader economic development implications for the country?*** By acquiring or investing in their portfolio companies, private equity firms play a major role in transforming these companies and increasing their value. In doing so, they may change their governance, management, business processes, financial structure, or employment. In our analysis, we examine the "value creation strategies" used by

private equity firms in Egypt, how they impact their portfolio companies, and what the developmental implications for the whole country are.

In answering the first research question, ***why did private equity activities grow so much and so fast in Egypt,*** we identified the top driving factors. In addition to all the global and macroeconomic trends discussed earlier, we attribute the growth of the private equity industry in Egypt to two key factors. First, the industry is dominated by local firms that relied on a mix of local knowledge and expatriate knowhow. These firms developed key competencies that provided them with a strong competitive advantage and enabled their growth. Second, these firms, while adopting global best practices in the industry, managed to adapt their business model and practices to the local market needs.

The prevailing notion in the literature is that most of private equity activities in emerging markets are conducted by global firms. Analysts (e.g., Lerner and Leamon 2008) argue that emerging market private equity is primarily a result of US and UK private equity firms seeking opportunities in emerging markets, as opportunities diminish and become more competitive in developed countries. However, our findings from the private equity industry in Egypt ran contrary to this notion. While it may be true that US- and European-based private equity firms are becoming increasingly interested in emerging markets, our analysis shows that, in Egypt, there is a rapidly growing home-grown private equity industry that is dominant. This industry is created by financial services veterans with long experience in the United States, along with those with strong domestic banking experience. In a way, this is similar to how the semiconductors industry and the information technology offshoring industry got started in Taiwan and India through their diaspora. These local firms developed several key

competencies that helped them perform and grow and provided them with a competitive advantage: access to capital, access to deals, deal structuring knowhow, business transformation and turnaround knowhow, and political access. These five competencies were present in most of the private equity firms that we examined.

In terms of ***their business model and practices***, our overarching hypothesis was that while the private equity model is transferable and useful in emerging markets, private equity as an investment model is particularly well-suited to emerging markets, and that private equity firms further adapt to the local peculiarities of doing business in such countries. To understand these inherent advantages, as well as the differences and necessary adaptations in business practices, we trace the end-to-end activities of private equity cycle, including fund initiation and setup, investing, portfolio management and exit.

The second research question focuses on outcomes: ***What is the impact of private equity firms on their portfolio companies?*** As they pursue their value creation strategies, how specifically do they shape these companies that they acquire or invest in? And how does that affect the overall economy? We found that in most transactions, private equity firms acted as a catalyst for ***initiating, consolidating, professionalizing, growing and globalizing*** their portfolio companies. We found numerous examples of private equity funds consolidating multiple small companies into larger, more competitive entities, especially in the manufacturing and food industries. They professionalized their acquisitions by hiring experienced management teams and installing proper corporate governance procedures that align the incentives of these management teams with the owners, and improving their management practices. They also grew these

companies and expanded their scope of operations from domestic markets to regional or global markets. By consolidating, professionalizing, growing and globalizing their acquisitions, we argue that they increased their competitiveness in regional and global markets.

Based on these findings, we argue that private equity firms in emerging markets are providing a new type of entrepreneurship that is emerging from the financial sector, as opposed to the traditional entrepreneurship models emanating from industry or technological circles. They are creating new green field companies in capital-intensive industries such as oil and gas, cement, transportation infrastructure and manufacturing. They are also providing capital for rapidly growing companies which have limited access to finance from the banking system. In this capacity, private equity funds are acting as a new breed of *"financial entrepreneurs,"* and in this capacity, are increasingly playing a positive role in economic development. One of the explanations for their positive role is the initial conditions and stage of development in Egypt, as well as most emerging markets: most economic sectors are fragmented and could benefit from consolidation strategies; companies are in need of growth capital; and medium companies could benefit from professionalization and regional growth. By playing the catalyst role for these types of transformations, private equity firms contribute to economic development.

Why is this important? As private equity investments in emerging markets grow, it is important to have a deeper understanding of their business practices and impact on their portfolio companies. This increased understanding has the potential to influence a number of government policies. If the belief prevailed that private equity investments have a positive impact on the economy, then

more would argue for positive government policies to support and attract private equity activities, similar to what many countries do to attract foreign direct investments (FDI). If the belief prevailed that these firms have a negative impact on the economy, then more would argue for stricter regulations to limit their activities, similar to what many countries do to limit speculative "hot money." Specifically, there are a number of policy issues relating to private equity that need to be examined, including regulations, transparency and taxation. We discuss these policy issues and implications in depth in the concluding chapter.

In the rest of this chapter, we briefly define the private equity business model; provide the theoretical foundation for the research; discuss the methodology and data used in the analysis; and specify the research contribution. We conclude by describing the structure of the dissertation.

1.2 Private Equity Defined

Private equity is an alternative investment class that provides investors, both individual and institutional, with professionally managed investment vehicles for equity investing in unregistered securities of private and publicly-traded companies[3] (Fenn, Liang and Prowse 1995). Private equity firms invest in new or

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[3] Throughout this document, we use the following terminology in describing three different types of company ownership: private, public and state. A private or privately-held company is owned by private investors and whose shares are not available to the general public or traded in an open market. A public, publicly-held, or publicly-traded company or corporation is primarily owned by private investors, and whose shares are available for the public and are traded in an open market. This is to be differentiated from a state-owned company, or state-owned enterprise (SOE) which is primarily owned by the State.

existing enterprises with the purpose of increasing their value over the short or medium run. Private equity funds invest in different situations, including buyouts, where the fund invests in existing (often distressed) companies through the acquisition of a significant or controlling stake; venture capital, where the investments are in new or small companies, often based on technological innovations; or growth capital, where they provide capital to fast-growing companies (Fischbein 2005, Lerner and Leamon 2008). Private equity funds maintain their investments for a limited period of time, typically 3-5 years. During this period, the portfolio company, in the case of buyouts, undergoes financial and operational restructuring or achieves its growth targets, or in the case of new innovation, the startup matures. At the end of this period the private equity fund exits the investment by selling the company through an initial public offering (IPO) in the stock market, to other companies (trade sale), or to other financial investors (secondary buyout) (Lerner and Leamon 2008, Fenn, Liang and Prowse 1995). Private equity funds usually capture significant profits that exceed the performance of publicly-traded companies; however, these returns reflect higher risks and volatility, along with the illiquid nature of the investments during the investment period.

1.3 Theoretical Foundation

The study of private equity is an emerging field of research in finance and economics. A growing number of studies examine private equity from different angles, including: business model and governance (Jensen 1989, Lerner 1995, Walker 2007); performance as an investment vehicle (Long and Ravenscraft 1993, Kaplan and Schoar 2003, Davis, Haltiwanger and Jarmin 2007, Taylor and Bryant

2007); and impact on portfolio companies, in terms of labor, wages and employment (McGuckin and Nguyen 2001, EVCA 2005, Amess and Wright 2007, Kearney 2007), productivity (Lichtenberg and Siegel 1987, Kaplan 1989, Lichtenberg and Siegel 1989, Harris Siegel and Wright 2005), and innovation (Hall 1990, Lichtenberg and Siegel 1990, Hall 1992, Hao and Jaffe 1993, Himmerlberg and Petersen 1994). The overarching hypothesis in this type of research is that private ownership of companies by private equity funds affects their behavior and performance, compared to public ownership in the form of publicly-traded corporations, and compared to family ownership.

In this research, we focus on private equity as an alternative form of ownership, governance and financing for firms, compared to family businesses and public corporations. Each of these three organizing models has its own distinct characteristics (Wright and Robbie 1998). In table 1.1, we compare these three organizing models. We examine how each ownership model provides a different structure for the relationship between investors or owners; intermediaries, such as private equity firms; boards of directors; and management.

Table 1.1 Comparing private equity, family business and public corporations

	Private Equity	*Family Business*	*Public Corporation*
Ownership	• Concentrated (institutional investors, high-net-worth individuals, family offices)	• Concentrated (entrepreneurs, family, few partners)	• Dispersed/ fragmented
Financing	• Access to equity by fund investors • Access to debt financing; high leverage (especially LBO's)	• Family financing and retained earnings → organic growth • Limited access to debt markets and conservative capital structure → low leverage	• Access to public equity and debt markets; medium leverage
Governance	• Investors → PE firm → Portfolio company board → Management • Agency issues between investors and PE firm (resolved through profit sharing incentives and fund term limit)	• Owners → Management • Limited agency issues (except in the case of minority shareholders) • May move to board structure, especially in the case of multi-generation businesses	• Shareholders → Board → Management • Agency issue (managed through management incentives; however, remains an issue)

Sources: the author

From a theoretical perspective, these relationships can be analyzed in the context of informational asymmetry and agency theory. ***Informational asymmetry*** is a situation where two contracting parties in a transaction do not have the same level of information about the situation, and where one party may have more or better information than the other. The informational asymmetry may exist *before* the contract occurs, which may lead to a *moral hazard* or *adverse selection* situation. It may also take place *after* the contract occurs, which may lead to a *principal-agent* problem (Mas-Colell, Whinston and Green 1995).

Moral hazard and ***adverse selection*** describe two situations of informational asymmetry that were first identified in the insurance literature. An example of a moral hazard is a situation where an insurance company is not able to observe if the insured is exerting sufficient effort to avert a loss (the same effort he would have exerted in absence of the insurance policy). An example of an adverse selection situation is where the insured knows more than the insurance company about the likelihood of an accident. In this situation, people with higher probability of an accident are more likely to buy an insurance policy, while those who are less likely to have an accident prefer not to purchase the policy. As a result, the insurance company ends up with an "adverse selection" situation. Moral hazard and adverse selection are two situations where the informational asymmetries exist prior to the time of contracting (Mas-Colell, Whinston and Green 1995).

The ***principal-agent problem,*** or agency theory, describes the relationship between a principal and an agent in a situation of informational asymmetry. Jensen and Meckling (1976) "define an agency relationship as a contract under which one or more person [the principal(s)] engage another person [the agent] to

perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal." This is the common situation in the context of a public corporation, where there is separation between ownership and management. The firm owner (the principal) hires a manager (the agent) to perform a specific task. However, the owner may not be able to observe all the manager's actions toward doing his job or may not know the same level of information about the firm performance. Agency theory literature distinguishes between two types of informational asymmetries: *hidden actions* and *hidden information*. Hidden action is a situation where the principal is not able to observe the actions of the agent. In this situation, the agent may be acting for his own self interest rather than the principal's interest. Hidden information is a situation where the agent has more intimate knowledge of the firm operations than the principal. These situations may lead to moral hazard if the agent is acting to maximize his own self interest rather than the principal's (Mas-Colell, Whinston and Green 1995; Jensen and Meckling 1976).

From a firm governance perspective, the agency problem raises two issues. The first issue is the alignment of interests between the principal and agent. The design of the governance process and performance incentives for management aims at aligning their interests and ensuring that the agents (management) are acting in the interest of the principals (shareholders). The second issue is the difference in risk tolerance, where the agent may be more risk averse or risk seeking than the principal. In public corporations, management risk tolerance should be observable based on their historical performance. However, in

situations of new management or changing market conditions, management behavior may differ.

Agency issues in the context of the separation between ownership and management in the corporation is a problem that is as old as modern Capitalism. In 1776, Adam Smith (1979) identified this problem in *The Wealth of Nations*:

> The directors of such [join-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion therefore must always prevail, more or less, in the management of the affairs of such a company.

In this research, we use informational asymmetries and agency theory to provide a theoretical framework to analyze private equity practices, and to understand the differences between the three forms of ownership: family businesses, public corporations and private equity as described in Table 1.1.

In the case of family businesses, the ownership is typically concentrated in the entrepreneur(s), founder(s), or their families in later generations. The concentration of ownership and direct involvement of the owner(s) in the management of the company limits agency issues[4]. However, this comes at the

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[4] Two secondary points to make: first, in general, there is an inherent principal-agent problem in any employer employee relationship, whether it is at the senior management level or throughout the company; however, we focus here on agency issues between owners and management; second, in a family business, agency issues exist in the case of minority shareholders. In this

expense of access to finance, be it in the form of equity or debt. Family businesses are also characterized by being risk averse, focusing on the long term, and putting a premium on maintaining the family ownership of the business. As a result, family businesses typically grow organically through retained earnings, and at a slower pace.

In the case of public corporations, ownership is typically dispersed or fragmented among a large number of shareholders, and an extra layer, the Board of Directors, is added to represent the interests of the shareholders. This is the classic principal-agent problem, where the owners and the board try to set the proper monitoring and reporting mechanisms to reduce the informational asymmetry, and design performance incentives to align the interests of the management with those of the shareholders. The results of these monitoring and incentive-setting actions, as well as any residual losses to the principal from the agent's actions, are considered the "agency costs" (Jensen and Meckling 1976).

In the case of private equity, the ownership is concentrated in the fund investors – typically institutional investors, high-net-worth individuals and family offices. Financing of private equity transactions takes place through the equity raised from the fund investors, debt from banks and other lenders, and sometimes, mezzanine financing[5]. Private equity transactions make extensive use of debt

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situation, the problem exists between the majority owner(s) (principal) and the minority owner(s) (agent), with the danger of majority owners conducting non-arms-length transactions (Morck and Yeung 2002).

[5] Mezzanine financing is a hybrid of debt and equity financing. It is debt capital that gives the lender the right to convert it to an ownership or equity interest in the case of default. It is generally subordinate to debt provided by senior lenders such as banks, but is senior to shareholders' equity. Mezzanine financing is typically used to finance the expansion of existing companies, and is usually provided to the borrower very quickly with limited due diligence on

financing, especially in leveraged buyouts. In terms of governance and agency issues, there are two levels of agency relationships. The first is between the investors and the private equity firm. In this relationship, the investor and private equity firm interests are aligned by providing generous profit sharing to the fund managers, in the form of carried interest, typically around 20%, and also by limiting the fund term (typically to seven years), which forces liquidation at the end of that period. The second relationship is between the fund managers and the portfolio company management. Private equity firms maintain the boards as a governance structure; however, they appoint the members of the board, who are typically fund management and trusted external experts. In this situation, the concentration of ownership in the hands of the fund managers, who are typically active in monitoring their portfolio companies, limits the agency issues.

In his seminal paper "The Eclipse of the Public Corporation," Michael Jensen (1989) predicted that the leveraged buyout (LBO) model used by private equity would eventually emerge as the dominant form of corporate organization. Jensen argued that the private equity LBO model provides concentrated ownership by active investors, strong corporate governance, aligned management incentives and efficient capital structure, and hence, it is a superior model to the public corporation, with its weak governance structure and dispersed shareholders. Because of these features, he argued that LBO ownership enables managers of portfolio companies to operate without short-term market pressures and focus on long-term investments and profitability (Lerner, Strömberg and Sørensen

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the part of the lender and little or no collateral on the part of the borrower. This type of financing is aggressively priced with the lender seeking a higher return than secured or senior debt (Investopedia 2009).

2008). While this debate has not been resolved in developed countries, his ideas may be just as relevant in the context of emerging markets.

In emerging markets, public corporations are not the predominant form of ownership, where family businesses, large diversified business conglomerates, and state-owned enterprises occupy the larger part of the economy. However, private equity, as a form of ownership, has been rapidly growing, and the debate about its efficiency as an ownership model or as an investment model is just starting. One interesting observation, which we explore later, is that private equity is serving as a catalyst for transforming family businesses into corporations. A large portion of private equity acquisitions are family businesses, which are restructured, later sold to large corporations or through the stock market in an IPO.

Another theoretical issue resulting from informational asymmetries is the ***transaction cost*** for investments. For investors seeking to invest in an emerging economy, their choices are limited: they can invest directly by acquiring/creating and managing a local company (foreign direct investments); they can invest by buying shares of publicly listed corporations through the stock exchange; or they can invest through private equity funds. While the option of creating or acquiring a local subsidiary is available to multinational corporations, it may not be a viable option for financial investors such as pension funds. Their options are investing in either public or private equity. In such a situation, their two primary concerns would be informational asymmetry, which may lead to exposure to higher, unanticipated levels of risk; and transaction costs, which include costs incurred for executing, monitoring and exiting the transaction.

This leads to a key question: *Are foreign investors better off investing in public or private equities in emerging markets?* While this research does not examine publicly-traded companies, we are able to gain insights on private equity practices in emerging markets, and how these may influence foreign investors' exposure to informational asymmetries, as well as their end-to-end transaction costs. Lerner & Leamon (2008) argue that "perhaps most persuasively, the types of environments where private equity funds have thrived in the United States are quite similar to those in developing nations: the investors have specialized in financing illiquid, difficult-to-value firms in environments with substantial uncertainty and information asymmetries."

1.4 Research Design

1.4.1 Research Questions and Hypotheses

We focus our research on two key questions, using Egypt as a case study. The first question is: ***Why did private equity activities grow so much and so fast in Egypt?*** Answers to this question also lend insight to a related question: What can a developing country do to attract private equity investments, based on this case of Egypt? There are several explanations in the literature for the growth of the private equity industry in emerging markets (Lerner and Leamon 2008, Lerner and Gurung 2008, Jensen 1989), focusing on global and macroeconomic trends, as well as the suitability of the private equity investment model for emerging markets. However, in our research, we examine two additional hypotheses, based on the case of Egypt. The first hypothesis is that the local "home-grown" private equity firms enjoy a competitive advantage, and were able to develop key competencies that enabled their success. These home-grown firms were

created by experienced professionals with long careers both in Egypt and in global financial institutions. The second hypothesis is that private equity firms have adapted their business model and practices to the local market needs and the conditions of operating in an emerging market. We identify a number of examples for how these firms have adapted to the local market needs. We expect the same situation to exist in other emerging economies with strong private equity industries; however, further research is required to confirm these hypotheses in other countries.

The second research question is: ***What is the impact of private equity firms on their portfolio companies? And what are the broader economic development implications for the country?*** Our examination of numerous private equity transactions executed in Egypt over the past 5-8 years shows a positive impact. In most situations, private equity firms played a catalyst role in transforming their portfolio companies to become larger, stronger, and more competitive. In our research, we examine the "value creation strategies" used by private equity firms in Egypt. Out hypothesis is that when private equity firms use value creation strategies that are focused on growth and competitiveness, they have a positive impact on their portfolio companies, and contribute to the broader economic growth in the country. In our research, we identify five value creation strategies used by private equity firms in Egypt: initiating new companies, and consolidating, professionalizing, growing and globalizing existing companies. These strategies are all focused on growth and competitiveness, and by following them, private equity firms contribute in a positive way to the country's economic development. We expect this hypothesis to apply to other emerging markets.

1.4.2 Methodology

In our research, we rely on qualitative research methods to build a case study of private equity in Egypt. Throughout the case, we examine different units of analysis, including: private equity firms, funds, transactions, and portfolio companies. Within the case, we use different qualitative techniques including process tracing, within-case analysis, and hypothesis testing (Yin 2002).

In Chapters 2 and 3, we establish a fact base for the private equity industry in emerging markets, the Middle East and North Africa (MENA) region, and Egypt. These two chapters focus on highlighting the demographics of the industry, especially in terms of size and growth rate, at the level of emerging markets, MENA region, and Egypt. However, the primary scope of the case study is private equity in Egypt.

In Chapter 4, we perform a *process tracing* for the private equity cycle through the four key stages: fund initiation and setup, investing, portfolio management and exit. In each section, we identify the governing theoretical framework and analyze the specific step within this framework. We also examine any specific findings that contribute to the research questions and hypotheses.

In Chapter 5, we analyze all private equity transactions against the second research question regarding the impact of private equity firms on their portfolio companies. We classify all transactions based on their impact, and examine a select number of transactions in detail. In this chapter, our unit of analysis is the private equity transaction. For the tabular classification, we analyze all transactions executed in Egypt since 1999 that have a public record. We do not

expect any selection bias because we analyzed the whole data set rather than a sample selection.

1.4.3 Data

Our case analysis is based on multiple data sources, including: (i) survey and interviews with ten private equity firms in Egypt; (ii) a data set on private equity firms in Egypt compiled by the author from Zawya, MIT Emergis, as well as other sources; (iii) a data set on private equity transactions in Egypt compiled by the author from Zawya, Zephyr, as well as other sources; (iv) a number of tables created by the author from publicly available data on the private equity firms' websites and other data sources; and (v) other secondary information sources on private equity firms, funds, and transactions. In the rest of this section, we explain the details of each of these data sources.

First, we use a structured survey and interviews conducted with ten private equity firms in Egypt (Table 1.2) over the period between July 2007 and October 2007. The ten private equity firms interviewed were selected based on access – we interviewed firms where we had personal contacts or could get a contact inside the firm. All the interviewed individuals were senior executives at the partner or managing director level. The ten firms interviewed are managing more than 80% of the private equity funds invested in Egypt. We have no reason to believe that there is a systematic bias in the sample selection.

Table 1.2 Private equity firms interviewed

Private Equity Firm	Firm Start Date in Egypt	Primary Ownership/ Nationality	Person Interviewed
Actis	2002	United Kingdom	Investment Principal
Beltone Financial	2007	Egypt	Senior Management
Carlyle Group	2007	International	Managing Director
Citadel Capital	2004	Egypt	Managing Director & Cofounder
Concord International Investments Group	2000	Egypt	Senior Director
EFG-Hermes Private Equity	1997	Egypt	Partner
Sphinx Capital/ Grandview	2005	Egypt	Managing Director
Haykala Investment Managers	2005	Egypt	Executive Director Associate Director
IT investment	1999	Egypt	Chief Investment Officer
Mansour & Maghraby Investment & Development (MMID)	1996	Egypt	Vice President

Sources: The author, based on survey of private equity firms in Egypt

The interview questions examined issues at the fund level and at the portfolio company level. At the fund level, we asked them about the fund background and history, their investment focus, the investment process and the government impact on their business. At the portfolio company level, we asked them questions on one or more of their portfolio companies, including the transaction background, their governance and performance management approach, their restructuring and value adding strategies, and their exit strategy. The complete interview questionnaire is included in Appendix I.

While interviewees provided a wealth of information on their private equity firms and their transactions, they did not always adhere to the scripted questions.

Some included more anecdotes that were useful in getting a deeper understanding of some of the questions.

Second, we use a data set on private equity firms in Egypt and MENA region. We compiled this data set based on primary data from two sources: Zawya (www.zawya.com), a specialized financial portal focusing on the Middle East and North Africa (MENA) region, and MIT Emergis (emergisglobal.com), a startup project in the MIT media lab focusing on private equity and venture capital data in emerging markets. This data set includes a complete list of all private equity firms and funds publicly announced that operate in the Middle East and North Africa (MENA) region. By combining data from both sources, we created a more comprehensive and complete data set about the region, with a special focus on Egypt. However, it is important to note that only publicly announced funds are included. Table 1.3 lists the data sources used to construct this data set.

Table 1.3 Data sources used

Source	Regional Coverage	Number of Funds	Number of Transactions	Date Downloaded
Zawya	MENA region			June 2008
- MENA		143	415	
- Egypt		12	42	
MIT Emergis	Emerging Markets			June 2008
- MENA		109	n/a	
- Egypt		29	n/a	
Zypher	Global			June 2008
- Egypt		n/a	38	

Notes:
List of funds downloaded includes some inactive or rumored funds.

Sources: The author

Third, we use a data set on the private equity transactions in Egypt. We compiled this data set based on primary data from two sources: Zawya, and Zephyr[6], a financial database for all global buyout transactions. This data set includes a broad list of transactions (buys/sells) conducted by private equity firms in Egypt, based on publicly announced information. It is important to note that the overlap between the two datasets was limited. This indicates that the data collection effort is far from being comprehensive; and that more transactions may exist, but are unaccounted for in either data set.

[6] Zephyr is a financial database that provides detailed information on business mergers, acquisitions and venture capital transactions. It includes more than 500,000 transactions, with up to 100,000 new transactions added each year. Zephyr's coverage goes back five years for international transactions and back to 1997 for transactions involving European and American companies.

Fourth, we create a number of tables from publicly available data on private equity firms' websites and other data sources, including a database of all senior executives in private equity firms in Egypt, covering their professional and educational background.

Fifth, we use other secondary sources on private equity firms, including articles, press releases, their websites, and other publicly available information. Some of these are collected from specialized financial portals that monitor private equity activities.

One important issue to highlight relates to data accuracy. During our analysis, we compiled a detailed data set of funds and transaction covering the MENA region for the period between 2003 and mid 2008, based on primary data from multiple sources that track such funds and transactions. This data set shows the actual size of private equity funds in the MENA region to be larger than the figures reported by industry sources such as EMEA and Prequin. This under-counting of the industry size is likely to be the same in other emerging markets.

1.5 Research Contribution

Up until recently, there were very limited private equity transactions in emerging markets. For example, in 2002, all emerging markets private equity funds combined raised $3.2 billion, a mere 3.1% of the $102 billion raised by the private equity industry globally. In 2008, emerging markets private equity fund raising reached a record $66.5 billion, growing more than 20 fold from 2002 despite the global financial crisis. This figure represented 15% of the $445 billion

raised by the private equity industry globally – a significant growth both in absolute and relative terms from 2002 (EMPEA 2009). However, our knowledge of how private equity transactions are conducted in emerging markets is limited. There is a limited, albeit growing literature of empirical research and case studies focusing on emerging markets private equity and venture capital. This dissertation contributes to this body of knowledge by providing a case study of private equity investments in Egypt. Through this case study, we make four contributions: first, we document the industry demographics in Egypt in terms of private equity firms, funds, investors, and transactions; second, we examine the private equity investment cycle and how the different actors behave at each stage of the cycle; third, we provide a qualitative assessment of the impact of private equity on the portfolio companies in Egypt; and fourth, we provide numerous detailed case examples of private equity transactions in Egypt, involving local, regional and international private equity firms.

1.6 Structure of the Dissertation

This dissertation is divided into six chapters, including an introduction and a concluding chapter. In **Chapter 2**, we provide an overview of the private equity industry in emerging markets and in the Middle East and North Africa (MENA) region. In **Chapter 3**, we examine the increasing importance of the private equity industry in Egypt by benchmarking it against domestic banking lending, foreign direct investments, the national investment plan, and stock market capitalization. We also examine at the evolution of the private equity industry in Egypt as a home-grown financial services industry and at how private equity funds are emerging as a new breed of "financial entrepreneurs." In **Chapter 4**, we analyze

the private equity cycle and business model and how private equity provides an effective investment vehicle for emerging markets. In **Chapter 5**, we examine the impact of private equity funds and how they initiate new businesses or transform their portfolio companies by consolidating, professionalizing, growing and globalizing them. In **Chapter 6**, we conclude by summarizing key research findings, revisiting the research questions and hypotheses, discussing policy issues and implications, and identifying ideas for future research.

*   *   *

CHAPTER 2: PRIVATE EQUITY IN EMERGING MARKETS AND THE MENA REGION

In this Chapter we provide an overview of the private equity industry in emerging markets, and then zoom in to the Middle East and North Africa (MENA) region.

2.1 Emerging Markets

The term emerging markets or emerging economies refers to developing countries that are undergoing rapid economic growth or industrialization. The term is used in the financial sector literature extensively to denote countries that represent the next wave of potential growth for the industry, especially as growth rates in developed countries stagnate. For example, Morgan Stanley Capital International (MSCI) tracks the performance of equity markets in 74 global markets. They group these markets into three categories: *developed markets, emerging markets,* and *frontier markets*. Currently, they include 22 countries in the emerging markets category; in the Americas: Argentina, Brazil, Chile, Colombia, Mexico, and Peru; in Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, and Thailand; in Europe: Czech Republic, Hungary, Poland, Russia, Turkey; in Africa and the Middle East: Egypt, Morocco, and South Africa. MSCI has created an index to track the performance of equity markets in these emerging markets. This MSCI emerging market index is designed to measure the performance of equity markets in these emerging economies, based on a float-

adjusted market capitalization index, with a base value of 100 as of December 31, 1987. Currently (as of end of June 2009), these 22 emerging markets represent 24% of world's stock market capitalization, the highest since the creation of the index (Bloomberg 2009).

Similarly, The FTSE Group, a UK-based data provider created as a joint venture between the Financial Times and the London Stock Exchange Group, defines emerging markets in two groups: advanced and secondary emerging markets, based on their national income and the development of their market infrastructure. FTSE defines advanced emerging markets to include: Brazil, Hungary, Mexico, Poland, South Africa, and Taiwan; and defines secondary emerging markets to include: Argentina, Chile, China, Colombia, Egypt, India, Indonesia, Malaysia, Morocco, Peru, Philippines, Russia, Thailand, Turkey, and Pakistan (Bloomberg 2009, Wikipedia 2009, Direxion Funds 2009, American Funds 2009). These two indexes are used by institutional investors in making their investment decisions in these emerging markets, and significantly influence the capital flows to private equity funds investing in these markets.

From an investor perspective, investing in emerging markets has three key characteristics. The first characteristic is the potential for higher returns. Emerging markets have high rates of economic growth; industrializing economic bases; growing middle classes with increasing purchasing power; and an improving market infrastructure. The second characteristic is a higher level of risk and market volatility, due to political, economic and currency risks. The third characteristic is that their performance is generally less correlated with developed countries, and hence, they can be used as a way to diversify an investment portfolio and reduce the overall portfolio risk (Investopedia 2009).

The combined effect of these three characteristics is that large institutional investors are becoming more interested in maintaining a portion, albeit a small portion, of their investment portfolio in emerging markets. For some institutional investors such US pension funds, their investments in emerging markets (or other "alternative" assets such as private equity) are capped by law to a limited amount, typically around 5% (Interview with US pension fund manager). However, these limited amounts still represent a significant inflow of capital for emerging markets.

2.2 Private Equity in Emerging Markets

Up until five years ago, private equity activities in emerging markets were very limited in size compared to the global size of the industry, which was primarily focused on developed markets in the United States and Europe[7]. For example, in 2002, all emerging markets private equity funds combined raised $3.2 billion, a mere 3.1% of the $102 billion raised by the private equity industry globally. In 2003 the figure was $3.5 billion, or 3.9% of the global industry.

Analysts (e.g., Gompers and Lerner 2001, Gurung and Lerner 2008, Lerner and Leamon 2008) attribute this limited size and share to several factors, including (i) the lack of sizable attractive opportunities in emerging markets, which were dominated by informal sector, state-owned enterprises, family-owned businesses or monopolistic conglomerates; (ii) limited investor guarantees due to underdeveloped economic laws, lack of enforcement or corruption; (iii)

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[7] Lerner and Leamon (2008) refer to a first wave of private equity investments in emerging markets, which took place during the 1990's. However, the growth in emerging markets private equity in the 1990's is still very limited when compared to the past five years.

regulations that limit foreign ownerships of domestic companies or assets; (iv) absence of active stock markets (or limited depth/ liquidity), which could provide an exit strategy for private equity funds; (v) strict financial controls on capital flows and expatriations of profits from foreign investments; and (vi) limited availability of local experienced bankers and financial advisory firms to support the industry.

However, over the last five years private equity activities in emerging markets started to grow exponentially. For example, in 2008, emerging markets private equity fund raising reached a record $66.5 billion, growing 19 fold from 2003, despite the global financial crisis. This figure represents 15% of the $445 billion raised by the private equity industry globally – a significant growth both in absolute and relative terms from the 2003 levels (EMPEA 2009). Analysts (e.g., Gurung and Lerner 2008, Lerner and Leamon 2008, EMPEA 2009) attribute this growth to a number of factors, including: (i) the globalization of the investments industry and a significant increase in liquidity available for investment globally; (ii) fierce competition and drying up of opportunities in developed economies; (iii) the increasing availability of lucrative opportunities in emerging markets due to economic liberalization, privatization programs, and rapidly growing private economies; (ivi) increasing availability of active domestic stock markets and domestic investors that provides for an exit strategy for private equity funds; (v) better protections for investors, especially with the globalization of investment laws, e.g., the impact of GATT and WTO on the harmonization of laws, increasing protection for foreign investments, and governments seeking/competing for FDI to increase investments in their economies; (vi) loosening of restrictions on foreign investors in many emerging markets to allow for partial or full ownership of assets and companies (e.g., Egypt, United Arab

Emirates) as well as allowances for repatriation of profits; and (iv) the growing availability of Western-trained bankers and professionals returning to their native countries such as India, China, Brazil or Egypt with strong expertise as well as connections to financial centers. All of these factors contributed to the creation of an environment that is conducive to the growth of the private equity model in emerging markets.

Table 2.1 highlights the growth in private equity fund raising figures both globally and in emerging markets from 2001 through 2008. However, the importance of private equity investments is actually substantially higher than these figures for two reasons. First, for most buyout transactions, which constitute the majority of private equity activities, the transactions are typically leveraged 1-4 times the base capital using debt or mezzanine financing, which multiplies the size of the assets under management by the private equity funds compared to the fund size (World Economic Forum 2008). The second issue relates to data accuracy. During our analysis, we compiled a detailed funds and transaction data set that covers the MENA region for the period of 2003 through mid 2008, based on primary data from multiple sources that track such funds and transactions. This data set shows the actual size of private equity funds in the MENA region to be larger than the figures reported by industry sources such as EMPEA and Prequin. This under-counting of the industry size is likely to be the same in other emerging markets.

Table 2.1 Private equity fund raising, globally and in emerging markets (2001-2008)
(Current US$ billions)

	Private Equity Fundraising		Emerging Markets as Percent of
Year	Emerging Markets	Global	Global Fundraising
2008	66.5	445.0	14.9%
2007	59.2	508.2	11.6%
2006	33.2	399.6	8.3%
2005	25.8	265.4	9.7%
2004	6.5	141.7	4.6%
2003	3.5	90.5	3.9%
2002	3.2	102.4	3.2%
2001	6.6	154.0	4.3%

Sources: EMPEA 2009a

In terms of their sectoral focus, Table 2.2 shows that among the 204 funds with closes in 2007, 118 funds were classified as "generalists," i.e., they are not focused on a specific sector, but rather diversify their investments across multiple sectors. These 118 funds were managing $39.1 billion, or 66.2% of the total capital raised. This reflects the smaller size of emerging markets, where sector specialization is harder than in developed countries. The fact that most funds prefer to be diversified across multiple sectors may also suggest that the source of value-creation in emerging markets is not deep sectoral knowledge, but rather generic financial, management and turnaround skills that can be applied to any sector. A smaller number of funds are sector focused, with 69 funds classified into nine sectors, and managing $17.1 billion, or 28.9% of the total.

Table 2.2 Sector focus among funds with closes in 2007

Sector Focus	Number of Funds		Total Value	
	Number	Percent	US$ Million	Percent
Generalist Funds	118	57.8%	39,137	66.2%
Sector-Focused Funds	69	33.8%	17,071	28.9%
Technology	34	16.7%	7,595	12.8%
Infrastructure	8	3.9%	3,395	5.7%
Energy	6	2.9%	1,538	2.6%
Natural Resources	1	0.5%	1,300	2.2%
Financial Services	3	1.5%	1,020	1.7%
Industrial/ Manufacturing	5	2.5%	981	1.7%
Consumer	4	2.0%	624	1.1%
Agriculture/ Agribusiness	4	2.0%	356	0.6%
Environment	4	2.0%	262	0.4%
Other/ NA	17	8.3%	2,952	5.0%
TOTAL	204	100%	59,160	100%

Sources: Global Investment House (2008), based on EMPEA data

Among the specialized funds, technology-focused funds came in as the first largest area, with 34 funds, managing $7.5 billion, representing 12.8% of the total capital raised. This is mainly driven by a wave of offshoring of technology services such as call centers and software development and support from the United States and Europe to emerging markets countries, especially in India, Philippines and Egypt.

Infrastructure-focused funds came in as the second biggest area, with eight funds managing $3.4 billion, representing 5.7% of the total capital raised. This is primarily driven by deregulation of infrastructure investments in many developing countries and the introduction of creative public financing schemes

such as Build-Own-Transfer (BOT) and Public-Private Partnerships (PPP) (Hall 2006).

Energy focused funds represented the third largest sector, with six funds managing $1.5 billion, representing 2.6% of the total capital raised. This is driven by investment opportunities in the energy sector in the wake of the significant increase in energy prices in 2007 and increase in local demand for energy in emerging markets.

* * *

In general, over the long-term, private equity investments provide higher returns than stock markets, reflecting higher investment risks as well as privileged access to non-publicly-traded opportunities. Table 2.3 compares returns of private equity, venture capital, and stock markets in different emerging markets and developed markets by region over the previous one, three, five and ten year periods, as of end of March 2008. These returns vary reflecting economic cyclicality and specific country/region/sector booms and busts. For example, US VC ten year returns of 32.8% are higher than the shorter periods (11.6%, 14.1% and 11.6% for one, three and five year returns, respectively) because the 10 year figures capture the huge returns during the technology boom in 1998-2000. Based on these data, the performance of emerging markets private equity can be put in perspective by comparing it to three major indices: (i) private equity in developed countries, (ii) publicly traded equities in emerging markets, and (iii) publicly traded equities in developed countries.

Table 2.3 Comparative returns of private equity (PE) and venture capital (VC) funds in emerging markets by region, in comparison to major stock indexes

Index	Annualized Returns			
	One year	**Three years**	**Five years**	**Ten years**
Emerging Markets PE & VC	28.5%	27.7%	25.8%	9.6%
Latin America & Caribbean PE	31.5%	26.1%	18.6%	1.1%
Asia (ex Japan) PE	25.7%	22.6%	21.2%	8.8%
CEE & Russia PE	66.9%	46.5%	47.3%	20.8%
MSCI Emerging Markets Index	21.7%	29.6%	36.0%	12.5%
US VC	11.6%	14.1%	11.6%	32.8%
US PE	11.2%	23.2%	24.1%	13.1%
Western Europe PE	37.1%	44.4%	38.0%	26.5%
S&P 500 Index	-5.1%	5.9%	11.3%	3.5%

Notes:

Figures as of March 31st, 2008.

CEE is Central and Eastern Europe region.

MSCI Emerging Markets Index is an index created by Morgan Stanley Capital International (MSCI). It is designed to measure the performance of equity market in global emerging markets. The Emerging Markets Index is a float-adjusted market capitalization index. As of May 2005, it consisted of indices in 26 emerging markets: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela (Direxion Funds 2009).

Standard & Poor's 500 Index (S&P 500) is an index consisting of 500 U.S. stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/ return characteristics of the large-cap universe (Direxion Funds 2009).

Sources: Global Investment House (2008); based on data from Cambridge Associates, LLC

First, comparing private equity returns [8] between emerging and developed markets reflects the evolution of the industry in emerging markets. The ten year returns of 13.1% in developed markets are higher than the 9.6% returns in emerging markets, reflecting the very small size and infancy of the private equity industry in developing countries. The five-year returns are almost similar: 24.1% vs. 25.8%, reflecting the beginning of the private equity boom in emerging markets. The three year returns (27.7% vs. 23.2%) and the one year returns (28.5% vs. 11.2%) reflect the increasing potential in emerging markets.

Second, comparing emerging markets private equity returns against emerging markets publicly-traded equity markets, measured by the MSCI index, shows a mixed story. The ten-year (9.6% vs. 12.5%), five-year (25.8% vs. 36.0%), and three-year (27.7% vs. 29.6%) returns show public equities over-performing private equity, although by small numbers. Only the one-year returns show private equity over-performing public equities (28.5% vs. 21.7%). One of the explanations to this phenomenon, provided by a fund manager, is that the performance of publicly traded and private equity funds in emerging markets is very similar, because the companies that are publicly traded are also still in early stages in terms of their management, financial controls, products or markets.

Third, aggregate long-term emerging markets private equity & venture capital ten-year returns of 9.6% are 2.6 times higher than the 3.5% returns delivered by the Standard & Poor S&P 500 index, which measures the performance of the largest 500 companies listed in the United States stock markets, for the same

[8] Private equity (PE) and venture capital (VC) returns in emerging countries are lumped together. However, VC figures in emerging countries are likely to be very small. Therefore, in the above comparison, I compare it to the US PE returns, which does not include VC figures.

period. The one, three and five year returns show a higher disparity, with emerging markets private equity and venture capital providing significantly higher returns than the S&P 500. These higher returns explain why emerging markets private equity is becoming attractive compared to United States equities.

Emerging markets private equity investments are deemed to have a higher risk compared to other investments such as US equities. In addition to business risks, investors account for other types of country risks. These risks include political risk arising from unanticipated changes in government policy; exchange rate risk arising from potential currency devaluation; and the cost of rent-seeking behavior (Lerner and Leamon 2008). In a survey of private equity investors (limited partners), EMPEA (2009) found that in 2008, they expected a 6.7% risk premium on their investments[9], compared to similar developed markets private equity funds.

2.3 Private Equity in the Middle East and North Africa (MENA) Region

The Middle East and North Africa (MENA) region is defined in many ways, depending on the context. For the purpose of this research, we define it to include the following 17 countries: in the Gulf: Saudi Arabia, Kuwait, Bahrain, Qatar, United Arab Emirates, Oman and Yemen; in the Levant: Iraq, Syria, Lebanon, and Jordan; and in North Africa: Egypt, Sudan, Libya, Tunisia, Algeria and Morocco. This region has a 2008 population of 335 million; with the most

[9] 2008 risk premium expectations in all emerging markets were, on average, 6-7%, except for Eastern Europe, where it was 5%.

populous three countries being Egypt (83 million), Sudan (41 million) and Morocco (35 million). It has a total GDP (in PPP Dollars) of $2,495 billion in 2008, with the top three countries being Saudi Arabia ($583 billion), Egypt ($443 billion), and Algeria ($236 billion). In 2008, the region's oil production was more than 28% of the total global oil production, primarily concentrated in Saudi Arabia (9.2 million barrels/day representing 11% of the total global production), United Arab Emirates (2.95 million barrels/day), and Kuwait (2.6 million barrels/day) (World Fact Book 2009).

Despite the grouping as a region, MENA economies vary widely. For example, Saudi Arabia, Kuwait, Qatar, Abu Dhabi, Algeria and Libya are resource rich and highly dependent on oil and gas revenues. Egypt, Syria and Morocco have more diversified economies, with a mix of agriculture/agri-business, manufacturing and services. However, they are also indirectly dependant on oil prices through remittances of expatriate labor working in oil-exporting countries, regional tourism, and FDI investments from oil-exporting countries (World Bank 2009). Economic regimes also vary. Countries like Egypt, Jordan and Morocco have been through several rounds of economic liberalization and Structural Adjustment Programs (SAPs) in the 1990's and early 2000's, mostly driven by internal financial crises and World Bank pressures. GCC countries are primarily market economies; however, asset ownership and the ability to conduct business are mostly limited to nationals. The rest of the countries in the region are in varying earlier stages of economic and financial reforms.

Table 2.4 Private equity fund raising by region in emerging markets (Current US$ million)

Region	2007		2008	
	US$ millions	Percent	US$ millions	Percent
Emerging Asia[1]	28,668	48.5%	39,660	59.6%
Central Europe, Russia & CIS	14,629	24.7%	5,559	8.4%
Latin America & the Caribbean	4,419	7.5%	4,461	6.7%
Middle East	5,027	8.5%	5,898	8.9%
Africa[2]	2,340	4.0%	3,218	4.8%
Multi-region	4,077	6.9%	7,721	11.6%
TOTAL	59,160	100%	66,517	100%

Notes:
[1] Emerging Asia excludes Japan, Australia and New Zealand
[2] Africa includes North Africa

Sources: EMPEA 2009c

Despite the growth in private equity activities in the MENA region, there is still much room for growth. For example, private equity investments as a percentage of GDP is ~0.3% in the MENA region, compared to 3.2% in the United States and 0.8% in the European Union, and 0.5% in emerging markets in Asia[10] (EMPEA 2009a).

MENA private equity funds are defined as the funds that include MENA region countries within their geographical focus. These may include funds managed by local/regional private equity firms or by global private equity firms. Within the MENA region, funds vary in their geographic coverage. Our analysis show that

[10] Emerging Asia excludes Japan, Australia and New Zealand

30% of the funds are regional funds (35 funds managing more than $6 billion) focusing on the whole MENA region, or a subset of it such as the GCC countries or North Africa. Some of these regional funds may include other neighboring countries such as Turkey, Iran, Pakistan or Sub-Saharan Africa. 70% of the funds (82 funds managing more than $10 billion) are focused on specific countries within the MENA region. Among these country funds, the top three countries in terms of attracting private equity investments are Egypt, United Arab Emirates, and Saudi Arabia (Global Investment House 2008).

Table 2.5 Private Equity funds in the MENA region, by year of first closing[11]
(Current US$ million)

	Year of first closing						
	Prior	**2004**	**2005**	**2006**	**2007**	**N/A**	**Total**
Number of Funds	29	10	21	18	8	31	117
Total Committed Capital	1,745	1,242	5,192	2,997	2,112	3,033	16,321

Notes:
Data as of end of June 2008.
Year of first closing indicates the year during which the fund executed its first transaction
N/A indicates year of first closing not available

Sources: Compiled by the author from Zawya, MIT Emergis, and individual funds data

[11] Year of first closing indicates the year during which the fund executed its first transaction

However, MENA funds, as defined above, do not include funds managed by local/regional private equity firms that are focusing their investments entirely outside of the region (e.g., in the US, UK, or other regions). It is worth noting that a significant portion of the private equity investments managed by regional MENA private equity firms are directed towards developed markets, especially the United States and the United Kingdom. Zawya estimates that in 2007/2008, around 45% of the MENA region's private equity investments were directed towards the United States and United Kingdom (Global Investment House 2008).

2.4 Conclusions

In this chapter, we establish four key points regarding private equity in emerging markets and the MENA region. First, over the past five years, private equity fund raising in emerging markets has grown exponentially, both in absolute and relative terms. In 2002, all emerging markets private equity funds combined raised $3.2 billion, a mere 3.1% of the $102 billion raised by the private equity industry globally; in 2003 the figure was $3.5 billion, or 3.9% of the global industry. In 2008, emerging markets private equity fund raising reached a record $66.5 billion, growing 19 fold from 2003, despite the global financial crisis. This figure represented 15% of the $445 billion raised by the private equity industry globally (EMPEA 2009).

The second point is that most private equity funds in emerging markets are "generalists." Among the 204 funds with closes in 2007, 118 funds managing $39.1 billion, or 66.2% of the total capital raised, did not have a sectoral focus.

The remaining 69 funds managing $17.1 billion, or 28.9% of the total, were classified into 9 sectors, with technology, infrastructure and energy as the top three areas. This reflects the smaller size of emerging markets, where sector specialization is harder than in developed countries. The fact that most funds prefer to be diversified across multiple sectors may also suggest that the source of value-creation in emerging markets is not deep sectoral knowledge, but rather generic financial, management and turnaround skills that can be applied to any sector.

The third point relates to the emerging markets private equity returns. In terms of three-year returns, emerging markets private equity returns are higher than developed markets private equity; similar to emerging markets publicly-traded equities; and significantly higher than developed markets publicly-traded equities. While these returns show the high potential for emerging markets private equity investments, they also reflect the risk premium expected by investments in a higher risk asset.

The fourth point relates to private equity investments in the MENA region, which are still small, despite the high growth in fund raising. For example, as a percentage of GDP, private equity investments in the MENA region are ~0.3%, compared to 3.2% in the United States and 0.8% in the European Union, and 0.5% in emerging markets in Asia (EMPEA 2009a). Within the region, the top three countries in terms of attracting private equity investments are Egypt, the United Arab Emirates and Saudi Arabia.

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CHAPTER 3: PRIVATE EQUITY IN EGYPT: A GROWING INDUSTRY

In this chapter, we analyze the private equity industry in Egypt, in terms of its size, structure, importance and ownership. We start by providing an overview of the industry size, sources of funding, and number of transactions in Egypt. Then, we compare private equity investments in Egypt[12], in terms of size and nature, against four investment benchmarks: (i) Foreign Direct Investment; (ii) domestic bank lending; (iii) national investment plan; and (iv) stock market capitalization. While each of these four benchmarks differs in nature from private equity, the comparison shows the increasing importance of private equity activities, and highlights some of the differences between private equity and these benchmarks. Then we analyze the history and ownership of a number private equity firms operating in Egypt. We find that the industry is primarily "home grown."

3.1 Overview of the Private Equity Industry in Egypt

As of mid-2008[13], there were 13 private equity firms managing 36 private equity funds focusing primarily on Egypt, with more than $6.4 billion in committed capital[14] (Table 3.1). While eight of these funds (with a total committed capital of

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[12] In our analysis, we use the available figures on private equity fund raising, rather than actual investments, which may be realized over a longer period after the fund is initiated.
[13] Data downloaded and compiled in July 2008.
[14] Committed capital represents the amount of money that the fund investors commit to the fund at the start. These funds are invested over the first 2-3 years of the fund's life as the fund managers identify good target investments based on their investment strategies.

$420 million) started operating prior to 2004, the real boom in the private equity investments began in 2004/05. In addition to the funds that are focused exclusively on Egypt, there are 35 regional funds that target Egypt along with other countries in the region.[15] Capital committed to these regional funds that include Egypt in its investment targets over the same period was around $6.1 billion. Of these, Egypt's share may be estimated to be at around 50% or $3.0 billion, bringing the total estimated private equity committed capital invested in Egypt to around $9.4 billion, most of which has been invested over the past five years.

The activities of these funds translated into an increase in the number and size of individual transactions (buy/sell). In the five year period between 2003/2004 to 2007/2008, there were 78 recorded private equity transactions (Table 3.2). The transaction value was available for only 37 of these transactions, totaling $8.0 billion, with an average transaction size of $215 million. If the remaining 41 transactions where values are not available have a similar average size, this would indicate a total of ~$16.8 billion of private equity transactions over the past five years. Based on the fund and transaction calculations, we estimate private equity investments in Egypt over the past five years to be in the range of $9.4 to $16.8 billion, or $1.9 to $3.4 billion annually. Through the rest of our analysis, we use the average of these two figures: $13.1 billion for the five-year period, and $2.6 billion annually. This figure corresponds to 1.6% of Egypt's 2008 nominal GDP of $158.3 billion (World Fact Book 2009) – a level of private equity investments that is significantly higher than the regional average and other

[15] There are an additional 46 funds with more than $3.8 billion that focus on other countries in the region, but do not cover Egypt.

emerging markets. For example, private equity investments as a percentage of GDP are ~0.3% in the MENA region, compared to 3.2% in the US and 0.8% in the European Union, and 0.5% in emerging markets in Asia (EMPEA 2009a).

Table 3.1 Private equity funds in Egypt and the MENA region (Current US$ million)

Fund Geographic Focus	Year of first closing						
	Prior	2004	2005	2006	2007	N/A	Total
Egypt Funds:							
Number of Funds	8	4	7	5	7	5	36
Fund Size/ Committed Capital ($M)	420	533	2,097	314	2,102	933	6,399
MENA Funds, covering Egypt:							
Number of Funds	9	5	6	5		10	35
Fund Size/ Committed Capital ($M)	1,088	544	1,912	1,410		1,170	6,124
MENA Funds, not covering Egypt							
Number of Funds	12	1	8	8	1	16	46
Fund Size/ Committed Capital ($M)	237	165	1,183	1,273	10	930	3,798
TOTAL MENA Region							
Number of Funds	29	10	21	18	8	31	117
Fund Size/ Committed Capital ($M)	1,745	1,242	5,192	2,997	2,112	3,033	16,321

Notes:
N/A indicates year of first closing not available

Sources: Compiled by the author from Zawya, MIT's Emerging Markets Portal (Emergis), and individual funds data; as of July 2008

Table 3.2 Private equity transactions in Egypt (2003-2008)
(Current US$ million)

Year	2003	2004	2005	2006	2007	2008	Total
Number of transactions	3	7	17	21	16	14	78
Total value of transactions	17.5	13.7	484.3	1,299.9	3,396.0	2,754.7	7,966.1
Average transaction value	9	7	81	100	340	689	215

Notes:
Based on completed private equity transactions in Egypt during the five-year period from mid-2003 to mid-2008
2003 figures are for the second half of the year; 2008 figures are for the first half of the year
Average transaction value is based on 37 transactions with available values

Sources: The author, based on data from MIT Emergis and Zawya

3.2 How Big Is Private Equity in Egypt?

We estimate private equity investments in Egypt over the past five years to be $2.6 billion annually on average, or 1.6% of Egypt's 2008 nominal GDP of $158.3 Billion (World Fact Book 2009). While this level of private equity investments is significantly higher than the region and other emerging markets, it is important to put it in perspective by comparing it with other benchmarks, such as foreign direct investments, national investment plan, domestic bank lending and stock market capitalization. In this section, we compare private equity figures to these benchmarks.

3.2.1 *Private Equity and Foreign Direct Investments (FDI)*

Foreign Direct Investment (FDI) is considered an indicator for economic growth and a catalyst for industrial development (Markusen and Venables 1999). FDI is important in three ways. First, foreign firms providing direct investments complement domestic savings in increasing the investments. This in turn translates into higher growth rates, capital formation and hence increased productivity and/or employment. Second, FDI is often credited with positive externalities in areas of technology transfer and labor/management training. Third, FDI growth is now considered a positive market signal for the potential of an emerging economy (Markusen and Venables 1999).

In the five year period between 2003/4 and 2007/8, FDI inflows to Egypt grew significantly, from an average of 0.5 billion annually during the period between 2000 and 2004, to $13.2 billion in 2007/2008 (Table 3.3). This trend may be attributed to two key factors: first, the increase in global and regional liquidity, especially from oil revenues; and second, major policy reforms implemented by the Egyptian government to liberalize the economy and attract foreign direct investments (World Bank 2009).

Table 3.3 Net FDI inflows to Egypt (FY2000/01 - FY2007/08)
(Current US$ million)

	Fiscal Year								
	Previous 10 Years Average	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Net FDI inflows	1,038.7	509.4	428.2	700.6	407.2	3,901.8	6,111.4	11,053.2	13,200.0
As a percent of GDP	1.7%	0.6%	0.5%	0.9%	0.5%	4.4%	5.7%	8.5%	8.1%

Notes:
Figures include foreign direct investments in petroleum sector as from FY 2004/2005.

Sources: Central Bank of Egypt - Balance of Payment time series; Ministry of Investment

Over the same period (2003/04 - 2007/08), private equity investments in Egypt grew at a similar rate to foreign direct investments. Prior to 2003/4 private equity investments in Egypt were less than $50 million annually. During the five year period of 2003/4 – 2007/8, private equity investments are estimated to have been at $13.1 billion. This amounts to 37.8% of the $34.7 billion total FDI inflows during the same period. It is important to note that FDI and private equity figures are not necessarily mutually exclusive. Depending on the sources of the fund and the structure of the transaction, some private equity funds may also be included as foreign direct investments, especially in the case of offshore funds. It is also important to highlight that private equity funds are often leveraged, using loans from banks or other financial institutions. This helps increase their impact in terms of total value of assets under management.

How do foreign direct investments compare to private equity in terms of (i) the source of the funds; (ii) the destination of the investments in terms of sectors and industries; and (iii) spillover effects and externalities? In terms of the **sources of funds**, foreign direct investments are direct transfers from multinational corporations with the purpose of building domestic subsidiaries, sometimes through acquisitions (Moran 1998, Chung 2001, Blomstrom and Kokko 2003). These investments are often for the medium or long term. In the case of private equity, the funds are either from domestic or foreign investors (breakdown data not available), and often with a medium-term view.

In terms of the **destinations of investments**, in 2007/08, foreign direct investments were primarily focused in three areas (Table 3.4): 54% were in creating new establishments and expanding existing ones; 35% were in investments in the oil and gas sector; 19% were in sale of assets to non-residents; while investments in real estate were less than 0.2%.

In terms of **spillovers and externalities**, FDI is often credited with transferring technology and management practices to their domestic subsidiary as well as to the whole industry including competition. These positive externalities were used as an argument for providing government incentives to attract FDI (Moran 1998, Chung 2001, Blomstrom and Kokko 2003, Louis, El-Mahdy and Handoussa 2004). In the case of private equity, the investors are not a multinational corporation with industry-specific knowledge, but rather are financial investors. However, the role of private equity firms in professionalizing management and business practices may result in other types of positive externalities.

Table 3.4 Sectoral distribution of net FDI inflows in Egypt (Current $ million)

	Fiscal Year					
Sector	**2004/05**	**2005/06**	**2006/07**	**2007/08**	**Total**	**Percent**
New establishments & expansions	925.6	3,347.8	5,227.2	6,400.0	15,900.6	46.4%
Petroleum sector	2,540.2	1,832.2	3,014.8	4,100.0	11,487.2	33.6%
Sale of assets to non-residents	390.8	905.7	2,772.2	2,300.0	6,368.7	18.6%
Real estate	16.5	25.7	39.0	400.0	481.2	1.4%
Net FDI inflows	**3,873.1**	**6,111.4**	**11,053.2**	**13,200.0**	**34,237.7**	**100%**

Sources: Central Bank of Egypt; Ministry of Investment

3.2.2 *Private Equity and the National Investment Plan*

Despite its transition to a market economy, Egypt maintained the legacy of creating five-year plans for national investments. These plans are produced by the Ministry of Economic Development (formerly, the Ministry of Planning), and describe the required investments by industry to reach the target levels of economic growth. Starting in 1990, with the implementation of the Structural Adjustment Program, the government started to break down the plan's target investments among the different sectors: government, economic authorities, state-owned companies (SOEs) and private companies. Since then, a growing portion of these investments have been carried out by the private sector (62% in 2006/07 compared to 48% in 2002/03). The latest five-year plan for 2002/03-2006/07 (Table 3.5) shows total required investments of $88.9 billion over the five year period.

Table 3.5 National investments broken down by source of investments (FY2002/03 - FY2006/07)

(Current US$ million)

	Fiscal Year					
Source of Investments	**2002/03**	**2003/04**	**2004/05**	**2005/06**	**2006/07**	**Total**
Government Sector	4,260	3,711	3,881	3,697	4,369	19,918
Economic Authorities	1,770	1,261	1,165	1,684	1,091	6,970
State-owned Companies	854	1,923	2,851	3,232	4,634	13,494
Private Sector	6,391	6,024	8,187	11,561	16,384	48,548
Total Investments	**13,275**	**12,918**	**16,084**	**20,175**	**26,478**	**88,930**

Sources: Central Bank of Egypt; converted from Egyptian Pound (LE) to US Dollars using annual official conversion rate (calculated from IMF GDP data)

During this period, private equity investments accounted for 14.8% of the total investment target, and 27% of private sector investments[16]. It is important to note that only a limited portion of private equity investments is directed towards new establishments.

[16] Comparison years do not match exactly. For private equity, we use figures from 2003/04 to 2007/08; and for investments, we use figures from 2002/03 to 2006/07. There is a one year mismatch. However, we do not expect this to significantly change the percent of contribution of private equity towards the investment plan.

3.2.3 Private Equity and Domestic Bank Lending

One of the key roles of banks is mobilizing domestic savings into investments in new and existing companies by extending credit to these companies. However, in many emerging markets banks are often unable to provide credit and financing to the majority of companies due to restrictions in the credit process and other issues. For example, in Egypt, only 21% of Egyptian companies are able to secure long term bank credit.

Table 3.6 shows that in 2007, banks in Egypt had a total of $171 billion in total assets and $118 billion in total deposits. They only extended $64 billion in loans (38% of total assets, and 54% of total deposits). A smaller portion of these loans ($43 billion) were extended to private businesses (excluding consumers, government, and public sector). This accounts for only 26% of their total assets and 37% of their total deposits. These figures have been declining over the past six years, indicating that banks are having increasing problems in extending credit to private sector companies. For example, total loans to the domestic private sector as a percent of the total bank assets declined from 39% in 2001 to 26% in 2007 – a 13 percentage points decline. In contrast, private equity investments over the past five years represent ~6.8%[17] of the bank loans extended to private sector companies in Egypt, which highlights the increasing role of private equity firms as an alternate channel for providing financing for new and growing companies.

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[17] Calculated based on $194 billion (LE 1,066 billion) in total loans extended to domestic private sector during the five years period between 2003 and 2007 and $13.1 billion in estimated private equity in Egypt over the same period.

Table 3.6 Bank loans, based on aggregate balance sheet for all Egyptian banks (Current LE Billion)

Fiscal Year, End of June	Previous 10 Years Average	2001	2002	2003	2004	2005	2006	2007
Total Assets = Total Liabilities	260	428	495	578	633	704	762	938
Total Deposits (liability)	172	291	341	403	462	520	569	650
Loans and Discounts (asset)	126	241	266	285	296	308	324	354
Total Loans / Total Assets	46%	56%	54%	49%	47%	44%	43%	38%
Total Loans / Total Deposits	70%	83%	78%	71%	64%	59%	57%	54%
Total Loans to Domestic Private Sector	71	165	185	200	206	206	215	239
Total Loans to Domestic Private Sector / Total Assets	25%	39%	37%	35%	32%	29%	28%	26%

Notes:
Total loans to domestic private sector excludes government, public sector, household sector and foreign sector

As of 7/6/2009, 1 Egyptian pound was equal to 0.18 U.S. Dollars. The Egyptian Pound was devalued in 2001/2003 by about 35%. In 2000, 1 Egyptian Pound was equal to 0.29 U.S. Dollars (Wikipedia 2009).

Sources: Central Bank of Egypt; Banks Aggregate Balance Sheet

3.2.4 *Private Equity and Stock Market Capitalization*

As of the end of June 2008, the Egyptian Stock Exchange had 372 listed companies and a market capitalization of $152 billion (World Federation of Exchanges (WFE) 2008). This market capitalization represents 96% of Egypt's 2008 nominal GDP of $158.3 Billion[18], which is a high figure compared to most developing countries. However, in an interview with one of the private equity firms, they indicated that the actual number of highly liquid investment grade companies is around 30. These companies represent most of the market capitalization and most of the trading activities. The rest of the 372 listed companies are not very active. Over the past few years, The Egyptian Capital Market Authority (CMA) delisted a number of these stocks that have limited liquidity or trading (Beltone interview).

In comparison, cumulative private equity investments over the past five years represent approximately 8.6% of the Egyptian Stock Exchange total market capitalization. On an annual basis, private equity investments in Egypt represent 1.7% of the total market capitalization, compared to 0.85% globally[19] (including all developed and developing countries). This figure confirms the high level of private equity activity in Egypt, both in absolute and relative terms.

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[18] In October 2008, the Egyptian Stock Exchange market capitalization declined to $85.3 billion, a 44% decline. However, this decline was consistent with other stock markets in developed and developing countries due to the global financial crisis. Later in 2009 the Egyptian Stock Exchange market capitalization recovered partially.

[19] Calculated based the following 2008 figures: global private equity fund raising of $445 billion (EMPEA 2009); and global market capitalization for domestic equity markets of $52,827 billion (WFE 2008).

3.4 The Home-Grown Private Equity Industry

Lerner and Leamon (2008) argue that the rapid growth in emerging markets private equity "[has] been fueled both by institutional investors based in developed nations, particularly the United States but also Canada and the United Kingdom, and by private equity firms." They argue that this is primarily driven by diminishing opportunities for these funds in many developed nations, and the growing and more visible potential in emerging markets. While it may be true that US- and European-based private equity firms are becoming increasingly interested in emerging markets, our analysis shows that, in Egypt, there is a rapidly growing home-grown private equity industry that is dominant. Future research is needed to confirm that the case of Egypt is not an anomaly; however, we expect the same story to exist in other emerging markets that have historically had a period of active financial markets, a strong domestic banking sector, and several attempts at economic reform, such as Brazil, Argentina, Turkey, South Africa or Malaysia.

It is important to highlight that while the private equity firms may be home-grown, the funds come from diverse sources. Interviews with private equity managers show that their sources of funding include domestic, GCC, and international sources. Institutional investors and high-net worth individuals (HNWI)[20] from Egypt and Arab Gulf countries constitute the most significant source of funding. In Chapter 4 we review the sources of funding in detail.

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[20] High net-worth individuals (HNWI) is "a classification used by the financial services industry to denote an individual or a family with high net worth. Although there is no precise definition of how rich somebody must be to fit into this category, high net worth is generally quoted in terms of liquid assets over a certain figure (e.g., $1 million); the exact amount differs by financial institution and region. These individuals often demand (and can justify) personalized services in investment management, estate planning, and tax planning." (Investopedia 2009)

In this section, we examine the hypothesis that the private equity industry in Egypt is primarily a home-grown industry. Private equity firms have adapted to the local business environment by assembling a mix of competencies that enables their success in a developing country context.

3.4.1 *Key Actors: Private Equity Firms and Their Founders*

Table 3.7 lists private equity firms with funds focusing on Egypt, or with major transactions in Egypt. The majority of these firms are home-grown, in the sense that they were created by Egyptian professionals, are incorporated in Egypt, or have significant investments in Egypt. In the remainder of this section we review some of these firms and their founders with two goals in mind: first, to establish a fact base on the key actors in the industry; and second, to test the hypothesis that the private equity industry in Egypt is a "home-grown" industry.

Table 3.7 Ownership of private equity firms with major transactions in Egypt (Current US$ million)

Private Equity Firm	Start Date in Egypt	Total Funds Under Management	Primary Ownership/ Nationality
El-Mansour and El-Maghraby Investment and Development (MMID)	1996	~1,100	Egypt
Capital Trust Group	1996	~250-300	International/ Arab
EFG-Hermes Private Equity	1997	~1,000	Egypt
IT Investment	1999	~110	Egypt
Concord International Investments Group	2000	154	Egypt
Actis	2001	3,000 (globally)	United Kingdom
Amwal Al-Khaleej	2002	1,000	Saudi Arabia
Injazat Capital	2003	5	United Arab Emirates
Citadel Capital	2004	2,465	Egypt
Technology Development Fund	2004	350	Egypt (Government-backed)
Sphinx Capital/ Grandview	2005	180	Egypt
Haykala Investment Managers	2005	60	Egypt
Shuaa Partners	2005	465	United Arab Emirates (Dubai)
Ripplewood Holdings	2006	230	United States
Beltone Financial	2007	~160	Egypt
Carlyle Group	2007	750 - 1,000 (target)	International

Sources: The author, based on private equity firms' websites and survey of private equity firms in Egypt

The first of these firms is El-Mansour and El-Maghraby Investment & Development (MMID). MMID was established in 1996 by two family conglomerates in Egypt and Saudi Arabia to act as their private equity investment arm[21]. MMID has executed a number of private equity transactions in Egypt, especially in the banking and insurance sectors (Mansour 2009).

The Egyptian Financial Group (EFG) was established in 1984 as the first local investment banking firm in Egypt. In its early years, EFG was the key player in creating, analyzing and managing the privatization program for the Government of Egypt. In 1996, it merged with Hermes Financial, which had more regional and international experience, to create EFG-Hermes. The company has grown to be the largest investment bank in the Middle East with a strong regional footprint, including Dubai, Saudi Arabia and Egypt. Besides private equity, the firm provides securities brokerage, asset management, investment banking, and research. EFG-Hermes is listed on the Egyptian and London Stock exchanges and as of June 2008 had a market capitalization exceeding US$ 3.5 billion. Currently, EFG-Hermes employs over 880 professionals in 13 regional offices. In 2007, their net profit was $160 million. EFG-Hermes' private equity investments started in 1997 with their first fund: Horus I. Since then, they have launched three other private equity funds at different stages of investing. In July 2006, the Dubai-based private equity firm Abraaj Capital bought a 24.62% stake in EFG-Hermes for $505 million, with the objective of expanding the firm's reach in the Gulf region. In December 2007, Abraaj Capital sold their stake to the Dubai Financial Group (DFG), a Dubai-based diversified financial investment company focusing

[21] MMID structure, investors, and portfolio companies are discussed in detail in Chapters 4 and 5.

on banking, investments and insurance regionally and globally, for $1.1 billion. This transaction values EFG-Hermes at $4.47 billion (EFG-Hermes 2009).

IT Investments[22] is a private equity and venture capital firm incorporated in Egypt and established in 1999. The firm was initiated by an MIT alumnus and one of the IT industry veterans in Egypt, Dr. Hisham El-Sherif. During the 1990's, El-Sherif was one of the leaders in the government who worked on creating the infrastructure for Egypt's IT and telecommunications industry. IT Investments is focused on investing in low to medium risk, early stage, startup and turn around companies in the telecommunications, information technology and high-tech industries. The firm's private equity and venture capital fund closed in 1999 with a subscribed capital of $110 million, primarily from Egyptian and regional institutional investors and high-net-worth individuals. The firm currently has investments in 14 portfolio companies at different stages of development.

Concord Investments International Group[23] was founded in 1988 as a US-based SEC-registered investment management company, focusing on portfolio management, investment strategy, corporate finance and strategic planning. The group is based in New York, with offices in Cairo and Tokyo. Concord manages investment portfolios and mutual funds of $2.3 billion worldwide, of which $1.2 billion are currently invested in Egyptian equities. Concord has executed and exited a number of successful private equity transactions in Egypt. Concord Group was founded by Mohamed Younis, one of the financial industry veterans.

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[22] IT Investments structure, investors, and portfolio companies are discussed in detail in Chapters 5 and 6.

[23] Concord Group structure, investors, and portfolio companies are discussed in detail in Chapters 5 and 6.

Younis graduated from Cairo University and later received his MBA from Harvard Business School. He worked in New York in the financial industry for more than 40 years, including 20 years as the founder and Chairman of the Concord Group. He is currently the Chairman of the international advisory board of the Egyptian Stock Exchange, and sits on a number of boards in Egypt and the United States.

Citadel Capital[24] is the largest private equity firm in Egypt and one of the largest in the region in terms of assets under management. The firm was established in 2004 by two veterans of the financial services industry in Egypt, and has since grown exponentially through the execution of some of the largest and most successful private equity transactions in Egypt and the region. Citadel Capital is solely focused on private equity investments, and currently[25] has around $2.5 billion in committed equity under management, invested in 19 "opportunity-specific Platform Companies with investments of more than $8.3 billion in 14 industries, including energy, mining, agri-foods, cement, transportation and retail" (Citadel Capital 2008, 2009). Since it began operations in 2004, Citadel Capital has raised and invested more than US$ 4.1 billion in equity, including over $750 million of its own capital. During the same period, the firm has generated more than $ 2.2 billion in cash proceeds from five successful exits, more than any other private equity firm in the region (Citadel Capital 2009). Citadel Capital was founded by two industry veterans with previous experience in investment banking and private equity in Egypt: Ahmed Heikal and Hisham El-Khazindar. Prior to founding the firm, Heikal was an executive board member

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[24] Citadel Capital structure, investors, and portfolio companies are discussed in detail in Chapters 5 and 6.
[25] As of mid-2008.

and Managing Director of EFG-Hermes Holding, where he has executed private equity, mergers and acquisitions, and initial public offering transactions. Heikal holds a Masters degree and a PhD in Industrial Engineering and Engineering Management from Stanford University. Prior to co-founding Citadel Capital, El-Khazindar, who holds an MBA from Harvard Business School, was an Executive Director of Investment Banking at EFG-Hermes (Citadel Capital 2009).

Sphinx Capital is a specialized private equity firm established in 2005, and owned by Citadel Capital and its own management. The firm manages Grandview Investments, a $103 million private equity fund focused on investing in mid-cap companies with an enterprise value of less than $25 million in Egypt and the region. Sphinx Capital was founded by Marianne Ghali, an experienced industry veteran who has executed a number of successful private equity transactions in Egypt and has also managed university endowment funds.

Haykala Investment Managers,[26] an Egyptian private equity firm, was founded in 2005 by the Commercial International Bank (CIB) and three members of Haykala's management team. Haykala started when the fund managers were working at CIB, where they conducted several turnaround transactions and then decided to spinoff the operation into a separate fund with participation from the bank, as well as other investors. CIB is the largest shareholder in the private equity firm, with a 40% stake; the remaining 60% is owned by high-net-worth individuals, institutional investors and the Haykala management team.

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[26] Haykala Investment Managers structure, investors, and portfolio companies are discussed in detail in Chapters 5 and 6.

Haykala's founders, Hisham Abdel-Fattah, Ahmed Amin, and Mohamed Khairat, have substantial experience in private equity, banking, and corporate finance. Prior to co-founding Haykala, Abdel-Fattah worked in CIB for more than 25 years, focusing on risk management, investment banking and turnarounds. He participated in more than 20 turnaround transactions in the food and beverages, construction and textiles industry. Amin had 16 years of experience at CIB, focusing on corporate and investment banking, restructuring and turnarounds. He also executed three major initial public offerings and advised on a major acquisition transaction. Khairat has 15 years of experience at CIB, focusing on corporate banking, investment banking, restructuring and private equity. He advised on large privatization transactions with the government. Khairat holds a Masters of Finance degree from London Business School (Haykala 2009, CIB 2009).

Beltone Financial was established in 2002 and provides asset management, investment banking, private equity, brokerage, and research services in the Middle East and North Africa region (MENA). It is headquartered in Cairo with more than 200 investment professionals in nine offices in the Middle East, London and New York. Beltone Capital is one of the fastest growing financial services firms in the region. For example, its asset management group has more than $4 billion in assets under management; its investment banking group has executed more than $4.9 billion in transactions; and its private equity group has raised more than $430 million in capital. Beltone research covers 52 companies across the region. The firm's co-founders, Aladdin Saba and Aly El-Tahry, had significant experience on Wall Street, where they both worked as investment bankers. In 1991, they moved to Cairo to establish a regional office for their US

firm, focusing on corporate finance and privatization. El-Tahry and Sabaa later co-founded Hermes Financial, which grew to become one of Egypt's top financial institutions. In 1996, Hermes merged with the Egyptian Financial Group (EFG) to form one of the region's largest financial institutions. At EFG-Hermes, El-Tahry managed the corporate finance and sales and trading divisions until he left in 1999; and Saba managed the asset management division, which he built from scratch to become the largest asset management operation in Egypt, with assets under management in excess of $500 million. In 2002, he left EFG-Hermes to rejoin El-Tahri in founding Beltone Financial. El-Tahry received an MBA degree from Purdue University in 1987, and has two degrees in physics and mechanical engineering. Saba holds an MBA from Wharton and a Masters degree in Biomedical Engineering. Saba also serves on the board of directors of the Central Bank of Egypt (Beltone 2009).

In addition to these local firms, a number of international players operate in Egypt; however, most of them operate through local offices that are staffed with experienced local staff. For example, Actis, a United Kingdom-based international private equity firm operating in emerging markets, initiated its operations in Egypt through expatriate staff. However, they quickly decided to change all of their local management team to nationals. "Previously they were all foreigners, and they probably saw more risks than they saw opportunities; in 2005/06, the team has been restructured, and now, it includes mainly local employees" (ACTIS interview). Similarly, The Carlyle Group, one of the largest United States-based private equity firms, started its presence in Egypt through a local office staffed by local professionals. They also established similar local offices in Beirut, Istanbul and Dubai as part of their broader Middle East regional strategy (Carlyle interview).

Through our review of private equity transactions executed in Egypt over the past decade, we found that the majority of these transactions were executed by local firms or regional/ international firms with a strong local presence. There were some exceptions in specific situations; for example, in secondary buyouts, where a local private equity firm sold to a regional one, such as the sale of the Egyptian Fertilizers Company by Citadel Capital to the Dubai-based Abraaj Capital. Another example is in the case of specialty transactions such as the case of SEKEM, an environmentally and socially focused bio-agriculture and bio-pharma company, which sought investments from a specialized European "green fund."

3.4.2 Key Competencies

Through our review of the individual founders and managers of these private equity firms, we found a mix of ***five key competencies or capabilities*** that existed in most of these firms, namely: access to capital, access to deals, deal structuring knowhow, business transformation and turnaround knowhow, and political access. We hypothesize that these five competencies or capabilities are necessary for the success of these firms, especially in emerging markets. These competencies also support the different stages of the private equity cycle, as discussed in detail in Chapter 4.

The first competency is *access to capital*. The majority of these private equity firms are financed through institutional investors, high-net-worth individuals and family offices from Egypt and the Gulf region. Most of these firms rely on the personal and professional networks of their founders to gain such access. Access

to debt through the local banking system is also critical for leveraged buyouts. The second competency is *access to deals*. A large number of private equity transactions in Egypt are in family businesses and other proprietary opportunities that are only accessible through the founders' personal and professional networks. The third competency is *deal structuring knowhow*. Structuring the private equity transaction requires deep financial, legal and organizational knowledge and experience, typically acquired through training at global investment banks. The fourth competency is *business transformation and turnaround knowhow*. In many transactions, the private equity firm implements a business transformation or turnaround program for their portfolio companies. A number of private equity professionals have acquired this experience through careers in management consulting, corporate restructuring or banking. The fifth competency is *political access*. Political access is used to create opportunities or to reduce exposure to political risks. Political access has been used to create opportunities in cases such as privatization, gaining privileged information, obtaining licenses, acquiring land allocations, or avoiding regulatory pressures. Political risks represent a major risk factor in emerging markets such as Egypt. They may emerge due to many factors such as changing government policies or regulations, limited protections for property rights, or the lengthy and cumbersome litigation process. Many private equity firms have or seek political access in different ways.

These five competencies were present, in varying levels, in most of the private equity firms reviewed. In Chapter 4, we review many of these competencies as we analyze the private equity investment cycle in depth. However, further research is needed to examine these capabilities in detail, and to assess how they

may provide private equity firms in emerging markets with competitive advantage.

One of the possible explanations for the growth of the "home-grown" financial services industry – private equity being one example – is the growing availability of experienced professionals. A number of the founders of these firms had successful careers in global institutions, and then moved to start entrepreneurial firms in their home country. Others had careers in local or regional institutions which gave them deep knowledge of the local market characteristics.

3.5 Conclusions

In this chapter, we establish two key points. The first point is that private equity investments in Egypt are notably high compared to other emerging markets and the region. We estimate private equity investments in Egypt over the past five years to be $2.6 billion annually on average, or 1.6% of Egypt's 2008 nominal GDP of $158.3 Billion (World Fact Book 2009). To understand the importance of these investments, we compare them to a number of benchmarks. Based on the average of the past five years, private equity investments in Egypt represent around 37.8% of the total FDI inflows; 27% of the target private sector investments in the national investment plan; and 6.8% of the bank credit extended to private sector companies. They also represent 1.7% of the Egyptian Stock Exchange market capitalization, compared to 0.85% globally in 2008, including all developed and developing countries. These benchmarks show the high level of private equity investments in Egypt, both in absolute and relative terms.

These high levels also raise two questions. First, why are private equity investments in Egypt higher than the rest of the region as well as other emerging markets? The second question is whether these higher figures make Egypt an anomaly, and limit the scope of our findings to this case. These two questions require more comparative analysis, which needs to be done in future research. However, it is likely that the findings from this case study would provide good hypotheses to test in other countries.

The second point in this chapter is that the majority of private equity activities in Egypt are performed by "home-grown" private equity firms. Over the past 5-10 years, a number of local private equity firms emerged and quickly expanded. They were mostly founded by experienced professionals, and have managed to create a competitive advantage for themselves, both domestically and regionally. These firms played the primary role in growing the industry over the past five years and are now aggressively expanding regionally. One hypothesis that needs to be tested in future research is whether the presence of these home-grown firms is responsible for the high level of private equity activities compared to other countries. Through our analysis of these firms, we also hypothesize about five key competencies that contribute to their competitive advantage, namely: access to capital, access to deals, deal structuring knowhow, business transformation and turnaround knowhow, and political access. These five competencies were present at varying levels in most of the private equity firms that we examined. In Chapter 4, we review many of these competencies as we analyze the private equity investment cycle in depth. However, further research is needed to examine these capabilities in detail, and to assess how they may provide private equity firms in emerging markets with competitive advantage.

CHAPTER 4: THE PRIVATE EQUITY CYCLE

The private equity business model in developed countries, especially in the United States and the United Kingdom, is well established and documented (e.g., Fenn, Liang and Prowse 1995, Wright and Robbie 1998, Gomper and Lerner 2004, Fischbein 2005). However, in emerging markets, private equity firms, especially the home-grown ones, are learning and experimenting with different ways of doing business to adapt to the realities of operating in developing countries and to accommodate local market requirements in their respective countries and regions (Lerner and Leamon 2008, Gurung and Lerner 2008). Some of these differences are institutional, such as the legal systems, investor protections, and contract enforcements; some have to do with the functioning of the market, such as information asymmetry; and some have to do with the macroeconomic environment, such as the fiscal policies, rate of economic growth, and government incentives. In this chapter, we compare the private equity business model between developed and developing countries to understand how private equity firms are adapting to the local needs and conditions of developing countries. To be able to compare the private equity business model in developing countries against their more mature counterparts in developed countries, we trace the end-to-end private equity cycle. Our overarching hypothesis is that while the private equity model is transferable and useful in emerging markets, private equity firms adapt to the local peculiarities of doing business in such emerging markets.

4.1 Private Equity Business Model in Developed Countries

Private equity firms provide professionally managed investment vehicles for equity investing in unregistered securities of private and publicly-traded companies (Fenn, Liang and Prowse 1995). Private equity firms are often created and managed by a small number of professional investment staff, often with investment banking or management consulting backgrounds. They typically organize their operations around funds, each with a specific **investment strategy**. An investment strategy may focus on a specific industry (e.g., telecom, manufacturing), stage of investment (e.g., venture capital, mature companies), situation (e.g., distressed company turnaround, mergers and consolidations), or geographic location (e.g., Asia, Latin America, or the Middle East and North Africa). Some firms also operate on a deal-by-deal basis rather than organizing around funds.

The typical private equity **process** or cycle takes place in four stages (Table 4.1). The first stage includes the fund initiation and setup. During this stage, the private equity firm identifies a specific investment opportunity; designs the fund strategy, which includes the countries, industries, and types of investments that the fund will focus on, as well as the targeted size for fund raising; and names the fund management team. Once the setup is completed, the private equity firm initiates fund raising, which may target individual or institutional investors. Once the fund is established and funded, the investing process starts. The fund management initiates their search for potential acquisition targets and manages the "pipeline" of incoming opportunities. Potential opportunities are analyzed against the fund strategy and based on negotiations with their owners. Detailed due diligence is conducted for companies that are identified as good matches

with the fund strategy and have a potential for increasing value over the short/medium term and generating acceptable return. The due diligence process spans across a number of areas, including financial, accounting, legal, physical assets, operations, intellectual property, management team, and risk. The private equity firm negotiates the terms of the transactions and the price with the seller. As the private equity firm assembles a portfolio of investments, it transitions to the third stage: portfolio management. This stage often lasts for 3-7 years, during which the private equity firm manages the acquired companies to increase their value, based on their business plan. The fourth and last stage is the exit, where the private equity firm looks for different options to liquidate its investment, either through the stock market through an initial public offering (IPO), to another company through a trade sale, or, sometimes, to another private equity firm or investor group through a secondary buyout (Fenn, Liang and Prowse 1995, Fischbein 2005, Lerner and Leamon 2008).

Table 4.1 Key stages and activities in the private equity investment cycle

Key Stages and Activities		
1. Fund Initiation & Setup	1.1	Setting up the fund structure
	1.2	Raising capital
2. Investing	2.1	Investment Strategy
	2.2	Deal sourcing and due diligence
	2.3	Structuring the transaction and pricing
3. Portfolio Management	3.1	Implementing value-creation strategy
	3.2	Governance & monitoring
4. Exit	4.1	Exiting the investment

Sources: The author, adapted from Wright and Robbie (1998), Gomper and Lerner (2004), and Lerner and Leamon (2008)

The distribution of funds within the MENA region among these different stages of the private equity cycle shows that the industry is still in its early stages. As of mid 2008 (based on data from Zawya Private Equity Monitor covering 2006 through mid 2008), 24% of the funds were still in the setup stage (either formally announced or rumored) and 30% of the funds were in the fund raising stage – a total of 54% of the funds in stage 1. Additionally, 45% of the funds were in stages 2 and 3, actively investing and managing their portfolio of investments. Only 1% of the funds are in stage 4, engaging in exit or liquidation of their investments[27] (Global Investment House 2008).

[27] This 1% estimate of funds in the exit stage is probably an underestimation. In Egypt alone, there were several funds in the process of divesting their investments. It is likely that the Global Investment House estimates are mostly focused on funds in the GCC countries, and may have omitted other funds in the broader MENA region.

Private equity firms use different strategies to **increase the value of their acquisitions**. In financially distressed companies, they employ financial engineering tools to restructure the company's balance sheet. In badly managed companies, they change the management team and improve reporting and accountability. In startup firms (venture capital), they provide seed capital, hire experienced management teams, help provide direction and strategy for the new firm, and open the doors for business partnerships and opportunities. We discuss these value creation strategies in depth in the next chapter.

4.2 Research Approach

Initial observation from interviews with private equity firms in Egypt show that the overall framework and process for conducting private equity activities are similar to those used in developed countries; however, the differences occur in the specific details and execution of each step. These variations include, for example, the mix of sources of capital; incorporation and legal domicile; types and demographics of investments; governance models; and exit strategies.

In this section, we identify and examine these differences in detail by performing a *process tracing* of the end-to-end activities in the private equity cycle (Table 4.1). For each activity in the private equity cycle, we go through the following set of questions. First, what are the typical practices in developed countries? How do private equity funds operate there? Second, based on economic theory and also based on our understanding of the situation in Egypt and developing countries in general, we hypothesize on what we would expect the practices to be in Egypt. Then, we compare our hypothesis with empirical evidence from interviews with

private equity fund executives, our data on private equity funds and transactions, and other publicly available data sources. We also examine alternative explanations, as well as the strength and validity of the empirical evidence. We conclude by discussing the implications of these findings with respect to the private equity industry, as well as their overall impact on the economy and any arising public policy issues. The limitation of this methodology is that there may not be enough empirical evidence or data points to make theoretical assertions or generalizations. However, this will provide the most insights based on the available data, and may clarify a hypothesis that can be tested empirically in future research.

Throughout this chapter, we draw data from a number of sources: our interviews with private equity fund managers in Egypt; confidential information provided by these fund managers; public information from their company websites and other financial reporting sources; annual reports; and other documents.

4.3 Stage 1: Fund Initiation and Setup

The two key steps in the first stage of initiating and setting up the private equity fund are setting up the fund's legal and governance structure and fundraising.

4.3.1 Setting up the Fund Structure

Setting up the legal and governance structure for a private equity fund is an important initial step. From a theoretical point of view, there are two key issues discussed in the literature involving private equity fund setup. The first issue is agency: what is the fund structure that best provides adequate protections for the

investors, while providing performance incentives for fund managers acting on behalf of the investors, along with sufficient decision making autonomy. The second issue is adaptation: how and why this structure varies across different countries, and what the implications of such variations may be.

Private equity funds in the United States and other developed markets are typically set up as limited partnerships, with the financial investors as the limited partners (LP) and the fund manager, be it a private equity firm or an individual fund manager, as the general partner (GP). Limited partners provide most of the invested capital, but do not play an active role in the fund management or decision making process. General partners are responsible for the management of the fund, including identifying and selecting potential investments, conducting due diligence, structuring and executing transactions, managing and monitoring portfolio companies, and eventually, exiting the investments. They are compensated through a management fee and a profit share (called the carried interest). The management fee typically ranges between 1.5% and 2.5% of the capital under management. The carried interest is typically 20% of the profit, provided that profits exceed a specific threshold, such as 12% (Lerner and Leamon 2008, Citadel Capital 2008b). The GP/LP structure provides sufficient protections for limited partners as well as a strong incentive structure for general partners to perform. The GP/LP fund structure also provides both investors and fund managers with preferential tax treatment. Most of the fund profits are treated as pass-through capital gains, and are not taxed at the fund level, but rather at the partner level. For general partners, this structure allows them to benefit from any tax-exempt status that some investors, especially institutional investors such as university endowments or pension funds, may enjoy (Lerner and Leamon 2008). For the limited partners, these profits are treated as capital

gains rather than income, which in many countries, including the United States, are taxed at lower rates than normal income[28].

The GP/LP structure has historically worked well for private equity funds by providing adequate protection for investors, performance incentives and decision making autonomy for fund managers. However, this structure is not available in many developing countries, including China and other Asian countries, where private equity funds are often structured as corporations (Lerner and Leamon 2008). In Egypt, the situation is similar, where the GP/LP structure is not available. Some private equity firms chose to incorporate as an Egyptian joint stock company (SAE); some chose to incorporate as an offshore limited partnership; while others chose hybrid strategies. In the next section we will review a number of case examples for each of these models.

The second issue is how this structure varies across different countries, and what the implications of these variations may be. LaPorta et al. (1997, 1998) demonstrate that the differences in legal origins between common law and civil law countries influence investor behavior. They find that common law countries provide better investor protections than civil law countries, and hence facilitate financial development. Lerner and Schoar (2004) and Kaplan, Martel and Strömberg (2003) examine private equity contracts and transaction structure empirically and similarly find that common law countries provide better investor protections. By analyzing the transaction structure in 210 private equity

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[28] The preferential tax status for private equity general partners has been very controversial in the US and UK over the past few years, where several private equity fund managers booked significant profits from private equity transactions and were taxed as capital gains rather than income, which reduced their tax liabilities significantly.

transactions in developing countries, Lerner and Schoar (2004) find that variations in legal origin, judiciary efficiency and rule of law among the sample countries influence the transaction structure, with private equity firms adapting their contract structure to the local environment.

In Egypt, the legal system is mostly based on French civil law tradition, with some local adaptation. Legal structures such as limited partnerships, which allow for the GP/LP model, are not available, and laws are typically very prescriptive and do not afford the contracting parties the flexibility to design the nature of their relationship as common law countries do. Additionally, the judiciary process is often cumbersome and lengthy. All these factors influence private equity firms' incorporation and domicile decisions. In the next section, we review a number of case examples and examine the decisions of private equity firms operating in Egypt.

4.3.2 *Case Examples of Private Equity Firms Operating in Egypt*

Among the private equity firms operating in Egypt, several chose to incorporate their funds locally, including IT Investments, as well as El Mansour and El Maghraby Investment and Development Company (MMID). A second group of private equity funds operating in Egypt chose to incorporate offshore, including Concord, Actis, and Haykala. A third group of private equity firms operating in Egypt chose a mixed domicile strategy, where some of their funds are incorporated locally, and others are incorporated offshore; Citadel Capital is one such firm.

IT Investments is incorporated in Egypt as a closed-end[29] joint stock direct investment company, with an authorized capital of LE 500 million and issued and subscribed capital of LE 375 million (equivalent to $110 million at the closing date in mid 1999). The company is privately held, with investors including local Egyptian banks and institutional investors, Arab institutional investors, Arab individual and family investors, and the fund management. These investors include a number of local banks such as National Bank of Egypt, Al-Wattany Bank of Egypt, and Misr Iran Development Bank; Egyptian institutional investors such as Al-Ahram Investment Company, Banque Misr Investment Account II, Egypt Investment Company, and the Egyptian Growth Investment Company; Arab institutional investors such as The Arab Fund for Economic & Social Development, and Kuwait Financial Center; Arab individual and family investors such as Solid Investments Holding (a Lebanese holding company owned by the Safadi group, a Lebanese family conglomerate), Choice Limited (a Cayman Islands registered holding company owned by Saudi investors), or Sheikh Mohamed Khalifa El-Seweidy from the United Arab Emirates; as well as individual investors and the fund managers, including Dr. Hisham El-Sherif, the founder and Chairman of IT Investments and Dr. Basel Hussein Roushdy, the Chief Investment Officer of IT Investments (IT Investments 2009).

In this structure, IT Investments, as a holding company, owns a stake (minority or majority) in its portfolio companies. One of the main differences between the holding company structure and the limited partnership is that in the case of the holding company, investors are not able to impose a specific duration after

[29] A closed-end fund is a collective investment scheme with a fixed number of shares that are offered during an initial subscription period. Unlike open-end mutual funds, closed-end funds do not stand ready to issue and redeem shares on a continuous basis (Wikipedia 2009).

which the fund will be dissolved (Lerner and Leamon 2008). The limited and pre-specified fund duration (typically 7-10 years) introduces discipline and accountability on the fund managers, who have to exit the investments, book the results, and return to their investors for any additional requests for funds. In absence of this discipline, fund managers can delay the liquidation of their investments for a long period of time. In the case of IT Investments, most of the transactions were conducted in the period between 1999 and 2001, and most of these companies are still in the fund's portfolio.

El Mansour and El Maghraby Investment and Development Company (MMID) is a second example of a private equity firm incorporated in Egypt. MMID was established in 1996 as an Egyptian joint stock company (SAE) and is primarily owned by two family conglomerates: Mansour Group, which owns around 60% of the company, and the El-Maghraby Group. Mansour Group is an Egyptian family conglomerate that operates in the automotive, manufacturing, retail distribution and food services sectors. The company is an agent for a number of international brands including General Motors, Chevrolet, Caterpillar, Phillip Morris, and McDonalds, as well as the local supermarket chain Metro and other businesses. The company is privately held and has an annual turnover exceeding $1 billion (Mansour Group 2009). El-Maghraby Group is a privately-held Saudi Arabian/ Egyptian family conglomerate with investments in medical care, tourism, and agriculture (Mansour Group 2009). MMID's Board of Directors includes seven members from both families. The company is also listed in the Egyptian Stock Exchange; however, it has limited trading and liquidity in the exchange. MMID acts as the private equity investment arm for the two family conglomerates and owns a diverse investment portfolio, including private equity, venture capital as well as stock market investment.

In this case, where the private equity fund has a concentrated ownership of a small number of investors (the two family conglomerates), the agency problem is limited, and the need for a GP/LP structure or other investor protection is not required. However, for minority investors (such as those who bought the portion of the company that is floated in the stock exchange), these minority shareholder guarantees become crucial to protect them from non-arms-length transactions (Morck and Yeung 2002).

A second group of private equity funds operating in Egypt chose to incorporate their funds offshore, including Haykala, EFG-Hermes, Concord, and Actis. Haykala Investment Managers is an Egyptian private equity firm founded in 2005 by the Commercial International Bank (CIB) and three members of Haykala's management team. CIB is the largest shareholder in the private equity firm, with a 40% stake; the remaining 60% is owned by high-net-worth individuals, institutional investors and the Haykala management team. Among the firm's lead investors are Mr. Samih Sawiris, who manages the real estate and hotel business of Orascom, the largest Egyptian family conglomerate; and Al-Futtaim Capital, one of the largest UAE family businesses. Haykala is managed by a team of professionals with substantial experience in private equity, banking, corporate finance, as well as oil and gas (Haykala 2009, CIB 2009).

In 2006, Haykala launched their first fund, Middle East Turnaround Investments Limited, which is incorporated as an offshore company in the British Virgin Islands (BVI). The fund, which is focused on turnaround of distressed assets, successfully raised $60 million. During 2006 and 2007, the fund acquired five investments, including two companies in the food and beverage industry (Enjoy and Honeywell), two companies in the steel sector (SOLS and SOMICO), and one

company in the oil field services sector (Premiere Casing Services). In 2008, Haykala did not make any new investments, and focused on managing and supporting the growth of its portfolio companies and preparing some of their portfolio companies for possible divestment and exit (Haykala 2009, CIB 2009, Haykala interview).

A second example of private equity firms operating in Egypt with offshore funds is EFG-Hermes, which launched a number of private equity funds over the past 12 years, all incorporated offshore in the Cayman Islands. The first fund, Horus I, was incorporated in 1997 with a committed capital of $54 million. The fund has been fully invested in 19 companies, almost all of which have been exited, with an aggregate IRR of 16% in US Dollars and 26% in Egyptian Pounds[30]. The second fund is Horus II, which was the largest general buyout fund focused on Egypt at the time of closing in 2005. The $155 million fund is fully invested in six companies and has already conducted two successful exits that have generated an IRR of 82% in US Dollars. The third fund, Horus Food & Agribusiness fund, was established in 2006 as the first private equity vehicle in Egypt focused on food and agribusiness. The $46 million fund is managed by EFG-Hermes Private Equity, in partnership with Rabo Bank, the biggest agricultural bank worldwide. To date, the fund has invested 57% of its committed capital in four companies and exited one of them at an IRR of 33% In US Dollars. The fourth EFG-Hermes fund, Horus III, was launched in late 2007, and successfully raised $555 million within two months of fund raising. The fund has expanded its scope from Egypt to the whole MENA region, where it has made eight investments to date using

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[30] The difference between the fund IRR in Egyptian Pounds and US Dollars is due to the devaluation of the Egyptian currency that took place during the fund life span. This is a specific example of how international investors in emerging markets are exposed to currency risks.

45% of its committed capital and with a broad sector diversification (EFG-Hermes 2009).

A third example of a private equity firm operating in Egypt but incorporated offshore is Concord International Investments Group. Concord Group was founded in 1988 and is based in New York, with offices in Cairo and Tokyo. The company is registered with the United States Securities and Exchange Commission (SEC) as an investment management company. Concord is one of the largest fund managers of Egyptian securities in the world, with more than $2.3 billion under management, half of which is invested in Egyptian equities. Concord set up its first private equity fund, the Egyptian Direct Investment Fund, in 2001. The $34 million fund is fully invested and has acquired controlling or significant minority interests in a number of Egyptian companies in the healthcare, financial leasing, food, and tourism sectors. In 2006, Concord launched its second private equity fund, Coral Growth Investments Limited. The $110 million is currently in the investment phase. Both are closed-ended funds domiciled offshore in the Channel Islands Stock Exchange.

While the three private equity firms, EFG-Hermes, Haykala and Concord, chose to domicile their funds offshore, they made different choices for the location of the private equity firm (the management firm). In the case of Concord, it is incorporated in the US and based in New York; in the case of EFG-Hermes and Haykala, they are incorporated in Egypt. The fund domicile decision is based on the interests of the investors, and their desire for legal flexibility, investor protections and tax privileges. In contrast, the private equity firm domicile decision is based on the management team's preference and where the founders are located.

A third group of private equity firms operating in Egypt chose a mixed strategy, where some of their funds are incorporated locally, and others are incorporated offshore. Citadel Capital is the most prominent example. Citadel Capital is the largest private equity firm in Egypt and among the largest in the region. Citadel Capital was created in 2004 by two seasoned investment bankers with previous private equity experience in Egypt and has since grown exponentially. As of mid 2008, the company managed $2.5 billion of committed capital, and managed 19 "opportunity-specific funds, controlling investments of more than $8.3 billion" (Citadel Capital 2008a). Citadel Capital is incorporated in Egypt as a joint stock company (SAE) and is primarily owned by its founders and partners. Under Citadel Capital, a number of holding companies were created to invest in different sectors, which Citadel calls "opportunity-specific platform companies." Each of these platform companies has a specific investment strategy and acts in a way similar to the traditional private equity funds. Each of these platform companies is a result of a specific acquisition or green field investment that Citadel Capital identifies on a "deal-by-deal" basis. Citadel Capital typically seeds these companies with a minimum of 10% of their capital, and then seeks funding from other investors to complete the target capital required for the specific platform company. For each of these opportunities, Citadel Capital seeks funding from a proprietary network of high-net worth investors in Egypt and the Arab Gulf region, many of whom have participated in previous Citadel transactions. From a legal perspective, a platform company is a holding company that acts as a special purpose vehicle (SPV)[31] that receives equity from Citadel

[31] A special purpose vehicle (SPV) is legal entity created solely to fulfill a specific, narrow, and often temporary objective or function, such as the facilitation of a transaction or the creation of a financial instrument. SPV's are usually created as a limited partnership or limited company, and

Capital and other financial investors, and receives debt from banks or other investors, and then conducts the acquisition of one or more companies. One such example is the Regional Investment Holding, a platform company SPV created by Citadel Capital to invest in Nile River transport. The company is 10% owned by Citadel Capital and 90% owned by financial investors. The company created and capitalized several subsidiaries to build and manage a fleet of river barges, river ports, and other logistics services (Citadel Capital 2008a, 2008b).

This structure is created to simulate some of the features of the typical GP/LP arrangement, such as the management fee and carried interest. It also provides investors with sufficient protection, as they maintain direct ownership of the platform companies and can influence its course if they so desire. However, unlike the GP/LP model, this arrangement does not have a limited duration for the fund. This arrangement is also not attractive for institutional investors from the United States and other developed countries who would rather not be direct owners in the platform companies due to the regulatory and tax limitations that they operate under.

Another major difference between Citadel's model and the typical fund structure is in the timing of the fundraising. In a typical fund structure, the capital is raised before the investment opportunity is identified. Investors commit their participation, and later, when the specific investments are identified, the fund draws down the required capital from the investors. In the case of Citadel Capital, they engage in fund raising after the specific investment opportunity has

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often incorporated in offshore destinations. SPV's are typically used by individuals or companies to isolate themselves from financial or third-party risks (Wikipedia 2009).

been identified. This model provides the investors with more control over their participation in each investment. However, it also provides them with a limited period of time to make their investment decision, which has been a significant issue for institutional investors with a longer decision making process.

To respond to these limitations, and enable institutional investors from the US, UK and other developed markets to participate in Citadel's investments, the firm decided to create a traditional private equity fund. The fund, called the Citadel Capital Joint Investment Fund L.P., was created in mid 2008 to raise $500 million, primarily from Western institutional investors, with $5 million minimum commitment for limited partners. The fund is incorporated in the Cayman Islands as a limited partnership, with Citadel Capital acting as the general partner. The fund has a limited term of seven years from the final closing date, and may be extended for two additional years. The fund would invest in each and every platform company that Citadel Capital creates in a pre-specified participation ratio. The fund has a management fee of 1% of the capital under management, and a profit sharing (carried interest) of 20% as long as the fund meets a 12% threshold; an additional 1% management fee is charged to the platform company (Citadel Capital 2008b).

By using this hybrid model, Citadel Capital is able to mobilize funds from two different types of investors. The first group is the high-net-worth individuals in Egypt and the Arab Gulf countries who are able to make fast decisions on a transaction by transaction basis, and are able to participate as direct owners in the platform companies. The second group is large institutional investors, primarily from the United States and United Kingdom, who require the legal GP/LP structure for legal, governance and tax reasons to be able to participate,

and who would also need a longer period to make investment decisions. The evolution of the legal and governance arrangement also signals the rapid growth of Citadel Capital as a private equity company that is evolving from a small domestic or regional player to a global private equity firm that is able to attract capital from different sources.

4.3.3 *Raising Capital*

Whether in developed countries or emerging markets, the sources of capital for private equity are similar: either institutional investors such as pension funds, investment funds, sovereign wealth funds; or high-net-worth individuals and family offices. In both cases, these sources may be domestic or foreign (Gurung and Lerner 2008). Additionally, banks and governments may also participate in financing private equity funds in some situations. However, the distribution of these sources varies from country to country, and between developed countries and emerging markets. The key to understanding the dynamics of raising capital in emerging markets private equity is understanding why each of these sources of capital decide to invest in emerging markets private equity rather than other traditional investment vehicles, such as the US stock market or domestic stock markets.

From an investor perspective, the first question is why invest in an emerging market rather than a developed market. There are two complementary explanations around this growing trend (Lerner and Leamon 2008). First, emerging markets are becoming much more attractive to investments due to higher growth rates, growing populations, economic and institutional reforms and privatization, and loosening of restrictions on foreign investments. At the

same time, developed markets are becoming less attractive for investments due to slow growth rates, unfavorable demographics, and higher valuations. While China and India have been on the forefront of this growing trend, Egypt has emerged as one of the leading markets in the Middle East and North Africa region for the same reasons mentioned above. The country has the largest population in the region, high economic growth rates, and has implemented an impressive package of economic reforms over the past years. These reforms have removed obstacles to doing business, improved investor protections, and created more opportunities for private sector investments.

In terms of the breakdown of capital invested in private equity funds operating in Egypt, anecdotal information from interviews shows that the majority of the capital comes from local and regional sources (Arab GCC countries), be it institutional or family/ individual sources. For example, one of the funds was created as a private equity investment arm for two wealthy families in Egypt and Saudi Arabia; another fund specializing in large transactions mentioned that they primarily raise capital through a proprietary network of 150 high-net-worth individuals and institutional investors in the Gulf region and Egypt; several private equity firms opened satellite offices in Dubai or Saudi Arabia, with an emphasis on fund raising, e.g., Beltone Capital and EFG-Hermes. All private equity firms interviewed mentioned this as a primary source of capital for their funds. The obvious reason for the increase in GCC investments in Egypt as well as other countries in the region is the increase of oil revenues over the past five years. Unlike previous oil revenue surges during the eighties and nineties, where most of the oil windfalls were invested in the United States and other developed markets, this time more of these surpluses are staying in the region or moving to other emerging markets in Asia. This is primarily due to the perception of

"political risks" among Arab investors in the aftermath of 9/11 – an issue that became more evident after the 2006 "Dubai Ports World" episode.

A second source of funding for several private equity firms operating in Egypt is domestic banks. For example, Haykala Investment Managers was created in partnership with the Commercial International Bank, the largest non-government owned bank operating in Egypt; and IT Investments received capital from three local banks, including the National Bank of Egypt, which is the largest government-owned bank in Egypt.

A third source of funding for some private equity firms is government. For the past five decades, governments in the United States and Europe have been heavily involved in the financing of early-stage companies, particularly in high-technology areas. For example, the United States government provided more than $3 billion to emerging firms through the Small Business Investment Company (SBIC) program between 1958 and 1969 – more than three times the total private venture capital investments during the same period; and $900 million in 1995 through the Small Business Innovation Research (SBIR) program. Similar programs in Germany accounted for more than 50% of their investments in high-technology firms (Lerner 1997). Lerner (1997) finds that companies that received SBIR funding grew significantly faster than a comparable set of firms did over a period of ten years. Many emerging countries are following a similar path to provide finance to private enterprise, especially in areas of small and medium enterprises (SMEs) and technology-intensive companies (IMC 2007). Several private equity firms in the US and UK were created by their respective governments as a way to provide financing for small and medium enterprises, and many similar programs continue to date. For example, Actis, one of the

funds operating in Egypt, is 40% owned by the United Kingdom government, with the objective of investing in former British colonies. Similarly, the Technology Development Fund was created by the Government of Egyptian, represented by the Ministry of Communications and Information Technology, in partnership with EFG-Hermes, a private equity firm, and Ideavelopers, a venture capital incubator (Ideavelopers 2009, MCIT 2009), with the purpose of supporting the growth of the technology sector in Egypt.

While there are examples of banks[32] and government funding private equity activities, the case examples reviewed and our interviews with private equity firms indicate that their participation remains limited compared to other sources of capital.

One category of private equity funding that is conspicuously limited is large US- and EU-based institutional investors, who typically constitute the largest source of finance for private equity. While these investors are present through some of the global private equity firms such as Actis or the Carlyle Group, their participation in local or regional funds remains limited. This may be attributed to four factors. First, global private equity firms rank the Middle East region at the bottom of emerging markets in terms of perceived attractiveness for investments, especially compared to other Asian countries (EMPEA 2009); second, many of the countries in the region have high political risk, and hence investors demand a high risk premium; third, many of the funds are not structured, legally or

[32] By bank participation in private equity financing we mean equity financing. Banks do participate in providing debt financing for leveraged buyouts, and in that role they heavily participate in financing private equity activities in Egypt. In fact, there is anecdotal evidence that banks are more open to provide debt financing to private equity transactions than they are to industry investors.

organizationally, in a way that is attractive to Western institutional investors; and fourth, local private equity firms are relatively new and have not established a solid track record yet. However, as the local and regional private equity firms grow and mature in their operations they are starting to target and increasingly attract this type of capital. For example, the two largest Egyptian firms initiated this process in 2008. Citadel Capital launched its Joint Investment Fund, a $500 million fund structured as a limited partnership (GP/LP) and domiciled in the Cayman Islands. The fund is primarily targeted towards Western institutional investors. Similarly, EFG-Hermes launched Horus III fund, a $555 million fund that is also structured as a limited partnership and domiciled in the Cayman Islands. It is likely that more of these funds will be created in the future, as the local and regional private equity firms establish their track record.

4.4 Stage 2: Investing

Once the private equity fund is established, the next step is to invest. To understand the investment stage, we examine three key questions. First: what do the private equity firms invest in, both in terms of the types of investments and sectors? Second: what is their investment process? How do they identify and source their potential investments? How do they perform the due diligence process? Third: how do they structure and price these transactions[33]? In this section, we examine the current practices in Egypt, and compare them to other practices in developed countries as well as other emerging markets.

[33] Transaction structure and pricing are key part of the investment process; however, our interviews did not gather transaction level data, so we do not cover this stage of the private equity cycle.

4.4.1 *Types of Investments*

In developed markets, private equity investments typically fall into three category types: venture capital, growth capital, and buyouts. Venture capital focuses on investing in early stage high risk businesses with innovative technologies or new business models that have not been proven yet. Growth capital focuses on companies in need of significant capital injections to support investment in new plant and equipment or other capital intensive operations. Buyouts focus on acquiring a controlling stake in distressed companies with the goal of turning them around through financial, management and operational restructuring.

In developing countries, the types of investment undertaken are different. Lerner and Leamon (2008) identify five areas where private equity firms in emerging markets are active: privatization, corporate restructuring, growth equity, strategic alliances and infrastructure funds. Privatization involves acquiring and restructuring recently privatized state-owned enterprises, which are often in need of significant investments and management restructuring. Corporate restructuring focuses on management and operational improvements, or on consolidating smaller companies to create larger entities. Growth equity focuses on companies with limited access to finance through the banking system, and in need of capital to grow their domestic or regional operations. Strategic alliances involve situations where multinational corporations have made acquisitions, joint ventures, or alliances in emerging markets, with limited knowledge of the local business environment. These corporations have sometimes welcomed partnerships with private equity firms that can provide local knowledge as well as monitoring for their local partnerships. Infrastructure funds focus on large capital intensive infrastructure projects in emerging countries, where

governments have created private sector financing schemes such as Build-Own-Transfer (BOT) (Lerner and Leamon 2008).

Our review of private equity transactions in Egypt showed the types of private equity investments to primarily fall under the categories of privatization, growth capital, turnarounds and consolidations. However, there were also occurrences of other types of investments not mentioned in the literature, such as family businesses or green field investments. In the rest of this section, we will review examples in each of these areas.

Privatization: In the 1990s and early 2000's, the Government of Egypt implemented a large-scale privatization program where the state withdrew from most sectors identified as non-strategic (Canara 2002, Abdel-Shahid 2002). The first phase of this program took place between 1994 and 1999, where state owned enterprises were organized into 27 sector/industry-specific holding companies. The program aimed at privatizing 314 state owned companies with approximate assets of LE 104 billion and more than one million employees, while excluding 85 companies from this phase of the privatization program (Carana 2002). As of mid 2002, 190 of the 314 state-owned enterprises were successfully privatized through various means. Of these, 54 companies were sold through initial public offerings and 28 were sold to anchor investors. After a period of economic slowdown, the privatization program picked up again in 2004, with an expanded scope to include industries such as insurance, banking and telecommunication. Between 2002 and mid 2007, an additional 120 state owned enterprises were privatized (Egyptian Ministry of Investments 2007).

Within the private equity transactions conducted in the past five years, few were recently-privatized companies. The most prominent recent example is the acquisition of the Egyptian Fertilizers Company by Citadel Capital in 2005[34]. In interviews with private equity fund managers, most highlighted that they shy away from privatization transactions. Since its inception in 1994, the privatization program in Egypt has attracted strong political and public opposition, and many transactions have become lightning rods for political battles, especially around two key issues: valuation and labor. Valuation of state owned enterprises in privatization transactions has attracted a lot of criticism, especially in transactions where privatized companies were sold to an anchor investor rather than through IPOs. Opponents of the program claimed that SOE's were under-valued and that the transactions were fraught with corruption. Many of these criticisms were justified, especially during the early years of the program where the privatization process was opaque and fraught with conflict of interest among the different parties involved. However, in the second wave of privatization that started in 2002/03, many of the companies offered for privatization were overvalued and did not provide an attractive opportunity for private equity firms. The second contentious issue is labor. Many of the state-owned enterprises had a bloated and under-trained labor force that was also heavily unionized and politically vocal, especially in the spinning, weaving and textiles industry. Despite their losses, the government continued to subsidize them for years to avoid political confrontations. One of the fund managers specializing in turnarounds specifically mentioned that "we stay away from socially and politically sensitive sectors or companies such as large textile and

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[34] This case is discussed in depth in Chapter 5.

weaving companies" (Interview). We have not identified any cases of private equity investments in such companies.

On the other hand, the privatized companies that were of interest for private equity are those in capital intensive areas, such as cement or fertilizers, e.g., the Egyptian Fertilizers Company. In these industries, labor is limited and the private equity strategy is more focused on growth. Most of these companies were profitable, but required significant capital injection to invest in additional plant and equipment. Private equity firms quickly restructured the company's balance sheet, injected additional capital, signed agreements to build additional production facilities and to increase their capacity, and strengthened management and financial controls. Through these actions, the value of the company increased significantly, and they were able to exit the transactions with significant profits.

Family businesses: A large number of private equity transactions in Egypt included family businesses in a variety of situations. In some transactions, private equity firms provided growth capital and acquired only a minority stake in the company. Examples include Actis, a private equity firm investing in Mo'men, a retail food chain[35] in 2008; and Triodos Bank and GLS Bank, investing in SEKEM, a bio-pharmaceutical and organic food producer. In these situations, the family owners continue to maintain control of their business and use the capital to implement their growth plans.

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[35] The Mo'men case is reviewed in detail in Chapter 6.

In other transactions, private equity firms acquired a controlling stake in the family business. For example, Citadel Capital acquired Rashidi-El-Mizan, a confectionary food producer, to consolidate it with other food producers into Gozour[36], a platform company for food and agri-businesses. Similarly, Haykala Investment Managers' acquired a controlling stake in the Sixth of October Light Sections Company (SOLS), which was established in 1988 by the Faltas family, to consolidate it with another similar company[37]. In these situations, the family was usually seeking to exit the business, and the private equity firm provided a suitable exit. Private equity funds represent a good buyer for family businesses because they are experienced in the process of professionalizing the management and creating a board governance structure that enables this business to be later sold through an IPO or another trade sale.

Growth capital: Limited access to finance is recognized as an obstacle for the growth of small and medium domestic companies in most developing countries. Egypt is no exception. For example, only 21% of the Egyptian companies have access to long-term bank credit compared to 79% that do not have access. Among the former, larger firms are more likely to have access (41.5%), compared to medium size (19.1%) and smaller (13.7%) firms[38]. In absence of long-term bank credit, most companies resort to personal savings of the founders or retained earnings to finance their growth. This type of organic growth limits the potential for these companies. Most of these limitations are not due to lack of capital, as most of the national banks are dealing with extra liquidity. However, it is

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[36] The Gozour case is reviewed in detail in Chapter 5.
[37] The SOLS case is reviewed in detail in Chapter 5.
[38] Based on our analysis of a 2003 World Bank survey of a random sample of 1,000 Egyptian companies.

primarily due to bureaucratic lending procedures and regulations that increase the risks of bank loans (World Bank Egypt ICA report 2004). Specifically, there are no bankruptcy laws in Egypt that provide the business owner(s) with limited liability. In most situations, business owners need to provide personal collateral for any bank loans, and they are held personally liable for these loans, with the threat of criminal litigation in the case of default. Similarly, bank loan officers are often held personally liable for the performance of their loan portfolios, with a number of high profile litigation cases. These two factors have significantly contributed to the narrowing of long-term credit markets in Egypt. In such a market, private equity becomes a possible alternative source of growth capital in some situations.

Many of the private equity transactions reviewed in Egypt were cases of growth capital. Examples include the acquisition of a controlling stake in Al-Borg medical laboratory by Abraaj Capital with the objective of growing its operations to other countries in the MENA region; the acquisition of a minority stake by Actis in Mo'men, a food retail chain[39] with the objective of expanding its vertically integrated supply chain and growing its geographic footprint; and the acquisition of Contact Car Company by Amwal Al-Khaleej fund, with the goal of expanding their car financing business to include used cars and insurance. In Chapter 5, we analyze a number of growth capital transactions in detail.

Turnaround: Acquiring and turning around distressed companies through leveraged buyout transactions is the traditional business model for private equity in developed economies. While most turnaround transactions in developed

[39] Both transactions are reviewed in detail in Chapter 5.

countries focus on downsizing by aggressively cutting cost and reducing labor, the nature of turnaround in private equity transactions in emerging markets is different. These turnarounds are more focused on changing or strengthening management, instituting governance processes, implementing financial and accounting controls, and changing the capital structure of the company.

The most prominent private equity turnaround case implemented in Egypt is for ASEC, a company that was acquired by Citadel Capital in 2005. In 2005, Haykala Investment Managers launched the first private equity fund focusing on turnarounds in Egypt, with $60 million in capital. During its first two years the fund made five acquisitions. Both cases are reviewed in detail in Chapter 5.

These examples highlight the different nature of turnaround transactions in emerging markets, where the funds are more focused on changing or strengthening management, instituting governance processes, implementing financial and accounting controls, and changing the capital structure of the company. In chapter 5, we review additional case examples where private equity helped "professionalize" the operations of their portfolio companies.

Consolidation: Many industries in Egypt are highly fragmented, with a large number of small and medium companies and no large players; agri-industries and retail distribution are two examples.

In Egypt, many of the private equity transactions were consolidations of several small companies into a larger, more competitive entity. For example, Citadel Capital's Gozour was created as a platform company for consolidating several food producers, and has successfully acquired several family businesses.

Another example is Haykala Investment Managers' acquisition of two steel manufacturers, SOLS and SOMICO. Haykala further injected capital into the consolidated company to expand its production capacity and to create a larger entity with more economies of scale. A third example is Citadel Capital's platform company, GlassWork, which was created to acquire and expand glass manufacturers in Egypt. In Chapter 5, we review several consolidation transactions in detail, demonstrating how consolidation is one of the most effective private equity value creation strategies in emerging markets.

Startups: The role of private equity in initiating new companies often takes place under the banner of venture capital, which invests in high-risk new businesses, based on innovative technologies or business models. However, private equity in emerging markets has shown two other unique models for initiating new companies. The first is in capital intensive green field investments, and the second is in joint ventures with other companies.

In Egypt, there are several case examples of the three models: venture capital, green field investments and joint ventures. For example, two venture capital funds supported more than 30 new startups. Most of these startups are focused on building technology services companies, such as IT offshoring services, software engineering and Internet portals. In doing so, they are introducing mature technologies and business models from developed markets to the local and regional market, rather than inventing new technologies or business models. Capital intensive green field investments include several oil and gas, transportation and infrastructure companies created by Citadel Capital. Joint ventures include the joint venture between Orascom Hotels Holding and Rotana Hotel Management Corporation in 2008 to create a new business-focused hotel

chain in Egypt. In Chapter 5, we examine each of these three models and review several case examples in detail.

4.4.2 *Investments Demographics: Sectors and Company Size*

The second piece to answering the question *"What do private equity firms invest in?"* is examining the industry focus and the company size distribution of their investments. Table 4.2 highlights the distribution of private equity transactions in Egypt during the five year period between mid-2003 to mid-2008 by industry. Table 4.3 shows the average transaction size in sectors with more than three transactions. Table 4.4 lists all the private equity transactions executed in Egypt over the past six years, by industry and by year.

The biggest industry by far in terms of number of transactions is telecommunications and information technology; however, most of these transactions are venture capital investments in startups or small companies. There are no large transactions in the telecommunications sector because the number of players is limited and the sector is highly regulated. Most of the companies in these investments are service-oriented IT companies, with limited need for large capital.

The next sector in terms of the number of transactions is basic materials, which includes cement, fertilizers, steel and other heavy industries. This sector also has the largest average transaction size by far – more than $1 billion per transaction on average. These transactions include the acquisition, turnaround and sale of ASEC Cement Holding and the Egyptian Fertilizers Company, both transactions executed by Citadel Capital, and considered the largest in the MENA region.

The third sector in terms of the number of transactions and average transaction size is financial services, which includes several large banking acquisitions and consolidation transactions, with an average transaction size of more than $350 million. The next two sectors are oil and gas, and pharmaceuticals and healthcare – both in terms of number of transactions and transaction size. This distribution of transactions shows that the majority of the private equity money is geared towards capital intensive sectors, namely: basic materials, financial services, oil and gas, and healthcare and pharmaceuticals. All of these sectors are highly regulated with high barriers to entry. In many of these transactions, private equity firms acquire companies that have operating licenses in these regulated areas and invest in expanding their capacity and scope of operations.

Many of these transactions are also driven by global or local regulatory changes. For example, the cement industry in the southern Mediterranean countries grew tremendously over the past five years because of the increased demand from Europe. As the European Union tightened its environmental regulatory regimes, many of the polluting industries immigrated to its southern neighbors, especially Egypt, Algeria and Syria – a movement that benefits from "pollution arbitrage." Some of the European cement companies, such as Italicimenti, made acquisitions of cement companies in Egypt, where they acquired Suez Cement, which later acquired ASEC Cement Company from Citadel Capital. Additionally, cement exports from south to north of the Mediterranean exploded. Similarly, in financial services transactions, some acquisitions were driven by the Government of Egypt's push to consolidate the banking sector, especially the small privately-

owned banks. Some of these consolidations, such as Credit Agricole's acquisition of several small banks in Egypt, were facilitated by private equity firms[40].

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[40] The Credit Agricole case is reviewed in detail in Chapter 5.

Table 4.2 Sector-focus of private equity firms in Egypt, based on actual transactions (2003-2008)
(Current US$ million)

Sector	Number of Transactions	Average Transaction Value
Telecoms and IT	16	9.5
Agriculture and Food	11	17.8
Basic Materials	10	1,006.6
Oil and Gas	9	44.3
Financial Services	9	357.2
Healthcare and Pharmaceutical	7	95.1
Infrastructure and Transport	6	n/a
Travel and Tourism	3	n/a
Consumer Goods	3	53.7
Industrial Manufacturing	2	37.3
Media	1	n/a
Construction	1	26.0
Total	**78**	**215.3**

Notes:
Based on completed private equity transactions in Egypt during the five-year period from mid-2003 to mid-2008

Sources: The author, based on data from MIT Emergis and Zawya

Table 4.3 Average transaction value by sector (2003-2008)
(Current US$ million)

Sector	Average Transaction Value	Based on (Number of transactions)
Telecoms and IT	9.55	5
Agriculture and Food	17.79	5
Basic Materials	1,006.63	5
Oil and Gas	44.34	7
Financial Services	357.15	5
Healthcare and Pharmaceutical	95.14	5
Consumer Goods	53.67	3
Total	**215.3**	**37**

Notes:
Based on completed private equity transactions in Egypt during the five-year period from mid-2003 to mid-2008; only sectors with 3 or more data points are listed; total includes all transactions

Sources: The author, based on data from MIT Emergis and Zawya

Table 4.4 List of companies receiving private equity investments in Egypt

Sector	Target Company	Number of Transactions						
		1995-03	2004	2005	2006	2007	2008	Total
Basic Materials	ASEC Cement Company			1				1
	Egyptian Fertilizers Company			1		2	1	4
	National Port Said Steel (NPSS)					1		1
	National Printing Company						1	1
	Sinai Holding for Marble & Investments					1		1
	Six of October for Metallurgical Industries Company						1	1
	Six of October Light Sections Company						1	1
Financial Services	Arab Amwal Holding Company				1			1
	Commercial International Bank (Egypt)				1			1
	Contact Car Trading Company		1				1	2
	EFG - Hermes				1	1		2
	Egyptian American Bank				1			1
	Egyptian Investment Company		1					1
	Sudanese-Egyptian Bank				1			1
Healthcare and Pharmaceuticals	Amoun Pharmaceuticals Industries Company				2			2
	Cairo Medical Tower Laboratory		1				2	3
	Minapharm Pharmaceuticals					1		1
	Undisclosed Company				1			1
Consumer Goods	Amwal Al Arabia Holding Company				2	1		3
Oil and Gas	East Mediterranean Gas Company			1	2	1		4
	Egyptian Propylene and Polypropylene Company				1	1		2
	Egyptian Refining Company					1		1
	Greenfield Refinery Company in Greater Cairo						1	1
	National Petroleum Company			1				1

Sector	Target Company	Number of Transactions						
		1995-03	2004	2005	2006	2007	2008	Total
Industrial Manufacturing	Modern Nile Cotton Company				1			1
	Premiere Casing Services					1		1
Construction	Undisclosed Company				1			1
Telecoms and IT	Advanced Smart Cards Company (Applications)			1				1
	Advanced Smart Cards Company (Manufacturer)			1				1
	Allied			1				1
	COLTEC			1				1
	EngNet			1				1
	IT Worx					1	1	2
	OpenCraft			1				1
	Orascom Telecom Holding		1					1
	Orascom Telecom WIMAX Limited				1			1
	OstazOnline			1				1
	Raya Holding for Technology and Communications	1	1	1				3
	RDI			1				1
	Smart Wireless Systems				1			1
	EBCTA	1						1
	LADIS	1						1
	CIT Group	1						1
	Nile Online	1						1
	Arab Internet Company	1						1
	Telcomedia	1						1
	TIBA-CITE Group	1						1
	PT Trust	1						1
	El Rowad	1						1
	E-Knowledge	1						1

Sector	Target Company	Number of Transactions						
		1995-03	2004	2005	2006	2007	2008	Total
Travel and Tourism	Club Ras Soma Hotel Company		1					1
	Orascom Hotel Holdings JV						1	1
	Soma Bay Hotel Company		1					1
Agriculture and Food	Al Nouran Holding					1		1
	Egyptian Food Company			1				1
	El Rashidi El Mizan Confectionery Factories	1						1
	SEKEM Group					1		1
	Wadi Holdings Company			1				1
	Rashidi El-Mizan	1					1	2
	Enjoy			1				1
	HoneyWell				1			1
	Gozour					1		1
	Mo'men (Fast Food Chain)						1	1
Infrastructure and Transport	Alexandria International Container Terminals						2	2
	Metito Water Treatment				1			1
	Sokhna Port Development Company			1				1
	National River Transportation Company				1			1
	National River Port Management Company				1			1
Media	Tanweer (Publishing)					1		1
Total		**13**	**7**	**17**	**21**	**16**	**14**	**88**

Notes:
2003 figures are for the second half of the year
2008 figures are for the first half of the year

Sources: Compiled by the author from multiple data sources, including MIT Emergis, Zawya, and private equity websites

Either noticeably absent or scarcely present from private sector transactions are sectors like textiles, construction, tourism, and retail distribution. The textiles industry is one that could significantly benefit from private equity both in terms of capital and restructuring experience. The sector is still one of the largest employers in Egypt and one where the country used to enjoy a strong competitive advantage. However, in several interviews, private equity executives specifically mentioned that they shied away from textiles companies due to labor and political issues. Most textiles companies are still state-owned enterprises that the government has struggled to privatize over the past years. First, most of the physical assets of these companies are depreciated and antiquated because the government has not invested in them since the sixties. However, if they were sold for low valuations, the sales would face strong political opposition. Second, these companies are overstaffed and have strong labor unions. Any potential acquirer would have to deal with these issues, and would likely face strong labor opposition in any restructuring process.

Construction is another large sector that has not seen significant private equity activities. We hypothesize that this is because of the sector structure, which lacks the medium size companies that could draw private equity investors. The sector is dominated by a small number of very large state-owned companies that focus on implementing government infrastructure and utilities projects (e.g., Arab Contractors - Osman Ahmed Osman; Nasr General Contracting - Hassan Allam). Beyond these large players, the rest of the construction sector is highly fragmented, especially in the residential construction area, which is dominated by a large number of informal contractors.

The small number of private equity investments in tourism does not match the sector's importance or high rate of growth. The sector also has a large number of medium size companies that could present potential acquisition targets. One possible explanation of this dearth of private equity investment is the high level of volatility in the sector's performance due to geo-political risks. Despite its attractiveness as a touristic destination, Egypt's tourism demand is highly volatile and is influenced by any local or regional event. Still, we believe that there is high potential for private equity participation in touristic real estate projects.

Another sector that is visibly absent from private equity transactions is retail – be it food or clothing. This is likely due to the sector structure. Most of the large retail chains are state-owned[41] and have attracted political controversies during several privatization attempts. A small number of international players attempted to enter the market in Egypt with varying levels of success. The British chain Sainsbury had a highly visible failure in Egypt in the 1990's; however, the French chain, Carrefour, has been very successful in its market entry. A number of local chains have started to emerge over the past ten years and have been steadily growing; however, the majority of the market is still fragmented and informal.

These sectors may present potential opportunities for private equity investments in the near future, especially as more consolidation of small and medium enterprises takes place.

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[41] State ownership of retail companies dates back to the 1960's, where most of the local department store chains were nationalized. Prior to that, these chains were primarily owned by foreign or local minorities.

4.4.3 *Deal Sourcing and Due Diligence*

"Deal sourcing" is the industry term for private equity firms' ability to identify opportunities for potential investment that satisfy their investment strategy (e.g., sector, investment size, value creation strategy) and risk appetite. For each transaction executed, a private equity firm examines and evaluates a number of potential transactions. A big part of the success of a private equity firm depends on its ability to generate a "deal flow" that will lead to profitable transactions. As the private equity firm examines the incoming opportunities, it conducts different levels of due diligence, where it assesses the company's financials, operations, assets, liabilities, management team, legal status, and any other factors that may influence the value of the company. The ability of the private equity firm to reach an accurate assessment of these variables as well as any risk factors is critical to the investment decision and company valuation.

Some private equity opportunities, especially the larger ones, are sourced through competitive bidding in public tenders, as in the case of The Nile Company for Food Industries "Enjoy", or the Egyptian Fertilizers Company. However, the majority of transactions are sourced through private opportunities that may be available only to one firm. The ability of a private equity firm to secure such "proprietary deal flow" is a major competitive advantage. Some analysts argue that local private equity firms enjoy such advantage due to their local knowledge and networks.

In developed countries, the private equity deal sourcing process depends mostly on personal and professional networks and contacts. The professional network includes professional services firms such as accounting firms, law firms and investment banks. These firms are often well connected and know first when

their clients are interested in selling their business or are in need of growth capital. They often connect their clients with private equity firms that they have existing relationships with. This introduction process is usually based on the trust between the client; their accountant, lawyer, or banker; and the private equity firm. On the personal network side, private equity partners often have a broad professional network that they continuously probe for such opportunities.

While the deal sources remain similar in emerging markets, the importance of the personal and professional networks are amplified. For example, private equity firms in Egypt identify personal and professional networks as the most common source for potential opportunities (Table 4.5), with all ten firms that we interviewed citing it. Next to that, they mention three different sources of leads: professional service firms that they work with, which include investment banks, accounting and law firms; "people knocking on our door;" and their own internal market research. Professional service firms and "people knocking on our door" are also part of the private equity firm's network. This highlights the importance of having deep connections in the business community for this industry.

Table 4.5 Deal sourcing: How private equity firms identify potential target companies

Deal Source	PE Firms Citing This Source	Number of Firms
Personal or professional network; fund shareholders	ACTIS, Beltone, Citadel, EFG-Hermes, Haykala, IT Investments, MMID, Sphinx, Concord, Carlyle	10
Professional services firms (investment banks, accounting and law firms)	Carlyle, Citadel, MMID, Sphinx	4
People approaching the PE firm	MMID, Sphinx, Beltone, IT Investment	4
Market research	Haykala, Concord, Sphinx, Carlyle	4
Privatization	Concord, Citadel Capital	2
Conferences and events	IT Investments	1

Sources: The author, based on survey of private equity firms in Egypt

Market research as a source of deals is used in different ways. Sometimes private equity firms scan publicly-traded companies to identify companies that may be looking for expansion while lacking capital or facing other obstacles. These companies are prime targets for private equity to help them in their rapid growth phase. However, when it comes to identifying family-owned companies, some private equity firms take unconventional routes. One of the interviewees mentioned that "sometimes we have someone drive around and look at factories and see who is in an expansion phase; we go and talk to them, tell them what we can do to help them and we build our relationship with them. For example, we met someone in the management of a marble company and only six months later, we started talking with them about a deal" (Actis interview).

The importance of the personal and professional network becomes clear when we examine the senior management teams in the private equity firms. An

analysis of all the founders, partners and managing directors in Egyptian private equity firms shows that all of them are Egyptian, even in international private equity firms operating in Egypt. Each firm's senior management team includes a mix of long-time managers from national banks, along with few who have worked in multi-national banks either in Egypt or abroad.

For this reason, most international private equity firms actively operating in Egypt maintains a domestic presence. For example, ACTIS, a UK-based international private equity firm operating in emerging markets, decided to change all of their local management team to nationals (ACTIS interview). Similarly, The Carlyle Group, one of the largest US-based private equity funds, started its presence in Egypt through a local office, staffed by locals. They also established similar local offices in Beirut, Istanbul and Dubai as part of a broader Middle East region strategy (Carlyle interview). Concord Investments, a US-based private equity firm (although founded by Egyptians) also maintains a local office, primarily for research and deal identification (Concord interview). In all these situations, most of the local private equity staff has strong international experience and education, but they also have the advantage of knowing the culture and business community. This pattern supports the argument that it is hard to conduct private equity transactions "remotely," i.e., through remote offices and brief business trips. International private equity firms that are serious about doing business in an emerging market need to have a strong local presence and local staff with knowledge of the country, from a business, legal, political and cultural perspective. Some examples of secondary buyouts by foreign firms with no local presence from local firms may support this hypothesis, as firms with strong local presence are able to identify lucrative opportunities before firms operating remotely. Abraaj Capital's acquisition of the Egyptian Fertilizers

Group from Citadel Capital and Cairo Medical Tower Laboratory from Concord Group are two examples.

The argument for the need for strong local presence is also emphasized through the due diligence process. During any private equity transaction, there is informational asymmetry between the company owners, who know all the details of their business, and the private equity investors, who need to conduct a detailed due diligence to ensure that they are aware of all the facts about the business, including all the financial, legal, operational, and managerial details. However, this informational asymmetry is exacerbated in the cases of non-local private equity firms. For example, an investment principal in one of the foreign private equity firms operating in Egypt mentioned that their foreign counterparts were not able to properly assess the risks: "They probably saw more risks than they saw opportunities;" and hence, they were reluctant to proceed with any investments. This limited ability to assess the risk exposure in a private equity opportunity is detrimental to any firm; if they are too conservative and see too much risk, they may end up with no transactions, and if they are too aggressive, they may end up with fatal mistakes.

A second key point on the due diligence process in Egypt relates to the nature of process. In developed countries, the typical due diligence process is about confirming the facts, uncovering any missing information, and assessing the risk. However, in some of the case examples examined in Egypt, the due diligence process also included a "transformation" component. Many of the private equity acquisition targets, especially in the case of family businesses, operate in an informal way, especially with regards to accounting, reporting and taxation; or maintain a legal structure that is not adequate for private equity investment,

such as partnerships. For example, in the case of Actis' investment in Mo'men, a local food retailer, Mo'men had to go through a "total legal restructuring of the group," where they had to create a new holding company; re-establish some of the companies that were registered as partnerships; and transfer the ownership of all the subsidiaries to the new holding company. This transformation had numerous tax implications that had to be settled (Schurgott 2008).

A third insight that we gained from the interviews is in comparing the due diligence process between private equity transactions to investments in publicly traded equity. One of the implicit assumptions in private equity investments is that there is additional effort that is required to identify and assess the opportunities, and to conduct due diligence and valuation. This is one of the justifications behind the high management fees and carried interest that is charged by the private equity firm; typically a 2% management fee and 20% carried interest. However, one of the equity fund managers highlighted the fact that the fees charged by publicly-traded equity funds in the MENA region are similar. For example, the Beltone MENA Equity Fund charges 1.75% management fee and 15% performance fee. The justification behind these fees is that selecting and conducting due diligence for publicly-traded equities in Egypt requires a level of effort that is close to private equity. The implication of such a statement is that there is limited transparency with even publicly-traded companies, to the point that such a high level of due diligence is warranted. An alternate explanation for these extremely high fees is that the market is still in its infancy stage and there is limited competition, and that once the number of funds increase, these fees will decline significantly.

4.5 Stage 3: Portfolio Management

Once the fund has completed its first investment, it moves into the portfolio management stage, where the private equity firms manage their portfolio companies with the objective of increasing their value, and in preparation for their eventual exit. During this stage, there are two key issues that we examine. First, what is their "mode of engagement" with their portfolio companies in terms of governance and management? And secondly, what value creation strategies do they deploy?

4.5.1 Governance and Management

Private equity firms in developed countries are typically actively engaged with their portfolio companies, especially in buyouts, turnarounds and venture capital situations. For example, they appoint board members, change management teams, alter the capital structure, dispose of assets or business units, merge the company with other entities, or consolidate operations.

In contrast, in the transactions that we reviewed in Egypt, the level of engagement of private equity firms with their portfolio companies varied widely, ranging from being passive investors, to playing supportive roles to the management, to taking active leading roles.

In earlier private equity transactions (for example, prior to 2004), a large number were passive investments, where the private equity firm played the role of an asset manager, similar to investing in publicly-traded equities. In many of these situations, the role of the private equity firm was selecting investments with a high success and growth potential, acquiring a stake (often, a minority stake),

and holding the investment for several years before the exit. Most of the investments of EFG-Hermes's first fund, Horus I, were of this type. Horus I Fund was created in 1997 as one of the very first private equity funds investing in Egypt, with $54 in committed capital. The fund made investments in 19 companies; most of them have exited by now. These investments include a 3% stake in Sidi Kerir Petrochemicals Company (SIDPEC) in 1997; 5% stake in NATGAS in 1998, which distributes natural gas to residential industrial and commercial properties; a 40% stake in SODIC in 2002, a real estate development company; a 40% stake in Orascom Hotels and Development in 1996; and a 49% stake in ACE-CIIC, a general insurance company (EGF-Hermes Private Equity 2009). In these transactions, the fund acquired a minority stake in well managed companies, mostly providing growth capital. The fund appointed members to the board of directors to monitor the investment, but maintained a passive role in the company's management.

Most of the private equity transactions conducted in Egypt during these early stages of industry development were similar in nature. However, since 2004, the private equity landscape changed, with the creation of a number of new private equity firms with a more aggressive and hands-on approach. Citadel Capital was among the first and most visible. The firm started with the vision that there was a need for more active private equity roles in restructuring distressed companies and creating new green field companies. Haykala, a private equity firm focusing on turnaround buyouts, was created in 2005. Other regional players, such as the Dubai-based Abraaj Capital, also became active in Egypt, with a similar approach.

As a result of this changed landscape and a rapid growth in the number of private equity transactions over the past five years, the level of engagement of private equity has varied across the spectrum, from passive, to supportive, to active.

A number of private equity funds continued with passive investments. In most of these situations, the private equity firm acquires a minority stake in a well managed company, mostly for growth equity. They appoint board member(s) to represent them in monitoring the portfolio company performance, but do not engage in much beyond that. For example, EFG-Hermes acquired a 10% minority stake in the Watany Bank of Egypt in 2006; 8% in Maridive Oil Services in 2007; and 14.3% in Sahara North Bahariya in 2008. Additional examples include MMID's 20% investment in Credit Agricole Egypt[42]; SHUAA Partners' investment in the joint venture between Orascom Hotels Holding and Rotana Hotel Management Corporation[43] in 2008 to create a new business-focused hotel chain in Egypt; and Triodos Bank and GLS Bank's investment in SEKEM in 2007, a bio-pharmaceutical and organic food producer seeking domestic and regional growth.

A second mode of engagement is when the private equity firm plays an active supportive role for the management of their portfolio company. These situations may be minority or majority investment in a company with strong management that enjoys the trust and support of the private equity firm. The private equity firm may strengthen the management team and help them in developing new

[42] The Credit Agricole case is reviewed in detail in Chapter 5.
[43] The Rotana/Orascom case is reviewed in detail in Chapter 5.

markets, products or services, but does not engage in active restructuring of the company. Examples include Actis' investment in a 28% minority stake in Mo'men, a domestic food retailer, to provide the company with growth capital to expand its vertically integrated operations and grow regionally (Schurgott 2008, Actis 2009); and the acquisition of a 79% majority stake in ITWorx by a financial consortium led by the EuroMena Fund to provide growth capital. In both situations, the private equity firm had trust in and strong support for the management team. Their mode of engagement was focused on supporting them in filling management gaps, especially in financial management and reporting; opening new regional markets; and professionalizing their operations. In Chapter 5, we review both cases in detail, honing in how the private equity firm engaged in "professionalizing" these portfolio companies.

The third mode of engagement is when the private equity firm takes an active and leading role in restructuring their acquisition, typically in turnaround situations of distressed assets, consolidations, or initiations of green field investments. Citadel Capital is one of the active private equity firms that often assume this role in their investments. For example, in their first acquisition of ASEC Holding, a financially distressed cement company in 2004, they changed the management team, restructured the company financially and operationally, and spun off some of its assets as separate companies. Similarly, they took a similarly active role in several of their consolidation platform companies, such as Gozour, where they acquired and consolidated multiple food and agri-businesses. They also assumed the same active role in initiating several green field companies to invest in capital intensive industries such as the Nile River

transportation and port management companies.[44] In all of these cases, the private equity firm appointed the management team, worked with them to set the business strategy, restructured the company's capital structure, and instituted governance processes and management incentives.

These three models (passive, supportive and active) show how private equity firms engage with their portfolio companies. One hypothesis, based on these three models, is that private equity firms that are more actively engaged with their portfolio firms are able to realize higher returns. While there is not sufficient empirical evidence to prove this hypothesis, there are some anecdotal case examples that may support it. A number of turnaround acquisitions by Citadel Capital have resulted in superior financial results, specifically the turnaround case of ASEC Holding, a cement producer, and the Egyptian Fertilizers Company. On the other hand, a number of passive minority investments by other funds have not resulted in comparable performance. It is not clear if these differences are due to the specific level of engagement by the private equity firm, or due to differences in the competency levels of individual funds. Future research in the exploration of these differences using a large empirical data set may be useful.

4.5.2 *Value Creation Strategies*

One of the key concepts behind private equity transactions is that they take place over a limited time duration, where the portfolio company is facing an unusual situation, and where the intercession of the private equity firm would create

[44] All of these cases (ASEC, Gozour, and Nile River Transportation and Ports) are reviewed in detail in Chapter 5.

significant economic value – value that exceeds "business as usual" and that also includes significant risks. In each transaction, the private equity firm identifies a clear "investment rationale," or "investment thesis", i.e., an argument on why and how the firm will be able to generate significant economic value by entering into a transaction. For example, many early private equity transactions in developed countries during the late 1970's and 1980's targeted large conglomerates that were trading below their net asset value. In these situations, the investment thesis was that breaking up the conglomerate and selling the individual business units separately would unlock value quickly (Baker and Smith 1998).

In emerging markets, investment theses are typically different, and more focused on growth. Table 4.6 highlights examples of value creation strategies used by private equity firms in Egypt, as recorded in the interviews conducted. From the case examples reviewed in Egypt and interviews with private equity firms, we identified a number of common investment theses that private equity firms identified as their value creation strategies, including initiating, consolidating, professionalizing, growing and globalizing companies. For example, in creating a new consolidation platform company for food and agri-business, Citadel Capital cites their investment rationale as the following: "Industry fragmentation across MENA and a lack of large scale investments have opened up multiple opportunities in the foods sector" (Citadel Capital 2008a). In Chapter 5, we develop each of these value creation strategies in detail, including detailed cases of private equity transactions in each strategy.

Table 4.6 Examples of value-creation strategies used by private equity firms

Private Equity Firm	Examples of Value Creation Strategies Utilized
Actis	Corporate governance; board empowerment; financial and managerial restructuring
Beltone	Management empowerment and financial restructuring; growth
Carlyle	Growth; expansion of expertise; financial restructuring; corporate governance
Citadel Capital	Turnarounds; consolidations; green field; financial engineering; growth capital
Concord	Management change; new investments; marketing for growth
EFG-Hermes	Management change; financial engineering; Greenfield
Sphinx/ GrandView	Board involvement; corporate governance; financial restructuring; growth; regional expansion; consolidation
Haykala	Financial restructuring; new investments; operational turnarounds; management change; growth
IT investment	Involvement in management; growth; mergers; greenfield
MMID	Management expansion; new investment financing; regional growth; marketing campaign expansion

Sources: The author, based on survey of private equity firms in Egypt

4.6 Stage 4: Exit

One of the key characteristics of private equity investments is the limited investment period. Private equity funds acquire or invest in their portfolio companies, with the intent to divest this investment in a short period of time, typically 3-7 years, during which they pursue a specific value creation strategy. The industry term for divesting the investment at the end of this period is "exit." This divestment is important for private equity investors because during the holding period, their investments are highly illiquid (Wright and Robbie 1998).

There are different ways through which a private equity fund may typically divest its investments, including: trade sale, sale to another financial investor through a secondary buyout, initial public offering (IPO), and share buy-back. The fund may also write off a bad investment (Wright and Robbie 1998).

In Egypt, all of these exit strategies are available to and used by private equity funds. Table 4.7 highlights the exit strategies mentioned by private equity firms interviewed. Trade sale, initial public offering and secondary buyouts were equally mentioned by the firms interviewed. However, they also mentioned two additional exit strategies. The first is selling through the Egyptian SME exchange, Nilex. Nilex was created in 2008 as an alternate exchange for small and medium enterprises, with the objective of providing access to capital to these companies based on a flexible regulatory and reporting framework and without the cumbersome requirements of the Egyptian Stock Exchange. Nilex listed its first two companies in 2008 and has attracted more companies since then. Nilex was mentioned as an option by IT Investments, which is a venture capital firm with a number of investments in small and medium startups that may benefit from this

exit strategy. The other exit strategy mentioned as an option by one of the firms is "asset sale." In this exit strategy, the private equity firm may be interested in selling some of the assets of the portfolio company independently, such as in the case of a real estate property that may be underutilized by the portfolio company. This strategy was mentioned by Haykala Investment Managers, a private equity firm specializing in turnaround operations. Asset sale may be particularly useful in distressed companies with significant financial liabilities. Asset sale may also refer to situations where the private equity firm divides the company into smaller entities (especially in the case of conglomerates) and sells them separately. There are very few examples of this exit strategy. The case of ASEC and Citadel Capital is one of the few and is discussed in detail in Chapter 5.

As the private equity industry is still in its early stages, most of the funds are in the investing or portfolio management stages and a small number of transactions have already been exited. Table 4.8 lists examples of exits executed to date. In the rest of this section we review the exit strategies and examples of exited transactions.

A ***trade sale*** is a sale of the portfolio company to another company, typically in the same business, such as a peer, competitor, conglomerate, or a company in an adjacent part of the value chain. This type of exit strategy is sometimes called a mergers-and-acquisitions exit (Povaly 2006). The European Venture Capital and Private Equity Association (EVCA) (2009) lists trade sales as the most common exit strategy used by private equity and venture capital firms in Europe in 2008, used in 40% of the exit transactions. Similarly, in the exit cases reviewed in Egypt, trade sale was the most common exit strategy. The sale of the Helwan Portland Cement Company by Citadel Capital to the Suez Cement Company 2005 at an

IRR of 287% is a typical example. Suez Cement Company is a subsidiary of Italcementi, one of the largest cement manufacturers worldwide. This exit is part of an industry consolidation, and also a reflection of the "pollution arbitrage" trend that is growing with stricter environmental regulations in Europe. The value of a business to a strategic investor is usually higher when strategic and operational synergies exist between the two businesses, which is demonstrated in this case. Synergies between Italcementi and Helwan Portland Cement include the ability to transfer technology to the Egyptian subsidiary and export its cement to European markets. These synergies make it possible for Italcementi to pay a higher premium on its acquisition than other potential bidders.

An ***initial public offering (IPO)*** is a sale of all or some of the company's shares to public investors, often through listing in a stock exchange. By listing in a stock exchange, the company's shares become highly liquid and investors can easily liquidate their investments. Exits through IPO's are cumbersome and costly to execute because listing the company in a public exchange requires significant due diligence and regulatory procedures. It provides the company, as well as the private equity firm, with increased visibility in the market; however, this comes at the price of additional reporting and scrutiny for the listed portfolio company. While many of the private equity executives interviewed mentioned IPO as a potential exit strategy, there is only one case identified where this took place. Raya Holding is a technology company that operates both in the technology retail sales as well as software development and IT services. The company went public in 2005, supported by Injazat Technology Fund, in the first private equity-backed IPO transaction in Egypt. However, the private equity fund owned only 6.79% of the company, and exited right before the IPO, rather than after the IPO.

A ***secondary buyout*** is a sale of a portfolio company by a private equity firm to another financial investor, such as another private equity firm. Typically, the second financial investor or private equity firm will have a different value creation strategy than the first. There are two large cases of secondary buyouts in Egypt. The first was the sale of Rashidi El-Mizan from Actis to Citadel Capital. Rashidi El-Mizan (REM) is a leading producer of sesame-based sweet (halawa) and sesame paste (tehina) in Egypt. Since 2000, the company went through a series of acquisitions and restructuring. First, it was acquired by Best Foods and Unilever, two multinational firms that had alternately held stakes in the company until 2003, when Unilever sold its stake to Actis, a UK-based private equity firm with operations in Egypt. Actis worked with REM's management team to transform the company from a small, three-generation-old family business into a regional player. In 2008, and after a successful transformation, Actis sold REM to Citadel Capital's Gozour, a consolidation platform company focusing on the food and agri-businesses. For Gozour, the investment rationale was not to turnaround REM, but rather to create a large integrated food production and distribution company. To execute this strategy, they acquired a number of companies across the value chain, REM being one of them.[45]

The second large case of secondary buyout is the sale of the Egyptian Fertilizers Company by Citadel Capital to Abraaj Capital in the largest secondary buyout transaction ever in the region. Citadel Capital, along with other regional investors, acquired the Egyptian Fertilizers Company in 2005. In the following three years the company went through a rapid expansion program that doubled its production capacity and increased its geographic footprint. In 2007, Abraaj

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[45] The case of Rashidi El-Mizan acquisition by Citadel Capital is discussed in detail in Chapter 5.

Capital came in with a lucrative offer that was attractive to Citadel Capital and the other investors. Abraaj Capital continued the growth strategy for the Egyptian Fertilizers Company, but ended up selling it through a trade sale to a strategic investor, making additional profits[46]. There were also other cases such as the sale of Cairo Medical Tower Laboratory by Concord Group to Abraaj Capital in 2008.

A ***share buy-back*** is a sale of the private equity or venture capital investment back to the company or entrepreneur that they initially acquired the shares from. This is typical in situations where the private equity or venture capital firm acquires a minority stake in a company or startup, and then decides to exit the investment, possibly due to underperformance. Typically, the company or entrepreneur would finance the buy-back using debt, which would increase the company's debt liabilities. One of the few examples of share buy-backs in Egypt is the case of Raya and Injazat Technology Fund, mentioned earlier. In this case, the venture capital fund sold its minority shares back to the company right before the IPO, possibly due to the lack of confidence in the results of the IPO.

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[46] The case of the Egyptian Fertilizers Company, Citadel Capital and Abraaj Capital is discussed in detail in Chapter 5.

Table 4.7 Exit strategies used by private equity firms

Exit Strategy	PE Firms Citing this Strategy	Number of Firms
Trade sale	ACTIS, Concord, EFG-Hermes, Haykala	4
Initial public offering (IPO)	MMID, ACTIS, Citadel, Concord	4
Secondary buyout (sale to financial investor)	Citadel Capital, Concord, Sphinx, IT Investments	4
SME exchange (NILEX)	IT Investments	1
Asset sales	ACTIS	1
Share buyback	EFG-Hermes	1

Notes:
Nilex is the Egyptian Exchange market for growing medium and small companies (including family-owned businesses), offering a clear access to capital and the benefits of being traded, based on a flexible regulatory framework, for both companies & investors, and a streamlined admission process (Nilex 2009).

Sources: The author, based on survey of private equity firms in Egypt

Table 4.8 Examples of private equity exits in Egypt

Company	PE Firm/ Fund	Year	Exit Description	Type
Egyptian Cement Company (ECC)	EFG - Hermes	2000	Sold to partners for 34% IRR	MBO
Sheraton Gezira	EFG - Hermes	2002	Sold to France's Accor; IRR of 32%	Trade Sale
NatGas	EFG - Hermes	2003	IRR of 65%	Private Placement
Vodafone Egypt	EFG - Hermes	2003	IPO with a US$ IRR of 37%	IPO
Arafa Group	EFG - Hermes	2003	Sold in a Management Buyout; IRR of 43%	MBO
ACE – CIIC	EFG - Hermes	2004	Sold to ACE with 36% IRR	Trade Sale
Lecico	EFG - Hermes	2004	IRR of 28%	Trade Sale
Raya Holding (IT services)	Injazat Technology Fund	2005	40% ROI, first venture backed IPO in Egypt	IPO
Helwan Portland Cement Company	Citadel Capital	2005	Sale to Suez Cement Company; IRR of 287%	Trade Sale
Sidi Kerir Petrochemicals Company (SIDPEC)	EFG - Hermes	2005	IRR of 40%	IPO
Egyptian Fertilizer Company	Citadel Capital	2007	Sold to Abraaj Capital for $1.4 Billion, a 3.6x investment multiple	Secondary Buyout
ASCOM Geology & Mining	Citadel Capital	2007	Partial exit in 2007; IRR of 972%	Trade Sale
Sixth October for Development and Investment (SODIC)	EFG - Hermes	2007	Sold through capital markets; IRR of 59%	IPO
Egyptian Fertilizer Company	Abraaj Capital	2008	Sold to Orascom Construction for $US 2.7 Billion, a 2x investment multiple	Trade Sale
Rashidi El-Mizan	Actis	2008	Sold to Citadel Capital's Gozour for LE 335 Million	Trade Sale

Sources: Compiled by the author based on private equity firms' websites, annual reports, industry reports, and financial news websites

4.7 Conclusions

In emerging markets, private equity firms, especially the home-grown ones, are learning and experimenting, as they adapt their business model to the realities of doing business in developing countries and the local market requirements in their respective countries and regions. Some of the differences that they face are institutional, such as the different legal systems, investor protections, or contract enforcement; some have to do with the functioning of the market, such as information asymmetry; and some have to do with the macroeconomic environment, such as the fiscal policies, rate of economic growth, or government incentives. In this chapter, we traced the end-to-end activities of the private equity cycle, including fund initiation and setup, investing, portfolio management and exit. At each step, we compared the private equity business model between developed and developing countries to understand how private equity firms are adapting to the local needs and conditions of developing countries. Our over-arching hypothesis was that while the private equity model is transferable and useful in emerging countries, private equity firms adapt to the local peculiarities of doing business in such emerging markets.

The first phase in the private equity cycle is fund initiation and setup, starting with setting up the fund legal and governance structure. From a theoretical point of view, the key issue discussed in the literature involving private equity fund setup is agency: what is the fund structure that best provides adequate protections for investors, while providing performance incentives for fund managers acting on behalf of the investors, along with sufficient decision making autonomy. In developed markets, private equity funds are setup as limited partnerships (GP/LP model). However, limited partnerships, as legal entities, are

not available in Egypt and many other emerging markets, especially those with legal systems based on French civil law. A large number of private equity funds in Egypt are domiciled offshore, which provides investors and fund managers with more flexibility in designing the fund structure. However, a number of funds are also incorporated domestically in the form of joint stock companies. In these situations, they try to contract around some of the legal limitations of joint stock companies by designing their contracts to simulate some of the features of the GP/LP fund, such as the management fees. However, one critical limitation of the joint stock or holding company is that it does not provide for term limits for the fund, a feature that provides significant protection for investors and a discipline mechanism for fund managers.

Raising capital is the next step in the fund initiation. In Egypt, anecdotal evidence from interviews indicates that the majority of private equity capital comes from local and regional (Arab GCC countries) sources, be they institutional or family/ individual sources. Additionally, there are some examples of banks financing private equity firms, and also one case of a government-sponsored venture capital firm to develop the information technology industry. However, the participation of large US- and EU-based institutional investors remains limited.

The second phase in the private equity cycle is investing. In terms of the types of investments, private equity firms in Egypt are investing heavily in family businesses. In some transactions, they provide growth capital and acquire a minority stake in the company, where the family owners continue to maintain control of their business and use the capital to implement their growth plans; in other transactions, they acquire a controlling stake in the family business and

implement a turnaround or consolidation program. Private equity firms are also investing in consolidations, where they are acquiring a number of small and medium companies and consolidating them to create larger more competitive entities. There are also some examples of investing in turnarounds and privatization. In the case of a turnaround, the focus is usually on improving management, financial controls and accounting practices. In the case of privatization, private equity firms are more inclined to invest in large capital intensive companies in sectors like cement or fertilizers, but shy away from labor intensive industries such as textiles.

In terms of the sectoral focus of private equity firms in Egypt, the biggest industry by far in terms of number of transactions is telecommunications and information technology; however, most of these transactions are venture capital investments in startups or small companies, with limited capital. In terms of transaction size, the biggest industry is basic materials, which includes cement, fertilizers, steel and other similar heavy industries. This sector has the second largest number of transactions and an average transaction size of more than $1 billion. These transactions include the acquisition, turnaround and sale of ASEC Cement Holding and the Egyptian Fertilizers Company, both transactions executed by Citadel Capital, and considered the largest in the MENA region. Other sectors with large private equity transactions are financial services, oil and gas, healthcare and pharmaceuticals. This distribution of transactions shows that the majority of the private equity money is geared towards capital intensive and highly regulated sectors, with high barriers to entry. In many of these transactions, private equity firms acquire companies that have operating licenses in these regulated areas and invest in expanding their capacity and scope of

operations. Noticeably absent from private sector transactions are sectors like textiles, construction, tourism and retail distribution.

In terms of deal sourcing, private equity firms in Egypt identify personal and professional networks as the most common source of potential opportunities, followed by professional service firms that they work with, which include investment banks, accounting firms and law firms. For this reason, most international private equity firms actively operating in Egypt, such as Actis or the Carlyle Group, maintain a domestic presence. This pattern supports the argument that it is hard to conduct private equity transactions through remote offices and brief business trips. International private equity firms that are serious about doing business in an emerging market need to have a strong local presence and local staff with knowledge of the country, from a business, legal, political and culture perspective. This argument is also emphasized through the due diligence process, which inherently is a situation of informational asymmetry between the company owners and the private equity investors. This informational asymmetry is exacerbated in the cases of a non-local private equity firm. In some case examples examined in Egypt, especially in family businesses, the due diligence process also included a "transformational" component. The target company needed to restructure its corporate and legal structure, to improve its accounting and financial controls, and to settle any outstanding tax liabilities.

The third stage of the private equity cycle is portfolio management. In terms of governance, the level of engagement of private equity firms with their portfolio companies varied widely. In earlier transactions (for example, prior to 2004), a large number of private equity firms were passive investments, playing the role

of asset managers, similar to investing in publicly traded equities. However, in the more recent transactions that we reviewed in Egypt (after 2004), the level of engagement of private equity firms with their portfolio companies varied, ranging from being passive investors, to playing supportive roles to the management, to taking active leading roles. A number of private equity firms continued with passive investments, mostly providing growth capital to companies with good management. In some transactions, private equity firms played an active supportive role, where they helped the portfolio companies strengthen their management teams or enter new markets. In a third type of transactions, typically turnarounds or green field investments, they assumed a leading role in creating and executing the business strategy. One hypothesis, based on these three models, is that private equity firms that are more actively engaged with their portfolio firms are able to realize higher returns. While there is no strong empirical evidence to prove this hypothesis, there are some anecdotal case examples that may support it. Future research comparing these three models of engagement using large sets of empirical data may be useful.

In terms of value creation strategies, we identified a number of common investment theses that private equity firms in Egypt identified as their value creation strategies, including initiating, consolidating, professionalizing, growing and globalizing companies. These value creation strategies are analyzed in depth in Chapter 5.

The fourth and last stage in the private equity cycle is exit, which may be conducted through a trade sale, secondary buyout, initial public offering (IPO), or share buy-back. In Egypt, all of these exit strategies were available to and used by private equity funds. However, we found that trade sale was the most

common strategy, but there were also cases of secondary buybacks and initial public offerings.

* * *

CHAPTER 5: IMPACT OF PRIVATE EQUITY ON PORTFOLIO COMPANIES

The impact of private equity funds on their portfolio companies has been studied in the literature from several angles, including the impact on employment, wages, productivity, performance, growth, innovation, and governance. Most of these studies focus on private equity transactions in developed countries, especially in the United States and the United Kingdom, using empirical studies of completed and exited transactions. Similar large-scale empirical studies are hard to replicate in emerging markets due to data limitations and the fact that most transactions are recent and have not exited yet. However, by contrasting the differences between the private equity approach and value creation strategies in developed countries vs. emerging markets, we would hypothesize that the impact of private equity firms on portfolio companies in emerging markets is substantially different, and likely to be positive, by producing larger, more professional and competitive local companies with a broader employment base. In this chapter, our research approach focuses on understanding these private equity value creation strategies in emerging markets, and how they impact the portfolio companies. Specifically, we hypothesize that private equity firms have a positive impact on the companies that they acquire in developing economies because they act as catalysts for **initiating, consolidating, professionalizing, growing and globalizing** their portfolio companies.

5.1 What do we know from the Literature?

The impact of private equity on the portfolio companies that they acquire has been studied in the literature from several angles, including impact on labor, wages and employment (McGuckin and Nguyen 2001, EVCA 2005, Amess and Wright 2007, Kearney 2007), productivity (Lichtenberg and Siegel 1987, Kaplan 1989, Lichtenberg and Siegel 1989, Harris Siegel and Wright 2005), performance and growth (Long and Ravenscraft 1993, Kaplan and Schoar 2003, Davis, Haltiwanger and Jarmin 2007, Taylor and Bryant 2007), innovation, in the form of investments in research and development (Hall 1990, Lichtenberg and Siegel 1990, Hall 1992, Hao and Jaffe 1993, Himmerlberg and Petersen 1994), and governance (Jensen 1989, Lerner 1995, Walker 2007). The overarching hypothesis in this type of research is that private ownership of companies by private equity funds affects their behavior and performance, compared to public ownership in the form of publicly-traded corporations. Historically, this research has been motivated by a vigorous debate in developed countries with a long history of private equity transactions on whether private equity ownership, especially in leveraged buyout (LBO) situations, has a positive or negative impact on the portfolio companies. On the one hand, proponents argue that private equity ownership improves the governance and increases the productivity and profitability of otherwise distressed or low-performing companies. Rappaport (1990) argues that private equity ownership provides a short-term "shock therapy" that improves the performance and governance of distressed or low-performing companies. Jensen (1989) argues that the concentrated ownership of private equity firms in LBO situations provides a superior ownership and governance structure over the long term, compared to the public corporation model. On the other hand, opponents argue that private equity firms capture

significant financial profits by taking a short-term approach by aggressively cutting costs, reducing employment through layoffs, and reducing investments in the future of the company (e.g., research and development). The most comprehensive look at the impact of private equity on portfolio companies came in a recent set of working papers on the globalization of alternative investments and the global economic impact of private equity, published by the World Economic Forum (2008), which examined these effects through several large-scale econometric studies using a data set of global private equity transactions executed over the past three decades, and through six case studies of private equity transactions in Europe, China and India.

In the first of these large-scale analytical studies, Lerner, Strömberg and Sørensen (2008) examined the impact of private equity on long-term investments in research and development, demonstrated through their patenting behavior. They constructed and analyzed a large data set of 495 firms that received private equity funding between 1983 and 2005, and had one or more successful patent filings during the three year period prior to the transaction or the five year period after the transaction. They found that the quantity and quality of research and development does not change: companies continue their research in fundamental areas, and produce similar volumes of patents. However, the focus of the research and development changes, as firms "pursue more economically important innovations": their research is focused on areas of core business, and their patents receive more citations (Lerner, Strömberg and Sørensen 2008).

In the second of these large-scale empirical studies, Davis et al. (2008) examined the private equity impact on employment, using a data set of 5,000 companies that received private equity investments during the period from 1980 to 2005,

and 300,000 United States establishments owned by these companies. They compared the employment patterns in these companies during the two-year period after the acquisition to a control group of companies with similar demographics that have not received private equity funding. They found that in the manufacturing sector (about a quarter of these companies), there is virtually no difference in the employment patterns between the private-equity backed companies and the control group. However, in other industries, especially in finance, insurance, real estate, retail trade and services, there is a rapid fall in existing jobs in private-equity backed companies – 7% greater than the control group, or a slower growth of 4% less than the control group. This pattern may indicate that private equity firms are reducing white-collar jobs rather than blue-collar jobs in these companies, an observation that is confirmed by Lichtenberg and Siegel (1990) in another paper. Another finding for Davis el al. (2008) is that private equity-backed companies create substantially more new green field jobs in their establishments (15% new jobs), compared to the control group (9% new jobs) during the two years after the acquisition.

In the third of these large-scale empirical studies, Cornelli and Karakas (2008) examine the private equity impact on governance, focusing on changes in board size, composition and role. Boards provide a critical role in the governance of publicly-traded companies, especially those with fragmented ownership, by appointing, setting compensation for and monitoring management, making strategic decisions such as mergers and acquisitions, and representing the long-term interests of the owners. While the shift from dispersed ownership based in public companies to a concentrated ownership in private equity may reduce the need for a board, private equity firms usually maintain the board as the main governance mechanism, while altering its size and composition. Cornelli and

Karakas (2008) analyze 88 private equity transactions in the United Kingdom during the period between 1998 and 2003 to understand the change in board structure after the change of ownership from public to private. They find that the new boards are smaller in size, have a different composition, and are more active and adaptive. The new boards are primarily composed of management and private equity firm employees (only the former in the case of management buyouts). Outside/ independent directors are reduced, and often replaced with employees of the private equity firms. The new boards are actively involved in complex and challenging situations. Private equity firms adjust their board representation based on the complexity of the transformation and the anticipated challenges (Cornelli and Karakas 2008). After the execution of the private equity transaction, and during the restructuring process, the CEO and board members' turnover is higher than comparable companies (or the same company prior to the transaction); this raises questions about private equity firms' long-term commitments.

5.2 Research Approach

While this body of empirical literature provides an understanding of the impact of private equity on portfolio companies, these findings are primarily based on transactions data from developed countries, and it is not clear if they can be extended to emerging markets. Most of these studies are based on transactions in the United States and the United Kingdom (e.g. Cornelli and Karakas 2008; Davis et al. 2008), and even when the data set includes global transactions (e.g., Lerner, Strömberg and Sørensen 2008), the majority of these transactions are still in developed countries. These large-scale empirical studies cannot be replicated for

emerging countries' private equity in the near future because of the limited number of transactions and the fact that most of these transactions were initiated over the past few years and have not yet been exited. From a theoretical point of view, we expect the outcomes of these studies to differ between developed countries and emerging countries due to several factors. Among these factors are the different market conditions and stages of development; the different value creation strategies used by the private equity firms; and the difference in the companies acquired in terms of their size, business challenges, governance, and management capabilities.

However, observations from private equity transactions in emerging markets highlight that the value creation strategies that private equity firms implement are different. On the one hand, the typical business model for private equity funds in developed countries, especially in leveraged buyout transactions, is to acquire companies that are suffering from financial, operational or management problems, and restructure them to become more profitable and hence, increase their value. The restructuring process, more often than not, is associated with replacing management, changing the financial structure to include higher leverage, aggressively cutting costs and reducing labor, downsizing or closing less profitable business units, and sometimes, breaking up the company into smaller entities that may be more valuable separately, or divestment of some assets, especially real-estate assets that maybe of high cash value on their own.

On the other hand, our observations from private equity transactions in emerging markets show different value creation strategies, focusing on growth. For example, changes in management are focused on strengthening and professionalizing the management team; changes in governance are focused on

establishing a board where it did not exist (especially in recently privatized state-owned enterprises, or family-owned businesses) or adding stronger members to existing boards; changes in financial structure, while still benefiting from high leverage, are focused on providing capital for new investments in new facilities or on regional/ global growth. In their review of two private equity transactions in India, Fang and Leeds (2008d) support this argument:

> Like most private equity transactions in India, as well as other emerging markets, it is noteworthy that these cases do not fit the profile of US and European buyouts – both involved minority investments rather than control, leverage was not a factor, and although major financial and operational restructuring was extremely important, neither transaction involved disruptive layoffs, management changes or other features that have been targeted by critics of Western buyouts. On the contrary, the cases illustrate that for economies like India that are in the midst of major structural changes, there are ample opportunities for more traditional "growth capital" investments in companies that are expanding rapidly, especially in sectors like retail and telecoms that are undergoing consolidation.

By contrasting the differences between the private equity value creation strategies in developed countries vs. emerging markets, we hypothesize that the impact on the portfolio companies is substantially different, and likely to be positive, by producing larger, more professional and competitive local companies, with a broader employment base.

In this chapter, our research approach focuses on understanding these private equity value creation strategies in emerging markets and how they impact the portfolio companies. Specifically, we hypothesize that private equity firms have a positive impact on the companies that they acquire in developing economies because they act as catalysts for ***initiating, consolidating, professionalizing, growing*** *and* ***globalizing*** portfolio companies. In other words, when private

equity firms adopt these growth-oriented value creation strategies, they are likely to create positive outcome for their portfolio companies as well as the broader economic development.

Private equity funds initiate new companies either through green field investments, venture capital investments, or by financing new joint ventures; they consolidate multiple small companies into larger more competitive entities; they professionalize their acquisitions by hiring experienced management teams and installing proper corporate governance procedures that align the incentives of these management teams with the owners; they grow these companies by investing in new operations, manufacturing facilities, or systems; and they expand their scope of operations from domestic markets to regional and global markets. By initiating new companies, and by consolidating, professionalizing, growing and globalizing existing companies, they increase their competitiveness in regional and global markets. In this context, private equity firms play the role of a Schumpeterian entrepreneur (Schumpeter 1950, 1961).

5.3 Private Equity Value Creation Strategies and Impact on Portfolio Companies

In the remainder of this chapter, we examine each of these five private equity value creation strategies (initiating, consolidating, professionalizing, growing and globalizing) in Egypt and identify specific examples where they are applied.

5.3.1 *Initiating New Companies*

Schumpeter (1950, 1961) puts the entrepreneur at the core of economic growth, as the innovator of new ideas, the risk taker, the agent of change, and the creator of new businesses. While initiating new ventures has often been in the realm of individual entrepreneurs, an analysis of private equity transactions in Egypt (Table 5.1) shows that private equity firms are actively engaged in initiating new companies as well as in supporting local entrepreneurs. There are three different business models used by private equity firms to initiate new companies: venture capital, green field investments, and joint ventures.

Venture Capital: Venture capital (VC)[47] is the typical business model used in developed countries to invest in startup companies. Venture capital firms undertake risky investment in unlisted startups or companies with high growth potential. Venture capital can be broadly classified based on the stage of development of the venture: seed capital is used by startups to finance the early stages of product innovation and company building; second round financing is used by young companies to further develop or expand the range of products; and development financing is used by established companies to develop alternative products or expand through acquisitions. The venture capital business model is based on a portfolio approach, where the fund invests small amounts of money in a large number of startups, with the expectation that many of them would fail or have limited success, and the hope that one of them would become a blockbuster success that would provide significant profits on exit. Startups supported by venture capital are usually based on innovative business

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[47] Venture capital funds are a special case of private equity, but are often treated separately in literature because their business model differs from the typical leveraged-buyout (LBO) model used by private equity firms.

models or new technologies, where the market potential has not been proven or sized yet. They are usually risky and carry a high potential for failure. Large private equity buyout funds rarely invest in early-stage ventures that have not yet proven their success.

Most of the venture capital-backed startups in Egypt were supported by two venture capital funds. The first fund, IT Investments, was initiated in 1999 by one of the IT industry veterans in Egypt, Dr. Hisham El-Sherif, an MIT alumnus. The fund had a subscribed capital of $110 million at closing in 1999, and is focused on investing in low-to-medium risk early stage, startup and turnaround companies in the telecommunications, information technology and high-tech industries. Currently, the fund has 14 portfolio companies at different stages of development. In the 1990's, El-Sherif was one of the leaders in the government who worked on creating the basic infrastructure for Egypt's IT and communications industry. In doing so, he created several governmental agencies, training institutes, nonprofits, and public-private partnerships in this area. Many of these organizations were later consolidated into a newly created Ministry of Communications and Information Technology (MCIT). As he transitioned from the government to the private sector, El-Sherif created IT Investments and continued to fund and support some of these initiatives as new startups. Table 5.1 highlights ten startup ventures that were funded by IT Investments between 1999 and 2001.

The second venture capital fund that is active in Egypt is the Technology Development Fund, which is a public-private partnership initiated by the Government of Egypt in 2004. The fund is sponsored by the Ministry of Communication and Information Technology (MCIT) and managed by EFG-

Hermes, one of the largest private equity firms in Egypt and the region. The fund is also advised by Ideavelopers, an incubation and venture capital advisory firm that is also initiated by MCIT and EFG-Hermes to support the fund-backed companies. The fund is focused on investing in startup companies in the communications and information technology space (EFG-Hermes Private Equity 2009, Ideavelopers 2009, MCIT 2009).

The Technology Development Fund is part of a government-supported "national innovation system" (Nelson and Rosenberg 1993, Lundvall and Johnson 1994, Kim and Nelson 2000, Nelson 2000, Stern, Porter and Furman 2000) aimed at growing the infant telecommunication and information technology industry in Egypt. Other components in this national innovation system include: Nile University, which is focused on providing graduate education in business and technology; the Information Technology Industry Development Agency (ITIDA), a quasi-governmental agency focused on developing, growing and promoting the industry, especially as a destination for IT and business process outsourcing and offshoring (BPO) activities; the Information Technology Institute (ITI), which provides specialized training programs in software development to fresh graduates, as well as professional and IT training programs to government employees; the National Telecom Institute (NTI), a center of excellence for applied research, graduate education and training in telecommunications engineering; and Smart Villages Company, a public-private-partnership to develop a series of technology and business parks to accommodate the industry office space and technology infrastructure needs (MCIT 2009).

Since its inception, the Technology Development Fund has backed more than 14 startups in communication and information technology (Table 5.1). While the

level of success of these companies is still to be judged, this will become more transparent as the fund starts to exit these investments. However, the results of the whole eco-system are starting to payoff: a new business report (Tholons 2008) ranks Cairo at the seventh position in the "Top 50 Emerging Global Outsourcing Cities," and the government is projecting that local IT outsourcing and offshoring companies will reach a milestone of more than $1 billion in revenues by 2010 – four times their 2005 revenues (Marson and Blodgett 2008).

There are very few examples of venture capital-backed companies that went public. One of these examples is Raya Holding, the largest IT holding company in Egypt, with gross revenues of $400 million in 2008. Raya was established in 1999 as a result of the merger of seven companies, and operates different business units, including software development and IT services, contact centers, mobile phone retail distribution, and commercial real estate and technology parks. In 2003, Injazat Technology Fund invested $5 million in Raya Holding for a 6.79% stake in the company, to fund Raya's domestic and regional growth in the Internet service provider (ISP) business, mobile phone distribution business, and IT integration and services business. Two years later, the fund sold its stake in the company for a 40% return. Later in the year, Raya Holding went public in an initial public offering (IPO) in the Egyptian Stock Exchange. (Raya Holding 2009)

Green Field Investments: Another business model that some of the large private equity firms in Egypt have adopted is initiating large "green field" companies in capital-intensive industries such as transportation or oil and gas. These are industries where the private equity firm identifies an attractive opportunity;

however, there are no existing companies operating in this area that they can acquire and grow, so they proceed to initiate a new business.

Citadel Capital has been a leader in initiating "green field" companies in capital intensive industries. Table 5.1 highlights the five green field companies they initiated since 2005, in the transportation and logistics, oil refining, commercial real estate, and glass manufacturing industries. The National River Transportation Company (NRTC) and The National River Port Management Company (NRPMC) are two examples of green field companies initiated by Citadel Capital in 2006 to capitalize on Egypt's underdeveloped and underutilized Nile river transportation and logistics network. In the 1960's, more than 20 million tons per annum were transported on the Nile River; today, this number has significantly fallen to less than 1.5 million tons, less than 1% of the total goods moved every year. This is primarily due to the underdeveloped river transportation infrastructure (Citadel Capital 2008a).

The first of these two companies, The National River Transportation Company (NRTC), was created in 2006 with committed equity of $80 million from Citadel Capital. NRTC will be building a fleet of state-of-the-art, fuel-efficient, environmentally friendly river barges to transport heavy industrial products across the Nile River. The planned fleet will be capable of transporting up to 9.12 million tons per annum by 2012 (Citadel Capital 2008a).

On the one hand, the continuous rise in fuel costs and reduction in fuel subsidies (to date and anticipated) are increasing the transportation cost for industries that rely on heavy bulk products and are significantly influencing their economics. This is particularly critical for industries such as cement, fertilizers, steel and

other industrial manufacturing industries. On the other hand, river transportation offers a low-cost efficient alternative to long-distance trucking, especially because the Nile River connects most large industrial cities in Egypt with large population centers and export ports. River transport will also reduce the burden on the road network which is currently supporting more than 95% of all goods transported in Egypt, but which is barely able to keep up with the rapid growth and demand (Citadel Capital 2008a).

NTRC began operations in May 2008 with a small fleet of refurbished barges. The company has also commissioned the building of 30 new barges to the Alexandria Shipyard and 32 new barges to the Arab Contractors Shipyard in Helwan. The first batch of these new barges will be operational in 2009. The first client for NTRC will be Al-Nasr Company for Coke & Chemicals, which contracted NTRC for one year to transport 750 thousand tons of coal and coke to its factories for $3.6 million (Citadel Capital 2008a).

The second of these two companies, The National River Port Management Company (NRPMC), was created in 2006 with committed equity of $32 million from Citadel Capital. NRPMC will build, own and operate a series of state-of-the-art river ports and logistics hubs along the Nile River that will handle bulk and container cargo. The port management company will operate in synergy with its sister company, NRTC, which operates the river barge fleet to provide high-quality door-to-door transportation and logistics services to the industrial and agricultural sector in Egypt (Citadel Capital 2008a).

The company has already started working on three ports on the Nile River and other navigable waterways. The first port is in Tebbin, 15 kilometers south of

Cairo, where the company has acquired a 55,373 square-meter plot of land. The Tebbin port will have a capacity of 4.5 million tons per annum and will be operational by 2010. The second port is in Imbaba, north of Cairo, where the company has rented a 27,500 square-meter plot of land. The Imbaba port will have a capacity of one million tons per annum and will be operational by the end of 2009. The third is in Alexandria, near the Alexandria Port, where the company has acquired an 81,000 square-meter plot of land. The port is in the design phase and should also be operational within the next few years (Citadel Capital 2008a).

Citadel Capital has recruited a strong management team of industry experts for both companies. Management is supported by local and international consultants including some of Europe's leading experts in river transport, such as the Netherlands' Royal Haskoning (Citadel Capital 2008a).

Citadel Capital has also engaged in creating other green field companies in the commercial real-estate sector, manufacturing of glass containers, and oil refining (Citadel Capital 2008a).

Joint Ventures: The third business model used by private equity firms to initiate new companies is through joint ventures (JV), which are partnership agreements between two or more companies to embark on a new business. In many situations, one of the companies is a multinational corporation that brings a specific product or manufacturing knowledge to the venture, and the other partner is a local partner with market knowledge, distribution network, or privileged market access. Private equity firms join this venture as a provider of capital and business knowledge.

OT WiMax is an example of this joint venture model. The company is a result of a joint venture agreement between Orascom Telecom (OT), a leading international telecommunications, and Intel Capital, the venture capital arm of Intel Corporation. The new venture will seek WiMAX (Wireless Interoperability for Microwave Access) spectrum licenses, establish commercial operations, and support the deployment of low cost broadband Internet access through WiMAX networks. Orascom Telecom is an Egyptian-based company with global operations in the Middle East, Africa, and South Asia. The company operates GSM mobile phone networks through a large geographic footprint, which includes Algeria, Pakistan, Egypt, Tunisia, Iraq, Bangladesh, Zimbabwe and North Korea, serving a total of more than 80 million subscribers[48] (Orascom Telecom Holding 2009). Orascom Telecom brings this market access to the joint venture, where it sees an opportunity to extend its existing GSM voice and data services into broadband Internet connectivity, using WiMAX technology, and offering advanced applications and services. Intel Capital is the venture capital investment arm of Intel Corporation. Intel Capital makes equity investments in innovative technology startups and companies worldwide, often leveraging Intel's technologies and capabilities. In this case, Intel Capital will provide the new venture with access to Intel's significant technical and marketing resources and capabilities, in addition to capital (Orascom Telecom 2006).

A second example of private equity-backed joint ventures is Centro Egypt. The joint venture, created in 2008 between Orascom Hotels Holding, Shuaa Hospitality Fund and Rotana Hotel Management Corporation, will invest in developing and operating a new budget business hotel chain in Egypt. The

[48] As of March 2009

venture will start by developing five "affordable, trendy, budget business hotels" in Cairo and other Egyptian cities, under the brand Centro by Rotana to address a clear gap in the hotels market in Egypt.

Orascom Hotels Holding is an Egyptian "global town developer specializing in planning, building and operating integrated, self-sufficient leisure and residential towns around the world," with current properties and operations in Egypt, Oman, Jordan, the United Arab Emirates, Switzerland, Mauritius, and Morocco, and plans to expand to other countries. The company is also the largest owner of hotel rooms in Egypt, with 5,800 rooms currently in operation, and a target of 10,000 rooms by 2010. Orascom's flagship development in Egypt's Red Sea coast, El-Gouna, began as a simple touristic real estate project, but has since evolved into a fast-growing fully independent town with a strong infrastructure and residential population (Orascom Hotels Holding 2009). This new venture will enable Orascom to diversify its properties beyond touristic village to include business-oriented hotels (Shuaa Partners 2008).

Shuaa Partners is the private equity arm of Shuaa Capital, a Dubai-based investment bank. Over the past five years, Shuaa Partners has launched several private equity funds focusing on investing in the Middle East and North Africa (MENA) region, including its inaugural fund, Shuaa Partners Fund I, which closed in 2005 with committed capital of $200 million; Frontier Opportunities Fund I, which closed in 2007 with committed capital of US$100 million; Hospitality Fund I, which closed in 2008 with committed capital of $165 million; and SHUAA Saudi Hospitality Fund I, which closed in 2008 with committed capital of $240 million. The first three funds are focused on the whole region, while the last one is focused solely on Saudi Arabia (Shuaa Partners 2009).

Rotana Hotels Management Corporation is a regional hotels chain operator founded in 1992 and headquartered in Abu Dhabi in the United Arab Emirates. Rotana currently manages 67 hotel properties across the Middle East and North Africa region, including luxury and business budget hotels in Abu Dhabi, Dubai, Al Ain, Sharjah, Fujairah, Ras Al Khaimah, Beirut, Kuwait, Syria, Sudan, Hurgada and Sharm El Sheikh, and new properties under development in Bahrain, Egypt, Iraq, Kurdistan, Lebanon, Oman, Qatar, Saudi Arabia, Syria and the United Arab Emirates. Rotana is one of the portfolio companies of Shauaa Capital and has received significant capital from the private equity fund since 2006. In 2005, Rotana announced the launch of a new hotel concept, "Centro by Rotana," designed to meet the growing demands of business travelers in the region. The new concept offers an affordable three-star business-friendly hotel chain. This new joint venture will focus on developing five Centro hotels in Egypt.

These three business models – venture capital, green field investments, and joint ventures – highlight how private equity is initiating new companies in Egypt, where private equity funds act as both the financier and risk taker. In the case of venture capital and joint ventures, they act as a catalyst for the initiation of these ventures by partnering with individual entrepreneurs or other companies. In the case of green field ventures, they act as the entrepreneur in actually initiating the new venture. Throughout the past five years, where the private equity model showed rapid growth, these funds were part of the creation of scores of new businesses in technology, infrastructure and other industries, with clear contribution to employment and economic growth. Absence the private equity model, it is unclear which, if any, of these ventures would have been initiated.

Table 5.1 Examples of private equity firms initiating new companies

Company	PE Firm/ Fund	Year	Description	Type
ECC	EFG Hermes	1995	First private Cement company in Egypt	Greenfield
EBCTA	IT Investments	1995	Provides software for banks to handle clearing and transaction settlements between banks	Venture Capital
LADIS	IT Investments	1996	Information system and support provider for clients in the legal community	Venture Capital
CIT Group	IT Investments	1997	M-Commerce solution and services provider. Provides e-payment solutions	Venture Capital
Nile Online	IT Investments	1999	Broadband infra-structure provider	Venture Capital
Arab Internet Company	IT Investments	1999	Provides R&D and value-added technology for ISPs and Internet professionals in Egypt, designed to compliment Nile Online's services	Venture Capital
Telcomedia	IT Investments	2000	Audio text and IDR services for the Arab World	Venture Capital
TIBA-CITE Group	IT Investments	2000	Regional distributer of IT products, solutions, services and enterprise management systems	Venture Capital
PT Trust	IT Investments	2000	Online payment and e-commerce platform provider	Venture Capital
El Rowad	IT Investments	2001	Creation of educational software and providing educational facilities to students and teachers in Egypt	Venture Capital
E-Knowledge	IT Investments	2001	Creating training tools for developing E-Learning environments	Venture Capital
Raya Holding (IT services)	Injazat Technology Fund	2003	Investment to develop Raya's domestic and regional Internet service provider (ISP) business, mobile phone distribution business, and IT integration and services business	Venture Capital
OstazOnline	Technology Development Fund	2004	Developing online educational tools and teaching aids for the Egyptian market	Venture Capital
Smart Cards Application	Technology Development Fund	2005	Implements and manages operations for state-of-the-art smart card solutions for government	Venture Capital

			agencies	
iModel it	Technology Development Fund	2005	Enables communication among researchers, research institutions, publishers, e-learning companies, and industry in the area of device modeling for microwave and optical domains.	Venture Capital
Flat World Consulting	Technology Development Fund	2005	Provides comprehensive engineering, computer-aided design (CAD) and 3D Rendering and Animation for the architectural/ engineering/ construction (AEC) industry	Venture Capital
Allied Information Technology Services	Technology Development Fund	2005	AITS provides business process outsourcing (BPO) and technology solutions to healthcare providers, including medical and legal transcriptions, call center services, medical billing and coding, BPO training services, and web-enabled software solutions to manage medical records	Venture Capital
Timeline Interactive	Technology Development Fund	2005	A software development company specializing in producing high quality games on all major platforms	Venture Capital
Research and Development International (RDI)	Technology Development Fund	2005	Software development house focusing on the creation of Arabic language technology, both written and spoken	Venture Capital
OpenCraft	Technology Development Fund	2005	Providing IT solutions to large corporate clients	Venture Capital
COLTECH	Technology Development Fund	2005	Arabic Language search and data analysis technology solutions	Venture Capital
Allied Soft	Technology Development Fund	2005	System development firm, specializing in security and offshore development	Venture Capital
Advanced Smart Card	Technology Development Fund	2005	Large-scale manufacturer of secure credit/plastic card	Venture Capital
National River Transportation Company	Citadel Capital	2006	A platform company for investments in transportation and logistics, focusing on Nile River transportation	Greenfield

National River Port Management Company	Citadel Capital	2006	A platform company to develop and manage a new port network along the Nile River	Greenfield
OT WiMax Limited	Intel Capital	2006	A joint venture between Orascom Telecom Holding and Intel Capital, the VC investment arm of Intel Corp. The new company will support the deployment of low cost broadband internet access through WiMAX networks. Intel Capital will also provide access to the significant technical and marketing resources of Intel	Joint Venture
IdealRatings	Technology Development Fund	2006	A service provider for financial institutions to identify Shariah-compliant instruments globally and manage the overall Shariah fund management process	Venture Capital
ConnectmeTV	Technology Development Fund	2006	A leading provider of integrated digital media delivery platforms in the Middle East, including software and application development, business management, product positioning, consumer marketing, sales distribution, operation and manufacturing	Venture Capital
Smart Wireless Systems	Technology Development Fund	2006	Provider of analog/mixed-signal and RF (Radio-Frequency) research and design solutions for ASIC (Application-Specific-Integrated-Circuit) development in different application segments	Venture Capital
Egyptian Propylene and Polypropylene Company	Amwaal Al-Khaleej	2007	Chemical company started by number of regional investors, expected to go commercial by 2010	Greenfield
Egyptian Refining Company	Citadel Capital	2007	New company that will construct, own and operate a new hydro-cracking facility and ancillary unit	Greenfield
Bonyan	Citadel Capital	2007	A specialty real-estate developer focusing on furniture and home accessories malls	Greenfield
GlassWorks	Citadel Capital	2007	A company set up to invest in the Glass manufacturing sector through both consolidation and greenfield projects	Greenfield
Beltone Retail	Beltone Financial	2007	Retail company set up to consolidate other retail brands in region	Greenfield

Al- Nouran Trading Corporation	Beltone Financial	2007	Greenfield investment in sugar manufacturing complex	Greenfield
Centro	Shuaa Partners	2008	A joint venture between Orascom, Shuaa and Rotana to operate budget business hotels	Joint Venture

Sources: Compiled by the author based on private equity firms' websites and annual reports, industry reports, and financial news websites

5.3.2 *Consolidating*

A large body of literature supports the argument that large-scale, professionally managed, and nationally-owned companies act as a strong engine for economic growth (e.g., Chandler 1959, Chandler and Hikino 1997, Amsden 2001). These companies are able to develop economies of scale in their industries; acquire, retain, develop and disseminate knowledge – be it technical or managerial knowledge; generate economic profits and strong cash flows that allow them to grow; produce competitive products and services that allow them to export or operate in other countries and regions; and act as growth anchors for their industry by developing suppliers and feeding industries. Economic historians like Alfred Chandler (1959, 1990) highlight the role of these companies during the United States industrialization. Chandler (1959) suggests that "the major innovation in the American economy between the 1880s and the turn of the century was the creation of the great corporations in American industry." More recently, Amsden (2001) highlights the role of these companies in the industrialization of latecomers – countries that industrialized post World War II such as China, India, South Korea, Taiwan, Brazil or Turkey.

However, empirical data show that in many industries in developing countries, the economy is fragmented and dominated by small family-owned business and the informal sector. For example, analysts estimate that around 82% of small enterprises in Egypt are informal (El Mahdi 2002). While small and medium enterprises (SMEs) and the informal sector provide significant employment and support for the majority of the poor segments of the population, they do not provide the growth in productivity or knowledge accumulation that supports rapid industrialization or export-led growth. Large companies tend to be

recently privatized state-owned enterprises, as well as some multinational corporations. While some sectors (such as banking, insurance, oil and gas, telecommunications) which are natural monopolies or government regulated oligopolies have large companies, the majority of sectors are fragmented. Egypt is a typical example, where most of the large companies in the economy are recently-privatized SOE's (e.g., steel, cement, telecommunications), natural monopolies or oligopolies (e.g., telecommunications, air transport, utilities), or multinational corporations (e.g., consumer goods). There are a few exceptions of family owned businesses that managed to grow into large companies or conglomerates (e.g., Orascom, Oriental Weavers).

Consolidations among companies in a specific sector often take place due to a variety of reasons, sometimes driven by government policy, and sometimes by market dynamics. For example, in 2005-2008, the Government of Egypt, with the support of the World Bank, implemented a banking reform program, with the purpose of strengthening the domestic banking sector. The program included, among other measures, forcing consolidation among the smaller banks in Egypt by raising their minimum capital requirements. Another example of market-driven consolidation took place when Sainsbury, a British food retailing chain, entered the Egyptian market in 1999. The food retail distribution market in Egypt is highly fragmented, and dominated by small mom-and-pop grocery stores. Sainsbury saw an opportunity to introduce a large supermarket model in Egypt, and by doing so, forced consolidation in the market as well as the similarly fragmented supplier base. Sainsbury's excursion was a failure, and the company decided to pull out of the market in 2001. However, the market witnessed some consolidation afterwards, with many of the small family-owned businesses

creating their own supermarket chains, and other global players entering the market in the following years, such as the French Carrefour chain.

One of the value creation strategies used by private equity firms is a consolidation strategy, where the private equity company acquires a number of small companies operating in the same sector or adjacent sectors and consolidates them into one larger entity. This strategy is particularly attractive in industries that are highly fragmented and without a dominant player; where a larger player would realize a competitive advantage; or where there is a need for large scale investments that cannot be provided by the smaller companies in the sector. Table 5.2 highlights examples of consolidation transactions conducted in Egypt, where the private equity firm consolidated several companies to create a larger economic entity that can realize economies of scale and scope.

One of these examples is Gozour, a consolidation platform company created by Citadel Capital with committed equity of $257 million. Gozour was established with the purpose of creating a vertically integrated regional agriculture and multi-category consumer foods conglomerate with three primary lines of business: agrifoods and dairy (Gozour Agri), fast-moving consumer goods (Gozour Foods), and intermediate industries such as wet-corn milling and sugar processing (Gozour Intermediate). The company has already acquired, fully or partially, seven agri-businesses: Dina Farms, Rashidi El-Mizan, El-Misriyyeen, El-Aguizy International, Mom's Foods, the National Company for Maize Products, and the Egyptian Company for Milk Powder (Citadel Capital 2008a, Abdel-Razek 2008).

The first acquisition, Dina Farms, is Egypt's largest private farm with 10,000 feddans[49] and several lines of business including agriculture, dairy and meat production. The company is the largest producer of fresh milk in Egypt with an annual capacity of 45,000 tons, a key supplier of diverse fruit and vegetable products both locally and regionally, and the largest supplier of milk to leading local producers of processed dairy products. In 2007, after the acquisition, Gozour expanded the company's capacity by acquiring three new milking stations from a Swedish company and upgrading five of its seven existing stations – a move that is expected to double the company's milk production capacity to 72,000 tons per year. The second acquisition was the 120 year old confectioner Rashidi El-Mizan (REM), Egypt's leading producer of sesame-based sweet (halawa) and sesame paste (tehina). Since 2000, the company has undergone deep restructuring under the management of Best Foods and Unilever; these two multinationals had alternately held stakes in the company till 2003, when Unilever sold its stake to Actis, a private equity firm based in the United Kingdom. REM's management team is credited for transforming the company from a small, three-generation-old family business into a regional player. The third acquisition is El-Misriyyeen, a popular manufacturer of a variety of cheese products that enjoy strong brand equity on the Egyptian market. While the company has been in financial distress and in need of capital injection and further restructuring, it had strong synergies with the rest of the portfolio. The other acquisitions include NCMP, which produces natural corn-based sweeteners such as fructose, glucose and sorbitol. NCMP also produces starch and multi-purpose starch derivatives along with other corn-based products. El-

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[49] The Feddan is an Egyptian unit of land area, often used in agricultural land. A feddan equals 1.038 acre or 0.42 hectare.

Aguizy International is a leading grower and exporter of produce, including grapes, green beans and strawberries. Mom's Foods is a specialty food-products exporter. Gozour is also in the process of identifying and negotiating other similar acquisitions (Citadel Capital 2008a, Abdel-Razek 2008). This type of vertical integration provides the consolidated company with a significant competitive advantage in controlling the cost of its raw material across the supply chain, which is becoming increasingly important in a market where the prices of agricultural commodities are turbulent and continue to rise. It also provides the company with the opportunity to consolidate its storage and distribution logistics operations and potentially realize significant cost reduction.

A second example of consolidation strategy is the acquisition and consolidation of SOLS and SOMICO, two Egyptian downstream steel processing companies, by Haykala, an Egyptian private equity firm, for an undisclosed amount. The Sixth of October Light Sections Company (SOLS) was established in 1988 by the Faltas family. SOLS is a producer of hot rolled angles and steel sections with an annual production capacity of 100,000 tons. The company's products are exported to over ten countries in the Middle East and Europe. Sixth of October for Metallurgical Industries Company (SOMICO) was established in 1996. SOMICO produces cold rolled coils used in a wide variety of industries such as automotive and home appliances, with an annual production capacity of 120,000 tons. In addition to consolidating the two companies and improving their governance, management and operational performance, Haykala is planning to expand their production capacity and diversify the product mix through new investments. The private equity firm is injecting $30 million to build a new galvanizing line producing hot dip galvanized steel sheets with an annual capacity of 200,000 tons to cater to the undersupplied local and regional markets

(Daily News Egypt 2008a). This type of horizontal integration, along with the increased production capacity, provides the consolidated company with better economies of scale and a competitive advantage, both in the domestic and export markets.

A third example of consolidation strategy is the acquisition of the Egyptian American Bank (EAB), and its consolidation with Credit Agricole Egypt and Calyon Bank, a transaction executed by the private equity firm of El-Mansour & El-Maghraby Investment and Development (MMID) in 2006. This transaction highlights a complex history of merging several small banks to create a more competitive entity that is also a subsidiary of a larger multinational bank.

Crédit Agricole is a diversified French bank with over 9,000 branches and 21 million clients in France and global operations in 60 countries. It is the largest bank in France, second in Europe and fifth in the world in terms of capital. The bank started its operations in Egypt in 2001 with a series of acquisitions, in partnership with the local private equity firm MMID. Their first acquisition was in 2001, where they jointly acquired 94% of Crédit International d'Egypte, a local Egyptian bank joint venture, previously owned by Crédit Commercial de France CCF and the National Bank of Egypt. In 2005, they executed their second acquisition by acquiring the branch of Crédit Lyonnais' in Egypt. While these acquisitions were small in size, they provided Crédit Agricole and MMID with a launch pad for further growth. This combined entity was consolidated under the name Calyon Bank. In January 2006, they added a third acquisition of a majority stake in the Egyptian American Bank, which has a sizable presence in the Egyptian banking sector. The Egyptian American Bank is the country's third largest privately-owned retail bank with 36 outlets and a market share of around

2%[50]. It serves more than 100,000 retail customers and around 800 institutional and corporate clients, and employs around 1,200 staff (El-Sirgany 2006).

The combined entity was further consolidated under the name of Crédit Agricole Egypt, with a total equity of $1.6 billion. Crédit Agricole Egypt is a joint venture between Crédit Agricole Group, which owns 60%, MMID, which owns 20%, and other small Egyptian investors. The bank is planning to grow rapidly to become a leading provider of retail, corporate and investment banking, as well as asset management and insurance services to the domestic market (El-Sirgany 2006). This example highlights a complex consolidation of three small/medium domestic banks into a subsidiary of an international bank, with the support of a domestic private equity firm. One of the drivers for this banking consolidation is government policy, which encouraged such consolidation as part of a banking sector reform program supported by the World Bank.

These transactions show specific examples where private equity firms played a catalyst role in the consolidation of smaller companies into larger, more competitive entities. In the first example, Gozour, the private equity firm, first identified the market opportunity first, then created the platform company, and then proceeded to execute a series of acquisitions. In the second example, the private equity firm simultaneously acquired and consolidated two similar size companies. In the third example, the transaction was driven by Crédit Agricole's interest in entering the Egyptian market and incrementally creating a platform for this market entry as opportunities arise. In all of these transactions, the

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[50] Prior to the banking sector reform, the sector was dominated by four large state-owned banks. Privately-owned banks are predominantly focused on niche markets and have very limited market share.

consolidated companies' management teams, along with the private equity firms, need to invest a significant time and effort in the post-merger management process, which includes integrating the business processes, supply chain, distribution networks, management teams, and company culture. The success of this process is a prerequisite for the new entities realizing their synergies, and therefore the private equity firms' ability to exit with a good return on investments.

Table 5.2 Examples of private equity firms consolidating portfolio companies

Company	PE Firm	Year	Description
ASEC Holding	Citadel Capital	2005	Sold of non-core business and bought a number of subsidiaries in Egypt and region
National Petroleum Company	Citadel Capital	2005	A platform company to acquire, operate, develop and exploit upstream oil and gas assets or companies in the MENA region (acquired 6 concessions and multiple companies)
Arab Cotton Ginning	Amwal Al Khaleej	2006	Consolidated a number of subsidiary companies through Amwaal AL Arabia Holding Company
Egyptian American Bank	MMID	2006	Merged with Credit Agricole in a joint acquisition
Egyptian Fertilizer Company (EFC)	Abraaj Capital	2007	Abraaj merged EFC with Orascom Construction Industry's Fertilizer division
Gozour	Citadel Capital	2007	Platform company to consolidate and grow leading consumer goods brands in agriculture and dairy, fast-moving consumer goods, and food intermediates
GlassWorks	Citadel Capital	2007	A platform company to invest in glass manufacturing through both consolidation and greenfield projects
Rally Energy Group	Citadel Capital	2007	Consolidated with NPC, another portfolio company
Wataniya	Eurofund	2008	Company later acquired Baddar, a competitor
SOLS and SOMICO	Haykala	2008	Bought and merged two steel companies

Sources: Compiled by the author based on private equity firms' websites, reports, and financial news websites

5.3.3 *Professionalizing*

One of the key ways of improving the performance of companies, especially family-owned businesses, is to transform them into more professionally managed enterprises. This can be done in several ways, such as (i) hiring a professional management team with strong skills and experience; (ii) creating the proper governance mechanisms that provide for strong management accountability and proper performance incentives; or (iii) modernizing the company's operations and processes across the different business functions. This type of transformation is particularly important in two cases: small and medium family-owned and managed businesses, and recently-privatized state-owned enterprises (SOE's). In both situations there is limited separation between ownership and management.

In the case of family-owned businesses, professionalizing the management becomes important during periods of rapid growth or transition from the founding generation to the next generations within the family (Hollander and Elman 1988, Barry 1989, Dyer 1989, Berenbeim 1990, Cromie, Stephenson and Monteith 1995). In the case of SOE's, changing the corporate governance structure and professionalizing the management is critical to their transition from state ownership to private ownership.

Corporate governance, defined as the way by which the relationship between the owners and managers of a company is organized, is a problem that is as old as modern Capitalism. In 1776, Adam Smith (1979) identified this problem in *The Wealth of Nations*:

> The directors of such [join-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion therefore must always prevail, more or less, in the management of the affairs of such a company.

At the core of corporate governance is the *agency* problem: *How do firms align the incentives of professional managers with the owners?* The nature of the agency problem depends on the ownership structure, which varies by country. In the US and the UK, most firms are widely-held by a broad distributed ownership base. In other countries, especially in emerging markets, most firms are part of family-owned business groups, where families own large, sometimes controlling, shares (Morck and Yeung 2002). In the widely-held corporations, the agency problem becomes an issue of ensuring that professional management performs their fiduciary duty of acting in the broad interest of public share holders. This is often achieved through aligning incentives with performance (e.g., linking financial performance to management compensation). In family businesses, with concentrated ownership, the agency problem becomes an issue of protecting minority shareholders' interests (Fama 1980, Schulze et al. 2001, Morck and Yeung 2002)

In private equity transactions, corporate governance is a critical part of the transformation. In many of the reviewed transactions in Egypt, the portfolio companies were family-owned prior to the private equity investment or acquisition, with little or no board of directors and corporate governance mechanisms. Part of the private equity transformation is instituting a board of

directors with proper governance processes and incentives for the management team. This also takes into consideration the private equity exit strategy. If the exit strategy is through a trade sale, then the emphasis on governance is usually short term; if the exit strategy is an IPO, then creating formal corporate governance is critical to the success of the transaction. While private equity offers concentrated ownership, similar to the family business situation, the nature of the private equity firm involvement is short-term by nature, so they do not typically interfere in the day-to-day management of their portfolio companies, but rather prefer to engage at the level of frequent (e.g., quarterly) board meetings.

In addition to instituting or changing corporate governance, private equity firms often replace or augment the management team of their portfolio company, depending on their value creation strategy. Table 5.3 highlights examples of how private equity firms helped professionalize the management and governance of their portfolio companies as a way to increase their value.

One of these examples is ITWorx, an Egyptian-based software professional services organization, with global clients and operations in North America, Europe, and the Middle East. The company provides Application Development Outsourcing services, Enterprise Application Integration, Business Intelligence, and Portals to Global 2000 companies. ITWorx serves different sectors, including financial services firms, educational institutions, telecommunication operators, media companies as well as governmental agencies. The company was started in 1994 by a small group of entrepreneurial software engineers, and has since grown tremendously to serve an extensive set of clients, including global corporations like United Technologies, Microsoft, Vodafone, and Mellon Bank. (ITWorx 2008, 2009) In 2007, ITWorx sales revenues were more than $20 million,

and the company employed more than 700 software developers and engineers in Egypt, Saudi Arabia, the United Arab Emirates and the United States (Arabian News 2008).

In January 2008, a consortium of three private equity firms acquired 79% of ITWorx for an undisclosed amount, in a move to provide the company with additional liquidity to rapidly grow its operations. The remaining 21% of the company will continue to be held by founders, management and employees. ITWorx was also planning to raise a second round of financing of around $8 million in 2008 to expand its local presence in key Middle East markets including Bahrain and Kuwait, and also to expand into new industry verticals including oil and gas, construction, and real estate. (ITWorx 2008, 2009, Arabian News 2008)

The first of the three parties that acquired ITWorx is the EuroMena Fund, a private equity fund dedicated to investing in the Middle East and North Africa (MENA) region, and managed by Capital Trust Group. The Group was formed in 1985 by several financial institutions, and then acquired by its own management in 1996. The Group provides advisory and investment banking services, and acts as the lead investor or co-investor with other financial institutions. It initiates, arranges, advises and invests in private equity, mezzanine debt and real estate. The Group operates in the United States, Europe, the Middle East and North Africa, and has offices in London, New York and Beirut (Capital Trust Group 2009). Capital Trust Group is the lead private equity firm in this transaction. The second investor is Venture Capital Bank (VCBank), the first dedicated Islamic venture capital bank in the MENA region. VCBank was established in Bahrain in 2005, with a paid up capital of $165 million, to provide an investment vehicle for high-growth Islamic-compliant companies

within the Middle East and North Africa. VCBank is active in four principal areas: venture capital and business development, private equity, real estate, and financial advisory (Venture Capital Bank 2009). The third investor is Proparco, which is the private sector financing arm of the French Development Agency (Agence Française de Développement AFD). Proparco was created in 1977 to advance economic growth, sustainable development and the Millennium Development Goals (MDGs) by financing private sector investments in developing countries through equity, loan and guarantee products (Proparco 2009).

Capital Trust Group, being the lead investor on the transaction, has worked with ITWorx to professionalize their corporate governance and management in several ways. First, Gilles de Clerck, a senior manager from the EuroMena Fund, joined ITWorx's board as the Chairman position. De Clerck has 15 years experience in business strategy and finance, and is actively involved in ITWorx at the strategic level. The company also strengthened its finance department by hiring a new Chief Financial Officer (CFO), who comes with more than 20 years of experience in accounting, auditing and financial control in various regional and multinational corporations, as well as other finance staff (Capital Trust Group 2009). The company also hired three senior marketing professionals to support its regional expansion in Europe and the Middle East. Finally, ITWorx maintained the rest of the management team, which includes the company's founders. In addition to strengthening the management team, the Capital Trust Group worked with ITWorx to institute stronger governance and reporting process. For example, they created a management incentive structure allowing the management team to benefit from the funds' capital gains upon exit, if it meets a specified performance hurdle rate. The company also set up monthly

reporting to provide transparency into performance, and started a monthly meeting for the executive committee to discuss performance, market trends and outlooks (Capital Trust 2009).

Capital Trust Group identifies its role in professionalizing and facilitating the transformation of small and medium enterprises, e.g., family business or entrepreneurial companies such as ITWorx, as an important value creation strategy. Part of this process is supporting improvements in the company's human resources practices, financing structure, business model, corporate governance and reporting. Another part is through active participation at the board and executive committee level, and maintaining personal relations with the management team. A third part is providing connections with banks, potential clients or partners (Capital Trust Group 2009). In doing so, the private equity firm provides support to their portfolio companies, beyond equity financing.

A second example is the case of BiscoMisr, which was partially acquired by a consortium led by Concord International Investments in January 2005 (El-Saadani 2007). BiscoMisr was established in 1957, and, for over 60 years has been a leading confectioner and producer of food products and a popular household brand in Egypt. The company was state-owned, until 1999, where the government floated 60% of the company in the Egyptian Stock Exchange, and retained the remaining 40%. This IPO privatization changed the legal status of the company, and some of its operations. However, while the company was profitable, the lack of an anchor investor driving change and transformation led to limited change in performance after privatization (El-Saadani 2007).

In January 2005, a consortium led by Concord Investments International acquired a majority stake in the company, including all government shared. The consortium included the American University Endowment Fund (Karnak) and the Commercial International Bank (CIB). The consortium acquired 61% of Bisco Misr. Concord paid LE 156 million ($28 million) for 56% of the company, and the rest went to the other partners (El-Saadani 2007). Concord Investments International Group id a New York-based investment management company focusing on investing in Egypt and the region. Concord manages a large portfolio of mutual funds focusing on Egyptian equities, and has also has successfully executed and exited a number of private equity transactions in Egypt (Concord 2009).

In their effort to turnaround BiscoMisr, Concord hired an experienced management team led by Samir Sabet, a veteran pharmaceutical executive with experience in Swiss Pharma and Novartis. The new team planned and executed a complete transformation and turnaround program to enable the company to modernize its operations, improve profitability, and grow locally and regionally. This program covered all areas of the company, including finance, operations, marketing, sales, distribution, and technology. In the finance area, the company moved from manual paper-based accounting to a new automated system. The finance function was expanded to include budgeting and financial control, and the team was strengthened with new hires. In the operations area, the company invested in modernizing and expanding its production facilities. In the marketing area, the company rebranded its products and focused on core profitable products. In the sales area, they implemented a new client database and started connecting with retail distributers rather than relying on a handful of wholesale distributors. This was coupled with the creation of a new

transportation fleet to distribute their own products. In the technology area, where the company did not rely on computers in its operations, they created a whole IT infrastructure from scratch. This included communications infrastructure between the different locations and spreading the use of computers in all departments. The company also implemented an Enterprise Resource Planning (ERP) system to manage and connect all its operations and reporting (El-Saadani 2007).

All of these changes required significant change in the skill sets that the company's employees had. BiscoMisr started by offering 600 of its 2,700 staff early retirements at the cost of LE 11 million ($2 million), and rehired a similar number of better skilled employees in their place. They also changed their compensation structure and provided a performance incentives, higher salaries and better healthcare coverage. Many employees were working two jobs to compensate for their meager salaries. They were requested to focus on their BiscoMisr job, in exchange for higher compensation that is performance based. This transformation program aiming at professionalizing BiscoMisr's management, operations, processes and employees is paying off. The company's product quality profitability and growth rates are all improving (El-Saadani 2007).

While this global financial crisis provided big challenges to private equity firms as well as their portfolio companies, it also offered some opportunities. Many of these companies were able to complement and upgrade their portfolio companies' management teams. Citadel Capital is a good example:

> The past year presented unique opportunities to upgrade management talent at the Platform Company level. Against that background, we completely overhauled management at two companies and brought new talent in at others. In 2009, Citadel Capital engaged top talent across its 19 Platform Companies and their Portfolio Companies, including one Chairman (Gozour), five Chief Executive Officers (ASEC Cement, Gozour Agri, Sphinx Glass, Bonyan, ASCOM Gold), two Chief Operating Officers (Egyptian Refining Company, NOPC / Rally) and five Chief Financial Officers (ASEC Cement, Sphinx Glass, Bonyan, NOPC / Rally, TAQA Arabia). (Citadel Capital Annual Report 2008)

These examples highlight how private equity firms are professionalizing their portfolio companies by strengthening their management capabilities and instituting corporate governance processes and practices. While these actions help private equity firms increase the value of these companies, they also improve the companies' performance and competitiveness over the long term. This strategy is particularly beneficial in developing countries where the majority of the companies are family-owned and do not have strong professional management teams or modern operations. Table 5.3 highlights a number of examples where private equity firms professionalized their portfolio companies as a value-creation strategy.

Table 5.3 Examples of private equity firms professionalizing portfolio companies

Company	PE Firm	Year	Description
Gezira Sheraton	EFG Hermes	1999	Installed a new CEO
SODIC	EFG Hermes	2002	Instituted a management change
BiscoMisr	Concord	2005	Hiring a new experienced management team; redesigning key processes, including marketing, production, and distribution; installing new financial controls, processes and systems; creating an IT infrastructure and ERP system
ASEC Holding	Citadel Capital	2005	Installed a new management team to turnaround the distressed firm
Egyptian American Bank	MMID	2006	New management by merging it with Crédit Agricole's operations
Commercial International Bank	Ripplewood	2006	Gained new Board Members that had Fortune 500 experience
National Petroleum Company	Citadel Capital	2007	Hired new CEO, Operations Director and created an Acquisitions Department
Rally Energy Group	Citadel Capital	2007	Hired a whole new management team
Nasr Housing	Beltone Financial	2007	Provided management direction to improve share price
ITWorx (IT software development)	Capital Trust Group	2008	Hired new sales team for regional expansion, created corporate governance, new Board of directors, management incentives, hired new CFO and strengthened finance

Sources: Compiled by the author based on private equity firms' websites, reports, and financial news websites

5.3.4 *Growing and Globalizing*

Growing a business seems like an intuitive goal that all companies would aspire toward, but that is not always the case. There are three reasons why companies do not always try to grow their business: (i) lack of will to grow, (ii) lack of skill to grow, or (iii) lack of capital to grow. The first is a matter of risk aversion, especially in many small and medium family businesses, where the owners may be satisfied with the profits generated, and may not be willing to take additional risk to grow the business. For example, Donckels and Fröhlich (1991) compare objectives, values and strategic behavior of family and nonfamily businesses using observations of 1,132 small and medium enterprises in eight European countries. They find that family businesses are typically risk averse, inwardly-focused, and demonstrate a conservative strategic behavior. "[R]isk aversion and fear of losing control of the business lead many family businesses to seriously limit their growth potential by not adopting generally accepted financial management policies" (Donckels and Fröhlich 1991). This risk averse behavior is often compounded by the limited skills and human capital, especially in technical, marketing, or product design areas, and the limited access to capital to finance the growth opportunities. For example, in Egypt, only 21.1% of firms have access to long-term bank credit compared to 78.9% that do not have access. Among the former, larger firms are more likely to have access (41.5%), compared to medium size (19.1%) and smaller (13.7%) firms[51].

Tables 5.4 and 5.5 highlight examples of private equity firms growing and globalizing their portfolio companies. One example is Mo'men, a local chain of

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[51] Based on our analysis of a 2003 World Bank survey of a random sample of 1,000 Egyptian companies.

fast-food outlets, which received investments from Actis, a United Kingdom-based private equity firm. Mo'men was founded in 1988 by two brothers at a small sandwich place in the Heliopolis suburb of Cairo, and has since grew to become one of the largest food chains in Egypt with 36 branches, as well as presence in Libya and Sudan. The company has expanded to include two other restaurant chains: a ready-made food label, while also operating its own meat and poultry production facilities. It also has plans to acquire a domestic coffee shop chain (Schurgott 2008).

Actis, founded more than 60 years ago, is a UK-based private equity investor focusing on investing in emerging markets. Actis has 11 offices in emerging markets and $7.6 billion in assets under management, out of which $1.5 billion are invested in Africa (Actis 2009). The private equity firm started its operations in Egypt in 2002 through a local office, and has since completed four transactions in Egypt. The firm's value-creation strategy is focused on growth: they invest in "existing, profitable, established businesses," with the objective of growing them and expanding their operations internationally (Schurgott 2008).

In September 2008, Actis acquired a 28% stake in Mo'men for $48.5 million, with the goal of providing capital to Mo'men for rapid growth domestically and regionally. For twenty years, the company was growing organically through retained earnings. Their negotiations with Actis started in 2006 and took more than two years to complete. As most family-owned businesses, control over their company was the key concern. For example, Sherif Elkhouly, the investment principal for Actis Egypt, comments on his initial interaction with Mo'men:

> When I spoke to [Mr. Mo'men] for the first time, the concept of private equity was completely new to him. It was a closed family-oriented

> business and the thought of having an 'outsider' coming into the shareholder base was taboo. It took quite a lot of work and explanation of what Actis is about and why it's in his company's interest to have Actis alongside them to get a second meeting and to explain more, to show him what we've done in this sector over the world before and what we've added to these businesses. It was a process of building trust (Schurgott 2008).

Once the two parties established a trust-based relationship, the discussion shifted towards the business plan. Mo'men established a five-year business plan, with specific milestones, projects, and investment requirements. The company plans to grow its local franchises across the country. They are also planning to expand their presence through franchising agreements in the region, starting with Sudan, Libya, Bahrain and the United Arab Emirates, and following in Saudi Arabia, Kuwait, and Qatar. They are also expanding its meat and poultry production and processing and bakery capacity, and looking into establishing other food processing facilities, including tomato paste, fruit pulp and frozen vegetables. They are also negotiating with other multinationals to establish a logistics and supply chain joint venture to support their operations. These actions will enable Mo'men to operate in a vertically integrated model, and have better control over their cost structure and supply chain (Schurgott 2008).

For Actis, the value creation strategy for this transaction is through the rapid growth, both domestically and regionally, of Mo'men. Their contribution to the transaction comes in the form of the capital injection, as well as the management support, which comes in various forms. First, Actis provides a strong presence at the board of directors' level, where they can monitor performance and advise the company on strategic decisions. Second, they also provide consulting support through their network of industry experts, and access to other markets through

their offices across the globe. Beyond that, they do not interfere in the day-to-day management of the company (Schurgott 2008).

This transition also had significant implications on Mo'men's corporate governance, which further supports the role of private equity in professionalizing their portfolio companies, as analyzed in the previous section. The company had to reorganize its operations and change its legal structure, moving from an ad hoc organization with some partnerships and some shareholder companies, to a holding company with multiple business units with clear boundaries. They had to create a board of directors, assign corporate management responsibilities, and institute formal governance and reporting processes. They also had to streamline their tax accounting and settle any outstanding tax issues (Schurgott 2008).

This example highlights a private equity value creation model that is completely focused on growth and regional/global expansion. The company had a successful growth story and a strong management team. The private equity firm did not go for a majority ownership, but instead accepted a minority share, with control remaining with the original family owners. Their contribution was to provide capital as well as business know-how and support during the fast growth process. In these types of transactions, the private equity exit strategy is more likely to be through a share sale back to the owners, or an initial public offering, rather than a trade sale to a multinational or another financial investor.

Another example of private equity growing and globalizing their portfolio companies is Al-Borg Laboratories, the largest private provider of medical lab tests in the Middle East, by Abraaj Capital, a Dubai-based private equity firm.

Al-Borg was founded in 1991, and has since served more than 10 million patients and conducted more than 29 million medical tests. Al-Borg operates a network of more than 60 medical labs across Egypt, as well as 14 labs in Saudi Arabia, four in the United Arab Emirates and one in Qatar. It employs more than a thousand medical professionals, including specialized lab physicians, experienced technologists and management staff, and conducts more than five million tests per year (Abraaj Capital 2008).

Abraaj Capital is a Dubai-based private equity firm that invests in Middle East, North Africa and South Asia (MENASA) region. The firm has $5 billion of assets under management in four funds: buyout funds I and II, real estate fund, and infrastructure and growth capital fund. The firm's investors include pension funds such as the Qatar Pension Fund and the Kuwaiti Public Institution for Social Security; international banks such as Deutsche Bank; regional holding companies such as Al Jaber Group (UAE), Al Qudra Holdings (Abu Dhabi); as well as wealthy individuals from the GCC countries. (Abraaj Capital 2008)

In May 2008, Abraaj acquired a 76.9% stake in Al-Borg Company for an estimated $143.7 million; the remaining shares are still publicly traded in the Egyptian Stock Exchange. The main objective of the transaction is to provide Al-Borg lab with additional capital and management support to grow its operations within the region due to three factors. The first factor is the region's demographics of a young and rapidly growing population with growing income and demand for quality healthcare. Second, the region is underserved in terms of medical service; for example, the average lab tests per capital is 2.5 in Egypt and six in Saudi Arabia, compared to 16 lab tests in Europe and 22 in the United States. The third factor is the potential for the lab to go beyond Egypt to cover the

whole region, which it has already started through its presence in three GCC countries. Providing regional growth requires two critical resources: trained experienced lab physicians and technicians, which Al-Borg has developed through ongoing professional training; and significant capital to finance the acquisition of the required equipment and technology, which requires constant upgrading every 3-5 years. This transaction provides the lab with access to capital for its regional growth (Abraaj Capital 2008)

These examples highlight a private equity value creation model based on growth and regional/global expansion. The companies in each of these examples are successful and rapidly growing; however, they need additional capital as well as support in setting their strategic direction, professionalizing management and gaining market-access, which the private equity firm is able to provide. Table 5.4 provides additional examples where private equity firms grew the operations of their portfolio companies domestically and regionally or globally as a value-creation strategy.

Table 5.4 Examples of private equity firms growing portfolio companies

Company	PE Firm	Year	Description
Lecico	EFG Hermes	1996	Investment for increasing capacity and new production lines
Vodafone Egypt	EFG Hermes	1999	Investment allowed for purchase of bandwidth and telcom license
ACE - CIIC	EFG Hermes	2000	Investment allowed for license acquisition
Rashidi El-Mizan	Actis	2003	Continue increasing capacity after purchase from Unilever
Raya Holding (IT services)	Injazat Technology Fund	2003	Investment to develop Raya's domestic and regional Internet service provider (ISP) business, mobile phone distribution business, and IT integration and services business
Enjoy	Haykala	2005	Potential to increase capacity by 120%
Sokhna Port Company	AIG African Infrastructure Fund	2005	Finalising development of port complex
BiscoMisr	Concord	2005	Investing additional LE 80 million ($15 million) to expanding production facilities, grow local markets, and implement ERP systems
HoneyWell	Haykala	2006	Growing firm in domestic market, with a focus on turnaround
East Mediterranean Gas Company	Ampal	2006	Growth in gas export capacity
Metito Water Treatment	Gulf Capital	2006	Growth in water desalination sector
Taqa	Citadel Capital	2006	Increased capacity to satisfy domestic consumption needs
Al Nouran Holding	Abraaj Capital	2007	Investment will allow for production of sugar production facility
Sinai Holding for Marble and Investments	Actis	2007	Investment will quadruple quarrying capacity as well as triple marble capacity

SEKEM Group	Gemeinschaftsbank	2007	Investment for increase in capacity and exportation abilities
Alexandria Container Terminal	MENA Infrastructure Fund	2007	Investment in growing industry
Gozour	Citadel Capital	2007	Platform company to consolidate and grow leading consumer goods brands in agriculture and dairy, fast-moving consumer goods, and food intermediates
Tanweer (Publishing media & distribution)	Citadel Capital	2007	Expanding publishing rights and number of stores nationally and regionally
Beard	Beltone Financial	2007	Investment in international manufacturing facilities
Cairo Medical Tower Laboratory	Abraaj Capital, Concord	2008	Rapid expansion, especially as governments in the region incentivise private-sector participation in the healthcare sector
Contact Car Company	Amwal Al Khaleej	2008	Expanded the firm's car financing to include used cars and insurance, planned entrance into the mortgage market
Mo'men (fast food chain)	Actis	2008	Looking for growing number of brands under management
Minapharm	BankInvest	2008	Growth in Biotech subsidiary
SOLS and SOMICO	Haykala	2008	Adding new production lines in steel sheet production

Sources: Compiled by the author based on private equity firms' websites, reports, and financial news websites

Table 5.5 Examples of private equity firms regionalizing/ globalizing portfolio companies

Company	PE Firm	Year	Description
Raya Holding (IT services)	Injazat Technology Fund	2003	Investment to develop Raya's domestic and regional Internet service provider (ISP) business, mobile phone distribution business, and IT integration and services business
ASEC Cement	Citadel Capital	2005	Acquired and expanded production and operations in Algeria, Sudan and Libya
National Petroleum Company	Citadel Capital	2005	Acquiring 6 upstream oil and gas concessions or companies in the MENA in Egypt and Sudan; Pakistan planned
Research and Development International (RDI)	Technology Development Fund	2005	Regional expansion of software company focusing on the creation of Arabic language software
OstazOnline	Technology Development Fund	2005	Regional expansion of online teaching aid online portal
BiscoMisr	Concord	2005	Expanding to regional markets in Africa and Arab countries; benefiting from the COMESA free trade agreement with neighboring African countries
Commercial International Bank	Ripplewood	2006	Investment allows for regional growth
Premiere Casing Services	Haykala	2007	Regional expansion into GCC countries
Cairo Medical Tower Laboratory	Abraaj Capital, Concord	2008	Planning to expand medical lab services regionally
Mo'men (fast food chain)	Actis	2008	Expanding fast food chain stores regionally
ITWorx (IT software development)	Capital Trust Group	2008	Assisted the company in expanding regionally through acquisitions

Sources: Compiled by the author based on private equity firms' websites, reports, and financial news websites

5.4 Conclusions

Private equity ownership of portfolio companies affects these companies in many ways, including employment, wages, productivity, performance, growth, innovation and governance, as demonstrated by many empirical studies conducted using data sets of completed private transactions in developed countries. While these studies are hard to replicate due to the recent nature of private equity transactions in emerging countries, qualitative review of these transactions show that the nature of the value creation strategies used by private equity differs from developed countries. By examining these value creation strategies, we hypothesize that the impact of private equity on their portfolio companies differs between developed countries and emerging markets. Specifically, we show that private equity firms have a positive impact on the companies that they acquire in developing economies because they act as catalysts for initiating, consolidating, professionalizing, growing and globalizing their portfolio companies.

Private equity firms initiated or participated in the initiation of a large number of venture capital-backed startups, joint ventures and green field companies. In venture capital, the emphasis is on providing capital and management support to individual entrepreneurs; in joint ventures, the emphasis is on supporting existing companies as they start a new line of business through a joint venture; and in green field companies, private equity firms acted as the entrepreneur and initiated new capital intensive companies. Private equity firms served as catalysts in consolidating several smaller companies into a larger more competitive entity using different strategies. In one example, the private equity firm identified the market opportunity first and created the platform company,

then proceeded to execute a series of acquisitions; in a second example, the private equity firm simultaneously acquired and consolidated two similar size companies; in a third example, the private equity firms worked with a multinational corporation to facilitate their entry into the Egyptian market through a series of acquisitions and consolidations. Private equity firms also professionalized their portfolio companies by strengthening their management capabilities and instituting corporate governance processes and practices. They hired new CEO's, marketing executives and finance executives; improved reporting practices; created new boards or strengthened existing ones; and provided guidance in business planning for new expansions and growth. These actions were particularly beneficial in developing countries where the majority of the companies are family-owned and do not have strong professional management teams or corporate governance processes. Lastly, private equity firms increased the value of their portfolio companies through growth and regional/global expansion. The companies in these examples are successful and rapidly growing; however, they required additional capital as well as support in setting their strategic direction, professionalizing management and gaining market-access, which the private equity firm was able to provide.

* * *

CHAPTER 6: CONCLUSIONS

In this chapter, we summarize the research findings; revisit our research questions and hypotheses; and discuss some policy issues and implications emerging from this research.

6.1 Summary of Research Findings

In Chapter 2, we examined the private equity industry in emerging markets and the MENA region, and establish four key points. First, over the past five years, private equity fund raising in emerging markets has grown exponentially, both in absolute and relative terms. In 2002, all emerging markets private equity funds combined raised \$3.2 billion, a mere 3.1% of the \$102 billion raised by the private equity industry globally; in 2003 the figure was \$3.5 billion, or 3.9% of the global industry. In 2008, emerging markets private equity fund raising reached a record \$66.5 billion, growing 19 fold from 2003, despite the global financial crisis. This figure represented 15% of the \$445 billion raised by the private equity industry globally (EMPEA 2009).

The second point is that most private equity funds in emerging markets are "generalists." Among the 204 funds with closes in 2007, 118 funds managing \$39.1 billion, or 66.2% of the total capital raised, did not have a sectoral focus. The remaining 69 funds managing \$17.1 billion, or 28.9% of the total, were classified into 9 sectors, with technology, infrastructure and energy as the top three areas. This reflects the smaller size of emerging markets, where sector

specialization is harder than in developed countries. The fact that most funds prefer to be diversified across multiple sectors may also suggest that the source of value-creation in emerging markets is not deep sectoral knowledge, but rather generic financial, management and turnaround skills that can be applied to any sector.

The third point relates to the emerging markets private equity returns. In terms of three-year returns, emerging markets private equity returns are higher than developed markets private equity; similar to emerging markets publicly-traded equities; and significantly higher than developed markets publicly-traded equities. While these returns show the high potential for emerging markets private equity investments, they also reflect the risk premium expected by investments in a higher risk asset.

The fourth point relates to private equity investments in the MENA region, which are still small, despite the high growth in fund raising. For example, as a percentage of GDP, private equity investments in the MENA region are ~0.3%, compared to 3.2% in the United States and 0.8% in the European Union, and 0.5% in emerging markets in Asia (EMPEA 2009a). Within the region, the top three countries in terms of attracting private equity investments are Egypt, the United Arab Emirates and Saudi Arabia.

In Chapter 3, we focused on the private equity industry in Egypt, and we established two key points. The first point is that private equity investments in Egypt are notably high compared to other emerging markets and the region. We estimated private equity investments in Egypt over the past five years to be $2.6 billion annually on average, or 1.6% of Egypt's 2008 nominal GDP of $158.3

Billion (World Fact Book 2009). To understand the importance of these investments, we compared them to a number of benchmarks. Based on the average of the past five years, private equity investments in Egypt represent around 37.8% of the total FDI inflows; 27% of the target private sector investments in the national investment plan; and 6.8% of the bank credit extended to private sector companies. They also represent 1.7% of the Egyptian Stock Exchange market capitalization, compared to 0.85% globally in 2008, including all developed and developing countries. These benchmarks highlight the high level of private equity investments in Egypt, both in absolute and relative terms.

These high levels also raise two questions. First, why are private equity investments in Egypt higher than the rest of the region as well as other emerging markets? The second question is whether these higher figures make Egypt an anomaly, and limit the scope of our findings to this case. These two questions require more comparative analysis, which needs to be done in future research. However, it is likely that the findings from this case study would provide good hypotheses to test in other countries.

The second point in Chapter 3 is that the majority of private equity activities in Egypt are performed by "home-grown" private equity firms. Over the past 5-10 years, a number of local private equity firms emerged and quickly expanded. They were mostly founded by experienced professionals, and have managed to create a competitive advantage for themselves, both domestically and regionally. These firms played the primary role in growing the industry over the past five years and are now aggressively expanding regionally. One hypothesis that needs to be tested in future research is whether the presence of these home-grown

firms is responsible for the high level of private equity activities compared to other countries. Through our analysis of these firms, we also hypothesize about five key competencies that contribute to their competitive advantage, namely: access to capital, access to deals, deal structuring knowhow, business transformation and turnaround knowhow, and political access. These five competencies were present at varying levels in most of the private equity firms that we examined.

In Chapter 4, we traced the end-to-end activities of the private equity cycle, including fund initiation and setup, investing, portfolio management and exit. At each step, we compared the private equity business model between developed and developing countries to understand how private equity firms are adapting to the local needs and conditions of developing countries. Our over-arching hypothesis was that while the private equity model is transferable and useful in emerging countries, private equity firms adapt to the local peculiarities of doing business in such emerging markets.

The first phase in the private equity cycle is fund initiation and setup, starting with setting up the fund legal and governance structure. From a theoretical point of view, the key issue discussed in the literature involving private equity fund setup is agency: what is the fund structure that best provides adequate protections for investors, while providing performance incentives for fund managers acting on behalf of the investors, along with sufficient decision making autonomy. In developed markets, private equity funds are setup as limited partnerships (GP/LP model). However, limited partnerships, as legal entities, are not available in Egypt and many other emerging markets, especially those with legal systems based on French civil law. A large number of private equity funds

in Egypt are domiciled offshore, which provides investors and fund managers with more flexibility in designing the fund structure. However, a number of funds are also incorporated domestically in the form of joint stock companies. In these situations, they try to contract around some of the legal limitations of joint stock companies by designing their contracts to simulate some of the features of the GP/LP fund, such as the management fees. However, one critical limitation of the joint stock or holding company is that it does not provide for term limits for the fund, a feature that provides significant protection for investors and a discipline mechanism for fund managers.

Raising capital is the next step in the fund initiation. In Egypt, anecdotal evidence from interviews indicates that the majority of private equity capital comes from local and regional (Arab GCC countries) sources, be they institutional or family/ individual sources. Additionally, there are some examples of banks financing private equity firms, and also one case of a government-sponsored venture capital firm to develop the information technology industry. However, the participation of large US- and EU-based institutional investors remains limited.

The second phase in the private equity cycle is investing. In terms of the types of investments, private equity firms in Egypt are investing heavily in family businesses. In some transactions, they provide growth capital and acquire a minority stake in the company, where the family owners continue to maintain control of their business and use the capital to implement their growth plans; in other transactions, they acquire a controlling stake in the family business and implement a turnaround or consolidation program. Private equity firms are also investing in consolidations, where they are acquiring a number of small and

medium companies and consolidating them to create larger more competitive entities. There are also some examples of investing in turnarounds and privatization. In the case of a turnaround, the focus is usually on improving management, financial controls and accounting practices. In the case of privatization, private equity firms are more inclined to invest in large capital intensive companies in sectors like cement or fertilizers, but shy away from labor intensive industries such as textiles.

In terms of the sectoral focus of private equity firms in Egypt, the biggest industry by far in terms of number of transactions is telecommunications and information technology; however, most of these transactions are venture capital investments in startups or small companies, with limited capital. In terms of transaction size, the biggest industry is basic materials, which includes cement, fertilizers, steel and other similar heavy industries. This sector has the second largest number of transactions and an average transaction size of more than $1 billion. These transactions include the acquisition, turnaround and sale of ASEC Cement Holding and the Egyptian Fertilizers Company, both transactions executed by Citadel Capital, and considered the largest in the MENA region. Other sectors with large private equity transactions are financial services, oil and gas, healthcare and pharmaceuticals. This distribution of transactions shows that the majority of the private equity money is geared towards capital intensive and highly regulated sectors, with high barriers to entry. In many of these transactions, private equity firms acquire companies that have operating licenses in these regulated areas and invest in expanding their capacity and scope of operations. Noticeably absent from private sector transactions are sectors like textiles, construction, tourism and retail distribution.

In terms of deal sourcing, private equity firms in Egypt identify personal and professional networks as the most common source of potential opportunities, followed by professional service firms that they work with, which include investment banks, accounting firms and law firms. For this reason, most international private equity firms actively operating in Egypt, such as Actis or the Carlyle Group, maintain a domestic presence. This pattern supports the argument that it is hard to conduct private equity transactions through remote offices and brief business trips. International private equity firms that are serious about doing business in an emerging market need to have a strong local presence and local staff with knowledge of the country, from a business, legal, political and culture perspective. This argument is also emphasized through the due diligence process, which inherently is a situation of informational asymmetry between the company owners and the private equity investors. This informational asymmetry is exacerbated in the cases of a non-local private equity firm. In some case examples examined in Egypt, especially in family businesses, the due diligence process also included a "transformational" component. The target company needed to restructure its corporate and legal structure, to improve its accounting and financial controls, and to settle any outstanding tax liabilities.

The third stage of the private equity cycle is portfolio management. In terms of governance, the level of engagement of private equity firms with their portfolio companies varied widely. In earlier transactions (for example, prior to 2004), a large number of private equity firms were passive investments, playing the role of asset managers, similar to investing in publicly traded equities. However, in the more recent transactions that we reviewed in Egypt (after 2004), the level of engagement of private equity firms with their portfolio companies varied,

ranging from being passive investors, to playing supportive roles to the management, to taking active leading roles. A number of private equity firms continued with passive investments, mostly providing growth capital to companies with good management. In some transactions, private equity firms played an active supportive role, where they helped the portfolio companies strengthen their management teams or enter new markets. In a third type of transactions, typically turnarounds or green field investments, they assumed a leading role in creating and executing the business strategy. One hypothesis, based on these three models, is that private equity firms that are more actively engaged with their portfolio firms are able to realize higher returns. While there is no strong empirical evidence to prove this hypothesis, there are some anecdotal case examples that may support it. Future research comparing these three models of engagement using large sets of empirical data may be useful.

The fourth and last stage in the private equity cycle is exit, which may be conducted through a trade sale, secondary buyout, initial public offering (IPO), or share buy-back. In Egypt, all of these exit strategies were available to and used by private equity funds. However, we found that trade sale was the most common strategy, but there were also cases of secondary buybacks and initial public offerings.

In Chapter 5, we examined private equity value creation strategies in Egypt using case examples of their transactions. Private equity ownership of portfolio companies affects these companies in many ways, including employment, wages, productivity, performance, growth, innovation and governance, as demonstrated by many empirical studies conducted using data sets of completed private transactions in developed countries. While these studies are hard to replicate due

to the recent nature of private equity transactions in emerging countries, qualitative review of these transactions show that the nature of the value creation strategies used by private equity differs from developed countries. By examining these value creation strategies, we hypothesize that the impact of private equity on their portfolio companies differs between developed countries and emerging markets. Specifically, we show that private equity firms have a positive impact on the companies that they acquire in developing economies because they act as catalysts for initiating, consolidating, professionalizing, growing and globalizing their portfolio companies.

Private equity firms initiated or participated in the initiation of a large number of venture capital-backed startups, joint ventures and green field companies. In venture capital, the emphasis is on providing capital and management support to individual entrepreneurs; in joint ventures, the emphasis is on supporting existing companies as they start a new line of business through a joint venture; and in green field companies, private equity firms acted as the entrepreneur and initiated new capital intensive companies. Private equity firms served as catalysts in consolidating several smaller companies into a larger more competitive entity using different strategies. In one example, the private equity firm identified the market opportunity first and created the platform company, then proceeded to execute a series of acquisitions; in a second example, the private equity firm simultaneously acquired and consolidated two similar size companies; in a third example, the private equity firms worked with a multinational corporation to facilitate their entry into the Egyptian market through a series of acquisitions and consolidations. Private equity firms also professionalized their portfolio companies by strengthening their management capabilities and instituting corporate governance processes and practices. They

hired new CEO's, marketing executives and finance executives; improved reporting practices; created new boards or strengthened existing ones; and provided guidance in business planning for new expansions and growth. These actions were particularly beneficial in developing countries where the majority of the companies are family-owned and do not have strong professional management teams or corporate governance processes. Lastly, private equity firms increased the value of their portfolio companies through growth and regional/global expansion. The companies in these examples are successful and rapidly growing; however, they required additional capital as well as support in setting their strategic direction, professionalizing management and gaining market-access, which the private equity firm was able to provide.

6.2 Revisiting Our Research Questions and Hypotheses

We started this research with two key questions: (i) *Why did private equity activities grow so much and so fast in Egypt?;* (ii) *What is the impact of private equity firms on their portfolio companies? And what are the broader economic development implications for the country?* In this section, we review these questions and hypotheses, and discuss our research findings.

In answering the first research question, *why did private equity activities grow so much and so fast in Egypt,* we identified the top driving factors. In addition to all the global and macroeconomic trends discussed earlier, we attribute the growth of the private equity industry in Egypt to two key factors. First, the private equity industry in Egypt is "home-grown" and is dominated by local firms that relied on a mix of local knowledge and expatriate knowhow. These firms developed key competencies that provided them with a strong competitive advantage and enabled their local and regional growth. These competencies include: access to capital, access to deals, deal structuring knowhow, business transformation and turnaround knowhow, and political access. We found these five competencies to be present at varying levels in most of the private equity firms that we examined.

Second, private equity firms, especially the home-grown ones, are learning and experimenting. While adopting global best practices in the industry, they also managed to adapt their business model and practices to the local market needs. These adaptations spanned the whole private equity investment cycle. For example, private equity firms adapted to legal limitations in several ways, including incorporating their funds in offshore locations and using contracts to

create similar governance structure to the GP/LP model. They also used value creation strategies, such as initiating new companies, consolidating small businesses into larger entities, or professionalizing and growing family businesses. These strategies are consistent with the types of opportunities available in emerging markets.

The second research question focuses on outcomes: *What is the impact of private equity firms on their portfolio companies? And what are the broader economic development implications for the country?* Based on our analysis of private equity transactions executed in Egypt over the past five years, we found that *private equity firms have had a positive impact on the companies that they invested in or acquired because they acted as catalysts for initiating, consolidating, professionalizing, growing and globalizing these companies*, as opposed to focusing on cost and labor reduction as a way of creating value.

We also found that *private equity firms in emerging markets, Egypt being a good example, are providing a new type of entrepreneurship that is emerging from the financial sector*, as opposed to the traditional entrepreneurship emanating from industry or technological circles. Throughout our analysis, we found a number of points that support this argument. First, there are numerous examples of transactions where the private equity firms are initiating or taking part in the initiation of new companies, including venture capital-backed startups, green field investments, and joint ventures. As we review these transactions, we find that private equity firms do play an entrepreneurial role in these situations, especially in green field situations. Similarly, in consolidation situations, the private equity firm is creating a larger, more competitive entity by assembling, consolidating and growing a number of smaller companies. We see this

entrepreneurial behavior among private equity firms that pursue an active engagement model with their portfolio companies, rather than ones that pursue a passive investment strategy[52]. Additionally, most of the private equity transactions reviewed included a focus on providing growth capital, as well as the private equity firm supporting the management in their growth activities through different measures, such as providing contacts to help in opening new markets, or hiring senior management.

In Chapter 5, we reviewed this hypothesis and found strong evidence towards the positive impact of private equity firms. However, few open questions remain. First, our observations are primarily based on the period between 2002 and 2008, which was a high growth period in Egypt and globally. The 2008/2009 recession and financial crisis resulted in a halt for most new private equity fund raising and investments, but the firms remained with their portfolio companies. Many of these portfolio companies were acquired at high valuations in 2007/2008, and are not likely to recover to the same levels. It is not clear how private equity firms will handle this situation, and if it will create any unexpected behaviors to recover their losses. Second, whether this argument can be extended to other countries is an open question. Private equity activities in Egypt are higher than many emerging markets, and the majority of the firms are home grown. It is not clear how similar/different the situation is in other emerging countries, and if private equity firms exhibit the same behavior or not.

[52] See section 4.5.1 for a discussion of the different engagement models.

6.3 The Private Equity Model in Emerging Markets

Based on our analysis of private equity firms, funds and transactions in Egypt and the MENA region, we argue that ***private equity is an effective model for investing in emerging markets for institutional investors and high-net-worth individuals***. As more of the global economic growth shifts towards emerging markets, institutional investors are seeking more exposure to these countries, and more capital flows are seeking attractive investments within these countries. However, the vehicles for these investments are limited. Capital markets in many emerging markets are not broad or deep enough, may not have the liquidity to support these inflows, and are often overvalued due to speculative demands. Private equity provides an alternative vehicle for these large investors. Private equity managers seek opportunities that are not publicly traded yet; they provide strong governance and accountability to their investors; they maintain an efficient capital structure; and they can structure their funds to maintain investors' tax exempt status. For the same reasons, private equity is also an attractive investment vehicle for the local or regional high-net-worth individuals and family investors who need to diversify beyond their core business and want to maintain their investments locally or in the region (which is a growing pattern in the Middle East).

Throughout our analysis, we found a number of points that support this argument. First, private equity firms provide investors with privileged access to transactions because of two reasons. First, private equity firms, through their extensive network, have access to proprietary transactions that are not available for other investors, even large institutional investors. Second, in situations of very large buy-outs, the transaction size creates a barrier to entry to most

investors. Only large private equity firms are able to create the required consortia to bid for such opportunities. Citadel Capital and Abraaj Capital have specifically demonstrated their ability to finance such very large transactions and profitably exit. This privileged access and barriers to entry provide private equity investors with opportunities for higher returns.

The second point in support of this hypothesis is that by conducting the deal sourcing and due diligence process, private equity firms reduce the informational asymmetries for investors, especially foreign investors with limited local knowledge. By using professional accounting and auditing firms, law firms, and other technical experts, private equity firms interviewed indicated that they conduct a thorough due diligence. They are aware of high-risk areas, especially around accounting and tax irregularities, and are able to scrutinize their target investments in a stronger way than most investors.

The third point is that private equity firms provide lower and predictable agency costs. Investors know that they will provide 20% of their profits to the private equity fund, and they know that this profit sharing mechanism will provide good alignment between their interests and the private equity firm's interest. Private equity firms have an additional incentive to perform as they seek the same network of investors for new fund and new investments, where creating and maintaining a strong track record becomes an additional performance incentive.

The fourth point is that private equity provides a competitive transaction cost, especially for foreign institutional investors. In Egypt, the cost of investing in private equity is comparable to investing in publicly-traded equities through an

investment fund. Additionally, the cost of due diligence and transaction execution is distributed over a number of investors.

However, we also found few points against our hypothesis. First, private equity investments are highly illiquid. Once investors commit to the fund, they are typically locked in until the fund liquidates, which makes this form of investment more appropriate to long term investors with access to liquidity elsewhere. This point became visible during the 2008/09 financial crisis, where several private equity firms could not draw down on their committed capital. The second issue is that private equity investments require a minimum investment threshold that makes it only accessible to institutional investors and high-net-worth investors. It is not accessible to retail investors. While some private equity firms have chosen to list in stock exchanges, this model is not widely spread through the industry. In 2008, Citadel Capital considered listing its shares, but pulled back due to the financial crisis.

One point that is relevant to this hypothesis, but which we have not examined in this research, is the capital structure in private equity transactions. Private equity firms in emerging countries are usually not able to leverage their transactions in the same ways as in developed countries. First, banks are reluctant to extend unsecured or excessive debt; and second, the cost of debt is typically much higher in emerging countries, especially those with high levels of inflation like Egypt. Exploring the capital structure in private equity transactions is a possible area for future research.

Based on this analysis, and our review of the private equity investment cycle in Egypt, we see evidence to support the argument that private equity is an

effective model for investing in emerging markets for institutional investors and high-net-worth individuals, and we expect to see increasing growth of emerging markets private equity, despite the global financial problems. However, more data points are needed to further test and establish this hypothesis. If this hypothesis stands, we expect private equity investments to increase, and we expect more funds from US- and EU-based institutional investments. We also expect a growth in the number of funds, which may dilute the industry returns both due to the "money chasing deals" phenomenon (Gompers and Lerner 2000), and also as less capable fund managers join the industry.

However, the real test for this model lies in the next few years. The 2008/2009 recession and financial crisis resulted in the halt of most private equity fund raising and investing activities. As the economy recovers, would investors return to investing in private equity funds in emerging markets?

6.4 Policy Issues and Implications

As private equity investments in emerging markets grow, it is important to have a deeper understanding of their business practices and impact on their portfolio companies. This understanding would influence a number of government policies. If the belief prevailed that private equity investments have a positive impact on the economy, then more would argue for positive government policies to support and attract private equity activities, similar to what many countries do to attract foreign direct investments (FDI). If the belief prevailed that these firms have a negative impact on the economy, then more would argue for stricter

regulations to limit their activities, similar to what many countries do to limit speculative "hot money."

Specifically, there are a number of policy issues relating to private equity that need to be examined. The first issue is regulation. As it stands today, private equity firms are not regulated as financial institutions. They incorporate locally as joint stock companies, or offshore as limited partnerships, and they are subject to corporate laws like any other company. However, as they grow larger and control more investments and companies, is there a reason to regulate them, similar to other non-banking financial institutions? The two key arguments in support of regulation are to provide additional transparency to the regulator and also to the public; and to limit any unforeseen systemic risks that may emerge from the industry. However, there does not seem to be a need for regulations to protect the investors due to the fact that all private equity investors are large institutional investors or qualified investors who are sophisticated enough to decide, manage and monitor their investments. This issue is important as the Government of Egypt just launched a new regulatory body, the Egyptian financial Services Authority, to regulate non-banking financial institutions, including insurance, real estate mortgage, or consumer credit cards as well as the capital market authority.

The second issue is transparency: how much disclosure should governments require from private equity funds operating in the country, regardless of their origin or domicile? By nature of being "private," private equity funds are not required to disclose any information to the public, but rather report to their investors. However, if private equity firms own, control and manage a sizable part of the economy, should there be public disclosure requirements? This issue

has been controversial in developed countries over the past few years (Walker 2007). If private equity firms are included under a regulatory regime, transparency should be the top objective.

The third issue is taxation. At the fund level, private equity funds are often incorporated in offshore tax havens to enable their tax-exempt investors such as pension funds to benefit from their tax status. However, this issue may be worth evaluating, especially in countries that have not instituted capital gains tax, such as Egypt. At the fund partners' level, the same issue exists. The GP/LP private equity structure considers partner profits as capital gains rather than normal income, and hence, they fall under a lower tax rate (this is the situation in countries that allow the GP/LP structure and that have capital gains tax. Over the past two years, Egypt considered implementing a capital gains tax on profits from the stock markets, however, the government decided against this policy in fear of driving down the markets. However, if a capital gains tax becomes an option in the future, then private equity investments may be included under the same tax regime. Having transparency into private equity investments would provide policy makers with information to design smart policies that would not drive private equity investors away.

The fourth issue is private equity funds legal structure. Most developing countries do not have the legal infrastructure to support private equity fund structure (limited partnerships). However, if private equity becomes a common investment vehicle in Egypt, the government may consider instituting this structure to attract more funds and further develop the country's financial services industry.

The fifth issue relates to using the availability of private equity capital toward large infrastructure projects using schemes like build-own-transfer (BOT) and public private partnerships (PPP). If more private equity funding becomes available, would it be a good policy to attract it to finance large infrastructure projects? Private equity firms have demonstrated their ability to attract and mobilize large investments in capital intensive areas, and could be useful in supporting investments in large infrastructure projects, given the right structure.

One important point to highlight, from an investor perspective: private equity money is highly illiquid and is tied to long-term investments, unlike "hot money," which focuses on speculations and can cause great macroeconomic problems. Private equity investors, by virtue of investing in illiquid multi-year investments, provide a vote of confidence in the overall economy and its prospects. Their interests are aligned with the overall performance and growth of the economy – they stand to make higher profits if the economy grows faster and if their portfolio companies grow more profitable. Therefore, it is in the interest of government to attract this type of capital.

All these are policy issues that need to be examined in light of the growing private equity presence in Egypt.

* * *

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APPENDIX 1: SURVEY QUESTIONNAIRE

Introduction and research objectives

"Access to finance" is one of the important factors for economic development – how does the national economy mobilize its savings (as well as foreign investments) and channel it to new and existing firms. It is a critical part of the development virtuous circle: efficient channeling of national savings and foreign money to investments, which in turn builds productive capacity, increases employment and productivity, and translates into more savings. This is specifically important in developing countries where there is a huge increase in population that needs to be matched by a corresponding increase in the mobilization of capital to provide employment opportunities for the growing workforce.

The objective of this research is to understand how the emerging Private Equity / Venture Capital activities influence economic development in Egypt, as an example of an emerging economy.

We are conducting interviews with all the leading PE/VC funds in Egypt to get insights on how their funds operate, and to document case studies of specific portfolio companies. We will as two sets of questions: the first on the fund as a whole and how it operates; and the second is on specific portfolio companies, and how operating under a PE/VC fund has affected this company's operations.

Confidentiality: the information provided will be used only in aggregate or without identifiable reference.

I. Fund-Level Questions

Fund Background

1. Can you provide a brief background on the fund:
   - How and when did it start?
   - Who are the founders?
   - What is the size of the fund ($, number of investment professionals)
2. When did you execute your first deal? What is the number of deals to-date? What is the average deal size?
3. What is the composition of the fund management team? (e.g., foreign fund manager as a partner? Investment bankers? Etc.)
4. What is the source of the fund capital?
5. What is the fund legal structure? (e.g., Law 95/1992, Law 8/1997, or Law 159/1981)

Fund Focus

Do you focus your activities on specific areas of investment, e.g.,

6. Sectors (e.g., oil and gas, real-estate, IT, telecom, tourism, infrastructure, manufacturing, retail and distribution, etc.)
7. Company size (e.g., small, medium, large)
8. Financing stage (e.g., startup financing, expansion, etc.)
   If not focused on startups and small businesses – why? To what extent do you think the Egyptian market is encouraging for Venture Capital funds?
9. Type of deals (e.g., LBO, turnarounds, VC startups, etc.)

Investment Process

Can you provide a quick overview of the specific stages of the investment process, and how you conduct it here? e.g.,

10. Deal leads: how do you identify target companies?
11. What is the due diligence process? Who performs it?
12. What is the investment decision making process? Who gets involved? What are their criteria?
13. What is the typical holding period for acquired companies?
14. What is the **value creation model**? (e.g., financial restructuring, new investments, operational turnaround, management change, etc.)
15. What is the **governance model** between the fund and the portfolio company? How much influence do you have in managing the portfolio company? How do you exert this influence?
16. What is the typical **exit strategy**? (e.g., stock market, strategic investor such as multinational corporations, asset sale, etc.)

Government Impact

17. How do you perceive the government role with respect to your fund operations? Are there any specific government policies that help/impede your operations (at the deal acquisition, restructuring, and exit stages), e.g.,
    - Bank credit issues when buying companies with significant banking debt
    - Labor issues during restructuring
    - Stock market laws or foreign ownership restrictions

II. Deal/Portfolio Company-Level Questions

The objective of this section is to go through some details for one or more of the portfolio companies that you are or have invested in.

Deal Background

18. What is the size of the portfolio company? (purchase $$)
19. Who was the previous owner? (private, family-owned, state-owned, etc.)
20. Was it a distressed company? Was it a privatized state-owned enterprise?
21. Why did they sell the company? Why did they prefer to sell to a fund rather than going for bank financing?
22. Did the company have debt financing before you purchased it? Did they have problems obtaining debt financing from banks?
23. What is the company name (only if this is not confidential information) and sector?

Governance & Performance Management

24. What changes did you make to the management team? Who are the new managers, if any? What is their background? How did you select them?
25. What changes did you make to the Board of Directors? Why? Who is representing the fund on the board of the company?
26. How did you set up the management team? What is the remuneration structure? What are the performance metrics for?
27. What are the monitoring and evaluation mechanisms? (e.g., quarterly board meeting, financial reports, etc.)
28. How involved are you as a fund in setting a new strategy for the portfolio company?

29. How involved are you as a fund in the day-to-day management of the portfolio company?

Restructuring

The objective of this section is to understand the type of restructuring that was performed on this company, e.g.,

30. Did you sell/divest any assets? What were they? (e.g., some factories, real-estate, etc.)
31. Did you grow or shrink the company?
32. Did you initiate new capital investments in the portfolio company? How did they finance them?

Exit strategy

33. If you sold the company:
    - What was your exit strategy? (e.g., stock market, strategic investor such as multinational corporations, asset sale, etc.)
    - What is the holding period?
    - What is the sale price?
34. If you sold the company more than a year ago: How is it currently performing?

Concluding Thoughts

35. What are your thoughts on how the PE/VC industry is contributing to economic development in Egypt?
36. Do you think that you – as an industry – are providing a viable alternative to the limitations of access to financing from the banking sector?
37. Any other thoughts?